What lies ahead for EU supply contracts for Russian gas?

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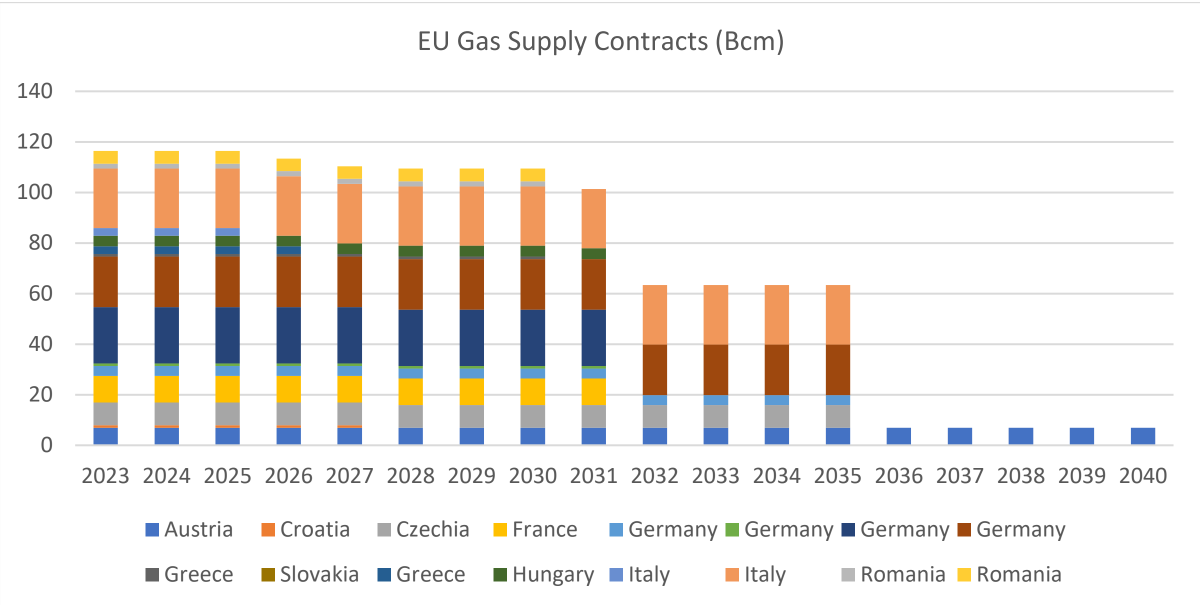
Plans by the European Union to cut Russian gas from its energy mix by 2027 and the protracted war in Ukraine cast significant uncertainty over the future status of existing long-term gas supply contracts between EU energy companies and Russia's state-owned gas giant Gazprom. As examined in this article, the outbreak of the war in 2022 led to varying responses from gas buyers against different scenarios. Some contracts that were terminated following the introduction a new decree by Moscow requiring payments in rouble. But many other agreements remain in force, even after pipeline supplies to most EU countries were suspended. The interruption of flows caused many EU importers to initiate arbitration cases against Gazprom for which hearings are not expected until next year. But in addition to legal disputes, the impact of many drivers – including political, commercial and climate-driven policy - is not to be underestimated against the unprecedented circumstances of the war. Furthermore, views that Russian gas imports may resume one day also raise questions over the framework of future trade between Europe and Russia, if any.

Halt in exports

According to CEDIGAZ data, at least 116.4 Bcm/year of annual contracted quantities (ACQ) via gas pipeline are still contracted between EU countries and Gazprom or one of its subsidiaries. Most of these contracts are set to expire between 2030 and 2035. This contracted volume is way above current export levels. Gas pipeline exports to EU customers fell from 146 Bcm in 2021 to around 61-62 Bcm in 2022. In the first nine months of 2023, Gazprom's pipeline exports were estimated at around 20 Bcm.



Russian gas is still flowing via Ukraine to EU buyers in Italy, Slovakia, Hungary, Croatia and non-EU state Moldova. Through the European string of the 31 Bcm/year Turk Stream pipeline, Gazprom still provides gas to the EU nations of Croatia, Hungary and Greece and to non-EU states of Serbia, Bosnia and Herzegovina and North Macedonia.

However, EU nations continue to import Russian LNG largely from the privately-owned Yamal LNG project - so far, only the United Kingdom has put sanctions on Russian LNG. This was despite the drive to wean Europe off Russian gas by 2027 under the REPowerEU plan issued by the European Commission (EC) in April 2022. The EC imposed sanctions on Russian coal, seaborne oil and oil products, but not on Russian gas which was responsible for 40% of European gas imports before the war.

For Anne-Sophie Corbeau, research scholar on global energy policy at Columbia University's School of International and Public Affairs, this was purely driven by economics. "This LNG is produced in the region and close to market," she said. "So, considering the cost of transport and netbacks, offtakers of Russian LNG made economic choices, plus there have been no sanctions on Russian LNG," she said.

As mentioned in the recent CEDIGAZ report 'Russian gas in Europe: Yesterday, Today, Tomorrow', even the Chinese stakeholder of the Yamal LNG project – CNPC (holds 20% share in Yamal LNG and has a long-term offtake contract for 3 mtpa or 4 Bcm/year) – was reported to be selling cargoes from the project on the European market instead of sending them to China.

Force majeure

The initial, most impactful interruption in Russian pipeline gas exports took place in June 2022, when Gazprom started to reduce exports through its chief export pipeline to Europe, the 55 Bcm/year Nord Stream pipeline. At the time, Gazprom argued that it was impossible to operate the link because international sanctions prevented the maintenance of gas-fired turbines that drive pipeline pumps. The company retroactively declared force majeure on 14th July on supplies that had been suspended from June 14th.

But these contracts are still legally valid, and the volumes concerned are simply 'dormant'. "Typically, force majeure suspends or freezes the obligations under the contract. The contract is not terminated," said Ana Stanic, energy lawyer at E&A Law. Some contracts contain a provision which enables a party to terminate the contract, after force majeure is in place for a specified period of time. "Not all contracts contain such provisions," Stanic insisted.

Soon after, in September 2022, the Nord Stream 1 and Nord Stream 2 pipelines were hit by underwater explosions near the Danish Island of Bornholm in the Baltic Sea, making both pipelines non-operational.

Independently from the explosion, several European buyers initiated arbitration proceedings against Gazprom for not fulfilling its gas delivery obligations following the interruption in June 2022 of flows through Nord Stream. The European companies are seeking damages and penalties from Gazprom as they were left scrambling for alternative supplies, often at a much higher cost than the contracted volumes with Gazprom. These included Italy's Eni, France's Engie, and Germany's RWE and Uniper which ended up being bailed out by the government. Others joined the list later with Czech energy company CEZ who said in February 2023 that it had formally started an international arbitration to a Geneva-based court against Gazprom.

It is not known if any of these companies is seeking the termination of the contracts. Even then, the force majeure declaration would need to be accepted and proven in the eye of the court.

Payment in rouble

Most hearings are not expected before May 2024, including for contracts scheduled to terminate in the mid-2030s. These cases come after the controversy over payment in roubles following the signing of a decree on 31 March 2022 by President Vladimir Putin which introduced a new payment mechanism, requiring European buyers to pay for Russian pipeline gas in roubles. The decree was initially rejected by European nations because of concerns that changing the currency for payments might be a breach of sanctions. But in a new guidance document issued by the European Commission on April 21, it suggested that it could be possible for European buyers of Russian gas to pay on the terms of the new decree without breaching EU law.

The decision was eventually left to be made at a company level. The arbitration case between Finland's Gasum and Gazprom was the first to become public on this issue. The tribunal accepted that the new decree represented a force majeure in favour of Gazprom but did not explicitly order Gasum to make any payment in rouble. The court left it to the two companies to continue negotiations to resolve the issue, which included outstanding payments of €300 mn. Gasum finally decided to terminate the contract which was running until 2031. It is unclear, whether Gazprom can and will make a claim against this decision. "This depends on whether the contract allows for early termination," Stanic said.

Stanic stressed that the Gasum award did not have a precedential value since every contract is different and arbitral awards are only binding as between the parties to the dispute. "But it is indicative of how an arbitral tribunal might look at the issue. It was the first tribunal, and it was early days," she said.

Sanctions on Russian gas?

Those who rejected the new payment mechanisms included Dutch Gasterra and Poland's PGNIG whose supply contracts expired in late 2022, thus helping them fast-track efforts to end imports of Russian gas as signalled by the REPowerEU plan.

Critically, in the absence of sanctions on Russian gas, REPowerEU is not a binding document, and does not influence the validity or maintenance of the long-term contracts between private entities.

On the other hand, the view that introducing sanctions on Russian gas may help build a case for European buyers to declare force majeure and end contracts has its problems. Not least because the seller may try to invoke this as evidence of collusion between private companies and governments, Stanic said.

Katja Yafimava, senior research fellow on the Oxford Institute for Energy Studies Gas Research Programme, commented that the EU's political pledge to eliminate dependence on Russian gas means some buyers – especially state-owned – could come under pressure from their governments to terminate contracts, even if at a cost.

This is already signalled by mounting pressure in the EU to ban Russian LNG imports. In Germany, officials are calling for the end of a legacy contract between state-owned Securing Energy for Europe (SEFE) and India's Gail for 2.5 mtpa of LNG supplies from the Yamal LNG project. The contract was inked in 2012 when SEFE, formerly known as Gazprom Germania, was still controlled by its parent company Gazprom, and before it was nationalised by Germany after Russia's invasion of Ukraine. Elsewhere, the industry is still assessing the impact of sanctions freshly imposed earlier this month by the US on Novatek's Arctic LNG 2 project, which is set to start exporting in coming months.

For energy expert Thierry Bros, formal sanctions on Russian gas and LNG from 2027 could be the next logical step in the EC's efforts to phase out Russian gas. "The 2027 deadline to fully cut Russian fossil fuels is a strong signal to the industry to expect such an embargo," he said. Bros argued that this deadline is an opportunity for EU entities to shape an alternative vision to diversify their business model, thus further addressing the moral imperative to cut ties Russia amid the ongoing war in Ukraine. "The reason why there was no embargo is because the EU was just too dependent on Russian gas. 2027 is a very challenging timeframe but it is not impossible," he added.

Future imports

In the meantime, the prospect that EU nations may resume imports of Russian piped gas one day is not ruled out. From a market perspective, Europe's rising dependence on imported LNG exposes it to increased price volatility, in turn damaging the economic competitiveness of industries and derailing climate-driven and sustainability efforts. "If some Russian contracts were to remain in place, they could cushion the impact of LNG price volatility," Yafimava said. "Contracts' volume could be renegotiated in this context," she added.

The outcome of the ongoing arbitration cases features among the key uncertainties regarding Russian gas exports to Europe. A report published by the Oxford Institute for Energy Studies in July 2023 states that "even if the contracts are ultimately ruled to have expired or been terminated then some of the flows could be returned via the spot or short-term traded market."

But the return of Russian gas volumes (even reduced) would likely raise significant debate and depends on multiple political and geopolitical variables, not least of all the end of a devastating war, the availability of infrastructure, and the willingness and moral acceptability from some EU nations to resume Russian gas imports.

Bros stressed that political leaders will need to play a major part. In one hypothetical scenario he proposes, a peace agreement could propose to use future proceeds of Russian pipe gas that cannot be rerouted easily for the reconstruction of Ukraine, based on the historical experience of the Iraqi-oil-for-food program.

This seems highly improbable as things stand and considering the protracted nature of the war. In the meantime, other timeframes and upcoming developments will be closely watched. One is the future composition of the European Commission after the next parliamentary election between next June and late 2024. The EU's decarbonization drive, its plans to adopt a tougher stance on unabated gas and ambitions to step up the deployment of renewable remains a key driver in the run-up to its 2027 deadline to cut off Russian gas. This is in addition to the prospect that the global LNG supply picture is expected to change by then, notably with the development of additional capacity by other major producers like Qatar Energy.