

Unpacking Naftogaz's multibillion win against Russia

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Gas drilling rigs off the Black Sea coast in western Crimea

More details have emerged about Naftogaz's multibillion-dollar win against Russia in an investment treaty dispute over seized Crimean assets – including the arbitrators' disagreement over the effect of a temporal limitation in the treaty and the relevance of sunk costs.

The Ukrainian state oil and gas company [announced](#) today that it has received a final award worth US\$5 billion in an arbitration it has been pursuing against Russia at the Permanent Court of Arbitration in The Hague since 2016.

A Hague-seated UNCITRAL tribunal issued the award by majority yesterday. The majority consisted of tribunal chair **Ian Binnie KC**, a former Canadian Supreme Court justice, and Swiss arbitrator **Charles Poncet**, who was Naftogaz's appointee.

Serbian arbitrator **Maja Stanivuković**, professor at the University of Novi Sad and president of the Belgrade Arbitration Center, issued a dissenting opinion.

GAR has confirmed the award requires Russia to pay US\$4.22 billion plus interest at the rate of 6-month EURIBOR +2% compounded semi-annually from March 2014. Naftogaz was also awarded nearly US\$25 million towards its costs.

Naftogaz had sought an even larger amount. It claimed the fair market value of the assets was over US\$5.18 billion and that it was entitled to interest at 9% compounded monthly – which would have resulted in an award worth around US\$10 billion.

The Ukrainian company says the award is the largest yet issued in the various arbitrations brought by Ukrainian investors who had assets seized in Crimea when Russia occupied the peninsula in 2014. Those cases have all been brought under the 1998 Ukraine-Russia bilateral investment treaty.

In the arbitration, Naftogaz used Covington & Burling, Aequo in Kyiv and in-house counsel. It also retained Gaffney Cline & Associates as quantum experts, and turned to NautaDutilh for related Dutch court proceedings.

After refusing to participate in the arbitration during the jurisdiction and liability phase, Russia retained Schellenberg Wittmer and Ivanyan and Partners in 2019 to represent it during the quantum phase, with FTI Consulting serving as its quantum experts. Ivanyan dropped off the case in mid-2021 and Schellenberg withdrew last year following Russia's invasion of Ukraine.

Around 70% of Naftogaz's claim was for the loss of upstream assets including special permits to develop and exploit oil and gas fields. The rest of the claim covered midstream assets including interests in operating gas pipelines and a gas storage facility; service assets including jack-up drilling rigs, marine vessels and helicopters; as well as interests in local distribution companies.

The tribunal majority already determined in a 2019 partial award that it had jurisdiction over the claims and that Russia had breached the BIT's provisions on expropriation, full and unconditional legal protection and most-favoured nation treatment. It found that the BIT obligations applied as of 18 March 2014 when Russia formally annexed the peninsula.

Stanivuković dissented from that award too. She did not believe Crimea could be considered part of the "territory" of Russia at the time of the alleged BIT breach. She also said the expropriatory acts occurred before the BIT became applicable and were attributable to the Crimean parliament rather than Russia; and that Naftogaz had not shown the property belonged to it rather than the state of Ukraine.

An issue that loomed large during the quantum phase was the effect of article 12 of the BIT, which restricts protection to investments "made" on or after 1 January 1992 – the date of the breakup of the Soviet Union.

While the majority acknowledged that temporal limitation in its partial award, the Hague Court of Appeal last year [held](#) that the award was insufficiently clear on that point. The court set aside the award only to the extent that the tribunal found it had jurisdiction over "all claims" rather than those relating to investments made on or after the 1992 date.

In the latest award, the majority said it was significant that the Hague court had referred to the temporal limitation as applying to "investments made" rather than "assets created" or "assets developed". It said the court confirmed the tribunal had jurisdiction to determine which assets are protected investments.

The majority accepted the Naftogaz entities' arguments that they only made their investments from 1998 onwards when they were incorporated and that they were not part of the same legal entity as their Soviet-era predecessors.

It also found the claimants had "bought" assets from the Ukrainian state in exchange for shares and that this was a real transfer of property interest rather than a transfer of operating rights as Russia argued.

The majority said the appropriate way to quantify the upstream assets was with a discounted cashflow (DCF) analysis derived from present and future net income, rather than apportioning the "sunk costs" of Naftogaz and its state predecessors in the historic development of the underlying oil and gas prospects, as Stanivuković believed.

While the underlying oil and gas resources are owned by the state, the majority said Naftogaz was not claiming in respect of those resources. Rather, its upstream investments were the permits allowing it to exploit the resources for profit.

Russia agreed that a DCF analysis was appropriate but said that historical development costs should be deducted from the present value of the permits, and that the absence of proof as to the precise portion of post-1992 expenditure by the claimants meant they had not met their burden of proving quantum.

But the majority said this approach was "misconceived" and the relevant question was how much the permits were worth in an "open and unrestricted market" on the valuation date in March 2014.

It said article 12 did not require an "artificial disaggregation of an asset's present day value into slices of various past contributions to the underlying resources". Even one of Russia's own experts had testified that in the real world, oil and gas assets are valued for what they are worth at the time of the acquisition without regard to their cost history.

The majority said the attempt to introduce "investment history" into a valuation exercise was "antithetical to the whole theory and practice" of fair market value, and that the parties to the BIT "cannot have intended to exclude investments in the extraction industries" from the treaty's protection.

However, the majority agreed with Russia that the value of the "use" of the upstream assets was to be assessed under a Russian-law scenario, even though this would result in a lower valuation. The majority said applying Ukrainian law would contradict the BIT, since Naftogaz's case presupposes the investments to have been made in Russia. It did not accept that this meant Russia was benefitting from its own wrongdoing.

Russia argued the Naftogaz entities were money-losing ventures and that the valuation of their assets should be adjusted accordingly but the majority said its mandate was to determine the fair market value of the assets rather than a hypothetical sale of shares in the claimant companies. "Many property-rich, cash-poor companies may lurch into bankruptcy but nevertheless possess assets of great value," it said.

The state also complained that two of the drilling rigs were at the centre of a corruption prosecution implicating Ukrainian government officials including the country's former president Viktor Yanukovich – meaning that Naftogaz could not recover compensation for them. The majority dismissed this as irrelevant. (Russia also raised illegality allegations during its challenge to

the partial award but did not pursue them at the court hearing.)

The majority also rejected Russia's various allegations of bad faith against Naftogaz, including relating to alleged non-disclosures and the risk of double recovery.

In her dissent from the final award, Stanivuković said she did not doubt that the oil and gas assets were worth more than US\$4 billion but said she was convinced a "fair part of that value was created by Soviet investments made before 1992" which fall outside the scope of the tribunal's jurisdiction. She said the claimants had not shown the investments they had made into the development of the assets nor the "value created thereby".

Earlier in the proceedings, there was a skirmish over an alleged confidentiality breach by Russia after the state submitted a report prepared by Naftogaz's Ukrainian law expert **Irina Paliashvili** as evidence in other Crimea-related proceedings – the *DTEK* arbitration and set-aside proceedings relating to the *Everest Estate* and *Belbek* awards. Russia later agreed to withdraw the report from those proceedings.

Russia is still pursuing an appeal with respect to the *Naftogaz* partial award before the Dutch Supreme Court.

NJSC Naftogaz of Ukraine (Ukraine) et al. v. The Russian Federation (PCA Case No. 2017-16)

Tribunal

- **Ian Binnie KC** (chair) (Canada)*
- **Charles Poncet** (Switzerland) (appointed by Naftogaz)
- **Maja Stanivuković** (Serbia) (appointed on Russia's behalf)*

* Appointed by **Michael Hwang SC**, the appointing authority designated by the PCA

Counsel to Naftogaz

- Covington & Burling

Partner **David Pinsky** and associates **Paris Aboro**, **Alex Gudko** and **Emma Nguyen*** in New York, partner **Jeremy Wilson** and associate **Ramon Luque** in London, and partner **Marney Cheek**, of counsel **William Lowery** and special counsel **Clovis Trevino** in Washington, DC

* No longer with the firm

- Aequo Law Firm

Partners **Pavlo Byelousov** and **Denis Lysenko**, senior associate **Ksenia Koriukalova** and associate **Oleksandr Kushch** in Kyiv

- Naftogaz in-house counsel

Deputy head of legal **Olga Ivaniv*** and senior lawyer **Olha Kotlyarska*** in Kyiv

* No longer with Naftogaz

Counsel to Russia

- Schellenberg Wittmer (from August 2019 until March 2022)

Partners **Elliott Geisinger** and **Anna Kozmenko** and counsel **Anne-Carole Cremades** in Geneva, **Christopher Boog** in Zurich and partner **Julie Raneda** in Singapore

- Ivanyan and Partners (August 2019 until June 2021)

Khristofor Ivanyan, **Baiju Vasani***, **Andrey Gorlenko** and **Elena Burova***

* No longer with the firm

- Prosecutor General's Office of the Russian Federation

Director general for international legal cooperation **Mikhail Vinogradov** in Moscow

- International Centre for Legal Protection of the Russian Federation

Director general **Andrey Kondakov** and **Sergey Morozov** and **Konstantin Ksenofontov** in Moscow

Expert witnesses for Naftogaz

- **William Cline, Robert George, Stuart Traver** and **Rawdon Seager** of Gaffney Cline & Associates (on fair market value of the oil and gas assets)
- **Evgeny Zhilin** of Quorus in Zurich
- **Irina Paliashvili** of RULG-Ukrainian Legal Group
- **Paul Stephan** of the University of Virginia Law School

Expert witnesses for Russia

- FTI Consulting (on quantum)

Stuart Amor, Matthias Cazier-Darmois, Carter Davis, and Boaz Moselle

- Vygon Consulting (on technical analysis and economic assessment of upstream assets)

Grigorii Vygon, Maria Belova, Sergey Klubkov and Sergey Ezhov

- **Oleksandr Vygovskyy** of Quantum Attorneys in Kyiv
- **Vitaly Melgunov** of Gubkin Russian State University of Oil and Gas (National Research University)

In the Dutch set-aside proceedings

Counsel to Russia

- Houthoff (withdrew in 2022 after the invasion of Ukraine)

Counsel to Naftogaz

- NautaDutilh

Partners **Mirjam van de Hel-Koedoot** and **Freerk Vermeulen**, senior associate **Pieter Fritschy**, associate **Aalt Colenbrander** and foreign associate **Tetyana Makukha** in Amsterdam

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