

FINAL AWARD

SCC Arbitration no. V2014/129

National Joint Stock Company

Naftogaz of Ukraine

Claimant

and

Public Joint Stock Company Gazprom

Respondent

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1. THE PARTIES TO THE DISPUTE AND THEIR COUNSEL

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2. THE ARBITRATORS

The Arbitral Tribunal has been constituted as follows:

- Naftogaz has nominated as arbitrator:

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3. THE DISPUTE AND ITS BACKGROUND

3.1 The Parties

- (1) The Claimant, National Joint Stock Company Naftogaz (NJSC, or "NAK" in Ukrainian) of Ukraine, is a Ukrainian wholly state-owned oil and gas company with over 170 thousand employees.
- (2) Naftogaz is Ukraine's largest oil and gas producer as well as the major importer, transportation provider through its wholly owned affiliate Public Joint Stock Company Ukrtransgaz ("Ukrtransgaz"), and marketer of Natural Gas, covering all segments of the Ukrainian gas market, from industrial users down to direct residential and commercial customers. Naftogaz and its subsidiaries produce over 90% of the oil and gas in Ukraine.
- (3) The Respondent, Public Joint Stock Company Gazprom (PJSC or "PAO" in Russian), is the world's largest gas extracting company with over 350 thousand employees. It is a publicly listed company situated in Moscow, Russia. According to the company's webpages, the Russian Federation (through the Federal Agency for State Property Management, OAO Rosneftgaz and OAO Rosgazifikatsiya) is a majority shareholder, holding 50.002 per cent of the shares. Gazprom is the biggest supplier of gas to Europe, approximately 50%-60% of which transit through Ukraine.
- (4) Gazprom accounts for 14 and 74 per cent of the global and Russian gas output respectively, and owns the world's largest gas transmission network - the Unified Gas Supply System of Russia with a total length of over 168 thousand kilometres.

3.2 The Dispute in Summary

- (5) This Arbitration ("the Transit Arbitration" or "the Gas Transit Arbitration") relates to a dispute under Contract No. TKGU dated 19 January 2009 between Gazprom and Naftogaz on volumes and conditions for transit of Natural Gas of Russian, Kazak, Turkmen or Uzbek origin through the territory of Ukraine from 2009 to 2019 (the "Contract" or the "Gas Transit Contract").

- (6) The Gas Transit Contract was entered into on the same day as the Gas Sales Contract between the same Parties and is related to the Gas Sales Contract, inter alia through the calculation of the transit tariff. A dispute related to the Gas Sales Contract was referred to arbitration on 16 June 2014, SCC Case No. V 2014/078 (“the Supply Arbitration” or “the Gas Sales Arbitration”). The disputes are handled in separate arbitration proceedings but in the same Arbitral Tribunal; a Separate Award in the Gas Sales Arbitration was rendered on 31 May 2017 and the Final Award in the dispute was rendered on 22 December 2017.
- (7) The Gas Transit Contract provides for the transit of very significant volumes of Natural Gas from the Russian Federation to European countries, covering approximately 50-60 per cent of Russian Natural Gas exports to Europe. The Gas Transit Contract is a long-term agreement for the use of the Ukrainian Gas Transmission System (“GTS”), a major infrastructure of vital importance to the Russian Federation as an energy exporter, and other European countries as energy importers. Such infrastructure is always subject to complex and changing regulatory requirements, and, like many long-term agreements, the Contract includes provisions allowing the Contract to be adapted in order to comply with the applicable legislation in Article 13.2.
- (8) In this Arbitration, Naftogaz claims (1) adjustment and replacement of alleged invalid and ineffective provisions on volumes and conditions for transit of Natural Gas through the territory of Ukraine, including transfer of Naftogaz’ rights and obligations under the Contract to the Ukrainian TSO Ukrtransgaz, (2) tariff revision and claim for underpayment of transit services under the Contract,, (3) and compensation for underdeliveries of transit volumes . Naftogaz also has claims for interest.
- (9) Naftogaz’ claims also encompass assignment of the Contract from Naftogaz to the Ukrainian Transmission System Operator (“TSO”), PJSC Ukrtransgaz (“Ukrtransgaz”).
- (10) Gazprom requests that the claims should be dismissed. Gazprom also requests that Naftogaz’ claims be rejected on the merits.

- (11) According to Gazprom, the Tribunal does not have the power to re-write the Contract in the manner requested by Naftogaz and, moreover, Naftogaz has not fulfilled the contractual requirements pursuant to the tariff review provisions.
- (12) Further, according to Gazprom, the Tribunal lacks jurisdiction to determine claims based on “energy law”.
- (13) According to Gazprom, the majority of Naftogaz’s claims for relief do not fulfil the procedural requirement that the claims must be specific in order to avoid any doubts as to the content of the operative part of the award claimed by Naftogaz.
- (14) Gazprom has counterclaims for payment pursuant to the Contract for gas which Naftogaz allegedly took in 2014 but did not pay for. Gazprom also has a counterclaim for compensation of alleged overpayments of the transit tariff in case Naftogaz’ claims in relation to the price in the Gas Sales Contract are successful. In addition, Gazprom also has claims for interest.
- (15) Naftogaz rejects Gazprom’s counterclaims on the merits.

3.3 The Background

3.3.1 An overview of European Principles for gas transit

- (16) Russia and Ukraine have a long history of cooperation in the gas sector. Since the Soviet era the countries are mutually reliant on each other Ukraine for gas supplies from Russia; Russia for transit through Ukraine into Europe.
- (17) Natural gas deliveries from the USSR commenced in the late 1940s when small quantities of gas from the Ukrainian Soviet Socialist Republic (the Dashava and Opory fields) were sold to Poland. In 1967, after construction of a gas pipeline connecting the Soviet gas transportation system with consumers in Czechoslovakia was completed, large-scale exports of gas to European countries began.

- (18) Transit of natural gas in Continental Europe was thus traditionally based on purpose-built pipelines and followed the different stages of large import projects. Special project pipeline companies covered the construction, financing and operation of the pipelines.¹
- (19) In the period preceding the liberalisation of European gas markets, there was no harmonised regulation of gas transit and transit tariffs. Transit arrangements were often subject to intergovernmental agreements, rather than to the authority of national regulators, and were complemented by private agreements. In this context, also third-party access was only granted on a negotiated basis.²The practice of determining transit tariffs and third-party access on a negotiated basis was maintained under a European Directive on gas transit from 1991.
- (20) Four methodologies have traditionally been used to set tariffs in high-pressure gas transit systems in Europe.
- (21) A first, simple tariff methodology is the postal methodology. Under this kind of tariff, a single fixed fee is charged for the transport of any volume of gas within the area covered by the tariff.
- (22) Distance-based tariffs are a second traditional methodology, whereby a charge is due by the shipper based on the distance between the entry and exit points indicated in the contract. The distance-based tariff system has generally been used in transit arrangements for Russian gas to Europe, inter alia through Ukraine, in the form of a commodity charge, i.e. a charge made for each unit of gas actually transported.
- (23) In the point-to-point tariff methodology, a specific tariff is quoted for every pair of entry and exit points within the system.

¹ The Energy Charter Secretariat, Transit of Natural Gas Monitoring Report on the Implementation of the Transit Provisions of the Energy Charter Treaty ("Transit of Natural Gas"), page 17.

² The Energy Charter Secretariat, Gas Transit Tariffs in selected Energy Charter Treaty Countries ("Gas Transit Tariffs"), page 23

- (24) Finally, in the case of entry/exit tariffs, a separate tariff is quoted for each entry and exit point in the system. Booking of capacity is done separately for each entry and exit point, whilst the actual movement of gas is subsequently based on the combination of the shipper's set of capacity contracts.
- (25) Until the late 2000s, the entry/exit tariff methodology was still only marginally employed, although it was developing into the norm inside the EU. In practice, however, this methodology was often combined with other methodologies to create hybrid systems.
- (26) Today, following the enactment of the so-called "Third Energy Package", the adoption of entry/exit tariff systems is mandatory under European energy and competition law.
- (27) The Third Energy Package also introduced the principle that tariffs should be cost-reflective, and abolished any distinction in treatment between transit and transmission of gas. Prior to the adoption of the Third Energy Package, there was a debate between cost-based pricing, if a transit line did not face effective competition from other transportation routes, and "competitive" pricing by reference to other pipelines, if the transit line faced effective competition. In the end, cost-based pricing prevailed as the dominant principle.
- (28) Tariffs are usually determined between the parties to a gas transportation agreement independently of the determination of the contract price under any gas sales agreement which the transportation contract is intended to service.³ Another feature found in gas transport arrangements is the so-called "ship or pay" principle. Pursuant to this principle, in order to guarantee a minimum level of income to the transporter in recouping its capital investment in the pipeline, the shipper may be required to pay for the transportation of a defined minimum quantity of gas per year. This payment is made on the basis of reserved capacity in the pipeline, regardless of whether the shipper actually delivers that quantity of gas for transportation.

³ Peter Roberts, *Gas Sales and Gas Transportation Agreements: Principles and Practice*, ("Gas Sales and Gas Transportation Agreements Gas Sales and Gas Transportation Agreements") page 224

3.3.2 The liberalisation of the European gas market

- (29) The development of gas markets in Continental Europe since the late 1950s was initially characterised by the existence of a single (or dominant) transmission company in each country, often created either from existing state-owned companies or from a mixture of gas producers and state-owned companies. The position of these companies, or groups of companies, has been described as one of "de facto [...] monopsony buyers, monopoly transmission companies and monopoly (wholesale) sellers".⁴ One exception to this pattern of organisation was Germany, where a number of high-pressure pipeline companies governed by private law agreements operated in delimited areas. However, even there, the composition of the individual concession agreements and the territorial delimitation resulted in a de facto monopoly of the transmission companies within each region.
- (30) This structure allowed European transmission companies to function as "gatekeepers" of their national or regional markets. The gatekeepers managed the demand/supply balance in their markets and were mostly successful in keeping competitors out.
- (31) This system remained for decades, and in the late 1990s most European gas industries were still characterised by "anti-competitive transmission structures featuring single transmission companies with de facto monopolies of transportation and imports".⁵ By 2010, however, this picture had changed totally, as a regulatory framework for the transmission of natural gas was being implemented in Europe. More specifically, a new European Union *acquis* on energy and competition had developed, which reflected newly introduced common rules for the internal market in natural gas, as well as conditions for access to natural gas transmission networks.
- (32) Since the 1990s, the EU has made substantial efforts to liberalise the European gas market by, inter alia, introducing and promoting a number of changes in the legal framework that affected the entire gas market in Europe.

⁴ Jonathan P. Stern, *Competition and Liberalization in European Gas Markets, A diversity of Models* ("Competition and liberalization in European gas markets"), page 12.

⁵ *Competition and liberalization in European gas markets*, page 172.

- (33) With regard to transit, already in 1991, the Directive "on the transit of natural gas through grids" (Directive 91/296/EEC) aimed at introducing the principles of fairness and non-discrimination in transit arrangements within the EU. At this early stage, however, no right of transit was granted to third parties, and transit contracts were negotiated between the entities responsible for the national transmission networks.
- (34) The first major initiative for liberalising the European gas markets came with the first gas market directive (Directive 98/30/EC), which introduced third party access to gas transportation and storage infrastructure on non-discriminatory and transparent terms.
- (35) The second EU gas market directive of 2003 (Directive 2003/55/EC) aimed at improving third party access to gas transportation networks by introducing requirements for legal unbundling of integrated gas sales and transportation companies, as well as additional transparency requirements. The obligation to ensure fair and non-discriminatory access to downstream high-pressure transmission networks was then assigned to national regulatory authorities.
- (36) The 2003 directive was further complemented by the provisions of Regulation No 1775/2005 on the conditions for access to the natural gas transmission networks. The non-discrimination principle was also applied in Regulation No 1775/2005 in relation to capacity allocation mechanisms and balancing rules, as well as tariff methodologies.
- (37) The 2003 directive repealed the 1991 transit directive. However, it did not provide for the termination of legacy transit contracts concluded under the terms of the latter, which were thus deemed to be still valid, albeit raising competition concerns. In addition, the effect of recognising the validity of historic long-term contracts was that transit flows were treated in a substantially different manner than other transmission services, notwithstanding the formal abolishment of the distinction between transit and transmission capacity in the 2003 directive.
- (38) Overall, the impact of the regulatory framework described above was rather limited, and in late 2008/beginning of 2009 no substantial changes in the gas market were expected as a result of EU

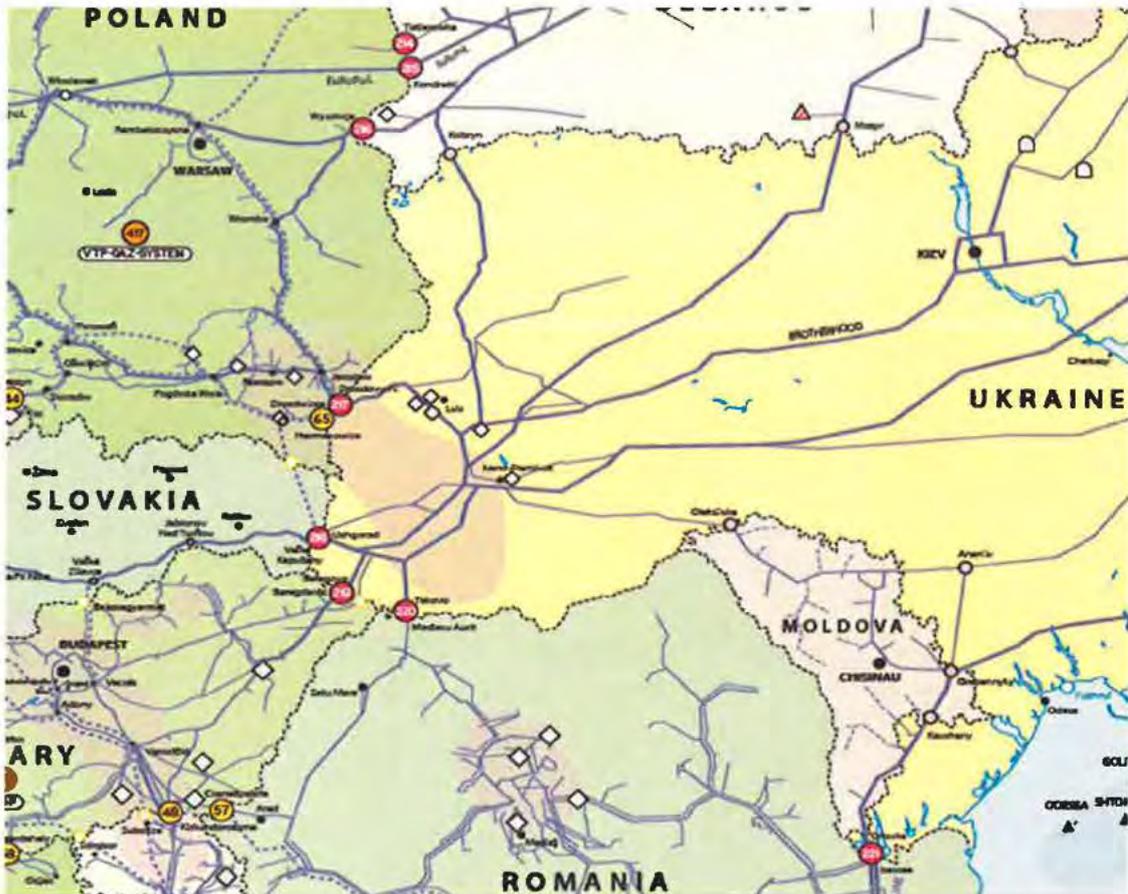
legislation. The gas markets within individual European countries were still not uniformly regulated, and the Continental European gas market was characterised by the same structures as before. In particular, non-discriminatory network access did not yet exist, and the rules on legal and functional unbundling as provided for in the second gas directive had not led to effective unbundling of the transmission system operators. In other words, the "gatekeepers" largely remained in control of the markets.

- (39) The third EU gas market directive of 13 July 2009 (Directive 2009/73/EC), and Regulation (EC) No 715/2009, continued the European Union's efforts to transform the European gas market by integrating the various national markets into a single liberalised market. This legislation provides *inter alia* for legally binding network codes in order to create a single gas market, and effective separation of network activities from supply and production activities (unbundling). The Directive became an effective tool to change the structures in the European gas market as it came to form a basis on which new structures could emerge after the turmoil of the financial crisis and its effects.
- (40) The provisions of this so-called "Third Energy Package" introduced an objective non-discrimination principle for third party access, establishing that access tariffs shall be applied in a non-discriminatory manner between network users. These rules prohibit national measures granting preferential capacity for cross-border transmission, meaning that any differentiation between gas transmission and gas transit is no longer allowed. This prohibition applies even when such capacity is conferred on the basis of contractual commitments antedating the internal market legislation. The validity of legacy transit contracts is thus no longer envisaged.

3.3.3 Soviet gas transportation arrangements

- (41) The historical role of Ukraine as a transit country means that the Ukrainian Gas Transmission System ("GTS") is one of the world's largest in terms of transit volumes, with an annual capacity at entry and exit points of almost 290 bcm and more than 175 bcm, respectively.

- (42) The Figure below is an excerpt from the European Network of Transmission System Operators for Gas's 2014 map of the European Natural Gas Network, and shows the Ukrainian GTS (gas pipelines shown as blue lines):



- (43) Excerpt from the map *ENTSOG The European Natural Gas Network (Capacities at cross-border points on the primary market)*, dated June 2014
- (44) The major part of the Ukrainian GTS together with most of the infrastructure for Russia's gas supplies to Europe was created during the Soviet period as part of the integrated system for gas supply of the former Soviet Union as well as its COMECON partners, and subsequently for export to Western Europe.

- (45) The Ukrainian GTS consists of three main transportation corridors that traverse Ukraine from east to west.
- (46) There are also some pipelines that cross Ukraine mainly from north/north-east to south. As a consequence of the way the Ukrainian GTS was structured, under the present Transit Contract, Natural Gas enters Ukraine from Russia, and from Russia via Belarus, while it exits Ukraine to Romania, Hungary, Slovakia, Poland and Moldova. Some gas may also cross Moldova and re-enter Ukrainian territory for further transit. In other words, the Ukrainian GTS was constructed as a unidirectional system to export gas westwards. The primary role of the Ukrainian GTS continues to be export of Natural Gas, i.e. supplying Russian as well as Kazakh, Turkmen and Uzbek gas to Europe.

3.3.4 Ukraine-Russia gas transit arrangements in 1991-2002

- (47) The dissolution of COMECON and the Soviet Union in 1991, led to rearrangements of the transport of Russian gas in and to the former COMECON states and FSU states. Ukraine, with one of the world's biggest pipeline systems, and the Russian Federation, with its natural gas deposits, made a number of arrangements to ensure safe transit of Russian gas to European countries and Moldova through the territory of Ukraine.
- (48) Former internal transportation arrangements within the Soviet Union became international transit arrangements through independent states. Since then, several gas trading and transit arrangements have been put in place between Russia and Ukraine. In the beginning, a barter system was adopted, where the Russian Federation effectively paid for transit with Natural Gas.
- (49) Gazprom continued to pay transit and storage fees to Ukraine by barter for more than a decade after independence. Under a 2001 Russo-Ukrainian agreement, only a small part of the fees began to be paid in cash, and Gazprom could supply Ukraine with Natural Gas in exchange for the transit services at its choice.

- (50) All FSU countries use a gas grid system which during the Soviet period had been administered as a single national entity under a uniform management. After the break-up of the Soviet Union the system was split and came under the management of several different countries while gas supplies continued to follow the original routes, irrespective of the new national borders.
- (51) In particular, with the partition of the Soviet gas transmission system along the new country borders, gas measuring stations (GMS) through which Gazprom had delivered gas to Naftogaz' and Ukrtransgaz' predecessor Ukgazprom were located at points far from the Ukrainian border. These GMS have later served as inland stations, not as border stations. However, the Ukrainian gas transportation system (GTS) still largely has the technical structure inherited from the FSU.
- (52) The first gas sales and transit arrangements were made on the inter-governmental level and were subsequently implemented by state-controlled companies: Russian Gazprom and, on the Ukrainian side Ukgazprom until 1998, and subsequently Naftogaz.
- (53) On 20 August 1992 the governments of Ukraine and Russia entered into the first such agreement to regulate the supplies of natural gas to, and the gas transit through the territory of Ukraine. The agreement was followed by a very similar one-year agreement in 1993 which also introduced a compensation for the operating costs of the Ukrainian GTS, amounting to USD 0,23 per every 100 km.
- (54) In 1994, the governments of Ukraine and Russia concluded a 10-year agreement for gas supply and transit until 2005 (supplemented in 2000 and 2001), under which prices and volumes were to be agreed annually in intergovernmental protocols. Such protocols were signed between Russia and Ukraine until 2005.
- (55) The gas transit agreements between Russia and Ukraine in this period were largely based on political considerations and barter arrangements, i.e. provision of transit services in return for gas supplies.

3.3.5 Gas transit arrangements in 2002-2007

- (56) On 21 June 2002 Naftogaz and Gazprom entered into a transit contract for the period from 2003 till 2013 (the "2002 Transit Contract"). The wording of the 2002 Transit Contract is similar to the wording of the Contract. Under the 2002 Transit Contract, Gazprom was obliged to transit not less than 110 bcm of gas through the territory of Ukraine to Europe and Moldova annually in the period from 2003 till 2013. The exact transit volumes and tariffs were to be set out in annual addenda to the contract. However, the "gas for transit" barter system prevailed also under the 2002 Contract.
- (57) On 9 August 2004 the Parties entered into Supplement No. 4 to the 2002 Transit Contract, pursuant to which a transit tariff was established for the 2005-2009 period at rate of USD 1.09375 for 1000m³ per every 100 km, while the price for supply of gas to Ukraine, in return for transit services was fixed at USD 50 per 1000 m³.
- (58) Additional gas volumes (e.g. of Central Asian/Turkmen origin) were supplied to Ukraine under separate intergovernmental agreements (e.g., with Turkmenistan in 1992-2006) through Ukrgazprom/Naftogaz or by various gas trading companies (e.g., Itera and Eural Trans Gas).
- (59) Since 2004, one such intermediary supplier of natural gas to Ukraine was RosUkrEnergo, a Swiss-based company co-owned by Gazprom and the group of companies owned and/or controlled by Mr. Dmytro Firtash, a businessman owning and/or controlling very large fertiliser (OSTCHEM, AZOT Cherkassy, STIROL), gas distribution (RosUkrEnergo), titanium (Crimean TITAN, Zaporizhzhya titanium) and banking (Nadra Bank) businesses in Ukraine (the "Firtash Group").

3.3.6 The 2006 Gas Crisis and further supply and transit arrangements between Gazprom and Naftogaz

- (60) Until 2005 gas transit and supply arrangements remained interconnected and interdependent. However, from 2005 Gazprom announced its intention to separate gas supply and transit and introduce market prices also for Ukraine.

- (61) A first step towards European contract standards was made in 2006, amidst Gazprom's restructuring of the supply relationships with former COMECON countries and former Soviet Republics aiming to capture more of the economic rent of gas supplies. In this context, a distinction was made between the treatment of transit and the sale and purchase of gas.
- (62) The transit of Russian gas to Europe and Moldova continued to be regulated separately by a transit contract between Gazprom and Naftogaz signed in 2002. But the transit tariff in that agreement was raised to compensate for an agreed higher gas price, and the gas transit barter scheme went out of use.
- (63) Thus, starting from 2006, the previous transit and sales arrangements, where transit services were paid for by gas deliveries, were discontinued and split into (i) a separate supply contract scheme involving Naftogaz, RosUkrEnergo AG ("RosUkrEnergo"); and (ii) the 2002 transit contract between Gazprom and Naftogaz.
- (64) Further, following the expiry of the above mentioned 1994 supply agreement and a failure to agree on an intergovernmental protocol governing gas supplies for 2006, Gazprom briefly suspended gas supplies to Ukraine from 1 January 2006.
- (65) Following the termination of gas supplies to Ukraine and subsequent negotiations, a new scheme for gas supplies to Ukraine was agreed and implemented in the Agreement on regulating relations in the gas sphere of 4 January 2006. Gas transit services continued under the 2002 Transit Agreement, but the gas for transit barter scheme went out of use, and the tariff was amended to compensate for the higher gas price under the 2006 gas supply agreement. The tariff was raised to USD 1.60 for 1000 m³ per every 100 km until 2011. The 2006 Agreement also provided that:
- RosUkrEnergo would be the sole importer of Natural Gas to Ukraine, purchasing gas from Gazprom's subsidiaries Gazexport LLC and Gazprom LLC;

- Naftogaz and RosUkrEnergo founded a joint venture CJSC "Ukrغاز-Energo" ("Ukrغاز-Energo") - for sales of the natural gas imported by RosUkrEnergo in the Ukrainian domestic market;
- RosUkrEnergo purchased gas from Central Asian countries (Turkmenistan, Kazakhstan and Uzbekistan) at their external borders and up to 17 bcm of natural gas from Gazprom, and then it resold these volumes to Ukrغاز-Energo;
- Ukrغاز-Energo resold the gas in the Ukrainian market (i) directly to industrial consumers and (ii) to Naftogaz which supplied natural gas to local distribution companies;

(66) Thus, starting from 2006, the previous transit and sales arrangements, where transit services were paid for by gas deliveries, discontinued and split into (i) a separate supply contract scheme involving RosUkrEnergo, Ukrغاز-Energo and Naftogaz, and (ii) the 2002 transit contract between Gazprom and Naftogaz, as amended.

(67) Under the above supply arrangements, Gazprom (through its subsidiaries) remained the only actual supplier of gas to Ukraine. RosUkrEnergo had no gas deposits and production capacities. The gas supplied had to be bought from Gazprom.

3.3.7 2008 gas supply arrangements

(68) On the basis of the 2006 gas supply arrangements, RosUkrEnergo accumulated significant revenues from importing the combination of Russian gas and cheaper Central Asian gas to Ukraine. Ukrغاز-Energo accumulated significant revenues from the re-sale of such natural gas to industrial consumers. Naftogaz continuously suffered from non-payment by the local distributors. In addition, Ukrغاز-Energo had a five-year gas purchase contract with RosUkrEnergo, while Naftogaz was supplied by Ukrغاز-Energo on a monthly basis.

(69) Against this background, Naftogaz required a new, direct gas sales contract with Gazprom to ensure secure gas supplies to Ukrainian consumers and increase its revenues through elimination of the supply scheme involving intermediaries.

- (70) In late 2007 and early 2008, the then Prime Minister of Ukraine Mrs. Yulia Timoshenko arranged for changes in Naftogaz' management. Mr. Oleg Dubina was appointed as Chairman of the Board on 24 December 2007, and [REDACTED] [REDACTED] Naftogaz' management was tasked to make new gas supply arrangements directly with Gazprom, without any middlemen.
- (71) On 12 March 2008, Naftogaz and Gazprom entered into an Agreement on development of relations in the gas field (the "12 March 2008 Agreement"). The Agreement inter alia implied that Gazprom or RosUkrEnergo should sell natural gas to Naftogaz in volumes of not less than 49.8 bcm, and that Naftogaz was obliged to resell parts of these volumes to a Gazprom subsidiary in Ukraine with a margin not higher than 0.01 USD per 1000 m³. Also under the 12 March 2008 Agreement, Naftogaz undertook to procure gas storage and transit through Ukraine's GTS of gas supplied by RosUkrEnergo under relevant contracts, as well as to procure transit for additional volumes of gas delivered under the 2002 Transit Contract (previously supplied by RosUkrEnergo).
- (72) Having removed one of the intermediaries Ukgaz-Energo and secured gas supplies for 2008, Naftogaz proceeded to seek direct long term supply and transit contracts with Gazprom. During a 31 March – 01 April 2008 meeting in Moscow, Naftogaz and Gazprom agreed in principle that Naftogaz could be the sole importer of Russian gas to Ukraine, and that RosUkrEnergo could be removed from the gas supply arrangements.
- (73) After the above agreement in principle was reached, the Parties commenced negotiations of direct long-term contracts for both sale and transit of natural gas based on market-based prices and tariffs which, inter alia, resulted in the conclusion of the Contract.
- (74) The magnitude of the Gas Transit Contract makes Ukraine the most important transit country in the world, as it transits the majority of Russian gas supplies to western and southern Europe even after the construction of the Nord Stream pipeline, which connects Russia and Germany directly across the Baltic Sea, and which was opened in 2011.

- (75) Europe's gas consumption in 2013 was about 541 bcm. Gas supplied by Gazprom accounted for more than 30% of that figure, namely 161.5 bcm. In 2013, approximately half of that volume, about 80 bcm, effectively passed through Ukraine's pipeline network. This amounts to circa 15% of total natural gas consumption in Europe.
- (76) By way of comparison, the minimum annual volumes of transit gas agreed by the Parties under the Gas Transit Contract are more than twice the amount of Russian gas transited through Belarus – the second most important transit country for Russian gas exports – which according to Gazprom's webpages amounted to less than 50 bcm in 2013.
- (77) The data above provide an indication of the importance of the Gas Transit Contract, not only to Naftogaz and Gazprom, but also to the Ukrainian, Russian, as well as European gas industries and economies.

3.3.8 The Notice of disputes

- (78) On 25 July 2014, Naftogaz sent a Notice of disputes to Gazprom informing of the changes necessary to be made to the Contract to align it with European and Ukrainian law, claiming compensation for underdeliveries of transit gas, and claiming adjustment of the transit tariff based on Swedish Contract law (the "Notice"). In its Notice, Naftogaz proposed to meet and negotiate at a neutral venue, previously used by the Parties in negotiations over the Gas Sales Contract, e.g. Brussels or Berlin.
- (79) Gazprom responded to Naftogaz' Notice by its letter of 18 August 2014 in which it stated its readiness to negotiate, but only in Moscow. Gazprom did not accept Naftogaz' claims, expressly rejected some claims, and requested further substantiation.
- (80) Naftogaz responded to Gazprom's letter by letter dated 9 September 2014, reiterating its willingness to negotiate and stating its readiness to present evidence and substantiate its claims in a meeting which it proposed could be held also at other neutral venues.

(81) The Parties have also met in trilateral discussions arranged by the European Commission, without reaching agreement. On 13 October 2014, Naftogaz submitted its request for Arbitration to the SCC Secretariat.

3.3.9 Ukraine's accession to the Energy Community and European competition and energy law

(82) The Energy Community Treaty between the European Union and the then nine Contracting Parties, Albania, Bulgaria, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Romania, Serbia and the United Nations Interim Administration Mission in Kosovo, provided inter alia for the establishment of an integrated energy market among the Parties from the entry into force of the Energy Community Treaty on 1 July 2006. The Treaty was originally entered into for a period of 10 years from 1 July 2006, but has later been extended for another 10 year period.

(83) Ukraine acceded to the Energy Community Treaty on 1 February 2011 and is entitled to all rights and subject to all obligations under the Energy Community Treaty pursuant to Article 1 (2) of the Protocol concerning the Accession of Ukraine to the Energy Treaty of 24 September 2010 ("Protocol").

(84) The Treaty is applicable to the territory of Ukraine by virtue of Ukraine's status as a Contracting Party to the Treaty and pursuant to the Law of Ukraine on Ratification of the Protocol concerning the accession of Ukraine to the Treaty establishing the Energy Community No. 2787-VI, dated 15 December 2010.

(85) Pursuant to Article 9 of the Constitution of Ukraine, the Treaty became part of the national legislation of Ukraine after its ratification by the Ukrainian Parliament. The Treaty's provisions are mandatory Ukrainian laws, and take precedence over any contradicting rules of the national laws of Ukraine on competition and energy.⁶

⁶ Article 19(2) of Law of Ukraine on International Treaties of Ukraine, No. N 1906-IV, dated 29 June 2004.

- (86) Pursuant to Article 10 of the Treaty, Ukraine is obliged to implement the *acquis* on energy in compliance with the time table for the implementation set out in Annex I to the Treaty. In particular, acceding to the Treaty, Ukraine undertook obligations to implement the so-called Second Energy Package (Directive 2003/55/EC, Regulation (EC) No 1775/2005 and Council Directive 2004/67/EC) by 1 January 2012, cf. Article 2 of the Protocol.
- (87) The Third Energy Package was implemented in the *acquis* on energy and competition law under the Treaty by Decision of the Ministerial Council of the Energy Community, dated 6 October 2011 ("Decision No 2011/02/MC-EnC").
- (88) The Parties to the Treaty were given until 1 January 2015 to implement the Third Energy Package, with the exception of Article 11 (on certification in relation to third countries) which shall apply from 1 January 2017, in their national legislation, cf. Article 3 of Decision No 2011/02/MC-EnC. Also, the separate deadlines on unbundling referred to in Articles 9(1) and 9(4) of the Third Gas Directive are replaced by the dates 1 January 2016 and 1 January 2017 respectively, cf. Article 8 of Decision No 2011/02/MC-EnC.
- (89) The main Ukrainian legislation establishing the general framework for the regulation of gas transit and implementing Ukraine's obligations under the Treaty, which is relevant to the Contract is:
- Law of Ukraine on Fundamentals of the Functioning of the Natural Gas Market (the "Ukrainian Gas Market Law"), dated 8 July 2010, No. 2467-VI, as amended, establishing the legal, economic and organisational basis for the functioning of the Ukrainian gas market and the Ukrainian GTS as well as state control thereof. This Law contains a number of provisions implementing the Second Gas Package regarding the independence of the operator of the gas transmission system (the "transmission system operator", the "TSO") and equal access to the gas transmission system. In particular, the Law prohibits a gas transportation undertaking from being engaged in production and supply of natural gas, and provides that a TSO shall be responsible for operating, maintaining and developing the transmission system and

its interconnections with other systems, cf. Article 2 (4) of Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas.

- Law of Ukraine On Pipeline Transport (the "Ukrainian Pipeline Transport Law"), dated 15 May 1996, No. 192/96-VR, as amended, inter alia establishing technical rules and standards for the operation of pipeline transportation installations as well as providing for the corporate model and requirements for companies active in pipeline transportation and/or surface storage of natural gas. The Ukrainian Pipeline Transport Law stipulates conditions for unbundling, and sets out the license requirements for a TSO;
- Law of Ukraine on Oil and Gas (the "Ukrainian Oil and Gas Law"), dated 12 July 2001, No. 2665-III, as amended, establishing the legal framework for business activities in production, transportation, storage and distribution of oil and gas which is aimed at "facilitating the competitiveness in the oil and gas complex" (Article 7). The Law defines transit of natural gas as the transmission of natural gas originated outside Ukraine and destined for consumers outside the territory of Ukraine by main-pipelines, i.e. high-pressure pipelines of the GTS of Ukraine, through the territory of Ukraine in accordance with relevant agreements;
- Law of Ukraine "On amendment of certain laws of Ukraine regarding reform of the management system of Unified Gas Transport System of Ukraine" (the "2014 Ukrainian GTS Reform Law"), dated 14 August 2014, No. 1645-VII, enacting important changes to the gas sector intended to implement the Energy Community Treaty in general, and the Third Energy Package in particular;
- Law of Ukraine on the Protection of Economic Competition (the "Ukrainian Competition Law"), dated 11 January 2001, No. 2210-III, providing for competition regulation applicable also to gas supply and transit in Ukraine and implementing Articles 101 and 102 TFEU prohibiting agreements restricting competition and abuse of a dominant position,

- A number of regulations and decisions of the Cabinet of Ministers of Ukraine (the "CMU"), the Ministry of Energy and Coal Industry of Ukraine (the "Ukrainian Energy Ministry"), and of the National Commission for the State Regulation of Energy and Utilities ("NCSREU") in the gas field, the most relevant of which are listed below:
- Ukrainian Energy Ministry's Decree No. 882 of 2 December 2013 entrusting Ukrtransgaz with functions of a TSO of the Unified Gas Transport System of Ukraine,
- Presidential Decree No. 694/2014 of 27 August 2014 on the establishment of the National Commission for the State Regulation of Energy and Utilities,
- Ukrainian Energy Ministry's Decree No. 726 dated 17 October 2014 approving and providing in the annex a model contract for natural gas transportation services by high-pressure pipelines through the territory of Ukraine (Model Gas Transportation Contract).

(90) The above-mentioned legislation and by-laws implement the requirements for an independent regulator with specific competences, and the unbundling requirements with regard to the system operators of the transmission and distribution system. The National Commission for State Regulation in Energy and Utilities (NCSREU), established in August 2014 by Presidential Decree No 694/2014, has replaced the National Energy Regulatory Commission ("NERC") as regulator. Ukrtransgaz, a wholly-owned subsidiary of Naftogaz, is designated as TSO of the Ukrainian GTS, cf. the Decree of the Ministry of Energy and Coal Industry of Ukraine No. 882 of 2 December 2013.

(91) On 9 April 2015, the Ukrainian Parliament adopted Law of Ukraine on the Natural Gas Market (the "New Gas Market Law"), which transposes the Third Energy Package in the gas sector of Ukraine. According to Chapter VIII (Final and Transitional Period Provisions) of the New Gas Market Law supersedes the old Ukrainian Gas Market Law which ceased to apply from 1 October 2015 (the commencement date for most of the provisions of the New Gas Market Law). The new Natural Gas Market Law establishes the legal, economic and organisational basis for the

functioning of the Ukrainian gas market and the Ukrainian GTS as well as a state control thereof. The New Gas Market Law, which was drafted with the assistance of the Energy Community Secretariat, was signed by the President on 30 April 2015. With the exception of certain provisions on unbundling, where the implementation deadline according to Decision 2011/02/MC-EnC is extended, Ukrainian legislation implementing the Third Energy Package has entered into force and has been given effect. The provisions on the unbundling of the gas distribution system operator commence at 1 January 2016, and the provisions on the unbundling of the TSO and the gas transportation system owner, investment planning and compliance programme (to ensure non-discrimination on the part of gas transmission system operator) commence at 1 April 2016. The Law also provides for a transitional regime for the operation of the gas distribution system operator during transitional period between 1 October 2015 and 1 January 2016, and gas transmission system operator for the period between 1 October 2015 and 1 April 2016.

- (92) Also, the Law provides the legal basis for the adoption of supplementary secondary legislation. Pursuant to Article 33 of the New Gas Market Law, the TSO is tasked with developing a gas transmission system code (the "Ukrainian Network Code") to be approved by the Regulator. The Network Code shall *inter alia* contain rules on secure and reliable operation of the system, commercial and technical conditions of access to the system, a list of services rendered by the operator, rules on balancing, determination of entry and exit points of the gas transmission system and on an action plan in the event of disruptions. Pursuant to Article 32 of the New Gas Market Law, the Regulator shall also approve a model contract on gas transportation, i.e. a standard contract that the TSO shall use when providing gas transportation services to network users.
- (93) The 2015 Gas Market Law provides the legal basis for the adoption of secondary legislation, *inter alia* on licensing of gas transportation activities, standard agreements on gas transportation, tariffs and the methodology for their determination. On 30 September 2015 the national regulator, NCSREU, adopted a series of resolutions with secondary legislative acts aimed at further implementation of the new Gas Market Law. Among others, the "Ukrainian Gas Transmission

System Code", the "Standard Natural Gas Transmission Contract", and the "Ukrainian Tariff Methodology" were adopted.

- (94) All resolutions entered into force from the date of their official promulgation.
- (95) The Ukrainian Gas Transmission System Code was officially promulgated on 27 November 2015 and entered into force from this date, except for certain provisions which enter into force 1 April 2017.
- (96) The Ukrainian Tariff Methodology was also officially promulgated on 27 November 2015 and thereby entered into force.
- (97) On 29 December 2015, the regulator adopted the following resolutions in accordance with the Tariff Methodology:
 - (98) Resolution No. 3156 of 29 December 2015 On application of incentive-based regulation in the field of natural gas transmission for PJSC "Ukrtransgaz",
 - (99) Resolution No. 3157 of 29 December 2015 On setting the long-term regulatory parameters or purposes of incentive-based regulation for PJSC "Ukrtransgaz",
 - (100) Resolution No. 3158 of 29 December 2015 On setting tariffs for PJSC "Ukrtransgaz" for services of natural gas transmission by trans-border pipelines for entry points and exit points,
 - (101) Resolution No. 3159 of 29 December 2015 On setting a general tariff for transmission of natural gas, tariffs for transmission of natural gas by main pipelines and distribution pipelines
- (102) All of the above resolutions entered into force on 1 January 2016. The market parties have been given until 27 February 2016 to implement the tariffs with effect as of 1 January 2016.

4. THE CONTRACT

4.1 The structure of the Contract

(103) The Contract is a long-term contract between National Joint Stock Company "Naftogaz of Ukraine" Kiev, Ukraine, the "Contractor", and Open Joint Stock Company (now: Public Joint Stock Company) Gazprom of Moscow, the Russian Federation, the "Client".

(104) The subject matter of the Transit Contract is the performance of transit services on a payment basis by Naftogaz, which has agreed to transport specific volumes of Natural Gas through the territory of Ukraine from the entry points at the borders between Ukraine and Russia, Belarus and Moldova, to the exit points at the borders between Ukraine and Romania, Hungary, Slovakia, Poland and Moldova. The term of the Transit Contract is 11 years.

(105) The Contract regulates the volumes and conditions for the transit of Natural Gas (i.e. gas of Russian, Kazakh, Turkmen or Uzbek origin) through the territory of Ukraine from 1 January 2009 to 31 December 2019. It provides for the transit of very significant volumes of Natural Gas through Ukraine to European countries. The minimum annual volume stipulated in the Contract amounts to 110 billion cubic metres ("bcm"), [REDACTED]

(106) The language of the Contract is Russian. In this Arbitration it has been translated into English.

(107) The Contract consists of a main body, which has been amended a number of times in the form of Addenda. After the Contract was signed, the Parties have entered into [REDACTED] Addenda to the Contract, as follows:

- [REDACTED]

- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]

[REDACTED]

1

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[REDACTED]

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[REDACTED]

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[REDACTED]

(108) The Addenda considered to be most relevant to the present dispute are [REDACTED]

[REDACTED]

4.2 The main contents of the Contract

4.2.1 Subject matter of the Contract. Article 2 of the Contract

(109) In the Contract, Naftogaz is referred to as the “Contractor” and Gazprom is referred to as the “Client”.

(110) Article 1 of the Contract contains definitions and applicable interpretations.

(111) Article 2 of the Contract reads:

“The subject matter of this Contract is the performance of transit services by the Contractor from 2009 to 2019 inclusive, on a payment basis for transit of Natural Gas through the territory of Ukraine by pipeline transport from Entry Points to Exit Points subject to the volumes and terms set out in Article 3 of this Contract.”

(112) Thus, the subject matter of the Transit Contract is the performance of transit services on a payment basis by Naftogaz, which has agreed to transport specific volumes of Natural Gas through the territory of Ukraine from the entry points at the borders between Ukraine and Russia, Belarus and Moldova, to the exit points at the borders between Ukraine and Romania, Hungary, Slovakia, Poland and Moldova. The term of the Transit Contract is 11 years.

4.2.2 Volumes of Natural Gas transit Article 3 of the Contract (as amended/clarified in Addenda)

4.2.2.1 Introduction

(113) Article 3 of the Transit Contract specifies the minimum volumes of gas to be delivered for transit in Article 3.1, as well as procedures for clarification of the annual volumes of transit gas, including their breakdown by quarter and destination, in Article 3.2. Article 3.3 of the Transit Contract sets out procedures for changes to the quarterly volumes, monthly volumes and destinations. Article 3.4 sets out rules for daily deviations, unauthorised gas withdrawals by Gazprom, and simultaneous delivery and redelivery of gas at Ukraine's Eastern and Western borders.

4.2.2.2 Article 3.1 of the Contract

(114) Pursuant to Article 3.1 of the Contract as amended, the minimum annual volumes of Natural Gas which Gazprom shall deliver for transit are 110 bcm,⁷ except for the years 2009 and 2011-2015, for which other volumes have been agreed. Furthermore, pursuant to the same Article, the Contractor shall ensure its acceptance and further transit through the territory of Ukraine to the Acceptance and Delivery Points on the border of Ukraine with Romania, Hungary, Slovakia, Poland and Moldova. Moreover, the Contractor shall ensure the proper operation of the gas transportation system of Ukraine at his own discretion and guarantee reliable and continuous transit through the territory of Ukraine of the Client's natural gas in the volume transferred for transit by the Client.

(115) Articles 3.1.1 to 3.1.4 of the Transit Contract, [REDACTED] [REDACTED] record the breakdown of the transit gas volumes by quarter and by destination [REDACTED] and the annual transit gas volumes to be delivered by Gazprom [REDACTED]

(116) Article 3.1.1 stipulates that the gas volumes to be transited in 2009 shall amount to 120.083 bcm. The Parties have subsequently entered into Addendum [REDACTED] Addendum [REDACTED] amending the gas volumes for the years from [REDACTED] inclusive. For [REDACTED] the gas volumes to be

⁷ The Russian original text uses the expression "HE MEHEE" which literally means "not less than"

transited shall [REDACTED]
[REDACTED]

4.2.2.3 Article 3.2 of the Contract

(117) Pursuant to Clause 3.2 of the Contract the annual gas volumes to be transited in the subsequent years (i.e. after 2009) and their allocation by quarters and by destination, shall be clarified in Addenda to the Contract. If no Addendum is concluded before the start of a Contract Year, it follows from Article 3.2 that the transit volume shall be equal to the sum of minimum annual quantity obligations under contracts concluded by Gazprom Export LLC with European buyers who receive gas through Ukraine. In that case, the minimum annual obligations shall be verified by an auditor.

4.2.2.4 Articles 3.3 and 3.4 of the Contract

(118) The annual volumes of transit gas through the territory of Ukraine are allocated by quarters and by destination, cf. Article 3.1.1 as amended.

(119) Pursuant to Article 3.3 first paragraph, the quarterly volumes of transit gas by destination can be changed by prior agreement at the latest 15 days prior to the beginning of the relevant Quarter.

(120) The allocation of quarterly volumes shall be conducted in equal parts by months, based on the average daily quarterly volume. Article 3.3 second paragraph also allows changing the monthly volumes of transit gas by prior agreement at the latest 10 days prior to the beginning of the relevant month.

(121) Reallocation of the flow of natural gas by destination is only permitted upon the Parties' written mutual consent, cf. Article 3.3 third paragraph.

(122) As a main rule, the delivery and acceptance of gas in a month is to be conducted evenly, cf. Article 3.4 first paragraph. The Transit Contract in general permits a deviation of daily volumes of "not more than +/- 6.5%" (except at one gas metering station, the GMS Uzhgorod, where the

permitted deviation is +/- 4,5%) from "the average daily, monthly volumes" that follow from Article 3.1.

- (123) Article 3.4 second and third paragraph regulate the situation if Gazprom without prior agreement withdraws transit gas volumes that exceed the permissible deviation according to Article 3.4 first paragraph.
- (124) According to Article 3.4 second paragraph, Gazprom shall not later than 36 hours prior to the moment of occurrence of excess deviations provide delivery of gas to Naftogaz as compensation for such deviations on the borders of the Russian Federation/Ukraine, the Republic of Belarus/Ukraine. In such case, the Parties shall agree on the volumes, destinations and duration of the Gas supply.
- (125) If Gazprom fails to compensate for exceeding the permitted deviation, Naftogaz shall not be responsible for enforcing the Contract's regulations for the delivery and acceptance of gas, cf. Article 3.4 third paragraph.
- (126) The Transit Contract imposes on Naftogaz a duty to keep the volume of available Natural Gas in every 24 hours at the exit point equal to the volumes injected at the entrance points, cf. Article 3.4 last paragraph. The Transit Contract thus does not fix any balancing system.

4.2.2.5 Articles 3.5 and 3.6 of the Contract

- (127) Article 3.5 of the Transit Contract provides that transit volumes exceeding the minimum volume determined in Article 3.1 are to be paid for according to the provisions of the Transit Contract, and Article 3.6 records that Naftogaz agrees to transit gas to the border of Moldova, for the purpose of further transit through Moldova to the Ukrainian-Moldovan border at Alekseyevka, for further transit.

4.2.3 Conditions for Gas transit Article 4 of the Contract

- (128) Pursuant to Article 4, the Contract shall be supplemented by an annually-concluded Technical Agreement. This Technical Agreement forms an integral part of the Transit Contract, cf. Article

7.1 and the definition of "Technical Agreement" in Article 1. However, the main transit conditions are regulated in the Contract itself, and the absence of a signed Technical Agreement shall not be an obstacle for the Parties' performance of their obligations under the Contract, cf. Article 4.1 second paragraph last item.

- (129) It follows from Article 4.2 that, in case of change in transit gas volumes, including as a result of force majeure circumstances, the Parties have agreed to immediately review the issues regarding volumes of transit gas, taking into account the work modes of compressor stations, main gas pipelines and the technical capabilities of gas supply systems. A reduction in the daily volume of gas supply at exit points of the gas transport system (GTS) shall only be possible in specific directions of gas transit, upon the Parties' written mutual agreement, cf. Article 4.3 first paragraph.
- (130) In case of a general reduction in the volume of gas supplies to the gas transportation system for transit, the volumes of transit gas shall be reduced pro rata in all directions, cf. Article 4.3 second paragraph.
- (131) Transit gas is supplied in a common gas stream and gas measurements shall be conducted at entry and exit points to be determined in the annually-concluded Technical Agreement, cf. Article 4.4. Technological losses of gas at the border sections of gas pipelines shall be determined in accordance with agreed documents.
- (132) Pursuant to Article 4.5, Naftogaz "*shall be responsible for ensuring the reliable and continuous functioning of the gas transportation system of Ukraine, including for the timely and complete provision of technical gas [fuel gas], as well as for any losses of Natural Gas on the territory of Ukraine, which was supplied by the Client for transit*".
- (133) Pursuant to Article 4.6, the Parties charge their subsidiaries with the technical implementation of the Transit Contract. Naftogaz has charged "*its obligations in the technical implementation of the contract to DK Ukrtransgaz*", cf. Article 4.6 second paragraph. A number of Gazprom affiliates,

including Gazprom Export, have been charged with carrying out Gazprom's technical obligations under the Transit Contract, cf. Article 4.6 first paragraph.

- (134) Upon the written instructions of Gazprom Naftogaz shall take measures restricting the transit of gas supplies in relevant directions, cf. Article 4.7.

4.2.4 Repair work on the gas transportation system and quality requirements of the transit gas Articles 5 and 6 of the Contract

- (135) Naftogaz' obligation to conduct repair work on the Ukrainian gas transportation system is expressed in Article 5.1, which also specifies that the repair works shall be agreed between the Parties in advance. [REDACTED]

- (136) The quality requirements of the transit gas at the entry and exit points, hereunder the admissible range of lowest calorific capacity (value), are specified in Article 6. Article 6.3, called "Standard Methods for Quality Determination", reads as follows:

[REDACTED]

4.2.5 Documentation of gas delivery and acceptance Article 7 of the Contract

- (137) [REDACTED]

- (138) According to Article 7.1 of the Contract, the Parties were obliged to enter into a Technical Agreement for 2009 in parallel with and simultaneously with signing the Contract. It follows from Article 7.1 that should the Parties fail to sign the Technical Agreement for each following year as intended, the Technical Agreement for the previous year shall apply.

- (139) Pursuant to Article 7.2 a Monthly Gas Delivery and Acceptance Report shall be prepared for each Gas Metering Station ("GMS"), i.e. the station(s) where the quantity and quality of transferred natural gas is measured and determined (cf. the definition in Article 1), and for each Gas Consumption Measuring Unit ("GCMU"), inaccurately transcribed as "GCMP" in the English translation of Article 7, i.e. the station intended for measuring the quantity of gas on the gas pipeline during its acceptance/delivery and consisting of one or several measuring pipelines (cf. the definition in Article 1). The daily figures of all metering streams for the reporting month shall be summarised, and technological losses and withdrawals of gas at the border sections of gas pipelines from GMS and GCMU to the border of Ukraine shall be deducted. The Monthly Gas Delivery and Acceptance Report is to be signed by representatives of the Parties on the first day of the month following the reporting month, cf. Article 7.3.
- (140) Additionally, a Consolidated Monthly Gas Delivery and Acceptance Report shall be prepared by summarising the daily volumes of gas fixed in the monthly Gas Delivery and Acceptance Reports for all Gas Metering Stations (GMS), cf. Article 7.4. This consolidated report is the basis for execution of the transit services price reports as described in Article 8 below.
- (141) The Parties shall prepare monthly documents confirming the quality of Natural Gas at the Gas Metering Station (GMS), and these documents form an integral part of the Monthly Gas Delivery and Acceptance Report, cf. Article 7.5.

4.2.6 Price for the transit of gas – Article 8 of the Transit Contract

4.2.6.1 Introduction

- (142) The price (tariff) provisions are found in Articles 8.1 to 8.6 of Article 8. Article 8.1 contains the price (tariff) formula. Article 8.2 regulates price reductions due to Advance Payments by Gazprom, Article 8.3 regulates the agreed monthly schedule for transit services rendered from Naftogaz to Gazprom against a previously received advance payment, and Article 8.4 specifies the pricing principles that shall apply once the advance payment is repaid. The estimated annual costs of the transit services for the years 2009 to 2011 are stipulated in Article 8.5 as amended

[REDACTED] Article 8.6 establishes that the price paid for gas transit by Gazprom under the Transit Contract includes taxes and duties, including VAT.

(143) Article 8 also contains a price (tariff) revision provision in Article 8.7.

(144) [REDACTED]

(145) It follows from Article 8.2 that part of the transit services rendered by Naftogaz under the Transit Contract, is payment for previously received advance payments. [REDACTED]

4.2.7 The Price Formula

(146) Article 8.1 contains the price (tariff) formula and reads as follows:

“The price for transit services of 1,000 (one thousand) cubic meters of Gas through the territory of Ukraine in 2009 is defined as equal to USD 1.7 (one dollar and 70 cents) per every 100 (one hundred) kilometres with the exception of the price for the services on transit of 1,000 (one thousand) cubic meters of Gas, as rendered in return for previously advance payments, as referred to in Clause 8.2 of this Article.

With effect from 2010, the price for services on transit of 1,000 (one thousand) cubic meters of Gas through the territory of Ukraine (T_n) shall be calculated on an annual basis for the transported volumes of Gas according to the following formula : “

$$T_n = A_n + K_{nj}^{mg} \text{ where}$$

A_n is the tariff, calculated according to the following formula:

$$A_n = 0.5 * A_{2010} + 0,5 * \{A_{n-1} x (1 + I_{n-1})\}$$

where:

A_{2010} = USD 2.04 per 1000 m³ per 100 km.

A_{n-1} constitutes the tariff for the year immediately preceding the current year of transportation.

For the calculation of the price for gas transit in 2010: $A_{n-1} = A_{2010}$.

I_{n-1} is the inflation level in the European Union, as published annually by Eurostat agency for the year immediately preceding the current year of transportation. For the calculation of A_n in 2010, $I_{n-1} = 0$.

K_{nj}^{mg} is the fuel tariff which is calculated monthly according to the following formula:

$$K_{nj}^{mg} = \frac{0,03 * P_{nj}}{L} * 100$$

where:

P_{nj} is the prevailing price for gas supplies to Ukraine in the given payment month under the Contract No. KP dated 19 January 2009 in USD per 1,000 cubic meters,

L is the distance of transportation in kilometres (km) equal to 1240 km,

n is the corresponding year of gas transportation, and

j is the corresponding month of gas transportation in year n .”

4.2.8 The Tariff

(147) The tariff, A_n , is a distance-based commodity tariff expressed by the volumes transported (in volumetric units).

- (148) The tariff, A_n , is the sum of a fixed part with a weight of 50% and an inflation adjusted part calculated on the basis of the tariff of the preceding year, also with a weight of 50%.
- (149) The fixed part, A_{2010} , is stipulated as USD 2.04/1000m³/100 km.
- (150) To adjust for inflation, the tariff for the preceding year is multiplied with the product of an agreed weighted factor, 1, and the inflation factor of the preceding year, I_{n-1} . The resulting product is then again multiplied with the tariff for the preceding year.
- (151) For 2010, the tariff, A_n , was USD 2.04/1000m³/100 km. The tariff for 2010 has been calculated in the following way:
- (152) The fixed part of the formula remains constant, i.e. USD 1.02/1000m³/100 km (50% of USD 2.04).
- (153) The inflation adjusted part was also USD 1.02/1000m³/100 km. This has been calculated in the following steps: The inflation factor, I_{n-1} , is 0 in 2010, cf. above. The tariff for the preceding year, A_{n-1} , fixed at USD 2.04/1000m³/100 km for 2010, is therefore multiplied with 1 ($1 + 0 = 1$). The product, USD 2.04/1000m³/100 km, is then multiplied with the agreed weight, 0,5, resulting in an inflation adjusted part of USD 1.02/1000m³/100 km.
- (154) The sum of the fixed part, USD 1.02/1000m³/100 km, and the inflation adjusted part, USD 1.02/1000m³/100 km, results in a tariff of USD 2.04/1000m³/100 km.

4.2.9 The Fuel Tariff

- (155) The Transit Contract requires that the volume of Natural Gas available in every 24 hours at exit points shall be equal to the volumes injected at entry points. Thus, the Transit Contract does not allow for leaks during transit and Naftogaz also has to separately procure fuel gas, i.e. gas (mixed with filtered, compressed air) required as fuel for compressors and/or heaters, which are integral parts of the pipeline system and needed in order to meet the delivery point specification.

- (156) It is common to charge for a small percentage of fuel gas and leaks. The purpose of the fuel tariff, K_{nj}^{mg} , is to compensate Naftogaz for the operational costs specifically related to fuel gas.
- (157) In general, the transit tariff will usually be determined between the transporter and the shipper independently of the determination of the contract price under any gas sales contract which the gas transit contract is intended to service.
- (158) In the Transit Contract, however, the fuel tariff is based on a percentage of the Contract Price for natural gas in the Gas Sales Contract entered into between the Parties.
- (159) The fuel tariff is arrived at by multiplying the prevailing Contract Price in a given month under the Gas Sales Contract between the Parties (P_{nj}) with an agreed weight of 0.03, and to divide the resulting product with a fixed transportation distance, 1240 km (L).
- (160) The Contract Price under the Gas Sales Contract is currently linked to other alternative fuels, i.e. gas oil (G) and fuel oil (M) (the "mg" in K_{nj}^{mg}). In this relation, i.e. the determination of the fuel tariff under the Transit Contract, the elements gas oil (G) and fuel oil (M), have no independent function.

4.2.10 The price (tariff), T_n , for transit services

- (161) The price (tariff) for transit services, T_n , was USD 2.04/1000m³ per 100 km in 2010. In 2014, the price (tariff), T_n , was USD 2.09/1000m³ per 100 km.[DÄREFTER?]

4.2.11 Price reductions due to advance payments

- (162) Pursuant to Article 8.2, in 2009 Naftogaz was obliged to provide services for transit of Gas in the amount of USD 250 million against an advance payment received from Gazprom in accordance with Supplement No. 4 dated 9 august 2004 to the Contract on the volumes and conditions for transit of Natural Gas through the territory of Ukraine in the period from 2003 to 2013, dated 21 July 2002, [REDACTED]

[REDACTED]

(163) Article 8.3 sets out the monthly schedule for the transit services rendered by Naftogaz to Gazprom against the previously received advance payment, and Article 8.4 specifies the pricing principles that shall apply once the advance payment is repaid. It follows from Article 8.4 that Gazprom then shall pay for Naftogaz' transit services at the price provided in Article 8.1.

(164)

[REDACTED]

4.2.12 The estimated price for gas transit services

(165) Article 8.5 of the Contract reads:

“The estimated cost of the services for transit of the Gas volumes specified in Clause 3.1 of Article 3 of this Contract through the territory of Ukraine in 2009 amounts to approximately USD 2,350,000,000 (two billion three hundred fifty million).”

(166) While the estimated cost of services for transit through Ukrainian territory in 2009 was approximately USD 2 350 000 000, the estimated cost amounts to approximately [REDACTED] and to approximately [REDACTED] for 2011, cf. Article 8.5 [REDACTED]. These estimates are based on the agreed gas volumes for transit under the Transit Contract as amended in the Addenda.

4.2.13 Taxes and duties included in the price for Transit Services

(167) Article 8.6 establishes that the price paid for gas transit by Gazprom under the Transit Contract includes taxes and duties, including VAT.

4.2.14 The Price Revision Clause Article 8.7 of the Contract

(168) Article 8 also contains a price (tariff) revision provision in Article 8.7 which, in Naftogaz' translation, reads:

"In case of a significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of this Contract, and if the price for transit services specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs in the European gas market, each Party is entitled to apply to the other Party with a request for revision of the price for transit services."

(169) Gazprom translates the tariff revision clause as:

"8.7. In the event of a material change in 2010 and subsequent years of the conditions of formation of transit tariffs at the European gas market, as compared to what the Parties reasonably expected at the time of entering into this Contract, and if the transit tariff specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs at the European gas market, each Party shall have the right to address the other Party with a request to reconsider the transit tariff."

(170) According to Article 8.7, each Party is, in Naftogaz' translation, entitled to request a revision of the price for transit services (in Gazprom's translation: request to reconsider the transit tariff) provided two conditions are met:

(171) First, there must have been a significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of the Contract. Thus, the earliest effective date for a tariff revision under the Contract is 1 January 2010.

(172) Second, the Price for transit services as provided for in Article 8.1 of the Contract does not correspond to the level of transit tariffs in the European gas market.

- (173) Pursuant to Article 8.7.1 the request for price revision (in Gazprom's translation: "*request to reconsider the transit tariff*") shall be made in writing, and be properly substantiated. After receipt of the request, the Parties are obliged to initiate negotiations within 20 days.
- (174) Pursuant to Article 8.7.2, if no agreement has been reached within three months from when the Parties entered into negotiations, the dispute may be referred to arbitration for final decision, in accordance with Article 12 of the Contract.

4.3 Payment procedure Article 9 of the Contract

- (175) Article 9 of the Contract sets out the payment procedure.
- (176) Article 9.1 establishes the principle that Gazprom shall pay in money for transit services rendered by Naftogaz.
- (177) Article 9.2 establishes the principle that the currency of payment under the Contract shall be US dollars.
- (178) Articles 9.3 to 9.5 set out the procedures and dates for invoicing, reconciliation of payments and the term of payment. Article 9.5 reads as follows:

"The Client shall pay for the services rendered by the Contractor on transit of Gas through the territory of Ukraine on a monthly basis by transferring money to the Contractor's account by the 20th day of the month following the month in which services were rendered based on the invoices issued by the Contractor in compliance with the Transit Services Price Report signed by the Parties in the actual calculated value of rendered services based on the common volume of the transported Gas as specified in the monthly reports and the prices for transit according to Clause 8.1 and Clause 8.2, taking into account the provisions of Clause 8.4.

If the Contractor issues an invoice after the 15th day of the month following the reporting month, the term of payment for services on transit shall be extended with the respective number of business days."

4.4 Liability of the Parties Article 10 of the Contract

(179) General obligation to perform Article 10 of the Transit Contract regulates the liability of the Parties under the Contract.

(180) Article 10.1 establishes the Parties' general obligation to perform the terms and conditions of the Contract and the principle that the Parties are liable for any damages caused by the Parties' failure to perform. Article 10.1 reads:

"The Client and the Contractor will undertake their best efforts to duly perform the undertaken obligations under this Contract.

Should the Parties fail to perform the terms and conditions of this Contract, each of the Parties shall reimburse the other Party for any proven damages caused by such failure to perform."

4.4.1 Delivery after transit and the required quality of natural gas

(181) Article 10.2 regulates the obligations of Naftogaz as regards the quality of the natural gas supplied at the agreed delivery points after transit through Ukrainian territory, i.e. at the Exit Points at the Ukrainian western border. The natural gas delivered at the Exit Points is required to have the same quality as the gas supplied at the Entry Points. If this quality requirement is not met, Naftogaz is obliged to restore the gas quality at its own expense. If the gas quality cannot be restored, Naftogaz is obliged to compensate Gazprom for proven damages, such as penalty payments made to third persons or discounts on the price of Natural Gas, caused by the inferior gas quality.

4.4.2 Delayed payments for transit services and penalty interest

(182) If Gazprom's payment for transit services rendered are delayed, Naftogaz is entitled to a penalty interest of 0.03% of the amount of overdue transferred monetary funds for each day of delay in payment, cf. Article 10.3.

4.4.3 Withdrawal of transit gas

(183) Pursuant to Article 10.4, the withdrawal by Naftogaz of natural gas supplied by Gazprom for transit shall be recorded under the Gas Sales Contract. The price for such withdrawn transit gas shall be determined in accordance with Article 4.3 of the Gas Sales Contract.

(184) Article 10.4 reads as follows:

“In case the Contractor withdraws Natural Gas supplied for transit by the gas transportation system of Ukraine all the gas withdrawn shall be recorded in the Contract on Sale and Purchase of Natural Gas between OAO Gazprom and NAK Naftogaz of Ukraine No. KP dated 19 January 2009.

The price for this gas shall be established in accordance with Clause 4.3 of Article 4 of the Contract on purchase and sale of natural gas between OAO Gazprom and NAK Naftogaz of Ukraine No. KP dated 19 January 2009.”

4.5 Article 12. Applicable Law and Arbitration

(185) Article 12 of the Contract regulates the applicable law and the dispute resolution mechanism of the Contract.

(186) Pursuant to Article 12.1, the Contract is regulated by the substantive laws of Sweden.

(187) Article 12.2 states that the Parties *"shall seek to resolve all disputes and controversies between themselves relating to the interpretation and application of this Contract by means of negotiations"*. If the Parties fail to reach a solution to the dispute by means of negotiations within 45 days upon the occurrence of the dispute, the dispute *"shall be finally resolved by arbitration in accordance with the Rules of the Arbitration Institute of the Stockholm Chamber of Commerce"*.

4.6 Miscellaneous Article 13 of the Contract

4.6.1 Replacement of legally invalid or ineffective provisions Article 13.2 of the Contract

(188) Article 13.2 of Article 13 reads as follows:

“If any of the provisions of the present Contract becomes legally invalid pursuant to the applicable legislation or ineffective, this shall not affect the validity of other provisions hereof. If any of the provisions of the present Contract becomes invalid or ineffective, the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have the economic effect as close as possible to that of the invalid or ineffective provision.”

(189) Article 13.2 provides that the validity of the Contract shall not be affected if any of its provisions becomes legally invalid pursuant to the applicable legislation or ineffective. Instead, the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have the economic effect as close as possible to that of the invalid or ineffective provision.

4.6.2 Amendments and Addenda to the Contract Article 13.6. of the Contract

(190) Article 13.6 of Article 13 of the Contract sets out the procedure for how amendments to the Contract shall be made. The Article reads:

“All and any amendments and Addenda to this Contract shall be in writing and shall be signed by the authorized representatives of the Client and the Contractor.

The Parties agreed that the said amendments and Addenda signed and sent by fax are binding provided that they are further confirmed by the original.

The Parties shall notify each other of changes to their bank details, legal addresses, telephone numbers and faxes within a five-day term following the occurrence of the respective changes.”

4.6.3 Assignments of the rights and obligations under the Contract Article 13.8 of the Contract

(191) Pursuant to Article 13.8 of Article 13 of the Transit Contract, neither of the Parties can assign its rights and obligations under the Contract to third parties without the written consent of the other Party.

4.6.4 Continuation of gas transit in case of dispute Article 13.12 of the Contract

(192) Article 13.12 of Article 13 of the Transit Contract stipulates that the gas transit shall continue in case of any dispute as regards any issue related to the performance or validity of the Contract.

4.7 The Technical Agreement

4.7.1 Introduction

(193)

[REDACTED] the Transit Contract shall be supplemented by [REDACTED] Technical Agreement [REDACTED].

(194)

[REDACTED]

(195)

[REDACTED]

(196)

[REDACTED]

(197)

[REDACTED]

(198)

[REDACTED]

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[REDACTED]

- [REDACTED]

- [REDACTED]

(199)

[REDACTED]

(200)

[REDACTED]

- [REDACTED]

- [REDACTED]

- [REDACTED]

4.7.2

(201)

[REDACTED]

[REDACTED]

(202)

[REDACTED]

(203)

[REDACTED]

4.7.3

(204)

[REDACTED]

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(214)

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[REDACTED]

(216)

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4.7.4

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[REDACTED]

4.7.5

[REDACTED]

(227)

[REDACTED]

(228)

[REDACTED]

(229)

[REDACTED]

(230)

[REDACTED]

[REDACTED]

(231)

[REDACTED]

4.8 Other legal documents relevant to the Contract

4.8.1 Introduction

(232) In addition to the Contract, certain other legal documents are of particular relevance to the Contract, as explained in the following.

(233) The Gas Transit Contract was entered into as a separate agreement on 19 January 2009. On the same date, the Parties also entered into Contract No. KP on the purchase and sale of Natural Gas in 2009 – 2019 (the "Gas Sales Contract", the "Sales Contract" or the "Supply Contract"). The Gas Sales Contract and the Gas Transit Contract are related. However, although negotiated and concluded in parallel, the Gas Sales Contract and the Transit Contract are separate contracts, stemming from separate legal relationships, regulating different subject matters and with different objectives.

(234)

[REDACTED]

(235) The Energy Community Secretariat has assessed the Transit Contract, and presented its findings in its Preliminary Compliance report of 3 December 2014.

(236) The Agency for Cooperation of Energy Regulators ("ACER") has considered the validity of legacy long-term transit arrangements on a general basis in light of the requirements of EU energy and competition law. The overall mission of ACER is to complement and coordinate the work of national energy regulators at EU level and promote the single EU energy market for natural

gas. As such it plays a central role in the development of EU-wide network and market rules. ACER's report provides an assessment of legal aspects concerning legacy long-term transit arrangements under EU legislation.

4.8.2 The Gas Sales Contract

(237) As mentioned above, Gazprom and Naftogaz also negotiated and entered into a long-term sales contract for Natural Gas of Russian, Kazak, Uzbek or Turkmen origin, on 19 January 2009 (the "Gas Sales Contract") in parallel with the Transit Contract. Although negotiated and concluded in parallel, the Gas Sales Contract and the Transit Contract are separate contracts, stemming from separate legal relationships, regulating different subject matters and with different objectives.

(238) As mentioned above, the Gas Transit Contract and the Gas Sales contract were entered into as separate agreements on the same date, and the Gas Transit Contract is to some extent related to the Gas Sales Contract.

(239) *First*, the transit tariff is linked to the Contract Price for natural gas received under the Gas Sales Contract.

(240) *Second*, Gazprom's advance payments for transit services by Naftogaz under the Transit Contract are earmarked to be used to pay for gas received under the previous and the current gas sales contracts.

(241) *Third*, the Transit Contract stipulates that any withdrawal by Naftogaz of Natural Gas supplied by Gazprom for transit shall be recorded and paid for under the Gas Sales Contract.

4.8.3 The Interim Agreement

(242) The Interim Agreement set out the framework enabling the delivery of gas from Gazprom to Naftogaz to cover domestic consumption in Ukraine during the winter period from 1 November 2014 until 31 March 2015, in order to safeguard the security of gas supply during this period.

(243) With regard to gas transit, the main objective of the Interim Agreement was to confirm continued transit during the interim period.



5. THE PROCEDURE

The procedural steps are listed below.

- (244) On 13 October 2014, Naftogaz submitted its Request for Arbitration.
- (245) On 15 October 2014, the SCC informed the Parties of Naftogaz's request for Arbitration and gave Gazprom until 29 October to submit its answer.
- (246) On 28 October 2014, Gazprom requested a time extension for its submission of its answer to Naftogaz's request for Arbitration.
- (247) On 3 November 2014, Naftogaz commented on Gazprom's request.
- (248) On 4 November 2014, based on the Parties' comments, the SCC granted Gazprom until 28 November to submit its answer.
- (249) On 28 November 2014, Gazprom submitted its answer to the request for Arbitration.
- (250) In its Request for Arbitration, Naftogaz proposed to constitute the same Arbitral Tribunal in the Gas Transit Arbitration (SCC Arbitration Case V2014/129) as in the Gas Sales Arbitration (SCC Arbitration Case V2014/78), consisting of Mr. Tore Wiwen-Nilsson as Chairperson, and as party-appointed arbitrators, former Supreme Court Justice Johan Munck and Mr. Jens Rostock-Jensen. Gazprom agreed in its Answer of 28 November 2014.
- (251) On 11 December 2014, the SCC confirmed the constitution of the same Arbitral Tribunal and informed on the advance on costs.
- (252) On 23 December 2014, Gazprom requested consolidation of the present SCC Arbitration Case V2014/129 concerning the Gas Transit Contract with the SCC Arbitration Case V2014/78 concerning the Gas Sales Contract. The request was sent to the SCC and directly to the Claimant.
- (253) On 29 December 2014, the SCC gave Naftogaz until 5 January to comment on Gazprom's request.

- (254) On 5 January 2015, Naftogaz provided comments to Gazprom's request.
- (255) On 5 January 2015, the SCC informed the Arbitral Tribunal of Gazprom's application, and requested the Tribunal to comment on it by 9 January 2015.
- (256) On 7 January 2015, the SCC gave Gazprom until 12 January to respond to Naftogaz' comments.
- (257) On 9 January 2015, the Tribunal commented on the issue of consolidation.
- (258) On 12 January 2015, 2015 Gazprom commented on Naftogaz' submission of 5 January 2015.
- (259) On 13 January 2015, the SCC informed that the consolidation issue would be referred to the SCC Board shortly.
- (260) On 13 January 2015, Naftogaz requested and was granted a possibility to comment on Gazprom's 12 January 2015 submission by 19 January 2015. After that date, the SCC would not expect any further exchange of briefs.
- (261) On 13 January 2015, the SCC forwarded to the Parties the Tribunal's e-mail of 9 January 2015 with comments to the issue of consolidation.
- (262) On 19 January 2015, Naftogaz submitted its final comments on the consolidation issue.
- (263) On 21 January 2015, Gazprom submitted unsolicited comments to Naftogaz' submission of 19 January 2015.
- (264) On 22 January 2015, the SCC confirmed receipt of Gazprom's comments and reminded the Parties that the SCC did not expect any further briefs.
- (265) On 28 January 2015, the Board of the SCC decided not to consolidate SCC Arbitration Case V2014/129 with SCC Arbitration Case V2014/78.

- (266) On 29 January 2015, after the Parties had paid the advance on costs, the case was referred to the Arbitral Tribunal by the SCC.
- (267) On 5 March 2015, a case management meeting was convened in Stockholm, Sweden. In this meeting, the Parties agreed to a Procedural Order No. 1 with a Provisional Timetable as Annex No. 1.
- (268) On 30 April 2015, Naftogaz submitted its Statement of Claim, including supporting documents, witness statements and expert reports.
- (269) On 16 October 2015, Gazprom submitted its Statement of Defence and Counterclaim, including supporting documents, witness statements and expert reports.
- (270) On 21 October 2015, the Procedural Time Table was amended.
- (271) On 30 October 2015, Gazprom submitted a request for Document Production.
- (272) On 25 November 2015, after having exchanged Document Requests, the Parties submitted a Joint Submission of Requests for Document Production where only Naftogaz made a request for production of document, and requested their production of only one document.
- (273) On 2 December 2015, the Tribunal decided to deny Naftogaz' Request for the Production of Document.
- (274) On 4 December 2015, with agreement of the Parties, the SCC appointed Professor Boel Flodgren as Administrative Secretary of the Tribunal.
- (275) On 29 January 2016, the Procedural Time Table was amended by agreement between the Parties.
- (276) On 27 April 2016, the Tribunal decided on the Requests for the Production of Documents.
- (277) On 11 May 2016, the Tribunal made a correction of its Decision on Request for Production of Documents April 2016.

- (278) On 5 February 2016, the counsel of Gazprom, Mr Matthew Saunders, confirmed that he was resigning from DLA Piper but only after “a lengthy contractual notice period”.
- (279) On 11 February 2016, Gazprom submitted a Request for further Document Production (the EY Report)
- (280) On 12 February Naftogaz was invited to comment on Gazprom’s request by 16 February 2016.
- (281) On 12 February 2016, Naftogaz submitted its Statement of Reply and Defence to Counterclaim, including supporting documents, witness statements and expert reports.
- (282) On 13 February 2016, Naftogaz submitted its Statement of Reply and Defence to Counterclaim along with the Expert Reply
- (283) On 13 February 2016, the Tribunal decided, subject to the confirmation by the Parties of their availability, that the hearing in this Arbitration should be held in the period 14 – 25 November 2016.
- (284) On 16 February 2016, Naftogaz submitted a comment on Gazprom’s request of 11 February for a document production order.
- (285) On 23 February 2016, Gazprom submitted a comment on Naftogaz’ response 16 February regarding Gazprom’s request 11 February for Document Production.
- (286) On 24 February 2016, the Tribunal asked for further clarification by Gazprom of its request for Document Production.
- (287) On 2 March 2016, DLA Piper submitted information about Mr Matthew Saunders no longer being involved in this Arbitration.
- (288) On 31 March 2016, after having communicated with Naftogaz on the issue, Gazprom submitted further information regarding its request for Document Production.

- (289) On 1 April 2016, the Tribunal issued the following instructions to the Parties:
- (290) 1. Naftogaz shall submit possible objections to Gazprom's Document Request no later than on 5 April 2016 and shall submit documents to which no objections are made by Naftogaz no later than on 12 April 2016.
- (291) 2. The parties shall at the latest on 15 April 2016 file a joint submission in accordance with paragraphs 4.5i) and 4.6 of procedural Order No. 1.
- (292) Any concerns regarding the confidentiality or sensitivity of information requested, with proposals for procedures to handle such concerns, should be addressed by the Parties in connection with the filing of the joint submittal.
- (293) On 5 April 2016, Naftogaz submitted its objections and comments to Gazprom's request for document production.
- (294) On 15 April 2016, the Parties submitted a Joint Submission of request for Document Production.
- (295) On 27 April 2016, the Tribunal decided on Gazprom's request 22 March for Document Production.
- (296) On 12 May 2016, the Parties submitted their agreement regarding the practical arrangements for the hearing in this Arbitration.
- (297) On 31 May 2016, submitted their agreement on outstanding items in respect of the timetable for the Arbitration. The Parties notified that the Pre-hearing Written Submissions would be limited to 50 pages.
- (298) On 21 June 2016, the Parties submitted their agreement on the extension of time for the submission of Gazprom's Statement of Rejoinder from 24 June to 6 July 2016. The Parties had also agreed that, in the event that Gazprom would not be able to submit an expert report relating to the matters arising from the review of the documents disclosed by Naftogaz pursuant to the

Tribunal's order dated 27 April 2016 by that date, such a report would be submitted by 15 July 2016.

- (299) On 6 July 2016, Gazprom submitted its Statement of Rejoinder and Reply to Defence to Counterclaim, including supporting documents, witness statements and expert reports.
- (300) On 3 August 2016, Naftogaz submitted a request for an additional round of pleadings or, alternatively, request for a cut-off date for new evidence.
- (301) On 5 August 2016, Gazprom submitted its response to Naftogaz' request for an additional round of pleadings or, alternatively, request for a cut-off date for new evidence.
- (302) On 8 August 2016, The Tribunal, considering the Parties' letters of 3 August and 5 August, made the following decision:
 - (303) 1. The Tribunal permits the Parties to each make one further submission on the merits, the Claimant at the latest on 26 August 2016 and the Respondent at the latest on 1 November 2016.
 - (304) 2. The Sur-Reply and Rejoinder of the Claimant may only address new issues and claims raised in the Respondent's Rejoinder of 6 July 2016 and clarifications required as a result of the Respondent's Rejoinder. No new issues may be raised and amplifications of earlier arguments only are not permitted. The Claimant may invoke new evidence but only as required to support by factual evidence and expertise what is addressed in the Sur-Reply and Rejoinder. The Sur-Reply and Rejoinder must not exceed 25 pages (excluding supporting evidence).
 - (305) 3. The Sur-Rejoinder and Sur-Reply of the Respondent may only address matters raised in the Sur-Reply and Rejoinder of the Claimant, and amplifications of earlier arguments only are not permitted. New evidence is only permitted to support what is addressed in the Sur-Rejoinder and Sur-Reply of the Respondent. The Sur-Rejoinder and Sur-Reply of the Respondent must not exceed 25 pages (excluding supporting evidence).
 - (306) 4. Except as set forth above, no new evidence is permitted, unless the Tribunal in its discretion determines that the Party seeking the permission of the Tribunal has been able to demonstrate

that it has not been possible for it to present the evidence before and that the evidence is relevant and material to the outcome of the dispute.

- (307) On 27 August 2016, Naftogaz submitted its Sur-Reply and Rejoinder to Counterclaim along with an Expert Sur-Reply.
- (308) On 8 September 2016, Gazprom informed that its legal team had been supplemented to include Alan Gourgey, QC, Kassie Smith QC and Thomas Sebastian, all of whom are self-employed barristers.
- (309) On 24 October 2016, Gazprom submitted a notification of names of experts and witnesses of fact to be present at the hearing or that Gazprom wished to cross-examine at the hearing.
- (310) On 24 October 2016, Naftogaz submitted a notification of names of experts and witnesses of fact that Naftogaz wished to be present at the hearing.
- (311) On 1 November 2016, Gazprom submitted its Statement of Sur-Rejoinder including supporting documents, witness statements and expert reports.
- (312) On 2 November 2016, the Tribunal sent to the Parties a suggested Agenda for the Planning Meeting to be held by telephone on 9 November. The Tribunal also asked for clarification and specification on certain items and a time-line, preferably a joint time-line, of events of relevance to the claims in the arbitration with expected response from the Parties no later than on 14 November 2016.
- (313) On 4 November 2016, the Parties submitted a suggested outline timetable for the hearing.
- (314) On 4 November 2016, the Tribunal commented on the suggested timetable for the hearing.
- (315) On 8 November 2016, Naftogaz submitted its Pre-Hearing Written Submission.
- (316) On 8 November 2016, Gazprom submitted its Pre-Hearing Written Submission.

- (317) On 9 November 2016, the Parties and the members of the Tribunal held a Pre-Hearing Planning Meeting in the form of a telephone conference at which also the Administrative Secretary was present.
- (318) On 14 November 2016, Naftogaz responded to the Tribunal's request of 2 November 2016 for clarification of certain items.
- (319) On 14 November 2016, Gazprom responded to the Tribunal's request of 2 November 2016 for clarification of certain items.
- (320) On 15 November 2016, the Tribunal asked for further clarification from Naftogaz on certain items to be provided before the start of the hearing.
- (321) On 16 November 2016, in response to the Tribunal's request of 2 November, Gazprom submitted its timeline of events and informed that the Parties had been unable to agree on a joint timeline.
- (322) On 16 November 2016, the Chairperson asked the Parties to make a new effort to agree on a gross timeline with all relevant dates with a disclaimer.
- (323) On 16 November 2016, Naftogaz submitted a request for clarification of Gazprom's request for dismissal dated 14 November 2016.
- (324) On 16 November 2016, Naftogaz submitted its timeline of events relevant to its claims and informed that it would proceed to agree on a joint timeline in accordance with the Chairperson's suggestion of 16 November.
- (325) On 17 November 2016, Naftogaz submitted a revised version of its timeline in replacement of the timeline submitted on 16 November 2016.
- (326) On 19 November 2016, the Parties met with the Administrative Secretary at the venue of the hearing to check that the technical equipment and other practical matters were in order.
- (327) Between 21 November - 4 December 2016, the Hearing took place in Stockholm.

(328) During the Hearing, the following persons appeared before the Tribunal at the request of Naftogaz:

(329) as witnesses of fact:

[REDACTED]

(330) as expert witnesses: Mr Carlos Lapuerta, dr Serena Hesmondhalgh, Professor Sir Francis Jacobs.

(331) During the Hearing, the following persons appeared before the Tribunal at the request of Gazprom:

as witnesses of fact:

[REDACTED]

as expert witnesses: Dr Boaz Moselle, Dr Katja Yafimava, Mr Bernhard Witschen, Professor Lars Henriksson.

(332) On 26 November 2016, Naftogaz submitted a Revised Relief Sought.

(333) On 28 November 2016, Gazprom submitted an application to admit new evidence including supporting documents, witness statement and expert report.

(334) On 28 November 2016, Naftogaz submitted its reply to Gazprom's application to submit new evidence.

(335) On 28 November 2016, the Tribunal decided that Gazprom should submit a more complete application to admit new evidence on 19 December 2016 and that Naftogaz should submit its response to this application on 30 January 2017.

- (336) On 30 November 2016, Gazprom submitted its response to Naftogaz' Revised Relief Sought of 26 November.
- (337) On 30 November 2016, the Tribunal decided, on the Parties' request, to have – after the Parties' closing statements on 4 December – a short discussion with the Parties on the procedural issues related to the outstanding issues caused by Gazprom's application of 28 November to admit new evidence and Naftogaz' amended Relief Sought of 26 November 2016.
- (338) On 1 December 2016, Naftogaz submitted its Explanatory note – requested by the Tribunal during the Hearing – regarding the roles and relationships between the parties involved (Naftogaz and Ukrtransgaz, and Gazprom and Gazprom Export) and the legal consequences thereof.
- (339) On 1 December 2016, Gazprom submitted its reply – requested by the Tribunal during the Hearing – regarding the distinction between Naftogaz and Ukrtransgaz and between Gazprom and Gazprom Export and the relevance of this in this Arbitration.
- (340) On 8 December 2016, the Tribunal provided the Parties with notes from the discussion at the closure of the Hearing on 4 December for review and comments.
- (341) On 12 December 2016, Gazprom submitted its objections and comments to Naftogaz's amended Relief Sought of 26 November 2016.
- (342) On 13 December 2016, the Tribunal provided the Parties with an amended version of the notes from the discussion at the closure of the Hearing.
- (343) On 19 December 2016, Naftogaz submitted its response to Gazprom's letter of 12 December 2016 regarding the amended Relief Sought.
- (344) On 19 December 2016, Gazprom submitted its Submissions on the Fuel Gas Issue together with supporting witness statement and expert reports.

- (345) On 20 December 2016, the Tribunal with the concurrence of the Parties requested extension of the date for the rendering of the Award until 30 June 2017.
- (346) On 20 December 2016, the SCC decided that the Final Award should be rendered by 30 June 2017.
- (347) On 20 December 2016, Gazprom applied for permission to submit the contracts between Naftogaz and Ukrtransgaz, which had been submitted by Naftogaz at the closing of the Hearing, into evidence in the proceedings and requested that contracts covering the periods 2010, 2012 and February 2015 also should be provided by Naftogaz and that all contracts should be submitted without redactions.
- (348) On 20 December 2016, Naftogaz was invited to comment on Gazprom's letter of 20 December 2016 no later than 21 December 2016.
- (349) On 21 December 2016, Naftogaz submitted its response to Gazprom's letter of 20 December 2016.
- (350) On 22 December 2016, with reference to the Tribunal's decision of the last day of the Hearing regarding the question of royalty tax savings, Naftogaz submitted an Explanatory Note (Pleading No. 8) on the Underdeliveries Claim and the Claim for underpayment of transit services with supporting documents.
- (351) On 23 December 2016, Naftogaz submitted its Post Hearing Brief with supporting documents.
- (352) On 23 December 2016, Gazprom submitted its Post Hearing Brief with supporting documents, for which it regarding four of the documents requested Naftogaz's consent to submit into evidence.
- (353) On 25 January 2017, in a letter to the Tribunal, Gazprom noted that Naftogaz did not object to the request by Gazprom in its letter of 20 December 2016 for submission of the contracts into evidence, but Gazprom sought removal of redactions in the contracts disclosed by Naftogaz on

3 December 2016 regarding the contractual relationship between Naftogaz and Ukrtransgaz with regard to transit volumes and tariffs. In the letter, Gazprom requested permission to have new contracts, now disclosed, covering 2010 and 2012, submitted into evidence and that they be included in Gazprom's request for the removal of redactions. Gazprom also noted that the contract covering February 2015 was yet to be provided.

- (354) On 27 January 2017, Naftogaz submitted Brattle Group's fourth report and accompanying appendix which had inadvertently been left out with the submission of Naftogaz's Explanatory Note of 22 December 2016.
- (355) On 27 January 2017, Gazprom submitted a request to submit its response to Naftogaz' Note of the 22 December 2016 by 10 February 2017.
- (356) On 27 January 2017, Naftogaz, referring to Gazprom's letter of 25 January (incorrectly referred to as of 26 January, but later, on 29 January, corrected to 25 January), asked for the Tribunal's directions as to when Naftogaz should provide its response.
- (357) On 28 January 2017, Gazprom's request of 27 January to submit its response by 10 February 2017 was granted.
- (358) On 28 January 2017, Naftogaz requested a corresponding prolongation to respond to Gazprom's pleading on the matter of fuel gas, i.e. to 10 February 2017.
- (359) On 28 January 2017, Naftogaz' request for prolongation to respond to Gazprom's pleading on the matter of fuel gas to 10 February 2017 was granted.
- (360) On 30 January 2017, in response to Naftogaz' request for directions of 27 January 2017, the Tribunal granted Naftogaz leave to respond to Gazprom's letter of 25 January no later than on 6 February 2017.
- (361) On 31 January 2017, in a letter to the Tribunal, Gazprom notified the Tribunal that Naftogaz' response in relation to the fuel gas issue is completely unrelated to Gazprom's response in

relation to the royalties issue and the fact that the same date (30 January 2017) had been chosen as the deadline for both Naftogaz' response in relation to the fuel gas issue and Gazprom's response in relation to the royalties issue was purely for practical reasons and for simplicity. In its letter, Gazprom asked of the Tribunal, when deciding the period of time within which Gazprom might be entitled to submit any response necessitated by Naftogaz' submission in relation to the fuel gas issue, now expected on 10 February 2017, to grant Gazprom the time needed for it properly to be able to respond to Naftogaz' new VAT claim.

- (362) On 6 February 2017, Naftogaz submitted its response to Gazprom's 25 January 2017 document production request with supporting documents.
- (363) On 10 February 2017, Gazprom submitted documents relating to Gazprom's application for the submission into evidence of the contracts between Naftogaz and Ukrtransgaz (Bundle T A-20).
- (364) On 10 February 2017, Gazprom submitted its rebuttal on the royalties issue and response to what Gazprom alleges to be Naftogaz' new VAT claims (Bundle T-A 21).
- (365) On 10 February 2017, Naftogaz submitted its Pleading No. C-10 regarding its underdelivery claim as regards avoided fuel gas costs with the following supporting documents: 1) Fourth witness statement by [REDACTED] ([REDACTED]), 2) Avoided fuel gas volumes and costs. A fifth report by Dr Hesmondhalgh ("Brattle 5"), 3) Naftogaz' Claims related to the Gas Transit Contract, a sixth expert report by Dr Hesmondhalgh ("Brattle 6") (Bundle T-Y 1).
- (366) On 10 February 2017, Gazprom requests permission to submit a response of no more than 25 pages on what Gazprom considers to be new claims and arguments raised by Naftogaz in Naftogaz' Post-Hearing Brief, and Gazprom proposes to make such a submission within three weeks of the Tribunal's grant of permission.
- (367) On 11 February 2017, Naftogaz, after having discovered small errors in the "Brattle 6" expert report submitted on 10 February 2017, submitted a corrected version of the "Brattle 6" expert report and corresponding corrected excel spread sheets.

- (368) On 12 February 2017, Gazprom was granted permission to submit its response of no more than 25 pages to what it asserts to be new issues in Naftogaz' Post-Hearing Brief no later than on 3 March 2017.
- (369) On 12 February 2017, Naftogaz requested leave to comment on Gazprom's response to what Gazprom asserts to be new issues in Naftogaz' Post-Hearing Brief and asked for directions as to when such a comment should be submitted.
- (370) On 12 February 2017, Naftogaz was granted leave to submit such a comment, the length of which should not be more than 25 pages, no later than two weeks after the receipt of the submission of Gazprom.
- (371) On 15 February 2017, Gazprom requested permission to respond to Naftogaz' "Submission on its Underdelivery Claim" dated 10 February 2017 and asked that the response be submitted by 17 March 2017.
- (372) On 2 March 2017, Gazprom, in an email, requested leave to submit a brief response to Naftogaz' 6 February 2017 letter regarding the production of copies of the contracts between Naftogaz and Ukrtransgaz without redactions relating to transit volumes and tariffs and leave to submit the response by no later than 6 March 2017.
- (373) On 2 March 2017, Naftogaz requested, as regards Gazprom's request of 2 March 2017 to submit a response to Naftogaz's 6 February 2017 letter, that the Tribunal
- 1) reject Gazprom's request, or
 - 2) alternatively, if the tribunal should grant Gazprom's request, to provide Naftogaz with an opportunity to respond.
- (374) On 3 March 2017, Gazprom submitted a comment to Naftogaz' request of 2 March 2017.

- (375) On 3 March 2017, Gazprom submitted its response in relation to the alleged new issues raised in Naftogaz' Post-Hearing Brief along with supporting documents (a new Hearing Bundle T-A 22).
- (376) On 6 March 2017, after a request from Gazprom, Gazprom was granted leave to submit its brief response to Naftogaz' 6 February 2017 letter by 7 March 2017.
- (377) On 7 March 2017, Gazprom submitted its response to Naftogaz' 6 February 2017 letter regarding Gazprom's 25 January 2017 request for an order that Naftogaz produce unredacted copies of contracts between Naftogaz and Ukrtransgaz. Gazprom maintained (art. 22 in the letter) its request that the Tribunal order Naftogaz to produce copies of the Contracts without redactions as to (a) transit volumes and (b) transit tariffs. In the event that Naftogaz would fail to produce such copies, Gazprom requested that the Tribunal draw negative inferences with respect to the information redacted from the Contracts.
- (378) On 16 March 2017, Gazprom, in an email, reminded of its request in its 15 February 2017 email, where Gazprom asked for permission to respond by Friday 17 March to Naftogaz' "Submission on its Undeliveries Claim" dated 10 February 2017. Gazprom now asked for permission to submit such a response by 22 March 2017.
- (379) On 16 March 2017, the Tribunal with reference to Gazprom's 7 March 2017 letter regarding Gazprom's request for transit contracts without redactions asked the Parties to explain their positions.
- (380) On 17 March 2017, Naftogaz, in response to the Tribunal's request for clarification of 16 March 2017, requested leave to submit such a clarifying letter on 22 March 2017.
- (381) On 17 March 2017, Naftogaz referring to the Chairperson's email of 12 February 2017 granting Naftogaz two weeks to respond from the date of Gazprom's submission on what Gazprom alleges were new issues raised in Naftogaz' Post Hearing Brief requested that the deadline for its response (which was the 17 March 2017 since Gazprom's submission was submitted on 3 March 2017) to be extended to 22 March 2017.

- (382) On 18 March 2017, Naftogaz' request of 17 March 2017 to have the deadline for its response to Gazprom's allegations regarding new issues in Naftogaz' Post Hearing Brief extended to 22 March 2017 was granted by the Tribunal.
- (383) On 22 March 2017, Naftogaz submitted its response to Gazprom's 7 March 2017 response and the Chairperson's 16 March 2017 request regarding the Parties' positions in the document production procedure regarding the contract redaction.
- (384) On 22 March 2017, Naftogaz submitted its response (Claimant's Pleading No. C-11) to Gazprom's submission of 3 March 2017 on the alleged new issues in Naftogaz' Post Hearing Brief together with Exhibit CL-298 ("Order No 86 and Resolution 856 on licencing conditions for conducting business activities of Natural Gas and Oil Gas Transportation by Main Pipelines").
- (385) On 22 March 2017, Gazprom submitted its reply on the fuel gas issue and its response to Naftogaz' 2016 underdeliveries claim together with the fifth witness statement of [REDACTED] and sixth expert report of Dr Boaz Moselle. The exhibits and supporting documents will form part of a new hearing bundle entitled "T-X 3".
- (386) On 28 March 2017, Gazprom submitted its response to Naftogaz' letter dated 22 March 2017 regarding the production of unredacted copies of contracts between Naftogaz and Ukrtransgaz.
- (387) On 30 March 2017, the Tribunal referring to Gazprom's request for document production (unredacted copies of contracts between Naftogaz and Ukrtransgaz) and Naftogaz' responses explained its understanding of the matter, which the Tribunal finds in some respects confusing, and asked the Parties to confirm or correct the Tribunal's understanding.
- (388) On 3 April 2017, Gazprom, in an email with three attachments, in response to the Tribunal's 30 March 2017 request for clarification regarding Gazprom's request for document production regarding unredacted copies of contracts between Naftogaz and Ukrtransgaz, explained the background for its request and reiterated its request that the Tribunal order Naftogaz to produce copies

of the indicated Naftogaz-Ukrtransgaz contracts without redactions as to transit volumes and tariffs.

- (389) On 7 April 2017, Naftogaz submitted its response to the Tribunal's 30 March 2017 submission regarding the request for unredacted copies of contracts between Naftogaz and Ukrtransgaz together with three attachments containing copies of contracts between Naftogaz and Ukrtransgaz.
- (390) On 11 April 2017, Gazprom submitted an alleged correction to Naftogaz' submission 22 March 2017 entitled "Naftogaz's submission in response to Gazprom's submissions concerning alleged new issues in Naftogaz's Post Hearing Brief".
- (391) On 12 April 2017, Naftogaz submitted an alleged correction to Gazprom's 11 April 2017 submission.
- (392) On 13 April 2017, Gazprom referring to Naftogaz' email to the Tribunal dated 7 April 2017 regarding the unredacted copies of contracts between Naftogaz and Ukrtransgaz – maintained its request for an order that Naftogaz produce the Naftogaz-Ukrtransgaz contracts without redactions as to transit volumes and tariffs. Gazprom also reiterated its position that Naftogaz did not understand Contract TKGU as obliging Gazprom to transit a minimum of 110 bcm per annum.
- (393) On 3 May 2017, Naftogaz submitted its response to Gazprom's pleading of 22 March 2017 regarding the fuel gas issue and underdeliveries (Claimant's Pleading No. C-12) together with a seventh expert report by Brattle ("Brattle 7". Exhibit C-237).
- (394) On 23 May 2017, the Chairperson had a telephone contact with the Parties about the way forward in the proceedings and the Parties expressed their understanding of the necessity for an extension of the time for the rendering of the Award (30 June 2017) and that this issue was to be discussed further on June 16, 2017.
- (395) On 30 May 2017, the SCC reminded the Tribunal that the date for the rendering of the Final Award was 30 June 2017, and that the Tribunal, among other things, should request the SCC to

determine the cost of the arbitration by submitting a description of the Tribunal's work no later than two weeks before the Award is to be rendered.

- (396) On 14 June 2017, Gazprom, referring to Naftogaz' fuel gas submission of 3 May 2017 with the accompanying Seventh Expert Report of Dr Serena Hesmondhalgh ("Brattle 7"), requested leave to submit at short response on the test of "robustness" and declared that it was in a position to serve its response within 7 days of being given permission by the Tribunal to do so.
- (397) On 15 June 2017, the Tribunal, in response to Gazprom's 14 June request, asked the Parties whether it would not be sensible for the Parties' experts to consult, at least as an initial effort.
- (398) On 15 June 2017, Naftogaz responded to the Tribunal's 15 June question in the following wording: "This seems like a sensible approach to us, and would be in line with the approach taken by the Parties in similar circumstances earlier."
- (399) On 16 June 2017, the Tribunal held a telephone conference with the Parties about the way forward. With the concurrence of the Parties the Tribunal was to seek extension of the time for rendering of the Award (in both Arbitrations) until 30 November 2017. It was noted that the proceedings had not yet been closed (in neither Arbitration) in accordance with Article 34 of the SCC Arbitration Rules. It was noted that:
- The Tribunal will consider the possibility of rendering a separate award (in V2014/129) which Naftogaz accepts while Gazprom reserves its position and will consider that possibility in the event that the Tribunal comes to such a conclusion.
 - The possibility to render simultaneous Final Awards in V2014/078/080 and V2014/129 was discussed.
 - The Parties are in consultation on how to proceed regarding the implementation of the Separate Award in V2014/078/080, and the Parties will come back with suggestions for a possible hearing.

- The Parties will consider the possibility suggested by the Tribunal that each Party consolidates its pleading (in V2014/129) for the purpose of the inclusion in the Award, subject to the Tribunal's review.

- (400) On 17 June 2017, the Tribunal requested an extension of the time for rendering of the Award.
- (401) On 19 June 2017, the SCC decided that the Final Award should be rendered by 30 November 2017.
- (402) On 26 June 2017, Gazprom informed that it did not agree to the Tribunal's suggestion that the Parties might each prepare a consolidated summary of their respective cases for inclusion in the Transit Award.
- (403) On 27 June 2017, the Chairperson confirmed receipt of Gazprom's decision of 26 June 2017 and further explained the intention behind the suggestion that each Party consolidate its pleadings.
- (404) On 27 June 2017, Naftogaz agreed to the Tribunal's suggestion that the Parties consolidate their pleadings.
- (405) On 11 July 2017, the Tribunal regarding Gazprom's request for production of non-redacted contracts between Naftogaz and Ukrtransgaz notified the Parties that production of non-redacted contracts would not add information that would be material to the outcome of the Arbitration.
- (406) On 21 July 2017, Gazprom referring to the telephone conference with the Tribunal on 16 June 2017 and to Naftogaz' proposal that the Tribunal issue simultaneous Final Awards in the Supply and Transit Arbitrations informed that it was unable to agree to Naftogaz' proposal since the Tribunal having invalidated Articles 2.2 and 2.2.5 of the Contract from 19 January 2009 there is currently no effective obligation upon Gazprom to supply, or upon Naftogaz to take gas under Contract KP. The revised supply and take-or-pay provisions which are to be negotiated between the Parties in advance of the Final Award will not come into effect until the date of the Final Award. Gazprom requests certainty as to its contractual rights and obligations as soon as

possible, and cannot agree to any further delay in the rendering of the Final Award in the Supply Arbitration pending the finalisation of the Final Award in the Transit Arbitration. Gazprom notes that, in contrast, such a delay would not affect Naftogaz' right to a revised price, which, pursuant to the Separate Award, takes effect from April 2014, independently of the date of the Final Award.

- (407) On 24 July 2017, Naftogaz confirmed its position that the Tribunal should aim at simultaneous Awards in the Sales and Transit Arbitrations. Simultaneous Awards would facilitate the settlement of the monetary claims, since the Separate Award in the Sales Arbitration results in a net monetary claim for Gazprom, whereas Naftogaz has submitted the major monetary claims in the Transit Arbitration. Naftogaz also explained that it trusts that the Tribunal will be in a position to proceed with the Transit case while the Parties are negotiating the outstanding issues in the Sales Arbitration, and that delay in the rendering of the Final Award in the Sales Arbitration can be avoided.
- (408) On 6 August 2017, Naftogaz raising a scheduling issue asked whether the Tribunal intended to make a decision regarding the Tribunal's suggestion accepted by Naftogaz that the Parties submit a consolidated pleading summarizing their position.
- (409) On 7 August 2017, the Tribunal answered Naftogaz' question of 6 August in the following wording: "Unless Gazprom has changed its mind, the Tribunal does not intend to decide that the parties should prepare a consolidated pleading of their many pleadings in the transit arbitration. Just to add to this, such consolidated pleadings could possibly have entailed an earlier award."
- (410) On 17 August 2017, Naftogaz, in an e-mail, referring to the Tribunal's e-mail of 15 June 2017, submitted information about the experts' consultations on the calculation of fuel gas savings and that there does not seem to be a scope for agreement on how to calculate saved fuel gas costs as a result of Gazprom's underdeliveries. Naftogaz requested that the fuel gas issue be decided by the Tribunal and that, in the interest of time, such decision should be based on the Parties'

submissions and the attached correspondence and, since the experts' positions are entirely clear, no further submissions should be allowed.

- (411) On 17 August 2017, Gazprom, in an e-mail, referring to Naftogaz' 17 August 2017 submission, explained that Naftogaz' suggestion that "*no further submissions should be allowed*" regarding the fuel gas issue was unacceptable and that Gazprom needed to consult with its experts with regard to the content of Naftogaz' e-mail and that Gazprom would revert to the Tribunal once it has done so.
- (412) On 24 August 2017, Gazprom, in an email, referring to its email of 17 August 2017, informed the Tribunal that it had consulted with its experts, and that there were a number of aspects of Naftogaz' email of 17 August 2017 which required comment. Whilst the exchange between the experts has been useful in clarifying certain issues relating to the Parties' respective calculations, the experts have not been able to arrive at a common position with respect to Dr Hemondhalgh's test of robustness. Accordingly, Gazprom seeks leave to respond to Naftogaz on this limited issue, and also to comment on the submissions made by Naftogaz in its email together with attachments dated 17 August 2017. Gazprom intends to provide such a response and comments accompanied by a note from Dr Moselle by next Friday, 1 September 2017.
- (413) On 25 August 2017, the Tribunal, in an email, suggested, before deciding how to proceed, that "*each party in a short submission presents in summary form its expert's method, the benefits of its expert's method over the method used by the other party's expert according to the respective expert, and the results its expert's method yields according to the expert. That would include in summary form why the robustness test 'is not good/is good'*". The length of such submission could be agreed by the Parties, failing which it would be decided by the Tribunal. The Parties were requested to respond to the suggestion by Monday, 27 August 2017, before noon.
- (414) On 25 August 2017, Gazprom, in an email, referring to the Tribunal's email of the same date, notified that it had not yet been permitted to make any submissions on the issue of robustness or

the two robustness analyses that have been submitted by Naftogaz. The email ends in the following way:

“The position of Gazprom’s experts is that the methodology employed by Dr Hesmondhalgh in conducting her robustness analyses is flawed. When properly performed, a robustness analysis of the parties’ respective models leads to significantly different results than those arrived at by Dr Hesmondhalgh. If a robustness analysis is to be applied as a means of assessing which of the parties’ models is to be preferred, then Gazprom must be permitted, first, to respond to the two robustness analyses put forward by Dr Hesmondhalgh, and, second, to put forward a robustness analysis that does not suffer from the defects inherent in the analyses performed by Dr Hesmondhalgh. Naftogaz should not be given the opportunity to make a third submission on the issue of robustness. Rather, Gazprom should now be afforded the opportunity to respond to Naftogaz’ first two submissions on the issue.”

(415) On 26 August 2017, the Chairperson sent the following email to Gazprom with a copy to Naftogaz:

“Am I not right to understand that the experts have exchanged views on their differences on the robustness test, with the latest exchange of views as per the attachments to the email from Naftogaz of 17 August 2017? If that is so should it not only be the text of the email itself of the email from Naftogaz of 17 August 2017 that you should wish to comment on? And if that is so I thought that the comments you may have could be incorporated into the brief submissions suggested yesterday. Please advice.”

(416) On 27 August 2017, Gazprom, in an email, answered the Chairperson’s questions in the email of 26 August and concluded:

“In principle, Gazprom can agree to the Chairman's suggestion of simultaneous submissions by the parties, but Gazprom should be permitted to include a brief note from Dr Moselle presenting his views on the robustness analyses conducted by Dr Hesmondhalgh as well as putting forward

his own robustness analysis. Only after this has been done will the Tribunal be in a position to compare the parties' respective models on the basis of both parties' respective robustness analyses."

- (417) On 27 August 2017, Naftogaz, in an email, referring to Gazprom's email of the same date, made the following statement:

"While Naftogaz remains of the principled opinion that the fuel gas discussion (which Gazprom negligently postponed until the end of the oral hearing) now should be closed without further submissions, simultaneous submissions as proposed by the Tribunal and Gazprom are acceptable to Naftogaz, provided that the "brief note" by Dr Moselle really is brief, i.e. limited to three pages, along the lines of Dr Hesmondhalgh's memo of 17 July 2017 sent to Dr Moselle and attached to our e-mail of 17 August."

- (418) On 27 August 2017, Gazprom, in an email, referring to Naftogaz' email of the same date, explained that it accepted to limit its legal submissions to three pages. However, it was not willing to limit the explanations of Gazprom's expert so restrictively, but it was confident that Dr Moselle would deal with the narrow issues described in Gazprom's previous email as efficiently as possible and at a length that is appropriate to the issues and their significance. Gazprom concluded:

"We suggest that Naftogaz also be permitted to include with its submission, should it elect to do so, a further note by Dr Hesmondhalgh, addressing the same, limited issues identified in our email of earlier today. We are confident that Dr Hesmondhalgh will also deal with these narrow issues at an appropriately brief length."

- (419) On 28 August 2017, Naftogaz, in an email, referring to Gazprom's email of 27 August 2017, agreed that the legal submissions should be limited to three pages and that the experts each submit a further note on robustness tests in the context of simultaneous submissions. However, Naftogaz did not accept the suggested extensiveness of Dr Moselle's further note and concluded:

“(W)e believe a further note by Dr Moselle of eight pages should be more than sufficient (excluding underlying material). That would leave ample five pages to comment on Dr Hesmondhalgh's four pages on robustness tests in Brattle 7 (Section IV.C), and three pages to present his own robustness (out-of-sample) test.”

(420) On 28 August 2017, the Chairperson, in an email to the Parties, concluded:

”(T)he parties are encouraged to come to an agreement on the further steps to be undertaken to finish the exchange of submissions on the fuel cost issue. For the Tribunal it is important that the different approaches can be fully understood by the Tribunal.”

(421) On 28 August 2017, Gazprom, in an email, provided the following information on the fuel gas issue (the robustness test/analysis):

”As a preliminary step, we will request that Dr Moselle provide his detailed robustness analysis to Dr Hesmondhalgh for her review.”

(422) On 28 August 2017, Naftogaz, in an email, referring to the Chairperson’s email and Gazprom’s email of the same date, provided the following information:

“After receipt of Dr Moselle's e-mail of 9 August 2017 (attachment 3 to our 17 August 2017 e-mail) it was concluded that there was no scope for agreement due to the significant disagreements on methodology, and Dr Moselle's rejection of even Dr Hesmondhalgh's compromise suggestion (to average the results of two remaining approaches, Dr Moselle's Alternative IV and Dr Hesmondhalgh's Total Flows). Rather than continuing a procedure that seemed fruitless, it was decided to leave the question to the Tribunal. However, Dr Hesmondhalgh will of course be willing to review Dr Moselle's robustness test (out-of-sample test). Such review may also make the possible subsequent simultaneous submissions more efficient. In that regard we note Gazprom's willingness to provide Dr Hesmondhalgh with Dr Moselle's robustness analysis and kindly ask that it also provides Dr Moselle's claim calculations.”

- (423) On 10 September 2017, the Chairperson, in an email, asked the Parties if they had anything to report on their progress with finalising the fuel cost issue.
- (424) On 11 September 2017, Naftogaz, in an email, provided the following answer to the Chairperson's question of 10 September: "*Gazprom was provided with Dr Hesmondhalgh's comments to Dr Moselle's robustness test and claims calculations on Wednesday 6 September 2017. As agreed between the Parties, we are awaiting GP's response and proposal for the way forward.*"
- (425) On 11 September 2017, Gazprom, in an email, confirmed that Dr Moselle had received Dr Hesmondhalgh's comments to his robustness test and claims calculations and that Gazprom would "*shortly be liaising with Naftogaz's counsel to agree next steps*".
- (426) On 19 September 2017, Naftogaz, in an email, informed the Tribunal, that "*the Parties have agreed to simultaneously submit their respective fuel gas pleadings with expert reports on Monday 25 September 2017*".
- (427) On 25 September 2017, Naftogaz, in an attachment to an email, submitted its Pleading on Fuel Gas under Naftogaz' Underdeliveries Claim, along with an Expert Report by Dr Hesmondhalgh (Exhibit C-238) as well as four exhibits (Exhibits C-239-C-242).
- (428) On 26 September 2017, Gazprom, in an attachment to an email, submitted its Submission in relation to the Fuel Gas Issue, along with the Seventh Expert Report of Dr Boaz Moselle dated 25 September 2017 ("Moselle 7"), referred to by Dr Moselle as his *Fourth Under-Delivery Calculation Report*, and Dr Hesmondhalgh's comments on Dr Moselle's robustness analysis dated 6 September 2017 ("Attachment 1").
- (429) On 13 October 2017, Naftogaz, with reference to the Tribunal's indication during the oral hearing in V2014/078/080 in Stockholm 9-10 October 2017, that the Award in V2014/129 only will be rendered by 28 February 2018, in an attachment to an email, submitted its Objection to further postponement of Award, alternatively request for Separate Award.

- (430) On 14 October 2017, the Tribunal invited Gazprom to comment on Naftogaz 13 October 2017 submission no later than by 17.00 CET on Monday 16 October 2017.
- (431) On 14 October 2017, on the request of Gazprom, Gazprom was permitted extension to respond to Naftogaz' 13 October 2017 submission until Friday 20 October 2017.
- (432) On 20 October 2017, Gazprom, in an attachment to an email submitted its response to Naftogaz' "Objection to further postponement of Award, alternatively request for Separate Award" dated 13 October 2017, along with Exhibit RLA-200.
- (433) On 22 October 2017, the Tribunal, in an email, in response to Naftogaz' 13 October 2017 objection, alternatively request, and to Gazprom's 20 October 2017 submission, sent the following information to the Parties:
- "The Tribunal ... would like to remind the parties that, until a further decision has been made, the proceedings will continue as indicated at the close of the hearing in the Supply Arbitration on 10 October 2017, based on an extension of the time for rendering a Final Award in the Transit Arbitration. Please, note that the Tribunal has not approached the SCC for an extension of the time for the rendering of the Final Award. The Tribunal finds that the appropriate procedure is for the Tribunal first to make a request for an extension, if it decides to make such request, and that thereafter views of the parties are submitted to the SCC. The Tribunal would appreciate that parties follow this procedure."*
- (434) On 24 October 2017, Naftogaz, in an attachment to an email, submitted, as Exhibit CL-299, the judgment of 6 September 2017 of the Court of Justice of the European Union in Case C-413/14 P *Intel Corporation Inc. v European Commission* (the "Intel judgment") along with, in the email, some brief comments on the relevance of the Intel judgement to the Transit Arbitration.
- (435) On 27 October 2017, Gazprom requested permission to comment on the Intel judgement by 3 November 2017 and on the same date the request was granted by the Tribunal.

(436) On 29 October 2017 the Tribunal submitted the following decisions to the Parties:

“The Tribunal has considered the Parties’ respective submissions in September and October 2017 regarding the outstanding issues from the Separate Award of 31 May 2017, in particular the issues addressed below.

In its written submission of 15 September 2017, Naftogaz has made a declaration of set-off between amounts that may be awarded it in the Transit Arbitration and amounts that it will be awarded to pay in the Supply Arbitration. With reference to this request for declaration of set-off, Naftogaz has also requested a stay in the Supply Arbitration until Naftogaz’ counterclaim in the Transit Arbitration has been finally resolved by a final and binding award. The claim for this intra Arbitrations set-off is a new request that Naftogaz has not made before. It is made years after the Arbitrations commenced, and more than three months after the Separate Award. Also the request for a stay is a new request that was made for the first time in a letter of 13 October 2017.

In a letter of 20 October 2017, Gazprom has objected to both the set-off and a stay. With reference to Article 25 of the SCC Rules, Gazprom claims that the set-off is a new defence which is made too late, and that it therefore should be rejected.

The Tribunal agrees that the set-off defence has been made too late. Naftogaz could have raised it much earlier in the Supply Arbitration. Already when Gazprom made its claim based on the Take or Pay provisions in the Contract in its Statement of Defence and Counterclaim in June 2015, it was clear that there would be a risk that the amounts awarded Gazprom in the Supply Arbitration could by far exceed the amounts awarded Naftogaz in the Supply Arbitration. Neither has Naftogaz advanced any justifiable reason for not raising this defence until now. For Gazprom, the requested stay would have disadvantages regarding the uncertainties relating to the ACQ and Take or Pay.

In sum, the Tribunal finds that it would be inappropriate to accept Naftogaz' late claim for an intra Arbitrations set-off. With reference to Article 25 of the SCC Rules, the Tribunal therefore decides that Naftogaz is not entitled to amend its defence in the Supply Arbitration by making the declaration of set-off between amounts awarded in the two Arbitrations.

The Tribunal also finds that a stay at this time of the proceedings would be impracticable and would upset the ongoing work with the Arbitrations. The work with the Transit Arbitration has been halted due to the need for the further hearing in the Supply Agreement on 9 and 12 October 2017. The Supply Arbitration is close to finalization after the hearing held on 9 and 10 October 2017, whereas the work with the Transit Arbitration is not nearly as advanced. As late as in September 2017, the Parties have made new submissions on the important Fuel Gas issue in the Transit Arbitration, and as late as 24 October 2017 Naftogaz has made a submission regarding the Intel case, to which Gazprom on 27 October 2017 has requested permission to respond. In the Supply Arbitration remain Post-Hearing Briefs from the hearing on 9 and 10 October 2017 (which should include answers to the questions put to the parties by the Tribunal), Cost Claims, and consultations by the Tribunal with the Parties' respective Experts by the end of November 2017.

Further, already since the SCC Institute on Naftogaz' request decided that the two Arbitrations should not be consolidated, it has been clear that the Arbitrations should proceed with a timeline according to which the Supply Arbitration would precede with a couple of months the Transit Arbitration. This has also been the case.

The result is obviously that in neither arbitration can a Final Award practically be possible to render by 30 November 2017, as also requested by Naftogaz as an alternative. The Tribunal has noted the alternative proposition by Naftogaz that the Tribunal renders a separate award in the Transit Arbitration on certain specific issues. The Tribunal has not considered that proposition as of now.

In conclusion, the time schedule indicated at the end of the hearing on 10 October 2017 shall apply with a Final Award in the Supply Arbitration on 22 December 2017 and a Final Award in the Transit Arbitration on 28 February 2018. In the Supply Arbitration, Post-Hearing briefs and Cost Claims shall be made on 10 November 2017, and Response to Cost Claims shall be made on 4 December 2017.”

(437) On 3 November 2017, Gazprom, in an email, submitted its comments on the relevance in the Transit Arbitration of the Intel Judgement.

(438) On 7 November 2017, the Tribunal, in an email to the SCC, sought extension for rendering the Final Award according to Article 37 of the SCC Arbitration Rules from the SCC Board until 28 February 2018.

(439) On 7 November 2017, Naftogaz, in an email, submitted the following:

“On 29 October 2017, the Tribunal made certain decisions in the Sales Arbitration (SCC V2014/78/80), namely to (a) deny Naftogaz’ request for a stay and (b) to dismiss Naftogaz’ set off defence raised on 15 September 2017 based on the declaration of set off that was made on 15 September 2017 whereby Naftogaz set off its claims in the Transit Arbitration against Gazprom’s residual claims in the Sales Arbitration as per 30 September 2017.

For the sake of good order and to reserve all its rights in respect of these decisions, Naftogaz hereby formally protests against them.

Naftogaz also reminds that whereas the Tribunal has procedurally dismissed Naftogaz’ set off defence described above, Naftogaz’ civil law act (Sw. civilrättsliga rättshandling), viz. the declaration of set off (Sw. kvittningsförklaringen), as such, remains.”

(440) On 9 November 2017, the SCC, in an attachment to an email, granted extension of the date for rendering of the Award until 28 February 2018.

(441) On 12 January 2018, The Chairperson held a telephone conference with the Parties' counsel Mr Mjaaland and Mr Chong from which the following notes were taken by the Chairperson:

“As you may have seen, I have written to Dr. Hesmondhalgh and Dr. Moselle regarding the Confidentiality Undertaking and their right to discuss the customs duty problem with you. As follow ups, I have noted that (i) Mr. Chong will come back regarding the possible assistance from Dr. Hesmondhalgh and Dr. Moselle in the transit case; (ii) if the Tribunal will have this opportunity, the Tribunal will indicate when the assistance will be required; (iii) Naftogaz will update its claims in the transit arbitration and possibly consult with Gazprom regarding the arithmetic's.”

(442) On 17 January 2018, Gazprom confirmed that it agrees to Dr Moselle assisting the Tribunal with calculations in the Transit Arbitration.

(443) On 29 January 2018, the SCC, in an attachment to an email, reminded the Tribunal of how the issues of costs and expenses and description of the Tribunal's work should be handled by the Tribunal before the rendering of the Award.

(444) On 2 February 2018, Naftogaz submitted an update of its claims and updated Relief Sought, along with Exhibit C-243 (“Brattle 9”).

(445) On 2 February 2018, Gazprom submitted two confidentiality undertakings, one signed by Dr Boaz Moselle on behalf of Cornerstone Limited, and one signed on behalf of FTI Consulting LLP.

(446) On 2 February 2018, a confidentiality undertaking was submitted by Dr Serena Hesmondhalgh.

(447) On 3 February 2018, the Chairperson invited Gazprom to respond to Naftogaz' 2 February 2018 submission no later than on 9 February 2018.

(448) On 5 February 2018, Naftogaz informed about a computational error in “Brattle 9” and that the error affected the updated calculation of Gazprom's counterclaim in the light of the Final Award in the Sales Arbitration and that Dr Hesmondhalgh made a correction according to the following:

§ 39 of Brattle 9 should be corrected as follows

"As Table 9 demonstrates, Gazprom's counter-claim based on unrevised Sales Contract Prices and late payment interest until 28 February 2018 would be \$7.2 million. However, I have updated this claim to take account the impact of the Final Award in the Sales Arbitration and this reduces the size of Gazprom's counter-claim by just over \$-2.6 million to \$-4.6 million." Similarly, § 15 of Naftogaz' pleading on the update of its claims should be corrected as follows: *"Gazprom's counterclaim (which Naftogaz rejects) is in any event overstated because of the revised Factual Price in the Sales Arbitration. Dr Hesmondhalgh has calculated that this reduces the counterclaim (including interest until 28 February 2018) from USD 7.2 million, to USD 4.6 million."*

(449) On 6 February 2018, the Chairperson held a telephone meeting with the Parties' counsel Mr Mjaaland and Mr Chong, the result of which is summarised as follows:

- The Parties will enquire Dr. Hesmondhalgh and Dr. Moselle about their availability for consultations this week for clarifications of Dr. Hesmondhalgh's report and spreadsheets, and for their availability for consultations with the Tribunal in the beginning of the week starting on 19 February with the intent that the Tribunal should have the answers by 22 February.
- Gazprom will submit its response to Naftogaz' submission of 2 February no later than on 15 February.
- The Parties will make simultaneous cost submissions on 16 February and rebuttals on 23 February, including updates of expert costs.

- (450) On 7 February 2018, the Tribunal, in an email to the SCC, requested the Board of the SCC to reconsider, in accordance with Article 45(3) of the SCC Rules, the advance on costs that was decided by the Board on 17 December 2015.
- (451) On 9 February 2018, Gazprom submitted, as attachments to an email, a New Defence that had arisen pursuant to section 36 of the Swedish Contracts Act, along with Factual Exhibits R-86 and R-87.
- (452) On 10 February 2018, Naftogaz was invited to respond to Gazprom's 9 February 2018 submission no later than on 16 February 2018.
- (453) On 13 February 2018, Naftogaz confirmed that Dr Hesmondhalgh was available on 19 21 February 2018 to assist the Tribunal with calculations.
- (454) On 14 February 2018, Gazprom confirmed that Dr Mozelle was available to assist the Tribunal with calculations during the period 19 to 22 February 2018.
- (455) On 16 February 2018, in an attachment to an email, Naftogaz submitted its Response to Gazprom's new Defence submitted 9 February 2018.
- (456) On 16 February 2018 submitted its Claim for costs
- (457) On 16 February 2018, Gazprom submitted its response to Naftogaz' Update of its Claims dated 2 February 2018 and Counterclaim arising as a Result of the Tribunal's issue of the Final Award in the Supply Arbitration along with the eighth Expert Report of Dr Boaz Moselle, plus Exhibits BM-153 to BM-155; and Exhibit R-88 - Confirmation of return of funds.
- (458) On 16 February 2018, Gazprom submitted its claim for costs.
- (459) On 18 February 2018, the Tribunal sent the draft Questions regarding the calculations to the Parties' experts Dr Hesmondhalgh and Dr Mozelle and during the following days the Experts communicated with the Chairperson regarding the calculations.

- (460) On 18 February 2018, Naftogaz was invited to comment on specifically defined issues in Gazprom's submission of 16 February 2018 no later than on 22 February 2018 by 12:00 CET, and no more without leave from the Tribunal.
- (461) On 21 February 2018, the SCC submitted its decision of the same date regarding the costs of the Arbitration
- (462) On 22 February 2018, Naftogaz submitted its comments to Gazprom's 16 February 2018 submission together with a Memorandum from Dr Serena Hesmondhalgh
- (463) On 22 February 2018, in an attachment to an email, the SCC informed the Tribunal about its amendment of its decision of 20 February 2018 concerning the costs of the arbitration.
- (464) On 23 February 2018, Gazprom submitted its Rebuttal Costs Submission
- (465) On 23 February 2018, Naftogaz submitted its Rebuttal and Update Costs Submission.
- (466) On 27 February 2018, the Dr Hesmondhalgh submitted the Experts' answers to the Tribunal's questions.
- (467) On 28 February 2018, the answers submitted on 27 February 2018 were confirmed by Dr Mosselle on the same date.
- (468) On 28 February 2018, the Tribunal decided to close the proceedings in accordance with Article 34 of the SCC Rules.

6. THE ARBITRATION AGREEMENT AND APPLICABLE LAW

(469) The Contract contains the following arbitration clause:

ARTICLE 12. ARBITRATION

"12.2. The Parties shall seek to resolve all disputes and controversies between themselves relating to the interpretation or application of this Contract by means of negotiations. Should the Parties fail to reach a mutually acceptable solution within 45 days upon the occurrence of any dispute or controversy, then any dispute, controversy or claim in connection with the present Contract either its breach, termination or invalidity shall be finally resolved by arbitration in accordance with the Rules of the Arbitration Institute of the Stockholm Chamber of Commerce. The Arbitral Tribunal shall consist of three Arbitrators. The place of arbitration shall be Stockholm, Sweden. The language of arbitration proceedings shall be Russian. The arbitral award shall be final and binding on both Parties.

12.3. Articles 12.1-12.2 hereof relating to arbitration, shall be binding on the Parties, their authorized representatives and legal successors, and the working of these Sections will remain in force regardless of the expiration or termination of the Contract."

(470) With regard to applicable law Article 12.1 of the Contract reads as follows:

"This Contract shall be governed by and is subject to interpretation in accordance with the substantive laws of Sweden."

(471) The Parties have agreed that the language of the Arbitration proceedings shall be English.

7. THE PARTIES' CASES

7.1 Naftogaz' Case

7.1.1 Introduction

- (472) Naftogaz principally claims that, based on competition law and related energy law, a number of provisions in the Contract, including the price for transportation services (the "tariff"), became invalid at the latest from 1 January 2010, and must be replaced pursuant to the amendment and severability provision in Article 13.2 of the Contract.
- (473) Naftogaz' claim also encompasses assignment of the Contract from Naftogaz to the Ukrainian Transmission System Operator ("TSO"), PJSC Ukrtransgaz ("Ukrtransgaz"), which in practice is implemented by replacing the Contract assignment clause with a clause allowing the Contract to be assigned to Ukrtransgaz or any other entity designated as Ukrainian TSO without Gazprom's consent. This and other claims for replacement of operational provisions will in practice have effect from the date of the Award.
- (474) Naftogaz' claim for replacement of the tariff will, however, have effect from the date the tariff became invalid. The replacement of the tariff results in very significant underpayments by Gazprom since 1 January 2010.
- (475) In the alternative to the claim for invalidity and replacement of the tariff, Naftogaz claims revision of the tariff with effect from 1 January 2010. This claim is based on Swedish Contract law, principally on application of the Contract price (tariff) revision provision in Article 8.7 of the Contract, alternatively on Section 36 of the Swedish Contracts Act. The result of both these approaches is the same, and also the same as the claim for invalidity and replacement of the tariff, i.e. a tariff which covers Naftogaz' costs of providing the relevant transit capacity to Gazprom, consistent with European principles for pricing of gas transportation services. Consequently, also this claim results in very significant underpayments by Gazprom since 1 January 2010, and a corresponding monetary claim for Naftogaz.

- (476) The monetary claims resulting from the replaced or revised tariff will effectively absorb Naftogaz' claims for compensation for underdeliveries of transit volumes since 2010 based on a regular application of the Contract liability clause and the then existing unamended tariff. The latter monetary claims are consequently now alternative to the tariff replacement/revision claims, except for the year 2009 for which Naftogaz claims neither replacement nor revision of the tariff.
- (477) For the year 2009, where Naftogaz claims neither replacement nor revision of the Contract, Naftogaz claims damages for Gazprom's underdeliveries of Natural Gas for transit since the Contract was concluded, based on a regular application of the general liability provision in Article 10.1 of the Contract.
- (478) In the alternative to the replacements or revisions claimed with effect from 1 January 2010, which result in significantly larger monetary claims, Naftogaz also claims damages for underdeliveries in 2010 – 2017, and until the date of the award.
- (479) Naftogaz claims a revision of the Contract tariff on two different legal bases, but with the same result and with the same effective date, i.e. 1 January 2010. In conformity with European principles for pricing of gas transport services as well as the Parties' intention to separate gas sales from gas transit, the revised tariff will not refer to the price under the Gas Sales Contract. This means that Naftogaz' claims for revision of the Contract Price in the Gas Sales Arbitration, with effect at the earliest from 20 May 2011, will not affect the revised tariff, and Gazprom will not have any claim for refund of excessive tariff payments if the Contract Price in the Gas Sales Contract is reduced as claimed by Naftogaz.
- (480) However, if the Tribunal should find that Naftogaz is entitled to a revised tariff only from a later point in time than 20 May 2011, Gazprom will have paid a too high tariff under the Transit Contract from the effective date of Naftogaz' price revision claim in the Gas Sales Arbitration until the effective date of Naftogaz' tariff revision claim in the Gas Transit Arbitration.

(481) Naftogaz' claim for compensation for underdeliveries of transit volumes and revision of the transit tariff may be quantified in monetary terms. The former is calculated as the difference between the transit payments Naftogaz would have received if Gazprom had delivered the agreed transit volumes, and the transit payments Naftogaz actually received, less saved costs. The latter is calculated as the difference between the new transit tariff as claimed by Naftogaz, and the prevailing transit tariff applied from the point in time when the claim was set forth (being 25 July 2014), until the award is made.

(482) Naftogaz' maximum monetary claim is approximately USD 14,9 billion, interest excluded.

7.1.2 Naftogaz' Claims

7.1.2.1 A summary of Naftogaz' view on the main issues

(483) The Contract is incompliant with European competition law and related energy law. In particular, the Contract is part of Gazprom's abusive overall strategy to partition Central and Eastern European markets by reducing its customers' ability to resell gas cross-border.

(484) In practice, the Contract as currently worded and implemented closes the Ukrainian gas transmission and gas sales markets to newcomers, preventing competition and allowing Gazprom to abuse its dominant position in Central and Eastern Europe. Importantly, the geographical location of Ukraine between Poland, Slovakia, Hungary and Romania means that Gazprom's foreclosure of the Ukrainian GTS restricts trade between EU Member States. EU competition law is therefore directly applicable to the Contract.

(485) There are four main aspects of the Contract which foreclose the GTS, restrict competition in the EU and the Energy Community, and are abusive. The Contract provisions implementing these aspects have been invalid or ineffective at least since 1 January 2010.

(486) First, the current party-relationship and technical implementation of the Contract prevents the designated Ukrainian Transmission System Operator (TSO), Ukrtransgaz, from exercising

effective control over the GTS, and in particular from arranging effective cross-border gas flows with neighbouring TSOs.

- (487) Second, the currently applied tariff does not cover Naftogaz' costs of providing the agreed services to Gazprom. The effect is to increase the costs for all other users of the GTS, which is discriminatory and effectively forecloses the system.
- (488) Third, the current delivery and transport obligations of Gazprom and Naftogaz respectively are based on an inefficient and prohibited "contract path" system, instead of the more efficient and mandatory "entry-exit" system.
- (489) Fourth, the Contract does not provide for a functional system for matching gas injections with gas withdrawals ("balancing").
- (490) Naftogaz' main claims in this Arbitration will address all the above issues by replacing the provisions of the Contract which are incompliant with European competition law and related energy law with revised, compliant, provisions pursuant to a regular application of the amendment and severability provision in Article 13.2 of the Contract.
- (491) In the alternative to replacement of the Contract tariff pursuant to European competition law and related energy law and Article 13.2 of the Contract, Naftogaz claims a revision of the tariff based on Swedish Contract Law, principally based on the Contract tariff revision provision in Article 8.7 of the Contract, alternatively based on Section 36 of the Swedish Contract Act.
- (492) The claims for tariff revision/replacement result in very significant identical underpayments by Gazprom from 1 January 2010, with a corresponding monetary claim for Naftogaz..
- (493) For the year 2009, where Naftogaz claims neither replacement nor revision of the Contract, Naftogaz claims damages for Gazprom's underdeliveries of Natural Gas for transit since the Contract was concluded based on a regular application of the general liability provision in Article 10.1 of the Contract.

(494) In the alternative to the replacements or revisions claimed with effect from 1 January 2010, which result in significantly larger monetary claims, Naftogaz also claims damages for under-deliveries from 2010 until the date of the Final Award).

7.1.2.2 The Mandate of the Tribunal

(495) Article 12.1 of the Contract provides that the Contract shall be governed by and is subject to interpretation in accordance with the substantive laws of Sweden.

(496) Pursuant to Article 12.2, disputes shall be finally resolved by arbitration in accordance with the SCC Rules, and the place of arbitration shall be Stockholm, Sweden. Consequently, the relevant procedural rules are the SCC rules and the procedural rules of Sweden as *lex arbitri* (the arbitration rules of the State where the arbitration takes place). In respect of the arbitration agreement the relevant law is also Swedish law by virtue of the fact that the Parties have not chosen a law specifically to govern the arbitration agreement and the place of arbitration is Stockholm, Sweden, cf. Section 48 of the Swedish Arbitration Act.

(497) This implies that the applicable law relevant to the issue of jurisdiction is the SCC Rules and practice under the SCC Rules and the Swedish Arbitration Act as applied in international arbitration. It also means that international arbitral practice under other institutional rules, like the ICC Rules, may be relevant.

(498) The other and primary source is the Contract itself and the intentions of the Parties. The contents of the Contract and the negotiations between the Parties prior to and after its conclusion are essential in order to identify the Parties' intentions.

(499) Article 13.2 obliges the Parties to replace any invalid and/or ineffective provisions in the Contract. It follows that the Tribunal's power to adjust and/or replace the terms which are rendered invalid by EU competition and energy law, primarily stems from Article 13 of the Contract.

(500) In relation to competition law, the Tribunal's power is explicitly confirmed by the Swedish Arbitration Act. Section 1, third paragraph, of the Swedish Arbitration Act reads in the translation of SCC:

"Arbitrators may rule on the civil law effects of competition law as between the parties."

(501) Thus, the Arbitral Tribunal has jurisdiction to rule on the effects of EU competition law on the Contract pursuant to Section 1 of the Swedish Arbitration Act.

(502) The basis for Naftogaz's claim for adjustment and replacement of invalid and ineffective provisions is the EU *acquis* on competition and energy law, which is Swedish law.

(503) EU secondary legislation on energy in reality operationalises the competition rules in Articles 101 and 102 TFEU. The Tribunal is therefore also empowered to rule on the effects of the EU *acquis* on energy.

(504) According to Article 8.7 of the Contract, each Party is entitled to a revision of the price for transit services on certain material conditions. Article 8.7.1t provides that a request for price revision shall be made in writing and be properly substantiated. Naftogaz made a written, substantiated request for revision of the price (tariff) under the Contract on 15 June 2009 which was followed by negotiations between the Parties where Gazprom rejected the request.

(505) The Tribunal's power to revise the tariff pursuant to Swedish Contract Law is based on Article 8.7, and Article 12 of the Contract.

(506) The Tribunal also has the power to revise the tariff provisions pursuant to Section 36 of the Swedish Contracts Act.

(507) The so-called general clause in Section 36 of the Swedish Contracts Act is a rule under which contract terms may be revised, i.e. adjusted or set aside. This also applies in business to business relations, and finds its most natural application in the context of long-term contracts.

- (508) Further, adjustments under Section 36 of the Swedish Contracts Act may be made even where the parties have agreed on mechanisms intended to address changed circumstances.
- (509) Section 36 of the Swedish Contracts Act is part of the "*substantive laws of Sweden*", which govern the Contract pursuant to Article 12.1 thereof and, as such, must be applied by courts and arbitral tribunals. Any tribunal that is to apply Swedish law is empowered to apply the Swedish Contracts Act and thereby, *inter alia*, Section 36.
- (510) The claims for compensation for under deliveries of transit volumes are based on a regular application of Article 10.1. Under the Contract, the Parties agreed that a Party which fails to perform its obligation shall be liable for damages caused by such failure to perform.
- (511) Thus, the Arbitral Tribunal has jurisdiction over Naftogaz' claim for damages pursuant to Article 10.1 of the Contract. The power to make an award on monetary damages lies at the very core of arbitral jurisdiction, and is undisputed.
- (512) It follows from the Tribunal's power to replace Article 8 pursuant to EU competition and energy law, and to revise the tariff pursuant to Swedish Contracts Law, that the Tribunal also has the power to rule on the effects of such replacement or revision.
- (513) Consequently, the Tribunal has the power to order that Gazprom make additional payments on the basis of the replaced or revised Article 8 from its effective date, 1 January 2010.
- (514) The procedural conditions for referring a dispute to arbitration are set out in Article 12.2 of the Contract, which provides *inter alia* for a negotiation period of 45 days from the occurrence of a dispute. This is the general rule on procedural conditions for arbitration, applicable to all of Naftogaz' claims, except the price revision claim based on the price revision clause in Article 8.7.
- (515) Naftogaz sent a Notice of disputes to Gazprom on 25 July 2014, informing of the changes necessary to be made to the Contract to align it with European and Ukrainian law, claiming

compensation for underdeliveries of transit gas, and claiming adjustment of the transit tariff based on the EU Competition and Energy Law and Swedish Contract law. Consequently, the mandatory 45-day negotiation period started on that date.

(516) Naftogaz submitted its Request for Arbitration on 13 October 2014. Thus, also this condition for referring the dispute to arbitration is fulfilled.

7.1.3 Documents relevant to the Contract

7.1.3.1 The Energy Community Secretariat's 3 December 2014 Preliminary Compliance Report on the Transit Contract

(517) With the opening of the EU gas market to competition and Ukraine's accession to the Energy Community, the legal and market context in which long-term transit agreements operate has changed significantly. European energy and competition legislation sets out specific requirements to how the transmission of natural gas shall be organised.

(518) In its report *Gas Transit in Ukraine – Preliminary EnC Compliance Report (the "Preliminary Compliance Report")* dated 3 December 2014, the Energy Community Secretariat has addressed compliance concerns as regards the Contract.

(519) The Energy Community's objective is to extend the EU internal energy market to South East Europe and beyond on the basis of a legally binding framework. The principal instrument to achieve this aim is the adoption of EU legislation, the so-called "*acquis communautaire*", on energy and competition as well as environment and for renewables. Under Article 94 of the Treaty establishing the Energy Community (the "Energy Community Treaty"), Ukraine's compliance with its obligations under the Energy Community Treaty are to be assessed with reference to the relevant rules and practice of their application by the EU institutions.

(520) In the report, the Energy Community Secretariat concludes that certain provisions of the Transit Contract and selected commercial practices arising therefrom may be considered as non-compliant with the EU *acquis communautaire* on energy and competition. According to the Energy

Community Secretariat, the compliance concerns relate to "*the terms and conditions for the operation of natural gas transmission activities, regulation of the natural gas sector, as well as competition rules*", cf. the Preliminary Compliance Report, page 1. At the same time, the Energy Community Secretariat points out that as "*the acquis on gas does not provide for any specific regard to or derogations vis-à-vis legacy gas transportation contracts, the Contracting Parties have to ensure a full alignment of the existing contracts in compliance with the EU acquis*", cf. the Preliminary Compliance Report, page 1.

7.1.3.2 The Agency for the Cooperation of Energy Regulators' Report of 9 April 2013 on Transit Contracts in EU Member States Final Results of ACER inquiry

- (521) In its Preliminary Compliance Report on the Transit Contract as such, the Energy Community Secretariat has referred to ACER's report, *Transit Contracts in EU Member States Final Results of ACER inquiry* (the "*Transit Contracts Report*"), dated 9 April 2013. The Transit Contracts Report considers the validity of historical (legacy) long-term contracts for natural gas transport within the EU for the purpose of delivery to another country (gas transit contracts) on a general basis.
- (522) With the opening of the EU gas market to competition, the context in which long-term transit agreements operate has changed significantly. ACER points out that as a consequence, the existing long-term transit contracts "*constitute an important practical obstacle to the internal gas market, as available capacity on cross-border import pipelines is limited and new entrants are not able to secure either transit capacity on key routes or entry capacity into new markets, in particular if former long-term capacity holders are hoarding capacity*", cf. the Transit Contracts Report.
- (523) At the onset of liberalisation many market participants argued that transit was special, and should be granted certain exemptions from liberalisation requirements. Certain aspects of the early legislation permitted transit to be treated differently. The principle of non-discrimination between transit and domestic transmission has since become firmly established. In its report, ACER presents an analysis of the Third Energy Package, and judgements by the European Court of Justice,

leading to the conclusion that the existence of pre-liberalisation long-term transit contracts does not justify any preferential treatment, cf. the *Transit Contracts Report*. The provisions of Directive 2009/73/EC and Regulation (EC) No 715/2009 – including those on tariffs, congestion management and capacity allocation – are equally applicable to both national transmission and gas in transit, cf. the *Transit Contracts Report*. Accordingly, ACER is of the opinion that the legal status and conditions of the existing transit contracts (entered into prior to the adoption of the relevant EU legislation) should be aligned with that of domestic transmission in order not to impede competition.

7.1.4 The European Commission's Statement of Objections to Gazprom of 22 April 2015

(524) In a press release of 22 April 2015, the European Commission has made public that it has sent a Statement of Objections to Gazprom for alleged abuse of dominance on Central and Eastern European gas supply markets, cf. Article 102 TFEU.

(525) According to the press release and the accompanying Factsheet, The Commission's preliminary findings in the Statement of Objections show that Gazprom may be abusing its dominant position in Central and Eastern Europe by (i) preventing cross-border flows of gas, (ii) charging unfairly high prices, and (iii) extracting commitments, in return for gas, to keep control over pipelines.

7.1.5 The Transit Contract is incompatible with the European Union *Acquis* on Energy and Competition

(526) EU energy and competition law has rendered a number of provisions of the Transit Contract concerning the terms and conditions for gas transit through the territory of Ukraine invalid and/or ineffective, cf. Article 13.2 of the Contract, according to which, invalid/ineffective provisions shall be adjusted and/or replaced. This Section shall provide a brief overview of the Transit Contract and how it relates to the EU *acquis*. The following overview primarily relies on the assessment made by independent institutions, i.e. the Preliminary Compliance Report by the European Community Secretariat as supplemented by ACER's report. The legal issues will be further developed and discussed below.

- (527) The Transit Contract affects the trade of natural gas within and between several Member States of the European Union. Thus, Articles 101 and 102 TFEU apply to the Contract on a stand-alone basis, regardless of the entry into force of the ECT for Ukraine.
- (528) In the present case, the most relevant legislation is the European Union *acquis* on energy and competition as defined in the Energy Community Treaty.
- (529) The Contract is governed by Swedish law, cf. Article 12.1 of Article 12 of the Transit Contract. As a Member State of the European Union, Sweden is obliged to implement EU legislation, including legislation which the European Union has committed to implement as a party to international agreements.
- (530) The Energy Community Treaty provided *inter alia* for the establishment of an integrated energy market among the Parties to the Treaty. Pursuant to Title II of the Treaty, the *acquis* on energy and competition, as well as on environment and for renewables, is extended to the territory of the Contracting Parties. Ukraine acceded to the Energy Community Treaty on 1 February 2011,⁸ and is, as a Contracting Party, obliged to implement the *acquis* in the Treaty within certain time limits established in the Protocol. The Treaty is part of the substantive law of Sweden with direct effect as an EU Member State, and is consequently directly applicable to the Contract as of the accession of Ukraine to the Treaty on 1 February 2011. The Treaty *acquis* is applicable to the territory of Ukraine pursuant to Swedish law and is also implemented in mandatory Ukrainian law.
- (531) The *acquis* includes the Third Energy Package (Directive 2009/73/EC and Regulation (EC) 715/2009), cf. Article 11 of and Annex I to the Treaty, and Articles 101 and 102 TFEU (which prohibit agreements restricting competition and any abuse of dominant position), cf. Article 18 of and Annex III to the Treaty.

⁸ Protocol concerning the Accession of Ukraine to the Treaty of 24 September 2010.

(532) The *acquis* on energy sets out specific requirements concerning the organisation of transmission of Natural Gas on the territory of the Parties to the Treaty, including in Ukraine. The main requirements are:

- A TSO shall be responsible for operating, maintaining and, if necessary, developing the GTS in a given area, including its interconnections with other systems, cf. Article 2(4) of both Directive 2003/55/EC and Directive 2009/73/EC.
- If necessary for the purpose of carrying out its functions relating to cross-border transmission, a TSO shall, have access to the network of other transmission system operators, cf. Article 18(2) of Directive 2003/55/EC and Article 32(2) of Directive 2009/73/EC.
- A TSO shall be responsible for granting non-discriminatory third-party access to the relevant infrastructure, cf. Articles 8(1)(b) and 18(1) of Directive 2003/55/EC and Articles 13(1)(b) and 32(1) of Directive 2009/73/EC.
- A TSO which is part of a vertically integrated undertaking shall have effective decision-making powers, independent from the integrated gas undertaking ("unbundling"), cf. Article 9(2)(c) of Directive 2003/55/EC.
- National energy regulators shall be responsible for and able to exercise effective regulatory oversight over terms and conditions for access to the GTS, cf. inter alia Recitals (13) and (16) and Articles 18(1), 25(2)(a) of Directive 2003/55/EC, and Recital (31) and Articles 32(1) and 41(6)(a) of Directive 2009/73/EC.

(533) The Transit Contract is not in line with and prevents the implementation of the above organisational requirements of EU legislation.

(534) In December 2013, Ukrtransgaz was designated TSO of the Ukrainian gas transport system.

(535) The Transit Contract requires that the volume of natural gas available in every 24 hours at exit points shall be equal to the volumes injected at entry points. The natural gas is provided in the common flow. *Inter partes*, Naftogaz is contractually responsible for the secure and stable functioning of the gas transport system of Ukraine as well as for any losses of the gas in transit. Ukrtransgaz is charged with the technical performance of Naftogaz' obligations under the Transit Contract.

(536) Additionally, the Energy Community Secretariat has pointed out that the Transit Contract has been implemented in such a way that Gazprom affiliates (specifically, Gazprom Export) act in the capacity of a "super-operator". It is Gazprom affiliates, rather than Ukrtransgaz, that act as matching partners for operators of neighbouring transmission systems in respect of gas flows through Ukrainian territory.⁹ In light of the above, the Energy Community Secretariat, in its Preliminary Compliance Report, observes that:

- the implementation of the Transit Contract may encroach on the principle of operational responsibility of Ukrtransgaz as TSO;
- the implementation of the Transit Contract may obstruct the effective unbundling of the Ukrainian gas transport system (which includes transmission, distribution and storage);
- the national regulator, the National Electricity Regulation Commission/ NERC (now replaced by the National Commission for the State Regulation of Energy and Utilities ("NCSREU")), is prevented from exercising effective regulatory oversight over the Transit Contract.

(537) The Treaty *acquis* on energy and competition also sets out further specific requirements relevant to the Contract, notably:

⁹ The Preliminary Compliance Report pages 14-15.

(538) EU energy legislation does not differentiate between transmission and transit of gas. Detailed rules on access conditions to gas transmission networks with an aim to ensure optimal utilisation of available capacity has been laid down in EU energy legislation, which is based on the following principles:

- Tariffs for transmission services shall be non-discriminatory,¹⁰ and cost-reflective.¹¹ Balancing rules shall be fair, non-discriminatory and transparent, based on objective criteria, reflect genuine needs taking into account the resources available to the TSO as well as market-based.¹² Capacity allocation and congestion management shall be non-discriminatory and transparent.¹³

(539) The abovementioned principles are currently being further developed in sector-specific EU legislation (Framework Guidelines and Network Codes).¹⁴ Thus, a Network Code on Gas Balancing (the "BAL NC") has been adopted and will enter into force as of 1 October 2015.¹⁵ Further, ENTSOG submitted a draft Network Code on harmonisation of tariff structures (the "Draft TAR NC") to ACER for consideration on 26 December 2014. These Framework Guidelines and Network Codes, while not necessarily finally adopted or in force, are developed by EU institutions in order to achieve the necessary degree of harmonisation, and are relevant to the interpretation and application of EU energy legislation and its requirements to the contract.

(540) The Energy Community Secretariat has also found that the terms and conditions of the Transit Contract are not in line with the general rules of Ukrainian legislation governing access to the gas transmission network as regards transportation tariffs, acceptance and transfer of gas, its

¹⁰ Article 18(1) of Directive 2003/55/EC, Article 3(1) of Regulation (EC) 1775/2005 and Article 32(1) of Directive 2009/73/EC and Article 13(1) of Regulation (EC) 715/2009.

¹¹ Recital (16), Article 25(2)(a) of Directive 2003/55/EC, Article 3(1) of Regulation (EC) 1775/2005, Recital (32) and Article 41(6)(a) of Directive 2009/73/EC and Article 13(1) of Regulation (EC) 715/2009.

¹² Recital (15) and Article 8(2) of Directive 2003/55/EC, Article 7(1) of Regulation 1775/2005, Recital (31) and Article 13(3) of Directive 2009/73/EC and Article 21(1) of Regulation (EC) 715/2009.

¹³ Article 5 of and Annex to Regulation (EC) 1775/2005 and Article 16 of and Annex I, as amended, to Regulation (EC) 715/2009.

¹⁴ Regulation 715/2009 Article 6, cf. Article 8.

¹⁵ Commission Regulation (EU) No 312/2014 of 26 March 2014 establishing a Network Code on Gas Balancing of Transmission Networks.

volumes and quality as well as other trading terms.¹⁶As stated by the Energy Community Secretariat,¹⁷ the provisions of the Transit Contract imply that general rules on balancing in Ukrainian legislation are not in practice applied to gas transit flows. A separate Balancing Agreement was entered into between Ukrtransgaz and Gazprom Export in 2010, but unilaterally terminated by Gazprom Export in June 2014.¹⁸

- (541) The legal basis for Naftogaz' claims are the EU *acquis* on energy and competition as set forth in the Energy Community Treaty and applicable pursuant to Swedish law. As a Contracting Party to the European Community Treaty, Ukraine is obliged to implement the EU *acquis* in its national legislation. This implementation process is on-going. To the extent the EU *acquis* is also implemented in mandatory Ukrainian law, Ukrainian energy and competition law is also an expression of the EU *acquis* on which Naftogaz bases its claims. Naftogaz also recalls that Articles 101 and 102 TFEU apply on a stand-alone basis, as the Contract affects trade within the EU.
- (542) In its report, the Energy Community Secretariat, based on the conclusions (page 33) in ACER's report, stated that *"as of 1 January 2015 at the latest, "the legal status and conditions of the transit contracts should be aligned with that of domestic transmission, in order not to impede competition, and the provisions of [the Third Gas Directive] and Regulation (EC) 715/2009 including those on tariffs, congestion management and capacity allocation are equally applicable to both national transmission and gas in transit".*" As discussed above, the implementation of the EU *acquis* in Ukrainian legislation is relevant to Naftogaz's claims. At the same time, the Treaty is directly applicable to the Contract as of Ukraine's accession to the Treaty on 1 February 2011. Furthermore, as EU law applies on a stand-alone basis, the EU *acquis* is applicable to the Contract already on 1 January 2010 at the latest.
- (543) In addition, the Contract has to meet the requirements of European competition law. Article 18(1)(a) of the Treaty and Article 101 TFEU prohibit agreements between undertakings that have

¹⁶ The Preliminary Compliance Report page 11.

¹⁷ The Preliminary Compliance Report page 19.

¹⁸ The Preliminary Compliance Report page 19.

as their object or effect the prevention, restriction or distortion of competition in energy markets within the Community. Article 18(1)(b) of the Treaty and Article 102 TFEU prohibit the abuse by one or more undertakings of a dominant position in the market of the Energy Community as a whole or a substantial part thereof.

(544) In summary, the EU *acquis* on energy and competition requires the terms and conditions of the Transit Contract to be adjusted and replaced with provisions in conformity with European energy and competition law, essentially to provide for the operational responsibility of Ukrtransgaz as national TSO and to provide for non-discriminatory conditions of access to the Ukrainian gas transmission network, particularly in respect of pricing, balancing, nomination, matching, allocation and entry-exit arrangements.

7.1.6 The negotiations of the Contract and subsequent negotiations and consultations

7.1.6.1 The negotiations of the Contract

7.1.6.1.1 The 2008 negotiations

7.1.6.1.1.1 Introduction

(545) Having agreed with Gazprom in principle on transition to direct and transparent relations based on European pricing principles, Naftogaz initiated further discussions and negotiations of new draft contracts for both sale to and transit of natural gas through Ukraine.

(546) Although the above mentioned 2002 Transit Contract would remain in effect to 2013, Naftogaz believed that the transition to new transparent relations with Gazprom based on European principles, also would entail conclusion of a new transit contract based on such principles.

7.1.6.1.1.2 The 13 June 2008 draft

(547) On 13 June 2008 Naftogaz initiated an exchange of draft documents for transition to direct and long-term gas supply relations and transit relations based on new contracts with Gazprom.¹⁹

¹⁹ Naftogaz' letter No. 24-501-2744, dated 13 June 2008 with a draft contract for gas transit attached.

(548) In the 13 June 2008 draft, Naftogaz suggested the following basic terms and conditions for the new long-term transit contract:

- the minimum transit volumes for the period from 2009 to 2019 (2030) shall constitute no less than 110 bcm (clause 3.1).
- the exact annual transit volumes for each year and their breakdown by directions and quarters shall be determined in addenda to the contract (clause 3.2). The price (tariff) for transit services for 2009 shall be fixed (clause 8.1). The draft did not provide for a specific tariff. Naftogaz suggested that within 2009-2012 the transit tariff may be changed by the parties' agreement, but not more than by 20 %;
- by 1 July 2009 the parties shall agree on a procedure for determining a price (i.e. price formula) for transit services "*taking into account the European pricing principles*". Starting from 2013 Naftogaz shall provide transit services based on these principles (Article 8.1);
- Gazprom shall provide Naftogaz with supplies of natural gas for operating requirements (fuel gas) in the volumes of 3,5 m³ for transit of 1000 m³ of gas per 100 km.
- A penalty to be paid in case of reduction of transit volumes by more than 5% (3% - in case of transit through GMS Uzhgorod) without prior agreement with Naftogaz.
- Ukrainian governing law and arbitration under the Rules of the International Commercial Arbitration Court at the Ukrainian Chamber of Commerce and Industry, the language of arbitration shall be Russian.
- The draft provided that if the Parties should fail to perform under the Contract, each Party would be liable for proven damages caused by such failure to perform. This provision was included in most of the subsequent drafts and also in the final Contract as Article 10.1 of Article 10.

- The draft also provided that the validity of the Contract shall not be affected if any of its provisions becomes legally invalid pursuant to the applicable legislation or ineffective. In this case, the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have an economic effect as close as possible to that of the invalid or ineffective provision. This provision was included in most of the subsequent drafts and also in the final Contract as Article 13.2 of Article 13.

7.1.6.1.1.3 The 2 October 2008 intergovernmental memorandum

(549) On 2 October 2008 the Government of the Russian Federation and the Cabinet of Ministers of Ukraine concluded a Memorandum on cooperation in the gas field (the "2 October 2008 Memorandum"). The Memorandum foresaw a three-year, step-wise transition to market-based prices for gas transit (item 2) and required secure continuous transit of gas through the territory of Ukraine on a long term basis.

7.1.6.1.1.4 The 16 October 2008 Agreement on principles

(550) On 16 October 2008 Gazprom and Naftogaz concluded an Agreement on the principles of long-term cooperation in the gas field between Naftogaz and Gazprom ("16 October 2008 Agreement"), providing, *inter alia*, for the following basic principles, terms and conditions related to gas transit:

- Naftogaz shall settle all outstanding debts for gas supply to Ukraine and timely pay for future deliveries, as a precondition for transition to direct long-term gas supply and transit contracts with Gazprom;
- by 1 November 2008 Naftogaz and Gazprom shall enter into a long-term contract for transit of natural gas through the territory of Ukraine;
- such long-term transit contract shall provide for a transit tariff at the 2008 level, adjusted by a reducing coefficient applied to the price of fuel gas (6.4 bcm);

- Naftogaz shall guarantee reliable and continuous transit of Russian natural gas through the territory of Ukraine, in annual volumes at the 2008 level, but not less than 120 bcm per annum; and
- The Parties will agree on joint gas exports to Europe.

7.1.6.1.1.5 The 23 (Naftogaz) and 29 (Gazprom) October 2008 drafts

(551) On 23 October 2008, Naftogaz provided Gazprom with a set of draft documents for implementation of the 16 October 2008 Agreement, including a new draft gas transit contract for 2009-2019 and a draft Technical Agreement for 2009. The draft gas transit contract was primarily based on Naftogaz's previous draft of 13 June 2008 but, consistently with the 16 October 2008 Agreement, provided for a larger transit volume obligation of no less than 120 bcm annually. The 23 October draft also provided that transit volumes may be adjusted annually in view of joint gas exports as agreed under the 16 October 2008 Agreement.

(552) This draft did not include a price (tariff) formula or a fixed price (tariff). Instead, the price was to be agreed between the Parties in addenda to the contract. A draft additional agreement No. 1 to the transit contract suggested a transit tariff of USD 1,7 per 1000 m³ per every 100 kilometres (item 2) and confirmed a three-year step-wise transition to market-based tariffs for gas transit through the territory of Ukraine (item 1).²⁰

(553)



(554) On 29 October 2008 Gazprom responded by providing its own set of draft documents, including a new draft gas transit contract, to Naftogaz.²¹

²⁰ Naftogaz letter No. 24-956-5223, dated 23 October 2008 with a draft contract for gas transit and draft addendum (with additional agreement) thereto, and a draft technical agreement and draft addendum thereto attached

²¹ Gazprom letter No. 06-2370, dated 29 October 2008 with a draft contract for gas transit and a draft addendum to the 2002 Transit Contract attached

(555) Gazprom's draft gas transit contract contained the following main terms:

- In the period 2009-2019, Gazprom shall deliver for transit through Ukraine's territory up to 125 bcm of natural gas annually (Article 3.1). The clause further provided that Naftogaz shall ensure transit of not less than 120 bcm of Gazprom's gas annually.
- The volumes of gas to be transited in 2009 were set at 124,213 bcm. The transit volumes for subsequent years were to be agreed annually in addenda to the contract.
- Gazprom's draft suggested the same fixed tariff of USD 1,7 per 1000 m³ per 100 km for all the years of the Contract (Article 8.1 of the draft).
- Similar to the provisions in the 2002 Transit Contract prevailing at that time, Gazprom suggested Swedish governing law and arbitration according to the rules of the SCC Arbitration Institute (Article 12). This dispute resolution clause appeared in all further drafts prepared by both Gazprom and Naftogaz and was also incorporated in the final version of the Contract.
- The draft contained a general liability clause providing for reimbursement of any proven damages caused by a Party's non-performance under the contract (Article 10.1) as well as the Parties' liability for violation of specific provisions of the Contract. In particular, the draft specified that Naftogaz was liable for delivering gas of lower quality than supplied by Gazprom at the Eastern border to the Western border and for unauthorised off-take of gas. Gazprom was liable for delayed payments.

(556) In the 29 October letter Gazprom also provided a draft addendum to the 2002 Transit Contract where the minimum transit volumes obligation for 2009-2013 was set at 120 bcm per year.

(557) On 31 October 2008, Naftogaz sent a letter to Gazprom with questions regarding Gazprom's 29 October 2008 draft gas sales and transit contracts.²²

²² Naftogaz letter No. 1/4-125-5382, dated 31 October 2008

(558) In respect of the draft gas transit contract, Naftogaz asked Gazprom:

- To explain how the suggested price (tariff) for transit services had been calculated;
- To explain how the given draft contract took into consideration the requirements of the 2 October 2008 Memorandum in relation to the "*step-wise transition within three years to market based price (tariff) for transit services through the territory of Ukraine*";
- To explain how Gazprom envisaged to consider in the price (tariff) for transit services the seasonal and daily irregularity of volumes of Russian natural gas transit through the territory of Ukraine.

7.1.6.1.1.6 The 13 November 2008 draft

(559) On 13 November 2008, Gazprom sent a letter with, *inter alia*, a new draft gas transit contract attached.²³

(560) This draft is very similar to Gazprom's draft of 29 October 2008. However, some adjustments were made to the price provisions in accordance with what the Parties agreed during the 11-12 November meeting, and are shown in track-change in the draft. Instead of the fixed transit tariff for the whole term of the contract (2009-2019), the transit tariff of USD 1,7 is fixed for 2009-2010 only, while the transit tariff for 2011-2019 shall be additionally agreed by the Parties, cf. Article 8.1 of the draft.

7.1.6.1.1.7 The negotiations in the end of December 2008

(561) Towards the end of 2008, it was clear that the Parties would be unable to agree on all issues in long-term agreements, in particular on the price formulae for both the sales and the transit contracts. Therefore, Naftogaz and Gazprom focused on fixing a price for gas and transit services and delivery volumes for 2009 under both contracts, and decided to resolve all other issues, including the price (tariff) formula for subsequent years in the course of 2009.

²³ Gazprom letter No. 06-2534, dated 13 November 2008 with a draft contract for gas transit and a draft addendum to the 2002 Transit Contract attached

- (562) On 26 December 2008, Gazprom presented a new draft transit contract, which Naftogaz commented on, on 29 December 2008. The draft contract demonstrates main disagreements and agreements between the Parties at that time, as well as a starting point for discussions during the January 2009 negotiations.²⁴
- (563) The volumes to be transited in 2009 are set at around 113-124 bcm. The annual volumes to be delivered for transit in subsequent years are set at 125 bcm in the 26 December 2008 draft and are left to be determined in the annotated draft. The volume provision in the 26 December 2008 draft is in line with the previous drafts, and confirms Gazprom's expectations of large future transit volumes.
- (564) The dispute resolution mechanism is identical to that contained in the 13 November 2008 draft. The Parties agreed on Swedish governing law and arbitration according to the rules of the SCC Arbitration Institute.
- (565) The Parties' disagreements are mainly related to the price (tariff) provisions and the provisions on liability for exceeding permitted quarterly and daily deviations at the specific exit points, as well as the quarterly breakdown of transit volumes.
- (566) In the annotated draft, Naftogaz argued that from 2011, the price (tariff) should be cost-reflective. In particular, Article 8.1 of the draft provided that with effect from 2011 the price (tariff) should include the costs of gas transport system operation, fuel gas, depreciation and investment costs. The cost-reflective approach was also discussed in the negotiations in January 2009 and was Naftogaz' main position.²⁵

(567)

[REDACTED]

[REDACTED] participated in the January 2009 negotiations.

²⁴ Gazprom's draft gas transit contract, dated 26 December 2008. Gazprom's draft gas transit contract, dated 26 December 2008, with annotations by Naftogaz, dated 29 December 2008

²⁵ Section 2, paragraph 17 of witness statement of [REDACTED], dated 29 April 2015.

- (568) In its comments to Article 8.1 of the annotated draft Naftogaz also disagreed with fixing a price for transit for two years. According to Naftogaz the tariff was to be fixed at USD 1,7 for 2009 only and was to be separately agreed for 2010-2019. This approach was further discussed during the 2009 negotiations.
- (569) In addition, Naftogaz stated that the transit tariff in 2009 should be linked to the price for gas under the sales contract.
- (570) The annotated draft contained a provision on Gazprom's liability in case of underdelivery of quarterly volumes for transit by more than 5% (3% - in case of transit through GMS Uzhgorod). In this case, Gazprom shall pay to Naftogaz a penalty which is calculated according to a formula, where the penalty is a product of the prevailing tariff multiplied by the volume of underdelivered gas exceeding 5% (3% - in case of transit through GMS Uzhgorod) of the agreed volumes and by length of transit. The Parties also disagreed on the quarterly breakdown of transit volumes: Naftogaz insisted on their even distribution, while Gazprom was interested in bigger volumes of gas during the autumn -winter season (quarters I and IV) and lower volumes during the spring-summer period (II and III quarters).
- (571) The last draft from 2008 from Naftogaz' archives is an undated draft with Naftogaz' annotations.²⁶
- (572) This draft is very similar to the annotated draft discussed above.
- (573) In addition to the comments and suggestions made by Naftogaz in the annotated draft, and in conjunction with the request for even quarterly transit volumes, Naftogaz suggested to sign a separate agreement on the use of Gazprom's gas in Ukrainian underground gas storages ("UGS") to create quarterly flexibility, cf. Article 3.1 of the draft, effectively a kind of balancing regime. This proposal is not found in any of the drafts from 2009 and was not included in the signed Contract.

²⁶ Undated draft gas transit contract of 2008, with Naftogaz's annotations

(574) The Party representatives failed to agree and sign a transit contract for 2009-2019 by 31 December 2008.

7.1.6.1.1.8 Naftogaz' internal memo of 23 December 2008

(575) (605) Prior to (what was expected to be) the last week of negotiations, Naftogaz summarised its position on various key elements in a memo dated 23 December 2008.

(576) This memo shows that Naftogaz planned for a transition to direct relations already in 2009, while the transition to European pricing principles were to take place gradually over three years. European formulas for both transit and sale of gas were to become effective from 2012.

(577) The memo also demonstrates that German prices netted back to the delivery points were considered as the relevant price indicators under the Gas Sales Contract. When calculating the price, Naftogaz based its calculations on the understanding that as of December 2008 the «... *minimum market rate for transit through the territory of Ukraine [is] at the level of 3.4 US dollars for 1000 cubic meters per 100 km*».

(578) With regard to the transit tariff, it was to be based on European pricing principles. In particular, as follows from the 23 December 2008 Memo, Naftogaz relied on the practices of European operators when developing a methodology for the calculation and formation of transit tariffs:

"Regarding the amount of tariff rate. In general, the transportation system operator (TSO) develops proposals regarding the methodology, on which the calculation of tariffs is based, for further approval by the national regulator. The fees must be not discriminatory, but reflect the actual expenses and to take into account the need for long-term expenses (investments) for the gas network (the requirements of the EU Gas Directive and the Energy Charter Treaty)" (Underlining by Naftogaz)

(579) In this regard, Naftogaz based its position on the principles of tariff calculation applied by TAG (Trans Austria Gasleitung GmbH) and WAG (West-Austria-Gasleitung) pursuant to which "the

tariff methodology has to guarantee the long-term maintenance of the network of gas pipelines and to encourage investments." (Underlining by Naftogaz)

(580) This discussion is also in line with [REDACTED] recollection of Naftogaz' position referring to an "Austrian model". This is in stark contrast to [REDACTED] recollection, rejecting that such a reference was made during the negotiations.

(581) In the 23 December 2008 Memo, Naftogaz concludes that it is premature to enter into a transit contract corresponding to European principles with effect from that point in time, and that further actions were to be taken. In particular:

"- [Naftogaz would have] to calculate the possibility of determining price indicators for Ukraine based on the price indices of German official authorities minus the cost of transportation through Ukraine, Slovakia and the Czech Republic.

- It is necessary to carry out significant work for principally bringing draft contracts on transportation (transit) and purchase of natural gas in line with the European requirements (technical, legal, etc.)...

- to take into account that the price of natural gas is the value that can vary considerably with time. The same applies to the cost of transportation services which shall depend on the inflation indices, capital improvement and other factors. In order to reduce the changes, the recognized European practice provides for supply of gas for operational purposes by the Customer under the transit contract".

(582) Thus, Naftogaz believed that a tariff under the new transit contract was to be in line with European technical and legal requirements and cost reflective, and that the price for gas under the new sales contract would be calculated under the netback principle based on the prices of gas in Germany. It also clearly demonstrates that Naftogaz prepared for a three-year transition period, during the course of which the Parties would further develop their contractual relationship to ensure it corresponds to the European principles within both gas sales and gas transport, in

accordance with the memorandum at a governmental level as well as in the *inter partes* agreement of October 2008. The 23 December 2008 Memo also demonstrates that Naftogaz believed that the contracts for gas sales and purchase and transit contract were to be balanced, as confirmed by Naftogaz' witnesses.

7.1.6.1.1.9 The January 2009 supply and transit interruption

(583) At 10 am Moscow time on 1 January 2009, Gazprom halted all deliveries of natural gas to Ukraine. Gazprom's central dispatching department informed Ukrtransgaz of the interruption by telefax No.03/1010-2535.

(584)



(585) Gazprom had excellent knowledge of how the GTS worked. Gazprom significantly reduced and sometimes totally cut gas deliveries, also for transit, to the Eastern regions of Ukraine entering Ukraine at the Gas Metering Stations Sudzha, Pisarevka, Sokhranovka, Valuiki, and Platovo.

(586) In violation of previous practice, Gazprom reduced and cut supplies unilaterally, without consultation with Ukrtransgaz's dispatching services. Some of the shifts in the gas supplies only became known to the dispatching services in Kiev post factum.

(587) The result was that Ukrtransgaz had to significantly shift the gas flows and the operation of the GTS in an improvised fashion. Supplies to the inhabitants and industry in the largest industrial region of Ukraine were threatened. As the specialists in Gazprom's dispatching services knew

very well, the situation was also a significant threat to the transit of Russian gas through Ukraine to Europe.

- (588) From 2 to 5 January 2009, gas deliveries to several EU Member States were affected, notably deliveries to Poland, Slovakia, Hungary, and above all to Bulgaria and Romania. On the night of 6 to 7 January 2009, all supplies from Russia through Ukraine to the EU were cut. There were no gas supplies from Russia to Europe from 7 January to 20 January, as is stated in the European Commission Staff Working Document SEC (2009) 977 (the "Commission's 16 July 2009 assessment").²⁷
- (589) Ukrtransgaz's dispatchers had experienced an interruption of supplies from Russia before, in 2006. However, on that occasion, gas supplies to the EU were restored after one day of disruptions and available storage capacities easily made up the shortfall (some 80 mcm).²⁸ The situation in 2009 was much worse because of Gazprom's systematic cuts of deliveries through the Eastern regions of Ukraine, which could lead to a humanitarian and technological disaster, and because Gazprom first limited, and then completely cut, gas deliveries into the GTS for transit to Europe.
- (590) Under the circumstances, Naftogaz had to reverse the gas flow in the GTS, to supply Ukrainian gas from storage and own production to the eastern regions. This was a risky emergency measure, which had not been theoretically considered or tested to such an extent before.
- (591) Naftogaz repeatedly requested Gazprom to meet and discuss the prevailing gas transit situation.
- (592) The European Commission invited the parties to meet in Brussels on 8-12 January 2009 to facilitate an agreement between the Russian government/Gazprom and the Ukrainian government/Naftogaz. This meeting resulted in an agreement providing for independent monitors from

²⁷ Commission Staff Working Document SEC (2009) 977 final, "The January 2009 Gas Supply Disruption to the EU: An Assessment", dated 16 July 2009

²⁸ Pages 19-23 of the Commission's 16 July 2009 assessment.

all the involved parties to oversee the gas transit on Russian and Ukrainian territory.²⁹ The monitoring confirmed that Gazprom did not deliver gas into the GTS.

(593) Naftogaz continued to invite Gazprom to new negotiations.³⁰

(594) However, despite all the above requests of Naftogaz and the EU's efforts to facilitate an agreement between the parties, gas transport from Russia to the EU via Ukraine only resumed on 20 January 2009.³¹

(595) This supply interruption was the background for the final negotiations of the Contract.

7.1.6.1.1.10 The negotiations of the Contract on 17-20 January 2009

(596) On 17-18 January 2009, Russian and Ukrainian government delegations met in the Russian government building in Moscow for final negotiations of the Gas Sales and Gas Transit Contracts. These intergovernmental negotiations were followed by further negotiations and discussions between representatives of Naftogaz and Gazprom on 18-20 January in Gazprom's Moscow headquarters.

(597) The intergovernmental negotiations mainly took place behind closed doors, directly between the Ukrainian and Russian Prime Ministers, Mrs. Yulia Tymoshenko (who had personal experience from the gas industry) and Mr. Vladimir Putin, sometimes joined by Gazprom's Chairman of the Board Mr. Alexey Miller alone or together with Naftogaz' Chairman of the Board, Mr. Oleg Dubina. On 18 January, Naftogaz' representatives were informed that the price (tariff) for transit would be USD 1.7 in 2009, for the following years the price (tariff) would be calculated pursuant to a formula based on Gazprom's standard contracts with European contractors.

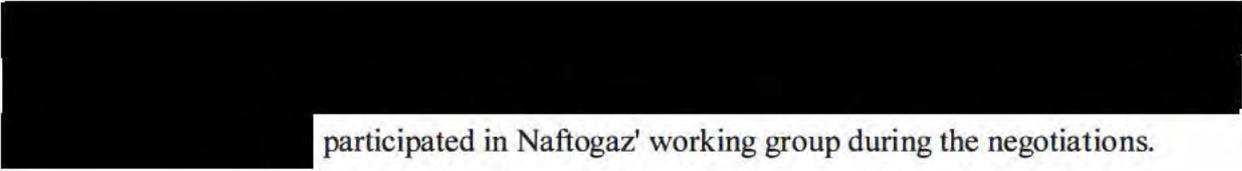
(598) The fixed tariff for 2009 was part of a larger package. This package included Naftogaz paying RosUkrEnergo's debt towards Gazprom and Gazprom Export of around USD 1.7 billion. In

²⁹ Page 4 of the Commission's 16 July 2009 assessment.

³⁰ Naftogaz' letter No. 24-36-138, dated 15 January 2009.

³¹ Pages 3-4 of the Commission's 16 July 2009 assessment.

return Naftogaz was given the property right to 11 bcm of natural gas stored in Ukrainian underground gas storages, previously belonging to RosUkrEnergo.

- (599) After the negotiations between the prime ministers, Naftogaz' representatives were instructed to formalise the agreement and finalise the Contract in cooperation with Gazprom's representatives.
- (600) At Gazprom's head office the teams of Naftogaz and Gazprom exchanged their preliminary drafts and suggestions of essential terms and conditions of the contracts for the supply and transit of gas. The Gas Sales Contract was discussed first. After agreeing on the main terms and conditions of the Sales Contract, the Parties proceeded to negotiate the text of the Transit Contract.
- (601) According to Gazprom's representatives, the draft provided by them was a "European standard contract" and the formula introduced in Article 8.1 thereof reflected a level of transit tariffs on the European gas market almost identical to the level in Gazprom's contracts with other European transit system operators.
- (602)  participated in Naftogaz' working group during the negotiations.
- (603) The earliest draft from the 18 – 20 January negotiations in Naftogaz' files is Gazprom's draft of 18 January 2009, 19:00.³²
- (604) Naftogaz has only six pages of the draft contract, pages 1-3 and 5-7. However, from these pages of the draft, it is clear that the volumes to be transported in 2009 were proposed to constitute 124,083 bcm, and that transit volumes for the following years were to be separately agreed on by the Parties in annual addenda. In case the Parties failed to agree on such addenda, the provision on the gas transit volumes for the previous year would apply to the subsequent year, cf. Article 3.2. The draft also introduces for the first time a provision imposing on Naftogaz the duty to keep

³² Draft Contract between Open Joint Stock Company "Gazprom", Moscow, Russian Federation and National Joint Stock Company "Naftogaz of Ukraine" Kiev, Ukraine, for transit of natural gas through the territory of Ukraine in 2009-2019, dated 18 January 2009, 19 00, pages 1-3 and 5-7

the volume of available Natural Gas in every 24 hours at the exit point equal to the volumes injected at the delivery points, cf. Article 3.4 second item of the draft, which also appeared in all subsequent drafts and in the final Contract.

(605) The next draft in Naftogaz's files is Draft Contract between Open Joint Stock Company "Gazprom", Moscow, Russian Federation and National Joint Stock Company "Naftogaz of Ukraine" Kiev, Ukraine, for transit of natural gas through the territory of Ukraine in 2009-2019, dated 19 January 2009, 02:00.

(606) The main terms of this draft are:

- Similar to the 18 January draft, only the annual transit volumes for 2009 (124,083 bcm) and their distribution by directions (i.e. exit points on Ukraine's western border) and quarters were provided, while annual gas transit volumes for subsequent years were to be agreed in addenda to the Contract (Article 3.1). However, if the Parties fail to conclude such addenda for a year, the annual gas transit volumes established for the previous year shall be applied for such year.
- The tariff for gas transit in 2009 was set at USD 1.7 per 1000 m³ per every 100 km, while tariffs for 2010 and subsequent years were to be calculated under a formula (Article 8.1). The draft contains two price (tariff) formulae, suggested by Gazprom and Naftogaz respectively.
 - Gazprom's formula is similar to the formula in the final version of the Contract, and contains one component based on the tariff in the previous year and the inflation index in the EU, and a fuel gas component based on the price for gas under the Sales Contract.
 - Naftogaz' suggested formula is based on transit operational costs, replacement costs of the Ukrainian GTS and its depreciation index and land lease costs, revenue tax rate, fuel gas price, as well as the prevailing price for gas under the Gas Sales Contract, i.e. it reflected the costs incurred in transporting the gas through Ukraine. The tariff is conditional on guaranteed volumes and term of transit.

- Article 8.3 of the draft of 19 January set out a monthly schedule for transit services rendered by Naftogaz to Gazprom against previously received advance payment.
- The draft provided for Swedish governing law and arbitration according to the rules of the SCC Arbitration Institute, cf. Article 12 of the draft.

(607) The last draft in Naftogaz's files is not dated, but is very similar to the final Contract.³³

(608) Main changes compared to the 19 January 2009, 02:00 draft are:

- The annual minimum transit volume is set at 110 bcm of natural gas, and the volume of gas to be delivered for transit in 2009 is set at 120,083 bcm, cf. Articles 3.1 and 3.1.1 of the draft;
- The permitted deviation of daily volumes for 2009 is more than +/- 10% while such deviations for subsequent years shall be determined in additional agreements to the Contract.
- The formula for calculating the transit tariff is in practice almost identical to the formula in the Contract.

(609) A pronounced difference between this last draft from Naftogaz' files and the final Contract, is the price (tariff) revision provision in Article 8.7 of the Contract, which does not appear in any of the draft contracts and was apparently first introduced in the final Contract. According to the witness statements of [REDACTED] and [REDACTED] the tariff revision clause was included in the Transit Contract after the Parties had signed the Gas Sales Contract, and Naftogaz insisted on incorporating some main arrangements agreed in the Gas Sales Contract also in the Transit Contract.

³³ Draft Contract between Open Joint Stock Company "Gazprom", Moscow, Russian Federation and National Joint Stock Company "Naftogaz of Ukraine" Kiev, Ukraine, for transit of natural gas through the territory of Ukraine in 2009-2019, undated.

- (610) On 19 January 2009, there was an official signing ceremony. However, the negotiations of the Contract continued into the early morning of 20 January. On 20 January, Gazprom and Naftogaz signed the Contract and normal gas transit to the EU via Ukraine resumed.
- (611) In conjunction with the finalisation of the Sales and Transit Contracts on 20 January 2009, a team from Naftogaz consisting of *inter alia* [REDACTED] and [REDACTED], were instructed to negotiate the terms and conditions of a Technical Agreement with a team of Gazprom's specialists led by [REDACTED]. However, the Parties were not able to finalise a Technical Agreement on that day and the negotiations continued into April 2009.

7.1.6.1.1.11 Negotiations of specific issues

7.1.6.1.1.11.1 The volume provisions Article 3

- (612) The minimum transit volume of 110 bcm per annum was not a significant topic of discussion during the negotiations.
- (613) The 110 bcm figure was consistent with the transit obligation in the 2002 Transit Contract, and appears in Naftogaz' 13 June 2008 draft. The minimum obligation was increased to 120 bcm in the 16 October 2008 Agreement on principles and Naftogaz' and Gazprom's 23 and 29 October 2008 drafts. In the last draft in Naftogaz' files as well as in the final Contract, the minimum volume was again set at 110 bcm per annum.
- (614) During the discussions, the Parties also discussed a possible increase in European demand for Natural Gas of volumes of up to 200 bcm, and Gazprom assured Naftogaz that 110-120 bcm would be transported through the Ukrainian GTS. Other pipelines then considered for construction would be used for the additional volumes.
- (615) Naftogaz never doubted the binding nature of Gazprom's minimum volume obligation and Naftogaz' corresponding capacity reservation and maintenance obligations.
- (616) In his witness statement [REDACTED] states that "*the annual volume expressed in clause 3.1 of the Contract TKGU was intended as no more than a forecast of volumes that it was anticipated*

might be delivered under the Contract". To further substantiate this position, ██████████ refers to the Parties' practice to agree on annual and quarterly transit volumes on an annual basis, *"when there is a better understanding of what consumption levels are likely to be"*.

(617) ██████████ explains that the discussion regarding minimum annual volumes was brief, since the Parties simply transposed the volume obligation Gazprom had under the 2002 contract, 110 bcm *per annum*, and used the same wording i.e. "не менее" "at least" ("*not less than*" in Gazprom's translation). The Parties understanding under the previous 2002 Contract had been that this posed a minimum volume obligation. This understanding is evident from Gazprom's letter of 5 January 2009, relating to Naftogaz' part of the volume obligation under the 2002 Transit Contract, i.e. to reserve capacity. In the letter, Gazprom emphasizes that:

(618) *"Article 3.1 of the Contract provides for an obligation of Naftogaz to ensure acceptance of natural gas in the volume not less than 110 bcm per year and its further transit through the territory of Ukraine. Therefore, the volume of transit of not less than 110 bcm per year was agreed by the Parties to the Transit Contract until 2013 inclusive"*.³⁴

(619) As ██████████ observes, Naftogaz' obligation to ensure specific volumes of transit (and therefore, its inability to use the capacity reserved for Gazprom under the Transit Contract) must reasonably be met with an equal corresponding obligation on Gazprom to deliver the volumes for which it has reserved capacity.

(620) Naftogaz questioned whether Gazprom really needed 110 bcm during the negotiations. However, Gazprom assured Naftogaz that it needed the volume of not less than 110 bcm, also having regard to the planned construction of the Nord Stream pipeline, which was intended to cover additional supplies.

³⁴ Letter from Gazprom to Naftogaz No. 06-13, dated 5 January 2009.

(621) Naftogaz had no reason to doubt Gazprom's assurances, since, in the preceding seven years, Gazprom had never failed to deliver at least 110 bcm.

(622) Thus, neither of the Parties assumed that Gazprom would not fulfil this obligation also under the new Transit Contract. Naftogaz' understanding was that the volumes would be agreed on a year by year basis, but would in any case not be less than 110 bcm in any year.

7.1.6.1.1.11.2 The tariff Articles 8.1 and 8.7

(623) When negotiating and entering into the Contract, the Parties were seeking to implement in the Contract a market-based transit tariff, based on European pricing principles.

(624) Naftogaz recalls, that already Naftogaz' first draft of 13 June 2008 indicated that after a transition period, the price was to be determined "*taking into account the European pricing principles*".

(625) The Parties disagreed on which European pricing model to apply.

(626) Naftogaz proposed to use the operational and investment costs of procuring gas transit through the GTS, including a reasonable rate of return as the basis for determination of the price for transit.

(627) The concept of cost-reflective pricing was informally referred to as the "Austrian" model during the negotiations, since Naftogaz referred to the practices of the Austrian TAG pipeline as a source of inspiration for the proposed tariff concept.

(628) Gazprom disagreed with this approach, mainly arguing that it would require complex calculations for which the parties did not have time. [REDACTED] re-quired data on particular investments and costs spent by Naftogaz or Ukrtransgaz on the Ukrainian GTS, indicated that Gazprom knew these costs very well, and that this approach would not benefit Naftogaz and Ukrtransgaz.

(629) Instead Gazprom suggested a different formula, which relied on volumes and distance of transportation, and assured Naftogaz that the formula was a standard for transit contracts with Gazprom's counterparties and resulted in a tariff level reflecting the level of transit rates on the European gas market, for example in Slovakia or Poland.

(630) The Parties eventually agreed on the formula suggested by Gazprom and hence based the tariff on the so-called competitive pricing model, which at that time also was considered to represent "European pricing principles", in line with the Parties' intentions. At the time, the Parties apparently also assumed that the tariff so established also effectively would cover Naftogaz' costs.

(631) In the words of Gazprom, the Gas Sales and Transit Contracts

"stipulate that from 2009 both countries switch in their relations in the gas sector to the generally accepted and transparent European gas pricing rules.

[...]

From January 1, 2010 the transit rate will be market based and will be calculated based on the generally accepted European formula".

(632) The price (tariff) revision clause was transposed from the Gas Sales Contract to the final Contract at a very late stage, apparently without much discussion of the details. The use of the European market as the reference market for changes was considered a confirmation of the Parties' intent to apply European tariff principles.

(633) Naftogaz internally considered the formulas for transmission tariffs in other European markets. The analyses showed that in order to cover its full costs, the tariff should not be lower than USD 5.11/1000 m³ per 100 km, assuming the transportation of 120 bcm of gas per year. However, Naftogaz was uncertain as to whether it could actually demand all its costs to be covered.

(634) Nonetheless, during the subsequent negotiations, Gazprom disregarded Naftogaz' calculations and tariff formula proposals based on the "Austrian model".

(635) However, Gazprom rejected any discussion of alternative formulas, claiming that they had extensive experience of paying transit tariffs in European countries and their "Slovakian" (from their contract in Slovakia) formula was the only relevant approach to determine the transit tariff in Naftogaz' case. Gazprom also maintained that their formula (with its base tariff) was fully reflective of the terms for determination of transit tariffs in the European gas market, and that the tariff for 2010-2019 would correspond to the level of transit tariffs in the European gas market. In particular, Gazprom clearly stated that from 2010 the tariff would correspond to the tariff in Slovakia, taking into account the difference in fuel gas costs.

(636) Due to the pressure and the political context surrounding the contractual negotiations at the time, the management of Naftogaz ultimately accepted Gazprom's formula. However, since the Transit Contract and in particular its tariff provisions had been decided on over a very short period, Naftogaz also insisted on a tariff revision clause, in case, contrary to the Parties' expectations, the tariff methodology and/or the tariff level were to prove not to correspond to European principles.

7.1.6.1.1.11.3 The general liability provision Article 10.1

(637) In the course of the negotiations, the Parties discussed various specific liability mechanisms. These mechanisms included the reservation of capacity or so-called "ship or pay" provisions, or penalties similar to those provided under Articles 6.5 – 6.6 of the Gas Sales Contract. In the end, the Parties did not reach an agreement on such specific liability mechanisms.

(638) However, the Parties did agree on the general liability provision in Article 10.1 of the Contract, a standard mechanism for reimbursement of proven damages caused by a failure to fulfil the Contract. It was Naftogaz' clear understanding that this provision gave Naftogaz the right to demand compensation for damages in case of underdelivery of transit volumes by Gazprom to Ukraine regardless of any specific liability mechanisms for underdelivery.

(639) As follows from the presentation of the draft contracts above, Article 10.1 did not cause any controversy. The provision was considered as an axiom accepted by both Parties.

7.1.6.1.1.11.4 Balancing

(640) The rudimentary balancing regime included in the final contract follows from Articles 3.4, 4.3 and 10.4 of the Contract. In particular, the Contract imposes a duty on Naftogaz to keep the volume of available Natural Gas at the exit point equal to the volumes injected at the entry points in every 24 hours, cf. the last paragraph of Article 3.4 of the Contract.

(641) Naftogaz' obligation to deliver the same amount of gas to Gazprom Export in the west of Ukraine, as it is delivered by Gazprom in the east of Ukraine, was introduced for the first time during the negotiations on 18-19 January 2009. According to Naftogaz' witnesses, Naftogaz did not at the time have sufficient experience in the technical and balancing cooperation on gas transit as applied between European TSOs. However, Naftogaz did suggest to include a balancing mechanism with a penalty for exceeding daily deviations of transit volumes, but Gazprom refused. Consequently, the Parties' previous practice formed the basis for the agreed provisions.

(642) Later, in 2010, Ukrtransgaz concluded a dispatching services agreement with Gazprom Export entitling Naftogaz to compensation for Gazprom Export's excessive volume deviations when withdrawing gas from the exit points at the western borders of Ukraine. This contract was subsequently terminated by Gazprom Export in 2014 without any explanation.

7.1.6.1.1.11.5 The replacement provision Article 13.2

(643) There was not much discussion over the provision in Article 13.2 of the Contract. The provision appears in most of the drafts prepared by both Gazprom and Naftogaz and its inclusion in the Contract appears to be a result of consensus on this matter.

7.1.6.1.1.11.6 The dispute resolution provision Article 12 of the Contract

(644) Starting from its first draft dated 29 October 2008 Gazprom insisted on Swedish governing law and arbitration according to the rules of the SCC Arbitration Institute, which was accepted by Naftogaz.

(645) Following the negotiation of the Gas Sales Contract and the arbitration clause, Naftogaz wanted to have a dispute resolution mechanism similar to the provision in the Gas Sales Contract, empowering the tribunal to finally resolve any dispute between the Parties, including disputes over transit tariff revision, validity of the contract provision and breaches of the Contract.

7.1.6.1.1.11.7 The discussions of a ship or pay clause

(646) [REDACTED] all allege in their witness statements that Naftogaz cannot claim damages for Gazprom's underdeliveries, since the Contract does not contain a ship or pay clause. The reason why the Contract does not contain such a provision is allegedly that Naftogaz had historically rejected Gazprom's offers to include it in exchange for "*associated obligations*", and in particular, "*flexibility*". This presentation of Naftogaz' position with regard to ship or pay and the reasons why it is not included in the Contract is incorrect.

(647) Naftogaz does not here rebut the Gazprom witnesses' understanding of a ship or pay clause and the workings of the damages clause under the Contract, since that is done below. Here, Naftogaz will clarify its position towards Gazprom's proposal for a ship or pay clause against "*associated obligations*".

(648) In this respect Naftogaz' witnesses recall that the Parties during the 2009 negotiations first agreed the Sales Contract and then started working on the Transit Contract.

(649) Once the Sales Contract had been finalised, Naftogaz requested that conditions similar to the provisions of the Sales Contract be included in the Transit Contract. In particular, Naftogaz requested a provision under the Transit Contract similar to Naftogaz' take or pay obligation under the Sales Contract. Gazprom responded that a ship or pay clause could only be introduced to the Transit Contract if Naftogaz undertook a number of additional obligations.

(650) [REDACTED] states in his witness statement that "*Gazprom has on several occasions proposed to Naftogaz including a ship or pay obligation in the transit contract in exchange for Naftogaz undertaking strict delivery obligations*". While he further states that "*Gazprom would never*

agree on a ship or pay transit contract with Naftogaz unless Naftogaz undertook such delivery obligations", he does not specify what "such [strict] delivery obligations" would be.

- (651) Further clarification can be found in [REDACTED] and [REDACTED] witness statements. [REDACTED] explains in [REDACTED] witness statement that as conditions for a ship or pay commitment, Gazprom demanded (i) flexibility of +/- 20 per cent at the exit points and (ii) immediate delivery rights. [REDACTED] states in [REDACTED] witness statement that in addition to these two demands, Gazprom sought a provision for "*damages/penalties payable for shortfalls in delivery of the nominated amounts*".
- (652) Notably, Gazprom succeeded in the inclusion of both immediate delivery rights and penalties for shortfalls in delivery caused by Naftogaz' withdrawals, in the final version of the Contract, cf. Articles 3.4 last paragraph and 10.4 of the Contract.
- (653) However, a flexibility of +/- 20 per cent at the exit points was impossible for Naftogaz to accept, both from a commercial perspective and from the perspective of security of supplies. Such a regulation would also have been unique in Europe and thereby contrary to the agreed underlying purpose of concluding these new contracts. Effectively, Gazprom asked to receive significant balancing services for free.
- (654) While shippers in the rest of Europe pay for 100 per cent of the capacity they book, irrespective of whether they use the capacity or not, Gazprom, by demanding +/- 20 per cent, wanted the option to, by booking 110 bcm, reserve the capacity for 132 bcm, but possibly only pay for the transportation of 88 bcm.
- (655) With regard to security of supply, such a flexibility obligation towards Gazprom would have obliged Naftogaz to deliver 20 per cent more gas at the exit points in the West than it received on entry points in the East. This would have put Naftogaz' ability to provide gas for domestic consumption at risk. This was particularly so, since Gazprom (contrary to what is normal

procedure in Europe) demanded Naftogaz to prioritise transportation of gas over deliveries to national consumers in Ukraine.

(656) Based on this, Gazprom's demand for "flexibility" was unacceptable to Naftogaz. However, in the end, Gazprom still got the flexibility of +/- 6.5 per cent (4.5 per cent at Uzhgorod), cf. Article 3.4 of the Contract. Such flexibility is unique in Europe.

(657) Thus, although Gazprom got the regulation on immediate delivery, which is set out in Article 3.4 last paragraph of the Contract, penalties for shortfalls caused by Naftogaz' withdrawals pursuant to Article 10.4 of the Contract and a unique flexibility of +/- 6.5 per cent (4.5 per cent at Uzhgorod), Naftogaz was not granted a ship or pay clause.

7.1.6.2 Subsequent discussions and negotiations

7.1.6.2.1 Negotiations of the Technical Agreement

(658) The Parties were not able to agree on and sign the Technical Agreement during the negotiations in January 2009. Consequently, the negotiations of this Agreement continued through April 2009.

(659)

[REDACTED]

(660)

[REDACTED]

7.1.6.2.2 Naftogaz' request for price (tariff) revision

(661) On 15 June 2009 Naftogaz requested a revision of the price (tariff) under the Contract, *inter alia* because:

"The decline in volumes of the transit of natural gas leads to a substantial decline in income for NAK Naftogaz of Ukraine for the providing of transit services and carries a threat for significant unplanned financial deficit of the Company in 2010 and subsequent years,"

(662) Naftogaz also pointed to the imbalance between the contractual obligations of the Parties under the Sales and Transit Contracts, and stated concerning the lack of a ship or pay clause under the Contract that:

"the absence of such an effective obligation of OAO Gazprom in the Transit Contract leads to a significant decrease in the effective price for transit of natural gas, which provides a basis for its revision in accordance with Clause 8.7 of the Contract."

(663) As a remedy, Naftogaz requested revising the tariff to include a payment guarantee for the agreed transit volume, effectively turning the volume-based tariff into a capacity charge:

"...we ask you to consider amending the Transit Contract in relation to OAO Gazprom's obligation in favour of NAK Naftogaz of Ukraine to guarantee the delivery of volumes of natural gas for transit through the territory of Ukraine and payment for the agreed volume of natural gas transit services."³⁵ (emphasis added by Naftogaz)

(664) Gazprom rejected the request referring to the package agreement for 2009, including various advance payments, and that:

"Besides, starting from the year 2010 the formula that accounts for Ukrainian expenses for transportation, will be in effect."³⁶

³⁵ Naftogaz's request for price revision, letter No. 1/4-67-3132, dated 15 June 2009.

³⁶ Gazprom's letter No. 06-1758, dated 5 August 2009.

(665) However, the price (tariff) formula in effect from 1 January 2010 did not account for Naftogaz' expenses for transportation. And Naftogaz continued to transport gas for Gazprom at a loss also in 2010.

(666) Naftogaz further quantified its losses and, in addition to the request for adjusting the tariff from a volume to a capacity basis, proposed revising the fuel tariff in two subsequent letters.³⁷

(667) However, Gazprom refused Naftogaz' claim for price revision.

(668) Gazprom alleges that Naftogaz failed to pursue its request for tariff revision and effectively by allegedly failing to act, gave Gazprom the impression that it no longer relied on its request for tariff revision.

(669) In [REDACTED] witness statement [REDACTED] states that

"between 2009 and 2014, Naftogaz always invoiced Gazprom for transit services pursuant to Contract TKGU (as amended), and Gazprom paid these amounts accordingly. During this time, Naftogaz did not claim for any additional payment for transit services beyond what it had invoiced for the transit services and what was paid by Gazprom. Gazprom accordingly proceeded on the assumption that its payments of those invoices were in final settlement of the transit services provided by Naftogaz in this period".

(670) However, these allegations are rebutted by Naftogaz' witnesses and documentation, as well as public statements made by Ukrainian and Russian officials.

(671) In addition to the request for tariff revision and follow-up communications, Naftogaz sent Gazprom a number of further follow-up letters in the course of the subsequent years. [REDACTED]

³⁷ Naftogaz's letter No. 24-572-4490, dated 10 August 2009, with attachment. Naftogaz's letter No. 24-765-6378, dated 6 November 2009, with attachment.

(672) In all these letters, Naftogaz proposed adjustments to the Contract tariff to at least some degree take account of the actual costs incurred on Naftogaz when providing transportation services. However, Gazprom did not respond to any of the letters.

(673) The issue of the Contract's tariff level was also raised at the political level in meetings between government officials of the two countries.

(674) The issue was raised by Mr Yushchenko already in December 2009 when he as president of Ukraine stated that:

" the market rate of transit tariff would provide NAK Naftogaz of Ukraine with additional \$4-billion

[...]

we have a market price for gas, but we do not have a market price for our transit".³⁸

(675) In September 2010, Mr Levochkin, then the Head of Ukraine's President's Administration, said that *"more effective usage of our own gas transportation system by way of an, if possible, increase of payment for gas transit and increase in volumes of transported gas"* is a priority in negotiations with Russia.

(676) As stated in the news report from Ukrainska Pravda,

"The head of the Administration noted that the negotiations are dynamic and the proposals from the Russian and Ukrainian sides are being discussed".³⁹

(677) The issue of transit tariff revision was yet again raised by Mykola Azarov, at the time prime minister of Ukraine, during his visit to Russia in June 2011. During a joint press-conference with

³⁸ Forum Information Agency, "President: Ukrainian-Russian gas trade agreements should be renegotiated", dated 10 December 2009.

³⁹ Ukrainska Pravda, "Yanukovich ordered to negotiate with Russia to the end" (Russian original with English translation), dated 1 September 2010.

Mr Azarov, the then Russian Prime Minister Valdimir Putin responded to Azarov's request as follows:

*"If our Ukrainian partners believe that things [transit arrangements] should be revised, then we need to sit down at the corporate level, and have the experts crunch the numbers again. We are not against recalculating, we are all for it."*⁴⁰

(678) However, the recalculations were never made and the issue remained open. In 2012 Mr Azarov again referred to the inadequacy of the transit tariff, and stated that it was "absurd" that Ukraine paid twice as much as gas from Russia as Germany paid, while *"Russia pays us only half of what the [providing of] transit costs us"*.⁴¹

(679) The issue of transit tariff revision was also discussed in 2013/2014. As the contemporaneous Eurobond issue prospectus for Ukraine stated:

*"As at the date of this Prospectus, the issue of gas tariffs for the transit of Russian gas through Ukraine is under discussion between Ukraine and Russia."*⁴²

(680) With regard to [REDACTED] point that Naftogaz did not claim a higher price when invoicing, [REDACTED] notes that Naftogaz, as a reasonable and prudent operator, only complied with the procedure under the Contract, which is that a Party may seek revision of transit tariff, but until revised all Contractual provisions including those on tariff are to be followed by the Parties, Article 13.12 of the Contract.

7.1.6.2.3 Negotiations and signing of Addendum [REDACTED]

⁴⁰ Press release of the Government of Russian Federation, "Prime Minister Vladimir Putin and Ukrainian Prime Minister Mykola Azarov hold joint news conference following a meeting of the Russian-Ukrainian Economic Cooperation Committee", dated 7 June 2011.

⁴¹ Sekodnya, "Commissioning of Nord Stream deprived Ukraine of 15% of profit" (Russian original with English translation), dated 24 May 2012.

⁴² Eurobonds issue prospectus (excerpt), dated 17 February 2014.

(681)

[REDACTED]

(682)

[REDACTED]

(683)

[REDACTED]

(684)

[REDACTED]

(685)

[REDACTED]

- [REDACTED]

- [REDACTED]

⁴³ Gazprom's letter No. 06-2438, dated 22 October 2009, with attached draft [REDACTED]

⁴⁴ Naftogaz's letter No. 24-853-7093, dated 9 December 2009, with attached [REDACTED] signed by Naftogaz.

(686)

[REDACTED]

7.1.6.2.4 Subsequent discussions in relation to Gazprom Export's role at the interconnection points, shipper codes, reverse and virtual reverse flows

(687) [REDACTED] presents in his witness statement a description of the current arrangements at the interconnection points in the West of Ukraine, in particular at the interconnection point Uzhgorod/Velke Kapusany between Ukraine and Slovakia. This is also elaborated on in [REDACTED] witness statement.

(688) Essentially, the Gazprom witnesses argue that under the current arrangements, Ukrtransgaz has no need for the shipper codes for Gazprom's deliveries through Ukraine, since the only gas at the moment being transported through Ukraine for export from Ukraine is the gas delivered for transportation by Gazprom.

(689) First, the arrangements described by [REDACTED] and [REDACTED] are in obvious breach of European legislation.

(690) Second, [REDACTED] and [REDACTED] descriptions are also factually incorrect. In his second witness statement [REDACTED] comprehensively explains how Gazprom's constant refusal to provide shipper codes to Ukrtransgaz effectively hinders Ukrtransgaz from performing its role as the Ukrainian TSO. In particular, [REDACTED] explains

- the particularities of Gazprom's/Gazprom Export's position at the various exit points in the West of Ukraine
- how Ukrtransgaz at numerous occasions since 2004 has requested that Gazprom provide it with shipper codes.

- How Gazprom's position has affected trade both between EU countries and between EU countries and Ukraine, providing several examples of when Gazprom has hindered the transport of gas by obstructing the necessary matching procedures, in particular at the interconnection point Uzhgorod/Velke Kapusany.

(691) [REDACTED] description is also rebutted by [REDACTED] in his second witness statement. [REDACTED] *inter alia* explains how Gazprom's/Gazprom Export's presence at Velke Kapusany/Uzhgorod hinders Ukrtransgaz from performing matching procedures, and why Ukrtransgaz's inability to perform such procedures due to the absence of Gazprom's shipper codes implies that no other shipper would transport gas through the interconnection point.

7.1.6.2.5 Subsequent discussions of transit volumes

- (692) Gazprom failed to deliver the agreed volumes of gas for transit already in January and February 2009, and has continued to breach its volume obligation in all subsequent years.
- (693) Already on 18 February 2009, Naftogaz sent a first letter to Gazprom explaining that the underdeliveries were causing losses for Naftogaz.⁴⁵
- (694) And as discussed above, Naftogaz requested price revision based on Gazprom's underdeliveries by its letter of 15 June 2009.
- (695) In a letter of 11 March 2010, Naftogaz notified Gazprom of its repeated violations of its transit volume obligations in 2009 and the first months of 2010, which had caused an income loss of approximately USD 490 million in 2009 alone. Naftogaz requested Gazprom to take appropriate measures to deliver the agreed transit volumes or to initiate revision of the Contract.⁴⁶

⁴⁵ Naftogaz' letter No. 24-165-798, dated 18 February 2009.

⁴⁶ Naftogaz' letter No. 24-119-1555, dated 11 March 2010.

- (696) On 8 June 2010, Naftogaz repeated the complaint, further quantifying the lost income in January May at approximately USD 300 million.⁴⁷
- (697) In 2011, Naftogaz sent two letters to Gazprom quantifying losses due to underdeliveries and requesting measures.⁴⁸
- (698) In the first ten months of 2011, Naftogaz' revenue losses amounted to more than USD 300 million, cf. the 10 November 2011 letter.
- (699) In January 2012, Naftogaz sent a letter to Gazprom quantifying the income lost due to Gazprom's underdeliveries in 2011 at more than USD 350 million, noted that Gazprom had not responded to previous requests, once more requested an amendment of the Contract, and reserved its rights in relation to all possible contractual measures.⁴⁹
- (700) In March 2012, Naftogaz again addressed Gazprom to express its concerns *inter alia* regarding continued underdeliveries.⁵⁰
- (701) In its letter No. 24-913/1.2-14 from 6 March 2014, Naftogaz quantified the underdeliveries of transit gas for the years 2012 and 2013, and requested an amendment of the Contract pursuant to Article 3.1.4, prolonging the term for provision of transit services in return for the advance payment set out in [REDACTED]. In this letter Naftogaz also emphasised that the revenue drops for transit services in 2012-2013 amounted to around a third of the value of the services.
- (702) Gazprom did not respond to Naftogaz' notifications of deviating volumes, and did not take any measures to remedy its constant breaches of its volume obligations.

⁴⁷ Naftogaz' letter No. 24-334-3455, dated 8 June 2010.

⁴⁸ Naftogaz' letter No. 24-5465/1.2, dated 12 September 2011. Naftogaz' letter No. 24-6414/1.2-11, dated 10 November 2011.

⁴⁹ Naftogaz' letter No. 24-220/1-12, dated 19 January 2012.

⁵⁰ Naftogaz's letter No. 24-1903/1.2-12, dated 23 March 2012.

(703) The underdeliveries continued in 2015, despite Naftogaz' initiation of arbitration proceedings in October 2014.

(704) In his witness statement [REDACTED] discusses Article 3.1.4 of the Contract as set out in [REDACTED] and suggests that *"the extension of the period over which services are to be charged against the advance payment was the only consequence of transit volumes being lower than 112 BCM reflected in clause 3.1.4"*. Naftogaz' witnesses reject [REDACTED] interpretation of the clause. Naftogaz has always considered that 112 bcm is the minimum annual volume obligation according to Article 3.1 of the Contract as amended [REDACTED]. As [REDACTED] notes, there is nothing in the Contract or [REDACTED] that indicates that the extension of the payment period was intended to limit the effects of Article 10 of the Contract, which provides for compensation of any proven damages.

(705) [REDACTED] explains that the possibility of extending the payment period was not meant as a consequence of Gazprom's breach of its volume obligation, but an option for the parties to amend the advance payment schedule attached to [REDACTED]. In this regard Naftogaz notes that [REDACTED] was drafted under the assumption of both Parties that the monthly transit volumes would not be changed, indicating the Parties' joint understanding of the minimum annual volumes of gas transit as a binding obligation under the Contract.

7.1.6.2.6 The balancing arrangements

(706) Due to the absence of an effective balancing mechanism under the Contract, Ukrtransgaz concluded a dispatching services agreement with Gazprom Export in 2010 (the "Balancing Agreement"). Pursuant to this agreement, Naftogaz was entitled to compensation for Gazprom Export's excessive volume deviations when withdrawing gas from the exit points at the western borders of Ukraine. [REDACTED] explained in his first witness statement that this agreement was subsequently unilaterally terminated by Gazprom Export in 2014, without any explanation.

(707) [REDACTED] and [REDACTED] alleges that the Balancing Agreement was terminated by the Parties jointly, by signing an addendum to the agreement.

- (708) However, neither [REDACTED] nor [REDACTED] mention the letter signed by [REDACTED] on behalf of Gazprom Export dated 17 June 2014, by which Gazprom Export notified Ukrtransgaz that it had "*decided to terminate the [balancing] agreement from 23 June 2014*".
- (709) As [REDACTED] explains in his second witness statement, pursuant to the 2010 Balancing Agreement, Ukrtransgaz had no contractual right to prevent or reject Gazprom Export's termination. Thus, the Parties' subsequent signing of the addendum does not change the fact that Gazprom Export unilaterally decided to terminate the Balancing Agreement.

7.1.6.2.7 Further negotiations on "Balancing gas" alleged offtakes in 2014

- (710) Gazprom's counterclaims are based on Naftogaz' alleged off-take of gas volumes in July, August, October and November 2014, a period when there was no agreement on deliveries of gas to Ukraine.
- (711) Gazprom has calculated the price for such alleged off-taken volumes pursuant to Article 10.4 of the Contract, which states that such offtakes shall be charged pursuant to Article 4.3 of the Gas Sales Contract. Article 4.3 of the Gas Sales Contract states that the price for unauthorised offtakes is the Contract Price multiplied by 1,5 for offtakes in the period from April to September, and multiplied with 3 for offtakes during the period from October to March inclusive.
- (712) Naftogaz' witnesses finds Gazprom's counterclaim unfounded. As [REDACTED] and [REDACTED] explain, due to a gas transmission system's technical characteristic, the TSO does not constantly control which volumes are injected to or offtaken from the GTS. Within a specific time period, e.g. during a day or a month, the volumes injected by Gazprom for transit may not be equal to the volumes offtaken from the system by Gazprom Export's buyers, thereby creating imbalance in the system.
- (713) It is commonly accepted in Europe that it is the Shippers' responsibility to ensure compliance with the system's balancing rules, i.e. ensuring that the volumes injected by the seller are equal

to those of off-taken by the buyer. A violation of the balancing rules will result in imbalance charges imposed by the TSO.

(714) However, the Transit Contract does not provide for an effective balancing system. Thus, the Contract does not provide any guidance as to the Parties' actions when such imbalance occurs, i.e. when European buyers' offtake more or less gas than injected into the system by Gazprom. In previous years of cooperation, the Parties used to record such volumes as delivered for Ukrainian off-takers under the Sales Contract, and legitimately offtaken. Thus, there were no penalties involved for passively maintaining the balance, but Naftogaz paid the prevailing Contract Price under the Sales Contract for any irregular offtake a European buyer made.

(715) However, starting from June 2014, Naftogaz has purchased gas under the Sales Contract on a pre-paid basis and such purchases does not necessarily occur every month.

(716) In the relevant months when Gazprom alleges that Naftogaz off-took transit gas there were no deliveries for Ukraine in the common gas flow, and Naftogaz did not take any gas. The relevant volumes were not taken by Naftogaz, but remained in the Ukranian GTS due to uneven off-take by Gazprom's European customers. To address this issue Naftogaz sent Gazprom a draft addendum to the Contract suggesting that

*"balancing volumes to be settled in the following months (i.e. in the next month Gazprom would have to deliver the agreed volumes less "balancing volumes" for the previous month)."*⁵¹

(717) Naftogaz did not receive any response from Gazprom. However, the Parties agreed during working meetings that such volumes should continue to be recorded as balancing volumes purchased under the Sales Contract. Proceeding from this agreement Naftogaz sent Gazprom corresponding delivery and acceptance reports reflecting the volumes as purchased by Naftogaz for balancing purposes.⁵²

⁵¹ Letter from Naftogaz to Gazprom No. 24-3320-1.4, dated 17 July 2014.

⁵² Letter from Naftogaz to Gazprom No. 14-5221-1.4, dated 13 August 2014.

- (718) However, Gazprom did not sign these reports and sent its own draft reports to Naftogaz with the price for balancing volumes calculated pursuant to Article 10.4, of the Contract, cf. Article 4.3 of the Gas Sales Contract. Evidently, Gazprom now considered the gas not taken by its customers as gas offtaken by Naftogaz without authorisation. This was in clear violation of the agreement the Parties had reached in the working meetings.
- (719) Naftogaz continuously attempted to resolve this issue and sent Gazprom a number of letters with attached draft addenda to the Contract and regulation of balancing volumes.
- (720) Gazprom either ignored the requests or refused the proposed amendments.
- (721) In this regard, [REDACTED] also notes that there were some months when European buyers took *more* gas than delivered by Gazprom for transit, in such cases Naftogaz used its own gas for balancing, cf. Section 10 [REDACTED].
- (722) [REDACTED] observes that if Gazprom believed that Naftogaz off-took "balancing volumes" without authorization, it should have notified Naftogaz of its position and requested Naftogaz to stop such unauthorized offtakes. However, no such notifications have been received.
- (723) [REDACTED] explains that on the contrary, some times the volumes off-taken by Gazprom's buyers from the Ukrainian GTS in the West have not been equal to Gazprom's deliveries of volumes for transit in the East, leading to an imbalance in the system. Ukrtransgaz has requested Gazprom to deliver in accordance with the Contract and the Technical Agreement.
- (724) However, Gazprom has intentionally ignored the requests and continues to benefit from its own balancing irregularities under the Contract.

7.1.6.2.8 The negotiations immediately preceding the present arbitration

- (725) On 25 July 2014, Naftogaz sent a Notice of disputes to Gazprom, *inter alia* informing of the changes to the Contract required to align it with European and Ukrainian law, claiming compensation for underdeliveries of transit gas, and claiming adjustment of the transit tariff based on EU

Competition and Energy Law and Swedish Contract law (the "Notice"). In the Notice, Naftogaz proposed to meet and negotiate at a neutral venue, previously used by the Parties in negotiations concerning the Gas Sales Contract, e.g. Brussels or Berlin.

- (726) By letter dated 18 August 2014, Gazprom alleged that Naftogaz' Notice did not meet the formal requirements to a "notice of arbitration", apparently confusing the Notice with a Request for Arbitration.
- (727) Gazprom nevertheless entered into a discussion of the merits of Naftogaz' Notice. Gazprom did not accept Naftogaz' claims, expressly rejected some claims, and requested further substantiation/documentation of other claims. Gazprom also stated its readiness to negotiate, but only in Moscow.
- (728) Naftogaz responded by letter dated 8 September 2014.
- (729) In the letter, Naftogaz appreciated Gazprom's questions regarding Naftogaz' claims, and stated its readiness to continue the negotiations, present evidence and substantiate its claims in a meeting which it proposed could be held also at other neutral venues, e.g. Stockholm, Oslo and London.
- (730) On 17 September 2014, Naftogaz sent a letter to Gazprom *inter alia* notifying Gazprom that based on data for the first eight months of 2014, Gazprom was likely to be in breach of its delivery obligations under the Contract also in 2014.
- (731) As pointed out in Naftogaz's letter of 8 September 2014, the Parties had recently met in trilateral discussions concerning the Gas Sales Contract, arranged by the European Commission. Such meetings continued also after Naftogaz' Notice. In the course of these meetings Naftogaz has sought to raise also the disputed matters under the Contract. However, Gazprom has consistently denied discussing any matters in relation to the Transit Contract in these meetings.

(732) On 13 October 2014, Gazprom responded to Naftogaz' 8 September 2014 letter, alleging that the trilateral discussions arranged by the European Commission were negotiations between Russia Ukraine the EU, and were not to be considered as negotiations related to the Gas Sales Contract. Further, Gazprom continued to insist on meeting in Moscow, and alleged that the preceding correspondence could not be considered as negotiations.

(733) Since the negotiations were not making any progress, Naftogaz on the same day, 13 October 2014, submitted its Request for Arbitration to the SCC.

7.1.7 Application of competition and energy Law

7.1.7.1 Naftogaz relies on European and Ukrainian competition and energy law

(734) IntroductionNaftogaz alleges that Gazprom breaches European and Ukrainian competition and energy law in relation to the following Articles of the Contract

7.1.7.1.1.1 Article 1 Definitions

(735) Article 1 of the Contract sets out definitions and interpretations of the terms used in the Contract. In order to bring the Contract into compliance with European and Ukrainian competition and energy law, existing definitions have been deleted and/or replaced, and new definitions added. The new definitions are consequential to removal of infringements of Articles 101 and 102 TFEU, Article 18 ECT and national Ukrainian competition law in other provisions of the Contract. The new definitions are based on the terminology in European energy law, cf. Article 2 of both Directive 2009/73/EC and Regulation 715/2009, which is now implemented in Ukraine, cf. the 2015 Gas Market Law Article 1 and the Gas Transmission System Code Chapter I.5.

7.1.7.1.1.2 Article 2 (Subject matter)

(736) Article 2 defines the subject matter of the Contract. In order to exclude references to transit and the contract paths established in the Contract, Article 2 has been replaced. The redefined subject matter of the Contract is consequential to removal of infringements of Articles 101 and 102 TFEU, Article 18 ECT and national Ukrainian competition law in other provisions. European energy law does not distinguish between transmission and transit, cf. Directive 2009/73/EC

Article 2(3) and Regulation 715/2009 Article 2(1)(1), cf. Directive 2009/73/EC Articles (1)(2) and 1(5). Also, contracts based on contract paths are prohibited, cf. Regulation 715/2009 Articles 13(1)(4), 14 and 16, which are now implemented in Ukraine, cf. the 2015 Gas Market Law Article 1 and Article 4(3) and (6).

7.1.7.1.1.3 Article 3 (Booked capacity)

(737) Article 3 is in its entirety based on a system of contract-paths in breach of Articles 101 and 102 TFEU, Article 18 ECT, Regulation 715/2009 Articles 13(1)(4), 14 and 16 and national Ukrainian competition and energy law. As already mentioned, the Third Energy Package has been implemented in mandatory Ukrainian law. The basic principles of capacity allocation and congestion management are now set out in Article 34 of the 2015 Ukrainian Gas Market Law and further detailed in the Ukrainian Gas Transmission System Code Chapters IX-XII and XV.

(738) In order to bring the Contract in compliance with European and Ukrainian competition and energy law, the contract paths under the Contract must be replaced with a long-term booking scheme for entry-exit capacity. Accordingly, Naftogaz proposes to replace Article 3 with a new provision which, in addition to Gazprom's minimum volume obligation established in Article 3.1, allocates the minimum volume obligation to capacity reservations per entry-exit point which are now in use or able to be used for the purpose of long-distance transmission through Ukraine for the remainder of the Contract on a non-interruptible basis, and establishes that additional capacity shall be booked in accordance with the terms and conditions for access to the Ukrainian transport system that follow from mandatory law and decisions by the Ukrainian regulator. The proposed Article 3 has been updated to exclude references to entry points which are not in use or not able to be used for the purpose of long-distance transmission through Ukraine.

7.1.7.1.1.4 Article 4 (Transit conditions)

(739) Articles 4.1 to 4.3 and Article 4.7 are all based on a contract path system in breach of European and Ukrainian competition and energy legislation, cf. Articles 101 and 102 TFEU, Article 18 ECT, Regulation 715/2009 Articles 13(1)(4), 14 and 16 and national Ukrainian competition and energy law.

- (740) Articles 4.1 and 4.3 have to be replaced with a booking system based on daily nominations and re-nominations and congestion management procedures, cf. the Guidelines on Congestion Management Procedures ("CMP Guidelines") in Annex I to Regulation 715/2009, as revised by Commission Decision of 24 August 2012 on Amending Annex I to Regulation 715/2009 of the European Parliament and of the Council on conditions for access to the natural gas transmission networks (the "revised CMP Guidelines") and Commission Regulation (EU) No 984/2013 of 14 October 2013 establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems (the "NC CAM").
- (741) The requirements of the Third Energy Package are implemented in mandatory Ukrainian legislation. The basic principles of capacity allocation are now set out in Article 34 of the 2015 Ukrainian Gas Market Law and further detailed in the Ukrainian Gas Transmission System Code Chapters IX-XII and XV. In order to bring the Contract in compliance with European and Ukrainian competition and energy legislation, Naftogaz proposes to replace Articles 4.1 and 4.3 with new contract provisions reflecting the nomination and re-nomination procedures applied to the Ukrainian transmission network. The proposed Article 4 has been updated to reflect changes in relevant Ukrainian legislation after the submission of the Statement of Claim.
- (742) Articles 4.4 and 4.5 refer to the Technical Agreement, which facilitates Gazprom's role as super-operator of the Ukrainian GTS in breach of European and Ukrainian competition and energy law, and must be replaced. The principle of gas delivered in the common gas flow set out in Article 4.4 first paragraph is continued in the replaced Article 4. Naftogaz proposes to regulate the issues of gas measurement, cf. Article 4.4 second paragraph, and risk for losses, cf. Article 4.5, in the replaced Article 7 which regulates delivery and acceptance of gas and metering of gas at the relevant points in the Ukrainian transmission network.
- (743) Article 4.6 first paragraph, which charges Gazprom affiliates with the Technical implementation of the Contract, must be replaced to reflect that gas suppliers and gas traders are not allowed to participate in gas transmission activities. Similarly, Article 4.6 second paragraph, which relegates

Ukrtransgaz to an agent implementing the Contract on behalf of Naftogaz, must be deleted to facilitate the assignment of the Contract.

7.1.7.1.1.5 Article 5 (Repair works)

- (744) Article 5 of the Contract regulates repair works, and refers to the Technical Agreement. Repair works are necessary to ensure system integrity and is therefore a task that lies within the operational responsibility and functions of the TSO, cf. Directive 2009/73/EC Article 13(1), cf. Article 2(4). The operational requirements of the Third Energy Package are implemented in Ukrainian legislation. The fact that repair works fall under the functions of the TSO now follows from the 2015 Gas Market Law Article 20(1), and the issue of repair works is regulated in detail in the Gas Transmission System Code Chapter VII.
- (745) In order to bring the Contract in compliance with European and Ukrainian energy legislation, Article 5 needs to be replaced with a new contract provision where the references to the Technical Agreement are deleted and which reflects that repair works is the responsibility of and is carried out by the Contractor.

7.1.7.1.1.6 Article 6.3 (Gas quality)

- (746) Article 6.3 of the Transit Contract refers to the Technical Agreement, and must be deleted. Naftogaz proposes to replace this provision with a new Article 6.3 that reflects the role and tasks of the TSO and the right to refuse off-spec gas. This is necessary to ensure system integrity and is therefore a task that lies within the operational responsibility and functions of the TSO, cf. Directive 2009/73/EC Article 13(1), cf. Article 2(4). The operational requirements of the Third Energy Package are implemented in Ukrainian legislation. The right to refuse off-spec gas now follows explicitly from the Ukrainian Gas Transmission System Code Chapter III, 1(13) and (15).
- (747) In order to bring the Contract in compliance with European and Ukrainian energy law, Article 6.3 needs to be replaced with a provision enables the Contractor to refuse to accept gas volumes that do not meet the quality requirements.

7.1.7.1.1.7 Article 7 (Delivery and acceptance)

- (748) Article 7 of the Transit Contract, which is supplemented by the Technical Agreement with Annexes and Additional Agreements, sets out the procedures for delivery and acceptance of gas at the relevant points in the Ukrainian gas transmission network.
- (749) As previously mentioned, the transmission system operator is to have the operational responsibility for the transmission network, including carrying out functions relating to cross-border transmission. Accordingly, delivery and acceptance of gas volumes are carried out by the TSO as an intermediary and on the basis of the independent reporting of the TSO. The Third Energy Package has been implemented in Ukraine and the delivery and acceptance of gas volumes reflecting the role and task of the TSO is now regulated in detail in Ukrainian energy legislation, cf. Article 20(1), cf. Article 22, of the 2015 Ukrainian Gas Market Law and Chapter III, 2 following in the Ukrainian Gas Transmission System Code.
- (750) In order to bring the Contract in compliance with European and Ukrainian competition and energy legislation, Article 7 needs to be replaced with a new contract provision which reflects the role and tasks of the TSO and is based on the delivery and acceptance procedures and metering procedures applied to the Ukrainian transmission network. The proposed Article 7 has been updated to reflect changes in relevant Ukrainian legislation after the submission of the Statement of Claim.

7.1.7.1.1.8 Article 8 (Tariff)

- (751) Article 8 regulates the tariff for the long-term transmission services provided under the Transit Contract and contains a tariff revision provision. The tariff formula leads to unfair and discriminatory pricing in breach of Articles 101 and 102 TFEU, Article 18 ECT and national Ukrainian competition law. Also, the tariff formula is not in compliance with the requirements of Directive 2009/73/EC Article 32(1) and Regulation 715/2009 Article 13(1), read in conjunction with the Agency for the Cooperation of Energy Regulators' ("ACER's") Framework Guidelines on rules regarding harmonised tariff structures for gas (the "Tariff FG") and the European Network of Transmission System Operators for Gas's ("ENTSOG's") draft re-submitted Network Code on

Harmonised Transmission Tariff Structures for Gas (the "draft re-submitted TAR NC"). Also, in order to ensure efficient regulatory oversight by national regulators, Directive 2009/73/EC Article 41(1) requires that tariffs are set or approved by the regulators.

- (752) The Third Energy Package is implemented in Ukraine. The 2015 Gas Market Law implements the abovementioned tariffication principles, and tasks the Ukrainian regulator with adopting a tariff methodology and tariffs based on these principles, cf. Article 4(3)(3) and (8) and Article 4(6). Based on the Tariff Methodology it has previously adopted, cf. Resolution No. 2517, the Ukrainian Regulator has set entry-exit tariffs for the Ukrainian GTN which entered into force 1 January 2016, cf. Resolution No. 3158. The Regulator's tariffs are based on the provision of fuel gas in kind, cf. also the principle set out in the Tariff FG. The Regulator has set tariffs for entry-exit points which are now in use or able to be used for the purpose of long-distance transmission through Ukraine.
- (753) In order to bring the Contract in line with European and Ukrainian competition and energy legislation, Article 8 should be replaced with a new contract provision that is in line with the tariffication principles implemented in Ukrainian energy legislation and the entry-exit tariffs adopted by the Ukrainian Regulator.
- (754) Article 8 shall incorporate the new tariffs set by the Regulator (Resolution No. 3158), Articles 8.1 (entry-exit tariffs) and 8.2 (specifies that the tariffs are ex VAT). Article 8.3 determines that tariff changes shall be binding on the Parties. This is in line with Article 7 of the Standard Contract, which establishes that the tariffs shall be based on the tariffs established by the Regulator.
- (755) Naftogaz submits a claim for replacement of the transit tariff principally from 1 January 2010. For 2016 and going forward, the entry-exit tariffs set by the Regulator will apply. For the period prior to 1 January 2016, the replacement tariff has been calculated by Naftogaz' experts based on the applicable European competition and energy law, as applied to the specific circumstances in Ukraine. In practice, this means that the experts have applied the tariff methodology determined by the Regulator.

(756) The proposed Article 8 reflects the tariffs set by the Regulator with effect from 1 January 2016. Any replacement/revision of the tariff with effect prior to 1 January 2016 only results in monetary claims based on the tariff methodology determined by the Regulator, cf. the preceding paragraph above.

(757) The proposed Article 8 excludes references to entry points which are not in use or able to be used for the purpose of long-term transmission. Also, the replaced Article 8 establishes that the tariffs set by the Regulator at any given time shall apply to the transport services provided under the Contract.

7.1.7.1.1.9 Article 9 (Payment)

(758) The replacement of Article 8 necessitates consequential amendments to Article 9. Article 9.1 has been changed in order to reflect the inclusion of fuel gas in kind. Naftogaz also proposes to update Article 9 in the revised Contract to reflect items VIII, 8.3 and 8.4 in the Ukrainian Standard Natural Gas Transmission Contract. Accordingly, Naftogaz proposes to delete Articles 9.3 and 9.4. In a system with capacity reservations and reporting carried out by the independent TSO, Articles 9.3 and 9.4 are no longer relevant, and similar provisions are not found in the Ukrainian Standard Natural Gas Transmission Contract item VIII, 8.3 and 8.4. Consequently, the current Article 9.5 becomes the new Article 9.3 which now implements the payment procedures established in the Ukrainian Standard Natural Gas Transmission Contract items VIII, 8.3 and 8.4.

7.1.7.1.1.10 Article 10.4 (Liability)

(759) A rudimentary balancing system is provided for in Article 10.4 of the Contract, together with Articles 3.4 and 4.3. This system is not in compliance with European and Ukrainian competition and energy legislation, cf. and Articles 101 and 102 TFEU, Article 18 ECT and national Ukrainian competition law as well as preamble (31) and Articles 13(3) and 41(6)(b) of Directive 2009/73/EC. The detailed balancing principles are set out in Article 21 of Regulation 715/2009 and further specified in Commission Regulation (EU) No. 312/2014 of 26 March 2014 establishing a Network Code on Gas Balancing of Transmission Networks (the "NC BAL"). The balancing requirements of the Third Energy Package is now implemented in Ukrainian legislation.

Article 35 of the 2015 Ukrainian Gas Market Law sets out the basic principles of balancing, which are further detailed in the Ukrainian Gas Transmission System Code Chapters XIII and XIV.

- (760) In order to bring the Contract in compliance with European and Ukrainian competition and energy law, Articles 3.4, 4.3 and 10.4 should be deleted and the balancing requirements left to mandatory Ukrainian law in accordance with the principle established in the new second paragraph of Article 13.2 and the replaced Article 13.6. As explained above, Naftogaz has proposed to replace Article 3 and 4 in their entirety, including Articles 3.4 and 4.3. This means that Article 10.4 will be deleted.

7.1.7.1.11 Article 13.2 (Replacement clause)

- (761) Efficient regulatory oversight by national regulators and minimum requirements as regards the tasks and powers of national regulators as well as the cooperation between national regulators on cross-border issues are prescribed by Directive 2009/73/EC Chapter VIII, in particular Articles 41(1), 41(6)(a) and (c), 41(9) and 41(10) and 42(2)(a)-(c), as well as by Articles 101 and 102 TFEU, Article 18 ECT and national Ukrainian competition law. The tasks and powers of regulators established in European energy legislation to ensure efficient regulatory oversight are now implemented in mandatory Ukrainian legislation, cf. Article 4, cf. Article 59, of the 2015 Gas Market Law.

- (762) In order to bring the Contract in compliance with European and Ukrainian competition and energy legislation, Article 13.2 should be replaced by a provision that in addition to its present contents concerning the replacement of invalid and inefficient provisions, expressly specifies that the Contract is subject to the terms and conditions for access to the Ukrainian transport system that follow from mandatory law and decisions by the Ukrainian Regulator.

7.1.7.1.12 Article 13.6 (Amendment clause)

- (763) In order to be in compliance with the efficient regulatory oversight requirements of European and Ukrainian competition and energy legislation, cf. Section 4.5.4.12 directly above, Article

13.6 should be replaced with a provision which specifies that the procedure of written and signed amendments does not apply in cases where the amendments follows from mandatory law or decisions by the Ukrainian Regulator pursuant to the new Article 13.2.

7.1.7.1.1.13 Article 13.8 (Assignment clause)

- (764) Article 9 of Directive 2009/73/EC requires that energy supply and generation be separated from the operation of transmission networks which shall be carried out by an independent transmission system operator. The transmission system operator has the operational responsibility for the transmission system, cf. Article 13(1)(a), cf. Article 2(4), of Directive 2009/73/EC, including carrying out functions relating to cross-border transmission, cf. Article 32(2) of Directive 2009/73/EC, and establishing operational arrangements with adjacent TSOs, cf. Article 12 of Regulation 715/2009, read in conjunction with ACER's Framework Guidelines on Interoperability and Data Exchange Rules for European Gas Transmission Networks (the "FG INT") and ENTSOG's draft Network Code on Interoperability and Data Exchange Rules (the "INT NC").
- (765) This means that the TSO is responsible for granting non-discriminatory third-party access to the transport infrastructure, cf. Directive 2009/73/EC Article 13(1) and Regulation 715/2009 14(1). This now follows from Article 20(1), cf. Article 22 and Article 24, of the 2015 Gas Market Law and the Gas Transmission System Code Chapter I.3. In short, gas suppliers and gas traders cannot be involved in the transmission of natural gas, cf. also Articles 101 and 102 TFEU, Article 18 ECT and national Ukrainian competition law.
- (766) In order to bring the Contract in compliance with European and Ukrainian competition and energy legislation, Article 13.8 should be replaced with a contract provision allowing the Contract to be transferred to any entity designated TSO without Gazprom's consent. This requires consequential amendments to Article 4.6, see above. Naftogaz' claims that the assignment provision in Article 13.8, requiring written consent of the other Party, principally is invalid and/or ineffective from 1 January 2010, and that it shall be replaced with a new provision with effect from the date of the award, which will allow Naftogaz to assign its rights and obligations under the Contract to Ukrtransgaz or any other entity designated as TSO by Ukrainian authorities without the

written consent of Gazprom. The Contract consequently continues to apply between Naftogaz and Gazprom until after the award and the assignment of the Contract to the TSO.

7.1.7.1.14 The Technical Agreement with Annexes and Additional Agreements

(767)



(768)



7.1.7.1.15 Effective dates of the replacement claims

(769) As indicated above, only Article 13.8 concerning the assignment of the Contract is requested to be replaced with effect from the award. Other provisions are principally requested to be replaced with new provisions with effect as of 1 January 2010, alternatively with effect as of 1 February 2011, alternatively with effect as of 1 January 2015 or the earliest date stipulated by the Tribunal. The point in time from which the replacement takes effect is only of practical importance for the tariff provision in Article 8 and for Naftogaz' consequential claim for compensation for underpayment, which will also affect the calculation of the claims for compensation for underdeliveries.

7.1.8 Application of European competition and energy law to the Contract

7.1.8.1 Violation of mandatory public law

7.1.8.1.1 Ordre public

(770) The competition law provisions relevant in this case are of an *ordre public* character. The Tribunal has an obligation to apply Articles 101 and 102 TFEU.

(771) Agreements that are contrary to the competition law provisions are void, and thus not enforceable. Therefore, when deciding on the annulment or enforceability of an award, national courts must raise a question of competition law, even of their own initiative if necessary, so as to ensure that the arbitration award does not permit a violation of competition law.

(772) This also means that arbitrators need to ensure that their awards can be enforced in jurisdictions where competition law rules are public policy, as in any country within the Energy Community, including Sweden and Ukraine. Accordingly, contracts subject to the laws of a member of the Energy Community should be applied and interpreted by arbitrators in a manner which would not bring them into conflict with mandatory requirements of public law, in particular competition law rules.

(773) This is expressed in a judgement by the Court of Justice of the European Union ("ECJ") concerning annulment of an arbitral award contrary to Article 101 TFEU (former Article 81 EC).⁵³

(774) The same principles apply to arbitral awards contrary to Article 102 TFEU (former Article 82 EC), cf. Bellamy and Child, pages 1262-1264.

7.1.8.1.1.1 Invalidity and its consequences

(775) A prohibited practice arising from a contract does not automatically invalidate the contract as a whole, as also follows from Article 13.2 of the Contract. In line with this, Naftogaz does not claim that the Contract is invalid as such due to competition law violations, but rather claims that certain provisions therein are invalid and that the severability clause in the Contract should be applied to replace certain of the invalid provisions.

⁵³ ECJ Judgment in Case C-126/97, *Eco Swiss China Time Ltd v Benetton International NV*, dated 1 June 1999, paragraphs 36-40

7.1.8.1.1.2 Public international law does not prevent the application of EU rules

(776) In accordance with public international law, EU competition law has jurisdiction if the agreement or practice is either *implemented in* or *produces effects* within the EU.⁵⁴ As summarised in Faull & Nikpay:⁵⁵

"Articles 101 and 102 apply irrespective of where the undertakings are located or where the agreement was concluded. Articles 101 and 102 may also apply to agreements and practices that cover third countries and are entered into or conducted by undertakings established in those countries, provided that the agreements and practices are capable of affecting trade between Member States. According to paragraph 100 of the Effect on Trade Guidelines, EU law is applicable if the agreement or practice is either implemented in or produces effects inside the EU. As such, the application of EU law is compatible with the requirements of public international law."

(777) The notions of "*implementation*" and "*effects*" within the EU have been interpreted in two leading cases before the EU courts *Woodpulp* and *Gencor*.

(778) In *Woodpulp*, the ECJ laid down the basis for the implementation doctrine, which means that when companies established outside the EU take steps to implement an agreement or a practice within the territory of the EU, Articles 101 and 102 TFEU are applicable, provided that there is an effect on trade between Member States.

(779) The ECJ went on to state that, in such a situation, the EU's jurisdiction to apply its competition rules is covered by the territoriality principle as recognised in public international law. The territoriality principle may be invoked where conduct either takes place within a nation's borders or the effects of the conduct are felt within those borde.

⁵⁴ The Effect on trade Guidelines, paragraphs 100-109.

⁵⁵ "The EU Law of Competition", at page 304.

(780) In *Gencor*, the General Court elaborated further on issues concerning the jurisdiction of the EU rules on competition. When considering the compatibility of the European Commission's decision with public international law the Court stated (paragraph 90):

"Application of the [Merger] Regulation is justified under public international law when it is foreseeable that a proposed concentration will have immediate and substantial effect in the Community."

(781) In *Gencor*, the General Court extended the scope of EU jurisdiction to also include the so-called *effects doctrine*. According to the *effects doctrine*, jurisdiction may be established when an agreement or practice has economic effects within a certain territory. It has thus been accepted that if it is foreseeable that an agreement or a practice will have substantial effect within the EU, EU law applies by virtue of the territoriality principle as recognised by public international law.

(782) In both of the General Court decisions in which the qualified effects doctrine has been applied (*Gencor* and *Intel*) were specifically concerned with the *Commission's jurisdiction* to apply the competition rules to undertakings based outside the EU. In both cases the courts held that the Commission's jurisdiction was justified as a matter of public international law where the agreement or conduct at issue had sufficiently significant effects in the EU.

(783) In a private law case no question of "jurisdiction" in this sense arises: the Tribunal simply needs to determine the applicable law in accordance with the relevant choice of law rules, and apply that law to the dispute. Public international law considerations are incorporated, to the extent appropriate, in the rules of private international law. It is not correct or appropriate to decline to apply a law which is otherwise applicable pursuant to the private international law rules for reasons of public international law. Public international law by its very nature cannot and does not apply directly to private law disputes.

- (784) That analysis is consistent with the opinion of Advocate General Nils Wahl's opinion in *Intel*.⁵⁶ Thus, the Advocate General expressly confined his reasoning to "*the issue of jurisdiction with regard to the public enforcement of EU competition rules*"⁵⁷ (Naftogaz' emphasis). He was careful to say nothing about cases of private enforcement,⁵⁸ thereby implicitly recognising that different considerations would apply to such cases.
- (785) In its judgment of 6 September 2017, the CJEU in Case C-413/14 P *Intel Corporation Inc. v European Commission* (the "Intel judgment") has clarified the so called Qualified Effects Doctrine (the "QED").
- (786) Whereas it was previously common ground between the Parties that the CJEU had not pronounced on the status of the QED, the Intel judgment confirms unequivocally the existence and validity of the QED as a part of EU law (cf. §§ 41-47 of the Intel judgment). In particular, the CJEU has found that where it is "*foreseeable that the conduct in question will have an immediate and substantial effect in the European Union*" then EU competition law applies (cf. § 49 of the Intel judgment).
- (787) The Gas Transit Contract concerns the transmission of very significant natural gas volumes through the territory of Ukraine and into EU countries. As noted by ██████████ in his witness statement: "*The volumes of gas transported by Gazprom to European offtakers is of such a large scale that such volumes cannot be easily rerouted through alternative routes.*"⁵⁹ Without the Contract, Russia would not be able to supply the full volumes that it is supplying into EU countries, which would instead have to source natural gas and/or other fuels from suppliers and traders in other countries.
- (788) For example, should Gazprom supply smaller volumes to Poland, buyers in Poland would have to import larger volumes of natural gas and/or other fuels from suppliers in other countries.

⁵⁶ Opinion of Advocate General Wahl, 20 October 2016, *Intel Corporation Inc. v European Commission* (Case C-413/14 P)

⁵⁷ *Ibid.*, § 267.

⁵⁸ *Ibid.*, footnote 176

⁵⁹ *See* ██████████ paragraph 17.

Considering the significant gas volumes transited under the Contract and the fact that Gazprom supplies a substantial share of total EU demand for natural gas, the Contract may in fact be among the agreements that have the largest impact on trade between EU countries.

- (789) In addition, several restrictive provisions in the Contract and abusive practices engaged in by Gazprom individually affect trade between EU countries, *inter alia*, by impeding exports into the EU from Ukraine, hindering suppliers located within the EU from marketing their gas on the Ukrainian market, as well as preventing the transit of gas between EU Member States through Ukraine.
- (790) Accordingly, the Transit Contract has an immediate, substantial and foreseeable impact on trade flows within the EU. The territoriality principle in public internal law is therefore satisfied, and EU competition law applies to the Contract.

7.1.8.1.2 Effect on trade under Articles 101 and 102 TFEU

7.1.8.1.2.1 The concept of effect on trade

- (791) The effect on trade criterion confines the scope of application of Articles 101 and 102 TFEU to agreements and practices that are capable of having a minimum level of cross-border effects within the EU.
- (792) The criteria determining whether an agreement or a practice may affect trade between EU Member States have been given a liberal interpretation, and even indirect or potential effects on the pattern of trade between EU countries are sufficient.⁶⁰

Trade between EU Member States: The concept of "trade" is not limited to traditional exchanges of goods and services across borders. It is a wider concept, covering all cross-border economic activity, including establishment. This interpretation is consistent with the fundamental objective of the TFEU to promote free movement of goods, services, persons and capital. The requirement

⁶⁰ *Effect on trade Guidelines*, paragraph 18 *et seq.*

that there must be an effect on trade "between EU countries" implies that there must be an impact on cross-border economic activity involving at least two EU countries;

May affect: The function of the notion "may affect" is to define the nature of the required impact on trade between EU countries. According to the standard test developed by the Court of Justice of the European Union, the notion "may affect" implies that it must be possible to foresee with a sufficient degree of probability on the basis of a set of objective factors of law or fact that the agreement or practice may have an influence, direct or indirect, actual or potential, on the pattern of trade between EU countries. In cases where the agreement or practice is liable to affect the competitive structure inside the EU, EU law jurisdiction is established;

Appreciability: The effect on trade criterion incorporates a quantitative element, limiting EU law jurisdiction to agreements and practices that are capable of having effects of a certain magnitude. Appreciability can be appraised in particular by reference to the position and the importance of the relevant undertakings on the market for the products concerned. The assessment of appreciability depends on the circumstances of each individual case, in particular the nature of the agreement and practice, the nature of the products covered and the market position of the undertakings concerned.

(793) As pointed out by the Energy Community Secretariat in its assessment, a market share above 30% is a reasonable indicator of market power. With this in mind, the Secretariat states that "it is clear that the degree of market power exercised by both Naftogaz and Gazprom on the relevant market exceeds the level below which competition concerns are unlikely to arise." Thus, the market power enjoyed by the Parties indicates that any restrictions on competition are likely to be in violation of Article 101 TFEU, much as in the case of Article 102 TFEU where a market share above 50% gives a presumption of dominance.

7.1.8.1.2.2 Effect on trade – whole agreement or individual provisions?

(794) When assessing the effect on trade criterion, it is not necessary to conclude that each provision in an agreement or each part of a practice is capable of affecting trade between EU Member

States (or between members of the Energy Community). Focus shall be on the whole agreement or practice when carrying out that analysis.

(795) In respect of Article 101 TFEU, it is the agreement as such which must be capable of affecting trade between EU Member States. If the agreement as a whole is capable of affecting trade between EU countries, EU law has jurisdiction over the entire agreement, including any parts of the agreement that individually do not affect trade between EU Member States, cf. the *Effect on trade Guideline* and Bellamy & Child, *European Union Law of Competition*.

(796) In the case of Article 102 TFEU, it is the abusive practice as such which must affect trade between EU Member States. This does not mean that each element of the behaviour must be assessed in isolation. A conduct that forms part of an overall strategy pursued by the dominant undertaking must be assessed in terms of its overall impact. Where a dominant undertaking adopts various practices in pursuit of the same aim, for instance practices that aim at foreclosing markets or competitors, in order for Article 102 TFEU to be applicable to all the practices forming part of this overall strategy, it is sufficient that at least one of these practices is capable of affecting trade between EU Member States, cf. *Effect on trade Guidelines*.

7.1.8.1.2.3 Effect on trade by the Contract and related practices

7.1.8.1.2.3.1 Article 101 TFEU (and Article 18(1)(a) ECT)

(797) The Contract regulates and is the basis for the transmission of substantial volumes of natural gas volumes through the territory of Ukraine and into several different EU countries. Gazprom is the most important supplier of natural gas into the EU. Gas is supplied at the wholesale level across borders within Europe, so a reduction of gas imported from Russia would immediately cause a buyer to source volumes from suppliers in other countries. Accordingly, the Contract has a significant effect on trade flows between EU countries.

(798) To establish that an agreement may affect trade within the meaning of Article 101, it is not necessary to establish a link between the restrictions of competition and the capacity of an agreement

to affect trade between EU countries, cf. *Effect on trade Guidelines*. It is sufficient that the agreement as such may affect trade between EU countries.

(799) Nevertheless, it may be added that the Contract contains several restrictions which individually contribute to isolating Ukraine from the EU market and to prevent transit between EU countries through Ukraine.

(800) Against this background it can be concluded that the Contract affects trade within the meaning of Article 101 TFEU and Article 18(1)(a) ECT, cf. to this effect also Section III.C of the Expert Reply.

7.1.8.1.2.3.2 Article 102 TFEU (and Article 18(1)(b) ECT)

(801) Gazprom's abusive practices, which are either manifested in or related to the Contract, form part of an overall exclusionary and exploitative strategy, of which also the Gas Sales Contract forms part. This overall strategy entails isolating Ukraine from the market for the wholesale of natural gas (which includes the EU countries Poland, Hungary and Slovakia in addition to Ukraine) and forcing Naftogaz to accept business methods and arrangements which restrict gas supplies between Naftogaz and EU countries and gas transit between EU countries through Ukraine.

(802) In particular, Gazprom's abusive strategy has the effects of

- forcing Naftogaz to subsidise Gazprom's gas sales into EU countries through a below-cost tariff;
- impeding exports into the EU from Ukraine *i.a.* by preventing (virtual) reverse flows;
- hindering suppliers located within the EU from marketing their gas on the Ukrainian market; as well as
- preventing the transit of gas between EU Member States through Ukraine.

(803) The possibility of transiting gas between EU countries through Ukraine is explained by Mr Lapuerta and Dr. Hesmondhalgh in their Expert Reply. They provide a figure illustrating an example where a supplier in Poland could use the Ukrainian grid to sell gas to Hungary. The figure is repeated below for ease of reference.



(804) Even in the absence of direct pipeline connections, additional gas produced in Poland (the green arrow in the figure) can be sold to Hungary through "virtual reverse flows": Polish imports from Ukraine is reduced by the same volume (the red dotted line) and this volume is redirected to Hungary (the blue arrow). This is just one example. As pointed out in the Expert Reply, similar diagrams can explain trade in either direction between any of Poland, Hungary, Slovakia and Ukraine. By impeding such trade, Gazprom's conduct directly affects trade flows between these countries.

(805) Restrictions on gas sales between Ukraine and an EU country also affect trade flows between EU countries. One example is Gazprom's refusal in June 2012 to permit reverse flows for the purpose of Naftogaz' gas purchases from RWE, as described in [REDACTED] witness statement

(cf. [REDACTED] Section 6.3.4). Such blocking of sales from Germany to Ukraine must be expected to affect trade flows between EU countries, since the RWE volumes in question would instead be sold to another buyer. Similarly, reduced imports to an EU country from Russia mean that larger volumes must be imported from another source.

(806) Since Gazprom's abusive practices form part of an overall infringement, it is sufficient that only one of the practices is capable of affecting trade within the EU (and the Energy Community). Accordingly, Article 102 TFEU and Article 18(1)(b) apply to each of Gazprom's practices under and related to the Contract and the Gas Sales Contract. The Expert Reply describes how Gazprom's abusive practices distort trade between EU Member States.

7.1.8.1.3 EU energy law as an operationalization of Articles 101 and 102 TFEU

7.1.8.1.3.1 Introduction

(807) In this context, the concept of operationalization means that the energy provisions are used as arguments in the application of Articles 101 and 102 TFEU and Article 18 ECT. The main principles contained in energy law can as a general rule be said to also follow from the application of Articles 101 and 102 TFEU to restrictive agreements and abusive behaviour (e.g. principles such as third-party access, non-discriminatory and cost-reflective pricing and unbundling). Often, the solutions found in energy law, which are designed to solve the competition concerns in question, constitute the most appropriate practical application of Articles 101 and 102 TFEU.

(808) Gazprom disputes that EU energy law operationalizes EU competition law, arguing that EU competition law and EU energy law apply separately and in parallel. Gazprom inter alia argues that the secondary energy market legislation has been adopted, not on the basis of Articles 101 and 102 TFEU (cf. Article 86(3) EC, now Article 106 TFEU (3)), but on the basis of Article 114 TFEU (i.e. the internal market provision in Article 95 EC).

(809) According to Gazprom, operationalization "*would appear to be a concept that Naftogaz has simply invented*". Gazprom's allegation is wrong. The relationship between competition law and

energy law is fundamental to the nature of the two sets of rules and they both serve to achieve effective competition.

(810) Furthermore, since competition and energy law have to be applied in parallel to the Contract (EU and ECT competition law, and ECT energy law), there is a need for harmonisation of the requirements of competition and energy law when replacing the problematic provisions with compliant ones. The principle of operationalization facilitates this harmonisation, and avoids differing requirements under competition and energy law respectively.

(811) EU competition law, i.e. Articles 101 and 102 TFEU, applies directly to the Contract, since it affects trade within the EU. The provisions of EU energy law relied on by Naftogaz, in particular Directive 2009/73 and Regulation 715/2009 of the Third Energy Package, constitute an operationalization of EU competition law. By referring to "operationalization" Naftogaz does not seek to rely directly on EU energy law provisions, but uses them as evidence of competition concerns and indications of how those concerns should be solved.

(812) The means and instruments introduced by the secondary energy market legislation are developed inter alia on the basis of the essential facilities doctrine, which is based on Article 102 TFEU. The essential facilities doctrine provides that when access to transport networks such as gas pipelines is indispensable to supply customers, such access must be granted on conditions that are non-discriminatory.

(813) Also, the secondary energy market legislation is based on the general prohibition against discriminatory and other anti-competitive practices, including discriminatory pricing, in Article 101 TFEU, and serves to specify its application in a sector specific context. The secondary energy market legislation was introduced on the understanding that the internal market for energy could not be achieved on the basis of application of Articles 101 and 102 TFEU on a case-by-case basis alone.

(814) The principle which the term "operationalization" is based on is well known and since long established under EU law. Sophie Robin-Olivier, in *The evolution of direct effect in the EU: Stock-taking, problems, projections*, in *International Journal of Constitutional Law*, explains that EU law has in fact developed several concepts where two norms of EU law are combined to produce legal effects (page 168):

"Among the various ways in which EU law norms are invoked before national courts, there is one which contrasts sharply with the Van Gend en Loos concept of direct effect: the combination of norms emanating from different sources of law. Indeed, in some cases, it seems as if effectiveness of European law depended not on the respective legal force of the norms invoked before the court, but on the relationship that they entertain. To be sure, this phenomenon is not specific to EU law, but it takes on specific forms in EU law, in light of the specific system of norms of that legal order.

Van Gend en Loos implied identification by judges of EU law norms possessing direct effect: such norms could be the basis for subjective rights. The case led to distinctions among, and the constitution of, different categories of norms, depending on their capacity to produce direct effect. Although this is not coming to an end, and the taxonomic enterprise must go on, since many new provisions of EU law come to life with an uncertain nature, the power accorded to normative combinations has made it less important than before to ascertain the exact effect of each provision of the law."

(815) And elsewhere (page 174-175):

"Considering the different categories of normative combinations that contribute to the development of EU law, it is no exaggeration to say that the effects of EU law in national courts no longer depend on the identification of norms capable of producing certain legal effects. Rather, it has become crucial to take into account the fact that EU law provisions are often effective when articulated with one another, or with norms borrowed from other legal systems, which are not necessarily binding, but can allow for an evolutive interpretation of the law."

(816) Of particular interest in the current case is the combination of a general principle capable of producing legal effects directly and horizontally and parallel detailed norms embracing the principle where the latter norms are not (or are argued not to be) directly effective. In Robin-Olivier's words (page 171):

"[m]ore original, and specific to EU law, are cases in which a directive and a general principle are combined to produce effects, the former being considered a mere "concretization" of the latter."

(817) This approach has been utilised by the ECJ in several cases e.g. *Mangold*⁶¹ and *Küçükdeveci*⁶², [cf. Robin-Olivier, pages 171-172 and Schütze, *European Constitutional Law*, pages 334-337.

(818) Of even greater interest is that the ECJ in these two cases combined a general non-discrimination principle with a directive (in itself clearly unable to produce direct *horizontal* effects), thereby effectively granting and imposing on individuals direct, horizontal and substantive rights and obligations conforming to the substantive content of the provisions of the directive.

(819) Thus, *in practice* the general principle made the directive provisions effective. *Theoretically* however, the legal basis was the general principle which was "concretized" (or "operationalized" in Naftogaz' terminology) by the directive provision. Hence, there is no doubt that Naftogaz' combination of EU norms is an established EU law concept and tool irrespective of whether it be termed "operationalization", "concretization" (cf. Robin-Olivier above and Leczykiewicz in *Oxford Handbook of European Union Law*, page 241) or "normative combination" (Robin-Olivier).

⁶¹ C-144/04 *Mangold*, 2005 E.C.R. I-09981

⁶² C-555/07 *Küçükdeveci*, 2010 E.C.R. I-00365

- (820) Leczykiewicz, at page 242, succinctly explains that the effect of this EU law principle is that "[a] contractual term is reviewed against a general principle that is taken to have the same substantive content as a Directive".
- (821) Naftogaz relies *inter alia* on the energy rules as operationalization (*aka* concretization) of the general principles for ensuring fair competition in Articles 101 and 102 of the TFEU and Article 18 of the ECT. Moreover, Naftogaz relies on a combination of the general prohibition against discrimination in Article 7 ECT and the detailed energy rules set out in 2009/73 and Regulation 715/2009. In this respect, Naftogaz invokes both the legal discrimination which would arise if the Arbitral Tribunal would not apply like cases like, as well as the factual discrimination of market participants to the benefit of Gazprom, which is inherent in the Contract.
- (822) *Mangold* and *Küçükdeveci* set out a general principle of EU law which was subsequently also recognised in *AMS*.⁶³
- (823) In *AMS*, however, the facts were different, as the general principle sought to be applied was in itself subject to considerable additional legislation measures in the EU and the Member States. The case therefore, on the facts, concerned a general principle not capable of having direct horizontal effect and was therefore distinguished by the Court. Nevertheless, the Court recognised the generality of *Küçükdeveci*.
- (824) *Mangold* also sets out another important principle. In *Mangold*, the time for implementing the directive and its provisions had not expired. However, this was not an obstacle for affording an individual the substantive rights set out in the directive provisions before the time for transposing the directive into national law had expired.
- (825) The explanation is that the legal basis for the normative combination is *the principle*, not the detailed EU law provisions (here in a directive). Hence, as the principle applied before the due date for the implementation of the detailed rules, there was no obstacle in relying on the principle

⁶³ Case C-176/12 *Association de médiation sociale v Union locale des syndicats CGT et al.*, at paragraphs 41 and 47.

as concretised by the directive provisions, even though the directive was not yet due for implementation, also see Dorota Leczykiewicz,

- (826) This is important in respect of the energy rules set out in Directive 2009/73 and Regulation 715/2009, as incorporated into the ECT. Hence, the fact that the ECT provides a timetable for implementing parts of the Third Energy Package into Ukrainian law cannot preclude the application of the non-discrimination clause operationalized/concretized by the detailed energy rules already from the time when Ukraine had acceded to the ECT on 1 February 2011, alternatively when the Third Energy Package had been incorporated into the ECT, i.e. from 6 October 2011. EU energy law applies as an operationalization of EU competition law at least from 1 January 2010, after the adoption of the Third Energy Package in 2009.
- (827) It should be emphasised that the above cases of combination have concerned a general provision of Community law (the EU Charter of Fundamental Human Rights) and the provisions of directives where the two were not explicitly connected to each other.
- (828) In this case, there is no debating that the detailed energy rules are connected to Articles 101 and 102 of the TFEU as well as Article 18 of the ECT, or that the detailed energy rules invoked by Naftogaz are connected to the non-discrimination provision in article 7 of the ECT and even designed to avoid discrimination between market participants. In fact, as regards Articles 7 and 18 of the ECT, there is not even a combination of two legal instruments (as in *Mangold*, *Küçükdeveci* and *AMS*), merely of rules contained in the same legal instrument, the ECT, the general provisions being set out in its body and the detailed provisions in the appendices.
- (829) Moreover, the combinations in *Mangold* and *Küçükdeveci* were between a general provision theoretically capable of having direct horizontal effect and a directive which according to EU case law normally cannot have provisions with direct horizontal effect (but in practice was given such effect). In this case, Naftogaz seeks a combination of two sets of rules which, as such, each have the capacity to have direct horizontal effect if the pre-requisites are met (the energy rules form

part of a treaty concluded by the EU which is directly applicable and can contain provisions with direct horizontal effect).

7.1.8.1.4 Abuse of a dominant position - Article 102 TFEU

7.1.8.1.4.1 Dominant position

(830) Article 102 TFEU prohibits undertakings holding a dominant position from abusing it. An undertaking is deemed to be dominant when it enjoys a position of economic strength, which enables it to prevent effective competition on the market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately consumers. The ECJ has defined dominance as:

*"a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers. Such a position does not preclude some competition, which it does where there is a monopoly or a quasi-monopoly, but enables the undertaking which profits by it, if not to determine, at least to have an appreciable influence on the conditions under which that competition will develop, and in any case to act largely in disregard of it so long as such conduct does not operate to its detriment."*⁶⁴

7.1.8.1.4.2 Abuse

(831) A dominant undertaking is not allowed to abuse its dominant position, i.e. it cannot hinder or eliminate competition through recourse to methods different from those which condition normal competition. Abuses may be defined as exclusionary (i.e., an abusive conduct which excludes or attempts to exclude other competitors from the market, e.g. by applying discriminatory measures) or exploitative (i.e. an abusive conduct aimed at directly exploiting customers or final consumers).

⁶⁴ ECJ Judgment in Case C-85/76, *Hoffmann-La Roche v Commission*, paragraphs 38-39

7.1.8.1.4.3 The relevant time for assessing abuse

- (832) Gazprom argues that whether a contractual term (or its enforcement) amounts to an abuse can only be judged as at the date of the agreement, since that allegedly is the only time at which a dominant firm can exercise its market power. It is not a defence for Gazprom to show that the disputed pricing and other terms were reasonable when they were agreed in 2009, if as a result of changed circumstances the enforcement of the terms now risks distorting competition.
- (833) Art 102 does not require any causal link between the dominance and the abuse. See: (i) *Continental Can* at §§ 26-27; (ii) *Hoffmann-La Roche* at § 51; (iii) *AstraZeneca* at § 354 (“an abuse of a dominant position does not necessarily have to consist in the use of the economic power conferred by a dominant position”); (iv) Sir Francis’s Transit Opinion, and (v) Sir Francis’s oral evidence in the Gas Sales Arbitration at Day 9 144 to 148.
- (834) There are many cases where the enforcement of a right by a dominant firm has been held to be abusive, or potentially abusive, even though the right does not derive from the dominant position. For example, owners of essential facilities, or patents, enjoy property rights which give them a dominant position that did not exist at the time when they acquired the relevant rights. See Sir Francis’s evidence in the Gas Sales Arbitration at Day 9 161 3-9. In *ITT Promedia* it was even held that a dominant firm could commit an abuse by exercising the fundamental right of access to the courts – a universal right in no way connected with dominance – under certain (necessarily extreme) circumstances. Further, the AMCU has found that Gazprom abused its dominant position as a purchaser of natural gas transit services by refusing to *renegotiate* existing contractual terms with Naftogaz.

7.1.8.1.5 The Expert Report

- (835) The key findings of the Expert Report⁶⁵ with respect to competition law issues are as follows, cf. Executive Summary in the Report:

⁶⁵ First Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh in the Gas Transit Arbitration, dated 30 April 2015.

- Gazprom has a dominant position in the natural gas markets of Ukraine and other European countries that rely heavily on Russian natural gas supplies. The Transit Contract gives Gazprom an important role in the related market for transporting natural gas to and from Ukraine. Other gas companies need access to the Ukrainian transportation network in order to compete with Gazprom for the sale of gas to consumers in Ukraine.
- A Ukrainian gas company can make more attractive offers to its customers in Ukraine if it also has the ability to sell any excess gas supplies in Germany and countries like Slovakia, the Czech Republic, Hungary, Romania and Bulgaria. By abusing its influence over the Ukrainian transmission network, Gazprom could limit the ability of competitors in Ukraine to sell excess supplies in Western Europe, which would put them at a competitive disadvantage when selling gas in Ukraine.
- Gazprom is a large provider of natural gas to the German natural gas market, with a sufficiently large market share to occupy a dominant position. By limiting the ability of competitors to sell excess supplies in Germany, Gazprom could affect the German market price and protect its own dominant position in Germany. A similar logic applies to other countries that rely largely on Gazprom supplies via Ukraine: Bulgaria, the Czech Republic, Greece, Hungary, Poland and Slovakia.
- The Contract creates a serious conflict of interest by giving Gazprom influence over a key asset that other gas companies need in order to compete successfully with Gazprom. To use the Ukrainian transportation network, competitors must disclose information concerning their gas sales transactions that would travel through Ukraine.
- Gazprom has abused its conflict of interest by refusing to permit "virtual reverse flows" over the Ukrainian transmission network. Virtual reverse flows provide an efficient mechanism for facilitating the trade of natural gas between at least ten European countries that are interconnected via the Ukrainian pipeline network. Refusing to permit virtual reverse

flows distorts trade, and limits the scope for competition in European countries where Gazprom has a dominant position.

- "Unbundling" would address the concerns related to Gazprom's access to commercially sensitive information, and Gazprom's distortion of trade between European countries. Naftogaz should assign the Transit Contract to Ukrtransgaz, and Gazprom should no longer be involved in the "technical implementation" of the Transit Contract.
- Gazprom should be subject to the same rules as competitors for balancing its natural gas supplies on the Ukrainian transmission system, and for using pipeline capacity. Gazprom should retain a long-term booking for "entry" capacity at the eastern borders of Ukraine, and "exit" capacity at Ukraine's western borders. The terms of the capacity booking should be identical to the terms for all other capacity bookings on the Ukrainian gas transportation network. Gazprom should be subject to the same balancing arrangements that apply to all entry and exit points.
- The pricing under the Transit Contract stands out for its failure to impose a fixed capacity charge. A fixed charge would generate substantial transit revenues regardless of the actual volumes of gas that Gazprom transits through Ukraine each year. If Gazprom continues to pay the low charges then the only way to recover costs is for the Ukrainian transportation network to charge substantially higher prices to other users of the pipeline network. However, the result would be to discriminate in favour of Gazprom, conferring upon it a decisive competitive advantage.

7.1.8.1.6 The Expert Reply

(836) The Expert Reply⁶⁶ responds to the criticisms of the Expert Report made in the Reports of Dr. Moselle and Mr Witschen.

⁶⁶ Second Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh in the Gas Transit Arbitration, dated 12 February 2016.

(837) According to the Expert Reply,

"Gazprom and its witnesses have ignored substantial portions of the empirical analysis in Brattle's First Report on Transit, have ignored the further work defining the market and explaining Gazprom's dominance in Mr Lapuerta's Second Report on Competition in the gas sales case, and they largely sidestep many of the key competitive issues in this case. The result is the adoption of several unrealistic and extreme positions."

(838) As reflected in the Executive Summary of the Expert Reply, it focuses on the following key elements of Gazprom's objections to the Expert Report and the Statement of Claim with respect to the claims based on competition and energy law:

- The geographic market: The analysis in the Expert Reply supports including Slovakia, Hungary and Poland in the geographic market for gas sales.
- Gazprom's dominant position in the gas sales market: The Expert Reply calculates Gazprom's market shares for a broader market consisting of Ukraine, Slovakia, Poland and Hungary. The conclusions of dominance are the same whether looking at production and sale in any one year or at the volumes under long-term contracts.
- Gazprom's abuse in the transmission market: Gazprom has a dominant position within gas sales, which it has leveraged to negotiate a transit contract that permits it to abuse the Ukrainian transportation network to gain access on preferential terms, and to impede the use of the network by rivals, which reinforces Gazprom's dominant position in the gas sales market.
- Access to commercially sensitive information: The Contract has put Gazprom in the position of abusing commercially sensitive information, in particular by permitting Gazprom Export to become the matching partner for neighbouring TSOs.

- Impeding virtual reverse flows: The implementation of virtual reverse flows should not be conditional upon negotiation or agreement with a dominant gas supply company. All of Gazprom's competitors should have equal access to the network, which should not depend on having a good commercial relationship with Gazprom's supply business.
- The lack of an entry/exit system, a separate capacity charge and balancing rules: An entry/exit system is an important ingredient for promoting competition in Ukraine, and exempting Gazprom from such a system would be discriminatory and distort the competitive playing field. The same applies to a separate capacity charge and balancing rules.
- The reasonableness of the transit tariffs: The use of historical costs is common in Europe and often reasonable, but in this case replacement costs are superior. Much of the Ukrainian network dates from the Soviet era in which the absence of a competitive market deprived historical accounting costs of any economic meaning. Several other East European countries also use replacement costs to measure the regulated asset bases of their transmission networks. This is in line with the methodology that the Ukrainian regulator has approved for implementation on 27 February 2016.

7.1.8.1.7 Application of Articles 101 and 102 TFEU - general

7.1.8.1.7.1 Factual background

(839) The assessment of the Energy Community Secretariat provides some general information on Ukraine's natural gas market. Naftogaz notes in particular that;

- Ukraine's economy is largely dependent on natural gas as a primary source of energy. Domestic natural gas production is unlikely to satisfy the country's entire demand in the short and medium term.
- Since disintegration of the Soviet Union in 1991, Russia has been the exporting state for the bulk of natural gas imported into Ukraine, which amounts on a constant annual basis to over

50% (up to 70% in certain years, e.g. in 2011) of the total natural gas consumption in the country.

- Until recently, the natural gas market in Ukraine remained heavily monopolised. At the time of execution of the Contract, Naftogaz was operating a monopoly for imports of natural gas and for further sale of imported natural gas in Ukraine.
- The gas transmission network of Ukraine is one of the largest in Europe. Its capacity at entry and exit points equals 288 bcm and 178.5 bcm, respectively. The total length of main gas pipelines equals 39,800 km.
- On the North-Western, Western, and South-Western borders of Ukraine, the Ukrainian gas transmission network is physically connected to gas pipelines in Poland, Slovakia, Hungary, Romania, and Moldova. The Ukrainian gas transmission network is conveniently located and capable of carrying significant amounts of natural gas.
- While in 2012-2013 the amount of gas in transit through Ukrainian territory decreased in absolute figures (by appr. 20% compared to 2011), its share in total volumes of gas reaching customers through Ukrainian pipelines has increased to 75% in 2013.
- The Ukrainian gas transmission network legally and physically belongs to a wider Unified Gas Transport System ("GTS") of Ukraine, i.e. an industrial complex designated for transmission, distribution, and storage of natural gas. Public Joint-Stock Company Ukrtransgaz ("Ukrtransgaz"), a 100% subsidiary of Naftogaz, is entrusted with the functions of the operator of the Ukrainian GTS.
- Transportation of gas constitutes a monopoly under the laws of Ukraine which is performed by Ukrtransgaz. Services related to the transmission of gas via main pipelines of the Ukrainian GTS are currently procured by Naftogaz, Gazprom, and, after partial market opening, a limited number of end-users.

- The Ukrainian GTS requires comprehensive modernisation and rehabilitation to increase its reliability and capacity to be able to transport the huge quantities of gas needed for both Ukraine and the EU without disruption.

7.1.8.1.7.2 The relevant market

7.1.8.1.7.2.1 Introduction

- (840) Market definition is a tool to identify and define the boundaries of competition between undertakings. The objective of defining a market in both its product and geographic dimension is to identify the actual competitors of the undertakings involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure. The market definition is the starting point for the assessment under both Article 101 and 102 TFEU.
- (841) The competition concerns related to the Contract arise based on two aspects of the gas market. Firstly, gas transmission is a natural monopoly which both gas suppliers and customers depend on, with obvious competition concerns in terms of potential for both discrimination, foreclosure and exploitation. The objective of the energy law discussed in Section 3 below is to remove the possible challenges to competition based on this aspect.
- (842) Secondly, Gazprom's dominant position within gas sales gives potential for influence on the operation of the gas transmission system which further leaves the Ukrainian gas market, as well as neighbouring gas markets vulnerable to abusive practices, as evidenced by the Contract. The Contract is a realization of the competition concerns related to the natural monopoly of the gas transmission system in Ukraine, imposed and amplified by Gazprom as a dominant supplier of gas. The Contract's effects on both the transit market and the gas sales market are fundamentally obstructing the development of a competitive and liquid market for natural gas in Ukraine and other countries affected by the lack and mode of gas transit caused by the Contract.

(843) Thus, both the market for transit of gas, and the market for sale of gas, are relevant for the assessment of the Contract under Articles 101 and 102 TFEU. This is in line with the approach of the Energy Community Secretariat in its assessment, cf. Part IV, 3.1.1 of the assessment:

"Competition concerns arising from and in connection with the Gas Transit Contract extend beyond the immediate market on which services under the Gas Transit Contract are procured (i.e. market for gas transportation via main pipelines). By analogy with the AKZO case, such practices, by their object and effect, are susceptible to affect competition on the wholesale downstream market for natural gas in Ukraine. This is so considering that Gazprom maintains a long-term gas supply contract with Naftogaz (covering a substantial portion of the downstream demand) and that alternative supplies of foreign natural gas can reach Ukrainian customers only via main gas pipelines."

(844) The AKZO case is a landmark judgement by the European Court of Justice (ECJ) on *inter alia* dominance and abuse under Article 102.

7.1.8.1.7.2.2 The gas transmission market

(845) The European Commission has confirmed (i) that the transmission of natural gas is a distinct market, (ii) that the transmission of gas constitutes a natural monopoly, (iii) that the market for transmission is not wider than national and (iv) may be limited to each pipeline (each entry point to each exit point), cf. Commission Decision in Case No COMP/M.3696 - E.ON/Mol, dated 21 December 2005.

(846) It is not necessary to further define each separate relevant market for transmission of gas, as Naftogaz (i.e. Ukrtransgaz) has a natural monopoly covering for all practical purposes the territory of Ukraine, and Gazprom exerts its influence over this grid by virtue of its dominant position within gas sales in the Ukrainian market.

- (847) In line with the Commission's decision in *Exxon / Mobil*,⁶⁷ long-distance wholesale natural gas transmission constitutes a separate market from the gas sales market.
- (848) Mr Lapuerta and Dr. Hesmondhalgh endorse this market definition. Naftogaz/Ukrtransgaz has a natural monopoly covering for all practical purposes the territory of Ukraine.
- (849) As pointed out in the Expert Reply, Gazprom purchases the majority of long-distance transmission services in Ukraine. The unfair transmission tariff imposed by Gazprom represents an abuse of both its dominant position in the gas sales market and its position as the dominant purchaser of gas transmission services through Ukraine.

7.1.8.1.7.2.3 The gas sales market

- (850) It is well established that natural gas constitutes a market separate from other energy products such as fuel oil, coal or electricity (cf. Expert Reply). The significant divergence that has arisen between the market prices for oil and natural gas – often referred to as the "decoupling" of these prices – is possible only because natural gas and oil are separate markets (cf. Expert Reply).
- (851) The relevant product market is the market for the upstream production and sale of natural gas ("the gas sales market"), which comprises the development, production and upstream supply of gas to large importers/wholesalers. This market has been established and delineated in a series of decisions of the European Commission.⁶⁸
- (852) The market for upstream production and sale of natural gas is considered to be separate from the market for the exploration of crude oil and natural gas.⁶⁹
- (853) The market for the upstream production and sale of natural gas is also separate from the market for downstream wholesale supply of gas, in which wholesalers resell gas to other wholesalers

⁶⁷ Commission decision in Case No IV/M.1383 - Exxon/Mobil, dated 29 September 1999.

⁶⁸ Case M 6984 *EPH / Stredoslovenska Energitika* (Exhibit CL-160 in the Gas Sales Arbitration), paragraphs 21-23, and Case M 6910 *Gazprom / Wintershall / Target Companies* (Exhibit CL-161 in the Gas Sales Arbitration), paragraphs 83-91.

⁶⁹ Paragraph 83 of the M.6910 *Gazprom / Wintershall / Target Companies* case; and, paragraph 12 of Case M.6801 *Rosneft / TNK-BP* (Exhibit CL-162 in the Gas Sales Arbitration).

and local distributors.⁷⁰ *The relevant geographic market includes Ukraine, Poland, Hungary and Slovakia*

(854) The relevant market could potentially include suppliers from the Energy Community and Norway, in addition to Ukraine and Russia, although the competitive pressure from suppliers in many of these countries is non-existent or very limited. The Energy Community Secretariat found in its Preliminary Assessment that the relevant product market is the market for natural gas procured to satisfy the demand of Naftogaz in performing its public utility functions. In the Expert Report (cf. its Section III.B), the relevant market was considered as extending to actual imports into Ukraine, but not to potential or actual imports from Western Europe.

(855) In merger proceedings before the European Commission under the EU Merger Regulation, Gazprom has taken the position that the market for the upstream production and sale of natural gas is EEA-wide, cf. paragraph 87 of the *Gazprom / Wintershall / Target Companies* case:

"The Parties submit that the market is EEA-wide, including all imports [...]"

(856) and paragraph 20 of the *Gazprom / A2A / JV* case (Exhibit CL-163 in the Gas Sales Arbitration):

"The notifying Parties submit that the wholesale supply of natural gas has an EEA scope."

(857) However, as pointed out by the European Commission, due to restrictions resulting from *inter alia* absence of pipeline connections to suppliers and lack of import capacity, each gas supplier does not exert the same level of competitive pressure throughout Europe.⁷¹

(858) Consistent with this, the Commission has in recent decisional practice indicated that the geographic market may be regional within Europe (that is, extending to a region covering several countries) rather than EEA-wide.⁷²

⁷⁰ *Gazprom / Wintershall / Target Companies*, paragraphs 60 et seq.; and, *EPH / Stredoslovenska Energitika*, paragraph 21.

⁷¹ Case M.4545 *Statoil / Hydro* paras 14-15 (Exhibit CL-164 in the Gas Sales Arbitration)

⁷² Paragraph 12 of *Rosneft / TNK-BP* (Exhibit CL-162 in the Gas Sales Arbitration).

(859) In a recent merger decision, the Commission indicated that

*"from a supply-side perspective, the Commission considers that the geographic scope of the market might be limited to the relevant pipelines systems and would therefore rather be regional or national".*⁷³

(860) In another recent decision, which involved Germany, the Commission referred to its market investigation in which a majority of the respondents had indicated *"that Germany forms part of a regional geographic market rather than the entire EEA territory"*.⁷⁴

(861) In the same case the Commission emphasised that there were *"no indications of restricted inter-connection capacity restraining the amount of gas that can flow between the Netherlands, Norway and Germany"*. The Commission ultimately did not conclude on the geographic market in that case, while the factors referred to suggested a regional market.

(862) Against this background, the European Commission's decisional practice confirms that pipeline systems play a crucial role to the definition of the relevant geographic market, and that, depending on the pipeline systems, the geographic market may be regional, or in some cases national.

(863) Gazprom claims that Naftogaz has failed to carry out a hypothetical monopolist test or the SSNIP test and failed to define the market by reference to any actual empirical evidence.

(864) However, Mr Lapuerta and Dr. Hesmondhalgh applied the SSNIP test to determine that potential imports from Germany did not constitute part of the relevant market (cf. Expert Report). While the Expert Report did not apply the SSNIP test separately for Ukraine's neighbouring countries, such an analysis has been carried out in the Expert Reply (cf. Expert Reply and its Appendix B). The SSNIP test shows that the relevant geographic market includes Poland, Hungary and the Slovak Republic, since the transportation costs of bringing gas from these countries to Ukraine are at the low end of, or below, the 5-10% range assumed under this test. In the absence of

⁷³ Case M.7316 *Det Norske Oljeselskap / Marathon Oil Norge*, paragraph 7 – (Exhibit CL-165 in the Gas Sales Arbitration)

⁷⁴ Para 88 of *Gazprom / Wintershall / Target Companies* (Exhibit CL-161 in the Gas Sales Arbitration).

concrete information on tariffs, Mr Lapuerta and Dr. Hesmondhalgh make the necessary assumption of a harmonised tariff system (cf. Expert Reply and its Appendix B). Their analysis confirms that imports from Germany is not part of the relevant market, and that Romania should also not be included.

(865) As noted by Mr Lapuerta and Dr. Hesmondhalgh, Gazprom has erected barriers to gas trade between the countries that form part of the relevant market, including by refusing to permit so-called "virtual reverse flows". Gazprom's refusal to permit virtual reverse flows is the reason that discounted tariffs are not available, as noted by Mr Lapuerta and Dr. Hesmondhalgh (cf. Appendix B to the Expert Reply).

(866) The fact that Gazprom has exercised control over the transportation network to artificially block gas trade between Ukraine and its neighbouring countries cannot affect the economic reality that Poland, Hungary and Slovakia are part of the same geographic market as Ukraine due to the limited costs involved in importing gas from these countries.

7.1.8.1.7.2.4 Conclusion

(867) Against this background, it can be concluded that the relevant product market is the market for upstream production and sale of natural gas. This market extends beyond Ukraine, although Gazprom's abusive and restrictive practices have largely succeeded in keeping the territory of Ukraine artificially separated from the rest of the market. Based on the SSNIP test carried out in the Expert Reply, the relevant geographic market includes the territories of Ukraine, Slovakia, Poland and Hungary

(868) As follows from established case-law under EU competition law, the gas sales market is a separate product market, and thus needs to be distinguished from other sources of energy like electricity and oil, cf. the Energy Community Secretariat's assessment and the Expert Report.

(869) The relevant market for gas sales is only briefly described in the Energy Community Secretariat's Preliminary Compliance Report on the Transit Contract. It is described in more detail in the Secretariat's Preliminary Assessment of the Sales Contract.

(870) With reference to that assessment, Naftogaz notes that

- The Sales Contract concerns upstream supply of gas in or to Ukraine. Foreign gas reaches the Ukrainian wholesale market via either Naftogaz or a group of independent importers.
- The infrastructure for import of gas to Ukraine is in practice controlled to a large degree by Gazprom due to its contractual relations with Naftogaz, based on both the Sales Contract and the Transit Contract. Under the current contractual regime, the potential for imports from other countries is limited.
- In principle, the relevant market could include suppliers from the Energy Community and Norway, in addition to Ukraine and Russia. On the other hand, the competitive pressure from suppliers in many of these countries is non-existent or very limited.
- It may be debatable whether the relevant market shall be separated from the upstream activities of independent importers. The Secretariat is of the opinion that the relevant market is the market for natural gas procured to satisfy the demand of Naftogaz in performing its public utility functions. We agree with this assessment, since independent importers do not currently act as competitors to Gazprom, as pointed out by the Secretariat.
- The precise market definition, both as regards the product and the geographic dimension, can however be left open, as Gazprom clearly has a dominant position in any case, with a consistent market share well above 50%, which gives a presumption of dominance according to established practice by the ECJ.⁷⁵

⁷⁵ ECJ Judgment in Case C-62/86, AKZO Chemie BV v Commission, dated 3 July 1991, paragraph 60.

- (871) It should also be noted, as pointed out by the Secretariat in its assessment of the Sales Contract, that the foreclosure effects of that Contract make it unlikely that Naftogaz will benefit from the anticipated market opening in Ukraine, which will probably lead to an increase in the volume of foreign gas procured by independent importers. This emphasizes the need to separate between the imports by Naftogaz and independent importers respectively, even though also in this case the precise market definition can be left open for the same reasons as stated above.
- (872) In the Expert Report, the relevant market is considered as extending to actual imports into Ukraine, but not to potential or actual imports from Western Europe, nor to gas that domestic Ukrainian producers must supply to Naftogaz,]cf. the relatively detailed discussion of this in Section III.A of the Expert Report. This nuance is, however, not consequential when it comes to the assessment that Gazprom has a dominant position in the relevant market.

7.1.8.1.8 Gazprom's position and anti-competitive practices

7.1.8.1.8.1 Gazprom has a dominant position

- (873) As the Energy Community Secretariat concludes in its assessment, Gazprom holds a dominant position on the relevant market for gas sales. As expressed in the Secretariat's assessment of the Sales Contract, Gazprom's position approximates that of a monopoly. Furthermore, as stated in the Secretariat's assessment of the Contract, *"in acting as a 'super-operator' of the Ukrainian GTS, Gazprom is de facto controlling essential facilities which are necessary to penetrate the relevant market."* As explained below, this position as "super-operator" stems from the Contract, and in particular the Technical Agreement, which is an integral part of the Contract.
- (874) The Expert Report also finds that Gazprom has a dominant position. The Report considers Gazprom's position based on a wider market definition than that of the Energy Community Secretariat. Still, the evidence of dominance is clear.
- (875) According to the Expert Report, Ukrainian natural gas production is approximately 20 bcm per year. Naftogaz and its subsidiaries control about 90% of all domestic production. According to

the Report, the relevant market includes the remaining 10% of domestic natural gas production, or approximately 2 bcm per year as of 2012.

- (876) Independent imports constitute another component of the relevant market, according to the Report. Beginning in 2012, several industrial companies received licenses to import gas independently for their own supply. In 2012 and 2013 they imported 8-9 bcm per year. Naftogaz had previously supplied these customers; barring any contractual commitments, Naftogaz could supply them again if the price proved competitive. Based on an article describing a large contract by Ostchem, a Ukrainian chemical company, it is estimated in the Report that Gazprom sold at least 5 bcm of the supplies purchased by independent importers in 2013.
- (877) Within the relevant gas sales market defined in the Expert Report, Gazprom has had a share ranging from 84% to 95% over time, cf. Table 1 of the Report. This range of market share is well above the presumption of dominance mentioned above, even though it is based on a wider market definition than that applied by the Energy Community Secretariat. According to the Report, *"there is no precedent in the natural gas industry where a producer supplied more than 80% of the market yet escaped a finding of dominance by the competition authority."*
- (878) The Expert Report also considers the "pivotal supplier" test applied to Gazprom and the relevant market. If any question remains over dominance, this test shows that Gazprom remains pivotal, i.e. other sources do not suffice to meet demand if Gazprom withdraws its supplies from the market, even after extending the size of the market to include supplies that are not currently economic. This was confirmed in the negotiations of the Interim Agreement.
- (879) In addition to making Article 102 TFEU applicable to any abuses by Gazprom in both the sales and the transmission markets, Gazprom's dominant position renders any restrictions on competition in the Contract highly likely to be in contravention of Article 101 TFEU.
- (880) In accordance with the decisional practice of the European Commission, the relevant product market is the market for the upstream production and sale of natural gas. Although Gazprom

have largely succeeded in keeping the Ukrainian market artificially separated from its neighboring countries, the analysis carried out in the Expert Reply demonstrates that the relevant geographic market includes the territories of Poland, Hungary, Slovakia and Ukraine.

- (881) Gazprom's share of the relevant market exceeds 50%, which gives rise to a presumption of dominance. Naftogaz was not in a position to exercise countervailing buyer power during the negotiations leading to the conclusion of the Contract in January 2009. Gazprom therefore holds a dominant position in the meaning of Article 102 TFEU.

7.1.8.1.8.2 The link between Gazprom's dominant position and the abuse

- (882) Gazprom further claims that Naftogaz has failed to establish that Gazprom is "leveraging" a dominant position on the gas supply market so as to engage in abusive behaviour on the gas transmission market. However, what Article 102 TFEU requires is a link between the dominant position and the abusive conduct, and such a link exists between Gazprom's dominant position in the gas sales market and its abusive conduct. The Transit Contract was negotiated simultaneously with the Gas Sales Contract and Gazprom's abuses affect the gas sales market (which as mentioned comprises not only Ukraine but also Poland, Hungary and Slovakia). In addition, Gazprom is a dominant purchaser of long-distance transmission services in Ukraine.

- (883) It would be up to Gazprom to prove that its conduct had an objective justification. Gazprom has failed to present any justifications for its conduct, which clearly illustrates that its conduct has not served and does not serve any legitimate purpose.

7.1.8.1.8.3 Gazprom's anti-competitive practices affect trade within the EU

- (884) The abusive and restrictive nature of the Contract affects trade not only within the Energy Community, but also within the EU as such.
- (885) The impact of the Transit Contract on inter alia the German market for natural gas is discussed in the Expert Report:

"In addition to facilitating imports of gas to Ukraine, the Ukrainian gas pipeline network permits companies like Naftogaz to export their excess supplies to natural gas markets in Western Europe such as Germany, which is Continental Europe's largest gas market. A Ukrainian gas company can make more attractive offers to its customers in Ukraine if it also has the ability to sell any excess gas supplies in Germany. By abusing its influence over the Ukrainian transmission network, Gazprom could limit the ability of competitors in Ukraine to sell excess supplies in Western Europe, which would put them at a competitive disadvantage when selling gas in Ukraine. Gazprom is a large provider of natural gas to the German natural gas market, with a sufficiently large market share to occupy a dominant position. By limiting the ability of competitors to sell excess supplies in Germany, Gazprom could affect the German market price and protect its own dominant position in Germany. Similar logic applies to other countries that rely largely on Gazprom supplies via Ukraine: Bulgaria, the Czech Republic, Greece, Hungary, Poland and Slovakia."

- (886) Perhaps even more disconcerting, as a consequence of the Contract and Gazprom's practices, the Romanian and Bulgarian gas markets are essentially blocked off from the gas market in other EU Member States due to the prevention of reverse gas flows through Ukraine. The restriction of reverse gas flows also affects countries such as Poland, the Czech Republic, Slovakia, Hungary, Bulgaria, Romania and Greece.
- (887) The Transit Contract affects competition within and between several Member States of the European Union. Thus, the Contract clearly affects trade within the EU under both Article 101 and 102 TFEU. This means that those provisions apply to the Contract regardless of the entry into force of the ECT for Ukraine, as EU competition law applies as such. This is the case even though it is a contract between companies in two countries which are not part of the EU, i.e. Ukraine and Russia. The relevant legal requirements under EU energy law and their application to the Contract.

7.1.8.1.9 The preliminary compliance report by the Energy Community Secretariat

(888) In the preliminary Energy Community compliance report, attached to the letter of 3 December 2014 from the Energy Community Secretariat to the Government of Ukraine, the Secretariat of the Energy Community has reviewed the Contract for compliance with the competition law provisions of the ECT, in addition to its energy law provisions.

(889) The Secretariat concluded in its assessment (cf. the first indent in the executive summary of the assessment, on page 1) that

"[c]ertain provisions of the Gas Transit Contract and selected commercial practices arising thereof may be considered as incompliant with the EU acquis communautaire, which is binding upon all the Contracting Parties to the Treaty establishing the Energy Community ("the Treaty"). This concerns the terms and conditions for the operation of natural gas transmission activities, regulation of the natural gas sector, as well as competition rules."

(890) Furthermore, with respect to violation of EU competition law, the Secretariat concluded (cf. the last three indents of the executive summary of the assessment, on page 2):

"The Gas Transit Contract, by fixing derogatory provisions in comparison with general rules applied for the use of the Ukrainian natural gas system, including the pricing of transit services, absence of balancing arrangements, non-application of transparent capacity allocation and congestion management rules, may be deemed as preventing, restricting or distorting the competition in the natural gas market of Ukraine, taking into account that none of the third parties are allowed to access the system to the extent it is exceptionally reserved for transit arrangements physically performed and operated by Gazprom."

The Gas Transit Contract restricts the use of interconnectors (entry and exit points to and from the Ukrainian gas system), the capacity of which is allocated for the benefit of Gazprom without any capacity allocation or monitoring rules applied. Such a restriction to access a significant

part of the natural gas infrastructure may be considered as restricting new market entries, establishing discriminatory business conduct and thus distorting the competition in the market.

Considering that Gazprom, being a major external natural gas supplier to Ukraine, has a critical role for the security of supply of natural gas in Ukraine and the functioning of the natural gas market, its role under the Gas Transit Contract which allows for the exceptional use of a significant part of the cross-border capacities of the Ukrainian natural gas system, operation of respective gas flows and prevention from any access of third parties may be evaluated as an abuse of Gazprom's dominant position in the Ukrainian gas market."

(891) The Contract is considered by the Energy Community Secretariat in relation to both Article 101 and 102 TFEU, concluding on violations of both provisions as summarized above. Naftogaz' assessment of the competition law issues related to the Contract is in line with the assessment of the Secretariat. Furthermore, Naftogaz finds the violations of competition law to be obvious and gross, as is also the case in respect of the energy law provisions discussed below.

7.1.8.1.10 The relevance of the Secretariat's assessment

(892) The preliminary assessment represents the preliminary views of the Secretariat, and it is the informed and documented opinion of an enforcement agency (comparable to the European Commission) that the competition and energy rules of the ECT have been violated.

7.1.8.1.11 Conclusions

(893) The compliance assessment of the Energy Community Secretariat is the statement of the institution under the ECT in charge of assessing and enforcing compliance, and carries considerable weight. The serious and manifest nature of Gazprom's breaches of ECT competition and energy law has warranted the Secretariat's active efforts in order to contribute to bringing the Contract in line with the Treaty. The allegation that the Secretariat is not acting independently and impartially is without any basis.

7.1.8.1.12 Gas transmission and the organisational requirements pursuant to EU energy law - the effect on the party-relationship under the Contract

7.1.8.1.12.1 The *acquis* on energy under the Energy Community Treaty

- (894) When the Energy Community Treaty was established, its Article 11 defined the *acquis communautaire* on gas as Directive 2003/55/EC and Regulation (EC) No. 1228/2003. In 2007 Regulation (EC) No. 1775/2005 was included in the *acquis* on energy in the ECT, cf. Articles 24 and 25 of the Treaty allowing for adaptation of the *acquis* and implementing amendments made to it. When Ukraine acceded to the Energy Community Treaty, it was stipulated that Directive 2003/55/EC and Regulation (EC) No. 1775/2005 were to be implemented in Ukrainian legislation from 1 January 2012, cf. Article 2 of the Protocol concerning the Accession of Ukraine to the Treaty Establishing the Energy Community.
- (895) In October 2011, the Energy Community Treaty was altered in order to transpose and implement the Third Energy Package on Gas (Directive 2009/73/EC and Regulation (EC) No. 715/2009) in the energy *acquis* under the Treaty. The Parties to the Treaty were given until 1 January 2015 to implement the Third Energy Package, with the exception of Article 11 (on certification in relation to third countries) which shall apply from 1 January 2017, in their national legislation, cf. Article 3 of Decision No 2011/02/MC-EnC by the Ministerial Council of the Energy Community of 6 October 2011 ("*Decision No 2011/02/MC-EnC*"). Also, the separate deadlines on unbundling referred to in Articles 9(1) and 9(4) of the Third Gas Directive are replaced by the dates 1 January 2016 and 1 January 2017 respectively, cf. Article 8 of Decision No 2011/02/MC-EnC.
- (896) Secondary legislation adopted by the Commission under the procedure laid down in Regulation (EC) No. 715/2009, will apply also to the Parties of the Energy Community. Decision No 2011/02/MC-EnG Article 28 explicitly states that the Energy Community shall endeavour to apply the network codes developed at European Union level under the Third Energy Package. Article 28 also establishes that Network Codes, once adopted at EU level, shall be included in the *acquis* applicable in the Energy Community by decision of the Permanent High Level Group (the "*PHLG*") after consultation with the Energy Community Regulatory Board (the "*ECRB*").

(897) The Energy Community Secretariat has developed a proposal for adapting the revised guidelines on congestion management procedures as well as the network code on capacity allocation for implementation in the ECT. In their position paper, the Energy Community Regulatory Board expresses the need to implementing guidelines and network codes in general, including the network code on balancing. The proposal has passed the Energy Community Regulatory Board for consideration and recommendation, cf. ECRB Position Paper on the Implementation of Third Internal Energy Package Network Codes in the Energy Community, dated 17 September 2014 and published on the Energy Community website on 25 November 2014.

7.1.8.1.12.2 The implementation of the acquis on energy in Ukrainian legislation the adoption of a new Natural Gas Market Law

(898) On 9 April 2015 the Ukrainian National Assembly adopted a new Natural Gas Market Law, the 2015 Gas Market Law, implementing the Third Energy Package.

(899) The 2015 Gas Market Law entered into force on 8 May 2015, with the majority of its provisions becoming effective on 1 October 2015. The few exceptions, which will be in place on 1 April 2016, are the provisions on unbundling of transmission systems and transmission system operators.

(900) While the 2015 Gas Market Law defines fundamental principles of the gas market operation (including, *inter alia*, unbundling and independence of TSO), tariffs, balancing rules, norms governing the powers of the Regulator, capacity allocation and congestion management, its general rules and principles are to be further specified in the secondary legislation.

(901) The 2015 Gas Market Law provides the legal basis for the adoption of secondary legislation, *inter alia* on licensing of gas transportation activities, standard agreements on gas transportation, tariffs and the methodology for their determination. On 30 September 2015 the national regulator, NCSREU, adopted a series of resolutions with secondary legislative acts aimed at further implementation of the new Gas Market Law. Among others, the "Ukrainian Gas Transmission

System Code", the "Standard Natural Gas Transmission Contract", and the "Ukrainian Tariff Methodology" were adopted.

- (902) With regard to the particular organisation of the Ukrainian gas transmission system, the principles of unbundling of transmission and production/supply and independent regulatory oversight and control pursuant to EU energy legislation follow from Ukrainian legislation, cf. the Preliminary Compliance Report.

7.1.8.1.12.3 The Ukrainian Regulator and its role

- (903) The Ukrainian regulator is the National Commission for State Regulation in Energy and Utilities (NCSREU), established in August 2014 by Presidential Decree No 694/2014 and replacing the previous regulator, the National Energy Regulatory Commission (NERC).
- (904) The Preliminary Compliance Report of the Energy Community Secretariat states, that under Ukrainian legislation the regulator is authorised, *inter alia*, to: set tariffs for transportation of natural gas via main pipelines, adopt tariff setting regulations for gas transmission services; adopt the procedure for setting and review of tariffs for gas transmission services; adopt methodologies for calculation of tariffs for gas transmission services; and, adopt model contracts for transportation of natural gas via main pipelines. The regulator sets a general transportation tariff, which is uniform for gas transmission and gas distribution activities. It also determines which portion of the general tariff that is allocated to the TSO, Ukrtransgaz, if relevant volumes of natural gas are transported via both main pipelines, i.e. the high-pressure pipelines, and distribution networks. It also sets a "direct line" tariff to apply if natural gas is transported via main pipelines and lines owned by the shipper.
- (905) According to applicable Ukrainian legislation and contrary to EU energy law, the general rules governing access to the gas transmission network, including the applicable tariffs for transportation and storage, rules governing acceptance and transfer of gas, its volumes and quality and balancing rules, shall not apply to gas transit contracts, cf. the Preliminary Compliance Report. This is now changing: The new Natural Gas Market Law has recently been adopted and

supplementary secondary legislation is being prepared. When this legislation has entered into force, it will apply to transmission, including transit, in general.

7.1.8.1.12.4 The role and tasks of Transmission System Operators

(906) A transmission system operator ("*TSO*") has the operational responsibility for the transmission system, cf. Articles 2(4) and 13(1)(a) of Directive 2009/73/EC (the "*Third Gas Directive*") and Articles 2(4) and 8(1)(a) of Directive 2003/55/EC (the "*Second Gas Directive*"). This operational responsibility and the related tasks follow from and are summarized in the definition of the term "transmission system operator" in Article 2(4) of both the Second and Third Directive, which reads as follows:

"a natural or legal person who carries out the function of transmission and is responsible for operating, ensuring the maintenance of, and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the transport of gas".

(907) The term "transmission" is defined as *"the transport of natural gas through a network, which mainly contains high-pressure pipelines, other than an upstream pipeline network and other than the part of high-pressure pipelines primarily used in the context of local distribution of natural gas, with a view to its delivery to customers, but not including supply"*, cf. Article 1(3) of Directive 2009/73/EC and Article 1(1) of Regulation 715/2009. The definition of transmission is negatively delimited. It does not include transport through an upstream pipeline network, which, according to Article 1(2) of Directive 2009/73/EC, is *"any pipeline or network of pipelines operated and/or constructed as part of an oil or gas production project, or used to convey natural gas from one or more such projects to a processing plant or terminal or final coastal landing terminal"*. Neither does transmission include distribution, i.e. *"the transport of natural gas through local or regional pipeline networks with a view to its delivery to customers, but not including supply"*, cf. Directive 2009/73/EC Article 1(5). Essentially, therefore, transmission is the transport of gas in high pressure pipelines except in the contexts of local deliveries to customers and gas production.

- (908) The term "transit" is used to indicate *"the inter-community transportation of gas from one or more network boundaries (entry-exit zones) to another. Transit potentially implies the transport of large gas volumes over long distances and enables the transportation of gas from the production sites, LNG regasification or storage facilities, to national markets and existing and future gas hubs"*, cf. *Transit Contracts in EU*. In other words, transit of natural gas requires the use of the high-pressure pipelines which constitute one transmission network to reach one or more other networks.
- (909) The Transit Contract regulates the terms and conditions for the transit of Natural Gas across Ukrainian territory through the Ukrainian GTN. The Transit Contract is subject to the EU rules on transmission, as the EU energy legislation does not distinguish between transmission and transit. The principle of non-discrimination between transit and domestic transmission is firmly established in EU energy law.
- (910) If necessary for the purpose of carrying out its functions relating to cross-border transmission, a TSO shall have access to the network of other transmission system operators, cf. Article 32(2) of Directive 2009/73/EC and Article 18(2) of Directive 2003/55/EC. Under the Third Energy Package, this right of the TSO has been further expanded in Article 12 of Regulation 715/2009, which requires TSOs to establish regional cooperation within the European Network of Transmission System Operators for Gas ("*ENTSOG*"), cf. Article 12(1), and to promote operational arrangements to ensure the optimum management of the network, cf. Article 12(2). With regard to the obligation of TSOs to promote operational arrangements, Article 12(2) of Regulation 715/2009 must now be read in conjunction with the Agency for the Cooperation of Energy Regulators' ("*ACER*") Framework Guidelines on Interoperability and Data Exchange Rules for European Gas Transmission Networks of 26 July 2012 (the "*FG INT*") and the draft Commission Regulation (EU) establishing a Network Code on Interoperability and Data Exchange Rules (the "*draft INT NC*"), which is developed by ENTSOG based on ACER's Framework Guidelines.
- (911) The Guidelines and the Network Code aim at facilitating commercial and operational cooperation between adjacent transmission system operators, and have been developed on the basis of

Article 8(6)(d) and (e) of Regulation 715/2009 and in accordance with the procedure in Article 6 of Regulation 715/2009. In order to ensure the interoperability of adjacent grids, the Guidelines and the Network Code require adjacent transmission system operators to enter into an interconnection agreement in respect of each interconnection point establishing operational arrangements to ensure the optimum management of the network. An interconnection point is basically the geographical location where two networks interconnect and gas can be exchanged from one network to another, often located at the border between two states.

- (912) A TSO shall be responsible for granting non-discriminatory third-party access to the relevant infrastructure, cf. Directive 2009/73/EC Articles 13(1) and Regulation 715/2009 Article 14(1). Such a responsibility also followed from the preceding Directive 2003/55/EC Article 8(1) and Regulation 1775/2005 Article 4(1).
- (913) This means that the Transit Contract has to be amended to allow the TSO whoever that may be the possibility to fulfil its tasks.

7.1.8.1.12.5 The unbundling requirement

- (914) In order to prevent incentives to obstruct third party access to infrastructure, EU energy legislation also requires that energy supply and generation be separated from the operation of transmission networks ("*unbundling*"). In practice, this means that neither a gas trader (like Gazprom) nor a gas supplier (like Naftogaz) is allowed to operate a transmission network (like the Ukrainian GTN).
- (915) Pursuant to the Second Gas Directive (2003/55/EC), cf. Article 9(2)(c), a TSO which is part of a vertically integrated undertaking shall have effective decision-making powers, independent from the integrated gas undertaking ("*functional unbundling*").
- (916) The Third Gas Directive (2009/73/EC) tightens the unbundling requirements as regards transmission system operators and introduces three alternatives;

- ownership unbundling (cf. Directive 2009/73/EC Article 9), i.e. where the ownership of production and supply is split from the ownership of gas transmission,
- independent system operator (cf. Directive 2009/73/EC Article 14), where transmission system networks may formally be retained under the ownership of energy supply companies, but the entire operation and control of the day-to-day business as well as maintenance and investment in the network are transferred to an independent company, i.e. neither owned nor controlled by the energy supply companies, or
- independent transmission system operator (cf. Directive 2009/73/EC Article 9). Under this model, energy supply companies retain ownership of the transmission networks, but the infrastructure and their operation are transferred to transmission subsidiaries who are legally independent and operate under their own name, under strictly autonomous management and under stringent regulatory control ("*legal unbundling*"). The designation of a TSO is preceded by a prescribed certification procedure, cf. Article 10 of Directive 2009/73/EC.

7.1.8.1.12.6 National regulatory authorities and efficient regulatory oversight

- (917) The development and functioning of the internal energy market requires efficient regulatory oversight by national regulatory authorities. As such, EU energy legislation establishes minimum requirements as regards the tasks and powers of national regulators as well as the cooperation between regulatory authorities on cross-border issues, cf. Directive 2009/73/EC Chapter VIII.
- (918) The aim is to ensure that national regulators are "*able to take decisions in relation to all relevant regulatory issues if the internal market in natural gas is to function properly, and to be fully independent from any other public or private interests*", cf. Preamble (30) of Directive 2009/73/EC.
- (919) An important task of the national regulators is the approval of conditions for third-party access *prior* to their entry into force, cf. Preamble (32) and Article 41(1) of Directive 2009/73/EC.

Pursuant to EU jurisprudence, it is not sufficient with an *ex-post* assessment of the access conditions, cf. *Commission v Sweden*.⁷⁶

- (920) *Inter alia* the national regulator shall fix or approve tariffs or the methodologies that they are based on, cf. Article 41(1)(a), and approve applicable balancing rules, cf. Article 41(6)(a).
- (921) The regulator is also tasked with approving standard transport contracts and transmission network codes, cf. Article 14(1) of Regulation 715/2009.
- (922) More generally, national regulators shall have the authority to require TSOs, if necessary, to modify their terms and conditions, including tariffs and the methodologies they are based on, to ensure that they are proportionate and applied in a non-discriminatory manner, cf. Article 41(10) of Directive 2009/73/EC.
- (923) Under the Second Energy Package, national regulators were tasked with monitoring, in cooperation with regulators of neighbouring systems, the capacity allocation and management rules in respect of available interconnectors, cf. Directive 2003/55/EC article 25(1)(a).
- (924) The Third Energy Package expand the scope of these functions by establishing a specific regime for cross-border issues, cf. Article 42 of Directive 2009/73/EC. National regulators are now required to consult and cooperate at least on a regional level, cf. Article 42(2)(a), in order to:

"foster the creation of operational arrangements in order to enable an optimal management of the network, promote joint gas exchanges and the allocation of cross-border capacity, and to enable an adequate level of interconnection capacity, including through new interconnections, within the region and between regions to allow for development of effective competition and improvement of security of supply without discriminating between supply undertakings in different Member States".

⁷⁶ ECJ Judgment in Case C-274/08, *Commission v Kingdom of Sweden*, dated 29 October 2009, cf. also the Preliminary Compliance Report page 18.

- (925) More specifically, the national regulators are required to coordinate the development of network codes, cf. Article 42(2)(b), and rules on congestion management procedures, cf. Article 42(2)(c).
- (926) At the national level, regulators shall be authorised to adopt or approve at least the methodologies for setting cross-border infrastructure access rules, including capacity allocation and congestion management procedures, cf. Article 41(6)(c). Also, the Regulator shall monitor the application of these rules, cf. Article 41(9) of Directive 2009/73/EC.
- (927) In practice, the competences of the regulator as described directly above, means that the provisions replacing those rendered invalid or ineffective by the EU competition and energy legislation, cf. Article 13.2 of the Transit Contract, must be either based on rules or methodologies approved by the regulator or subject to the approval of the regulator prior to entry into force. The fact that the gas transit under the Contract takes place across Ukrainian territory through the Ukrainian gas transmission network and the principle of non-discrimination between transmission and transit implies that the revised provisions must be in compliance with the rules or methodologies approved by the Ukrainian regulator.
- (928) A direct consequence of the requirement of regulatory oversight and approval is that the invalid or ineffective provisions shall be replaced by provisions based on the 2014 Ukrainian Model Contract, i.e. a standard contract that the TSO shall use when providing gas transportation services to network users adopted by Ukrainian Energy Ministry's Decree No. 726 dated 17 October 2014. In principle, the 2014 Ukrainian Model Contract only applied in the period from 17 October 2014 to 31 December 2014. However, pursuant to Article 32 of the New Ukrainian Gas Market Law, the transmission of natural gas shall be performed on the basis of a standard transmission contract that shall be approved by the Regulator. (On 30 September 2015, a "Standard Natural Gas Transmission Contract" was adopted by the national regulator, NCSREU.) Some adaptations have been necessary in order to take into consideration the particulars of the case, i.e. the replacement of invalid provisions in an existing contract, and to adhere to the principle that only the necessary changes due to the invalidity shall be made while at the same time ensuring the structural integrity and practical functionality of the Contract itself. Also, due to the

requirement of regulatory oversight and approval, it is necessary to include a provision which establishes that the Transit Contract is subject to mandatory Ukrainian legislation, including the Network Code and Model Contract with standard terms and conditions for transit, so that, consequently, mandatory adaptations to the terms and conditions for transmission will prevail between the Parties.

- (929) On 30 April 2015, the Ukrainian regulator, NCSREU, published a tariff methodology based on the requirements of EU energy law. The draft Tariff Methodology published on 30 April 2015 by the Regulator, was reviewed by ACER prior to its publication, and they had no objections to the methodology, cf. Section III.F.3 of the Expert Reply. The changes in the final Tariff Methodology adopted 30 September 2015 compared to the draft Tariff Methodology published 30 April 2015 are described in Appendix D to the Expert Reply. As described, the changes are relatively minor and have limited impact on the calculations.
- (930) The Brattle Group has calculated tariffs based on the final methodology, cf. the Expert Reply. Naftogaz submits tariffs calculated by The Brattle Group as Naftogaz' claim for cost-reflective tariffs, cf. the Expert Reply, Appendix D. .

7.1.8.1.12.7 The Ukrainian TSO and its functions

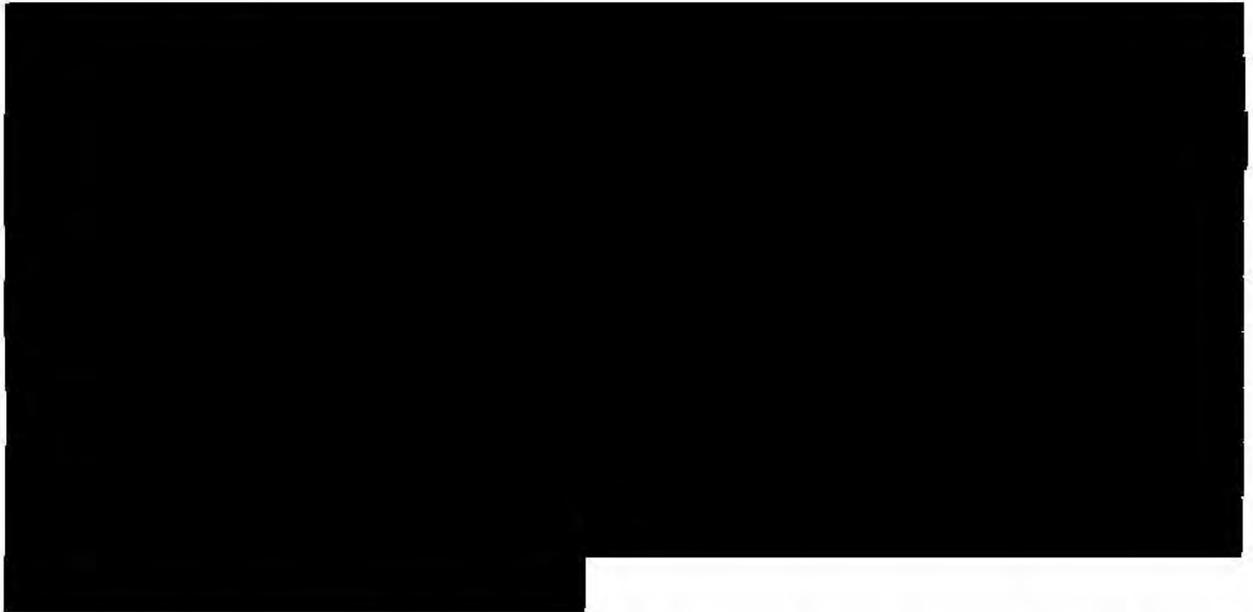
- (931) In December 2013 the regulator designated and certified Ukrtransgaz, a wholly-owned subsidiary of Naftogaz, as TSO of the Ukrainian GTS, cf. the Decree of the Ministry of Energy and Coal Industry of Ukraine No. 882 of 2 December 2013.
- (932) Gas transport is performed by Ukrtransgaz which is licensed to provide services of transportation of natural gas, petroleum gas and methane gas via pipelines in Ukraine, including transit, as well as to carry out activities of underground gas storage, cf. the Preliminary Compliance Report.
- (933) Under its licence, Ukrtransgaz is required to supply gas transportation services on contractual terms and based on tariffs approved by the regulator and not to assign the receipt of gas

transportation fees to any other entity. Gas transmission services shall be provided under standard contracts, based on a template approved by the regulator, cf. the Preliminary Compliance Report.

- (934) As TSO, Ukrtransgaz is also obliged to perform balancing of the amounts of natural gas injected into the system and delivered to consumers in the reporting period, including in case of gas carried under cross-border contracts, cf. the Preliminary Compliance Report. While there is no specific imbalance fee, the shipper is required to purchase gas storage services if more gas is injected than is delivered cf. the Preliminary Compliance Report. If an insufficient amount of gas has been injected into the system, the shipper must withdraw natural gas kept for it in gas storage or purchase the relevant amount of natural gas from either a guaranteed supplier (determined based on the location of the shipper's consumer) or Naftogaz, cf. the Preliminary Compliance Report.
- (935) Ukrtransgaz is also in charge of dispatch control of gas transit through Ukrainian territory in volumes determined by relevant cross-border contracts, cf. the Preliminary Compliance Report. For instance, according to Article 4.6 of the Transit Contract and Article 1.6 of the Technical Agreement between the Parties, Ukrtransgaz is charged with the technical implementation of the Contract on behalf of Naftogaz.
- (936) Gas transmission services are currently procured by Naftogaz, Gazprom and a limited number of end-users.
- (937) The organisation of the Ukrainian gas transmission system and the rights and obligations of the Regulator, NCSREU, and the TSO, Ukrtransgaz, are not reflected in the Transit Contract. Naftogaz has charged Ukrtransgaz with the technical implementation of the Transit Contract, cf. Article 4.6 second paragraph. Similarly, Gazprom has charged several affiliates (including the gas supplier Gazprom Export) with the technical implementation of the Contract on their part, cf. Article 4.6, first paragraph.
- (938) The Energy Community Secretariat has pointed out that the Transit Contract has been implemented in such a way that Gazprom affiliates, and specifically, Gazprom Export, act in the

capacity of a "super-operator", cf. the Preliminary Compliance Report. Consequently, it is Gazprom affiliates, rather than Ukrtransgaz, that act as matching partners for operators of neighbouring transmission systems in respect of gas flows through Ukrainian territory, cf. the Preliminary Compliance Report.

(939)



(940) After delivery and acceptance of transit gas at the Ukrainian western border, Gazprom Export arranges further transit to Europe with the Romanian, Hungarian, Slovak or Polish TSOs. In practice, Gazprom Export's representatives act as a matching partner with TSOs of adjacent transmission network systems on Ukraine's western border. Nominations of gas are usually made between Ukrtransgaz and Gazprom and Gazprom Export jointly. In practice, Gazprom Export directly provides Ukrtransgaz with weekly nominations, while daily nominations as a rule are provided by the dispatcher services of Gazprom. Gazprom Export performs this function as a matching partner on the basis of [REDACTED] which entrusts Gazprom Export with the operational control over the modes of gas transit through the territory of Ukraine and the coordination of Gazprom's representatives in Ukraine.

7.1.8.1.12.8 The Contract is non-compliant with and hinders the fulfilment of the operational requirements under EU energy legislation and must be amended

- (941) The Transit Contract as implemented by the Parties is non-compliant with the EU requirements for operational responsibilities, decision-making powers and independence of the transmission system operator, cf. also the Preliminary Compliance Report. The principle of unbundling transmission and production/supply as well as the requirement of independent regulatory oversight and control pursuant to EU energy legislation already follow from Ukrainian legislation.
- (942) Essentially, Gazprom, through Gazprom Export, controls the gas flows into and out of the Ukrainian GTS. The Transit Contract requires that the exact same volumes of natural gas that enter into the Ukrainian GTS at the entry-exit point at the Russian/Ukrainian border shall be simultaneously taken out at the entry-exit points at the western border of Ukraine - and it is specified which gas volumes are to be delivered at which entry-exit points. Also, the gas is re-delivered to Gazprom or more precisely to the permanent representatives of Gazprom Export at the exit-points at the western border of Ukraine, which are located on Ukrainian territory. In other words, the Ukrainian TSO has no control over the transit of natural gas volumes through Ukrainian territory.
- (943) Also, the implementation of the Gas Transit Contract between Naftogaz and Gazprom has been associated with a practice where Gazprom Export has entered into interconnection agreements with operators of transmission systems neighbouring the Ukrainian GTS and, *inter alia*, is acting as the matching partner in respect of gas flows from Ukraine. This is made possible by the provisions of the Transit Contract [REDACTED] [REDACTED] which give Gazprom Export control over the gas volumes arriving at Ukraine's western border, before they can be handed over to the operators of the neighbouring transmission systems. As such, Gazprom Export in effect controls the capacity utilisation of and the allocation of gas flows at the interconnection points at the western border of Ukraine.
- (944) In other words, Gazprom has control over both the gas flows into and out of the Ukrainian GTS and the capacity utilisation of and the allocation of gas flows at the relevant interconnection

points at the Ukrainian western border. In doing so, Gazprom is in a position to hinder competition to develop at either side of the relevant interconnection points. By controlling the interconnection point at the Ukrainian/Slovak border, viz. Uzhgorod/Veľké Kapušany, Gazprom obstructs the development of a competitive and liquid market for natural gas, both for Slovakia and Ukraine and other countries affected by the lack of gas transit to and from Slovakia and Ukraine, notably Hungary, Romania and Bulgaria, who are prevented from receiving reverse flow supplies from Europe via Ukraine. The same applies to the other interconnection points at the Ukrainian western border, but the Uzhgorod/Veľké Kapušany interconnection point is of particular importance due to the very large technical capacity available. Also, the majority of the gas flow for supply of the major markets in Europe pass through the Uzhgorod/Veľké Kapušany interconnection point.

- (945) This is illustrated by the fact that Ukrtransgaz and Eustream, the transmission system operator ("TSO") of the Slovak gas transmission system, have discussed the possibility of entering into an interconnection agreement regarding the relevant interconnection point at the Ukrainian/Slovakian border (Veľké Kapušany). So far, Ukrtransgaz and Eustream have not reached such an agreement. The reason for this is that Eustream already has entered into an interconnection agreement with Gazprom Export, cf. the reference to such agreements between Gazprom Export and "gas transportations organizations of European countries" in the attachments to the Witness Statement by [REDACTED]. The interconnection agreement entered into between Eustream and Gazprom Export, which is a system user, is clearly contrary to the unbundling requirements of Directive 2009/73/EC, cf. its Article 9(1)(b)(i). The principle that interconnection agreements shall be entered into between adjacent TSOs also follows from the principle of unbundling, i.e. separating network management from energy generation or supply activities. Furthermore, the interconnection agreement between Eustream and Gazprom Export also facilitates restrictive and abusive practices on the part of Gazprom.
- (946) In addition, Eustream argues that the practical conditions for entering into an interconnection agreement with Ukrtransgaz are not met. The matching of gas flow at interconnection points

between adjacent systems is based on the exchange of shipper codes. Shipper codes are the unique identification for shippers issued in a transport system by the system operator, and used in the nomination procedures of sellers and buyers under gas sales agreements to allow the system operators to balance the physical gas flows when sellers nominate their deliveries and buyers nominate their off-take. As the nominations contain the shipper codes, the system operator can identify the downstream shipper and verify that he has the necessary transportation capacity available. However, Gazprom refuses to inform Ukrtransgaz of its shipper code and the shipper codes of its counterparties, and thereby effectively hinders Ukrtransgaz in carrying out its function as a matching partner in practice.

- (947) The interconnection point between the gas transmission systems of Slovakia and Ukraine respectively is essential for the possibility of reverse flows from/via Slovakia to Ukraine. Seeking to diversify Ukraine's gas supply, Naftogaz has unsuccessfully sought to obtain access to unutilised capacity at this interconnection point and in the Slovak GTS in order to establish such reverse flows. The majority of the capacity in the Slovak GTS is booked by Gazprom under long-term transit agreements, but only partially used. This is an example of illegal capacity hoarding with the aim to prevent the diversification of supply of gas, which is made possible by Gazprom's control over the entry-exit point at the Ukrainian/Slovak border.
- (948) Although the Ukrainian legislator has implemented the requirement of legal unbundling of supply and transmission by designating Ukrtransgaz as TSO of the Ukrainian GTS, the current party-relationship and the implementation of the Transit Contract hinder any real functional unbundling. As mentioned above, Ukrtransgaz is only charged with the technical implementation of the Transit Contract. All other rights and obligations are vested with Naftogaz as the immediate party to the Transit Contract. Also, the role of Gazprom Export in the technical implementation of the Transit Contract effectively means that a gas supplier controls the transport of natural gas to and through Ukraine, Hungary, Slovakia and Romania, cf. above. In other words, the party-relationship under the Transit Contract cannot be upheld as it does not comply with and hinders

the fulfilment of operational requirements under EU energy legislation. The current party-relationship is also in violation of EU competition law.

- (949) Consequently, the party-relationship of the Transit Contract must be altered in order to comply with the organisational requirements of EU energy law, in order to allow for their transposition and application in Ukrainian legislation, cf. the Expert Report. Naftogaz' rights and obligations under the Contract must be transferred to Ukrtransgaz or another entity designated as TSO at the time of transfer. In order to facilitate the assignment of the Contract to the Ukrainian TSO, changes to a number of provisions in the Transit Contract are required with effect from the date of the award of the Tribunal.
- (950) First, Article 13.8 (i.e. the Assignment clause) of the Contract is invalid and must be replaced with a clause allowing the Contract to be transferred to any entity designated as TSO without Gazprom's consent.
- (951) Second, the requested changes to Article 13.8 in order to facilitate the transfer of the Contract to the Ukrainian TSO also render it necessary to delete Article 4.6 second paragraph, which charges Ukrtransgaz with the technical implementation of the Contract on behalf of Naftogaz, in its entirety. Accordingly, the current third paragraph of Article 4.6 will become the second paragraph of Article 4.6.
- (952) As explained in the Expert Report, the transfer of the Transit Contract to the Ukrainian TSO to fulfil the unbundling requirements, will only have the intended effect if Gazprom's role as a super-operator, i.e. in relation to operations, communications and signing agreements with other TSOs on matters related to transit at the Ukrainian western border, is simultaneously brought to an end.
- (953) EU energy legislation also requires that energy supply and generation be separated from the operation of transmission networks ("unbundling") in order to prevent incentives to obstruct third party access to infrastructure. Under EU energy legislation gas traders and gas suppliers are not

allowed to participate in gas transmission activities in the EU or the Energy Community. Accordingly, the references to gas suppliers and traders in Article 4.6 first paragraph, which charges Gazprom affiliates with the technical implementation of the Transit Contract, must be deleted. In particular, the reference to Gazprom Export must be deleted. For the same reasons, Topenergy BDC OAO, a joint venture between Bulgargaz and Gazprom which sold Russian gas in Bulgaria and which no longer exists, should also be deleted from Article 4.6 first paragraph. Similarly, the reference to Moldovagaz in Article 4.6 first paragraph must be replaced by references to the transmission system operators in Moldova, Moldovatransgaz and Tirasopoltransgaz. Naftogaz also proposes to update Article 4.6 to reflect the renaming of Beltransgaz OAO to Gazprom Transgaz Belarus OAO.

(954) The Technical Agreement negatively affects trade between EU member states, as it facilitates Gazprom's role as super-operator by cementing Gazprom Export's role at pre-border GMS at the Ukrainian western border where it is established as the matching partner in relation to the TSOs of the adjacent transmission systems in Slovakia, Poland, Hungary and Romania. As such, the Technical Agreement is invalid as of 1 January 2010.

(955)

[REDACTED]

(956)

[REDACTED]

(957)



- (958) Naftogaz requests that the Technical Agreement is declared invalid from 1 January 2010. The procedures laid down in the Technical Agreement will be replaced by the requirements in mandatory Ukrainian legislation, including the Ukrainian network code in order to facilitate mandatory regulatory oversight.
- (959) In order to comply with the requirements under the *acquis* on energy with regard to the functions of an independent TSO as described above, consequential changes are needed in the Transit Contract. Also, the invalidity of the Technical Agreement renders necessary consequential changes to provisions which refer to the Technical Agreement. The following provisions are invalid and must be replaced:
- (960) The reference to the Technical Agreement in the definition of the term "repair works" in Article 1 must be deleted.
- (961) According to Article 5, repair works are currently jointly agreed by Naftogaz and the Client. This is contrary to the requirements of EU energy legislation, see above. In order to reflect that it lies within the functions of the TSO to independently plan and execute the operation and maintenance of the pipeline network, Article 5.1 must be replaced. Article 5.2, which refers to the Technical Agreement, must be deleted. The procedures laid down in the Technical Agreement will be replaced by the requirements in mandatory Ukrainian legislation, including the Ukrainian network code in order to facilitate mandatory regulatory oversight.
- (962) As Article 6.3 refers to the Technical Agreement, it must be deleted. Changes are requested to Articles 13.2 and 13.6, to ensure that the procedures laid down in the Technical Agreement will be replaced by the requirements in mandatory Ukrainian legislation, including the Ukrainian network code.

- (963) In order to ensure the integrity of the gas transport system, the Contractor must be able to refuse to accept gas volumes that do not meet the quality requirements. Naftogaz proposes a new Article 6.3 to that effect.
- (964) Article 7 (on documentation of gas delivery and acceptance) is invalid and must be replaced in its entirety. While Article 7.1 refers to the Technical Agreement and the procedures established therein, Articles 7.2 to 7.5 regulates the jointly reporting by the Client and the Contractor of monthly gas delivery and acceptance. In order to comply with the requirements as regards the TSOs role and functions under EU energy legislation, the provision must be based on the principle that the metering shall be carried out by the independent TSO.
- (965) Further, NCSREU does not exercise any regulatory oversight over the Transit Contract, cf. the Preliminary Compliance Report, which refers to the *2014 Implementation Report*, issued by the Energy Community Secretariat.
- (966) Of particular importance in this context, is that neither the tariffs nor the other terms and conditions (in relation to capacity allocation, congestion management and balancing) of the Transit Contract have been approved by NCSREU.
- (967) The Ukrainian TSO has been tasked with developing a network system code which has been approved by the Ukrainian Regulator. Also, the transmission of gas shall be performed on the basis of a standard transmission contract that has been approved by the Regulator.
- (968) In order to facilitate the mandatory regulatory oversight as required under the *acquis* on energy, Articles 13.2 (the Replacement Clause) and 13.6 (the Amendment Clause) of the Transit Contract need to be replaced in order to allow the Contract to be amended to comply with mandatory Ukrainian legislation, including the Network Code and the Standard Natural Gas Transmission Contract, and the Regulator's decisions and mandatory adaptations of the terms and conditions for gas transmission without the Parties' consent.

7.1.8.1.13 Capacity allocation and congestion management

7.1.8.1.13.1 Introduction

- (969) The transport capacity of a pipeline is determined by its physical dimensions and pressure through the pipeline.
- (970) The term "technical capacity" is used to indicate the maximum firm capacity that the transmission system operator can offer to network users, taking into account the system integrity and the operational requirements of the transmission network, cf. Article 2(18) of Regulation 715/2009. Available capacity means the part of the technical capacity that is not allocated and is still available to the system at a given moment, cf. Article 2(20) of Regulation 715/2009.
- (971) Contracted capacity is used to describe the capacity that the transmission system operator has allocated to a network user by means of a transport contract, cf. Article 2(19) of Regulation 715/2009.
- (972) Capacity allocation is the method by which the technical capacity of a pipeline is allocated between network users. The capacity offered to network users can be firm, i.e. contractually guaranteed as uninterruptible, or interruptible. The capacity can be offered on short-term or long-term basis, i.e. less or more than one year. The capacity products offered by the transmission system operator are a combination of interruptibility and duration.
- (973) The pipeline can be congested, either physically or contractually. The term "physical congestion" is used to describe a situation where the level of demand for actual deliveries exceeds the technical capacity at some point in time, cf. Article 2(23) of Regulation 715/2009. While physical congestion is rare, contractual congestion, i.e. a situation where the level of firm capacity demand exceeds the technical capacity, is quite common. Hoarding of capacity is one way to hinder market entry and the development of competition in a particular market. This is why congestion management, i.e. management of the capacity portfolio of the transmission system operator with a view to optimise and maximise the use of the technical capacity and detect future congestion and saturation points, is essential. The Third Energy Package and its supplementing legislation

have established congestion management procedures, i.e. different mechanisms with one common goal to free booked, but unused, capacity. The term "unused capacity" is used to describe the situation where a network user has acquired firm capacity under a transport contract but which that user has not nominated by the deadline specified in the contract.

- (974) Traditionally, transport capacity has been contracted along so-called contract paths. This essentially means that the network user can only transport the gas along defined routes from the point where the gas is injected to the point where the gas shall be off-taken. The tariffs paid for the gas transport were also traditionally linked to length of the contract path, i.e. the transport distance. EU energy legislation seeks to establish more liquid markets by establishing entry-exit systems. This means that capacity is booked separately at pre-defined entry-points and exit-points. This gives the shipper greater flexibility in directing the transported gas to areas where the demand for gas is higher at a given point in time. At the same time, the transport tariffs are linked to the capacity reserved and not the distance the gas is transported. Distance-based tariffs are considered to limit competition, as the further removed from the customer a gas supplier is located, the more the gas supplier would have to pay for transport, increasing its price of gas.

7.1.8.1.13.2 The legal framework

- (975) Being able to trade gas independently of its location in the gas transport system is a prerequisite for enhancing competition through liquid wholesale gas markets. The only way to achieve this is to give network users the freedom to book entry and exit capacity separately, thereby creating gas transport through zones instead of along contractual paths, cf. Preamble (19) of Regulation 715/2009.
- (976) The preference for entry-exit systems to facilitate the development of competition is now reflected in Articles 13(4), 14 and 16 of Regulation 715/2009. Article 13(4) requires tariffs to be set in such a way as to allow system users to book entry and exit capacity separately. Article 14, on the other hand, stipulates that transmission system operators shall offer firm and interruptible third-party access services on both long and short-term basis. Article 16 establishes that the maximum capacity at all relevant entry and exit points shall be made available to market participants.

(977) While physical congestion of gas networks is currently rare, there is substantial contractual congestion, cf. Preamble (21) and (22) of Regulation 715/2009:

"The congestion-management and capacity-allocation principles for new or newly negotiated contracts are therefore based on the freeing-up of unused capacity by enabling network users to sublet or resell their contracted capacities and the obligation of transmission system operators to offer unused capacity to the market, at least on a day-ahead and interruptible basis. Given the large proportion of existing contracts and the need to create a true level playing field between users of new and existing capacity, those principles should be applied to all contracted capacity, including existing contracts."

(978) Article 16 of Regulation 715/2009 is supplemented by the principles of capacity allocation mechanisms and congestion management procedures concerning transmission system operators (the "CMP Guidelines") laid down in Annex I to Regulation 715/2009, as amended by Commission Decision 2012/490/EU of 24 August 2012.

(979) The rules laid down in Article 16 of Regulation 715/2009 and the principles in the CMP Guidelines have been further supplemented and harmonised in Commission Regulation (EU) No 984/2013 of 14 October 2013 establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems, adopted in accordance with the procedure in Article 6 of Regulation 715/2009.

(980) The Network Code on Capacity Allocation Mechanisms (the "NC CAM"), which applies to interconnection points (i.e. the geographical location where two networks interconnect and gas can be exchanged from one network to another, often located at the border between two states, only, establishes standardised capacity allocation mechanisms to be applied to relevant interconnections points in the European Union as required by Article 8(6)(g) of Regulation 715/2009. In addition to defining harmonised capacity allocation mechanisms, i.e. auction procedures, the code establishes a set of standardised bundled cross border capacity products at interconnection points between entry-exit zones. The term 'bundled capacity' means a standard capacity product

offered on a firm basis which consists of corresponding entry and exit capacity at both sides of every interconnection point, cf. the NC CAM Article 3(4). The code also specifies how adjacent transmission system operators shall cooperate to facilitate the sale and usage of bundled capacity. The NC CAM will apply from 1 November 2015.

7.1.8.1.13.3 Further on the requirements under EU energy law

- (981) The transmission system operator shall implement and publish non-discriminatory and transparent capacity-allocation mechanisms, cf. Article 16(2) of Regulation 715/2009).
- (982) Congestion management procedures in the event of contractual congestion involve use-it-or-lose-it rules and offers of short-term capacity products and auctions, cf. the CMP Guidelines point 2.2, as amended by Commission Decision 2012/490/EU.
- (983) It has also become an established industry practice to offer virtual reverse flow gas transmission services (also known as backhaul) in order to increase market liquidity. Reverse flow capacity can be made available both on a physical and virtual basis. Where the technical possibility to offer physical capacity in both directions does not exist, it is still feasible to ensure physical flow in the main direction and virtual reverse flow capacity in the other.
- (984) Virtual reverse flow gas transmission services (backhaul) enable gas traders to conclude contracts with the gas transmission operators for gas transmission in reverse to the physical gas flow direction in the pipeline. In other words, the gas transmission operators are netting the natural gas quantities contracted for transmission in the two opposite directions. The quantities contracted for transmission in the opposite direction shall be deducted from the quantities contracted for physical transmission in the main flow direction. Only the netted result shall be physically transported. For example, a European gas buyer who has natural gas available at Vel'ké Kapušany on the Slovak-Ukrainian border, may contract transmission of that gas through Ukraine to Tekovo on the Ukrainian-Romanian border. Physically, this transmission is then performed by directing gas flowing from East to West in Ukraine South to Tekovo directly, and deducting the volume which otherwise would have been physically delivered at Vel'ké Kapušany ("netting").

- (985) As regards virtual reverse flows, the European Court of Justice in its judgment of 5 June 2014 in Case C-198/12 (*the European Commission vs. Bulgaria*) has ruled that the Third Energy Package does not provide a legal obligation for transmission system operators to provide virtual reverse flow.
- (986) However, any agreement between adjacent transmission system operators restricting network users from access to virtual reverse flow arguably constitutes a violation of Article 101 TFEU, and discrimination in this respect a violation of Article 102 TFEU.

7.1.8.1.13.4 Capacity allocation and congestion management in the light of the Contract and its implementation between the Parties

- (987) The minimum quantities determined in the Transit Contract mean that Gazprom has reserved the majority of the capacity of the Ukrainian gas transmission network and at cross-border interconnection points in the Ukrainian gas transmission system. However, the capacity reservations made in the Transit Contract, are based on a system of point-to-point contract paths. This is, *inter alia*, reflected in the price formula in the Transit Contract, cf. the Preliminary Compliance Report, where the Energy Community Secretariat concludes that "*the price in the Gas Transit Contract is calculated based on a contract path*".
- (988) As explained in the Expert Report, "*the 'contract path' under the Gas Transit Contract means that Gazprom can only transport the gas along defined routes from the eastern borders of Ukraine to the western borders*".
- (989) Under the Transit Contract, Naftogaz is contractually obliged to reserve and maintain the capacity necessary to transit the agreed Natural Gas volumes, cf. Article 2, cf. Article 3, of the Contract. The Contract does not envisage the possibility for Naftogaz to sell unused capacity to other network users, but effectively prohibits Naftogaz from doing so. At the same time, Gazprom has systematically failed to deliver the agreed volumes of Natural Gas for transit for each year during the period 2009 to 2017 inclusive. While the underdeliveries by Gazprom have led to loss of income on the part of Naftogaz, Gazprom's behaviour also results in contractual congestion, as

the reserved capacity in the gas transmission network and at interconnection points remains blocked. This way, Gazprom *inter alia* hinders the possibility for virtual reverse flow and hence restricts trade between Member States.

- (990) In addition, Gazprom holds a monopoly on exports from the Russian Federation. The Ukrainian Gas Transmission system is essentially unidirectional. Given these circumstances, only Gazprom itself might allow third party gas to be physically transported from East to West through Ukraine. Consequently, virtual reverse flow (backhaul) is essential in order to diversify gas supply to Ukraine and ensure security of supply. Also, Hungary, Romania and Bulgaria are thus prevented from receiving reverse flow supplies from Europe via Ukraine. Bulgaria would in particular benefit from backhaul via Ukraine, as it still largely depends on Ukraine as a transit country and imports 95% of its gas from Russia as the primary supplier, cf. CIEP Fact Sheet on Russian Gas Imports to Europe and Security of Supply.
- (991) Also, the prices for natural gas in Bulgaria are among the highest in Europe.
- (992) After the European Court of Justice judgement in Case C-198/12 (*the European Commission vs. Bulgaria*), Bulgartransgaz, the Bulgarian transmission system operator, has put in place a system with virtual gas flow on a voluntary basis.
- (993) As pointed out by the Energy Community Secretariat in its Preliminary Compliance Report, Gazprom has used its role as a super-operator to create significant obstacles for reverse flows from the EU to Ukraine in the period 2013-2014, which results in "*significant restrictions of competition on the relevant market*".
- (994) The provision of virtual reverse flow gas transmission services requires agreements between adjacent transmission system operators. The specific concern addressed by the Energy Community Secretariat is that Gazprom Export as the "*de facto assignee*" of the responsibilities of the Ukrainian Transmission System Operator has withheld such agreements on virtual reverse flow (backhaul) with transmission system operators of adjacent gas transmission networks, cf. the Expert

Report. This concern is illustrated by the problems confronting Ukrtransgaz in its effort to enter into an interconnection agreement with Eustream, the Slovak transmission system operator. As described above, Gazprom Export's role is anchored in [REDACTED] between the Parties, which form an integral part of the Transit Contract.

- (995) Congestion management procedures also involve use-it-or-lose-it rules, offers of short-term capacity products and auctions. The introduction of active congestion management, including the provision of backhaul services, could facilitate the development of competition against Gazprom, not only in Ukraine, but also in Hungary, Romania and Bulgaria. The development of competition is not in Gazprom's interest. Due to this conflict of interest, Gazprom Export has no incentives to play a proactive role in introducing such measures, cf. the Export Report.

7.1.8.1.13.5 The Contract does not comply with the principles of capacity allocation and congestion management as required under EU energy legislation and must be amended

- (996) The contract path of the Transit Contract is not in line with the requirements of EU energy legislation, cf. *inter alia* Article 13(1) fourth paragraph of Regulation 715/2009, which reads:

"Tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system. Cost-allocation mechanisms and rate setting methodology regarding entry points and exit points shall be approved by the national regulatory authorities. By 3 September 2011, the Member States shall ensure that, after a transitional period, network charges shall not be calculated on the basis of contract paths."

- (997) The contractual path approach is an intrinsic part of the Transit Contract. The provisions where this contractual path is reflected, are invalid and need to be replaced pursuant to Article 13.2 of the Transit Contract. The relevant provisions are Articles 2, 3 and 4 of the Transit Contract. Naftogaz also claims that the Technical Agreement shall be declared invalid from 1 January 2010 and replaced in its entirety with effect from the date of the arbitral award, *inter alia* because it incorporates and details the contract paths of Article 3 and Article 4 of the Transit Contract.

(998) As also pointed out in the Expert Report, ACER has concluded that pro-active congestion management is key to overcoming the potentially anti-competitive effects of long-term transit contracts. In its report *Transit Contracts in EU*, ACER states that:

"the anti-competitive effect of transit contracts is expected to be alleviated through the application of capacity allocation and congestion management rules, which are equally applicable to transportation and transit capacity".

(999) The need for pro-active congestion management procedures will be solved by the assignment of the Contract to the TSO, Ukrtransgaz. The TSO shall also have the functions that Gazprom Export carries out today, and Gazprom Export must be relieved of any and all roles in the implementation of the Transit Contract.

(1000) With regard to entry-exit capacity, the contract paths under the Gas Transit Contract should be replaced with a long-term booking scheme for entry capacity at the eastern border of Ukraine and exit capacity at Ukraine's western borders, cf. the Expert Report. Essentially, this requires that the agreed volumes in the Transit Contract are converted into capacity reservations at the relevant interconnection points and thus provide the basis for the tariff.

(1001) With regard to booking and congestion management, the Transit Contract should clarify that the capacity is subject to the same booking and congestion management rules as all capacity on the Ukrainian pipeline network, cf. the Expert Report. This would result in no functional distinction between transit and domestic transport or exports.

(1002) The Ukrainian TSO has been tasked with developing a network system code which has now been approved by the Ukrainian Regulator. According to the Ukrainian Natural Gas Market Act Section 33, the Network Code shall contain provisions dealing with *inter alia*: (i) secure and reliable operation of the system; (ii) commercial and technical conditions of access to the system, as well as a list of services rendered by the operator, (iii) determination of entry and exit points of the

gas transmission system, (iv) rules for physical and commercial balancing and (v) an action plan in the event of disruptions.

(1003) In order to replace the contract paths under the Gas Transit Contract with a capacity-based entry-exit system, Articles 2, 3 and 4 must be replaced.

(1004) The wording of Article 2 needs to be replaced with wording that does not refer to the contract path in Article 3. At the same time, Article 2 should refer to gas transmission in order to comply with the requirements of EU energy legislation which do not distinguish between transmission and transit.

(1005) As Article 3 in its entirety is based on a system of contract-path, it is invalid and needs to be replaced. A new subparagraph is added to Article 3.1 in order to convert the minimum volumes of transit gas of 110 bcm per year to capacity reservations per entry-exit point on a quarterly basis. The entry and exit points and the allocated volumes per entry and exit point are specified in new Articles 3.2 and 3.3. The principle of evenly allocation of the quarterly capacity reservations per month is continued in Article 3.4. Also, the principle of non-interruptible capacity is established in Article 3.5. It should be noted that Naftogaz' proposal is based on the 2014 Model Contract, but that necessary adaptations have been made to reflect adjustment of an existing contract. When it comes to, *inter alia*, booking of additional capacities, the new Article 3 refers to the general terms and conditions of the Contractor as regulated by mandatory Ukrainian legislation.

(1006) The current Articles 4.1 to 4.3 and Article 4.7 are all based on a contractual path system and invalid in their entirety. Article 4.6 must be replaced in order to facilitate the unbundling requirements of EU energy legislation. In order to comply with the requirements of EU energy legislation, Articles 4.1 to 4.3 must be replaced with a booking system based on daily nominations and re-nominations. Article 4.4 second paragraph, which regulates gas measurements and refers to the Technical Agreement, must be deleted. Naftogaz proposes that the measurement of gas is to

be regulated in the new Article 7, and, subject to the requested adjustments to Articles 13.2 and 13.6, supplemented by mandatory Ukrainian legislation, including the Network Code.

- (1007) The principle that the natural gas is delivered in the common flow as established in the current Article 4.4 first paragraph, is continued and further detailed in Articles 4.9 and 4.11 in the replaced Article 4 based on the 2014 Ukrainian Model Contract. Similarly, the issue of risk for losses, now regulated in the existing Article 4.5, is regulated in Nafogaz' proposed Article 7.10.
- (1008) In order to facilitate matching of gas between TSOs of adjacent interconnection system, the new Article 4, in Article 4.2.2 obliges the Client to inform of its shipper code and the shipper code of its counterparty(ies).
- (1009) Also, consequential changes are required to Article 1, i.e. new definitions have to be added.
- (1010) The procedures laid down in the new Articles 3 and 4 may be replaced by the requirements in mandatory Ukrainian legislation, including the Ukrainian network code.

7.1.8.1.14 Tariffs

7.1.8.1.14.1 The legal framework

- (1011) Until recently, the approach to tariff setting for gas transmission services among EU Member States can best be described as heterogeneous. This hampers cross-border gas transmission, as access to gas transmission networks is made more complicated. In its policy document, *Assessment of Policy Options. Justification document for Framework Guidelines on rules regarding Harmonised Transmission Tariff structures*, dated 31 March 2014, , ACER explains that:

"inconsistent tariff structures across member states make using EU gas transmission networks for cross-border gas transportation more complex for network users. In addition, where tariff structures lack objectivity or do not reflect system costs, this can lead to inefficient use of the transmission networks, and potentially inefficient cross border gas trades".

- (1012) In order to facilitate the integration of European gas markets, EU legislators have increasingly introduced measures necessary to facilitate harmonisation of gas transmission tariff structures among EU Member States. The EU energy legislation on gas transmission tariffs is multi-layered as further explained below.
- (1013) Directive 2009/73/EC confers upon the National Regulatory Authorities (the "NRAs") the power to fix or approve the tariffs – or the methodologies on which these tariffs are based. The tariffs or sufficiently precise methodologies for their calculation must be approved by the NRA prior to entry into force, and published, cf. Articles 32(1) and 41(6)(a) of Directive 2009/73/EC. As pointed out by the Energy Community Secretariat in its report, on page 18, it follows from EU jurisprudence that no ex post review of tariffs may be accepted in place of prior approval, cf. Case C-274/08, *European Commission v Kingdom of Sweden*, ECJ Judgment of 29 October 2009, *para* 34. The question before the ECJ was whether Sweden had failed to adopt the necessary measures to ensure the correct implementation of Directive 2009/72/EC, and the judgement lays down the principle that Member States may not disregard the provisions expressly laid down in a legislative act. For our purpose, when amending the Transit Contract, it is important to ensure that the tariffs are subject to regulatory control and automatically adjusted if mandatory adaptations of the tariffs or the tariff methodology on which they are based are made by the Regulator.
- (1014) Directive 2009/73/EC also sets out the principles of non-discriminatory, cost-reflective and transparent tariffs, cf. preamble (32). These principles, and in particular the principle of cost-reflectiveness, are further amplified in Article 13 of Regulation 715/2009.
- (1015) Pursuant to Article 13(1) first paragraph of Regulation 715/2009, tariffs or the methodologies used to calculate them shall *"be transparent, take into account the need for system integrity and its improvement and reflect the actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent, whilst including an appropriate return on investments, and, where appropriate, taking account of the benchmarking of tariffs by the regulatory authorities"* as well as *"applied in a non-discriminatory manner"*. however, as explained below, benchmarking of tariffs is considered relevant only if

effective pipeline-to-pipeline competition exists. It is also specified that the tariffs, or the methodologies used to calculate them, shall avoid cross-subsidies between network users, cf. Article 13(1) third paragraph. Furthermore, tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system, cf. Article 13(1) fourth paragraph.

(1016) In order to achieve harmonised tariff structures across EU Member States, these principles and their practical application have been further specified. Pursuant to Article 6(2) and Article 8(6)(k) of Regulation 715/2009, Framework Guidelines, setting out clear and objective principles for the development of a Network Code on rules regarding harmonised transmission tariff structures and, subsequently, such a Network Code, shall be developed. By defining a set of common parameters, based on economic principles, for all aspects of tariff setting, and a common set of requirements on the publication of data relating to each stage in the process, the Framework Guidelines and subsequent Network Code are intended to improve the efficiency of gas trade and competition.

(1017) On 29 November 2013, based on a request from the European Commission pursuant to Regulation 715/2009 Article 6(2), ACER adopted Framework Guidelines on Harmonised Gas Transmission Tariff Structures (the "*Tariff FG*"), cf. ACER Decision 01-2013 on Framework Guidelines Gas Tariffs.

(1018) The Tariff FG sets out clear and objective principles and requirements for harmonising the gas transmission structures across the EU, which forms the basis for ENTSOG's Network Code. The Guidelines provide a closed range of possible cost allocation methodologies for implementation by NRAs, a set of standard instruments to enable the verification of the robustness and consistency of the chosen methodology, as well as standard provisions on revenue recovery and tariff setting.

(1019) Based on these Guidelines, ENTSOG has developed a *Network Code on Harmonised Transmission Tariff Structures for Gas* (the "*draft TAR NC*"), dated 26 December 2014.

- (1020) On 26 December 2014, ENTSOG submitted the draft TAR NC to ACER for evaluation. The *Opinion of the Agency for the Cooperation of Energy Regulators No 02/2015 of 26 March on the Network Code on Harmonised Transmission Tariff Structures ("ACER's Opinion No 02/2015")* was published on 30 March 2015.
- (1021) Essentially, on page 3 of its Opinion, ACER concluded that in a number of areas the draft TAR NC diverged from the policy objectives defined in Regulation 715/2009 and the Tariff FG and provided a lower degree of harmonisation than required, and that in other areas the draft TAR NC failed to address and analyse issues identified in the Tariff FG to be further developed by ENTSOG. Thus, ACER requested ENTSOG to revise the draft TAR NC in order to ensure its compliance with the Tariff FG and Regulation 715/2009.
- (1022) While Regulation 715/2009 establishes the principle of *inter alia* cost-reflective tariffs, it is the Tariff FG and the draft TAR NC that provide guidance on how this and other principles shall be achieved in practice. Consequently, when assessing the tariff provisions in the Transit Contract in the following, Naftogaz relies on the policy considerations and guidance found in the Tariff FG as well as the draft TAR NC, except for those approaches that have been rejected by ACER.
- (1023) The Tariff FG provides the principles on which rules on *inter alia* publication requirements, cost allocation methodologies and revenue reconciliation shall be based, as well as exhaustively lists which main primary and secondary cost allocation methodologies that may be applied. The draft TAR NC sets out an exhaustive list and details of the possible primary cost allocation methodologies and secondary adjustments as well as the principles for revenue reconciliation that may be applied. It also sets out the requirements for publishing the information on the parameters of the primary cost allocation methodologies, the applied secondary adjustment(s), if any, and other information related to the derivation of different transmission tariffs and the reconciliation of the regulatory account. ACER's Opinion No 02/2015 signals to which extent the rules in the draft TAR NC are aligned with the principles of the Tariff FG and identifies which draft provisions need to be revised.

- (1024) Despite the fact that the principles provided in Tariff FG is aimed at ENTSOG and that the detailed rules of the draft TAR NC, as reviewed by ACER in its Opinion No 02/2015, are still a work in progress , they are nevertheless authoritative and important factors when interpreting Article 13 of Regulation 715/2009, and applying it to the Contract.
- (1025) While Regulation 715/2009 establishes the principle of *inter alia* non-discriminatory and cost-reflective tariffs, the Tariff FG and the draft re-submitted TAR NC provide guidance on how this and other principles shall be achieved in practice. The Tariff FG and the draft re-submitted TAR NC are important interpretation factors and the policy considerations and guidance found in the Tariff FG as well as the draft re-submitted TAR NC are therefore relied on by Naftogaz. An important purpose of adopting rules on harmonised transmission tariff structures for gas is to facilitate greater market integration and the merging of entry-exit systems, cf. preamble (2) of the draft re-submitted TAR NC.
- (1026) As mentioned above, the Ukrainian regulator, on 30 April 2015, published a tariff methodology. In connection with the preparation of the draft methodology, the regulator asked Naftogaz to determine the value of its regulatory asset base (RAB) as of 31 June 2014 for the purpose of calculation of tariffs, cf. the Expert Report Section V.D.4.
- (1027) The network code on tariffs is intended to apply to all contracts from 1 October 2017, cf. the Tariff FG Section 1.4 and the draft TAR NC Article 50. This timeline still seems to apply despite ACER's request that ENTSOG revise the Draft TAR NC. While a final network code has yet to be adopted , the Tariff FG and the draft TAR are valuable when interpreting the principles of cost-reflective, transparent and non-discriminatory tariffs or tariff methodologies that follow directly from Article 13(1) first paragraph of Regulation 715/2009, which had direct effect from 3 September 2009.
- (1028) According to Article 50 of the draft TAR NC, its provisions shall not affect the level of transmission tariffs foreseen in the contracts which are concluded before the entry into force of the network code where such contracts foresee no change of their level except for the indexation, if

any. Consequently, this exemption only applies where the tariff is fixed and no revision of the tariff is foreseen between the Parties during the contract period. This proviso is not fulfilled in Naftogaz' case, as the Transit Contract explicitly allows for price revision, cf. Article 8.7 of the Contract. Furthermore, the tariff in the Transit Contract is invalid based on EU competition law directly and also as contrary to the requirements of Regulation 715/2009 Article 13. Accordingly, Article 50 does not apply in the present case.

7.1.8.1.14.2 Requirements under EU energy law

- (1029) Neither Directive 2009/73/EC nor Regulation 715/2009 foresees or implies a specific tariff structure. However, both legislative acts contain certain principles and requirements which the tariffs or the underlying methodologies need to comply with.
- (1030) Directive 2009/73/EC establishes the principle that gas transmission tariffs shall be non-discriminatory, cost reflective and transparent, cf. Recital (32) and Article 32(1). These criteria are further amplified in Article 13 of Regulation 715/2009.
- (1031) The tariffs or the underlying methodology shall take into account the need for system integrity, i.e. to maintain the pressure and quality requirements necessary in order to guarantee the transmission of natural gas from a technical standpoint, and its improvement, cf. Article 13 first paragraph and Article 2(9), which defines the term "system integrity".
- (1032) As regards the principle of cost-reflective tariffs, it follows from Article 13(1) first paragraph that the tariffs shall reflect the actual costs incurred "*insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent, whilst including an appropriate return on investment*".
- (1033) It also follows from Article 13(1) first paragraph and Preamble (8) of Regulation 715/2009, that benchmarking of tariffs by the regulatory authorities may be taken into account when setting tariffs, but is considered relevant only if effective pipeline-to-pipeline competition exists. In practice European pipeline operators have rarely been able to demonstrate effective pipeline-to-

pipeline competition, cf. the Expert Report. As explained in the Expert Report, the Ukrainian transportation network occupies a strategic geographic position that enables it to facilitate trade between many European countries and no other network connects the same set of countries. Thus, it is difficult to see how the Ukrainian transportation network faces effective pipeline-to-pipeline competition.

- (1034) Whether the tariffs shall be determined through market-based arrangements, such as auctions, is left for the Member States to decide, cf. Article 13(1) second paragraph.
- (1035) Article 13(1) third paragraph specifies that the tariffs or the methodologies used to calculate them shall be designed so as to avoid cross-subsidies between network users and provide incentives for investment and maintaining or creating interoperability for transmission networks.
- (1036) Transmission tariffs are required to be set in such a way as to allow system users to book entry and exit capacity separately, cf. Article 13(1) fourth paragraph.
- (1037) It is explicitly stated that Member States shall ensure that network charges shall not be calculated on the basis of contract paths, cf. Article 13(1) fourth paragraph third subparagraph.
- (1038) Where differences in tariff structures or balancing mechanisms would hamper trade across transmission systems, adjacent TSOs shall, in close cooperation with relevant NRAs, actively pursue convergence of tariff structures and charging principles, including in relation to balancing, cf. Article 13(2) of Regulation 715/2009. The draft TAR NC, with the reservations made by ACER in its Opinion No 02/2015, further harmonises the tariff structures and charging principles set out in Article 13 of Regulation 715/2009.
- (1039) The composition of allowed or target revenue is regulated in Article 4 of the draft TAR NC, which amplifies the principle of cost-reflective capacity-based entry-exit tariffs. Article 4(2) of the draft TAR NC states that "*transmission services revenue shall be recovered by transmission tariffs which are capacity-based*". Upon approval or determination by the NRA, a specific commodity-charge related to the volume actually flowed by network users could be established to

cover costs that are mainly driven by the volume actually flowed by networks users (such as compressor fuel cost), cf. the Tariff FG Section 3.1.1. In other words, the variable charges should reflect no more than the actual variable costs of the system, cf. the Expert Report Section V.D.1.

(1040) It follows from the Tariff FG and the draft TAR NC, that the role of benchmarking in establishing cost-reflective tariffs is quite limited. ACER's Opinion further reinforces the principle of cost-reflectiveness, rejecting Article 18 of the draft TAR NC and recalling the policy guidelines in the Tariff FG. According to the Tariff FG Section 3.3.2.3, benchmarking will only be allowed as a secondary adjustment and subject to strict criteria. One of the criteria is that there is "*proof that "effective pipeline-to-pipeline competition" exists, based on national and EU competition law, by demonstrating that the relevant competing systems imply a real choice for the system users*". Even if competition can be established, according to the Tariff FG, benchmarking will only be allowed if it benefits the system as a whole and does not introduce cross-subsidy by other users of the network, cf. ACER's Opinion No 02/2015. In addition, a decision to benchmark shall only be taken following consultation by the NRAs within the jurisdiction for the network points deemed to be in competition, cf. ACER's Opinion No 02/2015.

7.1.8.1.14.3 The price mechanism in the Contract

(1041) As previously mentioned, the transit tariff is not cost-reflective. Since the transit tariff does not cover related costs, Naftogaz is essentially carrying out transit services at a loss and other users of the Ukrainian GTS have to cross-subsidize Gazprom's use of the transmission system.

(1042) The Preliminary Compliance Report concludes that Gazprom is paying less than the full costs of transport, which increases costs for other network users. The concern is that below-cost transit tariffs can impose discriminatory cross-subsidies on other network users, cf. the Expert Report Section V.D.2.

(1043) Further, on page 19, the Energy Community Secretariat states that "*[i]t appears that the price calculation mechanism fixed in the Gas Transit Contract does not allow establishing a transit tariff which is cost-reflective.*" This conclusion is based on the following observations:

(1044) First, the Energy Community Secretariat points to the fact that *"the derivation of the base price of transit (USD 2.04) is not explained"*.

(1045) Second, the Energy Community Secretariat concludes that the fact that the charges increase over time pursuant to a mathematical formula *"rules out the cost-reflectivity of the transit tariff"*. The Energy Community Secretariat points out that:

"The actual price of transit is calculated using the base price and the actual price of transit in previous years, and depends on monthly fluctuations in the price of gas under the Gas Contract. Consequently, if the price in the Gas Contract goes down, the transit tariff will decrease respectively."

(1046) Third, the Energy Community Secretariat states that *"the price in the Gas Transit Contract is calculated based on a contract path"*.

(1047) The observations of the Energy Community Secretariat, referred to directly above, need to be supplemented by the negotiation history as follows:

(1048) As mentioned in the negotiation history above, the derivation of the base price of transit (USD 2.04) is apparently the result of a benchmarking exercise against the then Slovak transit tariff.

(1049) It should be noted that it is the Fuel Tariff, which is meant to cover variable costs linked to the transit and, as such, a minor element of the transit tariff, that is linked to the Contract Price in the Gas Sales Contract. The reason for the Fuel Tariff being linked to the Gas Sales Contract is that, at the time when the Transit Contract and the Gas Sales Contract were entered into, Naftogaz' only source of fuel gas was effectively the natural gas provided under the Gas Sales Contract. Domestic production was reserved for Ukrainian end users.

(1050) Alternative external sources were essentially not a feasible option, partly because the gas volumes provided under the Gas Sales Contract in reality exceeded demand and as such it would not be economically viable to buy fuel gas from other gas suppliers. The nominal Annual

Contract Quantity (the "ACQ") stipulated in the Gas Sales Contract (subject to revision), is 52 bcm, cf. *The Transit Dimension of EU Energy Supply*, which is approximately 112.53 per cent of the total natural gas consumption in Ukraine of approximately 46.21 bcm in 2009, cf. U.S Energy Information Administration (EIA), International Energy Statistics which lists Ukrainian gas consumption for 2009 as 1632 billion cubic feet (bft³), which is 46.21 bcm.

(1051) The fact that the transit tariff is not cost-reflective is, however, in any event, primarily caused by the way the fixed element of the transit tariff, which is meant to cover the constant costs of transit, and which accordingly constitutes the main element of the transit tariff, is structured. This view is supported by the Expert Report, which like the Energy Community Secretariat, concludes that the current transit tariff does not have a cost-reflective structure, but explains this in the Expert Report as follows:

"The vast majority of the costs of a gas transport system are constant or fixed, and do not vary with the volume of gas transported. In contrast the revenues under the Gas Transit Contract depend entirely on the volume of gas transported. If the volume of gas transported falls by 50%, the revenues will also fall by 50%, even though the total costs of transporting gas hardly change.

Cost-reflectivity requires the use of fixed capacity charges to recover the majority of the revenues of a pipeline network."

(1052) The tariff should cover capital cost plus a reasonable return on investment as well as operating costs. With regard to the determination of capital cost, "[s]tandard practice is to derive cost-reflective tariffs by reference to the depreciated value of the actual investments made in the pipeline network, known as the "regulated asset base" or RAB", cf. the Expert Report Section V.D.2.

(1053) As discussed above, the role of benchmarking in establishing cost-reflective tariffs is limited, cf. the Expert Report Section V.D.3, where it is stated that:

"In practice European pipeline operators have rarely been able to demonstrate effective pipeline-to-pipeline competition. It has therefore become standard to derive tariffs by reference to a Regulatory Asset Base [...]"

(1054) With regard to the particular characteristics of transit of natural gas through Ukraine, the situation is described as follows in the Expert Report:

"We do not see how Gazprom could demonstrate that the Ukrainian pipeline network faces effective pipe-to-pipe competition. As discussed above and illustrated in Figure 3, Figure 4 and Figure 5, the Ukrainian pipeline network occupies a strategic geographic position that enables it to facilitate trade between many European countries. No other network connects the same set of countries. The most reasonable approach to the determination of tariffs involves a methodology based on the measurement of the regulatory asset base, and on a reasonable return on investment."

7.1.8.1.14.4 The price mechanism in the Contract does not comply with EU energy legislation and must be amended

(1055) The Transit Contract establishes a transit price which is not cost-reflective or compliant with the entry-exit requirement in Article 13 of Regulation 715/2009.

(1056) Similarly, the price revision clause in Article 8.7 of the Contract indicates that not only the revision clause, but the price provision as a whole, is based on a principle of competitive pricing which is not in line with the requirements of EU energy legislation.

(1057) As both the tariff formula in the Contract and the price revision clause are clearly not in line with EU energy legislation, Article 8 of the Transit Contract shall be replaced pursuant to Article 13.2 of the Transit Contract to be aligned with the requirements under EU energy legislation.

(1058) In order to fulfil the requirements under EU energy law, a capacity-based entry-exit tariff is required. At the same time, it is a requirement under EU energy legislation that the tariffs or their underlying methodologies are set or approved by the regulator prior to the entry into force.

- (1059) In order to ensure non-discriminatory application of tariffs and avoid cross-subsidies between network users, Article 8 of the Transit Contract should be replaced. The price provision should state that the tariffs set/approved by the TSO/Ukrainian regulator at any given time shall apply. In addition, the provision should cite the tariffs calculated based on the tariff methodology determined/approved by the TSO/regulator at the relevant entry and exit points. As both EU competition law and related EU energy law apply directly to the Contract on a stand-alone basis, the revised cost-reflective tariff shall apply from at least 1 January 2010. As further explained below, having established that a cost-reflective tariff should have been applied from 1 January 2010, Naftogaz is entitled to payments corresponding to the difference between the amount due under the revised tariff and the amount actually paid for transport services by Gazprom.
- (1060) The current price mechanism in Article 8 includes a fuel tariff, in order to compensate Naftogaz for the operational costs specifically related to fuel gas. The Tariff FG Section 3.1.1 allows specific charges related to the volume actually flowed by network users. Such charges can be expressed in monetary terms or in kind, cf. the draft TAR NC Article 4.
- (1061) The cost-reflective tariffs are calculated on the basis that the assets required for transit must be fully depreciated by the end of 2019. The Transit Contract expires 31 December 2019. The most likely scenario is that Gazprom will cease transit through Ukraine after the expiry of the Contract. This will mean that a large part of the asset base will be unutilised and have to be fully depreciated by the end of 2019. The Expert Report Appendix 5.
- (1062) The overall revenues allowed to be recovered from transit will vary depending on the start date of the tariffs.
- (1063) The requested changes to Articles 13.2 and 13.6, ensures that the tariffs are subject to regulatory control and will automatically be adjusted in accordance with mandatory adaptations of the tariffs or the tariff methodology on which they are based.

(1064) European competition and related energy law applies to the Contract without being dependent on the accession of Ukraine to the Energy Community Treaty on 1 February 2011. Naftogaz therefore submits a claim for replacement of the transit tariff from 1 January 2010, when the presently applied tariff entered into force.

(1065) Having established that a cost-reflective tariff should have been applied from 1 January 2010, Naftogaz is entitled to payments corresponding to the difference between the amount due under the revised tariff and the amount actually paid for transport services by Gazprom.

7.1.8.1.15 Balancing

7.1.8.1.15.1 The requirements under EU energy law

(1066) Under EU energy legislation, the transmission system operator is obliged to establish balancing rules pursuant to a methodology approved by the national regulatory authority, cf. Article 13(3) and Article 41(6)(b) of Directive 2009/73/EC. The transmission system operator is required to publish the balancing rules, cf. Article 13(3) of Directive 2009/73/EC.

(1067) Pursuant to Article 21(1) of Regulation 715/2009, the balancing rules:

"shall be designed in a fair, non-discriminatory and transparent manner and shall be based on objective criteria. Balancing rules shall reflect genuine system needs taking into account the resources available to the transmission system operator".

(1068) The Energy Community Secretariat states that the balancing rules *"should be structured in such a way as to motivate system users to balance their input and off-take of natural gas while avoiding any threats to the system viability"*, cf. the Preliminary Compliance Report. This follows from Preamble (31) to Directive 2009/73/EC as well as from Article 21(3) of Regulation 715/2009: Imbalance charges shall be non-discriminatory and cost-reflective to the extent possible, while providing appropriate incentives on network users to balance the in-put and off-take of gas and not to endanger the system.

- (1069) Pursuant to Article 21(4) of Regulation 715/2009, Member States shall ensure that transmission system operators endeavour to harmonise balancing regimes and streamline structures and levels of balancing charges in order to facilitate gas trade. In order to facilitate such harmonisation and coordination, Commission Regulation (EU) No 312/2014 of 26 March 2014 establishing a Network Code on Gas Balancing of Transmission Networks has been adopted in accordance with the procedure established in Article 6 of Regulation 715/2009.
- (1070) This Network Code on Gas Balancing (the "BAL NC") sets out harmonised Union-wide balancing rules, including network-related rules on nominations procedures, rules for imbalance charges and rules for operational balancing between TSOs' systems as required by Article 8(6)(j) Regulation 715/2009. The BAL NC establishes the general principle that the network users shall be responsible for balancing their portfolios, cf. Article 4(1) of the BAL NC. In order to enable network users to balance their portfolios, the BAL NC sets out minimum requirements on the information flows necessary to implement a market-based balancing regime.
- (1071) The transmission system operators carry out any residual balancing of the transmission networks that might be necessary. In doing so, the BAL NC, cf. Preamble (5) and Article 9, requires the transmission system operator to follow the merit order, implying that transmission system operators will procure gas taking account of both economic and operational considerations, using products that can be delivered from the widest range of sources, including products sourced from LNG and storage facilities. The BAL NC aims to maximise the amount of the gas balancing needs met through the purchase and sale of short-term standardised products on the short-term wholesale gas market.
- (1072) It is explicitly stated that the specific nature of interconnectors needs to be taken into account when applying the balancing rules established in the Network Code, cf. Preamble (8) of the BAL NC. In particular, the BAL NC establishes specific rules as regards nominations and re-nominations at interconnection points, cf. Articles 13 to 17.

(1073) The BAL NC is applicable in the EU from 1 October 2015, cf. Article 53 of Commission Regulation 312/2014, and shall apply to balancing zones within the borders of the EU, with the exception of those that hold a derogation on the basis of Article 49 of Directive 2009/73/EC.

(1074) Once implemented in the ECT, Ukrainian legislation must be brought in line with the BAL NC. The Ukrainian TSO, Ukrtransgaz, in cooperation with the Ukrainian regulator, NSCREU, and network users, has worked out a network code, which contains *inter alia* provisions on balancing. The rules on balancing in the Ukrainian network code are based on the basic principles of balancing established in Article 35 in the new Natural Gas Market Law, which *inter alia* determines that rules on balancing shall be market based and give guidance on the level of imbalance charges.

(1075) According to the Energy Community Secretariat, cf. the Preliminary Compliance Report, Ukrtransgaz, as the Ukrainian TSO,

"shall perform balancing of the amounts of natural gas injected into the system and delivered to consumers in the reporting period, including in case of gas carried under cross-border contracts. While no specific fee is charged for imbalances, the shipper (i.e. the recipient of gas transmission service) is required to purchase gas storage services if more gas is injected than is delivered. If insufficient amount of gas has been injected into the system, the shipper must withdraw natural gas kept for it in the gas storage or purchase the relevant amount of natural gas from either a guaranteed supplier (determined based on the location of the shipper's consumer) or Naftogaz."

(1076) According to the Expert Report, balancing

"raises two key competitive concerns. First, the same rules should apply to all market participants so that no one company acquires an artificial competitive advantage or disadvantage. Second, even if the same rules apply to all market participants, balancing rules can distort competition among gas suppliers if the rules are too restrictive or penal in nature. Distortions

can arise because alternative suppliers differ naturally in their ability to balance their injections and withdrawals."

7.1.8.1.15.2 The balancing of input and off-take of gas under the Contract

- (1077) The Transit Contract, as supplemented by the Technical Agreement, does not provide for a functional balancing system.
- (1078) As a starting point, the Contract provides that the volume of natural gas available in every 24 hours at exit points shall be equal to the volumes injected at entry points, cf. Article 3.4 last paragraph. In other words, the responsibility for the balancing of in-put and off-take is placed with Naftogaz.
- (1079) However, some of the provisions of the Contract have a balancing purpose. The Contract is supplemented by Technical Agreement Article 3 and Annex No. 5.
- (1080) As described above, the delivery and acceptance of gas under the Transit Contract in a month shall as a main rule be conducted evenly, cf. Article 3.4 first paragraph. The Contract in general permits a deviation of daily volumes of *"not more than +/- 6.5%"* (except at one gas metering station, the GMS Uzhgorod, where the permitted deviation is +/- 4,5%) from *"the average daily, monthly volumes"* that follow from Article 3.1. In summary, Article 3.4 first paragraph of the Transit Contract gives Gazprom free balancing within the 6.5/4.5% ranges.
- (1081) Article 3.4 second and third paragraphs of the Transit Contract regulate the situation if Gazprom without prior agreement withdraws transit gas volumes that exceed the permissible deviation agreed in Article 3.4 first paragraph. Gazprom shall then not later than 36 hours prior to the moment of occurrence of excess deviations provide delivery of gas to Naftogaz as compensation for such deviations on the borders of the Russian Federation/Ukraine, the Republic of Belarus/Ukraine. If Gazprom fails to inject compensation gas, Naftogaz shall not be responsible for enforcing the Contract's regulations for the delivery and acceptance of gas. Given that it takes 36 hours to transit gas from the Eastern border to the Western border of Ukraine, cf. the Preliminary

Compliance Report, an obligation to inject compensation gas 36 hours prior to withdrawal actually does not suffice for balancing purposes due to lack of flexibility.

(1082) Also, Article 4.3 establishes procedural rules for how periodical reductions in the agreed daily volumes and/or a general reduction in the agreed volumes for transit shall be handled (directional or pro-rata reductions).

(1083) Naftogaz has described how the Transit Contract establishes procedural rules for a situation where Naftogaz withdraws gas volumes supplied by Gazprom for transit and consequently is in imbalance. Such withdrawals shall be recorded under and priced based on the Contract Price in the Gas Sales Contract, cf. Article 10.4. This provision might be said to impose balancing payments from Naftogaz to Gazprom. Once natural gas supplied for transit is withdrawn during transit, irrespective of the reasons for this, Naftogaz is in imbalance and has to buy balancing gas from Gazprom. In situations where Gazprom's clients do not off-take volumes on the Ukrainian border that corresponds to the input made by Gazprom at the Ukrainian Eastern border and Naftogaz has to place the surplus in storage, Naftogaz is placed in "imbalance". In practice, Naftogaz has to pay Gazprom when it essentially provides a balancing service to Gazprom. Such a practice is not only clearly dysfunctional and unreasonable, but might also be considered to lead to market foreclosure, as there is only one supplier of the balancing gas. Also, the balancing charges are linked to the Contract Price in the Gas Sales Contract and not market based, i.e. based on the prices at the European gas hubs.

(1084) The Energy Community Secretariat observes that "*in practice, general rules on balancing established by the relevant Ukrainian regulations do not apply to gas transit flows*", cf. the Preliminary Compliance Report.

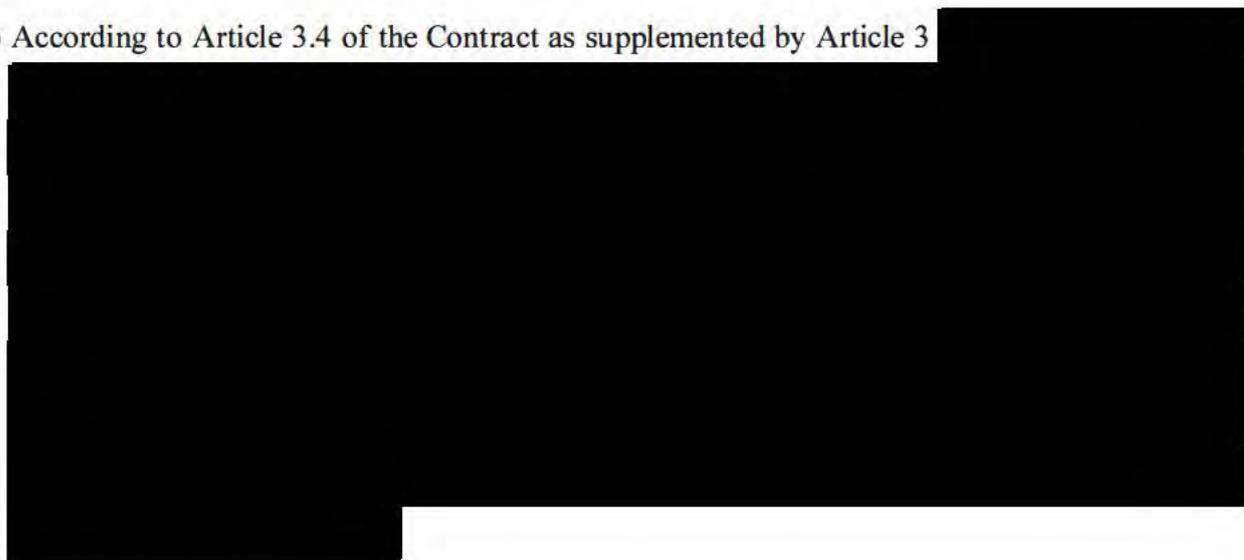
(1085) The lack of a balancing mechanism in the Transit Contract creates practical challenges for the functioning of the Ukrainian gas transmission network. The Energy Community Secretariat points out that "*[i]nstead, in 2010 Ukrtransgaz and Gazprom Export had entered into a separate balancing agreement pursuant to which "if the need for the supply of gas to Europe [was]*

significantly higher than the nomination previously submitted by [Gazprom Export], [Ukrtransgaz], if technically possible, compensated the necessary amount from its own reserves, followed by the Russian side payment for these services". This balancing agreement was unilaterally terminated by Gazprom Export in June 2014, which, according to the Energy Community Secretariat "*caused significant difficulties as "[p]hysical transit of natural gas volumes through Ukraine takes about 36 hours" and "[i]n the absence of such agreement, Ukrainian operator does not have a legal basis to compensate for significant gas consumption deviations on the same day"*", cf. the Preliminary Compliance Report.

7.1.8.1.15.3 The lack of a functional, market-based and non-discriminatory balancing mechanism in the Contract does not comply with EU energy law and the Contract must be amended

(1086) The rudimentary balancing system provided for in the Transit Contract, as supplemented by the Technical Agreement, is contrary to the principles of EU energy legislation.

(1087) According to Article 3.4 of the Contract as supplemented by Article 3



(1088) In addition, it is a requirement under EU energy legislation that balancing rules are established by TSOs pursuant to a methodology approved by the NRA.

(1089) Article 10.4 might be said to impose balancing payments from Naftogaz to Gazprom which might be considered to lead to market foreclosure contrary to European competition law, as Gazprom

is the only supplier of the balancing gas. In addition, such a solution also violates the principle of market-based balancing rules in Article 21(1), given that the balance charges are linked to the Contract Price in the Gas Sales Contract and not a market price for natural gas.

(1090) In order to avoid market distortions, it is also required that the balancing rules apply to all users of the Ukrainian gas transmission system. At the same time, EU energy legislation acknowledges that the balancing mechanism needs to take into account the particular characteristics of interconnectors.

(1091) The simplest solution to these breaches of European competition and energy law is to apply the same balancing rules to transit under the Transit Contract as to domestic transport under Ukrainian legislation, taking the particular characteristics of interconnectors into account. This solution is recommended in the Expert Report, where it is stated that: "*[m]ost jurisdictions contain detailed balancing rules as part of the network code*" and that "*Ukraine will have a network code shortly. The Gas Transit Contract should clarify that Gazprom will be subject to the same balancing rules applicable to all other market participant under the Ukrainian network code.*"

(1092) Also the rudimentary balancing provisions in Articles 3.4, 4.3 and 10.4 of the Contract must be deleted.

(1093) The requested changes to Articles 13.2 and 13.6 ensure that the mandatory rules on balancing in Ukrainian legislation, including the network code, will apply.

7.1.9 Gazprom's breaches of European and Ukrainian competition and energy law the tariff

7.1.9.1 Introduction

(1094) The tariff paid by Gazprom constitutes an unfair purchase price in breach of Article 102 TFEU and Article 18(1)(b) ECT. Gazprom exploited its dominant position within natural gas sales and Naftogaz' lack of alternative suppliers to obtain a tariff that does not reflect the costs of the pipeline network.

(1095) The below-cost tariff paid by Gazprom also results in price discrimination in breach of Articles 101 and 102 TFEU and Article 18(1)(a) and (b) ECT. Gazprom's arguments against the price discrimination claim are also discussed below.

(1096) EU and ECT energy law lay down tariff setting principles that reflect the broad prohibitions in Articles 101 and 102 TFEU, including that tariffs must be non-discriminatory and cost-reflective.

(1097) Mandatory Ukrainian law, i.e. Ukrainian competition law, ECT competition and energy law as Ukrainian law based on monism and mandatory Ukrainian energy legislation, also sets out tariff principles that apply to the Contract.

(1098) The illegality of the tariff leads to partial invalidity and ineffectiveness. Under Article 13.2 of the Contract, the existing tariff provision in Article 8 shall be replaced with a valid and effective provision with an economic effect as close as possible to that of the invalid/ineffective provision, as described below. In addition, Naftogaz claims payment and/or damages, as also set out below.

7.1.9.2 The tariff paid by Gazprom is unfair pursuant to Article 102 TFEU and Article 18(1)(b) ECT

7.1.9.2.1 Introduction

(1099) Naftogaz is of the view that the below-cost tariff paid by Gazprom is unfair, as it has "*no reasonable relation to the economic value of the product supplied*", cf. paragraph 250 of the *United Brands* judgment.

7.1.9.2.2 Article 102 TFEU and Article 18(1)(b) ECT apply to unfair purchase prices

(1100) It should be established at the outset that an unfair purchase price may constitute abuse of dominance. This follows from Article 102 TFEU

(1101) Article 18(1)(b) ECT must be interpreted in accordance with Article 102 TFEU.

7.1.9.2.3 The imposition of the unfair tariff constitutes an abuse of dominance

7.1.9.2.3.1 Introduction

- (1102) Article 102(2) *litra* (a) TFEU prohibits a dominant undertaking from "*directly or indirectly imposing*" an unfair price. Gazprom exploited its dominant position within natural gas sales and Naftogaz' lack of alternative suppliers to impose a tariff formula that did not ensure that the significant fixed costs of the pipeline network would be covered.
- (1103) Gazprom argues that the alleged abuse takes place in a market for gas transit services in Ukraine (and not in the gas sales market), and that Gazprom does not operate in the gas transit market. However, what case-law requires is "*a link between the dominant position and the alleged abusive conduct*". The link between Gazprom's dominant position and the unfair tariff is strong.
- (1104) Gazprom's abusive behaviour in imposing the unfair tariff relates directly to its sale of natural gas: the Transit Contract was negotiated simultaneously with the Gas Sales Contract. Naftogaz lacked viable alternative natural gas suppliers and had no other choice than reaching an agreement with the dominant supplier Gazprom. Gazprom was able to use its dominant position within gas sales to impose an unfair tariff under the Transit Contract.
- (1105) Moreover, the unfair tariff directly affects competition in the market dominated by Gazprom. First, the below-cost tariff implies that Naftogaz is forced to subsidise Gazprom's natural gas sales into the EU, including to Slovakia, Poland and Hungary (which form part of the relevant geographic market). The below-cost tariff is a subsidy that gives Gazprom an artificial advantage that helps to reinforce Gazprom's dominant position. Second, the below-cost tariff involves discrimination against third party gas suppliers wishing to transit gas through Ukraine for the purpose of sale in the above-mentioned countries that form part of the relevant market. As further discussed below, the discriminatory tariffs artificially reduce the competitiveness of competing gas supplies and therefore affects competition in the gas sales market.
- (1106) In addition, Gazprom is the dominant purchaser of long-distance gas transmission in Ukraine. Gazprom represents the entire volume of natural gas transited through Ukrainian territory and it also controls entry and exit points outside Ukraine through its subsidiaries. It is well established

that Article 102 applies not only to excessively high prices demanded by a dominant seller, but also to excessively low prices paid by a dominant purchaser. This has also been acknowledged by Gazprom, as noted above.

7.1.9.2.3.2 Gazprom was in a position to impose terms on Naftogaz

(1107) Gazprom was and is in a unique situation vis-à-vis Naftogaz. Naftogaz depended on the supply of natural gas from Gazprom, which had been interrupted in January 2009 when the agreement was concluded. Alternative external sources of gas were essentially not a feasible option.

(1108) Through arrangements outside Ukraine, Gazprom controlled entry and exit points prior to the conclusion of the Tariff Agreement. An example of Gazprom's use of its control of one such connection point – *Velke Kapušany* – to block gas flows through the Slovak GTS in 2004 is provided by ██████████ in his witness statement. As pointed out by ██████████ Ukrtransgaz was in reality prevented from arranging exports or imports of natural gas without Gazprom's consent to use the connection point.

(1109) Against this background, Naftogaz did not have any other options than signing agreements for the supply of natural gas from Gazprom and the transmission of natural gas for Gazprom.

7.1.9.2.3.3 Gazprom rejected proposals for a more cost-reflective tariffs

(1110) The tariff formula in the Transit Contract bears no relation to the costs incurred by Naftogaz in providing the transit service. During the negotiations, however, Naftogaz requested provisions that would have led to a more cost-reflective tariff.

(1111) Gazprom claims that there was *"no proposal by Naftogaz during negotiations of the Contract that the tariff should be "cost reflective""* and that Naftogaz did not *"present any data evidencing the "underlying costs" of the Ukrainian GTS"*. However, this is a misleading factual description, as pointed out above, which refers to the explanation provided by ██████████ in his witness statement.

(1112) During the negotiations, Naftogaz proposed to determine the tariff based on the operational and investment costs of procuring gas transit through the GTS, including a reasonable rate of return. The agreed tariff formula was instead based on Gazprom's proposal, which relied on volumes and distance of transportation.

(1113) Moreover, the Contract reserves a significant transit capacity for Gazprom without providing for fixed capacity charges. The lack of fixed capacity charges implies that Gazprom was able to reserve network capacity without paying any compensation. Since transported volumes have been significantly lower than Gazprom had assured Naftogaz, the tariff paid by Gazprom for actual volumes has fallen far short of the costs of operating the network. In its draft agreement of 13 June 2008, Naftogaz had proposed a penalty to be paid by Gazprom in case of reduction of transit volumes by more than 5 %. A provision to this effect was also included in the annotated draft. However, Gazprom assured Naftogaz that at least 110-120 bcm would be transported through the Ukrainian GTS, and the tariff formula in the Contract does not provide for fixed capacity charges.

(1114) Finally, as far as the tariff level is concerned, the internal Naftogaz memo dated 23 December 2008 shows that Naftogaz based its calculations on the understanding that as of December 2008 the "*... minimum market rate for transit through the territory of Ukraine [is] at the level of 3.4 US dollars for 1000 cubic meters per 100 km*". The tariff level set out in the Contract is significantly lower, at *USD 2.04* per 1,000 cubic meters per 100 kilometers (adjusted for 50% of the development in EU inflation, and with the addition of fuel gas costs).

7.1.9.2.3.4 Final negotiations under extreme time-pressure

(1115) The final negotiations of the Gas Sales Contract and the Transit Contract took place on 17-20 January 2009 in Moscow. The time-pressure on Naftogaz was extreme, due to Gazprom's gas supply interruption. The Transit Contract was finalised in the morning of 20 January 2009 after the negotiations of the Gas Sales Contract and also after the official signing ceremony on 19 January.

(1116) Together with Naftogaz' lack of other alternative gas suppliers, the supply interruption further limited Naftogaz' possibilities of negotiating a tariff formula that better ensured that the significant fixed costs of the pipeline network would be covered.

7.1.9.2.3.5 Conclusions

(1117) As follows from the above, Gazprom was able to use its dominant position within gas sales to impose an unfair tariff under the Transit Contract. This unfair tariff affects competition in the wholesale gas supply market (a market covering also Poland, Hungary and Slovakia), which is dominated by Gazprom. In addition, Gazprom is the dominant purchaser of gas transit through the territory of Ukraine. As a result, the unfair tariff imposed by Gazprom qualifies as an abuse of a dominant position within the meaning of Article 102 TFEU and Article 18(1)(b) ECT.

7.1.9.2.4 The assessment of the fairness of a price

7.1.9.2.4.1 Introduction

(1118) Naftogaz takes the view that the below-cost tariff paid by Gazprom is unfair, as it has "*no reasonable relation to the economic value of the product supplied*", cf. paragraph 250 of the *United Brands* judgment.

7.1.9.2.4.2 No single formula for determining whether a price is unfair

(1119) Naftogaz and Gazprom seem to agree that the general legal criterion that determines whether the price of a product or service is unfair is whether the price has "*no reasonable relation to the economic value of the product supplied*", cf. *United Brands*.

(1120) For the purpose of determining whether certain banana prices charged by United Brands met this general criterion, the ECJ applied a cost-based test in two stages. However, it follows from the judgment that comparing a price to relevant costs in order to determine whether the price is excessive is not an exhaustive, "one-size-fits-all" legal test for every type of product and in all scenarios. In particular, the ECJ stated that:

"This excess [that is, the difference between the price charged and the economic value of the product] could, inter alia, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production, [...]".

(1121) The reference in paragraph 252 of the judgment to *"the difference between the costs actually incurred and the price actually charged"* must be read in this context.

(1122) The ECJ went on to note that: *"Other ways may be devised and economic theorists have not failed to think up several of selecting the rules for determining whether the price of a product is unfair"*. This further clarifies that the so-called two-stage test applied to the pricing of bananas in that judgment is not the single valid approach which must be applied in all markets.

(1123) This understanding has been confirmed by the European Commission in its decision in the *Standard and Poor's* case, in which the Commission made clear that there is *"no single formula for determining whether a price is excessive"*. The Commission stated (cf. paragraph 27 of the Commission's decision of 15 November 2011 in case COMP/39.592 *Standard & Poor's*):

"According to the Court of Justice of the European Union a price is excessive where it 'has no reasonable relation to the economic value of the product supplied'. There is no single formula for determining whether a price is excessive. In United Brands, the Court envisaged a cost analysis."

(1124) As follows from the above, the two-stage test applied to bananas in *United Brands* is not the only approach to determining whether a price is unfair within the meaning of Article 102. Gazprom's argument that Naftogaz has not *"complied"* with the two-stage test in *United Brands* is therefore flawed.

(1125) In the context of gas transit tariffs, the regime set out in secondary EU legislation, in particular Directive 2009/73/EC and Regulation (EC) No 715/2009, is the most appropriate starting point, as it is directed specifically at the price of this service and also represents an operationalization

of the competition rules. As demonstrated by Mr Lapuerta and Dr. Hesmondhalgh in their first Expert Report and further detailed in the Expert Reply, the tariff paid by Gazprom deviates significantly from a cost-reflective tariff.

7.1.9.2.4.3 Comparison of tariff to prices of competing products

- (1126) Gazprom argues that Naftogaz should have carried out a comparison between the tariffs paid by Gazprom and the prices of competing products. In Gazprom's view, such a comparison is required in order to satisfy the second stage of the *United Brands* case.
- (1127) The two-stage test applied to the pricing of bananas in *United Brands* is not a general test for establishing whether the price of a product or service is unfair. Since there is no such single formula for determining whether a price is unfair, it does not follow from *United Brands* that a comparison with the price of competing products is a necessary step in determining whether the price of a product has "*no reasonable relation to the economic value of the product supplied*". Gazprom's argument is based on an erroneous interpretation of *United Brands*.
- (1128) Moreover, even in markets where the two-stage test applied in *United Brands* is the most appropriate approach for assessing whether a price is unfair, it follows from the judgment itself that a comparison with the price of competing products is not the only way to establish that the price of the product in question is unfair. The first stage of the test was to assess whether the profit margin was excessive. If yes, the second step was to assess "*whether a price has been imposed which is either unfair in itself or when compared to competing products*". It follows from this statement that in cases where such a two-stage test is an appropriate approach, the second stage of the test would not only be satisfied where the price is unfair when compared to competing products but also where the price is deemed "*unfair in itself*".
- (1129) Furthermore, the prices of competing products may only be a relevant benchmark where a market price can be established or estimated for competing products.

(1130) This has been confirmed by the European Commission in its decision of 25 July 2001 in case 36915 *British Post Office / Deutsche Post AG*. In assessing the fairness of Deutsche Post's tariff for incoming cross-border mail items, the Commission concluded that it was not possible to compare the tariff to competitors' prices (since the mail market was not open to competition) and therefore an alternative benchmark had to be used. The Commission stated at paragraph 159:

"According to the case law of the Court of Justice, the fairness of a certain price may be tested by comparing this price and the economic value of the good or service provided. A price which is set at a level which bears no reasonable relation to the economic value of the service provided must be regarded as excessive in itself, since it has the effect of unfairly exploiting customers. In a market which is open to competition the normal test to be applied would be to compare the price of the dominant operator with the prices charged by competitors. Due to the existence of DPAG's wide-ranging monopoly, such a price comparison is not possible in the present case. Furthermore, DPAG has only recently introduced a transparent, internal cost accounting system and no reliable data exist for the period of time relevant to this case. Consequently, the Commission is not in a position to make a detailed cost analysis of DPAG's average costs for the services in question during the relevant time period. An alternative benchmark must therefore be used."
(Footnotes omitted.)

(1131) It may be added that the benchmark used by the Commission in the case of Deutsche Post's tariffs was the REIMS II, an agreement that had been entered into between Deutsche Post and a number of other European postal monopolies, which provided an estimate of the costs of handling incoming cross-border mail.

(1132) In the case of gas transit through Ukraine, effective pipe-to-pipe competition does not exist. This was noted by Mr Lapuerta and Dr. Hesmondhalgh in their Expert Report and has been acknowledged Mr Witschen and [REDACTED]. Accordingly, the assessment of whether the tariff paid by Gazprom is unfair cannot involve a comparison with prices of "competing products".

(1133) However, given the significant deviation between the tariff paid by Gazprom and a cost-reflective price, the tariff must be considered as *unfair in itself*. The tariff deviates significantly from a cost-reflective level and the under-pricing of transit means that maintenance of and investments in the grid are underfinanced.

(1134) Consequently, a finding that the tariff paid by Gazprom is unfair within the meaning of Article 102 does not require a comparison with prices of competing products, as no meaningful comparison can be made.

7.1.9.2.4.4 Criteria provided by secondary legislation

(1135) It follows from the ECJ's case-law that where secondary legislation exists addressing the pricing of the type of product or service in question, such legislation may provide criteria for assessing whether the price paid is unfair. In *Ahmed Saeed*, which concerned *inter alia* whether tariffs imposed by an air carrier were unfair and therefore constituted abuse of a dominant position, the ECJ stated:

*"Certain interpretative criteria for assessing whether the rate employed is excessive may be inferred from Directive 87/601/EEC, which lays down the criteria to be followed by the aeronautical authorities for approving tariffs. It appears in particular from Article 3 of the directive that tariffs must be reasonably related to the long-term fully allocated costs of the air carrier, while taking into account the needs of consumers, the need for a satisfactory return on capital, the competitive market situation, including the fares of the other air carriers operating on the route, and the need to prevent dumping."*⁷⁷

(1136) In other words, the criteria set out in the EU directive in question for determining whether tariffs are acceptable were relied on in order to assess whether the tariff in question was unfair.

(1137) Similarly, when assessing whether tariffs for the transit of gas must be deemed unfair and in breach of Article 102 TFEU, regard should be had to the detailed rules set out the relevant

⁷⁷ Case C-66/86 *Ahmed Saeed Flugreisen and Others v Zentrale zur Bekämpfung unlauteren Wettbewerbs*, paragraph 43.

secondary legislation, in particular Directive 2009/73/EC and Regulation (EC) No. 715/2009. Like the directive referred to in *Ahmed Saeed*, these legal acts lay down criteria to be followed by national authorities for approving tariffs or the methodologies on which tariffs are based.

(1138) As further discussed below, secondary legislation on transmission tariffs provides that tariffs shall be cost-reflective and non-discriminatory. These principles further support that tariffs which deviate significantly from a cost-reflective level, or which involve discrimination between transmission customers, cannot be accepted under Article 102 TFEU.

7.1.9.2.4.5 Conclusion

(1139) The legal criterion that determines whether the price of a product or service is unfair is whether the price has "*no reasonable relation to the economic value of the product supplied*", cf. *United Brands* paragraph 250. There is no single formula for determining whether a price meets this criterion. A comparison with the price of competing products is not a necessary step in determining whether the criterion is met. However, where secondary legislation exists addressing the pricing of the type of product or service in question, it follows from EU case-law that such legislation may provide criteria for assessing whether the price paid is unfair.

7.1.9.2.5 The tariff is unfair due to the lack of capacity charges

7.1.9.2.5.1 Introduction

(1140) The tariff is unfair within the meaning of Article 102 TFEU and Article 18(1)(b) ECT because it fails to reflect underlying costs. This is the case for two reasons, which both separately and in combination result in an unfair price.

(1141) First, the tariff lacks fixed capacity charges, that is, charges which do not vary with the volumes of gas actually transited. Since the costs of transiting natural gas are mostly fixed and Gazprom has transited significantly lower volumes than Gazprom had ensured Naftogaz would be transited, the lack of a fixed capacity charge has resulted in an unfair transit price. Gazprom's claim that the "*overwhelming majority*" of Naftogaz' costs is fuel gas is not correct.

(1142) Second, the tariff has not been set on the basis of the regulatory asset base (RAB). Even if Gazprom had transited the gas volumes set out in the Contract, or if the tariff formula included fixed capacity charges, the tariff would be significantly below a cost-reflective level. Dr. Moselle and Mr Witschen allege that the RAB calculations presented in the Expert Competition Report are based on inappropriate assumptions, but their allegations have been rebutted in the Expert Reply, as discussed below.

7.1.9.2.5.2 The fixed costs of the network cannot be disregarded

(1143) As Mr Lapuerta and Dr. Hesmondhalgh note in their Expert Report, the vast majority of the costs of a gas transport system are fixed and do not vary with the volume of gas transported.

(1144) Gazprom argues that the *"overwhelming majority of the cost to Naftogaz of operating the Ukrainian GTS is the cost of fuel gas consumed by the system"*. In this context, Gazprom claims that the costs of the network assets have already been amortised. This is not correct. The average life of pipeline assets is significant and more than 50% of the assets have been commissioned later than 1987. However, Gazprom's argument also seems to imply that an assessment of the relevant costs involved in supplying a product should take account only of direct and variable costs, while fixed costs should be disregarded. Gazprom seems to interpret the reference in *United Brands* to *"the costs actually incurred"* too narrowly. However, ignoring the fixed costs would give a misleading picture of the relevant costs in supplying the transit service.

(1145) The position that only direct and variable costs involved in supplying the goods or services in question should be considered is contradicted by the *United Brands* judgment. With respect to assessing production costs, the ECJ took a broad view of the types of costs that may be relevant and noted that the assessment therefore may include some degree of discretion:

"While appreciating the considerable and at times very great difficulties in working out production costs which may sometimes include a discretionary apportionment of indirect costs and general expenditure and which may vary significantly according to the size of the undertaking, its object, the complex nature of its set up, its territorial area of operations, whether it

manufactures one or several products, the number of its subsidiaries and their relationship with each other, the production costs of the banana do not seem to present any insuperable problems." United Brands, paragraph 254;

(1146) The European Commission has confirmed that the depreciation of assets is relevant in assessing the cost-structure. This follows from the decision in the *Port of Helsingborg* case, which involved the question whether the said port levied excessive port charges. In assessing whether the lower port charges levied by another port (the port of Elsinore) could meaningfully be compared to those levied by the port of Helsingborg, the Commission pointed out that unlike the port of Helsingborg, the port of Elsinore did not depreciate its assets and that this fact "*would make a difference in the cost-structures of the two ports and possibly in the prices*" (cf. *Port of Helsingborg*”).

(1147) Against this background, the assessment of a cost-reflective price cannot be limited to direct and variable costs, but must take the fixed costs into account. In the case of gas transit, the fixed costs must be reflected in fixed capacity charges in order for the tariff prices to reflect "*the economic value of the product supplied*".

7.1.9.2.5.3 The network assets are not fully amortised

(1148) Gazprom argues that the cost of construction of the Ukrainian GTS "*is likely already to have been fully amortised and/or covered by what Gazprom has already paid to Naftogaz*".

(1149) On this point, Gazprom refers to the witness statement of [REDACTED] in which he argues that "*the average life of a pipeline such as those used in Ukraine is approximately 30-35 years*" so that the transmission system is "*fully amortised*". [REDACTED] goes on to argue that "*Gazprom has fully paid for the costs of construction of the Ukrainian pipeline system through the provision over the past two decades of enormous quantities of gas at heavily subsidised prices*".

- (1150) [REDACTED] argument regarding depreciation is contradicted by Mr Witschen's acknowledgement that: *"Normally, pipelines are depreciated over a period of 40-60 years."* (Cf. Witschen Report).
- (1151) Similarly, the RAB determined by Ernst & Young is based on an assumption that the pipelines should be depreciated over a period of 60 years (cf. Expert Reply). For compressors and other elements of the transmission network, the period was assumed to be 30 years and 50 years, respectively.
- (1152) Naftogaz considers that the lifetime assumptions used in the Ernst & Young determination are the most appropriate.
- (1153) The Expert Reply provides a figure showing the age distribution of the gas transmission assets in Ukraine's grid. Based on historic costs, at least 50% of the assets have been commissioned since 1987. Accordingly, the network assets are not fully depreciated and it is necessary to include allowances for a return on the assets.
- (1154) While [REDACTED] claims that Gazprom has already fully paid for the construction of the Ukrainian pipelines system through the provision of subsidised gas (cf. [REDACTED]), Mr Witschen claims that the revenues received by Naftogaz between 2002 and 2012 were sufficient to repay a new pipeline such as the Nord Stream pipeline (cf. Witschen Report).
- (1155) No empirical support or calculations have been provided in support of [REDACTED] claim regarding subsidised gas prices. Also, [REDACTED] has not explained why Gazprom should be willing to sign the Contract in 2009 if it really had believed that it had already paid for the Ukrainian pipeline system, as noted in the Expert Reply.
- (1156) Moreover, as noted by Mr Lapuerta and Dr. Hesmondhalgh in their report, Mr Witschen's calculation in this respect is misleading (Expert Reply). His calculation assumes a single pipeline, but the Ukrainian GTS consists of a network of pipelines with a total length several times greater

than he assumes. The calculation is also misleading for other reasons, as explained in the Expert Reply.

7.1.9.2.5.4 The claim that Naftogaz received the pipelines at no cost

- (1157) Mr Witschen argues that the construction costs of the network are irrelevant, claiming that Naftogaz received the pipeline assets "*at no cost*" following the dissolution of the Soviet Union (cf. Witschen Report). The argument seems to assume that Russia paid to build the assets when Ukraine belonged to the Soviet Union, so that tariffs based on the value of the assets (the regulatory asset base) would mean that Gazprom paid twice for the same assets (cf. Expert Reply).
- (1158) Such an argument is highly problematic, as discussed above. Moreover, it is not borne out by the facts.
- (1159) It was not the Russian Soviet Republic that paid the costs of the pipeline assets in Ukraine, and Mr Witschen provides no evidence to this effect. It was the Soviet government that took the decision to build the assets, as pointed out in the Expert Reply. As [REDACTED] explains in his second witness statement, Ukrainian economic entities contributed significantly to the development of gas deposits in the Russian Soviet Republic and also to the development of the Soviet gas industry in general. Also, after the collapse of the Soviet Union, Ukraine assumed the Soviet Union's obligations towards Bulgaria, Czechoslovakia (inherited by the Czech Republic) and the German Democratic Republic (inherited by the Federal Republic of Germany) arising from the development of the Yamburg gas field and the building of the main pipeline from Yamburg to the Soviet Union's western border, cf. [REDACTED]
- (1160) Furthermore, Ukraine paid for the pipeline assets by way of a significant transfer of assets to Russia which heavily outweighed what Ukraine retained. Ukraine and Russia's so-called 'zero-option' deal of 1994 left Ukraine with no liquid reserves and none of the essential institutional structure for running a market economy, while Russia gained significant financial assets, fixed assets and gold, diamond and copper stock. This is further explained in the Expert Reply, which also provides relevant literature.

(1161) In addition, Gazprom repeatedly attempted to negotiate ownership of the pipeline network by offering Naftogaz 'debt relief', which confirms that all parties accepted that the pipeline assets belonged to Ukraine. This is also confirmed by the fact that Gazprom entered into the Contract in 2009, which provides for a tariff that does provide some return (although significantly too low) on the existing network assets.

(1162) Ukraine's gas transportation system has also been upgraded substantially since the dissolution of the Soviet Union, as explained in [REDACTED]. Based on historic costs, at least 50% of the gas transmission assets have been commissioned since 1987, as seen from the figure in the Expert Reply.

(1163) The claim that Naftogaz received the pipeline assets for free is therefore incorrect.

7.1.9.2.5.5 Capacity charges are necessary to reflect Naftogaz' fixed costs

(1164) Gazprom has reserved a significant capacity in the network through the Contract and limited gas volumes are transported by third parties, in large part due to Gazprom's control of entry and exit points. The fact that the tariff formula is based solely on the volumes transported and these volumes have been lower than expected, has resulted in Naftogaz carrying out the transit service at a significant loss.

(1165) Since the costs of transiting natural gas are mostly fixed, charges for booked capacity which do not vary with the volumes of gas actually transited are necessary to ensure that Naftogaz's relevant costs are covered.

(1166) Most gas transmission contracts secure coverage of fixed costs, through capacity charges or ship-or-pay obligations. The lack of capacity charges or ship-or-pay obligations is an unusual feature of the Contract.

(1167) Once the Sales Contract had been finalised, Naftogaz requested a provision under the Contract similar to Naftogaz' take or pay obligation under the Sales Contract. Such a ship or pay clause would have prevented the revenue shortfall that has resulted from the lower transmission

volumes, in essentially the same way as a capacity charge. However, Gazprom would only accept a ship or pay clause in the Contract if Naftogaz undertook a number of additional obligations, in particular regarding "flexibility", which would essentially undermine the purpose of a ship or pay clause. These obligations were not acceptable to Naftogaz.

(1168) Moreover, "flexibility" does affect the need for capacity charges, and a dominant supplier should not set additional flexibility as a condition for accepting capacity charges, as noted by Mr Lapuerta and Dr Hesmondhalgh (cf. Expert Reply).

(1169) As described by Mr Lapuerta and Dr Hesmondhalgh in their Expert Reply, capacity charges were recommended as an efficient tariff model in a report prepared for the European Commission in 2010. Dr. Moselle, who has been appointed by Gazprom in these proceedings, co-authored the report, together with Mr. Lapuerta and a third expert, Paul Carpenter. Since then, ACER (the Agency for the Cooperation of Energy Regulators) has published framework guidelines (the "TARIFF FG") that reflect the same approach, and the European Network of Transmission System Operators for Gas ("ENTSOG") has re-submitted the draft Network Code on Harmonised Transmission Tariff Structures for Gas ("TAR NC") to ACER for consideration. Once adopted and entered into force (expected to be in 2017), the TAR NC will implement this approach as mandatory law. Accordingly, capacity charges have now been accepted as the most efficient tariff methodology. The tariffs determined by the Ukrainian regulator on 29 December 2015 are capacity charges, cf. below. The fact that the use of capacity charges is not yet mandatory in all EU and ECT jurisdictions does not prevent the application of Article 102 to a tariff that is unfair as a result of the absence of such charges.

(1170) In practice, a capacity charge is formulated as the amount of money payable for a given capacity unit at a given point in the network. For example, the tariffs determined by the Ukrainian Regulator are defined in US Dollars per 1000 cubic metres of firm capacity at the entry and exit points to the Ukrainian GTS. Even if the capacity reserved is not used, the full amount is charged.

(1171) Mr Lapuerta and Dr Hesmondhalgh discuss in greater detail the economic logic underlying a capacity charge (cf. their Expert Reply).

(1172) As noted in their report, the fact that the Contract involves large volumes does not reduce the need for a capacity charge. Mr Witschen's claim in his report that the lack of a capacity charge is due to the large volumes is difficult to understand and seems to be a speculation.

(1173) [REDACTED] cites a report from PFC Energy⁷⁸ which claimed that the tariff involves a premium as a protection against the risk involved in not having a capacity-based price (cf. [REDACTED]). However, the tariff does not involve a premium, as the tariff falls short of covering Naftogaz' costs even if Gazprom had transited the promised volumes. Moreover, there are no indications that Naftogaz during the negotiations assessed the risk of a shortfall in volumes and assessed the size of a premium (above-cost) element of the tariff, and weighed these against each other. Quite the opposite: the negotiations assumed that Gazprom would transit the volumes it had ensured. In short, Naftogaz was not compensated through a premium tariff.

7.1.9.2.5.6 Conclusion

(1174) The vast majority of the costs of a gas transport system are fixed and do not vary with the volume of gas transported. These fixed costs cannot be disregarded in the assessment of a cost-reflective price. Gazprom's claims that the Ukrainian gas network has been fully amortised and that Naftogaz received the assets at no cost are unfounded. To ensure that Naftogaz's relevant costs in providing the transmission service are covered, Gazprom must pay charges for the capacity it has booked so that the tariff does not vary with the volumes of gas actually transited (other than the fuel gas). The lack of such a capacity charge has led to a tariff that is unfair within the meaning of Article 102 TFEU.

7.1.9.2.6 The tariff is unfair because it is not based on the regulatory asset base (RAB)

⁷⁸ Assessment of Gas Transit Terms between Gazprom and Naftogaz, prepared for Gazprom by PFC Energy, dated January 2010

7.1.9.2.6.1 Introduction

(1175) The lack of a fixed capacity charge has in itself resulted in an unfair price. However, the tariff is so low that it would be unfair even if Gazprom had transited the agreed gas volumes or if the tariff had provided for a capacity charge. The appropriate methodology for determining a cost-reflective tariff is on the basis of the regulatory asset base (RAB). The tariff paid by Gazprom falls significantly below a cost-reflective tariff determined on this basis.

(1176) Mr Lapuerta and Dr. Hesmondhalgh have calculated a cost-reflective tariff for 2010 based on the contract path tariff structure of the Contract (as opposed to under entry-exit tariffs). The calculations have been made under two alternative assumptions (cf. the Expert Reply):

- Gazprom had transited the agreed volumes (or had paid for these volumes in full as a result of a capacity charge); and alternatively
- Gazprom transited only the actual volumes and therefore must pay a higher tariff.

(1177) The table provided in the Expert Reply is repeated below. It demonstrates the significant deviation between the contract tariff and cost-reflective tariffs under each of the two alternative assumptions (agreed volume or actual volume). The columns "Principal Jan-10" and "Alternative Feb-11" refer to Naftogaz' principal under-payment claim and the alternative under-payment claim, respectively.

Claim Date		Principal Alternative	
		Jan 10	Feb 11
Cost reflective revenues US\$ bln	[1] Table B2	4.94	4.94
Agreed volumes mcm	[2] Table B102	110,000	102,700
Actual volumes mcm	[3] Table B104	97,809	92,885
Assumed distance km	[4] Article 8.1, Transit Contract	1,240	1,240
Adjusted tariff level			
Agreed volumes US\$/'000m3/'00 km	[5] $[1] \times 10^8 / ([2] \times [4])$	3.62	3.88
Actual volumes US\$/'000m3/'00 km	[6] $[1] \times 10^8 / ([3] \times [4])$	4.08	4.29
Actual tariff US\$/'000m3/'00 km	[7] Table B34	2.04	2.06
Difference in tariff			
Agreed volumes US\$/'000m3/'00 km	[8] [5]-[7]	1.58	1.82
Actual volumes US\$/'000m3/'00 km	[9] [6]-[7]	2.04	2.23

(1178) Even if Gazprom had transited the agreed volume of 110,000 million cubic meters in 2010, the cost-reflective tariff would be USD 3.62 per 1,000 cubic meters per 100 kilometers, which significantly exceeds the USD 2.04 set out in the Contract. Moreover, a cost-reflective tariff based instead on the alternative assumption, i.e. on the actual volumes transited by Gazprom in 2010, is USD 4.08 per 1,000 cubic meters per 100 kilometers. This is 100% higher than the tariff set out in the Contract. In other words, given Gazprom's actual transit volumes, the tariff in the Contract covers only half of Naftogaz' costs, and imposed a loss of USD 2.04 per 1000 cubic meters per 100 kilometers on Naftogaz in 2010.

(1179) The significant shortfall under both assumptions demonstrates that, in the absence of an objective justification, the tariff under the Contract is unfair within the meaning of Article 102 TFEU.

(1180) These tariff amounts, which reflect the calculation carried out by Mr Lapuerta and Dr. Hesmondhalgh in their Report (cf. the Expert Report), are significantly higher than the tariff set out in the Contract. The very substantial difference between the tariff paid by Gazprom and the said cost-reflective tariff amounts makes clear that the tariff imposed by Gazprom is unfair and abusive.

- (1181) Naftogaz refers to the Expert Report, in which Mr Lapuerta and Dr. Hesmondhalgh provided a detailed assessment of the RAB determined in the EY report prepared for the competent Ukrainian authority (NCSREU).
- (1182) The assessment provided by Mr Lapuerta and Dr. Hesmondhalgh and the assumptions underlying it have been challenged on several points by Dr. Moselle, who essentially argues that the RAB calculation overstates Naftogaz' costs and would result in a too high tariff.
- (1183) It should be added that Mr Lapuerta and Dr. Hesmondhalgh have adjusted and updated their RAB calculations in their Expert Reply. The revised RAB calculations match the RAB finally approved by the Ukrainian regulator, which is somewhat lower than EY originally had estimated.
- (1184) The objections raised by Dr. Moselle against the assessment of the RAB may be summarised as follows:

The RAB assessment is based on the costs of replacing the Ukrainian pipeline assets, but a more appropriate approach would be to consider the historical costs incurred in building or acquiring the assets a "historical cost" method rather than a "replacement cost" method (cf. Moselle Report).

The assessment of depreciation is based on the factual assumption that there will be no transit flows after the expiry of the Contract in December 2019, which Dr. Moselle believes is questionable (cf. Moselle Report). He has also questioned whether it is correct as a matter of law to assume depreciation over a period ending in December 2019 (cf. Moselle Report).

The assessment of the rate of return is based on questionable assumptions (cf. Moselle Report).

The assessment of operating expenses (opex) does not make clear where the cost data is derived from and there is evidence suggesting that not all of Naftogaz' costs have been efficiently incurred (cf. Moselle Report).

(1185) Finally, Dr. Moselle has carried out a benchmarking of the tariff in 2013 and 2014 against other transit-type tariffs, with reference to a benchmarking report prepared by the Brattle Group for Gazprom Export in 2010. He concludes that the tariff was in the central or upper range of comparator tariffs in 2013 and 2014.

(1186) These objections will be addressed in turn below. Before going into these detailed issues, two more general objections raised by Dr. Moselle against Mr Lapuerta and Dr. Hesmondhalgh's assessment will be addressed.

7.1.9.2.6.2 The RAB assessment follows the Regulator's approach

(1187) Dr. Moselle claims that Mr Lapuerta and Dr. Hesmondhalgh's assessment relies on a number of subjective judgments, and other approaches consistent with EU regulatory practice would yield significantly different results (cf. Moselle Report, paragraphs 6.5 and 6.6).

(1188) However, Mr Lapuerta and Dr. Hesmondhalgh have not made their own RAB calculation based on a free choice among any number of equally appropriate methodologies. Their approach follows the methodology approved by the independent Ukrainian Regulator (cf. Expert Reply). The approved tariff will be implemented on 27 February 2016 with effect from 1 January 2016. As noted by Mr Lapuerta and Dr. Hesmondhalgh, the Regulator has adopted replacement costs as the basis for the tariffs applicable to all natural gas consumption in Ukraine. The government of Ukraine has no incentive to set an excessive rate-base, as it would only harm the competitiveness of Ukrainian industry.

(1189) Dr. Moselle claims that Mr Lapuerta and Dr. Hesmondhalgh have not estimated any of the revenue elements independently, but have relied on Naftogaz itself, studies commissioned by Naftogaz and the Ernst & Young report (cf. Moselle Report).

(1190) Dr Hesmondhalgh and Mr Lapuerta presented with their Expert Report the preliminary figures calculated by the renowned independent auditor and consultancy firm EY. These figures were

applied as the basis for Dr Hesmondhalgh and Mr Lapuerta's further analyses explained in the Expert Report.

(1191) It is standard to rely on calculations performed by an independent, renowned accounting firm such as EY. Similarly, under Article 3.2 of the Contract, the Parties have chosen to rely on a third-party auditor's assessment of Gazprom's volume obligations in the circumstances set out in that clause.

(1192) Moreover, these are the figures that the national Regulator applies when setting the future tariffs for entry and exit points, and which all market participants in Ukraine will have to abide to, also Ukrainian consumers, who in the end will be the one to cover the market participants' additional costs of transportation. Accordingly, there is no reason to question the calculations of the RAB, which formed the basis for the calculations presented in the Expert Report.

(1193) As explained in the Expert Reply, the Regulator estimated the RAB as of October 2015 to UAH 172 billion. In order to determine the RAB as of January 2010 (the principal claim) and February 2011 (the alternative claim), Mr Lapuerta and Dr. Hesmondhalgh made certain adjustments:

- assets constructed since 2010 were deducted (and under the alternative claim, assets constructed since 2011);
- assets in the temporarily occupied areas (Crimea, Eastern Ukraine) were added; and
- the value of remaining assets was adjusted in line with the methodology used by EY.

(1194) On this basis, the estimated initial RAB as of January 2010 is UAH 145 billion (the principal claim). It is UAH 167 billion as of February 2011 (the alternative claim), as detailed in the Expert Reply.

(1195) Mr Lapuerta and Dr. Hesmondhalgh calculated RAB values for subsequent years as follows:

- the value of the initial RAB was reduced each year to reflect depreciation;

- new assets constructed in each year were added and depreciated separately; and
- assets in the temporarily occupied areas were taken out from January 2015 (the start of the second regulatory period).

(1196) The RAB and depreciation figures for each year based on these calculations are shown in the Expert Reply.

7.1.9.2.6.3 Replacement cost method

(1197) The EY Report was based on the costs of replacing the pipeline assets – the "replacement cost" method. Dr. Moselle argues that a "historical cost" approach may be more appropriate (cf. Moselle Report). Such an approach would be based on the costs incurred in building or acquiring the assets.

(1198) As the main argument for the historical cost approach, Dr. Moselle argues that it *"allows the regulated company to achieve the allowed return on its actual investments, avoiding under or over compensation"* (cf. Moselle Report). However, this is a strong argument against using this approach in the case of the Ukrainian pipeline network.

(1199) In state-controlled or non-market economies, historic values of assets would have been determined by governmental authorities, who would have been influenced by political considerations. Such historic values need not ultimately reflect the true costs of investment and are essentially without economic meaning (cf. Expert Reply). As further explained in the Expert Reply, this problem has been recognised in international trade law, which distinguishes between non-market economies and market economies in determining "normal prices".

(1200) Ukraine was not a market economy when it was part of the Soviet Union. At that time, government decisions rather than market forces set the prices for asset purchases. Several other East European countries also use the replacement cost method to measure the RAB of their transmission networks (cf. Expert Reply).

(1201) Dr. Moselle's arguments in favour of a historical cost approach are discussed in greater detail in the Expert Reply, where Mr Lapuerta and Dr. Hesmondhalgh maintain that the replacement cost methodology represents the most appropriate approach.

(1202) In addition, the Ukrainian regulator has adopted this methodology in determining the RAB on which the tariffs for Ukrainian customers is based. Applying a different methodology in the case of Gazprom would lead to discriminatory prices. As noted above, the Ukrainian Regulator has published final tariffs for cross-border transmission services. The published tariffs apply with effect from 1 January 2016. Should a different methodology be used to calculate a unique tariff for Gazprom, the result would be discrimination between Gazprom and other customers.

(1203) Finally, it is worth noticing that Dr. Moselle's claim that a historical cost approach should have been used instead is expressed in quite tentative terms: "*...it can be argued that a historical cost approach valuation may be more appropriate...*" (cf. Moselle Report). This may have to do with the fact that he has previously taken a more favourable view of using a historical approach, in particular in the context of government-owned network assets, as documented in the Expert Reply.

(1204) Naftogaz maintains that the replacement cost methodology relied on by Mr Lapuerta and Dr. Hesmondhalgh is the most appropriate.

7.1.9.2.6.4 The depreciation period cannot extend beyond term of Contract

(1205) Naftogaz considers that Gazprom is unlikely to continue to transit natural gas through the Ukrainian network after December 2019, when the term of the Contract expires. As a result, the cost-reflective tariff presented in the Expert Report was based on the factual assumption that there will be no transit flows after the expiry of the contract (cf. Expert Report).

(1206) Dr. Moselle has offered some views on this factual assumption (cf. Moselle Report). He refers to a statement from Gazprom's Chief Executive Alexei Miller that the company may be

rethinking its intention to discontinue gas transit through Ukraine to Europe.⁷⁹ [REDACTED] cites Mr Miller's responses from the same press conference in full (cf. [REDACTED]).

(1207) However, the Reuters article mentions the important fact that Gazprom had previously said that it would in fact "*stop transporting gas to European customers through Ukraine after 2019*", even as late as a month earlier.

(1208) Moreover, Mr Miller's statements were made at a press conference in June 2015. Mr Miller's statements were inconclusive and did not involve any commitment on Gazprom's side, while at the same time fit well with Gazprom's defence in this arbitration. Naftogaz therefore believes that there are strong reasons not to accept the said statement without reservation. The same applies to any later statements to the same effect by Gazprom executives or Russian officials.

(1209) Based on the assumption that the transit flows will end in December 2019, the depreciation of the network assets has been accelerated to ensure that they will be fully depreciated by the end of December 2019 (cf. Expert Report).

(1210) In addition to challenging this factual assumption, Dr. Moselle has questioned whether this accelerated depreciation is correct from a legal perspective (cf. Moselle Report).

(1211) However, as noted by Mr Lapuerta and Dr. Hesmondhalgh in their report, there is no reasonable possibility that any other shippers than Gazprom would use most of the Ukrainian network. In this context, Mr Witschen points out in his report that:

"The current entry points were essentially determined by the process of demarcating Ukraine's borders, are exclusively connected to pipelines owned by Gazprom and can only be fed with Russian gas from these pipelines."

(1212) As also noted in the Expert Reply, long-term contractual commitments by the users to recover all of the underlying costs is the standard business model for European transit pipelines.

⁷⁹ Update 1 – Russia backs down from abandoning gas transit through Ukraine. Reuters, June 26, 2015

Assuming that transit flows from Russia cease after December 2019, Ukrtransgaz would have to recover all remaining capital costs from Ukrainian consumers. It would not be appropriate to have Ukrainian consumers bear the costs for portions of the network that they do not use, and have never used.

(1213) Against this background, it is clear that Gazprom will have to bear the majority of the costs of the transit system. Should Gazprom continue to transit gas through Ukraine after the assets have been fully depreciated, the tariffs would reflect this fact and be very low (cf. Expert Reply).

(1214) Moreover, as pointed out by Mr Lapuerta and Dr. Hesmondhalgh, the relief requested by Naftogaz would permit virtual reverse flows. Should the Tribunal grant the relief, other market participants may start to transit gas across Ukraine before the end of 2019 and would share the costs, in accordance with the tariff methodology (cf. Expert Reply).

(1215) As they also note, the Ukrainian Regulator has depreciated all the transit assets over the period to 2019 when calculating the actual cost-reflective tariffs for 2016. In other words, depreciation until the expiry of the Contract in 2019 is also consistent with the Regulator's methodology (cf. Expert Reply, Section V.C).

7.1.9.2.6.5 The cost of capital (rate of return)

(1216) The calculation of a cost-reflective tariff must include a reasonable rate of return on the value of the assets. The rate of return should be based on an appropriate weighted-average cost of capital (WACC). This approach seems to be accepted by Dr. Moselle (cf. Moselle Report).

(1217) The appropriate WACC as of June 2014 had previously been determined by the Ukrainian Ministry of Economics, which had retained PWC to replicate the WACC calculation. Mr Lapuerta and Dr. Hesmondhalgh relied on PWC's analysis to determine the relevant WACC values (cf. Expert Report).

(1218) In their Expert Reply, Mr Lapuerta and Dr. Hesmondhalgh have agreed with some of the points made by Dr. Moselle and have corrected their WACC calculations accordingly (cf. Expert

Reply). The difference is relatively small. Moreover, they have enclosed PWC's analysis with the Expert Reply.

(1219) However, Dr. Moselle's criticism on substance is largely unfounded.

(1220) Firstly, Dr. Moselle raises the question whether Mr Lapuerta and Dr. Hesmondhalgh have used the WACC values given to them by Naftogaz and that they have not reviewed themselves (cf. Moselle Report). However, this question relies on an incorrect statement that PWC had been retained by Naftogaz (cf. Expert Report), while PWC had in reality been retained by the Ministry of Economics. Mr Lapuerta and Dr. Hesmondhalgh intended to match the WACC that the Regulator would have used (cf. Expert Reply).

(1221) Secondly, Dr. Moselle believes it would be more appropriate to calculate the risk-free rate from the yields of 10-year bonds rather than 20-year bonds. However, the appropriateness of 10-year bonds depends on the assumed "market risk premium", that is, the extent by which stocks have outperformed the risk-free rate. The market risk premium used by PWC and Dr Moselle is derived from data using bonds of different durations. The average duration is approximately 15 years. As noted by Mr Lapuerta and Dr. Hesmondhalgh, there is no perfect match between market risk premium and risk-free rate, neither in PWC's calculation nor in Dr. Moselle's (cf. Expert Reply). Against this background, Mr Lapuerta and Dr. Hesmondhalgh have adopted PWC's calculation, since it has been approved by the Ukrainian Ministry of Economy and the regulator.

(1222) Thirdly, since he did not have access to the comparators used in PWC's estimation, Dr. Moselle made new calculations based on other values for the "beta" factor (that is, the factor measuring the level of risk of an investment that cannot be diversified through diversification) and the share of debt financing. Moreover, Mr Lapuerta and Dr. Hesmondhalgh have updated their beta calculations in the Expert Reply after they received and reviewed this information (cf. Expert Reply).

(1223) Fourthly, Dr. Moselle's new calculation was based on cost of debt estimates from different months than used by PWC, but PWC's calculation was based on the last available data, as described in the Expert Reply.

(1224) Accordingly, the adjusted WACC (rate of return) calculated in the Expert Reply, which is only slightly lower than the original calculation, is based on the most appropriate estimates available.

7.1.9.2.6.6 Operating costs (Opex)

(1225) Mr Lapuerta and Dr. Hesmondhalgh's assessment of the operating costs was based on data for 2011 to 2014 provided by Naftogaz, while data for 2010 and 2015 were extrapolated on the basis of changes in the Ukrainian producer price index (cf. Expert Report). The use of actual operating costs for each year was based on the assumption that the Regulator's tariff setting methodology would include an adjustment mechanism to account for differences between forecast and actual operating costs. However, the regulator's final methodology specifies that there will be no adjustments during the first regulatory period. As a result, Mr Lapuerta and Dr. Hesmondhalgh's updated analysis relies on actual costs only for the year prior to the start of the first regulatory period (cf. Expert Reply). Accordingly, their updated analysis is based on the approach that annual operating costs are derived from an assumed base level of costs, given by the actual costs in the year before the first regulatory period begins and then these costs are inflated for each of the years in the regulatory period using inflation forecasts available at the time that the allowed revenues are determined.

(1226) Dr. Moselle claims to have found "unexplained differences" between the data used for the years 2012 and 2013, and the operating costs provided for "transportation of natural gas" in Naftogaz' audited financial statements (cf. Moselle Report). However, there is no inconsistency. As pointed out in the Expert Reply, the data Dr. Moselle refers to are not provided in the annual accounts but are his own calculations of the difference between revenues and gross profits, which can include other expenses. Also, the data reported in the accounts include a subsidiary of Naftogaz which should not be included in the assessment of operating costs.

(1227) It may be added that Mr. Lapuerta and Dr. Hesmondhalgh's updated analysis does not rely on actual costs for 2012 and 2013.

(1228) Dr. Moselle also argues that *"there is evidence which suggests that not all of Naftogaz' costs may have been efficiently incurred"* (cf. Moselle Report). In this context he refers to an interview given by ██████████ in which he mentions that Naftogaz had previously *"for example spent 600 million dollars for geological research that did not lead to anything"*. However, as pointed out in the Expert Reply, no such costs are included in the operating or investment cost figures used by Mr. Lapuerta and Dr. Hesmondhalgh. Their cost figures are limited to costs related to the transportation network. Moreover, to the extent that Dr. Moselle believes that the historical costs of building the pipeline assets have not been efficiently incurred, this would be an additional argument supporting the use of a replacement cost methodology rather than a historical cost methodology.

7.1.9.2.6.7 The Brattle Group's 2010 benchmarking report did not assess cost-reflectivity

(1229) In its defence against Naftogaz' price revision claim, Gazprom has referred to the report prepared by the Brattle Group for Gazprom Export in 2010, which benchmarked the tariff under the Contract against other transit tariffs applicable at the time.⁸⁰ ██████████ and Dr. Moselle have also referred to the 2010 report (cf. ██████████ Moselle Report).

(1230) As mentioned in the Expert Report submitted with the Statement of Claim, the 2010 benchmarking report was co-authored by Mr. Lapuerta and Dr. Hesmondhalgh. The report concluded that the tariff lay broadly in the middle, or towards the upper end of the range of 62 comparator tariffs from seven pipeline systems examined. However, the 2010 benchmarking report did not address whether these other pipelines were in competition with Ukraine and it did not assess whether the tariff reflected the costs of the Ukrainian pipeline assets.

⁸⁰ "Benchmarking of Ukrainian Gas Transit Tariff to Other Comparable Tariffs. A Report for Gazprom Export" dated January 2010 by Serena Hesmondhalgh, Carlos Lapuerta and Penelope Dickson, The Brattle Group.

(1231) As further explained in the Expert Reply:

- The benchmarking report analysis included fuel gas costs as part of the tariffs. However, the need for fuel gas principally depends on the need to operate the compressors required to keep the gas moving along the pipelines, and the fuel gas requirements therefore vary with pipeline length. In 2011, Gazprom Expert's gas price forecast indicated that fuel gas costs would represent approximately 25% of the overall tariff under the Contract. Relatively high Ukrainian transit tariffs could reflect high fuel gas costs even if tariffs were below the level required to recover other operating costs of the Ukrainian pipeline network and to provide a reasonable return on the underlying assets.
- In addition, benchmarking will not provide insights into cost-reflectivity given that the costs of each network will vary, depending on factors such as 1) the age of the assets (which will influence the RAB) and 2) the differences in cost of capital (which may vary due to company and country specific factors).
- Also, the split between tariffs at different entry and exit points in an entry-exit system will vary.

(1232) As explained in the Expert Reply, such factors were addressed in the benchmarking report, where it was stated that where the comparator tariffs are based on an entry-exit or postage stamp basis, additional assumptions had to be made in order to arrive at figures that could be compared to the Ukrainian tariffs and that there were differences that they had not adjusted for.

(1233) The abovementioned factors would affect Dr Moselle's replication of the analysis for 2013 and 2014 (cf. Moselle Report). For the same reasons, the benchmarking report by PFC Energy submitted by Gazprom⁸¹ provides no insights into the relative cost-reflectivity of Ukrainian and other European transit tariffs either, cf. the Expert Reply. It should also be noted that the PFC

⁸¹ "Assessment of Gas Transit Terms between Gazprom and Naftogaz", A report for Gazprom Export by PFC Energy, dated January 2010.

Energy report points out that due to differences in pricing systems and volumes *"it is hard to make a direct comparison between Gazprom's Ukraine tariff and Western European tariffs"*.

(1234) Benchmarking against other transit-type tariffs is not relevant to Naftogaz's claim that the tariff is unfair. The basis for this claim is not a direct comparison with tariffs in other countries, but instead that the tariff is not cost-reflective. Since pipeline-to-pipeline competition does not exist in the case of the Ukrainian gas transmission system, no direct price comparison can be made.

(1235) A separate point is that the Brattle Groups's benchmarking report reflected on the lack of a ship or pay commitment for Gazprom, which was referred to as an "unusual" feature of the Ukrainian transit tariff. As noted in the 2010 report: *"The absence of such a commitment exposes Naftohaz Ukrayiny to higher volume risk than most regulated transportation companies."* To reflect the lack of such commitment, the 2010 report discounted the actual Ukrainian tariff by 30%.⁸² This approach illustrates that the lack of a ship or pay clause or other capacity booking charge is a significant deviation from a normal tariff, and that the volume risk imposed on the network owner through such a tariff is comparable to a lower tariff level.

7.1.9.2.6.8 Conclusion

(1236) As demonstrated by Mr Lapuerta and Dr. Hesmondhalgh in their Expert Reply, the methodology used by the Ukrainian Regulator in determining the RAB and a cost-reflective tariff is appropriate. Moreover, the updated calculations provided in the Expert Reply reflect the best available data.

(1237) The very substantial difference between the tariff paid by Gazprom and a cost-reflective tariff as calculated by the experts makes clear that the tariff imposed by Gazprom is unfair and abusive.

7.1.9.2.7 The unfair tariff affects competition

⁸² Page 1 of "Benchmarking of Ukrainian Gas Transit Tariff to Other Comparable Tariffs. A Report for Gazprom Export" dated January 2010 by Serena Hesmondhalgh, Carlos Lapuerta and Penelope Dickson, The Brattle Group.

- (1238) The unfair tariff involves abusive exploitation of Naftogaz, which as a result of the unfair tariff carries out transit services at a loss. The below-cost tariff paid by Gazprom involves a shortfall in revenues with the result that maintenance of and investments in the grid are underfinanced.
- (1239) Furthermore, the below-cost tariff implies that Naftogaz is forced to subsidise Gazprom's natural gas sales into the EU, including to countries that form part of the relevant geographic market. The transit tariff is a part of Gazprom's costs involved in selling gas to Slovakia, Poland and Hungary as well as to other EU countries. All else equal, the below-cost tariff is a subsidy that gives Gazprom a cost advantage compared to competing gas suppliers.
- (1240) Finally, the unfair tariff results in discrimination between Naftogaz and other buyers of transmission through Ukrainian territory. This discrimination in itself represents a separate abuse within the meaning of Article 102 TFEU and also an anticompetitive restriction under Article 101 TFEU.

7.1.9.2.8 The unfair tariff affects trade into and within the EU

- (1241) Gazprom's abuse of its dominant position is manifested in various provisions of the Contract. Together, and in conjunction with the Gas Sales Contract, they form part of an overall strategy to isolate the Ukrainian market and to force Naftogaz to accept business methods and arrangements which produce effects on competition within the EU and on trade between EU Member States. It would therefore be sufficient that only one of the abusive practices is capable of affecting trade within the EU (and the Energy Community). Naftogaz demonstrated that Gazprom's abuse does affect trade.
- (1242) However, even if the unfair tariff should be considered as a separate abuse, the requirement of effect on trade would be met. The unfair tariff implies that Naftogaz is subsidizing Gazprom's natural gas sales into the EU. Gazprom's lower costs of supplying EU countries is clearly liable to affect the pattern of trade between EU countries, since natural gas is supplied across national borders by suppliers and traders in several countries. In addition, the unfair tariff results in

discrimination between Gazprom and other buyers of transmission through the territory of Ukraine, which is also liable to affect actually or potentially the pattern of trade between EU countries.

(1243) On this background, the unfair tariff may affect trade between EU countries. It clearly also affects trade between Ukraine and EU countries.

7.1.9.2.9 The decision of the Anti-Monopoly Committee of Ukraine

(1244) Ukraine's competition law enforcement body, the AMCU, has concluded that Gazprom's insistence on the tariff under the Contract was in breach of Article 13 of the Ukrainian Competition Law. In its decision in case No. 143-26.13/108-15, the AMCU found that Gazprom held a dominant position within the Ukraine's natural gas transportation market as a buyer, and determined that Gazprom had breached Article 13 and Article 50 (2) of the Ukrainian Competition Law, which prohibits the abuse of a position of monopoly or dominance. The AMCU's conclusion is in line with Naftogaz' claim in this Arbitration.

7.1.9.2.10 Conclusion

(1245) Gazprom has exploited its position as a dominant gas supplier and unavoidable trading partner for Naftogaz to impose a transit tariff that results in an unfair price. The tariff deviates significantly from a cost-reflective price both due to the absence of a capacity charge and because the tariff fails to reflect the underlying costs of the network. Gazprom's imposition of the unfair price constitutes an abuse of a dominant position within the meaning of Article 102 TFEU and Article 18(1)(b) ECT.

7.1.9.3 Discriminatory pricing pursuant to Articles 101 and 102 TFEU and Article 18 ECT

7.1.9.3.1 Introduction

(1246) The below-cost transit tariff paid by Gazprom involves anti-competitive discrimination, since other network users face higher tariffs.

(1247) With regard to discrimination under Article 102 TFEU, Gazprom has referred to *litra* (c) of this provision, which prohibits a dominant company from "*applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage*". However, Naftogaz' price discrimination claim is not based on Gazprom having treated different trading parties differently. The Article 102 claim does not rely on *litra* (c). Instead, the below-cost tariff paid by Gazprom is abusive because it leads to discrimination between Gazprom and other network users in breach of Article 102 TFEU.

(1248) As regards discrimination under Article 101 TFEU, Gazprom argues that the transit tariff in Contract TKGU formed part of a freely-negotiated commercial agreement". Gazprom further argues that "Naftogaz has failed to establish that it had as its object or effect the prevention, restriction or distortion of competition in breach of Article 101 TFEU.

(1249) Finally, the price discrimination affects trade between EU countries and between ECT countries, as discussed below.

7.1.9.3.2 Discrimination in breach of Article 102 TFEU and Article 18(1)(b) ECT

(1250) Naftogaz is aware that third parties have wished to transit natural gas through the Ukrainian network, from one European country to another. Gazprom has been able to obstruct and prevent such transit, since Gazprom controls the necessary entry and exit points. As explained by [REDACTED], the refusal of Gazprom/Gazprom Export to provide Ukrtransgaz with the necessary shipper codes has prevented Ukrtransgaz from entering into interconnection agreements with the operators of transmission networks in neighboring countries.

(1251) Such third-party transit through Ukraine would involve gas volumes sold in competition with Gazprom to countries that form part of the relevant gas sales market (Poland, Hungary and Slovakia).

(1252) Third parties wishing to transit natural gas through Ukraine face higher tariffs than those paid by Gazprom. The Ukrainian Regulator has published final tariffs for cross-border transmission

services. The published tariffs, which apply with effect from 1 January 2016, are significantly higher than the tariff paid by Gazprom. As a network owner, Naftogaz is obliged to treat network users equally, but the tariff imposed by Gazprom in the Contract leads to discriminatory tariffs between Gazprom and other network users.

(1253) Gazprom cannot avoid liability for the discriminatory effect of its tariff on the basis that the third parties have not in fact transited gas through Ukraine. It is Gazprom who has been able to prevent competitors from transiting volumes through Ukraine through its control of the entry and exit points. This exclusionary conduct amounts to abuse by Gazprom in breach of Article 102 TFEU, as further discussed below. Since the failure of third parties to carry out gas transit must be attributed to Gazprom's illegal conduct, Gazprom cannot escape liability for the discriminatory effect of the below-cost tariff it has imposed under the Contract.

7.1.9.3.3 Article 101 TFEU and Article 18(1)(a) ECT apply to discriminatory pricing

(1254) The Contract involves a lower tariff for Gazprom than the tariffs that third parties face. Consequently, the Contract results in "*dissimilar conditions*" compared to "*equivalent transactions with other trading parties*". Since other parties wishing to transit gas through Ukraine are competitors of Gazprom in the sale of gas to countries that form part of the relevant gas sales market (Poland, Hungary and Slovakia), the price discrimination is "*placing them at a competitive disadvantage*".

(1255) Gazprom argues that "*the transit tariff in Contract TKGU formed part of a freely-negotiated commercial agreement*". However, whether an agreement has been freely negotiated or not is irrelevant for the application of Article 101 TFEU. Moreover, the reality is that Gazprom was in a position to impose a below-cost tariff on Naftogaz.

(1256) Gazprom further argues that "*Naftogaz has failed to establish that it [the tariff] had as its object or effect the prevention, restriction or distortion of competition in breach of Article 101 TFEU*". However, discriminatory tariffs directly affect the costs of supplying gas in competition with Gazprom, and therefore has an immediate impact on competition in the wholesale natural gas

market. Competition in the relevant wholesale natural gas market, which includes Poland, Hungary and Slovakia, is already restricted as a result of Gazprom's dominant position. Cost disadvantages faced by competitors wishing to supply gas in competition with Gazprom further exacerbate the competitive conditions.

(1257) Against this background, Naftogaz maintains that the below-cost tariff in the Contract infringes Article 101.

7.1.9.3.4 The discrimination affects trade into and within the EU

(1258) It would be sufficient that only one of Gazprom's abusive practices is capable of affecting trade within the EU, since they pursue an overall exclusionary and exploitative strategy and thus form part of a single infringement. Moreover, under Article 101 TFEU it is sufficient that the agreement as a whole may affect trade between EU countries whether or not each individual restriction may affect such trade.

(1259) However, even if the discriminatory tariff should be considered as a separate infringement, the requirement of effect on trade would be met. The tariff discriminates between Gazprom and other buyers of transmission through the territory of Ukraine. Third party transit through Ukraine would involve gas volumes sold in competition with Gazprom between or to EU countries (had Gazprom not blocked such transit). Discriminatory tariffs affect the costs of transiting gas between such countries by third parties and is therefore liable to affect the pattern of trade between EU countries.

(1260) The effect on trade may under Article 102 be actual or potential. Accordingly, the fact that Gazprom has prevented actual transit from taking place is not decisive. The discriminatory tariffs are liable to affect the patterns of trade had actual transit – physical or virtual – through Ukraine by third parties taken place.

(1261) Accordingly, the discriminatory tariffs may affect trade between EU countries. It also affects trade between Ukraine and EU countries.

7.1.9.3.5 The development of the tariffication principles in EU and ECT energy law

- (1262) Gazprom essentially argues that there was no development in tariffication principles from the Second Energy Package to the Third Energy Package. *Inter alia*, Gazprom points out that, with the exception of the compulsory introduction of entry-exit tariffs in Article 13(1)(4) of Regulation 715/2009, the wording of preamble (8) and Article 13(1)(1)-(3) of Regulation 715/2009 and preamble (7) and Article 3(1) of Regulation 1775/2005 is practically identical and that there was no difference in the tariffication principles in the Second Energy Package and the Third Energy Package.
- (1263) It is true that with the exception of the introduction of entry-exit tariffs, there were no major changes to the *wording* of the relevant provisions in Regulation 715/2009 compared to Regulation 1775/2005.
- (1264) However, with further references to ACER's 2013 report *Transit Contracts in EU Member States* (the "*Transit Contracts Report*"), there were *other changes* introduced with the Third Energy Package that affected the application of these tariffication principles to long-term transmission contracts.
- (1265) Firstly, the exemption for legacy long-term transmission contracts disappeared with the adoption of the Third Energy Package.
- (1266) The secondary energy market legislation does not distinguish between transmission and transit. This change was introduced with the Second Energy Package. Directive 2003/55/EC and Regulation 1775/2005 abolished the separate regime for transit by introducing a single category of transport, i.e. transmission. While Article 32(1) of Directive 2003/55/EC repealed Transit Directive 91/296/EEC, long-term contracts concluded under this Directive were allowed to persist. As explained in the *Transit Contracts Report*, the effect of recognising the validity of historic long-term contracts was that transit flows were treated in a substantially different manner than other transmission services, notwithstanding the formal abolishment of the distinction between

transit and transmission capacity. *Inter alia*, this means that the tariffication principles in the Second Energy Package did not apply to such contracts.

(1267) With the adoption of the Third Energy Package, the exemption for legacy contracts was abolished as Directive 2003/55/EC, cf. Article 53 of Directive 2009/73/EC, and Regulation 1775/2005, cf. Article 31 of Regulation 715/2009, were being repealed with effect from 3 September 2011. As explained earlier, the provisions of the Third Energy Package introduced an objective non-discrimination principle for third party access, cf. Article 32 of Directive 2009/73/EC, establishing that access shall be applied in a non-discriminatory manner between network users. These rules prohibit national measures granting preferential capacity for cross-border transmission, meaning that any differentiation between gas transmission and gas transit is no longer allowed. This prohibition applies even when such capacity is conferred on the basis of contractual commitments antedating the internal market legislation. In other words, under the Third Energy Package border-to-border transmission contracts can no longer be treated differently from domestic transmission contracts, regardless of when they were concluded.

(1268) Despite the fact that the exemption for legacy contracts was abolished, several EU Member States continued to treat border-to-border transmission different from domestic transmission and did not adjust long-term legacy contracts to comply with competition and energy law. ACER's inquiry revealed that the main focus of outstanding problems and issues is Eastern Europe, cf. the *Transit Contracts Report*. ACER concluded that there was strong evidence that historical capacity holders still obtained preferential access to transit capacity. It also concluded that transit was treated differently from national transmission with regard to conditions for network access, particularly in provisions related to applicable tariffs, balancing, capacity allocation and/or congestion management, cf. the *Transit Contracts Report*. ACER found that "*overall, in the majority of the transit countries, all evidence at April 2013 points to the fact that transit flows are treated differently from domestic transmission, applying different tariff prices or methodologies, as well as market and access rules*".

- (1269) Secondly, as also pointed out earlier, the Third Energy Package introduced de-coupled entry-exit tariff systems where tariffs may no longer be dependent on contract paths, including in the case of cross-border flows, cf. Article 13(1)(4).
- (1270) Article 32(1) of Directive 2009/73/EC and Article 13 of Regulation 715/2009 require access to be given to transmission networks on the basis of non-discriminatory, transparent and objective tariffs.
- (1271) The Expert Report, explains how "*entry-exit tariffs are superior to distance-based in the promotion of trade, liquidity and gas-to-gas competition*" and that the preference for entry-exit tariffs was "*based on the advantages of cost-reflectivity and the promotion of competition*".
- (1272) Distance-based tariffs or a so-called point-to-point tariff system are considered prone to discrimination.
- (1273) Under a system of distance-based pricing, the transportation costs are higher the longer away from the sales market the producer is located. This impacts the price at which the producer can offer its gas on the market, thus impeding competition.
- (1274) In *Jones, Vol. I*, it is explained how the discriminatory element in point-to-point systems e.g. occurs when the network users with large transportation portfolios take advantage of the "*portfolio effect*". In national markets dominated by one or few gas companies with large geographically balanced customer portfolios, these companies can optimise their overall transportation portfolio by creating internal swaps ("pooling" contractual paths), thus saving overall capacity costs. New market entrants, with a limited number of entrants, cannot do this. In other words, entry-exit tariffs limit the disadvantage small shippers would have in a point-to-point (contract path) system.
- (1275) The tariff in the Contract is calculated based on a contract path. The tariff is not cost-reflective or compliant with the entry-exit requirement in Article 13 of Regulation 715/2009.

Consequently, the Transit Contract has to be adapted to meet the requirements of the Third Energy Package.

(1276) In any event, the Ukrainian Regulator has adopted a Tariff Methodology in line with the requirements of the Third Energy Package and has established tariffs for the entry-exit points of the Ukrainian GTS which apply from 1 January 2016.

7.1.9.3.6 Objections of Gazprom

(1277) Gazprom seems to imply that it is not the actual costs that should be reflected in the tariffs, but rather those of "*an efficient and structurally comparable network operator*". This is clearly a misrepresentation of the meaning of Article 13(1) of Regulation 715/2009.

(1278) Article 13(1) of Regulation 715/2009 requires that the tariffs shall reflect the actual costs of the network operator in question, but sets constraints on the appropriate tariff level by requiring that these costs shall be efficiently incurred, i.e. "*insofar as such costs corresponds to the costs of an efficient and structurally comparable network operator*". The provision reflects that from a user's perspective, tariffs should reflect the cost of service, in a way that minimise cross-subsidies between these users, whilst from a regulatory perspective, tariffs are set so that an efficient TSO will recover its costs. Accordingly, when fixing or approving tariffs the regulator shall ensure that the transmission system operator is granted an appropriate incentive to *inter alia* increase efficiencies, cf. Article 41(8) of Directive 2009/73/EC.

(1279) Put simply, the qualification in Article 13(1) of Regulation 715/2009 only implies that the network operator shall be efficient and prudent.

(1280) Gazprom seems to imply that the Ukrainian GTS is not efficiently run, focusing on gas losses during transportation and the cost of fuel gas consumed by the system.

(1281) According to Gazprom, "*the overwhelming majority of the cost to Naftogaz of operating the Ukrainian gas transmission system is the associated cost of fuel gas consumed by the system*" and "*[t]his cost is expressly reflected in the transit tariff formula*".

- (1282) This argument fails to consider that Naftogaz' costs of *operating* the Ukrainian GTS are only a subset of the total cost-reflective tariffs should recover. As explained in the Expert Report, the vast majority of the costs of a gas transport system are constant or fixed, and does not (like the costs of fuel gas) vary with the volume of gas transported. Gazprom's allegation that Naftogaz does not incur any capital costs, which presumably underlies the argument, was rejected above.
- (1283) In his witness statement, [REDACTED] also seems to imply that the Ukrainian transmission network is not efficiently run and the costs not efficiently incurred by referring to Ukraine's loan from European Bank for Reconstruction and development (the "EBRD") and highlighting the information in EBRD's press release that Ukraine's authorities have estimated that the planned investments will reduce gas loss during transportation by one fifth. However, Ukraine's loan and the planned investments shows that Ukrtransgaz is in fact an efficient prudent operator. Acknowledging that there is room for improvement, investments are being made in the network system in order to reduce gas losses during transport. The resulting reduction in fuel costs will in turn result in lower operating costs and thus tariffs to the benefit of shippers using the Ukrainian GTS.
- (1284) [REDACTED] in his witness statement, seemingly argues that the costs of the Ukrainian GTS are not transparent. According to [REDACTED], "*the Ukrainian domestic transmission and distribution system is integrated with the transit pipelines*" and "*[i]t is therefore not possible to determine how much fuel gas is consumed for the purpose of domestic supplies, and how much gas is consumed for the purpose of transporting gas to the western borders*". [REDACTED] further states that "*there is no verifiable data made available to us with regard to how much fuel gas is consumed by the Ukrainian transmission system*".
- (1285) Many pipeline systems in Europe have transit systems that are integrated with domestic transmission, and, in such systems, it is impossible to determine with precision how much fuel gas is consumed for one purpose or another. Molecules of gas naturally spread out through the network, and it is not possible to trace the separate destinies of the molecules that originally entered the

network for transit purposes. There is nothing unique in the Ukrainian system's reliance on reasonable estimates to allocate fuel losses between transit and domestic consumption.

(1286) The Regulator has reviewed fuel gas losses when setting tariffs. Nothing in the Regulator's decision suggests that Naftogaz has operated the network inefficiently with respect to fuel gas. The data available show that aggregate system losses in the past vary from year to year, but there is no reason to believe that in earlier years the system was less efficient than the Regulator considers would be reasonable for 2016. The Regulator has in fact decided that on average 2.6% fuel gas losses for transit is reasonable looking forward to 2016, which is fairly close to 3%. The Regulator's methodology implies higher losses for some of the transit points that are further west, like Uzhgorod, which is at 2.7%, and which Gazprom uses heavily in the Contract. A relatively simple benchmark from Wingas suggests 2.74% for the distance mentioned in the Contract.

(1287) With respect to the issue of "verifiable data", the independent Ukrainian Regulator has seen sufficient verification to feel comfortable making a tariff decision, and there is no reason to second-guess the Regulator. The figures for previous years come from internal management data prepared in the ordinary course of business.

(1288) The basic rule of cost-reflectivity may only be deviated from where specific exceptions to this principle is created in the secondary energy market legislation and under the circumstances specified there. For example, when setting tariffs, benchmarking may be taken into account, but only in limited circumstances.

(1289) Article 13(1) of Regulation 715/2009 allows for "*where appropriate, taking account of the benchmarking of tariffs by the regulatory authorities*".

(1290) Gazprom, based on an erroneous interpretation of *United Brands*, argues that Naftogaz should have applied the particular two-stage test in *United Brands* and *inter alia* carried out a comparison between the tariffs paid by Gazprom and the prices of competing products. However, the

two-stage test applied to the pricing of bananas in *United Brands* is not a general test for establishing whether the price of a product or service is unfair.

- (1291) In any event, it follows from secondary energy market legislation that, when determining the tariff level in gas transmission, a comparison with competing products is of limited relevance.
- (1292) As mentioned in the Expert Reply, benchmarking is considered relevant only if effective pipeline-to-pipeline competition exists, cf. preamble (8) of Regulation 715/2009. As pointed out in the Expert Reply, the relevance of benchmarking is further developed in Third Energy Package, which extended the requirements of cost-reflectivity to all European transit contracts that had previously enjoyed exemptions under the Second Gas Directive.
- (1293) Section 3.3.2.3 of the Tariff FG, specifies that benchmarking is relegated to *"the point, where the TSO faces effective competition from other TSOs' point or route"* and states that benchmarking implies *"reducing the tariff at one point in order to attract greater gas flows. Higher capacity sales at this point would be expected to offset the need for increased tariffs at other points in order to collect allowed revenues"*. This is a necessary consequence of an entry-exit system where tariffs are set separately for each entry and exit point.
- (1294) Within the abovementioned frame, benchmarking is applied on a case by case basis, subject to strict criteria, cf. Section 3.3.2.3 Tariff FG and Article 10 of the draft re-submitted TAR NC. When applying benchmarking, such decision shall be based on *"proof that "effective pipeline-to-pipeline competition" exists, based on national and EU competition law, by demonstrating that the relevant competing systems imply a real choice for the system users"*, cf. Section 3.3.2.3 of the Tariff FG.
- (1295) In other words, benchmarking is only allowed as a secondary adjustment when determining the tariff at a given entry/exit point, provided there is effective pipeline-to-pipeline competition and the purpose of benchmarking is to reduce the tariff at the particular entry/exit point to increase the amount of contracted capacity, cf. Article 10(1) of the draft re-submitted TAR NC. Where

the forecasted capacity sales at the point where benchmarking is carried out are not expected to ensure the allowed revenue, transmission tariffs at other entry points or exit points may be increased, cf. Article 10(2) of the draft re-submitted TAR NC. The benchmarking is carried out by the regulator, which ultimately also decides whether or not to decrease the tariff at the given entry/exit point, cf. Article 10(4)

(1296) In practice, European pipeline operators have rarely been able to demonstrate effective pipeline-to-pipeline competition, cf. the explanation in the Expert Report. As pointed out in the Expert Reply, the parties agree that there is no relevant pipe-to-pipe competition on the Ukrainian transit route.

7.1.9.4 Application of ECT energy law as such to the tariff

(1297) According to Gazprom, Directive 2009/73/EC and Regulation 715/2009 do not apply to the Contract.

(1298) In the alternative, Naftogaz relies on ECT energy law as a parallel and independent legal basis for its claims for replacement of invalid and ineffective provisions in the Contract. Naftogaz does not rely on EU energy law as such.

(1299) ECT energy law applies as such to the Contract both as Swedish law pursuant to EU law and as mandatory Ukrainian law based on monism. Naftogaz applies the Third Energy Package to the Contract as Swedish law as of its inclusion in the ECT, i.e. as of 6 October 2011, except with regard to the tariffication provisions which have effect as of 3 September 2011. Naftogaz recalls that ECT energy law applies as Swedish law both by virtue of the horizontal direct effect of the Third Energy Package, legal discrimination pursuant to Article 7 ECT obliging a Swedish court or tribunal to apply the Third Energy Package as it would in relation to a similar contract involving an EU company, and factual discrimination pursuant to Article 7 ECT of which the Third Energy Package is a concretization/operationalization.

(1300) Gazprom argues that the Contract has no capacity charge due to the large volumes involved, the Witschen report. However, no sound explanation or documentation is provided for why large volumes would eliminate the need for a capacity charge.

(1301) Gazprom also challenges that Ukraine's entry-exit methodology involves a uniform ("postage stamp") tariff for entry points and individual tariffs for exit points, suggesting that this approach does not comply with the Tariff FG, cf. the Moselle report. In this respect Naftogaz refers to the Expert Reply, where it is explained that the entry-exit methodology is in compliance with the re-submitted revised draft TAR NC. The re-submitted revised draft TAR NC requires that the same primary allocation method is applied to entry and exit points, but allows for the "equalisation" of tariffs across specific sets of entry and exit points as a secondary adjustment, cf. Article 6, cf. Article 7 (Primary reference methodology: postage stamp methodology) and Article 9 (Secondary adjustment: equalisation).

(1302) Also, Naftogaz recalls that the Ukrainian regulator received comments on the draft tariff methodology from both the European Commission and ACER, which did not have any objections to the chosen approach.

7.1.9.5 Mandatory Ukrainian law

(1303) Article 18 ECT, which incorporates Articles 101 and 102 TFEU, applies as mandatory Ukrainian law as of the accession of Ukraine to the ECT, i.e. 1 February 2011. For the period before the entry into force of the ECT for Ukraine, Naftogaz relies on national Ukrainian competition law, i.e. as of 1 January 2010 at the latest. As mentioned above, the Ukrainian Competition Law was adopted on 11 January 2001, i.e. prior to Ukraine's accession to the ECT, but its provisions are, like Article 18 ECT, in line with the requirements of Articles 101 and 102 TFEU. With regard to the application of competition law to the Contract, Naftogaz refers to the presentation of competition law and the rebuttal of Gazprom's arguments above.

(1304) Naftogaz also recalls that ECT energy law applies as such as mandatory Ukrainian law. Due to Ukraine's monist system, the tariffication provisions of the Third Energy Package were directly

applicable in Ukraine as of the inclusion of the Third Energy Package in the ECT, i.e. 6 October 2011, with effect from 3 September 2011. ECT energy law applies as Swedish law both by virtue of the horizontal direct effect of the Third Energy Package, legal discrimination pursuant to Article 7 ECT obliging a Swedish court or tribunal to apply the Third Energy Package as it would in relation to a similar contract involving an EU company, and factual discrimination pursuant to Article 7 ECT of which the Third Energy Package is a concretization/operationalization. With regard to the issue of the applicability of ECT energy law to the Contract, Naftogaz refers to the rebuttal of Gazprom's arguments directly above.

7.1.9.6 Invalidity, ineffectiveness and replacement of the tariff

7.1.9.6.1 Consequences of relevant breaches

- (1305) Naftogaz' principal view is that each contravention of mandatory provisions discussed above, in and of itself suffices to render an offending contract clause, *in casu* Article 8, "ineffective" if not invalid under Article 13.2 of the Contract, thus triggering a replacement.
- (1306) In addition, the consequences of various breaches are invalidity pursuant to the applicable law, the ability under law to adjust the offending clause, and sanctions under public law and public international law. In each of these cases, the result would be invalidity or ineffectiveness and replacement under Article 13.2 of the Contract, including consequential adjustments.
- (1307) The next question is when the various breaches must be deemed to have occurred, determining the effective dates of invalidity and ineffectiveness, as well as replacement (except regarding the party-relationship where this is two different dates). As already explained, the relevant effective dates are in practice only of importance to the claim for replacement of the tariff Article, because the replacement of the existing Article with a new Article results in monetary claims for underpayment from the effective dates. The monetary claims will differ depending on the relevant effective date according to the findings of the Tribunal.

(1308) Naftogaz principally claims invalidity/ineffectiveness and replacement from 1 January 2010, alternatively as of 1 February 2011, alternatively with effect as of 1 January 2015 or the earliest date stipulated by the Tribunal.

(1309) The three specific dates set out in the Relief Sought refer to possible effective dates depending on the legal basis applied, i.e. Article 101 and 102 TFEU and national Ukrainian competition law (1 January 2010), Article 18 ECT (1 February 2011) and ECT energy law as Ukrainian law based on monism (1 January 2015). In addition, the date of incorporation of the Third Energy Package into the ECT, 6 October 2011, and the implementation date for the tariffication provisions of the Third Energy Package, 3 September 2011, may be relevant under European and Ukrainian energy law and Article 7 ECT.

7.1.9.6.2 The required replacement of the invalid and ineffective tariff

7.1.9.6.2.1 Replacement of Article 8

(1310) Under Article 13.2 of the Contract, the existing tariff provision in Article 8 shall be replaced with a valid and effective provision with an economic effect as close as possible to that of the invalid/ineffective provision. The new provision consequently needs to be compliant with mandatory law.

(1311) The Third Energy Package has been implemented in Ukraine, the Ukrainian regulator has adopted a tariff methodology based on the principles in the Third Energy Package, and has on this basis set entry-exit tariffs for the Ukrainian GTN, which entered into force on 1 January 2016. Therefore, the correct legal and practical approach in this case is to replace the existing tariff provision with a new provision in line with the tariffication principles implemented in Ukrainian energy legislation and the entry-exit tariffs adopted by the Ukrainian regulator.

(1312) Naftogaz submits a claim for replacement of the transit tariff principally from 1 January 2010, cf. above. For 2016 and going forward, the entry-exit tariffs set by the Regulator will apply. For the period prior to 1 January 2016, Naftogaz' claims for replacement/revision of the tariff can only result in monetary claims, as further described below. Therefore, the replaced/revised tariff

claimed by Naftogaz is defined to apply from 1 January 2016. This is similar to the approach in the SoC, where the replaced/revised tariffs were defined to apply in 2015.

(1313) In practice, Naftogaz has copied the tariffs published by the Regulator for the relevant entry and exit points and set them out in the Relief Sought, supplemented with information from the published tariff methodology to make the tariffs effective on a stand-alone basis. The relevant entry and exit points are the entry and exit points specified in the Contract, except entry and exit points which are not currently in use for long-distance transmission, cf. below. The tariffs as such are, like the tariffs calculated by Naftogaz to apply in 2015 based on the draft methodology published by the Ukrainian regulator, expressed in US Dollars per 1000 cubic metres of daily capacity at each entry and exit point. In addition, the tariffs published by the Ukrainian Regulator include a norm in percent for the amount of fuel gas to be provided in kind as payment for use of each exit point. The overall layout of the replaced/revised tariff is similar to the tariffs requested by Naftogaz, i.e. a table setting out the relevant entry and exit points and the relevant tariffs.

(1314) Naftogaz has claimed three different tariffs applicable for 2015. The tariffs differed depending on the date from which Article 8 was replaced/revised. This was because the overall revenues allowed to be recovered would depend on the start date of the tariffs. The Ukrainian regulator has only published one tariff. Naftogaz has taken into account the different revenues which are allowed to be recovered depending on the different start dates of its claims for replacement/revision of the tariff in account in the calculation of repayments/damages.

(1315) The Ukrainian Regulator has only set tariffs for entry-exit points which are now in use or able to be used for long-distance transmission through Ukraine. Accordingly, the Regulator has not set tariffs for the entry points Sokhranovka, Serebrianka, Prokhorovka, Belgorod and Platovo. Prokhorovka and Platovo are located in temporarily occupied territories and the other entry points are not in use for other reasons.

(1316) The proposed revised Article 8 has been updated accordingly. Firstly, the references to Sokhranovka, Serebrianka, Prokhorovka, Belgorod and Platovo in Article 8.1.1 are deleted.

Secondly, the entry tariffs and exit tariffs listed in Article 8.1.1 and 8.1.2 respectively have been updated to reflect the entry-exit tariffs approved by the Regulator.

- (1317) The replaced Article 8 also establishes that the tariffs set by the Regulator at any given time shall apply to the transport services provided under the Contract.
- (1318) As indicated above, any replacement/revision of the tariff with effect prior to 1 January 2016 can now only result in monetary claims. To calculate these claims, Naftogaz' experts have determined cost-reflective tariffs for 1 January 2010 and the other relevant starting dates based on the final methodology published by the Ukrainian regulator. In other words, the experts have applied European and Ukrainian competition and energy law as adapted to Ukrainian conditions and implemented.
- (1319) The payment/damages are calculated as the difference between the allowed revenues which the TSO would have been allowed to earn on long-distance transmission (transit) from the relevant starting date (principally 1 January 2010) plus the applicable taxes, and the payments made by Gazprom over the relevant time period, less fuel gas payments. The fuel gas payments are excluded because, under the prevailing tariff formula, Naftogaz's costs of procuring fuel gas are the same as the price Gazprom pays for fuel gas (the price of gas under the Gas Sales Contract). Therefore, Naftogaz neither gained nor lost from the provision of fuel gas, and will be in the same position if fuel gas is provided in kind, cf. the Expert Report. The experts have used the same methodology in the Expert Reply, but updated the calculations to take into account differences between the draft tariff methodology and the final tariff methodology, cf. the Expert Reply.
- (1320) As explained in the Expert Reply, the tariffs set by the Ukrainian Regulator for 2016 rely on a higher value of the assets on which Naftogaz (Ukrtransgaz) is allowed to make a return (the "RAB") than the RAB the experts use to calculate the replaced/revised tariffs it claims with effect from 2010/2011. Consequently, the tariffs set by the Ukrainian Regulator are higher than the tariffs which would have applied in 2016 based on Naftogaz' calculations. To avoid double

payments by Gazprom, Naftogaz has offset its monetary claims based on tariff replacement/revision for the period 2010/2011-2015 correspondingly.

(1321) The relevant offset is higher for the principal claim (introducing cost-reflective tariffs from 1 January 2010) than for the alternative claim (introducing cost-reflective tariffs from 1 February 2011). This is mainly because the RAB for the alternative claim is higher than for the principal claim due to increases in input prices between 2010 and 2011 and because of the additional year of depreciation until 2016 under the principal claim. By 2016, therefore, the tariffs effective from 2011 will be closer to the actual tariffs for 2016, reducing the offset.

(1322) Naftogaz' claims would have been higher if Naftogaz had relied on "normal depreciation" until 2016 and then, for consistency with the Regulator, had switched to accelerated depreciation for transit assets. Although the tariffs until 2016 would be lower if they were based on normal depreciation, the switch to accelerated depreciation in 2016 more than offsets this effect. This is because under such an approach the remaining value of the assets would be higher in 2016 than if they had been subject to accelerated depreciation from, say, 2010. Hence the required depreciation for the last four years is significantly higher than it would be if accelerated depreciation starts earlier. This "kick-up" in depreciation significantly reduces the "future offset" that Naftogaz applies to ensure that Gazprom does not pay twice for the same assets.

7.1.9.6.2.2 Consequential adjustments

(1323) The replacement of Article 8 renders consequential amendments to Article 9 necessary.

(1324) Originally, Naftogaz proposed to revise Article 9.1 (to reflect fuel gas in kind) and Article 9.5 (to delete references to the prevailing Article 8.4 and to better reflect a system with capacity reservations and reporting by the independent TSO).

(1325) Thereafter, common payment procedures have been established in the Ukrainian Standard Natural Gas Transmission Contract, items VIII, 8.3 and 8.4. The payment procedures in item VIII,

8.3 and 8.4 are developed to accommodate a system with capacity reservations and reporting by the independent TSO.

(1326) Naftogaz proposes to update Article 9 in the Revised Transit Contract to reflect items VIII, 8.3 and 8.4 in the Ukrainian Standard Natural Gas Transmission Contract. In a system with capacity reservations and reporting carried out by the independent TSO, Article 9.3 concerning reporting is no longer relevant, and a similar provision is not found in the Ukrainian Standard Natural Gas Transmission Contract. Consequently, Naftogaz proposes to delete Article 9.3. Accordingly, the prevailing Articles 9.4 and 9.5 become Articles 9.3 and 9.4. Naftogaz also requests that Article 9.4 (after renumbering Article 9.3) be adjusted to reflect the new terminology, i.e. that the term "transit" is replaced with the term "transmission". Article 9.5 (after renumbering Article 9.4) implements the mandatory payments procedures established in the Ukrainian Standard Natural Gas Transmission Contract. Naftogaz proposes to replace the renumbered Article 9.4 with the procedures set out in item VIII, 8.3 and 8.4.

(1327) Accordingly, new Article 9 is proposed to read as follows (*new wording in italics*):

(1328) "9.1 The Parties agreed that the Client shall pay for the services rendered by the Contractor on transit of Gas through the territory of Ukraine exclusively in monetary funds *except for technological gas delivered in accordance with this Contract*.

(1329) 9.2 The Parties agreed that price for services and cost of transit services under this Contract shall be determined in US dollars.

(1330) The currency of payment under this Contract shall be US dollars and/or Russian roubles. Expenses for transfer of monetary funds to the account of the Contractor shall be borne by the Client.

(1331) The payment in Russian roubles shall be made at the rate of the US Dollar established by the Central Bank of the Russian Federation on the date of payment.

(1332) The date of payment under this Contract shall be the date of debiting funds from the Client's account.

(1333) 9.3 The Parties shall reconcile payments on a quarterly basis by 25th day of the month following the reporting quarter based on the actual value of the Contractor's services on Gas *transmission* and payment for Gas *transmission* by monetary funds.

(1334) The mentioned reconciliation shall be recorded in the Payment Reconciliation Report.

"9.4 The Contractor shall send invoices to the Client's electronic mail.

Payment of the cost of the contracted capacity of others by the Client shall be made based on an invoice by transferring funds in the amount of the contracted capacity cost for the period of the Gas month to the account of the Contractor under the terms of 100 percent advance payment 5 (five) banking days before the beginning of the Gas month, in which the capacity shall be provided.

If the consumers of the Client settle their liabilities with it using a current account with the special regime of use, the payment by the Client (including the ordering of the capacity allocation) shall be made from the Client's current account with a special regime of use to the current account of the Contractor each banking day according to the algorithm of cost allocation established by the Regulator and shall be credited as the fee for transmission services (capacity allocation) in the month in which the funds were credited. The final payment for the rendered during the month services shall be carried out by the Client before the twentieth day of the month following the reporting month in accordance with the act on rendered services and having in mind the payment made before.

The Client shall pay to the Contractor the costs of contracted capacity notwithstanding whether the contracted capacity was fully used or not.

The price of the natural gas transmission services in the exit point comprises of two parts: the first one expressed in money form (is defined in accordance with tariffs in exit points and booked capacity in these points); the second one expressed in natural form of volumes of natural gas for the ensuring costs of the Client for the exit points (defined in percent as to the volume of the transported gas in exit points) that are given by the Client to the Contractor for each gas month in a form of Act of acceptance and delivery of natural gas before the tenth day of the month following the gas month.

In the payment orders the Client shall specify the Agreement number, the date of its signing, and the reporting period (month, year) for which the payment is made. If the Agreement number, the date of its Agreement signing, and the reporting period (month, year), for which the payment is made, are not specified in the Client's payment orders, the Contractor shall credit the funds received from the Client primarily to cover debts for provided gas transmission services, which appeared during the previous periods.

In case the Client exceeds the amount of contracted capacity at the entry/exit points to/from the gas transmission system during the period of gas month, the Client shall make an additional payment.

The calculation of the additional payment is based upon information defined by the Contractor in the report on using contracted capacity that shall be sent to the Client before the tenth day of the month following the gas month to the e-mail address and shall have the calculation of exceeding contracted capacity amount and invoice. The Client has to make payment before the fifteenth day of the month following the gas month."

7.1.9.6.3 The right to replacement of invalid or ineffective provisions

(1335) Gazprom denies that the Arbitral Tribunal has the power to replace contract terms under Article 13.2 arguing that the power rests solely with the Parties.

7.1.9.6.4 Gazprom's arguments as to "retroactive replacement"

(1336) Gazprom further argues that there is no right to what Gazprom calls a "retroactive replacement". However, where a price provision is in contravention of competition law, it is invalid as of the date when the unacceptable effects occur and cannot apply after that point in time. Hence, the replacement must for obvious reasons apply as from the date of the invalidity. There is no support whatsoever in Article 13.2 for Gazprom's position that a replacement could somehow only be made at some later date (which Gazprom fails to specify). Gazprom's argument would imply that a party could frustrate the replacement by refusing to agree on a replacement and then delaying the settling of the issue by arbitration, which is an entirely unreasonable interpretation of the Article.

(1337) In addition, Gazprom argues that "*Clause 13.2 can under no circumstances be interpreted as giving a party a right to payment before it has put forward such a claim*". However, what Gazprom *actually* means is that, allegedly, Naftogaz cannot be entitled to payment for *the period* prior to the date that the monetary claim is made. This reasoning is ill-conceived. First of all, Naftogaz's ground for payment is not Article 13.2. It is the fact that there will, after the replacement, be a tariff clause effectively applicable from the dates specified by Naftogaz which stipulates a higher tariff than that paid by Gazprom. Naftogaz' payment claim therefore rests on the simple principle under Swedish law (as under any law) that a party who has received less in payment than it has the right to has a claim for the remainder. Essentially, Gazprom's argument boils down to a proposition that under Swedish law a party cannot ever request additional payment for a period which has already expired. That is not the law of Sweden.

7.1.9.7 The damages claim under competition law

(1338) The right to receive damages for breach of Articles 101 and 102 TFEU is an established principle under EU competition law and safeguarded under Swedish law through Chapter 3, Section 25 of the Swedish Competition Act.

(1339) As a dominant undertaking on the market for natural gas, Gazprom has been obliged to have knowledge of the relevant tariff levels that were to apply for gas transit in Ukraine. Hence,

Gazprom has at least been negligent when applying, and refusing to adjust, the non-compliant tariff in the Contract.

(1340) The right to compensation includes the full real value of the damage suffered and comprises factual loss, loss of profit and interest from the time when the damage occurred, see the Statement of Reply and Defence to Counterclaim in the Gas Sales Arbitration.

(1341) Based on the above principles for the calculation of the damage suffered, the damages amount awarded relating to factual loss under Chapter 3, Section 25 of the Swedish Competition Act in relation to non-compliant pricing, corresponds to the difference between the pricing under the Contract and the pricing which would have applied with a tariff compliant with Articles 101 and 102 TFEU and relevant energy laws.

7.1.9.8 The claim for additional payments after replacement

(1342) The tariff (as invoked by Naftogaz) that should be applied following replacement of the non-compliant tariff by virtue of Clause 13.2 of the Contract is in accordance with competition law and energy law and is also as close as possible to the current tariff without violating applicable competition and energy laws. Therefore, the additional payments correspond to the difference between the tariff payments received by Naftogaz under the Contract during the relevant period and the tariff payments that Naftogaz should have received based on the tariff provisions that will be determined by the Arbitral Tribunal based on Naftogaz' requests for relief.

7.1.9.9 Gazprom's defences against Naftogaz' claims for payment/damages

(1343) Gazprom argues that Naftogaz is not entitled to additional payment since Naftogaz has given Gazprom reason to believe that its payments constituted a final settlement of its payment obligation for the transit services. The reason for this loss of right would be that Naftogaz has given Gazprom well-founded reasons to believe that Naftogaz did not have any claims for payment for transit services in addition to what had already been paid by Gazprom.

(1344) In order for any such effect to arise, the requirements set out above would need to be fulfilled. These requirements are not fulfilled. As Gazprom effectively invokes the same circumstances as set out in relation to Naftogaz' purported waiver of its right to a retroactive adjustment under Section 36 of the Swedish Contracts Act, Naftogaz refers for practical reasons to what it submits in relation Section 36 , where these arguments are rebutted.

(1345) Essentially, Gazprom has not had the justifiable impression that Naftogaz had waived its right to invoke competition law to claim against Gazprom either in the form of additional payments based on replacement of contractual clauses or as damages. In fact, claims based on competition law have not been up for discussion during the period when Gazprom alleges passivity. A party simply does not get the justifiable impression that the other waives its rights in a particular respect unless the issue (in this case competition law) is subject to discussion between the parties and one party then acts in a way that could reasonably be interpreted as an acceptance of the other party's legal position. Moreover, Naftogaz has not had any knowledge of Gazprom's alleged impression and Gazprom's impression is not in fact justifiable even if, which is denied, Gazprom actually got that impression.

(1346) Finally, Gazprom's response in relation to Naftogaz' notification clearly shows that Gazprom *de facto* did not believe that Naftogaz had waived all its right to additional payment. And, even if it did, Gazprom has waived any right to invoke this fact, essentially because Gazprom engaged in discussions regarding the merits of the tariff revision claim in 2014 without clarifying that its opinion was that Naftogaz had already waived its claims for additional payments in whatever shape or form.

7.1.10 Gazprom's other breaches of European and Ukrainian competition and energy law expanded

7.1.10.1 The party relationship under the Contract

7.1.10.1.1 Introduction

(1347) A number of provisions of the Contract provide Gazprom and Gazprom Export with a considerable degree of control over the Ukrainian GTS. This significant degree of control gives Gazprom and Gazprom Export a role which Naftogaz has, for the purposes of this arbitration, called the role of 'super-operator'. Gazprom has argued that this term does not exist; that Naftogaz is precluded from seeking a remedy under competition or energy law because the terminology it has employed is not known to either body of law. This is simply incorrect as a matter of law. Both competition and energy law are concerned with substance, not form, and the role assigned to Gazprom and Gazprom Export under the Contract, and the behaviour arising from it, constitute clear breaches of both systems.

7.1.10.1.2 Competition law

(1348) Gazprom's and Gazprom Export's ability to exercise control over the Ukrainian GTS i.e., its status as super-operator distorts competition in several ways. In exercising this control Gazprom abuses and entrenches its dominant position in the gas sales market under Article 102 TFEU. Also, by their very nature the terms of the Contract in this respect are anti-competitive and therefore also in breach of Article 101 TFEU.

(1349) Gazprom's position (i) gives Gazprom privileged access to commercially sensitive information about the Ukrainian GTS and its users, (ii) distorts trade in gas between countries by preventing agreements on virtual reverse flows, (iii) prevents the implementation of pro-active congestion management programs which facilitate competition, (iv) risks the understatement of available capacity, and (v) has the potential to affect Naftogaz' pipeline investment decisions.⁸³

(1350) First, Gazprom has privileged access to commercially sensitive information about the Ukrainian GTS and its third-party users. It is clear from recital 24 to Regulation 715/2009 of the TEP that individualised information about shippers is commercially sensitive and should be protected. The Contract entitles Gazprom and Gazprom Export to exchange and collect all technical and commercial information regarding gas transit flows through the Ukrainian GTS.

⁸³ §§ 60-92 Brattle 1, §§ 120-138 Brattle 2, and §§ 81-90 Brattle 3, in T-C 1 (T-PHB, tab II p. 273 to 283)

- (1351) In particular, pursuant to Article 7.4 Gazprom shall receive information of both gas transit through Ukrainian territory and gas supplies to Ukraine by third parties (with details of each supplier and customer). Article 3.13 of the Technical Agreement, which regulates the cooperation between Ukrtransgaz and Gazprom Export and the information exchange required to give effect to this cooperation, obliges Ukrtransgaz to provide Gazprom and Gazprom Export with the same information.
- (1352) Dr Moselle agreed that this kind of information sharing can be improper from a competition law perspective. The TEP unbundling rules seek to limit the scope for abuse by limiting the exchange of matching information with unbundled operators of the transmission network only. As Gazprom Export is the matching partner under the Contract, no potential Ukrainian gas company could actually export to another country (e.g., Poland) without Gazprom and Gazprom Export finding out. Imports and transit by third parties would be similarly monitored.
- (1353) The result adversely affects competition insofar as companies will naturally hesitate to send gas either to, from or through Ukraine knowing that Gazprom and Gazprom Export can monitor every transaction. Insofar as Naftogaz facilitates disclosure of competitively sensitive information to Gazprom and Gazprom Export pursuant to the Contract, this also constitutes a clear and unequivocal breach of Article 101(1) TFEU.
- (1354) Second, Gazprom distorts trade in gas between countries (including between EU Member States using Ukraine as a bridge) by preventing agreements on virtual reverse flows (VRF). According to Gazprom, to permit VRF the terms of the Contract would need to be changed. Specifically, Article 3.4 of the Contract on its face prohibits VRF at the exit points controlled by Gazprom pursuant to the Contract.
- (1355) [REDACTED] was very clear that there would be demand to use the Ukrainian GTS for VRF should it be permitted: *"there are many traders who would be willing to use the capacities that are unused by Gazprom because there's a lack of co-operation and interaction and Gazprom has*

been rejecting or refusing the Ukrainian side to provide such information needed for this co-operation".⁸⁴

- (1356) By exercising its powers under the Contract, for example by refusing to supply shipper codes, Gazprom pursues its strategy to partition central and eastern European gas markets by limiting customers' ability to resell gas cross-border. According to [REDACTED] Gazprom pursues different strategies at the cross-border points with Slovakia, Hungary, Poland and Romania. For example, the process for the exchange of shipper codes with the Slovak TSO, Eustream, at Veľke Kapušany differs from the transfer of gas from TSO to TSO at the Slovak-Austrian border.
- (1357) Further, cross border flows also rely on matching information being available. Gazprom Export is the matching partner at Veľke Kapušany for trades with Eustream in Slovakia. It is therefore both a trader and an operator, which puts it in a unique position. Gazprom has a conflict of interest in deciding whether to provide the necessary matching information because virtual reverse flows would increase competition for Gazprom from other gas companies to provide gas to numerous other EU Member States. Dr Moselle on this basis agreed that the prevention of VRF would be liable to effect trade between Member States.
- (1358) [REDACTED] acknowledged that the matching partner will normally be another TSO and not another shipper, and Mr Lapuerta confirmed that it was "highly unusual" for a gas supplier to decide on the allocation to third parties of gas received at metering stations. These arrangements put Gazprom in a position where it inevitably abuses its dominant position. It is no objective justification for the refusal to supply as Gazprom seems to suggest that to provide shipper codes or matching information would require an amendment to the Contract. Rather, it confirms the need to revise the Contract as claimed by Naftogaz.
- (1359) Gazprom argues that a refusal to permit VRF or provide shipper codes could only be abusive if shipper codes were an "essential facility" in the meaning of EU case law. However, Gazprom's argument is incorrect for the reasons provided by Sir Jacobs in his opinion, insofar as Gazprom's

⁸⁴ TD 3 151 11-16 and TD 4 4:4-17 (T-PhB, tab II p. 286 and 287)

refusal to provide shipper codes does not amount to an outright refusal to deal. The behaviour must therefore be analysed simply in terms of whether it restricts competition. And even if the refusal to provide shipper codes does not constitute an abuse in its own right, the fact remains that it is only because of the fundamentally anticompetitive nature of the Technical Agreement, and its appointment of Gazprom to the role of "super-operator", that Gazprom is in a position to dictate the terms on which any cross-border sales take place at all. It is primarily this fundamentally anti-competitive and abusive situation we propose that the Tribunal should rectify.

(1360) Further, Gazprom's focus on the possibility for Naftogaz/Ukrtransgaz to enter into arrangements for physical reverse flows in small newly built or refurbished pipelines not encompassed by the Contract serves as a distraction from the real issue, which is the total block on VRF in the major pipelines controlled by Gazprom through the Contract. As set out above, the restriction of VRF is liable to effect trade in and of itself and is abusive.

(1361) In addition, the Contract provides Gazprom with no incentive to play a proactive role in congestion management in order to keep the Ukrainian transportation system in balance. Congestion management through the "use-it-or-lose-it" rules could facilitate the development of competition for use of the Ukrainian GTS.

(1362) ██████████ confirmed that use-it-or-lose-it programs are a standard method for addressing congestion in Europe, but that the Contract would need to be amended to accommodate them. Brattle have found that conditions would be ripe to implement a pro-active congestion management program given the under-utilisation of the Ukrainian GTS as a result of the under-deliveries by Gazprom under the Contract.

(1363) By failing to permit good congestion management, Gazprom uses its agreement with Naftogaz under the Contract to exclude competitors from the Ukrainian GTS in breach of Article 101(1) TFEU.

(1364) In assessing whether Gazprom's position as a super-operator pursuant to the Contract gives rise to a breach of competition law it is highly relevant that the Contract also fails to comply with the prevailing conditions of EU Energy Law. The unbundling requirements of energy law are expressly designed to ensure fair and effective competition in natural gas markets. A failure to comply with these provisions is "*inherently likely to give rise to competition concerns*".⁸⁵

7.1.10.1.3 Energy law

(1365) The operation of the transmission network shall be carried out by a TSO, cf. Articles 13(1)(a) and 2(4) of the Directive. This is a general requirement applicable to all network users. An important part of the TSO's operational responsibility is to act as a matching partner of gas flows with other TSOs to ensure that the transport is compatible with the secure and efficient operation of the interconnected system, cf. Article 13(2)(c) of the Directive. The TSO is also responsible for cross-border transmission, cf. Article 12 of the Regulation. The party-relationship under the Contract and Gazprom and Gazprom Export's role on the Ukrainian western border contravene the unbundling requirements in the TEP.

(1366) The TEP unbundling requirements and the requirement that the TSO shall be exclusively responsible for the reliable and safe operation, maintenance and development of the Ukrainian GTS, have been implemented in Articles 20 and 22 of the 2015 Natural Gas Market Law and related secondary legislation. The Contract therefore also contravenes the unbundling requirements of the TEP as implemented in Ukrainian law.

7.1.10.1.3.1 The Ukrainian unbundling plan

(1367) The Ukrainian unbundling plan determines that the new TSO under the control of the Ministry of Energy and Coal Industry shall be established and sets out the schedule for its incorporation, the transfer of assets and the application for certification of the TSO. The unbundling plan was amended on 9 November 2016.

⁸⁵ §53 Sir Francis Jacobs Opinion in T-C 1 (T-PHB, tab II p. 302)

- (1368) In accordance with the amended schedule, the Cabinet of Ministers of Ukraine decided to establish Public Joint-Stock Company “Main Gas Pipelines of Ukraine (“MGPU”) on 9 November 2016.
- (1369) The unbundling plan foresees the completion of the unbundling process, i.e. the transfer of assets to the new company and its certification as the TSO, after the Award in these arbitral proceedings is rendered.
- (1370) Ukraine is in the process of implementing the TEP unbundling requirements. Ukraine has established the new TSO, Public Joint Stock Company "Main Gas Pipelines of Ukraine" (MGPU). Ukrainian authorities have concluded that the Contract needs to be transferred and revised prior to the completion of the organisational unbundling process, i.e. the transfer of assets to and certification of the new TSO⁸⁶. The transfer and revision of the Contract ensures operational unbundling, i.e. the unbundling of transmission and production/supply, and is also a prerequisite for the organisational unbundling.

7.1.10.1.4 Application of Articles 101 and 102 TFEU and ECT and Ukrainian competition law

7.1.10.1.4.1 Introduction

- (1371) Since Article 18 ECT, cf. Annex III of the ECT, incorporates Articles 101 and 102 TFEU, and since national Ukrainian competition law is based on the same provisions, Naftogaz will refer to only Articles 101 and 102 TFEU in this Section and in Sections below for simplicity. The discussions cover, however, the corresponding provisions in Article 18 ECT and in the Ukrainian competition law as well.

7.1.10.1.4.2 Gazprom's abusive and restrictive behaviour

- (1372) The issue of party-relationship under the Contract relates to both Naftogaz' and Gazprom's possible and actual interference in the operation of the Ukrainian GTS, as well as the role of the Ukrainian Regulator. EU and ECT rules on unbundling are now in place, and also implemented

⁸⁶ § 16 Naftogaz' 1 December 2016 Explanatory Note

in Ukrainian law. While provisions on unbundling of transmission system operators in line with Directive 2009/73/EC are adopted, cf. the 2015 Natural Gas Market Law Article 22 paragraph 2 item 5 and Articles 23-31, these provisions are to become effective as of 1 April 2016.

- (1373) This means that Naftogaz is (by law) not in a position to interfere in the operation of the Ukrainian GTS. The same applies to Gazprom and Gazprom Export, who interfere with the operation of the Ukrainian GTS by acting as super-operator, and thus obstruct the role of Ukrtransgaz as TSO. If the Contract were to be continued as is, the unbundling prescribed by the applicable energy rules in Ukraine would be futile. Such a continuation of the Contract in this respect would also be contrary to Articles 101 and 102 TFEU.
- (1374) As follows from Article 7(1) of Council Regulation (EC) No 1/2003, the European Commission may impose also structural remedies (in addition to behavioural remedies) in order to bring an infringement of Article 101 and/or Article 102 to an end. Unbundling of network and supply activities is a typical example of such a structural remedy. The field of energy is a typical example of a sector where conflicts of interests between network operators and suppliers have led to violations of Articles 101 and 102 TFEU, and where unbundling has been required in order to bring the violations to an end.
- (1375) In June 2005, the European Commission launched an inquiry into EU gas and electricity markets in order to investigate perceived market malfunctioning. The final report of 10 January 2007 on the Energy Sector Inquiry, provided a basis for launching a significant number of competition cases to address the concerns identified by the Commission in the course of the inquiry, which in turn provided further support for the Third Energy Package (see footnote 18 on page 1584 of Faull and Nikpay).
- (1376) The Energy Sector Inquiry concluded that new entrants often lacked effective access to networks, despite unbundling requirements found in the Second Energy Package. At the time, the Second Package only required legal and functional unbundling. The Enquiry found that vertical integration still created incentives to make operational and investment decisions not in the interest of

network/infrastructure operations, but rather on the basis of the supply interests of the integrated company, cf. Section 3.2.1 of the Commission Communication.

(1377) In the light of Gazprom's influence over and control of the Ukrainian GTS, this description of competition concerns is appropriate also in this case, even though Gazprom does not own the network. By virtue of Gazprom Export's role in particular, the Ukrainian GTS is not operated in line with the principles and objectives of Articles 101 and 102 TFEU, as well as the Third Energy Package.

(1378) The competition concerns mentioned above, which were closely related to the call for stronger unbundling measures in the context of the Third Energy Package, have been at the core of the European Commission's enforcement measures within the energy sector in competition cases following the Enquiry. In the RWE Gas Foreclosure case and the ENI case, the Commission required commitments from the parties for the divestment of transmission pipelines in order to remedy suspected capacity hoarding, margin squeeze and strategic underinvestment in pipelines.

(1379) Gazprom and Gazprom Export's obstruction of effective unbundling and regulatory oversight within the gas market in Ukraine is a clear example of how the leveraging described in Section VII, 6 has materialised. This is discussed in Section II.C of the Expert Reply:

"Gazprom claims that it cannot abuse the transit network because it is not the owner of the network, and does not provide transit services in competition with other companies. From an economic perspective its ownership of the transit network is not relevant, nor is its failure to provide transit or transmission services to third parties. The key economic concern is that Gazprom uses its control over the Ukrainian transmission network, which originates in the Transit Contract, to reinforce its dominant position in the gas sales business. Gazprom can erect barriers to competition in the gas sales business without actually providing or selling transportation services to third parties. The First Brattle Report assessed the relevant barriers such as the failure to permit virtual reverse flows."

(1380) Gazprom Export acts in the capacity of a "super-operator" in the sense that it is Gazprom affiliates, rather than Ukrtransgaz, that act as matching partners for operators of neighbouring transmission systems in respect of gas flows through Ukrainian territory. This confusion of operational responsibilities and decision-making powers and lack of independence of the transmission system operator, leaves the transmission system of Ukraine open to abusive and restrictive practices on the part of Gazprom. Gazprom, through Gazprom Export, controls the gas flows into and out of the Ukrainian GTS, obstructing also provision of virtual reverse flow gas transmission services.

(1381) Gazprom and Gazprom Export's obstruction of effective unbundling and regulatory oversight in the Ukrainian gas market is a gross abuse of its dominant position within gas sales, cf. Article 102 TFEU. Through that position, Gazprom has been able to gain control over the Ukrainian GTS by virtue of the Contract. Gazprom's exercise of that control has further aggravated its abusive behaviour. The Contract is also a gross violation of Article 101 TFEU, since it is an agreement which severely restricts competition as described above.

7.1.10.1.4.3 EU and ECT energy law as an operationalization of EU and ECT competition law

(1382) The lack of effective unbundling has been a major concern for the European Commission also in the aftermath of the Second Energy Package. From the start of the liberalisation of the internal gas market, unbundling has been considered a prerequisite for efficient third-party access to gas transport infrastructure.

(1383) The former incumbent gas companies are typically vertically integrated and engaged in all aspects of the supply chain, i.e. production, transport and supply of gas. When competition was introduced, the former monopolies held a 100% market share. Any gain in market share by new competitors meant a loss in market share by the former incumbent. The former incumbent necessarily endeavoured to prevent any loss of market share.

(1384) In other words, vertically integrated undertakings have a natural incentive to make third party access as difficult as possible. If it was able to do so, the former incumbent would most likely

favour its own supply activities, e.g. either by unjustified refusing requests for third party access or by setting discriminatory tariffs and other access conditions.

(1385) The Commission chose a dual approach to make sure that effective unbundling was achieved in the energy sector, i.e. enforcement of EU competition law and adoption of the Third Energy Package. Given the incentives to discriminate and the many ways available to do so which may be time-consuming and difficult to detect, a case-by-case imposition of fines on network companies found guilty of discrimination on the basis of competition law was considered inadequate to ensure fair network access, cf. Jones Vol. I, page 88 (paragraph 4.4).

(1386) More effective secondary energy market legislation was adopted in the Third Energy Package to allow for ex-ante application in order to *prevent* specific abusive and discriminatory practices, rather than ex-post enforcement of competition law to address such practices. In order to prevent unjustified refusals of access, interference by gas supply companies and cross-subsidization of the supply activities of vertically integrated undertakings, it has proven necessary necessary to separate network activities, both at transmission and distribution level, from supply activities, cf. preamble 6 of Directive 2009/73/EC. Accordingly, the internal market legislation has *inter alia* focused on separating transport, i.e. transmission and distribution, from production and supply.

(1387) From the introduction of the First Gas Directive (Directive 98/30/EC) till the adoption of the Third Energy Package, the unbundling requirements have been strengthened. While the First Gas Directive (Directive 98/30/EC) merely required accounting unbundling, i.e. separate accounts for the transmission/distribution activities and the other activities of the vertically integrated undertaking, the Second Gas Directive (Directive 2003/55/EC) required legal and functional unbundling, i.e. that transmission and distribution systems were operated by legally separate entities. Article 9 of the Third Gas Directive (Directive 2009/73/EC) gives Member States a choice between introducing ownership unbundling, i.e. which implies the appointment of the network owner as the system operator and its independence from any supply and production interests, or setting up a system operator or transmission operator which is independent from supply and

production interests, i.e. an independent system operator or an independent transmission system operator.

- (1388) Member States shall designate a transmission system operator and the system operator shall have specific tasks, including being responsible for operating, maintaining and developing the transmission facilities. The activities of the transmission system operator are subject to mandatory regulatory oversight and terms and conditions, including rules and tariffs, for access are either based on a methodology developed by or approved by the regulator. In short, under EU energy law, gas traders and suppliers are prevented from participating in the operation of a transmission network.
- (1389) The rules of the Third Energy Package are appropriate and necessary (as well as intended) to avoid the need for extensive enforcement measures pursuant to EU competition law. In line with this, the claims in the Relief Sought related to the party relationship under the Contract are appropriate to bring to an end the violations of Articles 101 and 102 discussed above. By making the adjustments in the Contract described, the Contract will be brought in line with EU competition law (and thus also ECT competition law and national Ukrainian competition law).
- (1390) An adjusted Article 13.8 allows the Contract to be transferred to any entity designated TSO without Gazprom's consent, whereas the adjusted Articles 13.2 and 13.6 provide that the Contract is subject to the terms and conditions for access to the Ukrainian GTS that follow from the mandatory provisions of Ukrainian legislation and regulatory framework at any given time. As the Energy Sector Inquiry and enforcement efforts of the European Commission show, these measures are necessary to both prevent and remedy breaches of Articles 101 and 102 with respect to ineffective unbundling and associated discriminatory practices.
- (1391) Further adjustments necessary to remedy Gazprom's breaches of Articles 101 and 102 with respect to the party relationship under the Contract are set out in the adjusted Article 4.6 and Article 7, and not least the deletion of the Technical Agreement, which all provide for the role of

Gazprom Export which interferes and obstructs the TSO's functions in a way that makes effective unbundling impossible.

7.1.10.1.5 Application of ECT energy law as such

7.1.10.1.5.1 Introduction

(1392) Gazprom alleges that Directive 2009/73/EC and Regulation 715/2009 do not apply to the Contract. That Directive 2009/72/EC and Regulation 715/2009 both apply is established above.

(1393) ECT energy law applies as Swedish law as of 6 October 2011 (or alternatively from 1 January 2015), with the exception of the tariffication principles which apply from 3 September 2011. ECT energy law applies as Swedish law with horizontal direct effect, based on legal discrimination pursuant to Article 7 ECT obliging a Swedish court or tribunal to apply the Third Energy Package as it would in relation to a similar contract involving an EU company, and based on factual discrimination pursuant to Article 7 ECT of which the Third Energy Package is a concretization/operationalization.

(1394) Gazprom argues that "*Naftogaz's proposed remedies and its arguments as to what the unbundling requirements of EU energy law require effectively ask the Tribunal to act as a public regulatory authority and to make assessments which, with respect, it is not equipped to carry out and which it should not be expected to carry out*".

(1395) This argument clearly misrepresents Naftogaz' position. Naftogaz' aim is to ensure that the Contract does not prevent compliance with its obligations under ECT energy law and the application of ECT energy law as implemented in Ukraine.

(1396) In December 2013 the Ukrainian regulator, NCSREU, designated and certified Ukrtransgaz as TSO of the Ukrainian GTS. Ukrtransgaz has specific, mandatory functions and obligations under Directive 2009/73/EC and Regulation 715/2009, as implemented in Ukrainian legislation.

(1397) The problem is that Gazprom and its affiliates, in their capacity as gas producer and gas supplier, are involved in and control the network activities, preventing actual unbundling in Ukraine and hindering Ukrtransgaz from carrying out its tasks.

7.1.10.1.5.2 Gazprom's role as super-operator hinders factual implementation of the unbundling requirements in ECT energy law

(1398) With regard to Gazprom's role as super-operator, controlling gas flows into and out of the Ukrainian GTS, Gazprom argues that Naftogaz's description is factually incorrect:

- Gazprom denies that Gazprom Export acts as "*matching partner*" with the relevant TSOs in Hungary, Poland and Romania. According to Gazprom, no matching process is carried out between Gazprom Export and those TSOs, and no nominations or shipper codes are communicated by Gazprom Export to those TSOs.
- Gazprom alleges that the only TSO in countries adjacent to Ukraine with which Gazprom Export coordinates delivery of volumes is Eustream, the Slovakian TSO. According to Gazprom, it only exchanges information relating to deliveries of Gazprom Export's own gas.
- Gazprom acknowledges that it, in its capacity as owner of the pipeline networks in Russia and Belarus and the GMSs at those entry points located within Russia and Belarus, controls the gas flow into the Ukrainian GTS at the entry points on Ukraine's eastern borders with Russia and Belarus.
- Gazprom denies that it controls the gas flows out of the Ukrainian GTS at Ukraine's western borders. According to Gazprom, the only role Gazprom representatives play at the GMSs "*is to record, jointly, with Ukrtransgaz representatives, the volumes of gas passing through the GMSs. This has always only been as regards Gazprom's own gas, in order to determine the volumes of gas transited under Contract TKGU and supplied under Contract KP*".
- Gazprom argues that "*the only involvement in transmission operations which Gazprom has is to check the volumes of its own gas being transited across the Ukrainian GTS*".

- In any event, to the extent that Gazprom has any "*control*" over gas flows into and out of the Ukrainian GTS, this is "*a necessary and unobjectionable function of the agreement between Gazprom and Naftogaz to transit gas from Russia and Belarus across the Ukrainian GTS*" and "*it is not contrary to the requirements of EU energy law, namely Directive 2009//3/EC and Regulation 715/2009*".

(1399) Essentially, Gazprom argues that today's practice functions well and that there is no reason to change it.

(1400) Gazprom acknowledges that it functions as a matching partner at the Slovak border point, but argues that it is limited to the extent necessary for the operation of its business. However, it is not for Gazprom to be involved in transmission operations at all.

(1401) The standard operating practice across Europe is for shippers to relay information to independent transmission system operators, who then aggregate the information and communicate directly. As explained in the Expert Reply, matching is important to preserve the pressure and stability of the pipeline network and matching injections and withdrawals serves as the baseline for identifying who did not respect their scheduled nominations and to what extent.

(1402) This is a legal requirement under the Third Energy Package. The operational responsibility of the transmission network and the provision of third-party access shall lie with an independent TSO which is not involved in production or supply of gas.

(1403) Eustream does not deny that it has refused to enter into an interconnection agreement with Ukrtransgaz due to existing contractual obligations with Gazprom Export. Eustream has also acknowledged that it is in a contractual relation with Gazprom and not Ukrtransgaz regarding the physical forward flow from Ukraine to Slovakia, cf. the minutes from the CEE TSO Coordination Meeting with the European Commission. Essentially, this confirms that Gazprom's/Gazprom Export's practice of exercising control over the gas volumes arriving at Ukraine's western

border through technical agreements is not isolated to Ukraine and its contractual relations with Naftogaz.

(1404) Gazprom argues that it only relies information relating to its own gas. However, this is only a partial truth. Gazprom's role at the Slovak border point means that it controls the flows in and out of Ukraine and is in a position to aggregate information on nominations of other shippers. As highlighted in the Expert Reply, Gazprom should not become the collector and aggregator of nominations from other shippers. Other shippers pose competitive threats, either in the form of virtual reverse flows, or in the form of exports from Ukraine and other types of long-term transmission. As described below, Gazprom has actually responded to potential competition by refusing to schedule virtual reverse flows. [REDACTED] gives several examples of gas imports to Ukraine which Gazprom has blocked in its capacity as matching partner at Veľké Kapušany, cf. witness statement of [REDACTED]

(1405) Gazprom denies that it acts as "*matching partner*" with the relevant TSOs in Hungary, Poland and Romania. However, Gazprom acknowledges that it is involved in transmission operations in Ukraine, albeit describing this as limited "*to check the volumes of its own gas being transited across the Ukrainian GTS*". With regard to Gazprom's role at the border points to Hungary, Poland and Romania respectively, [REDACTED] and [REDACTED] explanations clearly illustrates how Gazprom and Gazprom Export carry out the delivery and the matching of gas flows within the territory of Ukraine without the involvement of the TSO of the Ukrainian transmission network. By refusing to provide shipper codes, Gazprom and Gazprom Export also ensures that Ukrtransgaz is not able to provide the necessary aggregated information to carry out the matching function with the TSOs of the adjacent systems in Hungary, Poland and Romania respectively.

(1406) According to [REDACTED] Gazprom and Gazprom Export deliver all gas to Hungarian buyers at the Beregovo gas metering station within Ukraine, avoiding the need to communicate directly with the Hungarian TSO. As explained in Section III.A of the Expert Reply, Gazprom still has inappropriate control over cross-border flows with Hungary: By refusing to provide shipper codes to Ukrtransgaz, Gazprom prevents it from implementing the interconnection agreement

with the Hungarian TSO, which is necessary for the consolidation of nominations from other shippers. In Annex 18 to [REDACTED] the Hungarian TSO describes how Ukrtransgaz does not have the necessary information on nominations and shipper codes and how this leads to matching problems as there is several shippers' gas in the common flow.

- (1407) The same applies with respect to Poland, where [REDACTED] explains that deliveries to Polish buyers occur at Drozhdovichi within Ukraine. In an Annex to [REDACTED] the Polish TSO describes how they would incur the same problem with several shippers in the common flow.
- (1408) While Gazprom's argument that the Romanian TSO does not receive any shipper codes, given that the gas simply passes through Romania to other countries, might be true, it does not change the fact that Gazprom is involved in transmission services in breach of the requirements under ECT energy law.
- (1409) Naftogaz has described how gas traders and suppliers are prevented from participating in the operation of a transmission network in order to promote competition. The development of competition would involve more complex flows by more parties than just Gazprom, and, ironically, given the circumstances, it is not possible to schedule more complex flows unless Gazprom provides shipper codes to Ukrtransgaz, cf. the Expert Reply.
- (1410) The Contract, including the Technical Agreement with Annexes, contradicts the system required by ECT energy law. By refusing to adhere to mandatory ECT energy legislation, Gazprom is preventing Ukrtransgaz from exercising its functions and undertaking its obligations as TSO.
- (1411) Gazprom argues that its involvement in transmission operations does not threaten the purpose or objective of unbundling, i.e. "*to ensure effective separations of transmission network operations from the activities of production and supply*" with the objective to remove "*the incentive for vertically integrated undertakings to discriminate against competitors as regard network access and investment*". This line of argument is misleading.

- (1412) First, Ukraine has made all efforts to ensure the legal implementation of the unbundling requirements of ECT energy law. However, the Contract, including the [REDACTED] prevents effective unbundling to take place. When Gazprom questions whether there is effective unbundling between Naftogaz and Ukrtransgaz, they precisely address the problem Naftogaz seeks to resolve by facilitating the assignment of the Contract to the designated TSO.
- (1413) Second, Gazprom ignores that Gazprom's dual role over the use of the Ukrainian transportation network creates a serious conflict of interest that gives rise to competition concerns as discussed in the Expert Reply.

7.1.10.1.5.3 Gazprom's refusal to provide Ukrtransgaz with shipper codes prevents Ukrtransgaz from carrying out its functions as TSO and enter into interconnection agreements with adjacent TSOs

- (1414) The obligation to provide shipper codes now follows explicitly from Ukrainian legislation.
- (1415) That the TSO on a general basis is entitled to operational information from the shipper necessary to carry out its functions, is a given. This now follows explicitly from item III of the Standard Natural Gas Transmission Contract, which, according to Article 32 of the 2015 Ukrainian Gas Market Law and Chapter VIII, 1(1) of the Ukrainian Gas Transmission System Code, shall be the basis for the performance of transmission services.
- (1416) In addition, under the nomination and re-nomination procedures established in Chapter XI of the Ukrainian Gas Transmission Code, it is specified that the shipper is required to submit shipper codes (EIC-codes), cf. Article 1(2) and (8), and stipulated that the TSO carries out the verification of submitted nominations on the basis of compliance of seller/receiver code pairs (entry points) and seller/consumer code pairs (exit points), cf. Articles 5(1) and 6(1).
- (1417) With regard to Gazprom's refusal to provide Ukrtransgaz with shipper codes, Gazprom argues that "*Ukrtransgaz has no practical need for Gazprom Export's shipper codes*" and that "*[t]here is nothing in Contract TKGU or the Technical Agreement that would prevent Ukrtransgaz from entering into an interconnection agreement with the Slovakian TSO, for example, in respect of*

gas transported through Ukraine belonging to any party other than Gazprom, and it does not need access to Gazprom Export's shipper codes in order to do this".

- (1418) By arguing that Ukrtransgaz is free to enter into an interconnection agreement with respect to gas transported through Ukraine belonging to any party other than Gazprom, Gazprom is essentially saying that it can be exempted from the day-to-day operation of the Ukrainian GTS. This approach is not only inherently discriminatory, but completely disregards the requirements regarding operational responsibilities, decision making powers and independence of the transmission system operator under ECT energy law.
- (1419) Also, as explained in the Expert Reply, Gazprom's allegation is simply not realistic. In order to provide Eustream with a coherent and full picture of scheduled activity across the Slovakian border and ensure the integrity of the system at both sides of the border, Ukrtransgaz needs to provide a full and accurate picture of scheduled activity at the Slovakian border. In order to do so, Ukrtransgaz needs to consolidate the nominations of Gazprom with those of other shippers who may wish to export gas from Ukraine or import gas from Ukraine. If information is missing from Gazprom, then the resulting picture will not be full or accurate.
- (1420) An important aspect of the TSO's operational responsibilities is cooperation with adjacent TSOs and facilitating cross-border trade, including matching gas flows at the interconnection points between adjacent transmission systems, cf. Article 12 of Regulation 715/2009. Gazprom's refusal to provide Ukrtransgaz with shipper codes effectively hinders Ukrtransgaz from carrying out an important function as TSO.
- (1421) No shipper can choose whether or not to respect the organisation of the transmission network in question and the operational rights and responsibilities of the transmission system operator. A shipper using the transport services has to comply with the organisation and the operation of the Ukrainian GTS and provide the TSO with the information necessary for it to carry out its functions.

- (1422) Gazprom's argument that there is nothing preventing Ukrtransgaz from entering into an interconnection agreement with the Slovakian TSO is also misleading.
- (1423) Eustream has refused to enter into an interconnection agreement with Ukrtransgaz, partly because Gazprom refuses to inform Ukrtransgaz of the shipper codes of those (either Gazprom Export or counterparties) which are to take delivery of the gas in the Slovak transmission system, cf. [REDACTED]
- (1424) As explained in the Expert Reply, shipper codes play an important role in facilitating cross-border flows of natural gas: If a Ukrainian shipper wishes to inject a particular amount of gas into the Slovakian network, but there is no matching request to receive that amount of gas on the Slovakian side, then Eustream will refuse to accept the gas. Similarly, Eustream will not permit someone to schedule a withdrawal from the network unless there is a matching nomination for an injection.
- (1425) Ukrtransgaz and Eustream have therefore carried out a trial requesting shipper codes from Gazprom to allow standard matching procedures, but Gazprom declined to provide the information.
- (1426) That Gazprom's and Gazprom Export's refusal to provide Ukrtransgaz with shipper codes creates difficulties in the matching of physical forward flows from the Ukrainian transmission network into transmission networks in neighbouring countries at Ukrainian western border in general, is confirmed by the minutes from the CEE TSO Coordination Meeting with the European Commission, cf. an Annex to [REDACTED]. The problem is described as a "chicken and egg"- problem. With the pretext that Ukrtransgaz is not a matching partner to the EU TSOs, Gazprom does not provide nomination volumes and shipper code pairs to Ukrtransgaz. The lack of such data renders the proper matching of nominations/shippers impossible, making pro-rata allocations of transported volumes necessary. Because Ukrtransgaz does not get the necessary information, interconnection agreements have not been put in place with the adjacent TSOs in neighbouring countries.

(1427) In his witness statement, [REDACTED] argues that Ukrtransgaz has signed interconnection agreements and/or memoranda of understanding with other TSOs. However, as [REDACTED] explains in his witness statement, these agreements were signed in relation to the pipelines built for physical reverse flow supplies and respective GMS, and not in relation to the GMS where Gazprom's gas crosses the Western Ukrainian border. Ukrtransgaz and Eustream has, as mentioned by Gazprom, entered into a Memorandum of Understanding, but this applies only to the Budince GMS which is purpose built for physical flows from Slovakia to Ukraine, cf. [REDACTED]

(1428) This is confirmed by the minutes from the CEE TSO Coordination Meeting with the European Commission, cf. an Annex to [REDACTED] where it is also noted that interconnection agreements covering inbound interconnectors are far from EU standard.

(1429) With the assistance of the European Commission, an interconnection agreement was entered into in May 2015 between the Hungarian TSO, FGSZ, and Ukrtransgaz, but the implementation of the agreement relies on Gazprom providing shipper code pairs which it refuses to do, cf. [REDACTED]
[REDACTED]

7.1.10.1.5.4 Gazprom's prevention of virtual reverse flows is restrictive and abusive and prevents Ukrtransgaz from entering into interconnection agreements with adjacent TSOs

(1430) Gazprom implies that Naftogaz has alleged that Gazprom has blocked "actual reverse flows". Gazprom's presentation of Naftogaz' case is clearly incorrect. Naftogaz has never addressed the issue of physical reverse flows. The fact that Gazprom focuses on physical reverse flows, is an obvious distraction from the real issue, namely Gazprom's blocking of virtual reverse flows.

(1431) What Naftogaz has explained is that Gazprom actively has obstructed virtual reverse flow arrangements between Ukrtransgaz and adjacent TSOs.

(1432) With regard to virtual reverse flows, Gazprom arguments can be summarised as follows:

- That Gazprom Export has no objection in principle to participating in and facilitating virtual reverse flow arrangements at interconnection points.

- That virtual reverse flow *"is a complex legal exercise which requires agreement between all relevant stakeholders/network users on a number of complex technical issues"*. Gazprom does not specify the complex technical issues, but in his witness statement, [REDACTED] argues:
 - That *"a set of technical rules and procedures to govern the nomination process pursuant to which VRF capacity could be applied for and provided"* needs to be developed.
 - That *"on the basis of such rules and procedures, amendments to the existing contracts regulating the relationship amongst the TSO and network users of the interconnection point be negotiated and agreed"*.
 - That the focus is in particular on *"how the commercial and economic costs and benefits of such arrangements are to be reallocated needs to be discussed and negotiated"* and it is argued that *"the economic benefit of the efficiency associated with any VRF arrangement should be spread between the affected parties"*.
 - That Gazprom has *"not received any formal proposal from Naftogaz (or Ukrtransgaz) for virtual reverse flow"*, and that *"Naftogaz's and Ukrtransgaz's requests for Gazprom's shipper codes did not address any of the complex issues relevant to establishing virtual reverse flow arrangements"*.
 - That *"there is clear authority to the effect that the Third Energy Package does not make the provision of virtual reverse flow mandatory"* and *"there is therefore no breach of EU energy law in this regard"*.

(1433) Naftogaz has not argued that Articles 13, 14 and 16 of Regulation 715/2009 provide a legal obligation for transmission system operators to provide virtual reverse flow.

- (1434) However, Gazprom's obstruction of virtual reverse flow arrangements is restrictive and abusive pursuant to Articles 101 and 102 TFEU, having the effect of hindering competition to develop at either side of the relevant interconnection points. As explained in the Expert Report, Gazprom's obstruction of virtual reverse flow arrangements has effectively led to the isolation of the Ukrainian gas market and distorted trade between EU Member States. These negative consequences are illustrated by the problems confronting Ukrtransgaz in its efforts to enter into an interconnection agreement with Eustream, the Slovak transmission system operator.
- (1435) Under ECT energy law, the introduction of virtual reverse flow services only requires co-operation between the relevant TSOs. It is the TSOs that have to adopt technical rules and procedures to govern the nomination process. This is a direct consequence of the introduction of entry-exit systems with tariffs set separately for every entry point into or exit point out of the transmission system, cf. Articles 13(1)(4), 14 and 16 of Regulation 715/2009, which means that the actual physical flow of the gas is irrelevant. What is important is that the netting of flows ensures that the required gas volumes are made available to the respective buyers at the agreed exit point(s) at the agreed point in time. In other words, and contrary to what Gazprom alleges, such services can be introduced without the involvement of the network users and without affecting shipper contracts.
- (1436) As all other network users, Gazprom has to act in accordance with the rules prevailing at any given time. The fact that Gazprom essentially argues that it should benefit economically in order for it to accept virtual reverse flow arrangements, is thus quite remarkable.
- (1437) In any event, as explained in the Expert Reply, Gazprom will benefit indirectly from the introduction of virtual reverse flow arrangements: Given that virtual reverse flows do not involve any investment, the costs of providing virtual reverse flow should be lower than the cost of providing physical flows. This will necessarily be reflected in the tariff calculations, i.e. result in lower tariffs.

(1438) In [REDACTED] witness statement, it is pointed out that *"a VRF arrangement at the Ukrainian-Slovakian border would require the reallocation of physical deliveries and would consequently result in a reduction in gas flows passing through the Uzhgorod and Vel'ké Kapusany GMSs"*. Further, Gazprom express the opinion *"that the reduction in forward flow volumes with VRF would mean that Gazprom's capacity reservation is not utilised"*, cf. [REDACTED] witness statement, and that *"transit/transmission charges for unused forward flow capacity would need to be refunded to the relevant shipper(s)"*, cf. [REDACTED] witness statement.

(1439) Gazprom seems to ignore the fact that it would receive the same transportation service as in the absence of virtual reverse flows, cf. the Expert Reply. It is true that when a TSO carries out virtual reverse flow services, this will necessarily affect how the capacity of the transmission network is technically utilised and impact the physical flows through the system at any given time. While some of the reserved forward flow will not be utilised, virtual reverse flow arrangements necessarily imply that the capacity of other transmission systems have to be utilised to ensure the delivery of the gas, and this capacity is utilised free of charge, cf. the explanation in the Expert Reply.

(1440) As acknowledged by [REDACTED], cf. his witness statement, virtual reverse flows are "interruptible", which means that they take a lower priority than other transportation services. Accordingly, virtual reverse flow nominations would never take priority over Gazprom's nomination of exports to Slovakia, cf. the Expert Reply, and thus never threaten Gazprom's ability to satisfy its delivery obligations under existing contracts.

(1441) Gazprom apparently implies that the introduction of virtual reverse flows would be in breach of Naftogaz's obligation under the Contract and the Technical Agreement. Gazprom argues that *"Naftogaz is obliged to deliver to the western point (e.g. Uzhgorod) the same volume as is injected by Gazprom at the relevant eastern border entry point, for which services Gazprom pays transit fees (such fees being for the transit of all volumes through the entire territory of Ukraine to the western border exit point of Uzhgorod)"*, cf. [REDACTED] witness statement. Also,

Gazprom argues that a reduction of physical deliveries would impact the delivery and acceptance procedures stipulated under such contracts, cf. [REDACTED] witness statement.

(1442) Essentially, Gazprom seems to argue that the gas has to be transported physically in accordance with the current contract paths established in the Contract. However, the provisions where this contractual path is reflected, i.e. Articles 2, 3 and 4, as well as the [REDACTED] [REDACTED] which incorporates and details the contract paths of Articles 3 and 4 of the Transit Contract, are invalid and need to be replaced pursuant to Article 13.2 of the Transit Contract. Naftogaz requests that the contract paths under the Gas Transit Contract be replaced with a long-term booking scheme for entry capacity at the eastern border of Ukraine and exit capacity at Ukraine's western borders, subject to the prevailing booking and congestion management rules at any given time under mandatory Ukrainian legislation. If Naftogaz' claims are successful, there is no contractual basis for Gazprom's reasoning.

(1443) In any event, and as already explained above, the provision of virtual reverse flow services will not affect Gazprom's contractual obligations towards its buyers.

(1444) It's for the TSOs to decide if virtual reverse flow arrangements shall be established, not Gazprom.

7.1.10.1.6 The Contract is not a secondary market agreement

7.1.10.1.6.1 Introduction

(1445) Gazprom's main substantive argument under energy law is that the Contract allegedly is a secondary market agreement which allegedly is not covered by European and/or Ukrainian energy law. Gazprom's position is legally and factually incorrect.

(1446) Gazprom now states that "*[...] it is not in dispute as matters currently stand that the TSO for the Ukrainian gas transport system is Ukrtransgaz, a wholly owned subsidiary of Naftogaz*".⁸⁷ In addition, Gazprom now claims that Ukrtransgaz was the TSO of the Ukrainian GTS from 2005 onwards and, consequently, in January 2009 when the Contract was concluded. This is in stark

⁸⁷TD 11, 25 17-20 (T-PHB, tab II p. 167)

contrast to Gazprom's written submissions, where Gazprom and its experts has argued that Ukrtransgaz is not the TSO of the Ukrainian GTS or at least not a proper TSO in accordance with the TEP.

(1447) According to Gazprom, European and Ukrainian energy law provisions only apply to the TSO's terms and conditions for access to the transport system. Gazprom states that *"the rules upon which Naftogaz relies in Directive 2009/73/EC and Regulation 715/2009 impose obligations and requirements on the designated TSO"*. Furthermore, Gazprom states that the tariff resolution adopted by the Ukrainian Regulator (Resolution no. 3158) *"on its face applies to the tariff charged by the transmission system operator, specifically identified as Ukrtransgaz, to its customers and to no other tariff. It does not apply to the tariff charged by someone who is not a transmission system operator to his customers"*.⁸⁸ Similarly, Gazprom argues that *"the model contract applies to the contract between the TSO and its customers, in this case including Naftogaz, and not contracts between the TSO's customers and the customers of that customer"*.⁸⁹

(1448) On this basis, Gazprom concludes that *"the relationship that has been established is very simply as follows: the transmission system operator provides services to Naftogaz. Naftogaz is its customer. Naftogaz in turn contracts for the provision of services to its customer, Gazprom, and it ensures the provision of those services through its contract with the TSO Ukrtransgaz"*.⁹⁰

(1449) Naftogaz rejects all of Gazprom's assumptions.

7.1.10.1.6.2 The role of the Parties in January 2009

(1450) Naftogaz refers to its Explanatory Note of 1 December 2016 on the roles and relationships between the parties involved and the legal consequences thereof, where it was explained that Naftogaz was the *de facto* operator of the Ukrainian GTS when the Contract was concluded.

⁸⁸ TD 11, 23:10-16 (T-PHB, tab II p. 171)

⁸⁹ TD 11, 23:24 – 24:2 (T-PHB, tab II p. 171)

⁹⁰ TD 11, 23:17-23 (T-PHB, tab II p. 172)

(1451) Gazprom argues that "*Ukrtransgaz is not only now the designated TSO but has fulfilled this role since its foundation by decree. Accordingly, when Contract TKGU was signed Ukrtransgaz was already the TSO of the Ukrainian transmission network*".⁹¹

(1452) To support this view, Gazprom refers to various resolutions granting licences to Ukrtransgaz to conduct commercial activities that include natural gas transportation by main pipelines. What Gazprom omits to mention is that until the adoption of the 2015 Natural Gas Market Law, there was a clear distinction between gas transit through Ukrainian territory and domestic transportation within Ukraine.⁹² This distinction led to different licensing regimes (i.e. no licensing requirements for transit) and tariffs payable for transit and transportation services. While Ukrtransgaz has been granted licences to provide *domestic* transportation in accordance with Ukrainian legislation, Naftogaz has historically been in charge of *transit*. This allocation of responsibility between Naftogaz and Ukrtransgaz is described and documented in Naftogaz's Explanatory Note of 1 December 2016:

(1453) Pursuant to Resolution of the Cabinet of Ministers of Ukraine No. 747 dated 25 May 1998 (as amended on 15 December 2005) on *inter alia* the approval of Naftogaz' charter, Naftogaz was responsible for the "*creation and operation of the transit interstate systems of transportation of oil, oil products and natural gas*" (Naftogaz' emphasis). Resolution of the Cabinet of Ministers of Ukraine No 1173 dated 24 July 1998 subsequently delegated certain functions related to transportation and storage of gas to Ukrtransgaz as part of the vertically integrated Naftogaz-group.

(1454) Following adoption of the 2010 Gas Market Law, Naftogaz was formally vested with the functions of the operator of the Ukrainian GTS by Order of the Ministry of Fuel and Energy of Ukraine No. 463 dated 5 November 2010. This Order simply codified Naftogaz' de facto status as the operator of the Ukrainian GTS.

⁹¹ TD 11, 39:11-15 (T-PHB, tab II p. 173)

⁹² Cf. e.g. the definitions of transportation services and transit in Article 1 of the Law on Oil and Gas (CL-17 in T-F 1), effective from 2002. This distinction is also reflected in the definition of the term "consumer" in Article 1(12) of the Law on the Functioning of the Gas Market (CL-15 in T-F 1), effective from 2010, which distinguishes between transit, transportation of natural gas by main pipelines (i.e. transmission) and transportation of natural gas by gas distribution pipelines (i.e. distribution).

(1455) This allocation of responsibility between Naftogaz and Ukrtransgaz is confirmed by the AMCU Decision of 22 January 2016. The AMCU's analysis on substance confirms that Naftogaz is the operator in the meaning of the primary seller of capacity, and that Ukrtransgaz only is a technical service provider:

"NAK "Naftogaz of Ukraine" and PJSC "Ukrtransgaz" are connected by control relations within the meaning of Article 1 of the Law of Ukraine "On Protection of Economic Competition" and are a single entity of economic activity. In other words, in the market for the provision of natural gas transit by main pipelines through the territory of Ukraine, NAK "Naftogaz of Ukraine" is the seller of this service to other entities and PJSC "Ukrtransgaz" is a technical executor of that service." (emphasis added by Naftogaz).

(1456) Gazprom also seeks to anchor its view in the provisions of the Contract. Gazprom argues that there is agreement by Naftogaz to *procure* transit, implying that Naftogaz is not the primary supplier of transit services.⁹³ That argument is based on an incorrect translation of Article 3.1 of the Contract. Gazprom translates the word "обеспечивать"/"обеспечить" in the Russian original as "procure". But the original Russian word means to provide, to guarantee, to ensure.⁹⁴ What Article 3.1 actually says is that "the Contractor shall ensure its acceptance and further transit through the territory of Ukraine". In other words, Naftogaz provides or ensures the transit services as the primary supplier, it does not procure them from anyone else.

(1457) The contracts between Naftogaz and Ukrtransgaz also show that Gazprom's assertion that Ukrtransgaz was the TSO of the Ukrainian GTS from the outset is factually incorrect. They also show that the Contract never was a secondary market transaction. The point of the secondary market is that you sell capacity that you already have booked and is entitled to. However, the first contract on implementation of the Contract was entered into on 28 January 2009, i.e. *after* the conclusion of Contract. Subsequent contracts between Naftogaz and Ukrtransgaz have been

⁹³ TD 11 31: 20-25 and 32: 1-6 (T-PHB, tab II p. 179)

⁹⁴ Oxford Russian Dictionary, p. 267 (New Exhibit CL-297) (T-PHB, tab II p. 181)

concluded annually or even more frequently. Therefore, the primary transaction was the Contract. Only because Naftogaz controlled the Ukrainian GTS and Ukrtransgaz as the formal and de facto transit TSO, could it conclude the Contract without first booking the equivalent capacity with Ukrtransgaz for the term of the Contract.

(1458) In summary, Ukrtransgaz was *not* the TSO in January 2009 when the Contract was concluded. Ukrtransgaz was a technical service provider, as specified in Article 4.6.

7.1.10.1.6.3 The applicability of European and Ukrainian law to the Contract

(1459) Gazprom's argument that European and Ukrainian energy law does not apply to the Contract between Naftogaz and Gazprom is not tenable. The fact that certain provisions of the relevant energy law impose obligations on the TSO does not mean that these provisions are not applicable to other market participants and network users. The functioning and integrity of the system relies on the rules being generally applicable. A contract which is contrary to the requirements of the relevant energy law is in principle unlawful regardless of the status of the parties. In addition, the relevant energy law determines who the parties to such contracts can be. The relevant energy law consequently applies to the Contract.

(1460) The tariff requirements in EU and Ukrainian energy law may be used as an illustration. Here, Gazprom ignores that Article 13 of Regulation 715/2009 provides general requirements for tariff setting, although the tariffs shall be applied by the TSO when granting access to network users in general. Similarly, when Gazprom argues that the tariff set by the Ukrainian Regulator is addressed to Ukrtransgaz, it ignores that Ukrtransgaz under Ukrainian law is obliged to charge the tariff for access to the system in general and that the tariff applies irrespective of the existing contractual relationship. In other words, the TEP - also as implemented in Ukrainian legislation establishes a mandatory framework within which all shippers, including Gazprom and Naftogaz, have to carry out their activities, as also confirmed by the AMCU.

(1461) Ukrtransgaz is a wholly owned subsidiary of Naftogaz. The entire purpose of the TEP is to separate the activities of vertically integrated entities. Suppliers, like Naftogaz and Gazprom, cannot

be involved in transportation. Under the TEP, the TSO shall be exclusively responsible for the reliable and safe operation, maintenance and development of the gas transmission system, cf. Chapter III of Directive 2009//3/EC, in particular Article 13. This requirement now follows from Article 20 of the Ukrainian Natural Gas Market Law and Chapter V of the Ukrainian Gas Transmission Network Code. The TSO's tasks are set out in Article 22 of the Gas Market Law and are further detailed in the Gas Transmission System Code.

(1462) By law, Naftogaz is prohibited from participating in the operation of the Ukrainian GTS. On 11 February 2016, the Ukrainian Regulator ordered each of Naftogaz and Ukrtransgaz to adjust their contractual relations regarding the transit of natural gas, including the Transit Contract between Naftogaz and Gazprom, to ensure compliance with the Standard Gas Transmission Contract by 1 March 2016. Gazprom argues that it is only the contract between Naftogaz and Ukrtransgaz that should be brought in line with the Standard Gas Transmission Contract. However, Gazprom's reading of the Regulator's Decision is wrong.

(1463) ACER's 2013 report, *Transit Contracts in EU Member States*, confirms that the TEP applies to legacy contracts and that such contracts have to be aligned with the requirements of the TEP. The historical holders are no longer entitled to preferential access or different tariffs from domestic customers. Where necessary, such alignment would involve the assignment of such contracts to the TSO. Such an assignment is not a regular assignment between private parties. This is a regulated market and the contract is assigned to the entity designated by law to operate the pipeline system and licensed to carry out the transport services.

(1464) Gazprom, based on its experience of the transposition of EU legislation to transit in several Eastern European EU states, is well aware that the TEP applies to shippers in general and that the transit contracts have to be aligned with the requirements of the TEP. Gazprom has had to make changes to other contracts so as to not contravene the new regulatory environment with regulated tariffs, e.g. in Poland, but also in other countries.⁹⁵ However, the ACER 2013 Report shows that

⁹⁵ TD 4 127 22 – 128 16 (T-PHB, tab II p. 212)

Gazprom has developed strategies to avoid the full application of the TEP. One example is in the Czech Republic, where the historical contracts for the transit of Russian gas from Slovakia to Germany and the rest of Western Europe were transposed from the existing pipeline system to the new Gazelle pipeline which was granted an exemption from the third-party access requirements. While this move frees up capacity in the national pipeline system, it also allows for continued preferential treatment of the historical contracts within the TEP framework.

7.1.10.1.6.4 The character of the Contract

- (1465) The primary market is the term used to describe the market where the TSO allocates capacity to network users, cf. Article 2(22) of Regulation 715/2009. The secondary market is the market where network users trade unused capacity, cf. Article 2(6) and 16(3)(b). The TEP requires that capacity is freely tradeable and that the TSO facilitates such trade by adopting standardised contracts and recognising the transfer of primary capacity rights where notified by system users, cf. Article 22 of Regulation 715/2009. The purpose is to allow network users to resell unused capacity for congestion management purposes, cf. recital (21) and Article 16 of Regulation 715/2009.
- (1466) Naftogaz maintains that the Contract is a legacy contract and that the party- relationship under the Contract reflected the realities at the time. It was in fact Naftogaz that was responsible for the operation of the transit at the time of the conclusion of the Contract and that Ukrtransgaz merely technically implemented the Contract.
- (1467) Gazprom's assertion that the Contract must be considered a secondary market transaction from the outset is not credible. There is no mention of the Contract as a secondary market transaction in Gazprom's Defence. In addition, the following points should be noted:
- (1468) First, when the Contract was entered into on 19 January 2009, the concept of a primary and secondary market did not exist in Ukraine. This concept was introduced with the Second Energy Package, more specifically by Articles 5 and 8 of Regulation 1775/2005. However, Ukraine only

undertook an obligation to implement the Second Energy Package when it acceded to the ECT on 1 February 2011.

(1469) Second, the first contract between Naftogaz and Ukrtransgaz was entered into *after* the conclusion of the Contract. Mr Witschen confirmed in cross-examination that "[t]he primary shipper can only sell capacities they have booked and that are available to them. If they are not available to them then vis-à-vis the secondary shipper they have to make precautions because they can't sell anything that they haven't purchased before"⁹⁶ This confirms Naftogaz' conclusion that the Contract is the "primary" transaction.

(1470) Third, the solution Gazprom proposes means that Naftogaz would have to book capacity with Ukrtransgaz and thereafter provide this reserved capacity to Gazprom. Such a solution would contradict the nature and purpose of the secondary market as a congestion management tool. It follows explicitly from Article 16(3) of Regulation 715/2009 that the secondary market is established to give network users a possibility to sell capacity that they have booked, but do not need. Gazprom suggests the opposite, that Naftogaz shall knowingly book capacity it does not need for the purpose of resale. That the networks users sell off their excess capacity in the secondary market, means that this not a market for allocation of large scale and long-term capacity, but rather the trade of short-term capacities on a smaller scale.

(1471) Mr Witschen's argument that *"the main element that distinguishes a primary market transaction from a secondary market transaction is the fact that in a primary market transaction the relevant TSO is a counterparty, whilst in a secondary market transaction a TSO is not present"*, completely ignores the purpose of the secondary market. However, he acknowledges that *"[t]he option to trade capacity to third parties once it has been required from the TSO is in the interest of all participants (TSO, shippers and regulatory bodies)"* as *"[i]t is an efficient use of the transmission network and works against capacity constraints, e.g. caused by capacities booked but*

⁹⁶ TD 9 124:11-15 (T-PHB, lab II p. 220)

not used". He also confirms that the incentive to sell unused capacity lies in the shipper's chance to "*avoid stranded costs for capacity booked but not used*".

(1472) Fourth, the *commercial consequences* of Gazprom's approach indicate that the Contract is not a secondary market agreement. The solution proposed by Gazprom implies that Naftogaz should book capacity at the regulated tariffs for access to the Ukrainian GTS and then provide the reserved capacity to Gazprom at the excessively low (and not cost-reflective) tariff in the Contract. Gazprom essentially requests that Naftogaz subsidises Gazprom's gas transport. Rather than to sell excess capacity and save costs in line with the purpose of the secondary market, Gazprom requires Naftogaz to book excess capacity and incur losses.

(1473) On Gazprom's own assumptions, Naftogaz would be obliged to reserve capacity for transport of 110 bcm annually at regulated tariffs, but only be entitled to compensation for actual volumes transported by Gazprom at the lower tariff in the Contract. This would entail losses for Naftogaz of several billion USD per annum.

(1474) Gazprom superficially addresses this issue and dismisses it as a kind of a zero sum game between Naftogaz and Ukrtransgaz. This is factually incorrect, because a new TSO independent of Naftogaz is established and will take over the role after the award in this case has been rendered.

(1475) The Contract's character as a legacy contract did not change because the market was liberalised and Naftogaz now is prohibited from providing transport services. The Energy Community Secretariat's assessment of the Contract found it to be a legacy contract between two vertically integrated entities.

(1476) Also, contrary to what Mr Witschen implies in his reports, secondary market agreements have to be concluded within the relevant terms and conditions for access that follows from the legislative framework. It is a basic contractual principle that one can only transfer the rights one has. When asked if Gazprom, as a secondary shipper, may be exempted from changing regulations as determined by the Ukrainian regulator and implemented by the TSO, Mr Witschen acknowledged that

this is a legal issue. He proceeded to argue that the technical rules set by the TSO (nominations, exchange of shipper codes) remained the responsibility of the primary shipper. When asked why a primary shipper, if he remains fully responsible, would allow the secondary shipper to do anything else than follow the same rules, Mr Witschen could not provide a better answer than *"this is a question you need to ask a primary shipper because they decide what kind of obligations they pass on"*.⁹⁷ But as mentioned above, he eventually acknowledged that *"t]he primary shipper can only sell capacities they have booked and that are available to them"*.

(1477) It is quite obvious that Naftogaz cannot comply with the law and the terms and conditions of the Contract, including the Technical Agreement, at the same time. If Naftogaz were to comply with Ukrainian law, it would be in constant breach of contract and, as such, liable for damages under Article 10.1 of the Contract.

(1478) In short, turning the legacy contract (the "primary market" agreement) of 2009 into a secondary market agreement would not be in compliance with the *"economic effect as close as possible"* requirement of Article 13.2 of the Contract. Rather the opposite; it would be a fundamental change. Also, Gazprom has made no claim to this effect.

7.1.10.1.7 The Contract is not subject to transitional periods and/or mitigating measures (grandfathering)

(1479) Gazprom argues that *"[...] if EU energy law applied, as a legacy contract, Contract TKGU would qualify for "a certain degree of grandfathering" and "transitional solutions" should apply"* As a basis for their assertion, Gazprom refers to Dr Yafimava's reports. According to Gazprom, this means that *"Naftogaz's claims under energy law must be approached with extreme caution"*.

(1480) The main rule in the TEP and EU case law is that pre-liberalisation long-term transit contracts (or legacy contracts as Gazprom's calls them) do not receive any preferential treatment. There is no legal basis for any assertion to the contrary.

⁹⁷ TD 9 123:16 - 124:4 (T-PHB, tab II p. 226)

- (1481) Gazprom does not argue that the Contract *is legally exempted* from EU energy law, much less seeks to explain in what way the Contract is supposed to be subject to grandfathering. In other words, Gazprom has not set forth any legal argument, but only seeks to confuse matters.
- (1482) Gazprom has omitted to provide any support for the broad assertion in its written submissions that the Contract would qualify for "*a certain degree of grandfathering*" and "*transitional solutions*".
- (1483) The only provision that to a very limited extent can be said to safeguard existing contracts is Article 35 of the September 2016 Draft Tariff Network Code. Article 35 establishes that the Tariff Network Code "*shall not affect the levels of transmission tariffs resulting from contracts or capacity bookings concluded before the entry into force of this Regulation [specific date to be inserted by OP] where such contracts or capacity bookings foresee no change in the levels of the capacity- and/or commodity-based transmission tariffs except for indexation, if any*" [Naftogaz' emphasis]. Article 8.7 of the Contract is not an indexation clause, and foresees changes in the level of the Contract tariff. This exemption, if adopted, would therefore not apply.

7.1.10.1.8 Mandatory Ukrainian law

- (1484) When Ukraine acceded to the ECT, Article 11 referred to the Second Energy Package as the *acquis communautaire*. Ukraine has previously adopted measures to ensure legal unbundling.
- (1485) Ukraine has now implemented the Third Energy Package. When the Third Energy Package was incorporated into the Energy Community Treaty, Decision 2011/02/EnC-MC set separate implementation deadlines for the unbundling requirements.
- (1486) The unbundling requirements of Directive 2009/73/EC have been transposed by the Law on Natural Gas Market, allowing a choice between ownership unbundling and independent system operator. The unbundling provisions in the 2015 Gas Market Law, cf. Articles 23 (ownership unbundling) and 27-29 (independent system operator model), will apply from 1 April 2016. In other

words, the choice will have to be made prior to this date. Certification has to be done by 1 June 2016, in line with the Ministerial Council Decision on the adoption.

(1487) As mentioned above, Ukraine is in the process of implementing the TEP unbundling requirements. Ukraine has established a new TSO, Public Joint Stock Company "Main Gas Pipelines of Ukraine" (MGPU). Ukrainian authorities have concluded that the Contract needs to be transferred and revised prior to the completion of the organisational unbundling process, i.e. the transfer of assets to and certification of the new TSO. The transfer and revision of the Contract ensures operational unbundling, i.e. the unbundling of transmission and production/supply, and is also a prerequisite for the organisational unbundling.

(1488) For the time being, Ukrtransgaz is a combined transmission and storage system operator, a subsidiary legally unbundled from Naftogaz and not engaged in production or supply, with defined tasks and subject to regulatory oversight.

(1489) It is important to note that under the current legislation there is no question that the operation of the Ukrainian GTS is vested in, and the transport services shall be executed by, the designated TSO, i.e. Ukrtransgaz.

7.1.10.2 Capacity allocation and congestion management

7.1.10.2.1 Introduction

(1490) Under the Contract, Gazprom has reserved the majority of the capacity at the cross-border interconnection points at the Ukrainian GTS. While the reservation of capacity on the interconnection points is not problematic in itself, the fact that the Contract effectively blocks a functioning capacity allocation and congestion management, is contrary to competition law and energy law.

(1491) Gazprom says that the actual extent of the capacity reservation is not as severe as Naftogaz maintains. Brattle has concluded that Gazprom's reservation at Uzhgorod, which is the key point where gas moves from Ukraine to Western Europe, covers as much as 95% of the total capacity. That leaves practically no market share available for competitors. [REDACTED] disputes the

95% figure and says the actual is closer to 70%. In any event a reservation of 70% would still be a serious constraint.

(1492) The testimony of [REDACTED] and [REDACTED] showed that Gazprom's allegation that there have not been third party requests to use the network is incorrect. Also, Gazprom itself has prevented Naftogaz from exporting gas, by means of the destination clause in the Gas Sales Contract. Naftogaz explained during the Gas Sales Arbitration that that is a hardcore restriction of competition which has no conceivable justification. Gazprom should not be able to rely on that restriction to prove that there is no third-party demand for cross-border capacity.

(1493) The fact that Ukraine now imports a significant quantity of gas from suppliers other than Gazprom is irrelevant, because the capacity reservation still prevents Naftogaz from re-exporting the gas that it purchases.

(1494) Gazprom's final point that there is no competition on the downstream gas sales market in Ukraine because Naftogaz has an effective monopoly is factually incorrect. Here, it is sufficient to recall [REDACTED] testimony that 23 shippers, including Naftogaz, pay the new tariff. Also, the gas sales market is not limited to Ukraine.

(1495) Gazprom has not been able to show that its reservation of the majority of the capacity on the interconnection points does not have an anticompetitive effect. Mr Lapuerta explained clearly in his opening presentation how the long term commitment for capacity negatively impacts Naftogaz' competitive position and Gazprom has done nothing to rebut this.

7.1.10.2.2 Application of Articles 101 and 102 TFEU and Article 18 ECT

7.1.10.2.2.1 Gazprom's abusive and restrictive behaviour

(1496) A problem identified in the Energy Sector Inquiry of the European Commission was that new entrants were unable to secure transit capacity on key routes and entry capacity into new markets, cf. paragraph 22 of the Commission's Communication. Incumbents often controlled the primary capacity on transit pipelines, and they had little incentive to expand capacity or make capacity

available to serve the needs of new entrants. In many cases, new entrants were unable to obtain a sufficient amount of capacity even when transit pipeline capacity was expanded.

- (1497) In the case of Ukraine, Gazprom's and Gazprom Export's control over the Ukrainian GTS, including on the border points, raises the same competition concerns as those described in the Energy Sector Inquiry. As pointed out in the Expert Report, *"Gazprom Export has a conflict of interest because active congestion management could facilitate the development of competition against its affiliate Gazprom."*
- (1498) As in the case of unbundling, effective systems for capacity allocation and congestion management have been a priority for the European Commission in its enforcement efforts within the energy sector in the aftermath of the Sector Inquiry.
- (1499) In the GDF and E.ON gas foreclosure cases, the Commission accepted commitments to release significant amounts of capacity at the entry points into the French and German markets respectively. GDF and E.ON had reserved the capacity on a long-term basis.
- (1500) Naftogaz refers in this respect to a report from ACER which discusses the same issues. According to the ACER report, long-term reservations of a large proportion of entry capacities are likely to amount to refusal to supply and may therefore constitute an abuse of dominant position in breach of Article 102 TFEU, hampering competitors' access to downstream gas supply markets, to the detriment of end consumers.
- (1501) In the Swedish Interconnectors case, the Commission accepted commitments to subdivide the Swedish electricity transmission system into two or more bidding zones and to manage congestion in the Swedish transmission system without limiting trading capacity on interconnectors.
- (1502) Gazprom's obstruction of a functioning system for capacity allocation and congestion management in Ukraine constitutes a gross abuse of its dominant position pursuant to Article 102 TFEU. Furthermore, the Contract is a clear violation of Article 101 TFEU since it restricts competition as described above. Even though a system for capacity allocation and congestion management

in line with the Third Energy Package is now in place in Ukraine, the Contract effectively prevents its implementation.

7.1.10.2.2 EU and ECT energy law applied as an operationalization of EU and ECT competition law

- (1503) Just as in the case of unbundling etc. as described above, effective systems for capacity allocation and congestion management have been a priority for the European Commission in its enforcement efforts within the energy sector in the aftermath of the Second Energy Package and the ensuing Energy Sector Inquiry.
- (1504) The transport capacity of a pipeline is determined by its physical dimension and pressure through the pipeline. The pipeline can be congested, either physically or contractually. While physical congestion is rare, there is quite a substantial problem with contractual congestion. In other words, pipeline capacity is a scarce/finite resource.
- (1505) When the transmission networks were built, the vertically integrated undertaking or a consortium of such companies that constructed the networks typically contracted for all or almost all of the available capacity. Even if the company/companies did not need the capacity, it still reserved it for future needs. This gave rise to the following two questions: How should new capacity be allocated? How could existing capacity that is contractually reserved, but not used, be made available to new competitors?
- (1506) The Commission has accepted as commitments in competition cases the release of significant amounts of capacity at the entry points into the markets, where capacity had been reserved on a long-term basis for one or more particular companies. Furthermore, the Commission has accepted as commitments the reorganization of congestion management systems, *inter alia* in order to facilitate trading capacity on interconnectors.
- (1507) With the introduction of the concept of third party access, it was obvious that effective third-party access could easily be rendered ineffective by manipulating the available capacity. The vertically integrated companies have several covert ways to discriminate. One example is the

allocation of scarce capacity to the advantage of the vertically integrated undertaking. Another example is the manipulation of the available capacity to ensure that the lines required by competitors are congested, i.e. capacity hoarding. However, such discriminatory practices are difficult to detect and to prove.

(1508) In addition to the general obligation of non-discrimination imposed upon transmission system operators pursuant to Article 13(1)(b) of Directive 2009/73/EC, rules on capacity allocation and congestion management have therefore been developed to ensure the non-discriminatory allocation of the scarce resource that pipeline capacity is with the clear purpose to *prevent* abusive and discriminatory behaviour by the former incumbents.

(1509) Rules on capacity allocation and congestion management were first introduced with the Second Energy Package (in Article 5 and Annex I of Regulation 1775/2005), but further detailed and strengthened in the Third Energy Package (in Article 16 and Annex I of Regulation 715/2009).

(1510) The capacity allocation and congestion management principles were based on "the use-it-or-lose-it" principle also familiar in competition law, cf. preamble (11) of Regulation 1775/2005 which states that "*it is necessary to develop common rules which balance the need to free up unused capacity in accordance with the 'use-it-or-lose-it' principle with the rights of the holders of the capacity to use it when necessary*".

(1511) Both regulations aimed to free up unused capacity by enabling network users to sublet or resell their contracted capacities and by obligating the transmission system operator to offer unused capacity to the market, at least on a day-ahead and interruptible basis. While Regulation 1775/2005 introduced the principles of capacity allocation and congestion management for new or renegotiated transportation contracts, Regulation 715/2009 applies these general principles to all contracted capacities, both new and existing contracts.

(1512) Article 16 of Regulation 715/2009 regulates principles for capacity-allocation mechanisms and congestion-management procedures. These principles are further developed in the CMP

Guidelines included in Annex I, as amended by Commission Decision of 24 August 2012, to Regulation 715/2009. The Commission has also adopted a supplementary Commission Regulation which specifically establishes standardised capacity allocation mechanisms to be applied at interconnection points and a set of standardised bundled cross-border capacity products to be offered at interconnection points between entry-exit zones as well as specifying how adjacent TSOs shall cooperate to facilitate the sale and usage of such bundled capacity, i.e. the NC CAM.

(1513) As the Energy Sector Inquiry and the enforcement efforts of the European Commission show, the regime of the Second Energy Package with respect to capacity allocation and congestion management was not sufficient. Thus, the rules of the Third Energy Package on capacity allocation and congestion management are appropriate and necessary (as well as intended) to avoid the need for extensive enforcement measures pursuant to EU competition law.

(1514) Accordingly, the claims in the Relief Sought related to capacity allocation and congestion management are required to bring to an end the violations of Articles 101 and 102 discussed above. By making the adjustments in the Contract described below, the Contract will be brought in line with EU competition law (and thus also ECT competition law and national Ukrainian competition law).

(1515) The contract paths under the Contract must be replaced with a long-term booking scheme for entry-exit capacity, requiring the replacement of the prevailing Articles 2, 3 and 4 of the Contract (incl. consequential amendments in Article 1).

7.1.10.2.2.3 The Contract is contract path based and thus in breach of the entry-exit system requirements in ECT energy law

(1516) Gazprom argues that Naftogaz has failed to establish that the Contract is contrary to Regulation 715/2009 as a result of being based on contract paths, rather than on an entry-exit system. The basis for Gazprom's conclusion is as follows:

(1517) Article 13(1) of Regulation 715/2009 relates specifically to tariffs for access to transmission networks. It is not required as a matter of EU energy law that the tariff under the Contract should

be based on an entry-exit system, rather than on "*contract paths*". Gazprom also denies that this would lead to a "*more liquid market*" and/or "*give the shipper greater flexibility*" as Naftogaz argues.

(1518) There is no need for this flexibility as Gazprom has no need to purchase differing levels of capacity at the entry and exit points to the Ukrainian GTS, cf. paragraph 314 of [REDACTED] witness statement.

(1519) The purpose of an entry-exit system is to encourage a liquid wholesale market for gas within a gas transmission network. Regulation 715/2009 is not explicitly concerned with transit of gas across a gas transmission network.

(1520) The characteristics necessary for a functioning liquid wholesale market for gas where entry and exit capacity can be booked independently, are not present in the Ukrainian market, cf. the Witschen Report. The necessary characteristics are listed as: i) independent booking and use of entry and exit capacity, ii) unrestricted trading of gas within the network area, iii) a virtual trading point to which all network users have access from all entry and exit points, and iv) the availability of short term capacity products which are used for short-term trading between trading points.

(1521) Not all Member-States have transferred transit contracts onto an entry-exit system, cf. the Witschen Report, and it is not necessary to do so in order to comply with Regulation 715/2009.

(1522)

(1523) It is clear that the implementation of an entry-exit tariff system, as laid out in Regulation 715/2009, cf. Article 13(1)(4) (entry-exit tariffs), Article 14 (firm and interruptible third-party access services on both long-term and short-term basis shall be offered) and Article 16 (maximum capacity at all entry and exit points shall be made available), is compulsory and not contingent on other market developments.

(1524) Regulation 715/2009 provides the legal basis for adopting harmonised rules, cf. Articles 6 and 8, in order to promote the completion and functioning of the internal market in natural gas and cross-border trade, cf. Article 4. The subsequent adoption of supplementary legislation, *inter alia* the NC CAM, to ensure efficient allocation of the capacity on the interconnection points between two or more transmission networks, and the on-going work of adopting harmonised tariff systems which are consistent with the capacity allocation mechanisms and which facilitate the merging of entry-exit systems, cf. preamble (2) of the draft re-submitted TAR NC, shows that the focus is on gas trade both within and between transmission networks. This clearly contradicts Gazprom's argument that the purpose of an entry-exit system is to encourage a liquid wholesale market for gas *within* a gas transmission network and that Regulation 715/2009 is not explicitly concerned with transit of gas *across* a gas transmission network.

(1525) As mentioned in the Expert Reply, it not logical to recommend against the introduction of an entry-exit system because one of its elements is missing. Also, as explained in the Expert Reply, EU policy does not make the implementation of an entry-exit tariff system contingent on market developments.

(1526) In any event, with the implementation of the Third Package in Ukrainian legislation, the above-mentioned elements are now in place. According to Chapter IX of the Ukrainian Gas Transmission Network Code, entry and exit capacity can be booked independently. Both firm and interruptible capacity are available on both long-term and short-term basis. The Ukrainian tariff methodology also includes short-term products, cf. Section IV.A of the Expert Reply. As mentioned in the Expert Reply, a virtual trading point was introduced as of 1 January 2016.

(1527) The introduction of an entry-exit regime in Ukraine is thus entirely reasonable and should, over time, facilitate the development of a competitive wholesale gas market in Ukraine.

(1528) Naftogaz fails to see how the argument that Gazprom has no need to purchase differing levels of capacity at the entry and exit points to the Ukrainian GTS, is relevant. As mentioned in the Expert

Reply, the introduction of an entry-exit system is motivated by the general aim of developing competition and not the needs of one individual shipper.

(1529) Gazprom seems to imply that Ukraine can introduce an entry-exit system without applying it to Gazprom, cf. the Witschen Report. In effect, it is arguing that Ukraine is free to discriminate for or against Gazprom without regard to the consequences for competition. As pointed out in the Expert Reply, the economic issue is that the Transit Contract would reinforce Gazprom's dominant position if it remained exempt from the entry/exit system that Ukraine is now proposing for its pipeline network. Experience shows that the successful development of competition requires a level playing field for all market participants. This is why Regulation 715/2009 requires the introduction of a compulsory entry-exit system that applies to all network users.

(1530) Similarly, Naftogaz fails to see the relevance of the failure of some countries to implement EU legislation.

7.1.10.2.2.4 The Contract must be subject to the capacity booking and congestion management rules in ECT energy law

(1531) Gazprom argues that Naftogaz has failed to establish that the Contract is contrary to Regulation 715/2009 or that Gazprom should be subject to the same booking/congestion management rules as all users of the Ukrainian transmission network under Article 16 of Regulation 715/2009. The basis for Gazprom's conclusion is based on the following arguments:

- That "*[e]fficient congestion management procedures aim to achieve the "reallocation of unused capacity to those market participants who wish to make use of it, allowing more efficient and competitive use of the gas networks"*", cf. the Moselle Report.
- That Naftogaz/Ukrtransgaz, based on the procedure established in Article 3 of the Contract, is able to determine in advance Gazprom's capacity requirement under the Contract.

- That Naftogaz/Ukrtransgaz thus is able to determine in advance the capacity available for third-party use. Naftogaz/Ukrtransgaz can manage its capacity portfolio and freely market its available capacity to make the most efficient use of the capacity.
- That Naftogaz has failed to establish that Gazprom's capacity booking under the mechanisms set out in the Contract discriminates against other market participants/potential network users, or that it would prevent Naftogaz/Ukrtransgaz from producing non-discriminatory capacity allocation mechanisms and congestion management procedures.

(1532) Article 3 of the Transit Contract sets out binding volume obligations on the part of Gazprom. Gazprom is obliged to deliver at least 110 bcm of Natural Gas to Naftogaz for transit to European countries for the entire duration of the Contract, unless otherwise agreed. This minimum transit obligation on the part of Gazprom necessarily means that Naftogaz is contractually obliged to reserve corresponding transport capacity for Gazprom. This capacity is thereby blocked for use by others, even when Gazprom does not fulfil its minimum transit obligation.

(1533) Essentially, Gazprom's line of argumentation again implies that Ukraine is free to discriminate for or against Gazprom without regard to the consequences for competition. As explained in the Expert Reply, applying different capacity allocation mechanisms and congestion management procedures will discriminate between network users.

(1534) With regard to Gazprom's argument that Naftogaz has failed to establish that Gazprom's capacity booking under the mechanisms set out in the Contract discriminates against other market participants/potential network users, Naftogaz refers to the discussion of Gazprom's abusive and discriminatory behaviour in breach of European and Ukrainian competition law above.

7.1.10.2.3 Mandatory Ukrainian law

(1535) The Third Energy Package is now implemented in Ukrainian legislation. Article 34 of the 2015 Gas Market Law implements the basic principles of capacity allocation and congestion

management. These principles are supplemented by the provisions in Chapter IX-XII and XV of the Ukrainian Network Code.

- (1536) The rules on capacity allocation and congestion management in the Ukrainian Gas Transmission Network Code is an example of how the Ukrainian legislator has taken the NC CAM into account, even if it is not yet incorporated into the ECT. For example, the Gas Transmission Network Code has rules on the provision of bundled capacity at interconnection points, cf. *inter alia* Chapter IX, 1 no. 7 and 2 no. 4.
- (1537) The booking and congestion management rules are general in nature and apply to all shippers in the Ukrainian GTS, including Gazprom. Once a shipper chooses to make use of the transport services provided, the shipper cannot choose whether or not to respect the established procedures of the transmission network and the transmission system operator in question.
- (1538) By refusing to adhere to mandatory ECT energy legislation as implemented in Ukraine, Gazprom hinders the creation of a level playing field for existing and new network users.

7.1.10.2.3.1 Replacement of invalid and ineffective provisions

- (1539) In order to bring the Contract in line with European and Ukrainian competition and energy law, the contract paths under the Contract must be replaced with a long-term booking scheme for entry-exit capacity. This requires that the prevailing Articles 2, 3 and 4 are replaced.
- (1540) The correct legal and practical approach in this case is to replace the prevailing contract provisions reflecting the old contract path approach with new provisions in line with the principles implemented in the 2015 Gas Market Law and the Ukrainian Gas Transmission System Code adopted by the Ukrainian regulator.
- (1541) The replacement of Articles 2, 3 and 4 requires consequential adjustments to the prevailing Article 1. Naftogaz claims that new terms, i.e. "Main Pipeline", "Shipper Code", "Shipper Code of the Client", "Shipper code of the counterparty", "Shipper Pairs", "Technical Capacity" and "Available Capacity", are added to the list of definitions. In addition, Naftogaz claims that the

terms "Applied Time", "Contract Day", "Contract Month", "Quarter" and "Contract Year" are updated to reflect definitions in Chapter I,(1)(5) of the Ukrainian Transmission System Code, to read as follows:

"Applied Time" shall mean Universal Time Coordinated (hereafter UTC).

"Contract Day" shall mean a period of 24 hours commencing at 05:00 a.m. *UTC (from 07.00 Kiev time)* and ending at 05:00 a.m. *UTC (to 07.00 Kiev time)* on the following calendar day for the winter season, and from 04.00 *UTC (from 07.00 Kiev time)* of the day to 04.00 *UTC (to 07.00 Kiev time)* of the following day for the summer season. If the period of time between 05:00 a.m. of one calendar day and 05.00 a.m. of the following day comprises more or less than 24 hours (during switching from wintertime to summertime or vice versa), the rights and obligations of the Parties concerning day for such period shall change proportionally.

"Contract Month" shall mean the period commencing at 05:00 a.m. *UTC* on the first day of any calendar month and ending at 05:00 a.m. *UTC* on the first day of the following calendar month.

"Quarter" shall mean any of the following periods each consisting of three consecutive months and commencing at 05:00 a.m. *UTC* on the first day of any Quarter and ending at 05:00 a.m. *UTC* on the first day of the following Quarter:

I quarter: from January to March;

II quarter: from April to June;

III quarter: from July to September;

IV quarter: from October to December.

"Contract Year" shall mean a period of time commencing at 05:00 a.m. *UTC* on the first day of calendar year and ending at 05.00 a.m. *UTC* on the first day of the following calendar year

in which transit of Natural Gas is performed in compliance with the terms and conditions of this Contract."

(1542) Naftogaz requests that the prevailing Article 2, which defines the subject matter of the Contract, be replaced with a provision where the references to transit and the contract paths established in the Contract are excluded.

(1543) The prevailing Article 3 is in its entirety based on a system of contract-paths in breach of European and Ukrainian competition and energy legislation. Naftogaz requests that the prevailing Article 3 be replaced with a new provision which, in addition to Gazprom's minimum volume obligation established in Article 3.1, allocates the minimum volume obligation to capacity reservations per entry-exit point which are now in use or able to be used for the purpose of long-distance transmission through Ukraine for the remainder of the Contract on a non-interruptible basis, and establishes that additional capacity shall be booked in accordance with the terms and conditions for access to the Ukrainian transport system that follow from mandatory law and decisions by the Ukrainian regulator.

(1544) The Ukrainian regulator, NCSREU, has recently adopted entry-exit tariffs for the Ukrainian transmission network, but the Regulator has not adopted tariffs for the entry points Sokhrankovka, Serebrianka, Prokhorovka, Belgorod and Platovo as they are not in use or not able to be used for the purpose of long-distance transmission through Ukraine. Prokhorovka and Platovo are located in temporarily occupied territories and the other entry points are not in use for other reasons.

(1545) The proposed revised Article 3, where entry capacity is allocated per entry points, has been updated accordingly. The references to Sokhrankovka, Serebrianka, Prokhorovka, Belgorod and Platovo in Clause 3.2 have been deleted and the entry capacities previously allocated to these entry points have been allocated to the other entry points on a pro-rata basis.

(1546) Naftogaz requests that the prevailing Article 4 is replaced in its entirety. Articles 4.1 to 4.3 and Article 4.7 are all based on a contract path system in breach of European and Ukrainian competition and energy legislation. Articles 4.4 and 4.5 refer to the Technical Agreement, which facilitates Gazprom's role as super-operator of the Ukrainian GTS in breach of European and Ukrainian competition and energy law, and must therefore be replaced. The replacement of the prevailing Article 4.6 is addressed above.

(1547) Naftogaz requests that the prevailing Article 4 be replaced with a new contract provision reflecting the nomination and re-nomination procedures applied to the Ukrainian transmission network. Naftogaz proposes Article 4 to read as follows:

"4.1 Submission of nominations (re-nominations) to receive transmission shall be carried out according to the procedure established by the Gas Transmission Code approved by the National Energy and utilities Regulatory Commission Resolution No. 2493 of 30 September 2015. Forms for nominations and re-nominations shall be published by the Contractor on its official web-site.

4.2 The Natural Gas shall be supplied by the Client to the Contractor in a common gas stream.

4.3. The Client assigns its obligations in the technical implementation of this Contract to Gazprom Transgaz St. Petersburg LLC, Gazprom Transgaz - Kuban LLC, Gazprom Transgaz Volgograd LLC, Gazprom Transgaz Belarus OAO, Tiraspoltransgaz LLC and Modovatransgaz LLC.

Therefore, signatures on reports and other documents related to performance of this Contract by representatives of organizations/enterprises to whom the Parties have assigned the technical implementation of this Contract are not mandatory, with the exception of cases when such representatives were specially authorized by the Parties."

(1548) Naftogaz proposes to regulate the issues of gas measurement, cf. the prevailing Article 4.4 second paragraph, and the risk for losses, cf. the prevailing Article 4.5, in the replaced Article 7.

(1549) The provisions mentioned above are principally requested to be replaced with new provisions with effect as of 1 January 2010, alternatively with effect as of 1 February 2011, alternatively with effect as of 1 January 2015 or the earliest date stipulated by the Tribunal.

7.1.10.3 Balancing arrangements

7.1.10.3.1 Application of Articles 101 and 102 TFEU and Article 18 ECT

7.1.10.3.1.1 Gazprom's abusive and restrictive behaviour

(1550) As demonstrated, Gazprom Export unilaterally terminated the 2010 Balancing Agreement on 17 June 2014.

(1551) Gazprom's obstruction of functioning balancing arrangements in Ukraine is clearly abusive pursuant to Article 102 TFEU. It protects Gazprom's dominant position within gas sales, and prevents the integration between the Ukrainian gas market and neighbouring gas markets. The Contract's lack of functioning balancing arrangements is also a clear violation of Article 101 TFEU since it restricts competition as described above. Even though a system for balancing in line with the Third Energy Package is now in place in Ukraine, the Contract effectively prevents its implementation.

7.1.10.3.1.2 EU and ECT energy law as an operationalization of EU and ECT competition law

(1552)

(1553) Where the network users are unable to efficiently balance their input and off-take, the TSOs will have to undertake most of the network balancing to ensure the integrity of the system. In order to do so, the TSOs hold options to significant amounts of flexible gas, via long-term contracts, which could otherwise be traded in the wholesale market. Where TSOs currently hold long-term contracts to obtain flexible gas, a balancing regime that encourages TSOs to procure flexible gas on a short-term basis would allow flexible gas to be released to the wholesale market, which in turn may enhance competition and trading in markets that currently lack liquidity, cf. e.g. Section

1.1 of ACER, Framework Guidelines on Gas Balancing in Transmission Systems (the "BAL FG").

- (1554) Where the TSOs provide balancing services, the network user will be required to pay imbalance charges. However, if the imbalance charges do not reflect the cost of the TSOs' balancing the gas network, this can result in incentives for inefficient behaviour and cross-subsidies between network users which could be considered discriminatory, cf. e.g. Section 1.1 of BAL FG.
- (1555) That the general aim of EU and ECT energy law is to establish a level playing field and promote efficient competition by establishing common balancing rules is reflected in preamble (28) of Regulation 715/2009, which underscores the importance of laying down such rules "*to ensure that transmission system operators operate such mechanisms in a manner compatible with non-discriminatory, transparent and effective access conditions to the network*". Also, the purpose of the balancing rules is to provide a system which incentivises network users to optimise their gas portfolios options and obligations efficiently and as an outcome minimise the need for TSOs to undertake balancing actions.
- (1556) In short, EU and ECT energy legislation requires the development of market-based balancing services, cf. Article 21(1) of Regulation 715/2009, to avoid discrimination and cross-subsidisation of network users. Also, by ensuring that network users receive up-to-date information on their own balancing position as well as the system's balancing status during the balancing period, cf. Article 21(2) of Regulation 715/2009, network users are enabled to balance their portfolio efficiently. By imposing cost-reflective imbalance charges, cf. Article 21(3) of Regulation 715/2009, network users are also incentivised to actually balance their portfolios. This will in turn minimise the TSO's role in balancing, releasing gas volumes into the traded market, thus increasing liquidity.
- (1557) In addition, the harmonisation of balancing regimes is required in order to facilitate gas trading within the community, cf. Article 21(4) of Regulation 715/2009 and the BAL NC. *The existence of several balancing zones across the European Union (EU) and different balancing*

arrangements applying in neighbouring markets, entrenches the market power of incumbents and increases the barriers to new entry into the EU gas markets cf. e.g. Section 1.1 of the BAL FG.

- (1558) The claims in the Relief Sought related to balancing arrangements are required to bring to an end the violations of Articles 101 and 102. By making the adjustments in the Contract described below, the Contract will be brought in line with EU competition law (and thus also ECT competition law and national Ukrainian competition law).
- (1559) The rudimentary balancing system provided for in Articles 3.4, 4.3 and 10.4 of the Contract should be replaced with the balancing system provided for in the adjusted Clauses of the Contract as detailed below.
- (1560) Gazprom's first line of defence is to argue that the provisions of the Contract ensure balancing.
- (1561) Gazprom points out that "*[t]he purpose of balancing rules is to ensure that there is a balance between the input and off-take of gas on a transmission system so as to maintain the pressure of a pipeline system and not to endanger that system*". It then proceeds to argue that "*[t]he provisions of Contract TKGU, and the system of daily nominations by Gazprom, ensure that there is a balance between the amount of gas put into the Ukrainian GTS by Gazprom and the amount taken off the Ukrainian GTS for onward provision to Gazprom's European off-takers*" and that "*[t]ransit under Contract TKGU is therefore completely balanced*".
- (1562) It is true that, for safety and operational reasons, the in-put and off-take of gas from transmission networks needs to be balanced on a daily basis. However, the purpose of the balancing rules is clearly broader than achieving balanced input and off-take in a specific instance. The focus of EU and ECT energy law is on how such balance best should be achieved to avoid market distortions.
- (1563) As explained in the Expert Report, balancing raises several competitive concerns.

(1564) In the Expert Report, it is explained how "*[d]istortions can arise because alternative suppliers differ naturally in their injections and withdrawals. Larger established players find it relatively easy to balance due to the existence of large, diverse portfolios of gas supplies and customers. New companies tend to have greater difficulty balancing their smaller portfolios.*" For this reason, balancing rules are considered to be of particular importance for new market entrants, cf. preamble (28) of Regulation 715/2009.

(1565) In the Expert Report, it is also explained how the same balancing rules need to apply to all market participants in order to prevent that one company acquires an artificial competitive advantage or disadvantage. EU and ECT energy law requires that a general balancing system is put in place.

(1566) It is clear that the rudimentary balancing regime in the Contract does not fulfil these requirements.

(1567) As a second line of defence, Gazprom alleges that the provisions of the Contract are not contrary to the principles of EU energy legislation.

(1568) That the provisions of the Contract are not contrary to the principles of EU energy legislation is simply incorrect. Here it is sufficient to recall that the Transit Contract, as supplemented by the [REDACTED], is contrary to the principles of EU and ECT energy legislation as follows:

"According to Clause 3.4 of the Transit Contract, as supplemented by [REDACTED] and Clause 10.4 of the Contract, Naftogaz is essentially responsible for the balancing under the Contract. Further, Clause 10.4 effectively obliges Naftogaz to purchase balancing services from Gazprom. This is contrary to the general principle established in Article 4(1) of the BAL NC, i.e. that, as mentioned in VI, 3.5.1 above, the network users shall be responsible for balancing their portfolios. As described (in Section VI, 3.5.2), the Transit Contract allows Gazprom daily variations and essentially provides Gazprom with free balancing services within the stipulated range of allowed variations. This is contrary to the principle (described in Section VI, 3.5.1 above) of providing appropriate incentives on network

users to balance their input and off-take of gas by imposing imbalance charges, which shall be cost-reflective to the extent possible, cf. Article 21(3) of Regulation 715/2009.

[...]

As mentioned (in Section VI, 3.5.2 above), Clause 10.4 might be said to impose balancing payments from Naftogaz to Gazprom which might be considered to lead to market foreclosure contrary to European competition law, as Gazprom is the only supplier of the balancing gas. In addition, such a solution also violates the principle of market-based balancing rules in Article 21(1), given that the balance charges are linked to the contract price in the gas sales contract and not a market price for natural gas."

(1569) Gazprom and its Experts have not commented on the fact that the provisions of the Transit Contract in practice place the responsibility for the balancing of input and off-take of gas from the Ukrainian GTS with Naftogaz. As pointed out in the Expert Reply, Gazprom and its Expert, Mr Witschen, have simply ignored the concern that the Transit Contract brings into play the anti-competitive issues of the Gas Sales Contract due to the fact that Article 10.4 of the Transit Contract imposes a cost on Naftogaz if Gazprom does not balance its position. As previously explained, Article 10.4 of the Transit Contract means that if Gazprom withdraws less gas than it injects, and Naftogaz has to put gas into storage to balance the system, that gas is priced according to the penalty provisions in Article 4.3 of the Gas Sales Contract. The penalty price is equal to either 1.5 (in summer) or 3 (in winter) times the gas sales price.

(1570) Mr Witschen argues that there is no need for balancing rules because Gazprom always balances inputs and outputs as required under the Contract. Mr Witschen's objections to the need for functioning balancing arrangements in Ukraine are discussed in the Expert Reply:

"Mr. Witschen pointed out that Naftogaz is only obliged to have the volume of gas ready at the exit points that have been injected by Gazprom at the entry points on the same day. However, nothing prevents Gazprom from withdrawing less gas than it injects and, indeed, this is precisely

the circumstance that has led to Gazprom's counterclaim. The First Brattle Report clarified that to preserve the balance on the pipeline network, Naftogaz could have to put the unwanted gas into storage. The gas in storage would transfer to Naftogaz at a penalty price equal to either 1.5 (in summer) or 3 (in winters) times the price set in the Sales Contract. Our concern is that the Transit Contract therefore brings into play the anti-competitive issues of the Sales Contract. Mr. Witschen's discussion of balancing does not consider this point nor the penal nature of the transfer price."

(1571) Mr Witschen also argues that there is no need to apply balancing rules to the Transit Contract because the underlying volumes are transported through Ukraine to Europe and therefore would not participate in the Ukrainian market. This claim is also commented on in the Expert Reply:

"Mr. Witschen ignores the possibility that the gas exiting Ukraine may still be part of the relevant geographic market including Hungary, Poland and Slovakia, in which Gazprom is dominant. There will not be a level playing field unless Gazprom is subject to the same balancing rules as other participants in the same market."

(1572) This allegation is in fact contradicted by Gazprom's counterclaims. Naftogaz has been forced to balance differences between the volume delivered by Gazprom for transit and the volume off-taken by its customers, at its own expenses.

(1573) EU and ECT energy law requires that a general balancing system is established by the TSO pursuant to a methodology approved by the NRA in order to ensure the development of competition. As explained above, the same balancing rules need to apply to all market participants in order to prevent that one company acquires an artificial competitive advantage or disadvantage, cf. the Expert Report. As highlighted in the Expert Reply, it makes no policy sense to proceed on a case-by-case basis asking whether each network user may or may not be out of balance, or whether such imbalances would ever be material.

(1574) Gazprom's further arguments that "*there is thus no need for the volumes of gas transited under Contract TKGU to be subject to a balancing system which is applied to other users of the Ukrainian GTS*", and that "*a set of balancing rules for other users of the Ukrainian GTS can be put into place without reference to the transit of Gazprom's gas under the provisions of Contract TKGU*", thus clearly misses the point.

(1575) Also, by arguing that it can be exempted from the general balancing regime, Gazprom essentially adopts a discriminatory approach. Exempting the Contract from the general balancing regime would discriminate between Gazprom and other users of the Ukrainian GTS, leading to an unequal playing field that is not compatible with the development of effective competition.

(1576) With regard to Gazprom's argument that the Tribunal cannot be asked to apply a balancing regime expected to be included in future Ukrainian legislation, it should be noted that the Ukrainian balancing regime is in place.

7.1.10.3.2 Mandatory Ukrainian law

(1577) Third Energy Package is now implemented in Ukrainian legislation. Article 35 of the 2015 Ukrainian Gas Market Law implements the basic balancing requirements in Article 21 of Regulation 715/2009. These principles are supplemented by the provisions in Chapter XIII and XIV of the Ukrainian Network Code.

(1578) The balancing rules establish the principle that the shipper is responsible for balancing its in-puts and off-takes of gas in the transmission system and that the TSO provides balancing services only to ensure the functioning and integrity of the system, cf. Chapter XIII of the Ukrainian Network Code. This chapter *inter alia* also specifies the powers of and the actions available to the TSO to ensure the integrity of the system if it is threatened, ensures that the TSO has access to storage capacity for balancing purposes and sets out the procedures regarding reservation and utilisation of such storage capacity.

(1579) Chapter XIV of the Ukrainian Network Code sets out the TSOs obligation to calculate imbalances on a daily basis, cf. Article 2, and on monthly basis, cf. Article 3, and the procedures in this regard. It specifies the allowed daily imbalance on the part of the shipper and regulates the TSOs handling of imbalances that exceed the allowed daily imbalance, i.e. limitation/termination of delivery at relevant entry/exit points. In case of unsettled monthly imbalances, the TSO shall refuse to accept nominations from the shipper. It also specifies the shipper's obligation to inject gas into storage or sell gas if in-put exceeds off-take (positive imbalance) and to withdraw gas from storage or buy gas if in-put is less than off-take (negative imbalance). The TSOs balancing services, the cost of such balancing services and the settlement procedure are regulated in Chapter XV, Article 4.

(1580) Naftogaz proposes to bring the Contract in compliance with ECT energy law and mandatory Ukrainian legislation.

7.1.10.3.3 Invalidity, ineffectiveness and replacement of clauses relating to balancing

(1581) The following provisions of the Contract have contravened a number of mandatory provisions relating to balancing under relevant European and Ukrainian competition and energy law, including Articles 101 and 102 TFEU, Articles 18 and 7 ECT, the Third Energy Package and Ukrainian competition and energy law:

- Article 3.4 (Booked capacity)
- Article 4.3 (Transit conditions)
- Article 10.4 (Liability)

(1582) In order to bring the Contract in compliance with European and Ukrainian competition and energy law, Articles 3.4, 4.3 and 10.4 should be deleted and the balancing requirements left to mandatory Ukrainian law in accordance with the principle established in the new second paragraph of Article 13.2 and the replaced Article 13.6.

(1583) The provisions mentioned above are principally requested to be replaced with new provisions with effect as of 1 January 2010, alternatively with effect as of 1 February 2011, alternatively with effect as of 1 January 2015 or the earliest date stipulated by the Tribunal.

7.1.10.4 Restrictions on the use of interconnectors

(1584) IntroductionGazprom restricts the use of interconnectors at Ukraine's western border and hampers cross-border trade.

(1585) Gazprom argues that shipper codes are only necessary to establish VRF and that there is no obligation to provide VRF under energy law. However, both [REDACTED] and Mr Lapuerta's testimony clarified that the provision of shipper codes are necessary for the TSO to perform the matching process in accordance with Article 13(2)(c) of the Directive and Article 12 of the Regulation, whether it relates to physical forward flow, physical reverse flow or virtual reverse flow. In Ukraine, the obligation to provide shipper codes follows from Article 1(2) and (8) and Articles 5(1) and 6(1) of Chapter XI of the Ukrainian Gas Transmission System Code and item III of the Standard Gas Transmission Contract.

(1586) [REDACTED] testimony confirmed that there is no basis for Gazprom's argument that it cannot provide shipper codes for confidentiality reasons: A shipper code is a numerical code which only the TSO at the end destination would be able to decrypt. Also, Ukrtransgaz is subject to confidentiality measures in accordance with Ukrainian legislation and these include Naftogaz.

7.1.10.4.1 Application of Articles 101 and 102 TFEU and Article 18 ECT

7.1.10.4.1.1 Introduction

(1587) Gazprom denies that it has reserved the majority of the capacity of the Ukrainian GTS. Gazprom's assertion is in essence that Naftogaz has failed to establish by reference to empirical evidence that the minimum quantities determined in the Contract lead to a violation of Articles 101 and 102.

(1588) Gazprom denies having refused to engage in reverse flow arrangements and having impeded virtual reverse flow, including refusal to provide the matching information necessary, leading to the needless construction of new pipeline capacity.

(1589) Restrictions on the use of Ukraine's interconnectors follow from the position afforded to Gazprom Export in the Contract, in particular in the Technical Agreement, and Gazprom Export's exercise of that position. This practice effectively divides the Central and Eastern European and South East European markets by cutting Poland, Hungary, Romania and Bulgaria off from virtual reverse flows across Ukraine, preserving Gazprom's position in these markets.

(1590) All the claims based on competition and energy law in the Relief Sought which are relevant to Gazprom's restrictions on the use of interconnectors have already been introduced above. This is because the problems related to restrictions on the use of interconnectors will be remedied if Gazprom is forced to comply with the competition and energy rules discussed above.

7.1.10.4.1.2 Gazprom's abusive and restrictive behaviour

(1591) The Energy Sector Inquiry of the European Commission showed that cross-border sales did not impose any significant competitive constraints (cf. paragraph 21 of the Commission's Communication). Incumbents rarely entered other national markets as competitors, and insufficient or unavailable cross-border capacity and different market designs hampered market integration.

(1592) This description of lack of cross-border sales is appropriate also in the case of Ukraine. In fact, the situation in Ukraine is fundamentally problematic since a supplier (a supplier which is dominant) is in a position where it can and does obstruct cross-border sales. The party-relationship under the Contract, with Gazprom Export as a super-operator, is not compatible with an effective and neutral administration of the interconnection points. Gazprom's obstruction of a functioning system for capacity allocation and congestion management and proper balancing arrangements also undermines effective cross-border sales between Ukraine and its neighbouring countries.

(1593) Gazprom's restrictions on the use of interconnectors are discussed in detail in the Expert Reply (impeding virtual reverse flows) and (distorting trade between countries).

(1594) With respect to virtual reverse flows, the Expert Reply refers in to [REDACTED] belief that *"there must be agreement between all relevant stakeholders/network users as to the nomination process and technical rules governing"* virtual reverse flows and that *"Gazprom's participation in such a process would be essential"*. [REDACTED] statements in this respect are commented on in the subsequent paragraph of the Expert Reply:

"A dominant gas sales company has no natural financial incentive to permit virtual reverse flows, given that they facilitate the development of competition. Although it is generally desirable for the transmission system operator to consult with network users, the introduction of virtual reverse flows should not be conditional upon the agreement of the dominant gas sales company."

(1595) Thus, [REDACTED] statements confirm a fundamental concern, namely that Gazprom expects veto rights with respect to virtual reverse flows, and in fact practices its rights under the Contract and the Technical Agreement to that effect. An example referred to in the Expert Reply is the situation in 2013 when some physical reverse flow capacity was indeed unutilised at Hermanowice and Beregovo. Naftogaz still found it worthwhile to invest in the expansion of physical reverse flow at Budince/Uzhgorod, with a commitment to a five-year capacity booking with payments estimated at \$200 million, in spite of the already existing interconnection points. This was because of Gazprom's obstruction of virtual reverse flow at the main interconnection points.

(1596) The fact that Naftogaz made that considerable investment, which the Expert Report and Reply call "inefficient bypass", is illustrative of the abusive and restrictive nature of Gazprom Export position at the interconnection points, and the abuse of that position.

(1597) Some other statements by [REDACTED] illustrate how Gazprom abuses the close ties between the gas sales market and the gas transmission market. As discussed in the Expert Reply,

'██████████' states that 'Gazprom Export has no objection in principle to participating in and facilitating' virtual reverse flows, but that its objection in practice relates to the dispute with Naftogaz over the take-or-pay clause of the Gas Supply Contract: 'Gazprom has objected to the supply contracts that Naftogaz has entered into with suppliers in adjacent countries, whereby suppliers in those countries supply Naftogaz with gas via reverse flow pipelines. Gazprom's objection has been on the basis that Naftogaz has entered into such supply contracts in flagrant disregard of its own take or pay obligations to Gazprom under Contract KP. '''

(1598) To this mixing of alleged obligations under the Gas Sales Contract with essential functions under the Gas Transit Contract, the Expert Reply comments:

"From an economic perspective, a competitor's access to transportation services should not be conditional upon maintaining good contractual relations under its supply contract with the dominant supplier."

(1599) This is an understatement. This combination of claims under the Gas Sales Contract with the proper functioning of interconnectors is a gross case of combining Gazprom's dominant position in the sales market with its control over the interconnection points.

(1600) On the subject of distortion of physical gas flows, the Expert Reply describes how the effects of the Contract go beyond the relatively straightforward flows between Ukraine and its neighbouring countries. As an example, the Expert Reply mentions that each of Slovakia, Poland and Hungary can conduct trade with the other two using Ukraine as a bridge, even in the absence of direct pipeline connections.

(1601) Gazprom's restrictions on the use of Ukraine's interconnectors constitute a serious violation of Article 102 TFEU. They effectively prevent cross-border sales involving the main interconnection points of Ukraine. The Contract and its Technical Agreement also restrict competition in violation of Article 101 TFEU as described above.

7.1.10.4.2 Application of ECT energy law as such

- (1602) ECT energy law applies as Swedish law as of 6 October 2011 (or alternatively from 1 January 2015), with the exception of the tariffication principles which apply from 3 September 2011. ECT energy law applies as Swedish law based on the horizontal direct effect, based on legal discrimination pursuant to Article 7 ECT obliging a Swedish court or tribunal to apply the Third Energy Package as it would in relation to a similar contract involving an EU company, and based on factual discrimination pursuant to Article 7 ECT of which the Third Energy Package is a concretization/operationalization.
- (1603) When the secondary energy market legislation was first adopted, the focus was on liberalising natural monopoly markets in order to facilitate cross-border trade and ensure security of supply. The importance of cross-border trade is reflected in the adoption of the Energy Community Treaty and the establishment of the Energy Community as such, where the key aim is to extend the EU internal energy market to South East Europe and beyond on the basis of a legally binding framework.
- (1604) The focus on facilitating cross-border trade is evident throughout Directive 2009/73/EC and Regulation 715/2009.
- (1605) Efficient regulatory oversight by national regulators and minimum requirements as regards the tasks and powers of national regulators as well as the cooperation between national regulators on cross-border issues are prescribed by Directive 2009/73/EC Chapter VIII, in particular Articles 41(1), 41(6)(a) and (c), 41(9) and 41(10) and 42(2)(a)-(c).
- (1606) The transmission system operator has the operational responsibility for the transmission system, cf. Article 13(1)(a), cf. Article 2(4), of Directive 2009/73/EC, including carrying out functions relating to cross-border transmission, cf. Article 32(2) of Directive 2009/73/EC. Accordingly, the TSO is obliged to establish operational arrangements with adjacent TSOs, cf. Article 12 of Regulation 715/2009, read in conjunction with ACER's Framework Guidelines on Interoperability and Data Exchange Rules for European Gas Transmission Networks (the "FG INT") and ENTSOG's draft Network Code on Interoperability and Data Exchange Rules (the "INT NC").

(1607) The purpose of an entry-exit system and entry-exit tariffs, cf. Articles 13(1)(4), 14 and 16 of Regulation 715/2009, is to encourage a liquid wholesale market for gas both within and between transmission networks. This is confirmed by the subsequent adoption of supplementary legislation, *inter alia* the NC CAM, to ensure efficient allocation of the capacity on the interconnection points between two or more transmission networks, and the on-going work of adopting harmonised tariff systems which are consistent with the capacity allocation mechanisms and which facilitate the merging of entry-exit systems, cf. preamble (2) of the draft re-submitted TAR NC.

7.1.10.4.3 Mandatory Ukrainian law

(1608) The Third Energy Package, including the principles and provisions of particular importance to the use of interconnectors as mentioned above, is implemented Ukrainian energy legislation.

(1609) The tasks and powers of regulators established in European energy legislation to ensure efficient regulatory oversight are now implemented in mandatory Ukrainian legislation, cf. Articles 4 of the 2015 Gas Market Law. This includes an obligation to develop a competitive and functioning community-wide gas market in order to facilitate cross-border trade, cf. in particular Article 4(1)-(3), as well as an obligation to participate in regional cooperation for security of supply purposes with a particular focus on the utilisation of interconnectors, cf. Article 10.

(1610) Ukrainian legislation presupposes that the TSO shall cooperate with TSOs of adjacent systems in neighbouring countries, cf. Article 22(2)(6) and (5)-(7), and enter into interconnection agreements with adjacent TSOs, cf. *inter alia* Chapter I Article 3(8) of the Ukrainian Gas Transmission System Code.

(1611) The 2015 Ukrainian Gas Market Law does not distinguish between transit and transmission, and that the Ukrainian energy legislation applies in general. In particular, Naftogaz refers to the discussion of how Gazprom's role at the border points prevents unbundling in practice, and how Gazprom upholds and abuses its role at Ukraine's western border by refusing to provide shipper codes and the virtual reverse flow.

7.1.10.4.4 Invalidity, ineffectiveness and replacement of clauses relating to restrictions on the use of interconnectors

7.1.10.4.4.1 Replacement of invalid and ineffective provisions

(1612) Naftogaz recalls that in order to ensure that the Contract is in line with the requirements of European and Ukrainian competition and energy legislation and to ensure the application of the organisational requirements and responsibilities in Ukrainian energy legislation:

- Naftogaz requests that the prevailing Article 13.8 be replaced to facilitate the assignment of the Contract to the designated TSO.
- Naftogaz requests further that the prevailing Technical Agreement with Annexes and Addenda be declared invalid, as it facilitates Gazprom's role as super-operator of the Ukrainian GTS and implements and further details the contract paths established in the Contract, principally with effect from 1 January 2010, cf. above.
- Finally, Naftogaz requests that the prevailing Articles 13.2 and 13.6 be replaced in order to ensure that the Contract is subject to the terms and conditions for access to the Ukrainian transmission network that follows from mandatory Ukrainian legislation and that the prevailing Articles 1, 2, 3, 4, 5, 6, 7, 8, 9 and Article 10.4 be brought in line with the requirements of Ukrainian mandatory legislation.

7.1.11 The claim for revision of the transit tariff based on Swedish contract law [PÅ NY SIDA]

7.1.11.1 Naftogaz' claim for tariff revision pursuant to Article 8.7

(1613) Alternatively to a replacement pursuant to Article 13.2, Naftogaz claims a revision of the transit tariff based on Article 8.7 of the Contract, with the same effects, i e. a cost-reflective capacity based entry-exit system in conformity with mandatory law.

(1614) This alternative claim for tariff revision based on Swedish Contract Law also relates to Naftogaz' alternative claims for compensation for underdeliveries in two ways. First, the tariff revision

claim based on Swedish Contract Law will effectively absorb the alternative compensation claim in monetary terms as it leads to significantly higher payments of unpaid tariffs by Gazprom to Naftogaz. Second, Gazprom's unexpected failure to transport the agreed amounts of Natural Gas which is the main factual basis for the alternative compensation claim is also part of the factual basis for revision of the tariff based on Section 36.

7.1.11.2 Interpretation of the tariff revision clause

7.1.11.2.1 Introduction

(1615) The tariff revision clause is worded as follows in Naftogaz' translation:

"8.7 In case of a significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of this Contract, and if the price for transit services specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs in the European gas market, each Party is entitled to apply to the other Party with a request for revision of the price for transit services.

8.7.1 The request for revision of the price for transit services shall be made in writing and be properly substantiated by the requesting Party. After receipt by the relevant Party of the above request, the Parties shall enter into negotiations within 20 days and, if an agreement is reached, sign the respective addendum to this Contract.

8.7.2 If a written agreement on the revision of the price for transit services cannot be reached within 3 (three) months from the date of the beginning of the negotiations, then each party has the right to refer the matter to arbitration in accordance with Article 12 of the Contract for the passing of a final decision."

(1616) Gazprom translates the tariff revision clause as:

"8.7. In the event of a material change in 2010 and subsequent years of the conditions of formation of transit tariffs at the European gas market, as compared to what the Parties

reasonably expected at the time of entering into this Contract, and if the transit tariff specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs at the European gas market, each Party shall have the right to address the other Party with a request to reconsider the transit tariff.

8.7.1. The request to reconsider the transit tariff shall be submitted in writing and duly substantiated by the requesting Party. Upon receipt by the respective Party of such request, the Parties agree, within 20 days, to enter into negotiations and, if they reach an agreement, to execute the relevant supplement to this Contract.

8.7.2. If the Parties fail to reach a written agreement to reconsider the transit tariff within 3 (three) months after the negotiations commencement date, each Party shall be entitled to refer the issue to arbitration in accordance with Article 12 of this Contract for final resolution."

(1617) The differences between the translations are in Naftogaz' understanding immaterial. In the Gas Sales Arbitration Gazprom alleged that the Russian expression "peresmotr" [пересмотр] only means the process of reconsidering, but not the result of a revision/reconsideration i.e. a possible change/adjustment. This was comprehensively rebutted with Naftogaz' Reply in those proceedings. Notably, Gazprom is not making the same argument in the Gas Transit Arbitration and has apparently abandoned this misconceived position. Nor has Gazprom made any other objections to Naftogaz' translation of the tariff revision clause. Thus, in Naftogaz' understanding, Gazprom agrees that there are no material differences in the translations. However, Naftogaz notes that the Parties' different translations, in particular of the Russian expression "условий" ("uslovii") translated as "terms" by Naftogaz and as "conditions" by Gazprom, demonstrate that the authoritative Russian wording is more extensive than either translation suggests.

(1618) The Parties agree that Article 8.7 of the Contract is a tariff revision clause.

(1619) In other words, if the Tribunal finds that the procedural and material conditions for tariff revision are fulfilled, it is empowered to adjust the tariff.

(1620) Article 8.7, contains two cumulative conditions for a revision of the price for transit services (the tariff), namely:

- A significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of the Transit Contract; and
- The price for transit services as provided for in Article 8.1 of the Transit Contract does not correspond to the level of transit tariffs in the European gas market.

(1621) Naftogaz requested a revision of the price for transit services (the tariff) pursuant to Article 8.7 of the Contract on 15 June 2009. The revision would have effect from 1 January 2010, cf. Article 8.7.

(1622) The Parties' intention was that the Contract would apply the generally accepted European pricing principles for gas transport, which at the time were based on "competitive" pricing. However, when the Contract was entered into, there was a possibility that the pricing principles would change, thereby rendering the price payable under the contract off-market. The price revision clause was intended to address this possibility.

(1623) The first condition for a revision of the tariff was fulfilled by 1 January 2010. The terms for determination of transit tariffs had, contrary to the Parties' expectations, changed such that competitive pricing became entirely off-market and cost-reflective pricing came to be the prevailing principle. In fact, this pricing principle became mandatory under EU competition and energy law.

(1624) The second condition for a revision of the tariff was also fulfilled by 1 January 2010 justifying a price revision in accordance with Article 8.7 of the Contract.

(1625) The purpose of the first condition in Article 8.7 of the Contract is to exclude price revision in situations where the pricing principle has changed but where the price tariff under the Contract

nevertheless is not off-market. Any adjustment would under such circumstances presumably be unnecessary.

- (1626) It is clear that the term "*the level of transit tariffs in the European gas market*" must be given a reasonable interpretation in the light of the purpose of the second condition of the price revision clause. Indeed, the very purpose of the price revision clause is to cater for subsequent unexpected developments. Also, there are numerous examples from Swedish Supreme Court practice of changed circumstances being addressed by interpreting a clause to operate reasonably in the light of the changed circumstances.
- (1627) Normally when applying a provision which corresponds to the second condition of Article 8.7 of the Contract, there will be a numerical and uniform market price level to which all other prices on the market can be compared. Under such circumstances, the price under the Contract would have been compared to the relevant price level and it could be concluded if the price reflected such market price or not. However, the cost-reflective transit tariffs operate differently. They are intended to cover the costs for the transmission companies (and allow for an appropriate return of investment). As the tariffs are cost-reflective, they will differ between the different transmission service providers depending on the costs of such service providers (even though the tariffs are based on the same principle). Accordingly, prices that are all in line with the market will differ substantially if viewed numerically. "*The level of transit tariffs in the European gas market*" can therefore not be based on a numerical view, but must be read as a reference to the price level based on cost-reflective tariffs.
- (1628) In Naftogaz' view therefore, the second condition has been fulfilled if the price under the Contract does not correspond to Naftogaz' costs plus a reasonable return on investment.
- (1629) The tariff under the Contract did not cover Naftogaz' costs even assuming that Gazprom had fulfilled its delivery obligations under the Contract. Hence, the second condition for revision of the price was fulfilled as of 1 January 2010.

7.1.11.2.2 The jurisdiction and substantive powers of the Arbitral Tribunal under Article 8.7 of the Contract

7.1.11.2.2.1 Introduction

- (1630) Gazprom sets out seven procedural lines of defence, alleging that Arbitral Tribunal does not have the jurisdiction to decide Naftogaz' Claim based on Article 8.7 of the Contract. Naftogaz does not accept any of Gazprom's arguments. The Arbitral Tribunal has jurisdiction to finally decide on the tariff revision claim based on Article 8.7.
- (1631) The objections against the Tribunal's substantive powers are the same as the objections against the Tribunal's jurisdiction under a different heading, and must be rejected for the same reasons.

7.1.11.2.2.2 Naftogaz' claims for tariff revision is well within the scope of Articles 8.7 to 8.7.2 of the Contract

- (1632) Gazprom argues that the Tribunal lacks jurisdiction to consider Naftogaz' claim for a revision of Article 8 of the Contract since allegedly, the revision of Article 8 is not an "issue", (or "matter" in Naftogaz' translation), that can be referred to arbitration pursuant to Articles 8.7 and 8.7.1 of the Contract and "*the Tribunal is in any event bound by the limitations set out in clauses 8.7 and 8.7.1*". Gazprom further elaborates that this implies that "[a]t most, *the Tribunal's jurisdiction is limited to a "reconsider[ation]" of the "transit tariff" only [and does not extend to Naftogaz's claim for the substitution of an entirely new transit tariff based on completely different principles to those agreed to by the parties or to its claim for the deletion of the other sub-clauses of clause 8 and the insertion of entirely new provisions].*"
- (1633) First, Gazprom's argument is exaggerated, since most of the provisions of Article 8 regulated circumstances for 2009 only and were redundant from the date of the tariff revision, 1 January 2010.
- (1634) Second, the revision clause itself refers to significant changes in terms/conditions for tariff determination/formation, i.e. principles for tariff setting. When these principles change significantly compared to the Parties' reasonable expectations ("*those agreed by the parties*" in

Gazprom's formulation), then it is only logical and natural that the revised tariff relies on such principles, exactly *because* they are "*completely different*" from (or have changed significantly compared to) the Parties' agreement.

(1635) Third, there are simply no such "limitations" in Articles 8.7 and 8.7.1 of the Contract, as argued by Gazprom.

(1636) Finally, the tariff revision provision in Article 8.7 was included due to the uncertainty concerning the relevant principles prevailing when the Contract was entered into. Naftogaz had prepared for a transition period of three years,⁹⁸ which would result in a regulation in conformity with EU legislation. However, Gazprom's complete halt in gas deliveries both for consumption in Ukraine and for transit to EU countries, and the subsequent intense negotiations of the Gas Sales Contract left little room for hammering out the details in the allocated time. Thus, the Parties settled in practice on adjusting the 2002 contract to what Gazprom, and apparently Gazprom Export, assured Naftogaz was a European transit tariff, with the possibility to revisit the tariff in 2010 when the surrounding circumstances were less dramatic. The revision provision has to be considered against this backdrop.

(1637) Thus, it is incorrect when Gazprom asserts that had the

"parties intended to give the Tribunal the right to rewrite clause 8 in its entirety, then they would have included a number of provisions setting out the parameters and conditions for such a far reaching and unusual exercise."

(1638) The intention of the Parties was to have a provision allowing the tariff to be revisited if it turned out not to correspond to the tariff principles otherwise applied in the European gas market. However, the Parties did not foresee the extent of the future changes actually taking place, nor the immediate effects the changes would have on the European gas market.

⁹⁸ *Inter alia* Exhibits, C-90 and C-91 (the intergovernmental agreement of October 2008 and the memorandum between the Parties from October 2008).

(1639) Gazprom's argument really turns the issue upside down. If the Parties had intended to include specific "limitations" on the extent to which the tariff could be revised, they would have included such limitations in the wording.

7.1.11.2.2.3 The Arbitral Tribunal is not limited by the scope of the negotiations between the Parties prior to the opening of the price revision proceedings.

(1640) Gazprom claims that, pursuant to Articles 8.7. and 8.7.1, the Tribunal's jurisdiction is limited by the scope of the preceding negotiations. Alleging that the actual negotiations have not included a complete revision of the Tariff Formula, Gazprom concludes that the Tribunal lacks jurisdiction over Naftogaz' tariff revision claims.

(1641) This argument has no basis in the wording of Article 8.7. The matter which may be referred to arbitration is whether and how the tariff can be revised. Thus, the matter concerns the Parties' rights and obligations concerning the tariff and is not limited to the specific negotiations. If the latter should be the case, each Party would have an unreasonable, arbitrary power to tailor in advance its own future jurisdictional objections in arbitration, simply by refusing to discuss whatever issues it sees (un)fit.

(1642) In addition, and most importantly, the Parties' entitlement to a decision should not be limited by alleged procedural shortcomings. Substantive rights should be enforced even if parts of the machinery intended to give them effect break down.

(1643) Furthermore, Naftogaz sought at numerous occasions to initiate negotiations on the revision of the transit contract and in particular of the tariff level and methodology. Gazprom's depiction is thus incorrect. Gazprom's assertion that "*no negotiations took place regarding a review of the tariff pursuant to clause 8.7 of Contract TKGU, still less the wholesale replacement that Naftogaz now claims*" is imprecise at best. The reason why no such negotiations took place were Gazprom's approach of either ignoring or rejecting Naftogaz' efforts to initiate negotiations on substance both with regard to volumes and tariff.

(1644) That Gazprom repeatedly rejected to take part in substantial discussions, lastly in the discussions with the participation of the European Commission, demonstrates how a party could obstruct the workings of the intended procedure if one were to accept Gazprom's misconceived procedural position.

7.1.11.2.2.4 The Arbitral Tribunal's jurisdiction is not precluded by the alleged failure by Naftogaz to pursue its claims

(1645) Gazprom claims that the Tribunal's jurisdiction is precluded by the alleged failure of Naftogaz to pursue its claims.

(1646) In this respect, Gazprom has invoked that, pursuant to Swedish law, a party that, by failing to act, gives another party the impression that it no longer relies on a certain right, or for a long period of time fails to invoke its right, is deemed to have lost its right – in this case the right to rely on a request for tariff review.

(1647) In order for any waiver to be established under Swedish law based on passivity it is required that the passive conduct or actions can be regarded as creating a binding unilateral confirmation or waiver under normal rules of contract law.

(1648) Gazprom has not invoked that Gazprom actually has got the impression that Naftogaz has waived its right to retroactive tariff revision or that Naftogaz understood that Gazprom held this impression. Gazprom's (possible) assertion that Naftogaz has waived its right to retroactive revision therefore fails already for this reason.

(1649) Even if Gazprom claims that it has got a justifiable impression of a waiver and even if Naftogaz had been passive during the relevant period – which Naftogaz denies – a time period of six years is far too short to give any impression of a waiver. Gazprom has not invoked any other circumstances than Naftogaz' passivity that could result in such a waiver. Hence, there could be no justifiable impression even if Naftogaz had been passive.

(1650) A tariff revision is only closed by an addendum or award explicitly resolving the matter of tariff revision. There is no requirement in Article 8.7 to initiate arbitration within any particular point in time. Also, despite that relatively short negotiation periods are common in price revision clauses,⁹⁹ amicable price revisions have taken up to 5 years to finalise.¹⁰⁰ Gazprom's allegation that Naftogaz has failed to raise the matter of tariff revision in subsequent negotiations is wrong. Naftogaz' actions cannot be regarded as creating a binding unilateral confirmation or waiver under general rules of contract law. On the contrary, Gazprom's failure to raise this objection before submission of its Defence arguably means that Gazprom has forfeited the right to invoke that Naftogaz has waived the tariff revision claim.

7.1.11.2.2.5 The Arbitral Tribunal's jurisdiction is not precluded because the Contract "is no longer the same"

(1651) Gazprom claims that the Tribunal's jurisdiction is precluded since the Contract is no longer the same. Gazprom does not submit any authority in support of its allegations that

(1652) *[a]ny reference to arbitration must be based on [the 2009] request and that version of Contract TKGU (unless there was an express agreement that subsequent amendments would not affect the validity of a tariff review request).*

(1653) Gazprom does not even attempt to relate this argument to any legal norm. There is no such norm, and the argument may be rejected for that reason alone.

(1654) Pursuant to Article 8.7.2 of the Contract, a tariff revision is not closed before the Parties have reached a written agreement (or an arbitral tribunal has rendered an award in lieu of such agreement) "*on the revision of price (tariff) for transit services*". Other intervening agreements do not close the tariff revision process. None of the Parties' subsequent agreements have concerned revision of the tariff, and it is irrelevant that the Parties since the time of the request have agreed on various other unrelated matters, inter alia the schedule of services, allocation of annual

⁹⁹ For example the 120 days period in the price revision clause reproduced in paragraph 94 of the Award in ICC case 13504, Exhibit CL-17 in the Gas Sales Arbitration.

¹⁰⁰ Putting a Price on, page 164, Exhibit C-120 in the Gas Sales Arbitration.

volumes, payment procedures, inspection procedures and currency. That the Parties agreed on other non-related matters while the tariff dispute was on-going is only natural in a long-term business relationship. It does not give Gazprom the justifiable impression that Naftogaz has relinquished its claim for tariff revision. Addenda signed concerning agreements on other matters do not fulfil the procedural requirement to the closing of a tariff revision in Article 8.7.1. Gazprom's argument should be rejected.

7.1.11.2.2.6 What Naftogaz requests is normal construction of contracts, not gap-filling

- (1655) According to Gazprom, the Arbitral Tribunal lacks jurisdiction to revise Article 8 of the Contract as Naftogaz's tariff revision claim goes beyond contract interpretation.
- (1656) Swedish courts and arbitrators enjoy wide general powers in contractual matters. Contractual interpretation, implying of terms and adjusting contract terms all fall within the powers of the courts and arbitral tribunals without any need for specific mandates. Arbitrators have an inherent right when interpreting agreements to imply a price term and this exercise is not considered gap-filling under Section 1, second paragraph of the Arbitration Act.
- (1657) Gazprom argues that Naftogaz' price revision claim goes beyond contract interpretation as *"Naftogaz asks the Tribunal to re-write the tariff formula and all of the other tariff related provisions of [the Contract] (including absurdly the deletion of the tariff review provisions that Naftogaz itself relies on)"*.
- (1658) Gazprom is using the term "re-write" as if there existed some legal rule defining "re-writing" of contracts or clauses and prohibiting it. This is not the case. Hence, Gazprom's argument, even if it had been well-founded (which it is not) lacks legal relevance.
- (1659) In any event, Naftogaz is not asking the Arbitral Tribunal to "re-write" the existing tariff price provisions of the Contract in a manner which would imply filling gaps in the meaning of the Swedish Arbitration Act. Naftogaz's request for tariff revision including all other changes to the tariff related provisions of the Contract than the tariff itself is based on Article 8.7 of the

Contract and on the norm which the Parties applied to set the tariff initially, i.e. the generally accepted European pricing principles for gas transport. The norm set out in Article 8.7 is sufficiently distinct for the Tribunal to apply it as a matter of interpretation. It is not uncommon for Swedish courts to settle disputes regarding market prices.

(1660) To sum up, Naftogaz has not asked the Arbitral Tribunal to make any changes to the Contract which do not follow from the Contract, and has not asked the Arbitral Tribunal to engage in extra-judicial activities or to resolve the dispute without applying any contractual or legal norm. Naftogaz does not request the Arbitral Tribunal to decide *ex aequo et bono*. Therefore, the requested revision of the tariff would not be gap filling as suggested by Gazprom, and there is no need for any separate authorisation in accordance with Section 1, second paragraph, of the Swedish Arbitration Act.

(1661) In deciding on the Tribunal's jurisdiction, it is also irrelevant what objections Gazprom makes as to whether Article 8 and the original tariff pricing norm are or were such as Naftogaz claims. It is also irrelevant if Article 8.7 gives the Arbitral Tribunal a right to revise Article 8 in its entirety. It is sufficient to establish jurisdiction for the Tribunal that Naftogaz *claims* that its cause of action is based on the application of Article 8 and/or the original tariff pricing norm. Any objection against Naftogaz's view as to the interpretation of Article 8 or the existence of the contractual pricing principles invoked by Naftogaz only pertains to the substance of the case, not to the Arbitral Tribunal's *jurisdiction*. Hence, if the Arbitral Tribunal does not find that it has a right to revise any other provisions in Article 8 than Article 8.1, it shall only deny Naftogaz's request relating to such other clauses (Sw. *ogilla*), not declare that it does not have jurisdiction to revise the transit tariff (Sw. *avvisa*).

7.1.11.2.2.7 Even if Article 8.7 includes gap-filling, the Parties have given the Arbitral Tribunal jurisdiction in accordance with Section 1(2) of the Swedish Arbitration Act.

(1662) The Parties have given the Arbitral Tribunal an explicit mandate to refer the matter of tariff revision to arbitration for a final decision, cf. Article 8.7.2 *in fine*. Article 8.7 includes a specific stand-alone text providing that "the matter" may be referred to arbitration if the Parties fail to

agree. This reference would be unnecessary unless the Parties wanted to give the Arbitral Tribunal powers not already provided in the arbitration clause, or to clarify what would otherwise follow from the arbitration clause. It is a generally observed contract interpretation principle that contract texts should be interpreted to add something to the contract and not be interpreted such that they are superfluous.

(1663) Hence, the only explanation for this additional text in Article 8.7 is that the Parties wanted to be certain that the tariff could be adjusted by an arbitral tribunal if the Parties failed to agree. It is also not required that the mandate given in accordance with Section 1, second paragraph, of the Swedish Arbitration Act is explicit or that gap filling is specifically referred to. Given the wording of Article 8.7 and the intentions of the Parties, the Parties have at least given the Tribunal such an implicit mandate. A separate authorisation has accordingly been given in accordance with Section 1, second paragraph, of the Swedish Arbitration Act. The Tribunal is then authorised to finally decide on the revision of the tariff, whether that is considered gap filling or not.

7.1.11.2.3 Requirements to the request for tariff revision and the effects of entering into negotiations

7.1.11.2.3.1 Introduction

(1664)) Naftogaz requested a revision of the price for transit services (the tariff) pursuant to Article 8.7 of the Contract on 15 June 2009. The revision would have effect from 1 January 2010, cf. Article 8.7.

(1665) Gazprom argues that Naftogaz has not submitted a request for tariff revision in accordance with Article 8.7.2 of the Contract, presenting an elaborate list of alleged requirements to information to be presented in a request. In the following, Naftogaz rejects Gazprom's position.

7.1.11.2.3.2 Requirements to the timing of the request

(1666) Gazprom argues that Naftogaz could not submit a valid request for tariff revision before 1 January 2010, and refers to the wording of Article 8.7 "*material change in 2010 and subsequent years*" (Gazprom's translation), (in Naftogaz' translation the wording is "*significant change in*

[REDACTED]
[REDACTED] (Naftogaz' emphasis)

(1670) Gazprom's assertion that [REDACTED] only provided for a prepayment under the transit agreement, is consequently wrong. It is clear [REDACTED] that Gazprom's and Gazprom Export's claims against RUE were assigned to Naftogaz. This is also evident from [REDACTED] of the [REDACTED] in the case between [REDACTED] which quotes the preamble of the assignment contracts between Gazprom and Naftogaz:

[REDACTED]

(1671) As [REDACTED] agreed, Gazprom and Naftogaz entered into the assignment agreement in order for Naftogaz to acquire the 11 bcm of gas in storage. The subsequent dispute over the ownership to the gas in storage was decided on in June 2010, after a political regime change in Ukraine. The new Naftogaz management instated by the new regime, then chose not to defend itself against RUE's claims in those proceedings.

(1672) Furthermore, as [REDACTED] explains, Gazprom's reading of Article 8.7 would not make sense from a commercial perspective. Changes taking place in 2009 could obviously be considered in a possible tariff revision in 2010. This is also the way [REDACTED] understood the clause.

(1673) Gazprom's interpretation would also be contrary to the purpose of the contract, to transition to European gas pricing rules both in relation to gas sales and transit. Effectively, it would imply that changes in EU regulation, i.e. the adoption of TEP that took place in the second half of 2009, would not be deemed as changes to the terms for determination of transit tariffs. If that truly was Gazprom's intention when the Parties agreed on the text of Clause 8.7, that was not clear to Naftogaz, and there is no reason to uphold such unilateral intent by Gazprom to deviate from market practice.

7.1.11.2.3 Requirements as to substantiation of the request

(1674) The only guidance to the contents of a tariff revision request in Article 8.7.2 is the wording "*properly substantiated*". The term "properly" does not in itself provide any guidance to the level or kind of substantiation required. The term must be interpreted in its context.

(1675) When establishing the level of information required one must consider the purpose of the substantiation requirement. The purpose of substantiation requirements in price review requests is described as follows in the literature: "*[...] the basis for a request for price review must be somewhat specified so that the counterparty knows what he must be prepared to meet*" in the subsequent negotiations, cf. A. Brautased, *Norsk Gassavsetning*.

(1676) Thus, the request shall enable the receiving party to prepare for the following negotiations. The purpose of the notice is very similar to the notice requirement in Article 39 (1) CISG, and Section 32 (1) in the Scandinavian Sale of Goods Acts, where the symptoms or the indication of a non-conformity have to be included in the notice, but where the underlying explanation for the non-conformity can be documented at a later stage.

(1677) This is also how the principle has been expressed in a recent arbitral award concerning price revision.

(1678) The wording of Article 8.7.1 of the Contract does not call for the submission of a comprehensive explanation of the grounds for the request, nor is there a requirement to explain the grounds in a

detailed manner. Article 8.7.1 does not require documentation or proof that the material conditions to adjust the tariff as a result of tariff revision are fulfilled. The requirement for a properly substantiated request is meant to initiate a negotiation process, where the Parties together will consider market developments and the economics under the Contract.

(1679) Thus, the requirement to substantiate the reasons for a tariff revision request is not strict, it is rather meant as a formality to prepare the other contract party for the subsequent procedure. This is further supported by the fact that the Parties are both professional, operating in the gas and gas transport market in different countries, and are both well aware of the market developments. Thus, the level of detail necessary to enable the counterparty to prepare for negotiations following the request could be kept on a low level. The question is simply whether the counterparty understood that the requesting party sought a tariff/price revision.

(1680) Also, the historical relationship between Naftogaz and Gazprom confirms that the requirement to "properly substantiate" the request is not particularly strict. As [REDACTED], who drafted Naftogaz's tariff revision request, explains in his witness statement, the culture of negotiations between Gazprom and Naftogaz at the time meant that any request had to be simple and friendly, and that the reasons could be elaborated in subsequent meetings.

(1681) Consequently, Gazprom's argument that a party already at the initial stage of a tariff revision, in its request for tariff revision must demonstrate that the conditions have been fulfilled, is incorrect. This is a time consuming and resource demanding procedure that follows after the submission of a request for tariff revision.

(1682) Further, Gazprom alleges that the request does not satisfy the requirements of Articles 8.7 to 8.7.2 since it allegedly contains no justification for Naftogaz' request for tariff revision on the basis of the required preconditions. Gazprom's subsequent discussion is imprecise.

(1683) In its first request for tariff revision, dated 15 June 2009, Naftogaz stated that:

"For the first 5 months of 2009 the transit of natural gas by OAO Gazprom through the territory of Ukraine constituted 31 bcm, which is 40% less than in the same period of 2008, and 38% less than the volume provided for by the Contract No. TGKU dated 19 January 2009 on volumes and conditions for the transit of natural gas through the territory of Ukraine from 2009 to 2019 (hereinafter the Transit Contract)." (Naftogaz' emphasis)

(1684) The substantial and totally unexpected lasting decline in volumes delivered for transportation was caused by the significant decrease in European gas consumption resulting from the financial crisis, which in the course of 2009 proved much worse and long-lasting than previously anticipated by any market participant. Under the tariff system to be applied from 2010, a relevant condition for determining the effective tariff is the volumes transited, as explained by Naftogaz:

"[t]he decline in volumes of natural gas for transit leads to a substantial decline in the revenues of NAK Naftogaz of Ukraine from the provision of transit services and carries a threat of significant unplanned financial deficit for the Company in 2010 and in subsequent years, especially in the light of the planned commissioning of the gas pipeline "Nord Stream". (Naftogaz' emphasis)

(1685) Thus, Naftogaz clearly stated that Gazprom's unexpected reduction in gas volumes delivered for transit, would render the increase in the transit tariff foreseen under the Contract from 1 January 2010, insufficient to let Naftogaz cover its costs. This was an obvious change compared to the Parties' expectations.

(1686) Against this background, Naftogaz stated that:

"This problem is a consequence of the asymmetry of the contract conditions on transit and purchase of natural gas, signed on 19 January this year, in particular in terms of guarantees by the acquirer of minimum payments: if the Contract on the purchase and sale of natural gas requires NAK Naftogaz of Ukraine to buy at least 80% of the contracted volume of natural gas and provides for substantial penalties in case of failure to comply with such condition, the

Transit Contract does not provide for such an obligation of OAO Gazprom. Moreover the absence of such an obligation of OAO Gazprom in the Transit Contract leads to a significant decrease in the effective price for transit of natural gas, which provides a basis for its revision in accordance with Clause 8.7 of the Contract. (Naftogaz' emphasis)

(1687) Thus, the letter sets out that due to subsequent circumstances, Naftogaz would experience a significant drop in revenues from 1 January 2010 as a result of Gazprom's constant failure to deliver the volumes of gas agreed between the Parties. Gazprom's decrease in delivery volumes was a response to the market developments in Europe, where consumption fell drastically. *Inter alia*, the extent of Gazprom's reduction in delivered volumes as a response to market developments made it clear that from 1 January 2010, since even with this increase, Naftogaz would, contrary to the Parties' expectations, suffer a loss. Naftogaz also pointed out that the missing capacity payments under the Contract contributed to the loss. Naftogaz explicitly referred to its right to revise the tariff pursuant to Article 8.7. Thus, the letter and its content was in itself sufficient to prepare Gazprom for a subsequent discussion of the unexpected drop in transit volumes and the shortcomings of the tariff under the changed conditions.

(1688) In the final paragraph of its 5 August 2009 letter in response to Naftogaz' request, Gazprom confirms that they understood that the request was directed at the effective tariff payable by Gazprom:

"Proceeding from the above, we believe that the question on amending the Transit Contract in a way that will factually mean additional payments by OAO Gazprom for NAK Naftogaz of Ukraine services on natural gas transit is unacceptable."

(1689) Notably, Gazprom did not state, neither in its 5 August 2009 letter nor later, that the substantiation requirement pursuant to Article 8.7 had not been fulfilled, before Gazprom's Statement of Defence of 16 October 2015, some 6 years after Naftogaz had made the request. In August 2009, Gazprom addressed Naftogaz's request on the merits.

(1690) In the following months Naftogaz continued to pursue the issue. The topic was raised both at management level and at an intergovernmental level. However, every time Naftogaz raised the issue of tariff revision under the Contract, Gazprom refused to discuss the issue. The subsequent correspondence and meetings/negotiations confirm that Gazprom understood that Naftogaz requested a tariff revision.

(1691) Consequently, the procedural conditions for referring a claim for tariff revision under the Contract to an arbitral tribunal for a final decision is fulfilled. Gazprom's position on the validity of Naftogaz's request must be rejected.

(1692) Naftogaz does not rely only on its 15 June 2009 letter as a tariff revision request, but also on subsequent correspondence and follow up. The Relief Sought empowers the Tribunal to find a later effective date than 1 January 2010, if it considers a later action as Naftogaz' request. It is irrelevant that the various letters do not cross refer to each other.

7.1.11.2.3.4 The substantive conditions for tariff revision

(1693) The purpose of the first condition in Article 8.7 of the Contract is to exclude price revision in situations where the pricing principle has changed but where the price tariff under the Contract nevertheless is not off-market. Any adjustment would under such circumstances presumably be unnecessary.

(1694) It is clear that the term "*the level of transit tariffs in the European gas market*" must be given a reasonable interpretation in the light of the purpose of the second condition in the price revision clause. Indeed, the very purpose of the price revision clause is to cater for subsequent unexpected developments. Also, there are numerous examples from Swedish Supreme Court practice of changed circumstances being addressed by interpreting a clause to operate reasonably in the light of the changed circumstances.

(1695) Normally when applying a provision which corresponds to Article 8.7 of the Contract, there will be a numerical and uniform market price level to which all other prices on the market can be

compared. Under such circumstances, the price under the Contract would have been compared to the relevant price level and it could be concluded if the price reflected such market price or not. However, the cost-reflective transit tariffs operate differently. They are intended to cover the costs for the transmission companies (and allow for an appropriate return of investment). As the tariffs are cost-reflective, they will differ between the different transmission service providers depending on the costs of such service providers (even though the tariffs are based on the same principle). Accordingly, prices that are all in line with the market will differ substantially if viewed numerically. *"The level of transit tariffs in the European gas market"* can therefore not be based on a numerical view, but must be read as a reference to the price level based on cost-reflective tariffs.

- (1696) In Naftogaz' view therefore, the second condition has been fulfilled if the price under the Contract does not correspond to Naftogaz' costs plus a reasonable return on investment.
- (1697) The tariff under the Contract did not cover Naftogaz' costs even assuming that Gazprom had fulfilled its delivery obligations under the Contract. Hence, the second condition for revision of the price was fulfilled as of 1 January 2010.
- (1698) The effect of tariff revision under Article 8.7 is the corollary of the conditions, i.e. to revise the tariff according to the changed terms for tariff determination (the capacity-based, cost-reflective approach), to a level corresponding to the general tariff level in Europe, i.e. a level covering Naftogaz' costs. Thus, in the present case, the effects of applying Article 8.7 as interpreted above are the same as the effects of replacing Article 8 pursuant to European competition and energy law and Article 13.2 of the Contract, i.e. to revise the tariff to a cost-reflective, capacity-based tariff. This is in line with the Parties' agreement to introduce European pricing principles in the Contract.

7.1.11.2.3.4.1 The meaning of "terms for determination of transit tariffs in the European gas market"

(1699) In relation to tariff revision pursuant to Article 8.7, Gazprom argues that the reference to European principles, would take Naftogaz nowhere, since there allegedly was a clear confusion even between Naftogaz' witnesses as to what European principles meant.

(1700) Gazprom's argument is based on a confusion of different matters, and it may be useful to recall the backdrop for the conclusion of the sales and transit contracts.

(1701) The wording refers to European Union terms.

(1702) It is clear that "European principles" meant the principles and terms applied to gas sales and transit in the European Union.

(1703) However, when the Contract was negotiated in the autumn of 2008, and in January 2009, the *contents* of European (Union) principles for transit tariff determination were unclear. Naftogaz argued for a cost reflective tariff based on the Austrian TSO's approach, while Gazprom argued that a point to point tariff, based on what Gazprom at the time had agreed with the Slovakian TSO, Eustream, would be in conformity with European principles, and that it would allow Naftogaz to cover the relevant costs. Naftogaz could not verify Gazprom's argument, since tariffs at the time were still confidential, and it was not clear whether a transit provider could demand that the tariff fully covered his costs. The latter point is confirmed by the KEMA Report from December 2009 relied on by Gazprom and Dr Moselle:

"[t]he transmission charge includes the costs incurred in transporting natural gas through the Slovak transmission system. These are specifically understood to be the costs incurred in operation and maintenance and in meeting the natural gas quality standards, and the costs related to the balancing of the Slovak system. The treatment of existing assets and new investments is not clear." (Emphasis added by Naftogaz.)

(1704) Importantly, Gazprom in the negotiations argued that due to its size, another regime applied to Gazprom. Higher tariffs set by regulators did not apply to Gazprom, which was paying lower, negotiated, tariffs.

(1705) The transit market was in a state of flux when the Contract was entered into. At the time there were various terms for determination of tariffs in Europe, which all could be applied and reflect European terms for tariff determination. It was exactly due to this uncertainty that the tariff revision clause was inserted. Otherwise, tariff revision clauses are not regularly used in transit contracts. This uncertainty confirms that the subsequent changes were not reasonably expected by the Parties. Notably, Gazprom apparently expected (and still expects, at least in Ukraine) to be exempt from the principles.

(1706) Naftogaz' position is that the Third Energy Package adopted in the third quarter of 2009 has since been decisive for the terms for determination of transit tariffs in the European gas market.

7.1.11.2.3.4.2 The significant changes compared to expectations as of January 2010

(1707) As regards the significant changes to European tariff determination that took place with the adoption of the Third Energy Package, Naftogaz submits that

- Competitive pricing became entirely off-market, and cost reflective tariffs set by regulators came to be the prevailing principle;
- The Parties reasonably expected that tariffs were and would continue to be determined based on contract paths (point-to-point tariff methodology) which is the methodology applied under the Contract. However, Article 13 Regulation (EC) No. 1715/2009 abolished the practice of setting tariffs based on contract paths.
- Capacity based entry exit-tariffs calculated on a cost reflective basis allowing a TSO to recover 100 per cent of its full costs, with adjustments for unexpected underutilisation of capacities, became the only approach; and that

- The previous exemption for "*legacy contracts*" (long term gas transit contracts entered into under the transit directive (Directive 91/296/EEC)), was rescinded.

(1708) Also, the unexpected decline of transit volumes in 2010 and subsequent years are relevant changes in the terms for determination of transit tariffs. When the Contract was entered into, Gazprom explained that Nord Stream only would provide additional gas to take into account increased consumption in Europe, consistently with Nord Stream's publicly stated view in 2008. However, already in the course of 2009, it became clear that consumption in Europe decreased, and that Gazprom was delivering reduced volumes for transit. This was a change with effect on the terms for transit tariffs in the European market, since Naftogaz would have demanded a higher tariff per 1000m³ of gas transported, if it had known that Gazprom would not transport the agreed upon volume of 110 bcm annually.

(1709) Gazprom argues that the termination of the legacy contract exemptions and point to point as a relevant tariff methodology, were reasonably foreseen.

(1710) As regards the revocation of the exemption for legacy contracts, long term gas transit contracts entered into under the so-called Transit Directive from 1991 (Directive 91/296/EEC), were exempted from the first energy package of 1998. Gazprom argues that this exemption was repealed in 2004, and thus could not constitute a significant change for a contract from 2009.

(1711) However, contracts entered into in 1991-2004 including prolongations of such contracts, remained exempted under the Second Energy Package. During the 2009 negotiations Gazprom argued that Gazprom's other transit contracts, like the Contract, would be exempted from a Third Energy Package. This was a reasonable expectation, also because the Contract effectively was a prolongation of the existing 2002 transit contract.

(1712) Indeed, in relation to the substantive issues of Energy Law, Gazprom actively argues that the Contract still is exempted from the Third Energy Package, based on its incorrect "grandfathering" argument. In this respect, the Parties expected that the exemptions would be continued.

(1713) Finally, in this context, Gazprom argues that there is no analysis to suggest that the decision not to extend the exemption for legacy contracts constituted a *significant* change. Further Gazprom argued that in order to demonstrate that this decision did constitute a significant change to the terms for determination of transit tariffs in Europe, one "*would have to know how many legacy contracts there were, whether they were cost reflective et cetera*". This is wrong. The significance criterion in the first substantive condition is qualitative, not quantitative since (1) the number and exact terms of legacy contracts is confidential and unavailable, and (2) the second condition (level of tariffs) is the quantitative condition. The removal of the exemption was obviously qualitatively significant.

(1714) Notably, Gazprom further argues that the "*removal of point-to-point [...] in itself would not give rise to any change in the level of the tariff*". But Gazprom *does not argue* that the removal was not a significant change in the terms for determination of transit tariffs in Europe. Thus, Gazprom apparently accepts that the removal of point-to-point tariff determination is a significant change in the meaning of Article 8.7.

7.1.11.2.3.4.3 The changes that took place were not reasonably expected by the Parties when the Contract was entered into

(1715) As discussed above, it was highly uncertain what the final Third Energy Package would look like when the Contract was negotiated.

(1716) In particular, it is clear that the decision not to continue the exemption for legacy contracts was not reasonably expected by the Parties. On the contrary, Gazprom argued during the 2009 negotiations that its contracts would continue to be exempted.

(1717) As regards the removal of point to point as a valid tariff methodology, Gazprom argued that this change was reasonably foreseen, since the suggestion to remove point-to-point "*also appeared in documents preceding the Third Energy Package, the various proposals and was in the document which was the subject of the approval process which was concluded on 9 January 2009*". Apparently, these drafts were to be relied on by the Parties. However, this position is contradicted

by Gazprom's own arguments regarding the draft Network Code which passed comitology in September 2016. In this respect, Gazprom argues that while EU Regulations are in draft form, "*they are obviously not binding*", implying that they should not be considered. A draft which has passed comitology is still at "the stage at which Member States might make changes".

(1718) Furthermore, the draft TEP only passed comitology on 9 January 2009, in the middle of the gas crisis initiated when Gazprom stopped all gas deliveries to and through Ukraine. It is highly unlikely that the Parties had time to study the draft passing through comitology under such circumstances.

(1719) In the case at hand, even if the adoption of the Third Energy Package was foreseen, its final contents and effects, as well as other changes in the market, were unexpected.

(1720) That the change was unforeseen is also confirmed by Gazprom's on-going revisions of other contracts. ██████████ explained that Gazprom due to the various changes to legislation in countries implementing TEP, has had to make

"certain changes [...] not to be in contradiction between the existing contract and new rules what is possible to make.

Q. Exactly.

A. It is not only in Poland, but in other countries. But the major change in this respect is that the transit tariffs could not be voluntarily agreed between the parties of the contract but should get approval from the applicable regulator which is, in many cases, already executed but, in cases where contracts are still in place, it's either not touched at all or only partially amended."¹⁰¹ (Naftogaz' emphasis)

(1721) In conclusion, there have been significant changes to the terms for transit tariff determination in Europe in 2010 and subsequent years, as compared to what the Parties had reason to expect when

¹⁰¹ TD 4, 128:6-23 (T-PHB, tab III p. 120)

they concluded the Contract. This was apparently also accepted by Gazprom at the time, since it only commissioned reports on the level of transit tariffs and not on significant changes to the terms for determining such tariffs before or in January 2010.

7.1.11.2.3.4.4 The Tariff in Article 8.1 has failed to correspond to the level of transit tariffs in the European gas market since 1 January 2010

- (1722) Gazprom argues (i) that Naftogaz has not shown that the tariff did not correspond to the level of tariffs in the European market in 2010, and (ii) that Naftogaz's arguments are based on an approach where the clause should be "*construed as saying, if it is not calculated in accordance with the methodology in the regulated market in the EU it will not be cost reflective*".¹⁰² According to Gazprom this is not what the clause says, or what the Parties intended. Gazprom's position is apparently rather that the benchmarking exercise is solely meant to assess what Gazprom pays for transit through other countries with no regard for the particularities of either the Ukrainian transit system or the systems in other countries
- (1723) Gazprom's interpretation is incorrect, does not take into account the Parties' intentions when the Contract was entered into, and the economic principle that comparisons should be made on a like for like basis.
- (1724) There is no evidence indicating that the Parties intended to consider what Gazprom nominally would pay for transit in other countries. Rather, as is clear from the wording of Article 8.7, the Parties intended the tariff to reflect the "*terms for determination of transit tariffs in the European gas market*". Therefore, the benchmarking exercise under Article 8.7 has to take into account the mandatory change to cost reflective tariffs in Europe, meaning that the question is whether the level of the tariff reflects Naftogaz' costs in the same way as tariffs elsewhere in Europe reflect the system operator's costs.

¹⁰² TD 11, 212:12-25 (T-PHB, tab III p. 122)

(1725) The requirement to compare like for like applies irrespective of the significant changes that have taken place.

(1726) A like for like comparison of European tariffs has to consider the service provided and what costs the service provider incurs. Not taking these factors into account renders the calculations meaningless.

(1727) Apart from cost recovery, Dr Moselle agrees that it is important to make comparisons on an "apples for apples" basis. For example, if one transit system is utilised much more heavily than another, the comparison will be distorted if an adjustment is not made for this difference. All other things being equal, a higher utilisation will lead to a lower tariff, as Dr Moselle confirmed:

"it's just a question of arithmetic. So your tariff is your revenue requirement divided by the amount of capacity you sell, so if you divide by a bigger number you get a smaller answer. The answer is yes."

(1728) And again, if one transit system is supported by a long-term capacity booking and the other is not, then this may also need to be taken into account, as Dr Moselle explained.

"if you had a long-term commitment to use the system, then -- and in the absence of the long-term commitment you think it is going to be stranded then the long-term booking, in that case, would reduce the tariff. But it is not so much the long-term booking, it is the certainty that your asset won't be stranded."

(1729) Correcting for such differences confirms that the tariff level sought by Naftogaz in these proceedings is in line with tariffs elsewhere in Europe.

(1730) Thus, Naftogaz' benchmarking exercise with reference to whether the tariff is cost-reflective follows the wording of Article 8.7, conforms with the Parties' intentions to transfer to EU terms, and demonstrates that the current tariff fails to correspond to the level of transit tariffs in the European gas market.

7.1.11.3 The closure of a tariff revision request

(1731) Gazprom claims that Naftogaz has lost its claim for revision of the price due to passivity. Apparently, Gazprom considers that a request for price (tariff) revision is closed unless the requesting Party initiates arbitration immediately after the expiry of the three months negotiation period stipulated in Article 8.7.2.

(1732) However, pursuant to Article 8.7.1 last sentence, the Parties shall enter into negotiations within 20 days following a request for price revision and,

"if an agreement is reached, sign the respective addendum to this Contract".

(1733) Further, pursuant to Article 8.7.2, the matter may be referred to arbitration

"If a written agreement on the revision of the price for transit services cannot be reached within 3 (three) months from the date of the beginning of negotiations..."

(1734) Thus, the tariff revision procedure is only closed once the negotiations pursuant to Article 8.7.1 have ended with the signing of an addendum to the Contract recording the agreement on revision of the tariff, or, if no such addendum has been signed within three months after the start of negotiations, by an arbitral award pursuant to Article 8.7.2. Conversely, if no agreement is reached, and no addendum is signed, the tariff revision process is still open. There is no basis for Gazprom's complaints regarding commercial uncertainty caused by unresolved requests. Any such uncertainty may be avoided under the procedure in the Contract, i.e. by signing an addendum closing the transit tariff revision or, if the requesting Party refuses to do so, by bringing the matter to arbitration. Amicable price revision negotiations under long term gas sales agreements have taken up to five years to finalise.

(1735) Since no addendum revising the tariff has been signed, the tariff revision proceedings initiated on 15 June 2009 are still open.

7.1.11.4 The effects of tariff revision

7.1.11.4.1 The scope and subject of a tariff revision

(1736) The scope and subject of tariff revision is "*a revision of the price for transit services*". This formulation excludes the reference to Article 8.1 found in the substantive conditions for price revision. Thus, the reference is to Article 8 "Price for the transit of gas" in its entirety. Therefore, Article 8 in its entirety is subject to revision. The text does not restrict the scope of the revision in any way.

(1737) This wide scope of tariff revision is logical in the light of the substantive conditions. If the terms for tariff formation have changed significantly, the resulting revision of the Contract tariff must be equally significant.

(1738) In terms of specific effects, the revision shall mirror the conditions. Thus, in the present case, the effect is to revise Article 8 to reflect the current European principles for tariff setting. In practice, therefore, the revision claimed by Naftogaz pursuant to Article 8.7 is the same as the replacement claimed pursuant to competition and/or energy law and Article 13.2 of the Contract. In the present case, that means replacing the tariff provisions with provisions complying with the Third Energy Package with effect from 1 January 2010.

7.1.11.4.2 The effective date of revision

(1739) The effective date of tariff revision is not explicitly regulated in Article 8.7, except that it cannot be in 2009. Hence, a term as to effective date must be implied.

(1740) The tariff revision clause is based on the price revision clause in the Gas Sales Contract, and the same principles apply. And as price revision clauses imply retroactive payments so does the tariff revision clause. An effective date equal to the date of the request is the usual solution in the gas industry.

(1741) Given the purpose of a tariff revision clause, it is also entirely logical that tariff revision takes effect from the date of the request. If the tariff were to be adjusted with effect only from the date of the award, as Gazprom would have it, the adjustment would not reflect the situation which

triggered the revision. This would contradict the basic idea of tariff revision, to adjust the tariff to reflect the formation of tariffs in the European gas market from time to time. Moreover, if the effective date would be the date of the award, the requesting Party would effectively be deprived of its entitlement to a lower or higher (as the case may be) tariff following from the revision until the date the award. Pursuant to Article 13.12 of the Contract, Naftogaz is obliged to continue services also in case of disputes. Conversely, the other Party would have a strong incentive to delay and complicate negotiations and arbitral proceedings. Thus, a right to repayments from the date of the request is systematically and commercially the reasonable solution, and was the solution chosen in the Gas Natural case.¹⁰³

(1742) If the request date is not chosen, the Tribunal may imply a different effective date, e.g. the end of the negotiation period.

(1743) Naftogaz in the alternative relies on all correspondence and follow-up subsequent to the 15 June 2009 tariff revision request as possible tariff revision requests. The Tribunal is empowered to find a later effective date than 1 January 2010, if it finds that subsequent action by Naftogaz may qualify as a request.

7.1.11.4.3 Determination of the revised tariff

(1744) The Third Energy Package requires that transmission tariffs be cost-reflective. This requirement implies that the tariffs must enable the network owner to recover:

- a reasonable return on its regulatory asset base;
- the costs of the RAB itself i.e. a depreciation allowance; and
- its operating costs;

(1745) Within this broad framework, different approaches are possible. Once the particular circumstances of the market have been taken into account, there is only one correct methodology and

¹⁰³ CL-224 in T-F 13, pp. 3-4 and 6 (T-PHB, tab III p. 129 to 131)

tariff, and the Tribunal should not be led astray by the apparent uncertainty created by the Regulator's discretion. The Ukrainian Regulator has used its discretion and knowledge of the Ukrainian market in determining the cost-reflective transmission tariffs that should apply from 2016-19. Naftogaz submits that the Ukrainian Regulator is uniquely well placed to determine a tariff which adheres to the methodology and is adapted to the circumstances in the Ukrainian market.

(1746) The Regulator has also been conservative. With slightly other assumptions, the tariff could have been significantly higher. The tariff set by the Regulator for 2016 – 2019 amounts to USD 5.1 per 1000m³/100km.¹⁰⁴

(1747) In the specific case of Ukraine, the Regulator's development of a tariff methodology was subject to particular scrutiny by third parties. As ██████████ noted, the Energy Community Secretariat gas team

*"worked with the EU, with the World Bank, with the regulator on drafting and assessing these laws. They came to the conclusion that the tariff methodology is in line with the exemption of one element"*¹⁰⁵

(1748) The one element that ██████████ referred to is that capacity charges have not yet been implemented for domestic exit points, although they will be from April 2017 onwards.¹⁰⁶ The delayed introduction of capacity charges for domestic exit points has no effect on the level of tariffs at the cross-border exit points relevant to the present case, and no costs related to possibly lower revenues due to the volume-based charges for internal deliveries will be passed on to cross-border users, including Gazprom.

(1749) As regards Naftogaz' claim that cost-reflective tariffs should have been introduced prior to 2016, the question is whether the Ukrainian Regulator's considerations for the 2016 tariff also apply in

¹⁰⁴ R-64 in T-G 3, Tab 008, p. 24 (T-PHB, tab III p. 136)

¹⁰⁵ TD 6 31 16-20 (T-PHB, tab III p. 139)

¹⁰⁶ Ibid. 21-23 (T-PHB, tab III p. 139)

relation to these earlier periods. From Dr Hesmondhalgh's and Dr Moselle's testimony, it is clear that the three decisions that have to be taken that have the largest impact on tariffs are:

- how the RAB should be determined;
- how the depreciation allowance should be calculated; and
- how the allowed costs should be translated into entry and exit charges.

(1750) Dr Moselle and Dr Hesmondhalgh agree that there are effectively 2 main approaches: replacement costs and historical costs and that there are 3 different historical cost options: indexed, unindexed and acquisition value.¹⁰⁷ Dr Hesmondhalgh, and the Ukrainian Regulator rely on replacement costs. Whilst Dr Moselle accepts that replacement costs are an accepted methodology, he argues against their use on the grounds that they can lead to windfall gains or losses.¹⁰⁸ He ignores that outside of these proceedings, his view is (or at least was) that the "windfall" concern does not apply to state-owned entities.¹⁰⁹

(1751) In the case of Ukraine, the question of whether historical or replacements costs are theoretically preferable is irrelevant. There are no reliable historic costs, so replacement costs are the only possibility.

(1752) Dr Hesmondhalgh explained that this was so because

"some of the network was built in the Soviet era where reliability of any costs is highly questionable. You then have to worry about the fact that you have been through periods of hyperinflation subsequently and at least three changes of exchange rate".¹¹⁰

¹⁰⁷ BM I, 6.15, pages 64-65 (T-PHB, tab III p. 141 and 142)

¹⁰⁸ BM I, § 6.28 (T-PHB, tab III p. 143)

¹⁰⁹ Brattle II, § 205 (T-PHB, tab III p. 144)

¹¹⁰ TD 7, 87 24 – 88 1-4 (T-PHB, tab III p.145)

(1753) Dr Moselle accepts that he relies on unaudited historical costs¹¹¹ and that it is not clear to what extent these historical costs have been adjusted for inflation ("*I think they are partially indexed*").¹¹²

(1754) By contrast, the Ukrainian regulator and Dr Hesmondhalgh rely on the replacement costs calculated by EY in a detailed evaluation that took more than a year to complete and which was subject to a month long review by the Regulator and the State Property Fund of Ukraine ("SPFU"). Gazprom's objection that the valuation methodology was determined by the SPFU, suggesting that this indicates political interference, is incorrect on two counts. First, the SPFU is the valuation regulator in Ukraine and sets valuation standards for all companies in Ukraine, not just Ukrtransgaz. Second, EY in its valuation report comments that the SPFU has "*more strict standards for the use of valuation approaches and methods*" and "*the Methodology based on NVS [national valuation standards] meets the IVS [international valuation standards]*".¹¹³ Finally, as Dr Moselle effectively acknowledged, there is no other replacement cost assessment than the EY Report (which he characterised as "*a major undertaking*") on file in the present case. (The revaluation in Naftogaz' accounts for 2009 on file in the Gas Sales Arbitration cannot be relied on, because, as Dr Hesmondhalgh explained, the results showed evidence of economic obsolescence. In other words, the revaluation took into account the expected revenues under the Contract and would therefore make absolutely no sense as a method for determining the RAB for a tariff calculation independent of the current tariffs in the Contract.¹¹⁴) Consequently, if the Tribunal decides to rely on replacement costs, the EY Report should be relied on.

(1755) In respect of the RAB, Dr Moselle acknowledges that the costs of storage assets were *not* included in the RAB calculated by EY, and that Dr Hesmondhalgh had *not* double-counted assets. The inclusion of what Moselle calls distribution assets is correct - they are counted as transmission assets in Ukraine. Dr Hesmondhalgh explained that although gas distribution stations may

¹¹¹ TD 7, 108:24 - 109:1-2 (T-PHB, tab III p. 146 and 147)

¹¹² TD 8, 101:15 (T-PHB, tab III p. 148)

¹¹³ Exhibit ETR 55.44, pp. 48 and 49 (T-PHB, tab III p. 150 and 151)

¹¹⁴ TD 7, 131: 14-25 and 132 1-2

not be counted as transmission assets in Great Britain, they are treated as such in other countries such as Sweden, Finland, Switzerland and the US.

(1756) In terms of how the reasonable return to apply to the RAB should be calculated, there is no disagreement on methodology between the experts - the only disagreements are on the specific values to feed into the methodology. As Dr Moselle said

"The experts -- as Dr Hesmondhalgh and I may both be very odd, but we are odd in the same way in this respect."

(1757) The second important issue concerns whether or not the use of accelerated depreciation of transit assets is appropriate or not. The Ukrainian Regulator and Dr Hesmondhalgh only apply accelerated depreciation to the share of capacity that is deemed to be necessary for transit. Essentially this comes down to an assessment of the likelihood that there will be no transit flows after the end of the Contract. The possibility that there might be no such flows after 2019 was considered in Ukraine already in 2009.

(1758) As Dr Hesmondhalgh noted:

"We say there is sufficient uncertainty as to whether or not there will be flows after 2019 for it to be imprudent to assume that you are going to be able to recover the costs of the transit assets after that period. If in the event it transpires that there are further flows after 2019, then Gazprom will benefit from very substantially lower tariffs. They will be about 80 per cent lower because you will have taken out the full value of the assets".¹¹⁵

"I would also point out that Dr Yafimava admits there may be no transit flows after 2025 and that the level of transit flows in that period 2020 to 2025 could be very significantly lower than the current amount, up to the 110 Bcm that Ukrtransgaz is obliged to make available to

¹¹⁵ TD 6, 163:12-15 and 164 1-4 (T-PHB, tab III p, 158)

Gazprom. If you have small volumes for a relatively short extended period then that would not make a very material impact on our results".¹¹⁶

(1759) In other words, there is a high probability that there will be no transit flows after 2019, and accelerated depreciation is required.

(1760) Dr Hesmondhalgh also explained that Naftogaz' claims would have been higher if she had relied on "normal depreciation" until 2016 and then, for consistency with the Regulator, had switched to accelerated depreciation for transit assets. Although the tariffs until 2016 would be lower if they were based on normal depreciation, the switch to accelerated depreciation in 2016 more than offsets this effect. This is because under such an approach the remaining value of the assets would be higher in 2016 than if they had been subject to accelerated depreciation from, say, 2010. Hence the required depreciation for the last four years is significantly higher than it would be if accelerated depreciation starts earlier. This "kick-up" in depreciation significantly reduces the "future offset" that Dr Hesmondhalgh applies to ensure that Gazprom does not pay twice for the same assets.

(1761) Dr Moselle suggests that the decision on whether to use accelerated depreciation depends on whether Gazprom or Naftogaz should carry the risk of stranding of the transit assets. If the Tribunal should consider this relevant, the risk of stranding should be allocated to Gazprom because: 1) Historically, the Ukrainian transit system was built for use by the predecessors of Gazprom and its subsidiary Gazprom Export, 2) Gazprom's export monopoly from the Russian Federation and its exclusion of Central Asian producers from the Ukrainian system since 2006 mean that East-West transit through Ukraine is exclusively performed by Gazprom, and 3) Gazprom causes the stranding itself by constructing bypass pipelines like Nord Stream II and Turk Stream instead of remunerating Naftogaz for the full cost of the Ukrainian system.

(1762) Once the allowed revenues for Ukrtransgaz have been calculated, only one further step is required to determine Naftogaz' underpayment claims. This requires a decision to be made on how

¹¹⁶ TD 6, 163: 21-35 and 164:1-4 (T-PHB, tab III p. 158)

the allowed revenue should be split between transit and domestic consumption. Naftogaz' underpayment claims are simply equal to the percentage of the allowed revenues that should be allocated to transit users. There is no need to proceed further and determine entry and exit tariffs for each cross-border point, although Dr Hesmondhalgh has done so for completeness.

(1763) Dr Moselle has provided calculations showing what would happen if everybody paid the same entry and exit tariffs - so-called "postage stamp" tariffs, but he has not specifically endorsed this approach. *"on postage versus non-postage, I think that's the most difficult"* and *"as you can tell, I don't have a clear view on that"*. Dr Hesmondhalgh considers that the Regulator's approach of using capacity-weighted distances to determine the split is appropriate in the context of Ukraine. The point being that this ensures that Ukrainian customers do not subsidise transit users. She argued against postage stamp tariffs because

"In effect, what that would mean that domestic consumers would pay for 900 kilometres and transit would pay for 900 kilometres. If you were to do that then domestic customers would [be] cross-subsidising transit customers".

(1764) Domestic customers would be subsidising transit customers because the typical distance that gas flows through Ukraine for transit is nearly 1200 km, but it is only around 400 km for domestic customers. Moreover, the clear presumption under the Network Code on Harmonised Transmission Tariff Structures for Gas¹¹⁷ is that the capacity-weighted distance approach is to be preferred, and it is only in exceptional circumstances that postage stamp tariffs such as those calculated by Dr Moselle should be considered as a primary allocation methodology.

7.1.11.5 Naftogaz' claim for tariff revision pursuant to Section 36 of the Swedish Contracts Act

7.1.11.5.1 Introduction

¹¹⁷ CL-266 in T-F 16 Article 7, cf. also Article 4.3(a)(ii) allowing "[a]n exception" for partial revenue recovery by a commodity charge calculated "in such a way that it is the same at all entry points and the same at all exit points". (T-PHB, tab III p. 168 and 169)

(1765) A contract can be revised pursuant to Swedish Contract Law, in particular pursuant to Section 36 of the Contracts Act, considering the contents of the contract itself, circumstances when the contract was concluded and subsequent developments.

7.1.11.5.2 Relevant Principles of interpretation and contract revision

7.1.11.5.2.1 Section 36 in the Swedish Contracts Act

(1766) The so called general clause in Section 36 of the Contracts Act is a rule under which agreed contract terms may be revised, i.e. adjusted or set aside.

(1767) This principle therefore only comes into play after contract interpretation and implying of terms. For the operability of Section 36, it is required that the application of a specific clause is unconscionable (Sw: *oskälilig*) with reference to:

- a) the contents of the contract,
- b) the circumstances at the formation of the contract,
- c) circumstances arising later and/or
- d) other circumstances.

(1768) Hence, the scope of Section 36 is very wide.

(1769) It is important to note that Section 36 does not require that the term is unconscionable per se, but only that the application, at the time, is unconscionable. Therefore, a clause which was not unconscionable at the time of contract may nevertheless be set aside if its application subsequently has become unconscionable.

(1770) The general clause in Section 36 could be used not only to adjust (or "ignore") a specific unconscionable clause to reduce an obligation. It is also possible to modify the contract, so that an obligation is increased, or a new obligation imposed. If the unconscionable term is of such

importance to the contract that the rest of it could not fairly be upheld unchanged, the contract could be adjusted in other parts.

7.1.11.5.2.2 The application of the pre-requisite "unconscionable" is based on the contractual situation as a whole, although the application of section 36 is directed at (at least) one specific contract clause.¹¹⁸ The relevance of contractual revision mechanisms for revision under Section 36

(1771) Adjustments can be made although the parties have agreed on mechanisms intended to address changed circumstances. In fact, the inclusion of a clause intended to maintain balance would make it easier to rebalance the contract based on Section 36 as this would be in line with the parties' original overall intentions.

7.1.11.5.2.3 The effective date of the adjustment

(1772) Section 36 of the Contracts Act contains no limitations as to from what time the adjustment shall apply.

7.1.11.5.2.4 Typical cases

(1773) In the preparatory works, the legislator has suggested some guidelines concerning the application of the pre-requisite "unconscionable":

- A contract clause can be held to be unconscionable already on the basis of the content of the contract.
- A contract clause can also be considered as unconscionable per se. For instance, a clause which provides that one party may decide issues in its sole discretion is generally considered unconscionable, cf. Government Bill, 1975/76:81 page 118 *et seq.* In the same vein, the Supreme Court has censored (already by way of contract interpretation) clauses that purport to give one party a unilateral decision making right under the contract and

¹¹⁸ NJA 1989 p. 614.

required that such powers must always be exercised consistently, loyally and generally in a reasonable manner, see e.g. NJA 2005 p. 142.

- Clauses that are in conflict with law (even if the conflict is not with an applicable mandatory law), with general principles on which laws are based, morals or norms of different character are other examples. The preparatory works and jurisprudence also agree that a deviation from good market practice is a strong reason to set aside or adjust the deviating term, cf. SOU 1974:83 p. 145 *et seq.* and von Post, *Studier kring 36 § avtalslagen*, page 172. See also NJA 1983 p. 332 and RH 1990:108.
- Another factor strongly suggesting that an adjustment should be made is if a party has applied harder terms against one particular counterparty than it applies generally or applies terms generally used by it harder against one particular party, cf. SOU 1974:83 p. 145 *et seq.* and von Post, page 173.
- The circumstances at the formation of the contract also forms part of the context in which a contract clause is to be assessed. An important factor is whether a stronger party has abused its position during the negotiations, for instance by acting aggressively, taking the other party by surprise, exerting undue pressure or using other unconscionable methods to make the inferior party enter into the contract.
- A disparity between the values of each party's obligation can also be a reason to intervene, cf. Government Bill. 1975/76:81, pages 125 *et seq.*

7.1.11.5.3 Section 36 applies in business to business relations

(1774) In practice, Section 36 of the Contracts Act has been more frequently applied in consumer relations than in business to business relations, cf. von Post page 298. It is, however, beyond doubt that it applies also in business to business relations. In many cases, the underlying reason for the adjustment is such that it is irrelevant whether the parties are consumers or businessmen.

- (1775) A contributing reason for the less frequent application of section 36 to changed circumstances in business to business relations is also that changed circumstances are instead often dealt with in the context of interpretation or implying terms. In particular, cases from the time before the introduction of Section 36 show that the courts found different methods for addressing changed circumstances in business to business relations, without needing to resort to a specific rule on contract term adjustments.
- (1776) In several cases the Supreme Court has expressly confirmed that Section 36 in the Contracts Act is applicable in business to business relations, even though, *in casu*, the circumstances have not led the court to adjust the contract terms, cf. for instance NJA 1979 p. 483, NJA 1979 p. 666, NJA 1988 p. 230 and NJA 1992 p. 782.
- (1777) The Supreme Court has also in fact applied Section 36 in business to business relations e.g. in NJA 1994 p. 359.
- (1778) Appellate courts have also used Section 36 in business to business relation. In RH 1980:14, a company's fees were tied to the consumer price index. However, over time, the company's cost increases - as for the sector in general - rose considerably more than the consumer price index. The court of appeal therefore raised the fee. The court noted that the contract was for a rather long time (five years), that the loss was large in relation to the company's business volume, that the company did not have any other business partners of importance and that the unexpectedly large increase in costs was beyond the control of the parties.
- (1779) How Section 36 can be applied in sophisticated business to business relations is well illustrated in a much noted recent Swedish arbitral award rendered by Justice Stefan Lindskog, lawyer Axel Calissendorff and Jur. Dr. Eric M. Runesson concerning the accounting firm KPMG and the aluminium company Profilgruppen. Here, a contract term was adjusted under Section 36.
- (1780) KPMG had invoked a limitation of liability clause as defence to a malpractice claim. The arbitral tribunal held that even if section 36 of the Contracts Act should be applied cautiously in

commercial relations, nothing prevents an application thereof to business to business relations. Furthermore, it was held that the question of a possible adjustment should be decided after an overall assessment, cf. Svea HovR, T1085-11.

7.1.11.5.4 Section 36 and adjustment of long term contracts in general

(1781) Section 36 of the Swedish Contracts Act is regarded as the most important tool to adjust long-term contracts due to changed circumstances, cf. Grönfors and Dotevall, *Avtalslagen; en kommentar*, 2010, page 259.

(1782) Already in the preparatory works it was stated that there are strong reasons to use the general clause to adjust or ignore contract terms, due to changed circumstances. An example mentioned was that Section 36 could be used to adjust a clause to new legislation, especially for contracts concluded for very long terms, cf. Government Bill 1975/76:81, pages 126 *et seq.*

(1783) The legislator also observed that it is in the nature of things that reasons for adjustment etc. more often occur for long-term contracts. Cases concerning adjustment of the price in long term contracts due to change of circumstances have been rather frequent in Sweden. In many cases the price has been adjusted, and case law indubitably shows that Swedish courts share the Swedish legislator's willingness to rebalance contracts that over time have become unbalanced.

(1784) The argument for price adjustment in long-term contracts where the market price has changed unexpectedly is very strong. This is reflected by the fact that the legislator has pointed out that such changed circumstance would be reason to adjust a contract price also to the benefit of the stronger party, cf. SOU 1974:83 p. 164 and 166 *et seq.*

7.1.11.5.5 The relevance of contractual revision mechanisms for revision under Section 36

(1785) Adjustments can be made although the parties have agreed on mechanisms intended to address changed circumstances, cf. above. In fact, the inclusion of a clause intended to maintain balance would make it easier to rebalance the contract based on Section 36 as this would be in line with the parties' original overall intentions.

(1786) NJA 1983 p. 385 was about a 49-year leasehold. The parties had indexed the lease rent by linking it to the price of winter wheat. However, the price increases in winter wheat turned out to be much lower than the general cost development. Accordingly, the provision did not fulfil its purpose. The court held that the landowner could not foresee that the chosen index would become inadequate. Consequently, the Supreme Court substituted the link to the price of winter wheat with a consumer price index clause.

(1787) Further cases regarding adjustment of price in long-term contracts

(1788) In NJA 1923 p. 20, a seller sought adjustment of the price in a long term contract and the court, indirectly, affirmed his right to such adjustment.

(1789) In NJA 2005 p. 142, the Supreme Court also referred to cost changes to adjust price terms.

(1790) NJA 1994 p. 359 concerned a contract between a private company and a municipality where the company had transferred certain assets in exchange for an ever-lasting and cost free usufruct right. Many years later new legislation resulted in increased maintenance costs for the municipality. The court also noted that inflation had been high over time. The Supreme Court held that it would be unconscionable to uphold the cost free usufruct right due to the circumstances just mentioned, and hence imposed a fee in the contract based on section 36 of the Swedish Contracts Act.

(1791) The seller was obliged to sell goods at a pre-agreed price in German Mark. However, as the value of the German Mark fell dramatically there was a considerable difference between the value of the payment and the value of the goods that the seller was required to sell. The Supreme Court held that the payment obligation should be increased to fully reflect the true value of the payment obligation before the fall of the value of the German Mark. NJA 1930 p. 507 I.

7.1.11.5.6 The effective date of the adjustment

(1792) Section 36 of the Contracts Act contains no limitations as to from what time the adjustment shall apply.

- (1793) This is clear already from the wording of the clause. Moreover, the court's ability to adjust a term also includes the ability to adjust the clause by incorporating a chronological element, e.g. that the clause shall have a particular wording from a specified point in time.
- (1794) The preparatory works emphasise that it is important that the courts are free to choose the solutions that are most practical and best meet the parties' claims, cf. SOU 1974:83 p. 145. The legislator also leaves to judges and arbitrators to answer the general question of how far-reaching an adjustment in the pursuit of full fairness will apply in the individual case, cf. Government Bill, 1975/76: 81 page 138 *et seq.* In this respect, the scope of the adjustment in chronological terms is one parameter that the court or arbitration board would take into account.
- (1795) In case law, courts have applied different effective dates of adjustment, depending on the circumstances of the individual case. In NJA 1983 p. 385, the adjustment applied from the first year of lease which occurred after the writ of summons. In NJA 1994 p. 359 the Supreme Court decided that the starting point for the adjustment would be a time in the indefinite future when a property owner would move from his property. In RH 1980:14 a municipality applied for an order of pay against a company. The company disputed the order. The court of appeal adjusted the contentious amount also referring to a period before the order of pay and the dispute of the same.
- (1796) In some cases a party has already, before the writ of summons or request for arbitration where Section 36 is invoked, performed under the clause which the other party seeks to adjust. This does not preclude an adjustment under Section 36. The court or arbitral tribunal will simply need to take this circumstance into account in the analysis of unconscionability. One particularly relevant circumstance, in such case, will normally be whether and when the party claiming the adjustment has made the other party aware that an argument is raised that the performance according to the wording of the (unadjusted) clause at that time is not sufficient (e.g. that a price paid is not sufficient because the price should be adjusted upwards).

(1797) No particular form is required for such an objection. Also general objections would be relevant. For instance, in abovementioned RH 1980:14, the court noted that the company first had "*made the municipality aware*" of the fact that the disputed index clause did not give the company adequate compensation for cost increases, and later that the company had sought to "*bring about a change*" in the contract. Moreover, this is in line with general principles of Swedish law, under which a party does not forfeit a right to additional performance by the other party unless and until the first party knows that it could request more in terms of performance yet fails to object within a reasonable time.

(1798) Gazprom claims that Naftogaz is not entitled to what Gazprom characterises as a "retroactive adjustment" under Section 36. Gazprom uses expressions such as "it is not generally appropriate" and "it would as a rule be inappropriate" to seek adjustment of contract terms that have already been applied.

(1799) However, Gazprom does not present any legal support for that view. The reason is that there is no such support. On the contrary, as described in detail by Naftogaz above, and as follows from the text of Section 36, the provision contains no limitation as to from what time the adjustment shall apply. Moreover, the court's ability to adjust a term also includes the ability to adjust the clause by incorporating a chronological element, e.g. that the clause shall have a particular wording from a specified point in time.

7.1.11.5.7 Adjustment where contractual clauses conflict with mandatory law

(1800) Section 36 provides courts and arbitral tribunals scope not only to stamp a contract term as unconscionable in light of the circumstances in the specific case, but also as unconscionable *in itself* (Sw: *oskälilig i och för sig*), cf. K. Grönfors and R. Dotevall, *Avtalslagen en kommentar*, page 250.

(1801) The preparatory works make the example of a situation where a contract term clearly deviates from what can be deemed acceptable. In such case, Section 36 should be applied, and the contract term should be considered unconscionable no matter what circumstances otherwise exist. In this

context, the preparatory works specifically highlight *contract terms that are in conflict with law or good customs* (Sw: *goda seder*), cf. Government Bill 1975/76:81, page 121.

(1802) Furthermore, the Swedish legislator has pointed out several situations in which a contract may conflict with legal norms of different types, and thereby prompt application of Section 36:

- when contract terms conflict with *mandatory law*, especially *commercial administrative law* (Sw: *näringsrätt*);
- when contract terms conflict with *optional law* if the terms deviate from *legal policy statements from the legislator*; and
- when contract terms conflict with *public law*, such as international conventions implemented in Swedish law.

(1803) The legislator has underlined the strong reasons for the application of Section 36 on *contract terms in conflict with mandatory law*, cf. C-R von Post, *Studier kring 36 § avtalslagen med inriktning på rent kommersiella förhållanden*, 1999, p.140 *et seq.*

(1804) A contract term intended to sidestep binding rules, *or with that practical effect*, could be adjusted under Section 36, cf. Government Bill 1975/76: 81. It is also possible to apply mandatory rules by analogy, either if there is a relevant *lacuna* in the mandatory law, or if some rules are not formally applicable to the situation, but the same interests underlying the rules assert themselves also in this situation, cf SOU 1974:83 page 135 *et seq.*

(1805) A party's violation of a legal norm can form the basis for an adjustment of a contract clause under Section 36 of the Swedish Contracts Act, even though the provision in question does not apply directly to the contract between the parties, e.g. where the norm appears in legislation and administrative rules *closely connected to the relation that the contract seeks to govern*.

- (1806) For instance, the preparatory works emphasise that Section 36 of the Contracts Act should be used to achieve greater *conformity between civil law and commercial administrative law*, cf. Government Bill 1975/76: 81, page 103 *et seq.*
- (1807) It should be mentioned that energy law is a subset of commercial administrative law, and that there is therefore express support from the Swedish legislator to use Section 36 to align contracts between private parties to prevailing energy laws, cf. U. Bernitz, *Marknadsrätt: En komparativ studie av marknadslagstiftningens utveckling och huvudlinjer* (Stockholm, 1969), page 76 with footnote 33.
- (1808) Accordingly, Section 36 can be used where it is not conclusively established that all prerequisites for the application of specific mandatory legislation that would have otherwise applied to the contract have been triggered. Hence, a contract that has adverse effects on competition, but does not directly violate the prohibitions of the Swedish Competition Act, could in some cases still be adjusted under Section 36 of the Contracts Act, see U. Bernitz, *Den svenska konkurrenslagen*, 1996, page 84 and Government Bill 1992/93:56 page 77.
- (1809) Also commercial administrative rules of lower denomination may trigger Section 36. In NJA 1999 p. 408 the Swedish Supreme Court gave effect to the administrative rules of the Swedish Financial Supervisory Authority (Sw: *Finansinspektionen*) on a contract between a lender and a guarantor, and reduced a guarantee engagement pursuant to Section 36.
- (1810) The rules in question, which were issued under the Swedish Banking Act (1987:617), did not apply directly to the contract. However, the Supreme Court explicitly paid heed to the aim of the legislator that Section 36 should be used to reach conformity between civil law and commercial administrative law, cf. T. Ingvarsson, "*Borgensåtagande för kommersiell kredit jämkat med stöd av 36 § AvtL*" in *Juridisk Tidskrift 1999-2000* (2000), page 418.

- (1811) Professor Ulf Bernitz is of the opinion that contract clauses that contravene mandatory rules must be considered unconscionable, cf. U. Bernitz, *Standardavtalsrätt* (Stockholm, 2013) 8th edition, page 162.
- (1812) There is also a scope for adjustment of clauses that deviate from optional law (Sw: *dispositiv rätt*). In principle, parties are of course generally free to design contract terms that differ from optional rules. However, the legislator has pointed out that, when applying Section 36, regard could be given to those optional rules that express *legal policy statements from the legislator*, cf. Government Bill 1975/76:81, page 121.
- (1813) Another issue concerns contracts that conflict with *public international law* (Sw. *folkrätt*). The preparatory works to Section 36 identified Act (1971: 176) on Certain International Sanctions (replaced in 1996 by the International Sanctions Act (1996: 95)), cf. SOU 1974:83 as an example. If a contract between private parties that falls under Swedish law conflicts with sanctions imposed by an inter-governmental organization, adjustment under Section 36 may become necessary to ensure that the contract is in line with the public interest behind the sanctions, cf. von Post, page 183 *et seq.*
- (1814) The principle that public international law may have effect on the application of civil law rules and principles and hence, indirectly, on contracts, is a widely recognised principle in Swedish law (as well as in EU). For instance, actions of a private party in conflict with public international law are relevant circumstances for courts to consider regarding actions that might trigger a liability to pay damages. In a widely noticed judgement in a tort case, the Swedish Supreme Court recently held that actions by a trade union that violate rights under the European Convention for Human Rights is a relevant factor in determining a trade union's liability in tort, see the Supreme Court's judgement, 17 December 2015, in case nr T 3269-13.
- (1815) In summary, even though a legal norm may not directly regulate a certain contractual relationship so as to supply a mandatory contractual term or invalidate a contractual term, the prohibition might serve as a material and often decisive circumstance in the application of civil law rules,

notably to form the basis for an assessment of unconscionability of a contract term, and hence ground for adjustment under Section 36 of a contract term that stands out as unconscionable in the light of the prohibition in question.

7.1.11.5.8 How adjustment can/shall be done

- (1816) Section 36 of the Swedish Contracts Act is mandatory Swedish law. Thus, when a contractual clause is unconscionable the tribunal *must* adjust it. It is not a question of "appropriateness".
- (1817) Furthermore, when forming its judgement, the Tribunal cannot refrain from formulating a new adjusted content of the unconscionable clause, irrespective of how complicated this may be. For example, in the Profilgruppen case the tribunal stated that a court or a tribunal cannot be content with simply stating that a contract term is unconscionable – it has to give the contract term an acceptable content, cf. the award in the Profilgruppen case, Svea hovrätt, T1085-11, page 24-25.
- (1818) Ideally, the rewriting of the parties' contract should be a normative exercise – the preparatory works states that the Courts should "as far as possible" design their decisions in principle or otherwise in such a way that they can serve as guidance in similar situations. Backdrop law might serve as a benchmark when assessing what should be considered conscionable, even though it may not be attached so much importance that it in practice will become mandatory, cf. Government Bill, 1975/76:81, pages 122-123.
- (1819) However, if the normative exercise encounters obstacles that cannot be overcome, the court or tribunal may perform a freer assessment. In the Profilgruppen decision the tribunal explicitly refrained from giving the limitation of liability clause a "generally acceptable and meaningful content". Instead it carried out a more direct and concrete risk assessment by deciding a limiting amount that appeared to be conscionable with respect to the damage in question, cf. Svea hovrätt, T1085-11, page 24-25.
- (1820) Furthermore, the adjustment can be made even in relation to a historic or future period or event only, and need not to be *ab initio* and forever. For example, in the Profilgruppen case, the

adjustment of the limitation of the liability clause was aimed at one single, concrete and already past malpractice event.

7.1.11.5.9 Failed assumptions should be resolved pursuant to Section 36, not to the doctrine of assumptions

(1821) Failed assumptions by reason of changed circumstances should in the present case be resolved pursuant to Section 36. Hence, Naftogaz does not invoke the Swedish law doctrine of assumptions on a stand-alone basis.

(1822) In the present case, the Parties' assumptions of growth in the European gas market and, respectively, that "competitive" pricing would prevail as a commonly accepted European principle for setting gas transport tariffs have failed. One of the objectives of the claim for tariff revision pursuant to Section 36, is to align the Contract with the assumptions of the Parties when the Contract was entered into.

7.1.11.5.10 Abuse of contractual rights

(1823) It is important to note that Section 36 focuses on the effects of a contractual clause in the present situation and not merely statically on whether a clause as such is unconscionable. Related to this, is the fact that Section 36 can be utilised where the clause as such may not be unconscionable but a party has abused (Sw. *överutnyttjat*) the possibilities offered by the clause.¹¹⁹ This is particularly relevant in respect of Naftogaz' argument as to Gazprom's exploitation of the weaknesses of the present tariff.

7.1.11.5.11 Whether effects on "third parties" must always be disregarded

(1824) By reference to a statement in the Government Bill, Gazprom claims that effects on third parties cannot be taken into account in determining unconscionability under Section 36. This statement is not sufficiently nuanced, see also Lindskog, page 314, questioning the view that external interests can never be considered. The statement in the Government Bill should not be stretched beyond its intended scope as Gazprom seeks to do. Its focus is obviously, as the context shows,

¹¹⁹ Lindskog in *Altaleloven 100 år*.

the effects on "normal" private third parties. It is in fact well established that Section 36 can be used as a tool to adjust contract clauses that conflict with important principles of law or policies designed to protect third parties in the guise of the community at large. Therefore, whereas effects on individual third parties may not be relevant, effects that strike the community in which the parties operate are undoubtedly relevant. In the present case, Gazprom treats the country of Ukraine and the Energy Community as a "third party" the effects on whom should be disregarded. This is a misconceived argument for the reasons just stated.

7.1.11.5.12 Supreme Court precedent as to unconscionability of a tariff clause not in compliance with subsequently implemented tariff regulations based on cost reflectiveness

- (1825) In NJA 1994 p. 359, the Swedish Supreme Court has held that a tariff clause in a contract is unconscionable *per se* if the tariff regulation therein contravenes the tariff methodology (as to water and wastewater) subsequently laid down in administrative legislation.
- (1826) The circumstances in the case were as follows. A company had in the 1950s transferred its water- and sewage pipes to the municipality for a symbolic consideration. In return, certain beneficiaries were to enjoy exemption from connection and sewage tariffs for all future. Subsequently, administrative legislation was introduced stipulating that tariffs had to be set such that the total tariff outtake would be divided among the users on (simplified) a "fair and equitable" basis to cover the municipality's costs. Also, the municipality's cost for sewage treatment increased subsequent to the contract date. The municipality then sought to impose tariffs on one of the beneficiaries of the agreement despite the tariff exemption.
- (1827) The two lower courts simply held that if the tariffs of the contract, assessed from the contract date, materially deviated from the administrative law principle ("fair and equitable basis"), the deviation *per se* should be regarded as unconscionable.
- (1828) The Supreme Court stated the principle laid down in the administrative tariff regulation had to be taken into account in the unconscionability analysis and noted that the difference between the contractual tariff (essentially the value of the property initially transferred, less the symbolic

purchase price because no tariffs were then chargeable) and the required tariff as per the tariff regulation had increased over time, mainly due to the general price- and cost development and the investments made in the municipality's sewage treatment system, and that it was self-evident that such circumstances over time increased the necessity for adjustment. Therefore, the tariff clause of the contract was held to be unconscionable under Section 36 of the Contracts Act.

(1829) The Supreme Court thereafter noted, based on how the parties had argued the case, the court procedurally had only two alternatives for adjusting the contract – the position of the municipality (effectively the immediate termination of the exemption) and the position of the respondent. The court found that the difference between the contractual tariff and the stipulated tariff had not yet become so important that an immediate termination of the exemption was called for and adjusted the contract term to be valid only for as long as the respondent lived on the register property, in line with the position of the respondent (who was a natural person). There was a dissenting minority of two justices who held that since the respondent in his capacity as owner of the register property had been exempted from the fees for forty years, any further exemption would be unconscionable.

(1830) The case exhibits significant correlations with the present case:

- The party seeking an adjustment under Section 36 was not a consumer (a Swedish municipality);
- A tariff regulation was introduced subsequent to the contract date;
- The tariff regulation was based on the costs for the operator of a system (the tariffs had to be cost-reflective, as this is a fundamental legal principle for municipalities in Sweden according to the "*kommunala självkostnadsprincipen*");
- The tariff regulation was based on the principle that the costs for the operator of a system should be distributed by way of tariffication to all users on a fair and equitable (i.e. non-discriminatory basis); and

- A subsequent development accelerating the difference between the cost reflective tariff principle and the tariff.

(1831) Hence, there is excellent support in Swedish Supreme Court precedents for Naftogaz's position that the tariff clause in the Contract is unconscionable. In the present case, moreover, there are several additional factors that point to unconscionability that were not present in NJA 1994 p. 359.

7.1.11.6 Factual circumstances relevant to the contract law claim

7.1.11.6.1 Introduction

(1832) The presentation of the relevant factual circumstances below is structured according to the criteria for contract revision in Section 36. However, the discussion of the Parties' assumptions and the subsequent changes in circumstances may also be relevant to the interpretation of Article 8.7 presented above.

(1833) This presentation of relevant factual circumstances is based on Section V.D of the Expert Report and will serve as the basis for the legal discussion below.

7.1.11.6.2 The contract is unconscionable in itself

(1834) The price (tariff) under the Contract has at least since 2010, failed to reflect the European standard of covering the costs of the TSO. This divergence has been exacerbated by the lower volumes transported through Ukraine since the Contract was concluded. Due to *inter alia* the reduction in transported volumes, Naftogaz is today maintaining gas transport capacity for Gazprom at a net loss, which is unconscionable.

(1835) The imbalance between the Parties' performances, *viz.* the value of the service Naftogaz is asked to perform against the price Gazprom is asked to pay is obvious.

(1836) Even though the price (tariff) was supposed to be "*calculated based on the generally accepted European formula*" (Gazprom's 20 January 2009 press release) from 1 January 2010, Naftogaz

has since 1 January 2010 and already until 31 December 2014 lost USD 11.23 bln in revenues, cf the Expert Report, and subsequently even larger amounts, compared to the revenues which would have followed from the European pricing principles then applicable..

7.1.11.6.3 Circumstances at the conclusion of the Transit Contract

7.1.11.6.3.1 Introduction

(1837) One of the objectives of the claim for revision pursuant to Section 36 is to align the Contract with the assumptions of the Parties when the Contract was entered into, while also adjusting for the adverse effects of the then prevailing circumstances. The following three circumstances at the conclusion of the Contract were decisive for the final content of the Contract:

- Gazprom's interruption of gas supplies and the associated pressure on Naftogaz;
- The Parties' assumption of growth in the European gas market; and
- The Parties' assumption that "competitive" pricing would prevail as a commonly accepted European principle for setting gas transport tariffs

7.1.11.6.3.2 The January 2009 supply and transit interruption

(1838) Gazprom halted all deliveries of natural gas to Ukraine on 1 January 2009. Gazprom had halted deliveries of natural gas to Ukraine before, in 2006, but then the reduction of deliveries for transit to the EU and Moldova lasted only for 3 days and was less significant than in 2009. The situation in 2009 was much worse because Gazprom systematically cut deliveries through the Eastern regions of Ukraine, which could have led to a humanitarian and technological disaster, and because Gazprom first limited, and then completely cut, gas deliveries into the GTS for transit to Europe.

(1839) Also, the halt in supplies took place in the middle of the winter, a critical time of the year when the consumption in the Ukrainian market usually soars due to low temperatures. With no other

gas suppliers available at the time, Naftogaz could only supply the domestic market with natural gas stored in underground facilities.

(1840) Thus, when the Parties met for discussions of a new Transit Contract on 17 January 2009, Naftogaz was hard pressed to accept conditions it, under other circumstances, would not have acceded to.

(1841) Also, citing time constraints, Gazprom would not consider the underlying costs of the pipeline network in conjunction with the calculation of the competitive pricing mechanism prevailing under the Contract, cf. [REDACTED] witness statement. This lack of analysis led to a situation where the tariff quickly failed to reflect Naftogaz' costs of operating the Ukrainian pipeline system, cf. the Expert Report.

7.1.11.6.3 Assumptions of growth in the European gas market BF:JA (SOC (1204))

(1842) The general view of the European gas market in late 2008, as well as in early 2009 when the Contract was entered into, was that the market would continue to grow. In 2008 the International Energy Agency (the "IEA") forecast that European natural gas demand would grow by 1.5% per year up to 2015, adding roughly 1 bcm of gas per year.¹²⁰

(1843) Even though the financial crisis reached an acute stage in late 2008, with the collapse of Lehman Brothers, it took some time before European market participants revised their demand growth forecasts downwards, cf. the Expert Report. And when the Parties signed the Contract on 19 January 2009 it was still not clear whether the financial crisis would have long-term implications for the growth of demand for Natural Gas in Europe.

(1844) At the time the IEA said that:

¹²⁰ IEA, *Natural Gas Market Review*, 2008, page 37.

"[i]n the medium term we expect demand to rebound as the fundamental drivers behind gas demand growth are still present".¹²¹

- (1845) That Gazprom expected a continued growth in European gas demand is also evident from the fact that Nord Stream, two 1.224-kilometre offshore pipelines from Vyborg (Russia) to Lubmin (Germany) for transportation of natural gas from Russia to the energy markets in the European Union, was already commissioned when the Transit Contract was entered into. OAO [???] Gazprom holds 51% of the shares in Nord Stream AG, the Swiss-based company which planned, constructed and operates Nord Stream. The construction of the first pipeline began in April 2010 and by April 2012 both had been completed. Gas transport in the first pipeline started in mid-November 2011. In total, these two pipelines have the capacity of transporting 55 bcm annually from Russia to the European natural gas market.
- (1846) Nord Stream was constructed to meet only 25% of a projected increase in European gas demand, and as complementary to other pipelines.
- (1847) Gazprom's reservation of capacity for transporting the agreed Natural Gas volumes under the Transit Contract, in addition to its role in constructing Nord Stream, confirm that Gazprom expected a substantial growth in the European gas market at the time. Both Parties therefore assumed that, even in the light of the foreseeable increase in gas transport capacity from Russia to Europe, Gazprom would use the full contracted capacity under the Transit Contract. The subsequent drop in transit volumes was unforeseeable.
- (1848) This assumption is also evident from [REDACTED] witness statement. [REDACTED] explains in his witness statement that although the Parties agreed on a minimum annual volume of 110 bcm of Natural Gas to be transported through Ukraine, the Parties also discussed a demand increase in Europe of up to 200 bcm of Russian natural gas. Gazprom explained that 110-120 bcm would

¹²¹ EA, *Natural Gas Market Review*, 2009, page 20.

be transported through Ukraine, while the rest of such volumes would be transported through alternative routes.

7.1.11.6.3.4 Assumptions of competitive pricing as a commonly accepted principle for setting up gas transport tariffs

(1849) When concluded, the Contract was assumed to apply the generally accepted European pricing principles for gas transport. As explained by Gazprom in a contemporary press release:

"Russian gas transit to Europe across Ukraine and gas supplies to Ukrainian consumers were initiated under the agreements reached at night on January 18 by Russian Prime Minister Vladimir Putin and his Ukrainian counterpart Yulia Timoshenko. These agreements stipulate that starting from 2009 both countries switch in their relations in the gas sector to the generally accepted and transparent European gas pricing rules.

[...]From January 1, 2010 the transit rate will be market based and will be calculated based on the generally accepted European formula."

(1850) However, when the Contract was entered into, it was still not clear what the generally accepted pricing mechanism for transportation of Natural Gas in Europe would be. In particular, there was a struggle between the so-called competitive pricing mechanism, which presupposed competition between the transporters operating different pipelines, and the so-called cost-reflective tariff which allowed for a reasonable margin for the transporter.

(1851) The then prevailing EU legislation, Regulation EC No 1775/2005 Article 3 (1), prescribed that tariffs shall reflect actual costs incurred, but also allowed for "*where appropriate, taking account of the benchmarking of tariffs by regulatory authorities*". Thus, the competitive pricing mechanism was a relevant option in late 2008 and the beginning of 2009, when the Contract was entered into.

(1852) At the time, the Parties also assumed that competitive pricing based on agreed and expected transit volumes would cover Naftogaz' costs of transit.

7.1.11.6.4 Subsequent circumstances The later development in the European gas market

7.1.11.6.4.1 Introduction

(1853) The other objective of this claim for revision of the Contract pursuant to Section 36, is to adjust the Contract in line with subsequent circumstances. The main subsequent circumstances relevant to Naftogaz's claims are:

- The decisive establishment of cost-reflective pricing as the generally accepted principle for setting European gas transport tariffs;
- The unexpected and lasting drop in European gas demand after the Contract was concluded; and
- Gazprom's reaction to the drop in European gas demand

7.1.11.6.4.2 The establishment of cost-reflective pricing as the generally accepted European gas transport pricing principle

(1854) The Parties intended to apply standard European pricing principles under the Transit Contract from 1 January 2010 and for the term of the Contract. However, when the Contract was entered into, the generally accepted pricing mechanism for gas transport in Europe was still not decided on. Both competitive pricing and cost-reflective pricing were applied in European gas transportation contracts.

(1855) The competitive pricing mechanism was included as an optional pricing mechanism in the Third Energy Package with Regulation 715/2009, preamble (8), which states that "*benchmarking of tariffs by the regulatory authorities will be a relevant consideration*" when setting tariffs, but only "*if effective pipeline to pipeline competition exists*".

(1856) However, since the introduction of the Third Energy Package in July 2009, the European pipeline operators have rarely been able to demonstrate that such effective competition exists. The standard pricing mechanism for transportation of natural gas in Europe today, is therefore the cost-reflective pricing mechanism. The experts conclude that they cannot see how Gazprom could

demonstrate that the Ukrainian pipeline faces competition, cf. the Expert Report. Thus, based on the agreement to follow the development in Europe, the Parties are bound to revise the Contract accordingly.

(1857) Since the vast majority of the costs accrued by the operation of a gas transportation system are constant, irrespective of the volumes of gas transported, a capacity charge is required to recover the majority of the revenues of a pipeline network, cf. the Expert Report. A capacity charge gives the user a right but not an obligation to deliver gas for transportation. With a cost-reflective tariff the capacity charge is established at a level where it recovers the pipeline's fixed costs, and a commodity charge is added for the amounts of gas actually transported to cover the variable costs of transporting gas. In this way, the pipeline owner is ensured income based on the reservations made, independently of the actually transported volumes.

(1858) In contrast, the revenues under the Contract depend entirely on the volume of gas transported, with only the impractical option of damages available to Naftogaz if Gazprom does not use the reserved capacity. Also, as indicated above, and as further discussed below, the tariff under the Contract does not cover Naftogaz' costs, let alone a reasonable return on the investment, even assuming delivery of the agreed transit volumes.

7.1.11.6.4.3 Decisive changes in the European consumption of natural gas the forming of a European gas glut

(1859) In late 2008 and early 2009, no one foresaw the drop in consumption of natural gas that would take place in the course of the subsequent year, and its lasting effects on the European natural gas market. When the effects of the financial crisis hit the European gas market later in 2009, the main perception was that there would be a dip in the short term, but in the medium term the gas demand would rebound. However, due to several coinciding circumstances, the expected rebound never came. Recent forecasts are that by 2030, Europe will still consume less natural gas than it did in 2008.

(1860) Subsequent circumstances which affected European gas consumption are described in the Expert Report and summarised below:

(1861) The financial crisis led to two prolonged recessions in Europe, which again resulted in a decline in European energy intensive industry due to low economic growth and an emerging cost disadvantage compared to energy intensive industry in North America. With the decline in European energy intensive industry the need for Natural Gas decreased.

(1862) As North America increasingly exploited its own shale gas reserves, its need for coal imports decreased, triggering a significant decrease in coal prices throughout the world, including Europe. These low prices for coal led to a switch in the fuel of choice in European power production, from natural gas to coal, which resulted in a further decline in demand for natural gas in Europe.

(1863) As the prices for natural gas fell in North America, also LNG volumes intended for the North American market were diverted to Europe, further reducing the demand for natural gas through pipelines from Russia.

(1864) Finally, the subsidizing of renewable energy sources by many European countries has resulted in more electricity generation than anticipated from, in particular, solar power sources, which again has reduced the demand to generate electricity by natural gas.

(1865) These circumstances led to the significant reduction in gas consumption in Europe and a "gas glut", which again led to an even more significant reduction in volumes of gas actually transported by Gazprom, cf. the Expert Report.

7.1.11.6.4.4 The major gas suppliers' different responses to the gas glut in Europe

(1866) As described in the Expert Report, the above circumstances led to greater liquidity in the European market for natural gas and, from the third quarter of 2009, led buyers of natural gas under long term gas sales agreements to seek changes in the pricing mechanisms under their respective gas sales agreements.

(1867) Such requests for price revision were handled differently by the different gas suppliers. In particular, it has become evident that Europe's two largest gas suppliers chose radically different approaches.

(1868) The Norwegian oil and gas company, Statoil ASA, showed willingness to change the price mechanism under disputed gas sales agreements, shifting away from the historical oil-linkage towards open market-based pricing, to the point where Statoil in 2015 will have a portfolio with the majority of the gas priced to hubs.¹²²

(1869) This is further confirmed by an article in the Financial Times.

(1870) Gazprom's approach was rather to concede market shares and maintain its high prices, as it explained in a 2011 article in the Russian newspaper Moskovskiye Novosti:

"Deputy director of the Board of "Gazprom", chief executive officer of "Gazprom" export", Alexander Medvedev, noticed this spring in an interview for a corporate editorial, that in export sales the group has made a choice in favour of increase of profits, submitting to the loss of market shares. (Naftogaz' office translation)

(1871) On 9 April 2012, Gazprom's [REDACTED] explained to the Ukrainian newspaper Kyivpost that:

"Choosing between 154 bcm at a lower price and 150 at a higher our choice is to export 150. But 150 is a low volume. It is possible that exports will be higher. Even if they are at 150, the income effect will not decline, the income will be no less than with 164,' he said

During the recent revision of contract terms ' we tried to keep the price level, even if it led to the postponement of part of the [delivery] volumes to later dates,' Medvedev said."

(1872) Thus, Gazprom chose to sell less natural gas to maintain the price level and curtail exports to Europe, including exports that are transported through Ukraine.

¹²² Eldar Sætre, presentation on "Creating value from a strong position", dated 7 February 2013

(1873) The two suppliers' approaches and their effects are described by the energy price reporting and news agency Platts in its article *Gazprom insists on making its gas more expensive* from 2013,

"Gazprom is insisting on making its gas more expensive than customers are happy to pay... Norway, by contrast, has taken a flexible approach that seems better calculated to retain customers. Statoil's market share within Europe is growing at Gazprom's cost, thanks to contractual flexibility, helping to offset the diminished returns from oil linkage", said HIS analyst Roderick Bruce ...Gazprom has so far opted instead to reduce the base price of contracts for customers, retaining both oil-linkage and take-or-pay clauses. Statoil's decision to be first mover on bigger contractual concessions appears to have paid off, with both record volumes sold and higher profits - he said"

(1874) In concrete numbers, Gazprom exports to the 28member states of the European Union fell by 20 per cent between 2008 and 2012. Even though the export rebounded in 2013, the 2014 exports fell to only 58 per cent of the 2008 total, cf. the Expert Report.

(1875) Thus, in its efforts to protect its margins achieved on delivered natural gas, rather than its market share in the European gas market, Gazprom has since 2009 delivered significantly less gas to European customers than anticipated when the Contract was entered into.

(1876) However, while Gazprom has delivered less Natural Gas for transport through the Ukrainian gas transportation system, it has increased the utilisation of Nord Stream, as stated in Reuters' article *UPDATE 1- Russian gas to Slovakia via Ukraine lowest since at least 2011*, dated 15 September 2014:

"Russian gas deliveries entering Slovakia from Ukraine have fallen by about 17 percent since the weekend compared to levels in previous days, representing the lowest volumes since at least 2011, data from Slovak pipeline operator Eustream showed.

[...]

In recent months, a growing proportion of Russian gas shipments to Europe have been sent through the Nord Stream pipeline running from Russia to Germany under the Baltic Sea, avoiding Ukraine and cutting Kiev's income from transit fees.

A spokesman for Nord Stream said current capacity utilisation was about 72 percent, compared to the annual average of 65 percent."

(1877) Thus, the deliveries to the European gas market have to a large extent been transported through Nord Stream and not under the Contract, cf. the Expert Report.

(1878) In the book *Secure Energy for Europe – the Nord Stream Pipeline Project*, the financing of the project was described as easy partly because of the

"self-correcting nature of the cashflow under the GTA [Gas Transportation Agreement] which automatically adjusts to meet debt service. This helped render that key commercial contract which represents Nord Stream's sole source of revenue exceptionally strong and bankable".¹²³

(1879) Thus, apparently, a cost-reflective tariff mechanism is applied for transportation through Nord Stream, securing the investors a satisfying rate of return on their investment. This cost-reflective tariff mechanism also serves as an incentive for Gazprom to maintain the volumes transported through Nord Stream and serves to further explain Gazprom's choice of directing natural gas deliveries to Europe through Nord Stream rather than through Ukraine.

(1880) Thus, Gazprom has willingly reduced the gas volumes transported to Europe. By holding back volumes meant for Europe while at the same time not compensating Naftogaz, Gazprom has in effect transferred parts of the costs of its approach towards the market development, to Naftogaz and thereby protected its own revenues at Naftogaz's expense, cf. Section V.D.5 of the Expert Report.

¹²³ *Secure Energy for Europe – the Nord Stream Pipeline Project*, 2013, page 107.

7.1.11.6.5 Gazprom's objections - Naftogaz' bargaining position at the time of the conclusion of the Contract and its detrimental effect on the contents of the Contract

- (1881) Gazprom argues that Naftogaz did not have an inferior bargaining position. Gazprom relies on (i) Naftogaz' alleged countervailing buyer power and its position as the holder of the Ukrainian GTS, (ii) [REDACTED] witness statement, and (iii) an alleged missing connection between Naftogaz' claim for revision of the transit tariff and Gazprom's bargaining position.
- (1882) Gazprom's allegations of countervailing buyer power have been rejected. Also, Gazprom's actions in January 2009 endangered the health and safety of the population in South-eastern Ukraine as well as the technical integrity of the Ukrainian GTS, putting significant pressure on Naftogaz.
- (1883) The very significant differences between Naftogaz' negotiation position elaborated on above, set out in *inter alia* the memo of 23 December 2008, and the final version of the Contract, strongly suggest that Gazprom interrupted gas deliveries to set up the bargaining positions of the Parties before a final round of negotiations. The starting point in the latter round of negotiations was a draft by Gazprom where the principles were non-negotiable and only minor adjustments could be made.

7.1.11.6.6 Gazprom's objections - The content of the provision the price is unconscionable in itself

- (1884)) According to Gazprom's press release of 20 January 2009, the price (tariff) for 2009 was considered preferential while the price (tariff) for the years 2010-2019 was supposed to be market reflective.
- (1885) However, even though the price (tariff) under the Contract was reflective of the price level in the European gas transportation market in 2010, the underlying basis for the price (tariff) calculation was not. While other transporters have their costs covered under the transportation agreements based on cost-reflective pricing, Naftogaz receives a compensation for its services which results in a net loss, even assuming the delivery of the agreed volumes for transit in each year.

(1886) With time, this divergence has only increased, in step with the decrease in volumes transported through Ukraine under the Contract.

(1887) Such disparity between the values of each party's services is reason to intervene pursuant to Section 36, cf. *inter alia* Government Bill, 1975/76:81 pages 118-119 and 125-128 and NJA 1983 p. 332.

(1888) The adjustment pursuant to Section 36 should result in a price (tariff) which is conscionable in itself, i.e. restoring the balance between the Parties' performances: Naftogaz' costs of maintaining and operating the transportation system and Gazprom's payment for Naftogaz' services.

7.1.11.7 Gazprom's objections - The Contract tariff has always been and remains unconscionable

7.1.11.7.1 Gazprom's objections - The Contract Tariff was unconscionable when the Contract was entered into

7.1.11.7.1.1 The tariff is unconscionable in itself

(1889) Gazprom relies on the description of the tariff in 2010 by Naftogaz that "*even though the price (tariff) under the Contract was reflective of the price level in the European gas transportation market in 2010, the underlying basis for the price (tariff) was not*". Based on this, Gazprom alleges that there is no disparity between the values of the Parties' performances, since Naftogaz provided transit services and Gazprom paid a market reflective tariff for such services. However, "market prices" were not reflective of value under the legacy contracts until the introduction of the Third Energy Package in September 2009.

(1890) As also demonstrated above, the tariff was unfair and unconscionable in itself when the Contract was entered into, as it failed to cover Naftogaz's costs, cf. also the Expert Reply.

(1891) In this regard, the PFC report from 2010, commissioned by Gazprom Export and relied upon by Gazprom in these arbitration proceedings, describes the formula as inherently dysfunctional, as

"[i]t is possible to envisage a scenario where tariffs could decrease under the contract even while general price levels increase".

(1892) As Lindskog points out, p. 322, a typical case for adjustment of a commercial contract by Section 36 is when a clause already from the outset was defective although the defect would only become apparent upon a certain development. This is the exactly the case in this case.

7.1.11.7.1.2 Gasprom's objections - The tariff does not cover Naftogaz' costs

(1893) Gazprom alleges that Naftogaz did not propose a cost-reflective tariff during the negotiations and that both Parties assumed that the transit tariff would cover Naftogaz' costs. Allegedly, the failure to take into account Naftogaz' underlying costs cannot be said to be unconscionable in such circumstances. However, Gazprom's argument misses the point. It is precisely because the Parties assumed that the tariff would cover Naftogaz' costs while in reality it did not, that the tariff is unconscionable. Gazprom's allegation that Naftogaz did not propose a cost-reflective tariff is also false.

(1894) Moreover, the failure to take Naftogaz' costs into account was a result of the strong-arm tactics employed by Gazprom in the final negotiations.

(1895) Gazprom argues that Naftogaz has not provided any evidence to the effect that the tariff does not cover Naftogaz' costs, the majority of the costs to Naftogaz operating the GTS being the costs of fuel gas. This is incorrect, and was thoroughly rejected above.

(1896) Gazprom also alleges that the GTS itself is fully amortised. This argument has been rejected comprehensively above and in the Expert Reply.

(1897) Further, Gazprom argues that:

- The Energy Community Secretariat's Preliminary Assessment is hypothetical on the topic of costs

- Naftogaz has not provided any evidence that all other transporters have all of their costs covered
- Pursuant to the Third Energy Package, not all costs can necessarily be covered, only costs corresponding to those of an efficient and structurally comparable network operator

(1898) With regard to (i), the structure of the formula implies in itself that Naftogaz would not get its costs covered. This is also demonstrated by PFC's description of the formula's workings in its report. Concerning (ii), it is mandatory EU law that the TSOs shall have their costs covered. Finally, when it comes to (iii), Gazprom has not even tried to demonstrate that the costs incurred by Naftogaz when providing transport services to Gazprom are not those of an efficient and structurally comparable network operator.

(1899) Gazprom argues that "*it is not possible to say that a tariff calculated on a cost reflective or other basis is reasonable or unconscionable per se*". This is incorrect as a matter of Swedish law.

(1900) As explained above, the very concept of unconscionability includes, when possible, a measurement against the prevailing legal norms that are relevant to the legal relationship even if the norms do not as such apply so as to substitute the parties' contractual regulation. As pointed out by the Swedish legislator, there is a particularly strong reason to use Section 36 to align a contract with commercial administrative law (which includes energy law), cf. Government Bill 1975/76:81 p. 81. Indeed, this is one of the main reasons behind Section 36. Using Section 36 in this fashion is also a technique endorsed by the Swedish Supreme Court (cf. NJA 1999 p 408). As it has been established through the Third Energy Package that any pricing methodologies except cost reflective pricing are *prohibited*, it follows that there is an existing norm of considerable force and importance that makes it quite possible and in fact compelling to say that the Contract tariff, which is calculated on a non-cost reflective basis, is not reasonable and is unconscionable per se.

7.1.11.7.1.3 Gazprom's objections - The tariff is unconscionable having regard to other circumstances when the Contract was concluded

- (1901) Gazprom argues that it did not hold a dominant position and that Naftogaz does not claim that such a position was used to negotiate an unconscionably favourable contract for itself.
- (1902) This is a misinterpretation at best. It is Naftogaz' view that Gazprom held a dominant position and that Gazprom used this position to obtain a tariff which was unconscionably favourable for itself. Essentially, Gazprom leveraged its position as the dominant and pivotal gas supplier to Ukraine and parts of Central and Eastern Europe by cutting supplies in the middle of winter, first to Ukraine and then to other European countries and Moldova, to obtain advantages under the Contract, in particular in terms of the tariff.
- (1903) The differences in bargaining position are evident from a simple comparison between the most important provisions of the Transit and Sales Contracts:
- (1904) The mismatch between the transit tariff under the Gas Transit Contract and the Contract Price under the Gas Sales Contract is evident. While the Contract Price under the Sales Contract was increased by more than 100 per cent compared to the price under the previous agreement on gas purchases, from USD 179.5 to a Contract Price of USD 380 in 2009 and from 2010 exceeding USD 450, a price which has far exceeded the level of European gas prices with or without transportation costs, the tariff for transportation services was only increased by USD 0.1 in 2009 and thereafter with 25 per cent from 2010. Thus, in these two contracts Gazprom, under cover of introducing "European pricing principles" succeeded in introducing to Ukraine one of the absolute highest price levels for Natural Gas, while keeping the tariff for transit very close to the historic levels that it had enjoyed under the gas for transit schemes.
- (1905) Naftogaz also refers to its arguments in the Gas Sales Arbitration where Naftogaz has shown how Gazprom leveraged its position to obtain wholly unreasonable and even unlawful provisions in the Gas Sales Contract which was concluded simultaneously with the Contract.

(1906) This serves to demonstrate that Gazprom had a very strong negotiating position and exploited this to the full to obtain two Contracts of high value with very favourable conditions that it had not obtained but for this profound imbalance in negotiation power.

(1907) Further, Gazprom argues that neither the Parties' assumption of growth in the European gas market, nor the assumption that competitive pricing would prevail as a commonly accepted European principle for setting gas transportation tariffs could make the tariff unconscionable at the time when the Contract was entered into. However, these assumptions later failed, making the tariff in the Contract unconscionable due to subsequent circumstances and in the light of all circumstances as a whole.

7.1.11.7.2 Gazprom's objections - The tariff is unconscionable having regard to circumstances in general

(1908) Gazprom also asserts that the Contract's deviation from other European contracts does not make the Contract unconscionable stating that (i) the Contract was entered into after extensive negotiations between two well-advised parties and (ii) that there are many different types of contract and no party has the right to require a particular type of contract.

(1909) With regard to (i), Naftogaz has demonstrated above and in the Gas Sales Arbitration, that the Transit Contract in practice resulted from three days of intense negotiations based on a Gazprom draft where the major issues only to a very limited extent were open to negotiation. It was not the result of extensive negotiations but of what turned out to be close to a "take it or leave it" proposition presented by Gazprom, after it had reminded Naftogaz of the consequences if it did not yield to Gazprom's demands. Had the Contract been the result of extensive negotiations between Parties in more or less equal bargaining positions, the Contract would have been much less unbalanced.

(1910) Also, Gazprom's argument totally disregards that the Parties' intentions when the Contract was entered into was to align the Transit Contract with the European principles for transit. Despite this intention, expressed *inter alia* in the Intergovernmental Memorandum and the Agreement

on principles of 2 and 16 October 2008 respectively, as well as in Gazprom's press release upon conclusion of the Contract, the Contract with its tariff calculation mechanism actually did not reflect the prevailing principles for transportation of gas pursuant to mandatory EU competition and energy law.

(1911) Lindskog, p. 322-323, is of the view that a case which "*generally is relatively easily assessed*" under Section 36 is where a clause has received a content that did not in fact correspond to the parties' intentions, citing a Norwegian arbitral award where Section 36 (or rather, the equivalent provision, in the Norwegian Contracts Act) was used to adjust a clause in a commercial relation.

(1912) Thus, the Contract with its tariff calculation mechanism does not reflect the stated intentions of the Parties, and also for this reason has to be revised due to circumstances in general when the Contract was concluded.

7.1.11.7.3 Gazprom's objections - The Contract Tariff is unconscionable due to subsequent circumstances

7.1.11.7.3.1 Changes in EU energy law render the tariff unconscionable

(1913) Gazprom states that "*there is nothing in the regulatory changes that renders Contract TKGU or any term of Contract TKGU, unconscionable*".

(1914) However, as explained above, the preparatory works point specifically to contract terms contrary to legislation relevant to the legal relationship as an example of when Section 36 shall be applied, cf. Government Bill 1975/76:81, page 121, and C. R. von Post *Studier kring 36 § avtalslagen med inriktning på rent kommersiella förhållanden*, page 140.

(1915) There have been significant changes in European regulation since the Contract was entered into, in particular, the introduction of capacity based entry-exit systems as mandatory methodology and the removal of exemptions for transit contracts. This has rendered the tariff provision in Article 8.1 of the Contract unlawful as contrary to mandatory European competition and energy law as well as Ukrainian law and thereby unconscionable and subject to revision pursuant to

Section 36. In the context of determining unconscionability it is of no concern whether any of these legal provisions *apply* to the Contract such as to cause invalidity and or replacement of any clauses. It is sufficient that these norms are clearly designed to apply to transit of gas in Ukraine.

7.1.11.7.3.2 The decline in volumes of gas delivered for transportation renders the tariff unconscionable

(1916) Gazprom argues that "*the fact that Naftogaz has earned less money does not render Contract TKGU, or the tariff payable thereunder, unconscionable*". This argument does not respond to Naftogaz' detailed explanation of why the decline in gas volumes delivered for transport has made the tariff unconscionable. In particular, Gazprom does not even attempt to respond to Naftogaz' allegation that Gazprom deliberately has exploited the weaknesses of the current tariff under the Contract to protect itself against the unexpected market developments at Naftogaz' expense.

(1917) The deviations from the Parties' original assumptions due to subsequent circumstances are very significant. Gazprom's volume obligations were not discussed in detail when the Contract was concluded, since both Parties expected that Gazprom would continue to transit at least 110 bcm of Gas annually, as it had done in previous years under previous contracts. In fact, under the 2002 transit agreement Gazprom never failed on its volume obligations. During the 2009 negotiations the main question was whether Naftogaz could confirm that it had the capacity to transit the minimum volumes.

(1918) The Parties assumptions with regard to necessary transit volumes were also reflective of the general view at the time, cf. the Expert Report.

7.1.11.7.3.3 Gazprom's objections - Neither the changes in European energy law nor Gazprom's sudden diversion of gas flows were foreseeable when the Contract was entered into

(1919) Gazprom states that circumstances that were foreseeable when the Contract was entered into, cannot be claimed to constitute subsequent circumstances relevant for the consideration pursuant to Section 36, and that both the changes in European regulation and the fall in gas demand were foreseeable when the Contract was entered into.

(1920) This is incorrect.

(1921) The intention of the Parties was to enter into a transparent transit agreement in accordance with European standards, and they did not foresee that the capacity-based entry-exit system would be the sole legal option for calculating tariffs under the Third Energy Package, when they entered into the Contract. In particular, in late 2008 and early 2009 the contract path methodology was an applied principle in legacy contracts which had been exempted from the Second Energy Package. If the Parties had foreseen that the tariff would become unlawful in a mere 12 months' time, they would have agreed on another tariff.

(1922) If Gazprom did foresee that the capacitybased entry-exit tariff system would become mandatory under European competition and energy law, but intended to sidestep the impending mandatory rules, the tariff could still be revised pursuant to Section 36. This is so even if this was not even the intention but merely the effect.

(1923) Finally, foreseeability of a change in circumstance is but one of many factors in the overall assessment of unconscionability. It is not a decisive factor in and of itself.

(1924) With regard to volumes, Gazprom's expressed goal of obtaining Naftogaz' transportation capacity of 110 bcm per year, cf. Article 3.1 of the Contract, demonstrates that the Parties did not foresee the subsequent drop in European gas demand.

(1925) Further, when the Contract was entered into in January 2009, no market participants foresaw the impact the financial crisis was to have on the gas markets over the following years.

(1926) With regard to the gas industry as a whole, this is demonstrated by the statement from the IEA and in the Expert Report. In this regard, Naftogaz also recalls from the negotiation history that the Parties expected European gas consumption to keep increasing. Gazprom planned to cover such increased need for gas in Europe by transiting at least 110 bcm through Ukraine and by transporting additional gas through Nord Stream.

(1927) Adjustment under Section 36 is not excluded where a development was to some degree foreseeable. In particular this is the case when the ultimate effects of the foreseeable development were unforeseeable (see Lindskog, p. 324, footnote 47, noting that a distinction between these situations is not self-evident) and obviously even more so when the actual effects were aggravated by the other party.

7.1.11.7.3.4 Gazprom's objections - The changes to European regulation and the drop in European gas demand and the effects thereof render the tariff unconscionable pursuant to Section 36

(1928) The changes to European regulation render the regulation of the tariff in Article 8.1 of the Contract unlawful as contrary to mandatory European competition and energy law, and as such unconscionable pursuant to Section 36.

(1929) The sudden subsequent drop in European gas demand and the effects thereof lead to a situation where Naftogaz transited gas for Gazprom at a constant loss of USD 2.04/1000 m³ per 100 km already in 2010. The tariff is therefore unconscionable pursuant to Section 36.

7.1.11.7.4 Gazprom's objections - The situation under the Contract is exactly the kind of situation that implies application of Section 36

(1930) Gazprom argues that the Supreme Court cases NJA 1923 p. 20, NJA 1930 p. 507, NJA 1983 p. 583 and NJA 1994 p. 359 referred to by Naftogaz are not similar to the present case. In these cases, "*the change in circumstances was exceptional and long lasting*". Then, Gazprom argues, that in the case at hand, Naftogaz cannot point to any exceptional change in circumstances.

(1931) Since the changes in circumstances relied on by Naftogaz are in fact exceptional.

(1932) The changes in circumstances have rendered the tariff contrary to mandatory law. Also, rather than earning a margin for its provision of transportation services, Naftogaz (Ukrtransgaz) is transiting gas for Gazprom at a constant loss. Thus, also the consequences of these changes in circumstances are exceptional.

- (1933) The changes in circumstances are also long-lasting. The changes took place in the course of the first year after the entering into of the Contract, and will most probably last until the Contract expires eleven years later. Thus, the subsequently changed circumstances, will prevail for very nearly the whole contract period.
- (1934) In addition, the current case is very similar to NJA 1983 p. 385, in particular if the Arbitral Tribunal would find that the tariff revision clause is not wide enough to align the tariff and the tariff methodology to developments in the market. The Supreme Court pointed out that the link of the contract price to the price of wheat was *a manifestation of the intent* of the contracting parties to compensate the landowner for the deterioration of the value of money. However, the court continued, the index clause had not enabled the intended adjustment in line with the general price trend. Consequently, the Supreme Court substituted the link to the price of winter wheat with a consumer price index clause, see NJA 1983 p. 385.
- (1935) The same logic would apply here. The Parties intended to include a clause capable of aligning the tariff to developments in the market but in fact failed to achieve a clause that operated once this occurred. Given the Parties' demonstrated willingness to allow changes to the tariff, it is easier to secure the balance of the Contract by using Section 36, as it is in line with the Parties' original overall intentions.
- (1936) According to the views of Lindskog, page 322-323, there are strong reasons to adjust clauses that are pathological although the actual effects only appear at a later stage due to certain developments, and clauses which do not reflect the parties' overall intentions should generally be adjusted.
- (1937) Gazprom's arguments must consequently be rejected.

7.1.11.7.5 Consideration of all relevant circumstances

- (1938) Finally, unconscionability is assessed on the basis of all relevant circumstances and primarily focuses on the effects of the application of the clause in the particular case, and less on the clause

itself, see Lindskog in *Aftaleloven 100 år*, p. 325. It is therefore useful to recall the totality of pertinent facts:

- Gazprom's coercion at the time of the Contract;
- The overall effect of the Gas Sales Contract and the Contract and the overall imbalance created by these two Contracts;
- The changed circumstances as to tariff methodology, which were long lasting, exceptional and unforeseen;
- The changed circumstances as to the volumes to be transited, which were long lasting, exceptional and unforeseen;
- The deviation of the Contract from standard contracts in the gas transit market;
- The fact that the tariff is discriminatory;
- The incongruent development of the price for gas in the Sales Contract and the transit tariff in the Contract;
- The contravention of the mandatory tariff regulations of the Third Energy Package;
- The sanctions that could be imposed on Naftogaz and Ukraine for failing to adjust the Contract to such regulation in breach of the ECT;
- Gazprom's continued refusal of a revision of the tariff;
- Gazprom's utilization of this Contract together with other contracts as part of a general scheme to hinder competition in Central and Eastern Europe;
- Gazprom's answer to the Ukrainian authorities that only this Tribunal has jurisdiction over the Contract while at the same time rejecting any changes to the Contract in this arbitration;

- Gazprom's abuse of the weaknesses of the tariff and the Contract (cf, paragraphs 1243 and 1246 of the SoC and Lindskog, p. 306, footnote 3, pointing out that a reason for adjustment can be the abuse of the contract clause);
- The abuse/leveraging of Gazprom's dominant position, which is relevant under Section 36 even if the Tribunal may have found that some prerequisite under Article 102 TFEU for the application of that provision has not been fulfilled, cf. Bernitz, Den svenska konkurrenslagen, page 84 et seq.;
- The positions taken by Gazprom in this arbitration, deviating from the stated intentions of the Parties and Naftogaz's original understanding of Gazprom's position in terms of volume commitments and the operation of the tariff clause

7.1.12 The claims for compensation for underpayments of transit volumes of natural gas, and for payment for underdeliveries for transit based on the amended Article 8

7.1.12.1 Introduction and overview

(1939) In addition to the claims for replacement of invalid and ineffective provisions, and the claim for revision of the transit tariff based on Swedish Contract Law, Naftogaz submits monetary claims as specified below.

(1940) An amended, cost-reflective tariff with a fixed large capacity charge is applicable from 1 January 2010. Naftogaz is consequently entitled to receive an additional payment for its transit services in accordance with such amended, higher, tariff.

(1941) Naftogaz is entitled to receive compensation for Gazprom's underdeliveries of transit volumes of Natural Gas in 2009, based on the then existing price (tariff) and volume commitments.

(1942) In the alternative, and in addition to the claim for damages for underdeliveries in 2009 on the basis of the then existing tariff and volume commitments, should the Tribunal find that the replaced or revised tariff is applicable only from 1 February 2011, Naftogaz is entitled to compensation for damages caused by Gazprom's underdeliveries from 1 January 2010 to 31 January

2011 on the basis of the unamended tariff, together with an additional payment for its transit services from 1 February 2011 in accordance with the amended tariff.

(1943) Further in the alternative, and in addition to the claim for damages for underdeliveries in 2009, should the Tribunal find that the replaced or revised tariff is applicable from any later date than 1 February 2011, Naftogaz is entitled to compensation for underdeliveries from 1 January 2010 until the effective date of amendment of Article 8, together with compensation for underpayment for the period from the effective date of the amendment of Article 8, in accordance with the amended tariff.

(1944) Still further in the alternative, and in addition to the claim for damages for underdeliveries in 2009, should the Tribunal not grant the claim for amendment of the tariff, or only grant it from 1 January 2015, Naftogaz is entitled to compensation for damages caused by Gazprom's underdeliveries, based on the unamended tariff

(1945) The monetary claims based on the replaced or revised Article 8 are based on a regular application of the tariff provisions, as they result from the Arbitral Tribunal's award. Naftogaz has estimated that under a cost-reflective tariff compliant with the requirements pursuant to EU competition and energy law, the price (tariff) that Gazprom has effectively paid under the invalid tariff provisions currently set out in Article 8.

(1946) The objective of Naftogaz' claim for additional payments for transit services from 2010 based on the replaced or revised Article 8 is thus to enforce these provisions with effect from 1 January 2010, the effective date of their amendment.

(1947) Naftogaz' principal claim for underpayments and underdeliveries is now USD 14.865 billion, compared to a principal claim of USD 8.995 billion as set out in Naftogaz' pleading of 25 September 2017, which updated Naftogaz' relief sought in its Post-Hearing Brief of 22 December 2016.

(1948) Naftogaz' capital monetary claims are a combination of compensation for underdeliveries and compensation for underpayments, depending on the point in time from which the Tribunal will find that the revised, cost-reflective tariffs apply. Thus, in each combination, the underdelivery claim runs until the day before the underpayment claim starts.¹²⁴

(1949) In the period after 31 July 2016, Gazprom has not paid cost-reflective tariffs. Thus, Naftogaz has underpayment claims for this period in an amount between USD 2.452 billion and USD 4.881 billion, depending on the approach to VAT taken.¹²⁵ Gazprom was also in breach of its minimum transit obligation for the entire year of 2017. Thus, Naftogaz has an underdeliveries claim for this period of USD 0.274 billion.¹²⁶

(1950) Naftogaz takes account of the outcome of the Sales Arbitration, and updates the calculations of the fuel gas costs in accordance with the revised Factual Price under the Sales Contract as set out in the Sales Final Award. This affects both the underpayments and underdeliveries claims.

(1951) The fuel gas issue has been thoroughly debated between the Parties, having been the subject of several submissions and expert reports.¹²⁷ In particular, the Parties' experts have developed two opposing models for the calculation of fuel gas savings, i.e. Dr Hesmondhalgh's so-called "total flows", and Dr Moselle's so-called "Alternative IV" model. In updating Naftogaz's fuel gas calculations for the revised Factual Price in the Sales Arbitration, Dr Hesmondhalgh has also provided alternative calculations based on Gazprom's approach.¹²⁸

(1952) Naftogaz updates its calculations in respect of VAT.¹²⁹ Prior to 1 January 2016, transit revenues were not subject to VAT, and instead Naftogaz had to pay royalties based on the volumes

¹²⁴ Cf. § 4 Brattle 9.

¹²⁵ Cf. § 11 Brattle 9.

¹²⁶ *Ibid.*

¹²⁷ Cf. *inter alia* Gazprom's pleadings of 19 December 2016 and 22 March 2017 with accompanying documentation, as well as Naftogaz's pleadings of 10 February 2017 and 3 May 2017 with accompanying documentation.

¹²⁸ Cf. Appendix C Brattle 9.

¹²⁹ Cf. Section II.D. Brattle 9.

transited. Since 1 January 2016, transit revenues are subject to a 20% VAT.¹³⁰ In addition, Naftogaz recalls that compensation for underdeliveries under the Contract is subject to VAT.¹³¹

(1953) In Brattle 9, Dr Hesmondhalgh refers to her explanations in her earlier reports where she described the effects of VAT both for the underpayment claims and the underdeliveries claims.¹³² In order to ensure that Naftogaz' updated calculations encompass both Naftogaz' and Gazprom's views of the correct approach to VAT, Dr Hesmondhalgh has provided updated calculations under three approaches:

- the "VAT in the award" approach, which entails specifying the relevant VAT amounts as part of the Final Award. This is the correct approach in respect of the underpayment claims for 2016 and 2017;¹³³
- the "VAT on the award" approach, which "grosses up" the claims to ensure that Naftogaz retains the correct sum of money once VAT has been applied to the Final Award. This is the correct approach in respect of the underdeliveries claims for the years up to and including 2015,¹³⁴ and is the approach that the Ukrainian tax authorities will adopt also to the underpayment claims if the Final Award does not specify the amount(s) of VAT included in any capital amount(s) awarded¹³⁵;
- the "VAT ignored" approach, which ignores all VAT issues altogether. This is the approach that Gazprom has argued should be taken.¹³⁶

¹³⁰ Cf. §§ 9-10 of Naftogaz's Explanatory Note on the Underdelivery Claim, dated 22 December 2016 (T-A 17).

¹³¹ *Ibid.*, § 11 *et seq.*

¹³² Cf. in particular § 21 Brattle 9.

¹³³ As explained above, prior to 1 January 2016 transit revenues were not subject to VAT.

¹³⁴ Dr Hesmondhalgh explains that for the underdeliveries claims for 2016 and 2017 no VAT compensation is necessary, cf. § 21(ii) Brattle 9.

¹³⁵ Due to this practice of the tax authorities and to ensure that Naftogaz receives the correct amount even if the Tribunal should opt to not specify the amount of VAT within the amount(s) awarded, Naftogaz principally claims the higher amount resulting from the "VAT on the award" approach, alternatively the lower amount resulting from the "VAT in the award" approach subject to specification of the VAT included, cf. items 4, 5.2 (ii) - (iii) and 7.1 of Naftogaz's updated relief sought, Annex 1 to this Pleading.

¹³⁶ Cf. Gazprom's rebuttal on the royalties issue and response to Naftogaz's new VAT claim, dated 10 February 2017 (T-A 21).

- (1954) Naftogaz maintains its principal position that the Transit Contract volume provisions, including Article 3.2, have to be revised to conform to Ukraine's international obligations and implementing legislation.
- (1955) Naftogaz' claims for compensation for underdeliveries are based on a regular application of the provisions of the Contract on volumes of Natural Gas transit, cf. Article 3 of the Contract, and on the general liability provision in Article 10.
- (1956) Under Article 3 of the Transit Contract, Gazprom committed to deliver specific volumes of Natural Gas for transit. However, the transit volumes actually delivered were smaller than the contracted volumes. Therefore, Gazprom is in breach of the Contract, and Naftogaz has a claim for damages under Article 10.1 of the Contract.
- (1957) The objective of Naftogaz' compensation claims is to hold Gazprom to its contractual commitments and give Naftogaz compensation for transit capacity reserved and maintained for, but not used by, Gazprom under the Contract in 2009, and thereafter, depending on the effective date of amendment of Article 8.
- (1958) The monetary claims based on the replaced or revised Article 8 are based on a regular application of the tariff provisions, as they result from the Arbitral Tribunal's Award. Naftogaz has estimated that under a cost-reflective tariff compliant with the requirements pursuant to EU competition and energy law, the price (tariff) which Gazprom should have paid since 1 January 2010 for Naftogaz' transit services is significantly higher than the price (tariff) that Gazprom has effectively paid under the invalid tariff provisions currently set out in Article 8.
- (1959) The objective of Naftogaz' claim for additional payments for transit services in 2010-2017 based on the replaced or revised Article 8 is thus to enforce these provisions with effect from 1 January 2010, the effective date of their amendment.
- (1960) Below, Naftogaz specifies Gazprom's underdeliveries during the years 2009-2017, with submission of the relevant evidence, giving rise to claims pursuant to Article 10.1.

(1961) Naftogaz first sets out the calculation of the claim for damages for underdeliveries in 2009, which is now estimated at only USD 204 million instead of USD 475 million, included in the third Brattle report. The reason for the decline is that Dr Hesmondhalgh took account of avoided fuel gas costs in 2009 for the first time in the fifth Brattle report.¹³⁷

(1962) Then, Naftogaz sets out the calculation of the claim based on underpayment for the years 2010-2017 based on the replaced or revised Article 8. These two claims are Naftogaz' principal monetary claims. Further, Naftogaz sets out the monetary claims in the alternative, which are additional to the claim for damages for underdeliveries in 2009.

(1963) In particular, Naftogaz sets out the combined claim in the alternative for compensation for underdeliveries of transit volumes of Natural Gas from 1 January 2010 to 31 January 2011, and for additional payments for transit from 1 February 2011 to 31 December 2017 based on the replaced or revised Article 8.

(1964) Then, Naftogaz sets out the combined claim based on underdeliveries from 1 January 2010 until the tariff is amended and for additional payments thereafter.

(1965) The calculation of interest on Naftogaz' monetary claims is explained below in the context of the summary of the claims.

7.1.12.2 The legal bases for the claims

7.1.12.2.1 Article 3 of the Contract sets out binding volume obligations

(1966) The volumes of Natural Gas for transit through the territory of Ukraine from 2009 to 2019 are set out in Article 3 of the Contract, which has been presented in general terms above.

(1967) For ease of reference, the relevant part of Article 3.1 of the Contract is reproduced below:

¹³⁷ *Naftogaz' Claims related to the Gas Transit Contract of 19 January 2009. A sixth report*. Prepared for NJSC Naftogaz by Dr Serena Hesmondhalgh, dated 10 February 2017, "Brattle 6", p. 5.

"From 2009 to 2019 inclusive, [Gazprom] shall transfer to [Naftogaz] the Natural Gas for transit to European countries in the volume of at least 110 (one hundred ten) billion m³,¹³⁸ except for the years 2011-2015, on an annual basis at the Acceptance and Delivery Points on the border of the Russian Federation - Ukraine, the Republic of Belarus - Ukraine, the Republic of Moldova - Ukraine, and [Naftogaz] shall ensure its acceptance and further transit through the territory of Ukraine to the Acceptance and Delivery Points on the border of Ukraine with Romania, Hungary, Slovakia, Poland and Moldova." (emphasis added by Naftogaz)

- (1968) Article 3 was first amended and supplemented by [REDACTED], which [REDACTED] subsequently, the volume provisions [REDACTED] which further regulated the quantities to be delivered.
- (1969) Article 3.1 sets out a minimum quantity obligation for the transfer of Natural Gas for transit under the Contract.
- (1970) The wording of the Contract is clear: Gazprom is obliged to deliver *at least* 110 bcm of Natural Gas to Naftogaz for transit to European countries (hereinafter referred to as the "minimum transit obligation") for the entire duration of the Contract, unless otherwise agreed, cf. also Article 3.2 of the Contract.
- (1971) In [REDACTED]
- (1972) In Article 3.1.1 of the Contract, the Parties agreed on the exact volume commitment for the year 2009. Further, the Parties agreed on specific annual volumes for the years [REDACTED] Pursuant to Article 3 of the Contract

¹³⁸ The Russian original text uses the expression «НЕ МЕНЕЕ» which literally means «not less than».

as amended, the annual transit volume shall be 120.083 bcm in 2009, [REDACTED]
[REDACTED]

(1973) For the year [REDACTED], the Parties did not agree on an exact volume commitment. Rather, they agreed that the transit volume would [REDACTED], cf. Article 3.1.2 as amended [REDACTED]. Read in conjunction with the minimum transit obligation of 110 bcm set out in Article 3.1, [REDACTED], but not less than 110 bcm.

(1974) The provision on the minimum transit obligation and the provisions setting out specific annual volumes are as binding as any other provision under the Contract. This follows directly from the wording, and is also confirmed by the fact that the Parties estimated the cost of the transit services for the years [REDACTED] on the basis of the volumes agreed and the tariff applicable, cf. Article 8.5 of the Contract as amended by [REDACTED].

(1975) Further, Naftogaz entered into the Contract relying on Gazprom's assurances and the clear understanding that the minimum transit obligations are binding.

(1976) That the quantities agreed upon are binding is also a reasonable interpretation. It would be unreasonable for Gazprom to be able to reserve capacity in Naftogaz' transmission network with no corresponding obligation to actually use and pay for that capacity, in this case, enforceable by way of claims for damages.

(1977) The Transit Contract does not include a ship or pay obligation. However, Article 3 of the Contract sets out specific quantity obligations which are binding on the shipper, and which therefore may give rise to damages claims under Article 10.1. In a claim for damages for underdeliveries, in order to determine the compensation due, the cost savings associated with the smaller volumes actually transited in the system must be deducted from the lost revenues attributable to the

underdeliveries. This is also the main difference between a ship-or-pay claim and the present claims for damages for underdeliveries.

(1978) The shipper's minimum transit obligation is of paramount importance in the present instance, considering that the Transit Contract specifically obliges the transporter to maintain the gas transportation system, cf. Article 4.5 of the Contract.

(1979) In other words, there would be an evident imbalance in the Contract if Naftogaz were obliged to reserve capacity for Gazprom and to ensure the "*reliable and continuous functioning of the gas transportation system of Ukraine*", cf. Article 4.5 of the Contract, if Gazprom were not obliged to deliver the agreed volumes of Natural Gas for transit.

(1980) Below, Naftogaz presents relevant excerpts from the volume provisions as amended and supplemented by [REDACTED], which show the transit volumes that the Parties have agreed upon for each of the years [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

(1981) Thus, bearing in mind the minimum transit obligation of 110 bcm which applies unless otherwise agreed, the Natural Gas volumes which Gazprom agreed to deliver for transit for the years [REDACTED] [REDACTED] may be broken down as follows:

Year(s)	Transit volume obligation
2009	120.083 bcm

[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]

(1982) Each of these quantities is binding on Gazprom, and failure to deliver gives rise to a claim for compensation under Article 10.1.

(1983) For the years [REDACTED] the Parties have further agreed that [REDACTED]
[REDACTED]

(1984) The fact that the Parties envisaged the possibility to agree on an extension of the period for the provision of transit services as a remedy in the event that smaller quantities than agreed are delivered in the years [REDACTED], confirms the binding nature of the transit volume agreed for those years, i.e. [REDACTED]. Other remedies, in particular the entitlement to damages, remained unaffected.

(1985) Gazprom has systematically failed to deliver the agreed volumes of Natural Gas for transit for each year during the period between [REDACTED]. Consequently, Naftogaz is entitled to damages resulting from Gazprom's failure to use transit capacity reserved and maintained by Naftogaz under the Contract.

7.1.12.2.2 The Contract imposes a minimum transit obligation on Gazprom

(1986) The wording of the Contract is clear: Gazprom is obliged to deliver at least ("not less than", in Gazprom's translation) 110 bcm of Natural Gas annually to Naftogaz for transit to European

countries for the entire duration of the Contract, unless otherwise agreed. Gazprom argues that (i) the agreements between the Parties on other volumes to be transited in 2011-2015 and (ii) the procedure for determining the annual volumes for subsequent years if the Parties fail to specify them in Addenda to the Contract are inconsistent with the existence of a minimum transit obligation of 110 bcm per year for Gazprom.

(1987) That the Parties may at any time agree on different also lower volumes than 110 bcm is undisputed. This, however, does not detract from the fact that the 110 bcm minimum transit obligation continues to apply for years where no other agreement is reached, or from the fact that the different agreed volumes shall be binding in the years for which Addenda are concluded. In the present case, "specific" volumes have been agreed for the years [REDACTED], and a specific annual volume range [REDACTED]. Naftogaz' claims for damages are calculated based on these specific agreements and Gazprom's argument that something else might have been agreed is irrelevant. The procedure for determining annual transit volumes in Article 3.2 of the Contract is consequently only applicable for 2016 and the following years.

(1988) Gazprom relies on the witness statement of [REDACTED] and argues that the Parties jointly intended Article 3 of the Contract to be a mere "*forecast of the likely volumes it was anticipated might be delivered*". However, this is contradicted by Naftogaz' witnesses, who explain that the volumes of gas transit agreed were binding and Naftogaz would be entitled to compensation for damages in case of underdelivery, cf. *inter alia* [REDACTED] first witness statement and [REDACTED] first witness statement. Thus, there is no joint intention between the Parties, and the Tribunal should therefore rely on the wording of the Contract, cf. also *inter alia* [REDACTED]

(1989) Gazprom also argues that the non-binding nature of the annual volumes agreed for the years [REDACTED] follows from the Parties' agreement on specific consequences if the annual volumes actually delivered in the period [REDACTED] should be less than [REDACTED] Gazprom refers to [REDACTED]

- (1990) However, this agreement only confirms Naftogaz' interpretation. That the Parties envisaged the possibility to agree on an extension of the period for the provision of transit services as a remedy in the event that smaller quantities than agreed are delivered in the years [REDACTED] rather confirms the binding nature of the transit volume agreed for those years, i.e. [REDACTED]. If the obligation were not fulfilled, this would have consequences for the Parties' bargain. [REDACTED] does not exclude other remedies, cf. [REDACTED].
- (1991) On 30 December 2016, Gazprom forwarded a fax message to Naftogaz in which it purported to invoke the alternative auditor procedure under Article 3.2 of the Contract to adjust its annual volume commitments for both 2016 and 2017. Gazprom did not attach the auditor confirmation it purported to refer to.
- (1992) Naftogaz maintained its position that the Transit Contract volume provisions, including Article 3.2, have to be revised to conform to Ukraine's international obligations and implementing legislation. Further, on a non-prejudice basis, Naftogaz explained that any request for revision of the 110 bcm annual transit volumes set out in Article 3.1 must be received by Naftogaz in time to allow Naftogaz to consider the request and in case of non-agreement verify the auditor report before the start of the delivery year in question. Thus, in any event, Gazprom's request for revised volume obligations was set out too late, both with regard to 2016 and 2017.
- (1993) Gazprom argues that it "*cannot accept the statement of [Naftogaz] that it is too late for Gazprom to invoke the procedure in accordance with Article 3.2 of [the Contract]*" (clarifications by Naftogaz). In addition, Gazprom provided Naftogaz with the auditor report on the Gazprom Export Contracts for 2016 and 2017, which has since been submitted by Gazprom in these proceedings.
- (1994) Naftogaz maintains its position that "*Naftogaz does not have competence to agree on any transit volumes for 2016, 2017 or any subsequent year, that the entire exercise pursuant to Clause 3.2 of the Contract may become redundant, and that Gazprom in any event has submitted the requests and reports too late.*" In addition, Naftogaz objects that the methodology applied by

Gazprom's auditors is based on an incorrect application of Article 3.2, which excessively reduces Gazprom's volume obligation under the Contract. Further, Naftogaz notes that Gazprom's calculations may need to be adjusted in the light of the ENTSOG data on capacity bookings on entry points of GTSs in EU countries adjacent to the Ukrainian GTS. Finally, Naftogaz objects that Gazprom's request for adjustment of the volume obligation for 2017 would be in breach of the provisions on delivery flexibility under the Contract.

- (1995) Naftogaz maintains that Article 3.1 constitutes a minimum volume obligation on Gazprom. Gazprom maintains and repeats its defences in relation to Naftogaz' underdeliveries claim for 2009 to 2015 in respect of Naftogaz' underdeliveries claim for 2016. Naftogaz likewise maintains and repeats its rejection of Gazprom's defences against Naftogaz' underdeliveries claim for 2009 to 2015 in respect of Gazprom's defences against Naftogaz' underdeliveries claim for 2016. Below, Naftogaz rejects Gazprom's defence specific to the 2016 underdeliveries claim, viz. Gazprom's purported invocation of Article 3.2 to retroactively reduce its 2016 delivery obligation.
- (1996) Naftogaz' understanding of the interplay between Articles 3.1 and 3.2 is that the 110 bcm minimum transit obligation prevails unless the Parties agree otherwise pursuant to Article 3.2, entering into separate Addenda. Further, Article 3.2, second sentence, may only be invoked when the Parties are unable to agree on the annual volumes. Naftogaz also recalls that the Parties entered into separate Addenda on transit volumes for the years [REDACTED]
- (1997) Thus, Article 3.2, second sentence, sets out the procedure that shall be followed if Gazprom can demonstrate that for the subsequent year it does not need the 110 bcm minimum annual capacity that it has otherwise reserved in Article 3.1 of the Transit Contract or specifically committed to under a prevailing Addendum. In such a case, Gazprom shall notify Naftogaz of its reduced need, and provide an auditor report confirming that a reduction in the volume booking for the delivery year in question is justified.
- (1998) It must be noted that the procedure under Article 3.2 would be meaningless unless Article 3.1 is interpreted as establishing a binding (default) minimum obligation. If no obligation to deliver a

minimum of 110 bcm/year existed, there would not be a need to provide for an auditor procedure to determine the transit volumes. Gazprom could simply deliver gas for transit according to Gazprom Export's needs from time to time, and Naftogaz would have no say in the matter. Instead, Article 3.2 allows Gazprom to deviate from the 110 bcm annual minimum obligation, on the condition that it can prove through an auditor procedure that a lower volume is warranted based on Gazprom Export's needs.

(1999) Also, Gazprom appears to accept that the application of Article 3.2 would lead to a "minimum commitment" for Gazprom.

(2000) Article 3.2, second sentence, provides that this procedure may be invoked "[i]f the Parties have not concluded such Addendum prior to the beginning of the relevant Contract Year". Contrary to Gazprom's allegations, the wording of the clause consequently suggests that the auditor procedure shall take place in connection with the failure to agree on an Addendum, i.e. prior to the beginning of the relevant Contract Year. The obvious purpose of providing such notification is to free transport capacity in the GTS before the delivery year, thereby allowing Naftogaz to offer it to other shippers and mitigate the losses it otherwise would suffer if Gazprom does not deliver the minimum volume prescribed in Article 3.1, alternatively make further capacity available if the procedure should result in increased needs for Gazprom Export. providing such notification is to free transport capacity in the GTS before the delivery year, thereby allowing Naftogaz to offer it to other shippers and mitigate the losses it otherwise would suffer if Gazprom does not deliver the minimum volume prescribed in Article 3.1, alternatively make further capacity available if the procedure should result in increased needs for Gazprom Export. In both cases, Naftogaz would need reasonable advance notice. Thus, and contrary to Gazprom's assertion, there is an obvious time limit for when an auditor's confirmation can be submitted pursuant to Article 3.2. The auditor's confirmation must be provided sufficiently ahead of the delivery year in question to allow Naftogaz to adapt to Gazprom Export's changing needs.

(2001) For 2016, Gazprom has failed to invoke Article 3.2 in time for Naftogaz to i) verify the audit report and ii), subject to verification, offer the released transport capacity to other shippers. The

consequence of such failure is that Gazprom is obliged to deliver the agreed volumes, as set out in Article 3.1. To the extent Gazprom were to find that it does not need all the capacity that it has booked immediately before or after the start of the delivery year in question, it would be incumbent on Gazprom to sell its excessive capacity (if any) in the secondary market, e.g. by allowing exports by independent Russian or Central Asian producers to Europe. In particular, because Gazprom's belated invocation of Article 3.2 has prevented Naftogaz from even attempting to mitigate its losses in respect of 2016, Gazprom should not be allowed to now use Article 3.2 to reduce its liability. That delayed notification of circumstances allowing your counterparty to mitigate losses may lead to liability for damages follows from the general duty to co-operate underlying the CISG, as expressed for example in Article 79(4) CISG.

(2002) Naftogaz maintains that it would be incorrect to simply apply the aggregated amount of Gazprom Export's minimum delivery obligations to European off-takers as the minimum delivery obligation under the Transit Contract.

(2003) The understanding above is effectively accepted and applied by Gazprom itself, as evidenced by Gazprom's letter of 30 December 2016. In its letter, Gazprom states that its minimum annual quantities (MAQ) to Western European purchasers amount to 55 bcm in 2016 and 61 bcm in 2017, and specifies that "*taking into account the flexibility of deliveries provided for in the contracts with the European buyers, the increase in the gas transit volume may comprise up to 25%*". In addition, Gazprom quantifies its needs for gas transit to Moldova in 2017 in the amount of 3.05 bcm. Consequently, on the unverified assumption that the data provided by Gazprom to the auditors is complete and accurate, a more correct determination pursuant to Article 3.2 would result in minimum delivery obligations under the Transit Contract of 68.75 bcm ($55+(55*0.25)$) and 79.3 bcm ($61+(61*0.25)+3.05$) for 2016 and 2017, respectively. Gazprom's conclusion, that the delivery obligation under the Transit Contract in 2016 shall be set equal to Gazprom Export's minimum volume obligations is therefore contradicted by the very wording of the Contract clause and Gazprom's own statements.

- (2004) There are several factors that need the consideration of both Parties, prior to an adjustment of Gazprom's minimum volume obligation for a given year pursuant to Article 3.2, which confirms Naftogaz' position that the procedure pursuant to Article 3.2 must be invoked well ahead of the delivery year in question.
- (2005) Naftogaz' here calculates its claims for the second half of 2016 and all of 2017 concerning both for underpayments and for underdeliveries. Naftogaz has previously calculated its underpayment claims up to and including 31 July 2016, and its underdeliveries claims up to and including 31 December 2016.
- (2006) Naftogaz' capital monetary claims are a combination of compensation for underdeliveries and compensation for underpayments, depending on the point in time from which the Tribunal will find that the revised, cost-reflective tariffs apply. Thus, in each combination, the underdelivery claim runs until the day before the underpayment claim starts.
- (2007) In the period after 31 July 2016, Gazprom has not paid cost-reflective tariffs. Thus, Naftogaz has underpayment claims for this period in an amount between USD 2.452 billion and USD 4.881 billion, depending on the approach to VAT taken. Gazprom was also in breach of its minimum transit obligation for the entire year of 2017. Thus, Naftogaz has an underdeliveries claim for this period of USD 0.274 billion.
- (2008) Naftogaz takes account of the outcome of the Sales Arbitration, and updates the calculations of the fuel gas costs in accordance with the revised Factual Price under the Sales Contract as set out in the Sales Final Award. This affects both the underpayments and underdeliveries claims. The effect is to reduce Naftogaz' claims by between USD 35 million and USD 70 million, depending on the claim and approach.
- (2009) Based on Naftogaz's letter to Gazprom dated 15 June 2009 and other unspecified elements referred to by Gazprom as "*Naftogaz's own previous conduct and statements during the term of Contract TKGU*", Gazprom draws the arbitrary conclusion that:

"Naftogaz did not consider that Contract TKGU imposed minimum transit volume obligations on Gazprom; and

Naftogaz did not consider that it should be paid for the volumes specified in Contract TKGU in the absence of such volumes actually being transited and, accordingly, Naftogaz providing such services."

- (2010) Gazprom's allegations are contradicted by Gazprom's own admission that Naftogaz has frequently raised the issue of underdeliveries in its correspondence. The examples exhibited by Gazprom in the Defence demonstrate that Naftogaz considered the Contract to impose minimum transit volume obligations on Gazprom, and Gazprom to be in breach of such obligations.
- (2011) In particular, the correspondence quoted by Gazprom shows an escalation of Naftogaz' complaints, which eventually culminated in the notice of disputes of 25 July 2014 and the claim for damages brought in these arbitration proceedings.
- (2012) Less than a month after the signature of the Contract, Naftogaz drew Gazprom's attention to the volumes nominated by Gazprom being *"much lower than the planned contractual volumes"*.
- (2013) In a letter of 10 November 2011, Naftogaz notified Gazprom that *"over the ten months of the current year, [Gazprom] has systematically breached its obligations in relation to deliveries of natural gas volumes for their transit to the points of delivery at the borders of Ukraine with the neighbouring states"*, (Naftogaz' emphasis). It is apparent from this letter that Naftogaz considered that the Contract imposed minimum transit volume obligations on Gazprom. In the same letter, Naftogaz also notified Gazprom of the damages it was suffering due to Gazprom's breach of its obligations, i.e. the significant decline in revenues.
- (2014) In its letter of 19 January 2012, Naftogaz referred to the annual volume [REDACTED] and stated that failure to deliver the agreed volumes for transit *"may result in a breach of terms of [Contract TKGU]"*. In its letter of 23 March 2012, Naftogaz stated

that "Clause [REDACTED] [Contract TKGU] *contains an obligation... to deliver ... [REDACTED] cubic meters of natural gas for its transit*", (Naftogaz' emphasis).

7.1.12.2.3 The claim for compensation is not the imposition of a ship-or-pay clause

- (2015) Gazprom argues that Naftogaz' claim for damages for underdeliveries in effect amounts to the imposition of a "ship or pay" obligation on Gazprom; that the introduction of a ship or pay provision was discussed by the Parties, which deliberately decided not to include such a clause, and that Naftogaz' claim should therefore be rejected.
- (2016) Naftogaz does not dispute that specific mechanisms for Gazprom's liability in case of underdeliveries, e.g. payments based on reservation of capacity or so-called "ship or pay" provisions, were discussed but not included in the final version of the Contract.
- (2017) However, this does not detract from the Parties' agreement on a general liability provision, Article 10.1, which allows a Party to claim compensation for any losses caused by the other Party's non-performance of its obligations under the Contract. This provision was not discussed in detail, but it was clear that it would cover any non-performance under the Contract: it follows from the very nature of a general liability clause that it is not necessary for the parties to specifically state all the circumstances that would be covered by it. Contrary to what Gazprom suggests, Naftogaz understood that Article 10.1 would allow it to demand compensation for damages in case of underdelivery of transit volumes.
- (2018) Naftogaz disputes Gazprom's allegations that the claim for damages for underdeliveries in effect amounts to the imposition of a "ship or pay" obligation on Gazprom. There are a number of elements that distinguish Naftogaz' claim (and thereby its position under the Contract) from a ship or pay claim.
- (2019) Thus, contrary to Gazprom's allegation, it is not true that the calculation of any amount owing would be identical for a ship or pay claim as for Naftogaz' damages claim.

- (2020) The principled difference between a ship-or-pay claim and a damages claim is that the latter requires all prerequisites for damages to be fulfilled, i.e. a breach, a loss, and causality between the breach and the loss. A ship-or-pay claim, on the other hand, is a simple claim for payment, where such payment in itself constitutes fulfilment of the contractual obligation. There is no obligation to actually ship gas, and the transporter is not obliged to show any loss or causality.
- (2021) This is because "*[s]hip or pay is effectively a minimum capacity charge which is payable by the shipper in exchange for that minimum guaranteed capacity*", cf. Roberts. Thus, in case of the shipper's failure to pay for the capacity booked, the transporter may simply invoke that the invoices have not been paid; it would then be for the shipper to demonstrate the opposite.
- (2022) Thus, a ship or pay system is "automatic" and gives the transporter certainty of a regular cash flow.
- (2023) The liability system under the Contract, on the other hand, leads to liquidity constraints on Naftogaz, as pointed out by Naftogaz in its correspondence with Gazprom during the term of the Contract, cf. e.g. Naftogaz' letter of 19 January 2012, where Naftogaz complained that the underdeliveries resulted in "*a considerable decline in the amount of the Company's revenues for the services provided to [Gazprom]*", which in turn "*adversely affected the company's financial situation, which eventually had an impact on Naftogaz's ability to make timely payments to Gazprom for the natural gas imported in 2011*" (Gazprom's translation).
- (2024) Thus, Naftogaz' claim is far from a ship or pay claim in disguise. Contrary to Gazprom's objections, Naftogaz *has* been placed at a significant disadvantage by having to assert a damages claim on the basis of the general liability provision.
- (2025) Against this background, it was logical and justifiable that Naftogaz, faced with a decline in volumes delivered by Gazprom, sought to introduce a dedicated provision which would regulate Gazprom's payment obligation for the agreed volumes of Natural Gas for transit, similarly to the

take-or-pay obligation in the Gas Sales Contract, cf. Naftogaz' letter of 15 June 2009. Naftogaz' proposed amendment does not contradict a claim for damages, as Gazprom suggests.

- (2026) That the system under Article 10.1 of the Contract is more cumbersome than a ship or pay system is also apparent from the fact that Naftogaz is currently forced to defend itself against Gazprom's numerous objections typically related to damages claims, e.g. with regard to the calculation of damages and the alleged failure to mitigate the losses. It appears unlikely that Gazprom would have been able to concoct such objections had the Contract contained a straightforward ship or pay system similar to Gazprom Export's contract with Eustream.
- (2027) Gazprom argues that because Naftogaz in the present case calculates its damages as the lost revenues attributable to the underdeliveries, less saved operating costs, the *effect* of the damages claim is the same as a ship or pay claim. Apparently, the argument is that because Naftogaz is unable to mitigate its losses by selling transit services to others, it is prevented from seeking damages. Gazprom cannot rely on this argument. Naftogaz' inability to mitigate its losses is due to Gazprom's circumstances, i.e. Gazprom's monopoly on gas exports from and gas transmission through Russia, and its prevention of virtual reverse flows, which prevents cross-border gas transmission from West to East and North to South through Western Ukraine.
- (2028) A ship or pay clause would have been very different from a general liability provision. Ship or pay provisions reduce the uncertainty facing pipeline owners, providing them with steady cash flow that facilitates raising capital on more attractive terms (see the Expert Reply).
- (2029) Finally, Gazprom apparently argues that, because Naftogaz allegedly received the Ukrainian Gas Transmission System "*at no cost*" from the Soviet Union, no transit obligation is necessary under the Contract. Gazprom's observations do not appear to be of direct relevance to its defence against Naftogaz' claim for damages, which is based on the general liability provision found in Article 10.1 of the Contract. However, as Gazprom bases its argument on Mr Witschen's expert report, these assertions are rejected in the relevant context by Naftogaz' experts in the Expert Reply.

7.1.12.2.4 Article 10.1 of the Contract gives Naftogaz the right to compensation for damages caused by underdeliveries

(2030) It follows from the above discussion of the volume provisions, that failure to deliver the agreed annual transit volumes constitutes a breach of the Contract.

(2031) The provisions on liability contained in Article 10.1 of the Contract have been presented above. For ease of reference Article 10.1 is quoted in full below:

"The Client and the Contractor will undertake their best efforts to duly perform the undertaken obligations under this Contract.

Should the Parties fail to perform on the terms and conditions of this Contract, each of the Parties shall reimburse the other Party for any proven damages caused by such failure to perform."

(2032) Pursuant to Article 10.1, a Party that does not fulfil its obligations under the Contract is obliged to compensate the other Party for documented losses caused by the non-fulfilment. Liability for damages under Article 10.1 represents the main mechanism for enforcing the Parties' rights and obligations under the Contract. Thus, the payment of damages following Gazprom's failure to perform in respect of the volume obligations follows from a regular application of the Contract.

(2033) Specific performance, which is another typical remedy against a breach of contract, is not envisaged in the Contract. Such a remedy would in any event be inadequate for transportation/transit contracts such as the Transit Contract. When a shipper (Gazprom) fails to perform its obligation to deliver an agreed quantity of gas for transmission, the transporter (Naftogaz) has no interest in allowing let alone requiring the shipper to occupy capacity in the gas transportation system for a period beyond the agreed contract term.

(2034) The losses suffered by Naftogaz because of Gazprom's failure *"to perform on the terms and conditions"* of the Contract correspond to the lost revenues attributable to the underdeliveries, i.e. the differential between the amount Gazprom would have paid if it had fulfilled its obligations

and the amount paid for volumes actually delivered for transit, net of the variable cost savings associated with the smaller volumes actually transited in the system, cf. the Expert Report.

(2035) Gazprom argues that "[t]he obligation to compensate the other party for proven damages in the second paragraph of clause 10.1 relates to the obligation in the first paragraph for the parties to take all necessary measures for proper performance of their obligations under Contract TKGU", concluding that it follows that "damages would not be payable unless Gazprom had failed to take all necessary measures for the proper performance of its obligations".

(2036) This interpretation is wrong. The words "*such obligations*" in Article 10.1 refer to all of the Parties' "*obligations undertaken under this Contract*", and not exclusively to the obligation to "*take all necessary measures for proper performance*" thereof.

(2037) In any event, Gazprom has not produced any evidence that it has taken all necessary measures for the proper performance of its obligations under the Contract. On the contrary, the evidence available suggests that Gazprom deliberately has breached its obligations towards Naftogaz to (i) protect its margins in the European gas market, and (ii) favour its affiliate Nord Stream AG.

7.1.12.2.5 The higher price (tariff) under the replaced or revised Article 8 entitles Naftogaz to additional payments for its transit services in the years 2010-2014

(2038) The amended tariff for transit services applicable from 1 January 2010 is significantly higher than the invalid unamended tariff. Gazprom has consequently paid a much lower price for Naftogaz' transit services than it should have paid. Naftogaz is therefore entitled to the difference between the amount of money paid by Gazprom for transit of Natural Gas from 1 January 2010 and the amount of money calculated as payment for transit of Natural Gas pursuant to Article 8 as amended by the Tribunal's Award for the same period.

(2039) In the present instance, having established that a revised, higher price (tariff) applies under the Transit Contract from a certain date stipulated by the Tribunal, Naftogaz is entitled to receive payment, corresponding to the difference between the amount due under the amended price (tariff) from that date and the amount actually paid by Gazprom.

(2040) Naftogaz claims additional payments for the period from 1 January 2010 and until the Award is made. The full claims may not be calculated until the Award has been made, because the additional payments depend on the date of the award.

7.1.12.2.6 Gazprom has delivered smaller volumes than it was obliged to under the Contract from 2009 to 2014

(2041) Below, Naftogaz gives a detailed account of the volumes of Natural Gas actually delivered for transit by Gazprom in the years from 2009 to determine the lost revenues caused by and the cost savings associated with Gazprom's underdeliveries. The latter exercise will also fulfil Naftogaz' burden to prove the damages arising from Gazprom's failure to perform its obligations.

(2042) Article 3.1 of the Contract and/or [REDACTED] set out a minimum transit obligation and Gazprom has been in breach of this obligation every year since 2009.

(2043) The gas volume actually delivered by Gazprom for transit amounted to 95.819 bcm in 2009. This is documented in the Monthly Gas Delivery and Acceptance Reports for 2009, which the Parties have prepared and agreed pursuant to Article 7.2 of the Contract. The Reports show *inter alia* the volumes of Natural Gas delivered monthly for transit towards Moldova and other states, which are the relevant figures for the present exercise.

(2044) This volume is smaller than the volume Gazprom was obliged to deliver under the Contract in that year. As indicated above, the Parties had agreed that in 2009 the transit volume "*will amount to 120.083 bcm*", cf. Article 3.1.1 of the Contract. Thus, for 2009 the difference between the volume of gas to be delivered and the volume actually delivered amounts to 24.264 bcm.

(2045) The gas volume actually delivered by Gazprom for transit amounted to 97.808 bcm in 2010. This is documented in the Monthly Gas Delivery and Acceptance Reports for 2010.

(2046) This volume is smaller than the minimum transit obligation of 110 bcm agreed by the Parties and applicable in that year. For 2010, the underdeliveries therefore amount to [REDACTED] cm.

(2047) In 2011, the volume of Natural Gas actually delivered for transit amounted to 92.885 bcm. This is documented in the Monthly Gas Delivery and Acceptance Reports for 2011.

(2048) This volume is [REDACTED] short of the agreed volume of [REDACTED] for that year, cf. Article 3.1.3 of the Contract.

(2049) For each of the years 2012 to 2014, the agreed quantity of Natural Gas to be delivered for transit was [REDACTED], cf. Article 3.1.4 of the Contract. Instead, the volumes actually delivered by Gazprom amounted to 84.261 bcm in 2012, 86.125 bcm in 2013, and 62.196 bcm in 2014. This is documented in the Monthly Gas Delivery and Acceptance Reports for 2012, 2013, and 2014.

(2050) Thus, the difference between the volume of gas to be delivered and the volume actually delivered amounts to [REDACTED] for 2012, to [REDACTED] for 2013, and to [REDACTED] for 2014.

(2051) For the sake of convenience, Naftogaz summarises the figures in the preceding paragraphs in the table below and indicate the total amount of underdeliveries in 2009-2014:

Year	Transit volume obligation	Gas actually delivered	Differential
2009	[REDACTED]	95.819 bcm	[REDACTED]
2010	[REDACTED]	97.808 bcm	[REDACTED]
2011	[REDACTED]	92.885 bcm	[REDACTED]
2012	[REDACTED]	84.261 bcm	[REDACTED]

2013	████████	86.125 bcm	████████
2014	████████	62.196 bcm	████████
		Total	████████

(2052) For the year 2015, the transit volume obligation was ██████████ and the amount of gas actually delivered was 68.08 bcm. Thus, the differential for the year 2015 was 44.92 bcm.

(2053) For the year 2016, the transit volume obligation was 110 bcm but Gazprom, in fact, only transited 82.2 bcm.

(2054) For the year 2017, the transit volume obligation was 110 bcm, and the amount of gas actually delivered was 93.461 bcm.

(2055) Gazprom has delivered less gas than it was obliged to from 2009 to 2017 inclusive. Gazprom has been in breach since 2009 and is liable for damages.

(2056) Naftogaz is entitled to compensation for losses resulting from Gazprom's underdeliveries of transit volumes.

(2057) Naftogaz could not have mitigated the losses by selling the unutilised capacity to others. In particular, such possibility is not envisaged in the Contract. On the contrary, the corollary to Gazprom's obligation to deliver specific quantities of Natural Gas for transit, is an obligation for Naftogaz to reserve the corresponding capacity in its transmission network for Gazprom, cf. Article 3 of the Contract. Under the unrevised tariff, the capacity is not sold to Gazprom on a "use

it or lose it" basis. Thus, the Contract does not envisage the possibility for Naftogaz to sell unused capacity to others, but effectively prohibits Naftogaz from doing so.

(2058) In any event, it would have been factually impossible for Naftogaz to sell the unutilised capacity to other bidders. Gazprom holds a monopoly on gas exports from the Russian Federation. Furthermore, the Ukrainian Gas Transmission System (GTS) is essentially unidirectional. Finally, the Contract, the Technical Agreement, and their practical implementation between the Parties have largely left Gazprom and its subsidiary Gazprom Export in control of the GTS, a position Gazprom has abused to prevent the use of the GTS by third parties. Inevitably, given these circumstances, only Gazprom itself might have allowed third party gas to be transported through Ukraine and thus to mitigate the damages caused by its own underdeliveries.

(2059) In order to calculate the damages incurred by Naftogaz as a consequence of Gazprom's underdeliveries, variable avoided costs associated with such underdeliveries must be taken into account.

(2060) Having calculated the volumes of underdeliveries for the years from 2009 to 2017 inclusive, Naftogaz now proceeds to determine the damages incurred by Naftogaz as a consequence of Gazprom's underdeliveries.

(2061) Naftogaz' capital monetary claims are a combination of compensation for underdeliveries and compensation for underpayments, depending on the point in time from which the Tribunal will find that the revised, cost-reflective tariffs apply. Thus, in each combination, the underdelivery claim runs until the day before the underpayment claim starts.¹³⁹

(2062) Naftogaz had previously calculated its underpayment claims up to and including 31 July 2016,¹⁴⁰ and its underdeliveries claims up to and including 31 December 2016.¹⁴¹

¹³⁹ Cf. § 4 Brattle 9.

¹⁴⁰ Cf. the Relief Sought with Appendices annexed to the Post-Hearing Brief, dated 22 December 2016 (T-A 18).

¹⁴¹ Cf. Section V. Brattle 8.

(2063) In the period after 31 July 2016, Gazprom has not paid cost-reflective tariffs. Thus, Naftogaz has underpayment claims for this period in an amount between USD 2.452 billion and USD 4.881 billion, depending on the approach to VAT taken.¹⁴² Gazprom was also in breach of its minimum transit obligation for the entire year of 2017. Thus, Naftogaz has an underdeliveries claim for this period of USD 0.274 billion.¹⁴³

(2064) Dr Hesmondhalgh takes account of the outcome of the Sales Arbitration, and updates the calculations of the fuel gas costs in accordance with the revised Factual Price under the Sales Contract as set out in the Sales Final Award.¹⁴⁴ Dr Hesmondhalgh explains that this affects both the underpayments and underdeliveries claims. The effect is to reduce Naftogaz's claims by between USD 35 million and USD 70 million, depending on the claim and approach.

7.1.13 The claim based on underpayment for transit of natural gas from 2010 to 2014 based on the replaced or revised Article 8

(2065) Below, Naftogaz calculates the payments due by Gazprom for each of those years by subtracting the amount actually paid by Gazprom in each year from the total allowed transit price (tariff) applicable under the replaced or revised Article 8 in the same year.

(2066) The payments that Gazprom should have made in 2010 on the basis of amended prices (tariffs) in 2010 are USD [REDACTED]. Gazprom effectively paid USD 2.31 billion for transit services in the same year, excluding fuel gas costs. This is documented in the Monthly Transit Services Price Reports for 2010, which the Parties have prepared and agreed on the basis of the Monthly Gas Delivery and Acceptance Reports for the same year, cf. Clause 7.5, last paragraph, of the Contract.

(2067) Thus, the additional payment to which Naftogaz is entitled for transit in 2010 amounts to USD [REDACTED].

¹⁴² Cf. § 11 Brattle 9.

¹⁴³ *Ibid*.

¹⁴⁴ Cf. Section II.B. Brattle 9.

(2068) The payments that Gazprom should have made in 2011 on the basis of amended prices (tariffs) in 2010 are USD [REDACTED]. Gazprom effectively paid USD 2.20 billion, plus USD 0.28 billion of excessive fuel gas costs, but excluding other fuel gas costs, for transit services in the same year. This is documented in the Monthly Transit Services Price Reports for 2011.

(2069) Thus, the additional payment to which Naftogaz is entitled for transit in 2011 amounts to USD [REDACTED] billion.

(2070) The payments that Gazprom should have made in 2012 on the basis of amended prices (tariffs) in 2010 are USD [REDACTED]. Gazprom effectively paid USD 1.99 billion, plus USD 0.57 billion of excessive fuel gas costs but excluding other fuel gas costs, for transit services in the same year. This is documented in the Monthly Transit Services Price Reports for 2012.

(2071) Thus, the additional payment to which Naftogaz is entitled for transit in 2012 amounts to USD [REDACTED] billion.

(2072) The payments that Gazprom should have made in 2013 on the basis of amended prices (tariffs) in 2010 are USD [REDACTED]. Gazprom effectively paid USD 2.05 billion, plus USD 0.49 billion of excessive fuel gas costs but excluding other fuel gas costs, for transit services in the same year. This is documented in the Monthly Transit Services Price Reports for 2013.

(2073) Thus, the additional payment to which Naftogaz is entitled for transit in 2013 amounts to USD [REDACTED].

(2074) Finally, the payments that Gazprom should have made in 2014 on the basis of amended prices (tariffs) in 2010 are USD [REDACTED]. Gazprom effectively paid USD 1.44 billion, plus USD 0.03 billion of excessive fuel gas costs but excluding other fuel gas costs, for transit services in the same year. This is documented in the Monthly Transit Services Price Reports for 2014.

(2075) Thus, the additional payment to which Naftogaz is entitled for transit in 2014 amounts to USD [REDACTED].

(2076) In the table below, Naftogaz summarises the amounts indicated in the preceding paragraphs, and determine the amount of payments due by Gazprom for each year as well as in total:

Year	Amended payments	Actual amount paid	Additional Payment due
2010	USD [REDACTED] [REDACTED]	USD 2.31 billion	USD [REDACTED] [REDACTED]
2011	USD [REDACTED] [REDACTED]	USD 2.47 billion	USD [REDACTED] [REDACTED]
2012	USD [REDACTED] [REDACTED]	USD 2.57 billion	USD [REDACTED] [REDACTED]
2013	USD [REDACTED] [REDACTED]	USD 2.54 billion	USD [REDACTED] [REDACTED]
2014	USD [REDACTED] bil- [REDACTED]	USD 1.57 billion	USD [REDACTED] [REDACTED]
		Total	USD [REDACTED] [REDACTED]

(2077) Thus, Naftogaz' principal claim for underpayments and underdeliveries is USD 14.865 billion.

7.1.13.1.1 Underdeliveries and taxes

7.1.13.1.1.1 Tax regimes applicable to gas transit services in Ukraine

(2078) Until 1 January 2016 transit of natural gas transited through the territory of Ukraine were subject to taxation in the form of so called royalties. Under this period services related to transit of gas were VAT exempt.

(2079) The royalties for transit of natural gas were abolished as of 1 January 2016. As a consequence, VAT became payable on gas transit instead of royalties. The VAT basic rate is 20%, cf. Article I 93. I (a) of the Tax Code.

(2080) While it is true that the royalty taxes paid by Naftogaz are lower than they would have been if the volumes had been delivered, Naftogaz will instead have to pay value added tax (VAT) on the amounts received from Gazprom as damages for under deliveries. This VAT liability by far exceeds the amount of saved royalties.

7.1.13.1.1.2 Compensation for underdeliveries under the Contract is subject to VAT

(2081) In determining whether damages awarded for Naftogaz for under deliveries in this arbitration two issues arise: (i) are the payments made in respect of services that are subject to VAT and (ii) did the taxable event occur during the VAT exempt period or during the period when it is subject to VAT?

(2082) Supply of services within Ukraine is subject to VAT, cf. Article 185.1 of the Tax Code.

(2083) For the purpose of the Tax Code the term "*supply of services*" includes *inter alia* "*establishment of an arrangement to refrain from certain action (...)*", Article 14.1.185 of the Tax Code.

(2084) It is quite undisputable that the damages claim constitutes compensation for the loss of payment for a service supplied by Naftogaz to Gazprom. The Parties' connected obligations under the Contract that are relevant here are found in Articles 2 and 3.1 of the Contract

- Gazprom's obligation to deliver minimum volumes (not less than 110 bcm or as agreed in addenda) of natural gas for transit through Ukraine by Naftogaz;

- Naftogaz' obligation to ensure the proper operation of the gas transportation system of Ukraine and guarantee a reliable and continuous transit for such minimum volumes of Gazprom's gas.

(2085) Thus, Naftogaz' service to Gazprom includes e.g. the obligation to refrain from providing pipeline capacities and transit services to third parties to enable Gazprom to utilize that capacity. The place of supply is evidently within Ukraine (see Article 186.4 of the Tax Code under which the place of supply of services is generally the place where the contractor, here Naftogaz, is located, and Article 186.2 of the Tax Code).

(2086) Any payment for such Naftogaz service, whether direct or indirect as damages, is therefore subject to VAT under the new VAT regime to the extent the taxable event occurred after 1 January 2016.

(2087) The question is then whether any payment of damages in respect of under deliveries in 2009-2015 would be regarded as tax exempt because the services for which payment is made relate to 2009-2015 or whether the payments are subject to VAT because they will be made after 1 January 2016. In other words, the date of the taxable event needs to be established.

(2088) The general rule in terms of supply of services is that VAT obligations arise on the earlier of:

- the date on which monies are credited by the customer to the bank account of the taxpayer (service provider) as payment for the relevant services, or
- the date of a document the confirming provision of services by the taxpayer, cf. Article 187.1 of the Tax Code.

(2089) Under well-established practices of the Ukrainian courts and tax authorities, the document referred to in (b) is a bilateral transfer and acceptance protocol executed by both parties. No document of this type has been drawn up and signed by Gazprom and Naftogaz in respect of underdelivered volumes. Hence, if the damages for underdeliveries are awarded by the Tribunal, the

taxable event is the actual payment of the damages by Gazprom to Naftogaz. Since this will by necessity occur after 1 January 2016, Naftogaz will incur 20% VAT.

(2090) Ukrainian laws do not allow for a refund of VAT payable on top of the compensation for services, neither could it be offset against any other taxes payable by Naftogaz. Therefore, the VAT on compensation for the under deliveries is an additional cost for Naftogaz which would not have occurred in case Gazprom would have duly performed its obligations to supply the minimum transit volumes under Contract.

(2091) Gazprom must compensate Naftogaz for the loss constituted by the increased tax liabilities.

(2092) Thus, Gazprom's breach of contract has not resulted in a (royalty) tax cost saving but rather in an additional tax cost for Naftogaz amounting to the difference between the royalties otherwise payable and 20% VAT that will be incurred. This extra cost is an element of Naftogaz' loss and must therefore be compensated by Gazprom.

(2093) In this context Naftogaz notes that Article 8.6 of the Contract does not limit Naftogaz' recovery of losses that are caused by tax costs. As acknowledged by Gazprom, by Gazprom invoking tax cost savings, a damages calculation for breach of contract simply needs to compare the actual economic situation resulting from the breach of Contract with the hypothetical situation that would have occurred had Gazprom fulfilled the Contract. Naftogaz also notes that it is specifically Gazprom's failure to deliver and pay for the agreed volumes of natural gas during the periods when transit services were VAT exempt in Ukraine that aggravated Naftogaz' loss. Moreover, Article 8.6 by its wording does not even deal with payments of damages for non-deliveries, being restricted to payments for actual "gas transit".

7.1.13.1.1.3 Calculations

(2094) The VAT liability for 2009-2015 that will be incurred on account of Gazprom's breach of Contract amounts to an extra 20% on any amount of compensation. Hence, in any one of the Claims

scenarios, the VAT liability exceeds the saved royalties. The net effect for each Claim is set out in table 2 of the fourth report of Brattle.

(2095) In a scenario where damages for under deliveries are awarded for the period I January 2009 to 31 December 2015, the extra VAT cost amounts to USD 901 million. These VAT payments constitute real costs as Naftogaz cannot offset any other tax liability on account of having to pay such VAT. Moreover, it is Gazprom's failure to transit and pay for the volumes before 31 December 2015 that will cause this extra VAT cost. This is because the payments for actual transit would have been VAT exempt if the deliveries and/or payments had occurred before 1 January 2016, viz. as the Contract stipulates.

7.1.13.1.1.4 Fuel gas savings. Introduction

(2096) The fuel gas savings issue has been thoroughly debated between the Parties, having been the subject of several submissions and expert reports.¹⁴⁵ In particular, the Parties' experts have developed two opposing models for the calculation of fuel gas savings, i.e. Dr Hesmondhalgh's so-called "total flows", and Dr Moselle's so-called "Alternative IV" model. In updating Naftogaz' fuel gas calculations for the revised Factual Price in the Sales Arbitration, Dr Hesmondhalgh has also provided alternative calculations based on Gazprom's approach.¹⁴⁶ The experts are, however, in agreement about the calculations.

(2097) The dispute between the experts has now crystallised as whether to use Dr Moselle's Alternative IV approach or Dr Hesmondhalgh's Total Flows approach.

7.1.13.1.1.5 Dr Moselle's Alternative IV approach

(2098) Essentially, Dr Moselle argues that his Alternative IV approach, in which the equation is based on import volumes and transit volumes, should be used to determine avoided fuel gas costs, as this approach yields the best goodness of fit results and is more robust than Dr Hesmondhalgh's

¹⁴⁵ Cf. *inter alia* Gazprom's pleadings of 19 December 2016 and 22 March 2017 with accompanying documentation, as well as Naftogaz' pleadings of 10 February 2017, 3 May 2017, 17 August 2017, 25 September 2017 and 2 February 2018 with accompanying documentation.

¹⁴⁶ Cf. Appendix C Brattle 9.

approach based on his analysis. If one includes Naftogaz' claim for damages for VAT gross-up and otherwise applies the same data as Dr Moselle has used, Dr Hesmondhalgh finds that under his model Naftogaz' claim amounts to USD 3,876 mln.

7.1.13.1.1.6 Dr Hesmondhalgh's rejection of the Alternative IV approach

(2099) Dr Hesmondhalgh rejects Dr Moselle's Alternative IV since:

- i) not all of the parameters applied under that approach meet Dr Moselle's own 95% significance test;
- ii) the approach leaves out amounts of gas which also are present in the pipes causing additional fuel gas consumption; and
- iii) she finds it to be less robust than the Total Flows model.

7.1.13.1.1.7 Dr Hesmondhalgh's Total Flows approach

(2100) In comparison, all the parameters of Dr Hesmondhalgh's Total Flows approach meet the 95% significance test which Dr Moselle himself set out in his first report, the approach also takes into account all gas volumes in the pipelines and has proven more robust than Alternative IV in her various robustness analyses. Dr Moselle does not dispute Dr Hesmondhalgh's findings but states that they are based on a "non-standard" approach to robustness testing. Under Dr Hesmondhalgh's Total Flows approach and including Naftogaz's claim for reimbursement for the VAT that will be payable on any awards but would not have been payable if the correct sums had been paid prior to 2016, Naftogaz' underdeliveries claim amounts to USD 4,810 mln. (excluding interest), cf. Dr Hesmondhalgh's memo of 17 July 2017.

(2101) The Total Flows model is (a) better with regard to parameter certainty under hypothesis testing (notably, one parameter in Dr Moselle's model fails Dr Moselle's own test),¹⁴⁷ (b) equivalent with regard to goodness of fit,¹⁴⁸ and (c) more robust. Re. (c), the Total Flows model is more stable

¹⁴⁷ Section IV.A Brattle 8

¹⁴⁸ Section IV.B Brattle 8

under robustness testing, as some sub-samples of Alternative IV performed significantly worse when tested and were below the 95% significance level, and some even below a 90% level.¹⁴⁹

(2102) Dr Hesmondhalgh's model also most closely approximates the results that the Parties assumed when entering into the Contract. The 3% fuel gas charge set out in the Contract was an agreed approximation of actual fuel gas costs, expected to accurately reflect actual fuel gas costs.¹⁵⁰

(2103) Naftogaz' underdeliveries claim is based on the volumes which Gazprom did not deliver for transit in 2009-2016 pursuant to Article 3.1 of the Contract. Had Gazprom delivered the contracted volumes, it would have paid Naftogaz USD 6,754 mln. From that amount, both Parties deduct saved fuel gas costs which otherwise would have accrued to transport the outstanding volumes. Dr Hesmondhalgh's Total Flows model shows such savings of USD 2,359 mln. Based on Dr Moselle's Alternative IV model, Naftogaz has saved USD 3,125 mln on fuel gas. Thus, considering saved fuel gas costs alone, Naftogaz' claim for damages due to Gazprom's underdeliveries amounts to USD 4,395 mln, applying Dr Hesmondhalgh's Total Flows model, or USD 3,629 mln, if one were to apply Dr Moselle's Alternative IV model.

(2104) The Parties agree that also royalties saved by Naftogaz shall be deducted. This reduces Naftogaz' claim further by USD 421 million, to either USD 3,973 million pursuant to Dr Hesmondhalgh's Total Flows model, or to USD 3,208 million pursuant to Dr Moselle's Alternative IV, which reflects Gazprom's position on the calculation of Naftogaz' underdeliveries claim.

(2105) In addition, Naftogaz claims compensation for VAT which Naftogaz will have to pay on an award on damages pursuant to Ukrainian legislation, because Naftogaz is liable for VAT on transit revenues since January 2016. To put Naftogaz in the same position as it would have been if it had received the additional revenues on time, VAT has to be added to the damages.

¹⁴⁹ Section IV C Brattle 8

¹⁵⁰ Cf. also §§ 9-12 of Naftogaz's submission of 3 May 2017 (T-Y 2)

- (2106) Based on Dr Hesmondhalgh's Total Flows model, Naftogaz' underdeliveries claim amounts to USD 4,809 million with a VAT gross up. With interest this increases to USD 5,958 million. If one were to calculate fuel gas savings pursuant to Dr Moselle's Alternative IV model and add VAT gross up, Naftogaz' underdeliveries claim amounts to USD 3,876 million.
- (2107) Alternatively, the results of Dr Hesmondhalgh's Total Flows model and Dr Moselle's Alternative IV should be averaged.
- (2108) In the period after 31 July 2016, Gazprom has not paid cost-reflective tariffs. Thus, Naftogaz has underpayment claims for this period in an amount between USD 2.452 billion and USD 4.881 billion, depending on the approach to VAT taken. Gazprom was also in breach of its minimum transit obligation for the entire year of 2017. Thus, Naftogaz has an underdeliveries claim for this period of USD 0.274 billion.

7.1.13.1.2 Naftogaz' total claim including compensation for VAT and interest

- (2109) For the purpose of interest calculations and with reference to Claim 5.1 in Naftogaz' Relief Sought of 22 December 2016, as updated 2 February 2018, Naftogaz sets out its underdeliveries claim year by year:

"if in respect of underdeliveries, pursuant to Sections 3 and 6 (cf. (i)-(viii) or 4 and 6 (cf. (viii)) of the Swedish Interest Act on any compensation amount in respect of

any part of 2009 (USD [REDACTED], from 4 January 2010,

any part of 2010 (USD [REDACTED] from 2 January 2011,

any part of 2011 (USD [REDACTED] from 3 January 2012,

any part of 2012 (USD [REDACTED] from 2 January 2013,

any part of 2013 (USD [REDACTED] from 2 January 2014,

*any part of 2014 (USD [REDACTED] from 2 January 2015,
any part of 2015 (USD [REDACTED] from 4 January 2016, and
any part of 2016 (USD [REDACTED] from 2 January 2017 and
any part of 2017 (USD [REDACTED] from 2 January 2018, or
alternatively, in respect of each amount of compensation in (i)-(ix), from and including 26 August 2014, 16 October 2014, 4 May 2015, 15 February 2016, 29 August 2016, 5 February 2018 or the date of the award."*

7.1.13.1.3 Loss of right to payment/compensation

- (2110) As Naftogaz understands Gazprom, Gazprom invokes that (i) Naftogaz has waived its right to damages as it has been passive, and (ii) Naftogaz has lost its right to claim damages as it has not given proper notice of the claim.
- (2111) As set out above, the general liability clause in the Contract entitles Naftogaz to claim damages in compensation of any losses caused by Gazprom's failure to fulfil its obligation to deliver Natural Gas for transit in the volumes agreed. The Tribunal will examine Gazprom's objections only if it finds that such an entitlement exists under the Contract.
- (2112) In relation to the purported waiver invoked by Gazprom, it is required that the passivity may be regarded as a contractually binding waiver under normal rules of contract law in order for any such waiver to exist. However, a party cannot be regarded as having been given a justifiable impression that a right has been waived based only on passivity.
- (2113) Naftogaz denies that it has been passive during the time period that Gazprom invokes. However, even if Naftogaz had been passive, the time period invoked by Gazprom is far too short to give any impression of a waiver, Jcf. NJA 1993 p. 570 and NJA 1961 p. 26. There are also no specific circumstances in this case which could compensate for the short time period.

- (2114) As a reason against Naftogaz' claim, Gazprom argues that Naftogaz relied on Article 3.1.4 of the Contract in its correspondence with Gazprom and sought and proposed amendments to the Contract that would have entitled Naftogaz to the payment of transit fees for specific volumes even where they had not been delivered for transit.
- (2115) Article 3.1.4 was introduced to benefit Naftogaz and did not modify any other obligations of the Parties, cf. [REDACTED] 2; the fact that Naftogaz invoked this clause could not be interpreted as a waiver of Naftogaz' other rights under the Contract, including its entitlement to damages.
- (2116) In relation to Naftogaz' suggested amendments, such amendments were meant to clarify further the Parties' respective positions and possibly provide for a simpler procedure in case of non-performance, compared to having to assert a claim for damages. Nevertheless, the fact that the suggested amendments were not introduced does not in any way impair Naftogaz' right to claim damages. In any event, neither Naftogaz's reliance on Article 3.1.4 of the Contract nor its suggested amendments could have been sufficient to give Gazprom a justifiable impression of a waiver, especially considering that there is no consideration involved relating to the purported waiver.
- (2117) In relation to Gazprom's allegation that Naftogaz has lost any right to damages under Article 10.1 because it "*failed to give timely and proper notice of its claim*", Naftogaz simply notes that there is no such requirement under Article 10 of the Contract. Neither is there any general obligation under Swedish law to give notice in order not to lose the right to invoke a certain sanction based on breach of contract. Consequently, to infer any notice requirement by analogy, statutory support would have to be found in relation to a contractual type so similar as to justify such an analogy, and there would have to be a real need to clarify to the other party that there is a breach of contract.
- (2118) Swedish statutory provisions and case law regarding notice mainly relate to defects in goods or services. Clearly, the current dispute does not relate to any defects in the services provided by

Naftogaz. Instead, it is a dispute regarding breach of other parts of the Contract. There is therefore no statutory notice requirement which can be applied by analogy in the current situation.

(2119) Moreover, there is no need for clarification in the current situation. The reason for a notice requirement being invoked in relation to defects in goods or services is that it is the buyer of the goods or services that typically is in a better position to find out if such defects exist and that the seller or service provider may not be aware of the defect or the deficiency. However, the same does not apply to other types of breach of contract. Instead, the party who is in breach of contract typically is aware of the breach himself.

(2120) In the current situation, the Contract sets out specific volumes that shall be delivered for transit each year by Gazprom. Obviously, Gazprom is in control of the amount it delivers to Naftogaz and is therefore well aware of the volumes delivered each year, and of the fact that it is in breach of contract. In addition, there are no other reasons to request a notice in the current situation.¹⁵¹ Accordingly, there is no real need in the current situation to give notice.

(2121) In any event, i.e. even if there should be such a notice requirement, Naftogaz disputes that any failure to give notice entails that the right to invoke damages is lost. The only possible effect of a failure to give notice would be limitation of liability. Such limitation would depend on whether Naftogaz could be said to have contributed to increasing the loss by not giving notice. In the current dispute, Naftogaz cannot be said to have contributed to any loss as Gazprom has been well aware of the fact that it is in breach of contract. Accordingly, even if there should be a notice requirement and Naftogaz has failed to give such notice, Naftogaz' right to damages should not be limited.

(2122) Finally, Naftogaz has in fact given notice to Gazprom (and has not been passive). It is apparent that Naftogaz has given Gazprom notice regarding the breach of contract several times. It is not

¹⁵¹ Cf. for instance, Ramberg, *Reklamation mot advokater och revisorer*, pages 145 to 147.

required under Swedish law that a notice include a statement that a claim for damages will be pursued. A notice of the breach itself suffices. Clearly, Naftogaz's notices fulfil such requirement.

(2123) Naftogaz has also had reasons not to invoke any damages claim prior to the current dispute, cf. NJA 1992 p. 728. The Parties have been in discussions regarding changing the tariff to a tariff which covers Naftogaz' costs since June 2009. Such tariff would be applied retroactively. It is only natural that Naftogaz wished to await the outcome of such discussions prior to initiating a dispute regarding damages.

(2124) In sum, Naftogaz has not lost its right to claim damages based on any waiver of such claim or based on a failure to give notice, and Gazprom's objections should accordingly be rejected.

7.1.13.2 Naftogaz' interest claims

7.1.13.2.1 Naftogaz' interest claims in relation to Gazprom's underdeliveries

(2125) Naftogaz claims interest on any damages Gazprom is ordered to pay due to its breaches of the Contract consisting in failure to deliver the agreed volumes for transit. Naftogaz' primary position is that Gazprom is liable to pay damages based on Section 3 and 6 of the Interest Act. The due date for damages for underdeliveries is when the volume obligation should have been fulfilled i.e. not later than 31 December each year, or if the volume obligation is terminated at some other time during the year the last day of the month when the volume commitment applied. Interest starts accruing from and including the second day after the obligation to deliver gas should have been fulfilled or, if not a business day, the first business day after that.

(2126) Should the Tribunal reject Naftogaz' interest claims based on Section 3 and 6 of the Interest Act, Naftogaz in the alternative claims interestbased Sections 4(3), 4(4) and 6 of the Interest Act.

(2127) Pursuant to Section 4(3) of the Interest Act Gazprom is liable to pay interest from the day which occurred thirty days after Naftogaz demanded compensation for Gazprom's breaches of the Contract i.e. 26 August 2014 since the claims were made in Naftogaz' notice of disputes dated 25 July 2014. Should Gazprom not be ordered to pay interest from 26 August 2014 Gazprom is,

pursuant to Section 4(4) of the Interest Act, liable to pay interest from the date it received Naftogaz' Request for Arbitration or when claims for payments were made during the proceedings, i.e. 16 October 2014, 4 May 2015, 15 February 2016 or 29 August 2016. At the latest Gazprom is liable to pay interest from the date of the Award.

7.1.13.2.2 Interest on underpayments or damages

(2128) Naftogaz claims interest on any amounts Gazprom is ordered to pay due to its having paid too little for the transit services rendered by Naftogaz or as damages for breach of competition law. The legal basis for Naftogaz' interest claims in relation to underpayments is Sections 4 and 6 of the interest Act.

(2129) As regards any compensation amounts in respect of any period starting no earlier than 1 January 2010 and ending on 31 December 2015, pursuant to Section 4(4) of the Interest Act Gazprom is liable to pay interest from the day which it received Naftogaz' Request for Arbitration, or when claims for payments were made during the proceedings i.e. 16 October 2014, 4 May 2015, 15 February 2016 or 29 August 2016. At the latest, Gazprom is liable to pay interest from the date of the award. The reason why Gazprom may and should be ordered from 16 October 2014 is that the capital amount as of this date is as high as at 31 December 2015 (this is equally applicable to 4 May 2015 as an alternative date for calculation of interest).

(2130) As regards any compensation amounts in respect of any period starting no earlier than 1 January 2016 and ending 31 July 2016, pursuant to Section 4(4) of the Interest Act Gazprom is liable to pay interest from the date it received a claim for payment for this period i.e. 29 August 2016. At the latest Gazprom is liable to pay interest from the date of the Award.

7.1.14 The jurisdiction of the Arbitral Tribunal

7.1.14.1 Introduction

(2131) Below, Naftogaz briefly discusses the applicable law and the legal sources relevant to the issue of jurisdiction in the present arbitral proceedings. Naftogaz shall then proceed to address the jurisdiction of the Tribunal:

- in relation to the claims for replacement of invalid or ineffective provisions, which is based on EU competition and energy law on a stand-alone basis and as Swedish and Ukrainian law, and Article 13.2 of the Contract. This is also the foundation for the monetary claims based on Gazprom's underpayment under the replaced Article 8 in the Relief Sought;
- in relation to the claim for revision of the transit tariff pursuant to Swedish Contract Law. This claim is also an alternative foundation for the monetary claims based on Gazprom's underpayment under the replaced Article 8, in the Relief Sought;
- in relation to the claims for compensation for underdeliveries of transit volumes of Natural Gas in the Relief Sought; and,
- in relation to the claims based on underpayment for transit of Natural Gas based on the replaced or revised Article 8 in the Relief Sought.

(2132) Finally, Naftogaz shall address the procedural requirements for referring the dispute to arbitration, and recall that they have been fulfilled.

7.1.14.2 The applicable law and the relevant legal sources

(2133) Article 12.1 provides that the Contract shall be governed by and is subject to interpretation in accordance with the substantive laws of Sweden. A distinction is generally made between material and procedural rules, and as the rules concerning the jurisdiction of the Arbitral Tribunal are of a *procedural* nature, the latter are not regulated by Article 12.1 of the Contract.

(2134) Pursuant to Article 12.2, disputes shall be finally resolved by arbitration in accordance with the SCC Rules, and the place of arbitration shall be Stockholm, Sweden. Consequently, the relevant procedural rules are the SCC rules and the procedural rules of Sweden as *lex arbitri* (the arbitration rules of the State where the arbitration takes place). In respect of the arbitration agreement the relevant law is also Swedish law by virtue of the fact that the Parties have not chosen a law specifically to govern the arbitration agreement and the place of arbitration is Stockholm, Sweden, cf. Section 48 of the Swedish Arbitration Act.

(2135) This implies that the applicable law relevant to the issue of jurisdiction is the SCC Rules and practice under the SCC Rules and the Swedish Arbitration Act as applied in international arbitration. It also means that international arbitral practice under other institutional rules, like the ICC Rules, may be relevant.

(2136) The other and primary source is the Contract itself and the intentions of the Parties. The contents of the Contract and the negotiations between the Parties prior to and after its conclusion are essential in order to identify the Parties' intentions, have been thoroughly presented above.

7.1.14.3 The Arbitral Tribunal's jurisdiction over Naftogaz' claims

7.1.14.3.1 The Arbitral Tribunal's power to address issues of energy and competition law and rule on the latter's effects on the Contract

(2137) Article 13.2 of the Contract provides that:

"If any of the provisions of the present Contract becomes legally invalid pursuant to the applicable legislation or ineffective, this shall not affect the validity of other provisions hereof. If any of the provisions of the present Contract becomes invalid or ineffective, the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have the economic effect as close as possible to that of the invalid or ineffective provision."

(2138) Article 13.2 obliges the Parties to replace any invalid and/or ineffective provisions in the Contract. It follows that the Tribunal's power to adjust and/or replace the terms which are rendered invalid by EU competition and energy law, primarily stems from Article 13 of the Contract.

(2139) In relation to competition law, the Tribunal's power is explicitly confirmed by the Swedish Arbitration Act. Section 1, third paragraph, of the Swedish Arbitration Act reads in the translation of SCC:

"Arbitrators may rule on the civil law effects of competition law as between the parties."

(2140) Thus, the Arbitral Tribunal has jurisdiction to rule on the effects of EU competition law on the Contract pursuant to Section 1 of the Swedish Arbitration Act.

(2141) As explained above, the basis for Naftogaz's claim for adjustment and replacement of invalid and ineffective provisions is the EU *acquis* on competition and energy law, which is Swedish law.

(2142) As already explained above, EU secondary legislation on energy in reality operationalises the competition rules in Articles 101 and 102 TFEU. The Tribunal is therefore also empowered to rule on the effects of the EU *acquis* on energy.

7.1.14.3.2 The Arbitral Tribunal's power to revise the transit tariff pursuant to Swedish contract law

(2143) According to Article 8.7 of the Contract, each Party is entitled to a revision of the price for transit services on certain material conditions. Article 8.7.1 provides that a request for price revision shall be made in writing and be properly substantiated. Naftogaz made a written, substantiated request for revision of the price (tariff) under the Contract on 15 June 2009, which was followed by negotiations between the Parties where Gazprom rejected the request.

(2144) Article 8.7.2 provides that:

"If a written agreement on the revision of the price for transit services cannot be reached within 3 (three) months from the date of the beginning of the negotiations, then each party has the right to refer the matter to arbitration in accordance with Article 12 of the Contract for the passing of a final decision."

(2145) Thus, the Tribunal's power to revise the tariff pursuant to Swedish Contract Law is based on Article 8.7, and Article 12 of the Contract.

(2146) The Tribunal also has the power to revise the tariff provisions pursuant to Section 36 of the Swedish Contracts Act.

- (2147) The so-called general clause in Section 36 of the Swedish Contracts Act is a rule under which contract terms may be revised, i.e. adjusted or set aside. This also applies in business to business relations, and finds its most natural application in the context of long-term contracts.
- (2148) Adjustments under Section 36 of the Swedish Contracts Act may be made even where the parties have agreed on mechanisms intended to address changed circumstances.
- (2149) Section 36 of the Swedish Contracts Act is part of the "*substantive laws of Sweden*", which govern the Contract pursuant to Article 12.1 thereof and, as such, must be applied by courts and arbitral tribunals. Any tribunal that is to apply Swedish law is empowered to apply the Swedish Contracts Act and thereby, *inter alia*, Section 36.

7.1.14.3.3 The Arbitral Tribunal's power to grant damages as compensation for Gazprom's failure to perform its obligations

(2150) Article 10.1 of the Contract reads as follows:

"The Client and the Contractor will undertake their best efforts to duly perform the undertaken obligations under this Contract.

Should the Parties fail to perform on the terms and conditions of this Contract, each of the Parties shall reimburse the other Party for any proven damages caused by such failure to perform."

- (2151) Naftogaz recalls that the claims for compensation for underdeliveries of transit volumes are based on a regular application of Article 10.1. Under the Contract, the Parties agreed that a Party which fails to perform its obligation shall be liable for damages caused by such failure to perform.
- (2152) Thus, the Arbitral Tribunal has jurisdiction over Naftogaz' claim for damages pursuant to Article 10.1 of the Contract. The power to make an award on monetary damages lies at the very core of arbitral jurisdiction, and is undisputed.¹⁵²

¹⁵² Cf. Gary G. Born, *International Commercial Arbitration*, page 2480.

7.1.14.3.4 The Arbitral Tribunal's power to order Gazprom to make additional payments on the basis of the replaced or revised Article 8

(2153) It follows from the Tribunal's power to replace Article 8 pursuant to EU competition and energy law, and to revise the tariff pursuant to Swedish Contracts Law, that the Tribunal also has the power to rule on the effects of such replacement or revision.

(2154) Consequently, the Tribunal has the power to order that Gazprom make additional payments on the basis of the replaced or revised Article 8 from its effective date, 1 January 2010. In general, if one party seeks amounts due in payment for services, there is little basis for disagreement over the tribunal's power to grant such relief.¹⁵³

7.1.14.3.5 The Parties have sought to resolve the disputes by negotiations

(2155) The procedural conditions for referring a dispute to arbitration are set out in Article 12.2 of the Contract, which provides *inter alia* for a negotiation period of 45 days from the occurrence of a dispute. This is the general rule on procedural conditions for arbitration, applicable to all of Naftogaz' claims, except the price revision claim based on the price revision clause in Article 8.7.

(2156) Naftogaz sent a Notice of disputes to Gazprom on 25 July 2014, informing of the changes necessary to be made to the Contract to align it with European and Ukrainian law, claiming compensation for underdeliveries of transit gas, and claiming adjustment of the transit tariff based on the EU Competition and Energy Law and Swedish Contract law. Consequently, the mandatory 45-day negotiation period started on that date.

(2157) Further documentation of the Parties' negotiations relating to the present dispute prior to initiation of arbitration has been presented above.

(2158) Naftogaz submitted its Request for Arbitration on 13 October 2014. Thus, also this condition for referring the dispute to arbitration is fulfilled.

¹⁵³ Cf. Gary G. Born, *International Commercial Arbitration*, page 2478.

7.1.15 Naftogaz defence to Gazprom's counterclaims

7.1.15.1 Introduction

(2159) In its Defence, Gazprom has submitted two sets of claims, viz. (i) Payment Claims for transit volumes allegedly taken by Naftogaz in four months in 2014, i.e. July, August, October and November and not paid for by Naftogaz, and (ii) Interest Claims for the amounts not paid by Naftogaz. Gazprom also reserves the right to make additional counterclaims once the Tribunal has made its partial award in the Gas Sales Arbitration, i.e. claims related to Gazprom's alleged overpayment of the transit tariff.

(2160) Naftogaz maintains that Gazprom's counterclaims are without any basis in law and in fact, and rejects them in their entirety.

7.1.15.2 The payment claims

7.1.15.2.1 Gazprom's claims for payment if Naftogaz' claim for invalidity/ineffectiveness of Article 10.4 is granted

(2161) Gazprom claims payment (USD 3,368,126.03), interest excluded, for transit volumes allegedly taken by Naftogaz in four months in 2014, i.e. July, August, October and November, and not paid for by Naftogaz in accordance with Articles 4.5 and 10.4 of the Contract, cf. Article 4.3 of the Gas Sales Contract.

(2162) Pursuant to Article 10.4, all gas "*withdrawn*" (or "*offtaken*" in Gazprom's translation) (off-takes) shall be recorded as gas purchased under the Gas Sales Contract and priced at the *penal* rates specified in Article 4.3 of the Gas Sales Contract. These rates are 150% of the factual price in summer and 300% of the factual price in winter. This in itself shows that the term "*withdrawn*" in Article 10.4 only applies in case of deliberate offtakes of transit volumes for own consumption.

(2163) However, as ██████████ explained in his second witness statement, an amount of up to 3 million cubic meters of gas per day may stay within Ukraine for purely technical reasons. ██████████ emphasized that no-one was at fault.

(2164) The volumes Gazprom claims payment for amounts to 1.65 million m³ for August, 1.7 million m³ for September, 1.89 million m³ for November, and 4800 m³ for December 2014. These volumes are all far below balancing volumes caused by technical issues for any given day. Notably, Gazprom has no claim for September 2014, because European buyers then off-took *more* gas than Gazprom had injected.

(2165) Thus, the temporary gas imbalances are not due to Naftogaz *withdrawing* or *offtaking* gas in the sense of Article 10.4, but a result of the technical particularities of the Ukrainian GTS. The counterclaim should be rejected.

(2166) The counterclaim has no contractual basis if Naftogaz' claim for invalidity of Article 10.4 succeeds. Article 10.4 does not apply regardless of the reasons why transit gas remains in Ukraine, but only if Naftogaz "*withdraws*" the gas, i.e. deliberately. The penal rates payable under Article 4.3 of the Gas Sales Contract, viz. 150 and 300 %, confirm this. In any event, the claim shall be reduced based on the outcome of the Gas Sales Arbitration.

(2167) Pursuant to European competition law and related energy law, Article 10.4 of the Contract was invalid and/or ineffective in 2014. Thus, Gazprom's payment claims have no legal basis.

(2168) Article 10.4 of the Contract might be said to impose balancing payments from Naftogaz to Gazprom

(2169) The requirement pursuant to EU and ECT energy legislation to develop market-based balancing services to avoid discrimination and cross-subsidisation of network users was further elaborated above. Naftogaz has explained how this leads to Naftogaz' claims for invalidity/ineffectiveness and replacement of, *inter alia*, Article 10.4 of the Contract.

(2170) Consequently, if Naftogaz' claims are successful, Gazprom's counterclaim lacks any contractual basis and must be rejected.

7.1.15.2.2 Gazprom's payment claims should be rejected as a matter of fact

(2171) Even if the Tribunal should not reject Gazprom's payment claims because they lack contractual basis, Gazprom's claims must be rejected as a matter of fact.

(2172) Naftogaz disputes Gazprom's payment claims on a factual basis. The volumes allegedly withdrawn by Naftogaz are the difference between gas supplied for transit by Gazprom at Ukraine's Eastern border and gas taken by Gazprom and its customers at Ukraine's Western border. The difference occurred because Gazprom and its customers took less gas than Gazprom delivered. Consequently, the volumes have not been "withdrawn" by Naftogaz but delivered by Gazprom without any legal basis. In reality, Gazprom is attempting to impose penalties on Naftogaz because of its own inability to balance supplies and offtake, effectively charging Naftogaz for the privilege of providing balancing services to Gazprom. Consequently, the claim should be rejected on the merits since Gazprom caused the "offtake" itself, even if Clause 10.4 should be found to be valid and effective.

(2173) An account of the relevant facts related to alleged withdrawals of Natural Gas for transit by Naftogaz in July, August, October, and November 2014, is provided by [REDACTED] in her second witness statement and in [REDACTED] second witness statement.

(2174) In particular, [REDACTED] explains that, because of the lack of a properly functioning balancing mechanism in the Contract, Naftogaz was faced with the practical problem of dealing with differences occurred because Gazprom and its customers took less gas than Gazprom delivered. As long as gas was being supplied under the Gas Sales Contract, the Parties had solved these problems by documenting the "extra" Natural Gas for transit (not off-taken by Gazprom and its customers) as gas supplied under the Gas Sales Contract, i.e. at the regular price applicable under that contract, cf. [REDACTED]

(2175) In July 2014, however, Gazprom did not supply any volumes of gas under the Gas Sales Contract, which prompted Naftogaz to suggest a different arrangement for the balancing issue. Naftogaz proposed that the balancing volumes, i.e. the difference between the volume delivered by Gazprom for transit and the volume off-taken by its customers, be accounted in the corresponding delivery and acceptance reports as gas belonging to Gazprom, cf. [REDACTED]

(2176) Gazprom refused to agree to this arrangement, and instead issued its own version of the reports, documenting the balancing volumes as Natural Gas withdrawn without authorisation, to be priced according to the penalty provisions in Article 4.3 of the Gas Sales Contract, cf. [REDACTED]

(2177) In other words, Gazprom is attempting to impose penalties on Naftogaz because of its own inability to balance supplies and offtake, effectively charging Naftogaz for the privilege of providing balancing services to Gazprom.

(2178) Consequently, the claim should be rejected on the merits since Gazprom caused the "offtake" itself, and Article 10.4 cannot apply even if it should be found to be valid and effective.

7.1.15.2.3 Gazprom's payments claims should be reduced based on the outcome of the Gas Sales Arbitration

(2179) Gazprom's counterclaim (which Naftogaz rejects) is in any event overstated because of the revised Factual Price in the Sales Arbitration. Dr Hesmondhalgh has calculated that this reduces the counterclaim (including interest until 28 February 2018) from USD 7.2 million, to USD 4.6 million.

7.1.15.2.4 Claim in respect of set off

(2180) Gazprom has made a claim for set off to be specified upon receipt of the Final Award in the Sales Arbitration, asking the Tribunal to set off against any amount awarded to Naftogaz in this Arbitration against any amounts that may be awarded in favour of Gazprom in the Sales Arbitration. Gazprom has not yet specified this claim.

(2181) In light of the Final Award in the Sales Arbitration, Naftogaz has decided to waive its defences against Gazprom's claim for set off. Consequently, the Parties now agree that any amount awarded to Naftogaz in this Arbitration shall be set off against the amount awarded in favour of Gazprom in the 22 December 2017 Final Award in the Sales Arbitration. Naftogaz has amended its relief sought accordingly, to (i) no longer reject Gazprom's claim for set-off and (ii) specify its own, equivalent claim for set off. The amount awarded to Gazprom in the Sales Arbitration has not been paid yet partly because of the necessary correction of the Final Award on this point, partly because set off is the most practical form of settlement. Gazprom is compensated for the delay at the contractual late payment interest rate.

(2182) Independently of whether Gazprom's or Naftogaz' claim for set off is applied, the interest claim of the Party setting off should first be applied against the interest claim of the Party subjected to the set off, following which the capital claim of the Party setting off is applied first against any remaining interest claim of the other Party, second against the capital claim of the other Party.

(2183) Naftogaz updates its calculations of the future offset in respect of the underpayment claims.¹⁵⁴ In essence, the regulator's tariffs for the years 2016-2019 are higher than the tariffs that would have been applicable had cost-reflective tariffs been introduced at an earlier date.¹⁵⁵ The future offset is thus calculated to avoid double-counting in Naftogaz's underpayment claims. This is visually illustrated in Figure 2 on page 6 of Brattle 9.

(2184) The specific set off has been calculated as follows:

The total amount awarded to Gazprom in the Sales Arbitration is USD 2,029,823,867.2132. Late payment interest has accrued on the latter amount after 22 December 2017, and will amount to USD 29,323,851.09 on the scheduled date of the Final Award in this Arbitration, 28 February

¹⁵⁴ Cf. Section II C. Brattle 9.

¹⁵⁵ Cf. § 2 Brattle 9.

2018. Consequently, the total amount to be paid by Naftogaz to Gazprom is USD 2,059,147,718.30 (A).

The total amount (principal plus interest) to be paid by Gazprom to Naftogaz in the Transit Arbitration is USD 17,206,000,961.21, alternatively USD 16,760,644,811.64 of which USD 1,066,017,820.79 is VAT (B).

(2185) A netting of the total amounts (A) and (B), with the result that (A) is deducted from (B), results in a net total amount to be paid by Gazprom to Naftogaz of USD 15,146,853,242.90, alternatively USD 14,701,497,093.33 of which USD 1,066,017,820.79 is VAT.

(2186) In addition, as a practical matter and without prejudice to Naftogaz' other defences against Gazprom's counterclaim in this Arbitration for payment for gas allegedly taken under Article 10.4 of the Contract, Naftogaz requests the Tribunal to order a set off of any amount awarded to Gazprom in this arbitration against any amount awarded to Naftogaz in this arbitration remaining after the set off between the amount awarded to Gazprom in the Sales Arbitration and the amount awarded to Naftogaz in the Transit Arbitration, with any remaining interest due to Naftogaz applied before Naftogaz' capital amount, and against any interest awarded to Gazprom before any principal awarded to Gazprom.

7.1.15.3 The interest claims

(2187) Gazprom also claims interest (USD 575,474.02) on late payments of the gas allegedly taken in July, August, October and November 2014.

(2188) Gazprom's interest claim is conditional upon Gazprom's payment claims and should be rejected for the same reasons as the payment claims.

7.2 Gazprom's case

7.2.1 Gazprom's counterclaims

7.2.1.1 Counterclaim for payment in respect of transit volumes taken by Naftogaz

(2189) Gazprom's counterclaim against Naftogaz arises from the fact that Naftogaz took transit gas volumes in four months of 2014 for which it has not made payment.

(2190) Article 4.5 of the Transit Contract states that:

"[Naftogaz] shall be responsible for the procurement of secure and uninterrupted operation of the Ukrainian gas transportation system, including for the timely and full provision of the technological gas and for any losses of the Natural Gas as delivered by [Gazprom] for transit at the territory of Ukraine."

(2191) Article 10.4 of the Contract states:

"If the Natural Gas delivered to the Ukrainian gas transportation system for transit purposes is taken by ... [Naftogaz], the entire volume of such gas taken shall be documented as gas purchased under Contract for the purchase and sale of natural gas between OAO Gazprom and NAK Naftogaz of Ukraine No. _ of 19 January 2009.

The price of such Gas shall be set in accordance with point 4.3 of article 4 of Contract for the purchase and sale of natural gas between OAO Gazprom and NAK Naftogaz of Ukraine No. _ of 19 January 2009."

(2192) Article 4.3 of the Sales Contract (as referenced in Article 10.4 of the Transit Contract) states:

"If ... [Naftogaz] off-takes the Natural gas without agreement with ... [Gazprom] in the volume exceeding the Monthly delivery volume by more than six (6) percent, the price of 1000 m³ of the Gas off-taken in excess of this volume of the Gas shall be determined according to the following formula:

*$P_b = 1.5 * P_0(0.5xG/G_0 + 0.5xM/M_0)$ - from April to September inclusive,*

*$P_b = 3 * P_0(0.5xG/G_0 + 0.5xM/M_0)$ - from October to March inclusive,*

Where P_b is the price of the Gas exceeding the monthly delivery volume by more than six percent, in US dollars per 1,000 cubic meters of gas,

P_0 is the reference price in US dollars per 1,000 cubic meters of gas for gas exceeding the Monthly delivery volume by more than six percent and equal to USD 450 per 1,000 cubic meters,

where G_o , G , M_o and M are the parameters described in Clause 4.1 hereof.

Should the net calorific value of the delivered Natural gas be higher or lower than the basic net calorific value as stated in Clause 4.1 hereof in the Month of Delivery, the actual price of the Gas exceeding the Monthly delivery volume shall change correspondingly and shall be calculated according to the following formula:

$P_{xb} = P_b \times Q_{act}/8050$, where

P_{xb} is the actual price for the Gas exceeding the Monthly delivery volume by more than six (6) percent, in US dollars per 1,000 cubic meters of the Gas,

The remaining parameters shall correspond to the parameters specified in Clause 4.2 hereof.

All interim calculations and rounding shall be effected in accordance with Clause 4.1 hereof."

(2193) In summary, pursuant to the above provisions, Naftogaz is responsible for any loss of gas delivered by Gazprom to it for transit through Ukraine. Further, the Contract obliges the Parties to document, and Naftogaz to pay for, any transit gas volumes it takes as if such gas were gas purchased by Naftogaz from Gazprom under the Sales Contract. The price payable by Naftogaz to Gazprom for such gas is determined as it would be for supply gas off-taken by Naftogaz in amounts of more than 6% of the monthly delivery volume without Gazprom's agreement i.e. using the same formula as for gas generally supplied under the Sales Contract, but without

adjustment via coefficient "k" and instead multiplied by 1.5 for the months of April to September inclusive and 3 for the months of October to March inclusive.¹⁵⁶

(2194) In four months in 2014, in breach of Article 4.5 of the Transit Contract, Naftogaz took gas delivered to the Ukrainian transportation system by Gazprom for transit purposes. In particular:

in July 2014, 1,654.365 TCM¹⁵⁷ of Gazprom's transit gas was taken by Naftogaz;

in August 2014, 1,719.248 TCM of Gazprom's transit gas was taken by Naftogaz;

in October 2014, 1,896.305 TCM of Gazprom's transit gas was taken by Naftogaz; and

in November 2014, 4.843 TCM of Gazprom's transit gas was taken by Naftogaz.

(2195) In further breach of Article 10.4 of the Transit Contract, Naftogaz has failed to pay Gazprom for such gas in accordance with the provisions set out above.

(2196) Pursuant to Article 10.4 of the Contract, Gazprom drew up commercial delivery and acceptance statements in respect of the above volumes of gas, to document them as gas purchased by Naftogaz under the Sales Contract.¹⁵⁸

(2197) Naftogaz has persistently refused to sign these statements and has instead sent its own statements to Gazprom, which incorrectly categorise the above volumes as "*balancing volumes*" (Naftogaz having, at least in the case of the July 2014 volumes, apparently resiled from its original position, which was that the volumes "*would be charged towards deliveries under..[Contract KP]*").¹⁵⁹

(2198) Naftogaz asserts that the explanation for the differences in volumes between the gas delivered by Gazprom for transit at the entry points and the volumes delivered by Naftogaz at the exit

¹⁵⁶ Assuming the gas has a net calorific value that is not higher or lower than the basic net calorific value as stated Article 4.1 of Contract KP in the month of delivery; if that is the case a different formula is provided.

¹⁵⁷ Thousand cubic metres.

¹⁵⁸ Commercial delivery and acceptance statements issued by Gazprom in relation to the period July to November 2014, Nos 7 to 11.

¹⁵⁹ Letter No. 120599 from Naftogaz to Gazprom dated 2 September 2014; Commercial delivery and acceptance statements issued by Naftogaz, Nos. 7, 8, 9, 10 and 11.

points is that Gazprom and its customers took less gas than Gazprom delivered. The fact that volumes are contractually allocated on a monthly basis means that any daily shortfalls in deliveries to the exit points can be addressed through adjustment over the subsequent days and weeks of the relevant month - either through a reduction in volumes delivered to the entry points, or through an increase in deliveries by Naftogaz to the exit points - so as to minimise any monthly imbalance. Naftogaz had two options open to it in respect of monthly deficits in transit deliveries: (a) to elect to purchase gas under the Sales Contract, or (b) in the event of no purchases under the Sales Contract in the relevant month (which was the case in respect of July, August, October and November 2014), the volumes would fall to be dealt with pursuant to Article 10.4 of the Transit Contract. Naftogaz cannot and does not deny that the missing volumes which form the basis of Gazprom's Payment Claims, did in fact remain within Ukraine and, when delivered by Gazprom, the volumes were under Naftogaz' control.

- (2200) In breach of Article 10.4 of the Transit Contract, Naftogaz has failed to pay Gazprom for this gas. Naftogaz says in its defence that these volumes taken are "balancing volumes" and somehow this justifies the taking of the gas on this basis. This is denied. There is no support for this. The Transit Contract does not permit the retention of "balancing volumes" and Naftogaz does not point to any provision in the Contract enabling it to do so.
- (2201) Gazprom denies that these volumes should be categorised as "*balancing volumes*". As [REDACTED] explained in detail, the Balancing Agreement between Gazprom Export and Ukrtransgaz was terminated in July 2014. There is no contractual provision allowing Naftogaz to retain any "*balancing volumes*" from Gazprom's transit gas (or any other legal basis for it to do so).
- (2202) Further, to the extent that Naftogaz' reference to "*balancing volumes*" refers to the technical or fuel gas required to operate the GTS (including fuelling the compressors), provision in respect of fuel gas was directly incorporated into the transit tariff by way of Article 8.1 of the Contract and, specifically, element " K_{nj} " of the transit tariff formula, which effectively means that

Naftogaz is responsible for providing fuel gas and is compensated for doing so in the calculation of the transit tariff.

(2203) Naftogaz expressly acknowledged that this was the case in a letter to Gazprom dated 10 August 2009, in which it stated:

"During negotiations upon signing .. [Contract TKGU] .. Naftogaz .. and ... Gazprom agreed that the formula determining the price for services on transit will include the fuel component of the tariff reflecting the annual consumption of fuel gas in the amount of around 4.09 billion cubic meters necessary to procure transit of the gas of ... Gazprom.

*The formula for determining fuel component of the tariff in the text of ...[Contract TKGU] (Clause 8.1) is based on the annual consumption of fuel gas in the amount of around 3.3 billion cubic meters."*¹⁶⁰ (Emphasis and clarifications added by Gazprom.)

(2204) Naftogaz also acknowledges this in its Statement of Claim:

"..the price formula .. includes a fuel tariff component (K_{nj}^{mg}) whose purpose is to compensate Naftogaz for the operational costs specifically related to fuel gas".

(2205) Article 4.5 of Contract TKGU reflects that the tariff formula specifically takes account of fuel gas by expressly allocating responsibility for the provision of fuel gas to Naftogaz: "*[Naftogaz] shall be responsible ... for the timely and full provision of the technological gas".*

(2206) Further, [REDACTED] provides as follows:

[REDACTED]

¹⁶⁰ Letter No. 24-572-4490 from Naftogaz to Gazprom dated 10 August 2009.



(2207) It is abundantly clear from the above provisions that Naftogaz is not entitled to retain fuel gas from Gazprom's transit volumes.

(2208) Naftogaz' position that the transit volumes it has taken are "*balancing volumes*" is therefore unsustainable. Pursuant to Article 4.5 of the Contract Naftogaz is responsible for any losses of transit gas and Article 10.4 of the Contract provides an agreed mechanism through which volumes of transit gas appropriated by Naftogaz would be documented and paid for by Naftogaz. Naftogaz should comply with those provisions.

(2209) Gazprom has issued the following invoices to Naftogaz, reflecting a price for the gas calculated in accordance with Article 4.3 of the Contract (as mandated by Article 10.4 of the Contract):

1. invoice no. 41 dated 21 August 2014, in respect of the gas taken by Naftogaz in July, in the amount of US \$1,229,011.21;¹⁶¹
2. invoice no. 47 dated 11 September 2014, in respect of the gas taken by Naftogaz in August, in the amount of US \$1,286,135.04;¹⁶²
3. invoice no. 61 dated 11 November 2014, in respect of the gas taken by Naftogaz in October, in the amount of US \$2,764,205.87;¹⁶³ and
4. invoice no. 70 dated 11 December 2014, in respect of the gas taken by Naftogaz in November, in the amount of US \$7,051.99.¹⁶⁴

(2210) These invoices remain unpaid.

¹⁶¹ Gazprom invoice no. 41 dated 21 August 2014, in respect of the gas taken by Naftogaz in July, in the amount of US \$1,229,011.21.

¹⁶² Gazprom invoice no. 47 dated 11 September 2014, in respect of the gas taken by Naftogaz in August, in the amount of US \$1,286,135.04.

¹⁶³ Gazprom invoice no. 61 dated 11 November 2014, in respect of the gas taken by Naftogaz in October, in the amount of US \$2,764,205.87.

¹⁶⁴ Invoice no. 70 dated 11 December 2014, in respect of the gas taken by Naftogaz in November, in the amount of US \$7,051.99.

(2211) Initially in these proceedings Gazprom claimed the total amount of US \$5,286,404.11 from Naftogaz in respect of transit gas that has been taken by Naftogaz.

(2212) In Brattle Report 9, Dr Hesmondhalgh has revised downwards the value of this counterclaim to take account of the revised price under Gas Sales Contract (the Supply Contract) pursuant to the Supply Final Award. She arrives at a figure of US \$4,606,997 inclusive of late payment interest to 28 February 2018. That figure is agreed by Dr Moselle.

(2213) Accordingly, an award on the existing counterclaim should be made in this amount

7.2.1.2 Gazprom's counterclaims for interest

7.2.1.2.1 Introduction

(2214) Gazprom also counterclaims against Naftogaz in respect of the interest owed on the unpaid amounts referred to above. As set out above, Article 10.4 of the Contract provides that transit gas taken by Naftogaz "*shall be documented as gas purchased under Contract [KP]*". Accordingly, Gazprom claims for interest on these amounts in accordance with the provisions for the payment of interest set out in the Sales Contract, as particularised below.

(2215) Articles 5.1.1 to 5.1.4 of the Sales Contract (as amended) provide as follows:

[REDACTED]

[REDACTED]



(2216) Article 6.2 of the Sales Contract provides as follows:

"In the event of delay in payments for the Gas delivery hereunder, [Gazprom] is entitled to charge late payment interest to [Naftogaz] equal to 0.03% of the amount overdue for each day of delay in payment."(Clarification made by Gazprom)

(2217) Accordingly, late payment interest accrues on outstanding amounts in accordance with the provisions of the Sales Contract, in relation to invoices for actual deliveries, from the 11th day after its date of issue until the date the invoice is paid in full (pursuant to Articles 5.1.4 and 6.2 of the Sales Contract).

7.2.1.2.2 Invoices for July, August, October and November 2014

(2218) As stated above, Gazprom has issued invoices to Naftogaz, reflecting a price for the gas calculated in accordance with Article 4.3 of the Sales Contract (as mandated by Article 10.4 of the Transit Contract).

(2219) With the downward revision of the value taking account of the revised price under the Sales (Supply) Contract pursuant to the Supply Final Award, Gazprom's counterclaim in respect of transit gas that has been taken by Naftogaz but that has not been paid for in accordance with Gazprom's contractual entitlement, amounts to USD 3,368,126.03.

7.2.1.2.3 Interest claimed in relation to invoices in respect of gas taken by Naftogaz in July, August, October and November 2014

(2220) Gazprom's counterclaims for interest are the following:

1. in respect of invoice no. 41 dated 21 August 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of USD 718,904.31 at the rate of 0.03% for each day of delay in payment from 1 September 2014 until full payment has been made;
2. in respect of invoice no. 47 dated 11 September 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of USD 752,308.54 at the rate of 0.03% for each day of delay in payment from 22 September 2014 until full payment has been made;
3. in respect of invoice no. 61 dated 11 November 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of USD 1,890,837.65 at the rate of 0.03% for each day of delay in payment from 22 November 2014 until full payment has been made; and
4. in respect of invoice no. 70 dated 11 December 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of USD 6,075.54 at the rate of 0.03% for each day of delay in payment from 22 December 2014 until full payment has been made.

(2221) Pursuant to Article 5.1.4 of the Sales Contract, these invoices for the gas taken by Naftogaz should have been paid by the following due dates:

1. invoice no. 41 dated 21 August 2014, in respect of the gas taken by Naftogaz in July, by 31 August 2014;

2. invoice no. 47 dated 11 September 2014, in respect of the gas taken by Naftogaz in August, by 21 September 2014;
3. invoice no. 61 dated 11 November 2014, in respect of the gas taken by Naftogaz in October, by 21 November 2014; and
4. invoice no. 70 dated 11 December 2014, in respect of the gas taken by Naftogaz in November, by 21 December 2014.

(2222) However, in breach of Article 5.1.4 of the Sales Contract, Naftogaz failed to pay the invoices for gas taken in July, August, October and November 2014 by their respective due dates.

(2223) Therefore, pursuant to Articles 5.1.4 and 6.2 of the Sales Contract, late payment interest of 0.03% of the amount overdue accrues for each day of delay in payment as follows:

1. in relation to the invoice for gas taken by Naftogaz in July 2014, over the period from 1 September 2014 until the date of payment in full;
2. in relation to the invoice for gas taken by Naftogaz in August 2014, over the period from 22 September 2014 until the date of payment in full;
3. in relation to the invoice for gas taken by Naftogaz in October 2014, over the period from 22 November 2014 until the date of payment in full; and
4. in relation to the invoice for gas taken by Naftogaz in November 2014, over the period from 22 December 2014 until the date of payment in full.

7.2.1.3 The counterclaim for overpayment of transit fees as from 27 April 2014

7.2.1.3.1 The claim for overpayment

(2224) The Tribunal's decision, as reflected in the Supply Final Award, to revise the Supply Price in Article 4.1 of the Sales (Supply) Contract as from 27 April 2014 necessitates an adjustment to the transit tariff under Article 8.1 of the Transit Contract from 27 April 2014. This is because

one component of the formula (P_{nj}) for the transit tariff is the Supply Price under the Sales (Supply) Contract. A downward revision of the Supply Price therefore results, pursuant to the operation of the transit tariff formula, in a downward adjustment to the transit tariff payable by Gazprom from 27 April 2014.

(2225) Such adjustment has the necessary consequence that in the period from 27 April 2014 until the present, Gazprom has made certain overpayments of transit fees, and is therefore entitled to a refund of these amounts together with interest accrue under the Swedish Interest Act.

(2226) Gazprom's overpayment is quantified, and its entitlement to a refund is recognised, by Dr Hesmondhalgh in Brattle 9. The amount of the adjustment (excluding interest) is app. USD 44 million, as agreed by both Dr Moselle and Dr Hesmondhalgh.

(2227) Dr Hesmondhalgh applies a credit of this sum against the Naftogaz' underdeliveries claim. Gazprom objects to such course for two reasons: (1) there is no sum to be credited against because Naftogaz' underdeliveries claim should be rejected in its entirety, and (2) in any event, Gazprom does not seek set off as its primary remedy.

(2228) Gazprom's primary position in respect of the overpayments is to advance the claim as a new counterclaim. It is only if the Tribunal refuses recovery through that route that Gazprom seeks set-off against any sums awarded to Naftogaz on its claims.

7.2.1.3.2 Gazprom's claim for interest in respect of overpayment of transit fees

(2229) In addition to its claim for reimbursement of the capital amounts of the overpayments as set out above, Gazprom also claims statutory yield interest (Sw. *avkastningsränta*) on such capital amounts pursuant to the Swedish Interest Act.

(2230) Gazprom submits that yield interest should be payable on repayments/overpayments in the Transit Arbitration in the same manner as was awarded by the Tribunal in the Supply Arbitration in respect of Naftogaz' claims for repayments. In the Separate Award in the Supply

Arbitration, the Tribunal granted Naftogaz' claim for yield interest in respect of repayments of the contract price (Decision (12)).

(2231) The Swedish Interest Act is part of Swedish substantive law. Pursuant to section 1, the Swedish Interest Act applies to monetary claims, and it applies to the extent the parties have not contracted otherwise. The Transit Contract does not contain any provision on yield interest. Accordingly, the provisions of the Swedish Interest Act apply in respect of yield interest.

(2232) Section 2 of the Swedish Interest Act provides that, as an exception to the general rule that interest does not run until after a payment has become due, yield interest runs on refunds of overpayments (Sw. *återbetalningar*) in situations where a contract has been terminated because of a breach of contract or for other similar reasons.

(2233) Yield interest is calculated, pursuant to section 5 of the Interest Act, at 2% over the reference rate of the Swedish Central Bank.

(2234) Accordingly, Gazprom claims:

1. yield interest at 2% over the Swedish Central Bank reference rate from time to time from the day after the date of each original payment by Gazprom until the date of the Final Award in the Supply arbitration, i.e. 22 December 2017, being the date on which the refund should be made; and
2. delay interest at 8% over the Swedish Central Bank reference rate from time to time from and including 23 December 2017 until payment.

(2235) The interest up to 28 February 2018 has been calculated by Dr Moselle in the amount of USD 2,785,960.24.65.

(2236) Accordingly, Gazprom seeks an award in respect of its overpayments counterclaim in the total amount of USD 46,588,291.35.66.

7.2.1.3.3 Claim in respect of set-off

- (2237) Solely in the event that the Tribunal awards an amount to Naftogaz in respect of some or all of Naftogaz' monetary claims in the Transit Arbitration, Gazprom asks the Tribunal to set off against that amount amounts awarded in favour of Gazprom in the Supply Arbitration.
- (2238) Naftogaz makes a request for set-off (Sw. *kvittningsyrkande*), *i.e.* a request that the Tribunal makes a set off in the Transit award between the amount awarded to Gazprom in the Supply Arbitration and any amounts awarded to Naftogaz in the Transit Arbitration.
- (2239) This request for set-off presupposes that there has not yet been any valid set-off against the amount awarded to Gazprom in the Supply Arbitration in other words, that the amount awarded to Gazprom in the Supply Arbitration remains due and payable, and that interest continues to accrue on that amount.
- (2240) Naftogaz accepts that delay interest has continued to run on the amount awarded to Gazprom in the Supply Arbitration: "*Late payment interest has accrued on the latter amount [i.e. the total amount awarded to Gazprom in the Supply Arbitration, USD 2,029,823,867.21 cf. Final Award Sales Arbitration, subparagraph (v) of THE TRIBUNAL'S DECISION as corrected on 17 January 2018] after 22 December 2017, and will amount to USD 29,323,851.09 on the scheduled date of the Final Award in this arbitration, 28 February 2018*".¹⁶⁵
- (2241) Gazprom's position in response to Naftogaz' change of position with respect to inter-arbitration set off is as follows:
1. In the event that any amount is awarded to Naftogaz in the Transit Arbitration, then Gazprom agrees, in principle, that the Tribunal should perform a set-off between the amount awarded to Gazprom in the Supply Arbitration and any amounts awarded to Naftogaz in the Transit Arbitration;

¹⁶⁵ Naftogaz's Update dated 2 February 2018.

2. Gazprom and Naftogaz agree regarding the actual total interest accrued on the amount awarded to Gazprom in the Supply Arbitration which is USD 41,408,406.89.

(2242) Gazprom's agreement in principle as set out above is made on the express condition as confirmed by Naftogaz that interest will continue to run on the amount awarded to Gazprom under the Supply Final Award until the date of the Transit Final Award.

(2243) For the avoidance of doubt, since the same amounts cannot be set off twice over, it must follow from Naftogaz' change of position that Naftogaz now revokes its previous declaration of set-off (Sw. *kvittningsförklaring*). Gazprom hereby accepts such revocation.

(2244) Naftogaz also now asks the Tribunal "*to order a set off of any amount awarded to Gazprom in this arbitration against any amount awarded to Naftogaz in this arbitration remaining after the set off between the amount awarded to Gazprom in the Sales Arbitration and the amount awarded to Naftogaz in the Transit arbitration, with any remaining interest due to Naftogaz applied before Naftogaz's capital amount, and against any interest awarded to Gazprom before any principal awarded to Gazprom*".¹⁶⁶

(2245) Gazprom's position in response to Naftogaz' request for set-off as between amounts awarded in the Transit Arbitration is that in the event that any amount is awarded to Naftogaz in the Transit Arbitration, then Gazprom agrees, in principle, that a set off should be performed by the Tribunal as between any amount that may be awarded to Gazprom in the Transit Arbitration and any amount that may be awarded to Naftogaz in the Transit Arbitration.

7.2.2 Gazprom's defences to Naftogaz' claims

7.2.2.1 Restatement and resubmission of submissions in the Supply Arbitration

(2246) Gazprom relies on its submissions and evidence in the Supply Arbitration dealing with: (1) the negotiations in 2008 and 2009; (2) the January 2009 supply disruption; (3) virtual and physical reverse flow; (4) the applicability of EU competition law; (5) the applicability of the ECT; (6)

¹⁶⁶ Naftogaz's Update, paragraph 23.

the applicability of Ukrainian law; (7) the effects of an alleged breach of EU and/or Ukrainian law. Gazprom also refers to the answers given by Naftogaz' factual and expert witnesses in relation to these topics.

7.2.2.2 Gazprom's position regarding Naftogaz' claims for relief

7.2.2.2.1 Gazprom's position in general

(2247) Gazprom requests that the Tribunal dismisses (Sw. *avvisar*) Naftogaz' claims for relief 1, 2, 3, and 5, set out in more detail below.

(2248) In any event, Gazprom denies all of Naftogaz' claims. Accordingly, if not dismissed, or to the extent that they are not dismissed, Gazprom requests that the Tribunal rejects on the merits (Sw. *ogillar*) all the claims for relief sought by Naftogaz.

7.2.2.2.2 Gazprom's position as regards each claim for relief in turn

7.2.2.2.2.1 Claim 1

(2249) Naftogaz' Claim 1 for invalidity/ineffectiveness and replacement of the Contract so that the rights and obligations of Naftogaz can be assigned to PJSC Ukrtransgaz or any other entity designated as TSO by the Ukrainian authorities should be dismissed (i) since it is unspecified, (ii) since this Claim is not arbitrable and falls outside the "*civil law effects of competition law as between the parties*", and (iii) since the Tribunal does not have jurisdiction to rewrite the Contract in the manner requested by Naftogaz (except pursuant to section 36 of the Contracts Act), and (iv) in any event, since the Tribunal cannot rewrite the Contract in the manner requested by Naftogaz unless and until the parties have been given the opportunity to negotiate pursuant to Article 13.2 of the Contract, so as to "*agree to replace such invalid or ineffective provision with a new provision that would have the same economic effect as close as possible to that of the invalid or ineffective provision*".

(2250) If not dismissed, Claim 1 should be rejected on the merits by the Tribunal.

7.2.2.2.2 Claim 2

(2251) Naftogaz' Claim 2 for invalidity/ineffectiveness and replacement of major parts of the Contract should be dismissed, (i) since it is unspecified, (ii) since this Claim is not arbitrable and falls outside the "*civil law effects of competition law as between the parties*", and (iii) since the Tribunal does not have jurisdiction to rewrite the Contract in the manner requested by Naftogaz (except pursuant to section 36 of the Contracts Act), and (iv) in any event, since the Tribunal cannot rewrite the Contract in the manner requested by Naftogaz unless and until the parties have been given the opportunity to negotiate pursuant to Article 13.2 of the Contract, so as to "*agree to replace such invalid or ineffective provision with a new provision that would have the same economic effect as close as possible to that of the invalid or ineffective provision*".

(2252) If not dismissed, Claim 2 should be rejected on the merits by the Tribunal.

7.2.2.2.3 Claim 3

(2253) Naftogaz' alternative Claim 3 for revision of the Contract regarding Article 8 of the Contract should be dismissed (i) since it is unspecified, and (ii) since the Tribunal does not have jurisdiction to rewrite the Contract in the manner requested by Naftogaz (except pursuant to section 36 of the Contracts Act).

(2254) If not dismissed, Claim 3 should be rejected on the merits by the Tribunal.

7.2.2.2.4 Claim 4

(2255) Naftogaz' Claim 4 for compensation for alleged underdeliveries of transit volumes should be rejected on the merits by the Tribunal.

7.2.2.2.5 Claim 5

(2256) Naftogaz' Claim 5 for payment corresponding to alleged underpayments should be dismissed, (i) since the interest claim is unspecified, and (ii) since this Claim depends on Claims 2 and 3 which themselves should be dismissed.

(2257) If not dismissed, Claim 5 should be rejected on the merits by the Tribunal.

7.2.2.2.2.6 Claim 6

(2258) Naftogaz' new Claim 6 for rejection of Gazprom's counterclaim should be rejected on the merits by the Tribunal.

7.2.2.2.2.7 Claim 7

(2259) Naftogaz' new Claim 7.1 for set off between the Supply Arbitration and the Transit Arbitration should be rejected on the merits by the Tribunal, save that Gazprom accepts in principle that such a set off should be performed by the Tribunal as between the amount awarded to Gazprom in the Supply Arbitration and any amounts that may be awarded to Naftogaz in the Transit Arbitration.

(2260) Naftogaz' new Claim 7.2 for set off within the Transit Arbitration should be rejected on the merits by the Tribunal, save that Gazprom accepts in principle that such a set off should be performed by the Tribunal as between any amount that may be awarded to Gazprom in the Transit Arbitration and any amount that may be awarded to Naftogaz in the Transit Arbitration.

7.2.2.2.2.8 Claim 8

(2261) Naftogaz' Claim 8 in respect of costs should be rejected on the merits by the Tribunal.

7.2.2.2.3 Naftogaz' interest claims

(2262) Naftogaz seeks interest on its claims as set out in its Claims 5.1) and 5.2).

(2263) Gazprom denies that Naftogaz is entitled to interest on its claims as pleaded. In summary,:

1. In respect of Naftogaz's claims for interest pursuant to Sections 3 and 6 of the Swedish Interest Act, these claims should be rejected because a due date has not been determined in advance as required by Section 3. In particular, there is no support in the Contract for the assertion that any damages claims are due and payable on the first business day of each subsequent year, as apparently claimed by Naftogaz. There is furthermore no support in the Contract for the assertion that interest can be payable on capital amounts *before* alleged underpayments were made.

2. In respect of Naftogaz' claims for interest pursuant to Sections 4 and 6 of the Swedish Interest Act, these claims should be rejected because Naftogaz has not presented claims for determined amounts as required by Section 4 either in its "Notice of Disputes"¹⁶⁷ or in its Request for Arbitration. In particular:
 - interest cannot be claimed from 26 August 2014 in reliance upon the "Notice of Disputes", since that notice did not contain a demand for payment;
 - interest cannot be claimed from 16 October 2014 in reliance upon the Request for Arbitration, since the Request for Arbitration did not contain a demand for payment; and
 - interest cannot be claimed from 4 May 2015 in reliance upon the Statement of Claim, since the Statement of Claim did not contain a demand for payment.
3. Furthermore, interest is also not payable on Naftogaz' claims for underpayment in reliance upon the Tribunal replacing or revising the tariff provision (Article 8 in the Contract), since that alleged debt is not yet due and will not become due unless and until the Tribunal replaces or revises the tariff provision in the Final Award.
4. As regards Naftogaz' claims for damages for alleged breach of competition law, since these claims were first made in Naftogaz' Reply, interest is not payable in respect of these claims until 30 days after Gazprom received Naftogaz' Reply, *i.e.* until 30 days after 12 February 2016.

(2264) Accordingly, Gazprom's position is as follows:

1. Gazprom's primary position is that Naftogaz is not entitled to any interest before the date of the Final Award in the Transit Arbitration.

¹⁶⁷ "Notice of Disputes", dated 25 July 2014.

2. Gazprom's secondary position is that Naftogaz is not entitled to any interest until the date occurring 30 days after the date on which Naftogaz presented a claim for a determined amount as required by Section 4 of the Swedish Interest Act. Since Naftogaz' claims have changed considerably during the course of this arbitration, such date is:

- 21 January 2017 for the claims made in Naftogaz' Revised Relief sought dated 22 December 2016 (Naftogaz' claims in respect of 2012-2015);
- 12 March 2017, for the new claims made in Naftogaz' Revised Relief Sought dated 10 February 2017 (Naftogaz' claims in respect of 2016); and
- 4 March 2018 for the new claims made in Naftogaz' Revised Relief sought dated 2 February 2018 (Naftogaz' claims in respect of 2017).

(2265) In any event, Gazprom disputes Dr. Hesmondhalgh's calculations of interest.¹⁶⁸

(2266) Naftogaz claims interest on the entire capital amounts from various points in time when parts of the alleged "underpayments" had not even yet been made, and when no claim for payment had been submitted in this arbitration.

(2267) Gazprom disputes that interest pursuant to Sections 4 and 6 of the Swedish Interest Act can accrue on any debt before a claim for payment was made. Neither can any such interest on a claim for additional payment accrue before the alleged underpayment was made. The Tribunal should reject Naftogaz' claims for interest from any point in time before claims for payment of such amounts were submitted by Naftogaz in this Arbitration.

7.2.2.3 Naftogaz' pleaded case

(2268) Naftogaz asks the Tribunal to re-write the majority of the Transit Contract and to impose such a re-written contract on Gazprom. Further, Naftogaz requests the Tribunal to declare the Technical Agreement, with Annexes and Additional Agreements, invalid and/or ineffective. The

¹⁶⁸ See paragraphs 2.2(ii) and 2.3 of the Moselle Report 8.

extent of the re-writing sought by Naftogaz would fundamentally alter the contractual bargain entered into between the parties.

(2269) Naftogaz also brings various alternative claims for additional payments or compensation, all of which (except in relation to the Claim in respect of 2009) are dependent upon Naftogaz' requests to re-write the Contract.

7.2.2.3.1 The Tribunal has no power to re-write the Contract in the manner proposed by Naftogaz

(2270) In making its claims for replacement based on competition law and energy law, Naftogaz relies on Article 13.2 of the Contract, but that clause gives the Tribunal no power to impose a replacement on the parties without their consent. Simply put, the Tribunal has not been given power to re-write the Contract (*Sw. kompletteringsbehörighet*) pursuant to section 1(2) of the Swedish Arbitration Act of 1999.

(2271) In making its claim for revision of Article 8 of the Contract, Naftogaz relies on the tariff review clause at Article 8.7 of the Contract. However, the Tribunal does not have the power to re-write Article 8 of the Contract in the manner requested by Naftogaz. Moreover, Naftogaz has not fulfilled the contractual requirements pursuant to the tariff review provisions.

(2272) Further, the Tribunal lacks jurisdiction to determine claims based on "*energy law*", since such claims are not arbitrable and fall outside the scope of the "*civil law effects of competition law as between the parties*" pursuant to section 1(3) of the Swedish Arbitration Act of 1999.

(2273) For the above reasons the Tribunal is unable to consider the claims put forward by Naftogaz and such claims should therefore be dismissed.

7.2.2.3.2 In any event, Naftogaz' claims should be rejected

(2274) Even if the Tribunal could consider Naftogaz' claims, they should be rejected on the merits.

(2275) In many respects, the arguments presented by Naftogaz are too vague and unspecified to be answered in detail. In particular, Naftogaz has failed to explain why large portions of the

Contract should be regarded as invalid, relying instead on broad-brush assertions that the Contract needs to reflect the alleged requirements of the EU Third Energy Package.

- (2276) EU competition law, EU energy law and the Energy Community Treaty ("EnCT") do not apply to the Contract. In any event, there are no grounds for invalidating the Contract in the manner proposed by Naftogaz.
- (2277) Moreover, Naftogaz has failed to explain why, or on what basis, the lengthy replacements it proposes would be required. Naftogaz relies upon Article 13.2 of the Contract, but Naftogaz has no right under that clause to impose the proposed replacements on Gazprom.
- (2278) There is also no basis for Naftogaz' revision claims, since there are no grounds for revising the tariff in the manner proposed by Naftogaz, let alone the other provisions set out in Article 8 of the Contract. Naftogaz' alternative claim under Section 36 of the Swedish Contracts Act is also of no merit.
- (2279) Even if the Tribunal had jurisdiction, there is also no basis for Naftogaz' monetary claims. Naftogaz has no right to claim additional payments, compensation or interest.

7.2.2.4 It is also entirely inappropriate for the Tribunal to consider the energy law issues raised by Naftogaz

- (2280) Naftogaz is asking the Tribunal to involve itself in sensitive and complex political and regulatory issues, which go far beyond the contractual rights and obligations of the two contracting parties.
- (2281) What Naftogaz is asking the Tribunal to do is entirely inappropriate. Essentially, Naftogaz is asking the Tribunal to assume that the Third Energy Package (as contained in two pieces of EU legislation: Directive 2009/73/EC and Regulation 715/2009) has been implemented in Ukraine, to pre-judge how it might be implemented, and, effectively, to act as a national, public regulator of gas markets in Ukraine.

(2282) Even if (which is denied) Directive 2009/73/EC and Regulation 715/2009 apply to the Contract and the Tribunal has the jurisdiction to consider them, the Directive and the Regulation set out high-level principles for the liberalisation of gas markets. They leave substantial discretion to national governments as to exactly how those markets should be liberalised and how they should be regulated. Such regulation is to be carried out by national governments and national regulatory authorities.

(2283) The national public authorities are responsible for setting the detailed framework under which such regulation is to take place, for example, the tariffs to be charged for access to transmission networks, system balancing rules and rules for capacity allocation and congestion management. The detailed framework is set out in national laws and administrative rules. The setting of that detailed framework is a complex and lengthy process, which involves meticulous consideration of economic and other data and of regulatory matters. It is typically only carried out after extensive public consultation (and consultation with the European Commission). The setting of the detailed framework gives rise to sensitive political and regulatory issues.

(2284) These are not the sorts of processes that the Tribunal is equipped to carry out or that it should be expected to carry out.

7.2.2.5 Applicable law

7.2.2.5.1 Overview

(2285) Naftogaz has made various general comments about Swedish, EU and Ukrainian law.

7.2.2.5.2 Gap filling under the Swedish Arbitration Act

(2286) Article 13.2 of the Contract provides that, if any of the provisions of the Contract becomes invalid or ineffective, "*the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have the economic effect as close as possible to that of the invalid or ineffective provision*". Article 13.2 does not give any power to a third party such as the Tribunal to impose a revised contract on the parties.

(2287) Naftogaz raises several arguments against this, none of which have any merit:

1. It is not possible to construe any mandate for the Tribunal under Article 13.2 by means of contractual interpretation. The wording of Article 13.2 is clear and unambiguous it is for *the parties* to negotiate, not for any third party to impose a solution upon them. Any re-writing of the Contract would require the agreement of both parties as a result of a re-negotiation. There is no express right for the Tribunal to rewrite the Contract.
2. It is also not possible to imply an additional mandate for the Tribunal under Article 13.2 by means of "gap filling" under section 1(2) of the Arbitration Act. Naftogaz accepts that this section applies "*if a separate mandate to such effect has been given by the parties*". But no such separate mandate has been given by the parties to the Tribunal in Article 13.2 of the Contract.
3. Gazprom's position is supported by one of Naftogaz' legal authorities. See Anderson *et al.* at p. 120 , in which the author states as follows:

"The characteristic feature of a gap is that the parties have agreed that the contract is not "complete" on a particular issue yet have not allowed for the proper law of the contract to imply the missing provision into the contract. Instead, they have agreed to use a third party to supply the rule on that issue. This means that the parties must specifically have defined the scope of the gap to be filled. Also, the parties must have agreed what third party is to fill the gap. If these two preconditions are not met there should be no gap capable of being filled.

Therefore, a standard arbitration clause does not give the arbitrators the power under Section 1, second paragraph of the Arbitration Act to add contractual terms even if they find that the contract omits to regulate a specific issue."

4. In the present case, the Parties have not agreed for a third party to supply a new provision under Article 13.2 of the Contract. Nor has the scope of the gap to be filled been

specifically defined the scope of the gap is left undefined and depends on whether, and to what extent, there might be an invalid or ineffective provision. Nor have the parties agreed what third party is to fill the gap on the contrary, they have agreed that they should agree between themselves without the existence of any third party.

5. Gazprom also denies that there is any contractual basis or "*norm*" on which the Tribunal could base any such gap filling. Naftogaz says that the Tribunal knows what it would have to do, since a revised contract should simply be "*as close as possible*" to the original provisions. But Article 13.2 does not allow for an "*as close as possible*" provision to be imposed on the parties; there is a world of difference between parties agreeing upon a new provision, and a new provision being imposed on them. A "*norm*" for negotiation between the parties cannot be extrapolated and stretched into a "*norm*" for a third party to impose a new contract on the parties. These are entirely different scenarios.
6. Moreover, what does "*as close as possible*" actually mean? In practice, any negotiation between the parties assumes that there would be a process of give and take, with there being a range of different possible solutions to choose from. On what basis should a third party such as the Tribunal decide for the parties what precise solution to choose? No basis is given on which the Tribunal is entitled to take such a decision.
7. Naftogaz appears to suggest that the Tribunal would "*quite simply*" be applying the Third Energy Package. This premise is fundamentally flawed. Gazprom denies that the Third Energy Package is applicable. Even if it were, the Third Energy Package does not mandate specific contractual wording, as Naftogaz seems to suggest, but on the contrary, expresses only high-level principles, and minimum requirements, leaving substantial discretion to Member States for implementation. In short, there is simply no "*norm*" that would allow, or indeed require, the Tribunal to impose the extraordinarily detailed revised wording that Naftogaz now seeks to have imposed on Gazprom.

8. There is also no basis for adjusting Article 13.2 in the manner suggested by Naftogaz pursuant to Section 36 of the Contracts Act.
9. The doctrine of assertion (Sw. *påståendedoktrinen*) does not assist Naftogaz in this context. That doctrine simply provides that facts of "*double relevance*" to both jurisdiction and substance should be assumed to be true for the purposes of the jurisdictional argument. However, Naftogaz' jurisdictional argument relies on alleged facts: even if the facts claimed by that Naftogaz are assumed to be true, the Tribunal has not been given the mandate or jurisdiction to impose a revised contract on the parties under Article 13.2 of the Contract. In any event, the doctrine of assertion cannot be used to expand the scope of an arbitration agreement.
10. So-called "backdrop laws" do not assist Naftogaz in this context. There are no backdrop laws that would provide guidance for the Tribunal to impose a solution on the parties under Article 13.2. (The only possible exception would be Section 36 of the Contracts Act which, for the reasons set out below, does not assist Naftogaz.)
11. Finally, there is no "estoppel" against Gazprom in this situation. Naftogaz claims that Gazprom should somehow be estopped from raising the jurisdictional argument regarding Article 13.2 of the Contract, but there is simply no basis for Naftogaz' assertion here. Naftogaz refers to Gazprom's pleadings in the Supply Arbitration regarding Article 9.5 of the Sales Contract. However, not only is the Supply Arbitration a different case involving a different contract, but Gazprom has challenged the jurisdiction of the Tribunal under Article 9.5 of the Sales Contract now that Naftogaz had clarified the basis of its case. (It is true that Gazprom has not challenged the jurisdiction of the Tribunal under Section 36 of the Contracts Act, but that is because there is no jurisdictional argument in that respect.)

7.2.2.5.3 Arbitrability the Tribunal has no jurisdiction under energy law

(2288) Naftogaz has two principal arguments in this context: (a) that issues of energy law are capable of settlement between the parties and therefore arbitrable pursuant to Section 1(1) of the

Arbitration Act, and (b) that energy law is relied upon as part of competition law and is therefore arbitrable pursuant to Section 1(3) of the Arbitration Act.

(2289) Both these arguments are false.

7.2.2.5.3.1 Issues of energy law are not capable of settlement between the Parties

(2290) Section 1(1) of the Swedish Arbitration Act provides that "*[d]isputes concerning matters in respect of which the parties may reach a settlement may, by agreement, be referred to one or several arbitrators for resolution*". Thus, it is generally only "dispositive" (Sw. *dispositiva*) disputes that are arbitrable under Swedish law, whereas "indispositive" disputes, as a starting point, are not arbitrable. For example, questions of contract interpretation, which are private law matters that are capable of settlement between the contracting parties, are arbitrable. However, public law matters such as criminal law, family law or tax law, are not arbitrable.

(2291) Both Parties agree that it is only matters capable of being settled by agreement that are arbitrable under Section 1(1) of the Arbitration Act.

(2292) Naftogaz refers to NJA 2012 p. 790 and objects to Gazprom's use of the terms "dispositive" and "indispositive". Naftogaz also suggests that "*the element prohibiting a settlement needs to have a particular weight*". However, in order to put this objection into context, it is necessary to consider what the Supreme Court actually said in NJA 2012 p. 790 see in particular paragraphs 9-13 of the Supreme Court's judgment.

(2293) The question in that case was whether an arbitral award requiring the respondent to the arbitration to make payment of a debt under a loan agreement was invalid by reason of mandatory Russian law currency regulations. The Supreme Court noted that the loan agreement was governed by Swedish law, and that the disputed issue whether there was an obligation to pay was in nature dispositive (Sw. "*Tvistefrågan har gällt betalningsskyldigheten som sådan och är därmed av dispositiv natur.*" see paragraph 16 of the Supreme Court's judgement). Further, the Supreme Court found that the currency regulations, both previous Swedish currency

regulations and the foreign currency regulations relied upon, did not affect the parties' ability to reach a settlement in Sweden.

(2294) The present case, however, is very different.

(2295) Gazprom makes four points in response to the points made by Naftogaz:

1. The matter in dispute (Sw. *tvistefrågan*) is not merely the request for relief but also concerns the legal grounds relied upon.
2. In the present case, the matter in dispute is in nature indispositive. Whereas in the *Moscow Golf Club* case the respondent in the arbitration invoked foreign mandatory rules as a defence to a claim that was otherwise clearly dispositive, in the present claim the claimant bases its claim on foreign (allegedly) mandatory rules.
3. The (allegedly) mandatory element relied upon by Naftogaz in the present case clearly affects third parties and the public in general. Naftogaz is asking the Tribunal to put itself in the position of a regulator.
4. This is not a matter of burden of proof.

7.2.2.5.3.2 The matter in dispute is not merely the request for relief

(2296) Naftogaz states that "[t]he 'matter in dispute' that needs to be capable of being settled by agreement of the parties is ... the particular cause of action (Sw. *rättsföljd*) that the request for relief and the material facts invoked entails". In this context Naftogaz refers to Andersson et al, *Arbitration in Sweden*, p. 59. However, what Andersson et al. state in *Arbitration in Sweden* is in fact the following:

"When answering the question whether the parties may settle the dispute by agreement, a preliminary question arises. What is "the dispute"? For the purpose of the arbitrability analysis, the dispute is the particular cause of action that the arbitration concerns. In practice this means that 'the dispute' is a function of the prayer for relief and the material facts invoked. To

determine whether a claim for damages for breach of contract is arbitrable one therefore has to ascertain objectively what type of damages claim is at issue.

[Footnote: The doctrine of assertion does not apply to questions regarding arbitrability and public policy. Thus, an agreement providing for the bribery of state officials is unarbitrable even though the claimant places another label on it if the true character of the agreement is obvious from the material facts invoked or from the submissions and/or evidence presented, cf. The Bankruptcy Estate of Brattebergs Sågverk AB v. Mullsjö Maskinförsäljning AB, NJA 1992 p. 299.]"

- (2297) Thus, Naftogaz' reference to the Swedish term "*rättsföljd*" is not correct. The "*matter in dispute*" is not merely a question of the character of the prayer of relief (damages etc.). The question asked by Andersson et al is, what is "*the dispute*"? Not, what is the prayer for relief? The underlying facts as well as the substantive law applicable to those facts are important in the determination of whether "*the dispute*" is arbitrable. As noted in the passage above, Andersson et al state expressly that "... '*the dispute*' is a function of the prayer for relief and the material facts invoked". This is also clear from the example provided by Andersson et al in the footnote quoted above – where it is noted that an agreement providing for the bribery of state officials is unarbitrable even though the claimant places another label on it.
- (2298) The term used by the Supreme Court in the *Moscow Golf Club* case is "*the question in dispute*" (Sw. tvistefrågan). This is obviously more than merely the request for relief sought. Thus, in the *Moscow Golf Club* case itself, the question in dispute was whether the respondent had an obligation to make payment under a loan agreement. The Supreme Court pointed out that this question was in nature dispositive, i.e. capable of settlement between the parties.
- (2299) However, it is clear that the request for relief per se cannot be determinative. A request for relief seeking payment of money could, in other circumstances, be indispositive e.g. if the legal basis for payment were an agreement providing for the bribery of state officials (as in the

- (2306) Naftogaz further argues that "*Gazprom has not invoked any rule that would even allegedly prohibit the settlement of any of the disputed matters*". However, it is Naftogaz itself that argues that provisions in the Transit Contract are invalid because they violate mandatory law. This is the same as saying that the parties are not free to agree on those provisions. Further, Naftogaz' positions are contradictory. For example, Naftogaz argues that the tariff under the Transit Contract violates mandatory energy law and therefore is invalid. At the same time Naftogaz argues that "*it is almost inconceivable that commercial parties could not agree between themselves to settle a request for monetary relief*" which relates to the same energy law.
- (2307) In short, Naftogaz appears to suggest that energy law binds the parties in such a way that only one possible wording is possible, i.e. the completely revised contract that Naftogaz has asked the Tribunal to impose upon the parties. Thus, on Naftogaz' own case, the parties' hands are tied. This is all the more obvious when it is noted that Naftogaz claims that Gazprom is required by allegedly mandatory rules to pay a higher tariff. Thus, on Naftogaz' own case, the parties would be unable to settle the monetary claim for anything less than the full sum claimed.
- (2308) Also in relation to Naftogaz' claims for declaratory relief, Naftogaz appears to suggest that the only permissible contractual wording is the large-scale rewriting that it has requested the Tribunal to impose upon Gazprom. Thus again, on Naftogaz' own case, the parties would not be able to settle the declaratory claim on any basis other than by accepting the wording claimed by Naftogaz.
- (2309) Naftogaz attempts to suggest that the case is nevertheless capable of settlement as between the parties by suggesting that "*the disputed matter*" is "*the application of the severability clause, Clause 13.2, a contract term, and the prerequisites therein ("invalid" and "ineffective" and "as close as possible economically")*".
- (2310) However, it cannot be correct that the Tribunal can render provisions of the Contract invalid by merely applying Article 13.2 of the Contract. An application of Article 13.2 of the Contract does not render any contractual clause invalid. Article 13.2 does not provide any basis for

invalidity; it merely stipulates what is to occur in the event that one or several provisions of the Contract are found to be invalid or ineffective. In any event, as has just been noted above, Naftogaz claims that Article 13.2 could only be applied in accordance with mandatory law.

(2311) What is of crucial importance in this case is that Naftogaz' claims based on energy law lack a contractual basis. Naftogaz is asking the Tribunal to step into the shoes of and act as the Regulator. What Naftogaz is asking is for the Tribunal to assume that the Third Energy Package (as contained in Directive 2009/73 and Regulation 715/2009) has been implemented in Ukraine, to pre-judge how it might be implemented, and, effectively, to act as a national public regulator of gas markets in Ukraine. This is not within the power of an arbitral tribunal.

(2312) Further, from the energy law referred to by Naftogaz (i.e. "*in particular*" Directive 2009/73 and Regulation 715/2009), it is clear that the EU legislator intended for the regulatory authorities to have the sole responsibility for ensuring and monitoring compliance with the regulatory framework. For example, Article 41 of Directive 2009/73/EC (entitled "*Duties and powers of the regulatory authority*") sets out in detail the duties and powers of the regulatory authorities. It follows that the legislator did not intend for any other organ to perform the regulatory authorities' role or to have the corresponding powers.

(2313) The Tribunal cannot determine what exactly is invalid or not invalid under mandatory law that is for the Regulator to do. Equally, the Tribunal cannot determine what exactly an appropriate alternative contractual provision would be that is also for the Regulator to do, or alternatively for the parties to do under direction and supervision of the Regulator.

1. Member State Regulator has a great deal of discretion as to the setting of tariffs and/or the methodologies for setting them in order to balance these requirements/ objectives. The magnitude of this discretion is reflected in the extensive consultation requirements contained in the draft network code on transmission tariffs. Before setting transmission tariffs, EU Member State Regulators engage in a lengthy, far reaching and detailed consultation process.

2. As just one example, see Article 13.1, second paragraph, of Regulation 715/2009. It is for the Member State Regulator to seek to maintain a reasonable balance between different requirements/ objectives under that Regulation. The Regulator is given a substantial degree of discretion in carrying out this balancing exercise, and may even decide not to set tariffs but instead to let them be "*determined through market based arrangements such as auctions*".

(2314) Quite simply, what Naftogaz is asking the Tribunal to do goes far beyond what is possible for an arbitral tribunal to do. The Tribunal cannot act in the shoes of the Ukrainian public authority.

7.2.2.5.3.4 The question clearly affects third parties and the general public

(2315) The public law issues in question here are clearly matters of a certain "weight" (as suggested by the Supreme Court in the *Moscow Golf Club* case), in the sense that they affect third parties and also the general public.

(2316) In this connection, it is instructive to note the following passage from the Government Bill in relation to the Arbitration Act (Proposition 1998/99:35, p. 49):

(2317) In-house English translation: "*The question is whether the area that is arbitrable ought to be determined differently to what applies today. By comparison with other legal systems it can be noted that, for example in France, all disputes are considered to be arbitrable as long as they do not concern ordre public. [...] Against this background it may be questioned whether there is reason to widen the area that is arbitrable in a new Swedish arbitration act. Our current provision means, namely, that disputes in which the interest of the general public plays a significant part are often shut out of the area that is arbitrable.*"

[...]

By reference to what has been stated above, and since the investigation has not identified any need for reform, the government finds that there is not any basis for amending the basic rule that exists currently. The government therefore proposes that the general rule should still be

that arbitration agreements can be entered into concerning such questions that the parties can reach agreement upon."

(emphasis added by Gazprom)

(2318) Thus, since the government decided to preserve the general rule that only dispositive disputes could be arbitrable, the Government Bill made it clear that disputes in which the interest of the general public plays a significant part are often shut out of the area that is arbitrable under Swedish law.

(2319) In the present case, Naftogaz' own case makes it clear that the interests of third parties and of the general public are affected. The fact that third parties are, allegedly, potentially discriminated against is one of the principal grounds relied upon by Naftogaz (see, e.g. Naftogaz' Statement of Claim, para. 82: "*... the currently applied tariff does not cover Naftogaz's costs of providing the agreed services to Gazprom. The effect is to increase the costs for all other users of the GTS, which is discriminatory and effectively forecloses the system*").

(2320) In these circumstances, the matter in question is not arbitrable.

7.2.2.5.3.5 This is not a question of burden of proof

(2321) Naftogaz further claims that it falls on Gazprom "*to prove that the parties are restricted from settling such disputed matter by agreement between themselves.*" Naftogaz is wrong. There is no such "burden of proof" in relation to arbitrability. According to Section 33, first paragraph, first item of the Swedish Arbitration Act, an award is invalid if it includes determination of an issue which, in accordance with Swedish law, may not be decided by arbitrators. In this respect, any "burden of proof" is irrelevant.

7.2.2.5.4 Section 1(3) of the Arbitration Act

(2322) Section 1(3) of the Arbitration Act provides an express provision in respect of competition law, notwithstanding the general principle that only matters capable of settlement can be arbitrable. The legislature expressly recognised that competition law matters may, in some cases, not be

capable of settlement; yet the legislature considered it to be important to provide legislative support for arbitrators to be able to consider and determine "*the civil law effects of competition law*". See the Government Bill, Prop. 1998/99:35, p. 58:

In-house English translation: "*Since it is uncertain whether the arbitrators' right to determine the effects of competition law between the parties is in accordance with the suggested limitation of the area of law that is arbitrable [i.e. dispositive disputes], clarity is needed by means of a particular rule being included in the Arbitration Act. The Government therefore proposes that the arbitrators should be able to determine the civil law effects of competition law as between the parties*".

- (2323) As a threshold point, it is important to note that it is only "*the civil law effects*" of competition law that are arbitrable pursuant to Section 1(3) of the Arbitration Act. Gazprom denies that Article 18, 10 or 7 of the EnCT create any civil law effects that could be relied upon by the parties to this arbitration.
- (2324) The Swedish Supreme Court has also recently pointed out in the *Systembolaget II* case (NJA 2015 p. 438) that Section 1(3) of the Arbitration Act is a special procedural rule that constitutes an exception from the general rule that an arbitral award in respect of an indispositive question is invalid.
- (2325) As for energy law, it is notable that Naftogaz now apparently concedes that it is not relying upon energy law as a separate legal ground, but merely in order to support its competition law argument. Naftogaz states:

"Gazprom's argument that "claims related to energy law" are not arbitrable and should be dismissed in relation to Claims 1 and 2 (the replacement claims) and Claims 5 to 7 (the payment claims), is based on a misunderstanding of Naftogaz's claims. Naftogaz relies on competition law and contract law as primary legal bases for its claims. However, when applying

competition law, energy law might have to be relied on where the specific solutions in the secondary market legislation make it necessary."

"Naftogaz only relies on energy law as such to a very limited extent, and in the alternative to the application of energy law as operationalization of competition law."

(2326) This appears to be a concession by Naftogaz that energy law as a separate legal ground would fall outside the scope of Section 1(3).

(2327) In any event, Gazprom maintains that energy law as a separate legal ground does not fall within Section 1(3) of the Arbitration Act. Section 1(3) of the Arbitration Act mentions competition law, not energy law, and it is clear from the Government Bill (quoted above) the particular provision in Section 1(3) of the Arbitration Act was specifically intended to apply to competition law.

(2328) It is clear that competition law and energy law are entirely different bodies of law.

(2329) Gazprom also questions whether there are any "*civil law effects*" of the energy law relied upon by Naftogaz. On the contrary, the energy law invoked by Naftogaz provides for public law remedies notably actions by the Ukrainian regulator or remedies against Ukraine as a party to the EnCT.

(2330) In summary, insofar as Naftogaz' claims are based on "energy law", they are not arbitrable and should be dismissed by the Tribunal.

7.2.2.5.5 Swedish Contract Law

(2331) Unlike the Sales Contract, which is the subject of the Supply Arbitration, the Vienna Convention on the International Sale of Goods (CISG) is not applicable in the present case since the Transit Contract is not a contract of sale.

7.2.2.5.5.1 Contract interpretation as opposed to filling-out contracts

(2332) Gazprom agrees that the filling out of contracts (which Naftogaz incorrectly characterises as "*implying terms*") would only be of relevance when "*the interpretation of the contract has led to the conclusion that the contract does not address the issue (either because there is a lacuna or because a clause which ostensibly covers the situation is interpreted as not in fact covering the issue)*".¹⁶⁹

(2333) Therefore, if there is an express contractual provision regulating a particular issue, there is no room for gap-filling; one merely applies the contract.

7.2.2.5.5.2 Section 36 of the Swedish Contracts Act should only be applied very restrictively

(2334) Section 36 is applied very restrictively in Swedish law. It is generally thought of as a "last resort" if all other contract law arguments have failed.

7.2.2.5.5.3 Primarily for consumer protection and similar purposes

(2335) Section 36, paragraph 2, particularly refers to the position of consumers. Although Section 36 is, in theory, also applicable to contractual clauses between businesses, the Government Bill states clearly that it should be applied restrictively.¹⁷⁰

7.2.2.5.5.4 Section 36 cannot be used to adjust a bad bargain

(2336) It is important to emphasise that Section 36 cannot be used as a means of adjusting a bad bargain. If a commercial party freely enters into a contract then, as a general rule, it is bound by that contract. The Government Bill emphasises that, in a business context, it is crucial to be able to rely upon a contract and to be able to foresee its consequences.¹⁷¹

(2337) It is not enough to claim that a contract is generally unreasonable.

¹⁶⁹ Naftogaz' Statement of Claim, paragraph 676.

¹⁷⁰ Government Bill 1975/76:81, p. 104.

¹⁷¹ Government Bill 1975/76:81, p. 104.

(2338) A party invoking Section 36 needs to show that the application of a specific contractual term is unconscionable (Sw. *oskäligt*); a general allegation that a contract is unfair is not sufficient. The claimant needs to describe what specific circumstances make the application of the contractual term unconscionable.¹⁷²

7.2.2.5.5.5 Long-term contracts and changed circumstances

(2339) Although contractual terms in long-term contracts can, in theory, be modified in the event of changed circumstances, in practice exceptional circumstances are required.

(2340) Changed circumstances in and of themselves do not suffice. Rather, the change in circumstances must be shown to make a particular contractual term unconscionable.¹⁷³

(2341) In most cases, the parties have considered the possibility of changed circumstances and have taken account of the apportionment of risk in such circumstances, which is then reflected in the drafting of the contract. When circumstances that were taken into account by the parties at the drafting stage occur subsequently, there is no basis for adjustment under Section 36.

(2342) Further, Section 36 was not intended to function as a general price adjustment mechanism.

7.2.2.5.5.6 The effect on third parties cannot be taken into account

(2343) It is clear from the preparatory works to the Swedish Contracts Act that it is the effect on the contracting parties that is relevant in considering the possible application of Section 36. The effect on third parties is not relevant and cannot be taken into account.¹⁷⁴

7.2.2.5.6 The requirement for "specific relief" under the SCC Rules

(2344) Article 24 of the SCC Rules states:

¹⁷² The Tribunal cannot make this assessment with regard to circumstances other than those invoked by the Claimant. See Grönfors, Kurt and Rolf Dotevall, *Avtalslagen - en kommentar* (2010), p. 246.

¹⁷³ Government Bill 1975/76:81, p. 127.

¹⁷⁴ Government Bill 1975/76:81, p. 130.

"The Claimant shall, within the period of time determined by the Arbitral Tribunal, submit a Statement of Claim which shall include, unless previously submitted:

(i) the specific relief sought;

(ii) the material circumstances on which the Claimant relies; ..."

(2345) Therefore, in an arbitration under the SCC Rules, the Statement of Claim should include the specific relief sought. It is also a fundamental rule of Swedish procedural law that the claimant should state the specific relief sought, since Chapter 42 Section 2 of the Swedish Procedural Code provides that the request for relief should be specified.

(2346) Commentary on the SCC Rules from 1987 (which also serves as guidance for the 2010 SCC Rules since the wording "specific relief" has not changed) states that the SCC Rules require that the claimant states the "specific relief" sought, just as in court proceedings under the Swedish Procedural Code:

"In arbitral proceedings under the rules of the Institute it is required, as in proceedings in general court, that the claimant, sets forth a specific relief

...

If the claim concerns money, the claim should specify the exact amount. ... If the claimant seeks a prohibition or a performance, it must be clear what action the respondent shall refrain from or perform."

(2347) The requirement that the claimant should state the specific relief sought in an arbitration is in full conformity with the general principle in Section 24 of the Swedish Arbitration Act that the arbitrators shall afford the parties, to the extent necessary, an opportunity to present their respective cases in writing or orally.

7.2.2.5.7 The Tribunal's duty to dismiss unspecified requests for relief

(2348) If a request for relief is unspecified, such a claim is defective and invalid and must be dismissed by the tribunal. If a tribunal were to try an unspecified request for relief, the tribunal would commit an irregularity in the course of the proceedings which could constitute a clear ground for challenging the award. This follows from numerous statements made in relation to those provisions by leading scholars on Swedish arbitration.

(2349) A claim must be specific in order to avoid any doubts as to the content of the operative part of the award (Sw. *domslut*) claimed by the claimant. Therefore, the request for relief should be able to be "mirrored" in the tribunal's later award.

(2350) In summary, if the claimant's request for relief is not sufficiently specified, the request for relief should be dismissed.

7.2.2.6 Gazprom's defences to Naftogaz' principal claims for invalidity/ineffectiveness and replacement of the provisions of the Contract pursuant to European and Ukrainian competition and energy law

7.2.2.6.1 The application of competition law and energy law to the Contract: threshold issues

7.2.2.6.1.1 Naftogaz' purported "legal bases" for its claims under competition law and energy law

(2351) In support of its claims for invalidity/ ineffectiveness, Naftogaz relies upon a number of legal bases under European and Ukrainian competition and energy law.

7.2.2.6.1.2 Gazprom's summary response to Naftogaz' "legal bases" for its claims under competition law and energy law

(2352) Naftogaz has introduced a bewildering number of arguments and alternative bases for the purported application of competition law and energy law to this case. This approach, which is over-complex and unclear, exposes the fundamental weaknesses in Naftogaz' case. In reality, the position is much less complicated than Naftogaz would have the Tribunal believe:

1. Ukraine is not a member State of the EU;

2. EU competition law as contained in Articles 101 and 102 TFEU cannot be applied outside the European Union except in exceptional circumstances (which are not fulfilled in this case);
3. the EnCT does not expand the EU legal order to Ukraine (either as regards competition law, via Article 18 EnCT, or as regards energy law, via Articles 7 or 10 EnCT);
4. there is no legitimate basis for applying Ukrainian competition law or energy law to "trump" Swedish contract law, the *lex contractus* that was freely chosen by the parties in order to ensure neutrality; and
5. Ukrainian law is not relevant "*as a fact*" under Swedish contract law, nor do the alleged breaches of "energy law" lead to invalidity of the Contract under Swedish contract law.

(2353) Gazprom addresses the relevant threshold issues in the following order:

Competition Law:

1. Articles 101 and 102 TFEU do not apply in the present case. Naftogaz is unable to fulfil the requirements of the "*qualified effects*" test as a matter of public international law. Alternatively, and in any event, Naftogaz is unable to establish the requisite effect on trade between Member States for the purposes of Articles 101 and 102 TFEU.
2. Article 18 EnCT does not apply in the present case. The EnCT is not capable of affording rights on private individuals which may be enforced against other private individuals in a court or tribunal in the EU, nor does it otherwise have direct effect as a matter of EU law.
3. Ukrainian competition law is not applicable to the current dispute, whether pursuant to the Rome I Regulation or under Swedish law.

4. EU energy law does not apply as an "*operationalisation*" of Articles 101 and 102 TFEU. This concept is unknown to EU law and appears to have been invented by Naftogaz for the purposes of these proceedings.

Energy Law:

5. Article 10 EnCT does not operate so as to apply the requirements of the Third Energy Package (Regulation 715/2009 and Directive 2009/73) to the current dispute. Article 10 EnCT does not afford rights to private individuals which may be enforced against other private individuals in a court or tribunal in the EU, nor does it otherwise have direct effect as a matter of EU law.
6. Article 7 EnCT does not apply the requirements of the Third Energy Package to the current dispute either as a result of "*legal discrimination*" or as a result of "*factual discrimination*".
7. Ukrainian energy law is not applicable to the current dispute, whether pursuant to the Rome I Regulation or under Swedish law.

(2354) Before turning to address the detail, however, it is necessary to make some general, preliminary points on the approach which Naftogaz has taken to these aspects of its case.

(2355) This dispute is concerned with an agreement which regulates the terms and conditions for the transit of natural gas across Ukrainian territory through the Ukrainian gas transmission network. This agreement has been concluded by two private parties both established outside the European Union.

(2356) However, Naftogaz still attempts to rely on EU law as the legal basis for its claims. In order to do so Naftogaz simply ignores the public international law prohibition on the extraterritorial application of EU competition law to Ukraine. Instead, Naftogaz addresses EU competition law as if Ukraine was a member State of the European Union and that EU law was applicable.

In order to strengthen its position, Naftogaz even resorts to inventing new arguments without any foundation in EU law, such as its "*principle of operationalisation*".

(2357) Equally, Naftogaz refuses to address the fundamental problems with its case on the EnCT. The EnCT simply sets out a framework pursuant to which the *Contracting Parties* (including Ukraine, but not the European Union) agree to reflect relevant EU energy legislation in their own national legislation. A significant part of the EnCT, including Articles 10 and 18 EnCT, does not contain any commitment undertaken by the EU and it is therefore impossible for this part of the EnCT to give rise to any corresponding legal rights as a matter of EU law. In addition, the EnCT is not an international agreement that is capable of having direct effect in EU law and it is therefore not capable of affording rights to individual, private parties which may be exercised and/or relied upon in a dispute between those parties.

(2358) As regards Ukrainian law, it is only in the clearest cases of "*overriding mandatory provisions*" that one party (Naftogaz) which is wholly owned by the government of the country of the place of performance should be able to impose its own legislation on the other party (Gazprom), over and above the neutral governing law of the Contract that was freely agreed between the Parties. None of Naftogaz' arguments in the present case come close to showing that there are clear "*overriding mandatory provisions*" of Ukrainian law that must be applied by this Tribunal sitting in Sweden in respect of a Swedish law contract.

(2359) There is also no valid basis under Swedish contract law for applying Ukrainian law in the circumstances invoked by Naftogaz.

7.2.2.6.2 Competition law: threshold issues

7.2.2.6.2.1 Articles 101 and 102 TFEU have no direct application

(2360) Naftogaz' primary legal basis for its competition law claims is the direct application of Articles 101 and 102 TFEU to the Contract. Naftogaz also argues that Articles 101 and 102 TFEU are directly applicable to the Contract as part of Swedish law. Sweden is a Member State of the

EU and EU law must therefore be enforced in Swedish law. Naftogaz accepts that it follows that the two grounds put forward by it are effectively one and the same ground.

(2361) Naftogaz argues that Articles 101 and 102 TFEU apply to the Contract "*even though both Parties are established outside the EU and the Contract was concluded outside the EU*". Naftogaz argues that Articles 101 and 102 TFEU apply to the Contract "*under the principles of public international law*". Naftogaz also argues that Articles 101 and 102 TFEU apply to the Contract "*as the Contract and Gazprom's abusive and restrictive conduct affect trade between EU Member States*". These are two distinct issues.

(2362) Whether EU competition law, as a matter of public international law, can be applied to conduct that takes place outside the EU, is "*a question separate from*" that of the criteria laid down in Articles 101 and 102 TFEU as regards effect on trade between EU Member States.

7.2.2.6.2.2 Public international law prevents the application of Articles 101 and 102 TFEU to the Contract: the qualified effects doctrine

7.2.2.6.2.2.1 Introduction

(2363) Articles 101 and 102 TFEU apply within the territory of EU Member States only. This is clear from the text of the EU Treaties themselves and is reflected in the wording of Articles 101 and 102 themselves.

(2364) Article 52 TEU and Article 355 TFEU make it clear that the Treaty provisions (including Articles 101 and 102 TFEU) apply within the territories of the EU Member States (and certain overseas territories).

(2365) There are limited exceptions to this fundamental principle of territoriality: the single economic entity doctrine, the implementation doctrine and (possibly) the qualified effects doctrine.

(2366) Neither the single economic entity doctrine nor the implementation doctrine apply in the present proceedings. Therefore, in order to apply Articles 101 and 102 TFEU to Contract TKGU (a contract between two undertakings domiciled outside the EU as regards the transit of gas

outside the EU), Naftogaz must establish that (a) the qualified effects doctrine applies, and (b) it is fulfilled as a matter of fact in the present case.

(2367) Naftogaz argues that the qualified effects test can be ignored because Swedish law has been chosen by the parties as the governing law of the Contract. This is a novel argument and is unsupported by any authority.

(2368) Moreover, contrary to what is suggested by Naftogaz, Swedish law is not EU law. Swedish law and EU law remain separate legal orders. EU law should only be applied if and when it is applicable to the factual situation in issue.

(2369) In accordance with the principle of primacy of EU law, a national court must apply EU law and set aside any provision of national law which may conflict with it. It is in this manner the term "integral part" (of the laws of the Member States) shall be understood.

(2370) EU law may be constitutionally superior to the national laws of the Member States, but it is still a separate legal order. Consequently, although EU law must be respected and applied in Swedish law when (and if) it is applicable, the EU legal order and Swedish law remain distinct.

(2371) The Parties have chosen "Swedish law" to govern the Contract. EU law must only be considered as part of Swedish law if and when it is applicable.

(2372) In the present case, Articles 101 and 102 TFEU are only applicable if Naftogaz can establish that (a) the qualified effects doctrine applies, and (b) it is fulfilled as a matter of fact in the present case.

(2373) Naftogaz asserts that the General Court extended the scope of EU jurisdiction in *Gencor*¹⁷⁵ so as to include the *qualified effects doctrine*. According to Naftogaz, the *qualified effects doctrine* provides that, if it is foreseeable that an agreement or a practice will have substantial effect

¹⁷⁵ Case T-102/96 *Gencor Ltd v. Commission* (1999) ECR II-753.

within the EU, then EU law applies by virtue of the territoriality principle as recognised by public international law.

(2374) There are several reasons why an extraterritorial application of EU competition law should be interpreted restrictively.

(2375) First, the territoriality principle, under which the EU has the power to make laws affecting conduct within its own territory only, is a fundamental principle in public international law. The CJEU has on several occasions stressed that the EU must respect international law in the exercise of its powers, including the principle of territoriality.

(2376) Second, given the way in which it is worded, Article 101 TFEU (and Article 102 TFEU) was quite simply never intended to be applied in any extra-territorial manner.

(2377) Accordingly, too broad an interpretation of the territorial scope of EU competition law would encroach on the territoriality principle as recognised in public international law, sit uneasily with the wording of Articles 101 and 102 TFEU, and entail the risk of conflicts of jurisdiction with foreign competition authorities.

7.2.2.6.2.2.2 Limited extraterritorial application of EU competition law through the qualified effects doctrine

(2378) Naftogaz argues that EU competition law applies where an agreement or practice is either implemented in or produces effects within the EU. Naftogaz further argues that, if either criterion is fulfilled, the jurisdiction of EU law is compatible with the requirements of public international law.

(2379) However, despite several possibilities to do so, the CJEU has never applied Article 101 or 102 TFEU based on qualified effects in a situation where the agreement or conduct in question was not *implemented* in the EU.

(2380) The General Court (the EU court of first instance) and the EU Commission have applied EU competition law where conduct produces effects in the EU. The General Court has held that,

in order to justify the application of EU competition law "*according to the rules of public international law*" based on the potential effects of the conduct (where an abuse was implemented outside the EU between two parties established outside the EU), the criteria of "*immediate, substantial and foreseeable effect in the European Union*" must be satisfied. This is also referred to as the qualified effects test.

(2381) The test adopted by the General Court is a stringent one. As regards each of the criteria of "*immediate, substantial and foreseeable effect in the European Union*":

1. There must be a "*substantial effect*". The Court made clear that a detailed and thorough analysis of the potential effects of the agreement or practice in the EU is required in order to establish that these are "substantial". This is a significant hurdle. In *Intel*, the Court held that there was a "substantial effect" on the basis that the conduct at issue had the effect of "*weakening [Intel's] sole significant competitor at the worldwide level, by foreclosing it from the most important sales channels*".
2. The "substantial effect" threshold must not be confused with the test to establish whether trade between Member States has been affected pursuant to Articles 101 and 102 TFEU. As expressly recognised in *Intel*, it was the latter test that the General Court dealt with in *Haladjian Frères* finding that this separate test is only fulfilled if the effect on trade between Member States is "*substantial, that is to say, appreciable and not negligible*."
3. The criterion of "substantial effect" under the qualified effects doctrine represents a more stringent test than that used in *Haladjian Frères*. In order to justify jurisdiction under public international law, there must "*a threat to the effective competition structure in the common market*".
4. Further, in order for an agreement or practice to have "immediate" effect in the EU, the effects must be direct, rather than merely indirect or having a knock-on effect. In *Intel*,

the Court held that "*Intel's conduct was intended to produce an immediate effect in the EEA and was capable of doing so*".

5. In addition, the effect generated by the agreement or practice in the EU must have been foreseeable for the parties involved. In *Intel*, the court held that the effect of the conduct at issue "*was foreseeable for [Intel]. Indeed, that was the intended effect of its conduct*".

(2382) The General Court has also clarified that the "*effect in the European Union*" refers to a negative effect on competition within the EU. An extraterritorial effect of EU competition law in accordance with a qualified effects test could according to the General Court only be justified if there was a "*threat to the effective competition structure in the common market*".

(2383) Application of EU competition law according to the rules of public international law is therefore quite different to the regular "*effect on trade*" test used for the application of Articles 101 and 102 TFEU. While the public international law test refers to a negative effect on competition in the EU, the application of Articles 101 and 102 TFEU refers to an effect, positive or negative, on "*trade between Member States*" of the EU.

7.2.2.6.2.2.3 Naftogaz has failed to establish jurisdiction in accordance with public international law under the qualified effects test

(2384) The Contract will not fall within EU competition law under the qualified effects test unless it has "*immediate, substantial and foreseeable effect in the European Union*". There must be an effect on competition in the EU and this effect must be negative.

(2385) The Contract involves two parties neither of which are located in EU Member States, and it regulates activities in a non-Member State. It sets out the terms and conditions for the transit of natural gas across Ukrainian territory through the Ukrainian gas transmission network. The only direct effect on competition generated by the Contract would occur on the Ukrainian market. Competition in the EU can only be indirectly affected by the Contract (if it is affected at all).

- (2386) However, Naftogaz nevertheless argues that the Contract has "*an immediate, substantial and foreseeable impact on trade flows within the EU*" and therefore satisfies the qualified effects test.
- (2387) This assertion would appear to be made on the following bases.
- (2388) First, that "*the Gas Transit Contract concerns the transmission of very significant natural gas volumes through the territory of the Ukraine and into EU countries*" and that, without the Contract, "*Russia would not be able to supply the full volumes that it is supplying into EU countries, which would instead have to source natural gas and/or other fuels from suppliers and traders in other countries*". However, the fact that the Contract concerns the transit of a large volume of gas does not establish that it has a substantial, immediate and foreseeable negative effect *on competition* within the EU (as required by the qualified effects test: see above).
- (2389) Second, Naftogaz asserts that certain provisions of the Contract and/or conduct by Gazprom "*individually affect trade between EU countries, inter alia, by impeding exports into the EU from Ukraine, hindering suppliers located within the EU from marketing their gas on the Ukrainian market, as well as preventing the transit of gas between EU Member States through Ukraine*". Naftogaz states that it discusses these effects further (where it discusses effect on trade between Member States under Articles 101 and 102 TFEU). They are addressed by Gazprom below.
- (2390) These arguments are misconceived on the basis set out below: Naftogaz has been unable to establish any such potential effect on trade between Member States. In any event, however, establishing an effect on trade between Member States for the purposes of Articles 101 and/or 102 TFEU is not sufficient to establish jurisdiction under public international law. As explained above, these are different tests which are distinct. Both tests must be satisfied in order for EU competition law to be applied.

- (2391) Naftogaz relies upon two allegedly anticompetitive consequences of the Contract tariff. First, it is clear that this alleged abuse cannot be described as having any direct negative effect on competition in the EU. The services in question are not provided within the EU and the allegedly exploited party, Naftogaz, is not within the EU.
- (2392) Second, Naftogaz asserts that the Contract tariff "has the effect of excluding competitors of Gazprom because Naftogaz is forced to charge higher prices to third parties wishing to use the gas transmission system". Again, there is no direct negative effect on competition in the EU. Naftogaz' assumption is that Ukrtransgaz will, in the future, raise the tariffs it imposes on third parties seeking to use the Ukrainian GTS to export Ukrainian gas to Germany or to transit non-Ukrainian gas to Germany. The effect is on users of the Ukrainian GTS within Ukraine.
- (2393) That suffices to dismiss Naftogaz' qualified effects case, at least as far as the tariff is concerned.
- (2394) As far as the non-tariff provisions are concerned, Dr Moselle's analysis, as set out in his Third Report, indicates that the non-tariff provisions of the Contract do not have any "*immediate, substantial and foreseeable*" negative effect on competition *within the EU*. On the sharing of commercially sensitive information Dr Moselle was questioned about effects on competition within Ukraine but not effects on competition within the EU. Likewise, as far as virtual reverse flow ("VRF") is concerned, Dr Moselle was questioned about effects on trade between EU Member States but not about negative effects on competition within the EU. Naftogaz does not put forward any cogent case that VRF would immediately occur if Gazprom Export handed over shipper codes, much less that the absence of VRF has a substantial and foreseeable negative effect on competition within the EU (as opposed to Ukraine).
- (2395) In summary, the Contract does not give rise to immediate, substantial or foreseeable negative effects on competition in the EU and therefore the qualified effects test is not met. The Tribunal should reject all of Naftogaz' claims under Articles 101 and/or 102 TFEU because this basic threshold requirement is not met.

(2396) Even if Naftogaz were able to establish that the object of the Contract is to isolate Ukraine and restrict export and import of gas between Ukraine and the EU and transit through Ukraine, which is denied, there is no evidence that this alleged object would have a negative effect on competition in the EU which is immediate, substantial and foreseeable in nature.

(2397) In conclusion, in order to determine whether EU competition law, as a matter of public international law, can be applied to conduct that takes place outside the EU, there must be a negative effect on competition in the EU that is immediate, substantial and foreseeable to the parties. This effect has not been established by Naftogaz in this case.

7.2.2.6.2.2.4 The Intel judgement

(2398) Gazprom's interpretation of the qualified effects test is supported by the Opinion of AG Nils Wahl in *Intel*.¹⁷⁶ In paragraph 300 of his Opinion, AG Wahl said:

"I consider it to be particularly important that jurisdiction is asserted with restraint in relation to behaviour that has not, strictly speaking, taken place within the territory of the European Union. Indeed, to comply with a certain form of comity and, by the same token, to ensure that undertakings can operate in a foreseeable legal environment, it is only with a great deal of caution that the effect of the conduct complained of can be used as the yardstick for asserting jurisdiction. That is all the more important today. There are over 100 national or supranational authorities worldwide that claim jurisdiction over anticompetitive practices." (emphasis added by Gazprom)

(2399) Furthermore, AG Wahl found that it was not enough to establish that the conduct at issue influenced business choices. The Commission needed to go further and demonstrate that the conduct *"immediately or directly diminish[ed] Intel's competitors' ability to compete [...]"*¹⁷⁷

¹⁷⁶ Opinion of Advocate General Wahl, 20 October 2016, Case C-413/14P, paragraphs 299-303, 322-26.

¹⁷⁷ Opinion of Advocate General Wahl, 20 October 2016, Case C-413/14P, paragraph 322 Exhibit RLA-157.

- (2400) By an email of 24 October 2017, Naftogaz drew the attention of the Tribunal to the judgment of 6 September 2017 of the CJEU in the *Intel* case (the “*Intel* judgment”).¹⁷⁸ Naftogaz also provided its comments on the relevance of the *Intel* judgment to the Transit Arbitration.
- (2401) The *Intel* judgment is relevant to the threshold question of whether Articles 101 and/or 102 TFEU apply at all to the dispute in the Transit Arbitration.
- (2402) In the *Intel* judgment the CJEU held that the qualified effects test could serve as a basis for the Commission’s jurisdiction in the particular circumstances of that case. However, the *Intel* judgment does not alter Gazprom’s case that Articles 101 and/or 102 TFEU do not apply to the dispute in the Transit Arbitration.
- (2403) First, Gazprom’s primary argument is that Articles 101 and 102 TFEU apply within the territory of EU Member States only, and that the qualified effects test operates only as an exception to that fundamental principle of territoriality. In the *Intel* judgment, the CJEU reaffirms that “the *EU competition rules set out in Articles 101 and 102 TFEU are intended to prevent collective or unilateral conduct of undertakings limiting competition within the internal market*” (emphasis added by Gazprom). The CJEU therefore recognises the fundamental principle of territoriality in the *Intel* judgment.
- (2404) Second, it is correct that, in the *Intel* judgment, the CJEU has now (for the first time) applied the qualified effects doctrine. However, it is still the case that the doctrine has only been applied in cases involving public enforcement of EU competition law. The *Intel* judgment involves public enforcement of Article 102 TFEU by the European Commission.
- (2405) Gazprom therefore stands by its submission that the rationale for the application of the qualified effects doctrine in cases of public enforcement (i.e. that an exception to the territoriality principle may be justified in order to protect the effective competitive structure of the common

¹⁷⁸ Case C-413/14 P *Intel Corporation Inc v European Commission*.

market) is not obviously applicable to a dispute between private parties, and that the Tribunal should therefore be cautious in applying the qualified effects doctrine in the present case.

(2406) Third, the Intel judgment reinforces the point that the qualified effects test is a stringent one, and that each of the criteria of “*immediate, substantial and foreseeable*” negative effect on competition in the European Union must be satisfied. In particular, the CJEU held that Intel’s conduct had to be capable of producing an “*immediate*” or direct effect on competition in the EEA. On the facts of the *Intel* case, the CJEU held that such a direct effect was made out on the basis that Intel’s conduct formed part of “*an overall strategy intended to ensure that no Lenovo notebook equipped with an AMD CPU would be available on the market, including in the EEA*” (emphasis added by Gazprom). In other words, Intel’s conduct entirely excluded a competitor’s product from the EEA. It therefore had a direct/ immediate effect on competition in the EU.

(2407) By contrast, in the Transit Arbitration, even if the qualified effects doctrine applies, it is not fulfilled as a matter of fact. None of the matters upon which Naftogaz seeks to rely in this regard establish a direct or “*immediate*” effect on competition in the EU (at best they establish only an indirect effect).

(2408) In conclusion, therefore, it remains Gazprom’s case that Articles 101 and/or 102 TFEU do not apply to the dispute before the Tribunal in the Transit Arbitration.

7.2.2.6.2.2.5 Effect on trade whole agreement or individual provisions?

(2409) Naftogaz considers the question of whether it is able to argue that the whole Contract has an effect on trade between EU Member States, or whether it will have to prove that each of the individual provisions of the Contract has such an effect.

(2410) Naftogaz argues that if an agreement as a whole is capable of affecting trade between EU Member States, then EU law has jurisdiction over the entire agreement, “*including any parts of the agreement that individually do not affect trade between EU Member States*”. Further, where a

dominant undertaking engages in conduct in pursuit of the same aim, *"it is sufficient that at least one of those practices is capable of affecting trade between EU Member States"*. Naftogaz relies upon paragraphs 14 to 17 of the EU Commission's Effect on Trade Guidelines in this regard.

(2411) However, paragraph 17 of the Effect on Trade Guidelines makes it clear that, in order to take advantage of this approach, Naftogaz needs to establish that the allegedly abusive conduct *"forms part of an overall strategy"* pursued by Gazprom. If Naftogaz cannot do that, then each individual element of the impugned conduct must be assessed separately and proven by Naftogaz to affect trade between EU Member States.

(2412) Naftogaz asserts that Gazprom's practices, *"which are either manifested in or related to the Contract, form part of an overall exclusionary and exploitative strategy of which also the Gas Sales Contract forms part"*. No evidence is cited in support of this assertion of an *"overall exclusionary and exploitative strategy"*.

(2413) Therefore, Naftogaz has failed to establish an *"overall strategy"*. It thus needs to establish that each element of the alleged abuse affects trade between EU Member States.

(2414) Naftogaz also argues that there are several restrictions *"which individually contribute to isolating Ukraine from the EU market and to prevent transit between EU countries through Ukraine"*.

(2415) As regards Article 102 TFEU, Naftogaz argues that *"Gazprom's abusive strategy"* has an effect on trade between EU Member States in the following ways:

1. forcing Naftogaz to subsidise Gazprom's gas sales into EU countries through a below-cost tariff;
2. impeding exports into the EU from Ukraine, i.e. by preventing (virtual) reverse flows;
3. hindering suppliers located within the EU from marketing their gas on the Ukrainian market;

4. preventing the transit of gas between EU Member States through Ukraine.

(2416) Those arguments appear to be different (in whole or in part) from those originally relied upon by Naftogaz in its Statement of Claim. In its Statement of Claim Naftogaz focused on its ability and the ability of its competitors to sell their excess gas supplies in Germany. In any event, each of those arguments is misconceived:

1. Gazprom denies that the Contract tariff is below-cost. Gazprom further denies that the Contract tariff in any way "*subsidises*" its gas sales into EU countries. In any event, this argument of subsidised gas sales by Gazprom into EU countries does not establish an effect on trade between EU Member States for the purposes of Article 102 TFEU. Naftogaz does not explain how the alleged subsidy affects the pattern of trade. Nor does Naftogaz explain how it is said to affect trade between two or more EU Member States (rather than, say, Russia and the importing EU Member State).
2. As regards Naftogaz' argument that Gazprom's conduct impedes exports into the EU from Ukraine, i.e. by preventing virtual reverse flows, , if (which is denied) there is any effect on exports into the EU from Ukraine, this does not establish an effect on trade between two or more EU Member States (only an effect on trade between Ukraine and EU Member States).
3. As regards Naftogaz' argument that Gazprom's conduct hinders suppliers located in the EU from marketing their gas in the Ukraine, there is nothing in the Contract or in Gazprom's conduct which prohibits suppliers located in the EU from marketing their gas in Ukraine. Naftogaz' argument on effect on imports into Ukraine is wholly speculative and hypothetical. In any event, if (which is denied) there is any effect on imports into Ukraine from the EU, this does not establish an effect on trade between two or more EU Member States (only an effect on trade between Ukraine and EU Member States).

4. Naftogaz' argument that Gazprom's conduct prevents the transit of gas between between EU Member States through Ukraine is also wholly speculative and hypothetical. It is addressed in the following paragraphs.

(2417) Naftogaz argues that the Contract prevents the transit of gas between Slovakia, Poland and Hungary using the Ukrainian GTS. A particular example is given in Lapuerta and Hesmondhalgh Report 2. That example is where a supplier in Poland could use the Ukrainian grid to sell gas to Hungary. Further examples are given in the Lapuerta and Hesmondhalgh Report 2.

(2418) The examples given by Naftogaz in this regard are highly theoretical and speculative. They do not appear to be based on any factual evidence as regards the situation in Ukraine, Slovakia, Poland and Hungary. As explained in the EU Commission's Guidelines and case-law, "*[h]ypothetical or speculative effects are not sufficient for establishing*" the requisite effect on trade between Member States.

(2419) Mr Khandokhin, who is currently Advisor to the General Director of Gazprom Export LLC, and who is familiar with the structure and operation of the European and Ukrainian gas transmission systems, and with Gazprom's and Gazprom Export's arrangements for delivery of gas at and/or further transportation of gas from the exit points of the Ukrainian GTS, makes it clear that Gazprom has not "*blocked*" or "*refused to permit*" virtual reverse flow or that Gazprom has "*refused to permit efficient cross-border flows*" from Ukraine to these other countries.

(2420) As a result, Naftogaz has failed to establish to the requisite standard as a matter of EU law that the Contract as a whole and/or the practices of Gazprom may affect trade between EU Member States.

(2421) Naftogaz addresses the effect on trade of each of the individual alleged abusive practices by Gazprom. Gazprom responds to Naftogaz' case in that regard in below when it addresses Naftogaz' case on each of the alleged abuses. Naftogaz fails to establish to the requisite standard

as a matter of EU law that each of the alleged abusive practices by Gazprom may individually affect trade between EU Member States.

7.2.2.6.2.3 Article 18 EnCT has no horizontal direct effect under Swedish law and EU law

(2422) Naftogaz asserts that Article 18 of the EnCT has "*horizontal direct effect*" under Swedish law and EU law. According to Naftogaz, this provision could be applied as a matter of EU law between private parties situated within the territories of the Contracting Parties.

(2423) The parties agree that pursuant to Article 216(2) TFEU the EnCT is binding on the EU and thereby its Member States, including Sweden. However, it does not follow that private parties, such as Naftogaz, can invoke particular provisions of the EnCT as a matter of EU law in disputes governed by Swedish law. Gazprom maintains that Naftogaz cannot invoke Article 18 EnCT because the requirements for granting horizontal direct effect to that provision under EU law are not met in this case.

(2424) The parties differ on: (1) the content of the EU law test for when provisions in international agreements can be invoked by private parties within the internal legal order of the EU; and (2) the application of that test to Article 18 of the EnCT.

7.2.2.6.2.3.1 The test for when a provision in an international agreement concluded by the EU can be relied on before a court or tribunal in the EU

(2425) It must initially be underlined that the CJEU has never allowed a private party established outside the European Union to rely on a provision in an international agreement concluded by the EU against another private party established outside the EU. In addition, there is no drafting history or supplementary means of interpretation which suggests that the EU and the Contracting Parties to the EnCT have assumed (unprecedented) obligations to apply their national competition laws extra-territorially to private parties. To the contrary the Energy Community Secretariat describes the status quo as one where the "*system of competition and State aid law control [is] based on national enforcement*". Moreover, Council Decision 2006/500/EC, pursuant to which the EU approved the EnCT, is replete with statements that any decisions under

the EnCT which take effect within the EU are not meant to "go beyond the *acquis communautaire*" or "conflict with any part of the *acquis communautaire*". Naftogaz' interpretation is difficult to reconcile with the general approach of maintaining the status quo within the EU that is reflected in Council Decision 2006/500/EC.

(2426) Further, the requirements that must be met before a provision in an international treaty will be given effect in the internal legal order of the EU were first discussed in the seminal case of *International Fruit*. In that case the CJEU held that:

"Before the incompatibility of a Community measure with a provision of international law can affect the validity of that measure, the Community must first of all be bound by that provision.

Before invalidity can be relied upon before a national court that provision of international law must also be capable of conferring rights on citizens of the Community which they can invoke before the courts. ...

For this purpose, the spirit, the general scheme and the terms of the General Agreement must be considered" (emphasis added by Gazprom)

(2427) These requirements have been consistently applied by the CJEU when determining whether individuals can invoke provisions in international treaties concluded by the EU in domestic courts.

(2428) They are reflected, along with other requirements, in the more recent case of *Intertanko* where the Grand Chamber of the CJEU summarised the law as follows:

"It follows that the validity of a measure of secondary [EU]legislation may be affected by the fact that it is incompatible with such rules of international law. Where that invalidity is pleaded before a national court, the Court of Justice thus reviews, pursuant to Article [267 TFEU], the validity of the [EU]measure concerned in the light of all the rules of international law, subject to two conditions.

First, the [EU] must be bound by those rules (see Joined Cases 21/72 to 24/72 International Fruit Company and Others [1972] ECR 1219, paragraph 7).

Second, the Court can examine the validity of [EU] legislation in the light of an international treaty only where the nature and the broad logic of the latter do not preclude this and, in addition, the treaty's provisions appear, as regards their content, to be unconditional and sufficiently precise (see to this effect, in particular, Case C-344/04 IATA and ELFAA [2006] ECR I-403, paragraph 39)."(emphasis added by Gazprom)

- (2429) The first condition was explained by the CJEU in *Kupferberg*: "[a]ccording to the general rules of international law there must be *bona fide* performance of every agreement. "Although each contracting party is responsible for executing fully the commitments which it has undertaken it is nevertheless free to determine the legal means appropriate for attaining that end in its legal system unless the agreement, interpreted in the light of its subject-matter and purpose, itself specifies those means" (emphasis added by Gazprom).
- (2430) It is thus in relation to the commitments that it has undertaken, that each contracting party to an international agreement is free to determine the legal means appropriate for the full execution, e.g. whether the provision concerned has direct effect. It is evident that if there is no commitment undertaken by the EU, there cannot be a corresponding duty that could give rise to a right of an individual as a matter of EU law. That the particular provision in the international agreement must give rise to a commitment undertaken by the EU is accordingly a precondition to whether at all consider the subsequent issue of direct effect.
- (2431) All the provisions of different international agreements concluded by the EU in relation to which the CJEU has progressed to consider the issue of direct effect have contained commitments undertaken by the European Union.
- (2432) The case law of the International Court of Justice further confirms that the EU is only bound by the specific commitments undertaken in the concluded international agreement:

"[I]nternational organisations are subjects of international law and, as such, are bound by any obligations incumbent upon them under general rules of international law, under their constitutions or under international agreements to which they are parties". Accordingly, the EU is not bound by any obligations of an international agreement that it has not undertaken.

(2433) This summary of the relevant test has been endorsed by the CJEU and applied in subsequent cases. It should be noted that the test is a unified one: there is no suggestion in the case-law that the test for vertical direct effect (where the treaty provision is invoked by a private party against the EU Member State or the EU itself) is any different from the test for horizontal direct effect (where the treaty provision is invoked by one private party against another private party). In the present case, Gazprom is concerned with horizontal direct effect.

(2434) Based on this case law, it is Gazprom's position that a provision in an international treaty can only be invoked by a private party before a national court in the EU if the following four conditions are met:

1. the EU itself is bound by the specific rule in question;
2. the grant of direct rights to private parties and/or the imposition of direct obligations on private parties is consistent with the "*nature and broad logic*" of the treaty in question;
3. the treaty provision contains a sufficiently clear and precise obligation; and
4. the treaty provision is unconditional in that it is not subject to further implementing measures.

(2435) The first condition represents a primary condition that must be satisfied before considering the latter three conditions which jointly represent the so-called test for direct effect.

(2436) Naftogaz accepts that the third and fourth conditions must be met but it is far from clear whether it accepts that the first and second conditions must be met.

- (2437) Regarding the first condition, Naftogaz' position cannot be reconciled with the case law of the European courts. For example, in *Intertanko* the CJEU described the first condition set out above as one of "*two conditions*" that must be met before a private party can invoke an international law rule in the EU's internal legal order.
- (2438) As to the second condition, Naftogaz' failure to identify it as a separate condition cannot be reconciled with consistent case law of the CJEU. The CJEU has confirmed that there is a separate and distinct requirement to assess the "*nature and broad logic*" of the international treaty that is invoked and determine whether it is intended to confer direct rights and/or duties on private parties. In *Intertanko*, the CJEU applied this separate requirement and declined to give direct effect to certain provisions of UNCLOS because "*...individuals are in principle not granted independent rights and freedoms by virtue of UNCLOS*". In the *ATAA* case the CJEU applied this separate requirement to the bilateral Open Skies Agreement and concluded that it "*establishes certain rules designed to apply directly and immediately to airlines and thereby to confer upon them rights and freedoms*".
- (2439) Naftogaz asserts that the test for direct effect has developed so that "*the issue today is whether the provision invoked by a private party is of a kind which a judicial institution can apply without taking on a role as a legislator*". Naftogaz relies on three academic authors for this assertion. However, Naftogaz' position that the four conditions set out above can in effect be ignored because of the academic commentary is unsustainable.
- (2440) The academic materials that Naftogaz invokes deal with the question of whether provisions in the EU treaties or instruments promulgated by the EU have direct effect. However, the test for when provisions in international agreements concluded by the EU with third countries have direct effect is distinct. For instance, Schütze does not engage with the direct effect of a provision in an international agreement concluded by the EU in the passage that Naftogaz cites.

Schütze has a separate section concerning that issue which confirms Gazprom's reading of the case law. The section contradicts the test that Naftogaz puts forward.¹⁷⁹

(2441) Naftogaz' proposed test is impossible to reconcile with the case law of the European courts cited above. Contrary to Naftogaz' suggestions, there has been no change in the case law of the CJEU on this matter.

(2442) Naftogaz' references are misleading. There is extensive academic commentary on EU external relations law and the effect of treaties concluded by the EU and that commentary fully supports Gazprom's position.

(2443) In summary, the test for when a provision in an international treaty can be relied on before a court or tribunal in the EU involves four conditions: (1) the disputed provision must contain a commitment undertaken by the EU; (2) the grant of direct rights to private parties must be consistent with the "*nature and logic*" of the treaty; (3) the provision must contain a sufficiently clear and precise obligation; and (4) the provision must be unconditional. The first of these conditions is a primary condition that must be satisfied before considering the latter three conditions which represent the test for direct effect. Gazprom applies this test to Article 18 of the EnCT in the following part of this submission.

7.2.2.6.2.3.2 Application of the test for horizontal direct effect to Article 18 of the EnCT

(2444) In summary, it is Gazprom's position is that Naftogaz is not entitled to invoke Article 18 of the EnCT in this Arbitration because none of the four conditions for giving direct effect to that provision is met.

1. The first of the four conditions set out above is not met: Article 18 EnCT does not contain a commitment undertaken by the EU.

¹⁷⁹ R. Schütze, *European Constitutional Law* (Cambridge University Press, 2012) at pp. 337-342. Equally, Kapteyn, to whom Naftogaz refers in paragraph 805 of its Reply, confirms the test of direct effect of international agreements concluded by the EU (Kapteyn P. J. G. et al. (eds.) *The Law of the European Union and European Communities* (Alphen aan den Rijn, 2009) at pp. 518-519.

2. The second of the four conditions set out above is not met: it would be inconsistent with the "*nature and logic*" of the EnCT to give private parties the right to invoke Article 18 of the EnCT within the internal legal order of the EU.
3. The third of the four conditions set out above is not met because Article 18 EnCT does not contain a sufficiently clear and precise obligation.
4. The fourth of the four conditions set out above is not met because Article 18 is conditional and subject to further implementing measures.

7.2.2.6.2.3.3 First condition Article 18 EnCT does not contain commitments undertaken by the EU

- (2445) The EnCT does not contain similar obligations for all Parties (in contrast to for example the free trade agreement with Portugal which the CJEU had to interpret in *Kupferberg*). There is a clear division between the commitments of the EU as a Party to the EnCT on the one hand and the Contracting Parties on the other.
- (2446) This division of obligations is in accordance with the purpose of the EnCT to create a *legal and economic framework based on the EU acquis communautaire* related to energy. By exporting EU rules to the Contracting Parties, the Parties intended to create a regulatory and market framework upon the basis of EU legislation so as to ensure a stable and continuous energy supply. However, the Treaty does not contain any overarching obligation in this regard, binding on all the Parties to the EnCT. It is only the Contracting Parties which are obliged to implement the *acquis communautaire* as described in Title II of the EnCT.
- (2447) Accordingly, it follows from Article 3(a) EnCT and the definition therein of "*the extension of the acquis communautaire*" that the provisions under Title II of the EnCT (including Article 18 EnCT), are addressed to the Contracting Parties only, including Ukraine, and *not* to the EU as a "*Party*" to the EnCT. The EU has consequently not undertaken any obligations under these provisions. The wording of Article 18 EnCT itself further underlines the obligations *of the Contracting Parties* under these provisions.

- (2448) It should be emphasised that the fact that the provisions of Title II are only addressed to the non-EU parties to the EnCT is different to how international agreements concluded by the EU are generally drafted. The obligations under such agreements are normally addressed to third parties, as well as to the EU and its Member States. This is particularly the case with the EEA Agreement. The provisions of the EEA Agreement set out that the *acquis communautaire*, even though by definition already adopted by the EU, apply to all the Contracting Parties, the EFTA EEA States, as well as the EU and its Member States (as adapted for the purposes of the EEA Agreement).
- (2449) Naftogaz does not appear to dispute that Article 18 EnCT is addressed only to the Contracting Parties of the EnCT and not to the EU as a "Party" to the agreement. Instead Naftogaz refers to Article 6 EnCT and its resemblance to the loyalty obligation in Article 4(3) TEU.¹⁸⁰ Naftogaz therefore argues that the wording of Article 6 EnCT must mean that all obligations that rest on the Contracting Parties are obligations on the EU and its Member States.
- (2450) It should be noted that whether *Ukraine as a Contracting Party to the EnCT* is under an obligation to implement and apply Regulation 715/2009 and Directive 2009/73 by way of its national law in accordance with Article 10 EnCT is entirely irrelevant to an alleged right *in EU law* to rely on the EnCT before the courts in the EU and [REDACTED] is wrong to suggest otherwise.¹⁸¹
- (2451) It follows that Article 18 EnCT does not contain any commitment undertaken by the EU. Since these provisions do not generate an obligation on the EU, there cannot be a corresponding duty to enforce the content of this provision in EU law. With no duty to enforce Article 18 EnCT by the EU, a private party cannot rely on these provisions as a matter of EU law directly against another private party before a court or tribunal.

¹⁸⁰ Naftogaz refers to Article 4(3) TFEU rather than 4(3) TEU. However, Article 4(3) TFEU refers to what competence the EU and Member States shall have respectively in the areas of research, technological development and space. Article 4(3) TEU on the other hand refers to a provision worded in a similar manner to Article 6 EnCT.

¹⁸¹ [REDACTED] 2.

7.2.2.6.2.3.4 The grant of direct effect to Article 18 of the EnCT within the internal legal order of the EU cannot be reconciled with the "nature and logic" of the EnCT (Condition Two is not met)

(2452) If (contrary to Gazprom's submissions) Article 18 EnCT is found to contain a commitment undertaken by the EU, i.e. an obligation for the performance of which the EU is responsible, then the second of the four conditions set out above must be considered (the first leg of the test for direct effect).

(2453) In this regard, the CJEU has held that "*the nature and the broad logic* [of the international agreement], *as disclosed in particular by its aim, preamble and terms*" must be considered in order to determine whether the international agreement as a whole is capable of conferring enforceable rights on individuals as a matter of EU law. There are several reasons why neither the EnCT as a whole, nor Article 18 in particular, are capable of conferring rights on individuals in EU law.

(2454) First, the EnCT explicitly specifies that the substantive obligations of the EnCT are addressed to *the Contracting Parties* and not to the EU.

(2455) Article 3(a) EnCT clarifies that the activities of the Energy Community shall include "*the implementation by the Contracting Parties of the acquis communautaire on energy, environment, competition and renewables, as described in Title II* [of the EnCT], *adapted to both the institutional framework of the Energy Community and the specific situation of each of the Contracting Parties*" (emphasis and clarification added by Gazprom).

(2456) The obligation *for the Contracting Parties* to implement the *acquis communautaire* on energy, environment, competition and renewables is in Article 3(a) EnCT referred to as "*the extension of the acquis communautaire*". This term is subsequently used as the heading to Title II of the EnCT, under which the substantive obligations of the agreement are found.

(2457) Thus, while ignored by Naftogaz, the implementation of the *acquis communautaire* on energy, environment, competition and renewables, as set out under Title II of the EnCT in Articles 10,

16, 18 and 20 EnCT respectively, contain obligations for *the Contracting Parties* only, including Ukraine, and not for the EU as a "Party" to the EnCT.

- (2458) Similarly, the requirement to comply with "*generally applicable standards of the European Community*", as set out in Chapter VI EnCT under "Title II The Extension of the *Acquis Communautaire*" is addressed *to the Contracting Parties*. Article 22 EnCT provides that *the Contracting Parties* "*shall [...] adopt development plans*" to bring their electricity and gas sectors falling within the scope of the designated EU energy related directives into line with the "Generally Applicable Standards of the European Community".
- (2459) Accordingly, in order to achieve the legal and economic framework modelled upon the EU *acquis communautaire* and provided for by the EnCT, it is for the *Contracting Parties, including Ukraine*, to adopt the substantive EnCT commitments.
- (2460) Second, as set out in Article 3(a) EnCT, the EnCT requires the Contracting Parties *to implement substantive obligations into their own national legal orders*. The EnCT as a whole is not meant to in itself generate rights for individuals that can be directly relied on before a court or tribunal.
- (2461) Similarly, Articles 10, 16 and 20 EnCT provide that "[e]ach Contracting Party shall implement" EU legislation concerning energy, environment and renewables respectively.
- (2462) Article 18 EnCT is worded differently. Article 18(1) EnCT provides that certain anti-competitive measures "*shall be incompatible*" with the EnCT insofar as they may affect trade of electricity and gas that fall within the scope of designated EU energy related directives. Accordingly, there is no reference to implementation of this provision by the Contracting Parties.
- (2463) However, in light of Article 3(a) EnCT, which specifically provides for "*the implementation by the Contracting Parties of the *acquis communautaire* on [...] competition [...] as described in Title II below*" (emphasis added by Gazprom), it is clear that Article 18 EnCT is meant to confer an obligation upon the Contracting Parties to provide for the *acquis communautaire* on competition in their national legal systems in the same way as Articles 10, 16 and 20 EnCT.

- (2464) Further, the language of Article 18 itself also makes it clear that it is not meant to generate individual rights for private parties, but instead to impose an obligation on the Contracting Parties to implement the *acquis communautaire* on competition into their national legal systems.
- (2465) Articles 18(1)(a) and 18(1)(b) of the EnCT describe two sets of practices by undertakings which correspond to the practices described in Articles 101(1) and 102 TFEU. However, those provisions omit critical language that is to be found in Articles 101 and 102 TFEU. In particular: (1) they omit any reference to such practices being "*prohibited*"; and (2) they omit any reference to agreements and decisions being "*automatically void*".
- (2466) These deliberate omissions clearly imply that Article 18 does not purport to impose legal duties on private parties and does not purport to invalidate the acts of private parties. For this reason, Article 18 of the EnCT is not comparable to Articles 101 and 102 TFEU (and the finding of the CJEU that Articles 101(1) and 102 TFEU "*by their very nature ... produce direct effects in relations between individuals*"¹⁸² does not accurately describe the position under the EnCT).
- (2467) Naftogaz' response to this contention is that Article 18 of the EnCT should be read *as if* there is no difference between it and Articles 101 and 102 TFEU. Naftogaz relies on the fact that the text of Articles 101 and 102 TFEU is included in Annex III to the EnCT.
- (2468) However, Article 18(2) makes it abundantly clear that Annex III plays a very specific and limited role in the scheme established under the treaty. The practices mentioned in Article 18(1) are to be "*assessed on the basis of criteria arising from the application of the rules of Articles [101], [102] and [107] (attached in Annex III)*" (emphasis added by Gazprom). This provision seeks to achieve coordination of the substantive "*criteria*" for "*assessing*" conduct (i.e., conduct which is contrary to Articles 101 and 102, as applied in the EU, should also be "*assessed*" as contrary to Article 18 of the EnCT). However, it is not meant to harmonise the enforcement

¹⁸² Case 127/73 *Belgische Radio en Televisie v SV SABAM and NV Fonior* [1974], paragraph 18.

mechanisms under both treaties by imposing direct duties on private parties or providing for sanctions for invalidity.

(2469) The EU Commission's report on the Energy Community Treaty [COM(2011)105]¹⁸³ confirms that the EnCT is not meant to in itself generate rights for individuals that can be directly relied on before a court or tribunal, but rather sets out obligations upon the Contracting Parties to implement EU based rules into their national legal orders.

(2470) The extent to which Ukraine has implemented the competition law rules in Article 18 EnCT or when this was supposed to be done, as emphasised by ██████████ in his second witness statement, *has no relevance* for the character of the EnCT. Even if Ukraine had implemented all of its EnCT obligations on the same day that the EnCT entered into force (which it had not), an individual would still not have been able to directly rely upon the EnCT itself against another individual under EU law.

(2471) Third, under the EnCT, only *a Party* to the Treaty can be considered to be in breach of its provisions.

(2472) According to Article 90(1) EnCT, a private body may approach the Energy Community Secretariat with complaints concerning the failure *of a Party* to comply with a Treaty obligation. The Secretariat may then, as set out in Article 92(1) EnCT, bring forward this complaint to the Ministerial Council that in turn may determine whether there has been a *failure by a Party* to comply with the particular obligation of the EnCT. ██████████ confirms that the Secretariat monitors the state of compliance *of the Parties* to the EnCT and that it "*cannot act against a private party*".¹⁸⁴

(2473) It follows that an individual may only approach the Energy Community Secretariat if it considers that *a Party* has failed to comply with an obligation of the EnCT. The individual cannot rely

¹⁸³ Report from the EU Commission to the European Parliament and the Council under Article 7 of Decision 2006/500/EC (Energy Community Treaty), Document 52011DC0105.

¹⁸⁴ ██████████ Curiously, ██████████ asserts that the Secretariat has considered the Contract to be in violation of Articles 10 and 18 EnCT and that *Ukraine* therefore has failed to comply with the EnCT (██████████ at paragraph 40). However, as confirmed by ██████████ the Secretariat has no authority to examine a contract between two private parties.

upon the EnCT and put forward a complaint to the Secretariat regarding an alleged breach of the EnCT by *another individual*.

(2474) Accordingly, the terms of the EnCT specifically foresee the breach of the agreement by Parties *only*. The risk of a breach of the EnCT by individuals has deliberately *not* been considered in the agreement since the EnCT was *not* meant to confer rights upon individuals directly. This further underlines the EnCT as an international agreement incapable of generating direct effect in EU law of its provisions.

(2475) Finally, several examples are available in order to illustrate the sharp contrast between the EnCT, as an international agreement concluded by the EU that is meant to export rules based on EU law to contracting States for implementation into their national legal orders, and other international agreements concluded by the EU where the nature and broad logic clarifies that the Union has undertaken commitments meant to establish rights for individuals that in turn could generate direct effect (omitted here, SE REJOINDER (208)-(211)/BF).

7.2.2.6.2.3.5 In any event, Article 18 of the EnCT is not sufficiently clear and precise (Condition Three is not met)

(2476) Naftogaz refers to the literary similarity between Article 18 EnCT and Articles 101 and 102 TFEU and concludes that Article 18 EnCT therefore must be considered sufficiently precise and clear and that it therefore has direct effect. In addition, Naftogaz argues that Article 18(2) EnCT establishes the consequences of a breach of Article 18(1) EnCT and that therefore there is no uncertainty what the consequences of a breach of Article 18 EnCT are.

(2477) The similarity in the wording of Article 18 EnCT and Articles 101 and 102 TFEU, referred to also by ██████████¹⁸⁵ does not undermine Gazprom's arguments. When analysing whether a provision of an international agreement contains a clear and precise obligation which is not subject, in its implementation or effects, to the adoption of any subsequent measure, regard

¹⁸⁵ ██████████

must be had not only to the wording of the provision, but also to the object and purpose of the agreement. The wording is thus only one element of the analysis.¹⁸⁶

(2478) As stated above, the purpose of the EnCT is very different to that of the EU Treaties. While the aim of the former is limited to creating a *legal and economic framework* by exporting parts of the EU *acquis communautaire* related to energy to the Contracting Parties, the EU Treaties have wide ranging aims that provide for a far more advanced integration than that of the relationship between the Parties to the EnCT.¹⁸⁷

(2479) Further, contrary to Naftogaz' allegation, the *consequences* of a breach of Article 18 EnCT are not regulated by this provision and its effects must be provided for separately by the Contracting Parties.

(2480) Article 18(2) EnCT and its reference to Annex III of the EnCT do not undermine this interpretation. It is contrary both to the wording and to the purpose of Article 18(2) EnCT to infer that this provision would provide for the legal effects of a practice that has been found to be contrary to Article 18(1) EnCT. The provision simply provides that practices contrary to Article 18 EnCT shall be *assessed* on the basis of criteria arising from the application of Articles 101, 102 and 107 TFEU.

(2481) It follows from the above that Article 18 EnCT does not contain a clear and precise obligation that could confer a right on Naftogaz that could be invoked before the Tribunal. Accordingly, Article 18 EnCT does not satisfy the third condition.

¹⁸⁶ See e.g. Case C-162/96 A. *Racke GmbH & Co. v Hauptzollamt Mainz* [1998] ECR I-3655 at paragraph 31. See also Case 12/86 *Meryem Demirel v Stadt Schwäbisch Gmünd* [1987] ECR 3719 at paragraph 14.

¹⁸⁷ Article 3 TEU.

7.2.2.6.2.3.6 In any event, Article 18 of the EnCT is subject to further implementing measures (Condition Four is not met)

- (2482) Further, Article 18 of the EnCT cannot take direct effect because further implementing measures are contemplated under the EnCT.
- (2483) The EnCT contemplates that competition law rules will be transposed and adapted to the particular situation of the Contracting Parties.
- (2484) Article 18 EnCT cannot create private rights and obligations prior to transposition into national legal systems.
- (2485) The EU Commission's report on the Energy Community Treaty [COM(2011)105] states specifically that Article 18 EnCT is meant to be implemented into the national legal orders of the Contracting Parties, rather than to be applied directly:
- (2486) Naftogaz asserts, first, that Article 18 is effectively the same as Articles 101 and 102 TFEU and, second, that there is no need to transpose Article 18 of the EnCT into EU law and relies on a statement by ██████████ to this effect.¹⁸⁸ However, the EnCT Secretariat itself has acknowledged that Article 18 of the EnCT requires transposition into the domestic law of Member States.
- (2487) Articles 101(1) and 102 TFEU can be applied to private parties without further implementing measures. Article 18 of the EnCT contemplates that further measures have to be taken by the "*Contracting Parties*" individually and the Energy Community collectively before Article 18 can be applied. It follows that Article 18 of the EnCT cannot be given direct effect because that provision is conditional and subject to further implementing measures.
- (2488) Moreover, in its Annual Implementation Report dated 1 September 2015 it stated that "*Contracting Parties are under an obligation to introduce, to the extent the trade of network energy between the Contracting Parties may be affected, rules prohibiting cartels (agreements between*

¹⁸⁸ Naftogaz's Reply, paragraph 796.

undertakings, decisions by associations of undertakings and concerted practices), abuses of a dominant position, and rules prohibiting State aid." (emphasis added by Gazprom)¹⁸⁹

(2489) Furthermore, it is beside the point that the Energy Community has not adopted specific adaptation measures under Article 24 of the EnCT.¹⁹⁰ What matters is that the treaty contemplates that such adaptation measures may be imposed. The fact that specific adaptations have not been adopted implies that each Contracting Party will have had to find its own solutions when implementing Article 18 of the EnCT.

7.2.2.6.2.3.7 Naftogaz has not established that Gazprom's conduct affects "trade of Network Energy between Contracting Parties"

(2490) Under Article 18 of the EnCT, Naftogaz must establish that Gazprom's conduct affects "*trade of Network Energy between the Contracting Parties*". However, Naftogaz only seeks to establish that Gazprom's conduct "*affects trade between Ukraine and EU countries*".

(2491) However, effects on trade between Ukraine and the EU are in any event irrelevant under Article 18 of the EnCT: Naftogaz would have to show that Gazprom's conduct affects trade between Ukraine and other EnCT Contracting Parties (i.e., Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Moldova, Montenegro and Serbia).

7.2.2.6.2.4 Ukrainian law should not be given effect pursuant to rules of private international law

(2492) Since Gazprom has already made full submissions on the applicable rules of private international law, it is sufficient to summarise the key points here.

(2493) First, the parties did not choose Swedish conflict of laws rules or the Rome I or Rome II Regulations. They chose "*the substantive laws of Sweden*", which pursuant to the plain meaning of Article 12.1 and Article 22(2) of the SCC Rules is not a choice of Swedish conflict of laws rules. It follows that Swedish conflict of law rules, including the Rome I and Rome II

¹⁸⁹ Energy Community Secretariat, Annual Implementation Report, 1 September 2015.

¹⁹⁰ [REDACTED]

Regulations cited by Naftogaz, do not apply. The Tribunal must apply Swedish law and it has not discretion or ability to apply any other law. This is Gazprom's primary position and it is supported by Professor Kaj Hober.¹⁹¹

(2494) Second, and in any event, the Rome I Regulation does not apply, since pursuant to Articles 28 and 29 of that Regulation, it only applies to contracts concluded after 17 December 2009,¹⁹² whereas the Contract was concluded 11 months earlier than that, on 19 January 2009.

(2495) Third, even if the Rome I Regulation did apply, Article 9.3 thereto does not apply in this situation. Naftogaz has not shown that the provisions of Ukrainian law it relies upon are "*overriding mandatory provisions*", nor has Naftogaz shown that the provisions it relies upon "*render performance of the contract unlawful*". Gazprom refers to the discussion in Mistelis regarding the narrow ambit of international public policy, and to the *Hilmarton* case to which Mistelis refers in that passage.¹⁹³

(2496) The *Eco Swiss* case provides that a party can challenge an arbitral award for breach of public policy on the grounds that the arbitral award breaches Article 101 TFEU.¹⁹⁴ The ECJ stated (at paragraph 36 of its judgment) that Article 101 TFEU "*constitutes a fundamental provision which is essential for the accomplishment of the tasks entrusted to the Community and, in particular, for the functioning of the internal market*". Thus, an award in breach of Article 101 TFEU could be set aside on grounds of invalidity under section 33(2) of the Arbitration Act. It was also suggested by the Swedish Supreme Court in NJA 2015 p. 438 (the *Systembolaget II* case) that the same principles apply in the case of a breach of Articles 102 TFEU. However, not all areas of EU law would necessarily fall within the scope of public policy for these purposes. It is particularly questionable whether EU energy law would fall within the scope of public policy for these purposes. In any event, a decision by this Tribunal not to apply

¹⁹¹ Gazprom's Rejoinder, paragraph 236 1

¹⁹² See the Rome I Regulation.

¹⁹³ Mistelis, [Comparative International Arbitration](#), p. 418-42.

¹⁹⁴ Case C-126/97 *Eco Swiss China Time Ltd v Benetton International NV* [1999] 1999 I-03055. See para. 39 of the CJEU's judgment, in which the Court decided that "decided that "the provisions of Article 85 of the Treaty [of Rome] may be regarded as a matter of public policy within the meaning of the New York Convention".

Ukrainian competition law or Ukrainian energy law would not provide Naftogaz with grounds for seeking to set aside the award. The observations in the *Eco Swiss* case were limited to mandatory provisions of EU law.

(2497) Fourth, even if Article 9.3 of the Rome I Regulation did apply, it is a discretionary provision which, pursuant to Recital 37 of the Rome I Regulation, should only be exercised "*in exceptional circumstances*". In exercising the discretion regard should be had to the factors in the next paragraph.

(2498) Fifth, if the Tribunal were to go so far as to give effect to mandatory provisions of Ukrainian law, pursuant to the second sentence of Article 9.3 of the Rome I Regulation, "*regard shall be had to their nature and purpose and to the consequences of their application or non-application*". As regards their nature and purpose, the Ukrainian law resolutions relied upon by Naftogaz are public law resolutions applicable to Ukrtransgaz, not Naftogaz; they do not apply to the Contract. As regards the consequences of their application by the Tribunal in these proceedings, Gazprom refers to the following points:

1. It would interfere with party autonomy for the Tribunal to give effect to a law other than Swedish law, which the parties specifically selected.
2. This is particularly important in this case, where the parties - in effect state entities - specifically selected Swedish law for its neutrality, and with the intention of excluding application of their respective national laws, and accordingly, the political influence of state actors;
3. The Tribunal is asked to step into the shoes of the Ukrainian regulator, and in fact to go further than the regulator did;
4. Apart from the fact that the Ukrainian law provisions in question do not apply to the Contract, there are other potential public law sanctions, including warnings, fines, and the

suspension or revocation of licenses thus this is not a situation where there would be no other sanction;

5. This is an evolving situation involving several different entities which this Tribunal cannot regulate;
6. Unlike a decision by a national regulator, the Tribunal's decision may be enforceable under the New York Convention and have *res judicata* effect, even if the situation changes at a later date;
7. In any event, Ukraine has failed to implement the Third Energy Package ("TEP") properly;
8. The Ukrainian regulator is not independent (see below); and
9. The effect of applying Ukrainian law as requested by Naftogaz would be fundamentally unfair, resulting in a completely different contract without compensation to Gazprom.

(2499) Further, as regards the independence of the regulator, it is relevant that the main decisions which are relevant to these proceedings were taken in 2015 and early 2016, by the regulator, under Mr Vovk, during the period September 2015 to February 2016. What matters is the independence of the NCSREU in the period September 2015 to February 2016.

(2500) The law on independence of the regulator was only enacted by Ukraine much later. It was passed in September 2016 and signed by the President of Ukraine on 23 November 2016.

(2501) ██████████ sought to reassure the Tribunal with regard to the regulator's independence; but this evidence needs to be considered alongside what the Energy Community Secretariat was saying in its public statements at the relevant time.

(2502) The Energy Community Secretariat's July 2016 assessment clearly concluded that the NCSREU did not meet independence requirements under the Third Energy Package.

(2503) As late as 23 September 2016, the Energy Community Secretariat referred to overcoming "*existing independence shortcomings of the national energy regulatory authority as regularly pointed in the Secretariat's annual implementation reports*".

(2504) The Energy Community Secretariat itself stated at the time at which the regulator made the decisions, that the regulator did not meet the requirements of the TEP. This is a fundamental issue that the Tribunal cannot ignore.

(2505) [REDACTED] by saying that "*they were structural concerns on the regulator, not actual concerns that anybody would follow political orders in drafting secondary legislation*" (emphasis added by Gazprom).

(2506) But when pressed it rapidly became apparent that [REDACTED] was only making a statement about his personal knowledge.

(2507) And his personal knowledge about the extent to which, in practice, the NCSREU was influenced by the Ministry of Energy, the State Property Fund of Ukraine ("SPFU"), other parts of the Government of Ukraine, Naftogaz, Ukrtransgaz etc. was very limited.

(2508) The Tribunal obviously appreciates that the NCSREU cannot be compared to an independent regulator in a EU Member State such as Sweden.

(2509) It cannot be said that the NCSREU was independent at the time when the relevant regulatory decisions were made.

7.2.2.6.2.5 Ukrainian competition law is not applicable pursuant to Swedish law

(2510) As regards Ukrainian law, Naftogaz also argues that Ukrainian law applies "*as a fact*" pursuant to Swedish law.

(2511) Naftogaz claims that the reason for this is that the "*offending clauses*" "*fail [sic] to be performed in Ukraine where the clauses and performance are unlawful*".

- (2512) What Naftogaz appears to argue is that there would be a rule under Swedish contract law that provides for invalidity if the performance under a contract is prohibited under foreign mandatory law. However, there is no such rule under Swedish contract law.
- (2513) Extracts from legal sources that Naftogaz refers to only concern impossibility to perform due to a prohibition under foreign law. Impossibility to perform is, however, something completely different to actively applying foreign provisions in order to invalidate an agreement.
- (2514) The fact that courts under some circumstances may release a party from its obligation to perform in some aspect under a contract due to a foreign prohibition does not mean that there is an impossibility to perform. In short, the circumstances invoked by Naftogaz do not constitute a *force majeure* situation. Thus, the legal sources referred to by Naftogaz do not constitute support for Naftogaz' invalidity argument in this respect.
- (2515) In any event, if (which is denied) the circumstances invoked by Naftogaz had constituted a *force majeure* situation, then Article 11 of the Contract (headed "*Force Majeure*") would then be applicable. Naftogaz has not invoked Article 11 of the Contract, nor has it explained what contractual liabilities it alleges that either party might allegedly be unable to perform by reason of so-called *force majeure*.
- (2516) In fact, it is clear that there is simply no merit in any such argument. The parties are continuing to perform their contractual obligations pursuant to the terms of the Contract, and no *force majeure* situation exists that would prevent them from doing so.

7.2.2.6.2.6 EU energy law does not apply as an "*operationalisation*" of Articles 101 and 102 TFEU

- (2517) Naftogaz asserts that EU energy law, either directly or as part of the EnCT, is connected to Articles 101 and 102 TFEU as well as Articles 7 and 18 EnCT. Naftogaz argues that this requires EU energy law to be applied to the Contract as an "*operationalisation*" of EU competition law. According to Naftogaz, this concept is "*well known and since long established under EU law.*"

(2518) It appears that the sole purpose of invoking this concept is to enable Naftogaz to apply provisions of EU Energy law retroactively from 1 January 2010 or 1 February 2011 (prior to the 3 September 2011 and 6 October 2011 dates that otherwise apply if its EU energy law claims are considered without operationalisation). It is important to note that Naftogaz admits that its "*operationalisation*" claim would not support some of its claims for relief (but a full explanation of which of its claims are unsupportable has not been provided).

(2519) In any event, Naftogaz' arguments must be dismissed for four reasons.

(2520) First, even on Naftogaz' own account, this concept cannot apply unless Articles 101 and 102 TFEU or Articles 7 or 18 EnCT applies. However, as set out above (and below in relation to Article 7 EnCT), those provisions do not apply in the present case. Accordingly, it is not possible for them to constitute the basis of any "*principle of operationalisation*". That suffices to dismiss Naftogaz' contention.

(2521) Second, and in any event, the case law that Naftogaz cites does not support its contention.

(2522) In *Mangold* and *Küçükdeveci* the CJEU considered EU Directives that were held to embody a general principle of EU law. That principle, as given expression in the Directive concerned, was applied so as to preclude the application of a domestic law in the context of litigation between two private parties in an EU Member State. In both cases, the CJEU allowed an employee to rely directly on the general principle of non-discrimination on the ground of age in order to set aside national provisions contrary to that general principle of EU law.

(2523) In *AMS* the CJEU considered whether Article 27 of the EU Charter of Fundamental Rights, by itself or in conjunction with the provisions of Directive 2002/14, could be invoked in a dispute between private parties established in an EU Member State in order to preclude the application of a national EU Member State provision that was not in conformity with the Directive. However, Article 27 of the Charter was not considered to be sufficiently clear, precise or

unconditional to confer rights to the private parties and the Directive did not provide the necessary rules either.

(2524) In this case Naftogaz is not attempting to rely on a general principle of EU law in order to set aside a conflicting legal provision of an EU Member State that clearly falls within the scope of the EU Treaties.

(2525) Third, the academic references that Naftogaz has referred to do not in any way support its "*principle of operationalisation*". The academic references are concerned with the effects of different EU legal norms, such as general principles of EU law, within the EU legal order.

(2526) Fourth, the abstract account that Naftogaz gives of the historical connections and allegedly common goals pursued by energy regulation and competition rules does not justify any conclusion that Regulation 715/2009 and Directive 2009/73 can be imported wholesale into EU competition law.

(2527) Gazprom maintains that EU competition law should be applied according to the relevant legal texts. The scope of those legal texts cannot be expanded by reference to the concept of "*operationalisation*". This concept is unknown to EU law and appears to have been invented by Naftogaz for the purposes of these proceedings.

7.2.2.6.3 Energy law: threshold issues

7.2.2.6.3.1 Article 10 EnCT does not apply the requirements of the Third Energy Package to the current dispute

(2528) It is Gazprom's position that Article 10 of the EnCT (and through that provision Regulation 715/2009 and Directive 2009/73) cannot be relied upon by Naftogaz against Gazprom since the four necessary conditions set out above are not satisfied.

(2529) The first of the four conditions set out above is not met. Article 18 EnCT is found under Title II of the EnCT and does therefore not contain any commitment undertaken by the EU. Article

10 EnCT is also set out under Title II of the EnCT and the arguments considered in relation to Article 18 EnCT concerning the first condition apply equally to Article 10 EnCT.

- (2530) The second of the four conditions set out above is not met. It would be inconsistent with the "*nature and logic*" of the EnCT to give private parties the right to invoke Article 10 of the EnCT within the internal legal order of the EU.
- (2531) Further, the "*nature and broad logic*" of Article 10 itself and Title II precludes any inference that Article 10 was meant to confer direct rights and obligations on private individuals within the internal legal order of the EU. Article 10 of the EnCT does not bind the EU. Article 10 of the EnCT is explicitly addressed to "*each Contracting Party*" but it is not addressed to the EU. It is contrary to the "*nature and broad logic*" of the EnCT to require the EU to implement rules that are meant to be implemented by other parties to the EnCT.
- (2532) The third of the conditions set out above is not met. Article 10 of the EnCT does not contain a clear and precise obligation that could generate a private right that could be invoked by Naftogaz before a court or tribunal within the European Union.
- (2533) Naftogaz asserts that Article 10 EnCT is not unclear in itself and that Gazprom has erroneously had to rely on Article 3(a) EnCT in order to arrive at the conclusion that Article 10 EnCT is unclear. Naftogaz resorts to the rules in Directive 2009/73 and Regulation 715/2009 and argues that these are sufficiently clear and precise. In that context, Naftogaz is asserting that the adaptation in Article 3(a) EnCT refers to the technique and framework for the inclusion of Directive 2009/73 and Regulation 715/2009 into a Contracting Party's legal order.
- (2534) In addition, Naftogaz alleges that the CJEU has accepted direct effect in situations where the relevant legal instrument acknowledged the need for further legislative action.
- (2535) None of the arguments presented by Naftogaz are persuasive.

- (2536) For the benefit of clarity, it should be added that the qualification of Article 10 EnCT (as well as Article 18 EnCT) which is generated by Article 3(a) EnCT is not undermined by the CJEU's judgment in case C-162/00 *Pokrzeptowicz-Meyer* [2002] ECR I-1049. The Court held in this case that Article 37(1) of the European Agreement between the EU and Poland had direct effect in EU law.
- (2537) Article 37(1) provided that "[s]ubject to the conditions and modalities applicable in each Member State ... the treatment accorded to workers of Polish nationality, legally employed in the territory of a Member State shall be free from any discrimination based on nationality, as regards working conditions, remuneration or dismissal, as compared to its own nationals." (emphasis added by Gazprom). The CJEU found that the principal obligation not to discriminate in the latter phrase ("*the treatment accorded ... shall be free from discrimination ...*") was distinct from the former and was therefore capable of having direct effect.
- (2538) However, contrary to the wording of Article 37(1) of the European Agreement between the EU and Poland, Article 3(a) EnCT qualifies the entire Article 10 EnCT (as well as Article 18 EnCT) by requiring both provisions to be adapted not only to the specific situation of each of the Contracting Parties but also to the institutional framework of the Energy Community. The reasoning adopted by the CJEU in case C-162/00 *Pokrzeptowicz-Meyer* is therefore not applicable in this case. It is clear from the wording of Article 3(a) EnCT that the provisions of Articles 10 and 18 EnCT were not intended to apply directly and immediately to individuals.
- (2539) Whether the rules in Directive 2009/73 and Regulation 715/2009 are clear and precise is entirely irrelevant when interpreting whether Article 10 EnCT is directly effective under EU law. We are not concerned with the direct effect of EU legislative measures in the internal EU legal order, the issue refers to an alleged direct effect of a provision in an international agreement. In this context it should be emphasised that Directive 2009/73 and Regulation 715/2009 *as acts referred to in the list of acts included in the "acquis communautaire in energy" in Annex I*, constitute parts of an international agreement and not acts of EU law.

- (2540) Further, [REDACTED] specifically underlined that "*measures can be adopted to adapt the energy acquis in order to take into account both the institutional framework of the [EnCT] and the specific situation of the Contracting Parties*", which also follows from Article 3(a) EnCT. He acknowledged that this includes an adaptation of various target dates found in both Directive 2009/73 and Regulation 715/2009. It clearly also includes adaptations such as those relating to the tasks of the EU Commission set out in those acts and to the procedures for adopting guidelines.
- (2541) Moreover, contrary to the EEA Agreement, the EnCT does not contain a provision setting out the different requirements of the implementation into the national legal orders of the Contracting Parties of the EU regulations and directives listed in the Annexes to the EnCT, nor any provisions setting horizontal and specific adaptations to those regulation and directives applicable to all Contracting Parties. Accordingly, the Contracting Parties are free to implement and adapt EU related law in accordance with Articles 3(a) and 10 EnCT differently in accordance with their own specific situations. Consequently, the obligation set out in Article 10 EnCT is not sufficiently clear and precise.
- (2542) The CJEU jurisprudence to which Naftogaz refers concerns *EU Treaty provisions* and not provisions in an international agreement. The EnCT cannot be assimilated to the EU Treaties. The considerations which led to the interpretation of the EU Treaty referred to by Naftogaz do not apply in the context of the EnCT.
- (2543) It follows from the above that Article 10 EnCT does not contain a clear and precise obligation that could confer a right on Naftogaz that could be invoked before the Tribunal.
- (2544) The fourth condition as set out above is not met. Article 10 of the EnCT is not unconditional. Instead, it is subject to further implementing measures. It is clear from the terms of Article 10 itself that Regulation 715/2009 and Directive 2009/73 must be transposed into national law under Article 10 of the EnCT before they can be given any effect.

(2545) Article 10 provides that "[e]ach Contracting Party shall implement" the specified instruments.

(2546) Title II is concerned with coordination of national laws through a phased inter-state process of adaption and transposition. Indeed, the EnCT Secretariat has proposed a treaty change precisely because under Title II the *acquis communautaire* is not designed to immediately confer rights and obligations on private parties; instead further steps of adaptation and transposition are required. To quote the Secretariat:

*"The existing Treaty contains a major difference in terms of the effect of *acquis communautaire* between the European Union on the one hand and the legal orders of the Contracting Parties on the other, namely the lack of direct effect of Regulations in the latter. This deficiency creates major problems in the implementation of *acquis*. As long as Regulations did not yet play a central role in European energy legislation and, where they existed, were of rather general and limited scope, the lack of direct effect could still be tolerated. With Third Package, however, Regulations became a major tool of European energy legislation, for instance in the area of security of supply and most importantly, network codes. Given their dense and detailed content, any transposition by Contracting Parties in their national legal order risks destroying their systematic consistency and thus endangers the goals they pursue. Transposition also entails major delays.*

The Secretariat believes that giving direct effect to Regulations also in the Energy Community is the only way to make network codes equally effective for Contracting Parties and ensure homogeneity in the pan-European market. It notes that the proposed Treaty change will not pose problems for the legal order of Contracting Parties which generally follow a monist approach to international law already." (emphasis added by Gazprom).¹⁹⁵

¹⁹⁵ Energy Community Secretariat, Proposed Treaty Changes for the Ministerial Council in October 2016.

7.2.2.6.3.2 Article 7 EnCT does not apply the requirements of the Third Energy Package to the current dispute

(2547) Naftogaz has introduced a further ground for applying Regulation 715/2009 and Directive 2009/73 to Contract TKGU: it invokes Article 7 of the EnCT which prohibits "*any discrimination within the scope of [the EnCT]*".

(2548) Under the heading "*legal discrimination*" Naftogaz appears to argue that:

1. Article 7 of the EnCT has direct effect and Naftogaz is entitled to invoke that provision;
2. Sweden must comply with Article 7 of the EnCT which, in turn, implies that this Tribunal must comply with Article 7 of the EnCT as it is seated in Sweden;
3. Article 7 of the EnCT implies that this Tribunal is "*obliged to assess contracts concluded by Naftogaz in the very same way as a contract entered into by a Swedish or any other EU company*";
4. if the Tribunal fails to apply Regulation 715/2009 and Directive 2009/73 to the Contract, it will fail to treat Naftogaz in the same way as it would treat any other EU company;
5. Regulation 715/2009 and Directive 2009/73 must be applied to the Contract as of the dates when those provisions were incorporated into the EnCT because it was only from those dates that the Contract became "*clearly comparable to the same kind of contract entered into by a company in an EU Member State, as the same energy aquis applies in both cases*".

(2549) Gazprom is of the view that this chain of argument is fundamentally misconceived.

(2550) The conclusion that Regulation 715/2009 and Directive 2009/73 do not apply to the Contract does not involve any nationality-based discrimination. Even if a Swedish or EU company had contracted with Gazprom to transport gas across Ukraine the result would be no different. The

rules relating to direct effect do not vary depending on the nationality of the person seeking to invoke the relevant international treaty. This suffices to dismiss Naftogaz' argument.

- (2551) Under the heading "*factual discrimination*" Naftogaz makes a series of assertions that are very difficult to follow.
- (2552) First, Naftogaz asserts that Article 7 of the EnCT must be interpreted as if it incorporates the Third Energy Package and contraventions of provisions of the Third Energy Package by Gazprom should be treated as contraventions of Article 7 of the EnCT. It maintains that this is warranted because "*the detailed rules of the Third Energy Package are based on the same concept of discrimination as can be found in Article 7*".
- (2553) However, Article 7 cannot be inflated beyond the scope of its ordinary meaning to incorporate detailed rights and obligations set out in altogether separate legal instruments because Article 7 and those instruments are "*based on the same concept*". This type of argument cannot be reconciled with the customary rules of treaty interpretation. Like any provision in a treaty, Article 7 of the EnCT must be interpreted in accordance with its ordinary meaning taking into account the context and the object and purpose of the EnCT.
- (2554) Second, Naftogaz reiterates its reliance on the concept of "*operationalisation*": in particular, it asserts that the detailed rules of the Third Energy Package "*operationalise/concretise*" Article 7 of the EnCT. For the reasons set out above, Gazprom maintains that Naftogaz' concept of "*operationalisation*" has been invented by Naftogaz and is not recognised by EU law.
- (2555) Third, Naftogaz asserts that Article 7 of the EnCT has horizontal direct effect and imposes obligations on private parties such as Gazprom and Naftogaz. However, the only support for that assertion is an academic article by Robin-Oliver which does not deal with Article 7 of the EnCT (or Article 18 TFEU which Naftogaz claims corresponds to Article 7 of the EnCT).
- (2556) It is Gazprom's position that Article 7 of the EnCT is not meant to directly confer obligations on private parties to refrain from discrimination but is instead directed to the state parties to the

EnCT. In any event, Gazprom has not breached any duties not to discriminate on the basis of nationality by entering into the Contract and the provisions of the Contract cannot be invalidated on this basis.

7.2.2.6.4 The alleged breaches by Gazprom of EU and Ukrainian competition law and energy law

7.2.2.6.4.1 Introduction

(2557) Naftogaz discusses various general issues relevant to the violations of competition law and energy law which it asserts against Gazprom. Naftogaz develops its arguments to the effect that the tariff under Article 8 of the Contract is in breach of both competition law and energy law. Naftogaz addresses the other breaches of competition law and energy law which it asserts against Gazprom, i.e. (i) the party relationship under the Contract; (ii) capacity allocation and congestion management; (iii) balancing; and (iv) restrictions on the use of interconnectors.

(2558) Thus, it can be seen that, when addressing these substantive breaches, Naftogaz fails to distinguish between competition law and energy law. Such an approach is misconceived and potentially misleading. The legal bases for Naftogaz' claims for breaches of competition law and for breaches of energy law are quite different: Articles 101 and 102 TFEU as regards EU competition law and the Third Energy Package (Directive 2009/73 and Regulation 715/2009) as regards EU energy law. The requirements of those legal provisions and the tests to be applied in establishing breaches thereof are accordingly also quite different. Gazprom therefore addresses the alleged breaches of competition law separately from the alleged breaches of energy law.

7.2.2.6.4.2 Preliminary matters

(2559) Naftogaz makes a number of criticisms of the expert reports by Dr Moselle and Mr Witschen. Those criticisms are rejected in their entirety, and Gazprom stands by the content of those expert reports.

7.2.2.6.4.3 Alleged breaches of Article 102 of the TFEU

(2560) In order to establish a breach of Article 102 of the TFEU, Naftogaz has to establish that (a) an undertaking has a dominant position in the relevant market, and (b) the undertaking has abused that dominant position.

(2561) Article 102 does not prohibit dominance as such. There is no infringement of Article 102 of the TFEU by virtue solely of being dominant.

(2562) Similarly, there is no infringement by virtue solely of being 'abusive': conduct which would be abusive had an undertaking held a dominant position does not infringe Article 102 in the absence of such a position. As the Court of Justice stated in *Alsattel*, which concerned certain onerous contractual provisions, "*contractual practices, even if abusive ones, on the part of an undertaking ... do not fall within the prohibition in Article [102] where that undertaking does not occupy a dominant position on the relevant market*".¹⁹⁶

(2563) The Court of Justice has defined a dominant position under Article 102 of the TFEU as:

"... a position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant market by allowing it to behave to an appreciable extent independently of its competitors and customers and ultimately of consumers".¹⁹⁷

(2564) There are two stages to determining whether an undertaking holds a dominant position:

- defining the relevant product and geographic market; and
- assessing the degree of market power (or economic strength) enjoyed by the undertaking on the relevant market. This assessment involves consideration of various factors: not just

¹⁹⁶ Case 247/86 *Alsattel v Novasam* [1988] ECR 5987, paragraph 23.

¹⁹⁷ Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 30. Exhibit RLA-46

market share, but also barriers to entry and competitive constraints, such as countervailing buyer power.

(2565) In *Hoffmann-La Roche v Commission*, the Court of Justice defined the concept of abuse as follows:

*"The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition".*¹⁹⁸

(2566) First, this definition emphasises that an abuse involves *"recourse to methods different from those which condition normal competition"*. In particular, a dominant undertaking can still (despite its position of dominance) take action to protect *"its own commercial interests if they are attacked, and ... take such reasonable steps as it deems appropriate to protect its said interests"*.¹⁹⁹

(2567) Further, the definition of abuse emphasises the need for an analysis of the allegedly abusive conduct's effect on competition before an infringement can be established. It is the adverse effect on competition and the structure of the market which is relevant. The effect of the allegedly abusive conduct must be considered by reference to the particular factual context of this case.

(2568) Usually, an undertaking engages in abusive behaviour in the market in which it has been found to be dominant. However, in certain exceptional cases involving closely related markets, the

¹⁹⁸ Case 85/76 *Hoffmann-La Roche v Commission* [1979] ECR 461, paragraph 91. **Exhibit RLA-48.**

¹⁹⁹ Case 27/76 *United Brands v Commission* [1978] ECR 207, paragraph 189.

abusive conduct may take place and its effects arise on a different market from that on which the undertaking holds a dominant position. In such cases, there is said to be a 'leveraging' of market power by an undertaking from the dominated market to a related market, normally to the advantage of the dominant undertaking or of a company related to the dominant undertaking on that related market.

- (2569) For example, the limited cases in which the Courts have taken such an approach include *Telia-Sonera Sverige*,²⁰⁰ where an undertaking dominant on the upstream wholesale broadband market was held to have engaged in abusive behaviour, i.e. margin squeeze,²⁰¹ in the downstream retail market. In such margin squeeze cases, the dominant undertaking is also present on the downstream market (through its retail arm) and engages in such conduct in order to drive out its competitors in the related downstream market.
- (2570) In the present case, Naftogaz appears to be arguing that Gazprom has a dominant position on the "*gas sales market*", and is 'leveraging' its dominance in that market so as to engage in abusive behaviour on the related "*transit market*". The three "*categories of abusive and restrictive measures contained in the Contract*" upon which Naftogaz relies all relate to the transit market.
- (2571) However, as Naftogaz itself recognises, gas transmission in Ukraine is a monopoly which is held by Naftogaz (through its wholly owned subsidiary, Ukrtransgaz). Gazprom does not operate on that related transit market at all. Gazprom cannot therefore act so as to benefit itself (or a related company) on that related transit market: it does not operate on that market.
- (2572) Gazprom denies (a) that it has a dominant position on the "*gas sales market*", or (b) that it is 'leveraging' its dominance in that market so as to engage in abusive behaviour on the related "*transit market*".

²⁰⁰ Case C-52/09 *Telia-Sonera Sverige v Commission* [2011] 4 CMLR 951.

²⁰¹ i.e. setting wholesale prices for its retail competitors which leave them insufficient margin to compete effectively in the downstream market.

(2573) Even if a dominant undertaking engages in conduct which is *prima facie* an abuse, if that undertaking can demonstrate that there is an objective justification for that conduct, then there is no breach of Article 102 TFEU.²⁰²

7.2.2.6.4.3.1 Market definitions and dominance

7.2.2.6.4.3.1.1 Introduction

(2574) Naftogaz has clarified that it relies upon two relevant markets in this case. First, it argues that there is a market for the upstream production and sale of natural gas, which comprises the development, production and upstream supply of gas to large importers/wholesalers in Ukraine, Poland, Hungary and Slovakia ("the gas sales market"). Naftogaz argues that Gazprom has a dominant position on the gas sales market.

(2575) Second, Naftogaz argues that there is a market for the supply of wholesale natural gas transmission services through Ukraine ("the gas transmission market"). Naftogaz accepts that Naftogaz/Ukrtansgaz has a monopoly position on the gas transmission market. However, Naftogaz also argues that Gazprom is a dominant purchaser on that market.

(2576) The market upon which Naftogaz alleges that the abuse takes place for the purposes of Article 102 TFEU is the gas transmission market. Naftogaz argues that Gazprom leverages or uses its dominant position on the gas sales market in order to engage in abusive conduct on the gas transmission market. Naftogaz has now also introduced an argument to the effect that Gazprom also uses its position as a dominant *purchaser* on the gas transmission market in order to engage in abusive conduct on that market.

7.2.2.6.4.3.1.2 The gas sales market: market definition

(2577) Market definition is not an abstract, theoretical exercise. The relevant product and geographic market must be defined by applying the relevant EU law principles and must be based on actual empirical evidence.²⁰³ In order to define a relevant market, regard should be had to demand

²⁰² See *inter alia* Case C-95/04 P *British Airways v Commission* [2007] ECR I-2331 at paragraphs 68-69; Case C-52/09 *TeliaSonera Sverige* [2011] 4 CMLR 951 at paragraphs 75-76.

²⁰³ See the Commission's Notice on the definition of the relevant market for the purposes of Community competition law (97/C372/03).

substitutability, supply substitutability and potential competition. Demand substitution is particularly important, especially when considering the pricing behaviour of firms.²⁰⁴ In considering demand substitutability, the normal methodology to be used will be a hypothetical monopolist test or the SSNIP (small but significant non-transitory increase in price) test.²⁰⁵

(2578) Naftogaz had failed to base its case on any empirical evidence or to carry out any analysis of the relevant market, such as a hypothetical monopolist test or the SSNIP test.

(2579) Naftogaz appears to have accepted that criticism as, in the Lapuerta and Hesmondhalgh Report 2, Mr Lapuerta and Dr Hesmondhalgh have now carried out a form of SSNIP test analysis. As a result of having carried out that analysis, Naftogaz appears to have changed its case on the relevant geographic market, now asserting that "*the relevant geographic market includes the territories of Ukraine, Slovakia, Poland and Hungary*".

(2580) However, the status of Naftogaz' pleading as regards the relevant geographic market is unclear. Naftogaz asserts that "*the relevant geographic market includes the territories of Ukraine, Slovakia, Poland and Hungary*". However, Naftogaz has not withdrawn its previously pleaded case, which was to the effect that the relevant geographic market is *only* Ukraine. Naftogaz appears to seek to keep open the possibility of arguing this as an alternative market definition.

(2581) As regards the relevant product market and market definition more generally, Naftogaz has also failed to withdraw its previous pleadings and evidence in this regard, and its position is therefore also confused and unclear. In particular, Naftogaz appears to continue to rely upon the assessment of the relevant market by the Energy Community Secretariat and in the first Lapuerta/Hesmondhalgh Report.

(2582) This approach is unacceptable. The European Court has held that market definition is of "*essential significance*" in any case; as an assessment of dominance and of abuse can only be

²⁰⁴ *Ibid.*, paragraph 13

²⁰⁵ *Ibid.*, paragraph 17

carried out by reference to such market definition. Naftogaz' approach to market definition remains inadequate and confused.

7.2.2.6.4.3.1.3 The gas sales market: dominance

(2583) Naftogaz argues that Gazprom has a dominant position in "*the relevant market for gas sales*"

In this regard, it relies upon:

- The Energy Community Secretariat's Preliminary Compliance Report on the Transit Contract of 3 December 2014;
- The Energy Community Secretariat's Preliminary Assessment of the Sales Contract of 25 July 2014; and
- The Hesmondhalgh and Lapuerta Report.

(2584) As regards the Energy Community Secretariat's Preliminary Compliance Report of 3 December 2014, this appears to confuse the "*gas transmission market*" with the "*gas sales market*". It is thus of no evidential value in these proceedings.

(2585) The Energy Community Secretariat's Preliminary Assessment of the Sales Contract of 25 July 2014 and the Hesmondhalgh and Lapuerta Report both rely upon Gazprom's high market shares as evidence of its dominance in the "*gas sales market*". A 'pivotal supplier' test is also carried out in the Hesmondhalgh and Lapuerta Report.

(2586) These matters are, however, insufficient in themselves to establish Gazprom's dominance on the relevant market (even if the relevant market has been defined adequately by Naftogaz, which, for the reasons set out above, is denied).

(2587) As explained above, dominance is defined in EU law as "*... a position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition*"

on the relevant market by allowing it to behave to an appreciable extent independently of its competitors and customers and ultimately of consumers" (emphasis added by Gazprom).²⁰⁶

(2588) Dominance can only be established following consideration of a number of factors, including countervailing buyer power, i.e. the power of buyers to constrain an allegedly dominant undertaking's behaviour on the relevant market. The very definition of dominance requires that an allegedly dominant undertaking must be able to act independently of its customers.

(2589) As the European Commission explains:

"Competitive constraints may be exerted not only by actual or potential competitors but also by customers. Even an undertaking with a high market share may not be able to act to an appreciable extent independently of customers with sufficient bargaining strength".²⁰⁷

(2590) Gazprom maintains its argument that Naftogaz has failed to prove that Gazprom has a dominant position in the gas sales market. The Energy Community Secretariat's Preliminary Compliance Report of 3 December 2014 appears to confuse the gas sales market with the gas transmission market.

7.2.2.6.4.3.1.4 Market shares

(2591) Naftogaz asserts that Gazprom has a market share exceeding 50% "*under any conceivable regional or national market definition*". In this regard, Naftogaz relies upon Appendix B of the Lapuerta and Hesmondhalgh Report 2.

(2592) However, the figures upon which Naftogaz relies are inaccurate and do not correspond to the data published by Naftogaz and Ukrainian governmental authorities. Mr Lapuerta and Dr Hesmondhalgh explain that, in calculating these market share figures, they have used figures for consumption in Ukraine which exclude any imports that were injected into storage or used

²⁰⁶ Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 30.

²⁰⁷ *Communication from the Commission – Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings* (2009/C 45/02), paragraph 18.

to operate the compressors of the pipeline system itself. Such an approach is flawed. There is no reason to exclude fuel gas from the consumption figures: such gas is used to supply the natural gas to users in Ukraine and thus is part of the consumption of natural gas in Ukraine. In the data published by the Ukrainian authorities, fuel gas is included in the total consumption figures.

(2593) Moreover, the figures for Gazprom's share of natural gas supply as set out in Appendix B of the Lapuerta and Hesmondhalgh Report 2 only go up to 2013. It would appear that, since then, the share of imports of natural gas into Ukraine accounted for by Russian gas has dropped significantly to 37% in 2015. This would appear to be partly because of a sharp decline in Ukraine's gas demand and partly because of Ukraine's increased imports from European traders.

7.2.2.6.4.3.1.5 Countervailing buyer power

(2594) Naftogaz accepts that countervailing buyer power is a relevant factor in assessing whether a firm holds a dominant market position. This is a welcome concession: Naftogaz had previously ignored the issue of countervailing buyer power.

(2595) However, Naftogaz seeks to argue that Gazprom's arguments on countervailing buyer power cannot succeed for four reasons. It is Gazprom's case that each of Naftogaz' four reasons must be rejected.

(2596) First, Naftogaz disputes Gazprom's description of the negotiations of the Contract in 2009. In particular, Naftogaz asserts that the gas supply interruption resulted from Gazprom's actions. Gazprom rejects that assertion.

(2597) Gazprom also refers to the relevant parts of the evidence summarised above, and to the Yafimava Report, in which Dr Yafimava confirms her view that, in fact, "*Gazprom was in a weaker position than Naftogaz during the negotiations and therefore under more pressure to conclude the transit (and hence the supply) contract urgently*".

- (2598) ██████████ makes it clear that there was no immediate need to put in place a new transit contract in January 2009, but "*Naftogaz was in essence holding us hostage in negotiations by refusing to recommence supplies to our European offtakers until we did*".
- (2599) It is clear that Gazprom was effectively held hostage by Naftogaz by what was essentially a blockade of the main transit pipelines by Naftogaz/Ukrtransgaz. Gazprom was under huge pressure from the international community to resume transit supplies to Europe. In all the circumstances, it cannot reasonably be suggested that Gazprom was in a position to force Naftogaz to agree to anything, and it did not do so.
- (2600) Second, Naftogaz argues that Gazprom was an unavoidable trading partner for Naftogaz when the Contract was entered into in 2009. Further, Naftogaz argues that, as a matter of law, where a supplier is an unavoidable trading partner, its buyers cannot have relevant buyer power that could prevent the supplier from being dominant.
- (2601) The two cases upon which Naftogaz relies, *Tomra* and *Telekomm Polska*, do not establish such a proposition of EU law.
- (2602) As an initial point, these are both merely decisions of the EU Commission and their jurisprudential status is therefore minimal. It is correct, as Naftogaz pleads in paragraph 1029 of its Reply, that the *Tomra* case was appealed to the General Court and then to the CJEU. However, *Tomra's* appeals were dismissed and the issue of countervailing buyer power was not discussed by the Courts.
- (2603) There is no authority from the European Courts which supports Naftogaz' argument that where a supplier is an unavoidable trading partner, its buyers cannot have relevant buyer power that could prevent the supplier from being dominant.
- (2604) The European Courts' position on countervailing buyer power is clear: it is a relevant question of fact which must be considered in cases where dominance is in issue. In *Italian Flat Glass*, the General Court was critical of the fact that the EU Commission "*has not even attempted to*

gather the information necessary to weigh up the economic power of the three producers [alleged to be collectively dominant] against that of Fiat, which could cancel each other out". (clarification made by Gazprom)

(2605) The European Courts have *not* held that where a supplier is an unavoidable trading partner, its buyers cannot have relevant buyer power that could prevent the supplier from being dominant.

(2606) In fact, upon closer examination, it is clear that neither of the two EU Commission decisions cited by Naftogaz establish such a proposition either. In *Tomra*, for example, the availability of alternative sources of supply was just one of a number of facts considered by the EU Commission in assessing the issue of buyer power. These included that "*a comparison of the demand and the supply structure in the individual countries does not suggest that customers are able to outweigh Tomra's strong position on the supply side. Besides the generally three or four retail groups in many countries there are a number of smaller retail groups with low market shares, including groups which are active only in particular regions*" and that "*procurement of reverse vending equipment is not part of the core activities of retail groups. The circumstances of the case do not suggest that they were likely to act in a strategic manner in order to subsidise and actively build up competing suppliers to which large parts of the demand could be diverted*". It was only after having considered all of these factors that the EU Commission concluded that there was no countervailing buyer power.

(2607) On Naftogaz' own case, Gazprom only had a market share of between 52% and 75%. Therefore, Naftogaz does have alternative sources of supply for natural gas.

(2608) However, even if it did not have alternative sources of supply and (as Naftogaz argues) Gazprom was an unavoidable trading partner, Naftogaz could still have countervailing buyer power which could reduce or negate any market power on the part of Gazprom.

(2609) As a matter of law, this Tribunal is not precluded from considering the issue of countervailing buyer power even if (which is denied) Gazprom is an unavoidable trading partner for Naftogaz.

The role of the Tribunal is to consider what degree of countervailing buyer power exists and what effect it has.

- (2610) It is Gazprom's case that, in the circumstances prevailing in late 2008 and early 2009, Naftogaz had such a substantial degree of countervailing buyer power that Gazprom was in no position to impose any abusive Contract terms on Naftogaz and, as a matter of fact, it did not do so. Gazprom repeats and relies upon its Defence and Counterclaim in this regard.
- (2611) Third, Naftogaz argues that Gazprom can threaten to abandon Ukraine as a transit route to Western Europe and instead use other routes, such as Nordstream. Naftogaz further argues that Gazprom has threatened to do so.
- (2612) In order to assess the degree of countervailing buyer power which Naftogaz had, and the effect which such buyer power might have had in reducing or negating any market power on the part of Gazprom, it is necessary to look at the position between the parties when negotiation of the Contract was taking place in January 2009. That is the point of time at which any market power would have been exercised.
- (2613) In 2009, Gazprom was dependent upon Ukraine as a transit route in order to fulfil its supply obligations to importers in Western Europe (and continues to be so dependent). Although the Nordstream project was approved in principle by Gazprom prior to 2009, construction work on the pipelines did not start until April 2010. Gas deliveries from the Nordstream pipelines did not commence until the end of 2011. It is quite clear, therefore, that the Nordstream pipelines were not even available to Gazprom at the time of negotiation of the Contract in 2009.
- (2614) In any event, even with the construction of Nordstream, Gazprom could not (and still cannot) abandon Ukraine as a transit route to Western Europe in favour of other routes. Gazprom was (and still is) dependent upon Ukraine as a transit route in order to fulfil its supply obligations to importers in Western Europe.

- (2615) Even after Nordstream became operational at the end of 2011, Gazprom has remained dependent on Ukraine for transit of around 50% of its exports to Europe. While Gazprom would be able to re-route some of these gas flows via alternative routes, it would not be able to meet the contractual nominations of its buyers in Italy, south eastern European countries, western Turkey and some central European countries without using the Ukrainian GTS.
- (2616) It has been predicted that, even in 2020, Gazprom would still be unable to deliver all of its contracted export volumes to Europe without using the Ukrainian GTS.
- (2617) In effect, Naftogaz/ Ukrtransgaz was a pivotal supplier of transit services to Gazprom in 2009, and continues to be so. Gazprom would be unable to honour its supply contracts with importers in Europe without using the Ukrainian GTS. As the monopoly supplier of gas transit services across Ukraine, Naftogaz/ Ukrtransgaz was an unavoidable trading partner for Gazprom.
- (2618) Finally, Naftogaz argues that, as a market share in excess of 50% gives rise to a presumption of dominance, it is for Gazprom as the *prima facie* dominant player to demonstrate that other factors, such as countervailing buyer power, would warrant a different conclusion. On the facts, Gazprom has demonstrated that, in the circumstances pertaining in late 2008 and early 2009, Gazprom was in no position to impose abusive Contract terms on Naftogaz, and it did not do so.
- (2619) Even if the relevant market has been adequately defined, Naftogaz has failed to establish Gazprom's dominance. Naftogaz' case on dominance is based primarily on Gazprom's market shares. However, Naftogaz' market share figures are flawed. In any event, Gazprom's position is that, Naftogaz' countervailing buyer power, arising from its ability effectively to blockade Gazprom's transit supplies to Europe, cancels out any market power or dominance which Gazprom may otherwise have had. These issues were considered in detail in the Supply Arbitration and Gazprom relies upon its submissions in that arbitration in this regard.

(2620) In conclusion, Naftogaz has failed to prove that Gazprom was dominant. On the contrary, at the time that the Contract was entered into, Naftogaz' countervailing buyer power (arising from its ability effectively to blockade Gazprom's transit supplies to Europe) cancelled out any market power or dominance which Gazprom may otherwise have had.

7.2.2.6.4.3.1.6 A dominant position within the internal market or a substantial part of it

(2621) Naftogaz correctly asserts that the application of Article 102 TFEU requires "*a dominant position within the internal market or in a substantial part of it*". Gazprom agrees that the EU case-law has established that a dominant position covering one or more countries fulfils this criterion. It is emphasised, however, that this must be a dominant position covering one or more countries within the EU, i.e. one or more EU Member States.

(2622) Thus, the territory of the Netherlands may be sufficient to constitute a "*substantial part*" of the internal market: see *Michelin I*, as cited in Naftogaz' Reply. However, it is obviously the case that Ukraine is not a part of the internal market (substantial or otherwise) as it is not an EU Member State. Therefore, Naftogaz cannot rely upon establishing a dominant position within Ukraine alone in order to fulfil the requirements of Article 102 TFEU (that there is "*a dominant position within the internal market or in a substantial part of it*").

(2623) Naftogaz argues that it is able to fulfil the Article 102 TFEU criterion (that there is "*a dominant position within the internal market or in a substantial part of it*") if it is able to establish that Gazprom has a dominant position in a regional market defined as Ukraine, Slovakia, Poland and Hungary (or in a substantial part of that market). However, Naftogaz also appears to argue that it can fulfil this criterion even if it is only able to establish dominance on the basis of a national market, i.e. Ukraine alone.

(2624) That argument is clearly wrong. Ukraine is not a Member State of the EU. A dominant position in Ukraine cannot be "*a dominant position within the internal market or in a substantial part of it*" as required by Article 102 TFEU.

(2625) This remains the case even if (which is denied) "*Gazprom has isolated Ukraine through the Gas Transit Contract, erecting barriers to trade with other countries*" as Naftogaz argues. Such an argument cannot override the clear requirements of Article 102 TFEU that there be "*a dominant position within the internal market or in a substantial part of it*".

7.2.2.6.4.3.1.7 The gas transmission market: dominant purchaser

(2626) Naftogaz defines the gas transmission market as a market for the supply of wholesale natural gas transmission services through Ukraine. Naftogaz accepts that Naftogaz/ Ukrtransgaz has a monopoly position on the gas transmission market. However, Naftogaz now also argues that Gazprom is a dominant *purchaser* on that market.

(2627) Naftogaz relies upon this argument in support of its case that the transmission tariff in clause 8 of the Contract is an abuse by Gazprom of its dominant position in the (related) gas sale market, but also its position as the dominant purchaser on the gas transmission market. Naftogaz' substantive case on the abusive nature of the transit tariff is developed in its Defence and Counter-claim. Gazprom responds to Naftogaz' substantive case on abuse below.

(2628) However, Gazprom denies in any event that it has a dominant position as a *purchaser* on the gas transmission market.

(2629) A position of dominance under Article 102 of the TFEU has been defined by the CJEU as: "... *a position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant market by allowing it to behave to an appreciable extent independently of its competitors and customers and ultimately of consumers*".

(2630) By analogy, a dominant purchaser would have to be in a position to exercise market power so as to "*hinder the maintenance of effective competition on the relevant market*" and to behave independently of its competitors and suppliers.

- (2631) The sole basis upon which Naftogaz argues that Gazprom is a dominant *purchaser* of gas transmission services through Ukraine is that "*Gazprom purchases the majority of long-distance transmission services in Ukraine*". This is supported by a sole paragraph in the Lapuerta and Hesmondhalgh Report 2, where the factual allegation is repeated and it is asserted that "*competition economists widely acknowledge that large purchasers can also exert dominance over their suppliers*" as a matter of principle. At a later point in its Reply, Naftogaz makes a slightly different assertion to the effect that "*Gazprom represents the entire volume of natural gas transmitted through Ukrainian territory and it also controls entry and exit points outside Ukraine through its subsidiaries*".
- (2632) Naftogaz has failed to establish that Gazprom has a dominant position as a purchaser on the gas transmission market. Even if it is the case that Gazprom purchases the majority of long-distance transmission services in Ukraine (and Naftogaz' case is confused in this regard), this does not establish that Gazprom is a dominant purchaser.
- (2633) Any market power which Gazprom may have as purchaser of the majority of long-distance transmission services in Ukraine is counter-balanced by the market power which Naftogaz has as monopoly supplier of such services. Naftogaz accepts that Naftogaz/Ukrtransgaz has a monopoly position on the gas transmission market. Gazprom is only able to obtain long-distance transmission services in Ukraine from Naftogaz/Ukrtransgaz: it is the only supplier of such services. Therefore, Gazprom is in no position to behave independently of that supplier.
- (2634) Moreover, for the reasons set out above, Naftogaz/Ukrtransgaz was a pivotal supplier of transit services to Gazprom in 2009, and continues to be so. Gazprom would be unable to honour its supply contracts with importers in Europe without using the Ukrainian GTS. As the monopoly supplier of gas transit services across Ukraine, Naftogaz/Ukrtransgaz was an unavoidable trading partner for Gazprom.
- (2635) In all the circumstances, Naftogaz has failed to establish that Gazprom has a dominant position as a *purchaser* on the gas transmission market.

7.2.2.6.4.3.2 The link between Gazprom's dominant position and the abuse

- (2636) Gazprom maintains its case that, as a matter of legal principle, Naftogaz is unable to establish that Gazprom is leveraging its dominant position in the gas sales market so as to engage in abusive behaviour on the related gas transmission market. This is because the relevant EU case-law is clear that such conduct is only in breach of Article 102 TFEU where the dominant undertaking is present on the related market as well as on the market where it is dominant.
- (2637) Naftogaz/Ukrtransgaz is the only supplier of gas transmission services in the gas transmission market in Ukraine. Gazprom operates only on the gas sales market. Gazprom does not operate at all on the related gas transmission market. Therefore, as a matter of law, Naftogaz is unable to rely upon the links between the gas sales market and the gas transmission market (or the "*full circle*" which is described in the Lapuerta and Hesmondhalgh Report 2) for the purposes of Article 102 TFEU.
- (2638) Naftogaz seeks to argue that it need only establish "*a link between the dominant position and the alleged abusive conduct*". In other words, that it only needs to establish that there is a link between the gas sales market and the gas transmission market. In support of that argument, Naftogaz seeks to rely upon the cases of *TeliaSonera* and *Tetra Pak*. Naftogaz' expert also relies on the further case of *British Gypsum*.²⁰⁸ Naftogaz' reliance on those cases is misconceived. In each of those cases, the dominant undertaking was at least present on the market where the abuse is said to have occurred.
- (2639) The European Courts held that, for the purposes of Article 102 TFEU, the dominant undertaking must be present on the related market as well as on the market where it is dominant.
- (2640) In *TeliaSonera*, the Court made it clear that, in order to establish the requisite link between the two markets, the undertaking which is dominant in the upstream market must also be present in the downstream market. The abusive conduct in such a case was the dominant undertaking

²⁰⁸ Jacobs Transit Opinion, paragraphs 63-67.

using its position in the upstream market "*to drive out at least equally efficient competitors in the downstream market*".

(2641) In the *Tetra Pak* case, Tetra Pak was dominant on the aseptic markets, but was also present on the associated non-aseptic markets. Again, the dominant undertaking must be present on the related market as well as on the market where it is dominant.

(2642) Therefore, Naftogaz is unable to establish the requisite link between Gazprom's alleged dominant position (on the gas sales market) and the alleged abuse (on the gas transmission market) for the purposes of Article 102 TFEU. Its case under Article 102 TFEU should thus be dismissed for this initial reason of principle.

7.2.2.6.4.3.3 The relevant point in time for assessing abuse

(2643) Naftogaz addresses the issue of the relevant point in time for assessing abuse under Article 102 TFEU.

(2644) It remains Gazprom's case that the only point in time at which an abuse, such as an excessive pricing abuse, can take place is at the time when that price is negotiated. This is because that is the only point in time when the dominant seller can exercise its market power (and thus engage in abusive conduct).

(2645) Naftogaz criticises Gazprom's argument on the basis that the consequence of that argument would be that, if the Contract was not abusive when entered into in January 2009, then "*Gazprom would be free to exercise its rights under the Contract to their full extent and refuse any renegotiations that are not required by the Contract*".

(2646) That is correct. But such a consequence is neither surprising nor unlawful. Any party that has entered into a contract is able to exercise its rights under that contract to their full extent and to refuse any renegotiations that are not required by the contract. That is the position whether or not the party has market power. This consequence has nothing to do with the exercise of market

power; it is simply the consequence of having entered into a contractual arrangement. Such actions cannot, therefore, be abusive.

(2647) Naftogaz criticises Gazprom's case on the relevant time for assessing abuse on the basis that "[n]o case-law or other legal sources are offered in support of [its] position". However, Gazprom's position is the only coherent position as a matter of logic and economic analysis. Naftogaz' position that contractual terms can somehow become abusive as a result of external circumstances (e.g. changes in the price of oil), even though they were not abusive when entered into, is not supported by the case-law upon which Naftogaz seeks to rely. It is specifically denied that "*the position invoked by Gazprom has been rejected by the EU Courts*".

(2648) First, the case-law on the "*special responsibility*" of dominant undertakings says nothing about the relevant time for assessing abuse. It simply makes clear that conduct which is unobjectionable when engaged in by a non-dominant undertaking (such as a refusal to supply, for example) can be an abuse when engaged in by a dominant undertaking. That is uncontroversial.

(2649) Second, Naftogaz relies upon the judgments of the General Court and the CJEU in *Compagnie Maritime Belge*. However, Naftogaz has mischaracterised the Courts' judgments in that case. Contrary to what Naftogaz asserts, the Courts did not find that the implementation of an agreement may be an abuse of a dominant position "*even if the conclusion of that agreement did not in itself constitute an abuse*".

(2650) The General Court made it clear that no action was being taken against the conclusion of the agreement in issue simply because it had been entered into *before* the relevant legislation came into force. Therefore, action could only be taken against the continued implementation of the agreement *after* the date the relevant legislation came into force. The Court did not consider whether or not the conclusion of the agreement in issue itself constituted an abuse as a matter of substance.

(2651) Further, the CJEU held that:

"It is established, in the present case that Cewal sought to rely on the contractual exclusivity provided for in the Ogefrem Agreement in order to remove its only competitor from the market. Such conduct was in no way required by that agreement, since, under the second paragraph of Article 1 thereof, express provision is made for possible derogations, so that the requirements of Article [102] of the Treaty could be met" (emphasis and clarification added by Gazprom).

(2652) The CJEU therefore held that the conduct at issue in the case, which was held to be abusive, was not simply implementation of contractual terms. On the contrary, it was conduct which was not required by the agreement.

(2653) Finally, contrary to Naftogaz' case, the judgment of the General Court in *ITT Promedia* does not support Naftogaz' assertion that *"the implementation of a contract and the exercise of contractual rights by a dominant player may constitute an abuse, irrespective of whether the conclusion of the contract constituted an abuse"*.

(2654) In this regard, the statements in paragraph 140 of the General Court's judgment cannot be read in isolation. In the very next paragraph of its judgment, the General Court held that no abuse had been established in that case.

(2655) As regards the first condition set out in paragraph 140, i.e. whether Belgacom's claim exceeded what the parties could expect under the contract, the Court held that the claim fell within the ambit of the contract and so was not an abuse for the purposes of Article 102 TFEU.

(2656) As regards the second condition, the Court made it clear that the mere conclusion of an agreement (and the defending of Belgacom's rights under that agreement) cannot in itself be an abuse for the purposes of Article 102 TFEU. The Court said:

"... the applicant has not adduced any fact or legal argument to show in what respect that claim was not for the purpose of defending Belgacom's rights under the agreement of 9 May 1994, and explains ... that the alleged effect on competition which Belgacom's claim would have, if it were to succeed, is a consequence of the conclusion of that agreement at a time when the

publication of directories was an activity which was the subject-matter of exclusive rights reserved to Belgacom. Consequently, what is in point is not a justification but a mere finding that, in fact, it is not Belgacom's claim which causes the effects in question, but the conclusion of the agreement".

(2657) Thus, the relevant point in time to assess whether a contractual term is abusive is the time of negotiation of the relevant contract. This is because that is the only time when the dominant undertaking can exercise its market power (and thus engage in abusive conduct). The subsequent enforcement of contractual rights does not involve any exercise of market power. To the contrary, any party (dominant or non-dominant) can exercise contractual rights. For this reason, decisions to enforce contractual rights cannot, in themselves, be treated as an abuse of a dominant position. This issue was considered in detail in the Supply Arbitration and Gazprom refers to and relies upon its submissions in this regard in that arbitration.

7.2.2.6.4.4 The alleged anti-competitive terms of the Contract and/or anti-competitive conduct by Gazprom

7.2.2.6.4.4.1 The transit tariff: no breach of Articles 101 and/or 102 TFEU

(2658) Naftogaz' claims regarding the transit tariff imposed under the Contract are two-fold: (1) that the transit tariff is unfairly low and contrary to Article 102 TFEU/ Article 18(1)(b) EnCT; and (2) that the transit tariff is discriminatory and contrary to Article 101(1)(d) TFEU/Article 18(1)(a) EnCT.

(2659) Naftogaz argues that the tariff under the Contract is an unfairly low purchase price in breach of Article 102 TFEU (and Article 18(1)(b) EnCT). Essentially, the tariff is said to be unfairly low because it is alleged that it does not cover the costs of the pipeline network.

7.2.2.6.4.4.2 The tariff is not an unfairly low purchase price

7.2.2.6.4.4.2.1 The assessment of the fairness of a price

(2660) Gazprom maintains its case that in order to establish that a price is unfairly low so as to amount to an abuse under Article 102 TFEU, it is necessary to prove that the price paid bears no

reasonable relation to the economic value of the goods or services bought. Naftogaz accepts this argument. This is the test set out by the CJEU in the *United Brands* case.

(2661) Such a case is notoriously difficult to prove. Gazprom has been able to find only one case where the European Courts have considered whether a price is so low as to be "exploitative" and thus "unfair" under Article 102 TFEU. That case failed on its facts. Gazprom has been unable to find any case where a complainant has successfully proven that a dominant purchaser has exercised its buyer power to extract unfairly low prices from its suppliers in breach of Article 102 TFEU.

(2662) Although Naftogaz accepts that the test to be applied in such a case is that the price paid bears no reasonable relation to the economic value of the goods or services bought, Naftogaz does not accept Gazprom's argument that it is necessary to apply a two-stage test analogous to that applied to excessive pricing in *United Brands* as follows:

1. first "*the difference between the costs actually incurred and the price actually charged*" must be examined; and
2. then it must be determined whether a price has been imposed which is either unfair in itself or when compared to competing products.

(2663) However, Gazprom maintains its case that it is appropriate to engage in such a two-stage test. It is the case that in *United Brands*, the Court indicated that "*other ways may be devised*" in order to determine whether prices are unfair. However, the two-stage *United Brands* test has been applied in numerous subsequent and more recent cases. It has been applied in various industries including shipping, music licensing and postal services.

(2664) In Gazprom's submission, it is necessary, not only to carry out a comparison of the transit tariff with Naftogaz' costs, but also to consider whether the tariff is unfair when compared to competing products *or in itself*. Naftogaz argues that the assessment of whether the transit tariff is unfair cannot involve a comparison with prices of competing products because no market price

can be established or estimated for competing products. It asserts, however, that the tariff must be considered *unfair in itself* because of "*the significant deviation between the tariff paid by Gazprom and a cost-reflective price*".

(2665) In other words, Naftogaz argues that if the transit tariff is not "cost reflective" for the purposes of Directive 2009/73/EC and Regulation 715/2009, then it can be taken to be abusive for the purposes of Article 102 TFEU. Naftogaz asserts that, where there is secondary legislation which addresses the pricing of a particular product or service (here the Third Energy Package), this secondary legislation provides the criteria for determining whether the price is unfair for the purposes of Article 102 TFEU.

(2666) Naftogaz effectively collapses the question of whether a price is unfair for the purposes of Article 102 TFEU into a question of whether or not it is cost-reflective.

(2667) That approach is misconceived. It is not sufficient for the purposes of Article 102 TFEU to determine solely whether or not a price is cost-reflective. In order to find that a price is so low as to be "exploitative" and thus "unfair" under Article 102 TFEU, i.e. that the price is so low that it bears no reasonable relation to the economic value of the goods or services at issue, it is necessary to go further than looking solely at whether the price is cost-reflective and to consider whether the price is in itself (or by comparison with competing products) unfair.

(2668) In *Scandlines*, one of the few cases where the issue of excessive pricing has been considered in any detail under Article 102 TFEU, the EU Commission stated that:

"an analysis of excessive or unfair pricing abuse must focus on the price charged and its relation to the economic value of the product. While a comparison of prices and costs, which reveals the profit margin of a particular company may serve as a first step in such an analysis, this in itself cannot be conclusive as regards the existence of an abuse.

In line with what the Court has stated in paragraph 252 of the United Brands judgment, a distinction must be made between the assessment of the difference between the price and the production costs the profit margin and the assessment of whether the price is unfair."

(2669) One of the reasons given by the EU Commission for this approach was the inherent uncertainty of determining a company's costs and of determining what would be a reasonable profit margin. The EU Commission concluded that the economic value cannot simply be determined by looking at costs, but it must be determined "*with regard to the particular circumstances of the case and take into account also non-cost related factors such as [in that case] the demand for the product/ service*". In that case, the EU Commission held that there was insufficient evidence to find that the prices charged for the port services were excessive and abusive for the purposes of Article 102 TFEU.

(2670) In *Attheraces*, the English Court of Appeal took a similar approach. The Court held that it was not possible to conclude that a price was abusive for the purposes of Article 102 TFEU simply of the basis of a cost-plus approach: that is to say it was not sufficient merely to show that a price exceeds cost by more than a reasonable amount.

(2671) As to the role of Article 102 TFEU in considering excessive pricing, the Court also held that it was not to be used in order to regulate prices:

"It seems to us that the most that a successful challenge under Article 82 can achieve in a case like this is a re-negotiation, not a cost + limit on prices, for whatever else Article [102] does it does not create a European system for determining prices.

Article [102], as we said earlier, is not a general provision for the regulation of prices. It seeks to prevent the abuse of dominant market positions with the object of protecting and promoting competition".

(2672) The judgment in *Ahmed Saeed*, upon which Naftogaz relies, predates the case-law set out above by many years. In any event, in that case, the Court did not consider the question of excessive

pricing in any detail. The case certainly does not undermine the approach taken subsequently in the case-law to assessing the unfairness of a price: secondary legislation which sets out how a price is to be determined may be relevant to first question of whether the price reflects costs, but that issue is not determinative of whether the price is unfair for the purposes of Article 102 TFEU. The judgment in *Ahmed Saeed* does not suggest otherwise.

(2673) Therefore, by effectively collapsing the question of whether a price is unfair for the purposes of Article 102 TFEU into a question of whether or not it is cost-reflective, Naftogaz has taken an incorrect legal approach. It is therefore unable to establish that the transit tariff is unfair and abusive for the purposes of Article 102 TFEU.

7.2.2.6.4.4.2.2 The tariff is not so unfairly low as to be abusive for the purposes of Article 102 TFEU

(2674) Naftogaz argues that the transit tariff in the Contract is unfair for the purposes of Article 102 TFEU and Article 18(1)(b) EnCT because it fails to reflect underlying costs. Gazprom has already established that, as a matter of EU law, it is not enough to show that a price is below cost in order to establish that it is abusive and unfair for the purposes of Article 102 TFEU and Article 18(1)(b) EnCT.

(2675) Further, Naftogaz argues that the transit tariff fails to reflect underlying costs for two reasons "*which both separately and in combination result in an unfair price*". First, the tariff lacks fixed capacity charges and, second, it has not been set on the basis of the regulatory asset base (RAB).

(2676) However, neither Article 102 TFEU or Article 18(1)(b) EnCT require that a transit tariff be set with fixed capacity charges or by reference to a RAB. EU *competition* law does not require a price to be set in any particular way. For the purposes of Article 102 TFEU or Article 18(1)(b) EnCT, a seller can set a price (or agree a price with its customer) in any way that it wishes so long as the price is not set at such a level that it bears no reasonable relation to the economic value of the goods or services bought.

(2677) Fixed capacity charges and a regulatory asset base are concepts which Naftogaz has taken from EU *energy law*. Insofar as they have any application at all in this case (which is denied), they are relevant only to Naftogaz' case under EU energy law/ the Third Energy Package. Naftogaz blurs the distinction between EU competition law (the requirements of Articles 101 and/or 102 TFEU) and EU energy law (the requirements of the Third Energy Package).

(2678) In any event, Gazprom denies that the transit tariff is not cost-reflective for the purposes of the Third Energy Package. In particular, in that context, Gazprom rejects Naftogaz' assertions as regards (a) the lack of capacity charges and (b) the regulatory asset base (RAB).

(2679) The Parties' respective factual cases on whether the transit tariff is abusive are considered in detail in the various expert reports from Mr Lapuerta and Dr Hesmondhalgh (for Naftogaz) and Dr Moselle (for Gazprom). In summary, Gazprom's position is that:

1. Neither Article 102 TFEU or Article 18(1)(b) EnCT require that a transit tariff be set with fixed capacity charges or by reference to a RAB. EU competition law does not require a price to be set in any particular way. For the purposes of Article 102 TFEU or Article 18(1)(b) EnCT, a seller can set a price (or agree a price with its customer) in any way that it wishes so long as the price is not set at such a level that it bears no reasonable relation to the economic value of the goods or services bought.
2. Even if the tariff was not strictly cost-reflective (which is denied), that would not be sufficient for Naftogaz to establish that the tariff is abusive and unfair for the purposes of Article 102 TFEU or Article 18(1)(b) EnCT. Instead, a further assessment would have to be made of whether the price is unfair in itself. The fact that the transit tariff was (and continues to be) in the central or upper range of comparable European tariffs for 2010 and later years indicates that it is not unfair in itself.
3. In any event, it cannot be said that the transit tariff contained in the Contract is not cost-reflective. Different methodological approaches can be used to determine cost-reflective

tariffs. Naftogaz' calculations reflect methodological choices which result in tariffs higher than the tariff contained in the Contract. Gazprom's expert, Dr Moselle, has calculated cost-reflective tariffs using reasonable alternative assumptions which are significantly below the Contract tariff.

- (2680) The sole basis for Naftogaz' position appears to be the argument that cost-reflectivity is specified in EU energy law, and, pursuant to Case 66/86 *Ahmed Saeed*, this should be taken into account. However, *Ahmed Saeed* merely implies that the sectoral regulatory regime may furnish "*certain interpretative criteria*".
- (2681) *Ahmed Saeed* does not suggest that the rules of EU energy law can supplant or override the basic principles that are set out in Articles 101 and 102 TFEU.
- (2682) Sir Francis Jacobs also accepted that the concept of operationalisation would not override basic principles of competition law; that it would not allow for breaches of energy law to be treated as breaches of competition law; and that it would not allow for energy law to be imported wholesale into competition law.
- (2683) As Gazprom explains, standards such as cost reflectivity which may well be appropriate in the context of *ex ante* sectoral regulation are inappropriate in the altogether different context of an *ex post* liability regime (where clear and stringent tests are required to allow undertakings to make appropriate plans).
- (2684) In any event, as noted above, there is no unconditional requirement in EU energy law that cost reflective tariffs should be applied in all cases.
- (2685) When the correct approach is applied, it becomes apparent that there is a reasonable relationship between the tariff under the Contract and the economic value of the transit services provided by Naftogaz.

- (2686) Dr Moselle has demonstrated that the existing tariff is high in comparison to other transit tariffs. Dr Moselle has also explained that adjustments for actual transited volumes would not change his finding that the existing tariff is high in comparative terms. The transit tariff was (and continues to be) in the central or upper range of comparable European tariffs for 2010 and later years.²⁰⁹
- (2687) Mr Medvedev also explained that the current tariffs paid to Naftogaz are well above the tariffs that Gazprom pays in neighbouring Slovakia and Poland.
- (2688) Various different methodological approaches can be used to determine cost-reflective tariffs. Naftogaz' calculations reflect methodological choices which result in tariffs higher than the tariff contained in the Contract. Gazprom's expert, Dr Moselle, has calculated cost-reflective tariffs using reasonable alternative assumptions which are significantly below the Contract tariff.²¹⁰
- (2689) For these reasons, Naftogaz cannot establish that the tariff under the Contract is unfairly low so as to constitute an abuse for the purposes of Article 102 TFEU. In any event, even if cost reflectivity were determinative, as demonstrated in the next section, Naftogaz cannot establish that the tariff under Contract TKGU is not cost reflective.
- (2690) Furthermore, Naftogaz' costs are actually the charges it pays Ukrtransgaz. However, it is striking that in this Arbitration there has been no analysis at all of those charges.
- (2691) The transit tariff more than covers Naftogaz' actual costs of providing the gas transit services.
- (2692))Finally, Gazprom maintains the arguments that it is most likely that the transit tariff more than covers Naftogaz' actual costs of providing the gas transit services. [REDACTED] explains that the tariff formula in the Contract, which is distance based, is not difficult to understand and is cost-based in the sense that the predominant operational cost to Naftogaz in transiting gas is

²⁰⁹ Moselle Report 1, chapter 9.

²¹⁰ Moselle Report 2, Section 6.1, paragraphs 6.7 to 6.7.2.

fuel gas, and the greater the distance travelled, the more fuel gas is required. Further, at no time during negotiations of the Contract (or subsequently) did Naftogaz put forward a considered or reasonable proposal of a cost-based tariff calculated on the basis of objective, verifiable components.

(2693) However, even if the tariff was not strictly cost-reflective (which is denied), this is would not be sufficient for Naftogaz to make a case that the tariff is abusive and unfair for the purposes of Article 102 TFEU.

(2694) Naftogaz has failed to make any case that the tariff is in itself (or by comparison with competing products) unfair for the purposes of Article 102 TFEU and Article 18(1)(b) EnCT. On the contrary, the transit tariff under clause 8 of the Contract was (and continues to be) in the central or upper range of comparable European tariffs for 2010 and later years.

7.2.2.6.4.4.2.3 The tariff does not affect competition

(2695) Naftogaz asserts that the tariff affects competition in the EU because, by the allegedly below cost tariff, Naftogaz subsidises Gazprom's natural gas sales into the EU which gives Gazprom a cost advantage compared to other competing gas suppliers. It would appear that this argument is advanced both as a self-standing instance of abusive conduct under Article 102 TFEU, due to discrimination, and as an instance of an anticompetitive restriction under Article 101 TFEU. In particular, the alleged "*competing gas suppliers*" are not identified, nor are the costs advantages that Gazprom is supposed to enjoy vis-à-vis these competing gas suppliers identified or quantified to any extent whatsoever.

(2696) Insofar as the allegation is that Gazprom has advantageous terms relative to other competing suppliers of gas to Ukraine, the argument is misconceived. The Contract does not permit Gazprom to transport gas into Ukraine for sale to consumers or for injection into local storage. It relates only to transit across Ukraine. There is no competition between Gazprom and suppliers of gas to Ukraine.

(2697) Insofar as the allegation is that Gazprom has advantageous terms relative to other competing suppliers of gas to EU countries such as Slovakia, Poland and Hungary, the argument is also misconceived. Naftogaz' case amounts to no more than unsupported assertion. Naftogaz has failed even to identify the other suppliers of gas in Slovakia, Poland or Hungary with whom Gazprom is alleged to compete. Naftogaz has failed to make out any case as to how Gazprom is supposed to have received advantageous terms in comparison to those suppliers, nor are the costs advantages that Gazprom is supposed to enjoy vis-à-vis these competing gas suppliers identified or quantified to any extent whatsoever.

7.2.2.6.4.4.2.4 The tariff does not affect trade between Member States

(2698) Naftogaz addresses the question of effect on trade of the tariff under the Contract.

(2699) First, Naftogaz argues that the various provisions of the Contract, together and in conjunction with the Gas Sales Contract, form part of an "*overall strategy*" to isolate the Ukrainian market. Naftogaz argues, therefore, it need only establish that one of Gazprom's practices is capable of having an effect on trade between EU Member States. However, it is Gazprom's case that Naftogaz has failed to establish an "*overall strategy*". Naftogaz therefore needs to establish that each element of the alleged abuse (including the tariff) affects trade between EU Member States.

(2700) Second, Naftogaz asserts that "*the unfair tariff implies that Naftogaz is subsidising Gazprom's natural gas sales into the EU*" and that this is "*clearly liable to affect the pattern of trade between EU countries*". For the reasons set out above, Naftogaz has singularly failed to prove its case in this regard. It amounts to no more than unsupported assertion and "implication".

7.2.2.6.4.4.2.5 Conclusion on abusive pricing under Article 102 TFEU

(2701) In conclusion, Naftogaz has failed to establish that the transit tariff under the Contract is so low that it bears no reasonable relation to the economic value of the transit services at issue. Naftogaz has therefore failed to establish that the transit tariff is so low as to be "exploitative" and thus "unfair" under Article 102(a) TFEU.

7.2.2.6.4.4.3 The tariff does not result in discriminatory pricing

7.2.2.6.4.4.3.1 Introduction

(2702) Naftogaz has changed its case on discriminatory pricing under Article 101 and/or 102 TFEU (and/or Article 18 EnCT) from that originally set out in its Statement of Claim. Naftogaz now argues that the discrimination arises from differential tariffs charged to Gazprom and to other third parties who wish to transit natural gas through Ukraine in order to sell it in competition with Gazprom in countries such as Poland, Hungary and Slovakia. Naftogaz asserts that the published tariffs that such third parties would now have to pay are higher than the tariff paid by Gazprom under the Contract. Naftogaz says that it is irrelevant that such transit has not taken place because this has been due to Gazprom's conduct. This assertion as to Gazprom's conduct is denied but in any event it takes Naftogaz' case no further.

(2703) Thus, Naftogaz has now limited its case of discrimination to one under Article 101(1)(d) TFEU.²¹¹ Naftogaz relies on an apparent difference between the tariffs that Gazprom pays and the tariffs that "*other parties wishing to transit gas through Ukraine*" pay.²¹² It asserts that "[t]he Contract involves a lower tariff for Gazprom than the tariffs that third parties face". Gazprom denies that the tariff results in discriminatory pricing.

(2704) Article 101(1)(d) prohibits "*agreements between undertakings [...] which [...] apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage [...]*". The Transit Contract does not contain any term prescribing the tariffs that should be paid by parties other than Gazprom. Naftogaz is free to set those tariffs at a level that is higher, lower or equal to the level of the tariff paid by Gazprom. It follows that the Contract falls outside the scope of Article 101(1)(d) because it does not provide for discriminatory pricing.

²¹¹ Naftogaz' Sur Reply, paragraph 42.

²¹² Naftogaz' Reply, paragraph 1228.

(2705) The same test is applied to discriminatory pricing for the purposes of Article 101 TFEU as is applied under Article 102 TFEU. The same elements of the test need to be proven by Naftogaz.

(2706) In order to prove a case of discriminatory pricing, it is not sufficient to simply establish that different prices are charged to different customers. Naftogaz must show: (1) that it is comparing like with like; (2) that the prices charged for such "*equivalent transactions*" are different, without there being any objective justification for such difference; (3) that the "*other trading parties*" in such "*equivalent transactions*" are competing on an upstream or a downstream market and, if so, which one; (4) that the different prices being charged to those "*other trading parties*" are "*placing them at a competitive disadvantage*" vis-à-vis their competitors on that upstream or downstream market. Naftogaz does not even attempt to demonstrate that these four conditions are made out.

(2707) For the reasons set out above in relation to Article 102 TFEU, Naftogaz has failed to fulfil (or even to engage with) any of the elements necessary to prove discriminatory pricing in breach of Article 101(d) TFEU. Its case on discriminatory pricing under Article 101 TFEU therefore also fails.

(2708) Therefore, Naftogaz' claim under Article 101(1)(d) TFEU must be rejected.

(2709) It is noted that the published tariffs on which Naftogaz now relies only applied with effect from 1 January 2016, almost nine months after the date of the Statement of Claim in this arbitration. Therefore, Naftogaz' case on discriminatory pricing as now formulated would only be effective from 1 January 2016. In any event, however, Gazprom denies that Naftogaz is able to establish that the tariff has a discriminatory effect for the purposes of Article 101 and/or 102 TFEU in any event.

7.2.2.6.4.4.3.2 No effect on trade between Member States

(2710) Gazprom's allegedly abusive practices are capable of having an effect on trade between EU Member States since they form part of an "*overall exclusionary and exploitative strategy*".

However, it is Gazprom's case that Naftogaz has failed to establish an "*overall strategy*". Naftogaz therefore needs to establish that each element of the alleged abuse (including the tariff) affects trade between EU Member States.

(2711) Second, Naftogaz asserts that the allegedly discriminatory tariff affects the costs of transiting gas between or to EU countries and its therefore liable to affect the pattern of trade between EU Member States. Insofar as such conduct may affect trade between Russia and an EU country, it does not affect trade between two or more EU Member States and therefore does not fulfil the requirements of Article 101.

7.2.2.6.4.4.4 The party-relationship under the Contract: no breach of Articles 101 and/or 102 TFEU

7.2.2.6.4.4.4.1 Introduction

(2712) In its Statement of Claim, Naftogaz addresses this category of EU energy law requirements and in summary, Naftogaz' complaint appears to be as follows:

1. The Ukrainian regulator, NCSREU, designated Ukrtransgaz as the transmission system operator ("TSO") for the Ukrainian gas transmission network.
2. However, the rights and obligations of the regulator, NCSREU, and the TSO, Ukrtransgaz, are not reflected in the Contract. Specifically:
 - Gazprom acts in the capacity of a "*super operator*" of the Ukrainian GTS. In practice, Gazprom Export acts as a matching partner with TSOs of adjacent transmission network systems on Ukraine's western borders, i.e. the Romanian, Hungarian, Slovak and Polish TSOs.
 - Gazprom has control over both gas flows into and out of the Ukrainian GTS and the capacity utilisation of and the allocation of gas flows at the relevant interconnection points at the Ukrainian western border.

- Gazprom has obstructed reverse flows between Ukraine and each of Slovakia, Hungary, Romania and Bulgaria. This is particularly a problem for reverse flows at the interconnection point between Ukraine and Slovakia at Uzhgorod/Velke Kapusany.
- Gazprom has refused to inform Ukrtransgaz of its Shipper Codes and the Shipper Codes of its counterparties, thus hindering Ukrtransgaz in carrying out its function as a matching partner in practice.

(2713) It would appear that Naftogaz' objections to the Contract and/or Gazprom's conduct are three-fold in this regard:

1. First, Naftogaz asserts that "*Gazprom's role as super-operator hinders factual implementation of the unbundling requirements in ECT energy law*".
2. Second, Naftogaz asserts that "*Gazprom's refusal to provide Ukrtransgaz with shipper codes prevents Ukrtransgaz from carrying out its functions as TSO and entering into interconnection agreements with adjacent TSOs*".
3. Third, Naftogaz asserts that "*Gazprom's prevention of virtual reverse flow is restrictive and abusive and prevents Ukrtransgaz from entering into interconnection agreements with adjacent TSOs*".

(2714) In making its case as regards the party relationship under the Contract, Naftogaz fails clearly to set out how it is said that each of its three objections amount to an abuse of a dominant position for the purposes of Article 102 TFEU. On the contrary, Naftogaz' case in this regard blurs the distinction between EU competition law on the one hand and EU energy law on the other hand. This is an impermissible and obstructive approach.

(2715) Gazprom addresses Naftogaz' case on the party relationship under the Contract under EU competition law, i.e. Article 102 TFEU (and Article 18(1)(b) EnCT). Naftogaz' case on the party

relationship under the Contract for the purposes of EU energy law (the Third Energy Package) is addressed by Gazprom below.

(2716) Gazprom denies that its conduct as described by Naftogaz is correct as a matter of fact, or that, in any event, it amounts to an abuse of a dominant position in breach of Article 102 TFEU.

(2717) Insofar as Gazprom has any "*control*" over gas flows into and out of the Ukrainian GTS, this is a necessary and unobjectionable function of the agreement between Gazprom and Naftogaz to transit gas from Russia and Belarus across the Ukrainian GTS. It is not contrary to the requirements of EU energy law, namely Directive 2009/73/EC and Regulation 715/2009.

(2718) Naftogaz' complaints are incorrect as a matter of fact:

- The suggestion that Gazprom Export acts as "*matching partner*" with the relevant TSOs in Hungary, Poland and Romania is simply incorrect. No matching process is carried out between Gazprom Export and those TSOs, and no nominations or shipper codes are communicated by Gazprom Export to those TSOs. The only TSO in countries adjacent to Ukraine with which Gazprom Export coordinates delivery of volumes is Eustream, the Slovakian TSO. The only information that Gazprom exchanges with Eustream is information relating to deliveries of Gazprom Export's own gas. Gazprom Export does not communicate any nominations to Eustream in respect of any other party's gas, nor does it receive any nominations from Eustream in respect of any other party's gas.
- Gazprom controls the gas flow into the Ukrainian GTS at the entry points on Ukraine's eastern borders with Russia and Belarus. This is because Gazprom owns and controls the pipeline networks in Russia and Belarus, and the GMSs at those entry points are located within Russian and Belarussian territory. There is no demand for capacity at these entry points except from Gazprom.
- As for the gas flows out of the Ukrainian GTS at Ukraine's western borders, all of the relevant GMSs are located in Ukrainian territory and are owned and operated exclusively by

Naftogaz/Ukrtransgaz. Gazprom has no control over them. The only role that Gazprom representatives play at these GMSs is to record, jointly with Ukrtransgaz representatives, the volumes of gas passing through the GMSs. This has always only been as regards Gazprom's own gas, in order to determine the volumes of gas transited under the Contract and supplied under Contract. The allegation that Gazprom has control over capacity utilisation of and the allocation of gas flows generally at the relevant interconnection points at the Ukrainian western border is incorrect.

(2719) In making its case as regards the party relationship under the Contract, Naftogaz fails clearly to set out how it is said that each of its three objections amount to an abuse of a dominant position for the purposes of Article 102 TFEU. On the contrary, Naftogaz' case in this regard blurs the distinction between EU competition law on the one hand and EU energy law on the other hand.

(2720) Gazprom first addresses Naftogaz' case on the party relationship under the Contract under EU competition law, i.e. Article 102 TFEU (and Article 18(1)(b) EnCT). Naftogaz' case on the party relationship under the Contract for the purposes of EU energy law (the Third Energy Package) is then addressed.

(2721) Gazprom denies that its conduct as described by Naftogaz is correct as a matter of fact, or that, in any event, it amounts to an abuse of a dominant position in breach of Article 102 TFEU.

7.2.2.6.4.4.2 Gazprom's alleged role as "super-operator": no breach of Article 102 TFEU

(2722) It would appear that Naftogaz' case as regards Gazprom's alleged role as "super operator" is made primarily under EU energy law (rather than EU competition law). Naftogaz argues that Gazprom's alleged role as "super operator" "*hinders factual implementation of the unbundling requirements in ECT energy law*" (emphasis added by Gazprom). The thrust of Naftogaz' objections is that Gazprom's alleged role as "super operator" hinders unbundling of the TSO (Ukrtransgaz) which is a "*legal requirement under the Third Energy Package*". Naftogaz

complains that Gazprom is "*refusing to adhere to mandatory ECT energy legislation*" and the "*legal requirements under the Third Energy Package*".

- (2723) Naftogaz' case on Gazprom's alleged role as "super operator" for the purposes of EU energy law (the Third Energy Package) is addressed by Gazprom below.
- (2724) The only specific allegation of "*competition concerns*" as regards Gazprom's alleged role as "super operator" is the allegation that "*Gazprom's dual role over the use of the Ukrainian transportation network creates a serious conflict of interest*". This case is made by cross reference to the Lapuerta and Hesmondhalgh Report 2.
- (2725) The Lapuerta and Hesmondhalgh Report 2 relate to virtual reverse flows; distortion of trade between countries (as regards virtual reverse flows); and "*other unbundling issues*". Naftogaz' case on virtual reverse flows is addressed by Gazprom below. Dr Moselle responds to the "*competition concerns*" raised in the Lapuerta and Hesmondhalgh Report 2 in his second report. Gazprom adopts and repeats the points made in this regard in the Moselle Report 2.
- (2726) Naftogaz also makes various generalised assertions that unbundling is required under EU competition law as well as EU energy law. That is not the case. Article 102 TFEU prohibits abuse of a dominant position. A failure to unbundle is not, and has never been considered, an abuse of a dominant position for the purposes of Article 102 TFEU. As Dr Moselle explains, before the deadline for compliance with the unbundling requirements of the Third Energy Package expired, a number of EU transmission system operators did not comply with such requirements. However, it was never suggested by the EU Commission that such a failure to unbundle was an abuse of a dominant position for the purposes of Article 102 TFEU.
- (2727) Naftogaz has failed to identify any case where a failure to unbundle has been found to be an abuse of Article 102 TFEU. The authorities and commentaries to which Naftogaz refers in its Reply refer to unbundling as a failure to comply with the requirements of the Third Energy

Package (and the generally pro-competitive objectives which it pursues), rather than any breach of the specific provisions of Article 102 TFEU.

(2728) Naftogaz has therefore failed to make any case under Article 102 TFEU as regards Gazprom's alleged role as "super operator".

7.2.2.6.4.4.3 Shipper codes and virtual reverse flow: no breach of Article 102 TFEU

(2729) At the heart of Naftogaz' cases on both shipper codes and virtual reverse flow is that Gazprom's alleged conduct in refusing to provide shipper codes and in preventing virtual reverse flow is preventing Ukrtransgaz from entering into interconnection agreements with adjacent TSOs, thus "*having the effect of hindering competition to develop at either side of the relevant inter-connection points*".

(2730) As regards the provision of shipper codes, Ukrtransgaz has no practical need for Gazprom Export's shipper codes.²¹³ [REDACTED]

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(2731) As regards reverse flow arrangements:

1. Neither the Contract nor Gazprom's conduct has blocked actual reverse gas flows. Gazprom's consent is not required in order for Naftogaz to set up reverse flows at any interconnector and, contrary to Naftogaz pleaded case, reverse flow pipelines have been put in place and are already in operation at the interconnection points between Ukraine and each of Slovakia and Hungary. Similarly, Naftogaz has failed to establish

213 [REDACTED]

214 [REDACTED] See also [REDACTED] as regards a request from Naftogaz to Gazprom for its shipper codes for volumes of natural gas transported from Ukraine to Hungary.

and there is no evidence that anything in the Contract or Gazprom's conduct could prevent Naftogaz from setting up reverse flows in the future.²¹⁵

2. As regards virtual reverse flow (VRF or "backhaul"), this is a complex legal exercise which requires agreement between all relevant stakeholders/network users on a number of complex technical issues.²¹⁶ Gazprom Export has no objection in principle to participating in and facilitating virtual reverse flow arrangements at interconnection points, and in fact does so at a number of interconnection points where backhaul capacity is available.²¹⁷ However, Gazprom has not received any formal proposal from Naftogaz (or Ukrtransgaz) for virtual reverse flow.²¹⁸ Naftogaz' and Ukrtransgaz' requests for Gazprom's shipper codes did not address any of the complex issues relevant to establishing virtual reverse flow arrangements.²¹⁹
3. Naftogaz made a complaint to the European Commission regarding access to the interconnection point between Ukraine and Slovakia at Uzhgorod/Velke Kapusany. That complaint is unfounded.²²⁰

(2732) At the heart of Naftogaz' competition law case on shipper codes and VRF is the proposition that Gazprom is under a duty to provide shipper codes to Ukrtransgaz. If such a duty existed (which is denied), it would be a surprising and onerous one: it would require Gazprom to transact with a counterparty (Ukrtransgaz) which is not an existing customer and to consent to arrangements which carry the risk that they may result in breaches of Gazprom's contractual obligations to other customers.

(2733) Gazprom's case in this regard is as follows:

215 [REDACTED]
218 [REDACTED]
217 [REDACTED]
218 [REDACTED]
219 [REDACTED]
220 [REDACTED]

1. Such a duty can only arise if shipper codes can be classified as "*essential facilities*" within the meaning of EU competition law.
2. Shipper codes cannot be treated as essential facilities within the meaning of EU competition law.
 - The refusal to provide shipper codes and to consent to VRF is not "*likely to eliminate all competition in the [relevant] market on the part of the person requesting the service*".²²¹ Despite the lack of virtual reverse flow arrangements, competition in the import market in Ukraine, which appears to be the relevant market, has developed significantly
 - Gazprom's refusal to provide shipper codes is capable of being objectively justified. In particular, as [REDACTED] explains, Naftogaz' requests for shipper codes do not address a number of complex issues that must be resolved before Gazprom can consent to VRF.
 - Third, it is not the case that "*there is no actual or potential substitute in existence for*" VRF arrangements. Physical reverse flow is available with Slovakia, Hungary and Poland. Physical reverse flow is clearly a substitute for virtual reverse flow: it has enabled the development of significant competition in the import market into Ukraine.²²² Furthermore, all existing physical reverse flow into Ukraine is not fully utilised, so there is potential for it to be used further.²²³

(2734) In any event, even if a more general test for abuse were applied, Naftogaz has not established that Gazprom's refusal to consent to VRF would have any anticompetitive effects.²²⁴

²²¹ *Bronner v Mediaprint*, paragraph 41 at Exhibit RLA 67. See also Bellamy & Child, *European Union Law of Competition*, 7th edn., 2013 at paragraphs 10.137 to 10.138..

²²² Moselle Report 2.

²²³ Moselle Report 2. Also see Yafimava 1. See also [REDACTED].

²²⁴ See Moselle Report 2.

- (2735) Furthermore, given the extremely close links between Ukrtransgaz (the current operator of the Ukrainian GTS) and Naftogaz (which is engaged in "*the functions of production or supply*" in Ukraine), it would be inappropriate and potentially anti-competitive were Gazprom to provide its confidential shipper codes to Ukrtransgaz/ Naftogaz where Naftogaz is a potential competitor to Gazprom in onward supply of gas outside Ukraine.²²⁵
- (2736) In summary, Naftogaz/ Ukrtransgaz has no need for Gazprom Export's shipper codes (which simply identify the party to which particular quantities of Gazprom's gas is to be delivered) in order to enter into interconnection agreements with adjacent TSOs. As a matter of fact, Ukrtransgaz has entered into interconnection agreements with the TSOs of a number of EU Member States adjacent to Ukraine, including Eustream as regards the Budince interconnection point. This has enabled Naftogaz to purchase substantial quantities of gas from European suppliers by way of physical reverse flow via interconnections with adjacent EU Member States for import into Ukraine. In fact, the share of gas imported into Ukraine from Russia has dropped from 74% in 2014 to 37% in 2015 (the difference being made up of imports to Ukraine adjacent EU Member States).
- (2737) The only activity for which Ukrtransgaz would need to have Gazprom's shipper codes would be for the implementation of virtual reverse flows. As regards virtual reverse flows, Gazprom repeats the points which make it clear that Gazprom has not blocked or restricted Ukrtransgaz from entering into virtual reverse flow arrangements.
- (2738) Gazprom participates and makes use of VRF at many interconnection points in Europe where it is established and has no principled objection to its use. However, at interconnection points where VRF is established there is a clear set of rules, procedures and agreements which address all relevant issues and allocate responsibilities and liabilities of all affected parties. Such arrangements are not in place at any exit point of Ukraine.

(2739) As regards Vel'ké Kapušany, as regards which Naftogaz makes particular complaint, at no time has Naftogaz or Ukrtransgaz approached Gazprom or Gazprom Export with a considered proposal for VRF, either alone or together with Eustream. Nor has Gazprom or Gazprom Export received such a proposal from Eustream or the Slovakian TSO. On the contrary, it would appear to be in Eustream's commercial interests not to agree to VRF at Vel'ké Kapušany, as such arrangements would impact on its income from Gazprom's transit fees at that interconnection point. As a result, in response to Ukrtransgaz' requests for reverse flow from Slovakia, Eustream has put into operation bi-directional reverse flow to Ukraine through a second interconnection point on its border with Ukraine (at Budince) using the Vojany-Uzhgorod pipeline. In this way, Eustream receives ship or pay fees from Gazprom Export in respect of Vel'ké Kapušany and from Naftogaz in respect of Budince.

(2740) Therefore, there is nothing in Naftogaz' assertion that the failure on the part of Ukrtransgaz to establish VRF at Vel'ké Kapušany is due to the Contract and/or Gazprom's conduct.

(2741) In any event, Naftogaz has failed to make any case to the effect that a refusal to provide virtual reverse flow arrangements is in breach of Article 102 TFEU.

(2742) In principle, under Article 102 TFEU, an undertaking is free to choose for itself the parties with whom it wishes to enter into contractual relations. Even as regards a dominant undertaking, that freedom may only be restricted in certain, limited circumstances. A dominant undertaking may only be required to maintain supplies with an existing customer, or to grant access to an "essential facility" to new customers in certain circumstances.

(2743) In the present case, Ukrtransgaz is not an existing "customer" of Gazprom as regards the supply of shipper codes and/or virtual reverse flow arrangements. Therefore, Naftogaz would have to establish that Gazprom has failed to grant Ukrtransgaz access to an "essential facility" in breach of Article 102 TFEU.

- (2744) First, Naftogaz would have to prove that access to shipper codes and/or virtual reverse flow arrangements constitutes access to an "essential facility". The meaning of an "essential facility" is a fact-specific issue that depends upon the presence of "technical, legal or even economic obstacles" preventing the would-be user of the "facilities" from competing on the relevant market. Essential facilities may be information or assets. Typically, essential facilities have been held to include intellectual property rights, "*access to a place such as a harbour or an airport or to a distribution system such as a telecommunications network*".
- (2745) Naftogaz has failed to prove that access to shipper codes and/or virtual reverse flow arrangements constitutes access to an "essential facility". Assuming that the relevant market is the import of gas to Ukraine (which, in any event, Naftogaz has failed to establish), access to shipper codes and/or virtual reverse flow arrangements is not "essential" to allow such imports to take place. In this regard, Gazprom repeats paragraph 460 above: as a matter of fact Ukrtransgaz has entered into interconnection agreements with the TSOs of a number of EU Member States adjacent to Ukraine, which has enabled Naftogaz to purchase substantial quantities of gas from European suppliers for import to Ukraine.
- (2746) Second, in order for a refusal to grant access to an essential facility to constitute an abuse for the purposes of Article 102 TFEU, Naftogaz must prove that said refusal "*be likely to eliminate all competition in the [relevant] market on the part of the person requesting the service*"; that "*such refusal be incapable of being objectively justified*", and that "*the service in itself is indispensable to carrying on that person's business, inasmuch as there is no actual or potential substitute in existence for that [service]*".
- (2747) Naftogaz is unable to prove such matters in the present case.
- (2748) First, despite the lack of virtual reverse flow arrangements, competition in the import market in Ukraine has developed significantly: see paragraph 460 above. Therefore, the absence of virtual reverse flow arrangements is not "*likely to eliminate all competition in the [relevant] market*".

- (2749) Second, any refusal by Gazprom to supply shipper codes to Ukrtransgaz/Naftogaz is objectively justified: Naftogaz' and Ukrtransgaz' requests for Gazprom's shipper codes did not address any of the complex issues relevant to establishing virtual reverse flow arrangements.
- (2750) Third, it is not the case that "*there is no actual or potential substitute in existence for*" virtual reverse flow arrangements. Physical reverse flow is available with Slovakia, Hungary and Poland. Physical reverse flow is clearly a substitute for virtual reverse flow: it has enabled the development of significant competition in the import market into Ukraine: see paragraph 460 above. Furthermore, all existing physical reverse flow into Ukraine is not fully utilised, so there is potential for it to be used further.
- (2751) There is nothing in Naftogaz' experts' argument that physical reverse flow is not a substitute for virtual reverse flow or that it is more costly than virtual reverse flow, see Moselle 2.
- (2752) Naftogaz argues that the essential facilities test set out in *Bronner* is inapplicable. However, in its Preliminary Assessment of the Contract, the Energy Community Secretariat accepted that the "*essential facilities*" test was the correct test under competition law to apply to Gazprom's alleged failure to provide shipper codes and the allegation that Gazprom has "*denied [Naftogaz] the possibility to launch virtual reverse flows*" (clarification made by Gazprom).
- (2753) Naftogaz' primary argument now is that this case is not a case of refusal to supply because on the facts "*there hasn't been an outright refusal to deal with Naftogaz [...]*". But this assertion is not supported by evidence. Gazprom has consistently refused to supply Ukrtransgaz and Naftogaz with shipper codes and has consistently refused to consent to any modification of the Contract to facilitate VRF (for good reason, as set out above). The fact that Gazprom supplies gas to Naftogaz does not alter the fact that, as far as shipper codes and VRF are concerned, there is a refusal to supply. Contrary to what Professor Jacobs asserts, Gazprom's position is

not comparable to the situation in the case of *TeliaSonera*. This is not a case where Gazprom has imposed specific and onerous terms for access to shipper codes and VRF.²²⁶

(2754) Professor Jacobs also appears to rely on the Commission Decision in *Slovak Telecom*.²²⁷ The Slovak Telecom decision found that the rule in *Bronner* did not apply in circumstances where the supplier was "*already bound by an ex-ante obligation to give access to ULL to AOs, which was imposed by the competent Slovak telecoms authorities under the applicable regulatory regime*".²²⁸ By way of contrast, there is no obligation on Gazprom under EnCT energy law to give access to shipper codes or to facilitate VRF. Contrary to what Professor Jacobs asserts, the *Slovak Telecom* decision does not support the assertion that a duty to supply shipper codes can arise as a matter of competition law in such a situation independent of the requirements set out in *Bronner*.

(2755) In any event, even if a different test were applied, Naftogaz cannot establish that Gazprom's conduct has anti-competitive effects and is, therefore, abusive.

(2756) Naftogaz' experts have not properly analysed whether there is any adverse effect on competition. Mr Lapuerta refers to "*inefficient bypass*" because of the costs associated with building physical reverse flow capacity. But Mr Lapuerta admitted that he has not compared the costs associated with building physical reverse flow capacity with the increased benefits to Naftogaz in terms of security of supply. This is notwithstanding the fact that Mr Lapuerta himself recognised that "[p]hysical reverse flows might in theory convey additional security of supply that justifies their higher costs"²²⁹ and the fact that [REDACTED] evidence suggests that figures for the costs associated with building physical reverse flow capacity would have been available to Naftogaz.

²²⁶ See Jacobs Opinion.

²²⁷ See Jacobs Opinion.

²²⁸ *Slovak Telecom* Case AT:39523, para, 370. See also Communication from the Commission – Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (2009/C 45/02), paragraph 62.

²²⁹ H&L3, paragraph 104.

- (2757) Mr Lapuerta's justification for his omission was that no such analysis is necessary because there was "*no objective justification for denying virtual reverse flows*". But this approach is erroneous. Under the applicable legal test Naftogaz must demonstrate that the conduct in question has "*the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition*".²³⁰ The fact that GP-Export may have been unjustified in not supplying shipper codes is immaterial in the absence of a showing of an anti-competitive effect. In any event, Gazprom's conduct was justified in the circumstances.
- (2758) The evidence shows that neither Gazprom nor GP-Export acted unreasonably in refusing to provide shipper codes and/or nominations to Naftogaz or Ukrtransgaz.
- (2759) Article 3.4 of the Contract provides that the volumes of gas transferred by Naftogaz to the exit points from Ukraine will be the same as the volumes of gas transferred by Gazprom at the entry points into Ukraine every day. By definition, VRF would result in lower volumes of transit gas leaving the exit points from Ukraine. It follows therefore that any VRF transaction would require an amendment of the Contract and a modification of Gazprom's contractual rights under Article 3.4. Gazprom indicated this in correspondence but Naftogaz never sought to agree amendments which protected Gazprom's interests: it simply demanded shipper codes and nominations. It proposed no steps to protect Gazprom's interests under an entirely legitimate clause.
- (2760) VRF would also require an amendment to GP-Export's contracts with its off takers. But there was no recognition of this by Naftogaz and no proposals were made by Naftogaz or Ukrtransgaz seeking to address such issues or to negotiate an appropriate fee with Gazprom.
- (2761) The implementation of VRF arrangements would require agreement on operational and technical issues at the border of Ukraine. Here again, Naftogaz or Ukrtransgaz made demands for shipper codes and nominations without taking any further steps to resolve these technical issues.

²³⁰ Case 85/76 *Hoffman-La Roche*, paragraph 91.

(2762) One example is of a technical issue is the need for agreement on a single GMS where volumes would be measured (as opposed to situation as at present where there are two GMSs such as Vel'ké Kapušany in Slovakia and Uzhgorod in Ukraine). ██████████ agreed that in order to implement an interconnection agreement including VRF "both TSOs need to agree on a single gas metering station".

(2763) As regards the efforts in 2013 to establish an interconnection agreement with Eustream in order to enable VRF at Vel'ké Kapušany. ██████████ said that in an "informal meeting" with unnamed reps of Eustream Naftogaz was told that Eustream could not enter into such an agreement because of its obligations to Gazprom under their agreement with Gazprom: ██████████ However:

- Eustream did not ask GP-Export for its shipper codes or for its agreement to amend their contracts. This was confirmed by ██████████.
- Because Eustream would have been paid more by Gazprom for its reservation of physical flow capacity at Vel'ké Kapušany than it could have charged for VRF at that point it was not in Eustream's commercial interests to enable VRF for Naftogaz at that interconnection point. It was more sensible for Eustream commercially to recommission the pipeline at Budince for physical reverse flow from Slovakia to Ukraine. And that is exactly what happened. This was explored with ██████████.

(2764) As regards shipper codes in respect of exports to Poland, Hungary and Romania, it is the case that GP-Export does not provide shipper codes to the relevant TSOs. As explained by ██████████ ██████████, the gas is delivered by GP-Export to third party shippers who arrange with TSOs for further transportation. This was accepted by ██████████ as regards the specific example of Hungary.

(2765) In conclusion, Naftogaz has failed to prove that that Gazprom's alleged conduct in refusing to provide shipper codes and in preventing virtual reverse flow is in breach of Article 102 TFEU.

7.2.2.6.4.4.4 No effect on trade between Member States

(2766) In addressing the party-relationship under the Contract, Naftogaz does not plead any case to the effect that the alleged breaches of Article 102 TFEU have an effect on trade between Member States. Gazprom denies that the alleged breaches of Article 102 TFEU as regards the party-relationship under the Contract (which are in themselves denied) have any effect on trade between Member States. Gazprom reserves its right to plead further to this issue if Naftogaz develops its case in that regard.

7.2.2.6.4.4.5 Capacity allocation and congestion management: no breach of Articles 101 and/or 102 TFEU

7.2.2.6.4.4.5.1 Introduction

(2767) Naftogaz makes its case on capacity allocation and congestion management under EU competition law.

(2768) Naftogaz concludes that "*Gazprom's obstruction of a functioning system for capacity allocation and congestion management in Ukraine*" is an abuse of its dominant position under Article 102 TFEU and/or in breach of Article 101 TFEU.

(2769) In summary, therefore, Naftogaz' case under EU competition law is that Gazprom's reservation of the "*majority*" of the capacity of the Ukrainian GTS forecloses competition and is therefore in breach of Articles 101 and/or 102 TFEU. The remainder of points relate to EU energy law under the Third Energy Package, and are therefore considered below.

(2770) As regards the use of interconnection capacity by importers of gas into Ukraine, it is clear that Ukrtransgaz has entered into interconnection agreements with the TSOs of a number of EU Member States adjacent to Ukraine, which has enabled Naftogaz to purchase substantial quantities of gas from European suppliers. This is confirmed in Naftogaz's annual report for 2015 and in a press release from Naftogaz dated 25 November 2016 which notes that Ukraine had not imported any gas from Russia since 25 November 2015. There is no evidence of unsatisfied demand in this regard. On the contrary, [REDACTED] accepted that physical reverse flow capacity

from Slovakia, Poland and Hungary was sufficient for Ukraine's total import needs and that Gazprom's consent was not needed for such flows.

- (2771) The long-term reservation of capacity on a network may amount to an abuse for the purposes of Article 102 TFEU. However, in order to do so, it has to be shown that, in all the circumstances, such reservation would foreclose competition on the relevant downstream market.
- (2772) The three EU Commission Decisions upon which Naftogaz relies are all cases where undertakings gave commitments to the EU Commission pursuant to Article 9(1) of Regulation 1/2003. These commitments were given instead of the EU Commission reaching a final decision on the allegations of anti-competitive behaviour. Therefore, in these Decisions, the EU Commission did not make any formal decisions to the effect that there had been breaches of Article 102 TFEU. The statements made by the EU Commission in those cases are in the nature of preliminary views or "minded-to" decisions on such matters.
- (2773) In any event, the approach taken by the EU Commission to establishing a breach of Article 102 TFEU in those cases is as follows. The EU Commission found that:
1. The TSOs had reserved extremely high levels of capacity for themselves (or related undertakings) so that virtually no capacity was available for third parties. In GDF gas foreclosure, the EU Commission found that only 20% of capacity at entry points and 10% of capacity at the terminal was put on the market. In E.ON gas foreclosure, the EU Commission found that E.ON had generally booked between 65% and 100% on its various networks so that "*only little or no free capacity has been available to competitors wanting to transport gas into EGT's network*" (emphasis added by Gazprom) and that this was due to "*the almost exclusive reservation of the network through E.ON*" (emphasis added by Gazprom).

2. There was "*considerable unsatisfied demand from third-party shippers*" for the capacity. In *E.ON gas foreclosure*, the EU Commission found "*steady and significant demand by transport customers for firm and freely allocable capacities which could not be satisfied by E.ON*".
3. The reservation of capacity foreclosed competition in the downstream supply markets. In *GDF gas foreclosure*, the EU Commission stated that the result of the capacity reservations was that "*third-party shippers did not have access to this capacity under conditions that would allow them to exert effective competition on the downstream gas supply markets in these zones*". In *E.ON gas foreclosure*, the EU Commission found that the reservation of capacity was "*was hampering competitors' access to the downstream gas supply markets, to the detriment of consumers*".

7.2.2.6.4.4.5.2 No breach of Article 101/102 TFEU resulting from Gazprom's "capacity reservation"

(2774) Naftogaz has failed to establish the necessary requirements to establish a breach of Article 101 and/or 102 TFEU in this case:

1. Naftogaz asserts that that "*Gazprom has reserved the majority of the capacity of the Ukrainian gas transmission network and at cross-border interconnection points in the Ukrainian gas transmission system*". However, Naftogaz has provided no evidence of the actual levels of capacity reservation. In fact, as [REDACTED] explains in detail in his second witness statement, there is significant available capacity at all exit points from Ukraine, including at the Uzhgorod interconnection point, and nothing in the Contract that would prevent Naftogaz from selling this unused capacity to other network users. Moreover, there is further significant entry capacity available at Vel'ké Kapušany from Eustream.
2. Naftogaz has failed to establish that there is unsatisfied demand from third-party shippers. Naftogaz has never requested that Gazprom release any of the capacity that Naftogaz

alleges that Gazprom has booked, either under Contract TKGU or under the Eustream Contract. Nor has it received any such request from Eustream.

3. As regards the use of interconnection capacity by importers of gas into Ukraine, it is clear that Ukrtransgaz has entered into interconnection agreements with the TSOs of a number of EU Member States adjacent to Ukraine, which has enabled Naftogaz to purchase substantial quantities of gas from European suppliers. The share of gas imported into Ukraine from Russia has dropped from 74% in 2014 to 37% in 2015 (the difference being made up of imports to Ukraine adjacent EU Member States). There is no evidence of unsatisfied demand in this regard.
4. As regards foreclosure of "*competition on the downstream gas supply markets*", as far as Gazprom is aware, there is no competition on the gas supply market in Ukraine. Naftogaz is the *de facto* monopoly in Ukraine. There is therefore no foreclosure of downstream gas supply.

(2775) Dr Hesmondhalgh and Mr Lapuerta attempt to respond to the first two points above in their third report.²³¹ However, even on Dr Hesmondhalgh and Mr Lapuerta's account the available capacity at one interconnection point, Uzhghorod, exceeds 20 percent. The Tribunal should prefer [REDACTED] evidence to that of Dr Hesmondhalgh and Mr Lapuerta.

(2776) In conclusion, Naftogaz has failed to make any case that Gazprom's reservation of capacity in the Ukrainian GTS under Contract TKGU forecloses competition and is therefore in breach of Articles 101 and/or 102 TFEU.

7.2.2.6.4.4.5.3 No effect on trade between Member States

(2777) Addressing capacity allocation and congestion management, Naftogaz does not plead any case to the effect that the alleged breaches of Articles 101 and/or 102 TFEU have an effect on trade between Member States. Gazprom denies that the alleged breaches of Articles 101 and/or 102

²³¹ Hesmondhalgh & Lapuerta Report 3.

TFEU as capacity allocation and congestion management (which are in themselves denied) have any effect on trade between Member States. Gazprom reserves its right to plead further to this issue if Naftogaz develops its case in that regard.

7.2.2.6.4.4.6 Balancing: no breach of Articles 101 and/or 102 TFEU

7.2.2.6.4.4.6.1 Naftogaz fails to make out any case as regards balancing arrangements under EU competition law

(2778) Naftogaz argues that:

1. The Contract does not provide for a functional balancing system;
2. the lack of a balancing mechanism in Contract TKGU creates practical challenges for the functioning of the Ukrainian gas transmission system;
3. The Contract is contrary to the principles of EU energy legislation; and
4. the Tribunal should apply the same balancing rules to transit under the Contract as to domestic transport under Ukrainian legislation, i.e. the Ukrainian network code.

(2779) By Articles 13(3) and 41(6) of Directive 2009/73/EC, transmission system operators are required to set rules for balancing the GTS which are "*objective, transparent and non-discriminatory, including rules for the charging of system users of their networks for energy imbalance*". Any such charges/ tariffs have to be set by reference to a non-discriminatory and cost reflective methodology.

(2780) The purpose of establishing balancing rules is explained in Recital (31) of the Preamble to Directive 2009/73/EC as follows:

"In order to ensure effective market access for all market players, including new entrants, non-discriminatory and cost-reflective balancing mechanisms are necessary. This should be achieved through the setting up of transparent market-based mechanisms for the supply and purchase of gas, needed in the framework of balancing requirements. National regulatory

authorities should play an active role to ensure that balancing tariffs are non-discriminatory and cost-reflective. At the same time, appropriate incentives should be provided to balance the in-put and off-take of gas and not to endanger the system." (Emphasis added by Gazprom.)

(2781) Similarly, in Recital (28) of the Preamble to Regulation 715/2009, the purpose of balancing rules is explained as follows:

"Non-discriminatory and transparent balancing systems for gas, operated by transmission system operators, are important mechanisms, particularly for new market entrants which may have more difficulty balancing their overall sales portfolio than companies already established within a relevant market. It is therefore necessary to lay down rules to ensure that transmission system operators operate such mechanisms in a manner compatible with non-discriminatory, transparent and effective access conditions to the network." (Emphasis added by Gazprom.)

(2782) As explained in the Hesmondhalgh and Lapuerta Report, balancing refers to *"the need to match the amount of natural gas injected into a pipeline network and withdrawn from it within relatively narrow limits, to maintain the pressure of a pipeline system"*.²³²

(2783) Therefore, the purpose of balancing rules is to ensure that there is a balance between the in-put and off-take of gas on a transmission system so as to maintain the pressure of a pipeline system and not to endanger that system. This may require *"the charging of system users ... for energy imbalance"*. However, such charges should be transparent, non-discriminatory and cost-reflective so as not to discourage new entrants *"which may have more difficulty balancing their overall sales portfolio than companies already established within a relevant market"*.²³³

(2784) The provisions of the Contact, and the system of daily nominations by Gazprom, ensure that there is a balance between the amount of gas put in to the Ukrainian GTS by Gazprom and the amount taken off the Ukrainian GTS for onward provision to Gazprom's European off-takers.

²³² Hesmondhalgh and Lapuerta Report.

²³³ See also Witschen Report.

Transit under the Contract is therefore completely balanced.²³⁴ There is thus no need for the volumes of gas transited under the Contract to be subject to a balancing system which is applied to other users of the Ukrainian GTS. Other users may need to be incentivised to ensure balancing on the Ukrainian GTS by being charged for energy imbalances, etc. However, the provisions of the Contract ensure that the transit volumes of gas transported across Ukraine for Gazprom are balanced in any event.²³⁵

(2785) Therefore, there is nothing in Naftogaz' argument that the Contract is contrary to the principles of EU energy legislation; or that the Tribunal should apply the same balancing rules to transit under the Contract as to domestic transport under Ukrainian legislation. In any event, the Tribunal cannot seriously be asked to impose a balancing regime which does not even yet exist: Naftogaz argues that the Tribunal should apply the balancing regime to be set out in the Ukrainian network code.

(2786) Further, for the reasons set out in the preceding paragraphs, there is nothing in Naftogaz' argument that the Contract does not provide for a functional balancing system. Under the Contract, in-puts and off-takes of gas onto the Ukrainian GTS are perfectly balanced. Nor is there anything in Naftogaz' argument that the lack of a balancing mechanism in the Contract creates practical challenges for the functioning of the Ukrainian gas transmission system. A set of balancing rules for other users of the Ukrainian GTS can be put into place without reference to the transit of Gazprom's gas under the provisions of the Contract.

(2787) It is the case that the Contract does not give Gazprom sufficient flexibility to vary delivery nominations, nor does it impose obligations upon Naftogaz to fulfil such varied nominations. However, it is Naftogaz which has always resisted committing to provide such flexibility to Gazprom.²³⁶ As a result of Naftogaz' refusal to agree to greater flexibility (particularly at Uzhgorod) subsequent to the signing of the Contract, Gazprom Export sought to offer additional

²³⁴ Witschen Report.

²³⁵ See also Witschen Report.

²³⁶ [REDACTED], paragraphs 40 to 44; [REDACTED] paragraphs 37 to 44.

sums to Ukrtransgaz for additional balancing services. This led to the signing of the Balancing Agreement in October 2010. The 2010 Balancing Agreement was terminated with Ukrtransgaz's express agreement in 2014.

- (2788) The meaning of "balancing services" under the Balancing Agreement is quite different from that which it is given under EU energy law. The purpose of the Balancing Agreement was to address the problems caused by the lack of flexibility afforded to Gazprom by the Transit Contract as regards meeting Gazprom's varying delivery obligations to European off-takers (it might more appropriately be called a "flexibility" agreement). The Transit Contract is not in breach of EU energy law requirements on balancing. Neither the existence nor the subsequent termination of the Balancing Agreement makes any difference to that submission.
- (2789) Naftogaz develops its case as regards balancing arrangements under Articles 101 and/or 102 TFEU. Gazprom maintains the case that Naftogaz has failed to make out any case as regards balancing arrangements under EU competition law.
- (2790) Naftogaz claims that "*the lack of a balancing mechanism in the Contract creates practical challenges for the functioning of the Ukrainian gas transmission network*"; and that "*the same balancing rules should apply to all users of the Ukrainian gas transmission system in order to avoid market distortions. The Contract is obstructing the implementation of such a system*". Those arguments disclose absolutely no case to the effect that there is an abuse of dominance contrary to Article 102 TFEU and/or an anti-competitive agreement for the purposes of Article 101 TFEU.
- (2791) Naftogaz refers to the Energy Sector Inquiry of the EU Commission and cites a passage from the EU Commission's Report which talks about balancing and unbundling. But these comments do not support any assertion of specific breaches of Article 101 and/or 102 TFEU in the context of balancing. Rather, they are comments in support of the EU Commission's proposals for more effective regulation of the single market in gas which was to be introduced subsequently in the Third Energy Package.

(2792) Naftogaz suggests that "*Gazprom's obstruction of functioning balancing arrangements in Ukraine is clearly abusive pursuant to Article 102 TFEU*" on the basis that "*it protects Gazprom's dominant position within gas sales, and prevents the integration between the Ukrainian gas market and neighbouring gas markets*". Naftogaz also asserts there to be a restriction of competition for the purposes of Article 101 TFEU on the same basis.

(2793) Gazprom denies that it has obstructed functioning balancing arrangements in Ukraine. Naftogaz fails to particularise its case that Gazprom's alleged obstruction of balancing arrangements in Ukraine (presumably as a result of the existence of the Contract) "*protects Gazprom's dominant position within gas sales, and prevents the integration between the Ukrainian gas market and neighbouring gas markets*". But, in any event, Naftogaz has failed to identify any case where an obstruction of balancing arrangements has been found to be an abuse of Article 101 and/or 102 TFEU.

(2794) Rather, it would appear that Naftogaz' concerns as regards balancing arrangements are really no more than a concern that the Contract is "*is in blatant violation of the rules on balancing of the Third Energy Package, c.f. Article 21 of Regulation 715/2009*". Naftogaz' case on balancing for the purposes of EU energy law (the Third Energy Package) is addressed by Gazprom below.

(2795) Naftogaz has therefore failed to make any case under Article 101 and/or 102 TFEU as regards Gazprom's alleged obstruction of balancing arrangements in Ukraine.

7.2.2.6.4.4.6.2 No effect on trade between Member States

(2796) Addressing balancing arrangements, Naftogaz does not plead any case to the effect that any alleged breaches of Articles 101 and/or 102 TFEU have an effect on trade between Member States. Gazprom denies that any alleged breaches of Articles 101 and/or 102 TFEU as regards balancing arrangements (which are in themselves denied) have any effect on trade between Member States. Gazprom reserves its right to plead further to this issue if Naftogaz develops its case in that regard.

7.2.2.6.4.4.7 Restrictions on the use of interconnectors: no breach of Articles 101 and/or 102 TFEU

7.2.2.6.4.4.7.1 Introduction

(2797) Naftogaz asserts that "*the essence of the abuse on the part of Gazprom is capacity hoarding and underutilisation*". Naftogaz then refers to European Commission and ACER material on long-term capacity reservation agreements. Naftogaz does not appear to argue that Gazprom is engaged in such practices under the Contract, but that "[t]hese practices have similar effects to the practices under the Contract discussed below" (emphasis added by Gazprom).

(2798) Naftogaz' complaints appear to be two-fold:

1. First, Naftogaz argues that Gazprom has reserved the majority of the capacity of the Ukrainian GTS and at cross-border interconnection points in the Ukrainian GTS. Limited access to pipeline capacity, in particular, to the export points at Ukraine's western borders, could prevent or deter gas producers and suppliers in Ukraine from selling their gas in other countries.
2. Second, Naftogaz argues that, by refusing to engage in reverse flow agreements, Gazprom has distorted trade between various European countries; and, by impeding virtual reverse flow, including refusal to provide the matching information necessary, Gazprom has prompted the needless construction of new pipeline capacity.

(2799) As to Naftogaz' first complaint, Gazprom's case is as follows:

There is nothing in the Contract that prevents Naftogaz and its competitors from selling their excess gas supplies. The Hesmondhalgh and Lapuerta Report does not explicitly claim that the Contract has actually impeded exports to other countries. Nor has Naftogaz established or provided any evidence that this is the case.²³⁷

²³⁷ Moselle Report

- (2800) Historically, there have been no excess volumes of gas to export from Ukraine.²³⁸ Naftogaz is a heavy importer of gas from Russia, and independent Ukrainian producers have been required under Ukrainian law to sell all domestic production to Naftogaz.²³⁹ Moreover, it has not been established and there is no evidence that Ukrainian suppliers would have any incentives to export gas to the EU in the future.²⁴⁰
- (2801) Moreover, all of the GMSs (gas metering stations) at export points on Ukraine's western border are controlled and exclusively operated by Naftogaz/Ukrtransgaz. Neither Gazprom nor Gazprom Export exerts any physical control over these GMSs. The only role played by Gazprom Export representatives at these GMSs is to jointly confirm the volumes of gas passing through each GMS, which have only ever been volumes of gas transited under the Contract and therefore belonging to Gazprom.²⁴¹
- (2802) As to the allegation that "*[I]ack of access to export capacity would limit the offtake flexibility that Naftogaz can offer to customers in Ukraine*", Naftogaz has not established or provided any evidence as to Naftogaz' ability or inability to offer off-take flexibility to its customers. It is claimed that such an outcome would impose additional costs on Naftogaz by requiring it to use domestic storage instead of buying and selling gas in Germany.²⁴² However, since Naftogaz already owns vast quantities of gas storage, it is highly implausible that it would choose instead to rely on the German market for flexibility. Furthermore, any payment which Naftogaz would have to make for use of domestic storage would be made to itself.²⁴³
- (2803) As to the allegation that "*[I]imiting gas flows to Western Europe can prevent the Ukrainian gas market from getting rid of excess supplies*" for example to Germany, again, Naftogaz fails to

²³⁸ [REDACTED]

²³⁹ [REDACTED]

²⁴⁰ Moselle Report.

²⁴¹ [REDACTED]

²⁴² Hesmondhalgh and Lapuerta Report.

²⁴³ See Moselle Report.

establish and provides no evidence for this claim. Nor is there any economic analysis to support the claim.

(2804) Therefore, Naftogaz has failed to establish by reference to actual empirical evidence that "*the minimum quantities determined in the transit contract*" have as their object and/or effect the prevention, restriction or distortion of competition pursuant to Article 101 TFEU, or that they are abusive pursuant to Article 102 TFEU. Naftogaz' case in this regard is purely theoretical and pays no regard to the factual and economic context.

(2805) Naftogaz sets out its case on restrictions on the use of interconnectors under EU competition law. Naftogaz argues that "*Gazprom's restrictions on the use of Ukraine's interconnectors constitute a serious violation of Article 102 TFEU. They effectively prevent cross-border sales involving the main interconnection points of Ukraine*".

(2806) However, upon examination, it becomes clear that the allegations made by Naftogaz add nothing new to Naftogaz' case; they simply overlap with allegations made in other parts of its case as regards capacity reservation, obstruction of cross-border sales, restrictions on VRF and physical cross-border gas flows. None of these numerous allegations (either separately or together) make out any case of a breach of Article 101 and/or 102 TFEU.

7.2.2.6.4.4.7.2 No anti-competitive reservation of capacity

(2807) First, Naftogaz asserts that Gazprom has denied that it had reserved the majority of the capacity of the Ukrainian GTS. This wholly mischaracterises what was said by Gazprom, which in fact addressed Naftogaz' argument that Gazprom's reservation of capacity under the Contract could prevent or deter gas producers and suppliers in Ukraine from exporting their gas to other countries. In that regard, Gazprom repeats and relies upon the arguments set out in its Defence and Counterclaim.

(2808) Naftogaz' case on alleged impeding of exports is also addressed in the Moselle Report 2. In summary, it is the case that there is nothing in the argument that the Contract or Gazprom's

conduct has in any way blocked exports of gas from Ukraine: any lack of exports of gas from Ukraine is due to "*high export duties, a restricting licensing regime and quotas*", rather than any action on the part of Gazprom.

(2809) Insofar as Naftogaz seeks to make a case as regards reservation of capacity, Gazprom's case on capacity reservation under Article 102 TFEU is set out above.

7.2.2.6.4.4.7.3 No anti-competitive obstruction of cross-border sales

(2810) Second, Naftogaz makes a myriad of allegations in respect of Gazprom's alleged obstruction of cross-border sales. Naftogaz asserts that "*the party-relationship under the Contract, with Gazprom as a super-operator, is not compatible with an effective and neutral administration of the interconnection points. Gazprom's obstruction of a functioning system for capacity allocation and congestion management and proper balancing arrangements also undermines effective cross border sales between Ukraine and its neighbouring countries*".

(2811) Gazprom's response to Naftogaz' case on the party-relationship under the Contract (particularly Gazprom's alleged role as super-operator) under EU competition law is addressed above. Gazprom's response to Naftogaz' case on capacity allocation and congestion management under EU competition law, as well as Gazprom's response to Naftogaz' case on balancing arrangements under EU competition, law are also addressed above.

7.2.2.6.4.4.7.4 No anti-competitive restriction on virtual reverse flows and inefficient bypass

(2812) Third, Gazprom's response to Naftogaz' case on virtual reverse flows under EU competition law is addressed above.

(2813) The issue of "inefficient bypass" is addressed in Moselle Report 2.

7.2.2.6.4.4.7.5 No anti-competitive restriction on physical cross-border gas flows

(2814) Finally, Naftogaz appears to argue that "*the effects of the Contract*" could negatively affect physical gas flows between, for example, Slovakia, Poland and Hungary using Ukraine as a

"bridge". Naftogaz refers to statements made in Lapuerta and Hesmondhalgh 2 and argues that this *"also illustrates how Gazprom's abusive behaviour affects trade between EU Member States"*.

(2815) Similar assertions were made by Mr Lapuerta in the Supply Arbitration. The statements made in this regard are highly theoretical and speculative. They do not appear to be based on any factual evidence as regards the situation in Ukraine, Slovakia, Poland and Hungary.

(2816) By contrast, [REDACTED] and who is familiar with the structure and operation of the European and Ukrainian gas transmission systems, and with Gazprom's and Gazprom Export's arrangements for delivery of gas at and/or further transportation of gas from the exit points of the Ukrainian GTS, gave evidence in this regard in the Supply Arbitration. As regards physical reverse flow, he explained that Mr Lapuerta's suggestion that Ukraine could act as a "bridge" between Poland, Hungary and Slovakia is impractical and unrealistic for a number of reasons.

1. First, there is limited or no physical reverse flow capacity from the countries adjoining Ukraine (i.e. Poland, Slovakia, Hungary and Romania) to Ukraine. The majority of the pipelines in Ukraine transports gas westwards from Russia and Belarus towards Europe. Moreover, the existing reverse flow pipelines from Slovakia, Poland and Hungary to Ukraine are not being utilised to their full capacity, suggesting that there is insufficient supply or demand to warrant any expansion of the existing infrastructure. Even if fully utilised, the volumes of gas that the existing reverse flow pipelines are capable of transporting, whilst not negligible, are insufficient for Ukraine to be able to position itself as a major transit route for trade between the countries adjoining Ukraine.
2. Second, the existing infrastructure either already facilitates direct trading between Poland, Slovakia, Hungary and Romania, or there are plans in place to construct infrastructure that would facilitate it. There is consequently little reason for the countries adjoining Ukraine to use Ukraine as a "bridge" for supplies between them. In fact, the countries

adjoining Ukraine appear to be seeking to expand available pipeline routes so as to be able to circumvent, or avoid, Ukraine in the event of another disruption of supplies from Russia. Further, Mr Lapuerta's suggestion that Ukraine act as a "bridge" between neighbouring countries does not take into account the commercial interests and motivations of the national transmission system operators, or "TSOs", whose revenues are made up in large measure by entry and exit tariffs (or transit tariffs) for gas transported through their GTSS.

3. Third, Ukraine does not currently have the infrastructure that would be required for it to establish itself as a gas trading hub between its adjoining countries.

(2817) In conclusion, Naftogaz has failed to make out any case of a breach of Article 102 TFEU arising from the use of Ukraine's interconnectors.

7.2.2.6.4.4.7.6 No effect on trade between Member States

(2818) Addressing the use of interconnectors, Naftogaz does not plead any case to the effect that any alleged breaches of Article 102 TFEU have an effect on trade between Member States. Gazprom denies that any alleged breaches of Article 102 TFEU as regards the use of interconnectors (which are in themselves denied) have any effect on trade between Member States. Gazprom reserves its right to plead further to this issue if Naftogaz develops its case in that regard.

7.2.2.6.4.5 Alleged breaches of Ukrainian competition law

(2819) As regards the application of Ukrainian competition law, Naftogaz argues, first, that Article 18 ECT applies as mandatory Ukrainian law and, second, that national Ukrainian competition law applies, the requirements of which are in line with the requirements of Article 101 and 102 TFEU.

(2820) No separate positive allegations of breach of Ukrainian competition law are made by Naftogaz. In fact, Ukrainian competition law is only mentioned as regards the transit tariff under the Contract. No mention is made of Ukrainian competition law at all as regards Naftogaz' allegations

relating to the party relationship under the Contract, its allegations relating to capacity allocation and congestion management, its allegations relating to balancing arrangements, or its allegations relating to restrictions on the use of interconnectors.

(2821) It would appear, therefore, that Naftogaz makes no separate positive arguments under Ukrainian competition law, but simply relies upon the arguments that it has already put forward as regards breach of EU competition law. Gazprom has responded to Naftogaz' case under Article 18 ECT and/or Articles 101 and/or 102 TFEU as regards each of its five categories of alleged abusive terms/conduct: (a) the tariff ; (b) the party relationship under the Contract; (c) capacity allocation and congestion management; (d) balancing; and (e) restrictions on the use of interconnectors. Gazprom therefore repeats and relies upon its submissions as already set out above.

(2822) It follows that, if Naftogaz fails to convince the Tribunal as regards breach of EU competition law, it cannot logically succeed as regards breach of Ukrainian competition law.

7.2.2.6.4.6 Alleged breaches of EU energy law

(2823) Gazprom maintains that Naftogaz has failed to establish any breach of EU energy law.

(2824) The aim of the Third Energy Package is to promote the development of a common gas market in the European Union, i.e. within the EU borders: see Article 40 of Directive 2009/73/EC.

(2825) Directive 2009/73/EC and Regulation 715/2009 set out common rules on conditions for access to natural gas transmission networks in the EU. Those common rules cover matters including tariffs for third party access to transmission networks; congestion management and capacity allocation principles; and balancing rules. The rules are expressed at a high-level of principle. They set out minimum requirements and leave substantial discretion to Member States.

(2826) Article 23 of Regulation 715/2009 provides for Guidelines to be published by the EU Commission "*providing the minimum degree of harmonisation required to achieve the aims of this Regulation*". Article 26 provides that Member States may "*maintain or introduce measures that*

contain more detailed provisions than those set out herein or in the Guidelines referred to in Article 23".

(2827) The first step in the procedure is that the EU Commission requests ACER to submit to it non-binding framework guidelines setting out clear and objective principles for the development of network codes in each of the relevant areas. ACER shall submit the network code to the EU Commission and recommend that it be adopted. A network code is not binding until it has been adopted by the EU Commission in the form of a Regulation.

7.2.2.6.4.6.1 The energy acquis under the EnCT

(2828) Article 10 of the EnCT provides that Contracting Parties "*shall implement the acquis communautaire on energy in compliance with the timetable for the implementation of those measures set out in Annex I*". The term "*acquis communautaire on energy*" is defined in Article 11 of the EnCT as meaning "*the acts listed in Annex I of this Treaty*".

(2829) The only relevant acts listed in Annex I of the EnCT (relating to gas rather than to electricity) were Directive 2009/73/EC and Regulation 715/2009.

(2830) It is therefore the case that, even if the requirements of the Third Energy Package directly apply to the Contract via Article 10 EnCT (which for the reasons set out above is denied), the only legal requirements which apply are those set out in Directive 2009/73/EC and Regulation 715/2009. The detailed requirements set out in the EU network codes Regulations do not apply, as those Regulations are not listed in Annex I of the EnCT.

(2831) Naftogaz appears to recognise that the EU Network Codes do not apply as they have not been included in the EnCT. In its submissions on capacity allocation and congestion management under Ukrainian law, Naftogaz refers to the rules on capacity allocation and congestion management in the Ukrainian Gas Transmission Systems Network Code as being "*an example of how the Ukrainian legislator has taken the NC CAM into account, even if it's not yet incorporated into the ECT*".

7.2.2.6.4.6.2 The Third Energy Package does not apply to the Contract

(2832) Furthermore, it is Gazprom's case that the Third Energy Package requirements do not apply to the Contract in any event.

(2833) The Third Energy Package (as contained in Directive 2009/73/EC and Regulation 715/2009) imposes duties and obligations on transmission system operators.

(2834) The term "*transmission system operator*" is defined in Article 2(4) of Directive 2009/73/EC as follows:

"[...] a natural or legal person who carries out the function of transmission and is responsible for operating, ensuring the maintenance of and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meeting reasonable demands for the transport of gas".

(2835) The legal person responsible for operating the Ukrainian gas transmission system is Ukrtransgaz. Ukrtransgaz is a separate legal entity from Naftogaz (although Ukrtransgaz is a 100% subsidiary of Naftogaz).

(2836) Naftogaz itself is absolutely clear that it is Ukrtransgaz (not Naftogaz) which is responsible for operating the Ukrainian gas transmission system. Naftogaz states "*there is no question that the operation of the Ukrainian GTS is vested in, and the transport services shall be executed by, the designated TSO, i.e. Ukrtransgaz*".

(2837) However, the Contract is between Gazprom and Naftogaz. Article 4.6 of the Contract does refer to Naftogaz delegating the technical implementation of the Contract to Ukrtransgaz, but Ukrtransgaz is not a party to the Contract with Gazprom. It is Naftogaz which supplies the gas transmission services to Gazprom under the Contract: under Article 3.1 thereof, Naftogaz undertakes to ensure the functionality of the Ukrainian GTS and guarantees the transit of Gazprom's gas through Ukraine.

(2838) There must be arrangements in place between Ukrtransgaz and Naftogaz (unknown to Gazprom) which enable Naftogaz to fulfil its obligations to Gazprom under the Contract. These arrangements may be characterised as follows: a primary supply of gas transmission services from Ukrtransgaz (the operator of the Ukrainian GTS) to Naftogaz, and then a secondary supply or re-selling of those gas transmission services by Naftogaz to Gazprom.

(2839) However, Naftogaz is not the operator of the Ukrainian GTS. It is not a transmission system operator for the purposes of the Third Energy Package (as defined in Article 2 of Directive 2009/73/EC). The requirements of the Third Energy Package therefore do not apply to Naftogaz, nor do they apply to Naftogaz' contractual arrangements with Gazprom, i.e. the Contract.

(2840) Insofar as the Third Energy Package requirements as to the transit tariff, unbundling, capacity allocation and congestion management, balancing and the use of interconnectors apply to any legal entity in Ukraine, they apply to Ukrtransgaz (as operator of the Ukrainian GTS). They do not apply to Naftogaz. Thus, they cannot and do not apply to the Contract between Naftogaz and Gazprom.

7.2.2.6.4.6.3 Grandfathering of existing transmission contracts under the Third Energy Package

(2841) The EU Commission has adopted a cautious approach in respect of existing capacity contracts (i.e. the contracts signed before the Third Energy Package entered into force, such as the Contract). The Third Energy Package neither explicitly safeguarded these contracts nor did it explicitly annul them. However, the EU network codes developed under the Third Energy Package have provided a number of safeguards in respect of certain provisions of these contracts such as capacity allocation mechanisms (e.g. no mandatory capacity bundling for existing capacity contracts until expiry, see below) and tariffs (e.g. transitional and mitigation measures, see below), thus effectively establishing a transitional regime for these contracts envisaging a significant degree of "grandfathering".

(2842) In any event, if EU energy law applied, as a legacy contract, the Transit Contract would qualify for "*a certain degree of 'grandfathering'*" and "*transitional solutions*" should apply (see Yafimava 1, and Yafimava 2,). Moreover, the mitigating and transitional provisions in the draft Network Code on Harmonised Transmission Tariff Structures for Gas for Re-Submission to ACER would apply (see Yafimava 1, and Yafimava 2). In the circumstances, Naftogaz' claims under energy law must be approached with extreme caution.

(2843) The EU Commission has been particularly concerned about the impact of the Third Energy Package on Gazprom's existing supply and transit contracts (pursuant to which Gazprom is the largest supplier of gas to the EU). As result, the EU-Russia Gas Advisory Council discussed these issues extensively in the first half of the 2010s. It is clear from these discussions, as summarised in Dr Yafimava's Expert Report, that:

"there has been mutual understanding as well as explicit acknowledgement on the part of the EU and Russia that although the new contracts will have to comply with the TEP and the EU network codes, there exists a certain degree of "grandfathering" in respect of existing contracts, and that transitional solutions are necessary and should be agreed in order to safeguard both the security of supply and security of transportation under existing contracts during the period of the EU's transition towards a new model of the gas market. By contrast, Naftogaz's request effectively to re-write Contract TKGU (the expiry date of which is in the mid-range of Gazprom's European LTTCs' expiry dates), which governs transit of around half of Russian gas exports to Europe, goes against this logic".

(2844) Given the concerns expressed by the EU Commission and the EU-Russia Gas Advisory Council as regards Gazprom's existing contracts in particular, and given the flexible approach taken to existing contracts under the Third Energy Package generally, this Tribunal should treat Naftogaz' request effectively to rewrite the Contract so as to (allegedly) reflect the requirements of the Third Energy Package with extreme caution. In any event, Gazprom denies that the provisions of the Contract and/or its conduct breach the requirements of the Third Energy Package as alleged by Naftogaz.

7.2.2.6.4.6.4 The transit tariff: no breach of the Third Energy Package

(2845) Article 13 of Regulation 715/2009 sets out a large number of requirements for tariffs for access to a transmission network. The tariffs at issue are for access to a transmission network generally, either for transit across that network or for domestic transmission within the network.

(2846) The Article 13 requirements include that the tariffs, or the methodologies used to calculate them:

1. are "*transparent*";
2. "*take into account the need for system integrity and its improvement*";
3. "*reflect the actual costs incurred, insofar as such costs correspond to those an efficient and structurally comparable network operator*";
4. include "*an appropriate return on investments*";
5. take "*account of the benchmarking of tariffs by the regulatory authorities*";
6. are "*non-discriminatory*";
7. "*shall facilitate efficient gas trade and competition*";
8. avoid "*cross-subsidies between network users*";
9. provide "*incentives for investments*";
10. "*maintaining or creating interoperability for transmission networks*";
11. "*are set separately for every entry point into or exit point out of the transmission system*";
12. "*shall neither restrict market liquidity nor distort trade across borders of different transmission systems*".

- (2847) It can be seen that a large number of different (and possibly competing) requirements and/or objectives are to be applied to the setting of tariffs under the Third Energy Package. These requirements/objectives may sometimes pull in different directions and/or suggest different approaches to the setting of tariffs for different purposes.
- (2848) For example, whereas a distance-based tariff may be more cost reflective for transit, particularly longer distance/higher volume transit, than for shorter distance/smaller volume domestic transmission, an entry-exit system may lead to cross-subsidisation of that longer distance/ higher volume transit, b shorter distance/smaller volume domestic transmission.
- (2849) It is for the Member State regulator to seek to maintain a reasonable balance between these different requirements/objectives. The regulator is given a substantial degree of discretion in carrying out this balancing exercise.
- (2850) ACER published Framework Guidelines on Harmonised Gas Transmission Tariff Structures on 29 November 2013. However, as explained above, such Framework Guidelines are non-binding.
- (2851) The EU Commission then invited ENTSOG to draft a Network Code on Tariff Structures on Gas Transmission Networks. On 26 December 2014, ENTSOG submitted its draft network code to ACER in line with the procedure contained in Article 6(6) of Regulation 715/2009. On 26 March 2015, ACER produced its Reasoned Opinion to ENTSOG on the network code in line with the procedure contained in Article 6(7) of Regulation 715/2009.
- (2852) ACER has not yet submitted to the EU Commission a network code on gas transmission tariff structures with a recommendation that it be adopted pursuant to Article 6(7) of Regulation 715/2009. No such network code has therefore yet been adopted by the EU Commission.
- (2853) Therefore, the Network Code on Harmonised Transmission Tariff Structures for Gas to which Naftogaz refers is only a draft. It is not yet part of a binding part of EU energy law. The only

binding legal requirements regarding transmission tariffs that currently exist as a matter of EU energy law are those contained in Directive 2009/73/EC and Regulation 715/2009 themselves.

(2854) In any event, the draft network code on transmission tariffs makes it clear that substantial discretion is to be given to the national regulator as to exactly how transmission tariffs are to be set. This point is developed further below, where Naftogaz' particular allegations as to the transit tariff under the Contract are addressed.

7.2.2.6.4.6.5 The transit tariff in the Contract does not breach the requirements of the EU Third Energy Package

7.2.2.6.4.6.5.1 Naftogaz' case on the Contract transit tariff

(2855) Naftogaz' case that the Contract transit tariff does not comply with the requirements of the Third Energy Package may be summarised as follows:

1. First, the Contract tariff is in breach of the Third Energy Package because it is set on a contract-path basis rather than by reference to entry- and exit-points as required by Article 13 of Regulation 715/2009.
2. Second, the Contract tariff is in breach of the Third Energy Package because it is not cost-reflective as required by Article 13 of Regulation 715/2009. The Contract tariff is said to fail to be cost-reflective for two reasons: it lacks (i) fixed capacity charges, and (ii) explicit reference to a regulatory asset base (RAB).

7.2.2.6.4.6.5.2 The Contract tariff is not discriminatory

(2856) Although Naftogaz refers to the "*principles of non-discriminatory and cost-reflective tariffs in EU and ECT energy law*" (emphasis added by Gazprom), no detailed case is developed by Naftogaz to the effect that the Contract tariff is discriminatory and therefore in breach of the requirements of the Third Energy Package (as opposed to EU competition law). Insofar as any case is advanced by Naftogaz in this regard, Gazprom repeats and denies that the Contract tariff is in breach of the Third Energy Package on the basis that it is discriminatory.

(2857) Naftogaz' case that the Contract transit tariff does not comply with the requirements of the Third Energy Package may be summarised as follows: (1) the tariff is in breach because it is set on a contract-path basis rather than by reference to entry- and exit-points as required by Article 13 of Regulation 715/2009; (2) the tariff is in breach because it is not cost-reflective as required by Article 13 of Regulation 715/2009, in particular because it lacks (i) fixed capacity charges, and (ii) is not set by reference to an explicit regulatory asset base (RAB).²⁴⁴

7.2.2.6.4.6.5.3 Contract-path versus entry/exit-point based tariffs

(2858) Naftogaz argues that the Contract tariff is in breach of the Third Energy Package because it is set on a contract-path basis rather than by reference to entry- and exit-points as required by Article 13 of Regulation 715/2009. Gazprom denies that there is any breach of the Third Energy Package in this regard.

(2859) The transit tariff in the Contract is calculated in Article 8 of the Contract by reference to the distance that the gas is transported. Therefore, it is in effect a point-to-point (distance-based) tariff. However, this does not mean that the Contract tariff is in breach of the requirements of the Third Energy Package.

(2860) As regards whether tariffs are required to be set on an entry/ exit-point basis (rather than by reference to a contract path), Article 13(1) of Regulation 715/2009 provides that "[t]ariffs for network users shall be set separately for every entry point into or exit point out of the transmission system. [...] By 3 September 2011, the Member States shall ensure that, after a transitional period, network charges shall not be calculated on the basis of contract paths" (emphasis added by Gazprom). It is therefore up to Member States to introduce tariffs on an entry/exit point basis (rather than on a contract path basis). However, that requirement is only to be introduced "*after a transitional period*". There is no immediate requirement for tariffs to be on a contract-path basis only. The length of the transitional period is a matter for the discretion of the Member State.

- (2861) This would appear to be because a distance-based tariff may be more cost reflective for transit, particularly longer distance/higher volume transit, than for shorter distance/smaller volume domestic transmission. Moreover, an entry-exit system may lead to cross-subsidisation of that longer distance/higher volume transit, than for shorter distance/smaller volume domestic transmission. Therefore, the introduction of an entry-exit system for transit may not be consistent with the Article 13 objectives of cost-reflectiveness and lack of cross subsidy. As a result, a requirement for tariffs to be on a contract-path basis is only to be introduced after a transitional period (the length of which is a matter for the discretion of the Member State).
- (2862) Moreover, as Dr Yafimava explains, the EU decided to introduce an entry-exit tariff system in order to boost liquidity in the EU gas market by incentivising a shift of gas trading to hubs, due to compulsory bundling of entry and exit capacity in new contracts. Given that there is no gas hub in Ukraine (either for physical deliveries and balancing, or for risk management), an introduction of the entry-exit system in Ukraine would not automatically result in the establishment of liquid market but would lead towards cross-subsidisation of transit by domestic transmission.
- (2863) In the circumstances, given the discretion which is given to the national regulator, the provision of Article 13(1) of Regulation 715/2009 which provides that tariffs are to be calculated on an entry-exit basis "*after a transitional period*" cannot be directly applicable as a matter of EU law without implementing legislation which includes details of such "*a transitional period*".
- (2864) Therefore, the fact that the tariff under Article 8 of the Contract is not based on an entry-exit system does not breach the requirements of Article 13 of Regulation 715/2009: the requirement that tariffs are to be calculated on an entry/exit basis is not directly applicable as a matter of EU law.
- (2865) Naftogaz' interpretation of Article 13(1) of Regulation 715/2009 as requiring that tariffs be set on an entry-exit basis by 3 September 2011 is unsustainable. Article 13(1) provides for a transitional period before network charges are no longer allowed to be calculated on a contract path basis and the length of that transitional period is left to the discretion of individual Member

States. It follows that Article 13(1) of Regulation 715/2009 is not directly applicable (as a matter of EU law) and is, therefore, incapable of invalidating any provision of the Transit Contract.

(2866) In any event, the practical significance of this claim is unclear. Naftogaz has not responded to Dr Moselle's analysis that the use of entry-exit tariffs, rather than a contract-path system, would make no necessary difference to the tariff payable under the Contract, see Moselle Report 2.

(2867) In conclusion, therefore, it is denied that the Contract tariff is in breach of the Third Energy Package because it is set on a contract-path basis rather than by reference to entry- and exit-points.

(2868) In any event, there are alternative approaches to setting cost-reflective, entry-exit tariffs under which Gazprom would pay Naftogaz considerably less than what it is paying under the Contract, see Moselle 2. The use of entry-exit tariffs, rather than a contract-path system, would thus make no difference to the tariff payable under the Contract.

7.2.2.6.4.6.5.4 The cost-reflectiveness of the Contract tariff

(2869) As indicated above, Naftogaz argues that the Contract tariff is in breach of the Third Energy Package because it is not cost-reflective as required by Article 13 of Regulation 715/2009. The Contract tariff is said not to be cost-reflective for two reasons: (i) it lacks fixed capacity charges, and (ii) it lacks an explicit regulatory asset base (RAB). Gazprom denies that there has been any breach of the Third Energy Package in this regard.

Capacity Charges and RAB

(2870) First, there is no requirement in the Third Energy Package (Directive 2009/73/EC or Regulation 715/2009) that transmission tariffs must contain (i) fixed capacity charges, or (ii) an explicit regulatory asset base (RAB). Article 13 of Regulation 715/2009 does not descend to such detail: it simply requires that a transmission tariff be cost-reflective (amongst other things).

(2871) Second, the draft network code on transmission tariffs does refer to capacity charging and a RAB. However, the draft network code is not binding as a matter of EU law.

(2872) In any event, the draft network code does not require that transmission tariffs must contain (i) fixed capacity charges, or (ii) an explicit regulatory asset base (RAB):

1. Article 4(2) of the draft network code provides that tariffs are to be "*capacity based [...] unless otherwise foreseen in this paragraph*" (emphasis added by Gazprom). In certain circumstances, the transmission services revenue may also be recovered by commodity-based transmission tariffs, i.e. by way of a flow-based charge or a complementary revenue recovery charge. Moreover, Article 4(5) of the draft network code provides that "*with the aim of promoting efficient use of the transmission system, alternative capacity- or commodity-based transmission tariffs set in a manner other than as referred to in paragraph 2 may be introduced subject to the approval of the regulatory authority for specific capacity products*". Thus it can be seen that a capacity-based transmission tariff is not mandatory.
2. The network code provides that the transmission services revenue (which is to form the basis of the transmission tariffs) is to be based on one of a number of primary cost allocation methodologies. Article 6 of the draft network code provides that various parameters may be used for the application of a given primary cost allocation methodology, including "*where relevant*" the regulated asset base (Article 6(1)). Moreover, Article 8(1) provides that "[t]he necessity to use the information referred to in Article 6 as a parameter for a given primary cost allocation methodology shall be determined by its relevance therefor". Thus, the use of the RAB is not mandatory. It is only to be used where it is considered to be relevant to the particular primary cost allocation method chosen to be used.

(2873) Third, and consistent with the legal position that there is no requirement that transmission tariffs must contain (i) fixed capacity charges, or (ii) an explicit RAB, it is the case that a number of

EU Member States fix their transmission tariffs without reference to fixed capacity charges or to an explicit RAB. As Dr Moselle explains, no fixed capacity fee is found in transmission tariffs in Estonia, Bulgaria or Romania. Moreover, Spain fixes its transmission tariffs without reference to an explicit RAB. Naftogaz' experts criticise the position taken by these EU Member States as not consistent with best practice. But, such practices are not in breach of the requirements of the Third Energy Package. Moreover, although the EU Commission has engaged in an extension process of compliance assurance with the Third Energy Package, it has not taken any action against these Member States for breach of EU law. Even if Naftogaz' criticisms as to best practice are correct (which is denied), it is not for this Tribunal to regulate "best practice", but to consider the legality of conduct.

(2874) In any event, Dr Moselle has calculated cost-reflective tariffs based on a RAB, but using reasonable alternative assumptions to those used by Naftogaz' experts, and has obtained tariffs significantly below those contained in the Contract. The use of a RAB would make no difference to the level of the Contract tariff.

Cost-reflectiveness generally

(2875) Gazprom denies that the tariff under Article 8 of the Contract is in breach of the Third Energy Package because it is not cost-reflective.

(2876) First, Gazprom maintains its case that Naftogaz has failed to establish that the Contract tariff does not reflect Naftogaz' actual costs. In particular:

1. Gazprom maintains its case that the overwhelming majority of the cost to Naftogaz of operating the Ukrainian GTS is the cost of fuel gas. The fact that the 16 October 2008 Agreement specifically provided that the transit tariff was to be set at the 2008 level with an adjustment for fuel gas reflected the parties' mutual acknowledgement that only "cost" to be consider in relation to the transit tariff was the cost of fuel gas consumption "*required for the functioning of the [GTS] of Naftogaz*".

2. As a matter of principle, it is recognised that a distance-based tariff may be more cost reflective for transit. The tariff in the Contract is a distance based formula, comprising a base tariff, an adjustment for inflation and a fuel gas component. It is cost-based in that the predominant operating cost to Naftogaz in transiting fuel is fuel gas, and the greater the distance travelled, the more fuel gas is required. Naftogaz asserts that its fixed costs should also be taken into account in determining whether the Contract tariff is cost-reflective. However, it fails to provide any actual detail of its alleged fixed costs.
3. Gazprom maintains its case that the Ukrainian GTS is likely to already be fully amortised. As Dr Yafimava explains, the Ukrainian GTS was built over the period spanning the late 1960s to the early 1980s, thus its major part should be fully depreciated by now. By comparison, when Gazprom was partially privatised in 1992, it had "*a fully depreciated set of production and pipeline assets*".²⁴⁵ Further, as [REDACTED] explains, the Ukrainian GTS is very old and in need of significant investment in reconstruction and modernisation.²⁴⁶

(2877) Second, as Dr Moselle explains, different methodological options (all consistent with Third Energy Package requirements) can be used to calculate a cost-reflective tariff. Dr Moselle has calculated cost-reflective tariffs using reasonable alternative assumptions to those used by Naftogaz' experts and has obtained tariffs significantly below those contained in the Contract.

(2878) Naftogaz' experts make a number of criticisms of Dr Moselle's calculations. Each of those criticisms is ill-founded and/or misconceived. Gazprom's case in this regard is as follows:

(2879) It is inappropriate in all the circumstances for Naftogaz' experts to base their calculation of the RAB on the basis of numbers determined by Naftogaz' own consultants, EY. This approach gives rise to a potentially significant conflict of interest.

²⁴⁵ Yafimava Report.

²⁴⁶ [REDACTED]

- (2880) A historical cost approach is preferable to a replacement cost approach. As Dr Moselle explains, there are significant practical drawbacks to the use of a depreciated replacement cost approach, and not using actual cost data can result in changes in a TSO's returns that are completely unrelated to its performance (i.e. windfall gains or losses). The fact that the Ukrainian GTS was built under a state-controlled or non-market economy (i.e. under Soviet control does not mean that a historical cost approach is inappropriate: several countries in the EU, such as Poland, Romania, Slovenia, Croatia, Estonia, Latvia and Lithuania which are also former communist states based their regulatory RAB for determining gas transmission tariffs on historical cost.
- (2881) Moreover, it is not appropriate to base a calculation of an appropriate tariff for the Ukrainian GTS by reference to its "replacement value". This is because, first, the Ukrainian GTS is most likely to be fully amortised, and, second, the Ukrainian GTS in its existing form, configuration and operations is quite simply not worth "replacing".
- (2882) All transit assets should be fully depreciated over their remaining useful life, rather than by 2019 (the expiry of the Contract). That is, the depreciation period should extend beyond the term of the Contract. This is because it is not factually correct to assume that there will be no transit flows through Ukraine after 2019.²⁴⁷ Moreover, Naftogaz' approach that, because of uncertainty regarding the continuation of flows after 2019, the network should be fully depreciated by that date, is not economically justifiable.²⁴⁸
- (2883) Naftogaz' experts have used a WACC (weighted average cost of capital) calculated by PwC. Although Naftogaz' experts have made some changes to their approach to the WACC in response to Dr Moselle's first report, there are still a number of problems with that WACC identified by Dr Moselle in his second report.²⁴⁹ Modifying some of the WACC inputs with

²⁴⁷ Moselle Report 2. See also the Yafimava Report.

²⁴⁸ Moselle Report 2.

²⁴⁹ Moselle Report 2.

reasonable alternatives leads to WACC values that are significantly lower than those used by Naftogaz' experts.²⁵⁰

- (2884) As regards operating costs, there are a number of reasonable differences of view in relation to the opex allowance used by Naftogaz' experts which have the potential to significantly reduce the level of the "cost-reflective" tariff calculated by them.
- (2885) Dr Moselle has also identified various changes made by Naftogaz' experts in their second report as regards tax and exchange rate methodology which are unjustified and which have the effect of unjustifiably increasing the level of the "cost-reflective" tariff calculated by them between their first and second reports.
- (2886) As regards the allocation of the "allowed revenue" to transit, there are two primary methodologies recognised in the draft network code for transmission tariffs for the allocation of allowed revenues (i.e. costs) between entry and exit points: the "capacity weighted distance" methodology (which is what Naftogaz' experts purport to use) and the "postage stamp" methodology (which Dr Moselle uses). By using the "postage stamp" methodology, which is equally recognised as valid under the Third Energy Package, Naftogaz's experts proposed tariff is reduced by up to 63%.
- (2887) In the circumstances, Dr Moselle concludes that the changes to the rate-making and asset valuation methodologies for the calculation of the Contract tariff proposed by Naftogaz' experts' in their second report result in in an "*unacceptable windfall gain for Naftogaz*" of USD 13.034 billion (this figure has increased from USD 11.23 billion in their first report).
- (2888) Third, the transit tariff under Article 8 of the Contract was (and continues to be) in the central or upper range of comparable European tariffs for 2010 and later years.²⁵¹

²⁵⁰ Moselle Report 2

²⁵¹ Moselle Report 2 A similar conclusion can be drawn from a report prepared by the European Regulators' Group for Electricity and Gas: see Moselle 2.

- (2889) Finally, the requirement found in Article 13 of Regulation 715/2009 that a transmission tariff should "*reflect the actual costs incurred, insofar as such costs correspond to those an efficient and structurally comparable network operator*" is just one of a large number of different (and possibly competing) requirements and/or objectives are to be applied to the setting of tariffs under the Third Energy Package. These requirements/objectives may sometimes pull in different directions and/or suggest different approaches to the setting of tariffs for different purposes.
- (2890) As a result, the Member State regulator has a great deal of discretion as to the setting of tariffs and/or the methodologies for setting them in order to balance these requirements/ objectives. The magnitude of this discretion is reflected in the extensive consultation requirements contained in the draft network code on transmission tariffs.²⁵² As explained by Gazprom and in the Moselle Report 1, before setting transmission tariffs, EU Member State regulators engage in a lengthy, far reaching and detailed consultation process. With respect, this is not a process which this Tribunal is equipped to do or should be expected to do.
- (2891) Naftogaz seeks to reassure the Tribunal in this regard by asserting that the Ukrainian regulator (NCSREU) has formulated a methodology for the setting of transmission tariffs and, indeed, has set tariffs to be applied to transit across Ukraine, which can and should be applied to Gazprom by the Tribunal in this case. Gazprom denies that such an approach would either be appropriate or open to the Tribunal as a matter of law.
- (2892) First, the Ukrainian transmission tariff methodology which came into force on 27 November 2015 is made under Article 4 of the Ukrainian Natural Gas Market Law of 9 April 2015. The compliance or otherwise of a tariff with that methodology, or with the tariffs established by NCSREU pursuant to that methodology, would be a matter of Ukrainian law, not a matter of EU law under the Third Energy Package. No breach of EU energy law is therefore established by a failure of the Contract tariff to reflect the Ukrainian transit tariff set by NCSREU.

²⁵² See Articles 21 to 23 of the draft Network Code.

(2893) Second, and in any event, the Ukrainian law in this regard is in breach of the requirements of EU law, i.e. the Third Energy Package. Ukrainian transmission tariffs therefore cannot and should not be applied by this Tribunal as a matter of Ukrainian law in any event.

(2894) Finally, even if the Ukrainian tariff should be applied by the Tribunal as a matter of Ukrainian law (which Gazprom denies), the tariffs established by NCSREU only came into effect from 1 January 2016, some nine months after the date of the Statement of Claim in this case. At its very highest, Naftogaz' case that the Contract tariff should be amended so as to reflect the tariff established by NCSREU would only apply from 1 January 2016.

The Contract tariff does not breach the requirements of the TEP as to cost reflectiveness

(2895) In all the circumstances, Gazprom denies that the Contract tariff is in breach of the Third Energy Package because it is not cost-reflective as required by Article 13 of Regulation 715/2009 either generally, or because (i) it lacks fixed capacity charges, and (ii) it lacks an explicit regulatory asset base (RAB).

(2896) Gazprom denies that the tariff under Article 8 of the Contract is in breach of the Third Energy Package because it is not cost-reflective. First, Naftogaz has failed to establish that the Contract tariff does not reflect Naftogaz' actual costs. Second, different methodological options (all consistent with Third Energy Package requirements) can be used to calculate a cost-reflective tariff. Dr Moselle has calculated cost-reflective tariffs using reasonable alternative assumptions to those used by Naftogaz' experts and has obtained tariffs significantly below those contained in the Contract. Naftogaz' experts' criticisms of Dr Moselle's calculations are ill-founded and/or misconceived. Third, the transit tariff under Article 8 of the Contract was (and continues to be) in the central or upper range of comparable European tariffs for 2010 and later years.

7.2.2.6.4.6.6 Cost-reflectivity

(2897) In summary, Gazprom here addresses the legal requirements (as regards tariffs) that are actually imposed by EU/EnCT energy law and by EU/EnCT competition law. Further below,

Gazprom explains that the tariff under the Contract is cost-reflective (when that term is properly understood as a matter of EU/EnCT law).

7.2.2.6.4.6.6.1 EU/EnCT energy law

(2898) In support of its cost-reflectivity requirement under European energy law Naftogaz relies on Article 13(1) of Regulation 715/200. However:

1. Article 13(1) does not apply to the Contract because it deals with tariffs "*applied by*" TSOs but Naftogaz is not a TSO; and
2. Article 13(1) does not have horizontal direct effect in any event as it does not impose a sufficiently clear, precise and unconditional obligation of cost-reflectivity.

(2899) On the question of whether Article 13(1) applies to a tariff which is charged by a party other than a TSO, Naftogaz argues that "*the fact that certain provisions of the relevant energy law impose obligations on the TSO does not mean that these provisions are not applicable to other market participants and network users.*" No authority is cited by Naftogaz in support of that assertion and it is clearly wrong.

(2900) Article 13(1) only refers to "*tariffs [...] applied by the transmission system operators*". Therefore, it does not, and cannot, regulate tariffs applied by parties other than TSOs. Mr Witschen was absolutely clear in his expert evidence that, as a matter of market practice, tariffs in a secondary market contract are not subject to regulation.

(2901) On the question of whether Article 13(1) has horizontal direct effect, Naftogaz does not attempt to establish that Article 13(1) imposes a clear, precise and unconditional obligation that tariff provisions in transit contracts be set at cost reflective levels. This is not a matter that Sir Francis Jacobs has considered.

(2902) However, given the plain terms of Article 13(1) it is apparent that Member States can choose not to apply cost reflective tariffs and opt for "*market-based arrangements*" instead. There is

no "*unconditional*" obligation to apply cost reflective tariffs, and the discretion given to the regulator in applying this requirement prevents it from operating as a directly effective rule that private parties can invoke.

7.2.2.6.4.6.6.2 EU/EnCT competition law

(2903) Naftogaz's primary claim regarding the transit tariff imposed under the Contract is that it is unfairly low and therefore an abuse of a dominant position contrary to Article 102 TFEU/ Article 18(1)(b) EnCT. It is common ground that, in order to establish that a price is unfairly low so as to amount to an abuse under Article 102 TFEU, Naftogaz must prove that the price paid by Gazprom bears no reasonable relation to the economic value of the services bought. This is the test set out by the CJEU in the *United Brands* case.

(2904) However, Naftogaz effectively turns the question of whether a price is unfairly low for the purposes of Article 102 TFEU into a question of whether or not it is cost-reflective. That approach is misconceived.

(2905) The sole basis for Naftogaz' position appears to be the argument that cost-reflectivity is specified in EU energy law, and, pursuant to Case 66/86 *Ahmed Saeed*, this should be taken into account. However, *Ahmed Saeed* merely implies that the sectoral regulatory regime may furnish "*certain interpretative criteria*".

(2906) There is no unconditional requirement in EU energy law that cost reflective tariffs should be applied in all cases.

(2907) When the correct approach is applied, it becomes apparent that there is a reasonable relationship between the tariff under the Contract and the economic value of the transit services provided by Naftogaz.

(2908) Various different methodological approaches can be used to determine cost-reflective tariffs. Naftogaz' calculations reflect methodological choices which result in tariffs higher than the tariff contained in the Contract. Gazprom's expert, Dr Moselle, has calculated cost-reflective

tariffs using reasonable alternative assumptions which are significantly below the Contract tariff.²⁵³

(2909) For these reasons, Naftogaz cannot establish that the tariff under the Contract is unfairly low so as to constitute an abuse for the purposes of Article 102 TFEU. In any event, even if cost reflectivity were determinative, Naftogaz cannot establish that the tariff under the the Contract is not cost reflective.

(2910) Furthermore, Naftogaz' costs are actually the charges it pays Ukrtransgaz. However, it is striking that in this arbitration there has been no analysis at all of those charges.

7.2.2.6.4.6.7 The requirements of Article 13.2 of the Contract

(2911) Naftogaz needs to establish that the replacement tariff meets the requirements of Article 13.2, namely the new provision must have "the economic effect that would be as close as possible to the economic effect of the provision that became invalid or ineffective" ("the Closest Economic Effect Test" or "CEET").

(2912) In determining whether the replacement tariff meets the CEET, it is imperative that the Tribunal takes full account of the basis upon which those claims are made because satisfaction of the CEET requires the replacement tariff (assuming it is higher than the existing tariff) to be as low as possible without infringing the laws which rendered the existing tariff invalid or ineffective.

(2913) There is no basis on which the Tribunal can conclude that the proposed replacement tariff, based on the methodology applied by the Ukrainian regulator in 2015, (the "Ukrainian Methodology") satisfies the CEET. That methodology laid out one route to arrive at a cost reflective tariff. There are many others as explained by Dr Moselle. Even if (contrary to what is submitted

²⁵³ Moselle Report 2.

above), a cost reflective tariff is needed to satisfy the CEET, Naftogaz has entirely failed to establish that following a tariff satisfies the CEET.

(2914) Indeed, the conclusion that Naftogaz has failed to satisfy the CEET is hardly surprising when one considers the instructions given to H&L. They were not instructed to determine a tariff that satisfied the CEET. They were instead asked to follow as closely as possible the Ukrainian Methodology and followed that instruction faithfully. Indeed, so faithfully did they follow that instruction that when the regulator changed his methodology between H&L1 and H&L2, H&L adjusted their calculations in H&L2 to follow the changed methodology.²⁵⁴ Having given that instruction, it is for Naftogaz to explain why such instruction meets the economic effect test under Article 13.2. It has completely failed to do so. Indeed, it has not even attempted to do so.

(2915) It is only with respect to the European energy law claims under the EnCT that the tariff replacement is even claimed on the grounds of the need to meet alleged energy law requirements. As explained above, (i) the EnCT is not directly applicable and cannot be relied on to invalidate Article 8.1 of the Contract, (ii) even if the EnCT applies, the requirement for a regulated tariff is limited to the tariff charged by the TSO, and does not therefore apply to the Contract. Even if Naftogaz somehow overcomes these points, and establishes a need for a cost reflective tariff from October 2011, the tariff sought is certainly not the lowest (i.e. closest to the contractual tariff) cost reflective tariff that could be imposed as a replacement to the existing tariff.

(2916) The Ukrainian Methodology involves numerous choices on options available to arrive at a cost reflective tariff. In almost all cases, the option chosen leads to a higher cost tariff. In those circumstances, it is hardly surprising that the tariff proposed by Naftogaz fails to meet the CEET.

(2917) Before addressing the evidence in relation to the lowest cost effective tariff, two further points should be noted:

²⁵⁴ See Dr Hesmondhalgh at [T7 70 5-15]

1. The question of whether Naftogaz' proposed tariff is the lowest cost effective tariff in compliance with the CEET is relevant not only to tariff replacement under Article 13.2, but also to the separate and indeed preceding issue as to whether the tariff under the Contract is at a level which is cost reflective. If (contrary to Gazprom's submissions) the Tribunal reaches the unlikely conclusion that (for example) competition law requires the tariff to be cost reflective, Naftogaz must establish that (for example in 2010) the contractual tariff is not cost reflective. This it has failed to do. As Dr Moselle has explained, legitimate choices in the methodology for a cost reflective tariff result in the conclusion that the level of the existing tariff is at or very close to a cost reflective level.²⁵⁵
2. In circumstances where the replacement tariff is being sought on the basis of invalidity of the tariff under competition and/or energy law, the criterion for the new tariff is satisfaction of the CEET. The criterion is not a "fair and reasonable" tariff.

(2018) The legitimate choices which could have been made to arrive at a much lower cost reflective tariff include (but are not limited to) valuing the regulatory asset base ("RAB") on a historic cost basis, ensuring consistency between depreciation for setting the RAB and for setting tariffs, setting tariffs by volume (the so-called postage stamp approach), reflecting Naftogaz' actual costs rather than estimated costs regarding taxation, exchange rates etc.

7.2.2.6.4.6.7.1 RAB

Replacement cost versus historic cost

(2019) Dr Hesmondhalgh and Mr Lapuerta followed, in accordance with their instructions, a Depreciated Optimised Replacement Cost ("DORC") approach. Their figure as at 1 January 2010 for the RAB on this basis was UAH 145.4 bn.²⁵⁶

²⁵⁵ See Moselle 2.

²⁵⁶ H&L2, p 214 table 26.

(2920) As Dr Hesmondhalgh confirmed, she did not have instructions from her client to calculate allowed revenue on any basis other than the Ukrainian methodology. Thus, in determining the RAB she applied a DORC and not any other approach.

(2921) It is not in dispute that the RAB for a cost reflective tariff can be arrived at using historical costs rather than replacement costs.

(2922) The historical cost approach, as to which there are a number of variants, is the most common approach for EU regulators as explained in Moselle 1, paragraph 6.34 and clearly supported by the CEER Report on EU Regulatory practice (2015).

(2923) Whilst it is not in dispute that a historic cost approach is a legitimate option for a cost reflective tariff methodology (which is as far as Gazprom needs to go given the CEET requirement), there are also strong reasons for preferring a historic cost approach to replacement cost:

1. The historic cost approach avoids windfall gains and is typically perceived to ensure a greater degree of fairness between the TSO and its customers.
2. Replacement cost is most likely to have economic support where there is a realistic prospect of new entry and competition in the market for transportation (which in this context would mean Ukrtransgaz and another company competing to build new pipelines). This is because it is designed to "*provide efficient price signals to market participants*" to promote efficient entry. In Ukraine in the period in 2010 to 2015 (and even now) there is no realistic prospect of competition for gas transmission services. Thus the economic justification for preferring a replacement cost approach does not apply.
3. Replacement cost methodology is complex to implement, requires significant input on costs, extensive estimation and a plethora of hypothetical engineering assumptions (e.g. related to optimisation).

4. Use of the replacement cost approach gives pipeline owners considerable discretion over the potential outcome of studies to revalue their assets, the objective of the pipeline owner being to maximise its tariff income. This was a point made by Mr Lapuerta in the paper he co-authored with Dr Moselle in 2000.

(2924) In an extraordinary statement for a supposedly independent expert, Dr Hesmondhalgh sought to express an expert opinion that the Ukrainian Government, as the owner of Naftogaz, was not motivated by any desire to maximise the tariff. The statement is extraordinary not only because this is obviously a question of fact and not opinion, but also because her attempt to excuse her client's owner from any motivation to maximise tariff income was unsubstantiated and obviously partial.

(2925) Not only is a historic cost approach a legitimate approach to take (and indeed the most common approach for regulators in Europe), but it would lead to a massively lower tariff than that proposed by Naftogaz. The replacement cost approach was mandated by the SPFU and provides Naftogaz with an enormous windfall gain (around USD 13.46bn)

(2926) The real reason why the obvious route of using a historic cost approach was not investigated by Dr Hesmondhalgh was that her instructions did not require or allow her to do so.

(2927) The Tribunal should conclude that a historic cost approach is a permissible basis for arriving at a cost reflective approach and that this would have led to a far lower tariff than that proposed. For that reason alone, the proposed tariff does not satisfy the CEET.

7.2.2.6.4.6.7.2

RAB value derived from the Ernst & Young Report

(2928) In following the Ukrainian Methodology, Dr Hesmondhalgh started with the value of the RAB as at June 2014 provided by EY (UAH 175 bn). She then made a series of adjustments to arrive at a value of the RAB for 1 January 2010. Those adjustments are described in Hesmondhalgh-Lapuerta². This involved taking 40,000 assets making up the GTS and adjusting for changes in exchange rates, wages and material costs, and then adjusting to take account of depreciated life.

- (2929) The EY Report did not purport to be an independent report. It was a report commissioned by Naftogaz to support its arguments for the new tariff that was to be set by the regulator.
- (2930) In her reports, Dr Hesmondhalgh provided no justification for not starting with the 31 December 2009 revaluation to arrive at an RAB at 1 January 2010. In oral evidence she referred for the first time to reference in the 2010 accounts to "*economic obsolescence*" in page 40 of the accounts as a justification for not using the value in those accounts (her other justification was that the value was "*not relevant*" because she had the EY valuation). She clearly had made no inquiries to ascertain the impact of "*economic obsolescence*" on the replacement valuation as at 31 December 2009. If a reduction in value was being made for "*economic obsolescence*", one would expect this to be reflected in the accounts under the heading "*impairment*". This is because the reduction for economic obsolescence is a reduction in the asset book value and the means for recording this is through an "impairment" charge. If one looks at the accounts at page 39 there is an impairment charge of UAH 1.45bn. So the justification advanced belatedly by Dr Hesmondhalgh is misplaced. This is because one can quantify the impact related to "*economic obsolescence*" and it is minor.
- (2931) In following her instructions, she relied on the EY valuation. In Moselle 2, Dr Moselle sets out detailed and justified concerns as to the reliability of the EY Report.
- (2932) But for the instructions given by Naftogaz to its experts, one would have expected that even if a replacement cost approach was to be followed for the RAB as at 1 January 2010, the obvious course would have been to start from the valuation actually carried out as at 31 December 2009. This of course would have resulted in a far lower RAB value than that now contended for, and accordingly in a far lower tariff as from January 2010.

7.2.2.6.4.6.7.3 Depreciation

- (2933) Depreciation comes into play in the determination of a tariff based on a replacement value RAB in two ways:

1. First, in determining the RAB value at a particular date, it is necessary to first determine the replacement cost and then to depreciate that to reflect how far into its useful (economic) life the asset is. Thus, if you are valuing a replacement pipe where the new cost is UAH100m and its economic life is 60 years and it is 15 years old, then the discount necessary to arrive at the depreciated replacement cost is 25%, resulting in a depreciated replacement value of UAH 75m.
2. Secondly, depreciation going forward is relevant in arriving at the allowed revenues which must be recovered in arriving at the allowed revenue.

(2934) EY arrived at its 2014 RAB value on the basis that the economic life of each asset was the same as its technical life. On that basis, the weighted average of the remaining life of the assets was 25 years. Clearly, if EY had assumed in making its valuation in 2015 for the value at June 2014 that the economic life would have ended in 2019 because there would be no more transit services, the assets would have been very near the end of their economic life as at June 2014. The consequence of that would have been a much lower RAB value (because the depreciation under step 1 above would have been very much greater).

(2935) In arriving at the 2010 RAB value, Dr Hesmondhalgh did not change the assumption underlying the EY valuation as to economic life. She applied the same economic life to work backwards from the 2014 value to a January 2010 value.

(2936) Subsequent to the EY report and following representations made by Naftogaz and Ukrtransgaz, the Ukrainian Minister of Fuel approved a decision to assume for the purposes of fixing the tariff that transit would end in 2019, so that there would be no further economic life of the GTS. This is a decision to which [REDACTED] as the responsible minister within the department, was a party.

(2937) Dr Hesmondhalgh was instructed to assume for the purposes of H&L1 that there would be no transit flows after 2019 *"in the light of statements made by Gazprom in 2014"*. On that

assumption, Dr Hesmondhalgh made a determination of the tariff on the footing that the allowed revenues should ensure full recovery of the depreciated cost (as at 2010) over the next 10 years. This has been done under claim 5 on the basis of a combination of the underpayments based on the new tariff from January 2010 to December 2015 coupled with the allegedly applicable tariff set by the regulator for 2016 to 2019 to enable that recovery. Because the 2016 tariff was set to enable full recovery of the alleged depreciated cost between 2016 and 2019 (ie in just 4 years rather than over 10 years), Dr Hesmondhalgh has provided for an offset.

- (2938) Since the purpose of this exercise by Dr Hesmondhalgh is to ensure recovery of the full depreciated cost by the end of 2019, save as regards the timing for the receipt of the new tariff, it should not matter whether the tariff is accelerated from 2016 or from 2010.
- (2939) However, even assuming no transit after 2019, what does make an enormous difference to the RAB value and therefore to the allowed revenue recoverable between 2010 and 2019 is the inconsistent and indeed contradictory approach taken by Dr Hesmondhalgh to the economic life of the GTS. For the purposes of assessing how far into its economic life the GTS is when arriving at the depreciated replacement cost in 2010 she has taken EY's assumptions (*i.e.* the technical life with no cut off in 2019); yet for the purposes of assessing the remaining economic life from 2010 onwards, the economic life is assumed to end in 2019.
- (2940) These contradictory approaches are irreconcilable. If for the purposes of setting the tariff from 2010, Dr Hesmondhalgh was assuming that the economic life of the assets would end in 2019, then the RAB value as depreciated replacement cost should have been calculated on the same basis. This would have resulted in a much lower RAB than the UAH 146bn applied by Dr Hesmondhalgh and would consequently have resulted in much lower allowed revenues over the period 2010 to 2019 than that implicit in her calculations. Dr Moselle explained that applying a consistent approach utilising the assumption of economic life ending in 2019 results in a reduction of claim 5 by USD 5.68bn, see Moselle 3.

- (2941) The assumption that Naftogaz instructed its expert to make, namely that there would be no transit flows after 2019, on the basis of statements made in 2014, is in any event not supported by the evidence. Gazprom has a continuing need to transit gas through Ukraine after 2019 as explained by Dr Yafimava. Also [REDACTED] gave evidence as to Gazprom's continuing need to transit across Ukraine. It is of note that the EY Report prepared in 2015 carried a forecast of transit volumes through Ukraine up to 2022 with 76 bcm projected for 2022.
- (2942) In her third report Dr Hesmondhalgh surprisingly embellished her instructions by saying that it became apparent from 2010 onwards (rather than 2014) that there would be no transit after 2019. She was unable in her oral evidence to provide any substantiation for her 2010 date.
- (2943) Given that the instruction that transit would end in 2019 (a definitive statement that extends not only to Gazprom's use of the GTS but anyone else's use post 2019) has not been made out, the justification for the accelerated depreciation falls away. The consequence is that depreciation and allowed revenues fall to be determined on the basis of the economic life assumed by EY. On that basis, the replacement tariff and the underpayment claim for 2010 to 2015 is far too high. Claim 5 is overstated by USD 1.10 bn.

7.2.2.6.4.6.7.4 Inclusion of distribution assets

- (2944) The RAB for the purposes of a cost reflective tariff in respect of transit should be limited to the assets utilised for transit of gas. These include the high pressure pipelines along which gas travels both for transit across Ukraine and for transmission within Ukraine. In respect of assets such as pipelines used both for transit and for domestic transmission, an apportionment needs to be made.
- (2945) Assets which are not used for transit at all should not be included in the RAB for transit purposes. The EY RAB includes distribution assets which are only used for distribution of gas to customers within Ukraine. The value of those assets should therefore be excluded. The position is clearly explained in Moselle 2 and Moselle 3. These distribution assets make up around 7%

of the RAB value. There is no justification for their inclusion. Their removal reduces claim 5 by USD 0.42bn.

7.2.2.6.4.6.7.5 OPEX

Exchange rate

(2946) With respect to exchange rates, in the First Export Report by Dr Serena Hesmondhalgh and Mr Lapuerta the correct approach was taken of looking at actual costs in terms of actual exchange rate in each month to convert from UAH to USD. This was then changed in H&L2 for no good reason to look at an exchange rate at the start of January 2010. This change of approach was dictated by a combination of following the approach of the regulator (who was fixing a tariff going forward rather than retrospectively) and the instruction to Dr Hesmondhalgh to follow the Ukrainian Methodology.

(2947) There is no justification for applying a forecast exchange rate when one knows what the actual exchange rate was. Dr Moselle calculates the differences in Naftogaz' claims resulting from this impermissible change. It amounts to USD1.8bn just for claim 5.

7.2.2.6.4.6.7.6 Tax

(2948) It is convenient to address tax under the OPEX heading, even if strictly speaking it is an additional cost outside OPEX. With respect to tax, there is a similar story. It is common ground that tax payable by Naftogaz on profits from transit must be taken into account within OPEX. In H&L1, the correct approach was taken of using the corporate tax rates that were actually in place for the time period of the damages claim (2010 – 2015). In H&L2 this approach was modified without any justification being given to apply the tax rate that was expected at the start of the hypothetical regulatory period (in the case of Naftogaz' claim this was 1 January 2010 when there was of course no regulated tariff in Ukraine). The difference between the rate at the start of the period (25%) and that which was in place during the period 2010 to 2015 is set out in Moselle 2.

(2949) Again Dr Hesmondhalgh and Mr Lapuerta seek to explain their approach by saying they was following the regulator. That is an explanation but not a justification and for the approach on assessing tariffs retrospectively and no justification is advanced.

(2950) It is obvious that, where you are retrospectively deriving a tariff for 2010 following a tariff which itself has been derived from an RAB not calculated until 2015, actual costs for OPEX should be taken into account. No one can seriously argue otherwise and indeed this was the approach taken in the First Export Report by Dr Hesmondhalgh and Mr Lapuerta .

7.2.2.6.4.6.7.7 Royalties

(2951) Naftogaz pays the Ukrainian Government "royalties" on volumes of gas transited. The dispute between the experts on this concerns whether in calculating OPEX royalties on actual volumes transited should be used or those on (higher) hypothetical volumes.

(2952) Dr Moselle's opinion is that royalties actually paid (ie paid on actual volumes transited) should be used. This is because the methodology should give a tariff that compensates Naftogaz for its actual costs and not for costs it has not incurred. H&L does not argue otherwise but simply (and irrelevantly) says it is following the regulator.

Applying actual costs rather than hypothetical costs results in a lower tariff and a lower under-payment claim.

7.2.2.6.4.6.7.8 Potential efficiency gains

(2953) In his first report, Dr Moselle pointed out that the First Export Report by Mr Dr Hesmondhalgh and Mr Laouerta might be overstating OPEX by not adjusting for potential efficiency gains as done in many regulatory schemes. H&L's reaction to this was to determine whether there was an adjustment (downwards) to be made for potential efficiency gains and concluded unreasonable that there should be none.

(2954) The stance taken by Dr Hesmondhalgh and Mr Lapuerta is unreasonable as is abundantly clear from Naftogaz' own accounts that Naftogaz suffered throughout the relevant period (2010

onwards) not only from corruption but also from wide-ranging inefficiencies in operation. There is no justification for refusing to make an adjustment for potential efficiency gains.

(2955) Dr Moselle does make an adjustment to allow for this. This is set out in Moselle 2. The difference to claim 5 is USD 307mn.

7.2.2.6.4.6.7.9 Split between domestic transmission and transit

(2956) The high pressure pipeline network is used both for transit and domestic transmission. In arriving at the allowed revenues for the purposes of the tariff, an apportionment must be made between these two uses.

(2957) In arriving at its apportionment (on average 77% for transit and 23% for domestic transmission), Dr Hesmondhalgh applied a volume/distance methodology (so-called "*capacity weighted distance*") for both transit and domestic volumes to arrive at an apportionment. She justified this on the basis that it was one of the allocation methods envisaged in the Framework Guidelines, a code which is only in draft form.

(2958) Dr Moselle explains in Moselle 1 why Dr Hesmondhalgh has not in fact followed this methodology. It is of note that the regulator himself has applied a volume/distance methodology in setting the tariff for transit but has applied a volume only methodology (the so-called "postage stamp" approach as the tariff like a letter is not set for distance as well as volume) for domestic transmission

(2959) Dr Moselle draws attention to another methodology permissible under the same Framework Guidelines, namely allocation on basis of volume only (ie postage stamp approach). This methodology results in a very different apportionment, on average 50%. Adopting that apportionment results in a massive reduction in the tariff and in the underpayment claim. In relation to claim 5 the reduction in the underpayment claim would be around USD 7.1bn.²⁵⁷

²⁵⁷ See Moselle 2.

(2960) As Dr Moselle explains, the postage stamp methodology (in contrast to Dr Hesmondhalgh's and Mr Lapuerta's capacity weighted distance methodology) is a recognised methodology used in 14 EU Member states.

(2961) It is not necessary for the Tribunal to decide which methodology is to be preferred. All the Tribunal has to decide is whether a postage stamp methodology is a permissible methodology to arrive at a cost reflective tariff. If it is, then given the requirements of Article 13.2 and given that it produces a lower tariff than the rival methodology, the postage stamp methodology should be applied for the purposes of setting any replacement tariff under Article 13.2 (and indeed for determining whether the current tariff was at the relevant time, 2010, 2011 or later) a cost reflective tariff.

7.2.2.6.4.6.7.10 Rate of Return

(2962) In arriving at the allowed revenue, the rate of return on the RAB must be allowed for.

(2963) The differences between the experts in relation to rate of return, other than those arising from the RAB value and depreciation) are set out in Moselle slide 17. Once again, the task for the Tribunal is not to decide which expert is right. Rather, it is to decide whether Dr Moselle's opinions on these issues represent a permissible way to arrive at a cost reflective tariff.

(2964) Thus for example, Dr Hesmondhalgh uses for the risk free rate a 20 year bond rate whilst Dr Moselle uses a 10 year bond rate which he says is more commonly used in EU regulatory practice. Dr Hesmondhalgh does not say that use of a 10 year bond is wrong, nor could she. The same applies to other components of the WACC calculation.

(2965) The difference if Dr Moselle's judgments are followed is a reduction in the tariff and a reduction in claim 5 of USD 900 million.

7.2.2.6.4.6.7.11 Conclusions

(2966) Dr Hesmondhalgh has, in accordance with her instructions, stuck to the Ukrainian Methodology as applied by the regulator. She has not considered whether a lower cost reflective tariff could

be determined. Indeed she did not consider the requirements of Article 13.2 at all - she was not instructed to.

(2967) It is clear that in numerous respects a cost reflective tariff can properly be arrived at which is very much lower than the tariff advanced by Naftogaz for 2010 onwards. Depending on the adjustments to be made the tariff may be close to, if not lower than, the existing tariff at say 2010.

(2968) The proposed replacement tariffs self-evidently do not satisfy the CEET and were not arrived at with that in mind. Any one of a number of potential and justifiable changes in methodology would result in a much lower tariff whether this be application of the historic cost approach for RAB, or the utilisation of the 31 December 2009 accounts valuation for the purposes of RAB at 1 January 2010, or applying a consistent depreciation approach, or having regard to actual operating costs and tax or utilising a postage stamp approach.

(2969) For all these reasons, Naftogaz has failed to satisfy the CEET and has no basis therefore for requiring its replacement tariff, let alone for maintaining its consequent underpayment claim.

7.2.2.6.4.6.8 The party-relationship under the Contract: no breach of the Third Energy Package (EU energy law)

7.2.2.6.4.6.8.1 Introduction

(2970) Naftogaz argues that Gazprom's conduct is in breach of EU competition and energy law as regards the party relationship under the Contract. As indicated above, Naftogaz' objections to the Contract and/or Gazprom's conduct are three-fold in this regard:

1. First, Naftogaz asserts that "*Gazprom's role as super-operator hinders factual implementation of the unbundling requirements in ECT energy law*".
2. Second, Naftogaz asserts that "*Gazprom's refusal to provide Ukrtransgaz with shipper codes prevents Ukrtransgaz from carrying out its functions as TSO and enter into inter-connection agreements with adjacent TSOs*".

3. Third, Naftogaz asserts that "*Gazprom's prevention of virtual reverse flow is restrictive and abusive and prevents Ukrtransgaz from entering into interconnection agreements with adjacent TSOs*".

(2971) Naftogaz' case on the party relationship under the Contract blurs the distinction between EU competition law and EU energy law. This is an impermissible and obstructive approach.

(2972) Gazprom here addresses Naftogaz' case on the party relationship under the Contract for the purposes of EU energy law (the Third Energy Package). Naftogaz' case under EU competition law was addressed by Gazprom above.

7.2.2.6.4.6.8.2 Gazprom's alleged role as "super-operator": no breach of the Third Energy Package

(2973) Naftogaz argues that Gazprom's alleged role as "super operator" "*hinders factual implementation of the unbundling requirements in ECT energy law*". The thrust of Naftogaz' objections is that Gazprom's alleged role as "super operator" hinders unbundling of the TSO (Ukrtransgaz) which is a "*legal requirement under the Third Energy Package*". Naftogaz complains that Gazprom is "*refusing to adhere to mandatory ECT energy legislation*" and the "*legal requirements under the Third Energy Package*".

(2974) Naftogaz further argues that "*Gazprom and Gazprom Export, who interfere with the operation of the Ukrainian GTS by acting as super-operator, and thus obstruct the role of Ukrtransgaz as TSO. If the Contract were to be continued as is, the unbundling prescribed by the applicable energy rules in Ukraine would be futile*".

(2975) Article 9 of Directive 2009/73/EC makes provision for TSOs to be unbundled, i.e. it is required that there be effective separation between the operation of transmission networks and the activities of production and supply of gas. Article 9 provides that Member States should ensure that the same person or persons are not entitled "*directly or indirectly to exercise control over an undertaking performing any of the functions of production or supply*" and "*directly or indirectly*

to exercise control or exercise any right over a transmission system operator or over a transmission system".

(2976) This unbundling can be achieved in a number of different ways (at the discretion of the Member State). Member States can choose between three possible methods of unbundling: "*ownership unbundling*", whereby the transmission system is owned by a company that is not active as a producer or supplier; "*independent system operator*", whereby a person other than the system owner operates the system; or "*independent transmission owner*", whereby the system owner acts as operator but with strong separation requirements between the parts of its business which act as owner and as operator. Moreover, a Member State is allowed to determine that existing arrangements remain in place because they provide stronger protection than the independent transmission owner option would provide.

(2977) Although Ukraine has submitted a proposal to the Energy Community, it is the case that Ukrtransgaz does not yet comply with the requirements imposed on transmission system operators by the Third Energy Package (specifically Articles 9 and 10 of Directive 2009/73/EC) as to independence, unbundling and certification. On 1 July 2016, it would appear that the Ukraine Government passed a resolution on the unbundling of Ukrtransgaz. As at the date of this pleading, Gazprom has not yet been able to consider the implications of this Government resolution.

(2978) In fact, it would appear that there are extremely close links between Ukrtransgaz (the current operator of the Ukrainian GTS) and Naftogaz (which is engaged in "*the functions of production or supply*" in Ukraine) which are clearly contrary to the requirements of Article 9 of Directive 2009/73/EC. According to the Energy Community Secretariat, "*Ukrtransgaz mainly carries out day-to-day operations, whereas the making of general operational and financial decisions as well as the functions of asset management is entrusted mainly to the holding company, Naftogaz*". Moreover, "*Ukrtransgaz [...] only receives a part of the "transit" revenues (the percentage is unknown), whereas the main revenue goes to Naftogaz*". These links are contrary

to the requirement that the transmission system operator (Ukrtransgaz) be independent from the production/supply undertaking (Naftogaz) contained in Article 9 of Directive 2009/73/EC.

(2979) Article 13 of Directive 2009/73/EC sets out the tasks of transmission system operators.

(2980) In summary, these are to

1. *"operate, maintain and develop under economic conditions secure, reliable and efficient transmission [...] facilities to secure an open market, with due regard to the environment"*;
2. *"refrain from discriminating between system users or classes of system users, particularly in favour of its related undertakings"*;
3. provide sufficient information to other TSOs, storage system operators, distribution system operators, etc. sufficient information *"to ensure that the transport ... of natural gas may take place in a manner compatible with the secure and efficient operation of the interconnected system"*;
4. *"provide system users with the information they need for efficient access to the system"*;
5. *"build sufficient cross-border capacity to integrate European transmission infrastructure accommodating all economically reasonable and technically feasible demands for capacity and taking into account security of gas supply"*;
6. *to adopt balancing rules*;
7. to *"procure the energy they use for the carrying out of their functions according to transparent, non-discriminatory and market based procedures"*.

(2981) It is denied that the alleged role of Gazprom (or Gazprom Export) as "super-operator" prevents or would prevent Ukrtransgaz from performing these tasks of a TSO for the purposes of the

Third Energy Package (even if it were a properly constituted and independent TSO for those purposes).

(2982) Gazprom does not act as an "operator" of the Ukrainian GTS ("super" or otherwise). It simply puts its own gas on to the Ukrainian GTS and, once that gas has been carried across the Ukrainian GTS to Ukrtransgaz/Gazprom, Gazprom accepts that gas and checks that the volumes delivered on to the GTS are the same as those taken off it.

(2983) Finally, it is denied that the alleged role of Gazprom (or Gazprom Export) as "super-operator" prevents Ukrtransgaz from engaging in "*effective unbundling*". In this regard, Naftogaz refers in particular to paragraph 962 of its Statement of Claim. In the latter paragraph, Naftogaz asserts that "*the Ukrainian legislator has implemented the requirement of legal unbundling of supply and transmission by designating Ukrtransgaz as TSO of the Ukrainian GTS*". As indicated above, it is clearly not the case that Ukraine has complied with the legal requirements contained in Article 9 of Directive 2009/73/EC as to unbundling by designating Ukrtransgaz as TSO.

(2984) Naftogaz further asserts that "*the current party-relationship and the implementation of the Transit Contract hinder any real functional unbundling*". That is not the case. It is Ukraine that has failed to ensure effective unbundling of the Ukrainian TSO. Gazprom is not responsible for that failure.

(2985) In all the circumstances, Naftogaz has failed to establish that Gazprom's alleged role as "super operator" is in breach of the requirements of the Third Energy Package.

7.2.2.6.4.6.8.3 Shipper codes and virtual reverse flow: no breach of the Third Energy Package

(2986) Naftogaz' case is that Gazprom's alleged conduct in refusing to provide shipper codes and in preventing virtual reverse flow is preventing Ukrtransgaz from entering into interconnection agreements with adjacent TSOs. As regards the factual context of these allegations, Gazprom maintains the submissions set out in its Defence and Counterclaim.

(2987) In any event, there is no rule under the Third Energy Package which would require Gazprom (or Gazprom Export) to provide its shipper codes to Ukrtransgaz, nor is there any rule under the Third Energy Package which would require Gazprom (or Gazprom Export) to enter into virtual reverse flow arrangements.

(2988) As regards shipper codes, Naftogaz asserts that Gazprom's refusal to provide shipper codes "*hinders Ukrtransgaz from carrying out an important function as TSO*", i.e. its responsibilities under Article 12 of Regulation 715/2009. Naftogaz describes these Article 12 responsibilities as being "*cooperation with adjacent TSOs and facilitating cross border trade, including matching gas flows at the interconnection points between adjacent transmission systems*".

(2989) Naftogaz does not correctly describe what Article 12 of Regulation 715/2009 provides. Article 12 simply sets out a general obligation on TSOs to engage in regional cooperation as follows:

"1. Transmission system operators shall establish regional cooperation within the ENTSO for Gas to contribute to the tasks referred to in Article 8(1), (2) and (3). In particular, they shall publish a regional investment plan every two years, and may take investment decisions based on that regional investment plan.

2. Transmission system operators shall promote operational arrangements in order to ensure the optimum management of the network and shall promote the development of energy exchanges, the coordinated allocation of cross-border capacity through non-discriminatory market-based solutions, paying due attention to the specific merits of implicit auctions for short-term allocations and the integration of balancing mechanisms"

(2990) Any alleged failure by Gazprom to provide shipper codes to Naftogaz has not prevented it from establishing interconnection arrangements with adjacent TSOs in order to facilitate physical reverse flow. Shipper codes are not required, for example, for Naftogaz to be able to export gas from Ukraine, or for Naftogaz to arrange for imports of gas via physical reverse flow into Ukraine.

- (2991) Moreover, any alleged failure by Gazprom to provide shipper codes to Naftogaz could not prevent or hinder Ukrtransgaz from carrying out its responsibilities as set out in Article 12 of Regulation 715/2009. Naftogaz has declined to explain how any such alleged failure could do so.
- (2992) Furthermore, given the extremely close links between Ukrtransgaz (the current operator of the Ukrainian GTS) and Naftogaz (which is engaged in "*the functions of production or supply*" in Ukraine) described above, it would be inappropriate and potentially anti-competitive were Gazprom to provide its confidential shipper codes to Ukrtransgaz/ Naftogaz where Naftogaz is a potential competitor to Gazprom in onward supply of gas outside Ukraine.
- (2993) Shipper codes can serve no practical purpose other than implementing virtual reverse flow to Ukraine. As regards virtual reverse flows, Naftogaz itself recognises that there is no legal obligation under the Third Energy Package for TSOs to provide virtual reverse flow. There is clear authority to the effect that the Third Energy Package does not make the provision of reverse flows mandatory.
- (2994) Indeed, in 2013 there were at least 19 cross-border gas interconnection points in the EU that did not offer virtual reverse flows.
- (2995) In any event, Gazprom has not acted unreasonably so as to prevent Ukrtransgaz from entering into virtual reverse flow ("VRF") arrangements. Gazprom in fact participates and makes use of VRF at many interconnection points in Europe where it is established, and has no principled objection to its use. However, the provision of shipper codes by Gazprom would not in itself be sufficient in order to establish VRF. In order to establish VRF at any interconnection point there would need to be a set of arrangements in place that addresses the entire array of technical, financial and legal issues that arise from VRF trades.
- (2996) Naftogaz complains, in particular, that Eustream has refused to enter into an interconnection agreement with Ukrtransgaz "*partly*" because Gazprom has failed to provide its shipper codes. However, at no time has Naftogaz or Ukrtransgaz approached Gazprom or Gazprom Export

with a considered proposal for VRF, either alone or together with Eustream. Nor has Gazprom or Gazprom Export received such a proposal from Eustream or the Slovakian TSO. On the contrary, it would appear to be in Eustream's commercial interests not to agree to VRF at Vel'ké Kapušany, as such arrangements would impact on its income from Gazprom's transit fees at that interconnection point. As a result, in response to Ukrtransgaz' requests for reverse flow from Slovakia, Eustream has put into operation reverse flow to Ukraine through a second interconnection point on its border with Ukraine (at Budince) using the Vojany-Uzhgorod pipeline. In this way, Eustream receives ship or pay fees from Gazprom Export in respect of Vel'ké Kapušany and from Naftogaz in respect of Budince.

(2997) ██████████ responds in particular to the allegations made by ██████████ for Naftogaz that, in June 2012, Gazprom's actions in refusing to supply its shipper codes allegedly prevented Naftogaz from buying gas from RWE by way of VRF from Slovakia to Ukraine. Eustream did not request that Gazprom Export provide or confirm shipper codes for the purposes of the testing procedure, or indeed otherwise liaise with Gazprom Export with requests to facilitate VRF from Slovakia to Ukraine in 2012/13. As explained above, it would appear that that Eustream has its own commercial motivations for refusing to enter into an interconnection agreement with Ukrtransgaz in respect of Vel'ké Kapušany.

(2998) Therefore, there is nothing in Naftogaz' assertion that the failure on the part of Ukrtransgaz to establish VRF at Vel'ké Kapušany is due to the Contract and/or Gazprom's conduct.

(2999) In conclusion, Naftogaz has failed to make any case that Gazprom's alleged conduct in refusing to provide shipper codes and in preventing virtual reverse flow is in breach of the Third Energy Package.

7.2.2.6.4.6.8.4 Capacity allocation and congestion management: no breach of the Third Energy Package

Introduction

(3000) Naftogaz makes its case as regards capacity allocation and congestion management under EU energy law. In this regard, Naftogaz' arguments are, in summary, as follows:

1. The Contract is contract path based and thus in breach of the entry-exit system requirements under Article 13(1) of Regulation 715/2009.
2. The Contract must be subject to the capacity booking and congestion management rules under Article 16 of Regulation 715/2009.

(3001) As regards capacity allocation and congestion management under EU energy law, it is Gazprom's case that Naftogaz has failed to establish any breach of the Third Energy Package requirements as regards capacity allocation and congestion management.

No breach of the entry-exit requirements

(3002) Naftogaz has failed to establish that the Contract is contrary to Regulation 715/2009 as a result of it being based on contract paths, rather than on an entry-exit system.

(3003) In this regard, Gazprom maintains the case set out in its Defence and Counterclaim in this regard. The criticisms of Mr Witschen's approach to this issue, which are made in Naftogaz' Reply, are addressed and rebutted in Section 5 of his Second Report.

(3004) Gazprom also addresses the issue of entry-exit requirements and repeats those submissions here.

7.2.2.6.4.6.9 No requirement for the Contract to be subject to Article 16 of Regulation 715/2009

(3005) Further, Naftogaz has failed to establish that the Contract is contrary to Article 16 of Regulation 715/2009, or that Gazprom should be subject to the same capacity allocation and congestion management rules as all users of the Ukrainian GTS.

(3006) Article 16 provides as follows:

"1. The maximum capacity at all relevant points referred to in Article 18(3) shall be made available to market participants, taking into account system integrity and efficient network operation.

2. The transmission system operator shall implement and publish non-discriminatory and transparent capacity-allocation mechanisms [...]

3. The transmission system operator shall implement and publish non-discriminatory and transparent congestion management procedures [...]".

(3007) Efficient capacity allocation and congestion management procedures aim to achieve the *"reallocation of unused capacity to those market participants who wish to make use of it, allowing more efficient and competitive use of the gas networks"*.

(3008) Thus, insofar as it applies in this case (which Gazprom denies), Article 16 imposes obligations on the operator of the Ukrainian GTS, i.e. upon Ukrtransgaz. Article 16 imposes high-level obligations on TSOs as regards capacity allocation mechanisms and congestion management procedures. Detailed requirements as to capacity allocation mechanisms are set out in Regulation 984/2013 establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems. Detailed requirements as to congestion management procedures are set out in Annex I to Regulation 715/2009.

(3009) In summary, it is Gazprom's case that there is nothing in the Contract that would prevent Ukrtransgaz from fulfilling the requirements of Article 16 of Regulation 715/2009. Moreover, the detailed requirements as to capacity allocation mechanisms and congestion management procedures do not apply to interconnection points between EU countries and third countries. Therefore, those requirements do not apply to the Contract, which is concerned with entry- and exit-points to and from Ukraine (rather than intra-EU entry- and exit-points). In any event, the rules recognise that existing contracts (such as the Transit Contract) may remain in existence

until their expiry date and not be subject to the capacity allocation mechanisms and congestion management procedures.

(3010) Gazprom develops these points as follows.

7.2.2.6.4.6.9.1 Article 16 of Regulation 715/2009

(3011) First, there is nothing in the Contract that would prevent Ukrtransgaz from fulfilling the requirements of Article 16 of Regulation 715/2009. Under the Contract there is a clear procedure for determining the volumes of Gazprom's gas that will be transported across the Ukrainian GTS. Ukrtransgaz is able to determine in advance the capacity that is available for third-party use. Thus, Ukrtransgaz can manage its capacity portfolio and can freely market its available capacity to make the most efficient use of capacity pursuant to Article 16 of Regulation 715/2009. Therefore, it is not the case that Contract TKGU is contrary to Article 16 of Regulation 715/2009.

7.2.2.6.4.6.9.2 Congestion management procedures under Annex I to Regulation 715/2009

(3012) Second, Annex I to Regulation 715/2009 sets out binding Guidelines on the "*principles of capacity-allocation mechanisms and congestion-management procedures concerning transmission system operators and their application in the event of contractual congestion*". Annex I sets out detailed rules to deal with congestion, i.e. to ensure that unused capacity is made available for use and/or more efficient allocation to potential users.

(3013) The Annex contains, at Article 2.2, four main mechanisms to deal with congestion (which have different implementation times): the surrender of contracted capacity, an oversubscription and buy-back scheme, and a long-term use-it-or-lose-it ("UIOLI") mechanism (which are to be implemented from 1 October 2013), and a firm day-ahead UIOLI mechanism (which is to be implemented from 1 July 2016).

(3014) However, article 2.2.1, paragraph 1 of Annex I to Regulation 715/2009 makes it clear that the requirements of Article 2.2 "*shall apply to interconnection points between adjacent entry-exit*

systems [...] between two or more Member States or within the same Member State" (emphasis added by Gazprom). However, it only provides that such requirements "may [...] apply to entry points from and exit points to third countries, subject to the decision of the national regulatory authority" (emphasis added). It is therefore the case that the measures for congestion management as set out in Annex I of Regulation 715/2009 are not mandatory for entry and exit points to and from Ukraine (as a third country).

(3015) In this regard, Dr Yafimava explains:

"ACER has published the lists of interconnection points to which the network code on Capacity Allocation Network Code applies (as part of its annual reports on contractual congestion on interconnection points). Notably, interconnection points between Ukraine and Poland (Drozdovichi-Drozdowicze) and between Ukraine and Hungary (Beregdaroc-Beregovo) were included whereas interconnection points between Ukraine and Romania (Isaccea-Orlovka, Isaccea-Orlovka I, Isaccea-Orlovka II, Isaccea-Orlovka III, and Mediesu Aurit-Tekovo) and between Ukraine and Slovakia (Uzhgorod-Vel'ké Kapušany) were marked as 'non-CAM relevant' (CAM being shorthand for "capacity allocation mechanism"). This suggests that the Polish and the Hungarian national regulatory authorities decided to apply the Capacity Allocation Network Code to interconnection points with third countries (such as Ukraine), whereas the Slovak and the Romanian regulators have made no such decision".

7.2.2.6.4.6.9.3 Capacity allocation mechanisms under the Network Code (Regulation 984/2013)

(3016) Finally, the Network Code on Capacity Allocation Mechanisms (Regulation 984/2013) sets up "*standardised capacity allocation mechanisms in gas transmission systems*". The Network Code provides that "*auctions shall be used for the allocation of capacity at interconnection points*" (Article 8.1). Therefore, all available capacity (including capacity made available as a result of the application of the congestion management procedures set out above) shall be allocated by way of "*an auction procedure for relevant interconnection points within the Union*"

(emphasis added by Gazprom). The Network Code sets out how adjacent TSOs are to cooperate in order to facilitate such capacity auctions.

- (3017) Article 2 of Regulation 984/2013 provides that "*this Regulation shall apply to interconnection points*" (emphasis added). However, it provides only that it "*may [...] apply to entry points from and exit points to third countries, subject to the decision of the national regulatory authority*" (emphasis added). It is therefore the case that the measures for capacity allocation as set out in the Network Code on Capacity Allocation Mechanisms (Regulation 984/2013) are not mandatory for entry and exit points to and from Ukraine (as a third country).
- (3018) As explained above, it would appear that the Polish and the Hungarian national regulatory authorities have decided to apply the Network Code on Capacity Allocation Mechanisms to interconnection points with third countries (such as Ukraine), whereas the Slovak and the Romanian regulators have made no such decision.
- (3019) In any event, the Network Code recognises that existing contracts (such as the Transit Contract) may remain in existence until their expiry date and not be subject to the capacity allocation mechanisms. For example, one of the core provisions of the Network Code is the requirement that capacity products on either side of an interconnection point must be offered in a single bundle (insofar as there is firm capacity). This means that adjacent TSOs must bundle their capacity products and offer the bundle in the capacity auction. This ensures that bidders for capacity are able to obtain both entry and exit capacity (and do not run the risk of only obtaining capacity on only one side of the border).
- (3020) In this regard, Article 20.5 of the Network Code (Regulation 984/2013) provides that "*all capacity shall be bundled at the earliest opportunity*". However, as regards "*existing transport contracts for unbundled capacity*", they are allowed to continue in existence until their expiration date (as long as they are not "*renewed, prolonged or rolled over*" after that date). It is only after expiry of such contracts, that the capacity reserved under such contracts becomes "*available capacity*" for the purposes of the Network Code, and therefore subject to the auction

process. Therefore, as an existing transport contract for unbundled capacity, the Contract is not subject to the requirements of the Network Code (until its expiry date).

Conclusion on application of detailed rules on capacity allocation and congestion management

(3021) Naftogaz is therefore wrong to claim that the "*rules on capacity and congestion management are compulsory*" in the present case. Further, it is not the case that Gazprom should be subject to the same capacity allocation and congestion management rules as all users of the Ukrainian GTS. The Contract relates to transit across Ukraine and, as explained in the previous paragraphs, the measures for capacity allocation and congestion management as set out in Regulation 715/2009 and the Network Code on Capacity Allocation Mechanisms are not mandatory for entry and exit points to and from Ukraine. In any event, the rules recognise the existence of existing contracts (such as the Transit Contract TKGU) and do not require them to be disturbed before their expiry date.

7.2.2.6.4.6.9.4 Balancing: no breach of the Third Energy Package

(3022) Naftogaz sets out its case on balancing under EU energy law. In summary, Naftogaz' case appears to be as follows:

1. The "*rudimentary balancing regime in the Contract*" does not fulfil the requirements of the Third Energy Package.
2. The provisions of the Contract "place the responsibility for the balancing of input and off-take of gas from the Ukrainian GTS with Naftogaz". In particular, clause 10.4 of the Contract "imposes a cost on Naftogaz if Gazprom does not balance its position".

Balancing under the Third Energy Package

(3023) By Articles 13(3) and 41(6) of Directive 2009/73/EC, transmission system operators are required to set rules for balancing the GTS which are "*objective, transparent and non-*

discriminatory, including rules for the charging of system users of their networks for energy imbalance". Any such charges/ tariffs have to be set by reference to a non-discriminatory and cost reflective methodology.

- (3024) The purpose of such balancing rules is to ensure that there is a balance between the in-put and off-take of gas on a transmission system so as to maintain the pressure of a pipeline system and not to endanger that system. This may require "*the charging of system users [...] for energy imbalance*". However, such charges should be transparent, non-discriminatory and cost-reflective so as not to discourage new entrants "*which may have more difficulty balancing their overall sales portfolio than companies already established within a relevant market*".
- (3025) The primary responsibility for ensuring balancing is on the network users themselves. In Article 21(3) of Regulation 715/2009, it is stated that imbalance charges must provide "*appropriate incentives on network users to balance their input and off-take of gas*" (emphasis added).
- (3026) Regulation 312/2014 establishing a Network Code on Gas Balancing of Transmission Networks sets out detailed balancing rules. However, in common with the other Network Codes, the detailed provisions of the Code only apply within the borders of the EU: Article 2 of Regulation 312/2014 provides that it "*shall apply to balancing zones within the borders of the Union*" (emphasis added by Gazprom). Therefore, in common with other Network Codes, its provisions do not apply to the Contract. Thus, insofar as Naftogaz seeks to rely on detailed requirements of the Balancing Network Code, their arguments should be rejected.
- (3027) As a matter of principle, however, it should be noted that the Balancing Network Code recognises and reinforces the position set out in Directive 2009/73/EC and Regulation 715/2009 that the primary responsibility for ensuring balancing is on the network users themselves: Article 4.1 of the Balancing Network Code (Regulation 312/2014) provides that "*the network users shall be responsible to balance their balancing portfolios in order to minimise the need for transmission system operators to undertake balancing actions set out under this Regulation*".

(3028) Naftogaz appears to accept that this is the case. Naftogaz states that "where the network users are unable efficiently to balance their input and off-take, the TSOs will have to undertake most of the network balancing to ensure the integrity of the system" (emphasis added by Gazprom).

The balancing regime under the Contract does not breach Third Energy Package requirements

(3029) Naftogaz' first argument is that the "*rudimentary balancing regime in the Contract*" does not fulfil the requirements of the Third Energy Package.

(3030) Gazprom maintains the case that the provisions of the Contract, and the system of daily nominations by Gazprom, ensure that there is a balance between the amount of gas put in to the Ukrainian GTS by Gazprom and the amount taken off the Ukrainian GTS for onward provision to Gazprom's European off-takers. Transit under the Contract is therefore completely balanced.

(3031) In this way, Gazprom has accepted responsibility for balancing in respect of its gas transiting through Ukraine. This is consistent with the principle under the Third Energy Package that the primary responsibility for ensuring balancing is on the network users themselves. The provisions of the Contract ensure that in-puts and off-takes of gas onto the Ukrainian GTS are balanced. This is also consistent with the requirements of the Third Energy Package as set out above.

(3032) Naftogaz asserts that "*it is clear that the rudimentary balancing regime in the Contract does not fulfil*" the requirements of the Third Energy Package. However, there is nothing which make good this assertion (Naftogaz simply gives a generalised description of the balancing requirements of the Third Energy Package). The provisions of the Contract are consistent with the requirements of the Third Energy Package.

(3033) Under its second argument, Naftogaz argues that "*the Transit Contract allows Gazprom daily variations and essentially provides Gazprom with free balancing services within the stipulated range of allowed variations*". This appears to be a reference to the provisions of Article 3.4 of

the Contract, under which there are permissible variations in transit volumes of up to +/-4.5% at the Uzhgorod exit point and +/-6.5% at all other exit points.

- (3034) There is an important conceptual distinction between balancing (for the purposes of the Third Energy Package) and flexibility, which Naftogaz appears to blur, see the Yafimava Report.
- (3035) The minimal flexibility of +/-4.5% at the Uzhgorod exit point and +/-6.5% at all other exit points under the Contract is not in breach of the Third Energy Package requirements. Article 4.1 of the Balancing Network Code (Regulation 312/2014) provides that "*the network users shall be responsible to balance their balancing portfolios in order to minimise the need for transmission system operators to undertake balancing actions set out under this Regulation*" (emphasis added by Gazprom). The minimal flexibility under Article 3.4 of the Contract is not inconsistent with this provision.
- (3036) In any event, the minimal flexibility under Article 3.4 of the Contract does not prevent Ukrtransgaz (the operator of the Ukrainian GTS) from fulfilling its obligations under the Third Energy Package as regards balancing. The provisions of the Contract and the Technical Agreement ensure that in-puts and off-takes of gas onto the Ukrainian GTS are balanced.
- (3037) Naftogaz also objects to the provisions of Article 10.4 of the Contract on the basis that it "*imposes a cost on Naftogaz if Gazprom does not balance its position*".
- (3038) On the contrary, Article 10.4 of the Contract provides that "*if the Natural Gas delivered to the Ukrainian gas transportation system for transit purposes is taken by [Naftogaz], the entire volume of such gas taken shall be documented as gas purchased under [Contract KP]*" and the price for such gas shall be set in accordance with Article 4.4(3) of the Sales Contract.
- (3039) In other words, it is only if Naftogaz has failed to hand back to Gazprom the same volume of gas at the western border of Ukraine, as it had accepted from Gazprom at the eastern border of Ukraine, that it must pay for the difference. This does not "*impose balancing payments from Naftogaz to Gazprom*", nor does it amount to the imposition of "*a cost on Naftogaz if Gazprom*

does not balance its position". Article 10.4 simply requires Naftogaz to pay for Gazprom's transit gas if it takes such gas for itself.

(3040) In conclusion, Naftogaz' case that the Contract is contrary to the balancing requirements of the Third Energy Package should be rejected.

7.2.2.6.4.6.9.5 Restrictions on the use of interconnectors: no breach of the Third Energy Package

(3041) Naftogaz makes its case on restrictions on the use of interconnectors under EU energy law. No positive case is made by Naftogaz that the Contract and/or Gazprom's conduct as regards the use of interconnectors is in breach of the requirements of the Third Energy Package. Naftogaz simply makes various submissions about general aims and provisions of the Third Energy Package.

(3042) Insofar as necessary, Gazprom repeats and relies upon the previous Sections of its Statement of Rejoinder as regards alleged breaches of the requirements of the Third Energy Package. In any event, Naftogaz has failed to make out any case that the Contract and/or Gazprom's conduct as regards the use of interconnectors is in breach of the requirements of the Third Energy Package.

7.2.2.6.4.7 Alleged breaches of Ukrainian energy law

7.2.2.6.4.7.1 The relevant provisions of Ukrainian energy law

(3043) Naftogaz relies upon the 2015 Ukrainian Gas Market Law, which was adopted by the Ukrainian National Assembly on 9 April 2015, and which came into force on 8 May 2015. The majority of its provisions became effective on 1 October 2015, except for the provisions on the unbundling of transmission systems and transmission system operators, which became effective on 1 April 2016.

(3044) As Naftogaz explains, the 2015 Ukrainian Gas Market Law sets out "*fundamental principles of the gas market operation*", including provisions on unbundling and independence of the TSO. However, "*tariffs, balancing rules, norms governing the powers of the Regulator, capacity*

allocation and congestion management, its general rules and principles are to be further specified in secondary legislation".

(3045) The provisions of Ukrainian secondary legislation upon which Naftogaz relies are as follows:

1. The Ukrainian Gas Transmission System Code, which (mainly) came into force on 27 November 2015.
2. The Standard Natural Gas Transmission Contract. Naftogaz does not specify when that came into force, but it does state that, on 11 February 2016, the Ukrainian regulatory (NCSREU) ordered Naftogaz and Ukrtransgaz to bring their contractual relations regarding the transit of natural gas in compliance with the aforementioned Standard Contract by 1 March 2016.
3. The Ukrainian Tariff Methodology, which also came into force on 27 November 2015.

(3046) It is also the case that the Ukrainian regulator (NCSREU) adopted various resolutions in accordance with the Ukrainian Tariff Methodology on 29 December 2015, including Resolution No 3158 on trans-border tariffs, and Resolution No 3159 on domestic tariffs.

(3047) As explained above, the relevant provisions of Ukrainian energy law did not come into effect until various dates in late 2015 and early 2016 (all of which postdate Naftogaz' Request for Arbitration in this case (13 October 2014) and the date of Naftogaz' Statement of Claim (30 April 2015)). At its very highest, therefore, any case pleaded by Naftogaz which is based on provisions of Ukrainian energy law cannot apply prior to these dates in late 2015 and early 2016.

(3048) Gazprom maintains that Ukrainian energy law is not applicable either pursuant to Article 9(3) of the Rome I Regulation or pursuant to Swedish law. Moreover, it is Gazprom's case that these provisions of Ukrainian law cannot apply in any event, as they are contrary to the requirements of the Third Energy Package (which they are supposed to implement). Alternatively, neither

the Contract nor the alleged conduct on the part of Gazprom breaches any requirements of Ukrainian energy law.

7.2.2.6.4.7.2 The lack of independence of the Ukrainian regulator (NCSREU) contrary to the requirements of the Third Energy Package

- (3049) As a Contracting Party to the Energy Community, Ukraine is obliged to comply with the energy *acquis*, including Directive 2009/73/EC and Regulation 715/2009, by 1 January 2015.
- (3050) The Third Energy Package sets out stringent requirements as to the independence of the national regulatory authority. Directive 2009/73/EC obliges Member States to "*guarantee the independence*" of the regulatory authority and to "*ensure that it exercises its powers impartially and transparently*" by ensuring that the regulatory authority is "*legally distinct and functionally independent from any other public or private entity*", and its staff and the management "*act independently from any market interest*" and "*do not seek or take direct instructions from any government or other public or private entity*" (Article 39.4 of Directive 2009/73/EC).
- (3051) Furthermore, Member States must "*in particular ensure that the regulatory authority can take autonomous decisions [...] has separate annual budget allocations, with autonomy in the implementation of the allocated budget*" and that "*the members of the board or, in absence of a board, its top management are appointed for fixed term of five up to seven years, renewable once*" (Article 39.5 of Directive 2009/73/EC).
- (3052) Ukraine has failed to fulfil its obligations in this regard. The Ukrainian regulator (NCSREU) does not fulfil the independence requirements of the Third Energy Package.
- (3053) Article 1(32) of the 2015 Ukrainian Gas Market Law defines the Regulator for the purposes of that Law as being NCSREU. Article 4(1) provides that "*the state regulation of the natural gas market shall be performed by the Regulator*" and the remainder of Article 4 sets out the principal tasks, "*competences*" and rights of the Regulator. However, the 2015 Ukrainian Gas Market Law does not contain any provisions guaranteeing the independence of NCSREU. To Gazprom's knowledge, nor does any other provision of Ukrainian law.

(3054) On the contrary, the 2015 Ukrainian Gas Market Law provisions on certification of a TSO require NCSREU to take into account the views of the Ukrainian Ministry of Energy and the Coal Industry (Article 26.3). This is clearly contrary to the requirements of the Third Energy Package that the regulator acts independently and does *"not seek or take direct instructions from any government or other public or private entity"* (Article 39.4 of Directive 2009/73/EC).

(3055) Moreover, the presidential directive which set up NCSREU makes it clear that the regulatory authority is not independent from the state, as it is *"subordinated to the Ukrainian president of Ukraine and accountable to the Ukrainian parliament"*.

(3056) The Energy Community Secretariat has repeatedly and publicly acknowledged the lack of independence of NCSREU and the failure by Ukraine to adopt and implement the necessary legislation to that effect. The Secretariat's assessment of the independence of NCSREU is published on its web site:

1. In relation to NCSREU's decision making powers, it points to undue political intervention in the regulator's independence. It underlines that NCSREU can be liquidated by and is subordinate to decisions of the President of Ukraine, and cites two examples of the Ukrainian President having used its authority to dismiss the management of NCSREU:

"Ukraine has not yet transposed the Third Package with regard to the regulatory authority. In the light of this, [NCSREU]'s competences need to be extended to the complete set of regulatory powers and objectives foreseen under the Third Energy Package.

[NCSREU] has suffered from its lack of independence. It is the only regulatory body in the Energy Community whose establishment is not solely based on legislation. Instead, it is established and can be liquidated by act of the President. The President has made use of this legal possibility already twice in the past as a tool for dismissing [NCSREU]'s management undue political intervention in the regulator's independence.

The independence criteria stipulated in Articles 35(4-5) and 37(16) of Directive 2009/72/EC and Articles 39(4-5) and 41(16) of Directive 2009/73/EC are not met. Legislation in principle grants [NCSREU] independence in its activities. However, [NCSREU]'s decisions are not final but subject to review by the State Committee for Regulatory Policy of Ukraine. NEURC is also legally subordinated to the President.

A legal prohibition for top management to execute political functions exists but restrictions to having an interest in regulated utilities or having an employment relationship with the energy sector including sanction dismissals in case of noncompliance are not in place." (emphasis added by Gazprom.)

2. The Secretariat has further pointed to NCSREU's lack of financial independence from the Ukrainian government:

"[NCSREU] does not have financial independence in setting and allocating its Annual Budget and deciding about human resources. [NCSREU] is financed from the State Budget. Fees for licensed activities up to an overall limit defined by the Cabinet of Ministers are transferred to the State Budget. The use of [NCSREU]'s budget is subject to decisions of the Ministry of Finance based on the Budget Code. [NCSREU]'s staff and management salaries are coupled to those of the public sector."

3. The Secretariat has identified the following "changes in law and regulatory practice" as "key priorities for [NCSREU] in order to comply with the Third Energy Package":

"• [NCSREU]'s competences need to be expanded to the complete set of regulatory powers and objectives foreseen under the Third Energy Package.

• [NCSREU] needs to be granted full financial independence including autonomy in setting staff salaries.

• [NCSREU]'s decisions need to be final.

- [NCSREU] *needs to be established by law only and should not be subordinated to the President.*

- *A rotation scheme for Board members needs to be introduced.*

- *Independent appointment criteria and a transparent procedure for selection of Board members including a selection committee of neutral experts have to be put in place."*

4. Notably, the Secretariat has urged Ukraine to approve and submit to the Ukrainian parliament a Law on the Energy Regulatory Authority, compliant with the Third Energy Package.
5. Ukrainian commentators have also identified a number of ways in which NCSREU fails to fulfil the independence requirements of the Third Energy Package.

(3057) As regards the independence of the regulator, it is relevant that the main decisions which are relevant to these proceedings were taken in 2015 and early 2016, by the regulator, under Mr Vovk, during the period September 2015 to February 2016. What matters is the independence of the NCSREU in the period September 2015 to February 2016.

(3058) The law on independence of the regulator was only enacted by Ukraine much later. It was passed in September 2016 and signed by the President of Ukraine on 23 November 2016.

(3059) ██████████ sought to reassure the Tribunal with regard to the regulator's independence; but this evidence given during the hearing needs to be considered alongside what the Energy Community Secretariat was saying in its public statements at the relevant time.

(3060) The Energy Community Secretariat's July 2016 assessment clearly concluded that the NCSREU did not meet independence requirements under the Third Energy Package.

- (3061) As late as 23 September 2016, the Energy Community Secretariat referred to overcoming "existing independence shortcomings of the national energy regulatory authority as regularly pointed in the Secretariat's annual implementation reports".
- (3062) The Energy Community Secretariat itself stated at the time at which the regulator made the decisions, that the regulator did not meet the requirements of the TEP. This is a fundamental issue that the Tribunal cannot ignore.
- (3063) ██████████ sought to minimise the public statements of the Secretariat by saying that *"they were structural concerns on the regulator, not actual concerns that anybody would follow political orders in drafting secondary legislation"* (emphasis added by Gazprom).
- (3064) It was apparent that ██████████ was only making a statement about his personal knowledge.
- (3065) And his personal knowledge about the extent to which, in practice, the NCSREU was influenced by the Ministry of Energy, the State Property Fund of Ukraine ("SPFU"), other parts of the Government of Ukraine, Naftogaz, Ukrtransgaz etc. was very limited.
- (3066) He did not have personal knowledge that the NCSREU was influenced by the Ministry of Energy or the SPFU in setting the valuation methodology;
- (3067) He did not have personal knowledge that the NCSREU was influenced by the Ministry of Energy letter on accelerated depreciation;
- (3068) He had never even seen the tariff resolutions; and
- (3069) He did not know the background of the head of the NCSREU, Mr Vovk.
- (3070) Mr Vovk was only 24 years when appointed, by Presidential Decree (not an independent selection committee), with no prior experience in the energy sector; his only prior experience was working in a Russian confectionary company co-owned by the President of Ukraine.

(3071) ██████████ confirmed that he participated in the decision making within the Ministry of Energy on accelerated depreciation which led to the letter from the Ministry of Energy to the NCSREU of 17 December 2015.

(3072) ██████████ seemed unconcerned with protecting the independence of institutions in Ukraine.

(3073) The Tribunal obviously appreciates that the NCSREU cannot be compared to an independent regulator in a EU Member State such as Sweden:

1. At the time it made its decisions it did not meet the TEP requirements on independence;
2. Its decisions in this case will have a disproportionate effect on Gazprom, a foreign entity, which is the only real payer of tariffs set for gas transit; and
3. It has no interest, mandate or ability to regulate in a manner which protects the interests of Gazprom as a consumer of Naftogaz.

(3074) In short, it cannot be said that the NCSREU was independent at the time when the relevant regulatory decisions were made.

(3075) This failure by Ukraine (in breach of its obligations under the EnCT) to comply with the requirements of the Third Energy Package as regards the independence of the Ukrainian regulator (NCSREU) has the following consequences:

1. As noted above, it would be unfair and unconscionable for the Tribunal to impose upon Gazprom any rules and regulations which would be applied by the Ukrainian regulator in these circumstances.
2. Naftogaz cannot "*cherry pick*" which aspects of the Third Energy Package are to be applied in this case and which are not.
3. The Ukrainian energy laws set out above purport to implement the requirements of the energy *acquis communautaire* in line with Ukraine's obligations under Article 10 of the

EnCT. Insofar as they fail to do so, they are contrary to Ukraine's obligations under the EnCT and cannot be relied upon in the current proceedings.

4. In particular, any provision of primary or secondary Ukrainian legislation which requires the involvement of the Ukrainian regulator, such as the setting of tariffs, balancing rules, capacity allocation and congestion management rules, etc., cannot be applied to and/or relied upon against Gazprom in the current proceedings because it would be unfair and unconscionable for the Tribunal to impose upon Gazprom such rules and regulations which would be applied by a regulator which fails to comply with the independence requirements of Third Energy Package.
5. Moreover, it would be unconscionable and unfair for this Tribunal to impose upon Gazprom tariffs which have been set in Resolution No 3158 on trans-border tariffs in purported implementation of Third Energy Package principles by a regulator that conspicuously fails to comply with the independence requirements of the Third Energy Package.

(3076) In any event, and without prejudice to these preliminary arguments, for the reasons set out below, the Contract and/or Gazprom's conduct does not breach Ukrainian legal requirements as regards the transit tariff under the Contract; the party-relationship under the Contract; capacity allocation and congestion management arrangements; balancing arrangements and the use of interconnectors.

7.2.2.6.4.7.3 Transit tariff: no breach of Ukrainian energy law

(3077) Naftogaz argues that EnCT energy law applies as mandatory Ukrainian law, due to Ukraine's monist system. Naftogaz also argues that EnCT energy law applies as Swedish law both by virtue of the horizontal direct effect of the Third Energy Package and/or non-discrimination principles under Article 7 EnCT. Naftogaz then cross refers to its arguments under EnCT energy law.

(3078) There is no basis for applying Ukrainian law "as a fact" pursuant to Swedish law or otherwise.

- (3079) Naftogaz argues that the provisions of the Contract that allegedly contravene Ukrainian mandatory law should be declared invalid under Swedish law since the performance of these clauses would be unlawful in Ukraine. As support for this, Naftogaz refers to various legal sources. None of these sources support Naftogaz' case.
- (3080) The question of Ukrainian law as a fact and impossibility of performance can be ruled out. Naftogaz has not proved that it is legally impossible for any party to perform the Contract and it has in any event not proved that the consequence of such impossibility would render any contract clause invalid under Swedish law.
- (3081) Furthermore, Naftogaz argues that a provision that is "ineffective" under Ukrainian law must be replaced even if Ukrainian law does not apply. This argument has no merit.
- (3082) Article 13.2 of the Contract provides: "*If any provision of this Contract becomes invalid from viewpoint of applicable law or ineffective [...]*". The word "invalid" in Article 13.2 means invalid under applicable law, *i.e.* under Swedish law. It does not provide room for invalidity under Ukrainian law.
- (3083) What then does "ineffective" mean? The Russian word that has been translated as "*ineffective*" means "*inoperative*".²⁵⁸ It does not mean "invalid under foreign law". If it did mean "*invalid under foreign law*", that would undermine the Parties' agreement in Article 12.1 that Swedish substantive law alone would govern the contract, as well as the limitation in the introductory clause of Article 13.2 that only invalidity from the "*viewpoint of applicable law*".
- (3084) Naftogaz is unable to establish a legal basis for its claims in EU and/or Ukrainian energy/competition law.

²⁵⁸ See Gazprom's oral submissions at [T2 191:1-4] regarding the meaning of the Russian word "*недействительный*".

(3085) Naftogaz argues that the effect of Gazprom's case on the applicability of European and/or Ukrainian law is to create a "*legal vacuum*".²⁵⁹ However, it is quite clear that the Contract does not operate in a "*legal vacuum*".

(3086) Gazprom's case on the transit tariff under the Third Energy Package is set out above. Gazprom repeats and relies upon those submissions in this context.

(3087) The provisions of Ukrainian national law on transit tariffs, i.e. the Ukrainian Tariff Methodology and NCSREU's Resolution No 3158 on trans-border tariffs, are relied upon by Naftogaz in its case as regards what should replace the tariff provisions of the Contract (once they have been held to be invalid/ineffective due to their non-compliance with EU energy law). Naftogaz submits that the "*correct legal and practical approach in this case is to replace the existing tariff provision with a new provision in line with the tariffication principles implemented in Ukrainian energy legislation and the entry-exit tariffs adopted by the Ukrainian regulator*".

(3088) Gazprom submits that this would not be the "*correct legal and practical approach in this case*" for the following reasons:

(3089) First, the Tribunal should not replace the Contract tariff with a tariff set by NCSREU, the Ukrainian regulator, who fails to comply with the independence requirements of the Third Energy Package.

(3090) Second, the Tribunal should not replace the Contract tariff with a Ukrainian tariff which is also unlawful and/or contrary to the requirements of the Third Energy Package for the following additional (and alternative) reasons:

1. NCSREU has set different tariffs for cross-border transit and domestic transmission under Resolution No 3158 on trans-border tariffs and Resolution No 3159 on domestic tariffs. This differential regulatory treatment is contract to the requirements of the Third Energy

²⁵⁹ See NAK-PHB, paragraph 25.

Package which, as Naftogaz stresses, make no distinction between (trans-border) transit and (domestic transmission).

2. The application of the Ukrainian methodology and tariffs calculated on its basis would lead to a three-fold increase in the annual transit payment to be made by Gazprom under the Contract in 2016 to 2019. However, the Ukrainian tariff legislation does not make any provision for mitigating measures, a transitional period, or safeguards in respect of existing contracts. This is contrary to the draft EU Network Code on Tariffs. If such provisions were in place, the Ukrainian tariff would not apply until after expiry of the Contract, if at all.
3. The Ukrainian tariff legislation stipulates a significantly shorter publication notice, before the tariffs and their methodologies enter into force, than is envisaged in the draft EU network code on tariffs. Again, the Ukrainian tariff would appear to have been set in a way which is contrary to the requirements of the Third Energy Package.
4. In any event, the Ukrainian tariff legislation does not require a cost-reflective tariff. Again, this is contrary to the requirements of the Third Energy Package.

(3091) In all the circumstances, therefore, it would not be the "*correct legal and practical approach in this case*" for the Tribunal to replace the Contract tariff with the tariff set by the Ukrainian regulator, even if the tariff provisions of the Contract are found to be unlawful and invalid (which is denied in any event).

(3092) Naftogaz claims that with effect from 1 January 2016 the tariff under the Contract is in breach of Ukrainian law, that the tariff provision in the contract is as a result invalid and must be revised in accordance with the requirements of the Ukrainian regulator, in particular Resolution

No. 3158 of 29 December 2015. Naftogaz argues that this resolution is binding for Naftogaz and Gazprom as a matter of Ukrainian law.²⁶⁰

(3093) Naftogaz' case on this is summarised as follows:

"The tariff in the Contract does not comply with the tariffs set by the Regulator and must be aligned."

(3094) The new tariff which it seeks in its replacement Article 8.1 is derived from the table of tariffs set by the regulator by his resolution of 29 December 2015. This tariff takes effect from 1 January 2016 and this of course is why the claim from 1 January 2016 is on the terms of the new tariff (the 2016 tariff).

(3095) Naftogaz' claim for breach of Ukrainian law in respect of the tariff and contract terms has no merit. Even if Ukrainian law is applicable, the provisions of Ukrainian law upon which it directly relies, i.e. the resolutions on tariff and contract terms do not apply to the Contract. On the contrary, the resolutions only apply to the contract between a TSO and its customer. It is beyond dispute that (1) Ukrtransgaz is the only TSO, (2) that Naftogaz is not a TSO, and (3) Ukrtransgaz is not a party to the Contract or to the Technical Agreement (which Naftogaz also seeks to replace).

(3096) The resolutions do apply to the contract between Ukrtransgaz and Naftogaz under which Ukrtransgaz agrees with Naftogaz to provide on its behalf the services required of Naftogaz under the Contract.

(3097) The Tariff and other terms of this Contract must therefore be brought into line with the tariff and contract terms resolutions so as to comply with Ukrainian law. It appears that even as at this date this has not been done. Until that is done, Naftogaz is obliged as a result of a further resolution to continue to perform its obligations under the Contract.

²⁶⁰ See Naftogaz' Sur-Reply, paragraph 63 last sentence.

- (3098) In short, far from the resolutions of the regulator rendering the Contract (including its tariff) invalid, those resolutions have no application to the validity or effectiveness of the Contract and, insofar as they have any relevance at all, mandate Naftogaz to perform the contract.
- (3099) Because of the centrality of Naftogaz' claims under Ukrainian law to its tariff claim form January 2016 and to its claim for replacement terms, Gazprom highlights briefly some key points.
- (3100) It is not in dispute that, as matters currently stand (and that is all that matters for the purposes of this arbitration), the TSO for the Ukrainian GTS is Ukrtransgaz, a wholly owned subsidiary of Naftogaz. This is confirmed by Naftogaz.
- (3101) As already noted above, Ukrtransgaz is not a party to the Contract or the Technical Agreement. Naftogaz is under an obligation under Article 3.1 to procure the acceptance and further transit of gas delivered by Gazprom for transit. Naftogaz in turn contracted with Ukrtransgaz under various agreements (some of which have now been disclosed) from January 2009 onwards for Ukrtransgaz to perform on Naftogaz' behalf the transit services required under the Contract.
- (3102) The contractual analysis is clear: the only parties to the Contract are Naftogaz and Gazprom; Naftogaz in turn sub-contracts the provision of services to Ukrtransgaz, the TSO, under various written contracts. In its letter dated 1 December 2016, Naftogaz makes repeated reference to Naftogaz as the "*de facto TSO*". There is no such concept either under Ukrainian law or European energy law (and Naftogaz does not suggest otherwise). The resolutions and the underlying provisions of the TEP are directed at the contract with a TSO as defined. That definition is only satisfied in Ukraine by Ukrtransgaz.
- (3103) The same letter makes a number of submissions as to which of Ukrtransgaz or Naftogaz was licenced to transit gas in 2009 and 2010. Those matters are irrelevant to the question at issue (application of Ukrainian energy law from 2015/6 onwards) as it is not in dispute that from 2015 Naftogaz was not and is not a TSO and did not have and does not have a licence to transit gas. That is why it is necessary for Naftogaz to sub-contract with Ukrtransgaz for the provision

of transit services. In any event, the factual matters advanced by Naftogaz in its letter concerning 2009/10 are incorrect for the reasons given by Gazprom.

(3104) Provisions of the TEP demonstrate that the regulated tariff is required for the "primary market", being the contract between the TSO and his customers, and not for the secondary market where the contract is between persons who are not TSOs.

(3105) Turning to Ukrainian law:

(3106) The tariff resolution of the regulator upon which Naftogaz relies was made by the regulator pursuant to the powers given to him under article 4(2)(8) of the Gas Market Law. The tariff relates specifically to "transmission" and "transmission" requires a licence under article 20 and the licensee is the TSO. In Ukraine this is Ukrtransgaz. Article 32 states that the transmission services (i.e. the services provided by the TSO) must be performed on the basis of the transmission contract, a contract that needs to be approved by the regulator.

(3107) The resolutions on tariff and contract terms to which reference was made above were made by the regulator in pursuance of the powers given under article 4(2)(8) and article 32 of the Gas Market Law.

(3108) It is clear from the face of the resolutions and the matter set out above that:

1. Ukrtransgaz is currently the only designated TSO.
2. The tariff resolution applies to the TSO's contractual charges to the TSO's customers but not to charges under any contract to which the TSO is not a party. In particular it does not apply to charges under a contract between the TSO's customer (in our case, Naftogaz) and the customer's customer (in this case Gazprom).
3. The contract terms resolution and the attached standard form contract applies only to the contract between the TSO and its customer; it does not apply to the contract between the TSO's customer and that customer's customer.

4. For these reasons, there is absolutely no merit in the claim that the tariff under the Contract is in breach of the tariff resolution and likewise no merit in the claim that the terms of the Contract are required to conform with the standard form contract attached to the contract terms resolution.

(3109) The final resolution of the regulator to which reference was made by Gazprom and on which Naftogaz relies is a resolution dated 11 February 2016. This requires Ukrtransgaz and Naftogaz to bring their contractual relations into line with standard contract by 1 March 2016. This is entirely unsurprising if one bears in mind that the contract between them is subject to both the tariff and the contract terms resolution.

(3110) The same decision of the regulator provides that until this is done Naftogaz must perform the Contract and Ukrtransgaz must perform its contract dated 31 March 2015 (now disclosed by Naftogaz). There is no evidence to date that Naftogaz and Ukrtransgaz have brought their contract into line as required by the regulator. It must follow that the resolution on which Naftogaz relies in this arbitration, far from assisting Naftogaz' claim, actually requires Naftogaz to continue to perform the very contract which Naftogaz would like the Tribunal to believe is an invalid contract under Ukrainian law.

(3111) For all these reasons, Naftogaz' claims based on breach of the tariff and contract terms resolutions should be rejected. There is no other basis for Naftogaz to maintain its claims from 1 January 2016 for the tariff set by the regulator or the change to standard contract terms. In any event, as already pointed out, the replacement terms sought by Naftogaz are not the standard contract terms and Naftogaz has not established any other basis for its proposed terms.

Party relationship under the Contract: no breach of Ukrainian energy law

(3112) Naftogaz develops its case on the party-relationship under the Contract as a matter of Ukrainian law. Naftogaz relies primarily on provisions of the 2015 Ukrainian Gas Market Law and of the Ukrainian Gas Transmission Network Code. It makes submissions as regards (a) unbundling,

(b) interconnection agreements and (c) shipper codes. Each of those submissions is addressed by Gazprom below.

7.2.2.6.4.7.4 Unbundling

(3113) It is the case, as set out by Naftogaz, that the 2015 Ukrainian Gas Market Law allows for a choice between ownership unbundling and independent system operator. It would appear that Ukraine has decided to proceed with the option of ownership unbundling, and has made a proposal to the Energy Community Secretariat in that regard. However, despite the deadline of 1 June 2016 for certification of the unbundled TSO, the Secretariat has not yet approved Ukraine's proposal. On 1 July 2016, it would appear that the Ukraine Government passed a resolution on the unbundling of Ukrtransgaz. Gazprom has not yet been able to consider the implications of this Government resolution.

(3114) For the reasons set out above, although Ukrtransgaz is the operator of the Ukrainian GTS and appears to have been designated as TSO by Ukraine in 2013, it is not a properly independent TSO (contrary to the requirements of the EU energy law). In particular, it retains significant links with Naftogaz, which is engaged in the production and supply of natural gas, contrary to the independence requirements of EU energy law.

(3115) Naftogaz makes reference to the requirements of Articles 20 and 22 of the 2015 Ukrainian Gas Market Law, which stipulate various rights and obligations of the Ukrainian TSO. Naftogaz then argues that "*the Contract, including the Technical Agreement with Annexes, prevents real functional unbundling from taking place*". Gazprom denies that this is the case.

(3116) There is nothing in the Contract (or Gazprom's conduct), which prevents Naftogaz from carrying out the requirements of Articles 20 and 22 of the 2015 Ukrainian Gas Market Law. Article 20.1 simply provides that:

"A gas transmission system operator shall be exclusively responsible for reliable and safe operation, maintenance, and development (including new construction and re-construction) of the

gas transmission system for purposes of meeting the expected demand of subjects of natural gas market for transmission services [...]"

- (3117) Article 22 sets out more detailed requirements on the TSO, including developing a gas transmission system code, elaborating a gas transmission system development plan, taking necessary measures to ensure security of supply, performing balancing function,; cooperating with other TSOs inside and outside Ukraine, taking measures to increase rational use of energy resources and to protect the environment, etc.
- (3118) Gazprom denies that there is anything in the Contract (or Gazprom's conduct), which prevents Naftogaz from carrying out the requirements of the aforementioned Articles 20 and 22 of the 2015 Ukrainian Gas Market Law.
- (3119) In summary, Gazprom simply puts its own gas on to the Ukrainian GTS and, once that gas has been carried across the Ukrainian GTS to Ukrtransgaz/Gazprom, Gazprom accepts that gas and checks that the volumes delivered on to the GTS are the same as those taken off it.
- (3120) It is particularly denied that there is anything in the Contract (or Gazprom's conduct) which prevents Ukrtransgaz from engaging in "*real functional unbundling*". In this regard, Naftogaz asserts that "*the Ukrainian legislator has implemented the requirement of legal unbundling of supply and transmission by designating Ukrtransgaz as TSO of the Ukrainian GTS*". As indicated above, it is clearly not the case that Ukraine has complied with the legal requirements contained in Article 9 of Directive 2009/73/EC as to unbundling by designating Ukrtransgaz as TSO.
- (3121) For the reasons set out above, it is Ukraine that has failed to ensure effective unbundling of the Ukrainian TSO. Gazprom is not responsible for that failure.

7.2.2.6.4.7.5 Interconnection with adjacent TSOs

(3122) Naftogaz refers to provisions of the 2015 Ukrainian Gas Market Law and of the Ukrainian Gas Transmission System Code, which presuppose that the Ukrainian TSO shall cooperate with and enter into interconnection agreements with adjacent TSOs.

(3123) As explained above, as a matter of fact, Ukrtransgaz has entered into interconnection agreements with the TSOs of a number of EU Member States adjacent to Ukraine, including Eustream as regards the Budince interconnection point. This has enabled Naftogaz to purchase substantial quantities of gas from European suppliers by way of physical reverse flow via interconnections with adjacent EU Member States for import into Ukraine. In fact, the share of gas imported into Ukraine from Russia has dropped from 74% in 2014 to 37% in 2015 (the difference being made up of imports to Ukraine adjacent EU Member States).

(3124) There is nothing in the Contract (or Gazprom's conduct) which prevents Naftogaz/ Ukrtransgaz from cooperating with adjacent TSOs and/or entering into interconnection agreements with them.

7.2.2.6.4.7.6 Shipper codes

(3125) Naftogaz asserts that the "*obligation to provide shipper codes now follows explicitly from Ukrainian legislation*". It would appear to be the case that, under Chapter XI of the Ukrainian Gas Transmission System Code, it is envisaged that, in order to receive transmission services, a transmission systems customer has to submit to the Ukrainian TSO nominations for entry/exit points which include EIC-codes.

(3126) However, given the extremely close links between Ukrtransgaz (the current operator of the Ukrainian GTS) and Naftogaz (which is engaged in "*the functions of production or supply*" in Ukraine), it would be potentially anti-competitive were Gazprom or Gazprom Export to provide its confidential shipper codes to Ukrtransgaz/Naftogaz where Naftogaz is a potential competitor to Gazprom in onward supply of gas outside Ukraine.

(3127) In all the circumstances, unless and until the independence of the Ukrainian TSO can be guaranteed, it would be anti-competitive and potentially unlawful for Gazprom to be compelled to provide its confidential shipper codes to Ukrtransgaz/Naftogaz. It is wrong for the Tribunal to be asked selectively to apply particular provisions of Ukrainian law (as regards shipper codes), when Ukraine has failed to comply with fundamental legal requirements as to the independence of its TSO.

7.2.2.6.4.7.7 Capacity allocation and congestion management: no breach of Ukrainian energy law

(3128) Naftogaz develops its case on capacity allocation and congestion management as a matter of Ukrainian law. Naftogaz asserts that Article 34 of the 2015 Ukrainian Gas Market Law and Chapters IX-XII and XV of the Ukrainian Gas Transmission System Code implement the requirements of the Third Energy Package as regards capacity allocation and congestion management in Ukraine.

(3129) First, Naftogaz asserts that these rules of capacity allocation and congestion management are *"an example of how the Ukrainian legislator has taken the NC CAM²⁶¹ into account, even if it's not yet incorporated into the ECT"*. By this submission, Naftogaz appears to recognise and accept the point made by Gazprom to the effect that, even if the requirements of the Third Energy Package directly apply to the Contract via Article 10 EnCT (which is denied), the only legal requirements which apply are those set out in Directive 2009/73/EC and Regulation 715/2009. The detailed requirements set out in the EU network codes Regulations do not apply, as those Regulations are not listed in Annex I of the EnCT.

(3130) In any event, Naftogaz asserts that *"[b]y refusing to adhere to mandatory ECT energy legislation as implemented in Ukraine, Gazprom hinders the creation of a level playing field for existing and new network users"*. Therefore, Naftogaz' argument appears to be as follows: the Ukrainian rules on capacity allocation and congestion management implement the requirements

²⁶¹ Regulation (EU) No 703/2015 establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems.

of ECT energy law (i.e. the Third Energy Package); the Contract and/or Gazprom's conduct is contrary to the requirements of ECT energy law as regards capacity allocation and congestion management; therefore the Contract and/or Gazprom's conduct is contrary to the requirements of the Ukrainian rules on capacity allocation and congestion management.

(3131) Gazprom's case on capacity allocation and congestion management as a matter of EU energy law (i.e. the Third Energy Package) is set out above. Gazprom repeats and relies upon its submissions in that regard in response to Naftogaz' case under Ukrainian law, and in support of its denial that the Contract and/or Gazprom's conduct is contrary to the requirements of the Ukrainian rules on capacity allocation and congestion management.

7.2.2.6.4.7.8 Balancing arrangements: no breach of Ukrainian energy law

(3132) Naftogaz develops its case on balancing requirements as a matter of Ukrainian law. Naftogaz asserts that Article 35 of the 2015 Ukrainian Gas Market Law and Chapters XIII and XIV of the Ukrainian Gas Transmission System Code implement the requirements of Article 21 of Regulation 715/2009 as regards balancing arrangements in Ukraine.

(3133) Naftogaz' argument appears to be as follows: the Ukrainian rules on balancing implement the requirements of EU energy law (i.e. the Third Energy Package); Contract TKGU is contrary to the requirements of EU energy law as regards balancing; therefore Contract TKGU is contrary to the requirements of the Ukrainian rules on balancing.

(3134) Gazprom's case on balancing arrangements under the Third Energy Package is set out above. For the reasons set out therein, Naftogaz' case that the Contract is contrary to the balancing requirements of the Third Energy Package (and therefore of Ukrainian balancing rules) should be rejected.

7.2.2.6.4.7.9 Restrictions on the use of interconnectors: no breach of Ukrainian energy law

(3135) Naftogaz develops its case on the use of interconnectors as a matter of Ukrainian law. Naftogaz asserts that the relevant requirements of the Third Energy Package "*including the principles*

and provisions of particular importance to the use of interconnector" are implemented into Ukrainian energy legislation.

(3136) Naftogaz does not make any independent case under Ukrainian law as regards restrictions on the use of interconnectors, but essentially repeats generalised assertions made earlier under the Third Energy Package as regards TSO's obligations to cooperate with adjacent TSOs and to develop interconnection agreements, and as regards unbundling, shipper codes and virtual reverse flow.

(3137) Gazprom has addressed all of these issues previously. For the reasons set out above, Gazprom denies that the Contract and/or Gazprom's conduct is in breach of the requirements of Ukrainian energy law as regard the use of interconnectors.

7.2.2.6.5 Invalidity and ineffectiveness and their consequences

(3138) In the event that the Tribunal were to find that any of the clauses of the Contract are in breach of EU competition law or the EnCT or Ukrainian law, the Tribunal must then consider the implications of such a breach, if any.

(3139) Naftogaz asserts that clauses 1, 2, 3, 4, 5, 6.3, 7, 9, 10.2, 10.4, 13.2, 13.6 and 13.8 as well as the Technical Agreement with Annexes and Additional Agreements should be declared invalid and/or ineffective and in some cases replaced with new provisions. Furthermore Naftogaz requests that Article 8 should be replaced with a new provision.

7.2.2.6.5.1 There is no basis in EU competition law for a finding that any provision of the Contract is invalid or ineffective

(3140) Naftogaz relies on a direct application of Articles 101 and 102 TFEU and argues that a breach of any of these provisions must result in the invalidity of that provision.

(3141) Article 101(2) TFEU states that "*[a]ny agreements or decisions prohibited pursuant to this Article shall be automatically void*". However, Naftogaz has still failed to explain how and to what extent each separate provision is prohibited by reason of EU competition law, and how

and to what extent each separate provision is invalid (or ineffective). Instead, Naftogaz' case rests on generalities.

- (3142) EU competition law only takes effect on the Contract insofar as clauses are actually in breach of EU competition law. For the reasons set out above, Gazprom does not accept as a matter of substance that any of the impugned provisions of the Contract are in breach of EU competition law.
- (3143) Naftogaz asserts that EU competition law should apply, regardless of whether the qualified effects test is made out and regardless of whether there is an effect on trade between Member States, merely because Swedish law has been chosen as the governing law. This argument is not supported by any authority and cannot be supported as a matter of principle. Professor Henriksson has dealt with Naftogaz' argument in more detail in his Transit opinion.
- (3144) The Intel judgment is relevant to the threshold question of whether Articles 101 and/or 102 TFEU apply at all to the dispute in the Transit Arbitration.
- (3145) In the Intel judgment the CJEU held that the qualified effects test could serve as a basis for the Commission's jurisdiction in the particular circumstances of that case. However, the Intel judgment does not alter Gazprom's case that Articles 101 and/or 102 TFEU do not apply to the dispute in the Transit Arbitration.
- (3146) The qualified effects test is not met on the facts of this case. Naftogaz now appears to argue that the Contract affects competition in the German, Romanian, Bulgarian, Macedonian, Moldovan, Serbian, and Bosnian markets. But the effects to which Naftogaz refers are remote and hypothetical and rest on assumptions rather than fact. In any event, they do not establish an immediate, substantial and foreseeable negative effect on competition in the EU.
- (3147) Naftogaz has not responded to Gazprom's detailed arguments that the provisions of the Contract do not affect trade between EU Member States.

(3148) Contrary to what Naftogaz suggests, there is no legal vacuum for competition rules if EU competition rules do not apply to this case before this Tribunal. As explained by Professor Henriksson in his Transit Opinion, the principle of territoriality simply implies that a court or tribunal sitting in the EU cannot apply EU competition law to a dispute where the contract is implemented outside the European Union and both parties are established outside the EU. The application of Ukrainian competition rules is a matter for a Ukrainian court or tribunal. In any event, a lack of application of other competition laws to a particular contract cannot constitute a legal basis for the application of EU competition law.

(3149) Even if the Tribunal were to conclude that any of the impugned provisions of the Contract are in breach of EU competition law, Naftogaz has failed to prove that the particular far reaching invalidations sought by Naftogaz are required pursuant to EU competition law. In particular:

1. As regards Claim 1, Naftogaz has failed to explain why the non-assignment provision at Article 13.8 is invalid. Naftogaz has failed to show that invalidity of this clause is required under the various different legal bases that it relies upon. In fact, the scant explanation that it does provide suggests that this cannot be so. As a matter of competition law, Naftogaz claims that this is merely "*consequential to removal of infringements in other provisions*", but none of this explains why Article 13.8 is allegedly invalid.
2. As regards Claims 2 and 3, Naftogaz seeks to invalidate virtually all of the Contract – namely, Articles 1, 2, 3, 4, 5, 6.3, 7, 8, 9, 10.2, 10.4, 13.2, 13.6 and the Technical Agreement with Annexes and Additional Agreements. However, Naftogaz has failed to explain why the complete invalidity of all these various provisions is required under the various different legal bases that it relies upon. Again, Naftogaz makes very general statements in its pleadings, but none of this explains why all the many words, sentences, paragraphs and whole pages that Naftogaz seeks to have invalidated are allegedly invalid.

7.2.2.6.5.2 There is no basis in EU energy law as an "operationalisation" of EU competition law for a finding that any provision of the Contract is invalid or ineffective

(3150) Naftogaz has not explained its case regarding invalidity pursuant to EU energy law. However, Naftogaz seems to have abandoned its previous claim based on EU energy law and has instead developed its concept of "*operationalisation*". As a result of this invention, Naftogaz seems to argue that the consequences of an application of EU energy law is connected to the consequences of a breach of Articles 101 and 102 TFEU. For the reasons set out above, there is nothing in Naftogaz' arguments on "operationalisation" in any event.

(3151) It follows that Naftogaz is no longer putting forward an invalidity claim based only on EU energy law.

7.2.2.6.5.3 There is no basis in the EnCT for a finding that any provision of the Contract is invalid or ineffective

7.2.2.6.5.3.1 Invalidity based on Article 18 EnCT

(3152) Naftogaz argues that a breach of Article 18 EnCT results in the same consequences as a breach of Articles 101 and 102 TFEU, i.e. invalidity.

(3153) As underlined by Naftogaz, Article 18(2) EnCT states that "*any practice contrary to this Article shall be assessed on the basis of criteria arising from the application of the rules of Articles 81, 82 and 87 of the Treaty establishing the European Community*" (current Articles 101, 102 and 107 TFEU).

(3154) Naftogaz argues that the wording of Article 18(2) EnCT only deals with a situation when a practice has already been found to be contrary to Article 18(1) EnCT and that it is the consequences of such a breach that shall be assessed in light of the full *acquis communautaire* on competition. Thus, according to Naftogaz, the consequences of breaching Article 18 EnCT are the same as under the EU rules on competition.

- (3155) This reading of Article 18(2) EnCT is impossible to sustain in light of the wording and purpose of this provision and it is denied that any provision of the Contract is invalid or ineffective by reason of the EnCT.
- (3156) The wording of Article 18(2) EnCT refers to "*practices contrary to this Article*". The wording used indicates that it is these practices that are meant to be assessed on the basis of criteria arising from the application of the rules of Articles 101, 102 and 107 TFEU. The literal meaning of the term "*any practices contrary to this Article*" in Article 18(2) EnCT does not in any way imply that the Parties intended for this provision to refer to the consequences of a practice that has been found to be contrary to Article 18(1) EnCT. Accordingly, even if the Tribunal would find that Article 18 EnCT can be relied on by Naftogaz against Gazprom (which is denied), there is nothing in the EnCT to suggest that such reliance could result in invalidity of any of the provisions in the Contract.
- (3157) Moreover, as set out above, Article 18 EnCT is addressed to the Contracting Parties only and not to the EU. Accordingly, Article 18 EnCT has not been implemented in EU or Swedish law. It follows that a breach of Article 18 EnCT is not regulated in EU or Swedish law.
- (3158) Gazprom maintains that Naftogaz cannot invoke Article 18 EnCT because the requirements for granting horizontal direct effect to that provision under EU law are not met. This matter has also been considered in detail in the Supply Arbitration and Gazprom refers the Tribunal to its submissions in that arbitration and to Professor Henriksson's Opinion in these proceedings.
- (3159) If Article 18 of the EnCT were applicable, Naftogaz would also need to demonstrate that the provisions of the Contract it complains about affect trade in "*Network Energy*" between EnCT contracting parties. It has failed to do so. The assertion made in Hesmondhalgh and Lapuerta 3 is speculative.

7.2.2.6.5.3.2 Invalidity based on Article 7 and 10 EnCT

(3160) In addition, Naftogaz argues that a provision in the Contract that is in breach of Articles 7 and 10 EnCT must result in the invalidity of that particular provision of the Contract.

(3161) Naftogaz argues that a breach of EnCT energy law is regulated under Swedish law and results in invalidity. Alternatively, Naftogaz asserts that a breach of EnCT energy law renders the particular provisions of the Contract ineffective according to Article 13.2 of the Contract.

(3162) This interpretation of the EnCT is contrary to the purpose and wording of this agreement. Article 10 EnCT is addressed to the Contracting Parties only and not to the EU. Accordingly, Article 10 EnCT has not been implemented in EU or Swedish law. In any event, even if the Tribunal would find that Article 10 EnCT can be relied on by Naftogaz against Gazprom (which is denied), there is nothing in the EnCT to suggest that such reliance could result in invalidity of any of the provisions in the Contract.

(3163) Further, as discussed above, Article 7 EnCT only implies that when the Parties apply the provisions of the EnCT, they shall ensure that there is no discrimination. Article 7 EnCT is accordingly not a provision that has been implemented in EU or Swedish law. In any event, even if the Tribunal would find that Article 7 EnCT can be relied on by Naftogaz against Gazprom (which is denied), there is nothing in the EnCT to suggest that such reliance could result in invalidity of any of the provisions in the Contract.

(3164) It follows that a breach of Articles 7 and 10 EnCT is consequently not regulated in Swedish law as argued by Naftogaz and neither of these provisions can result in invalidity of any part of the Contract.

7.2.2.6.5.3.3 Invalidity based on alleged breach of the requirements of the Third Energy Package

(3165) Even if the EnCT could be relied upon by Naftogaz, Naftogaz has failed to explain how and to what extent each separate provision that it seeks to invalidate is prohibited by reason of an

alleged breach of the requirements of the Third Energy Package, and how and to what extent each separate provision is invalid (or ineffective). Naftogaz' case rests on generalities.

(3166) For the reasons set out above, Gazprom does not accept as a matter of substance that any of the impugned provisions of the Contract are in breach of the requirements of the Third Energy Package.

(3167) Even if the Tribunal were to conclude that any of the impugned provisions of the Contract are in breach of the requirements of the Third Energy Package, Naftogaz has failed to prove that the particular far reaching invalidations sought by Naftogaz are required pursuant to the requirements of the Third Energy Package. In particular:

There is no basis in Ukrainian law for a finding that any provision of the Contract is invalid or ineffective

7.2.2.6.5.3.4 No invalidity or ineffectiveness based on a breach of Articles 7, 10 or 18 EnCT as part of Ukrainian law

(3168) Naftogaz seems to suggest that the consequences of a breach of Article 18 EnCT as part of Ukrainian law should be interpreted in the same way as the consequences of Articles 101 and 102 TFEU. Based on this assertion, it seems as if Naftogaz puts forward that a provision of the Contract is invalid if it is found by the Tribunal to be in breach of Article 18 EnCT as part of Ukrainian law.

(3169) In addition, without providing any justification for it, Naftogaz also asserts that a violation of Articles 7 and 10 EnCT as part of Ukrainian law also must result in invalidity.

(3170) Gazprom denies that any of the provisions of the Contract are invalid by reason of Articles 7, 10 or 18 EnCT as part of Ukrainian law.

7.2.2.6.5.3.5 Invalidity based on Article 9(3) of Rome I

(3171) Naftogaz asserts that a violation of Articles 7, 10 and 18 EnCT as mandatory Ukrainian law will render the offending clauses invalid in accordance with Article 9(3) of the Rome I Regulation and Swedish law.

(3172) However, as set out above, there is no basis for the application of Ukrainian law, either pursuant to Article 9(3) of the Rome I Regulation or pursuant to Swedish law. In any event, for the reasons set out above, the effect of any such application of Ukrainian law should not be the invalidity of the clauses as claimed by Naftogaz in its requests for relief.

(3173) Naftogaz seems to suggest that the Regulator has agreed to abstain from taking action until the present case is resolved. On the contrary, the decision states: "*NJSC Naftogaz of Ukraine, PJSC Ukrtransgaz shall by 01.03.2016 bring their contractual relations regarding transit of natural gas in compliance with the Standard Natural Gas Transmission Contract approved by Resolution of the National Commission for State Regulation of Energy and Utilities dated 30.09.2015 No. 2497 (hereinafter the Standard Contract)*".

7.2.2.6.5.3.6 Ineffectiveness based on Article 13.2 of the Contract

(3174) According to Naftogaz, violations of Articles 7, 10 and 18 EnCT as mandatory Ukrainian laws will also render the offending clauses ineffective pursuant to Article 13.2 of the Contract.

(3175) However, the simple answer to this is that Article 13.2 of the Contract does itself render any clause invalid or ineffective. On the contrary, the clause sets out what the parties shall do "[i]f any of the provisions of the present Contract becomes legally invalid pursuant to the applicable legislation or ineffective".

(3176) In any event, and for the avoidance of doubt, Gazprom denies that any of the provisions of the Contract have become "*ineffective*". Gazprom further denies that there is any basis upon which the Tribunal should "*declare ineffective*" any of the provisions of the Contract.

7.2.2.6.5.3.7 Invalidity based on national Ukrainian competition law

(3177) Naftogaz argues that national Ukrainian competition law applies to the Contract and a breach of Ukrainian competition law "may" allegedly result in invalidity. Notably, however, Naftogaz does not say that Ukrainian competition law renders any provision of the Contract automatically valid. Thus, on Naftogaz' own case, the Contract remains valid under Ukrainian competition law unless and until any part of it is found to be invalid, fully or partially.

(3178) There is no basis for a finding that any provision of the Contract is invalid or ineffective under general principles of Swedish contract law.

(3179) Naftogaz incorrectly claims that under Swedish contract law, the consequence of a breach of certain mandatory provisions would be invalidity.

(3180) In this context, Naftogaz refers to the Supreme Court case NJA 1997 p. 93 and two influential articles by the late professor Håkan Nial and professor Jan Andersson.²⁶² However, Naftogaz misinterprets and draws completely incorrect conclusions of the mentioned case and articles.

(3181) In NJA 1997 p. 93, the Swedish Supreme Court set out a test regarding in which situations a breach of mandatory law should lead to invalidity of a contract *inter partes*, even if it is not expressly stipulated in the relevant piece of legislation. The Supreme Court's test obviously requires that it must first be concluded that the legislation in question in fact provides for mandatory regulation of a certain issue. In this context, it should be mentioned that, whereas both Andersson and Nial discuss the effect of breaches of legal prohibitions (Sw. *legala förbud*) and not mandatory legislation in general, the Supreme Court in NJA 1997 p. 93 merely refers to "*acts contrary to law or bones mores*".

(3182) In NJA 1997 p. 93, the Supreme Court first identified that under Swedish law, in contrast to what is the case in many other countries, there are no general provisions stating that acts contrary to law or bones mores are invalid. Instead, invalidity may follow from general legal

²⁶² Nial, *Om förvärv i strid mot legala förbud* and Andersson, *Legalta förbud och ogiltighet – En teleologisk studie*, both in the Norwegian legal journal *Tidskrift for Rettsvitenskap*.

principles. The Supreme Court concluded that whether a contract contrary to law should be invalid, even if this has not been stipulated in the relevant piece of legislation, will depend on the following factors:

1. the purpose/objective of the relevant provision;
2. the need for an invalidity sanction to sanction it; and
3. the consequences that such sanction may entail, e.g. in relation to contract parties acting in good faith.

(3183) Thus, as is clear from the Supreme Court's test, invalidity is not an automatic effect of any transgression of mandatory law. To the contrary, having regard to the Supreme Court's conclusions, it is clear that if a court or arbitral tribunal considers invalidity as a sanction against a breach of mandatory law, this decision must be preceded by a thorough and careful analysis of whether invalidity is an appropriate measure having regard both to the general objective of the relevant legislation and the effect *in casu*.

(3184) Gazprom will comment below on the different elements of the Supreme Court's test.

7.2.2.6.5.3.8 The purpose/objective of the relevant energy law does not require an invalidity sanction

(3185) As regards the purpose/objective of the relevant legal prohibition, Andersson is of the view that there is no objective which is of such character that invalidity is always called for. However, certain rules have such purpose that invalidity may be called for. Such purposes are e.g. the protection of human rights, the interest of protecting national integrity and the protection of individuals (e.g. consumers and employees). No such reasons exist as regards the contractual relationship between the Parties in the present case.

(3186) In terms of legislative objectives, which do not relate to one of the contracting Parties but to a third party interest or the protection of a third party collective, it is not possible, according to Jan Andersson, to say that there is a weak presumption for invalidity, as was the case before.

Today, the same amount of weight is regularly attached to the protection of the general trade. The result is that a third party interest rarely weighs in favour of invalidity.

(3187) Naftogaz claims that Andersson is of the opinion that "*mandatory rules that protect public interests, and particularly those rules that stem from the EU, 'weigh heavily in favour of invalidity'*". Naftogaz further claims that this conclusion is supported by the case NJA 1997 p. 93. Naftogaz is incorrect and the references to Andersson and NJA 1997 p. 93 are misleading.

(3188) Andersson's view is in fact that there is no presumption that breaches of mandatory rules that protect public interests would be invalid. Andersson states:

"What weight do purposes of a general nature then carry overall in the assessment of invalidity? The answer is that it depends. Where, in respect of a certain prohibition, purposes of a general nature may be compiled with purposes pertaining to aspects of individual justice, i.e. "the weaker party" (protective purpose), it appears that a presumption of invalidity can be made. [...]

In the event a legal prohibition is based only on purposes of a general nature, and no consideration of "the weaker party" is called for (protective purpose), a similar presumption can scarcely be made. Whether or not invalidity is a legal remedy must quite simply be determined in respect of each prohibition. Certain purposes of a general nature point to invalidity others do not.

As follows from the aforementioned conclusion, it is a relatively open question whether or not the violation of a legal prohibition, which is only induced for purposes of a general nature, leads to invalidity."

(3189) The above quote shows that Naftogaz assertion that mandatory rules that protect public interests would "*weigh heavily in favour of invalidity*" is incorrect.

- (3190) In terms of the case NJA 1997 p. 93, there is no basis for Naftogaz' assertion that the case supports the view that mandatory rules that protect public interests would "*weigh heavily in favour of invalidity*". The Supreme Court has only concluded that where invalidity is caused by a public interest, it should be considered ex officio. This is something completely different than to say that invalidity is called for as soon as a legal prohibition or mandatory rule concerns a public interest, which is not the case. As Andersson states there is no such presumption the issue has to be determined in relation to each prohibition.
- (3191) In terms of the energy law referred to by Naftogaz, Naftogaz claims that "*invalidity is required due to the strong public interest involved*" and that the need for invalidity "*is further reinforced by the interplay with the competition rules*". There is no basis for Naftogaz' assertions.
- (3192) The EU energy law referred to by Naftogaz does not only have as an objective to uphold competition on the energy market. As regards tariffs, it is clear from, e.g., Article 41.6(a) of Directive 2009/73/EC that the tariffs established by the regulatory authority, or the methodology used to establish the tariffs, shall allow necessary investments in the networks and LNG facilities to be carried out in a manner allowing those investments to ensure the viability of the networks and LNG facilities. Thus, in other words, the tariff provisions of Directive 2009/73/EC also have the objective to ensure the viability of the natural gas infrastructure. The fact that the tariffs must also include an incentive to construct new infrastructure is also emphasised in Regulation (EC) No 715/2009.
- (3193) Further, it is clear from both Directive 2009/73/EC and Regulation (EC) No 715/2009 that it is the regulatory authority that is to ensure compliance of the regulatory framework. In this respect, according to Directive 2009/73/EC, the regulatory authorities shall be provided with certain powers enabling them to carry out this duty, see Article 41.4 of Directive 2009/73/EC. Such powers include, *inter alia*, the right to issue binding decisions on natural gas undertakings and to impose penalties of up to 10% of the annual turnover on natural gas undertakings not complying with their obligations.

(3194) However, there is no mention of the need for an invalidity sanction to ensure compliance with the gas regulation and gas directive. To the opposite, Article 41 of Directive 2009/73/EC clearly defines the powers which from the EU legislator's side are considered necessary in order to ensure compliance with the regulatory framework.

7.2.2.6.5.3.9 There is no need for an invalidity sanction to prevent transgressions of energy law

(3195) As regards the second factor identified by the Supreme Court, the question is whether an invalidity sanction is necessary to ensure an efficient impact of the rules in question.

(3196) In this context, it should be noted that Håkan Nial has stated the following:

"In the absence of another sanction, one readily falls back on civil law invalidity since one rather regard a legal prohibition as something more than a platonic desire on the part of the legislature. Where, on the other hand, other sanctions penalties government regulation and the like enforce the prohibition in such a manner that a civil law invalidity rule has little or no consequence, there is, from the relevant point of view, less cause to employ invalidity."

(3197) In other words, Nial was of the view that where there is another sanction, there is less need for an invalidity sanction.

(3198) This view was also adopted by the Swedish Supreme Court in the case NJA 1953 p. 99. The Supreme Court concluded that certain agreements had been concluded in violation of a certain legal prohibition. As regards the effect of this violation, the Supreme Court stated that "[t]he effect thereof must particularly in consideration of the fact that the law does not impose a penalty or other sanction in the event of a breach of the prohibition be deemed to be that the agreements are invalid".

(3199) Thus, when determining whether there was a need for an invalidity sanction, the Supreme Court took into consideration if the law provided for other sanctions for breaches of the prohibition in question.

- (3200) In conclusion, the existence of other sanctions may render an invalidity sanction unnecessary or uncalled for.
- (3201) As set out above, Directive 2009/73/EC provides that the Member States shall provide the regulatory authority at least with certain powers to ensure the compliance of the regulatory framework. These powers are listed in Article 41 of Directive 2009/73/EC. The powers comprise, inter alia, the right to act as dispute settlement authority, the right to monitor and demand information and the right to sanction breaches of the regulatory framework by imposing penalties on natural gas undertakings. Thus, it is clear from Directive 2009/73/EC that there are in fact other available sanctions. Further, as mentioned above, it is clear that the EU legislator has not been of the view that "*invalidity is required due to the strong public interest involved*" or that an invalidity sanction "*is deemed necessary for the efficiency of the rules*", as Naftogaz claims.
- (3202) Naftogaz further claims that invalidity is called for in the current situation "*as it presumably appears unlikely that actions from Ukrainian regulatory authorities [...] would bring Gazprom to accept an amendment of the Contract*". Naftogaz' statement constitutes mere speculations and is also irrelevant in the context of whether the sanction of the alleged breaches of energy law (which are denied) leads to invalidity of the Contract under Swedish law. The relevant issue is whether or not sanctions are available under the regulatory framework in question, not the likelihood that one of the Parties will adhere to such sanctions.

7.2.2.6.5.3.10 The consequences of an invalidity sanction

- (3203) The final factor to take into consideration in the Supreme Court test is whether invalidity can be considered to be a reasonable sanction for the parties or whether it causes them, or someone of them, so severe inconveniences that the inconveniences are not proportionate to the violation of the prohibition and the effect that can be received through the invalidity.
- (3204) Håkan Nial states the following:

"In large transactions and, particularly, following major price fluctuations, the invalidity for one of the parties may be economically catastrophic; the speculative possibilities entailed in the invalidity is also hardly attractive. Accordingly, it must be said that there is cause to use invalidity as a consequence only cautiously and only where it is truly called for by compelling reasons."

(3205) Thus, invalidity should only be used with caution and not provide one of the parties with speculative opportunities after price fluctuations.

(3206) In the present case, if the Tribunal would find that the Contract violates energy law (which is denied), invalidity does not constitute a necessary, reasonable or appropriate sanction.

(3207) In summary, there is no support under Swedish contract law for Naftogaz' assertion that the alleged breaches of allegedly mandatory law (which are denied) would lead to invalidity of the Contract under Swedish contract law. The test set out in the Swedish Supreme Court case NJA 1997 p. 93 results in the conclusion that a violation of the relevant energy law should not result in invalidity *inter partes*. The objective of the relevant energy law does not call for an invalidity sanction, an invalidity sanction is not necessary to ensure an efficient impact of the energy law rules in question and the consequences of such sanction would be unreasonable.

7.2.2.6.5.3.11 Consequences of a finding of invalidity of a provision of the Contract

(3208) In the event that the Tribunal were minded to make a finding of invalidity, there are procedural reasons why the Tribunal would not be entitled to do so.

(3209) Gazprom's primary position is that it is not open to the Tribunal to make a finding of invalidity *per se*. This is for the simple procedural reason that neither party is claiming invalidity as a separate claim Naftogaz' claims are for invalidity and replacement, not for invalidity as a separate claim.

(3210) Gazprom's secondary position is that, in the event that (contrary to Gazprom's case) the Tribunal were minded to make a finding of invalidity and the Tribunal were to determine that it was open

to it to make a finding of invalidity per se, then the Tribunal must give the parties an opportunity to negotiate a replacement provision in accordance with the express wording of Article 13.2 of the Contract

7.2.2.6.5.3.12 Replacement

(3211) Naftogaz states that its claims for invalidity are independent from its claims for replacement. Gazprom denies Naftogaz' suggestion that Gazprom has breached an obligation to negotiate and agree on a replacement clause.

(3212) As regards Naftogaz' claims for replacement, Gazprom maintains its position that the Tribunal lacks jurisdiction and substantive power to revise or replace the Contract pursuant to Article 13.2 of the Contract, and that accordingly Naftogaz' claims for replacement should be dismissed. Alternatively, if not dismissed, Naftogaz' claims for replacement should be rejected on the merits.

The Tribunal lacks jurisdiction and substantive power to determine Naftogaz' claims based on competition law and Article 13.2 of the Contract, since the Tribunal has not been given jurisdiction or substantive power to revise or replace the Contract.

(3213) The Tribunal lacks jurisdiction and substantive power to revise or replace the Contract pursuant to Article 13.2 of the Contract. Article 13.2 gives no power to the Tribunal to impose any replacement on the Parties.

The Tribunal lacks jurisdiction and substantive power to determine Naftogaz' claims based on competition law and Article 13.2 of the Contract, since the Tribunal has not been given jurisdiction or substantive power to revise or replace the Contract.

(3214) In any event, the Tribunal lacks jurisdiction and substantive power to revise or replace the Contract pursuant to Article 13.2 of the Contract unless and until the Parties have been given an opportunity to negotiate a replacement provision in accordance with the express wording of Article 13.2 of the Contract.

The replacement clauses proposed by Naftogaz are not required by EU competition law, or by the EnCT, or by the provisions of the Third Energy Package, or by Ukrainian law.

(3215) In any event, even if it were found (contrary to Gazprom's case), that the Tribunal did have jurisdiction to replace provisions of the Contract pursuant to Article 13.2, the replacement provisions requested by Naftogaz should not be adopted by the Tribunal.

(3216) Naftogaz apparently accepts that any replacement must have an economic effect as close as possible to the terms that have been struck down.

(3217) However, Gazprom denies that the replacement terms sought by Naftogaz are required either by EU competition law, or by the EnCT, or by the provisions of the Third Energy Package, or by any of the other various theories relied upon by Naftogaz.

(3218) Again, Naftogaz' case in this respect is in very general terms. Naftogaz relies upon Article 13.2 of the Contract and suggests that, since any new provision would itself need to be valid and effective, the Tribunal "*will have to substitute invalid/ineffective clauses with clauses closely modelled on or replicating the provisions of the Third Energy Package*".

(3219) However, Naftogaz' case in this respect makes no sense:

1. First, the Tribunal has no jurisdiction or power to replace any contractual provisions pursuant to Article 13.2 of the Contract. Article 13.2 provides only that "*the parties shall agree*" to replace an invalid or ineffective provision with a new provision.
2. Second, even if the Tribunal had such jurisdiction or power, given that (as stated above) the Third Energy Package does not require specific clauses to be invalidated, there is consequently no obligation upon the Tribunal to require specific clauses to be "*modelled on*" or "*replicated*" in a certain way. In fact, the Third Energy Package gives considerable discretion to the member states, and in turn to regulators in those member states. The

Third Energy Package does not regulate in detail the precise wording of particular contracts.

3. Third, even if the Third Energy Package did impose such regulations or requirements, Naftogaz has failed to prove that the specific highly-detailed replacements that it seeks would be required pursuant to the requirements of the Third Energy Package. In particular:

- As regards Claim 1, Naftogaz has failed to explain why the non-assignment provision at Article 13.8 is invalid. Naftogaz has failed to show that the replacement of this clause is required pursuant to the requirements of the Third Energy Package, and that the exact wording that it proposes is required. In fact, the scant explanation that it does provide suggests that this cannot be so. As a matter of energy law, Naftogaz claims that the TSO should have access to the network of other TSOs, and that there should be co-operation between TSOs, but none of this explains why the revised Article 13.8 as worded by Naftogaz must be imposed upon Gazprom.
- As regards Claims 2 and 3, Naftogaz seeks to replace virtually all of the Contract namely, Articles 1, 2, 3, 4, 5, 6.3, 7, 8, 9, 10.2, 10.4, 13.2 and 13.6. However, Naftogaz has failed to explain why the replacement of all these various clauses is required pursuant to the requirements of the Third Energy Package, nor does Naftogaz explain why the exact wording that it proposes is required. Again, Naftogaz makes very general statements in its pleadings, but none of this explains why all the many words, sentences, paragraphs and whole pages that Naftogaz seeks to insert into the Contract must be imposed upon Gazprom.

(3220) Furthermore, the contract as rewritten by Naftogaz produces an arrangement that is fundamentally different from the commercial deal that was struck between Gazprom and Naftogaz in January 2009. [REDACTED] explains that the effect of the revisions is not only to "*change both the nature and extent of the financial commitments that Gazprom entered into in January*

2009," but also to "place an unacceptable level of commercial risk upon the shoulders of Gazprom, by allocating responsibility for all commercial and operational decisions to Naftogaz and/or the Ukrainian regulator, a body... widely understood to lack independence."

7.2.2.6.6 Defences to Naftogaz' monetary claims

7.2.2.6.6.1 There is no basis for the monetary claims sought by Naftogaz

7.2.2.6.6.1.1 Gazprom's position

(3221) Gazprom denies Naftogaz' claim for additional payment. Gazprom maintains that:

1. Naftogaz has no right to additional payments since Article 8 should neither be declared invalid nor be replaced.
2. In any event, Naftogaz is not entitled to any retroactive replacement.
3. In any event, Naftogaz has no right to additional payments since Naftogaz has given Gazprom reason to believe that its payments constituted a final settlement of Gazprom's payment obligation for transit services.

(3222) Gazprom further denies Naftogaz' claim for damages based on breach of competition law.

7.2.2.6.6.1.2 Development of Gazprom's objections to Naftogaz' payment claim based on a replaced Article 8

Article 8 should neither be declared invalid nor be replaced

(3223) Naftogaz has no right to additional payments since Article 8 should neither be declared invalid nor be replaced by application of Article 13.2.

7.2.2.6.6.2 In any event, Naftogaz is not entitled to any retroactive replacement

(3224) If the Tribunal, contrary to Gazprom's position, were to conclude that Article 8 should be declared invalid and replaced based on Article 13.2, then Article 8 can in any event not be replaced retroactively.

- (3225) A replacement can in no event go beyond what the Parties have agreed under Article 13.2. The Tribunal must consequently examine if the Parties have agreed in Article 13.2 that a Party can require a retroactive replacement.
- (3226) It is Gazprom's position that the Parties have *not* agreed that a Party can require a retroactive replacement under Article 13.2. This is clear from the wording of Article 13.2 which says nothing about retroactivity.
- (3227) Naftogaz seems to agree that the Parties have not agreed that a replacement according to Article 13.2 shall have retroactive effect.
- (3228) Naftogaz seems to accept that Article 13.2 does not give the Parties any express right to require a retroactive replacement. Instead, Naftogaz tries to support its retroactivity claim by stating that there is no support in Article 13.2 that a replacement could *not* be made retroactively.
- (3229) Gazprom denies that the absence of wording on retroactivity could ever mean that the parties have agreed that a replacement can take effect retroactively against one Party's will.
- (3230) Naftogaz further argues that a price provision which is in breach of competition law would be invalid as of the date "*the unacceptable effects occur*", and on this basis asserts that "[h]ence, *replacement must for obvious reasons apply as from the date of invalidity*".
- (3231) However, the question is not whether there are any "reasons" for applying a replacement retroactively. The question is whether there is a contractual basis in the Contract for a retroactive replacement, and there is not.
- (3232) In any event, there are no "*obvious reasons*" why a replacement based on Article 13.2 must apply retroactively. It cannot simply be assumed that a replacement provision should necessarily be applied from the date of invalidity. Why is that "obvious"? In fact, Article 13.2 requires the Parties to agree, which presupposes that they must negotiate, and negotiations typically and usually take time.

(3233) In this context it should be remembered that, if a Party suffers damage due to the fact that it has abided by a provision which is later declared invalid based on competition law, such Party has the possibility of claiming *damages*. Hence, the suffering Party is already protected under the Swedish Competition Act. Consequently, there is no necessity or "*obvious reason*" to replace an invalid contract provision retroactively.

(3234) If the Tribunal were to conclude that it cannot be established whether or not the Parties have agreed that a Party may require retroactive replacement, there would be a gap in the Contract. The Tribunal has not been given the mandate to fill such gap.

7.2.2.6.6.3 In any event, Naftogaz has no right to additional payments since Naftogaz has given Gazprom reason to believe that its payments constituted final settlements of Gazprom's payment obligations for transit services

(3235) If, contrary to Gazprom's position, the Tribunal were to conclude that Article 13.2 gives a Party the right to require a retroactive replacement of Article 8, Naftogaz still has no right to additional payments.

(3236) Naftogaz appears to agree with Gazprom that a right to additional payment can be excluded based on a contract law analysis of the conduct of the Parties.

(3237) The Parties, however, address this matter from two different angles. Naftogaz focuses on what would be required in order for a *waiver of right* to occur, whereas Gazprom's position is that the Tribunal should determine whether Gazprom *had justified reasons to believe that its payments constituted final settlements of debts*, and that Naftogaz therefore has no right to additional payment.

(3238) A right to additional payment in case of underpayments is excluded if the payer had justified reasons to believe that its payment constituted a final settlement of debt. In cases where the payer made payment under an invoice, the recipient must almost always understand that the payer believed its payment to be final. If the recipient of the payment wishes to request additional payment, it must give notice soon after ("*strax efter*") payment has been made.

- (3239) NJA 1991 p. 3 I and II (the "1991 Cases") confirm that the relevant test to be applied in cases of alleged underpayments is whether the payer had justified reasons to believe that its payment constituted a final settlement of debt. In these two cases, the recipient of payments for electricity later claimed additional payments because it had charged too little. The payer had paid in accordance with invoices.
- (3240) The Supreme Court stated in the 1991 Cases that "*it should [...] be considered to be of importance if the person against whom the claim is made has had reason to perceive an earlier payment as a final settlement of debt*" (emphasis added by Gazprom).
- (3241) Naftogaz claims additional payments for services that were invoiced as from 2010. Gazprom had every reason to trust the issued invoices. Naftogaz never made any objections to the paid amounts nor did it in any way reserve its right to additional payments. Naftogaz did not pursue a claim for additional payment until it submitted its Statement of Claim ("SoC") on 30 April 2015.
- (3242) It would have been easy for Naftogaz to reserve its rights or inform Gazprom that it considered itself entitled to additional payments, but it chose not to do so.
- (3243) It is evident that it would be contrary to the general interest of legal security and business relations (Sw. *omsättningsintresset*) if there would be a right to additional payment after such long time and in such very high numbers, when the payer had every reason to believe that its payments were final.
- (3244) Naftogaz claims that it has not waived its claim for additional payment. However, Gazprom has not claimed that Naftogaz has waived any claim. Gazprom's case is that Gazprom's payments constituted final settlements of debts, from a contractual law point of view. Naftogaz' waiver arguments are irrelevant and misconceived.
- (3245) If the Tribunal, contrary to Gazprom's position, would conclude that (i) it has the authority to decide new contract terms based on Article 13.2 and that (ii) it can replace contract clauses with

retroactive effect based on Article 13.2., then Naftogaz still has no right to additional payments for 2010 2015 because:

1. The proposed new Article 8 does not support the underpayment claim ; and
2. Gazprom had justified reasons to believe that its payments constituted final settlements of Gazprom's payment obligations for transit services.

(3246) Naftogaz' underpayment claim (i.e. its claim for additional payments for past periods) is a contractual claim based on the new wording of the Contract. This means that if there is no support in the new wording of the Contract for Naftogaz' claims, the claims shall be rejected.

(3247) It is in connection with Naftogaz' claims for additional payments for past periods that the significance of the very late change in Naftogaz' Relief Sought dated 26 November 2016 becomes clear. Until 19 November 2016, there was no basis for Naftogaz' underpayment claim for 2010 2015 because the proposed new Article 8 did not set out any tariffs for these years. This has now changed so that Article 8 would set out tariffs for 2010 2015. Again, the underpayment claim is not based on competition law or energy law, it is solely based on the Contract, as written.

(3248) Gazprom has requested that the amended wording of the proposed new Article 8 be dismissed.If not dismissed, this Gazprom's objection falls.

(3249) However, Naftogaz still has no right to any additional payments for the years 2010 2015 because Gazprom had justified reasons during January 2010-April 2015 to believe that its payments constituted final settlements of Gazprom's payment obligations for transit services. Also, Naftogaz does not have any underpayment claim for 2015.

7.2.2.6.6.4 Development of Gazprom's objections to Naftogaz' damages claim based on competition law

(3250) Naftogaz introduces a damages claim based on an alleged breach of competition law.

- (3251) Naftogaz states that Gazprom "*has been obliged to have knowledge of the relevant tariff levels that were to apply for gas transit in Ukraine*" and that Gazprom has "*at least been negligent when applying, and refusing to adjust, the non-compliant tariff in the Contract*".
- (3252) Gazprom denies Naftogaz' damages claim in its entirety. As set out above, Gazprom has not committed any breach of European competition law and related energy law. In any event, Gazprom has not acted intentionally or negligently which is a requirement for a right to damages under Chapter 3, Section 25 of the Swedish Competition Act.
- (3253) Gazprom has not known nor should it have known "*the relevant transit tariff levels that were to apply for gas transit in Ukraine*". Naftogaz has not even explained what transit tariffs Gazprom should have been aware of or how Gazprom should have obtained such knowledge. It is Naftogaz, not Gazprom, which has "*applied*" the contractual tariff in all its invoices. Further, Gazprom was never presented with the tariff formula now claimed by Naftogaz. Also, since that formula is based on a decision by the National Commission for the State Regulation of Energy and Utilities ("NCSREU") of Ukraine of 29 December 2015 it is an impossibility that Gazprom would, or should, have known of or applied that formula during the years 2010 2015.
- (3254) In any event, Naftogaz has not suffered any compensable damage. The alleged damage was not foreseeable to Gazprom at the time the Contract was concluded and is therefore not compensable according to CISG Article 74. Gazprom could never have foreseen that it would be liable to pay damages for not paying a transit tariff which was not set, or even presented, at the time the payments were made.
- (3255) In addition to the above, Naftogaz has lost any right to invoke the alleged breach of competition law/energy law since Naftogaz has not given Gazprom notice of breach in due time.
- (3256) There exists under Swedish law a general obligation to give notice of breach in commercial relationships, i.e. also without express statutory support. The effect of failure to give such notice

is a preclusion of rights.²⁶³ The time limit for giving such notice varies depending on the parties and the circumstances of the case. A couple of months has been accepted a few times and five months has been considered too late.

(3257) Naftogaz has put forward three different starting points for the alleged breach of European competition law and related energy law; 1 January 2010, 1 February 2011 and 1 January 2015. When assessing the time within which Naftogaz should have given notice of this alleged breach, these dates are the starting points. Naftogaz has not given notice of breach of European competition and related energy law until in its Request for Arbitration dated 13 October 2014. This clearly constitutes a late notice of breach in relation to the alleged claims of 1 January 2010 and 1 February 2011. If Naftogaz' letter of 25 July 2014 would be considered a notice of breach, which is contested, this would also constitute a late notice in relation to the dates 1 January 2010 and 1 February 2011.

(3258) Naftogaz has belatedly advanced a non-contractual claim for damages for breach of Ukrainian competition law. In order to prevail on this claim Naftogaz must meet a number of requirements. It has failed to meet these. Failure to meet any of these requirements must result in the rejection of the claim.

(3259) No jurisdiction: This is a non-contractual claim for damages. It does not fall within the scope of the arbitration clause in the Contract (Article 12.2). The legal basis for that claim is Ukrainian competition law and it relates to the level of the tariff paid by Gazprom. This non-contractual claim is a tort claim. It is not a dispute or disagreement "*related to the interpretation and application*" of the contract within the meaning of the clause. It is a claim for breach of a foreign law simpliciter. It does not therefore fall within the scope of this arbitration clause.

²⁶³ See Gazprom's SUP ARB Rejoinder, the arbitral award in *PCG Tools AB v. Bergenstråhle & Lindvall Aktiebolag*, and Johnny Herre in *Festskrift till Gertrud Lennander*, p. 139.

(3260) Ukrainian law is not applicable: For the reasons given above, Ukrainian law is not applicable. This is even if Naftogaz' arguments as to the applicability of Ukrainian law by virtue of article 6(3) of Rome II are correct.

(3261) As a matter of law and in any event, its argument as to the application of Rome II is wrong for a number of reasons:

1. Naftogaz argues that, for non-contractual claims, Article 6(3) Rome II lays down a mandatory rule that such claims are governed by the law of the country where the market is affected. Thus, according to Naftogaz, to the extent that the market in the EU is affected, EU competition law is automatically applicable.
2. Concerning Rome II and the applicability of Ukrainian law, Naftogaz again seems to rely on Article 6(3) Rome II and has argued that "*Ukrainian competition law is applicable to this issue pursuant to Art 6(3) Rome II*".
3. There are two separate, but interlinked, explanations as to why Naftogaz has fundamentally misunderstood the application of Article 6(3) Rome II and why neither EU law nor Ukrainian law can be applied based on this provision in this case.
 - First, the wording of Article 6(3)(a) Rome II, which is relevant here, explicitly restricts this provision as basis for applying competition law to circumstances that sufficiently affects competition within the EU internal market.
 - It is clearly set out in Article 6(3)(a) Rome II that this provision is only applicable if the non-contractual obligation arises out of a "restriction of competition". This term, "restriction of competition", is defined in recital 23 Rome II and Article 6(3)(a) Rome II is consequently limited to what this definition entails. Accordingly, it is not simply sufficient to argue that a particular law of a country must apply only because the market in that country is affected, as suggested by Naftogaz.

- Recital 23 Rome II reads as follows:

"For the purposes of this Regulation, the concept of restriction of competition should cover prohibitions on agreements between undertakings, decisions by associations of undertakings and concerted practices which have as their object or effect the prevention, restriction or distortion of competition within a Member State or within the internal market, as well as prohibitions on the abuse of a dominant position within a Member State or within the internal market, where such agreements, decisions, concerted practices or abuses are prohibited by Articles 81 and 82 of the Treaty or by the law of a Member State."

- Consequently, according to Recital 23 Rome II, only anti-competitive actions which have as their object or effect the prevention, restriction or distortion of competition within a Member State or within the internal market or abuses of a dominant position within a Member State or within the internal market fall within the definition of the term "restriction of competition" as used in Article 6(3)(a) Rome II, provided that these alleged anti-competitive actions or abuses are prohibited by Articles 101 and 102 TFEU.
 - However, in order for anti-competitive conduct to be prohibited by Articles 101 and 102 TFEU, Naftogaz must of course first establish that these provisions apply. In order to do so we are back where we started. Naftogaz must then establish that the qualified effects doctrine exists and is satisfied and, in addition, that the "effect on trade between Member States test" is satisfied. This it has failed to do.
4. Secondly, if the term "restriction of competition" would include effects of anticompetitive behaviour on competition within the internal market which would include lesser effects than those otherwise required under Articles 101 and 102 TFEU in order to establish jurisdiction under EU law, this would of course also mean that an alleged anti-competitive abuse outside the European Union could fall within Article 6(3)(a) Rome II and be

considered by a court in an EU Member State in circumstances where EU competition law otherwise would not be applicable.

5. The territorial restrictions of Articles 101 and 102 TFEU could thereby easily be circumvented by simply arguing that an alleged extraterritorial anti-competitive behaviour somewhere outside the European Union has some effect on competition within the EU internal market and that therefore the law of the country where the market otherwise is affected shall apply. This is surely not what the drafters had in mind when they restricted Article 6(3)(a) Rome II in accordance with recital 23 Rome II.

(3262) In conclusion, the required effects on competition within the EU internal market which are required under Article 6(3)(a) Rome II in order to satisfy the requirements of this provision must go hand in hand with the effects otherwise required under EU competition law in order to establish jurisdiction. This reading follows directly from the wording of recital 23 Rome II and the definition of the term "restriction of competition" therein as well as from the need not to circumvent the territorial restrictions of EU law inherent in Articles 101 and 102 TFEU. Consequently, the effect on competition within the internal market must at least coincide with the effects required under the qualified effects doctrine. Gazprom has addressed the meaning of the criteria under this doctrine at length. Neither EU law or Ukrainian law can become applicable under Article 6(3)(a) Rome II unless Naftogaz is able to satisfy this steep hurdle. Gazprom has demonstrated that they are unable to do so.

(3263) No infringement of Ukrainian competition law: Naftogaz has failed to establish that the tariff under the contract leads to infringement of Ukrainian completion law.

(3264) No entitlement to bring a damages claim: The conditions for bringing a damages claim on the basis of Ukrainian competition are not met. These conditions are set out in Gazprom's Supply Sur-Rejoinder paragraph 159. There was no finding by the ACMU that the tariff was of itself in breach of Ukrainian completion law.

(3265) Damages have not been proved: Naftogaz claims damages on exactly the same basis as its underpayment claims. The implicit assumption of such damages claim is that the minimum tariff that would comply with Ukrainian competition law is a tariff following the methodology of the Ukrainian regulator in 2015. There is absolutely no basis for such assumption. If the reason for breach is that the tariff is found not be cost reflective, then damages fall to be assessed on the basis of the lowest cost reflective tariff. That is certainly not the tariff applying the regulator's methodology for all the reasons given above.

(3266) Gazprom maintains its defences to Naftogaz' claims for interest as set out in its previous submissions , with the following additions:

1. In respect of Claims 4 Naftogaz claims interest on the entire capital amounts from various points in time when parts of the alleged "underpayments" had not even yet been made, and when no claim for payment had been submitted in this Arbitration.
2. Naftogaz has presented no support for its position. Gazprom disputes that interest pursuant to Sections 4 and 6 of the Swedish Interest Act can accrue on any debt before a claim for payment was made. Neither can any such interest on a claim for additional payment accrue before the alleged underpayment was made. The Tribunal should reject Naftogaz' claims for interest in Claims 4 from any point in time before claims for payment of such amounts were submitted by Naftogaz in this arbitration.
3. Naftogaz has a claim for interest pursuant to Sections 3 and 6 of the Swedish Interest Act, which refers to additional payments or damages for alleged breach of competition law. In any event, Gazprom disputes that Section 3 of the Swedish Interest Act is applicable in relation to Naftogaz's interest claim. The due date of the claim has not been established in advance as required under Section 3 of the Swedish Interest Act. Naftogaz has not presented any support for, or explained, why this claim would be due for payment on any specific date. Consequently, no interest pursuant to Sections 3 and 6 of the Swedish

Interest Act can accrue on Naftogaz' claim for additional payment or damages for alleged breach of competition law under Claim 8 (vii) from any of the dates invoked by Naftogaz.

(3267) In any event, no interest can accrue on any debt before any claim for payment was made by Naftogaz. Consequently, the Tribunal must reject Naftogaz' claim for interest from any point in time before Gazprom received Naftogaz' Sur-Reply.

7.2.2.7 Defences to Naftogaz' alternative claim for revision of the Transit Tariff on the basis of Swedish contract law

7.2.2.7.1 Introduction

(3268) As an alternative to its claims for invalidity and/or ineffectiveness as regards Article 8 of the Contract, Naftogaz also makes an alternative claim for revision of the transit tariff "*with effect as of the earliest date from and including 1 January 2010 as the Tribunal will determine*", based on the tariff review clause at Article 8.7 of the Contract.

(3269) Naftogaz seeks tariff revision under Article 8.7 on the basis of what it says was a tariff revision request by letter dated 15 June 2009.

(3270) The claim is wholly misconceived for a number of reasons to be developed below. In summary:

1. First, the claim fails on a variety of procedural grounds, namely that Naftogaz has failed to comply with the procedural conditions set out in Article 8.7 itself.
2. Secondly, and closely related to the first point, the request that was made, and is relied upon as the request triggering the machinery of Article 8.7, is self-evidently not a request to revise the tariff: tellingly, it was never suggested by Naftogaz that a request to revise had been made until nearly 6 years after the 15 June 2009 letter had been sent. It must follow that the claim fails if Naftogaz fails to demonstrate to the Tribunal's satisfaction that the letter of 15 June 2009 was a tariff revision request within the meaning of Article 8.7.

3. Thirdly, and in any event, the substantive grounds are not met, namely, the two substantive conditions set out in Article 8.7 itself. These have been referred to by the parties as being "trigger conditions 1 and 2" because, if Article 8.7 has not been triggered successfully (i.e. the conditions are not met), then there is no proper basis for the Tribunal to conduct a tariff revision exercise.
4. Fourthly, even if the substantive grounds are met, Naftogaz is not entitled to the revision of the tariff sought let alone to the wholesale "rewrite" of Article 8. The tariff revision Naftogaz seeks is not in fact a "revision" of the tariff, as the clause envisages and permits, but a wholesale "re-writing" of the entirety of Article 8 - including on Naftogaz' case (until it served its Pre-Hearing Submissions) the deletion of the tariff revision provision itself. The primary case submitted by Naftogaz is that the existing provisions of Article 8 should be deleted in their entirety and their primary case is that Article 8.7 is deleted and replaced with one-sided clauses in Naftogaz' favour which on any basis, would never have been agreed to by Gazprom had the draft clauses been put before Gazprom in a contractual negotiation.
5. Fifthly, even if the Tribunal is inclined in principle to order a tariff revision in Naftogaz' favour, Gazprom submits:
 - The Tribunal will have to determine the question as to what the proper level of the revised tariff should be. It is Gazprom's case that the level that Naftogaz seeks and invites the Tribunal to order is unjustified and will generate a very substantial windfall in Naftogaz' favour.
 - The Tribunal should reject the request by Naftogaz to have any revised tariff applied and ordered to apply retroactively by the Tribunal. Gazprom submits that a retroactive tariff revision is not permissible in this case.

6. Finally, even if the Tribunal finds against Gazprom in respect of each of the points above, Gazprom submits that the conduct of Naftogaz gives rise to the defence of waiver in Gazprom's favour, and the Tribunal is requested to find in Gazprom's favour in respect of this defence.

(3271) Article 8.7 of the Contract provides (in Gazprom's translation):

"8.7 In the event of a material change in 2010 and subsequent years of the conditions of formation of transit tariffs at the European gas market, as compared to what the Parties reasonably expected at the time of entering into this Contract, and if the transit tariff specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs at the European gas market, each Party shall have the right to address the other Party with a request to reconsider the transit tariff.

8.7.1 The request to reconsider the transit tariff shall be submitted in writing and duly substantiated by the requesting Party. Upon receipt by the respective Party of such request, the Parties agree, within 20 days, to enter into negotiations and, if they reach an agreement, to execute the relevant supplement to this Contract.

8.7.2 If the Parties fail to reach a written agreement to reconsider the transit tariff within 3 (three) months after the negotiations commencement date, each Party shall be entitled to refer the issue to arbitration in accordance with Article 12 of this Contract for final resolution."

(3272) Gazprom and Naftogaz agree that Article 8.7 is a tariff revision clause and that the Tribunal would have been empowered to revise the tariff if the procedural and substantive conditions set out therein had been met. However, for the reasons set out below, Gazprom maintains that these procedural and substantive conditions have not been met.

(3273) Gazprom makes the following observations by way of introduction in relation to the provisions of Article 8 contained in the Contract:

1. The tariff under the Contract was the product of negotiations between Gazprom and Naftogaz. What the Parties were prepared to accept and what they were not prepared to accept can be seen from the travelling drafts. It is clear, as will be seen below, that Gazprom was not prepared to accept cost reflective tariffs proposed by Naftogaz during the negotiations.
2. The tariff agreed is a distance-based tariff or, alternatively, a "point to point" tariff. It can be readily seen that the tariff for transit is that specified in Article 8.1 (and Article 8.2).
3. The tariff agreed under Article 8.1 is set for 2009 at USD 1.7 subject to prepayment provisions.
4. The tariff formula in Article 8.1 for 2010 onwards is based on starting rate of USD 2.04 with a part indexation element representing a tariff component and fuel gas component.
5. The fuel gas component is fixed on the assumption of a 3% fuel component and contract price so that Naftogaz is compensated within the contract tariff for its use of fuel gas.
6. Article 8.2 provides for a pre-payment tariff for 2009. This was to be extended in supplements and can be seen in Supplement 9 to the Agreement, see e.g. Article 3 of Addendum No. 9.
7. The provision in Article 8.7 for the revision of the tariff is clearly a reference to the tariff in Article 8.1, because that is what Article 8.7 refers to.

7.2.2.7.2 The Tribunal has no jurisdiction over Naftogaz' revision claims and these claims should therefore be dismissed (Sw. *avvisade*)

(3274) The Tribunal does not have any jurisdiction over Naftogaz' revision claims since:

1. Naftogaz has not submitted a duly substantiated request to review the tariff, meaning that the necessary preconditions to the exercise of rights under Articles 8.7 to 8.7.2 of the Contract have not been met;
2. even if Naftogaz had submitted a duly substantiated request, Articles 8.7 and 8.7.1 of the Contract require the Parties to enter into negotiations that are limited in scope to a review of the transit tariff and do not include the complete re-writing of Article 8 sought by Naftogaz;
3. Naftogaz' tariff revision claims fall outside the scope of Article 8.7.2 of the Contract;
4. the Tribunal's jurisdiction is in turn limited by the scope of the negotiations according to Articles 8.7 and 8.7.1 of the Contract and the actual negotiations have not included the complete re-writing of Article 8 pursuant to Article 8.7 sought by Naftogaz;
5. even if the Tribunal had any jurisdiction, such jurisdiction is now precluded by Naftogaz' failure to pursue its claims;
6. even if the Tribunal had any jurisdiction, such jurisdiction is now precluded by the fact that the Contract is no longer the same as it was when the request for revision was made; and
7. in any event, the parties have not given the Tribunal any power to make a wholesale revision of Article 8 pursuant to paragraph 1(2) of the Swedish Arbitration Act.

7.2.2.7.3 Naftogaz has not submitted a duly substantiated request, meaning that the necessary preconditions to the exercise of rights under Articles 8.7 to 8.7.2 of the Contract have not been met

7.2.2.7.3.1 Introduction

(3275) Articles 8.7 to 8.7.2 of the Contract set out procedural preconditions that must be met before the Parties enter into negotiations to review the tariff

(3276) The requirement for the submission of a written, duly substantiated request constitutes a mandatory pre-negotiation requirement, which must be satisfied before any tribunal will have jurisdiction. It has not been satisfied in this case.

(3277) The contractual prerequisite that any request be duly substantiated is not merely a formalistic requirement. Rather, it is self-evidently necessary in order to ensure that the subsequent *inter partes* negotiation obligations can operate effectively and informed negotiations can take place, by providing the responding party with sufficient information to enable productive negotiations.

(3278) Naftogaz has not submitted a request to review the transit tariff that complies with Articles 8.7 to 8.7.2 of the Contract. Naftogaz relies on its letter dated 15 June 2009 (the "2009 Request") as its request for review of the tariff pursuant to the Contract. However, crucially, being dated 15 June 2009, the 2009 Request was submitted more than six months before both:

1. any "*material change in 2010 and subsequent years of the conditions of formation of transit tariffs at the European gas market*" (emphasis added by Gazprom) (as stipulated in Article 8.7 of the Contract) could possibly have occurred (the earliest such date being 1 January 2010); and
2. the date when Naftogaz itself asserts that the two substantive conditions in Article 8.7 that are required for a tariff review request were satisfied, i.e. 1 January 2010.

(3279) Therefore, at the time when Naftogaz asserts it made a valid request to review the tariff in the Contract, it was impossible for the conditions necessary for such a review to have been satisfied. Indeed, Naftogaz does not now even assert that the conditions were satisfied at the time of the 2009 Request, relying on 1 January 2010 (and unspecified dates thereafter).

(3280) No explanation is given by Naftogaz as to this significant anomaly, the effect of which is that Naftogaz has submitted no duly substantiated request to review the transit tariff in compliance with Articles 8.7 and 8.7.1 of the Contract. This fundamental failure prevents any claim by Naftogaz to review the transit tariff pursuant to Articles 8.7 to 8.7.2 of the Contract.

(3281) Further, the 2009 Request does not satisfy the requirements of Articles 8.7 and 8.7.1 in any event, since it contains no justification of Naftogaz' request for tariff review on the basis of the required preconditions. Indeed, it could not have done so given that it was sent more than six months before such preconditions could have been satisfied and before Naftogaz could have had any grounds for requesting a tariff review.

(3282) The only justification given by Naftogaz in the 2009 Request for reviewing the tariff in accordance with Article 8.7 is the reduction in transit volumes given the stated absence of an obligation on Gazprom in the Contract to pay Naftogaz for minimum transit volumes (in direct contradiction to the position now taken by Naftogaz in these proceedings - see below):

".. the absence of such an obligation of [Gazprom] in [Contract TKGU] leads to a significant reduction of the effective natural gas transit rate, which gives grounds for its reconsideration under Clause 8.7 of [Contract TKGU]". (clarifications made by Gazprom)

(3283) Naftogaz' fundamental inconsistency in relation to the 2009 Request also demonstrates the fallacy of Naftogaz' reliance on the tariff review clause in general. By June 2009, in the 2009 Request, Naftogaz was already complaining about the contractual provisions it had agreed a mere five months before. However, notably, Naftogaz' complaints were about the volumes being delivered for transit and the lack of a minimum volume/payment obligation on Gazprom, rather than being complaints about the tariff *per se*:

"This problem is caused by the dissymmetry of the natural gas transit and purchase terms under the contracts signed on 19 January this year, in part of the acquiring party's provision of guarantees on the minimum level of settlements."

(3284) It is evident that Naftogaz' complaints about the provisions of the Contract were not a result of, as it now asserts, changes to conditions in relation to the formation of European transit tariffs or the tariff in the Contract becoming out of step with the European market, but rather that

Naftogaz later considered it had struck a bad bargain given the reduction in the volumes that were being transited.

(3285) Naftogaz' position (both in June 2009 and now) is also directly contrary to Naftogaz' expressed view just a few months earlier in January 2009, which was that the agreements were favourable to Ukraine and in particular that one of the successes achieved by Naftogaz in the negotiations specifically concerned the transit tariff formula (see the contemporaneous public statements of [REDACTED] on 21 January 2009, stating that the January 2009 arrangements with Gazprom were "*a victory of Ukraine in general and [Naftogaz] in particular*" and, with specific reference to the transit tariff, that "*a major victory of our negotiations with Gazprom was that at last the latter recognised that the average length of transit through Ukraine makes up to 1240 km*".)

(3286) Naftogaz also now attempts to mischaracterise its 2009 Request as seeking the remedy of "*revising the tariff to include a payment guarantee for the agreed transit volume, effectively turning the volume-based tariff into a capacity charge*". In fact, what Naftogaz sought was the introduction of a ship or pay obligation of the kind it now effectively asserts the Contract gives it in any event:

"..please consider we ask you to consider the possibility of amending amending [Contract TKGU] ... to guarantee the delivery of volumesprovision of natural gas volumes ... and payment for the agreed volume of natural gas transit services."

(3287) Contrary to Naftogaz' assertion, it is clear from the plain words of the 2009 Request above that no "revision" of the tariff or formula itself was suggested in the 2009 Request. What Naftogaz actually suggested in the 2009 Request was the inclusion of a ship or pay obligation on Gazprom equivalent to Naftogaz' take or pay obligation in the Gas Sales Contract, not any revision to the tariff.

7.2.2.7.3.2 The procedural conditions

(3288) The following procedural conditions must be fulfilled before a tribunal can revise the transit tariff. If any of these conditions remain unfulfilled, the tribunal has no jurisdiction and/or no substantive power under Article 8.7 to review the tariff pursuant to the tariff review request.

1. The requesting party must submit a request for the revision of the tariff to the counterparty under Article 8.7.1 ("Condition A").
2. The request must be made in writing ("Condition B")
3. The request must be "[duly/properly] *substantiated*"("Condition C").
4. The grounds for the tariff revision as pursued in front of the tribunal must be presented, at least in outline, in the request and maintained in the negotiations ("Condition D").
5. The tariff revision sought by the requesting party must be presented to the requesting party in the request, or at least in the negotiations ("Condition E").
6. The request must be made no earlier than 1 January 2010 ("Condition F").
7. The parties must have entered into negotiations within 20 days of the request, being received by the counterparty ("Condition G").
8. The negotiations must have been unsuccessful; in particular there must have been a failure to reach written agreement within three months of the commencement of the negotiations ("Condition H").

(3289) Each of these procedural conditions is addressed below.

(3290) Condition A: Naftogaz does not dispute that this condition needs to be satisfied. Nor could it. It is expressly stipulated in the last sentence of Article 8.7 and the first sentence of 8.7.1. It follows that the request must seek a change in the tariff under Article 8. Gazprom contends that the revision requested by the requesting party must be a change to the price for the transit

services as represented by the tariff formula. This is because Article 8.7.1 expressly so provides. Indeed Naftogaz' own translation of Article 8.7.1 states that "[t]he request for revision of the price for transit services shall be made in writing..." (emphasis added by Gazprom). Accordingly, if the request submitted does not seek a revision of the price, Condition A will not be satisfied.

- (3291) Condition B: This condition is not in dispute, but it is nevertheless an important condition. Accordingly, it is not possible for Naftogaz to make an oral request for revision of the transit tariff, or for Naftogaz to supplement orally a request that has otherwise been made in writing.
- (3292) Condition C: Article 8.7.1 expressly provides that the request must be "properly substantiated" (taking Naftogaz's translation) or "*duly substantiated*" (taking Gazprom's translation). Gazprom agrees with Naftogaz that the difference in the translations of this phrase is immaterial. However, the express words "properly/duly substantiated" cannot be ignored. They clearly are an important element of a valid request under Article 8.7. The requirement is not just that the request should be "*substantiated*" but that the substantiation should be "*proper*" or "*due*".
- (3293) With respect to the request for "substantiation", this is not merely a formalistic requirement. Rather, it is self-evidently necessary for the purpose of ensuring that the subsequent *inter partes* negotiation obligations can operate effectively and informed negotiations can take place, by providing the counterparty with sufficient information to enable productive negotiations
- (3294) For these reasons, the "substantiation" requirement imports a requirement that the requesting party must set out in its request, at least in outline, the reasons for the request.
- (3295) Naftogaz strives hard to cut down the substantiation requirement to the point of extinction. Naftogaz submits that a tariff revision request does not need to contain any description of the grounds on which revision is sought. In Naftogaz' view, as long as "*the counterparty understood* [from the request] *that the requesting party sought a tariff/price revision*" the request should be treated as duly substantiated. For Naftogaz, a bare statement that a party is requesting

a tariff revision, without any description at all of supporting grounds, complies with Article 8.7.1.

(3296) Naftogaz' position should be rejected for the following reasons:

1. Naftogaz' interpretation makes the requirement that a tariff revision request be "*duly substantiated*" meaningless. It effectively ignores those words of the contract.
2. Naftogaz' interpretation runs contrary to how similar requirements have been interpreted in the Gas Sales Contract context. In that context it is well established that a price review notice must contain a description of the grounds for seeking review. In ICC Case 9812 the tribunal held that "... *it is not sufficient only to request a price review without identifying any circumstance(s) at all*".²⁶⁴ Naftogaz itself cites Brautaset who states that a revision request (in the Gas Sales Contract context) must be "*somewhat specified so that the counterparty knows what he must be prepared to meet*" in the negotiations. There is no reason to take a different approach in the Transit Contract context (and indeed, Naftogaz does not argue to the contrary).
3. Naftogaz' interpretation has the consequence of undermining the negotiation process envisaged in Article 8.7.1.
4. Naftogaz cannot rely on the "*culture of negotiations between Naftogaz and Gazprom at that time [i.e., in 2009]*". The interpretation of Article 8.7.1 should not vary depending on whether or not particular officials, for instance Mr Dubina of Naftogaz and Mr Miller of Gazprom, "*had a friendly relationship*"²⁶⁵ at a given point in time.²⁶⁶

²⁶⁴ Final Award in Case 9812, August 1999 (Published in ICC International Court of Arbitration Bulletin, Vol 20/2, 2009).

²⁶⁵ [REDACTED]

²⁶⁶ [REDACTED] refers to Naftogaz' own considerations and decisions regarding the preparation of the 15 June 2009 Letter [REDACTED] 2). These unilateral decisions cannot be an expression of the *mutual intent* of the parties regarding the interpretation of Article 8.7.1.

5. Contrary to what Naftogaz contends, the fact that the parties to transit contracts are usually "*professional*" and well aware of market developments does not imply that the requirement of substantiation can be dispensed with. In the gas price review context the parties are also professional but that has not led tribunals to dispense with substantiation requirements.
6. Naftogaz refers to an unnamed "*recent arbitral award concerning price revision*" drawing analogies from notices of non-conformity under Article 39(1) of CISG and Section 32(1) of the "*Scandinavian Sale of Goods Acts*". Gazprom cannot respond to this argument given that that no copy of the "*recent arbitral award*", and the underlying contract to which it relates, has been provided. Nor has Naftogaz explained its case on this point in any detail. The requirements under Article 39(1) of CISG for a notice of non-conformity of goods, or for a notice of complaint (Sw. *reklamation*) under Section 32(1) of the Swedish Sale of Goods Act, are not relevant in this context. What is relevant is the particular requirements as set out in Article 8.7.1 of the Contract. In any event, Article 39(1) of CISG expressly requires that there must be a notice "*specifying the nature of the lack of conformity*". A failure to provide any description at all would not be sufficient in that context.

(3297) It is of note that, despite its attempts to write out the substantiation requirement from Article 8.7, Naftogaz concedes that the "substantiation" requirement necessitates some level of explanation within the request as to the grounds for the request.

(3298) Gazprom does not contend that the reference to "*substantiation*" in Article 8.7.1 requires a detailed and comprehensive explanation. The clause does not import such a requirement. It must however require at least an outline description of the grounds relied upon. Anything less will be to ignore the express contractual requirement for substantiation.

(3299) Article 8.7.1 also requires that the request be "*properly*" substantiated. Under Article 8.7, a party is not entitled to apply to the other party for a tariff revision unless the two substantive

conditions under Article 8.7 are satisfied. The substantiation contemplated by Article 8.7.1 is clearly intended to be by reference to those two substantive conditions, otherwise (a) there would be little point in requiring the substantiation and (b) the counterparty receiving the request would have no way of determining, even on a provisional basis, if the request was properly founded.

- (3300) It follows that in order for the substantiation to be proper, it must at least be capable of satisfying the two substantive conditions. So, for example, a request that seeks tariff revision on the grounds that the requesting party believes it negotiated the original tariff badly would not amount to a proper substantiation, since such substantiation could not of itself justify an entitlement to apply to the counterparty for a revision of the tariff.
- (3301) Condition D: This requirement is self-evidently necessary to ensure that, in default of agreement, the grounds for the request as pursued before the Tribunal are the same grounds as relied upon in the revision request and in the subsequent negotiations. This is obvious when one considers that the Tribunal's jurisdiction under Article 8.7 is only engaged when the parties have failed to arrive at an agreement on the new tariff. If the requesting party could rely on completely different grounds before the Tribunal to those advanced in the revision request and in the negotiations, this would render pointless the requirement under Article 8.7 for the request to be "*substantiated*". If the requesting party could drop its earlier grounds and rely on new grounds before the Tribunal, the mandated negotiation process under Article 8.7 would be completely undermined.
- (3302) Condition E: Upon a proper interpretation of Article 8.7.2, the Tribunal's jurisdiction and/or substantive power to revise the tariff is limited by the scope of the negotiations, which took place between the parties as required by Article 8.7.1. If the tariff revision requested by a party in its letter of request and/or maintained in the negotiations is different to that advanced before the Tribunal, the Tribunal has no jurisdiction or substantive power in relation to this later tariff revision.

(3303) Naftogaz submits that the requesting party is entitled to put forward a particular tariff revision in the arbitration process even if it has never been previously proposed to the counterparty in the revision request or during negotiations. Naftogaz' interpretation should be rejected for the following four reasons:

1. Naftogaz' interpretation cannot be reconciled with the text of Article 8.7.2 which provides that the "[*issue/matter*]" referred to arbitration is the failure of the Parties' negotiations over tariff revision. Accordingly, the mandate of the Tribunal does not extend to other matters, which are outside the scope of the Parties' negotiations. A tariff revision that has not been proposed (either in the tariff revision request or during the course of negotiations) has no connection with the failed negotiations between the parties and is, therefore, outside the tribunal's mandate.
2. Naftogaz' interpretation undermines the preference for negotiated solutions that is inherent in the scheme established under Article 8.7 of the Contract. If (as suggested by Naftogaz) tariff revisions were allowed to be presented for the first time in arbitration, this would risk an arbitration going ahead with respect to a revision request that could have been the subject of a negotiated settlement.
3. Naftogaz is wrong to suggest that if Gazprom's position is accepted "*each Party would have an unreasonable arbitrary power to tailor in advance its own future jurisdictional objections in arbitration, simply by refusing to discuss whatever issues it sees (un)fit*". To the contrary, a counterparty does not have a valid objection merely because it has refused to discuss a particular revision during meetings convened between the Parties. It only has a valid objection if the proposed revision was not presented to it, either in the revision request or during negotiations.
4. Naftogaz is wrong to assert that its "*entitlement to a decision should not be limited by alleged procedural shortcomings*" and it is wrong to rely on the final award in ICC Case 13504. In ICC Case 13504 the tribunal allowed parties to submit supplementary

evidence in light of "*difficulties*" they faced. The failure to give notice of a tariff revision is not comparable to the failure to meet a deadline to provide supportive evidence. In any event, the Parties to the Transit Contract do not face any particular "*difficulty*" in presenting their revision proposals in a timely manner.

(3304) Condition F: Under Article 8.7, the right to apply for a revision of the tariff only arises if the substantive conditions are satisfied. Since the first substantive condition is that a "significant change" has occurred in 2010 and subsequent years, it must follow that the request cannot be made earlier than 1 January 2010. If that was not the case and if, as Naftogaz asserts (and Gazprom disputes), a tariff revision can be made retroactively to the date of the request, Naftogaz would be able to secure a tariff revision with effect from a date prior to 1 January 2010. That clearly was not the intention of the parties. If they had so intended, Article 8.7 would have referred to a significant change occurring after the date of the Contract.

(3305) Condition G: This cannot be in dispute. It is what Article 8.7.1 says. The requirement for negotiation over a period of at least three months (see Articles 8.7.1 and 8.7.2) ensures that the parties attempt to seek agreement on the revised tariff with the option of referral to arbitration only arising where agreement has proved not to be possible. The requirement in Article 8.7.1 for the negotiation to commence within 20 days of the request being made provides certainty as to whether a tariff revision request is being pursued. Without such a requirement, the counterparty could be left in a position of uncertainty for months, if not years, as to whether the requesting party plans to implement its tariff revision request by commencing negotiations.

(3306) Condition H: Again, this cannot be in dispute. It is what Article 8.7.2 says. Negotiations did not commence let alone fail prior to the commencement of Arbitration.

7.2.2.7.3.3 Naftogaz' 15 June 2009 Letter does not comply with Article 8.7.1 because it did not make a request to revise the Tariff: Condition A is not met

(3307) In order to comply with Condition A, Naftogaz needed to make a request to revise the tariff.

(3308) The only request upon which Naftogaz relies is its letter dated 15 June 2009 (the "15 June 2009 Letter"). On no sensible view can it be said that this letter makes a request for a revision of the tariff. This is the case whether the Tribunal accepts Gazprom's argument that a revision of the tariff under Article 8.7 is confined to a change to the price formula, or whether it accepts Naftogaz' argument that a revision of the tariff extends to a revision of the entirety of Article 8 ("Tariff for the Gas Transit"). The letter is clear in its terms; it seeks amendment of the Transit Contract:

"In view of the foregoing, please consider the possibility of amending the Transit Contract in part of JSC «GAZPROM» undertaking an obligation in favour of NAK Naftogaz of Ukraine to guarantee the provision of natural gas volumes for transit through the territory of Ukraine and payment for the agreed volume of natural gas transit services similarly to the Contract for the Sale and Purchase of Natural Gas in 2009-2019 dated 19 January 2009"

(3309) The requirement for a guarantee on delivery volumes was in effect a request for amendment of Article 3 of the Contract. It has nothing to do with a revision of the price formula, let alone of the provisions of Article 8.

(3310) Naftogaz points to the fact that it explicitly referred to its right to revise the tariff pursuant to Article 8.7. It is correct that, in the penultimate paragraph of the 15 June 2009 Letter, Naftogaz contended that the absence of the equivalent of a ship or pay obligation in the Contract leads to *"a significant reduction of the effective natural gas transit rate"* and that this *"gives grounds for its reconsideration under Clause 8.7 of the Contract"*. However, as is plain from a reading of the letter, Naftogaz did not then seek to exercise its right under Article 8.7 to revise the tariff. Rather, having noted its right to apply to revise the price, it sought instead to propose an amendment of the Contract by the inclusion of a guarantee on delivery volumes.

(3311) Furthermore, it is evident from Gazprom's response to this letter that Gazprom did not understand the letter to be requesting a tariff revision, but rather (as it was) a proposal to amend the

Contract by include a guarantee for delivery volumes.²⁶⁷ That proposal was rejected by Gazprom in its letter of 5 August 2009. This concluded the communications between the parties on the issue.

(3312) Furthermore, if Naftogaz' letter of 15 June 2009 had been intended as a tariff revision request, Naftogaz would have commenced negotiations within 20 days to agree tariff revision, in accordance with Article 8.7.2. No such negotiations were instituted for the obvious reason that there had been no tariff revision request.

(3313) Naftogaz refers to correspondence between Naftogaz and Gazprom in 2009 and 2011. However, none of these letters referred back to Naftogaz's letter of 15 June 2009 or referred to there being an outstanding request for tariff revision under Article 8.7. Indeed, the first time that Naftogaz suggested that the letter of 15 June 2009 was a tariff revision request under Article 8.7 was in its Statement of Claim in this Arbitration.

(3314) For these reasons, the tribunal should find that Condition A has not been satisfied. The consequence must be the dismissal of the tariff revision claim.

7.2.2.7.3.4 Naftogaz' 15 June 2009 Letter does not comply with Article 8.7.1 because it is not "properly [duly] substantiated": Condition C is not met

(3315) Gazprom has objected to Naftogaz' 15 June 2009 Letter on the basis that it was not "*duly substantiated*". Gazprom's position is that in order to be "*duly substantiated*" a tariff revision request must contain, at a minimum, a summary or outline description of the grounds for contending that the substantive conditions in Article 8.7 are made out. Furthermore, it is Gazprom's position that, if the grounds set out in a revision request are incapable of satisfying the substantive conditions of Article 8.7 the tariff revision request cannot be described as "*duly substantiated*" (Condition C).

²⁶⁷ See Letter No. 06-1758 from Gazprom to Naftogaz dated 5 August 2009. See also Medvdev 2, Kuznets 2, and Korobanova.

(3316) The fundamental shortcoming of the 15 June 2009 Letter in this regard is that it refers to a ground for tariff revision which is incapable, even if assumed to be factually correct, of supporting a conclusion that the substantive conditions in Article 8.7 are made out.

1. The 15 June 2009 Letter identifies the absence of any obligation on Gazprom under the Contract to pay Naftogaz for minimum transit volumes, which is said to lead to a significant reduction of the effective natural gas transit rate, as giving grounds for a tariff revision (though, as stated above, Naftogaz did not go on in the letter to seek a revision of the tariff).
2. However, this reason: (1) does not involve any change connected with the European gas market, much less any change (occurring after 1 January 2010) which affects transit tariff formation in that market; and (2) does not involve any comparison between transit tariffs in the European gas market and the transit tariff established under the Contract.
3. The 15 June 2009 Letter does not even assert that the reduction of the natural gas transit rate will continue to occur in 2010 and subsequent years. The furthest it goes is to say that the reduction of natural gas transit volumes "threatens to cause a significant unplanned financial deficit of the Company in 2010 and subsequent years." (emphasis added by Gazprom).
4. As a consequence, the ground for tariff revision set out in the 15 June 2009 Letter is simply incapable of supporting any conclusion that Conditions One and Two are met.

(3317) Naftogaz' main response to this objection is that there is no need to set out any grounds at all in a tariff revision request. However, this response is based on an erroneous interpretation of Article 8.7.1.

(3318) Naftogaz makes two further responses, both of which should also be rejected.

1. Naftogaz notes that the 15 June 2009 Letter refers to "... Gazprom's unexpected reduction in gas volumes delivered for transit [rendering] the increase in the transit tariff foreseen under the Contract from 1 January 2010 insufficient to let Naftogaz cover its cost" and concludes that "[t]his was an obvious change compared to the Parties' expectations". However, it is not enough for any unexpected change to be identified. The unexpected change must relate to the conditions for transit tariff formation in the European gas market. The change that Naftogaz refers to has nothing to do with transit tariff formation in the European gas market.
2. Naftogaz argues that "the letter and its content was [sic] in itself sufficient to prepare Gazprom for a subsequent discussion of the unexpected drop in transit volumes and the shortcomings of the tariff under the changed conditions". The 15 June 2009 Letter needed to identify grounds which are capable of supporting a conclusion that the substantive conditions in Clause 8.7 are met. It does not do this. The fact that it allegedly identifies "*shortcomings of the tariff under ... changed conditions*" in some broad sense is immaterial, and insufficient to meet the requirements of Clause 8.7.

(3319) To conclude, the 15 June 2009 Letter does not comply with Condition C because it does not refer to grounds which are capable of supporting a transit tariff revision under Clause 8.7. The tariff revision claim should be dismissed for this reason also.

7.2.2.7.3.5 Naftogaz' tariff revision claim cannot be advanced as the revisions proposed by Naftogaz were not presented to Gazprom in the 15 June 2009 Letter or in the course of negotiations between the Parties: Condition E is not met

(3320) Gazprom has objected to Naftogaz' tariff revision claim on the basis that the revisions put forward by Naftogaz in this Arbitration "[were] *not presented to Gazprom or identified by Naftogaz in any correspondence or during any negotiations prior to Naftogaz's filing of its Statement of Claim in these proceedings on 30 April 2015*".

- (3321) Naftogaz' primary response to this objection is a legal one: it contends that there is no requirement that a tariff revision be presented to the non-requesting party in advance of arbitration. That response has been addressed, and comprehensively rebutted, by Gazprom.
- (3322) That still leaves the question of whether Naftogaz, as the requesting party, has, as a matter of fact, complied with the requirement to convey the revisions that it seeks to Gazprom, the non-requesting party. While Naftogaz asserts that it has "*sought at numerous occasions to initiate negotiations on the revision of the transit contract and in particular of the tariff level and methodology*" it does not (and could not) suggest that the specific revisions that it currently seeks were described, even in outline or summary form, in any document or oral exchange between the parties prior to 30 April 2015 (when Naftogaz filed its Statement of Claim).
- (3323) Naftogaz also asserts that Gazprom took an approach "*of either ignoring or rejecting Naftogaz's efforts to initiate negotiations on substance both with regard to volumes and tariff*". It is not clear what conclusion Naftogaz seeks to draw from this assertion. In particular, it is not apparent how this assertion, even if it were correct, would allow this Tribunal to grant a tariff revision which was never previously presented by Naftogaz and thus never discussed between the parties. Gazprom notes that, even if a non-requesting party refuses to participate in negotiations (as required under Article 8.7.1), the requesting party is still required to present the revision it seeks. It can always present the revision sought by means of correspondence if the non-requesting party is intransigent.
- (3324) In summary, the revisions proposed by Naftogaz were not presented to Gazprom in the 15 June 2009 Letter or in the course of negotiations between the Parties. Condition E has not been satisfied.
- (3325) Accordingly, the Tribunal cannot assume jurisdiction over Naftogaz' price revision claim, nor does it have substantive power to do so.

7.2.2.7.3.6 The 15 June 2009 Letter was made before 1 January 2010: Condition F is not met

(3326) Condition F has not been satisfied because the 15 June 2009 Letter pre-dated 1 January 2010. In short, the "event" of "*a material change in 2010*" self-evidently cannot take place until 2010, and there was no such "event" when Naftogaz submitted its request dated 15 June 2009. On this ground also, the tariff revision claim should be dismissed.

7.2.2.7.3.7 The Parties did not commence negotiations within 20 days of the request or at all in relation to the 15 June 2009 Letter: Condition G is not met

(3327) It is a question of fact whether the Parties commenced negotiations to agree a new tariff in accordance with the request within the 20 day period. The failure to commence negotiations within 20 days is sufficient in itself to result in the failure to meet Condition G. The consequence of such a failure must be that the tariff revision request is no longer operable.

(3328) Alternatively, even if the requirement to commence negotiations is not time-critical, it is clear that there must have been negotiations pursuant to a tariff revision request, since it is only where those negotiations have been unsuccessful after a period of 3 months that a party is entitled to refer the matter to arbitration.

(3329) As a matter of fact, Naftogaz did not seek to initiate negotiations with respect to the 15 June 2009 Letter, whether by 5 July 2009 or at all. [REDACTED] refers to eight letters from Naftogaz to Gazprom between 10 August 2009 and 15 September 2011: none of those letters contain a request to revise the transit tariff pursuant to Article 8.7 of the Contract nor a request to Gazprom to enter into tariff revision negotiations in accordance with Article 8.7. This is hardly surprising given that the letter of 5 July 2009 was not a tariff revision request but a request for a volume guarantee provision. That request was swiftly rejected in Gazprom's letter of 10 August 2009, bring to an end that chain of correspondence.

(3330) Naftogaz also refers to four press reports and an extract from a prospectus which either: (1) state that Ukrainian officials were unhappy about the level of the tariff under the Contract; or (2) state that the matter of the tariff level was the subject of discussion between Russia and

Ukraine. Again, none of these statements remotely establish that Gazprom failed to comply with its obligations under Article 8.7.1 of the Contract.

(3331) Accordingly, Condition G has not been satisfied. This is a further reason to dismiss the tariff revision claim.

7.2.2.7.4 Naftogaz' tariff revision claim involves unauthorized gap-filling and therefore the Tribunal lacks jurisdiction pursuant to Section 1(2) of the Swedish Arbitration Act

(3332) For the reasons set out above, Naftogaz seeks tariff revision in circumstances which fall outside the scope of Article 8.7 of the Contract. In these circumstances, the Tribunal has no express jurisdiction under Article 8.7, nor can any such jurisdiction be implied.

(3333) Gazprom maintains its objection that the Tribunal accordingly lacks jurisdiction pursuant to Section 1(2) of the Swedish Arbitration Act. Naftogaz' Claims that rely upon Article 8.7 of the Contract should be dismissed accordingly.

(3334) For the record, Gazprom denies Naftogaz' assertion that "*arbitrators have an inherent right when interpreting agreements to imply a price term*". Naftogaz refers to Section 45 of the Swedish Sale of Goods Act, which provides as follows:

(3335) In-house English translation: "*If the price does not follow from the contract, then the purchaser shall pay what is reasonable by reference to the type and nature of the good, usual price at the time of the purchase and the circumstances in general.*"

(3336) However, it will be apparent that the circumstances covered by Section 45 of the Swedish Sale of Goods Act are entirely different from the present case.

7.2.2.7.5 Naftogaz has waived, or otherwise lost through passivity, its right to pursue its claim for tariff revision

(3337) In any event, even if the Tribunal were to find that Naftogaz did make a valid tariff revision claim by means of its 15 June 2009 Letter (despite the lack of subsequent negotiations),

Gazprom maintains that Naftogaz has abandoned any such claim, or it must be treated as having lapsed by reason of Naftogaz' failure diligently to pursue it within a reasonable time.

(3338) Naftogaz states in response that, in order for passivity or actions by a party to be considered a waiver of a claim, it is required that "*(i) the other party has in fact interpreted the actions/passivity as the expression of an intention of a waiver, (ii) this impression must be justifiable/reasonable, and (iii) the person who has taken the relevant actions, or has been passive, must have understood the other person's impression*".

(3339) Naftogaz states further:

"Gazprom has not invoked that Gazprom actually has gotten the impression that Naftogaz has waived its right to retroactive revision or that Naftogaz understood that Gazprom held that impression"; and

that in any event, with reference to NJA 1993 p 570 and NJA 1961 p. 26, "*a time period of six years is far too short to give any impression of a waiver*".

(3340) Naftogaz' position is misconceived, both as a matter of law and on the facts.

(3341) As a matter of law, it is notable that Naftogaz has failed to comment on the later Supreme Court case, NJA 2002 p. 630, that Gazprom relied on in its Defence and Counterclaim (paragraph 463 and footnote 384), in which the court stated:

In-house English translation: "*Loss of a right on grounds of passivity can however arise, as the restaurant [which is a party to the case] has claimed, according to general commercial law principles.*" ... "*A requirement to give notice of the fact that a claim is made can, however, exist when a party knows that the other party has acted in a certain way in reliance upon a legal judgment that is incorrect (cf section 6(2) of the [Swedish] Contracts Act) or when a party has given the opposite party reason to believe that he has given up his rights (see e.g. NJA 1961 p.*

26) or when a party during a very long time has failed to pursue its claim (see e.g. NJA 1993 p. 570 and Karlgren, Passivitet, 1965 p. 10 et seq)."

(3342) Further, in the Swedish Supreme Court case NJA 1961 p. 26, is relevant and useful in this context.

(3343) Gazprom knows of no statement of the Swedish Supreme Court, or other authority, that could support the Naftogaz' assertion that "*a time period of six years is far too short to give any impression of a waiver*". There is no such authority. In any event, each case must, of course, turn on its own facts.

(3344) On the facts of the present case, Gazprom maintains that:

(3345) By not asking for a tariff revision, but instead asking for a volume guarantee, Naftogaz gave Gazprom the clear impression by its 15 June 2009 Letter that it was not seeking a revision of the tariff at all under Article 8.7 of the Contract;

(3346) This was all the more the case, given that Naftogaz actually referred to Article 8.7 of the Contract in its 15 June 2009 Letter and suggested (wrongly) that it would have had grounds to seek a tariff revision yet, despite referring to the possibility of tariff revision, Naftogaz did not ask for a tariff revision;

(3347) By not pursuing any negotiations under Article 8.7 within 20 days or at all for tariff revision pursuant to the 15 June 2009 letter, despite the contractual requirement for such negotiations within such time period if a tariff review request is to be implemented, Naftogaz further gave Gazprom the clear impression that it was not seeking a revision of the tariff at all under Article 8.7 of the Contract;

(3348) By not pursuing tariff revision pursuant to its 15 June 2009 Letter until service of its Statement of Claim in these proceedings, a period of almost 6 years, Naftogaz gave Gazprom the clear

impression that it was not seeking to implement any request within its 15 June 2009 Letter to revise the tariff under Article 8.7.

(3349) Naftogaz claims that it should not be considered to have waived any claims, since it "*continuously challenged the tariff throughout the time period between January 2010 and July 2014*". However, at no time in any such correspondence did Naftogaz refer back to its 15 June 2009 Letter or otherwise indicate that it was seeking to implement a request for tariff revision made in such letter. Thus, at no time upon receipt of such correspondence did Gazprom have any reason to suppose that Naftogaz intended to exercise a right to claim a tariff revision under Article 8.7 of the Contract based on that letter. In actual fact, of course, Naftogaz had no such intention.

7.2.2.7.6 The substantive conditions

7.2.2.7.6.1 Introduction

(3350) Naftogaz asserts that Article 8.7 of the Contract contains "*two cumulative conditions*" for a review of the transit tariff, as follows:

1. there must be a "*material change in 2010 and subsequent years of the conditions of formation of transit tariffs at the European gas market, as compared to what the Parties reasonably expected at the time of entering into [Contract TKGU]*" ("Condition One"); and
2. the "*price for transit services as provided for in Article 8.1 of the Transit Contract does not correspond to the level of transit tariffs in the European gas market*" ("Condition Two").

(3351) Naftogaz asserts that:

1. Condition One is allegedly met because "*with the adoption of the Third Energy Package[...] in particular Directive 2009/73/EC and Regulation (EC) No. 715/2009, the principle of cost-reflective, non-discriminatory tariffs for transmission services*

prevailed and became established and mandatory EU energy and competition law [...]
This means that the terms for determination of transit tariffs in the European gas market had changed, contrary to the Parties' expectations, as reflected in the agreed tariff as well as in the tariff revision clause" (the "TEP Cost-Reflective Tariff Requirement Ground" in short).

2. Condition Two is allegedly met because "*The relevant market level [...] is [...] the price level based on cost-reflective tariffs [...] the price under the Contract does not correspond to the price under a cost reflective tariff, which would cover Naftogaz' costs plus a reasonable return on investment, but is significantly lower*" (the "Cost Reflective Comparison Ground" in short).

(3352) By way of contrast, in the 15 June 2009 letter the ground on which a contract amendment was sought was that the Contract did not contain any obligation to pay for minimum transit volumes. It is apparent that this ground is altogether distinct and separate from the TEP Cost-Reflective Tariff Requirement and Cost-Reflective Comparison Grounds that Naftogaz advances in this arbitration. [REDACTED] appears to accept that the 15 June 2009 letter does not set out any of the grounds for tariff revision that Naftogaz belatedly advances in this arbitration. He states that "*the analysis of significant changes of terms for determination of transit tariffs and their level in the European gas market can be rather complex [...] to include this discussion in our request did not seem practical [...]*" (emphasis added by Gazprom).

(3353) The total change between the ground notified in the 15 June 2009 Letter and the two grounds advanced in this Arbitration, and the total change in the revision sought, is fatal to Naftogaz' price revision claim. The Third Energy Package Cost-Reflective Tariff Requirement and Cost-Reflective Comparison Grounds ground, are outside the scope of, and not connected to, the specific ground identified in the 15 June 2009 Letter.

(3354) The stark difference between the substantiation advanced in the 15 June 2009 letter and that advanced before the Tribunal is illustrated by the difference in the Contract revision sought.

The 15 June 2009 letter sought a guaranteed volume delivery obligation. In contrast the revision sought before the Tribunal by way of tariff revision is a re-written Article 8 which contains no guaranteed volume delivery obligation but rather provision for "*daily tariffs for entry and exit capacity booked on a non-interruptible basis at the entry and exit points [...]*."

(3355) Gazprom submits that Naftogaz' claim for tariff revision should be rejected on the merits. Naftogaz cannot discharge its burden of establishing that the two substantive conditions for a tariff revision are met in this case.

(3356) The Parties, disagree about how the substantive conditions are to be interpreted.

7.2.2.7.6.2 Condition One has not been met

(3357) In support of its argument that Condition One is satisfied, Naftogaz asserts that the "*terms for the determination of transit tariffs*" had, contrary to the parties' expectations, "*changed such that competitive pricing became entirely off-market and cost-reflective pricing came to be the prevailing principle*". Naftogaz states that "*in fact .. this [cost-reflective] pricing principle became mandatory under EU competition and energy law*".

(3358) Naftogaz cannot establish that Condition One is met because:

1. contrary to Naftogaz' assertion, the terms for determination of transit tariffs in the European gas market had not materially changed;
2. alternatively, insofar as there was a material change, the parties had reason to expect such change as at the date of the Contract; and
3. in any event, any such change falls outside the scope of Article 8.7 because it occurred prior to 1 January 2010.

7.2.2.7.6.2.1 No material change

(3359) The argument that cost-reflective pricing for transit tariffs represented a "*material change*" in 2010 and subsequent years to the conditions of formation of transit tariffs in the European gas

market as compared to what the parties reasonably expected in January 2009 pursuant to Article 8.7 of the Contract is misconceived, for the following reasons:

1. cost-reflective transit tariffs did not constitute a material change to the conditions of formation of transit tariffs in the European gas market in 2010 or thereafter; and
2. in any event, to the extent that cost-reflective tariffs did constitute a material change in the conditions of formation of transit tariffs in the European gas market in 2010 and thereafter, the parties could reasonably have expected such a change in January 2009.

(3360) Naftogaz asserts to have identified the material change. It said that cost-reflective pricing came to be the prevailing principle as the cost-reflective pricing principle became mandatory under EU competition and energy law. Naftogaz relies in this regard on the introduction in 2009 of the Third Energy Package.

(3361) Contrary to Naftogaz' statement that "*[t]he Third Energy Package .. introduced the principle that tariffs should be cost-reflective*", the principle of cost-reflective pricing for transit services was established in the European Union as early as 2003.²⁶⁸

(3362) Regulation 1775/2005 further confirmed this principle.

(3363) Naftogaz argues that the reference in Regulation 1775/2005 to "*the benchmarking of tariffs*" allowed "*competitive pricing*", as opposed to cost-reflective pricing, to remain a "*relevant option*". However, Regulation 1775/2005 simply envisaged the benchmarking of tariffs to be a "*relevant consideration*" in the context of calculating cost-reflective transit tariffs in certain circumstances. Rather than being an alternative to cost-reflective tariff formation (and the two options being mutually exclusive as implied by Naftogaz), benchmarking was envisaged as part of the process of forming cost-reflective tariffs "*where appropriate*". The key principle of cost-reflective tariff formation itself was clearly set out in and required by the Regulation.

²⁶⁸ See Directive 2003/55/EC of 26 June 2003 (known as the "Second Gas Directive"), Recital 16.

- (3364) Mr Witschen has explained that the existing requirements for cost-reflective transit tariff calculation were maintained by the Third Energy Package in 2009 and that the relevant regulations set a binding approach for tariff formation by reference to principles of cost-reflectiveness.
- (3365) All of these regulatory developments took place before 1 January 2010 and therefore the use of cost-reflective transit tariffs in the EU cannot constitute a "*material change in 2010 and subsequent years*" to the conditions of formation of transit tariffs as referred to in Article 8.7 of the Contract. Indeed, Mr Witschen's view is that even before the Third Energy Package was adopted in 2009, the principles of transit tariff formation in the EU on the basis of cost-reflectiveness were clear.
- (3366) Therefore, Naftogaz' suggestion that it was "*not clear*" in January 2009 what the generally accepted pricing mechanism for the transportation of gas in the EU would be (in particular whether the "*competitive pricing*" mechanism or cost-reflective tariffs would be used) is obviously wrong. To the contrary, EU regulation since 2003 had referred to and reinforced the principle of cost-reflective transit tariffs. There can also be no doubt that when the Third Energy Package was passed in July 2009, it was clear that transit tariff pricing should be cost-reflective. Since Condition One requires a material change "*in 2010 and subsequent years*" (emphasis added by Gazprom), this in itself is sufficient to defeat Naftogaz' argument that cost-reflective pricing constituted such a change.
- (3367) Gazprom has pointed out that the provisions within the Third Energy Package regarding the introduction of cost-reflective pricing are in virtually identical terms to Regulation 1775/2005 and therefore pre-dated the Contract.
- (3368) Naftogaz seeks to meet the failure to establish material change for the purposes of Condition One by arguing that the Third Energy Package introduced material change by (1) abolishing the exemption for legacy contracts and (2) abolishing the practice of setting tariffs based on contract paths.

(3369) However, Naftogaz is wrong in asserting that the exemption for legacy contracts was removed for the first time under the TEP. In fact, the exemption was removed with effect from September 2005 by Regulation 1775/2005 with respect to the requirements for setting nondiscriminatory and cost-reflective tariffs. The fact that some contracts in the market were exempted and that exemption was removed by TEP does not of itself constitute a material change as required by the first condition. Naftogaz' position on this issue was unsupported. Mr Lapuerta accepted that he was unable to provide any evidence as to: (1) the number of supposedly "exempt" legacy contracts in operation as at January 2009, (2) whether any of the legacy contracts in existence were concluded on a costs reflective basis or not, (3) when transit contracts, which were not costs reflective, had their terms changed to a costs reflective basis and (4) what percentage of contracts concluded after 2003 within the EU were not on a costs reflective basis. A number of experts gave evidence on the issue as to the price formation mechanisms in the European gas market including within the EU as at January 2009.

(3370) Another change sought to be relied upon by Naftogaz is that entry/exit capacity charges must be imposed onto the Contract by the TEP and no longer can a point to point tariff exist in the contract as per the Transit Contract. This was a change made by the TEP and the evidence demonstrated that this change was in fact foreshadowed in both the June and July 2008 and January 2009 versions of the TEP and implemented materially in those terms in July 2009.

(3371) Confronted with the obvious difficulty of satisfying Condition One on the basis of the "material change", Naftogaz seeks to invoke separate and additional grounds for tariff revision in the form of the purported decline in volumes shipped by Gazprom. Naftogaz states that the "*decline of transit volumes in 2010 and subsequent years is a relevant change in the terms/conditions for determining transit tariffs in the meaning of Clause 8.7*". It also asserts that Gazprom has failed to address this "*relevant change*".

(3372) Gazprom's response is three-fold:

1. First, Naftogaz is wrong to suggest that the transit volumes were identified as a ground for tariff revision. Naftogaz was absolutely clear that the basis on which it sought a tariff revision was the altogether different ground that "... [by 1 January 2010] *The terms for determination of transit tariffs had, contrary to the Parties' expectations, changed such that competitive pricing became entirely off-market and cost-reflective pricing came to be the prevailing principle.... In fact, as illustrated above, this pricing principle became mandatory under EU competition and energy law.*"
2. Second, this ground is, in any event, outside the scope of Article 8.7 of the Contract. The volumes of gas shipped by Gazprom through Ukraine do not, and cannot, alter the "*conditions of formation of transit tariffs [in] the European gas market*". Naftogaz does not explain how this could be the case. In this regard, it is noteworthy that Naftogaz' experts, Mr Lapuerta and Dr Hesmondhalgh make no reference to this matter in their expert report titled "*Change in European Transit Tariff Formation*".
3. Third, Naftogaz is not entitled to advance this ground for tariff revision because Condition D of Article 8.7 (discussed above) is not met. Naftogaz' current ground refers to volume decreases in 2010 and subsequent years. That ground could not have been identified in a June 2009 letter which predated any such volume declines by more than a year.

(3373) The final area of difference between the Parties on the interpretation of Condition One concerns the test for unexpected change. It is clear from the language of Article 8.7 that this is an objective test. Article 8.7 refers to "*what the Parties had reason to expect*"; it does not refer to what the Parties subjectively expected. Naftogaz proposes a combination of subjective and objective tests, both of which must be satisfied; namely that the Parties must subjectively have had the expectation in question and that such expectation must have been based on reasonable grounds. There is no basis for such a dual test. It is clear from Article 8.7 that the test is an objective one, namely what the parties had reason to expect.

7.2.2.7.6.2.2 Change reasonably expected

- (3374) Even if (which is denied) it was the case that cost-reflective tariff formation constituted an event of material change in 2010 and subsequent years to the conditions of formation of transit tariffs in the European gas market, Condition One would still not be satisfied, since such change was reasonably expected by the parties at the time of entering into the Contract.
- (3375) The various provisions set out above demonstrate that the principle of cost-reflective transit tariffs was enshrined in EU legislation from at least 2003 and that it was expressed in mandatory terms in legislation that was in effect on the date the Contract was signed on 19 January 2009.
- (3376) The development of the Third Energy Package from the Second Energy Package is described by Mr Witschen. As apparent from this table, both the first draft of the Third Energy Package dated 19 September 2007 and the second draft dated 12 June 2008 required non-discriminatory, cost-reflective tariffs and an entry-exist system with a ban on point-to-point tariffs, being the very changes which Naftogaz now relies upon for the purposes of its tariff revision request.
- (3377) The content of The Third Energy Package (which was to be formally adopted later in 2009) was well known to interested parties in the European gas industry by January 2009. Again, as stated above, the Third Energy Package included Regulation 715/2009 which, using virtually identical language to the relevant provision in Regulation 1775/2005, expressed the requirement for cost-reflective tariff formation in mandatory terms (Article 13(1): "*Tariffs, or the methodologies used to calculate them ... shall ... reflect the actual costs incurred*" (emphasis added by Gazprom)).
- (3378) It is simply not credible to suggest that two such major players in the European gas industry as Naftogaz and Gazprom would not have been aware in January 2009 that cost-reflective pricing was a commonly accepted principle in EU gas transport pricing (the Second Gas Directive, which contained such a principle, having been passed more than five years before).

(3379) Naftogaz knew full well at the time of signing the Contract about the adoption of cost reflective tariffs in the European gas market:

1. Naftogaz had set up a special unit to investigate cost reflective pricing principles of up to 4 people. [REDACTED] evidence was that the unit was set up and worked on tariff rates for several months prior to the Contract being signed in January 2009.
2. Naftogaz had information and analysis on cost reflective pricing including:
 - The information that was reduced to an internal memo on 23 December 2008 which showed that Naftogaz had conducted extensive work on cost reflective pricing and in particular its own work on the Slovakian regulatory position for entry/exit tariffs.
 - [REDACTED]
 - [REDACTED]
 - [REDACTED]
 - [REDACTED]
 - [REDACTED]
 - [REDACTED] specialist knowledge and expertise in this area. He admitted that the SEP, which was in force in January 2009, required cost reflective pricing.
3. Naftogaz had sought a cost reflective tariff in the Contract and this can be seen from the draft Transit Contract which is timed on 19 January 2009 at 2am where Article 8.1 appears.

(3380) It is clear from the final version of the Contract that Gazprom did not accept the cost reflective tariff proposal that Naftogaz suggested and this was accepted by Naftogaz' witnesses: see for example, [REDACTED] And there was no possible way that Naftogaz could have thought that

the tariff in the Contract was cost reflective because the tariff was lower than Naftogaz' research had demonstrated. Naftogaz' own research and analysis into European tariffs, in particular Austrian tariffs, had estimated a cost reflective tariff for itself being in the order of at least USD 5.11 per 1000 cubic metres: see [REDACTED], who he accepts this and says that there was talk amongst Naftogaz that the tariff rate "*shouldn't be no less than 3.5*", and also [REDACTED]

(3381) The conclusion to draw from this evidence is that Naftogaz knew from its own investigation and analysis of the adoption in Europe of cost reflective pricing and consequently there was no material change in this respect by the introduction of TEP, or alternatively, there was no material change not reasonably known to Naftogaz as required by Condition One.

(3382) In summary, Gazprom and Naftogaz must reasonably have expected in 2009 that cost-reflective pricing would be a commonly accepted principle in gas transportation in the EU during the term of the Contract and accordingly Condition One cannot be satisfied.

7.2.2.7.6.2.3 Change occurred prior to 1 January 2010

(3383) Naftogaz does not dispute that, as a matter of fact, the material change which it invokes in this case, the shift to cost-reflective tariffs in the Third Energy Package, arose prior to 1 January 2010 (the Third Energy Package was adopted in July 2009 and entered into force on 3 September 2009). Gazprom submits that, as a consequence, the "*material change*" invoked by Naftogaz is outside the temporal scope of Article 8.7.

(3384) Naftogaz' only response is that, as a matter of interpretation of Article 8.7, a material change which commences prior to 1 January 2010 can trigger a tariff revision. Naftogaz' position cannot be sustained in light of the language used in Article 8.7 (which refers to material changes "*in 2010 and subsequent years*").

(3385) For this reason as well, Naftogaz fails to establish compliance with Condition One.

(3386) In conclusion, the Tribunal should conclude that Condition One has not been satisfied. Accordingly, the request for tariff revision should be rejected on the merits.

7.2.2.7.6.3 Condition Two has not been met

7.2.2.7.6.3.1 Naftogaz fails to conduct the correct comparison

(3387) Naftogaz asserts that Condition Two has been fulfilled because "*the tariff under the Contract did not cover Naftogaz's costs even assuming that Gazprom had fulfilled its delivery obligations under the Contract*". This is on the basis that Naftogaz interprets the wording "*the level of transit tariffs at the European gas market*" in Article 8.7 of the Contract as a reference to a "*price level based on cost-reflective tariffs*".

(3388) Naftogaz' suggestion that the wording of Condition Two in Article 8.7 should be interpreted as requiring the transit tariff in the Contract to "*correspond to Naftogaz's costs plus a reasonable return on investment*" is unjustifiable and wrong. The plain wording of the relevant part of Article 8.7 states that a party has a right to request a tariff review "*if the transit tariff specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs at the European gas market*". Self-evidently, this requires a comparison between the tariff in the Contract and the level of other transit tariffs in the European market, not the imposition of a completely different comparison point (i.e. Naftogaz' costs plus a reasonable rate of return on investment). The use of the words "*level of transit tariffs*" in Article 8.7 makes it clear that the comparison required in Condition Two is essentially a benchmarking exercise to determine whether the values of the relevant tariffs correspond, not an assessment by reference to Naftogaz alone on the basis of a particular principle of tariff formation.

(3389) This also demonstrates a fundamental inconsistency in Naftogaz' arguments in relation to tariff revision, which is that Naftogaz of necessity relies on Article 8.7 of the Contract for its tariff revision claims, which requires a comparison between the transit tariff in Transit Contract and "*the level of transit tariffs at the European gas market*". However, Naftogaz also relies for the purposes of its claims on the assertion that "*competitive pricing*" for transit services is now "*entirely off-market*" and therefore, it follows from Naftogaz' position that no valid comparison between the level of transit tariffs in Europe can be made.

(3390) Naftogaz attempts to circumvent this central inconsistency in its case by a convoluted interpretation of Condition Two, arguing that *"the term 'the level of transit tariffs in the European gas market' must be given a reasonable interpretation in the light of the purpose of the price revision clause"* and that *"the purpose of the price revision clause is to cater for subsequent unexpected developments"*. Naftogaz argues further that, as cost-reflective tariffs differ between different transmission service providers depending on the costs they incur, the wording *"the level of transit tariffs in the European gas market"* cannot *"be based on a numerical view, but must be read as a reference to the price level based on cost-reflective tariffs"*.

(3391) This is not only contrary to the clear wording of Condition Two, but does not make sense given that (even if it should be read as a reference to prices based on cost-reflective tariffs), some comparison of tariffs in the market must be required to determine whether the Contract corresponds with them, and not an examination of Naftogaz' costs (an approach entirely unjustified by the Contract). In any event, the parties must have been fully aware in January 2009 when agreeing the Contract of the EU regulatory position (as set out above) that transmission pricing should be cost-reflective. They chose to enter into the Contract (including its tariff formula) and agreed the wording of Article 8.7 in a form that expressly requires a comparison between the Contract tariff and *"the level of"* other transit tariffs in the European gas market in order for any price review to take place. Had the parties meant Condition Two to mean *"if the price under [Contract TKGU] does not correspond to Naftogaz's costs plus a reasonable return on investment"*, that is what Article 8.7 would have said. It does not, and Naftogaz' self-serving attempt to distort the wording and interpretation of Condition Two must fail.

(3392) As far as Condition Two is concerned, the primary disagreement between the Parties relates to the manner in which transit tariffs in the European gas market are to be compared to transit tariffs under the Contract. Gazprom's position is that both sets of transit tariffs must be compared by reference to their values. That is the only way of assessing whether their *"levels"* are similar. However, Naftogaz' position is that *"one cannot solely consider the level of transit*

tariffs in the meaning of absolute figures, but has to consider also the basis for transit tariffs in the European gas market compared to the basis for the Contract tariff".

(3393) In Gazprom's view, there is a fundamental difference between a clause requiring that the "*levels*" of two sets of tariffs must "*correspond*" and a clause requiring that two sets of tariffs must be set according to corresponding methodologies. Condition Two of Article 8.7 is absolutely clear: it mandates consideration of tariff values (or "*levels*") not tariff setting methodologies.

(3394) In short, Condition Two should be applied and interpreted according to its express terms as set out in the Contract. As described above, the wording of the Contract is particularly important where it is embodied in formal written contractual documents.

It is no longer disputed that the level of the tariff under the Contract corresponds to the level of European transit tariffs.

(3395) Gazprom has provided detailed evidence from Dr Moselle regarding tariff levels. In his first report, Dr Moselle concluded that the tariff under the Contract "*was in the central or upper range of comparator tariffs in 2010... and in 2013 and 2014...*". This specific conclusion has not been challenged by Naftogaz or its experts. Naftogaz' experts simply maintain that "*benchmarking is inappropriate, and ... tariffs must reflect underlying costs*". Accordingly, the Tribunal must proceed on the basis that the tariff *level* under the Contract corresponds to the *level* of European transit tariffs.

(3396) Actually, the Contract tariff does correspond to the level of transit tariffs in the European gas market. Both Naftogaz' experts in these proceedings, Dr Hesmondhalgh and Mr Lapuerta, when considering the transit tariff in 2010, and Gazprom's expert, Dr Moselle, in his report, have conducted comparisons between the tariff in the Contract and other tariffs. These comparisons result in the conclusion that the transit tariff in Article 8.1 of the Contract corresponded to the level of transit tariffs in the European gas market in January 2010 and continued to do so thereafter. Consequently, Condition Two is not satisfied

(3397) Condition Two necessitates a comparison between the transit tariff under the Contract and transit tariffs in the European gas market by reference to the values of levels of those tariffs. That is the only way of assessing whether the "*level*" of the tariff under the Contract corresponds to the "*level*" of transit tariffs in the European gas market.

(3398) It is undisputed that Naftogaz has failed to conduct such a comparison. Instead, Naftogaz and its experts have conducted a comparison between the transit tariffs under the Contract and Naftogaz' own costs. It follows that Naftogaz has no basis for asserting that Condition two is met: the comparison it has conducted is irrelevant.

(3399) In any event, even if Article 8.7 required an assessment of whether the tariff under the Contract is cost-reflective (and it does not), Naftogaz has failed to establish that the tariff under the Contract does not correspond to its actual costs plus a reasonable rate of return.

(3400) In fact, as set out above and contrary to Naftogaz' assertions, it is likely that the Transit Tariff in the Contract does cover (and, further, exceeds) Naftogaz' costs of providing transit services, since:

1. the cost of the construction of the Ukrainian GTS has been fully amortised;
2. there has been little or no further investment by Naftogaz into the GTS; and
3. Naftogaz' main operating cost (i.e. fuel gas) is expressly catered for in the transit tariff formula in the Contract.

(3401) Therefore, even if Naftogaz' interpretation of Condition Two is correct, it has still failed to establish that Condition Two is satisfied.

(3402) In conclusion, the Tribunal should conclude that Condition Two has not been satisfied. Accordingly, the request for tariff revision should be rejected on the merits for this reason too.

7.2.2.7.7 In any event, Naftogaz is not entitled to the relief it seeks

7.2.2.7.7.1 Introduction

(3403) Naftogaz' Claim 3 is for the replacement of Article 8 with a new Article 8 as set out in its claims for relief. In addition, Naftogaz claims monetary amounts equal to the difference between the amount payable under the revised Article 8 and the amount actually paid by Gazprom for various periods starting from 1 January 2010.

(3404) Gazprom's position on Naftogaz' Claim 3 is as follows:

1. Naftogaz' Claim 3 cannot be granted since wholesale revision sought by Naftogaz is entirely outside the scope of a "tariff review" claim pursuant to Article 8.7 and must therefore be dismissed.
2. The Claim remains unspecified and must be dismissed, since Naftogaz fails to explain explicitly and unequivocally what tariff should be applied between the parties.
3. In substance, Naftogaz is not entitled to the wholesale revision that it now seeks.
4. In any event, Naftogaz cannot obtain a retroactive tariff revision.

7.2.2.7.7.2 The relief sought cannot be granted as it involves a wholesale rewriting of the tariff formula as well as the non-tariff formula of parts of Article 8

(3405) Naftogaz seeks the wholesale replacement of the entirety of Article 8 of the Contract on the basis of the tariff review provision in Article 8.7. However, for the reasons set out above, Gazprom denies that Naftogaz has demonstrated that the conditions for review of the tariff have been satisfied. To the contrary, neither of the relevant conditions has been satisfied and Naftogaz' claim for tariff review must fail.

(3406) In any event, the revisions Naftogaz seeks (being the replacement of the whole of Article 8 with completely new provisions on the basis of entirely different principles to those agreed by the parties) are inappropriate and outside the scope of a "*tariff review*" claim. Naftogaz asserts that, since the Contract tariff is the product of a price formula and not a fixed figure, "*the price is adjusted by revising the formula and its parameters*". However, the new tariff provision

Naftogaz seeks to impose is not a revision to "*the formula and its parameters*", but the introduction of a completely different tariff system based on entry/exit principles.

(3407) There is no wording in the tariff review provision to support Naftogaz' (convenient) conclusion that the effect of a tariff revision under Article 8.7 is the same as the effect of replacing Article 8 of the Contract pursuant to European competition and energy law i.e. the introduction of a cost-reflective, capacity based tariff. In any event, entry/exit systems (such as that forming the basis of the tariff structure proposed by Naftogaz to replace the tariff in the Contract):

1. have not been universally adopted in all EU member states given the need to take into account the individual circumstances of particular countries, existing transport/transit contracts and long term contracts; and
2. are unlikely to be feasible in Ukraine in any case, given the lack of, in particular, an independent choice of entry and exit points.

(3408) Under the guise of tariff revision under Article 8.7, Naftogaz is attempting to seek a completely new Article 8, in particular to effect a change so that the tariff is wholly different namely, a capacity booking tariff where the price is determined by reference to volumes at entry and exit at particular points with different tariffs applying at particular exit points.

(3409) The Tribunal will also note that Article 8.7 of the Contract has been deleted from the proposed new "rewritten" Contract. That means that Naftogaz' primary case which it makes to the Tribunal is to remove the ability for further tariff revision.

(3410) This is a real legitimate concern for Gazprom and is not a provision that Gazprom would ever have agreed in negotiations with Naftogaz.

7.2.2.7.7.3 The relief sought cannot be granted as Naftogaz has failed to make any claims for "specific relief" under Article 24 of the SCC Rules

(3411) Claim 3 remains unspecified and must be dismissed, since Naftogaz has failed to explain explicitly and unequivocally what provision should be applied between the Parties.

(3412) Gazprom maintains that the new clauses that Naftogaz seeks to impose by way of replacement are not specific, since the suggested taxes and fees referred to, and any changes to the tariffs or the tariff methodology, are entirely unspecified. Gazprom is unable to defend itself against this suggested revised wording. It is, in effect, a moving target.

7.2.2.7.7.4 In any event, Naftogaz cannot obtain a retroactive tariff revision

(3413) If the Tribunal, contrary to Gazprom's position, were to conclude that Article 8 should be revised, then such revision can in any event not be made retroactively. Gazprom refers to what it has stated in the Defence and Counterclaim in this respect and adds the following.

7.2.2.7.7.4.1 Retroactivity has not been agreed

(3414) Gazprom maintains that Article 8.7 of the Contract should be construed by applying Swedish general principles of contract interpretation. In doing so, the wording of the clause is the starting point. The wording of Article 8.7 says nothing about retroactivity. Had the Parties intended that a tariff revision would take effect as from the date of the tariff revision request, this could easily have been stated in the Contract. The absence of such wording clearly demonstrates that the Parties did not agree on any retroactivity. Absent any agreement on retroactivity, no retroactivity shall apply.

7.2.2.7.7.4.2 Retroactivity does not follow from the system of the Contract

(3415) Naftogaz states that "*repayments are the normal and default solution, and follow from the system of the tariff revision clause.*"

(3416) Naftogaz admits that this argument is based on an analogy of gas sales agreements and states that such analogy is "*perfectly appropriate*". It continues to state that the practice in the gas industry is the natural starting point for constructing the Transit Contract. Naftogaz then refers specifically to the price revision clause in the Gas Sales Contract and alleges that the tariff clause in the Transit Contract should be construed in the same way and that the proper construction is that retroactivity is implied. Naftogaz also refers to Brautaset in support of its interpretation of Article 8.7.

- (3417) Gazprom also denies that Brautaset's analysis of five particular Norwegian gas sales agreements would in any way be relevant to the construction of the tariff revision clause in the Transit Contract. Importantly, and as also stated in the Supply Arbitration the contracts analysed by Brautaset apparently contained an express provision on retroactivity, which the Transit Contract does not.
- (3418) Moreover, even if the tariff revision clause would be construed in the same way as the price reconsideration clause in the Gas Sales Contract, no retroactivity would apply, since the proper construction of the tariff reconsideration clause is that no retroactivity is agreed or implied.
- (3419) It is further contested by Naftogaz that the system of the tariff revision provision requires that a tariff revision would have retroactive effect. It does not. To the contrary, considering how the tariff revision clause is structured, it is logical that the parties did not agree that a tariff revision would have retroactive effect.
- (3420) Had retroactivity been agreed and if Article 8.7 were to be interpreted generally as Naftogaz suggests, then Article 8.7 would mean that a party could request tariff revision without stating what revision it seeks or from which date the request is sought. The requesting party could then negotiate for the prescribed time (three months) still without specifying what revision it seeks (or from which date), and if no agreement is reached, the requesting party could be passive for years until it someday decided to commence arbitration. In such arbitration it could request a tariff revision which it had not before requested and which the parties had consequently not negotiated and could obtain such revised tariff to apply with retroactive effect years back. This would be an imbalanced, unfair and unreasonable system where the party requesting tariff revision could act as it wished, and where there would be no predictability whatsoever for the other party.
- (3421) Naftogaz argues that if retroactivity is not accepted as from the date of the request for tariff revision, then "the requesting Party would effectively be deprived of its entitlement to a lower or higher (as the case may be) tariff following from the tariff revision until the date of an

agreement or an award". However, this is circular reasoning. It presupposes that the Transit Contract gives the Parties a right to tariff revision as from the date of a request for such revision. The point is that the Contract does not give the Parties such right. It does not set a date from which a request for tariff revision shall apply. Since the Transit Contract does not give either party a right to tariff revision as from a certain date, it is logical that a request for tariff revision shall not apply retroactively from the date of the request.

(3422) Naftogaz also states that, absent a right to retroactive price revision, a party would "*have a strong incentive to delay and complicate negotiations and arbitral proceedings as much as possible*". However, the facts of this case demonstrate that this argument is without merit. In this case, it is Naftogaz that has waited five years before commencing arbitration proceedings, not Gazprom. It is further Naftogaz that has failed to notify Gazprom at any point during that time that it intended to seek a retroactive tariff revision (or what tariff revision it would seek), and has commenced an arbitration regarding a tariff revision which has not been the subject either of a request for tariff revision or of negotiations. It is, therefore, Naftogaz that has delayed and complicated the arbitral proceedings.

(3423) Hence, Gazprom maintains that retroactivity does not follow from the system of tariff revision in Article 8.7 of the Transit Contract.

(3424) Accordingly, any tariff revision should take effect as from the date of the Award, or alternatively as from the date of the Request for Arbitration at the earliest.

7.2.2.7.8 In any event, Naftogaz has no right to additional payment in respect of the tariff revision claims

7.2.2.7.8.1 Introduction

(3425) Naftogaz seeks tariff revision based on Swedish Contract law by application of the tariff revision clause in the Contract (Article 8.7). The proposed revised Article 8 would be effective as from 1 January 2010 (with alternative dates). Naftogaz claims monetary amounts equal to the

difference between the amount payable under the revised Article 8 and the amount actually paid by Gazprom for various periods starting from 1 January 2010.

7.2.2.7.8.2 Naftogaz has given Gazprom reason to believe that its payments constituted a final settlement of Gazprom's payment obligation for transit service

(3426) If the Tribunal, contrary to Gazprom's position, would conclude that Naftogaz can request tariff revision with retroactive effect, Naftogaz still has no right to additional payments since Gazprom has had justified reasons to believe that its payments for transit services constituted final settlements of debts. This objection has been elaborated upon above.

(3427) Even if, contrary to Gazprom's arguments above, the Tribunal finds that the tariff can be revised with retroactive effect, Naftogaz cannot claim additional payments based on such revision, for the reasons set out below.

(3428) Under Swedish law, where a debtor has paid less than it actually owes, the creditor cannot claim additional payment if, by way of the creditor's conduct, the creditor has given the debtor reason to believe that the creditor does not have any further claim for payment. The creditor's passivity can have the same effect. The creditor is considered contractually bound by the payments made and the debtor should, accordingly, be considered to have discharged its payment obligation.

(3429) In this case, from 2010 to 2014 Naftogaz: (i) invoiced Gazprom in accordance with the Contract and the tariff in the Contract; and (ii) received the corresponding payments from Gazprom without making any objection as regards the paid amount. Moreover, Naftogaz did not pursue any claim for additional payments until after several years had elapsed. As a result of its conduct, as well as its passivity, Naftogaz has given Gazprom well-founded reason to believe that Naftogaz did not have any claims for payment for transit services in addition to the amounts already paid by Gazprom.

(3430) Gazprom has, thereby, had reason to view its payments as final settlements of Gazprom's debts for the transit services rendered by Naftogaz. Gazprom has also acted on the assumption that the payments made constituted a final settlement of Gazprom's debt in relation to the rendered transit services. Therefore, Naftogaz has become bound by the payments made and Gazprom should be considered to have discharged its obligation to pay for the transit services rendered during the years 2010 to 2014.

7.2.2.7.8.3 Article 8, as revised according to Naftogaz' claim, does not state what tariff should apply for the years 2010 2015. Consequently, there is no support in the revised Article 8 for the additional payments claimed by Naftogaz for these years

(3431) As stated in relation to the claim based on competition law, Naftogaz claim for additional payment directly based on the proposed new Article 8

7.2.2.7.8.4 The calculation of the claim for additional payment is incorrect and misconceived

(3432) As Dr Moselle explains, there is a strong prima facie case that the amount sought would represent an unacceptable windfall gain for Naftogaz. This windfall arises from the extraordinarily high hypothetical tariffs determined by TBG. Many of Dr Moselle's concerns with TBG's approach apply equally to that of the NCSREU. These issues are considered in the Moselle Report 2.

7.2.2.7.8.5 Quantum/New Tariff

(3433) In any event, even if there is an entitlement to revision of the tariff from 1 January 2010 to take account of the changes in the European market by that time in the setting of tariffs, this would go no further than a cost reflective tariff fixed on an entry/exit basis. The level of that tariff would be set to ensure that it was cost reflective. There would be no reason whatsoever to set it in line with the Ukrainian methodology created 5 years later, let alone in line with decisions made by a regulator 5 years later.

(3434) A cost reflective tariff could and should, in line with Article 8.7, be much lower than that claimed by Naftogaz.

7.2.2.7.8.6 Conclusion on Naftogaz' tariff revision claims

(3435) In summary, for the reasons set out above, Gazprom denies that Naftogaz is entitled to any revision of the tariff in the Contract on the basis of clauses 8.7 to 8.7.2 of the Contract (or at all). Accordingly, and for the reasons set out above, Naftogaz is not entitled to any additional payment based on its tariff revision claims.

7.2.2.8 Defences to Naftogaz' alternative claim for revision of the Transit Tariff pursuant to Section 36 of the Swedish Contracts Act

7.2.2.8.1 Introduction

(3436) As a further alternative to its claims for invalidity/ineffectiveness and replacement, Naftogaz also claims that "*the tariff may be revised pursuant to Section 36 of the Swedish Contract Act and its inherent doctrine of failed assumptions*".

(3437) However, there is no basis for applying Section 36 of the Swedish Contracts Act or the doctrine of failed assumptions in these circumstances.

7.2.2.8.2 Section 36 of the Swedish Contracts Act can only be used very restrictively

(3438) Naftogaz appears to be seeking to give the impression that it is always possible to obtain an adjustment of a contract under Section 36 of the Swedish Contracts Act in situations where the circumstances have changed. This presents an entirely misleading picture of the circumstances in which Section 36 of the Swedish Contracts Act can be used.

(3439) Section 36 of the Swedish Contracts Act can only be used very restrictively. In summary:

- (i) Section 36 is primarily used for consumer protection and similar purposes; it cannot be used to adjust a bad bargain;
- (ii) a general allegation that a contract is unfair is not sufficient;
- (iii) exceptional circumstances are required to modify long-term contracts in the event of changed circumstances;

(iv) Section 36 was not intended to function as a general price adjustment mechanism;
and

(v) further, Section 36 of the Swedish Contracts Act cannot be applied to subsequent circumstances which were foreseeable at the time the Contract was entered into.

(3440) Gazprom's position in relation to Naftogaz's alternative claim under Section 36 is, accordingly, as follows:

1. Since it is an exception to the general principle of *pacta sunt servanda*, Section 36 is applied restrictively in commercial contracts.
2. The relevant "fact patterns" do not provide reasons for a "revision" pursuant to Section 36.
3. The circumstances when the Contract was concluded do not render the Contract unconscionable.
4. Subsequent circumstances have not made the Contract unconscionable.
5. There is in any event no basis for the adjustment requested by Naftogaz.
6. There is no basis for a repayment to be made.
7. The doctrine of assumptions (Sw. *förutsättningsläran*) does not apply.

(3441) Naftogaz is incorrect to suggest that Section 36 of the Swedish Contracts Act can be used to adjust or replace a price mechanism if "*the price adjustment mechanism turns out to be imperfect and unable to fulfil its purpose*". Section 36 of the Swedish Contracts Act cannot be used to re-write a bad bargain. If Naftogaz ends up regretting the contract drafting that it agreed to, it cannot use Section 36 in order to create a completely different contract.

- (3442) In short, there is no basis for the application of Section 36 of the Swedish Contracts Act. Section 36 could only be applied if Naftogaz could show that a term or condition of the Contract was "*unconscionable*". As will be shown below, Naftogaz is nowhere close to being able to make such an argument.
- (3443) Naftogaz makes much of the "*overall assessment*" that it claims is required under Section 36. Hence, Naftogaz says that "*even though no single circumstances in isolation may be sufficient to tip the scales, the circumstances as a whole may no doubt do so*".
- (3444) Gazprom strongly disagrees. The circumstances as a whole are not unconscionable and come nowhere close to satisfying the exacting requirements of Section 36.
- (3445) There was no "*coercion*" by Gazprom at the time of entering into the Contract. As has been shown, *inter alia*, in the Supply Arbitration, Gazprom strongly rejects Naftogaz' allegation that Gazprom's actions in January 2009 endangered the health and safety of the population in South-eastern Ukraine and the technical integrity of the Ukrainian GTS.
- (3446) The "*overall effect*" of the Sales Contract and the Transit Contract is not unconscionable, nor is it "*imbalanced*". Naftogaz' witness [REDACTED] actually concluded that Naftogaz achieved a reasonably balanced contract. In any event, there is nothing in this respect that is unconscionable.

7.2.2.8.3 Naftogaz did not have an inferior bargaining position

- (3447) According to Naftogaz, Section 36 of the Swedish Contracts Act should be applied since Naftogaz held an inferior bargaining position. However, Naftogaz' description of its allegedly inferior bargaining position is fundamentally incorrect.
- (3448) As has already been noted in response to Naftogaz' allegation of abuse of dominant position, Naftogaz has wholly ignored the countervailing buyer power that it exercised during negotiations with Gazprom that led to the conclusion of the Transit Contract and the Gas Supply Contract in January 2009. Naftogaz' position as the holder of a monopoly over the Ukrainian GTS

and, therefore, Naftogaz' position as the dominant transporter of Russian gas to Europe can be, and was in this instance, used by Naftogaz as a powerful weapon in its negotiations with Gazprom.

(3449) ████████ denies that Naftogaz had an inferior bargaining position.

(3450) Further, there appears to be no connection between Naftogaz' claim that the tariff is unconscionable and Gazprom's allegedly dominant position. Naftogaz does not allege that Gazprom used an allegedly advantageous bargaining position in order to negotiate an unconscionably favourable contract for itself. On the contrary, Naftogaz' witness ████████ concludes that Naftogaz actually achieved a reasonably balanced contract despite what he describes in his witness statement as Gazprom's exceptionally strong bargaining position.

7.2.2.8.4 Even if Section 36 of the Swedish Contracts Act could be applied, there is no basis for its application since the Contract tariff is not unconscionable

(3451) Even if, contrary to the above, the Tribunal finds that Section 36 of the Swedish Contracts Act is potentially applicable, Naftogaz has failed to establish that the Contract tariff is unconscionable and should be adapted in the manner argued for by Naftogaz.

(3452) Under Section 36 of the Swedish Contracts Act, a contract term or condition may be modified or set aside if such term or condition is unconscionable having regard to the contents of the contract, the circumstances prevailing at the time the contract was entered into, subsequent circumstances and circumstances in general.

(3453) Therefore, circumstances that may cause a contract term to be unconscionable can be divided into two groups *either* circumstances that existed at the time when the contract was entered into, *or* subsequent circumstances occurring after the contract was entered into that have caused the contract term to become unconscionable.

7.2.2.8.5 The Contract tariff is not unconscionable having regard to circumstances that existed at the time when the Contract was entered into

7.2.2.8.5.1 The Contract Tariff is not unconscionable in itself

(3454) Naftogaz attempts to argue that the tariff in the Contract is unconscionable in itself.

(3455) However, Naftogaz does not claim that that the amount of the tariff is unconscionable. Naftogaz states that "*even though the price (tariff) under the Contract was reflective of the price level in the European gas transportation market in 2010, the underlying basis for the price (tariff) calculation was not*". Therefore, Naftogaz appears to accept that the tariff was reflective of market prices, at least in 2010.

(3456) Naftogaz, in essence, claims that the tariff is unconscionable because the tariff has not been calculated on a cost-reflective basis, and that, accordingly, there could be a disparity between the values of the parties' performances. However, it is difficult to understand how Naftogaz means that the tariff can at the same time correspond to market prices and yet nevertheless be unconscionable in itself.

(3457) At the time when the contract was entered into, Naftogaz provided transit services and Gazprom paid a market reflective tariff for such services. This cannot be unconscionable in the sense of Section 36 of the Swedish Contracts Act.

7.2.2.8.5.2 The allegation that Naftogaz does not cover its costs is without merit

(3458) Naftogaz' argument is based on the concept that a tariff that has been calculated on a cost-reflective basis *per se* would be reasonable, and that a tariff that has not been calculated on that basis *per se* would be unreasonable. In short, Naftogaz claims that it must be able to collect a tariff which covers all its costs, however high those costs may be.

(3459) However, Naftogaz's argument is groundless:

- (i) As has already been noted above, there was no proposal by Naftogaz during negotiations of the Contract that the tariff should be "*cost reflective*", nor did Naftogaz present any data evidencing the "*underlying costs*" of the Ukrainian GTS. In fact, as Naftogaz accepts, both parties assumed at the time the Contract was entered into that

the transit tariff would cover Naftogaz's costs. Any alleged failure to take account of Naftogaz' underlying costs cannot be said to be unconscionable in such circumstances.

- (ii) Further, as noted above, Naftogaz has produced absolutely no evidence to the effect that the tariff in the Contract does not cover its actual costs. On the contrary, it is most likely that the tariff more than covers Naftogaz' actual costs of providing the gas transit services. The overwhelming majority of the cost to Naftogaz of operating the Ukrainian GTS is the cost of fuel gas consumed by the system. That cost is expressly reflected in the transit tariff formula. The cost of the construction of the Ukrainian GTS itself (which in any event Naftogaz did not incur since Ukraine inherited the existing GTS following the collapse of the Soviet Union) is likely already to have been fully amortised and/or covered by what Gazprom has already paid to Naftogaz. Naftogaz has failed to establish that Gazprom is paying less than the full costs of transport.
- (iii) In fact, Naftogaz' argument is hypothetical. Naftogaz relies largely on the Energy Community Secretariat Preliminary Assessment, but that Preliminary Assessment does not conclude that the transit tariff fails to cover Naftogaz' costs which would have required a detailed analysis of Naftogaz' actual costs but rather that, depending on what happens to the gas price under Gas Supply Contract, the price calculation mechanism in Transit Contract "*could fail to cover Naftogaz's costs*" at some unspecified time in the future.
- (iv) Naftogaz also gives the misleading impression that other transporters of gas have all of their costs covered. No evidence is provided in support of this surprising assertion.
- (v) Moreover, to the extent relevant, the Third Energy Package (which is relied on heavily by Naftogaz) does not require that all costs are covered. As the Energy Community Secretariat Preliminary Assessment points out, the Third Energy Package

requires tariffs to be cost-reflective, i.e. such as to "*take into account the need for system integrity and its improvement and reflect actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent, whilst including appropriate return on investments, and where appropriate taking account of the benchmarking of tariffs by the regulatory authorities*".²⁶⁹ (Emphasis added by Gazprom.)

- (vi) It cannot be said to be unreasonable *per se* that a company does not cover its costs. This argument must depend on whether or not those costs themselves are reasonable.

(3460) Consequently, it is not possible to say that a tariff calculated on a cost-reflective or other basis is reasonable or unconscionable *per se*.

(3461) Further, Naftogaz has not referred to any factual circumstances in support of the argument that the tariff formula is inherently unconscionable.

7.2.2.8.5.3 The Contract tariff is not unconscionable having regard to other circumstances that existed when the Contract was concluded

(3462) It is not clear which circumstances Naftogaz in fact invokes when it claims that the Contract tariff is unconscionable having regard to "*other circumstances when the contract was concluded*". However, Naftogaz refers to three circumstances which it claims "*were decisive for the final content of the Contract*". These circumstances are (i) "*Gazprom's alleged interruption of gas supplies and the associated pressure on Naftogaz*", (ii) "*[t]he Parties' assumption of growth in the European gas market*", and (iii) "*[t]he Parties' assumption that 'competitive' pricing would prevail as a commonly accepted European principle for setting gas transportation tariffs*".

(3463) Naftogaz' assertion that Gazprom held a dominant position and that Naftogaz' bargaining power was inferior in relation to Gazprom is incorrect. In any event, Naftogaz does not claim that

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Energy Community Secretariat Preliminary Assessment, page 18.

Gazprom used an allegedly advantageous bargaining position in order to negotiate an unconscionably favourable contract for itself.

(3464) As regards the two other alleged circumstances, these matters could not make the tariff unconscionable at the time when the Contract was entered into. The mere fact that the parties may have had ideas about how the market would develop does not make the Contract, or any term of the Contract, unconscionable. It is natural that commercial parties speculate on future developments on the relevant market when entering into agreements. Further, commercial parties are responsible for their own assumptions and speculations as regards future events.

(3465) In this context, it should also be emphasised that Gazprom does not accept that the Parties had a common perception or assumption regarding future market developments.

(3466) In terms of principles for setting the tariff, Naftogaz itself notes that "*[w]hen concluded, the Contract was assumed to apply generally accepted European pricing principles for gas transport*". It is difficult to understand how Naftogaz means that this circumstance in itself would render the Contract tariff unconscionable.

7.2.2.8.5.4 Circumstances in general

(3467) In support of its allegation that the tariff is unconscionable, Naftogaz also points to the fact that the Contract includes other provisions that it asserts are "*unusual and which impose undue insecurity on Naftogaz*". It is entirely unclear how this relates to the alleged unconscionability of the tariff.

(3468) Naftogaz also asserts that these "*unusual*" provisions imply "*a major deviation from the European model, which would be discriminatory against Naftogaz compared to transporters of natural gas under contracts with well-functioning provisions*".

(3469) The fact that the Contract may differ from other contracts does not make the Contract tariff unconscionable, nor would it be discriminatory. The Contract was entered into after extensive

negotiations between two well-advised commercial parties. Needless to say, there are many different types of contract, and no party has a right to require a particular type of contract.

(3470) In any event, the Contract tariff is not discriminatory.

7.2.2.8.6 The Contract Tariff is not unconscionable due to subsequent circumstances

7.2.2.8.6.1 Introduction

(3471) Naftogaz relies on (i) changes in European regulation, (ii) decline in volumes, (iii) alleged lack of foreseeability of these changes, and (iv) that this is supposedly "*exactly the kind of situation that implies an application of Section 36*".

(3472) Naftogaz' argument is without merit. The tariff in the Contract is not unconscionable due to circumstances occurring after the Contract was entered into. In particular, as explained further below:

- (i) changes in EU legislation do not render the Contract tariff, as agreed between Naftogaz and Gazprom, unconscionable;
- (ii) the fact that the volumes of gas transited have declined does not make the Contract or the tariff unconscionable;
- (iii) in any event, both changes in circumstances relied on were foreseeable;
- (iv) this is not otherwise a situation in which the change in circumstances has become unconscionable; and
- (v) even if the Tribunal were to conclude that the Contract tariff has become unconscionable at any point during the period since 2009, Section 36 of the Swedish Contracts Act cannot be used to rewrite the Contract by inserting entirely new tariff provisions as requested by Naftogaz.

7.2.2.8.6.2 Changes in EU regulatory legislation do not render the Contract Tariff unconscionable

- (3473) Naftogaz appears to be arguing that the adoption of the Third Energy Package on 13 July 2009 in the European Union has made the tariff formula in the Contract unconscionable. Naftogaz's argument is fundamentally flawed.
- (3474) EU energy law is limited in its territorial application to the Member States of the European Union. Ukraine is not a Member State of the European Union and it is therefore denied that EU energy law, namely Directive 2009/73/EC and Regulation 715/2009, is applicable to the claims put forward by Naftogaz. As admitted by Naftogaz, the Contract regulates the terms and conditions for the transit of natural gas across Ukrainian territory through the Ukrainian gas transmission network.
- (3475) Within the "*European gas transport market*", Naftogaz appears to be suggesting that a fundamental change occurred to "*European pricing principles*" with the adoption of the Third Energy Package on 13 July 2009. However, this suggestion is simply wrong. In fact, the Second Energy Package in particular, the Second Gas Directive, Directive 2003/55/EC, dated 26 June 2003 as well as Regulation (EC) No. 1775/2005, dated 28 September 2005 contained virtually the same language as regards "*cost-reflective*" tariffs as Directive 2009/73/EC and Regulation 715/2009, dated 13 July 2009, to which Naftogaz refers.
- (3476) There is nothing in these alleged regulatory changes that renders the Contract, or any term of the Contract, unconscionable.

7.2.2.8.6.3 The fact that the volumes of gas have declined does not make the Contract or its tariff unconscionable

- (3477) Naftogaz' second complaint is that, as a result of the decline in transit volumes, Naftogaz' transit revenues have declined. However, the fact that Naftogaz has earned less money does not render the Contract, or the transit tariff payable thereunder, unconscionable.

(3478) When parties enter into long-term agreements they know that the circumstances surrounding such agreements can change. Changed circumstances in and of themselves do not suffice; rather, the change in circumstances must be shown to make a particular contractual term unconscionable.

7.2.2.8.6.4 In any event, both changes in circumstances relied upon were foreseeable

(3479) In any event, the changes referred to by Naftogaz were foreseeable at the time the Contract was entered into, i.e. 19 January 2009.

(3480) Naftogaz itself states that "*there was a debate prior to the adoption of the Third Energy Package concerning the price mechanism under transportation agreements*". Further, players in the gas industry were already aware of the content of the Third Energy Package by January 2009. Therefore, any changes to the European regulatory framework (to the extent there were any such relevant changes) were not "unexpected" as Naftogaz claims.

(3481) In any event, "*cost-reflective*" pricing was already required by EU legislation in 2003 and 2005. Therefore, the principle of "*cost-reflective*" pricing within "*European pricing principles*" was well-known to both parties long before the Contract was entered into.

(3482) Regarding the decline in volumes, Naftogaz states that "*the financial crisis had a great impact on the European gas market*". Naftogaz itself acknowledges that "*the financial crisis had reached an acute stage in late 2008, with the collapse of Lehman Brothers*". Although Naftogaz claims that it "*was still not clear whether the financial crisis would have long-term implications for the growth of demand for Natural Gas in Europe*", a potential decline in transit volumes was clearly foreseeable and should have been taken into account by the parties during their contractual negotiations.

(3483) It is not possible to claim, in relation to Section 36 of the Swedish Contracts Act, that subsequent circumstances have made a contract unconscionable when the relevant circumstances were foreseeable at the time the contract was entered into.

7.2.2.8.6.5 This is not a situation in which the change in circumstances has become unconscionable

(3484) The case law shows that, in order for Section 36 of the Swedish Contracts Act to be applied in cases of changed circumstances, the change in question needs to be exceptional. In the present case, Naftogaz cannot point to any exceptional change in circumstances,

(3485) Naftogaz refers to five Swedish Supreme Court cases in support of its argument NJA 1983 p. 385, NJA 1923 p. 20, NJA 2005 p. 142, NJA 1994 p. 359 and NJA 1930 p. 507 I. None of these cases is similar to this case. NJA 2005 p. 142 does not even refer to Section 36 of the Swedish Contracts Act. In each of the other cases mentioned, the change in circumstances was exceptional and long-lasting.

(3486) In short, there is nothing unconscionable about the change in circumstances in the present case.

7.2.2.8.7 In any event, Naftogaz is not entitled to the adjustment it seeks

(3487) Further, and in any event, it would be entirely inappropriate for the Tribunal to completely re-write Article 8 in its entirety as requested by Naftogaz.

(3488) Naftogaz is not asking the Tribunal to adjust the Contract in order to restore the balance between the parties in the event that it is determined that a particular contract term is unconscionable. Instead, Naftogaz is asking the Tribunal to re-write the entire Article 8 completely in a manner that would now be more preferable to Naftogaz. The Tribunal is not entitled to carry out such a task within the ambit of, and by reference to, Section 36 of the Swedish Contracts Act. There is no case law in which a Swedish court or tribunal has re-written a contract in such a manner.

(3489) Naftogaz cannot claim a retroactive adjustment of the Contract Tariff pursuant to Section 36 of the Swedish Contracts Act.

7.2.2.8.7.1 Naftogaz is not entitled to retroactive adjustment under Section 36 of the Swedish Contracts Act

(3490) Section 36 of the Swedish Contracts Act allows a court or tribunal to adjust a contract in order to restore the balance between the parties in the event that it is determined that a particular contract term is unconscionable.

(3491) It is not generally appropriate in such circumstances to seek retroactive adjustment of contract terms that have already been applied. It would, as a rule, be inappropriate for a court or tribunal, by use of Section 36, to rewrite history as regards contractual obligations already performed.

(3492) In any event, Naftogaz has not provided any reason for why such a retroactive adjustment would be required.

7.2.2.8.7.2 Moreover, Naftogaz has lost its right to claim retroactive adjustment under Section 36 of the Swedish Contracts Act

(3493) It was not until 25 July 2014 that Naftogaz communicated that it considered the Contract tariff to be unconscionable and that it should be modified according to Section 36 of the Swedish Contracts Act. If Naftogaz considered the Contract tariff to be unconscionable in January 2010, then it ought to have brought a claim under Section 36 of the Swedish Contracts Act at that stage, or should at least have notified Gazprom that it considered the tariff unconscionable. It did not.

(3494) According to Swedish law principles, where an aggrieved party fails to claim invalidity for a long period of time or acts in a manner that is inconsistent with such a claim, that party may be deemed to have expressed an intention to have waived its right to make a claim. The consequence of such behaviour is loss of the opportunity to claim invalidity. The same principles also apply to claims for adjustment under Section 36.

(3495) Naftogaz did not state in January 2010 that it considered the tariff to be unconscionable under Section 36 of the Swedish Contracts Act.

(3496) Moreover, in addition to being passive, Naftogaz has also since January 2010 repeatedly: (i) invoiced Gazprom based on the tariff that it now claims is unconscionable; and (ii) relied upon the tariff terms in the Contract (including the renegotiation clause of the Contract).

(3497) In summary, Naftogaz has, by its express and implied behaviour, lost any potential right to claim retroactive adjustment of the Contract prior to its Request for Arbitration pursuant to Section 36 of the Swedish Contracts Act.

7.2.2.8.8 Naftogaz has no right to additional payments based on its claims in relation to Section 36 of the Swedish Contracts Act

(3498) Naftogaz has no right to any adjustment of the tariff under Section 36 of the Swedish Contracts Act. Therefore, it follows that Naftogaz has no right to additional payments based on its claims in relation to Section 36.

(3499) In any event, Naftogaz is not entitled to the adjustment it seeks and Naftogaz' claims for additional payments must also be rejected for this reason.

7.2.2.8.9 Moreover, Naftogaz has no right to additional payment based on its claims in relation to Section 36 of the Swedish Contracts Act since Naftogaz cannot claim a retroactive adjustment of the Contract Tariff as requested

(3500) Naftogaz cannot claim a retroactive adjustment of the Contract tariff as requested and, accordingly, Naftogaz' claims for adjustment of the tariff in relation to Section 36 of the Swedish Contracts Act cannot be granted. Therefore, Naftogaz has no right to additional payment based on its claims in relation to Section 36.

7.2.2.8.10 In any event, Naftogaz is not entitled to additional payment since Naftogaz has given Gazprom reason to believe that its payments constituted a final settlement of its payment obligation for the transit services

(3501) Under Swedish law, where a debtor has paid less than what he actually owes, the creditor cannot claim additional payment if, by way of his behaviour, he has given the debtor reason to believe that the creditor does not have any further claim for payment. The creditor's passivity can have

the same effect. The creditor is considered contractually bound by the payments made and the debtor should, accordingly, be considered to have discharged his payment obligation.

(3502) In the present case, Naftogaz has (i) invoiced Gazprom in accordance with the Contract and the Contract tariff and (ii) received the corresponding payments from Gazprom without making any objection as regards the paid amount. Moreover, Naftogaz has (iii) not pursued a claim for additional payments until after several years have elapsed. As a result of its behaviour, as well as its passivity, Naftogaz has given Gazprom well-founded reason to believe that Naftogaz did not have any claims for payment for transit services in addition to what had already been paid by Gazprom.

(3503) Gazprom has, thereby, had reason to view its payments as final settlements of Gazprom's debts for the transit services rendered by Naftogaz. Gazprom has also acted on the assumption that the payments made constituted a final settlement of Gazprom's debt in relation to the rendered transit services. Thereby, Naftogaz has become bound by the payments made and Gazprom shall be considered to have discharged its obligation to pay for the transit services rendered..

7.2.2.8.11 The Swedish law doctrine of assumptions is not applicable

(3504) Naftogaz has referred, in passing, to the Swedish doctrine of assumptions. However, it is entirely unclear what relevance Naftogaz means that this doctrine would have in the present case.

(3505) The Swedish law doctrine of assumptions is irrelevant in this context. First of all, the doctrine of assumptions cannot lead to an adjustment of a contract, only to invalidity.

(3506) Second, the doctrine of assumptions has not been applied by the Supreme Court in recent years and can, at a minimum, be said to have a very limited practical importance under Swedish contract law. For example, in case NJA 1999 s.575 the Supreme Court rejected a party's request for the doctrine of assumptions to be applied.

(3507) There is no basis for applying the doctrine of assumptions in the present case. There are a number of specific prerequisites that would have to be fulfilled, and Naftogaz has not even begun to make out a case in that regard.

7.2.2.8.12 Conclusion as regards Naftogaz' claim for adjustment of the Tariff under Section 36 of the Swedish Contracts Act or otherwise

(3508) The adjustment requested by Naftogaz should not be ordered. Reference is also made in this respect to the detailed points that Gazprom made in the Sales Arbitration.

(3509) In the present case:

1. Naftogaz seeks to impose an adjustment which would be highly one-sided in favour of Naftogaz. This is not an attempt to balance the contract. On the contrary, Naftogaz' proposed adjustment would create a highly unbalanced contract.
2. Naftogaz does not seek to uphold the Parties' original intentions as at the time when the contract was entered into. On the contrary, Naftogaz seeks to depart from the parties' original intentions fundamentally.
3. Naftogaz asks the Tribunal to engage in complex, technical issues. This is very far from the sort of simple adjustment that was envisaged in the preparatory works to the Contracts Act such as reduction of the amount of a penalty or damages, increasing time limits, increasing the length of a contract's validity, or imposing a requirement of materiality in the event of a breach of contract.

(3510) The Tribunal is in no position to rewrite the Contract in this way. It is not possible for the Tribunal to make the various complex choices that would be required only the parties, with their knowledge of the industry and of the particular commercial circumstances, would be in a position to do so.

(3511) In summary, for the reasons set out above, Gazprom denies that Naftogaz is entitled to an adjustment of the Contract tariff under Section 36 of the Swedish Contracts Act or otherwise. In any event, no retroactive adjustment can be made.

7.2.2.9 Defences to Naftogaz' claims for compensation for underdeliveries of transit volumes of natural gas

7.2.2.9.1 Introduction

(3512) In addition to Naftogaz' claims based on competition/energy law and Swedish contract law, Naftogaz also claims that it is entitled to receive compensation for Gazprom's alleged underdeliveries of transit volumes under the Contract.

(3513) Naftogaz seeks compensation for damages in respect of alleged under-deliveries in the event that its other claims to replace or revise the transit tariff are not upheld, Naftogaz also seeks compensation for damages caused by Gazprom's alleged under-deliveries for all subsequent years until the effective date of any amendment of the transit tariff.

(3514) Gazprom denies that Naftogaz is entitled to any compensation or damages in respect of any alleged under-deliveries under the Contract, irrespective of any replacement or revision of the transit tariff, for the following reasons:

1. there is no obligation on Gazprom under the Contract to transfer any minimum volume of gas to Naftogaz for transit;
2. Naftogaz' claim for damages for under-deliveries in effect amounts to the impermissible imposition of a "ship or pay" obligation on Gazprom, contrary to the Parties' agreement;
3. Gazprom is not in breach of the Contract and therefore no damages are payable under Article 10.1 of the Contract;
4. Naftogaz' claims for damages are overstated;

5. Naftogaz has failed to mitigate its alleged damages; and
6. Naftogaz has lost any alleged right to damages since it failed to notify Gazprom of the claim and/or to pursue its claim until its letter dated 25 July 2014.

(3515) In summary, it is Gazprom's position that:

1. If there is a minimum volume obligation under Articles 3.1 or 3.2, (1), the parties intended that there would be no financial liability on Gazprom to compensate Naftogaz in the event of any volume shortfalls; (2) as a consequence, Article 10.1 of the Contract must be interpreted so as not to apply to breaches in respect of volume shortfalls under Article 3 of the Contract; and the Parties conducted themselves accordingly.
2. Article 3.1 of the Contract does not impose a minimum volume obligation on Gazprom and on a proper construction of the Article, it is subject to whatever is agreed in Article 3.2 of the Contract which does not specify minimum volumes;
3. In any event, Naftogaz has lost its right to compensation by reason of its conduct and/or by reason of its passivity;
4. In any event, Naftogaz cannot claim compensation for the years 2009, 2010, 2012, 2013, 2014 and 2015 given the terms of the specific agreements reached by the parties in Supplements to the Contract; and
5. In any event, Naftogaz has overstated its claim for compensation.

7.2.2.9.2 Gazprom's alternative defence

(3516) Gazprom also advances an alternative defence, for the event that the Tribunal does not accept the defences referred to above, and for the event that in rejecting those defences the Tribunal decides (contrary to Gazprom's case) that Articles 3.1 and 3.2 do give rise to financial liability in circumstances where alleged minimum annual volumes are not met.

(3517) Gazprom submits as an alternative defence to Naftogaz' payment claim that if (contrary to its case) it does have an obligation to make payment under Articles 3.1 and/or 3.2 of the Contract, then the amount it is ordered to pay pursuant to those Articles should be adjusted (Sw. *jämkad*) to zero by the Tribunal pursuant to Section 36 of the Contracts Act. This defence only arises if the Tribunal has rejected Gazprom's primary case that the Contract does not impose any obligation on Gazprom to make payment to Naftogaz pursuant to Articles 3.1 and/or 3.2 and only arises if the Tribunal has found that such an obligation does arise.

(3518) The ground for seeking such adjustment is that enforcing such payment obligation will lead to a severe imbalance in the overall contractual relationship between Gazprom and Naftogaz (as constituted by Gas Sales Contract and the Transit Contract).

7.2.2.9.3 The Contract does not impose a minimum transit volume obligation on Gazprom

(3519) Naftogaz' under-deliveries claims are based on the fundamental premise that, through the Contract, Gazprom is under an obligation to provide minimum volumes of gas for transit by Naftogaz through Ukraine. In this regard, Naftogaz relies on Article 3.1 of the Contract, which it asserts obliges Gazprom to deliver at least 110 BCM of gas to Naftogaz per year for onward transit, unless otherwise agreed. Naftogaz also relies on the provisions of [REDACTED] [REDACTED] which amended, *inter alia*, parts of Article 3 of the Contract, in support of its assertions regarding Gazprom's minimum delivery volume obligations for the years [REDACTED]. Gazprom denies that there is any obligation on it to deliver a minimum volume of gas to Naftogaz for transit, whether in Article 3.1 or any other provision of the Contract.

(3520) Article 3.1 of the Contract, as amended by [REDACTED] and in relevant part, provides as follows:

"During the period 2009-2019 inclusively, [Gazprom] transfers to [Naftogaz] for transit to the countries of Europe, the Natural Gas in the volumes not less than 110 (one hundred and ten) [BCM] [REDACTED] per annum at the Delivery and Acceptance Points on the border between the Russian Federation and Ukraine, between the Republic of

Belarus and Ukraine, and between the Republic of Moldova and Ukraine, and [Naftogaz] procures its acceptance and further transit through the territory of Ukraine to the Delivery and Acceptance Points on the border between Ukraine and Romania, between Ukraine and Hungary, between Ukraine and Slovakia, between Ukraine and Poland, between Ukraine and Moldova."

(3521) However, the Contract also envisaged that the volume of transit gas in each contract year would be different, and that such volume, together with quarterly breakdowns of the distribution of the volume by route, would need to be agreed separately for each year. This reflected the fact that the arrangements in the Contract were entirely for the purposes of serving the supply needs of Gazprom Export's European customers, and that this demand was difficult to predict. As explained by [REDACTED]:

"In planning delivery flows through Europe, Gazprom/Gazprom Export takes into account its total supply obligations to all its European off-takers. Gas supplies to Europe are of such a scale that it is very difficult if not impossible to predict with a high degree of confidence the levels of natural gas consumption over the long term."²⁷⁰

(3522) For 2009, the anticipated annual volume of gas for transit was stated in Article 3.1.1 of the Contract and a quarterly breakdown of the distribution of the volumes by route was agreed.

(3523) In respect of subsequent years, Article 3.2 of the Contract provides:

"The annual volumes of the Gas transit through the territory of Ukraine and their breakdown by the Quarters (including [their breakdown] by the destinations) in the subsequent years shall be specified in Supplements to this Contract. In case of the Parties' failure to execute such Supplement prior to the commencement of the relevant Contractual Year, the volumes of the Gas transit in the relevant year shall be determined based on the aggregate obligations to supply minimum annual quantities of Gas under the contracts of OOO Gazprom Export with the

²⁷⁰ [REDACTED] 1.

European buyers which receive the Gas transited through the gas transportation system of Ukraine. In that case such minimum annual obligations under the contracts of OOO Gazprom Export have to be confirmed by the auditor."

(3524) Therefore, pursuant to Article 3.2, both (i) the annual volume of gas for transit through Ukraine; and (ii) the quarterly breakdown of the distribution of such volume by route, for each subsequent year, were to be specified in supplementary agreements. Where no supplementary agreement was executed prior to the start of a contractual year, transit volumes in that year were to be determined based on Gazprom Export's minimum annual contractual supply obligations with European buyers supplied via Ukraine, subject to confirmation by an auditor. The inextricable link between the annual volumes to be transited under the Contract and the needs of Gazprom's European customers was therefore evident and known to Naftogaz when the Contract was entered into, and was even expressly referred to in the Contract itself.

(3525) As these provisions in the Contract reflecting the agreement of different total volumes each year and referencing Gazprom Export's supply obligations as the default position in the absence of agreement suggest, the annual volume of 110 bcm stated in Article 3.1 of the Contract was not intended as a commitment by Gazprom to transit a minimum volume, but simply as a forecast of the likely volumes it was anticipated might be delivered under the Contract, to ensure that sufficient capacity to meet Gazprom's transit needs was available in Naftogaz' system.

(3526) [REDACTED] confirms that this was the Parties' intention and, in particular, that both parties understood that transit volumes would depend on the levels of Gazprom Export's supplies to European offtakers:

"The annual volume expressed in clause 3.1 of Contract TKGU was intended as no more than a forecast of the volumes that it was anticipated might be delivered under the Contract. Gazprom only injects volumes into the pipeline once they have been nominated for delivery by offtakers. The transit volumes therefore are directly dependent on levels of natural gas consumption by Gazprom's European offtakers. The usual practice between Gazprom and

Naflogaz has always been to agree annual and quarterly transit volumes on an annual basis, when there is a better understanding of what consumption levels are likely to be. Upon signing Contract TKGU, we anticipated that this practice of agreeing annual and quarterly volumes on an annual basis would continue. In this regard, I note that clause 3.2 of Contract TKGU provides for this practice to continue, and that in the absence of such agreement the annual volume would be Gazprom Export's minimum annual gas supply obligations [...]

I consider that this provision reflects the parties' mutual understanding that transit volumes depend directly upon the levels of Gazprom Export's supplies to European off-takers."²⁷¹

(3527) Further, even if Article 3.1 does constitute a binding minimum transit volume obligation of 110 bcm per annum for certain years, such alleged binding obligation was expressly [REDACTED] [REDACTED] wording inserted into Article 3.1 in [REDACTED]

(3528) The volume position in respect of each individual contract year is set out below.

(3529) For 2009, as stated above, Article 3.1.1 of the Contract provides for the anticipated transit volume to be "comprise 120,083" bcm and sets out the quarterly breakdown of the distribution of the volumes by route.

(3530) For 2010, Article 3.1.2 of the Contract, as amended by [REDACTED], provides that the anticipated transit volume shall "[REDACTED]" bcm (emphasis added by Gazprom) and states the quarterly breakdown of the distribution of the volumes by route, in accordance with Article 3.2 of the Contract. The use of the wording [REDACTED] with the obvious implication that volumes could be less than [REDACTED], specifically confirms that the parties did not intend there to be a minimum volume applicable to that year.

²⁷¹ [REDACTED] 1.

(3531) For 2011, Article 3.1.3 of the Contract, as amended by [REDACTED], provides that the anticipated transit volume shall [REDACTED] " bcm and states the quarterly breakdown of the distribution of the volumes by route, in accordance with Article 3.2 of the Contract.

(3532) Self-evidently, and as noted by [REDACTED] both the [REDACTED] " bcm wording for 2010 and the agreed volume of [REDACTED] for 2011 are inconsistent with the existence of a minimum transit obligation of 110 bcm per year as asserted by Naftogaz.

(3533) For the years 2012, 2013 and 2014, although the parties agreed in Article 3.1.4 of the Contract, as amended by [REDACTED] a general provision that the annual transit volume for the years 2012 to 2015 would [REDACTED] bcm, there was no specific agreement for each year and no agreement regarding the quarterly breakdown of the distribution of such volume by route pursuant to Article 3.2 of the Contract. [REDACTED] explains that:

*"In relation to the period after [REDACTED], I note that there was no agreement of specific annual and quarterly volumes (including the breakdown by route) for each year, as in the two years preceding the date when [REDACTED], gas consumption levels had fluctuated dramatically and specific annual and quarterly volumes for the period [REDACTED] could not be forecasted with any real degree of accuracy."*²⁷²

(3534) [REDACTED] further explains that it was for this reason that Article 3.1.4 of the Contract, as supplemented by [REDACTED], provides as follows:

"In [REDACTED] the annual volume of the Gas transit shall comprise [REDACTED] If the annual volume of the Gas transit in [REDACTED] comprises less than [REDACTED] the Parties may agree on extending the period of services to be provided by the Contractor to be charged against the Advance Payment."

(3535) [REDACTED] explains the background to this clause:

²⁷² [REDACTED]

"...at the same time as entering into [REDACTED] Gazprom agreed to pay Naftogaz an advance payment for transit services in the amount of US \$1,587,620,000, which sum was to be allocated as prepayments for transit services on a monthly basis over the period until November 2015 (the "Advance Payment")... as set out in an appendix to [REDACTED]. The purpose of the Advance Payment was to assist Naftogaz to pay for gas supplies under Contract KP, and this is reflected in the corresponding [REDACTED] to Contract KP of the same date (see paragraphs 3 and 4 thereof)."²⁷³

(3536) This provision confirms that the volumes stated in the Contract were not intended to be minimum annual transit obligations that were binding on Gazprom. To the contrary, it demonstrates that the parties clearly anticipated the possibility that the transit volumes in the years [REDACTED] might be less than the stated [REDACTED] per year. It also provides for a specific consequence in circumstances where the annual volume comprised less than [REDACTED], which does not involve any payment obligation on Gazprom (i.e. that the parties may agree on extending the period of services to be provided by NAK to be charged against the "Advance Payment"). This directly contradicts the premise, which is fundamental to Naftogaz' claim, that the remedy for transit volumes being less than those stated in the Contract is the payment of the transit fee by Gazprom as if such volumes had in fact been transited. Gazprom's understanding, which is also consistent with the position adopted by Naftogaz until as late as March 2014 (although contrary to Naftogaz' pleaded position now) is that, pursuant to Article 3.1.4, the only consequence of transit volumes not reaching [REDACTED] per year i [REDACTED] was an extension of the period over which services were to be charged against the Advance Payment. [REDACTED] states:

"To my knowledge, the extension of the period over which services are to be charged against the Advance Payment was the only consequence of transit volumes being lower than the [REDACTED] reflected in clause 3.1.4 of Contract TKGU (as amended by [REDACTED] that was discussed and agreed with Naftogaz. It was never agreed that there would be a penalty payable by, or other

²⁷³ [REDACTED] 1.

financial consequence for, Gazprom in such event. An extension of the period over which services are to be charged against the Advance Payment would mean the following for Gazprom:

- (i) the amount of cash payable by Gazprom to Naftogaz each month would increase; and*
- (ii) the amount of the Advance Payment attributed to the transit services (together with the applicable discount) would decrease."²⁷⁴*

(3537) Naftogaz' own previous conduct and statements during the term of the Contract confirm (contrary to the assertions of its witnesses in these proceedings) that it did not view the Contract as imposing minimum transit volume obligations on Gazprom. On 15 June 2009, Naftogaz wrote to Gazprom stating as follows in relation to the imbalance it perceived between the obligations and benefits of the parties respectively in the Gas Supply Contract and the Transit Contract:

"This problem is caused by the dissymmetry of the natural gas transit and purchase terms under the contracts signed on 19 January this year, in part of the acquiring party's provision of guarantees on the minimum level of settlements: : whereas the Contract on the purchase of natural gas obliges [Naftogaz] to acquire no less than 80% of the contracted volume of natural gas and provides for significant penalties if this term is not performed, the [Contract TKGU] does not contain such an obligation of [Gazprom].

[...] please consider the possibility of amending the [Contract TKGU] in part of [Gazprom's] undertaking an obligation in favour of [Naftogaz] to guarantee the provision of natural gas volumes for transit through the territory of Ukraine and payment for the agreed volume of natural gas transit services similarly to the [Contract KP]." (emphasis added by Gazprom.)

(3538) No entitlement of Naftogaz to damages is asserted in Naftogaz' letter of 15 June 2009 . Rather, Naftogaz seeks to re-negotiate the Transit Contract to include the guaranteed delivery by

²⁷⁴ [REDACTED] 1.

Gazprom of transit volumes and payment by Gazprom for transit services in respect of such volumes, equivalent to the take or pay obligations on Naftogaz in the Gas Supply Contract. Had the Transit Contract contained (and had Naftogaz believed it contained) binding minimum volume obligations and an entitlement of Naftogaz to compensation in the event such volumes were not met, Naftogaz' proposed amendment would have been superfluous.

- (3539) Further, in 2009 Gazprom sent Naftogaz a draft of [REDACTED] to be signed by Naftogaz. Naftogaz replied with its own draft supplementary agreement, which contained penalty provisions to be applied if Gazprom delivered less gas than the estimated contractual volumes. Gazprom did not accept Naftogaz' proposal and consequently Naftogaz signed [REDACTED] as drafted by Gazprom. Again, it is evident from this that Naftogaz did not intend or consider the annual volumes referred to in the Transit Contract to be minimum volume obligations or that Gazprom would be obliged to pay for such volumes even where they were not delivered for transit.
- (3540) It should be recalled that the Parties agree that: "*[t]he starting point and prevailing principle of any interpretation of a contract under Swedish law is the mutual intent of the parties at the time of execution of the contract.*"
- (3541) As regards Article 3.1 of the Contract, it is Gazprom's position that the mutual intent of the Parties was not to include a minimum volume obligation. This is confirmed by (i) the drafting history of the Contract, (ii) the text of the Contract and the supplementary agreements, (iii) the Parties' use and application of the similar wording in the predecessor 2002 Contract, and (iv) the subsequent conduct of the Parties. This will be further elaborated upon below.
- (3542) First, the drafting history of the Contract and the witness evidence regarding the negotiations between the parties indicates that the parties did not intend to include a minimum volume obligation in Contract.

- (3543) ██████████ states that it is simply not credible for ██████████ to suggest that, as at January 2009 when the Contract was being negotiated, the parties could have believed that Gazprom would transit at least 110 BCM per year.²⁷⁵
- (3544) ██████████ also explains that Gazprom was uncertain about the volumes it would need to transit through Ukraine and, therefore, was reluctant to assume any minimum volumes obligation.
- (3545) In drafts dated 26 December 2008 and 29 December 2008 (and one further undated draft) Naftogaz had proposed the inclusion of an obligation that Gazprom provide minimum volumes on a quarterly basis. See Article 10.4 of Exhibits C-96, C-97 and C-99. See also the annotation by Naftogaz that these clauses were "*ECONOMICALLY PROFITABLE to the Company and impose [...] on Gazprom strict obligations to deliver gas for transit*". However, those proposed clauses were removed from the final version of the Contract. This gives a clear indication that the Parties did not intend to impose "*strict obligations to deliver gas for transit*" on Gazprom. ██████████ explains that Gazprom rejected those clauses because it did not want to assume any minimum volume obligation.²⁷⁶

7.2.2.9.4 Naftogaz' claim for damages for under-deliveries in effect amounts to the impermissible imposition of a "ship or pay" obligation on Gazprom

- (3546) Naftogaz argues, on the basis (contrary to Gazprom's position set out above) that the Contract does contain minimum transit volumes obligations binding on Gazprom, that clause 10.1 of the Contract entitles it to be compensated for the "*proven damages*" caused by the breach of such obligations by Gazprom. Naftogaz asserts that the measure for calculating its "*proven damages*" in these circumstances, i.e. its losses for breach of the alleged minimum volume obligations, "*correspond to the lost revenues attributable to the underdeliveries i.e. the differential between the amount Gazprom would have paid if it had fulfilled its obligations and the amount paid for*

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volumes actually delivered for transit, net of the variable cost savings associated with the smaller volumes actually transited in the system".

(3547) Therefore, the effect of Naftogaz' claim for breach of the alleged obligation to deliver minimum volumes for transit is that Gazprom would be obliged to pay Naftogaz the full transit tariff in respect of such minimum volumes, irrespective of whether such volumes were actually transited by Naftogaz or not (less a small deduction in respect of "*variable cost savings*", which is addressed below). This is tantamount to the imposition of a "ship or pay" obligation on Gazprom, since it has exactly the same effect as such a provision. The imposition of such an obligation is directly contrary to the wording of the Contract and the parties' clear intentions when they entered into the Contract.

(3548) A "ship or pay" obligation is a clause that foresees that a certain minimum transit volume per year - below the maximum volumes agreed - has to be used or be paid for if not used. Mr Witschen explains why contractual provisions to secure a minimum income for a pipeline operator (primarily long-term capacity booking agreements), are sometimes agreed, primarily as a financial safeguard when, as is normally the case, huge financial investments are made into the construction of transit pipelines:

"New gas supplies from production areas that are a long distance from the consuming areas mean that huge investments are needed. Investments are necessary for exploration and production and also for the dedicated transport pipelines, which can bridge several thousands of kilometres. The financing of dedicated long distance pipelines is only feasible if the banks can rely on secured income of the pipeline owner until the pipeline is amortized and the loan is repaid. Therefore, new dedicated export pipelines awaiting construction still depend on agreements which guarantee a certain level of income for the pipeline owner/operator. Recent examples are the transport pipelines for Shah Deniz gas and the Nord-Stream pipeline for the export of Russian gas from Vyborg through the Baltic Sea."²⁷⁷

²⁷⁷ Witschen Report.

(3549) However, in the case of the Ukrainian transit system, the pipelines and system were constructed decades ago, when Ukraine was part of the Soviet Union. At that time, the Ukrainian transit system was an integral part of the large gas production, transportation and storage system that was the unified gas system of the Soviet Union. Following the collapse of the Soviet Union in December 1991, when Ukraine became a sovereign state, Ukraine (and, thereby, Naftogaz) effectively inherited the parts of the Soviet Union's unified gas system that were now on Ukrainian territory without having made any investment at all into the parts of the system it acquired. Mr Witschen explains this historical background in his report and summarises:

*"As explained above, when the Soviet Union split up overnight in December 1991, Ukraine inherited the part of the Unified Gas System on its territory, which became part of the State Property Fund and is for exclusive use by Naftogaz / its 100% affiliate Ukrtransgaz. Thus no investment costs were incurred by Naftogaz or any other entity (except for some refurbishment of the system on which there is unclear information and normal necessary maintenance etc.)"*²⁷⁸

(3550) This means that Naftogaz never made any investment into the construction of its pipeline system that would require the protection of a minimum income obligation, whether in the form of a ship or pay clause or any other type of provision. Again, Mr Witschen explains the importance of the historical background of the formation of the Ukrainian transit system to the question of the need for minimum income obligations equivalent to what Naftogaz now argues for:

*"While a minimum income system is necessary for the financing of new investments, this requirement is not necessary for the transit system in Ukraine. The pipes and compressors of the Ukrainian transit system were mainly installed during the Soviet period and transferred to Ukraine (and ultimately Naftogaz) without cost. Therefore, no capital expenditure was incurred by Naftogaz."*²⁷⁹

²⁷⁸ Witschen Report.

²⁷⁹ Witschen Report.

(3551) Further, Naftogaz has been operating its transit system without any significant investment and receiving transit fees (or an equivalent value through the supply of gas) from Gazprom since 1992. Consequently, even had Naftogaz invested in the construction of a new system, such system has been fully amortised. Mr Witschen explains:

*"Ukraine has been operating the existing transmission system independently since 1992, shortly after the collapse of the Soviet Union, a period which itself would have been more than sufficient to allow for the amortization of even a newly constructed pipeline system. The transit fees (without fuel gas) paid by Gazprom since 2002 alone would be sufficient to pay for a new transit system comparable to the Ukrainian system...Where a system is fully amortized, the income from transit services (in excess of the operating and fuel costs incurred by a reasonable and prudent operator) is pure profit for the owner and a minimum income provision is not required in order to repay investment costs. This is an important reason why the specific situation of transit through Ukraine allows for an agreement without the need for ship-or-pay or any minimum income provision."*²⁸⁰

(3552) Further, [REDACTED] comments:

*"Given that the Ukrainian transmission system was constructed in the 1960s to 1980s, and that the average life of a pipeline such as those used in Ukraine is approximately 30-35 years, I consider that, first, the Ukrainian transmission system is fully amortised, and second, that Gazprom has fully paid for the costs of construction of the Ukrainian pipeline system through the provision over the past two decades of enormous quantities of gas at heavily subsidised prices."*²⁸¹

²⁸⁰ Witschen Report.

²⁸¹ [REDACTED]

(3553) Therefore, unlike with many other pipelines and transit systems, there is no need for any form of minimum income obligation in relation to the Ukrainian transit system and, indeed, none was agreed.

(3554) It is common ground that the Contract does not contain an express ship or pay provision. In fact, the issue of whether or not the transit arrangements between Gazprom and Naftogaz should contain a ship or pay provision was discussed and the parties deliberately decided not to include such a clause.

(3555) By the time of the negotiations over 19 and 20 January 2009, it was clear that Naftogaz sought to impose a "ship or pay" obligation on Gazprom in relation to volumes in like terms to that negotiated under the Supply Contract.²⁸² That obligation arose under Article 2.2.5 of the Supply Contract and required Gazprom to pay for any shortfalls below 80% of annual contract volumes. The request for such a provision only makes sense if Gazprom was not regarded as being under a strict financial liability for shortfalls in volumes, a liability which if it existed could well be greater than a liability to pay for shortfalls below 80%.

(3556) ██████████ described the attempt by Naftogaz to have such a clause inserted into the Contract (which would invariably have imposed financial obligations on Gazprom if the minimum volumes were not in fact transited).

(3557) Gazprom did not agree to this and ██████████ accepts that "*it was obvious for me and for other representatives of Naftogaz that the ship or pay principle would not work in the framework of the transit contract*".²⁸³ It is not suggested (nor could it be) by Naftogaz that Gazprom had moved in any way from its position that it was not prepared to accept financial liability for underdeliveries.

²⁸² ██████████

²⁸³ ██████████

(3558) Gazprom's evidence confirms the position that Gazprom did not agree to financial liability for underdeliveries.

(3559) ██████████ explains that, contrary to Naftogaz' assertions, it was Gazprom (not Naftogaz) that on several occasions suggested including a ship or pay clause in the contractual arrangements for transit. ██████████ confirms:

*"The issue of Gazprom and Naftogaz entering into a ship or pay contract - i.e. moving from a transit contract to a capacity reservation contract under which payment is made regardless of volumes actually transported - has been the subject of discussions and negotiations between Gazprom and Naftogaz for several years, but a decision to enter into it has never been adopted. Gazprom has always been ready - and has even proposed to Naftogaz - to enter into a ship or pay obligation in exchange for Naftogaz undertaking stricter delivery obligations and to provide Gazprom with greater flexibility, but Naftogaz has always refused, and consequently the proposals have been rejected by both sides."*²⁸⁴

(3560) In fact, it was Naftogaz that refused to countenance a ship or pay provision, because it refused to accept the concomitant obligations that it would have had to undertake, in particular strict delivery obligations. ██████████ sets out the position as follows:

"In fact, the concept of agreeing to a ship or pay provision had been discussed between Gazprom and Naftogaz and was rejected. Gazprom has on several occasions proposed to Naftogaz including a ship or pay obligation in the transit contract in exchange for Naftogaz undertaking strict delivery obligations, but Naftogaz has refused all such proposals, being unwilling to agree to the latter. I explain the nature of such delivery obligations and why Gazprom has sought them in greater detail below. I note that Gazprom would never agree to a ship or pay

transit contract with Naftogaz unless Naftogaz agreed to undertake such delivery obligations."²⁸⁵

(3561) [REDACTED] also recalls:

*"[T]he ship or pay mechanism was rejected because Naftogaz refused to commit to the associated obligations, in particular the obligations to provide flexibility that Gazprom was seeking. Gazprom's position was that its willingness to undertake a ship or pay commitment was directly conditional upon Naftogaz agreeing to such obligations."*²⁸⁶

(3562) [REDACTED] explains that the issue of ship or pay had been under discussion between Gazprom and Naftogaz for several years and explains that Gazprom has consistently taken the position in the negotiations of the Contract *"that it would not undertake to pay penalties for under-deliveries if Naftogaz did not commit to granting Gazprom, in particular, greater flexibility and undertake corresponding delivery obligations at the exit points"*.²⁸⁷

(3563) [REDACTED] also recalls that in October 2008 Naftogaz proposed a draft transit contract containing a penalty similar to a ship or pay clause (further demonstrating that Naftogaz did not consider this to be already covered by the Contract as its current case suggests), which did not include any proposals by Naftogaz to undertake the reciprocal obligations that would be required to meet Gazprom's needs. Accordingly, *"no similar wording or variation of this clause was included in Contract TKGU"*.²⁸⁸

(3564) It is inconceivable that, having expressly decided not to include a ship or pay provision in the Contract, the parties intended Articles 3 and 10.1 of the Contract to amount to an indirect ship or pay provision, as argued by Naftogaz. The provisions of the Contract do not have such

²⁸⁵ [REDACTED]

²⁸⁶ [REDACTED]

²⁸⁷ [REDACTED]

²⁸⁸ [REDACTED], paragraph 53.

effect. That this was both parties' understanding of the position is confirmed by Naftogaz' correspondence on the topic of introducing a ship or pay provision equivalent to the take or pay provision in the Gas Supply Contract in June 2009.

- (3565) On Naftogaz' account of the negotiations Naftogaz was able to obtain a concession that was economically equivalent to a "*ship or pay*" obligation from Gazprom for free. However, this is both implausible and wrong.
- (3566) In any event, during the negotiations of the Contract, Naftogaz must have understood that Gazprom did not mean to undertake a binding minimum transit volume obligation or an obligation to pay damages corresponding to non-payments for under-delivered volumes. Since Naftogaz must have understood this and did not inform Gazprom that it had a differing intention before entering into the Contract (to the extent that was the case) Naftogaz is bound to Gazprom's perception of the contractual content in line with Section 6, paragraph 2 of the Swedish Contracts Act.
- (3567) A ship or pay obligation (and, it follows, any minimum income obligation tantamount to ship or pay as now argued for by Naftogaz) would have required a suite of other contractual provisions to accompany it, which the Contract does not contain. [REDACTED] and [REDACTED] outline the typical features of transmission contracts containing a ship or pay obligation, which include:
- (i) express use of the words "ship or pay";
 - (ii) a clear statement of the percentage of the capacity booking in respect of which the ship or pay obligation applies;
 - (iii) a clear expression of the obligation to pay regardless of whether the capacity is used;
 - (iv) the ability to book capacity on a daily basis;
 - (v) express provision for calculation of the transmission/transit fee;

- (vi) express provision for reduction of the ship or pay obligation in the event of a shortfall in capacity offered by the transporter; and
- (vii) strict delivery obligations mirroring the obligations of Gazprom Export to its customers, including:
 - provision for immediate, guaranteed delivery of nominated volumes to the specified delivery point;
 - damages/penalties payable for shortfalls in delivery of the nominated amounts; and
 - significant flexibility with regard to fluctuations in nominations from day to day (within the technical parameters of the relevant pipeline).²⁸⁹

(3568) The Contract contains none of these provisions.

(3569) It follows that the parties would not have agreed a ship or pay obligation unless such provisions were included, and Gazprom in particular would not have agreed (and did not agree) a ship or pay (or equivalent) obligation unless its requirements, as outlined by [REDACTED] and [REDACTED] were met.

(3570) As confirmed by [REDACTED] contrary to what Naftogaz implies, it is denied that Gazprom gave any oral assurances with regard to future transit volumes.

(3571) In effect, Naftogaz' underdeliveries claim, through a distortion of the agreed contractual provisions relating to annual volumes and damages for breach of contract, is nothing more than an opportunistic attempt to impose an onerous (and non-existent) contractual term on Gazprom in circumstances where Naftogaz has not been required to fulfil any of the concomitant obligations

²⁸⁹ [REDACTED]

on it that would have been included in such a term. This is impermissible and should be rejected by the Tribunal.

(3572) Naftogaz argues that the distinguishing feature of its claim for damages as compared to a ship or pay claim is its deduction of the cost savings associated with the smaller volumes actually transited in the system. Naftogaz apparently itself accepts that, in every other way, its under-deliveries claim is effectively a ship or pay claim.

(3573) However, contrary to Naftogaz' argument, its deduction of "savings" does not distinguish its claim from a ship or pay claim, but instead reinforces the fact that the essence of its claim is exactly the same as ship or pay. The only "savings" that Naftogaz deducts from the transit fees for the purposes of its under-deliveries claim are the costs of fuel gas.²⁹⁰ However, a contractual ship or pay obligation would not in any event include charges for fuel gas, because, since fuel gas is only required when gas is actually transported, that would result in an unfair benefit for the contractor by it being paid for fuel that was not needed. [REDACTED] confirms that "[s]hip or pay fees do not typically include fuel gas, which is dealt with in the contract separately."²⁹¹ Further, Mr Witschen explains:

*"In the case of a ship or pay contract, fuel costs are only incurred when gas is transported. They are proportional to the volumes transported. Any minimum ship obligation would have to contain a provision that for volumes not taken but to be paid for the fuel component would not be invoiced: otherwise the contractor would benefit unfairly by being paid for fuel not used. There is no such provision in Contract TKGU."*²⁹²

(3574) Put simply, a ship or pay obligation would also necessarily involve the deduction of fuel gas costs and there is therefore no difference at all between Naftogaz' claim and a ship or pay claim. Naftogaz' suggestion that it has been placed at a "significant disadvantage" by having to assert

²⁹⁰ See Hesmondhalgh and Lapuerta Report, Appendix 3, paragraph 176.

²⁹¹ [REDACTED], paragraphs 64 to 66.

²⁹² Witschen Report

a damages claim on the basis of a "*cumbersome general liability provision*" is disingenuous in the extreme given that the calculation of any amount owing would be identical for a ship or pay claim as for Naftogaz' damages claim and that it is apparent that there is no other difference whatsoever between such claims.

(3575) Finally, in the TBG 2010 Benchmarking, Naftogaz' own experts in these proceedings, Dr Hesmondhalgh and Mr Lapuerta, concluded that the Ukrainian transit tariff "*is unusual in that it does not incorporate a "ship-or-pay" commitment, which would require users to book and pay for capacity even if they do not use it*".²⁹³ Dr Hesmondhalgh and Mr Lapuerta went on to say that:

*"The absence of such a commitment exposes [Naftogaz] to higher volume risk that most regulated transportation companieswe have assumed that the Ukraine faces major volume risk, in which case the absence of a ship-or-pay commitment has seriously degraded the value of its existing tariff."*²⁹⁴

(3576) Evidently, Naftogaz' own experts, when reviewing the tariff in the Contract, did not consider that there was any obligation on Gazprom to pay for capacity that it did not use in the manner Naftogaz now suggests, and they identified this as a serious risk facing Naftogaz.

(3577) Gazprom's position is further supported by the text of the Contract as well as the text of the supplementary agreements reached by the parties.

(3578) A clear indication that Article 3.1 contains a non-binding forecast (as opposed to a minimum volume obligation) comes from Article 3.2. Article 3.2 provides that "[t]he *annual volumes of the Gas transit through the territory of Ukraine and their breakdown by the Quarters (including [their breakdown] by the destinations) in the subsequent years shall be specified in Supplements to this Contract*" (emphasis added by Gazprom). Article 3.2 goes on to provide that if no

²⁹³ TBG 2010 Benchmarking.

²⁹⁴ TBG 2010 Benchmarking.

agreement is reached by the Parties on an annual basis then the volumes of gas to be transited is to be based on an audit of Gazprom Export's aggregate obligations to its European offtakers. Naftogaz is, therefore, clearly wrong to contend that "... *the 110 BCM minimum transit obligation continues to apply for years where no other agreement is reached*". The view that a binding minimum annual volume of 110 BCM is set out in Article 3.1 is difficult to reconcile with Article 3.2 (which provides for altogether different means of determining volumes).

- (3579) A further indication that the Parties did not intend to include a minimum volume obligation comes from the frequent use of the term ██████ by the Parties in the Contract and in supplementary agreements. In particular the term ██████ " is found above the three tables in Article 3.1.1. Naftogaz conspicuously fails to include this critical phrase in its translation of Article 3.1.1 of the Contract. Likewise, the phrase ██████ is used in ██████. ██████. If the Parties intended to impose minimum volume obligations they would not have used the phrase ██████ ". Instead, they would have used the phrase "*not less than*".
- (3580) The practice of the Parties under the predecessor 2002 Transit Contract (which contains an almost identical clause) supports the view that Article 3.1 of the Transit Contract was not intended to impose a binding minimum volume obligation. In his second witness statement Mr ██████ responded to ██████ reliance on the practice under the 2002 Transit Contract to support Naftogaz' interpretation of Article 3.1.
- (3581) ██████ pointed out that, contrary to the suggestions made by ██████ and ██████, in fact in every one of the six years preceding the Contract in which the 2002 Transit Contract was in force 2003, 2004, 2005, 2006, 2007 and 2008 the volumes of gas transited to European countries under the 2002 Transit Contract fell below the forecasted volume of 110 bcm per annum set out in Article 3.1 of that contract.
- (3582) Even though the volumes transited to European countries within the scope of Article 3.1 of the 2002 Transit Contract were less than 110 bcm in each year in which the 2002 Transit Contract

was in force, Naftogaz did not refer to Article 3.1 of the 2002 Transit Contract in its complaints to Gazprom. Instead, Naftogaz referred, as the basis for its complaints about transit volumes, to the relevant supplements to the 2002 Transit Contract in which the annual volume and its breakdown by destinations and quarters were specified.

(3583) Thus, as [REDACTED] pointed out, it is the supplements in which the annual volume and its breakdown by destinations and quarters were specified that Naftogaz and Gazprom followed and regarded as binding while the 2002 Transit Contract was in force (not the 110 bcm forecast specified in Article 3.1 of that contract).

(3584) Consequently, given the Parties' past practice, they had every reason to intend - and understand - Article 3.1 of the Contract to include a non-binding forecast only, and not a minimum delivery obligation sanctioned by damages. As will be seen below, this is also how the Parties applied Article 3.1.

(3585) The subsequent conduct of the Parties shows that Naftogaz did not seek compensation from Gazprom for underdeliveries over a five year period and accepted, from the very outset, that the Contract did not contain binding minimum volume obligations. These facts also support Gazprom's interpretation.

(3586) As to the correspondence, note should in particular be taken to Naftogaz' letter of 15 June 2009, in which Naftogaz sought an amendment to the Contract, namely, a guarantee by Gazprom of gas volumes and payment therefore. Such amendment would hardly be necessary if Gazprom was already under a strict liability to compensate for shortfall in volumes. The third paragraph of the letter complains of the absence of an obligation on the part of Gazprom.

(3587) Further letters from Naftogaz where complaint was made about underdeliveries but no allegation of liability to compensate was made let alone a demand for payment of compensations, are:

1. Letter 9 December 2009

2. Letter 11 March 2010
3. Letter 8 June 2010
4. Letter 10 November 2011
5. Letter 19 January 2012
6. Letter 23 March 2012
7. Letter 6 March 2014

(3588) Despite shortfalls in volumes as against the minimum volumes specified in Article 3.1 of the Contract having occurred not only in 2009 but in each of the subsequent contract years, there is no allegation until July 2014 that Gazprom is under an obligation to compensate by payment of damages under Article 10.1 or otherwise. Indeed, on numerous occasions Naftogaz complained about shortfalls but did not suggest that Gazprom was under financial liability to compensate it. This is highly material. Given the huge sums involved (many billions of dollars on Naftogaz' case) and potentially due if Gazprom had financial liability as is now claimed, it is inconceivable that Naftogaz would not have raised it until its letter of 25 July 2014.

(3589) ██████████ stated clearly in his evidence:

"Gazprom would not have agreed to [relaxation of take or pay under Contract KP] had we thought it was Naftogaz's understanding that it retained a claim for lost transit fees against Gazprom for transiting an annual volume less than that anticipated. Naftogaz never invoiced Gazprom for such fees, nor to my knowledge did it ever, until it commenced these arbitration proceedings, suggest either in correspondence or otherwise that it believed it had or intended to pursue such a claim against Gazprom in respect of the lower than anticipated volumes. Indeed it appears to me from Naftogaz 15 June 2009 request for a ship or pay that Naftogaz's understanding was in fact the same as Gazprom's that Naftogaz did not in fact have

a right to seek payment from Gazprom for the transit fees that it would have received had the volumes actually transited been high than what they were."

- (3590) ██████████ made the self-evident point that Naftogaz was not a "charitable organisation". This makes it all the more clear that Naftogaz' financial difficulties are attributable to systemic problems in Ukraine and particularly its below cost pricing policy for domestic customers, not to Gazprom or the Transit Contract. Naftogaz did not then understand Gazprom to have financial liability for underdeliveries when it (through the hand of ██████████) wrote to Gazprom on 15 June 2009 and on 11 March 2010. ██████████ was asked why, for instance in 2009, when the claimed financial liability for underdeliveries amounted to approximately USD 500 million, no demand for compensation was made. ██████████ acknowledged rightly that this was "a considerable sum all the time and for everybody" but could not, it is submitted, provide a cogent explanation for it. It is submitted that the only realistic explanation is that Naftogaz did not consider Gazprom had such liability.
- (3591) Accordingly, for this reason also, Gazprom submits that the Tribunal should conclude that the Parties did not intend Gazprom to be under financial liability for volume shortfalls and is not so liable: further, that Article 10.1, upon which Naftogaz seeks to rely, should not be construed as applying to breaches of Article 3.1 in this case; and finally, the Parties conducted themselves for several years in line with this intention.
- (3592) It is clear from both its correspondence and other conduct that Naftogaz did not consider Gazprom to be under any financial liability for underdeliveries. Such conduct on the part of Naftogaz is directly relevant to the interpretation of the Contract.
- (3593) Gazprom denies that it is under an obligation to provide minimum volumes of gas for transit by Naftogaz. The reference to 110 bcm "during the period 2009-2019" in Article 3.1 of the Contract was intended as a forecast/estimate of the likely transit volumes that were anticipated by both parties but it was not meant to create a binding contractual obligation to supply a minimum annual volume of gas for transit.

(3594) In summary, it was never the Parties' intention that Article 3.1 [REDACTED] [REDACTED]), or any other provision of the Transit Contract, would constitute a binding minimum transit obligation.

7.2.2.9.5 No damages are payable under Clause 10.1 of the Contract

(3595) Gazprom is not under any obligation to deliver specific volumes under the Contract. Consequently, there is no basis for Naftogaz to claim compensation pursuant to Article 10.1 of the Contract.

(3596) Article 10.1 of the Contract:

"[Gazprom] and [Naftogaz] shall take all necessary measures for proper performance of their obligations undertaken under this Contract.

If the Parties are in breach of such obligations under this Contract, each of the Parties shall compensate the other Party for the proven damages caused by such failure to perform."

(3597) The obligation to compensate the other party for proven damages in the second paragraph of Article 10.1 relates to the obligation in the first paragraph for the Parties to take all necessary measures for the proper performance of their obligations under the Contract. Therefore, damages would not be payable unless Gazprom had failed to take all necessary measures for the proper performance of its obligations.

(3598) Gazprom has taken all necessary measures for the proper performance of its obligations under the Contract and consequently no damages are payable pursuant to Article 10.1.

(3599) Further, pursuant to Article 10.1 of the Contract, Naftogaz is only entitled to be compensated for "*proven damages*". In the absence of any ship or pay provision (as set out above), Naftogaz has not proven it has suffered any damages as a result of a breach of any obligation by Gazprom and, therefore, is not entitled to any compensation.

(3600) This is because, in the absence of a "ship or pay" provision, Gazprom has no obligation to pay the transit tariff in respect of gas volumes not actually delivered for transit. Accordingly, Naftogaz has no claim for compensation in respect of the non-payment of such fees and Naftogaz has not claimed any additional damages as a result of any alleged breach of the Contract by Gazprom.

7.2.2.9.6 Naftogaz cannot claim damages for loss of profit or other indirect loss pursuant to Article 10.1 of the Contract for breach of Article 3.1

(3601) Gazprom's understanding when entering into the Contract was that under Article 10.1 Naftogaz would only be entitled to bring a claim against Gazprom in the event it suffered some form of direct damage as a result of a failure by Gazprom to perform its obligations under the contract.

(3602) For example, if Gazprom breached its obligation to maintain the pressure in the pipeline within the agreed technical parameters set out in the [REDACTED], and there was an accident such as an explosion damaging the pipeline itself attributable to the actions of Gazprom.

(3603) However, Gazprom certainly did not understand Article 10.1 to cover loss of profit or lost revenue.

(3604) Accordingly, Gazprom maintains that Article 10.1 should not be interpreted as giving Naftogaz a right to claim for damages for loss of profit by reason of underdeliveries. As Gazprom's witnesses show, Article 10.1 was never intended to be applied in that way.

(3605) Under Swedish law, loss of profit is generally considered to be an indirect loss. See the statutory definition of indirect loss at section 67, second paragraph of the Swedish Sale of Goods Act.

(3606) It was Gazprom's understanding that Article 10.1 should not cover indirect loss such as loss of profit. Accordingly, the phrase "*proven damages*" was used. Gazprom maintains that this phrase should be interpreted as being intended to mean "*direct damages*".

7.2.2.9.7 Naftogaz' claim for damages is overstated

(3607) Naftogaz claims compensation in an amount corresponding to the tariffs that Gazprom would have paid had the minimum volumes that Naftogaz asserts been delivered for transit. From the tariffs for the undelivered volumes of gas, Naftogaz has only deducted saved costs for fuel gas. All other costs that Naftogaz has saved should be deducted from any compensation for loss of profit payable to Naftogaz.

(3608) In this context, it should be noted in particular that Naftogaz, as a basis for its claim for revision of the tariff in the Contract, asserts that the tariff results in a net loss and does not cover Naftogaz' costs.

(3609) If, contrary to Gazprom's various defences, the Tribunal finds that Gazprom is liable to pay damages to Naftogaz to compensate for the shortfall in transit volumes alleged by Naftogaz, then the Tribunal should find that Naftogaz' damages claim has been substantially overstated.

7.2.2.9.8 Naftogaz has failed to mitigate its alleged damage

(3610) Naftogaz has not demonstrated that it has tried to mitigate its damage. It is a general principle under Swedish contract law that a party suffering damage must try to mitigate its damage. If the party fails to do so, it must bear a corresponding part of the loss itself.

(3611) It is obvious that Naftogaz should have been able to mitigate its alleged loss by cutting costs, i.e. the costs of personnel and other operating expenses. As a result of its failure to do so, Naftogaz cannot be entitled to the damages it claims.

7.2.2.9.9 In any event, Naftogaz has lost its right to damages by reason of its conduct and/or by reason of its passivity

(3612) Naftogaz has lost any alleged right to damages since it has failed to notify Gazprom of the claim and has failed to pursue the claim.

(3613) From 2009 to 2014, Gazprom delivered gas for transit under the Contract without Naftogaz ever stating that it considered itself to have a right to claim damages for the alleged under-deliveries. Although Naftogaz frequently sent correspondence to Gazprom in relation to the

Contract, Naftogaz never asserted any claim or entitlement to damages for alleged under-deliveries until it sent the notice of dispute that was the precursor to these proceedings on 25 July 2014. This was despite Naftogaz frequently raising the issue of alleged under-deliveries in its correspondence.

(3614) For example:

(i) in a letter dated 18 February 2009:

"in January and February of the current year, the volumes of natural gas transit through the territory of Ukraine stated in nominations received from [Gazprom] are much lower than the planned contractual volumes";

(ii) in a letter dated 10 November 2011:

"over the ten months of the current year, [Gazprom] has systematically breached its obligations in relation to deliveries of natural gas volumes for their transit to the points of delivery at the borders of Ukraine with the neighbouring states ... The shortfall in the delivery of natural gas volumes for transit...results in a significant decline in the amount of the [Naftogaz's] revenues for the services provided to [Gazprom]";

(iii) in a letter dated 19 January 2012:

"in 2011 alone, [Contract TKGU] provided for the gas transit volume of 102.7 billion cubic meters...The actual transit [volume] over that period was a mere 92.9 billion cubic meters...The shortfall in the delivery of natural gas volumes for transit through the territory of Ukraine...resulted in various disruptions in the orderly operation of the Ukrainian GTS and a considerable decline in the amount of the [Naftogaz's] revenues for the services provided to [Gazprom]";

(iv) in a letter dated 23 March 2012:

"[Naftogaz] is concerned about the current significant reduction in the volumes of gas delivered for transit through the territory of Ukraine to European importing states. With the approved contractual annual volumes (112 billion cubic meters), the daily transit volume in the amount of 200-210 million cubic metres in March this year may result in a breach of the terms of [Contract TKGU]"; and

(v) in a letter dated 6 March 2014:

"notwithstanding that Clause 3.1.4 of [Contract TKGU] contains an obligation... to deliver ... 112 billion cubic meters of natural gas for its transit... the actual [volume] transported in 2012 was 84.3 billion cubic meters and in 2013, 86.1 billion cubic metres... in 2012-2013, the annual shortfall in the transit revenues amounted to nearly one third of the cost of services provided".

(3615) Thus, Naftogaz failed to give proper notice of its claim (Sw. *reklamera*).

(3616) In fact, as late as the 6 March 2014 letter, not only did Naftogaz fail to assert any claim for damages in respect of Gazprom's failure to meet the alleged volume commitments in the Contract, but Naftogaz expressly referred only to the provisions of Article 3.1.4 of the Contract and that *"in the event of a decline in the annual gas transit volume, it is possible to change the terms of services provided in return for the advance payment received under [REDACTED]"* in the context of Naftogaz' potential remedy in such a situation. As stated above, this is consistent with Gazprom's understanding that the only consequence of delivering less than [REDACTED] of gas for transit in the years [REDACTED] was an extension to the period over which services were to be charged against the Advance Payment (confirmed by [REDACTED] and consistent with Naftogaz' waiver of any entitlement to damages as set out below.

(3617) By not stating that it considered itself entitled to damages for underdeliveries, Naftogaz has implicitly waived any right to damages that it might otherwise have had. Gazprom has had well-founded reasons to believe that Naftogaz did not intend to pursue a damages claim on the basis of the alleged underdeliveries.

(3618) To the contrary, Naftogaz' behaviour indicated that it did not consider itself entitled to damages. Naftogaz sought and proposed amendments to the Contract that would have entitled Naftogaz to the payment of transit fees for specific volumes even where they were not delivered for transit. No entitlement to an existing claim for compensation was referred to by Naftogaz. This is inconsistent with the position now asserted by Naftogaz that it is (and, it follows, has always been) entitled to such payment under the existing provisions of the Contract.

(3619) Accordingly, Naftogaz' conduct has led Gazprom to believe that Naftogaz did not consider itself entitled to compensation for the alleged under-deliveries. Naftogaz' behaviour has justified Gazprom's understanding that Naftogaz did not intend to pursue a claim for damages on the basis of the alleged under-deliveries.

(3620) Further, under general contractual principles of Swedish law, loss of a right can occur due to passivity. In the well-known Swedish arbitral award in the case between KPMG and Profilgruppen, the arbitral tribunal stated :

*In-house English translation: "There is a general legal principle that a right can be lost as a consequence of passivity over a long period of time. It applies in both contractual and non-contractual relations. The principle is based on trust. The creditor's long-term passivity typically leads to a risk that the debtor acts on the assumption that he is free from debt. From that perspective the principle has some similarities to passivity as a legal fact which can form the basis of an agreement (waiver). What is a long time depends on the circumstances, inter alia the basis for the claim and the nature of the claim. What constitutes a long time can be considered to be shorter in a contractual relationship than in a non-contractual relationship."*²⁹⁵

(3621) In line with the above, Naftogaz has lost any right to damages that it may have had due to its long term passivity. In particular, as set out above, Naftogaz now asserts damages claims dating

²⁹⁵ Arbitral Award dated 22 December 2010 in the case *Profilgruppen v KPMG*, page 35.

back to 2009, having failed to take any action over a five year period to pursue such claims. This falls within the principle of long-term passivity outlined above.

- (3622) Gazprom maintains that Naftogaz had a general duty under Swedish law to give a timely notice of its claim, and that it has failed to comply with that duty by not giving any notice of claim whatsoever for over 5 years, until 25 July 2014.
- (3623) Gazprom denies that notice of claim has been given by Naftogaz. Naftogaz claims that "*a notice of the breach itself suffices*". However, Naftogaz did not give any notice of breach. A proper notice of breach must include a clear statement that the other party has committed a breach of contract. There was no so-called "*neutral reklamation*". It is clear from the 15 June 2009 letter that Naftogaz did not consider Gazprom to be in breach of contract; instead, Naftogaz asked Gazprom to "*please consider the possibility of amending the Transit Contract in part of [Gazprom] undertaking an obligation in favour of [Naftogaz] to guarantee the provision of natural gas volumes [...]*". Far from alleging breach, Naftogaz politely asked Gazprom if it would consider amending the Contract in order to insert such a commitment.
- (3624) Gazprom denies that a failure to give notice would only entail a limitation of liability. On the contrary, as Gazprom has stated in the Supply Arbitration, the effect of failure to give such notice is a preclusion of rights. The time limit for giving such notice varies depending on the parties and the circumstances of the case. A couple of months has been accepted a few times and five months has been considered too late.
- (3625) Naftogaz suggests that its suggested amendments to the Contract would not have given any impression of waiver, especially in the absence of consideration. This is contested. First, Gazprom relies on those amendments as proof that Naftogaz did not consider itself entitled to damages for underdeliveries, and its consistent behaviour showed this. Second, Naftogaz' conduct in this regard demonstrates that, in any event, Naftogaz has lost any right to damages because Naftogaz gave Gazprom well-founded reasons to believe that Naftogaz did not intend to pursue a damages claim.

- (3626) Gazprom also denies that the time period here is too short to establish passivity. In fact, there is no authority for Naftogaz' assertion that a time period of six years would be too short. This is certainly sufficient time to establish passivity in circumstances where no notice of claim has been given in the first place.
- (3627) Gazprom relies on the following four facts and circumstances in support of its contention that Naftogaz has lost its right to damages by reason of its conduct or by reason of passivity.
- (3628) First, Naftogaz's 15 June 2009 letter gave Gazprom the clear impression that Naftogaz did not consider that there was an enforceable minimum volume obligation binding upon Gazprom in the Contract. Further, by not asking for compensation for failure to supply alleged minimum volumes at the time, Naftogaz gave Gazprom the clear impression that Naftogaz was not making such a claim.
- (3629) Naftogaz attempts to explain away the contradiction between its position in this Arbitration and its letter of 15 June 2009 by making a distinction between: (1) a minimum transit volume obligation; and (2) a true "*ship-or pay*" clause. Naftogaz asserts that this letter is concerned solely with the absence of a true "*ship or pay*" clause in the Contract but it says nothing about whether Naftogaz was relying on a minimum volume obligation. (Naftogaz asserts that the substantive difference between a minimum volume obligation and a true "*ship or pay clause*" is that the latter would allow Naftogaz to claim additional sums for losses that were avoided by Naftogaz). However, if Article 3.1 did, in fact, contain a minimum volume obligation Naftogaz would have had no cause for complaint. The "*decrease ... [in] income*" and "*unplanned financial deficit*" that it expressed concern about would be neutralised (or much reduced) by way of compensation for breach of such an obligation. It follows that the only persuasive reading of the letter of 15 June 2009 is that Naftogaz was complaining about the absence of a minimum volume obligation rather than making a complaint about its ability to obtain additional sums corresponding to avoided losses under a true "*ship or pay*" clause.

- (3630) Second, by frequently raising the issue of alleged underdeliveries in other correspondence including in its letters of 18 February 2009, 10 November 2011, 19 January 2012, 23 March 2012 and 6 March 2014 without asking for damages for the failure to supply alleged minimum volumes, Naftogaz gave Gazprom the clear impression that Naftogaz had no claim for compensation under Article 3.1 and would not make such a claim in the future. In its letters Naftogaz did not claim compensation for past losses sustained because of breach of contract (which would have been the natural response if it believed that the Contract contained a minimum volume obligation). Instead, Naftogaz asked Gazprom to alter its conduct prospectively by providing greater volumes or to amend the Contract. Naftogaz is therefore wrong to suggest that this correspondence "*demonstrate[s] that Naftogaz considered the Contract to impose minimum transit volume obligations on Gazprom, and Gazprom to be in breach of such obligations.*"
- (3631) Third, it is noteworthy that under the 2002 Transit Contract Naftogaz was prompt in bringing demands for compensation on account of alleged underdeliveries to the attention of Gazprom. Against this background, Gazprom was justified in concluding that Naftogaz' failure to make prompt claims for compensation implied that it had waived any rights it may have had.
- (3632) Fourth, Gazprom acted in reliance upon the fact that Naftogaz was not making a claim for compensation. In the absence of such a claim, Gazprom agreed to make advance payments to Naftogaz in respect of transit fees, as well as agreeing to relax certain take or pay claims, as part of an overall commercial package. In particular, Gazprom gave advance payments to Naftogaz under the Contract in order to assist Naftogaz with meeting its financial liabilities under the Sales Contract. Gazprom would not have provided such assistance to Naftogaz had it known that Naftogaz intended to claim for underdeliveries in the manner that it now has done.
- (3633) For these reasons, Naftogaz has lost its right on grounds of passivity and/or conduct, pursuant to inter alia NJA 2002 p. 630. A party cannot be passive if it wishes to make a claim for breach of contract and a notice of claim should be made within a reasonable time. Naftogaz is in breach

of this principle in that it failed to give notice of claim for over five years, until 25 July 2014. The effect of its failure to give notice is a preclusion of its rights.

7.2.2.9.10 In any event, Naftogaz cannot claim compensation for the years 2009, 2010 and 2012-15

(3634) In any event, Gazprom is not liable to pay damages to Naftogaz for the years 2009, 2010, 2012, 2013, 2014 and 2015 in light of more specific agreements reached by the Parties.

1. For 2009, the use of the phrase "*shall comprise*" in Article 3.1.1 of the Contract must be considered in conjunction with the phrase "*up to*" used immediately afterwards. The use of the latter phrase ("*up to*") indicates that Gazprom retained a discretion not to provide the volumes in Article 3.1.1.
2. For 2010, [REDACTED] makes it clear that Gazprom retained the discretion to transit volumes of [REDACTED] or less because, again, the phrase [REDACTED] is used in paragraph 1 of [REDACTED] (and repeated in paragraph 7 of [REDACTED]). Naftogaz' assertion that the phrase "[REDACTED]" should be read as [REDACTED] cannot be reconciled with the plain meaning of the words used by the parties.
3. For the years [REDACTED], the legal consequence of Gazprom transiting volumes of less than [REDACTED] is clearly specified in that provision. The sole legal consequence is that "*the Parties may agree on extending the period of services to be provided by the Contractor to be charged against the Advance Payment*". Naftogaz contends that this phrase "*does not exclude other remedies*" such as monetary compensation for lost revenues. However, if monetary compensation was contemplated then the "Advance Payment" would need to be netted off against such monetary compensation (before arriving at any extended period for services to be provided by Naftogaz). But this process of netting off is not mentioned in [REDACTED]. That

implies that the parties did not contemplate that Gazprom was under any obligation to compensate for underdeliveries below [REDACTED] during those years.

(3635) In conclusion even if (which is denied) it was intended there should be financial liability for volume shortfalls, upon a proper construction: (1) the volume requirement for [REDACTED] were maximum sums; (2) the volume requirement for [REDACTED] was still subject to further determination under Article 3.2 which required (i) a breakdown of volumes into "Quarters" to be specified in supplements to the contract, (which in the event did not occur), and (ii) in default, determination of volumes was to be calculated by an auditor confirming the quantity of the delivery obligations of GP-Export to its European buyers; and (3) in any event, and redress was limited only to the particular and expressly specified remedy in [REDACTED] in respect of advanced payments.

7.2.2.9.11 Underdeliveries claim for 2016 and 2017

(3636) Underdeliveries claims for additional years, 2016 and/or 2017 should not be included in the claim and the Tribunal should not rule on the matter.

(3637) As set out above, it is clear from Article 3.2 in the Contract that the volume obligation is to be determined, in default of agreement between the Parties, following the express procedure set out in the clause: namely, "*[...] the volumes of the Gas transit in the relevant year shall be determined based on the aggregate obligations to supply minimum annual quantities of Gas under the contracts of OOO Gazprom Export with the European buyers which receive the Gas transited through the gas transportation system of Ukraine. In that case such minimum annual obligations under the contracts of OOO Gazprom Export have to be confirmed by the auditor.*"

(3638) There was no evidence before the Tribunal about this express procedure and its state of progress that would enable it to make any determination in this respect.

7.2.2.9.12 Alternative defence pursuant to Section 36 of the Swedish Contracts Act

- (3639) As a result of new circumstances that have arisen by reason of the Tribunal's Awards in the Supply Arbitration, dated 31 May 2017 and 22 December 2017 (Arbitration V 2014/78/80) (the "Supply Awards") Gazprom advances a new defence to Naftogaz' underdeliveries claim.
- (3640) Gazprom submits as an alternative defence to Naftogaz's payment claim that if (contrary to its case) it does have an obligation to make payment under Articles 3.1 and/or 3.2 of the Contract, then the amount it is ordered to pay pursuant to those Articles should be adjusted (Sw. *jämkad*) to zero by the Tribunal pursuant to Section 36 of the Contracts Act. This new defence only arises if the Tribunal has rejected Gazprom's primary case that the Contract does not impose any obligation on Gazprom to make payment to Naftogaz pursuant to Articles 3.1 and/or 3.2 and only arises if the Tribunal has found that such an obligation does arise.
- (3641) The ground for seeking such adjustment is that enforcing such payment obligation will lead to a severe imbalance in the overall contractual relationship between Gazprom and Naftogaz (as constituted by the Supply Contract and the Transit Contract).
- (3642) In the Supply Awards, the Tribunal decided to change fundamentally and reduce Naftogaz' Take or Pay obligation. It would be fundamentally unbalanced and unconscionable to require Gazprom to make payment in full under Articles 3.1 and 3.2 of the Transit Contract in circumstances where Naftogaz' Take or Pay obligation in Gas Sales Contract has, by operation of the Supply Awards, been removed for the period 2009 to 2017 and severely reduced thereafter.
- (3643) As regards the timing of this submission, the new defence arises directly as a result of the Tribunal's decision in the Final Award in the Supply Arbitration, in particular, the Tribunal's application of Section 36 to the Take or Pay provisions in the Gas Sales Contract. It was not therefore a defence that could have been raised prior to or during the course of the Transit hearing or in the course of the post hearing submissions. It was only when the Final Award in the Supply Arbitration was issued on 22 December 2017 that the parties knew the extent of the adjustment that had been made by the Tribunal.

- (3644) Gazprom's primary position is that Section 36 of the Swedish Contracts Act can only be used very restrictively in commercial contracts such as this. However, in circumstances where the Tribunal has already used Section 36 of the Swedish Contracts Act in the Supply Arbitration, consistency requires that a similar adjustment be made in the Transit Arbitration, particularly with regard to consideration of the imbalance of the Parties' overall contractual bargain resulting from the adjustments made to the Take or Pay provisions in Gas Sales Contract.
- (3645) For the purposes of Section 36, the "*contractual relation*" is not the Gas Sales Contract in isolation but the Gas Sales Contract in conjunction with the Transit Contract.
- (3646) In its Supply Awards, the Tribunal fundamentally changed and reduced Naftogaz' take or pay obligation under the Gas Sales Contract.
- (3647) The consequence of the Tribunal's decisions was that for the period from 2009 to 2017, Naftogaz had no Take or Pay obligation and therefore no obligation to purchase a minimum quantity of gas from Gazprom. If (contrary to Gazprom's defence in the Transit Arbitration) Articles 3.1 and 3.2 imposed financial liability upon Gazprom in the event of its failure to deliver required minimum volumes for transit (referred to below as the "Transit Minimum Volume Obligations" or "MVO"), then:
1. In the context of the Parties' overall contractual relationship, there was a degree of symmetry and balance between (a) the Take or Pay obligation assumed by Naftogaz under the Gas Sales Contract, to make payment if minimum volumes were not taken, and (b) the MVO assumed by Gazprom under the Transit Contract.
 2. The removal of the Take or Pay obligation for the period 2009 to 2017 and its adjustment thereafter created asymmetry and imbalance with the MVO.
 3. The imbalance is so great that Section 36 should be invoked to redress that balance.

- (3648) The Gas Sales Contract and the Transit Contract were negotiated and entered into at the same time. Furthermore, they were negotiated as a package deal. There was no question of the Parties concluding the Gas Sales Contract without concluding the Transit Contract at the same time and vice versa.
- (3649) It is not in dispute that both contracts were negotiated in parallel in late 2008 and in the course of the meetings in January 2009, and that both contracts were executed on 19 January 2009.
- (3650) The Agreement on the Principles of Long-term Cooperation in the Gas Field concluded by the Parties on 16 October 2008 records the agreement of the parties to conclude at the same time a long-term contract for supply of natural gas and a longterm contract on transit of gas.
- (3651) The key negotiation between the Russian and Ukrainian leaders on 18 January 2009 related to both the supply and transit agreements.
- (3652) Gazprom's primary position is that the Transit Contract does not impose any financial liability on Gazprom resulting from a volume commitment. However, if the Tribunal were to decide otherwise, and conclude that the Transit Contract does impose such liability, then it is clear that there has been a high degree of symmetry between the Parties' financial obligations in the Gas Sales Contract and the Transit Contract, including between the Take or Pay provisions and the MVO.
- (3653) The removal of the Take or Pay obligation under Article 2.2.5 of the Gas Sales Contract in its entirety for the period 2009 to 2017 and its replacement by a Take or Pay obligation for a very much lower volume for 2018 and 2019 has created asymmetry between the Gas Sales Contract and the Transit Contract and a severe imbalance in the contractual relationship, if a financial liability for underdeliveries were to be imposed on Gazprom.
- (3654) The lack of symmetry and the imbalance necessarily follows from the removal/substantial adjustment of the correlative obligation to the MVO, and the lack of any financial sanction on

Naftogaz (at least for 2009 to 2017) for failing to meet its volume obligations whilst at the same time imposing a financial obligation on Gazprom for failing to meet its volume obligations.

(3655) In the Supply Awards, the Tribunal decided that Naftogaz' Take or Pay obligations should be invalidated in respect of past periods and revised in respect of those years remaining under the term of the Contract as at the date of the Final Award (namely, 2018 and 2019) to a level of less than half (40%, being 80% of 50%) of Naftogaz' actual "needs". It is clear from the wording of the Tribunal's decision that, had that decision been made earlier, a revision of Naftogaz' Take or Pay obligation would have also been made in respect of earlier years, again by reference to Naftogaz' "needs". If, contrary to Gazprom's primary case, the Tribunal is persuaded that Article 3.1 of the Transit Contract does impose financial liability upon Gazprom in the event of a failure to deliver for transit the alleged required minimum volumes, and if the Tribunal also rejects Gazprom's defences based on Article 3.2 of the Transit Contract, Gazprom would be bound by an obligation, both in respect of past and future periods, to transit volumes much higher than its own actual needs in circumstances where Naftogaz' corresponding obligation to take delivery of volumes under the Gas Sales Contract has been invalidated in respect of past periods and reduced to less than half of its actual needs in respect of future periods.

(3656) Gazprom's "needs" in respect of transit volumes for these purposes have been reviewed and verified by independent auditors Financial and Accounting Consultants Limited Liability Company (also known as FBK), in accordance with the process set out in Article 3.2 of the Transit Contract, and confirmed in letters from FBK to Gazprom Export LLC dated 30 December 2016. A summary of the confirmed "*aggregate obligations to supply minimum annual quantities of Gas under the contracts of [Gazprom Export] with European buyers which receive the Gas transited through the gas transportation system of Ukraine*" ("Aggregate Obligations to Supply the MAQ of Gas") for the years 2012 to 2017 is set out below:

Aggregate Obligations to Supply the MAQ of Gas (million m³/year):

2012	2013	2014	2015	2016	2017
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- (3657) In fact, the actual volumes transited by Gazprom have, in each of the years set out above, been higher than the above-mentioned Aggregate Obligations to Supply the MAQ of Gas. Thus, Gazprom has already transited and paid for volumes pursuant to the Transit Contract higher than its actual needs.
- (3658) The imposition on Gazprom of financial liability for failing to meet its volume commitment under the Transit Contract - which is clearly higher than Gazprom's needs - in circumstances where Naftogaz has been relieved from liability for its correlative obligation under the Gas Sales Contract, would be unconscionable. It would therefore be unconscionable for Naftogaz to receive payment from Gazprom pursuant to Naftogaz' underdeliveries claim.
- (3659) Accordingly, for all the reasons set out above, Gazprom asks that Naftogaz' underdeliveries claim be rejected in its entirety.

7.2.2.9.13 Response to Nafogaz' updated underpayments claims

7.2.2.9.13.1 Introduction

- (3660) Gazprom contends that Naftogaz's claims for underpayment should be rejected in their entirety and that there is no basis for revisions to the tariff.
- (3661) It follows that there have been no underpayments and the underpayments claim should be dismissed.
- (3662) If, contrary to Gazprom's submissions, the Tribunal determines that the tariff should be changed and further that it should be changed with retrospective effect, then the quantum of the underdeliveries claim will obviously be dependent on the tariff set.
- (3663) If the tariff is set on a cost reflective basis, there are several alternatives to the tariff proposed by Naftogaz. These have been discussed in Moselle Reports 1 to 3 where he considers several reasonable alternative approaches to setting cost reflective tariffs, in particular with regard to

RAB, depreciation, the rate of return applied on the RAB, operating costs and exchange rates as well as the allocation of Ukrtransgaz's allowed revenues between transit and domestic gas transmission.

- (3664) In the Moselle Report 8, Dr Moselle refers to these alternative approaches. In Tables 7 and 8 he shows the impact of the reasonable alternative approaches to setting cost reflective tariffs on Naftogaz' updated underpayment claims as those claims are quantified in Brattle Report 9 (as corrected in Moselle Report 8). The impact of these alternative approaches on Naftogaz' claims (not just those based on a new tariff from 2016, but also where the tariff is fixed from earlier dates) is in most cases enormous.²⁹⁶
- (3665) Even if the Tribunal were to fix the tariff on the basis of the regulated tariff fixed by the Ukrainian regulator (the "2016 Tariff"), as well as in cases where it fixes a cost reflective tariff on other bases from 2010 onwards, corrections need to be made to the calculation of Naftogaz' updated underpayment claim made in Brattle Report 9. These corrections are addressed in Moselle Report 8. They are summarised below.

7.2.2.9.13.2 Adjustment for fuel gas

- (3666) The existing tariff under the Contract is set on the basis that the fuel gas is provided by Naftogaz. If a cost reflective tariff is applied, the cost of fuel gas is borne by Gazprom. In calculating the level of underpayment, both Dr Hesmondhalgh and Dr Moselle in order to make a true comparison between the revenue received by Naftogaz under the existing tariff and the revenue it would have received under a cost reflective tariff, have deducted from the revenues derived from the existing tariff the fuel gas costs incurred.
- (3667) However, where the experts differ is that Dr Hesmondhalgh has calculated the fuel gas costs incurred on the basis of an assumption that the volume of fuel gas used as a percentage of transit

²⁹⁶ See Table 7 of the Moselle 8 Report.

volumes is 3% whilst Dr Moselle has calculated the costs by reference to actual fuel gas usage. This usage is lower than the 3% used by Dr Hesmondhalgh.

(3668) There is no justification for using an assumed figure when actual fuel gas consumption figures are available.

7.2.2.9.13.3 Treatment of discounts

(3669) As noted in the Moselle Report 8, Dr Hesmondhalgh's calculations take into account only part of the discounts offered by Naftogaz to Gazprom in exchange for advance payments of transit fees. This may be an inadvertent error by Dr Hesmondhalgh. If, however, the omission of part of the discount was deliberate, then it could only have been on the basis that she has assumed that the part of the discount granted in exchange for advance payments would have ceased to be available where Gazprom is paying cost reflective tariffs. Such assumption is not part of Naftogaz' pleaded case. In any event, there is no basis for making such an assumption.

7.2.2.9.13.4 Valuation of the future off-set

(3670) In Brattle 9, Dr Hesmondhalgh explains the rationale for the future offset. She then goes on to make an adjustment for the value of the future offset to take account of the fact that (assuming Naftogaz succeeds in securing an award for the 2016 Tariff), Gazprom will not be paying the new tariff until the Award is delivered. The adjustment she makes is to discount the value of the future offset (valued as at 31 December 2015) to reflect the time value of money between 31 December 2015 and the date of the Award.

(3671) If Naftogaz succeeds in persuading the Tribunal to give it pre-award interest, no discount on the future offset is appropriate since Naftogaz will already be receiving compensation for the delay in payment of the 2016 Tariff by an award of interest.

7.2.2.9.13.5 VAT

(3672) In addition to corrections for these three matters, Dr Hesmondhalgh's figures must be adjusted for 2016 and 2017 to remove VAT. In Brattle report 9, she states that "*VAT effects arise in two*

ways during 2016 and 2017." She then explains that "*Naftogaz has been paying VAT which it claims Gazprom should have been paying*". She further explains that if Gazprom had been paying (in 2016 and 2017) the tariffs set by the regulator, the amount of VAT that Naftogaz would have had to pay would have increased.

(3673) However, there is no evidence that Naftogaz is out of pocket in respect of VAT. Naftogaz has adduced no evidence that it has been paying VAT which Gazprom should have been paying, let alone that it is in the amounts now being claimed.

(3674) In these circumstances, Gazprom contends that no addition should be made for VAT.

(3675) Dr Moselle has modified Dr Hesmondhalgh's calculations in order to correct for the three errors identified above, namely those in respect of (a) the fuel gas costs, (b) discounts, and (c) the future offset. The corrections are presented in Table 3 of Moselle Report 8. The table also adjusts Dr Hesmondhalgh's figures to remove the VAT element.

7.2.2.9.14 Quantum of underdeliveries/underpayments claim

7.2.2.9.14.1 Introduction

(3676) The amounts claimed by Naftogaz are:

USD 14,864,669,277.45, alternatively USD 14,419,313,127.88

of which USD 1,066,017,820.79 is VAT (cf. Appendix 1).

(3677) Naftogaz' claims for interest are the following:

in respect of underdeliveries, pursuant to Sections 3 and 6 (cf. (i)-(viii) or 4 and 6 (cf. (viii)) of the Swedish Interest Act on any compensation amount in respect of

(i) any part of 2009 (USD [REDACTED]) from 4 January 2010,

(ii) any part of 2010 (USD [REDACTED]) from 2 January 2011,

- (iii) any part of 2011 (USD [REDACTED]) from 3 January 2012,
- (iv) any part of 2012 (USD [REDACTED]) from 2 January 2013,
- (v) any part of 2013 (USD [REDACTED]) from 2 January 2014,
- (vi) any part of 2014 (USD [REDACTED]) from 2 January 2015,
- (vii) any part of 2015 (USD [REDACTED]) from 4 January 2016, and (
- viii) any part of 2016 (USD [REDACTED]) from 2 January 2017, and
- (ix) and part of 2017 (USD [REDACTED]) from 2 January 2018, or
- (x) alternatively, in respect of each amount of compensation in (i)-(ix), from and including 26 August 2014, 16 October 2014, 4 May 2015, 15 February 2016, 29 August 2016, 5 February 2018 or the date of the award; and

(3678) in respect of underpayment or damages:

- (i) on any compensation amount in respect of any period starting no earlier than 1 January 2010 and ending 31 December 2015 (USD 6,633,707,493.52), interest pursuant to Sections 3 and 6 or 4 and 6 of the Swedish Interest Act from and including 16 October 2014, 4 May 2015, 4 January 2016, 15 February 2016, 29 August 2016, 5 February 2018 or the date of the award, and
- (ii) on any compensation amount in respect of any period starting no earlier than 1 January 2016 and ending 31 July 2016 (USD 2,675,740,609.32 alternatively USD 2,532,640,387.22, of which USD 392,047,899.77 is VAT), interest pursuant to Sections 4 and 6 of the Swedish Interest Act from and including 29 August 2016, 5 February 2018 or the date of the award, and
- (iii) on any compensation amount in respect of any period starting no earlier than 1 August 2016 and ending 31 December 2017 (USD 4,881,129,242.47, alternatively USD

4,578,873,315.00, of which USD 673,969,921.02 is VAT), interest pursuant to Sections 4 and 6 of the Swedish Interest Act from and including 5 February 2018 or the date of the award.

(3679) The underdeliveries claims are

1. for 2009 based on an alleged minimum volume obligation of 120.083 bcm;
2. for 2010 based on an alleged minimum volume obligation of [REDACTED] bcm;
3. for 2011 based on an alleged minimum volume obligation of [REDACTED] bcm;
4. for 2012 based on an alleged minimum volume obligation of [REDACTED] bcm;
5. for 2013 based on an alleged minimum volume obligation of [REDACTED] bcm;
6. for 2014 based on an alleged minimum volume obligation of [REDACTED] bcm;
7. for 2015 based on an alleged minimum volume obligation of [REDACTED] bcm.
8. for 2016 based on an alleged minimum volume of 110 bcm
9. for 2017 based on alleged minimum volume of 110 bcm

(3680) With respect to the 2009-2015 underdeliveries claim and fuel gas savings:

1. Gazprom submits that in calculating its damages Naftogaz has failed to give credit for all cost savings, namely costs that it would have incurred had it transited the alleged shortfall volumes. The savings for which Naftogaz has failed to give full credit relating to royalties and fuel gas.
2. With respect to royalties, Naftogaz has accepted that it has failed to give credit for savings in respect of royalty payments totalling up to \$421.3m that would have been due on the alleged shortfall volume, but argued for the first time in its Underdeliveries Note 5 that it would incur VAT liabilities on any damages awarded. That new

argument is a bad one for the reasons given in Gazprom's rebuttal submission on the royalties issue.

3. With respect to fuel gas savings, Gazprom has explained that Naftogaz has failed to give sufficient credit for fuel gas savings that have been made by Naftogaz by not having to transit the alleged shortfall volumes.
4. Naftogaz has accepted that the relationship is non-linear and accepts that fuel gas savings were understated in its previous quantification of its claim for 2010 to 2015. It also accepts that it failed to allow for fuel gas savings in respect of 2009 underdeliveries.

(3681) The total adjustment made by Naftogaz by way of increased cost savings for 2009 to 2015 compared to its previous quantification amounts to \$570m of which \$252m relates to 2009 (where previously no cost savings are shown) and the balance (of \$318m) relates to 2010-2015.

7.2.2.9.14.2 Fuel Gas

(3682) The Tribunal gave directions on 29 November 2016 that each party would have an opportunity to put in further material on the important question of the effect of quantum in the event of a finding by the Tribunal that Gazprom had been in breach of a minimum deliveries obligation.

(3683) Gazprom submits that the reduction in volumes of transit gas arising out of underdeliveries leads to a very substantial saving on the part of Naftogaz in terms of fuel gas saved.

(3684) With respect to Naftogaz' underdeliveries claims and fuel gas savings, the Parties' experts have considered nine different models in total (six suggested by Dr Moselle, and three by Dr Hesmondhalgh), and have conducted hypothesis testing on each of the models in order to assess its: (1) "goodness-of-fit", and (2) robustness. On the basis of these tests, the experts agree that of all nine models proposed, Dr Moselle's Alternative equation 4 and Dr Hesmondhalgh's Total Flows Model both outperform the other seven models. For ease of reference, those models are set out below:

(3685) Dr Moselle's Alternative Equation 4: Monthly fuel gas volume = $1.54 \times (\text{monthly transit volume}) + 4.43 \times (\text{monthly imports volume})$.

(3686) Dr Hesmondhalgh's Total Flows Model: Monthly fuel gas volume = $2.66 \times (\text{Transit} + \text{Imports} + \text{Domestic Production})$.

(3687) Naftogaz has offered what it calls "Dr Hesmondhalgh's compromise suggestion", this being "to average the results of ... Dr Moselle's Alternative IV and Dr Hesmondhalgh's Total Flows [models]." This offer of a "compromise" would involve splitting what is in financial terms a difference of US \$765 million between the results produced by the Parties' respective models. That suggestion is inappropriate in circumstances where one model outperforms the other on all metrics the models have been tested against, namely, goodness-of-fit and robustness. The task before the Tribunal, if it finds that Gazprom does have financial liability for shortfall transit volumes, is to choose the model that performs the best based on the application of appropriate and accepted statistical tests. That model is Alternative Equation 4.

7.2.2.9.14.3 Royalties

(3688) There is a further point in relation to quantum which should be mentioned here. That is the effect on the quantum of royalties in the event that the Tribunal finds that Gazprom was in breach of a minimum deliveries obligation.

(3689) Dr Moselle has opined on various issues that are relevant to quantum including royalties which he described as a purely "*mathematical*" adjustment to the damages for underdeliveries claim.

In short:

1. "Royalties" are a sum of money that is paid to the Ukrainian government for the use of the transit infrastructure in Ukraine.
2. It is not in dispute that Naftogaz and/or Uktransgaz paid royalties for gas transited through Ukraine at least until 2015.

3. Dr Hesmondhalgh and Mr Lapuerta have omitted to deduct from the calculation of quantum the effect of a deduction which must be made to any damages to reflect the saving of royalties payments (which vary according to volumes of gas transited).
4. It is evident that the saving that Naftogaz has benefitted from is up to US\$361million by way of royalty payments avoided. Dr Moselle's calculation is derived from (and indeed it is supported by) the EY Extractive Industries Transparency Initiative "EITI" Report of Ukraine 2013 from which it is clear that royalties were charged per 1000 cubic metres per 100km. This report shows that royalties have been paid on distance/volume formula and therefore royalties have been saved by transiting less. The amount saved is simply the difference between contracted volumes and actual volumes multiplied by royalty payment.
5. Gazprom's submission is that royalties must be deducted from any damages award in Naftogaz' favour.

7.2.2.9.14.4 VAT

- (3690) There is no evidence that Naftogaz is out of pocket in respect of VAT. Naftogaz has adduced no evidence that it has been paying VAT which Gazprom should have been paying, let alone that it is in the amounts now being claimed.
- (3691) Gazprom's position is that (i) there is no VAT-taxable supply since Naftogaz has failed to establish that it provided any services to Gazprom, in return for payment of a sum (indirectly) by way of damages, (ii) any payment of damages for alleged underdeliveries should correctly be characterised as compensation for losses suffered by Naftogaz, not a "supply of services" by Naftogaz, and consequently does not attract VAT under Ukrainian law; and (iii) even if the Tribunal were to conclude that (a) the Contract obliged Naftogaz to refrain from offering transit services to third parties and (b) any damages awarded to Naftogaz attract VAT, the supply of these (fictional) services must be deemed to have been provided over the period 1 January 2009 to 31 December 2015. Since Naftogaz' own case is that VAT is applicable only on transit

services provided on or after 1 January 2016, the damages cannot attract VAT liability, and Naftogaz' claim that the services are only provided when Gazprom pays the damages is nonsensical.

(3692) In these circumstances, Gazprom contends that no addition should be made for VAT.

(3693) Naftogaz's calculation of its 2017 Underdeliveries Claim as made in the Brattle 9 is US \$273,776,022. In contrast, Dr Moselle's calculation is US \$216,562,793.²⁹⁷ Dr Moselle's figure is arrived at using Alternative Equation 4 and removing the VAT element. Further, his calculation does not include interest (as to which see Section V below). Accordingly, the value of Naftogaz's 2017 Underdeliveries Claim is significantly overstated.

7.2.2.10 Defences to Naftogaz' interest claims

7.2.2.10.1 Naftogaz' interest claims in relation to its claims for damages for alleged underdeliveries

7.2.2.10.1.1 Introduction

(3694) In relation to its claims for damages for alleged underdeliveries Naftogaz claims interest pursuant to Sections 3 and 6 of the Swedish Interest Act (1975:635) (Sw. *Räntelagen*) from and including 4 January 2010 (and certain other dates), or, in the alternative, pursuant to Sections 4 and 6 of the Swedish Interest Act from and including 26 August 2014 (30 days after Naftogaz sent its "Notice of Disputes") or 16 October 2014 (the day after Gazprom received Naftogaz' Request for Arbitration).

(3695) As regards Naftogaz' alternative payment claims Naftogaz is now also claiming interest in the alternative pursuant to Sections 4 and 6 of the Swedish Interest Act from and including 4 May 2015 (the first business day after Gazprom received Naftogaz's Statement of Claim) or from and including 15 February 2016 (the first business day after Gazprom received Naftogaz's Reply) or from the date of the award.

7.2.2.10.1.2 Section 3 of the Swedish Interest Act is not applicable

(3696) Section 3, first paragraph, of the Swedish Interest Act provides:

(3697) Official English translation: "*Where payment on a debt, the due date of which has been established in advance, is not made during the period for payment, interest shall accrue on the debt commencing on the due date.*"

(3698) The due date of Naftogaz' alleged damages claim has not been established in advance. Therefore, Section 3 of the Swedish Interest Act is not applicable and interest cannot be calculated from 2 January 2010, or from any other of the alleged due dates in Naftogaz' alternative claims for damages.

(3699) Naftogaz refers to an extract from Walin and Herre. The full quote is:

In-house English translation: "*What can be said is probably only that there in general is no specific due date for damages claims and similar claims. Sometimes a due date can be established, and purely subsidiary obligations should perhaps in principle be regarded as due and payable when the main obligation should have been fulfilled.*"²⁹⁸

(3700) The above quote relates to Section 4 of the Swedish Interest Act (the application of which presupposes that the debt is due and payable) and does not provide any basis for Naftogaz to argue that a claim for damages would have a due date established in advance as required under Section 3 of the Swedish Interest Act. The quote does not provide any support for Naftogaz' argument that Section 3 of the Swedish Interest Act would be applicable in the situation at hand.

(3701) In summary, Section 3 of the Swedish Interest Act cannot be applied in relation to Naftogaz' claim for damages. Thus, the Tribunal should reject Naftogaz' claim for interest from the asserted respective due dates of Gazprom's alleged obligation to deliver gas.

²⁹⁸ Walin and Herre. *Lagen om skuldebrev m.m. En kommentar*, 2011 page 304.

- (3702) Naftogaz asserts that "[...] *the damages stipulated in Article 10 of the Contract is subsidiary to the obligation of Gazprom to deliver the agreed volumes of Natural Gas for transit and subsidiary damages obligations are due and payable at the same time as the main obligation should have been fulfilled. The main obligation, i.e. the transit of the agreed volume of gas, should have been fulfilled by Gazprom 31 December in each year. The damages are therefore due and payable on the first business day each subsequent year.*"
- (3703) However, there is no support in Article 10 of the Contract for this assertion. In fact, there is no mention of any due date at all in Article 10 of the Contract. Further, the obligation of a party to compensate the other party for proven damages pursuant to Article 10 of the Contract is not a "subsidiary" damages obligation to any obligation to deliver certain volumes of natural gas for transit. Article 10 of the Contract is only a general liability clause and all claims for damages thereunder are subject to general rules of tort law (such as the demand for causality, that all losses suffered need to be proven and the obligation to mitigate any loss, etc.). Thus, there is no support in the Contract for the assertion that any damages claims are due and payable on the first business day each subsequent year.
- (3704) As regards the quote from Walin and Herre, Gazprom maintains that it relates to Section 4 of the Swedish Interest Act. Furthermore, it does not provide any support for Naftogaz' argument that its claims for damages would have due dates established in advance as required under Section 3 of the Swedish Interest Act. On the contrary, it is clear from the quote that in general there is no specific due date for damages claims.
- (3705) In summary, Section 3 of the Swedish Interest Act is not applicable in relation to Naftogaz' claims for damages for alleged underdeliveries. Therefore, the Tribunal should reject (Sw. *ogilla*) all Naftogaz' claims for interest based on this provision.

7.2.2.10.1.3 Naftogaz is not entitled to interest pursuant to Section 4 of the Swedish Interest Act based on its "Notice of Disputes"

(3706) In the alternative, Naftogaz claims interest from and including 26 August 2014 with reference to its "Notice of Disputes" and states that "[f]rom the information regarding the transited volumes each year, it is easy for Gazprom to assess the damages suffered by Naftogaz as they follow directly from the Contract [...]".

(3707) However, the "Notice of Disputes" does not contain a demand for payment of a specified sum nor a demand for compensation presented together with reasonably required evidence of the claim.

(3708) Moreover, Gazprom refutes that any assessment could be made based on the information presented in the "Notice of Disputes" as the transited volumes of gas is of course only one of several parameters required to determine the amount of any damages or similar compensation. For example, the "Notice of Disputes" does not contain any information on what costs Naftogaz has saved in relation to the volumes not transited or otherwise how Naftogaz has mitigated its losses. That no assessment could be made is also supported by the fact that even in the Request for Arbitration, Naftogaz itself could only estimate its loss but not present any calculations. Furthermore, the "Notice of Disputes" does not contain any information regarding transited volumes of gas for 2014 or 2015.

(3709) Consequently, no interest pursuant to Sections 4 and 6 of the Swedish Interest Act can accrue on any of Naftogaz' claims for damages for alleged underdeliveries from and including 26 August 2014. In any event, no interest can accrue from and including 26 August 2014 on any of Naftogaz' claims for damages for alleged underdeliveries in 2014 or 2015.

7.2.2.10.1.4 Naftogaz is not entitled to interest pursuant to Section 4 of the Swedish Interest Act based on its Request for Arbitration

(3710) Further, and in the alternative, Naftogaz claims interest from and including 16 October 2014 (the day after Gazprom received Naftogaz' Request for Arbitration) with reference to Section 4 paragraph 4 of the Swedish Interest Act.

(3711) Although Section 4 paragraph 4 may apply by analogy in arbitral proceedings, Gazprom maintains that the Request for Arbitration did not contain sufficient information regarding the calculation of the claims for damages nor the circumstances on which Naftogaz based its claims in order for such to serve as a starting point for accrual of interest. Consequently, the Tribunal should reject Naftogaz' claims for interest on its damages claims from and including 16 October 2014.

(3712) Moreover and as previously stated, no delay interest can start to accrue before any claim for payment was made by Naftogaz. As expressed by Stefan Lindskog:

In-house English translation: "As regards claims which have been made during on-going legal proceedings, interest should probably in the corresponding manner start to accrue from the point in time when the other party has received the claim."

(3713) Naftogaz' Request for Arbitration did not contain any claim for damages for alleged underdeliveries in 2014 and 2015. Consequently and in any event, the Tribunal should reject any claims for interest on Naftogaz' claims for damages for alleged underdeliveries in 2014 and 2015 from and including 16 October 2014.

7.2.2.10.1.5 Naftogaz is not entitled to interest pursuant to Section 4 of the Swedish Interest Act based on its Statement of Claim

(3714) Finally and further in the alternative, Naftogaz has asserted that it is entitled to interest pursuant to Section 4 paragraph 4 and Section 6 of the Swedish Interest Act from and including 4 May 2015 (the first business day after Gazprom received the Statement of Claim).

(3715) However, the Statement of Claim did not contain any claim for damages for alleged underdeliveries in 2015. Consequently, and in any event, the Tribunal should reject any claims for interest on Naftogaz' claims for damages for alleged underdeliveries in 2015 from and including 4 May 2015.

7.2.2.10.2 Naftogaz' interest claims in relation to its claims for additional payment

7.2.2.10.2.1 Introduction

(3716) Naftogaz claims interest pursuant to Section 4 paragraph 4 and Section 6 of the Swedish Interest Act on its claims for additional payment subject to the Tribunal replacing or revising the tariff provision (Article 8 in the Contract) with effect as of 1 January 2010 or 1 February 2011 (or from several other dates). Naftogaz claims interest from and including 16 October 2014 (the day after Gazprom received the Request for Arbitration), alternatively from and including 4 May 2015 (the first business day after Gazprom received the Statement of Claim), alternatively from and including 15 February 2016 (the first business day after Gazprom received the Reply) or, alternatively as from the date of the award.

7.2.2.10.2.2 Naftogaz is not entitled to interest before the date of the Award

(3717) Section 4 paragraph 4 of the Swedish Interest Act provides as follows:

Official English translation: "*Notwithstanding the provisions set forth in paragraphs one, two, and three above, interest on any debt which is due and payable shall be payable not later than the day on which service of process is made in respect of an application for summary collection proceedings or a writ in proceedings seeking payment of the debt.*" (Emphasis added by Gazprom).

(3718) Thus, in order for interest to accrue pursuant to Section 4 paragraph 4 of the Swedish Interest Act it is a prerequisite that the debt is due and payable.

(3719) The debts on which Naftogaz claims interest are according to Naftogaz "*Subject to the Tribunal replacing or revising Article 8 under 2) and 3) [...]*". Thus, for the debts to exist it is, according to Naftogaz, required that the Tribunal changes the tariff in Article 8 of the Contract and that such changed tariff applies retroactively. Hence, the debts do not exist, nor are they due and payable before the Tribunal has granted Naftogaz' requests for relief in its award. Consequently, the Tribunal should reject Naftogaz' claims for interest pursuant to Sections 4 and 6 of the Swedish Interest Act from any date before the date of the Award.

7.2.2.10.2.3 In any event, Naftogaz is not entitled to interest from and including 16 October 2014

(3720) Gazprom maintains that no interest pursuant to Section 4 paragraph 4 and Section 6 of the Swedish Interest Act can accrue on any of Naftogaz' claims for additional payment from and including 16 October 2014 since the Request for Arbitration did not contain any claim for payment. As previously stated, Naftogaz only sought declaratory relief in the Request for Arbitration.

(3721) Naftogaz states that "*[i]f a declaratory relief is changed to a relief which includes a request for payment, interest accrues under Section 4, paragraph, 4 of the Swedish Interest Act already from the date of receipt of the request for arbitration. Moreover, the quote by Lindskog referred to by Gazprom in paragraph 720 of the Defence relates to a situation where the claim itself has been made during the proceedings. Naftogaz's claim was made in the Request for Arbitration, even though it was specified in the Statement of Claim.*" (emphasis added by Gazprom).

(3722) Gazprom refutes these assertions. Naftogaz has not changed (nor specified) its declaratory relief sought in the Request for Arbitration into a payment claim. Naftogaz still seeks declaratory relief in respect of replacing or revising the tariff provision (Article 8) in the Contract. Instead Naftogaz has advanced new claims for payment based on its declaratory relief sought. Thus, Naftogaz' assertions above are incorrect.

(3723) Consequently, the Tribunal should reject Naftogaz' claims for interest pursuant to Sections 4 and 6 of the Swedish Interest Act on its claims for additional payment from and including 16 October 2014.

7.2.2.10.3 Naftogaz' interest claims in relation to its claims for damages for alleged breach of competition law

(3724) Naftogaz sets out alternative claims for damages for alleged breach of competition law including interest thereon. Naftogaz claims interest on its damages claims pursuant to Section 4 paragraph 4 and Section 6 of the Swedish Interest Act from the same dates as for the claims for additional payment, i.e. from and including 16 October 2014, alternatively from and including

4 May 2015, alternatively from and including 15 February 2016 or, alternatively as from the date of the Award.

(3725) However, as previously stated, no interest can accrue on any debt before any claim for payment was made by Naftogaz. Consequently, the Tribunal should reject Naftogaz' claims for interest pursuant to Sections 4 and 6 of the Swedish Interest Act on its claims for damages for alleged breach of competition law from any point in time before Gazprom received Naftogaz' Reply.

(3726) No interest pursuant to Sections 3, 4 and 6 of the Swedish Interest Act can be awarded on higher (or other) amounts than the ones which are claimed by Naftogaz in this Arbitration. Consequently, the Tribunal should under all circumstances reject Naftogaz' claims for interest to the extent they are made in relation to higher (or other) amounts than Naftogaz claims as principal amounts in this Arbitration.

(3727) Furthermore, Gazprom notes that in some of its claims, Naftogaz requests the Tribunal to order Gazprom to pay to Naftogaz interest pursuant to Sections 3 or 4 and 6 of the Swedish Interest Act on negative amounts.

(3728) It is not clear to Gazprom how the Tribunal could ever order it to pay a negative amount to Naftogaz. The claims for interest on negative amounts are nonetheless disputed.

7.2.2.10.4 Interest on claims for additional payment, alternatively damages for alleged breach of competition law

(3729) Subject to the Tribunal replacing or revising Article 8 of the Contract with effect as of any later date than 1 February 2011 but prior to 1 January 2016, Naftogaz requests that the Tribunal "*[...] [orders] Gazprom to pay to Naftogaz compensation for underdeliveries from 1 January 2010 to the last day of the month preceding the effective date of amendment of Article 8 as per 2) or 3) above and compensation for underpayment for the period from the effective date of the amendment to Article 8 to 31 December 2015 based on Article 8 as amended by the Tribunal's award or alternatively as damages for breach of competition law [...]*".

(3730) Naftogaz then claims different amounts depending on "*If the Tribunal awards compensation for underpayments/damages for breaches of competition law [...]*" from various dates. Naftogaz also sets out claims for interest pursuant to Sections 3 and 6 of the Swedish Interest Act on "*compensation amount[s]*" relating to different time periods.

(3731) Gazprom understands it as though Naftogaz claims interest pursuant to Sections 3 and 6 on such "*compensation amount[s]*" which relate to additional payment or damages. As previously stated, interest pursuant to Section 3 of the Swedish Interest Act is only payable if the due date of the debt has been established in advance. Gazprom disputes that the due dates in relation to any of Naftogaz' claims for additional payment or damages have been established in advance. Gazprom also notes that Naftogaz has not provided any support (factual or legal) for the contention that its claims for additional payment or damages would have due dates which have been established in advance. Consequently, and in any event, no interest pursuant to Sections 3 and 6 of the Swedish Interest Act can accrue on any of Naftogaz' claimed "*compensation amount[s]*" relating to additional payment or damages from any of the dates invoked.

7.2.2.10.5 Interest on damages for alleged underdeliveries

(3732) Furthermore, Naftogaz has argued that Gazprom should have fulfilled its "*main obligation*", i.e. to transit certain volumes of natural gas by 31 December each year and that the (alleged) subsidiary damages claims are therefore due and payable the first business day each subsequent year. Based on this, Naftogaz has argued that its claims for damages for alleged underdeliveries have due dates established in advance as required under Section 3 of the Swedish Interest Act.

(3733) However, Naftogaz now claims interest pursuant to Section 3 of the Swedish Interest Act on "*compensation amount[s]*" for alleged underdeliveries from dates which have no connection to when Gazprom's alleged main obligation should have been fulfilled. This further illustrates that the due dates of the damages claims for alleged underdeliveries have not been established in advance.

8. RELIEF SOUGHT BY THE PARTIES

8.1 Relief sought by Naftogaz

(3734) Naftogaz requests the Arbitral Tribunal to render an award:

1) Declaring

that Article 13.8 is invalid and/or ineffective;

that with effect from the date of the award, Article 13.8 is replaced with a new provision which reads:

13.8 Neither Party can assign its rights and obligations under this Contract to third parties without the written consent of the other Party, except that the Contractor shall have the right to assign its rights and obligations under this Contract to PJSC Ukrtransgaz or any other entity designated as TSO by Ukrainian authorities without the written consent of the other Party.

2) Declaring:

that with effect as of the earliest date from and including 1 January 2010 stipulated by the Tribunal, the following provisions of the Transit Contract, including the Technical Agreement, are invalid, and/or ineffective:

2.1) Article 1

2.2) Article 2

2.3) Article 3

2.4) Article 4

2.5) Article 5

2.6) Clause 6.3

2.7) Article 7

2.8) Article 9

2.9) Clauses 10.2 and 10.4

2.10) Clauses 13.2 and 13.6

2.11) The Technical Agreement with Annexes and Additional Agreements

that with effect as of the earliest date from and including 1 January 2010 stipulated by the Tribunal, the following provisions shall read as follows:

2.1.1) Article 1:

The definition of "Technical Agreement" shall be deleted.

The following definitions are amended as follows:

"Applied Time" shall mean Universal Time Coordinated (hereafter UTC).

"Contract Day" shall mean a period of 24 hours commencing at 05:00 a.m. UTC (from 07.00 Kiev time) and ending at 05:00 a.m. UTC (to 07.00 Kiev time) on the following calendar day for the winter season, and from 04.00 UTC (from 07.00 Kiev time) of the day to 04.00 UTC (to 07.00 Kiev time) of the following day for the summer season. If the period of time between 05:00 a.m. of one calendar day and 05.00 a.m. of the following day comprises more or less than 24 hours (during switching from wintertime to summertime or vice versa), the rights and obligations of the Parties concerning day for such period shall change proportionally.

"Contract Month" shall mean the period commencing at 05:00 a.m. UTC on the first day of any calendar month and ending at 05:00 a.m. UTC on the first day of the following calendar month.

"Quarter" shall mean any of the following periods each consisting of three consecutive months and commencing at 05:00 a.m. *UTC* on the first day of any Quarter and ending at 05:00 a.m. *UTC* on the first day of the following Quarter:

I quarter: from January to March;

II quarter: from April to June;

III quarter: from July to September;

IV quarter: from October to December.

"Contract Year" shall mean a period of time commencing at 05:00 a.m. *UTC* on the first day of calendar year and ending at 05:00 a.m. *UTC* on the first day of the following calendar year in which transit of Natural Gas is performed in compliance with the terms and conditions of this Contract.

"Repair Works" shall mean repair works on the operating equipment of the transportation system used for natural gas transit under this Contract,

2.2.1) Article 2:

ARTICLE 2 SUBJECT MATTER OF THE CONTRACT

The subject matter of this Contract is the performance of transmission services by the Contractor from 2009 to 2019 inclusive, on a payment basis for transmission of Natural Gas on the territory of Ukraine by pipeline transport according to the terms and conditions of this Contract.

2.3.1) Article 3:

ARTICLE 3 BOOKED CAPACITY AT ENTRY-EXIT POINTS

3.1 From 2009 to 2019 inclusive, the Client shall transfer to the Contractor the Natural Gas for transit to European countries in the volume of at least 110 (one hundred ten) billion cub.m, except for the years 2011-2015, on an annual basis at the Acceptance and Delivery Points on the border of the Russian Federation - Ukraine, the Republic of Belarus - Ukraine, the Republic of Moldova - Ukraine, and the Contractor shall ensure its acceptance and further transit through the territory of Ukraine to the Acceptance and Delivery Points on the border of Ukraine with Romania, Hungary, Slovakia, Poland and Moldova. The minimum volumes of transit gas of 110 bcm per year are allocated as reserved capacity per entry-exit point as specified in Clauses 3.2 and 3.3 below. The Contractor shall ensure the proper operation of the gas transportation system of Ukraine at his own discretion and guarantee reliable and continuous transit through the territory of Ukraine of the Client's natural gas in the volume transferred for transit by the Client.

3.2 Accordingly, the Client has booked the following entry capacities, in total and at particular entry-exit points for the years 2016-2019:

ENTRY CAPACITIES (1000 m ³ per day)				
	Q1	Q2	Q3	Q4
Entry Points				
Sudzha 1400	187,162	178,205	179,456	218,113
Sudzha 1200	10,305	9,812	9,881	12,009
Pisarevka	58,906	50,010	48,828	62,203
Kobrin	0	10,724	16,643	6,622

Mozyr	375	11,553	11,867	11,619
Valuiki	40,810	18,436	14,111	37,000
Total	297,558	278,740	280,786	348,066

3.3 Accordingly, the Client has booked the following exit capacities, in total and at specific points, for the years 2016-2019:

EXIT CAPACITIES (1000 m ³ per day)				
	Q1	Q2	Q3	Q4
Exit Points				
Uzhgorod	213,050	197,503	192,131	238,246
Beregovo	11,211	15,748	18,045	25,380
Orlovka	51,364	47,999	50,678	56,104
Tekovo	3,249	3,260	3,225	3,237
Drozdovichi	4,760	7,580	10,245	13,039
Oleksiyivka	1,823	871	846	1,579
Hrebennyky	11,160	5,330	5,179	9,667
(ATI)				

Hrebenyky (SHDKRIJ)	941	449	437	815
Total	297,558	278,740	280,786	348,066

3.4 The quarterly capacity reservations are allocated in equal parts by days.

3.5 The Contractor shall provide access to capacity on a non-interruptible basis excluding when repair works are performed on the gas transportation system in accordance with Article 5 of this Contract, as well as accidents and imposing of restrictions hereunder.

3.6 The Contractor may determine entry and exit points for which, taking into account technical restrictions, capacity (contractual capacity) may be different in particular months of the year. The Contractor shall publish the list of such entry and exit points at its web-site as well as inform the Client in writing.

3.7 If the Client needs capacity in addition to the capacity reservations specified in Clause 3.2 and 3.3 above, the Client shall reserve such additional capacity in accordance with the Contractor's booking rules developed on the basis of the terms and conditions for access to the Ukrainian transport system that at any given time follow from the mandatory provisions of Ukrainian legislation and regulatory framework, including network codes and standard terms and conditions, adopted or decided by the Ukrainian regulator.

2.4.1) Article 4:

ARTICLE 4 CONDITIONS FOR GAS TRANSIT

4.1 Submission of nominations (re-nominations) to receive transmission shall be carried out according to the procedure established by the Gas Transmission Code approved by the National Energy and Utilities Regulatory Commission Resolution No. 2493 of 30 September 2015. Forms for nominations and re-nominations shall be published by the Contractor on its official web-site.

4.2 The Natural Gas shall be supplied by the Client to the Contractor in a common gas stream.

4.3. The Client assigns its obligations in the technical implementation of this Contract to Gazprom Transgaz St. Petersburg LLC, Gazprom Transgaz - Kuban LLC, Gazprom Transgaz Volgograd LLC, Gazprom Transgaz Belarus OAO, Tiraspoltransgaz LLC and Moldovatransgaz LLC.

Therefore, signatures on reports and other documents related to performance of this Contract by representatives of organizations/enterprises to whom the Parties have assigned the technical implementation of this Contract are not mandatory, with the exception of cases when such representatives were specially authorized by the Parties.

2.5.1) Article 5:

ARTICLE 5 REPAIR WORKS

If there is a need to conduct the Repair Works, inter alia, technological operations, including the internal defectoscopy of pipes, the Contractor shall notify the Client of the schedule of such Repair Works in advance, and this shall relieve the Parties from mutual sanctions related to the breaches of the Gas transit schedule, caused by conducting the Repair Works. The Contractor undertakes to conduct all necessary Repair Works, including technological operations, related to the initiation, control of the passage and acceptance of scrapers and internal pipe defectoscopes, ensuring the reliable and continuous functioning of the gas transportation system of Ukraine."

2.6.1) Clause 6.3:

6.3 If the quality of gas delivered at the delivery and acceptance points to the gas transmission network of the Contractor does not comply with the requirements in Clauses 6.1 and 6.2., the Contractor shall have the right not to accept the delivery of gas in full subject to the Contractor's notification of the Client in writing (by e-mail). Acceptance of gas shall be resumed by the Contractor once the composition and physical and chemical characteristics of the natural gas are brought in line with the quality requirements in Clauses 6.1 and 6.2.

2.7.1) Article 7:

ARTICLE 7 DOCUMENTATION OF GAS DELIVERY AND ACCEPTANCE

7.1 Delivery and acceptance of gas at entry and exit points at the border of Ukraine shall be effected under the procedure for access and connection to the Unified Gas Transportation System of Ukraine as approved by the Ukrainian Regulator from time to time.

7.2 Metering of gas at entry and exit points at the border of Ukraine shall be effected under the procedure for access and connection to the Unified Gas Transportation System of Ukraine as approved by the Ukrainian Regulator from time to time.

7.3 The Contractor shall bear all risks related to loss of gas during its transmission from the entry point to the exit point on the territory of Ukraine unless he proves that the loss occurred without any default on his part; the Client shall bear all risks related to loss of gas outside the territory of Ukraine.

2.8.1) Article 9:

9.1 The Parties agreed that the Client shall pay for the services rendered by the Contractor on transit of Gas through the territory of Ukraine exclusively in monetary funds except for technological gas delivered in accordance with this Contract.

9.2 The Parties agreed that price for services and cost of transit services under this Contract shall be determined in US dollars.

The currency of payment under this Contract shall be US dollars and/or Russian roubles. Expenses for transfer of monetary funds to the account of the Contractor shall be borne by the Client.

The payment in Russian roubles shall be made at the rate of the US Dollar established by the Central Bank of the Russian Federation on the date of payment.

The date of payment under this Contract shall be the date of debiting funds from the Client's account.

9.3 The Parties shall reconcile payments on a quarterly basis by 25th day of the month following the reporting quarter based on the actual value of the Contractor's services on Gas transmission and payment for Gas transmission by monetary funds.

The mentioned reconciliation shall be recorded in the Payment Reconciliation Report.

9.5 The Contractor shall send invoices to the Client's electronic mail.

Payment of the cost of the contracted capacity of others by the Client shall be made based on an invoice by transferring funds in the amount of the contracted capacity cost for the period of the Gas month to the account of the Contractor under the terms of 100 percent advance payment 5 (five) banking days before the beginning of the Gas month, in which the capacity shall be provided.

If the consumers of the Client settle their liabilities with it using a current account with the special regime of use, the payment by the Client (including the ordering of the capacity allocation) shall be made from the Client's current account with a special regime of use to the current account of the Contractor each banking day according to the algorithm of cost allocation established by the Regulator and shall be credited as the fee for transmission services (capacity

allocation) in the month in which the funds were credited. The final payment for the rendered during the month services shall be carried out by the Client before the twentieth day of the month following the reporting month in accordance with the act on rendered services and having in mind the payment made before.

The Client shall pay to the Contractor the costs of contracted capacity notwithstanding whether the contracted capacity was fully used or not.

The price of the natural gas transmission services in the exit point comprises of two parts: the first one expressed in money form (is defined in accordance with tariffs in exit points and booked capacity in these points); the second one expressed in natural form of volumes of natural gas for the ensuring costs of the Client for the exit points (defined in percent as to the volume of the transported gas in exit points) that are given by the Client to the Contractor for each gas month in a form of Act of acceptance and delivery of natural gas before the tenth day of the month following the gas month.

In the payment orders the Client shall specify the Agreement number, the date of its signing, and the reporting period (month, year) for which the payment is made. If the Agreement number, the date of its Agreement signing, and the reporting period (month, year), for which the payment is made, are not specified in the Client's payment orders, the Contractor shall credit the funds received from the Client primarily to cover debts for provided gas transmission services, which appeared during the previous periods.

In case the Client exceeds the amount of contracted capacity at the entry/exit points to/from the gas transmission system during the period of gas month, the Client shall make an additional payment.

The calculation of the additional payment is based upon information defined by the Contractor in the report on using contracted capacity that shall be sent to the Client before the tenth day of the month following the gas month to the e-mail address and shall have the calculation of

exceeding contracted capacity amount and invoice. The Client has to make payment before the fifteenth day of the month following the gas month.

2.9.1) Clause 10.2:

10.2 The quality of Gas provided by the Contractor at the exit points, shall comply with the quality requirements in the adjacent transportation system(s). The Contractor compensates the Client for proven damages caused by payment of penalty to third persons or by providing a discount to the price of Natural Gas due to the Contractor's failure to meet the quality requirements in the adjacent transportation system.

2.10.1) Clause 13.2:

13.2 If any of the provisions of the present Contract becomes legally invalid pursuant to the applicable legislation or ineffective, this shall not affect the validity of other provisions hereof. If any of the provisions of the present Contract becomes invalid or ineffective, the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have the economic effect as close as possible to that of the invalid or ineffective provision.

This Contract is subject to the terms and conditions for access to the Ukrainian transport system that at any given time follow from the mandatory provisions of Ukrainian legislation and regulatory framework, including network codes and standard terms and conditions, adopted or decided by the Ukrainian regulator. Changes in the regulatory framework are binding on the Parties. In case of changes, this Contract shall be revised accordingly in order to be in compliance with the changes.

2.11.2) Clause 13.6:

13.6 All and any amendments and Addenda to this Contract shall be in writing and shall be signed by the authorised representatives of the Client and the Contractor, except in

such cases where the amendments to this Contract follows from mandatory Ukrainian legislation or rules or decisions by the Ukrainian regulator pursuant to Clause 13.2.

The Parties agreed that the said amendments and Addenda signed and sent by fax are binding provided that they are further confirmed by the original.

The Parties shall notify each other of changes to their bank details, legal addresses, telephone numbers and faxes within a five-day term following the occurrence of the respective changes.

2.12) alternatively, in respect of all provisions for which Naftogaz's requested provisions under 2.1.1-2.11.2 are denied, that all such provisions are replaced by one clause which reads as follows:

In respect of any matters left unregulated by this Contract, following subsequent invalidation or ineffectiveness of any contract provision, and until the Parties may agree on a contractual regulation of such matter in accordance with this Contract, the Parties shall be bound to apply and comply with the terms and conditions for access to the Ukrainian transport system that at any given time follow from the mandatory provisions of Ukrainian legislation and regulatory framework, including network codes and standard terms and conditions, adopted or decided by the Ukrainian regulator.

3.) Declaring, with effect as of the earliest date from and including 1 January 2010 as the Arbitral Tribunal will determine,

3.1) that Article 8 shall read as follows:

ARTICLE 8 PRICE FOR THE TRANSIT OF GAS

8.1 Gas transportation tariffs for entry and exit points are as follows:

8.1.1 The daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are: [*Here Naftogaz asks the Tribunal to include the relevant tariffs set out in Appendix 2 that match the effective date determined by the Arbitral Tribunal*]

8.1.2 From 1 January 2016, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission system of Ukraine	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars per 1000 cubic meters, VAT excluded	US Dollars per 1000 cubic meters, VAT excluded	percent
Beregovo	-	31,03	2,58%

Valuiki	12,47	-	-
Hrebenyky (ATI)	-	16,74	1,73%
Hrebenyky (SHDKRI)	-	21,33	2,01%
Drozdovichi	-	25,73	1,91%
Kobrin	12,47	-	-
Mozyr	12,47	-	-
Oleksiyivka	-	32,16	2,65%
Orlovka	-	23,12	2,11%
Sudzha 1200	12,47	-	-
Sudzha 1400	12,47	-	-
Tekovo	-	28,99	2,46%
Uzhgorod	-	32,80	2,69%

8.2 The required taxes and fees payable on the territory of Ukraine, shall be added to the gas transportation tariffs for entry and exit points.

8.3 If the competent authorities of Ukraine decide to change the gas transportation tariffs or the methodology for the calculation of gas transportation tariffs for entry and exit points stipulated by the Contract, these tariffs or this tariff methodology shall be binding upon the Parties and

the Contractor shall notify the Client of such decision in writing with reference to the revised tariffs as published.

3.2) or, in the alternative to 3.1, that Clauses 8.1 and 8.6 shall read as follows:

8.1 Gas transportation tariffs for entry and exit points are as follows:

8.1.1 The daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are: [*Here Naftogaz asks the Tribunal to include the relevant tariffs set out in Appendix 2 that match the effective date determined by the Arbitral Tribunal*]

8.1.2 From 1 January 2016, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission system of Ukraine	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars per 1000 cubic meters, VAT excluded	US Dollars per 1000 cubic meters, VAT excluded	percent
Beregovo	-	31,03	2,58%
Valuiki	12,47	-	-
Hrebenyky (ATI)	-	16,74	1,73%
Hrebenyky (SHDKRI)	-	21,33	2,01%
Drozdovichi	-	25,73	1,91%
Kobrin	12,47	-	-
Mozyr	12,47	-	-

Oleksiyivka	-	32,16	2,65%
Orlovka	-	23,12	2,11%
Sudzha 1200	12,47	-	-
Sudzha 1400	12,47	-	-
Tekovo	-	28,99	2,46%
Uzhgorod	-	32,80	2,69%

8.6 The required taxes and fees payable on the territory of Ukraine, shall be added to the gas transportation tariffs for entry and exit points.

3.3) or, in the alternative to 3.1 and 3.2, that Article 8.6 is invalid or ineffective and that Clause 8.1 shall read as follows:

Until the Parties agrees otherwise in accordance with this Contract, the Parties shall be bound to apply and comply with the tariffication provisions under the terms and conditions for access to the Ukrainian gas transport system that at any given time follow from the mandatory provisions of Ukrainian legislation and regulatory framework, including network codes and standard terms and conditions, adopted or decided by the Ukrainian regulator and for any period where no tariffication provisions of such type exists, the tariff for the transmission of gas shall be equal to a reasonable price (Sw. *skäligt pris*).

3.4) or, in the alternative to 3.1-3.3, that Article 8 is invalid or ineffective in its entirety

3.5) or, in the alternative to 3.1-3.4, that Clauses 8.1 and 8.6 are invalid or ineffective in their entirety

4) Ordering Gazprom to pay to Naftogaz USD 14,864,669,277.45, alternatively USD 14,419,313,127.88 of which USD 1,066,017,820.79 is VAT (cf. Appendix 1).

5) Ordering Gazprom to pay interest on the partial amounts aggregating the amount awarded under 4) until full payment is made by Gazprom:

5.1) if in respect of underdeliveries, pursuant to Sections 3 and 6 (cf. (i)-(viii) or 4 and 6 (cf. (viii)) of the Swedish Interest Act on any compensation amount in respect of

- (i) any part of 2009 (USD 199,585,585.61) from 4 January 2010,
- (ii) any part of 2010 (USD 278,020,305.81) from 2 January 2011,
- (iii) any part of 2011 (USD 196,486,040.72) from 3 January 2012,
- (iv) any part of 2012 (USD 570,794,814.79) from 2 January 2013,
- (v) any part of 2013 (USD 555,366,559.92) from 2 January 2014,
- (vi) any part of 2014 (USD 1,344,179,263.09) from 2 January 2015,
- (vii) any part of 2015 (USD 1,099,726,058.20) from 4 January 2016, and
- (viii) any part of 2016 (USD 609,963,486.33) from 2 January 2017, and
- (ix) and part of 2017 (USD 273,776,021.77) from 2 January 2018, or
- (x) alternatively, in respect of each amount of compensation in (i)-(ix), from and including 26 August 2014, 16 October 2014, 4 May 2015, 15 February 2016, 29 August 2016, 5 February 2018 or the date of the award; and

5.2) if in respect of underpayment or damages:

on any compensation amount in respect of any period starting no earlier than 1 January 2010 and ending 31 December 2015 (USD 6,633,707,493.52), interest pursuant to Sections 3 and 6 or 4 and 6 of the Swedish Interest Act from and including 16 October 2014, 4 May 2015, 4 January 2016, 15 February 2016, 29 August 2016, 5 February 2018 or the date of the award, and

on any compensation amount in respect of any period starting no earlier than 1 January 2016 and ending 31 July 2016 (USD 2,675,740,609.32 alternatively USD 2,532,640,387.22, of which USD 392,047,899.77 is VAT), interest pursuant to Sections 4 and 6 of the Swedish Interest Act from and including 29 August 2016, 5 February 2018 or the date of the award, and

on any compensation amount in respect of any period starting no earlier than 1 August 2016 and ending 31 December 2017 (USD 4,881,129,242.47, alternatively USD 4,578,873,315.00, of which USD 673,969,921.02 is VAT), interest pursuant to Sections 4 and 6 of the Swedish Interest Act from and including 5 February 2018 or the date of the award

6) In relation to Gazprom's counterclaim

Rejecting the counterclaim in its entirety, except that the set off requested in §§ 1140 to 1143 Gazprom's Rejoinder is accepted as such.

7.1) In relation to set off between the Sales Arbitration and the Transit Arbitration

Ordering Gazprom to pay to Naftogaz the net total amount of USD 15,146,853,242.90, alternatively USD 14,701,497,093.33 of which USD 1,066,017,820.79 is VAT; and

Ordering Gazprom to pay to Naftogaz interest on the above sum owing to Naftogaz out of the above net total amount, i.e. USD 15,146,853,242.90, alternatively US

14,701,497,093.33 of which USD 1,066,017,820.79 is VAT, pursuant to Sections 4 and 6 of the Swedish Interest Act from the date of the Award and until full payment is made.

7.2) In relation to set off within this Transit Arbitration

Ordering a set off of any amount awarded to Gazprom in this arbitration against any amount awarded to Naftogaz in this arbitration remaining after the set off between the amount awarded to Gazprom in the Sales Arbitration and the amount awarded to Naftogaz in the Transit arbitration, with any remaining interest due to Naftogaz applied before Naftogaz's capital amount, and against any interest awarded to Gazprom before any principal awarded to Gazprom

8) In relation to claims 1) to 7) above

Ordering Gazprom to compensate Naftogaz for its costs of arbitration in an amount to be specified later together with interest pursuant to Section 6 of the Swedish Interest Act (Swedish *räntelagen (1975:635)*) as from the date following the final award until full payment is made and, as between the Parties, alone to bear the arbitrators' fees and expenses and the SCC administrative expenses, and to compensate Naftogaz for any amounts that Naftogaz had paid or will pay to the SCC in relation to the arbitration including, but not limited to, Naftogaz's part of the advance on costs.

Relief sought by Gazprom

Dismissal/rejection of Naftogaz' claims.

Gazprom seeks the following revised counterclaims.

1. An ORDER that Naftogaz makes payment to Gazprom in respect of transit gas that has been taken by Naftogaz but that has not been paid for in accordance with Gazprom's contractual entitlement, in the total amount of US \$3,368,126.03

2. AN ORDER that Naftogaz makes payment to Gazprom of late payment interest accrued pursuant to clause 10.4 of the Contract (and, accordingly, pursuant to clauses 5.1.1 to 5.1.4 of the Gas Sales Contract):
- in respect of invoice no. 41 dated 21 August 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of US \$718,904.31 at the rate of 0.03% for each day of delay in payment from 1 September 2014 until full payment has been made;
 - in respect of invoice no. 47 dated 11 September 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of US \$752,308.54 at the rate of 0.03% for each day of delay in payment from 22 September 2014 until full payment has been made;
 - in respect of invoice no. 61 dated 11 November 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of US \$1,890,837.65 at the rate of 0.03% for each day of delay in payment from 22 November 2014 until full payment has been made; and
 - in respect of invoice no. 70 dated 11 December 2014, on the full invoiced amount (as revised pursuant to the Supply Final Award) of US \$6,075.54 at the rate of 0.03% for each day of delay in payment from 22 December 2014 until full payment has been made.
3. An ORDER that Naftogaz makes payment to Gazprom as compensation for overpayments of the transit tariff in the total amounts of \$43,802,331.12 plus:²⁹⁹
- yield interest at 2% over the Swedish Central Bank reference rate from time to time from the day after the date of each original payment by Gazprom until the date of the Final Award in the Supply Arbitration, *i.e.* 22 December 2017, being the date on which the refund should be made; and

²⁹⁹ See Section 4 of Moselle Report B.

- delay interest at 8% over the Swedish Central Bank reference rate from time to time from and including 23 December 2017 until the date of the award.
- 4. An ORDER that the Tribunal perform a set-off in the Final Transit Award as between the amount ordered to be paid by Naftogaz to Gazprom in the Final Supply Award and any amounts that may be ordered to be paid by Gazprom to Naftogaz in the Final Transit Award.
- 5. An ORDER that the Tribunal perform a set-off in the Final Transit Award as between any amount that may be awarded to Gazprom in the Transit Arbitration and any amount that may be awarded to Naftogaz in the Transit Arbitration.
- 6. An ORDER that Naftogaz shall make payment to Gazprom as compensation for all costs incurred by Gazprom in these proceedings, and as between the parties all fees and costs of the Tribunal and of the SCC Arbitration Institute, together with interest on all such amounts in accordance with sections 4 and 6 of the Swedish Interest Act from the date of the award until full payment has been made.

9. THE TRIBUNAL'S REASONS

9.1 Introduction

(3735) In deciding the Parties' claims, as set out in this Award, the Tribunal has carefully considered all of the submissions made and evidence adduced by the Parties, including allegations, witness/expert statements, legal authorities, and arguments not mentioned in the discussion below or otherwise in this Award. The reasoning given below summarizes what the Tribunal considers relevant for its decisions. If and to the extent that facts, witness/expert statements, legal authorities, or arguments advanced by the Parties are not addressed in the reasoning, they would not have changed the Tribunal's conclusions.³⁰⁰

(3736) The Tribunal has taken into account the cross-references to the Supply Arbitration made by the Parties regarding set-off, factual matters and issues as well as to legal arguments primarily relating to competition law.

9.1.1 Jura novit curia

(3737) The Tribunal has concluded, and made it clear to the Parties, that it will not apply the doctrine of "*jura novit curia*" in this Arbitration being an international arbitration between non-Swedish Parties. Needless to say, this does not apply as far as applicable mandatory law is concerned.

9.1.2 Issues of interpretation of the Contract

(3738) The answer to many of the issues in the Arbitration requires an interpretation of the Contract and the Parties' intentions.

(3739) The relationship between Gazprom and Naftogaz is not merely a normal commercial relationship. With the two states controlling the Parties, and the importance of the Contract to the economy of Russia and of Ukraine, in combination with the Supply Contract, the relationship has also been political. Russia and Ukraine, and Gazprom and Naftogaz, have had longstanding

³⁰⁰ The Tribunal has adopted the terminology of the Parties' using "*dismiss*" meaning "*avvisa*" and "*reject*" meaning "*ogilla*".

relations where considerations other than merely commercial considerations have often been decisive.

(3740) Although the intention has been to move into a new, more “*European*” relationship when the two Contracts were entered into in 2009, the special circumstances of the relationship continued also after 2009. Also, after the entering into the Contracts in 2009, the political leaders of the two states have intervened.³⁰¹

(3741) These circumstances have to be considered in the interpretation of the Contract. Needless to say, the case has, however, been examined by the Tribunal from a strictly legal point of view.

(3742) Further, the interpretation is complicated by the Contract in some decisive aspects being unprecise and simplistic, and its provisions not also being very well formulated. The Contract text may well reflect mutual intentions, but not necessarily exhaustively.

(3743) In many instances, there is little or no evidence regarding which intentions the Parties had, and sometimes it seems as if the Parties have not given any thought to what the Contract terms should mean.

(3744) The Parties often rely on their Experts’ findings and conclusions regarding factual matters, and the Parties sometimes base their conclusions on the Experts’ interpretation of the Contract. However, the expert reports are in many respects based on approximations, which leads to uncertainties or doubts regarding their conclusions.³⁰²

(3745) Further, conclusions of the experts do not always strictly follow from their factual findings, and sometimes, which may be inevitable, they tend to be legal rather than factual. These circumstances entail complications, when assessing the expert reports and in determining the disputed issues.

³⁰¹ For example a meeting between the then Prime Minister of Ukraine, Mykola Azarov, and the then Prime Minister of Russia, Vladimir Putin on 7 June 2011, the trilateral negotiations in the third quarter of 2014 arranged by the European Commission, the Interim Agreement with the Energy Ministers of Russia and Ukraine assisted by the European Commission.

³⁰² For example, Dr. Hesmondhalgh's and Dr. Moselle's reports regarding fuel gas consumption.

(3746) Absent any clear basis for attributing a particular meaning to a provision of the Contract, the Tribunal has interpreted such provision in accordance with Swedish law regarding interpretation of contracts, which essentially means interpreting the provisions in accordance with the plain and ordinary meaning of the words used.

9.2 The structure of the Tribunal's Reasons

(3747) In the following, as regards Naftogaz' claims, the Tribunal follows generally the structure of Naftogaz' claims:

- (i) Naftogaz' Claims for Replacement or Invalidity based on competition and energy law;
- (ii) Tariff Revision pursuant to Article 8.7;
- (iii) Tariff Revision pursuant to Section 36 of the Swedish Contracts Act;
- (iv) Naftogaz' Claim for Underpayment;
- (v) Naftogaz' Claim for Underdeliveries; and
- (vi) Naftogaz' Interest Claim.

(3748) Gazprom has counterclaims for payment in respect of transit volumes alleged to have been taken by Naftogaz and for overpayments resulting from the lower fuel price decided by the Final Award in the Supply Arbitration. These issues will be dealt with subsequently.

(3749) Finally, the Tribunal will consider the set-off agreed by the Parties to be made between the amount of payment ordered in the Final Award in the Supply Arbitration to be paid by Naftogaz to Gazprom, together with interest thereon, and the amount that the Tribunal decides are due in this Arbitration.

(3750) Further, Gazprom has raised a number of objections as to what Gazprom calls the jurisdiction of the Tribunal, and has also requested dismissals in relation to a number of claims. However,

the Tribunal sees no reason to consider in this Award any such objections other than those which are relevant to the claims addressed by the Tribunal in its Reasons.

9.3 Naftogaz' claims for replacement or invalidity based on competition and energy law

(3751) Naftogaz alleges that a number of clauses in the Contract³⁰³ are in violation of fundamental competition and energy law principles.

(3752) In section 1.1 below, the clauses of the Contract, which Naftogaz alleges are in violation of competition and energy law principles, are listed. In section 1.2 below, Naftogaz' allegations are considered and decided on by the Tribunal.

9.4 List of clauses in the Contract which Naftogaz alleges are in violation of competition and energy law

(3753) Naftogaz alleges that Gazprom breaches European and Ukrainian competition and energy law in relation to the following Articles of the Contract:

9.4.1 Article 1 (Definitions)

Article 1 of the Contract sets out definitions and interpretations of the terms used in the Contract.

(3754) It is Naftogaz' position that in order to bring the Contract into compliance with European and Ukrainian competition and energy law, the definition of "Technical Agreement" must be deleted and the definitions of "Applied Time", "Contract Day", "Contract Month", "Quarter", "Quarter Year", and "Repair Works" must be amended.

9.4.2 Article 2 (Subject matter)

(3755) Article 2 defines the subject matter of the Contract^h

³⁰³ Contract No. TKGU dated 19 January 2009 between National Joint-Stock Company "Naftogaz of Ukraine", Kiev, Ukraine, and Open Joint-Stock Company "Gazprom", Moscow, The Russian Federation, On the volumes and conditions for transit of Natural Gas through the territory of Ukraine in 2009-2019.

(3756) It is Naftogaz' position that in order to exclude references to transit and the contract-paths established in the Contract, Article 2 must be replaced.

9.4.3 Article 3 (Booked capacity)

(3757) Article 3 is in its entirety based on a system of contract-paths.

(3758) In order to bring the Contract in compliance with European and Ukrainian competition and energy law, the contract-paths under the Contract must in Naftogaz' opinion be replaced with a long-term booking scheme for entry-exit capacity.

9.4.4 Article 4 (Transit conditions)

(3759) Clauses 4.1 to 4.3 and Clause 4.7 are all based on a contract-path system in breach of European and Ukrainian competition and energy legislation, in Naftogaz' opinion.

(3760) Naftogaz alleges that Clauses 4.1 and 4.3 must be replaced with a booking scheme based on daily nominations and re-nominations and congestion management procedures.

(3761) Clauses 4.4 and 4.5 refer to the Technical Agreement, which facilitates Gazprom's role as super-operator of the Ukrainian GTS which Naftogaz alleges is in breach of European and Ukrainian competition and energy law, and must, in Naftogaz' opinion, be replaced. The principle of gas delivered in the common gas flow set out in Clause 4.4, first paragraph, is continued in the replaced Article 4.

(3762) Clause 4.6, first paragraph, which charges Gazprom affiliates with the Technical implementation of the Contract must, in Naftogaz' opinion, be replaced to reflect that gas supplies and gas traders are not allowed to participate in gas transmission activities.

(3763) Similarly, Clause 4.6, second paragraph, which relegates Ukrtransgaz to an agent implementing the Contract on behalf of Naftogaz, must be deleted to facilitate the assignment of the Contract.

9.4.5 Article 5 (Repair)

(3764) Article 5 of the Contract regulates repair works and refers to the Technical Agreement.

(3765) Naftogaz alleges that repair works are necessary to ensure system integrity and therefore is a task that lies within the operational responsibility and functions of the TSO.

9.4.6 Clause 6.3 (Gas Quality)

(3766) Clause 6.3 of the Contract refers to the Technical Agreement and should, in Naftogaz' opinion, be deleted and replaced with a new clause which reflects the role and task of the TSO.

9.4.7 Article 7 (Delivery and Acceptance)

(3767) Article 7 sets out the procedures for delivery and acceptance of gas at the relevant points in the Ukrainian gas transmission network.

(3768) Naftogaz alleges that in order to bring the Contract in compliance with the European and Ukrainian competition and energy legislation, Article 7 needs to be replaced with a new contract provision which reflects the role and task of the TSO.

9.4.8 Article 8 (Tariff)

(3769) Article 8 regulates the tariff for the long-term transmission services provided under the Transit Contract and contains a tariff revision provision.

(3770) Naftogaz alleges that in order to bring the Contract in line with the European and Ukrainian competition and energy legislation, Article 8 should be replaced with a new contract provision that is in line with the tariffication principles implemented in the Ukrainian energy legislation and entry exit tariff adopted by the Ukrainian regulator.

9.4.9 Article 9 (Payment)

(3771) Article 9 implements payment procedures. Naftogaz proposes to delete Clauses 9.3 and 9.4 as irrelevant in a system where capacity reservations and reporting are carried out by the independent TSO.

9.4.10 Clause 10.4 (Liability)

(3772) Clause 10.4 of the Contract provides for a rudimentary balancing system. The system is not in compliance with European and Ukrainian competition and energy legislation. In order to achieve this, Clauses 3.4, 4.3 and 10.4 should be deleted and balancing requirements left to mandatory Ukrainian law.

9.4.11 Clause 13.2 (Replacement Clauses)

(3773) Clause 13.2 concerns the replacement of invalid and inefficient provisions.

(3774) Naftogaz alleges that in order to bring the Contract in compliance with European and Ukrainian competition and energy legislation, Clause 13.2 should be replaced by a provision that in addition to its present contents concerning the replacement of invalid and inefficient provisions, expressly specifies that the Contract is subject to the terms and conditions for access to the Ukrainian transport system that follows from mandatory law and decisions by the Ukrainian regulator.

9.4.12 Article 13.6 (Amendment Clause)

(3775) Article 13.6 provides for a procedure of written and signed amendments.

(3776) Clause 13.6 should be replaced with a provision which specifies that the procedure of written and signed amendments does not apply in cases where the amendments follow from mandatory law or decision by the Ukrainian regulator.

9.4.13 Article 13.8 (Assignment Clause)

(3777) Article 13.8 requires written consent of the other Party¹

(3778) In order to bring the Contract in compliance with European and Ukrainian competition and energy legislation, Naftogaz proposes that Clause 13.8 should be replaced with a contract provision allowing the Contract to be transferred to any entity designated TSO without Gasprom's consent.

9.4.14 The Technical Agreement with Annexes and Additional Agreements

(3779) The Technical Agreement implements and further details the contract-paths established in Clause 3.1 of the Contract.

(3780) It is Naftogaz' opinion that in order to bring the Contract in compliance with European competition and energy law, the Technical Agreement should be deleted. The Ukrainian Gas Transmission System Code now serves the purpose that the Technical Agreement has served until recently.

9.5 The Tribunal's findings

(3781) Naftogaz claims are based on alleged breaches of Articles 6 and 13 of the Ukrainian law on competition, Article 18 ECT as Ukrainian law, Articles 101 and 102 TFEU, Article 18 ECT as EU law, and Article 10 ECT and the relevant articles in Regulations 715/2019 and Directive 2009/73 as incorporated into the ECT, as part of EU law.

9.5.1 Introductory remarks

(3782) Naftogaz has requested the Tribunal to take the role of the Ukrainian regulator when requesting the Tribunal to invalidate and replace the Articles of the Contract listed above. Naftogaz alleges they constitute breaches of competition or energy law, but the Tribunal finds that they rather than being breaches of competition and energy law could be considered to be incompatible with energy law, and that their invalidation and replacement may be desirable in the interest of enhancing competition conditions or in eliminating less desirable restrictions and limitations.

(3783) The task to implement such invalidations and amendments for such purposes is the task of the regulator, and only the regulator has the necessary overview, competence and means to do so.

For example, the necessary measures to satisfy requirements of unbundling and congestion management procedures are far too complex for an arbitral tribunal to safely impose such requirements on an operator of transit of gas.

(3784) Below, the Tribunal will consider the requests of Naftogaz in more detail.

9.5.2 Ukrainian competition and energy law

9.5.2.1 Naftogaz' position

(3785) It is Naftogaz' position that the Tribunal should give effect to the relevant provisions of Ukrainian competition and energy law pursuant to Article 7(1) of the Rome Convention.

(3786) Naftogaz alleges that Articles 6 and 13 of the Ukrainian law on competition, which mirror Articles 101 and 102 TFEU with respect to competition in Ukraine, constitute mandatory provisions applicable irrespective of the law governing the Contract.

(3787) Naftogaz further alleges that competition law has the status of mandatory public policy in the EU and so falls within the EU narrower category of overriding mandatory provisions referred to in Article 9(3) of Rome I Regulation (*sic*).

(3788) The same applies to Ukrainian energy legislation. The legislation is regarded as crucial both by Ukraine and the EU for the safeguarding of the social and economic organisation of Ukraine.

9.5.2.2 Gazprom's position

(3789) It is Gazprom's position that Ukrainian competition law is not applicable to the current dispute, whether pursuant to the Rome I regulation or as a matter of Swedish law.

(3790) It is Gazprom's position that Gazprom and Naftogaz have mutually agreed that the Contract would not be governed by the law of either of their respective countries but instead by a neutral governing law Swedish law ✓

(3791) Consequently, Gazprom alleges that pursuant to Clause 12.1 of the Contract and Article 22(1) of the SCC Rules, the Tribunal's mandate is to apply "*the substantive laws of Sweden*" to the merits of the dispute in this arbitration.

(3792) Having further chosen Stockholm as the seat of arbitration according to Clause 12.2 of the Contract, the Parties have expressly chosen Swedish law both as the governing law of the Contract (*lex contractus*) and as the procedural law of the Arbitration (*lex arbitri*).

9.5.2.3 The Tribunal's findings

(3793) The Tribunal finds that Ukrainian competition law is not applicable to the present dispute, whether according to the Rome Convention regulation or national Swedish law.

(3794) With regard to the Rome Convention, it is only in cases of mandatory provisions, as defined in the Convention Art. 7(1) that a party may be able to impose its own legislation on the other party despite the governing law of the Contract that was agreed between the parties. The Tribunal notes in this respect that Naftogaz is owned by the Ukrainian government.

(3795) The Tribunal finds that Naftogaz has not satisfied the burden of proving that mandatory provisions of the Ukrainian law could be applied in respect of the Swedish law contract. The Tribunal notes in this respect that as a general rule, foreign states' public law may not be applied by Swedish courts or arbitration tribunals apart from cases where the opposite follows from Sweden's international obligations.³⁰⁴

(3796) As the Tribunal finds that it cannot apply Ukrainian competition law, any effect on the Ukrainian market becomes irrelevant to the Tribunal's findings. In this connection, the Tribunal cannot alter clauses of the Contract so that they better reflect the requirements of Ukrainian law. As mentioned above, it is not the role of the Tribunal to implement desirable reforms to meet energy policy targets or requirements according to Ukrainian legislation. As noted above, those³⁰⁴

³⁰⁴ Bogdan, *Svensk Internationell privat- och procesrätt*, 8th edition, p. 74 et seq. with references.

actions which follow from the requirements of the Ukrainian authorities are within the competence of these authorities

9.5.3 Application of EU competition law

(3797) The dispute concerns transit of natural gas from the Russian Federation through Ukraine both outside the EU according to a contract entered into between companies residing in those two countries.

(3798) According to Article 12.1 of the Contract, "*this Contract shall be governed by and is subject to interpretation in accordance with the substantive laws of Sweden*".

(3799) Before assessing whether the above-mentioned circumstances are in breach of competition or energy law rules as alleged by Naftogaz, the Tribunal must determine whether EU law, and more specifically EU competition law, applies to the dispute either as a result of direct applicability of Articles 101 and 102 TFEU (see below), as a result of the Contract's reference to the laws of Sweden (see below), indirectly by way of Clause 18 of the Energy Community ("EnCT") (see below).

(3800) Only if the Tribunal concludes that EU competition or energy law applies directly or indirectly, will it be necessary to assess whether one or more of the mentioned circumstances are contrary to EU competition or energy law.

9.5.4 Are articles 101-102 TFEU directly applicable in this matter?

9.5.4.1 Naftogaz' position

(3801) Naftogaz alleges that EU competition rules are mandatory public policy within the EU and must be given effect by courts and tribunals sitting in an EU member state, see *ECO Swiss*³⁰⁵ and see *NJA 2015, p. 438*.³⁰⁶ As far as concerns contractual claims, this is an effect of Article 9(2) of 2

³⁰⁵ CL-70ITF4.

³⁰⁶ CL-109ITF6.

Rome I, which provides that "*nothing in this regulation shall restrict the application of the overriding mandatory provisions of the law of the forum*".

- (3802) For non-contractual claims, Article 6(3) of Rome II lays down a mandatory rule that such claims are governed by the law of the country where the market is affected. Thus, to the extent that the market in the EU is affected, EU competition law is automatically applicable.
- (3803) The fact that Articles 101 and 102 TFEU apply pursuant to relevant private international law makes it unnecessary to consider whether the application is justified under rules of public international law, by virtue of the qualified effects doctrine.
- (3804) In relation to EU competition law, it is Naftogaz' position that the territoriality principle is not relevant. If, however, the Tribunal was to hold that the territoriality principle is relevant, the qualified effects doctrine is satisfied; the Contract affects trade between member states within the meaning of Articles 101 and 102 TFEU, and Article 18 ECT has direct effect.
- (3805) Finally, it is the position of Naftogaz that the Contract affects trade between the contracting parties.

9.5.4.2 Gazprom's position

- (3806) Gazprom alleges that public international law prevents the application of Articles 101 and 102 TFEU to the Contract. It is Gazprom's position that in order to justify the application of EU competition law, the criteria of immediate, substantial and foreseeable effect in the EU must be satisfied (also known as the Qualified Effects Doctrine test).
- (3807) It is Gazprom's position that Naftogaz has failed to establish jurisdiction under the Qualified Effects Doctrine test as a matter of fact. Gazprom further alleges that Articles 101 and 102 TFEU require that trade between EU member states must be affected which has not been proven by Naftogaz/

9.5.4.3 The Tribunal's findings

(3808) The question for the Tribunal to decide is whether EU competition law is to be applied in a dispute between private parties to an agreement between two parties established outside the European Union and which is implemented outside the EU.

(3809) The Tribunal notes as a starting point that Articles 101 and 102 TFEU do not contain any legislative jurisdiction outside the territory of the EU. This is also known as the principle of territoriality.

(3810) The principle of territoriality is a fundamental international law principle and entails that a state or the EU only has powers to make laws that affect its own territory.

(3811) In *Woodpulp*,³⁰⁷ paragraph 18, the CJEU confirmed that

"...the Community's jurisdiction to apply its competition rules to such conduct is covered by the territoriality principle as universally recognized in public international law".

(3812) The Tribunal finds that the territorial scope of Articles 101 and 102 is made clear by the wording of the articles themselves which refer to trade between "*Member States of the European Union*". In this respect the Tribunal further refers to the opinion of Advocate General Wathelet in the *InnoLux* case³⁰⁸. Under the heading "*The territorial scope of EU law*", Advocate General Wathelet writes i.a.:

"38 Indeed, unlike the Sherman act, the wording of articles 101 TFEU and 102 TFEU clearly states that those articles exclusively relate to practices which restrict competition within the European Union, rather than outside it."

³⁰⁷ Exhibit CL-113

³⁰⁸ C-231-14

(3813) The Tribunal furthermore refers to Advocate General Nils Wahl in his opinion in the Intel case³⁰⁹ where he i.a. writes as follows:

"288 The first point I would make is a simple and self-evident one. To determine whether the Commission can apply EU competition rules to specific conduct, the starting point must be the wording of articles 101 and 102 TFEU. Far from affording the Commission carte blanche to apply EU competition law to behaviour where ever it occurs and no matter whether it has any clear link to the EU territory, those provisions are concerned with collective or unilateral anti-competitive conduct within the internal market: Article 101 TFEU prohibits agreements or practices "which have as their object or effect the prevention, restriction or distortion of competition within the internal market"; and article 102 TFEU for its part, prohibits "any abuse within the internal market".

289 The jurisdiction rule for the application of the EU competition rule is thus clearly imbedded in those provisions. Although, article 102 TFEU is somewhat less clear, article 101 TFEU is very explicit in that it applies to any conduct that has anti-competitive effects on the internal market."

(3814) Though the CJEU did not follow Mr Wahl's opinion when ruling upon the Intel case (see below), his statement now quoted must be considered as an authoritative opinion on EU law.

(3815) The Tribunal further finds that the principle of territoriality is not confined to the public law enforcement of Articles 101 and 102 TFEU, as further alleged by Naftogaz³¹⁰. This is apparent

³⁰⁹ C413/14

³¹⁰ Post-Hearing Brief (130)

from *Gencor*³¹¹, where the Court considered whether the application of the EU merger regulation was contrary to the principle of territoriality, thus extending the territoriality principle beyond public law enforcement.

(3816) There are three recognised exceptions to the territoriality principle; namely the single economic entity doctrine, the implementation doctrine, and the qualified effects doctrine.

(3817) Both Parties agree that the first two are irrelevant to the dispute at hand.

(3818) The question is hereafter whether the qualified effects doctrine applies.

(3819) On 6 September 2017, the CJEU rendered judgment in the Intel case.³¹² In its judgment the CJEU found that the qualified effects doctrine applied in a situation where an American company, Intel, had concluded an agreement with a Chinese company, Lenovo, where the conduct at issue was not implemented in the EEA, and Intel did not sell products to Lenovo in the EEA.

(3820) Against that background, the Tribunal finds that the qualified effects doctrine applies to the present dispute.

(3821) The Tribunal does not attach importance to the fact that the Intel case was not as the case at hand a dispute between two private parties, as the Tribunal fails to see that the underlying considerations would be significantly different from those in a case concerning public enforcement of EU competition rules, as in the Intel case.

(3822) According to the applicable qualified effects doctrine, it is for Naftogaz to prove that the Contract is capable of having "*foreseeable*", "*immediate*", and "*substantial*" effects within the EU.³¹³ The question hereafter is whether Naftogaz has met this burden of proof.

³¹¹ Exhibit CL-114

³¹² C-413/14

³¹³ See paragraph 48 of the Intel case, C-413/14. The Tribunal notes that paragraph 48 only mentions "*effects on the EEA*", not effects solely on competition.

- (3823) As noted in paragraph 49 of the Intel judgment, the qualified effects doctrine allows the application of EU competition law to be justified under public international law when it is "*foreseeable*" that the conduct in question will have an "*immediate*" and "*substantial*" effect in the EU.
- (3824) In paragraph 51, the Court states that it is sufficient to take account of the probable effects of conduct on competition in order for the "*foreseeability*" criterion to be satisfied.
- (3825) The Tribunal agrees with Gazprom that the qualified effects test is a stringent test and that each of the criteria "*immediate*", "*substantial*" and "*foreseeable*" negative effect on competition in the EU must be satisfied.
- (3826) The CJEU held that Intel's conduct had to be capable of producing an "*immediate*" or direct effect on competition in the EEA, see section 52 of the Intel Judgment.
- (3827) Intel's conduct entirely excluded competitors' products from the EEA. Therefore, it had a direct / immediate effect on competition in the EU.
- (3828) In the case at hand, however, the criteria of the qualified effects doctrine are not fulfilled as a matter of fact. None of the circumstances, upon which Naftogaz seeks to rely in this regard, establish a direct negative effect on competition within the EU.
- (3829) In this connection, the Tribunal notes that it is not sufficient for Naftogaz to prove that the Contract tariffs or non-tariff provisions have an anti-competitive effect within Ukraine. Naftogaz bears the burden of proving not only that there is a negative effect on competition within the EU, but further that this negative effect is "*immediate*", "*substantial*" and "*foreseeable*". The Tribunal finds that that burden of proof has not been met by Naftogaz.
- (3830) In this connection, the Tribunal notes that in the Hesmondhalgh and Lapuerta Report 3, Naftogaz seeks to rely on a number of circumstances that allegedly establish a direct and substantial negative effect on competition in the EU. The Tribunal finds, however, that none of these circumstances sufficiently document a direct and substantial effect on competition in the

EU. Reference is made to Dr. Boaz Moselle's 3rd Expert Report, chapters 3 and 4, in which a number of criticisms of the Hesmondhalgh and Lapuerta Report are raised. The Tribunal finds that the comments and objections in Dr. Moselle's 3rd Expert Report cast such doubt on the conclusions of the Hesmondhalgh and Lapuerta Report that the Tribunal finds that Naftogaz has not met the burden of proving that the Contract gives rise to immediate, substantial or foreseeable negative effect on competition in the EU and therefore the qualified effect test is not met.

9.5.5 Do Articles 101 and 102 TFEU apply due to the Contract being governed by Swedish law?

9.5.5.1 Naftogaz' position

(3831) Naftogaz argues that since the Parties have chosen the law of an EU member state to govern the Contract, there can be no objection in principle to applying EU competition law to the claim, and there is no need to have recourse to principles of public international laws whether EU law can properly be applied.

9.5.5.2 Gazprom's position

(3832) Materially, Gazprom has argued that the Parties chose Swedish law and not EU law, and that EU law should only be applied if and when it is applicable to the factual situation.

9.5.5.3 The Tribunal's findings

(3833) The Tribunal finds that Swedish law and EU law are distinguishable and that the Contract's reference to the material laws of Sweden is not in itself a reference to EU law as well. As a member state of the EU, Sweden is under an obligation to respect the primacy of EU law and apply EU law when it is applicable. In this respect, the Tribunal refers to the judgments in case 26/62 (Van Gend en Loos) and case 106/77 (Simmenthal).

(3834) Both these cases on the one hand recognise the constitutionally superior nature of EU law but on the other hand regard EU law as separate legal order²

(3835) The Tribunal finds that EU law should be applied, if and when it is applicable to the factual situation in issue.

(3836) In the present case, Articles 101 and 102 TFEU are only applicable if Naftogaz can establish that the qualified effects doctrine applies, and it is fulfilled as a matter of fact in the present case. As concluded above, the Tribunal finds that Naftogaz has not been successful proving that the qualified effects test is fulfilled.

(3837) On this background, the Tribunal finds that Naftogaz has not proven that the Contract affects competition in the EU and therefore Articles 101 and 102 TFEU do not apply. The mere reference to the laws of Sweden in the Contract does, in the opinion of the Tribunal, not alter this fact.

9.5.6 Article 18 EnCT

(3838) Naftogaz relies on article 18 EnCT for its competition law claims, and Articles 10 and 11 and Annex 1 EnCT for its energy law claims.

9.5.6.1 Naftogaz' position

(3839) In addition to Articles 101-102 TFEU, EU law also includes the EnCT Article 18, which essentially replicates Articles 101 and 102 TFEU and applies them to agreements and conduct which effect trade between Contracting Parties. It is Naftogaz' position that Article 18 EnTC has direct effect as a matter of EU law with the consequence that Naftogaz is entitled to rely on a breach of competition rules in Article 18(a) and (b) directly in proceedings before the court or tribunal where EU law applies.

(3840) It is Naftogaz' position that the provision of an international agreement concluded by the EU such as the EnCT has direct horizontal effect and may be relied on by private parties when it is "operational".

9.5.6.2 Gazprom's position

(3841) It is Gazprom's position that a provision in an international treaty can only be invoked by a private party before national courts in the EU, if the following four conditions are met:

- (i) the disputable provision must contain a commitment undertaken by the EU,
- (ii) the grant of direct rights to private parties is consistent with the "nature and broad logic" of the treaty in question,
- (iii) the treaty provision contains a sufficiently clear and precise obligation,
- (iv) the treaty provision is unconditional in that it is not subject to further implementing measures.

(3842) It is Gazprom's submission that Naftogaz is not entitled to invoke Article 18 EnCT in this Arbitration because none of the four conditions are met.

9.5.6.3 The Tribunal's findings

(3843) The Energy Community is an international organisation dealing with energy policy. The organisation was established by an international treaty in October 2005. The treaty entered into force in July 2006. The treaty establishing the Energy Community brings together the EU on the one hand and the following contracting parties on the other hand: Albania, Bulgaria, Bosnia, Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Romania, Serbia and the United Nations Interim Administration Mission in Kosovo.

(3844) On 24 September 2010, Ukraine signed a protocol concerning the accession of Ukraine to the EnCT, and Ukraine subsequently acceded to the EnCT on 1 October 2011. The Russian Federation has not signed the EnCT.

(3845) The key goal of EnCT is to extend the EU internal energy market to South East Europe and beyond on the basis of a legally binding framework.

(3846) Article 18 of EnCT provides as follows

"1. The following shall be incompatible with the proper functioning of the Treaty, insofar as they may affect trade of Network Energy between the Contracting Parties:

(a) all agreements between undertakings, decisions by associations of undertaking and concerted practices which have as their object or effect the prevention, restriction or distortion of competition,

(b) abuse by one or more undertakings of the dominant position in the market between the Contracting Parties as a whole or in a substantial part thereof,

(c) any public aid which distorts or threatens to distort competition by favouring certain undertakings or certain energy resources.

2. Any practices contrary to this Article shall be assessed on the basis of criteria arising from the application of the rules of Articles 81, 82 and 87 of the Treaty establishing the European Community (attached in Annex III)."

(3847) The question for the Tribunal to decide is whether Article 18 of the Energy Community Treaty and the energy rules in the TEP (as referred to in Annex 1) have direct effect as a matter of EU law, and if so whether the treaty creates rights and obligations for individuals.

(3848) The issue has not been decided by the CJEU. There is therefore no relevant case law which addresses the question of the direct effect of the EnCT or the interpretation of Article 18 EnCT.

(3849) Naftogaz' expert, Sir Francis Jacobs, has stated that other treaties have been held by the CJEU to have direct effect. Four treaties have been mentioned in this respect. Firstly, the European[^]

Economic Area Treaty, from which, however, Professor Jacobs stated there could not be drawn any conclusions.³¹⁴

(3850) Secondly, Sir Francis Jacobs has referred to three agreements – the EU-Poland Agreement, the EU-Slovakia Agreement and EU-Russia Agreement. These treaties all contain provisions which explicitly grant rights to individuals and which explicitly impose commitments of the EU. Article 18 EnCT does not do this, and there is therefore no relevant comparison between the three agreements and the EnCT.

(3851) The Tribunal finds that Naftogaz’ reliance on Article 18 EnCT as a way of indirectly applying EU competition law requires Naftogaz to prove that Article 18 EnCT has direct effect as a matter of EU law.

(3852) As a starting point, the Tribunal notes that the addressees of article 18 EnCT are the Contracting Parties, not the EU.

(3853) With reference to Article 3 (a)³¹⁵, the heading of Title II, “THE EXTENSION OF THE ACQUIS COMMUNAUTAIRE” and all of the provisions of Title II, the Tribunal finds that the EnCT only imposes obligations on the Contracting Parties to implement the *acquis communautaire* into their own national law. The Contracting Parties are under a similar obligation with regard to each of the categories of *acquis communautaire* listed under Title II.

(3854) This interpretation of the EnCT is supported by the EU Commission³¹⁶ and the EU Council³¹⁷ as well as the EnCT itself, whose website reads as follows[†]

³¹⁴ Ref. T9 123:21-23.

³¹⁵ Article 3 (a) states that for the purpose of Article 2, the activities of the Energy Community shall include the implementation by the Contracting Parties of the *acquis communautaire* on energy, environment, competition and renewables.

³¹⁶ Exhibit RLA-110

³¹⁷ Exhibit RLA-183

"By the entry into force of the Energy Community Treaty on 1 July 2006, the Contracting Parties are under an obligation to introduce, to the extent the trade of network energy between the Contracting Parties may be affected, rules prohibiting cartels (agreements between undertakings, decisions by associations of undertakings and concerted practices), abuses of a dominant position, and rules prohibiting State aid. Moldova and Ukraine are under the same obligation from May 2010 and Feb 2011 respectively.

.....

While the Contracting Parties, pursuant to Article 6 of the Treaty, are obliged to ensure efficient implementation of their obligations under the Treaty, of which efficient enforcement of the rules in substance is an important aspect, specific Energy Community acquis on competition and State aid law enforcement (procedures, institutions, sanctions, remedies etc.) are currently lacking."³¹⁸

(3855) The Tribunal notes that Article 4 of the EnCT Rules of Procedure for Dispute Settlement under the Treaty specifically states:

"Dispute settlement procedures must relate to a violation by a Party of Energy Community law and may not concern disputes between private parties."

³¹⁸ Gazprom Closing-Bundle pages 379-380

(3856) The fact that pursuant to Article 216 (2) TFEU, the EnCT is binding on the EU and thereby its member states, including Sweden, does, however, not mean that Article 18 in EnCT confers rights and obligations to a private party as a matter of EU law.

(3857) In *International Fruit*³¹⁹ as reflected in *Intertumbo*³²⁰ and *Kupferberg*³²¹ and a number of other cases³²² the ECJ has held that the following conditions must be met in order for an individual to invoke a provision in an international treaty concluded by the EU:

1. Article 18 EnCT must contain a commitment undertaken by the EU

The Tribunal finds that Article 18 EnCT is addressed to the Contracting Parties only and does not impose any commitments or obligations of the EU³²³ and that it therefore cannot be a corresponding duty to enforce the content of this provision in the EU law. As there is no duty by the EU to enforce Article 18 EnCT, a private party cannot rely on this provision as a matter of EU law directly against another private party before a court or tribunal.

2. The grant of direct rights to private parties and/or the imposition of direct obligations on private parties is consistent with the "*nature and broad logic*" of the treaty in question

In order to determine whether the EnCT as a whole is capable of conferring enforceable rights to individuals, regard must be had to the nature and purpose of the agreement.

The nature and purpose of the EnCT is to create a legal and economic framework based on the EU *acquis communautaire*, related to energy. By exporting the EU rules to the Contracting Parties, the parties intended to create a regulatory market framework. This export of rules is to

³¹⁹ Joined cases 21/72 to 24/72 *International Fruit Company and Others*.

³²⁰ Case C-308/06

³²¹ Case 104/81

³²² Cases C-12/06, C-121/06, C-366/10 and C-363/12

³²³ This was accepted by Sir Francis Jacobs, T9 131:25 – 132:16, and [REDACTED], T4 169.8-23 and 170:25-171:5

be achieved by the Contracting Parties implementing the *acquis communautaire* into their national laws. The grant of the direct effect is not consistent herewith.

3. The treaty provision contains a sufficient and clear precise obligation

The Tribunal notes that the parties to the treaty have not chosen the same wording as in Articles 101 and 102 TFEU. The drafters of the EnCT thus chose not to impose a clear and direct prohibition on the entire competitive conduct, as contrary to Articles 101 and 102 TFEU - they did not include a provision setting out that prohibited conduct shall be automatically void. The Tribunal finds that Article 18 EnCT is not sufficiently clear and precise, since it is for the Contracting Parties to decide what the civil consequences of anti-competitive conduct contrary to Article 18 EnCT should be.

4. Treaty provision is unconditional in that it is not subject to further implementing measures

The Tribunal notes as it appears from article 3 a) of the ECT that the Contracting Parties are to implement the *acquis communautaire* into their national laws as adapted to the specific situation of each of the Contracting Parties. Therefore, Article 18 is not unconditional, since it is subject to further implementing measures.

Thus, the Tribunal finds that Article 18 EnCT has no direct effect as a matter of EU law and that consequently Naftogaz is not by way of Article 18 EnCT entitled to rely on a breach of Articles 101 and 102 TFEU.

In conclusion, the Tribunal finds that Article 18 EnCT and the energy rules in the TEP (as referred to in Annex I) have no direct effect. *Ø*

9.5.6.4 Operationalisation

(3858) Naftogaz also relies on EU energy rules (Regulation 715/2009 and Directive 2009/73/EC), not as an independent legal basis for its EU law claims, but rather in support of its claims under Articles 101 and 102 TFEU and Article 18 ECT.

(3859) The provisions of EU energy law are relied on in so far as they "*operationalize*", "*concretize*" or effectively codify principles of competition law in the energy sector.

(3860) Gazprom has disputed that a concept of "*operationalization*" exists and submits that EU competition law should be applied according to the relevant legal texts. The scope of those legal texts cannot be expanded by reference to the concept of "*operationalization*".

(3861) The Tribunal finds - and both Parties agree to this - that the concept of "*operationalization*" cannot apply unless Articles 101 and 102 TFEU or Articles 7 or 18 of ECT apply. As said above, those provisions do not apply in the present case and accordingly it is not possible for them to constitute the basis of any principle of "*operationalization*".

(3862) Thus, Regulation 715/2009 and Directive 2009/73 cannot be imported into EU competition law by virtue of the so-called concept of "*operationalization*".

9.5.6.5 Conclusion

(3863) In conclusion the Tribunal finds that EU competition law does not apply to the dispute, neither as a result of direct applicability of Articles 101 and 102 TFEU, nor as a result of the Contract's reference to the laws of Sweden, nor indirectly by way of Clause 18 of the Energy Community Treaty, nor by the virtue of so-called operationalization.

9.6 Tariff Revision

9.6.1 Tariff Revision based on Article 8.7

(3864) It is not in dispute that Article 8.7 is a tariff revision clause in the sense that it gives the power to an arbitral tribunal to revise the tariff pursuant to Article 8.7. However, Gazprom has a 

number of other defences both as to what Gazprom calls the “jurisdiction” of the Tribunal and to the merits.

(3865) It is convenient to reiterate the text of Article 8.7 here. The Parties have different views on how to correctly translate the text into English.

(3866) Naftogaz translates the tariff revision clause:

"8.7 In case of a significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of this Contract, and if the price for transit services specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs in the European gas market, each Party is entitled to apply to the other Party with a request for revision of the price for transit services.

8.7.1 The request for revision of the price for transit services shall be made in writing and be properly substantiated by the requesting Party. After receipt by the relevant Party of the above request, the Parties shall enter into negotiations within 20 days and, if an agreement is reached, sign the respective addendum to this Contract.

8.7.2 If a written agreement on the revision of the price for transit services cannot be reached within 3 (three) months from the date of the beginning of the negotiations, then each party has the right to refer the matter to arbitration in accordance with Article 12 of the Contract for the passing of a final decision."

(3867) Gazprom translates the tariff revision clause:

"8.7. In the event of a material change in 2010 and subsequent years of the conditions of formation of transit tariffs at the European gas market, as compared to what the Parties reasonably expected at the time of entering into this Contract, and if the transit tariff specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs at the European gas

market, each Party shall have the right to address the other Party with a request to reconsider the transit tariff.

8.7.1. The request to reconsider the transit tariff shall be submitted in writing and duly substantiated by the requesting Party. Upon receipt by the respective Party of such request, the Parties agree, within 20 days, to enter into negotiations and, if they reach an agreement, to execute the relevant supplement to this Contract.

8.7.2. If the Parties fail to reach a written agreement to reconsider the transit tariff within 3 (three) months after the negotiations commencement date, each Party shall be entitled to refer the issue to arbitration in accordance with Article 12 of this Contract for final resolution."

(3868) The Tribunal does not find that the differences in translations into English are decisive to the interpretation of Article 8.7. The Parties agree that differences between the translations are immaterial.

9.6.1.1 Are the pre-requisites for a submittal to arbitration under Article 8.7 met?

(3869) Naftogaz relies on one letter of alleged request for price revision, the letter of 15 June 2009, which Naftogaz claims is sufficiently substantiated. Naftogaz argues that the request from 15 June 2009 still is open as no agreement has been reached.

(3870) Gazprom has a number of objections which will be dealt with here.

(3871) The objections of Gazprom regarding the requirement of Article 8.7. can be summarised as follows:

The Tribunal lacks jurisdiction and/or substantive power to consider Naftogaz' revision claims as presented in this Arbitration because:

- (i) The letter from Naftogaz of 15 June 2009 does not contain sufficient substantiation to oblige Gazprom to enter into negotiations;

- (ii) No negotiations took place between the Parties as required by Article 8.7.1; and
- (iii) The grounds for revision stated by Naftogaz in the letter of 15 June 2009 are not the same as those advanced in this Arbitration.

(3872) The 15 June 2009 letter reads:

“For the first 5 months of 2009 the transit of natural gas by OAO Gazprom through the territory of Ukraine constituted 31 bcm, which is 40% less than in the same period of 2008, and 38% less than the volume provided for by the Contract No. TGKU dated 19 January 2009 on volumes and conditions for the transit of natural gas through the territory of Ukraine from 2009 to 2019 (hereinafter the Transit Contract).

The decline in volumes of natural gas for transit leads to a substantial decline in the revenues of NAK Naftogaz of Ukraine from the provision of transit services and carries a threat of significant unplanned financial deficit for the Company in 2010 and in subsequent years, especially in the light of the planned commissioning of the gas pipeline “Nord Stream”. The lack of funds needed to finance the gas transportation system may negatively affect its operating efficiency, which brings the threat to the stability of supplies of Russian gas to the EU countries and Ukraine.

This problem is a consequence of the asymmetry of the contract conditions on transit and purchase of natural gas, signed on 19 January this year, in particular in terms of guarantees by the acquirer of minimum payments: if the Contract on the purchase and sale of natural gas requires NAK Naftogaz of Ukraine to buy at least 80% of the contracted volume of natural gas and provides for substantial penalties in case of failure to comply with such condition, the Transit Contract does not provide for such an obligation of OAO Gazprom. Moreover, the absence of such an obligation of OAO Gazprom in the Transit Contract leads to a significant decrease in the effective price for transit of natural gas, which provides a basis for its revision in accordance with Clause 8.7 of the Contract.

Taking into account the abovementioned, we ask you to consider amending the Transit Contract in particular in relation to OAO Gazprom's obligation in favour of NAK Naftogaz of Ukraine to guarantee the delivery of volumes of natural gas for transit through the territory of Ukraine and payment for the agreed volume of natural gas transit services by analogy with the Contract on the purchase and sale of natural gas in 2009 -2019 from 19 January 2009."

(3873) The Tribunal makes the following observations as regards the letter of 15 June 2009. A close look at the letter shows that in it Naftogaz refers to a reduction of transit volumes during the first 5 months of 2009, and states that this is less than the volumes provided for in the Transit Contract, and that the decline in volumes *"leads to a substantial decline in the revenues of NAK Naftogaz of Ukraine from the provision of transit services and carries a threat of significant unplanned financial deficit for the Company in 2010 and in subsequent years"*, and, moreover, that the absence of an obligation of Gazprom to transit a minimum volume of natural gas with substantial penalties in case of a failure to comply with such obligation *"leads to a significant decrease in the effective price for transit of natural gas, which provides a basis for its revision in accordance with Clause 8.7 of the Contract"*. Naftogaz, with reference to these circumstances, asks Gazprom to *"to consider amending the Transit Contract in particular in relation to OAO Gazprom's obligation in favour of NAK Naftogaz of Ukraine to guarantee the delivery of volumes of natural gas for transit through the territory of Ukraine and payment for the agreed volume of natural gas transit services by analogy with the Contract on the purchase and sale of natural gas in 2009 -2019 from 19 January 2009"*.

(3874) The Tribunal does not find that the 15 June 2009 letter addresses the conditions for tariff revision in accordance with Article 8.7. It does not say anything about *"a significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of this Contract,"* nor that *"the price for transit services specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs in the European gas market,"*. Moreover, it was sent before 2010, which is not what Article 8.7 presumes. Even if that does not mean that a request

with reference to Article 8.7 could not validly be made before 1 January 2010, the circumstances and the letter of 15 June 2009 do not reflect a situation that would justify acceptance of an earlier request.

(3875) The Tribunal agrees with Naftogaz that the requirement of substantiation shall not be interpreted as a strict condition where all facts and legal arguments and the revision requested should have to be set out in the request pursuant to Article 8.7. However, there must nevertheless be a minimum reflection of what Article 8.7 requires that has to be satisfied. That is not the case here.

(3876) Naftogaz claims that the answer from Gazprom of 5 August 2009 shows that Gazprom understood that the letter of 15 June 2009 was a tariff revision request.

(3877) Gazprom's answer to the letter is essentially as follows.

“With reference to the request of NAK Naftogaz of Ukraine of 15 June 2009 ... to amend the terms and conditions of the Contract on the volumes of and terms for transit of the natural gas through the territory of Ukraine..., namely, to provide for the obligation of OAO Gazprom to NAK Naftogaz of Ukraine to guarantee the supply of certain volume of natural gas for transit through the territory of Ukraine ... we inform you on the following....

taking into account the advance payments made in 2004 and 2008, OAO Gazprom has already paid for natural gas transit through the territory of Ukraine during this year and partially in the year 2010. Taking into account that during the last years OAO Gazprom pays for natural gas transit in advance without interest on advance payments, we consider, that this makes the price for transit more economically efficient.

Besides, starting from the year 2010 the formula that accounts for Ukrainian expenses for transportation, will be in effect.✓

Proceeding from the above, we believe that the question on amending the Transit Contract in a way that will factually mean additional payments by OAO Gazprom for NAK Naftogaz of Ukraine services on natural gas transit is unacceptable."

(3878) The Tribunal does not find that it follows from this letter that Gazprom did understand that Naftogaz requested a tariff revision, even less a tariff revision relying on Article 8.7. In essence, the letter of 15 June 2009 and the answer from Gazprom deals with issues of volume and the effect on Naftogaz' revenues resulting from the volume drop.

(3879) As evidence of the alleged understanding of Gazprom that a tariff revision process had been opened, Naftogaz has invoked two reports comparing the tariff under the Contract with other European tariffs for gas transit commissioned by Gazprom before January 2010³²⁴, and related statements by [REDACTED], which statements Naftogaz does not consider credible.

(3880) [REDACTED] explanation was that after the end of 2009, when the tariffs was to be calculated in accordance with the formula in the Contract, Gazprom was concerned to ensure that the tariff following from the formula was generally in line with international industry standards, and that the findings were for Gazprom's internal purposes only.

(3881) These circumstances could perhaps be a reflection of such understanding of Gazprom, but could also be explained as has been made by [REDACTED]. Without any further evidence and in combination with the other circumstances discussed here, the Tribunal does not find that these reports suffice to prove that Gazprom had understood that the letter of 15 June 2009 was a request for tariff revision under Article 8.7.

(3882) Naftogaz has also, in support of its alleged request in the letter of 15 June 2009, referred to letters that allegedly contained tariff revision requests. Naftogaz relies here on the witness ✓

³²⁴ "Benchmarking of Ukrainian Gas Transit Tariff to Other Comparable Tariffs" (R-16) and "Assessment of Gas Transit Terms between Gazprom and Naftogaz" (R-17).

³²⁵ [REDACTED], § 65 (T-PHB, tab III p. 10).

statement of [REDACTED] and letters enclosed to her witness statement³²⁷. However, neither the evidence given by [REDACTED], nor any of these letters contain any reference to a tariff revision pursuant to Article 8.7. The letters, and the Addenda attached to some of the letters, are about other matters, such as adjustment of the fuel gas component, penalties for deviations in the transit volumes, price estimates for customs clearance purposes, inflation, documentation, calculation of average weighted distances of transit, rounding in calculations, etc. [REDACTED] speaks broadly of tariff rates changes, including relying on the aforementioned letters. However, in the opinion of the Tribunal, [REDACTED]' evidence and these letters do not help Naftogaz' claim that it has made a proper request for a revision of the transit tariff based on Article 8.7.

(3883) The above means that Naftogaz has not proven that it has made a request for a revision of the tariff in accordance with Article 8.7. That means that Naftogaz' claim for a revision of the tariff based on Article 8.7. has failed. From that follows that the Tribunal does not have to consider the other aspects invoked and argued in relation to the tariff revision request.

9.7 Tariff Revision pursuant to Section 36 of the Swedish Contracts Act

(3884) Naftogaz has invoked Section 36 of the Swedish Contracts Act as a basis for revision of the tariff.

(3885) Section 36 is of general application and allows courts to set aside or modify contractual terms or contracts in their entirety on the basis of unconscionability.

(3886) Section 36 is primarily applied in disputes between consumers and commercial parties. The second paragraph of Section 36 expressly provides that when assessing whether or not a contract term or condition is unconscionable, it is especially important whether one of the parties,

³²⁶ [REDACTED] § 41,

³²⁷ Annexes 15 – 22 to [REDACTED] C-AM 15 to C-AM 22 [Naftogaz' letter No. 24-572-4490, dated 10 August 2009, with attachment. Naftogaz' letter No. 24-765-6378, dated 6 November 2009, with attachment KOLLA.]

due to being a consumer or otherwise, is in an inferior position in the contractual relationship. Though the principle of unconscionability is technically applicable in relationships between commercial parties, the principles *pacta sunt servanda* (“agreements must be kept”) and *rigor commercialis* (freedom of contract) are fundamental in Swedish Contract Law, and Section 36 is therefore seldom applied in such cases. (See, e.g., Jan and Christina Ramberg, *Allmän avtalsrätt*, 8 edition p. 175 et seq with references). The Supreme Court has expressly stated that particular restrictiveness shall be observed in application of Section 36 to commercial relationships (see e.g. NJA 1984 p. 229 and NJA 1992 p- 782).

- (3887) Naftogaz has invoked a number of reasons why the tariff in Naftogaz’ opinion is unconscionable and have been so since 2010. Naftogaz submits *inter alia* that Naftogaz had an inferior bargaining position when the Contract was entered into, that the Contract in itself is unconscionable as the revenues fail to reflect European standard of covering the costs of the TSO, that the decline in volumes of gas delivered renders the tariff unconscionable, that the tariff was based on failed assumptions regarding future developments, and abuse of rights by Gazprom's exploitation of the weaknesses of the present tariff. These and other arguments invoked by Naftogaz must of course be considered but are not in the opinion of the Tribunal sufficient to allow the Tribunal to apply Section 36 in the present case, especially since it cannot be sufficiently concluded from the evidence that Naftogaz has been in an inferior position as compared to Gazprom during the negotiations.
- (3888) When submitting that the tariff should be revised pursuant to Section 36, Naftogaz especially stresses the fact that the tariff in the Contract should be a cost reflective tariff under Ukrainian law and that the Contract tariff is not and has not been cost reflective as required.
- (3889) It is true that the legislator has indicated that Section 36 may be used to align contract terms with commercial administrative law. It is also true that Section 36 may sometimes be used to adapt a contract regulation to administrative requirements.

(3890) Section 36 was applied in the Separate Award in SCC Arbitration No. V 2014/078/080 between the Parties (the Supply Arbitration) with respect to the Take or Pay-provisions in the Supply Contract, which were declared invalid. The main reason for this position by the Tribunal was that the Take or Pay-provisions deviated from generally accepted principles of competition. In the case at hand, the situation is different, since there is in the Tribunal's view no such obvious deviation from generally accepted principles of competition.

(3891) Further, the Tribunal must bear in mind the restrictiveness that shall be observed in application of Section 36 to commercial relationships and consider the fact that the Contract in Article 8.7 contains an explicit tariff revision clause, which cannot be claimed to be imperfect or unable to fulfill its purpose.

(3892) Moreover, above, the Tribunal has found that Ukrainian law is not applicable to the present dispute.

(3893) For these reasons, the Tribunal holds that the tariff cannot be considered to be unconscionable so as to justify its modification or setting aside pursuant to Section 36 of the Swedish Contracts Act. Naftogaz' claim must therefore fail insofar as it is based on Section 36.

9.8 Naftogaz' Underpayment Claim

(3894) Naftogaz' capital monetary claims are a combination of compensation for underdeliveries and compensation for underpayments, depending on the point in time from which the Tribunal will find that the revised, cost-reflective tariffs apply. Thus, in each combination, the under-delivery claim runs until the day before the underpayment claim starts.

(3895) However, as the Tribunal has rejected Naftogaz' claims for a revision of the tariff, there remains no claim for underpayments, except in relation to the adjustment to the transit tariff as a result of the adjustment of the price for gas under the Supply Contract, where the element (P_{nj}) the

formula in Article 8.1 of the Contract is determined by the price for the gas under the Supply Contract.

(3896) This has been dealt with by the Parties in connection with Gazprom's claim for overpayments, and the Tribunal does so also, see below

9.9 Naftogaz' Underdeliveries Claim

9.9.1 Dismissal of Gazprom' submission of 9 February 2018

(3897) On 9 February 2018, Gazprom submitted a new defence to Naftogaz' underdeliveries claim invoking Section 36 of the Swedish Contracts Act alleging that new circumstances had arisen by reason of the Final Award in the Supply Arbitration. Gazprom in essence alleges that there would be a "severe" imbalance if the Tribunal were to uphold Naftogaz' claim for underdeliveries while having rejected Gazprom's claims relating to take or pay by the Final Award in the Supply Arbitration by the application of Section 36 of the Swedish Contracts Act.

(3898) Naftogaz has objected to this as they allege unsolicited new defence and requests its dismissal pursuant to Article 25 of the SCC Rules. Naftogaz claims that at the latest, Gazprom could have presented this new defence after receipt of the Separate Award in the Sales Arbitration on 31 May 2017, where the Tribunal granted Naftogaz' request for an adjustment of the take-or-pay provisions, leaving only the precise scope to be determined later.

(3899) Naftogaz has added that the notion that the Tribunal's decision somehow affects the contractual balance between the Parties was at the latest conceived by Gazprom when it prepared its challenge of the Separate Award, dated 7 November 2017, and that Gazprom has not credibly explained why it waited until only 19 days prior to the scheduled rendering of the Final Award in this arbitration to present this new defence.✍

(3900) Further, Naftogaz claims that in terms of the relevant facts (Gazprom's alleged "needs" for transit) is not unjust to Gazprom; Gazprom had the opportunity to invoke these facts directly towards Naftogaz pursuant to Article 3.2 Contract years ago, but chose not to do so.

(3901) As to prejudice to Naftogaz, Naftogaz alleges, had Gazprom made this new defence at the first available opportunity, i.e. in the 16 October 2015 in its Defence, Naftogaz would have had the opportunity to cross-examine [REDACTED] relied on by Gazprom, and, more importantly, Naftogaz could have requested the author(s) of the audit reports, FBK, and/or the relevant manager(s) in Gazprom Export on whose statement(s) FBK relies to appear for cross-examination in the evidentiary hearing and/or request production of the contracts and letters referred to in the FBK reports within the agreed timetable.

(3902) According to Naftogaz, for the Tribunal to admit this new defence and ensure due process would be to fundamentally change the agreed procedural timetable and provide for a new round of document requests and a second evidentiary hearing, the inevitable consequence being a very significant delay in the rendering of the Final Award, which would severely prejudice Naftogaz and the Ukrainian State.

(3903) The Tribunal agrees with Naftogaz that Gazprom has not presented any credible justification for the introduction of the new defence at this very late time in the proceeding, just 19 days before the planned rendering of the Final Award in this Arbitration, and that for the reasons stated by Naftogaz, there would be serious consequences if the Tribunal were to admit it.

(3904) The Tribunal thus finds that it would be inappropriate to allow the new defence.

9.9.2 The Merits

(3905) Naftogaz has a series of claims for alleged underdeliveries of transit volumes of natural gas during a number of years. They are in addition to the claims for replacement of invalid and ineffective provisions and to the claim for revision of the transit tariff based on the price revision clause in Article 8.1 and in the alternative based on Section 36 of the Swedish Contracts Act.

For 2009, it is based on the then existing price (tariff) and volume commitments. For the years 2010 – 2016 [2017] the claims depend on from which year the Tribunal would replace or revise the tariff, such that the claim for underdeliveries are based on an unamended tariff up until the date from which the Tribunal would decide to replace or revise the tariff, and thereafter based on the amended higher tariff.

(3906) As the Tribunal has concluded that there is no basis for replacing or revising the tariff under Article 8.7, the Tribunal will consider the claims for underdeliveries for all years 2009 – 2016 based on the unamended tariff.

9.9.2.1 Article 3 and [REDACTED]

9.9.2.1.1 Gazprom's obligation to transit volumes of gas

(3907) The Parties have different views on whether or not the Contract obliges Gazprom to transit as a minimum the volumes set forth in Article 3.1., as amended by [REDACTED]

(3908) For ease of reference the relevant provisions of the Contract, as amended by [REDACTED] are reproduced here.

(3909) In Naftogaz' translation the relevant part of Article 3.1 of the Contract, as amended by [REDACTED] reads:

"From 2009 to 2019 inclusive, [Gazprom] shall transfer to [Naftogaz] the Natural Gas for transit to European countries in the volume of at least 110 (one hundred ten) billion m [REDACTED] [REDACTED] [REDACTED] on an annual basis at the Acceptance and Delivery Points on the border of the Russian Federation - Ukraine, the Republic of Belarus - Ukraine, the Republic of Moldova - Ukraine, and [Naftogaz] shall ensure its acceptance and further transit through the territory of Ukraine to the Acceptance and Delivery Points on the border of Ukraine with Romania, Hungary, Slovakia, Poland and Moldova." (The [REDACTED] clarifications made by the Tribunal) X

[REDACTED]

(3914) For the year 2009, Article 3.1.1 (which is unamended by [REDACTED] states that the volume of transit Gas should amount to 120.083 billion m3, and how that volume should be distributed by route to different European countries during the quarters of the year.

(3915) Article 3.2 reads: "*The annual volumes of the Gas transit through the territory of Ukraine and their breakdown by the Quarters (including [their breakdown] by the destinations) in the subsequent years shall be specified in Supplements to this Contract. In case of the Parties' failure to execute such Supplement prior to the commencement of the relevant Contractual Year, the volumes of the Gas transit in the relevant year shall be determined based on the aggregate obligations to supply minimum annual quantities of Gas under the contracts of OOO Gazprom Export with the European buyers which receive the Gas transited through the gas transportation system of Ukraine. In that case such minimum annual obligations under the contracts of OOO Gazprom Export have to be confirmed by the auditor.*" (Gazprom's translation).

(3916) A starting point for the Tribunal is that it finds Article 3.1. fairly straight forward when it says that Gazprom shall transit a certain minimum volume, and that Article 3.2. does not state that the volume set forth in Article 3.1. is not binding or subject to Supplements (or Addenda) in accordance with Article 3.2. being executed or similar.³²⁹ The testimony of the witnesses regarding the negotiations and the intentions of the Parties are mostly contradictory and generally follows the interests of the Party who has called the witness³³⁰. Only in some instances has the Tribunal found that the testimonies are helpful in understanding the meaning of the Contract.

(3917) Gazprom relies on Article 3.2 of the Contract, and alleges that it shows that the volume of gas to be transited under the Contract was "*inextricably*" linked to the needs of Gazprom's

³²⁹ The Tribunal does not find that there are any merits to Gazprom's assertions regarding "an impermissible" attempt to incorporate a "ship-or-pay" clause.

³³⁰ [REDACTED] 2 and 3); [REDACTED] 2 and 3); [REDACTED] (3) and [REDACTED]).

European customers, which circumstance was known to Naftogaz, and that the volume 110 billion m3 was not intended as a commitment of Gazprom to transit a minimum volume.

(3918) In a sense, of course, the volumes agreed in the Contract with ██████████ must be linked to Gazprom's needs under its contracts with its customer in Western Europe, but that does not mean that these volumes could not be binding. It is difficult to imagine that Gazprom would agree on volumes with Naftogaz, which Gazprom did not estimate corresponded to its existing and estimated contractual supply obligations, which Gazprom had to honour to its customers. The fact that Article 3.2 refers to "*the aggregate obligations to supply minimum annual quantities of Gas under the contracts of OOO Gazprom Export with the European buyers*", and that this "fall-back" provision comes into play, when, for a particular year, the Parties cannot agree, give the impression that the intent was that this provision was intended for exceptional situations.

(3919) In any event, as mentioned above, the Parties have agreed on Addenda for the years 2010 - 2015.

(3920) Gazprom refers to the evidence given by ██████████³³¹, who has stated that the commitment under the Contract was *intended as no more than a forecast of the volumes it was anticipated might be delivered under the Contract*", to ensure that sufficient capacity to meet Gazprom's transit needs was available in Naftogaz' system, and that Naftogaz understood this.³³²

(3921) Naftogaz' witnesses ██████████, ██████████ and ██████████ tell a different story, stating that the formula for the tariff was agreed on the basis that there was a minimum volume of transit of 110 billion m3. ✓

³³¹ ██████████ 1 §§ 27 and 28.

³³² The fact that the Parties did not agree on a "ship-or-pay" clause does not mean that Article 3.1. of the Contract could not be a binding minimum transit obligation of Gazprom.

³³³ TD 4 47: 17-22 (T-PBH tab III p. 225).

³³⁴ ██████████ 1 § 20 (T-PBH tab III p. 226 and 227)

³³⁵ ██████████ 1 § 27 (T-PBH tab III p. 228) and ██████████ 2 § 41 - 43.

(3922) Also, as regards other aspects of the issue of the binding nature of Article 3.1, [REDACTED]³⁶, as a witness called by Gazprom, and [REDACTED]⁷, [REDACTED]⁸ and [REDACTED] as witnesses called by Naftogaz, made contradictory statements.

(3923) With these (largely) conflicting testimonies, the Tribunal does not find it possible to decide this issue on the basis of them.

(3924) It remains an undisputed fact that specific annual volumes have been agreed for the years 2010, 2011, 2012, 2013, 2014 and 2015, in accordance with Article 3.2, with quarterly allocations for 2010 and 2011, and with a flexible volume for the years 2012 – 2015. Similarly, for 2009 the Contract sets forth a volume (higher than 110 billion m3) which is allocated quarterly in the manner prescribed in Article 3.2.

(3925) It seems reasonable to interpret Article 3.2. as having no more meaning than to serve the practical purpose to give precision regarding the volumes that, based on an annual forecast in the year immediately preceding the Contract Year, could be anticipated to be demanded by Gazprom’s European customers during the Contract Year (“*[T]he annual volumes of transit of Gas ... in the subsequent years [to 2009] shall be clarified [“specified” in Gazprom’s translation] in Addenda ...*” [Clarification and underlining made by the Tribunal]). The volume 110 billion m3 was determined in the beginning of 2009 and shall according to Article 3.1 apply for the entire period on the Contract of 19 year. It goes without saying that demands of gas by Gazprom’s European customers will vary over the years and could not be forecasted with any accuracy in 2009 for each of the 19 years; Article 3.2 seems to have become the instrument to cater for this problem.

(3926) In any event, if, as contended by Gazprom, Article 3.2 qualifies Article 3.1 in the sense that the requirement of Article 3.2, that specific annual volumes should be agreed in separate

³³⁶ [REDACTED] 2 and 3.

³³⁷ TD 4 47: 17-22 (T-PBH tab III p. 225).

³³⁸ [REDACTED] 1 § 20 (T-PBH tab III p. 226 and 227)

³³⁹ [REDACTED] 1 § 27 (T-PBH tab III p. 228)

Supplements (or Addenda), and has the effect that the volume set forth in Article 3.1 is not binding, the Tribunal makes the observation that [REDACTED]

(3927) To the Tribunal this means, failing any convincing evidence to the contrary, that at least for the three years 2009, 2010 and 2011, for which a fixed volume has been agreed in Article 3.1.1. and in accordance with Article 3.2, respectively, there is a binding minimum obligation of transit volumes. The view that annual volumes and their breakdown by quarters set forth in Addenda were binding is expressed by [REDACTED]³⁴⁰

(3928) Moreover, the Tribunal does not find the testimony of [REDACTED] credible when he compares with the wording of the 2002 Contract³⁴¹ and claims that the wording is “*almost identical save that the Contract excludes reference to intergovernmental memoranda*”. When comparing Articles 3.1.1 and 3.2. of the two Contracts, one will find an important difference. Whereas Articles 3.1. and 3.2 of the Contract say that the annual volumes shall be 110 billion m3 (Article 3.1.1) and that the annual volumes and their breakdown quarterly from 2010 shall be set forth in Supplements to the Contract, Article 3.1. of the 2002 Contract says (in Gazprom’s translation) that the volumes of transit of Russian gas shall be (“*no later than [sic.]*”) 110 billion m3 per annum, and that the “*volumes of transit of Russian natural gas through the territory of Ukraine will be adjusted on the basis of annual intergovernmental protocols for the respective year and set forth in annual Supplements to this Contract*” (underlining made by the Tribunal) (Article 3.1.) and that the “*annual distribution of the volumes of Russian natural gas set forth in point 3.1 of this Contract, through the territory of Ukraine for its consumers by quarter (and routes) shall be determined by the Parties in Supplements to this Contract...*” (Article 3.2).

(3929) The provision in the 2002 Contract that the annual volume 110 billion m3 shall be adjusted and the annual volumes be set forth in Supplements changes entirely the meaning of Article 3.1, ↙

³⁴⁰ [REDACTED] 2 §§ 82 - 84

³⁴¹ [REDACTED] 2 § 85

subordinating the 110 billion m3 to the adjusted volumes, making the volumes in the Supplements the binding volumes rather than the 110 billion m3 volume³⁴². It is then entirely natural that Naftogaz in its letters complaining about the failing volumes under 2002 arrangement refers to the Supplements.

(3930) The Tribunal notes that Naftogaz objected to the failures by Gazprom to meet the volumes stated in the Supplements to the 2002 Contract which confirms that Naftogaz considered these volumes as binding minimum volumes.³⁴³

(3931) Further, the Tribunal does not find Gazprom's argument, that the use of expression "*up to*" in some places should indicate that the Parties had not intended to include a minimum volume obligation, convincing. The phrase "*up to*" is used in Gazprom's translation of Article 3.1.1 (however not in Naftogaz' translation of Article 3.1.1) with respect to the quarterly allocation, but not for the total annual volume 2009, and in [REDACTED] [REDACTED] for the year 2010, For the rest, in Article 3.1 of the Contract the phrases used are "*not less than*" and "*shall comprise*" (in Gazprom's translation) and "*or at least*" "*or will amount to*" (in Naftogaz' translation).³⁴⁴ The phrase used in Article 3.1 for the 110 billion m3 is "*not less than*" (in Gazprom's translation) and "*at least*" (in Naftogaz' translation).

(3932) The logic of Gazprom's argument is that in all those instances where the Contract uses the phrases "*not less than*" and "*shall comprise*" (in Gazprom's translation) and "*or at least*" "*or will amount to*" (in Naftogaz' translation), the volumes are binding obligations of Gazprom, and the only cases where there would be no binding obligation of Gazprom would be the total

³⁴² The statement of [REDACTED] §§ 22, 29 and 30) that still the volume 110 billion m3 set forth in Article 3.1 of the 2002 Contract is the binding figure is surprising but does not make a difference to the Tribunal's conclusions.

³⁴³ The statements by [REDACTED] regarding Addendum No. 1 of 4 January 2006 and the volumes agreed in that Addendum and the volumes actually transited, are not convincing in that he refers to, and compares with, Article 3.1 of the 2002 Contract, which does not seem to be the correct "benchmark", as that Article gives priority to Supplements and Addendum 1 expressly refers to transit to South Russia and Kursk Oblast. See also [REDACTED] 3 §§ 14 – 19.

³⁴⁴ See also [REDACTED] 2 § 165.

volume of [REDACTED] for annual volumes for 2010 and for the quarterly allocation for 2009 and 2010. However, it follows from Article 3.1., that even with Gazprom's interpretation, the annual volume obligation of Gazprom for 2010 would in any event not be less than 110 billion m3 ([REDACTED]).

(3933) Without any sensible explanation, which there is none, the Tribunal does not consider that the use of the phrase "up to" to mean that there is no minimum transit volume obligation for Gazprom.³⁴⁵

(3934) An interpretation of Article 3.1. would not be complete without considering also the second sentence of Article 3.1. where it is stated: *"The Contractor shall ensure the proper operation of the gas transportation system of Ukraine at his own discretion and guarantee reliable and continuous transit through the territory of Ukraine of the Client's natural gas in the volume transferred for transit by the Client."* There are no exceptions to this obligation (other than force majeure). There is no dispute that this was a legal obligation of Naftogaz to transit 110 billion m3.³⁴⁶

(3935) The effect of the second sentence of Article 3.1. is that Naftogaz will have to reserve transit capacity for Gazprom in the volume of 110 billion m3, to the extent that no other volume has been agreed as is the case of Addendum 9. If Gazprom were right that it had no volume obligation, Naftogaz would have to reserve capacity for Gazprom without being paid for the capacity that Gazprom would not use, and without the possibility to sell such unused capacity to anyone else.

(3936) The Tribunal does not consider that the use of the words "up to" (or similar phrases) does in any way limit a possible liability of Gazprom for underdeliveries.

(3937) The remaining volumes for the years 2016 and 2017. ✓

³⁴⁵ See also for example [REDACTED] 3 §§ 33 - 35.

³⁴⁶ TD 4 165: 1-10 (T-PHB, tab 1 p. 22) and [REDACTED] 2 § 165.

(3938) These volumes are not dealt with in any Supplements (or Addenda).

(3939) For 2016, Gazprom refers to Article 3.2 and alleges that for these years the annual volume should be determined on the basis of "*the aggregate obligations to supply minimum annual quantities of Gas under the contracts of [Gazprom Export] with the European buyers which receive the Gas transited through the [GTS] of Ukraine [...] to be confirmed by an auditor*" (explanations made by Gazprom). Gazprom alleges that by a letter (sometimes called a fax message) dated 30 December 2016 from Gazprom to Naftogaz, Gazprom informed Naftogaz of the results of an audit undertaken pursuant to Article 3.2, determining the relevant annual volume for 2016 to be [REDACTED] and of a letter dated 30 December 2016 from [REDACTED] [REDACTED] to Gazprom Export determining the minimum annual quantities of gas in 2016 to be [REDACTED] and setting out the basis of its determination.³⁴⁷

(3940) Similarly, Gazprom refers to Article 3.2 for volumes for 2017 with the same arguments and with reference to the same letter to Naftogaz of 30 December 2016³⁴⁸. Gazprom has for 2017 also referred to a letter from [REDACTED] dated 30 December 2016 claiming that [REDACTED] had determined the minimum annual quantities of gas in 2017 to be [REDACTED].³⁴⁹

(3941) According to Gazprom, the 2016 letter to Naftogaz says with respect to 2016:

"According to clause 3.2 of Contract No TKGU dated 19 January 2009 [...] the [MAV] of gas, confirmed by an independent auditor, under Contracts of [Gazprom Export] with its European off-takers receiving gas transmitted via the as transportation system of Ukraine constituted [REDACTED] [REDACTED] (clarification made by Gazprom) √

³⁴⁷ Gazprom invokes two Exhibits, R-84 and R-85, but neither of them contains a copy of any of these letters; Gazprom has obviously made a mistake here. What Gazprom states is Exhibit R-84 should be the letter to Naftogaz being C-235 and to which Gazprom refers in an earlier submission. Gazprom has tried to correct its mistakes by introducing two new Exhibits, R-86 and R-87 both being alleged letters from [REDACTED] dated 30 December 2016, by its late submission of 9 February 2018.

³⁴⁸ Again referring to the incorrect Exhibit R-84.

³⁴⁹ Exhibit R-67 also introduced by its submission of 9 February 2018.

(3942) According to Gazprom, the 2016 letter to Naftogaz says with respect to 2017:

"According to clause 3.2 of Contract No TKGU dated 19 January 2009 [...] in 2017 the [MAV] of Gas under the contracts of Gazprom Export LLC with European buyers which receive the gas transited through the gas transportation system of Ukraine, confirmed by the independent auditor, will comprise [REDACTED] cubic meters." (clarification made by Gazprom)

(3943) The quote above in respect of 2016 is correct whereas the quote above in respect of 2017 is not a correct quote from letter of which a copy has been submitted as C-235. Moreover, the letter also states with respect to 2017 that *"taking into account the flexibility of deliveries provided for in the contracts with the European buyers, the increase in the gas transit volume may comprise [REDACTED]"*

(3944) Naftogaz responded to the December 2016 letter by fax on 3 February 2017³⁵⁰ claiming *inter alia* that any request for revision of the 110 bcm annual transit volumes set out in Article 3.1 must be received by Naftogaz in time to allow Naftogaz to consider the request, and, in case of non-agreement, and to verify the auditor report before the start of the delivery year in question, and that, in any event, Gazprom's request for revised volume obligations was set out too late, both with regard to 2016 and 2017.

(3945) To this, Gazprom has argued that Naftogaz' interpretation of how Article 3.2 is to be applied does not reflect, and is contrary to, the express wording of that provision; the wording of Article 3.2 is clear. Briefly, according to Gazprom, it is not for Naftogaz to *"verify the auditor report"* - either at all or *"before the start of the delivery year in question,"* as the very reason for inclusion of the provision requiring confirmation by an auditor was to provide that verification be done independently of Naftogaz; the contract contains no provision for challenge of the auditor's confirmation, no doubt because such challenge was not contemplated, nor was any provision included for *"verification"* by Naftogaz of the auditor's report. Further, Gazprom's submission of an auditor's confirmation is not subject to a time limit, the logical consequence of the /

³⁵⁰ Exhibit C-236.

wording being that the auditor confirmation is to be performed only after the year preceding the year in question has concluded, i.e. only after the parties have failed to agree volume provisions for the year in question.

- (3946) Naftogaz response is that the wording of the clause consequently suggests that the auditor procedure shall take place in connection with the failure to agree on an Addendum, i.e. *prior to the beginning of the relevant Contract Year*, that the obvious purpose of providing such notification is to free transport capacity in the GTS before the delivery year, thereby allowing Naftogaz to offer it to other shippers and mitigate the losses it otherwise would suffer if Gazprom does not deliver the minimum volume prescribed in Article 3.1, alternatively make further capacity available if the procedure should result in increased needs for Gazprom Export.
- (3947) In both cases, according to Naftogaz, it would need reasonable advance notice. Thus, and contrary to Gazprom's assertions, there is an obvious time limit for when an auditor's confirmation can be submitted pursuant to Article 3.2.; the auditor's confirmation must be provided sufficiently ahead of the delivery year in question to allow Naftogaz to adapt to Gazprom Export's changing needs.
- (3948) Naftogaz adds the following as to the wording of Article 3.2. Article 3.2 establishes that Gazprom's delivery obligation shall be determined "*on the basis of*" Gazprom Export's minimum volume obligations towards European purchasers receiving gas via the Ukrainian GTS. That does not imply that the delivery obligation shall equal the minimum volume obligations. Gazprom Export's minimum volume obligations to European buyers that are provided with gas deliveries through Ukraine will typically be based on the buyers' take or pay obligations whereby the buyers will be obliged to offtake around 80 per cent of the full volume under the respective contracts. If Gazprom Export's purchasers order more than their minimum obligations, Gazprom will require more capacity. Such capacity must have been booked prior to the delivery year. Thus, since Gazprom's delivery obligation shall be determined *on the basis of* Gazprom Export's minimum volume obligations, the figure must be increased at least by 20 per^{cent}

cent, to take into account the possibility that Gazprom Export's buyers may order volumes up to the maximum under the respective contracts.

(3949) This is according to Naftogaz effectively accepted and applied by Gazprom itself, as evidenced by Gazprom's letter of 30 December 2016.³⁵¹ In its letter, Gazprom states that its minimum annual quantities (MAQ) to Western European purchasers amount to ██████ in 2016 and ██████, and specifies that "*taking into account the flexibility of deliveries provided for in the contracts with the European buyers, the increase in the gas transit volume may comprise ██████*" and adds that Gazprom quantifies its needs for gas transit to Moldova in 2017 in the amount of ██████. Consequently, on the unverified assumption that the data provided by Gazprom to the auditors is complete and accurate, a more correct determination pursuant to Article 3.2 would result in minimum delivery obligations under the Contract of ██████

(3950) Gazprom's conclusion, however, is that the delivery obligation under the Transit Contract in 2016 shall be set *equal* to Gazprom Export's minimum volume obligations is therefore contradicted by the very wording of the Contract clause and Gazprom's own statements. Naftogaz in its answer of 3 February 2017 also presented figures that puts in doubt the reliability of Gazprom's figures. In the fax letter Naftogaz refers to amounts of gas actually delivered in January 2017 that indicate that the per annum volume for 2017 could be significantly higher than according to what Gazprom has stated in its 30 December 2016 letter.

9.9.3 The Tribunal's findings

(3951) The Tribunal finds as regards an annual volume for 2016, that the evidence does not show that Gazprom has followed the procedure pursuant to Article 3.2 or, in any event, has done so correctly. ↙

³⁵¹ Exhibit R-84 (T-X 3)

- (3952) As regards an annual volume for 2017, the Tribunal does not find that Gazprom should have correctly followed the procedure pursuant to Article 3.2.
- (3953) The Tribunal agrees with the understanding of Naftogaz that for an application of Article 3.2 to have the effect of reducing the annual volume it must satisfy the purpose of the system established by Article 3.2, that Gazprom quantifies its needs for gas transit providing information of free transport capacity in the GTS before the delivery year, thereby allowing Naftogaz to offer it to other shippers and mitigate the losses it otherwise would suffer if Gazprom does not deliver the minimum volume prescribed in Article 3.1.
- (3954) According to the Tribunal, the procedure implemented by Gazprom has clear deficiencies. The issue of annual minimum volumes was an issue in the Arbitration already from the outset, and at least from the beginning of 2016 it was clear that Naftogaz would claim for underdeliveries also for 2016 and implicitly also for 2017. This notwithstanding, Gazprom did not request application of Article 3.22 until by its letter of 30 December 2016, in which it merely informed Naftogaz of the MAQ confirmed by an independent auditor according to Article 3.2 for both 2016 and 2017, with the caveat that for 2017 the volume may [REDACTED] No auditor report was submitted by the letter; that did not occur until 16 February 2016.
- (3955) As stated above, for 2016 it is clearly too late to invoke Article 3.2 on 30 December 2016. To suggest a reduced volume for 2017 [REDACTED] does not accord well with the purpose and meaning of Article 3.2. Further, Naftogaz has called into question the accuracy of Gazprom's figure for 2017.
- (3956) All in all, the Tribunal does not find that Gazprom has properly applied Article 3.2 for 2017 such that it has effectively achieved a reduction of the annual volume of [REDACTED] according to Article 3.1.

9.9.4 The Tribunal's Conclusions

- (3957) In conclusion, Gazprom's obligation to transit annual volumes is for the years: ✓

2009 120.083 billion m3

2010 110 billion m3³⁵²

[REDACTED]

[REDACTED]

[REDACTED]

9.9.4.1 Gazprom's liability for underdeliveries

(3958) [REDACTED], on whose statements³⁵³ Gazprom relies, states that the reason for not agreeing on specific annual and quarterly volumes for the years after 2011 was that due to dramatic fluctuations in the two years preceding the signing of [REDACTED] in [REDACTED], such volumes could not be forecasted with any degree of accuracy, and that this was also the reason for that [REDACTED] providing that, if the annual volume of gas transited in the years [REDACTED] will be less than [REDACTED], the parties may agree on [REDACTED] further states that [REDACTED] "was the only consequence of transit volumes being less than [REDACTED] [REDACTED]", and that it "was never agreed that there would be a penalty or other financial consequences for Gazprom in such event."

(3959) [REDACTED] is seemingly right that no penalty or other financial consequences were agreed, but that does not necessarily exclude that there may be financial consequences if the annual volume [REDACTED] was not transited. In effect, what he says is that the Parties did not agree ✓

³⁵ [REDACTED] has the figure [REDACTED] bmc for the year 2010. However, the Parties agree that the words "amount up to" gave Gazprom the discretion to deliver any volume between bmc but not less than 110 bmc.

³⁶ [REDACTED] 1 §§ 29 - 32, 34 - 36.

on anything in terms of financial consequences, except [REDACTED]

(3960) Relying on the evidence given by [REDACTED], Gazprom alleges that [REDACTED] was the *only* consequence of the annual transit volumes being lower than the [REDACTED] reflected in Article 3.1.4 (as amended by [REDACTED])

(3961) [REDACTED], the possibilities of [REDACTED] can be seen as a natural consequence of Gazprom transiting less than the annual transit volumes [REDACTED]. The alternative that [REDACTED]. With Naftogaz' words, the [REDACTED] could be seen as "[REDACTED]"

(3962) On the premise that the annual transit volumes are binding, the position of Gazprom, that [REDACTED] should be an exclusive remedy, is contradicted by the requirement that [REDACTED]. It is in effect a claim for a limitation of liability without any agreement recorded in the Contract to the effect that Article 10.1. should be excluded from application.

(3963) In conclusion, the Tribunal does not consider that [REDACTED] excludes Naftogaz from claiming damages.

9.9.4.1.1 Article 10.1

(3964) With reference to the first paragraph of Article 10.1., Gazprom alleges that it has taken all necessary measures for the proper performance of its obligations under the Contract, and that ✓

³⁵⁴ [REDACTED] 1, § 36.

therefore no damages are payable. Gazprom does not in this connection invoke any convincing evidence in support of this allegation. Therefore, the Tribunal rejects this defence.

- (3965) Further, Gazprom, with reference to statements made by [REDACTED] claims that the Parties did not intend that Gazprom would be subject to “*any financial liability*” in the event that the volumes specified in the Contract were not met. In this respect, Gazprom invoked the 2002 Transit Contract and the penalty provision therein, which were not included in the Contract, and what happened in the negotiations that lead to the Contract³⁵⁵. Arguing among other things, that it refused to accept a penalty for underdeliveries, and a “ship-or-pay” clause, as requested by Naftogaz, and that this shows that Gazprom did not agree to undertake a financial liability.
- (3966) It may well be that the 2002 Contract’s provisions were not carried forward to the Contract, that various drafts with penalty provisions similar to those of the 2002 Contract were rejected by Gazprom, and that discussions referred to by [REDACTED] occurred, but the Contract says what it says³⁵⁶, whatever Gazprom now states were its intentions or its understandings³⁵⁷.
- (3967) As concluded above by the Tribunal, the Contract obliges Gazprom to transit minimum volumes, and Article 10.1. sets forth that, if a party is in breach of the obligation to take all necessary measures for the proper performance of the obligations undertaken under the Contract, the party in breach shall compensate the other party for the proven damages caused by such failure.³⁵⁸
- (3968) The letter to which Gazprom refers, which are the same as are dealt with below, cannot be construed to limit Gazprom’s liability for failure to transit minimum volumes of gas. Again, the Contract says what it says.✓

³⁵⁵ [REDACTED] §§ 19 – 25; [REDACTED] 2 §§72 and 130 – 149.

³⁵⁶ [REDACTED] 2 § 134.

³⁵⁷ Different understandings, [REDACTED] 2 §§ 44 – 52; [REDACTED] 2 §§ 37 -39.

³⁵⁸ Gazprom’s arguments about “strict liability” are misplaced as there is no question about strict liability being provided for by Article 10.1.

(3969) Gazprom has further claimed that Article 10.1. does not give Naftogaz any right to claim loss of profit or other indirect loss. Also in this respect, Gazprom refers to [REDACTED] who states that it was his understanding that Gazprom would only be liable under Article 10.1. for what he calls “*direct damage*”, and that it “*cannot*” have been the understanding of Naftogaz that Gazprom was willing to enter into an obligation requiring Gazprom to pay transit fees for underdeliveries.

(3970) These statements are not supported by any other evidence.; they seem to be afterthoughts. They are not convincing.

(3971) In this respect, Gazprom also argues that it would follow from Swedish law that the words “*proven damages*” in Article 10.1. should mean that indirect damage, such as lost profit, was not covered. The Tribunal does not agree.

9.9.4.1.2 Failure to notify and passivity

(3972) The Tribunal will now consider the defence of Gazprom that Naftogaz should have lost its right to damages by reason of its conduct or passivity.

(3973) In essence, Gazprom alleges that Naftogaz has failed to notify Gazprom of its claim and that Naftogaz has failed to pursue the claim.

(3974) Gazprom relies on six letters in support of its contention that Naftogaz never asserted any claim or entitlement to damages for alleged underdeliveries until by its notice of dispute pursuant to Article 12.2 of 25 July 2014: the letters of 15 June 2009, 18 February 2009, 10 November 2011, 19 January 2012, 23 March 2012 and 6 March 2014³⁶⁰. However, there are additional letters from Naftogaz of 11 March 2010, 8 June 2010 and 12 September 2011³⁶¹ which address the issues of underdeliveries.✍

³⁵⁹ [REDACTED] §§ 148 and 149

³⁶⁰ R-20, R-19, and R-23 – R-26.

³⁶¹ C-117, C-118 and C-119.

(3975) In all these letters, Naftogaz complains about underdeliveries and raises the issue of the resulting financial consequences for Naftogaz. In the letters of 18 February 2009, 11 March 2010, 10 November 2011 (in this letter, Naftogaz also refers to repeated requests for rectification), 19 January 2012, 23 March 2012 and 6 March 2014, Naftogaz expressly alleges that the failure by Gazprom to transit contractual volumes constitutes breach of contract. However, in none of the letters, Naftogaz makes an express claim for damages.

(3976) In the letter of 15 June 2009, only about six months after the signing of the Contract, Naftogaz suggested an amendment to the Contract to the effect that effectively a “ship-or-pay”³⁶² clause should be added to the Contract. On 9 December 2009, Naftogaz sent a draft [REDACTED], which contained a penalty for underdeliveries³⁶³. Both these suggestions were rejected by Gazprom, which may be understandable, not least in view of the short time that had passed since the signing of the Contract, as it is understandable that Naftogaz did not at that time make a reservation regarding a damages claim. Opposite to what Gazprom claims, these suggestions rather indicates that at the time Naftogaz had the view that there was an obligation of minimum transit volumes and that Naftogaz pursued its claim in this respect. These suggestions can be understood as an effort to introduce a stricter regime, as concerns both the introduction of a guaranteed obligation and of remedies, to force Gazprom to adhere to the alleged contractual minimum transit volumes, rather than an effort to introduce an obligation of minimum transit volumes. In any event, they cannot be taken as evidence for that Naftogaz had the understanding that the Contract did not contain a minimum transit volume obligation, nor for that Gazprom could have been given the impression that Naftogaz did not make a claim that there was such obligation.

(3977) As regards the other letters, they clearly show that Naftogaz considered the Contract to impose on Gazprom an obligation of transit of minimum volumes and, as concerns the letters of 10 ✓

³⁶² It is not in dispute that in the negotiations a “ship-or-pay” clause was raised and that such clause was not included in the final version of the Contract. The fact that the Parties did not agree on a “ship-or-pay” clause does not mean that Article 3.1 of the Contract could not be a binding minimum transit obligation of Gazprom.

³⁶³ C-115.

(15?) November 2011, 19 January 2012, 23 March 2012 and 6 March 2014, that Naftogaz considered that Gazprom was in breach of such obligation. In the letter of 25 July 2014 under Article 12.2. Naftogaz expressly raised its claim for damages. Moreover, in the letter of 19 January 2012, Naftogaz expressed that it reserved “*all of its rights with respect to possible actions in accordance with the agreed contracts*”.

(3978) The Tribunal agrees with Naftogaz, in summary, that absent any express statutory support (which there is none for claims of the nature dealt with here), or contractual duty to the effect that a claim must be raised within a specific period of time, the regular period of ten years for prescription will apply³⁶⁴. This is qualified by general principles of Swedish law that a party may lose its rights through passivity, where the party knows that the other party has been influenced to behave in a certain manner in reliance on a legal assessment that is incorrect, or when a party has given the other party the impression that the first party has relinquished its right, or when a party for a very long period omits to assert its right, ref. for example NJA 2002 p 630 and references therein³⁶⁵.

(3979) The relevant question here is then, if there is support for the view of Gazprom that Gazprom had reasons to believe that Naftogaz did not intend to pursue a claim for damages. And further, if that belief, if it existed, had in any way impacted on Gazprom business activities.

(3980) The historical relationship between the two states, and between the parties to the Contract, and how various issues have been handled in the past, must be taken into account when assessing the events from mid-2009, and whether or not Naftogaz should be considered to have relinquished a damages claim. The evidence shows that the relationship has not been formalistic but rather pragmatic in line with the past practices from before January 2009. The letters from Naftogaz are not formal or “*legalistic*” in style or content. This changed, however, after the crises in April 2014. ✓

³⁶⁴ NJA 2002 p. 630.

³⁶⁵ CI-119

(3981) Has Naftogaz' conduct in requesting amendments to the Contract in its letter of 15 June 2009 and its suggested draft [REDACTED] with penalty provisions that would have entitled Naftogaz to payments of transit fees for volumes of gas not transited, without mentioning that there was an existing claim, or the reference to Article 3.1.4. and [REDACTED] had the effect that Gazprom had reasons to believe that Naftogaz did not consider itself entitled to compensation for alleged underdeliveries? The Tribunal does not find that to be the case.

(3982) In the opinion of the Tribunal, these circumstances from 2009 could not reasonably change Gazprom's perception of Naftogaz' position regarding transit volumes, since the issue was kept alive by Naftogaz' subsequent repeated expressed concerns regarding the low volumes transited, and the resulting financial consequences for Naftogaz and by Naftogaz' claim that Gazprom was in breach, which Naftogaz also stated in the letter of 6 March 2014 in which Naftogaz referred to [REDACTED]

(3983) Gazprom has also referred to two letters of 7 April 2006³⁶⁶ claiming that they show that under the 2002 Contract Naftogaz was "*prompt*" to demand compensation on account of underdeliveries, against which Gazprom was justified in concluding that Naftogaz' failure to make "*prompt*" claims for compensation implied that it had waived any rights it may have had. These two letters claimed contractual penalties for underdeliveries in 2003 and 2004 some two to three years back, respectively. The Tribunal makes the observation that the claim was for contractual penalties, which in the opinion of the Tribunal is clearly distinguishable from a damages claim. The Tribunal does not find that these two letters imply that Naftogaz should have waived anything.

(3984) Gazprom has also claimed that it has acted in reliance on the fact that Naftogaz was not making a claim of compensation when [REDACTED] ✓

³⁶⁶ R-51 and R-52

██████████, as well as agreeing to relax certain “take-or-pay” claims under the Supply Contract as part of an overall package. According to Gazprom, Gazprom would not have provided such assistance to Naftogaz, had it known that Naftogaz intended to claim compensation for underdeliveries. Gazprom relies in this respect on the testimony of ██████████⁶⁷.

(3985) As ██████████ states, the concessions were made because Naftogaz did not have financial resources to purchase the volumes of gas agreed under the Supply Contract and to meet its “take-or-pay” obligations under the Supply Contract. According to ██████████ ██████████ ██████████ for the reason that Naftogaz suffered from liquidity problems and was unable to pay for the gas supplies. Further as ██████████ states, the solution that was eventually negotiated, including after discussions between the Russian and Ukrainian prime ministers, was that Gazprom would forego claims against Naftogaz in respect of failure to meet the “take-or-pay” obligation for 2009, 2010 and 2011, which must be considered to be a significant concession. In the light of these statements, it is fair to say that the concessions also served a self-interest of Gazprom.

(3986) It could well be true what Gazprom claims now, but it could perhaps also be the opposite. Facing a possible claim, Gazprom perhaps thought it feasible to divert a claim this way as the concessions largely addressed the problems that Naftogaz had told Gazprom that it had.

(3987) Gazprom’s argument in this respect is a proposition with many facets.

(3988) The notion, that what Naftogaz intended at the time when Gazprom made the concessions would have been decisive for Gazprom’s willingness to make the concessions, is problematic. First, Gazprom, through ██████████, could not with certainty today say what Gazprom would have done, if Gazprom knew at the time that Naftogaz had intentions to bring a claim for damages. The motives for agreeing to make the concessions were not altruistic or necessarily entirely commercial, as would seem to follow from the involvement of the prime ministers. Second, to have intentions is a state of mind; Gazprom could of course not know anything about ✓

³⁶⁷ ██████████ §§ 173 – 183

(3991) On the basis that there is no express statutory rule for claims of the nature dealt with here, nor a contractual duty in the Contract to the effect that a claim must be raised within a specific period of time, the Tribunal considers that Naftogaz' letter of 25 July 2014 under Article 12.2 suffices as notification that Naftogaz claims damages. Taking into account the letters of 18 February 2009, 11 March 2010, 10 November 2011, 19 January 2012, 23 March 2012 and 6 March 2014, Gazprom could not have been unaware that Naftogaz considered that the Contract obliged Gazprom to transit minimum annual volumes of gas, and that, from at least 1 November 2011, Naftogaz claimed that Gazprom was in breach of that obligation. Nor could Gazprom, having received these letters, have been given the impression that Naftogaz had waived its right to claim that the Contract obliged Gazprom to transit minimum annual volumes of gas and that Gazprom was in breach of that obligation, or that Naftogaz had waived an entitlement to damages.

(3992) The Tribunal's conclusion is that Naftogaz has not lost its right to claim damages for underdeliveries as a result of an alleged failure to timely put Gazprom on notice of its claim, or as a result of passivity on the part of Naftogaz.

9.9.4.1.3 Mitigation

(3993) Gazprom asserts that Naftogaz has not demonstrated that it has tried to mitigate its damage, and that it is obvious that Naftogaz should have been able to mitigate its alleged loss by cutting costs, i.e. the costs of personnel and other operating expenses. As a result of its failure to do so, Naftogaz cannot be entitled to the damages it claims. In any event, Naftogaz has failed to make required deductions and has failed to mitigate its loss. The amount of its claim should be reduced accordingly.

(3994) Naftogaz claims that it is Gazprom who bears the burden of invocation (Sw. *åberopsbördan*) and the burden of proof (Sw. *bevisbördan*) in all these respects. As Gazprom has not invoked anything except that Naftogaz "obviously" should have been able to cut costs, Gazprom has not fulfilled any of its burdens. Moreover, it is not possible for Naftogaz to defend itself against

Gazprom's abstract allegations. Further, the damaged party is only obligated to take actions to mitigate its losses which are *reasonable* given the relevant circumstances,

(3995) According to Naftogaz, the relevant point in time for determining whether mitigation measures should have been taken is at the time of the breach of contract. As the obligation in Article 3 of the Contract to transit certain volumes of gas is an annual obligation, the breach of contract is only crystallised at the end of the year. It is simply not possible to cut any costs retroactively. When the breach has occurred, it is too late to cut costs relating to Gazprom's failure to deliver gas during the year. If Gazprom had been of the opinion that Naftogaz should have cut its costs for future time periods, Gazprom should have informed Naftogaz that it did not intend to transit the agreed volumes for such time periods, which it did not³⁶⁹. Naftogaz fails to see how Naftogaz could mitigate its losses by cutting costs in relation to a future breach of contract which Naftogaz was not even aware would occur. For future periods, Naftogaz has been compelled to organise itself to have capacity and readiness to transit the volumes of gas that Gazprom could contractually require Naftogaz to transit. Naftogaz is not allowed to sell unused capacity to others or limit its personnel for such future time periods. On the contrary, the corollary to Gazprom's obligation to deliver specific quantities of Natural Gas for transit is an obligation for Naftogaz to reserve the corresponding capacity in its transmission network for Gazprom, and to make all arrangements necessary to fulfil such obligation. Moreover, it would have been factually impossible for Naftogaz to sell any unused capacity to others.

(3996) The only costs which Gazprom has suggested might have been saved are costs relating to Naftogaz' personnel. It has not been reasonable for Naftogaz in the current situation to cut such costs. Naftogaz is not in a position to hire and dismiss its personnel during different time periods based on speculations as to whether Gazprom would fulfil its obligations in the future.

(3997) The Tribunal is convinced by the arguments of Naftogaz, and thus, rejects Gazprom's objection regarding mitigation. ✓

2, paragraph 55

9.9.5 Naftogaz' claim for compensation for underdeliveries

9.9.5.1 Introduction

(3998) There is no disagreement about the principles on how to calculate Naftogaz' losses. The amount of fees that Gazprom would have paid if it had transited the minimum volumes that the Contract obliges Gazprom to transit (the underdelivered volumes of gas), less the revenues that Naftogaz has in fact received under the Contract, less all costs that Naftogaz has saved as a result of the underdeliveries. The issue between the parties is how to determine the costs that Naftogaz has saved.

(3999) Naftogaz has had a number of alternative claims depending on how the price for gas has been determined in the Supply Arbitration and from when such price shall be applicable.

(4000) Nor is there any disagreement about the minimum volumes required by the Contract, except for 2016 and 2017, or the actual volumes transited.

9.9.5.2 The calculation of Naftogaz' losses

(4001) As a result of the rejection by the Tribunal of Naftogaz' claims for a replacement of Article 8 or revision of the tariff on all grounds invoked by Naftogaz, the transit fees shall be the prevailing tariff fees, which then shall be used to calculate the amount of fees that Gazprom should have paid in the event that Gazprom delivered for transit the minimum volumes of gas according to the Contract.

(4002) The cost items which the Parties have argued about are: the volume of fuel gas saved, costs of royalties (i.e. tax) alleged to be saved and VAT costs alleged to be additionally incurred.

(4003) There is no dispute between the Parties regarding the amount of gas actually delivered for transit or the transit fee (in the case that revision has been rejected).

9.9.5.2.1 Fuel gas

(4004) As a result of the outcome of the Supply Arbitration, there is no issue regarding the fuel gas price. √

- (4005) The issue to be dealt with here is how to calculate the volumes of fuel gas saved. The Experts have presented a number of reports addressing models to calculate the consumption of fuel gas, and they argue about which is the better model.³⁷⁰ They have “crystallised” their choices to two models, which they call “final specifications” of the relationship between fuel gas consumption and gas transit: “Alternative Equation 4” (suggested by Dr. Moselle³⁷¹) and “Total Flow” (suggested by Dr. Hesmondhalgh³⁷²). A principle difference between the two is that Alternative Equation 4 model does not include domestic production which the Total Flow model does; as follows from the name the Total Flow model includes all gas flowing through the Ukrainian gas transportation system.
- (4006) Dr. Hesmondhalgh has also suggested an additional model being an average of the two “Alternative Equation 4” and “Total Flow” models.³⁷³ Dr. Moselle does not consider averaging of the two models appropriate because he finds his Alternative Equation 4 better.³⁷⁴
- (4007) The economic effect of the choice of model on the underdeliveries claim is significant.
- (4008) The task for the Tribunal is now to determine which of the models suggested by the Experts most reliably represents the relationship between fuel gas consumption and transit volumes.
- (4009) There is no dispute regarding the science as to the relationship between fuel gas consumption and transit volumes, or that, for the purposes of calculating fuel gas savings, the relationship between fuel gas consumption and transit volumes is not linear.³⁷⁵ ↵

³⁷⁰ Dr. Hesmondhalgh “Brattle 5, Brattle 6, Brattle 7 and Brattle 8, and Dr. Moselle “Fourth Expert Report”, “Fifth Expert Report” and “Sixth Expert Report”. In addition, they have each submitted a Memorandum, Dr. Hesmondhalgh of 6 September 2017 and Dr. Moselle of 25 September 2017. They have also exchanged three emails on the matter, Exhibits BM-138, -139 (with a memorandum of Dr. Hesmondhalgh –the “17 July Hesmondhalgh Memorandum”) and -141. A correction of the interest calculation in the “17 July Hesmondhalgh Memorandum” was submitted by Naftogaz on 17 August 2017.

³⁷¹ Moselle 3, Section 5.

³⁷² Brattle 8, Section III.

³⁷³ Brattle 7.

³⁷⁴ The Moselle Memorandum of 25 September 2017, paragraph 2.3.

³⁷⁵ Gazprom’s Reply Submission on the Fuel Gas Issue of 22 March 2017, § 13; Brattle 5 §§ 23 – 2; and Naftogaz’ Submission of 3 May 2017, paragraphs (9) – (12).

- (4010) The Experts agree on a number of areas (mechanics of calculations, data of fuel gas consumption and gas flows in the Ukrainian pipe line system and required, adjustments to this data, and measures to compare model performance, and that the Moselle III model should not be used) and on all arithmetic aspects of the analyses³⁷⁶, and that all calculations are arithmetically correct³⁷⁷. The remaining disagreement is which of the two models should be used.
- (4011) The Experts have used two procedures to compare the two models, “goodness- of-fit” (“the extent to which values predicted by a model differ from observed values”) and “robustness” (“how sensitive a model is to the data used to estimate it”). They have also discussed the relevance of the differences between the models regarding hypothesis testing (“significance of coefficients”).³⁷⁸
- (4012) The Experts agree that the Alternative Equation 4 model performs better than the Total Flow model from a “goodness-for-fit” perspective³⁷⁹, whereas the Parties disagree regarding which model is preferable from a robustness perspective, with Dr. Hesmondhalgh preferring the Total Flow model, and Dr. Moselle preferring the Alternative Equation 4 model. Further, it seems to the Tribunal that the Total Flow model has better results than the Alternative Equation 4 model³⁸⁰ regarding significance.
- (4013) The disagreements seem to boil down to statistical significance (the hypotheses testing), what can be considered a standard statistical analysis, and the result of the robustness tests.
- (4014) However, the Tribunal realizes that it cannot sensibly delve deeply into the highly technical arguments in relation to statistical methodologies, and the differences between the methods addressed in the Expert reports, to decide on the avoided fuel gas consumption. ✓

³⁷⁶ Brattle 8, Sections II and IV.

³⁷⁷ The Brattle memorandum of 6 September, and the Moselle memorandum of 25 September 2017, paragraph 3.1.

³⁷⁸ The meaning of these concepts is explained for example in Appendix A (“goodness-for-fit”) and Appendix B (hypothesis testing) of Moselle 6, and in Brattle 7, Section IV C (robustness) and Brattle 7, Section III B 1(hypothesis testing)

³⁷⁹ Brattle 8, paragraph 24 and Table 2, and the Moselle memorandum of 25 September 2017, paragraph 2.4.

³⁸⁰ Brattle 8, Section IV A. and table 2, and the Moselle Memorandum of 25 September 2017, paragraphs 5.2 – 5.5.

(4015) Instead, Naftogaz has suggested that the Tribunal may simply prefer the result which is closest to the Parties' agreed approximation of actual fuel gas consumption in the Transit Contract, based on their joint experience of running the Ukrainian GTS since operations started in Soviet times, i.e. 3 % (based on an assumption of a linear relationship).³⁸¹ The Tribunal is not convinced that this method, although in a sense attractive, is appropriate in view of the reports of the Experts.

(4016) Notwithstanding the limitations for the Tribunal in making an informed determination based on the technical arguments of the Experts, it is clear to the Tribunal that both of the models suggested by the Experts have uncertainties as to estimating the volumes of fuel gas saved, and that each model has its own distinctive uncertainties. In these circumstances, the Tribunal considers that an average of the two models makes sense. In this respect, the Tribunal notes that Dr. Moselle's objection to averaging the results of the two models is not of a principle nature, and that he himself has made calculations of the average of his models II and III.³⁸² There is no other evidence that would show that using an average is not appropriate.

(4017) The differences of the models in financial terms are shown by figures calculated by the Experts:

Under-deliveries claim for 2009-2016 (USD million)

	Alternative Equation 4	Total Flows model	Average of Alternative Equation 4 and Total Flows model
Under-delivery claim without VAT gross-up	3,208	3,973	3,591
Under-delivery claim with VAT gross-up	3,876	4,809	4,343

Source: Exhibit BM-142 – 17 August 2017 Naftogaz Submission.³⁸³

³⁸¹ Naftogaz' Submission of 3 May 2017, paragraph (12).

³⁸² Moselle 6, paragraph 6.8 and table 8, and also Brattle 7, paragraph 115.

³⁸³ These figures are incorrectly based on the original Contract Price under the Supply Contract, but does not change the Tribunal's conclusion.

(4018) There is nothing in this table that would contradict a conclusion that using an average is fair.

(4019) In conclusion, the Tribunal decides that the volume of saved gas from lower transit volumes shall be calculated by the average result of the two models Alternative Equation 4 and Total Flow.

9.9.5.2.2The Royalty Tax

(4020) The Parties now agree that the royalty tax is a cost savings that shall be deducted from the lost revenues of Naftogaz. The royalties for transit of natural gas were abolished as of 1 January 2016. As a consequence, from that date VAT became payable on gas transit instead of royalties.

9.9.5.2.3The VAT Issue

(4021) Gazprom has in its written submission of 10 February 2017 objected to Naftogaz' claim for VAT as part of Naftogaz' damages claim for underdeliveries asserting that this additional claim has been made too late. However, the Tribunal has not found that Gazprom has made a request for a dismissal. The Tribunal therefore does not consider the issue of dismissal, and, thus, will consider the VAT claim on the merits.

(4022) The issue is whether damages awarded Naftogaz for underdeliveries shall attract VAT in accordance with the new legislation taking effect as of 1 January 2016, according to which "*the supply of services, where the place of supply of such services is located in the customs territory of Ukraine*", are subject to VAT at 20 %. As regards underdeliveries before 1 January 2016, Naftogaz claims that since the award would be issued after 1 January 2016, after which date Ukrainian VAT legislation had changed, VAT would be payable on any damages relating to such claim, as a result of the date of the award.

(4023) Naftogaz argues that, for the purpose of the Tax Code, the term "*supply of services*" includes *inter alia* establishment of "*an arrangement to refrain from certain action [...]*", and that Naftogaz' service to Gazprom includes e.g. the obligation to refrain from providing pipeline

capacities and transit services to third parties to enable Gazprom to utilize that capacity. Naftogaz further argues that any payment for such Naftogaz service, whether direct or indirect as damages, is therefore subject to VAT under the new VAT regime to the extent the taxable event occurred after 1 January 2016.

(4024) The Tribunal is not convinced by this line of thought.

(4025) In the opinion of the Tribunal, the damages are compensation for losses suffered by Naftogaz for the failure by Gazprom to deliver gas for transit services whether prior to or after 1 January 2016 in breach of Gazprom's obligation to transit minimum volumes of gas through Ukraine. The damages are calculated as the lost revenues in form of fees that would have been payable by Gazprom. The damages are not for an alleged service provided by Naftogaz to refrain from providing pipeline capacity to third parties. This is not how Naftogaz has presented its claim in the Arbitration, and that is not how Naftogaz has calculated its losses; a claim based on such alleged service would have had to be calculated differently, by reference to the lost income from fees that would have been paid by third parties for volumes of gas that they would have transited. Moreover, the service that Naftogaz shall provide to Gazprom under the Contract is to transit gas for Gazprom through the Ukrainian GTS. The Contract does not include any obligation of Naftogaz to provide the service to Gazprom to refrain from providing pipeline capacities and transit services to third parties, nor any payment for any such service. This is different from the obligation that within the minimum volumes of transit of gas Naftogaz had to reserve capacity for Gazprom. There is no "*establishment of an arrangement to refrain from certain action [...]*". Thus, in the view of the Tribunal, the amount awarded is for damages for lost profit, and is not a payment for services rendered.

(4026) The Tribunal has found that Gazprom has convincingly established that under Ukrainian law compensation for loss of profit does not attract VAT.³⁸⁴

³⁸⁴ For example, Gazprom's Rebuttal on the Royalty Issue, §§ 36 and 37 with footnotes 26 – 30.

(4027) As the Tribunal has found that the payment for Gazprom's failure to deliver for transit the minimum volumes of gas which Gazprom were obliged to deliver is to characterize as damages for lost profit and not for services rendered, Naftogaz claim for compensation for VAT must fail.

9.9.5.3 Naftogaz' Interest Claim

(4028) In relation to its claims for damages for alleged under-deliveries, Naftogaz claims interest according to Sections 3 and 6 of the Swedish Interest Act from and including 2 January 2010, and from certain other due dates, being two days from and including the day on which Naftogaz claims that Gazprom's obligation to deliver gas for transit should have been fulfilled³⁸⁵, or, in the alternative, according to Sections 4 and 6 of the Swedish Interest Act from 26 August 2014 (30 days after Naftogaz sent its "*Notice of Disputes*" of 25 July 2014³⁸⁶), or 16 October 2014 (the day of Naftogaz' Request for Arbitration)³⁸⁷. At the latest, Naftogaz claims interest from the date of the Award.

(4029) Gazprom denies that Naftogaz is entitled to interest on its claims as pleaded. According to Gazprom, in respect of Naftogaz' claims for interest pursuant to Sections 3 and 6 of the Swedish Interest Act, these claims should be rejected because a due date has not been determined in advance as required by Section 3, and, in particular, there is no support in Contract for the assertion that any damages claims are due and payable on the first business day of each subsequent year, as apparently claimed by Naftogaz. Further, according to Gazprom, interest cannot be claimed from 26 August 2014 in reliance upon the "*Notice of Disputes*", since that notice did not contain a demand for payment; the same applies to interest claimed from 16 October 2014 in reliance upon the Request for Arbitration, since the Request for Arbitration did not contain a demand for payment; and interest from 4 May 2015 in reliance upon the Statement of

³⁸⁵ Being no later than on 31 December each year, thus 3 January 2011, 3 January 2012, 2 January 2013, 2 January 2014, 2 January 2015, 2 January 2016, 2 January 2017 and 2 January 2018; where the minimum volume obligation terminated at some other point in time during the year, the second day, or, when not a "business day", the "first business day", after the last day of the month when the minimum volume obligation applied. There is no dispute as to what is a "business day".

³⁸⁶ C-5 and C - 124.

³⁸⁷ Or some other dates when claims were made by Naftogaz during the arbitral proceedings, 4 May 2015, 15 February 2016 or 29 August 2016.

Claim, since the Statement of Claim did not contain a demand for payment. Gazprom's primary position is that Naftogaz is not entitled to any interest before the date of the Final Award.

(4030) The Tribunal does not find that Sections 3 and 6 of the Swedish Interest Act are applicable. The Tribunal does not consider that a due date has been established in advance for damages for the failure to fulfil the obligation to deliver minimum volumes of gas. The quote from Wahlin & Herre "*Lagen om Skuldebrev m.m. En kommentar*", 2011. page 304³⁸⁸ does not, in the opinion of the Tribunal, support Naftogaz.

(4031) However, the Tribunal finds that the "*Notice of Dispute*" fulfils the conditions of Section 4 paragraph 3 of the Swedish Interest Act. The "*Notice*" clearly contains a claim for damages, specifies the basis for the claim, being the alleged obligation of Gazprom to deliver for transit certain specified minimum annual volumes, and that the claim is for losses caused by a failure by Gazprom to fulfil its alleged contractual obligations relating to delivery of annual volumes of gas for transit. As to Gazprom's objection that the "*Notice*" does not contain any information regarding volumes transited for 2014 and 2015, the Tribunal finds that the information in the "*Notice*" of 25 July 2014, is what reasonably can be required (Sw. "*skäligen kan begäras*")³⁸⁹, the "*Notice*" being from 2014.

(4032) Thus, interest on amounts of damages for underdeliveries shall commence thirty days from the day of Gazprom's receipt of the "*Notice of Dispute*" *i.e.* on 26 August 2014³⁹⁰.

9.9.6 Conclusion on Naftogaz' Underdeliveries Claim

(4033) In conclusion, based on the above regarding Gazprom's obligation to transit volumes of gas, the prevailing tariff fees, fuel gas volumes, royalty tax, VAT and interest, the Tribunal has determined that Gazprom shall pay to Naftogaz as damages for underdeliveries in the amount set forth under "*The Tribunal's Conclusion as to Quantum following from the above*" ✓

³⁸⁸ CL-103.

³⁸⁹ Gazprom has not made the same objection for 2016.

³⁹⁰ Gazprom has not objected to the 26 August 2014 being the date of receipt of the "*Notice*".

9.10 Gazprom's Counterclaims for Payment in respect of Transit Volumes Allegedly Taken by Naftogaz

(4034) Gazprom refers to Article 10.4 of Contract which states:

"If the Natural Gas delivered to the Ukrainian gas transportation system for transit purposes is taken by ... [Naftogaz], the entire volume of such gas taken shall be documented as gas purchased under Contract for the purchase and sale of natural gas between OAO Gazprom and NAK Naftogaz of Ukraine No. _ of 19 January 2009.

The price of such Gas shall be set in accordance with point 4.3 of article 4 of Contract for the purchase and sale of natural gas between OAO Gazprom and NAK Naftogaz of Ukraine No. _ of 19 January 2009."

(4035) According to Article 4.3 of the Supply Contract, Naftogaz would be obliged to pay a price which is higher than the regular price according to Article 4.1. of the Supply Contract.

(4036) According to Article 4.5 of the Contract, on which Gazprom also relies, Naftogaz is responsible for the fuel gas ("technological gas") for the operation³⁹¹ of the Ukrainian GTS and for any losses of gas delivered by Gazprom for transit.

(4037) The issue is, if, as alleged by Gazprom, Naftogaz without authorisation off-took gas from the volume of gas delivered by Gazprom for transit, with the consequence that Article 10.4. and the increased price according to Article 4.3 of the Supply Contract should apply, or, if, as alleged by Naftogaz, the volume of gas, which was delivered by Gazprom for transit but not off-taken by Gazprom's European customers, was not off-taken by Naftogaz according to Article 10.4., but rather the result of a need of balancing, which meant that the volumes of gas not off-taken by Gazprom's customers during July - November 2014 were accounted for in the acceptance statements for the next month³⁹².

³⁹¹ [REDACTED]

³⁹² As was done for example in Statement 8, R -28

(4038) The Tribunal finds that the evidence³⁹³ supports the position of Naftogaz that the differences in gas volumes during July - November 2014 could not be characterized as unauthorized off-take of gas by Naftogaz that would justify the application of Article 10. 4..

(4039) The Tribunal thus rejects Gazprom's counterclaim.

9.10.1 Gazprom's Counterclaim for Payment in respect of Alleged Overpayments of Transit Fees as from 27 April 2014

(4040) Gazprom claims a refund for the amounts of overpayments it has made as from 27 April 2014 as a result of the adjustment to the transit tariff under Article 8.1 of the Contract necessitated by the revised the price in Article 4.1 of Supply Contract pursuant to the Final Award in the Supply Arbitration. This is because one component of the formula (P_{nj}) for the transit tariff is the price under the Supply Contract. A downward revision of the price in the Supply Contract therefore results, pursuant to the operation of the transit tariff formula, in a downward adjustment to the transit tariff payable by Gazprom from 27 April 2014.

(4041) The Parties are in agreement of the amount, USD 44 million.

(4042) The claim for refund is made as a counterclaim with interest. Interest is claimed as yield interest according to Sections 2 and 5 of the Swedish Interest Act from the date of the day after the date the original payment by Gazprom until the date of the Final Award in the Supply Arbitration, 22 December 2017, and as delay interest according to Sections 3 and 6 of the Swedish Interest Act from and including 23 December 2017.

(4043) Naftogaz has objected to Gazprom's calculation of interest and has asserted that interest on overpayments should be calculated as yield interest from the dates that Gazprom received the refunds, which it eventually was not entitled to, and as delay interest from 23 December 2017³⁹³

³⁹³ [REDACTED] 2, section 10, and TD 4, 57:18 - 25 and 61:4 - 15; [REDACTED] 2, section 6; [REDACTED] 2 §§ 9 and 13, and TD 5, 85: 1- 25, 86: 1 - 25, 88: 1 - 25, and 88: 1- 25; [REDACTED] 2 §§ 54 - 61.

(4044) The Tribunal decides that interest shall accrue as set forth under "The Tribunal's Conclusions as to Quantum following from the above".

9.11 Set-Off

(4045) The Parties are in agreement that the Tribunal shall set-off amounts owing between the Parties pursuant to the Sales Arbitration and this Arbitration. The effect of this is that a single net amount shall be ordered to be paid by one party.

(4046) However, Gazprom has qualified its agreement by inviting Naftogaz to confirm that that the previous declaration of set-off made by Naftogaz in the Supply Arbitration, which was dismissed by the Tribunal, is "revoked", failing which Gazprom has reserved the right to "*make further submissions on this point*". The reason for Gazprom's concern is that Naftogaz should not be able to set-off the same amounts twice. Naftogaz then refused to give such confirmation.

(4047) It appears to the Tribunal as evident that it is not possible to make a set-off with the amount twice. Thus, the Tribunal does not find any reason to proceed with further submissions on this point, in particular not in view of the very late stage of the Arbitration of this "distraction", and disregards the reservation of Gazprom.

(4048) Consequently, the Tribunal will make the agreed set-off.

9.12 The Tribunal's Conclusion as to the Quantum following from the above

(4049) The Tribunal has made the following conclusions and findings that:

(i) Gazprom's obligation to transit annual volumes is for the years:

2009	120.083 billion m3,
2010	110 billion m3,

[REDACTED]

- (ii) the tariff is the prevailing, unamended tariff, applicable from time to time during the years 2009–2017, with due regard to the effect of the revised price for gas decided by the Final Award in the Supply Arbitration of 22 December 2017 on the component (Pnj) of the transit tariff under Article 8.1 of the Transit Contract;
- (iii) fuel gas cost savings to be applied to Naftogaz' claims for underdeliveries shall be calculated by the average result of the two models Alternative Equation 4 and Total Flow;
- (iv) royalty tax shall be a cost savings in the calculation of Naftogaz' claim for underdeliveries until but not including 1 January 2016;
- (v) no amount of VAT shall be included in the amount of damages claimed by Naftogaz for underdeliveries for any period;
- (vi) interest on Naftogaz' damages claim regarding underdeliveries shall not commence on any amount earlier than from and including 26 August 2014, which means that this applies to underdeliveries claimed for the years 2009, 2010, 2011, 2012 and 2013; Naftogaz' damages claim regarding underdeliveries for the years 2014, 2015, 2016 and 2017 shall carry interest from the first business day the year immediately after the year for which there is a underdeliveries claim, i.e. 2 January 2015, 4 January 2016, 2 January 2017 and 2 January 2018, respectively; interest shall be the rate of interest applicable from time to time during the period from these dates according to Section 4, paragraph 3 and Section 6, paragraph 1 of the Swedish Interest Act until full payment is made;
- (vii) interest on Gazprom's claim for overpayment of transit fees shall be calculated as yield interest according to Sections 2 and 5 of the Swedish Interest Act at the applicable rate from time to time for periods when Gazprom has "over-paid" until the date of the Final Award in the Supply Arbitration, i.e. until 22 December 2017, and as delay interest according to Sections 4 and 6 of the Swedish Interest Act at the applicable rate

decimal places. Using data rounded to four decimal places would increase the claim by USD7,983.84.³⁹⁵ In view of the insignificance of the amount, the Tribunal accepts this without any further considerations.

(4052) Based on these conclusions and findings, and the below assumptions³⁹⁶, Dr. Hesmondhalgh and Dr. Moselle have calculated interest on overpayments:

- Interest on negative over-payments is always yield interest i.e. it does not switch to delay interest at any point
- Interest on positive over-payments is yield interest until 22 December 2017 and delay interest thereafter.
- Interest on the payments that Gazprom made but which were returned to it by Naftogaz is calculated for the period between the payment and repayment.
- In terms of when interest begins accruing we have assumed:
 - 27 April 2014 for the payments for the months April to June 2014;
 - 22 August 2014 for under-payment for July 2014;
 - 10 November 2014 for under-payments for the months August to October 2014;
 - The dates on which Gazprom made payments for all other months.

(4053) On this basis, they find that the set off between the Sales Arbitration and between the claims in the Transit Arbitration is as follows: ✕

³⁹⁵ This issue did not arise in the Sales Arbitration because it only has an impact in some months and in none of the months where it has an impact in the Transit Arbitration were there deliveries under the Supply Contract.

³⁹⁶ The Tribunal has accepted these assumptions as refinements of the divergent positions of the Parties.

		Tribunal's Instructions \$
Gazprom's residual claim in the Sales Arbitration	[1]	-2,071,232,274.10
Gazprom's claim in the Transit Arbitration		
Gazprom's capital claim in the Transit Arbitration	[2]	-43,693,395.36
Gazprom's interest claim in the Transit Arbitration	[3]	1,738,690.84
Gazprom's gross claim in the Transit Arbitration	[4] [2]+[3]	-41,954,704.53
Naftogaz's claim in the Transit Arbitration		
Naftogaz's capital claim in the Transit Arbitration	[5]	3,911,539,328.54
Naftogaz's interest claim in the Transit Arbitration	[6]	761,980,312.85
Naftogaz's gross claim in the Transit Arbitration	[7] [5]+[6]	4,673,519,641.40
Naftogaz's residual claim in the Transit Arbitration	[8] [1]+[4]+[7]	2,560,332,662.77

(4054) The Tribunal accepts the calculations of Dr. Hesmondhalgh and Dr. Moselle and concludes that the net amount payable by Gazprom to Naftogaz, principal and interest included, as per 28 February 2018, is USD 2,560,332,662.77. ✕

10. COSTS

10.1 Introduction

(4055) Article 43(4) and (5) of the SCC Arbitration Rules 2010 provide that the Final Award shall (i) include the Costs of the Arbitration, (ii) specify the individual fees and expenses of each member of the Arbitral Tribunal and SCC, and (iii), at the request of a party, apportion the Costs of the Arbitration between the parties, having regard to the outcome of the case and other relevant circumstances.

(4056) Article 44 of the SCC Arbitration Rules provides that, unless otherwise agreed by the parties, the Arbitral Tribunal may in the final award upon the request of a party, order one party to pay any reasonable costs incurred by another party, including costs for legal representation, having regard to the outcome of the case and other relevant circumstances.

(4057) Each Party has requested the Tribunal to order that the other Party bear the Cost of Arbitration and its own costs and expenses, and to order the other Party to pay to it the costs and expenses it has incurred as per the below.

10.2 Naftogaz' claims for costs

(4058) Naftogaz requests the Arbitral Tribunal to render an award ordering Gazprom to compensate Naftogaz for its Costs of Arbitration together with interest pursuant to Section 6 of the Swedish Interest Act (Swedish *räntelagen (1975:635)*) as from the date following the Final Award until full payment is made and, as between the Parties, alone to bear the Arbitrators' fees and expenses and the SCC administrative expenses, and to compensate Naftogaz for any amounts that Naftogaz has paid or will pay to the SCC in relation to the Arbitration including, but not limited to, Naftogaz' part of the advance on costs.

(4059) Naftogaz' costs are based on the amounts invoiced to and paid or payable by Naftogaz. They are presented in the currency actually invoiced to Naftogaz. The costs incurred by Naftogaz have been in EUR. ✓

10.3 Claimant's costs of arbitration

10.3.1 External counsel fees and expenses

(4060) Naftogaz claims costs for external counsel fees and expenses in the amount of EUR 7 103 347.87 [REDACTED]

[REDACTED]	[REDACTED]

Expert witnesses fees and expenses

(4061) Naftogaz claims costs for expert witnesses fees and expenses in the amount of EUR 1 979 841.86 [REDACTED]

[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]

Fact witnesses expenses

(4062) Naftogaz claims costs for fact witnesses expenses in the amount of UAH 4 027 937.19 and EUR 1 331.57 [REDACTED]

[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]

[REDACTED]	[REDACTED]

10.3.2 Own expenses

(4063) Naftogaz claims costs for the expenses incurred by Naftogaz for travel and lodging of its representatives for meetings concerning the Arbitration and attendance at the hearings in the amount of UAH 795 485.36 [REDACTED]

[REDACTED]	[REDACTED]

10.3.3 Own work

(4064) Naftogaz claims compensation for its internal costs, i.e. for the work of Naftogaz' own employees relating to the dispute and loss of time, in the amount of UAH 21 282 294.19. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

10.3.4 Other costs

(4065) Naftogaz claims other costs in the amount of EUR 267 536.49, broken down as follows: *j*

Description	Amount, EUR
Arbitration venue and related costs (Naftogaz' 50% share)	72 559.97
Transcription services, OPUS2 (Naftogaz' 50% share)	85 493.03
Interpretation services, Eurasian (Naftogaz' 50% share)	12 055.90
iPads for the Arbitral Tribunal (Naftogaz' 50% share)	2 003.99
Security services, November-December 2016 hearing, Vesper	95 423.60

10.3.5 Total costs claimed

(4066) In the table below the cost items above are summarized:

Description	Amount
External counsel fees and expenses	EUR 7 103 347.87
Expert witnesses fees and expenses	EUR 1 979 841.86
Fact witnesses expenses	UAH 4 027 937.19 <i>plus</i> EUR 1 331.57
Own expenses	UAH 795 485.36
Own work	UAH 21 282 294.19
Other costs	EUR 267 536.49

(4067) Thus, subject to the update due on 23 February 2018, the total costs claimed by Naftogaz are EUR 9 352 057.79 *plus* UAH 26 105 716.74. 

(4068) On 16 February 2018, Naftogaz specified the above costs it incurred up to and including 16 February 2018.

(4069) Below is an overview of the additional costs claimed after that date and up to and including 23 February 2018.

10.3.6 External counsel fees and expenses

(4070) Naftogaz claims additional costs for external counsel fees and expenses in the amount of EUR 44 022.25 [REDACTED]

[REDACTED]	[REDACTED]

10.3.7 Expert witnesses fees and expenses

(4071) Naftogaz claims additional costs for expert witnesses fees and expenses in the amount of EUR 18 500 [REDACTED]

[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]

10.3.8 Total costs claimed

(4072) The costs specified above should be added to the total costs claimed by Naftogaz as indicated in § 16 of its 16 February 2018 Claim for Costs.

(4073) Thus, the total updated costs claimed by Naftogaz are EUR 9 414 580.04 *plus* UAH 26 105 716.74. ₤

10.3.9 Fees and expenses of the Arbitral Tribunal and of the SCC

(4074) Naftogaz also requests that the Arbitral Tribunal shall order that, as between the Parties, Gazprom alone shall bear the costs of the Arbitral Tribunal and the SCC as they will be determined by the SCC.

10.3.10 Cost allocation

(4075) Regardless of the outcome of the arbitration, Gazprom shall cover all Naftogaz' costs related to Gazprom's belated request for production of the technical implementation agreements between Naftogaz and Ukrtransgaz, which was made negligently or against better knowledge, and ultimately rejected by the Tribunal. Naftogaz has calculated these costs to amount to EUR 27 281.

10.3.11 VAT

(4076) Naftogaz disputes that Gazprom's VAT is eligible for compensation as claimed by Gazprom for certain legal fees.

10.3.12 Currencies

(4077) It seems probable that Gazprom has converted amounts invoiced in other currencies into USD (except for costs payable to the SCC Institute which are stated in EUR). Naftogaz disputes that Gazprom has in fact incurred the costs it claims it have incurred. Naftogaz' costs are based on the amounts invoiced and presented in the currency actually invoiced.

10.4 Gazprom's claim for costs

10.4.1 Gazprom's Costs Submissions dated 16 February 2018

(4078) Gazprom claims in full costs up to 16 February 2016 in the table below, and in more detail a specified separately.

Costs of the Arbitration:

(4079) Gazprom claims reimbursement of the full amount of the advances on costs that it has paid to the SCC Institute, as follows ✓

TOTAL LEGAL FEES			9,628,572.09

Expert/Consultant Fees:

TOTAL EXPERT/CONSULTANT FEES			3,520,603.47

10.5 Gazprom's claim for reimbursement of VAT paid on legal fees incurred

(4080) Gazprom further claims reimbursement of VAT paid on legal fees incurred, as set out separately.

10.6 Total amounts claimed

(4081) In summary, Gazprom claims the following amounts:

In respect of fees paid to the SCC Institute: **EUR 617,200.00**;

In respect of costs of the arbitration, legal fees and expert fees: **USD 13,115,114.07**; and

In respect of VAT: **USD 2,360,720.63**.

10.7 Gazprom's Request for Relief in respect of Costs

(4082) Gazprom asks the Arbitral Tribunal to issue an ORDER that Naftogaz shall make payment to Gazprom as compensation for all costs incurred by Gazprom in these proceedings, in the total amounts of **EUR 617,200** and **USD 15,475,834.70**, and as between the parties all fees and

costs of the Tribunal and of the SCC Arbitration Institute in such amounts as will be finally determined by the Arbitral Tribunal in its Final Award, together with interest on all such amounts in accordance with sections 4 and 6 of the Swedish Interest Act from the date of the award until full payment has been made.

10.8 Response to Naftogaz' Comments regarding Gazprom's Request for Production of the Technical Implementation Agreements

(4083) Gazprom objects to Naftogaz' assertions that this request for production of documents was made "belatedly", "negligently" or "against better knowledge". On the contrary, Gazprom maintains that this request was made as soon as reasonably practicable once Gazprom was made aware of the existence of the documents which were to be the subject of its request, and was fully justified, for the reasons set out in letters to the Tribunal.

10.9 The Tribunal's conclusions as to costs

(4084) Both Parties have argued extensively, with legal and factual arguments, for their views that the other Party shall bear the Costs of the Arbitration and the costs incurred by it.

(4085) The Arbitral Tribunal finds that Naftogaz has succeeded only in part on its claims in the Arbitration, having lost on its claims based on competition and energy law, and based on price revision under Article 8.7 and Section 36 of the Swedish Contracts Act.

(4086) In accordance with Swedish law and practice that each Party would normally bear its own costs if the claimant partly wins, but loses with respect to a substantial part of its claims, the Arbitral Tribunal concludes that it is reasonable that each of the Parties shall bear its own costs, and that the fees and expenses of the Arbitral Tribunal and the SCC shall be borne by the Parties in equal shares.

(4087) The Parties shall be jointly and severally liable to the Arbitrators, the Secretary and the SCC for the Costs Arbitration.✓

11. THE TRIBUNAL'S DECISION

(4088) The Tribunal decides all claims and relief sought in this Arbitration as follows:

TO ORDER

(i) Public Joint Stock Company Gazprom to pay to National Joint Stock Company Naftogaz of Ukraine the amount of USD 2,560,332,662.77 (two billion five hundred and sixty million three hundred and thirty-two thousand six hundred sixty-two US dollars and seventy-seven cents) and interest on any amount of delay in payment after 28 February 2018, at the rate of interest applicable from time to time during the delay according to Section 4, paragraph 3 and Section 6, paragraph 1 of the Swedish Interest Act, until full payment is made.

TO REJECT

- (ii) All Naftogaz' reliefs in its Relief Sought dated 2 February 2018 under 1), 2), 3) and 5.2);
- (iii) Gazprom's relief sought by its 16 February 2018 Submission under 112.1 and 112.2;
- (iv) All the Parties' monetary claims and claims for interest except as included and netted in the amount ordered above;
- (v) All objections as to the jurisdiction of the Tribunal relevant to the Order for payment made by the Tribunal.

TO ORDER

(vi) The Parties jointly and severally to pay the following amounts in accordance with SCC' decision dated 21 December 2017: 

Tore Wiwen-Nilsson

Fee	EUR	450,000.00
Expenses	SEK	1 676.00
Per diem allowance	EUR	500.00

Johan Munck

Fee	EUR	270,000.00
Expenses	SEK	22,532.00
Per diem allowance	EUR	500.00

Jens Rostock-Jensen

Fee	EUR	270,000.00
Expenses	DKK	20,343.56
Per diem allowance	EUR	6,000.00

Secretary of Tribunal Boel Flodgren

Expenses	SEK	678.00
Per diem allowance	EUR	500.00

Stockholm Chamber of Commerce

Administrative fee	EUR	60,000.00 ✎
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The SCC' expenses

Reimbursement of costs to Tore Wiwen-Nilsson and Boel Flodgren EUR 15,136.79

As between the Parties, the abovementioned fees and expenses shall be borne by the Parties 50 per cent each.

Each of the Parties shall bear its own costs.

NOTE

Pursuant to Section 41 of the Swedish Arbitration Act, a party or an arbitrator may bring an action in the District Court against the award regarding the payment of compensation to the arbitrators. Such action must be brought within three months from the date upon which the party received the award, and in the case of an arbitrator, within the same period from the announcement of the award. Where correction, supplementation, or interpretation has taken place in accordance with Section 32 of the Swedish Arbitration Act, the action must be brought by a party within three months from the date upon which the party received the award in its final wording, and in the case of an arbitrator, within the same period from the date when the award was announced in its final wording. Pursuant to Section 43 (3) of the Swedish Arbitration Act, the competent District Court in this case is the District Court of Stockholm (Sw. *Stockholms tingsrätt*).⁷

Place of Arbitration: Stockholm, Sweden

Date: 28 February 2018

The Tribunal



Johan Munck



Jens Rostock-Jensen



Tore Wiwen-Nilsson
Chairman

APPENDICES

Appendix 1: Naftogaz' claims

	VAT in award			Of which, VAT	VAT on award		
	Under-deliveries	Under-payments	Total		Under-deliveries	Under-payments	Total
Principal amounts, \$ mln							
4	200	-	200	-	200	-	200
5	-	12,533	12,533	1,066	-	12,979	12,979
6	309	13,241	13,550	1,066	309	13,686	13,995
7.1	367	11,610	11,978	1,066	367	12,056	12,423
7.2	412	11,289	11,700	1,066	412	11,734	12,146
7.3	475	13,745	14,220	1,066	475	14,191	14,665
7.4	1,045	9,735	10,781	1,066	1,045	10,181	11,226
7.5	1,601	7,619	9,220	1,066	1,601	8,065	9,665
7.6	2,945	9,018	11,963	1,066	2,945	9,463	12,408
8	4,045	7,112	11,156	1,066	4,045	7,557	11,601
9	4,655	3,393	8,048	507	4,655	3,608	8,263
10	4,928	-	4,928	-	4,928	-	4,928

Appendix 2: Revised or replaced tariffs for 2010 – 2015

- 1) If the Tribunal revises or replaces the tariff with effect from 1 January 2010 or any date thereafter prior to 1 January 2011:**

From 1 January 2010, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission system of Ukraine	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars per 1000 cubic meters, VAT excluded	US Dollars per 1000 cubic meters, VAT excluded	percent
Beregovo		34,27	2,97%
Valuiki	10,51	-	-
Hrebenyky (ATI)		19,57	2,00%
Hrebenyky (SHDKRI)		24,28	2,31%
Drozdovichi		26,53	2,46%
Kobrin	10,51	-	-

Mozyr	10,51	-	-
Oleksiyivka		35,43	3,05%
Orlovka		26,13	2,43%
Sudzha 1200	10,51	-	-
Sudzha 1400	10,51	-	-
Tekovo		32,17	2,83%
Uzhgorod		37,68	3,20%

From 1 January 2011, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission system of Ukraine	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars per 1000 cubic meters, VAT excluded	US Dollars per 1000 cubic meters, VAT excluded	percent
Beregovo		35,56	2,96%
Valuiki	10,02	-	-
Hrebenyky (ATI)		20,59	1,99%
Hrebenyky (SHDKRI)		25,39	2,30%
Drozdovichi		27,68	2,45%
Kobrin	10,02	-	-

Mozyr	10,02	-	-
Oleksiyivka		36,74	3,04%
Orlovka		27,27	2,43%
Sudzha 1200	10,02	-	-
Sudzha 1400	10,02	-	-
Tekovo		33,42	2,83%
Uzhgorod		39,03	3,19%

From 1 January 2012, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		30,69	2,96%
Valuiki	8,93	-	-
Hrebenyky (ATI)		17,67	1,99%
Hrebenyky (SHDKRI)		21,85	2,30%
Drozdovichi		23,84	2,45%
Kobrin	8,93	-	-
Mozyr	8,93	-	-
Oleksiyivka		31,71	3,04%
Orlovka		23,48	2,43%
Sudzha 1200	8,93	-	-
Sudzha 1400	8,93	-	-
Tekovo		28,82	2,83%
Uzhgorod		33,70	3,19%

From 1 January 2013, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		28,94	2,96%
Valuiki	8,70	-	-
Hrebenyky (ATI)		16,58	1,99%
Hrebenyky (SHDKRI)		20,54	2,30%
Drozdovichi		22,44	2,45%
Kobrin	8,70	-	-
Mozyr	8,70	-	-
Oleksiyivka		29,92	3,04%
Orlovka		22,10	2,43%
Sudzha 1200	8,70	-	-
Sudzha 1400	8,70	-	-
Tekovo		27,17	2,83%
Uzhgorod		31,81	3,19%

From 1 January 2014, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		26,72	2,96%
Valuiki	8,47	-	-
Hrebenyky (ATI)		15,16	1,99%
Hrebenyky (SHDKRI)		18,87	2,30%
Drozdovichi		20,63	2,45%
Kobrin	8,47	-	-
Mozyr	8,47	-	-
Oleksiyivka		27,63	3,04%
Orlovka		20,32	2,43%
Sudzha 1200	8,47	-	-
Sudzha 1400	8,47	-	-
Tekovo		25,06	2,83%
Uzhgorod		29,40	3,19%

From 1 January 2015, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		14,48	2,96%
Valuiki	3,72	-	-
Hrebenyky (ATI)		8,50	1,99%
Hrebenyky (SHDKRI)		10,42	2,30%
Drozdovichi		11,33	2,45%
Kobrin	3,72	-	-
Mozyr	3,72	-	-
Oleksiyivka		14,95	3,04%
Orlovka		11,17	2,43%
Sudzha 1200	3,72	-	-
Sudzha 1400	3,72	-	-
Tekovo		13,62	2,83%
Uzhgorod		15,86	3,19%

- 2) If the Tribunal revises or replaces the tariff with effect from 1 January 2011 or any date thereafter prior to 1 January 2012 (e.g. 1 February, 3 September or 6 October 2011):

From 1 January 2011, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
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system of Ukraine	US Dollars per 1000 cubic meters, VAT excluded	US Dollars per 1000 cubic meters, VAT excluded	percent
Beregovo		39,04	2,96%
Valuiki	11,39	-	-
Hrebenyky (ATI)		22,47	1,99%
Hrebenyky (SHDKRI)		27,79	2,30%
Drozdovichi		30,32	2,45%
Kobrin	11,39	-	-
Mozyr	11,39	-	-
Oleksiyivka		40,34	3,04%
Orlovka		29,87	2,43%
Sudzha 1200	11,39	-	-
Sudzha 1400	11,39	-	-
Tekovo		36,67	2,83%
Uzhgorod		42,87	3,19%

From 1 January 2012, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		33,82	2,96%
Valuiki	10,21	-	-
Hrebenyky (ATI)		19,36	1,99%
Hrebenyky (SHDKRI)		24,00	2,30%
Drozdovichi		26,21	2,45%
Kobrin	10,21	-	-
Mozyr	10,21	-	-
Oleksiyivka		34,96	3,04%
Orlovka		25,81	2,43%
Sudzha 1200	10,21	-	-
Sudzha 1400	10,21	-	-
Tekovo		31,75	2,83%
Uzhgorod		37,17	3,19%

From 1 January 2013, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		32,02	2,96%
Valuiki	9,99	-	-
Hrebenyky (ATI)		18,22	1,99%
Hrebenyky (SHDKRI)		22,65	2,30%
Drozdovichi		24,76	2,45%
Kobrin	9,99	-	-
Mozyr	9,99	-	-
Oleksiyivka		33,11	3,04%
Orlovka		24,38	2,43%
Sudzha 1200	9,99	-	-
Sudzha 1400	9,99	-	-
Tekovo		30,05	2,83%
Uzhgorod		35,22	3,19%

From 1 January 2014, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic me- ters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		29,74	2,96%
Valuiki	9,79	-	-
Hrebenyky (ATI)		16,76	1,99%
Hrebenyky (SHDKRI)		20,92	2,30%
Drozdovichi		22,91	2,45%
Kobrin	9,79	-	-
Mozyr	9,79	-	-
Oleksiyivka		30,77	3,04%
Orlovka		22,55	2,43%
Sudzha 1200	9,79	-	-
Sudzha 1400	9,79	-	-
Tekovo		27,88	2,83%
Uzhgorod		32,75	3,19%

From 1 January 2015, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic me- ters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		17,54	2,96%
Valuiki	4,69	-	-
Hrebenyky (ATI)		10,24	1,99%
Hrebenyky (SHDKRI)		12,58	2,30%
Drozdovichi		13,70	2,45%
Kobrin	4,69	-	-
Mozyr	4,69	-	-
Oleksiyivka		18,12	3,04%
Orlovka		13,50	2,43%
Sudzha 1200	4,69	-	-
Sudzha 1400	4,69	-	-
Tekovo		16,50	2,83%
Uzhgorod		19,23	3,19%

- 3) **If the Tribunal revises or replaces the tariff with effect from 1 January 2012 or any date thereafter prior to 1 January 2013**

From 1 January 2012, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry point	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		40,40	2,96%
Valuiki	11,97	-	-
Hrebenyky (ATI)		23,20	1,99%
Hrebenyky (SHDKRI)		28,72	2,30%
Drozdovichi		31,35	2,45%
Kobrin	11,97	-	-
Mozyr	11,97	-	-
Oleksiyivka		41,76	3,04%
Orlovka		30,88	2,43%
Sudzha 1200	11,97	-	-
Sudzha 1400	11,97	-	-
Tekovo		37,94	2,83%
Uzhgorod		44,39	3,19%

From 1 January 2013, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		37,67	2,96%
Valuiki	11,51	-	-
Hrebenyky (ATI)		21,52	1,99%
Hrebenyky (SHDKRI)		26,70	2,30%
Drozdovichi		29,17	2,45%
Kobrin	11,51	-	-
Mozyr	11,51	-	-
Oleksiyivka		38,94	3,04%
Orlovka		28,73	2,43%
Sudzha 1200	11,51	-	-
Sudzha 1400	11,51	-	-
Tekovo		35,36	2,83%
Uzhgorod		41,41	3,19%

From 1 January 2014, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		34,39	2,96%
Valuiki	11,05	-	-
Hrebenyky (ATI)		19,46	1,99%
Hrebenyky (SHDKRI)		24,25	2,30%
Drozdovichi		26,53	2,45%
Kobrin	11,05	-	-
Mozyr	11,05	-	-
Oleksiyivka		35,56	3,04%
Orlovka		26,12	2,43%
Sudzha 1200	11,05	-	-
Sudzha 1400	11,05	-	-
Tekovo		32,25	2,83%
Uzhgorod		37,84	3,19%

From 1 January 2015, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		19,13	2,96%
Valuiki	5,19	-	-
Hrebenyky (ATI)		11,14	1,99%
Hrebenyky (SHDKRI)		13,71	2,30%
Drozdovichi		14,93	2,45%
Kobrin	5,19	-	-
Mozyr	5,19	-	-
Oleksiyivka		19,76	3,04%
Orlovka		14,71	2,43%
Sudzha 1200	5,19	-	-
Sudzha 1400	5,19	-	-
Tekovo		17,99	2,83%
Uzhgorod		20,99	3,19%

- 4) **If the Tribunal revises or replaces the tariff with effect from 1 January 2013 or any date thereafter prior to 1 January 2014**

From 1 January 2013, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		36,69	2,96%
Valuiki	10,90	-	-
Hrebenyky (ATI)		21,06	1,99%
Hrebenyky (SHDKRI)		26,08	2,30%
Drozdovichi		28,47	2,45%
Kobrin	10,90	-	-
Mozyr	10,90	-	-
Oleksiyivka		37,93	3,04%
Orlovka		28,04	2,43%
Sudzha 1200	10,90	-	-
Sudzha 1400	10,90	-	-
Tekovo		34,46	2,83%
Uzhgorod		40,32	3,19%

From 1 January 2014, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		33,64	2,96%
Valuiki	10,51	-	-
Hrebenyky (ATI)		19,14	1,99%
Hrebenyky (SHDKRI)		23,79	2,30%
Drozdovichi		26,01	2,45%
Kobrin	10,51	-	-
Mozyr	10,51	-	-
Oleksiyivka		34,79	3,04%
Orlovka		25,61	2,43%
Sudzha 1200	10,51	-	-
Sudzha 1400	10,51	-	-
Tekovo		31,57	2,83%
Uzhgorod		37,00	3,19%

From 1 January 2015, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		19,70	2,96%
Valuiki	5,37	-	-
Hrebenyky (ATI)		11,46	1,99%
Hrebenyky (SHDKRI)		14,10	2,30%
Drozdovichi		15,36	2,45%
Kobrin	5,37	-	-
Mozyr	5,37	-	-
Oleksiyivka		20,34	3,04%
Orlovka		15,14	2,43%
Sudzha 1200	5,37	-	-
Sudzha 1400	5,37	-	-
Tekovo		18,52	2,83%
Uzhgorod		21,60	3,19%

- 5) **If the Tribunal revises or replaces the tariff with effect from 1 January 2014 or any date thereafter prior to 1 January 2015**

From 1 January 2014, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		38,13	2,96%
Valuiki	11,13	-	-
Hrebenyky (ATI)		21,95	1,99%
Hrebenyky (SHDKRI)		27,14	2,30%
Drozdovichi		29,61	2,45%
Kobrin	11,13	-	-
Mozyr	11,13	-	-
Oleksiyivka		39,41	3,04%
Orlovka		29,17	2,43%
Sudzha 1200	11,13	-	-
Sudzha 1400	11,13	-	-
Tekovo		35,82	2,83%
Uzhgorod		41,88	3,19%

From 1 January 2015, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		21,03	2,96%
Valuiki	5,79	-	-
Hrebenyky (ATI)		12,22	1,99%
Hrebenyky (SHDKRI)		15,04	2,30%
Drozdovichi		16,39	2,45%
Kobrin	5,79	-	-
Mozyr	5,79	-	-
Oleksiyivka		21,72	3,04%
Orlovka		16,15	2,43%
Sudzha 1200	5,79	-	-
Sudzha 1400	5,79	-	-
Tekovo		19,77	2,83%
Uzhgorod		23,07	3,19%

6) If the Tribunal revises or replaces the tariff with effect from 1 January 2015 or any date thereafter prior to 1 January 2016

From 1 January 2015, the daily tariffs for entry and exit capacity booked on non-interruptible basis at the entry and exit points listed below are:

TARIFFS

for natural gas transmission services for entry and exit points from the gas transmission system, located at the state border of Ukraine and norms for covering gas expenses of PJSC "Ukrtransgaz" for industrial and technological uses and regulatory losses of natural gas, which are determined in kind depending on transmission volumes for exit points (VAT excluded)

Name of the entry point to the gas transmission system of Ukraine / exit point from the gas transmission	The tariff for the entry points	The tariff for the exit point	The norms for covering gas expenses for industrial and technological uses and regulatory losses of natural gas for exit points
	US Dollars	US Dollars	percent

system of Ukraine	per 1000 cubic meters, VAT excluded	per 1000 cubic meters, VAT excluded	
Beregovo		31,90	2,96%
Valuiki	9,22	-	-
Hrebenyky (ATI)		18,40	1,99%
Hrebenyky (SHDKRI)		22,73	2,30%
Drozdovichi		24,79	2,45%
Kobrin	9,22	-	-
Mozyr	9,22	-	-
Oleksiyivka		32,97	3,04%
Orlovka		24,42	2,43%
Sudzha 1200	9,22	-	-
Sudzha 1400	9,22	-	-
Tekovo		29,97	2,83%
Uzhgorod		35,03	3,19%

DEFINITIONS AND EXPLANATIONS (V2014/129)

Acceptance and Delivery Points	The relevant GCMP and GMS where the technical acceptance and delivery of gas is performed (measurement of quantity and quality of gas, documentary registration of acceptance/delivery of Gas);
ACER	Agency for the Cooperation of Energy Regulators;
ACERs Opinion No 02/2015	Opinion of the Agency for the Cooperation of Energy Regulators No 02/2015 of 26 March on the Network Code on Harmonised Transmission Tariff Structures
ACQ	Annual Contract Quantity
AMCU	Anti-Monopoly Committee of Ukraine
Backhaul [REDACTED]	To offer virtual reverse flow gas transmission services [REDACTED]
Balancing Mechanism	Mechanisms aiming at matching the amount of natural gas injected into the transmission network and withdrawn from it within relatively narrow time limits, in order to maintain the pressure of the transmission system
BAL NC	Network Code on Gas Balancing of Transmission Networks (Commission Regulation (EU) No 312/2014 of 26 March 2014)
BCM (bcm)	Billion cubic metres (a unit of measurement of volumes of gas delivered or transited)
BM7	Memorandum of Dr Boaz Moselle, dated 25 September 2017
BNetzA	The German networks regulator
Brattle 2	Second Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh in the Gas Transit Arbitration, dated 12 February 2016
Brattle 6	Sixth Expert Report by Dr Serena Hesmondhalgh, dated 10 February 2017
Brattle 7	Seventh Expert Report by Dr Serena Hesmondhalgh, dated 3 May 2017
Brattle 8	Eight Expert Report by Dr Serena Hesmondhalgh, dated 25 September 2017
Brattle 9	Ninth Expert Report by Dr Serena Hesmondhalgh, dated 2 February 2018
Bundled Capacity [REDACTED] [REDACTED] [REDACTED]	Standard capacity product offered on a firm basis which consists of corresponding entry and exit capacity at both sides of every interconnection point [REDACTED] [REDACTED] [REDACTED]

Capacity allocation	The method by which the technical capacity of a pipeline is allocated between network users
CEET	The "Closest Economic Effect Test" (under Article 13.2 of the Contract)
Client	PJSC Gazprom
CMP Guidelines	The principles of capacity allocation mechanisms and congestion management procedures concerning transmission system operators laid down in Annex I to Regulation 715/2009, as amended by Commission Decision 2012/490/EU of 24 August 2012
CMU	The Cabinet of Ministers of Ukraine
Congestion management	The management of the capacity portfolio of the transmission system operator with a view to optimise and maximise the use of the technical capacity and detect future congestion and saturation points
Contract	Contract No TKGU dated 19 January 2009 on volumes and conditions for the transit of Natural Gas through the territory of Ukraine from 2009 to 2019
Contract KP	Contract No. KP dated 19 January 2009 between Open Joint Stock Company Gazprom and National Joint Stock Company Naftogaz of Ukraine for the sale and purchase of natural gas in 2009-2019
Contract TKGU	Contract No. TKGU on the volumes and terms of transit of natural gas through the territory of Ukraine for the period 2009-2019 between Gazprom and Naftogaz dated 19 January 2009
Contract day	A period of 24 hours commencing at 10:00 a.m. Moscow Time and ending at 10:00 a.m. Moscow Time on the following calendar day. If the period of time between 10 a.m. of one calendar day and 10 a.m. of the following day comprises more or less than 24 hours (during switching from winter time to summer time or vice versa), the rights and obligations of the Parties concerning day for such period shall change proportionally;
Contract Month	The period commencing at 10:00 a.m. Moscow Time on the first day of any calendar month and ending at 10:00 a.m. Moscow Time on the first day of the following calendar month;
Contract path	The transport of gas along predefined routes from the point where the gas is injected to the point where the gas shall be off-taken
Contract Year	The period of time commencing at 10:00 a.m. Moscow Time on the first day of a calendar year and ending at 10:00 a.m. Moscow Time on the first day of the following calendar year in which transit of Natural Gas is performed in compliance with the terms and conditions of the Contract;
Contracted capacity	The capacity that the transmission system operator has allocated to a network user by means of a transport contract
Contractor	NJSC Naftogaz of Ukraine
Contractual congestion	A situation where the level of firm capacity demand exceeds the technical capacity
Coppi 1	First Expert Report of Dr Lorenzo Coppi, dated 12 June 2015
Coppi 2	Second Expert Report of Dr Lorenzo Coppi, dated 14 March 2016
Coppi 3	Third Expert Report of Dr Lorenzo Coppi, dated 26 August 2016

CRE	The French regulator
Cubic meter of Natural Gas/m³	The amount of natural gas occupying the volume equal to one cubic meter at a temperature of 20 degrees Celsius and at an absolute pressure of 0.101325 MPa
[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]
DORC	Depreciated Optimised Replacement Cost
Draft INT NC	The draft Commission Regulation (EU) establishing a Network Code on Interoperability and Data Exchange Rules
Draft TAR NC	ENSOGs Network Code on Harmonised Transmission Tariff Structures for Gas of 26 December 2014 (referred to, for instance, in Naftogaz' SoC (1039))
Draft re-submitted TAR NC	ENTSOG's Network Code for Re-submission to ACER, dated 31 July 2015
DSO	Distribution System Operator
EBRD	European Bank for Reconstruction and Development
ECRB	The Energy Community Regulatory Board
ECJ	Court of Justice of the European Union
ECRB	Energy Community Regulatory Board
ECT	The Energy Community Treaty
EnCT	The Energy Community Treaty
Entry point	The geographic point (points) at the place of crossing by gas pipelines of the state border of the Russian Federation - Ukraine, the Republic of Belarus - Ukraine, the Republic of Moldova - Ukraine;
ENTSOG	The European Network of Transmission System Operators for Gas
EREG	European Regulators' Group for Electricity and Gas (predecessor of ACER)
Eustream	The transmission system operator of the Slovak gas transmission system
Exit point	The geographic point (points) in the place of crossing by gas pipelines of the state border of Ukraine - Poland, Ukraine - Slovakia, Ukraine - Hungary, Ukraine - Romania, Ukraine - the Republic of Moldova; Expert Reply (Second Expert Report) in SCC Arbitration V2014/129, prepared by Dr Serena Hesmondhalgh and Mr Carlos Lapuerta, dated 12 February 2016
Expert Reply	First Export Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh in the Gas Transit Arbitration, dated 30 April 2015
Export Report	The Slovak transmission system operator
Eustream	
FG INT	ACERs Framework Guidelines on Interoperability and Data Exchange Rules for European Gas Transmission Networks of 26 July 2012
Firm capacity	Capacity contractually guaranteed as uninterrupted
[REDACTED]	[REDACTED]

Functional unbundling	The firm remains integrated but reorganises its to ensure organisation, decision-making and book-keeping so that the costs of the network services can be identified
Gas Sales Arbitration Gas Sales Contract	SCC Arbitration Case No. V2014/078/080 Contract No. KP dated 19 January 2009 between the Open Joint Stock Company Gazprom of Moscow, Russian Federation, and the National Joint Stock Company Naftogaz of Ukraine, Kiev, Ukraine, on the purchase and sale of Natural Gas in 2009-2019
Gas Transit Arbitration Gas Transmission System Code Gazprom/Respondent	The present SCC Arbitration Case No. V2014/129 NCSREU's Resolution No. 2493 of 30 September 2015 On Approval of the Gas Transmission System Code Open Joint Stock Company (OJSC, or "OAO" in Russian) Gazprom – the Respondent in these arbitral proceedings;
GCMP	Inaccurate translation of GCMU in the English translation of the Transit Contract (cf. Naftogaz' Statement of Claim (334))
GCMU	Gas Consumption Measuring Unit, a station intended for measuring the quantity of gas on the gas pipeline during its acceptance/delivery and consisting of one or several measuring pipelines. The following units are defined as Gas Consumption Measuring Units in the Contract: Volchansk GCMU, Loznaia GCMU, Limanskoie GCMU, GCMU of the looping of the ATI gas pipeline;
GDS GMS	Gas Distribution Station The Gas Metering Stations where the quantity and quality of transferred natural gas is measured and determined. The following stations are defined as Gas Metering Stations in the contract: Sudzha GMS, Sokhranovka GMS, Serebrianka GMS, Pisarevka GMS, Valuiki GMS, Platovo GMS, Mozyr GMS, Kobrin GMS, Belgorod GMS, Prokhorovka GMS, Alekseievka GMS, Kaushany GMS , Uzhgorod GMS, Beregovoy GMS, Drozdovichi GMS, Orlovka GMS, Tekovo GMS, Grebeniki GMS, and Ananiev GMS
GTS	Gas Transmission System
Henriksson 2	Second legal opinion by Professor Lars Henriksson, dated 25 August 2016
Hesmondhalgh- Lapuerta2	Second Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh in the Gas Transit Arbitration, dated 12 February 2016
Hoarding of capacity	To hinder market entry and the development of competition in a particular market
IEA (draft) INT NC	International Energy Agency ENTSO's draft Network Code on Interoperability and Data Exchange Rules
Intel judgement	Judgement of 6 September 2017 of the Court of Justice of the European Union in Case C-413/14 P <i>Intel Corporation Inc. v European Commission</i>
Interconnection point	The geographical location where two networks interconnect and gas can be exchanged from one network to another, often located at the border between two states

Interruptible capacity

Capacity contractually specified as interruptible

Kilocalorie /kcal

Is a unit of energy, one kilocalorie corresponds to 1/859.845 kWh;

Kilowatt hour/kWh

Is a unit of energy, one kilowatt hour corresponds to 859.845 kcal;

[REDACTED]

Lapuerta and Hesmondhalgh 1

Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh, dated 30 April 2015

Lapuerta and Hesmondhalgh 2

Second Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh, dated 12 February 2016

Lapuerta and Hesmondhalgh 3

Third Expert Report by Mr Carlos Lapuerta and Dr Serena Hesmondhalgh, dated 26 August 2016

Legacy contract

Legal unbundling

Long term gas transit contract entered into under the transit directive (Directive 91/296/EEC)

The transmission network services shall be independent at least in terms of its legal form, organisation and decision-making from other activities not relating to transmission. In other words, the network services are provided by a separate firm/subsidiary; which still is connected with the production and trade activities of the previous integrated firm via a holding structure

Main pipeline

A particular Ukrainian term for the high-pressure pipelines that forms the gas transmission network

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Mcm

Million cubic metres

[REDACTED]

[REDACTED]

[REDACTED]

Public Joint Stock Company "Main Gas Pipelines of Ukraine"

MGPU

	Decree No.726 of the Ministry of Energy of Ukraine, dated 17 October 2014, and Annex 1. Thereto
Model Gas Transportation Contract	First Expert Report of Dr Boaz Moselle, dated 16 October 2015
Moselle 1	Second Expert Report of Dr Boaz Moselle, dated 6 July 2016
Moselle 2	Third Expert Report of Dr Boaz Moselle, dated 26 August 2016
Moselle 3	Fourth Expert Report of Dr Boaz Moselle, dated 28 November 2016
Moselle 4	Fifth Expert Report of Dr Boaz Moselle, dated 19 December 2016
Moselle 5	Sixth Expert Report of Dr Boaz Moselle, dated 22 March 2017
Moselle 6	Seventh Expert Report of Dr Boaz Moselle, dated 25 September 2017, referred to by Dr Moselle as his <i>Fourth Under-Delivery Calculation Report</i>
Moselle 7	Eighth Expert Report of Dr Boaz Moselle, dated 16 February 2018
Moselle 8	Transmission system operator in Moldova
Moldovatransgaz	Transit Minimum Volume Obligations
MVO	
Naftogaz/Claimant	The National Joint Stock Company "Naftogaz of Ukraine" – Claimant in these arbitral proceedings;
Naftogaz' RfA	Naftogaz's Request for Arbitration;
NAK	National Joint Stock Company Naftogaz (in Ukrainian)
Natural Gas or Gas	Any hydrocarbon or mixture of hydrocarbons (consisting mainly of methane) and non-flammable gas in the gaseous state of Russian, Kazakh, Turkmen or Uzbek origin;
NBU	National Bank of Ukraine
NC BAL	Network Code on Gas Balancing of Transmission Networks
NC CAM	Network Code on Capacity Allocation Mechanisms
NCSEPU	The National Commission for State Energy and Public Utilities, the Ukrainian regulator
NCSREU	The National Commission for State Regulation in Energy and Utilities – the Ukrainian regulator, established in August 2014 (Förkortas så i N:s SoR/BF)
NERC	National Energy Regulatory Commission, replaced by NCSREU
Network Code on Capacity Allocation Mechanisms /the NC CAM	Commission Regulation (EU) No 984/2013 of 14 October 2013 establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems and supplementing Regulation (EC) 715/2009 of the European Parliament and of the Council

Network Code on Gas Balancing/the BAL NC	Commission Regulation (EU) No 312/2014 of 26 March 2014 establishing a Network Code on Gas Balancing of Transmission Networks
NJSC	National Joint Stock Company Naftogaz
Nord Stream	Two 1.224 kilometre offshore pipelines from Vyborg (Russia) to Lubmin (Germany) for transportation of natural gas from Russia to the energy markets in the European Union
NRA	National Regulatory Authority
OFGEM	The British energy regulator
Ownership unbundling	The ownership of energy generation and supply and the operation of transmission networks are separated
Party	Means either the Client (Gazprom) or the Contractor (Naftogaz) separately, and "Parties" shall mean both the Client and the Contractor collectively;
PCC	Physical and Chemical Characteristics
PFC Energy	An international consultancy firm,
PHLG	The Permanent High Level Group (of the Energy Community)
Physical congestion	A situation where the level of demand for actual deliveries exceeds the technical capacity at some point in time
Preliminary Compliance Report	Gas Transit in Ukraine. Preliminary EnC Compliance Report, with cover letter dated 3 December 2014
Quarter	Means any of the following periods each consisting of three consecutive months and commencing at 10:00 a.m. Moscow Time on the first day of any Quarter and ending at 10:00 a.m. Moscow Time on the first day of the following Quarter (January to March, April to June, July to September, October to December);
RAB	Regulatory Asset Base
Reply	Naftogaz' Statement of Reply and Defence to Counterclaim, dated 12 February 2016
SCCU	Superior Commercial Court of Ukraine
Second Gas Directive	Directive 2003/55/EC
Shipper Code	The unique identification for shippers issued in a transport system by the system operator, and used in the nomination procedures of sellers and buyers under gas sales agreements to allow the system operators to balance the physical gas flows when sellers nominate their deliveries and buyers nominate their off-take
SoC	Naftogaz' Statement of Claim in SCC Arbitration case V2014/129
SPFU	State Property Fund of Ukraine
Standard Natural Gas Transmission Contract	NCSREU's Resolution No. 2497 of 30 September 2015 On Approval of the Standard Natural Gas Transmission Contract
TAG	Trans Austria Gasleitung GmbH
Tariff FG	ACERs Framework Guidelines on Harmonised Gas Transmission Tariff Structures of 29 November 2013, cf. ACER Decision 01-2013 on Framework Guidelines Gas Tariffs (referred to, for instance, in Naftogaz' SoC (1035))

Tariff Methodology	NCSREU's Resolution No. 2517 of 30 September 2015 On Approval of the Methodology for determining and calculation of tariffs for natural gas transportation for entry and exit points on the basis of incentive based regulation
TBG	The Brattle Group
TBG 2010 Benchmarking	The Brattle Group Report (specifically including Dr Hesmondhalgh and Mr Lapuerta), produced in January 2010 for Gazprom Export, that compared the tariff in Contract TKGU to other "comparable tariffs"
TCM	Thousand cubic metres (price of gas is generally referred to in USD per TCM)
Technical Agreement	An annual document, being an integral part of the Transit Contract, which regulates regimes for gas transit, gas delivery to the consumers of Ukraine, mutual relationships between the Parties during Natural Gas transit through the territory of Ukraine, obligations of the Parties' representatives at the acceptance and delivery points as well as distribution of common gas volumes between Entry/Exit Points;
Technical capacity	The maximum firm capacity that the transmission system operator can offer to network users, taking into account the system integrity and the operational requirements of the transmission network
TEP	Third Energy Package
TFEU	The Treaty on the Functioning of the European Union
Thielen Report	Expert Report of Dr Walter Thielen, dated 19 December 2016
Third Energy Package	Directive 2009/73/EC and Regulation (EC) 715/2009
Third Gas Directive	Directive 2009/73/EC
Tirasopoltransgaz	Transmission system operator in Moldova
T_n	Means the tariff under the tariff formula in Clause 8.1 of the Contract;
Topenergy BDC OAO	A joint venture between Bulgargaz and Gazprom which sold Russian gas in Bulgaria and which no longer exists
Transit	The transportation of natural gas through a country or gas system en route to the final customer
Transmission	The transport of natural gas through a network which mainly contains high-pressure pipelines
TSO	Transmission System Operator
UCC	The Commercial Code of Ukraine
Ukrainian GTN/GTN	The Ukrainian Gas Transmission Network;
Ukrainian GTS/GTS	The Ukrainian Unified Gas Transport System, which comprises infrastructure designated for transmission (the GTN), distribution and storage;
Ukrtransgaz	Public Joint Stock Company Ukrtransgaz - The Ukrainian TSO;
Unbundling	The separation of energy generation and supply from the operation of transmission networks
Unused capacity	a situation where a network user has acquired firm capacity under a transport contract which that user has not nominated by the deadline specified in the contract

UTC	Universal Time Coordinated, see “Applied Time” in Naftogaz’ Relief Sought The Ukrainian National Assembly
Verkhovna Rada	
Virtual reverse flow (backhaul), VRF	Means deliveries against the physical flow via contractual and financial transactions; virtual reverse flow gas transmission services (backhaul) enables gas traders to conclude contracts with the gas transmission operators for gas transmission in reverse to the physical gas flow direction, meaning that the gas transmission operators are netting the natural gas quantities contracted for transmission in the two opposite directions.
WACC	Weighted-average cost of capital
WAG	West-Austria-Gasleitung
Witschen Report	Expert Report of Mr Bernhard Witschen submitted with Gazprom's Defence, dated 14 October 2015
Witschen 2	Second Expert Report by Mr Bernhard Witschen, dated 14 March 2016
Witschen 3	Thrid Expert Report by Mr Bernhard Witschen, dated 26 August 2016