



WHITE PAPER

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The War in Ukraine: Downstream Ripple Effects on the European Gas Market

European energy companies face unprecedented uncertainty as a result of Russia's invasion of Ukraine. A potential reduction or cessation of Russian gas imports is not unforeseeable and would invariably affect all market segments in Continental Europe.

This *White Paper* addresses the potential downstream ripple effects on European gas markets and the legal arguments which may be raised in response to continued contractual performance if imports are reduced or stopped. These arguments include recourse to common contractual provisions such as price review, hardship, and force majeure. Reliance on legal doctrines of frustration of purpose and termination for cause may also be possible depending on the gravity of the resulting situation.

TABLE OF CONTENTS

REDUCTION OR CESSATION OF RUSSIAN GAS SUPPLIES WILL AFFECT THE ENTIRE EUROPEAN GAS MARKET	1
A Brief Introduction to the European Gas Market.....	1
Consequences for the Upstream Market.....	1
Consequences for the Downstream Market	2
PRICE REVIEW CLAUSES.....	2
HARDSHIP AND FORCE MAJEURE CLAUSES.....	3
SUBSEQUENT IMPOSSIBILITY.....	3
FRUSTRATION OF PURPOSE	3
TERMINATION FOR CAUSE	4
CONCLUSION	4
LAWYER CONTACTS	4
ENDNOTES.....	5

REDUCTION OR CESSATION OF RUSSIAN GAS SUPPLIES WILL AFFECT THE ENTIRE EUROPEAN GAS MARKET

A Brief Introduction to the European Gas Market

In addition to the humanitarian toll and the upheaval of everyday life, Russia's war on Ukraine has had a profound impact on global business. The European energy market is likely one of the most highly affected industries.

The majority of the natural gas in continental Europe is imported, with the lion's share of those imports originating in Russia. As recently as 2021, for example, 90% of the natural gas consumed in the European Union ("EU") was imported. Nearly half of that supply—45.3% to be precise—was supplied by Russia. Norway and Algeria rounded out the top three for countries of origin—their gas totaled 23.6% and 12.6% of 2021 EU imports respectively.¹

To date, the EU has not placed any war-related restrictions on Russian gas imports. That situation, however, is under review and may change. It is not unforeseeable that Russian gas supplies may be curtailed or stopped outright if the war continues. This could occur, for example, as a result of:

- (i) EU sanctions;
- (ii) An EU embargo on imports; and/or
- (iii) The Russian government ordering Gazprom to stop deliveries to the EU.

In fact, as of the writing of this *White Paper*, Gazprom has indeed already stopped deliveries of natural gas to two countries, Poland and Bulgaria, beginning in April 2022. Additionally, and independent of (i)-(iii) above:

- (iv) European importers' internal policy choices may drive a reduction or cessation in Russian gas imports to Continental Europe.

Ripple effects will be felt on the entire European gas market if Russian supplies of natural gas are reduced or stopped. The reason for this is complex, and includes the fact that the majority of natural gas in Europe is delivered by pipeline. Pipelines can only import a finite quantity of natural gas and their capacities are usually fully booked well in advance. This

means that Norway, Algeria, or other pipeline suppliers cannot simply "turn up the tap" and make up for Russian shortfalls in supply because there is no more space within the pipeline with which to bring natural gas to Continental Europe.

While liquefied natural gas ("LNG") is an alternative to natural gas supplied by pipeline because it can be transported by ship, it is expensive and requires re-gasification. Re-gasification can only occur at specially designed facilities, which are relatively scarce. If Russian gas imports fall dramatically or stop altogether and LNG is the intended replacement, additional re-gasification facilities will have to be built. This process can be expected to take several years assuming things run smoothly.

Another leading factor exacerbating the potential downstream ripple effects is the complex contractual framework under which natural gas is supplied at all segments of the market. Gas has historically been imported under long-term contracts that specify the volume and price (or a mechanism for arriving at a price) for years and even decades at a time. This system has many perceived advantages, including securing the long-term supply of natural gas and ensuring that the massive investments associated with exploration, production, and transportation are covered and risks minimized.

Once natural gas arrives in Continental Europe, it is invariably sold by the importers to other parties in the market who may sell it again before it eventually makes it to the ultimate user such as a household, factory, or power plant. The majority of these "trades," like the initial import, are contractual and have historically been facilitated by what is known as "back-to-back contracts." In simplified terms, this arrangement means that the buyer-importer enters into a contract with the seller-exporter for the purchase of a certain quantity of natural gas. The importer then enters into additional contracts with buyers in the downstream market to sell that same quantity of natural gas. In an ideal world, every molecule of imported natural gas is accounted for and sold even before it arrives.

Consequences for the Upstream Market

As outlined above, there are four main scenarios under which gas supplies to Continental Europe could be reduced or stopped. They are as a result of (i) EU sanctions; (ii) an EU embargo on imports; (iii) stoppages in delivery; and/or (iv) European importers choosing to stop or limit their Russian imports.

Under the first two scenarios, it is likely that importers may rely on illegality or impossibility to escape liability for failure to off-take and pay for natural gas contractually specified quantities of natural gas.² This legal theory excuses non-performance when:

- An unforeseen event occurs after the contract is made, which makes performance objectively impossible; or
- Performance were to require an illegal act, e.g., an action prohibited by law.

The third scenario does not give rise to any serious concerns of breach of contract on the part of the importer. The question arises, however, whether the stoppage in Russian gas deliveries would amount to a breach of contract by the seller and if recourse—including the cost to cover with another supplier—is possible. Analysis of each affected contract would be required in conjunction with the grounds given for the stoppage. Furthermore, most of these contracts contain arbitration clauses, which require the parties to arbitrate disputes before neutrals who will determine the outcome.

The fourth scenario differs from the rest because it involves a degree of choice on the part of the importer and does not result in the reduction of natural gas supplies because of extrinsic factors. It will not be discussed in this *White Paper*, which will instead focus on actions beyond the control of the importers that affect the natural gas supply.

Consequences for the Downstream Market

Invariably, the downstream gas market will also be affected by so-called “ripple effects” if Russian gas supplies to Europe are reduced or stopped.

Ceteris paribus, if the supply of natural gas in Continental Europe drops and demand remains constant, the price will increase. Thus, from a purely economic perspective and without any sort of intervention, it is foreseeable that the price of gas will increase—and may increase dramatically—if Russian gas no longer reaches the European market.³

Importers, who are contractually bound to sell-on their (Russian-)supplied gas to other buyers, will be forced to secure those supplies from other sources. This will be challenging in the short-term given the anticipated increase in price, limited pipeline capacities, and the costs and logistics of securing and importing LNG from geographically remote regions

such as North America, the Middle East or even Australia. In some instances, importers may not be able to secure missing Russian quantities of gas from other sources.

In the sections that follow, we analyze whether and to what extent importers and their downstream partners may rely on common contractual provisions or general civil law concepts with respect to contractual performance.

Our analysis is based on our understanding of the European gas market and contracts in general. We refer mostly to contractual provisions commonly found in gas sales contracts, and to general civil law principles, because the majority of the sales contracts in Continental Europe are governed by civil law. Because this *White Paper* is general in nature without reference to any specific contract or applicable law,⁴ we reiterate that each individual contract must be analyzed before any sort of advice can be given or a course of action planned. Contractual or statutory notice requirements must also be met.

PRICE REVIEW CLAUSES

Most long-term gas supply contracts contain price review clauses that enable a revision of the contractual purchase price for natural gas if circumstances change beyond what the parties reasonably expected. Depending on the precise wording of the price review clause, importers facing increased costs associated with securing gas from alternate sources may seek to increase the purchase price for the gas they supply to the downstream market. In doing so, they would seek to increase the price of natural gas to the point where they continue to cover their costs and secure a margin (profit).

Contractual price reviews are not without limit. Most contracts limit the number of times the purchase price may be revised throughout the life of the contract or specify they may only take place within a certain timespan. Needless to say, these features may restrict an importer’s actions depending on when their last price review took place. So-called “joker” clauses may provide relief—they often provide access to a price review at any time. They are, however, scarce and usually limited to once in the contract’s lifespan.

Short- or shorter-term contracts and those with lower volumes do not necessarily contain price review “release valves”—i.e., a

mechanism under which to release some pressure—because their truncated lifespans do not warrant a periodic reassessment of risk allocation.

HARDSHIP AND FORCE MAJEURE CLAUSES

Many gas supply contracts will contain a hardship clause. These clauses memorialize the parties' agreements with respect to what should happen in the event that one were to experience a "hardship."

Parties wishing to invoke such clauses should pay close attention to what constitutes a hardship. While the term may be defined in the contract, that is not always the case. In such instances, the law of the jurisdiction specified in the contract likely provides guidance.

The UN Convention on Contracts for the International Sale of Goods ("CISG") is one body of law that may provide guidance, and is frequently applicable to long-term gas supply contracts. Under Article 79 of the CISG, a party is not liable for a failure to perform any of its obligations if it proves that the failure was due to an impediment beyond its control and that it could not reasonably have been expected to have taken the impediment into account at the time of the conclusion of the contract or could not have avoided or overcome it or its consequences.

This is a high standard, and courts and tribunals interpreting Article 79 of the CISG have traditionally been reluctant to exempt a party from contract performance if they are affected by price fluctuations, especially if these fluctuations are typical in the commodity trade.⁵ Thus, under the CISG, the seller bears the risk of price increases for the goods it buys from its supplier.⁶ This may be true even in cases of extreme price spikes.⁷ Nevertheless, there are also instances where price increases were so severe as to have excused performance. For example, a seller was deemed to have had the right to renegotiate the contract when there was a 70% increase in its purchase price after the contract was concluded.⁸

If and to what extent a hardship exists will depend on many factors, including the extent of import reduction and whether importers will be able to secure alternatively sourced gas to meet their downstream contractual obligations. It is clear, however, that the war in Ukraine and any subsequent reductions

in Russian gas imports were not foreseeable, two key factors that will contribute to hardship arguments.

In addition to hardship clauses, civil law-governed gas supply contracts may also include a force majeure clause. These clauses apply to unforeseeable circumstances that prevent the fulfillment of contracts when there are intervening acts of God (fire, flood, etc.), war and armed conflicts.⁹ They will release both parties from liability or obligation for the duration of the force majeure event, and some clauses may even permit termination for a prolonged force majeure event.

Whether importers will be able to successfully rely on hardship or force majeure clause in their downstream activities will depend on the scope of the ripple effects, precise wording of the clauses, and the law applicable to the contract.

SUBSEQUENT IMPOSSIBILITY

Many civil law jurisdictions permit termination of a contract for "subsequent impossibility" if performance of the contract becomes legally or factually impossible for reasons not attributable to either party.¹⁰ An extremely high standard must be met in order to rely on this extra-contractual remedy.

The classic example of subsequent impossibility involves a contract for the sale of a car. After the contract was concluded and before it can be performed (e.g., exchange of the purchase price for the car), a storm destroys the car. Naturally, without the car, it would be impossible to perform the contract.

Whether and to what extent subsequent impossibility may be relied upon must be carefully considered. If alternately sourced gas is available on the market, it will be more difficult for an importer to rely on subsequent impossibility. Conversely, if no such gas is obtainable, a valid impossibility argument may exist.

FRUSTRATION OF PURPOSE

Civil law also recognizes the doctrine of "frustration of purpose," which is sometimes referred to by its Latin name: *clausula rebus sic stantibus*.¹¹ Under this doctrine, modification of the contract may be demanded to the extent that one of

the parties cannot reasonably be expected to perform without modification if the circumstances that were the basis for the contract significantly changed after its conclusion, and if the parties would not have concluded the contract or would have concluded it with different terms if they had foreseen this change. If modification is impossible or unreasonable, the disadvantaged party may revoke or terminate the contract.

Courts generally apply a strict standard to their analysis of these requirements. Under Austrian law, for instance, the doctrine only applies if the change in circumstances cannot be allocated to the sphere of risk or responsibility of the party resorting to the doctrine.¹² Moreover, according to the prevailing view, the doctrine only applies when facts have not been expressly included in the contract.¹³ A German court considering the issue recently concluded that even where a contract could be terminated, the terminating party may be obliged to pay the other party a share of the losses caused by the termination.¹⁴

Importers may be able to rely on frustration of purpose depending on the gravity of the ripple effects and the history of their specific contract formation. They may first seek modification of their contracts by, for example, lowering the volume which must be delivered, increasing contractual flexibility, or amending the price or price mechanism. If these modifications prove to be futile, a termination may be appropriate.

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TERMINATION FOR CAUSE

In exceptional circumstances, contracts may also be terminated by either party for good cause without application of the otherwise applicable termination dates and notice periods.¹⁵ For example, a good cause shall be deemed to exist under Austrian law if the continuation of the contractual relationship has become unreasonable due to loss of confidence in the contractual partner, serious defaults in performance, or the discontinuation of the basis of the business. Similarly, under German law, termination is possible if a party cannot reasonably be expected to continue performance when taking into account all of the circumstances and weighing the interests of both parties.¹⁶

Whether circumstances rise to warrant termination for good cause by either party to a downstream contract will depend on the facts and circumstances of each individual case.

CONCLUSION

Since each contract and underlying law will differ, parties are advised to seek the assistance of experienced counsel when planning their mitigation strategy and managing any disputes that may arise as a result of Russian ripple effects.

ENDNOTES

- 1 Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, REPowerEU: [Joint European Action for more affordable, secure and sustainable energy](#), COM(2022) 108 final.
- 2 Most of the larger volume long-term contracts are “take-or-pay” contracts and require buyers to pay for natural gas even if quantities are not (immediately) off-taken. If this is the case, the result would be the same: the duty to pay for natural gas irrespective of off-take would be excused.
- 3 For the sake of simplicity, we do not consider seasonal fluctuations in demand and assume demand will remain constant without consumers switching to other fuel sources.
- 4 It should not be assumed that the general civil law principles discussed herein apply equally in every civil law jurisdiction.
- 5 CISG Opinion No. 20 on hardship, at para. 7.9.
- 6 CISG Case No. 1106.
- 7 ICC Case No. 6281.
- 8 CISG-online Case No. 1963.
- 9 German courts’ interpretation of force majeure provisions typically involves an extraordinary, external event caused by elementary forces of nature or the actions of third parties, which is unforeseeable according to human insight and experience and cannot be prevented or rendered harmless by economically acceptable means.
- 10 See, for instance, Sec. 275 of the German Civil Code („BGB“) and Sec. 1447 of the Austrian Civil Code („ABGB“).
- 11 See for instance, Sec. 313 BGB.
- 12 RIS-Justiz RS0044463
- 13 *Koziol – Welser/Kletečka*, *Bürgerliches Recht* 1¹⁴ (2015) at para. 510 et seq.
- 14 OLG Celle, 2 U 64/21, judgement of 2 December 2021.
- 15 RIS-Justiz RS0018305; RS0027780.
- 16 Sec. 314 BGB.

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