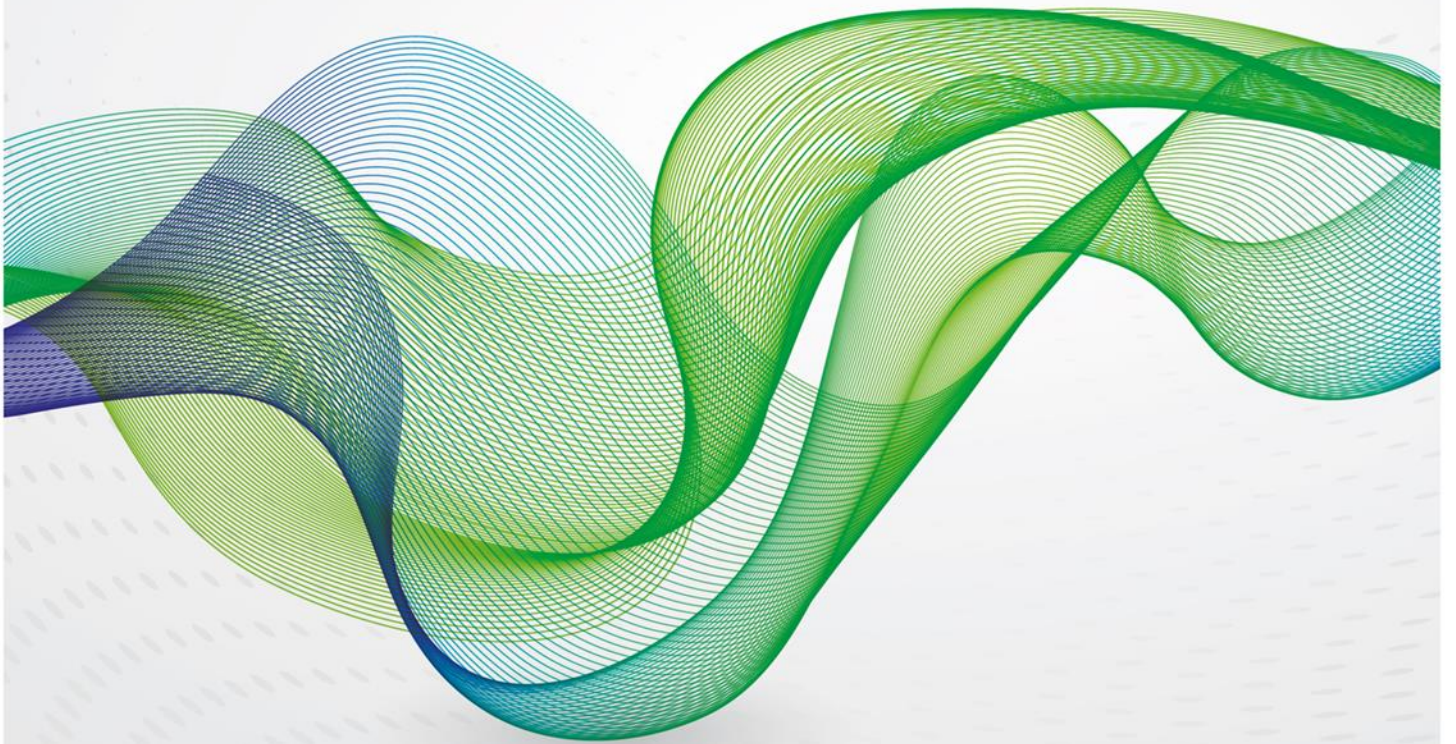


April 2022

Rouble gas payment mechanism: implications for gas supply contracts



On 31 March 2022, President Putin signed a Decree on the Special Procedure for the Fulfilment by Foreign Buyers of Obligations to Russian Natural Gas Suppliers (subsequently referred to as ‘the Decree’), which, in essence, requires buyers from ‘unfriendly’ countries to pay in roubles for gas delivered to them after 1 April 2022.¹

The key objective of this comment is to discuss the impact of the new payment mechanism introduced by the Decree on long-term gas supply agreements (GSAs). We first explain the key currency and payment provisions in GSAs (Sections 1 – 4) and summarize the Decree (5) before moving to a discussion of its potential implications (6) and conclusions (7).

1. Currency provisions in gas supply contracts

Currency is a vital part of gas supply contracts, where parties do not wish to leave room for ambiguity. Accordingly, GSAs take a prescriptive approach and typically specify the currency in which the contract price is to be calculated, invoices are to be issued, and payments are to be made.

The currency of the contract price is always stated in GSAs. Contract price provisions either expressly mandate the calculation of the contract price in a specified currency (for example, ‘*the Contract Price shall be determined in US dollars*’) or identify the currency for the relevant components of the price formula (such as the price of heavy fuel oil expressed in ‘*US dollars/tonne*’). As a general rule, GSAs stipulate one currency for the contract price (commonly US dollar or euro).

Invoicing and payment provisions refer to the relevant provisions for the calculation of the contract price but also ordinarily specify the currency for the seller’s invoice and buyer’s payment (for example, ‘*Invoicing and Payment for Natural Gas delivered under the Contract shall be affected in US Dollars.*’) The option to pay in a different currency than the currency prescribed by the contract is a rare occurrence, which can be found in some GSAs and applies mainly in the event of a buyer’s force majeure.²

2. Payment provisions

GSAs contain a robust set of payment provisions, which, at a minimum, define when, where, and how payment is to be made by the buyer against the seller’s invoice.³

The regulation of the due date tends to be concise. Contracts typically require prompt payment for gas (for example, within seven business days after receipt by the buyer of the seller’s invoice). In a more detailed (but usually straightforward) manner, GSAs specify the place of payment, the mode of payment, and what constitutes payment under the contract.

2.1 The place of payment

GSAs usually require that the payment is made to the bank account nominated by the seller. That could be the seller’s own bank account or a third-party account. The bank account can be either identified in the contract (for example, ‘*Amounts due to the seller shall be paid in EUR into an account in Bank X*’), or described, more broadly, as ‘*the bank account of the Seller*’ or ‘*the bank account designated by the*

¹ An unofficial translation of the Decree is appended to this comment.

² A sample provision allowing for the payment in an alternative currency in a force majeure context reads along the following lines: *If the buyer is unable to make any payment in the currency specified by the contract for reasons of force majeure, the buyer shall arrange to make payment in any alternative available and readily convertible currency which will yield to the seller an amount in USD equivalent to the amount the seller would have received if payment has been made in the currency prescribed by the contract.*

³ The seller is typically responsible for invoicing, but some GSAs allow the buyer to prepare their own invoice.

Seller. Applying broad formulations, GSAs will further stipulate the deadline for the bank account to be initially designated (for example, *'no later than 90 days prior to the Date of First Regular Delivery'*) and potentially changed (say, *'not less than 90 days before any redesignation is effective.'*) Some contracts will further require that the bank designated by the seller is located in a certain region or jurisdiction (for example, allowing for the choice of *'another bank located in the Federal Republic of Germany'*) or is of certain nature (for example, *'a first-class bank'*). A formulation seen in LNG contracts for deliveries to Asia would require the parties to cooperate in the designation of their respective remitting and receiving banks in order *'to minimize for the buyer the time and expense required for transferring funds.'*

2.2 The mode of payment

The method for payment is usually addressed in little detail in GSAs. Some contracts require payment to be executed by *'bank transfer'* (which is sometimes further qualified as *'direct'*, *'electronic'*, or other). It is not unusual to see contracts that do not address any technical aspects of the payment process and only refer to *'amounts being paid'* into a specified bank account.

2.3 The fulfilment of payment obligation

GSAs typically define what constitutes payment under the contract, often referring to the notion of 'full amount'. The definition of 'full amount' is contract-specific but is often understood as *'the amount due without reduction, offset or withholding of any kind for any reasons including taxes, exchange charges or bank transfer changes.'* The payment obligation is usually deemed as fulfilled as soon as the payment reaches the bank account nominated by the seller. A sample formulation to that effect reads along the following lines:

Buyer's deposit in immediately available funds in the full amount due pursuant to [Seller's] invoice with the [Seller's] bank shall constitute full discharge and satisfaction of the payment obligation under this Agreement.

3. Disputed amounts

If the buyer disputes any amounts, GSAs usually take a binary approach and differentiate between the circumstances where the buyer is obliged to pay the full amount or disregard the invoice. Less commonly, GSAs provide for other arrangements, including, for example, partial payments.

3.1 Payment in full

In the event of a dispute as to the contents of the invoice, gas supply contracts typically require that all disputed amounts are nonetheless paid in the full amount by the buyer on a provisional basis against the seller's invoice. In parallel, they require the buyer to notify the seller of the reasons for such disagreement and stipulate the process for the subsequent payment adjustment.

3.2 Payment disregarding an invoicing error

The key (and often only) exception from the obligation to pay the disputed amounts in full is an invoicing error of a contractually defined nature (for example, a *'manifest'*, *'obvious'*, or *'computational'* error). In such circumstances, a contract may allow the buyer to *'pay the correct amount, disregarding such error.'*

3.3 Other arrangements

Some other contractual arrangements that may apply to disputed amounts include payments of a defined amount to be paid in respect of any disputed invoice and payments to third-party accounts (for example, escrow accounts). Another alternative (and the opposite of the full-payment option) is for the buyer to withhold the payment of all invoiced amounts pending the resolution of the dispute.

4. Consequence of buyer's failure to pay

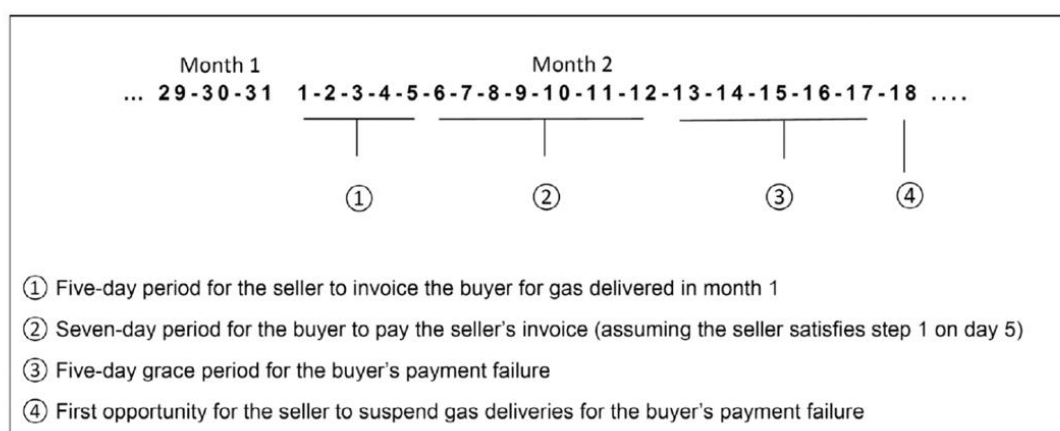
GSA stipulate various protections for the seller against the risk of a payment failure by the buyer, including interest on late payments, suspension of deliveries, and, in the most severe form, contract termination.

4.1 Late payment interest

The primary sanction in the event of the buyer's failure to pay is an obligation to pay late payment interest on the outstanding amount from the due date of the invoice. The interest rate is contract-specific and can comprise, for example, a combination of a LIBOR rate and a certain percentage supplement.

4.2 Suspension of deliveries

The seller's right to suspend deliveries is a standard consequence of the buyer's failure to pay in GSAs. A typical monthly invoicing and payment cycle including the suspension rights for the seller looks as follows:



Source: Peter Roberts, *Gas and LNG Sales and Transportation Agreements: Principles and Practice*, 6th ed, 2020, 171.

As shown above, the seller's right to suspend the delivery of gas in the event of payment failure by the buyer could become effective in less than two weeks after the receipt of the invoice by the buyer.

The ramifications of the suspension of deliveries are (at least to some extent) explained in the contract. For example, the relevant provisions may expressly confirm the right of the seller to sell gas to a third party for the duration of the suspensory event and stipulate that the suspension of deliveries '*shall not constitute a failure of the seller to deliver LNG.*'

4.3 Contract termination

Finally, the seller could be entitled to terminate the contract in response to the buyer's payment failure. The contract termination right mainly applies to a prolonged failure of the buyer to make payment and can be exercised by the seller, for example, after 60 days from the due date of the relevant invoice.

5. The Decree

5.1 Background

Amidst the war in Ukraine and a tense sanctions situation, on 23 March 2022, President Putin announced that the currency of payment for Russian gas delivered to buyers from ‘unfriendly’ countries⁴ ‘will be changed to roubles.’⁵ In his remarks, President Putin highlighted to need to limit Russia’s exposure to asset freezes and ordered Central Bank and the Russian Government to finalize plans for rouble gas payments within a week. The Decree, issued on 31 March 2022, establishes a ‘special procedure’, which contains several instructions and is generally meant to establish the rouble payment mechanism.

5.2 Scope of application

The Decree concerns the supplies of natural gas by Gazprom to buyers from several ‘unfriendly’ countries (including major EU importers of Russian gas) that are executed under gas supply contracts from 1 April 2022.

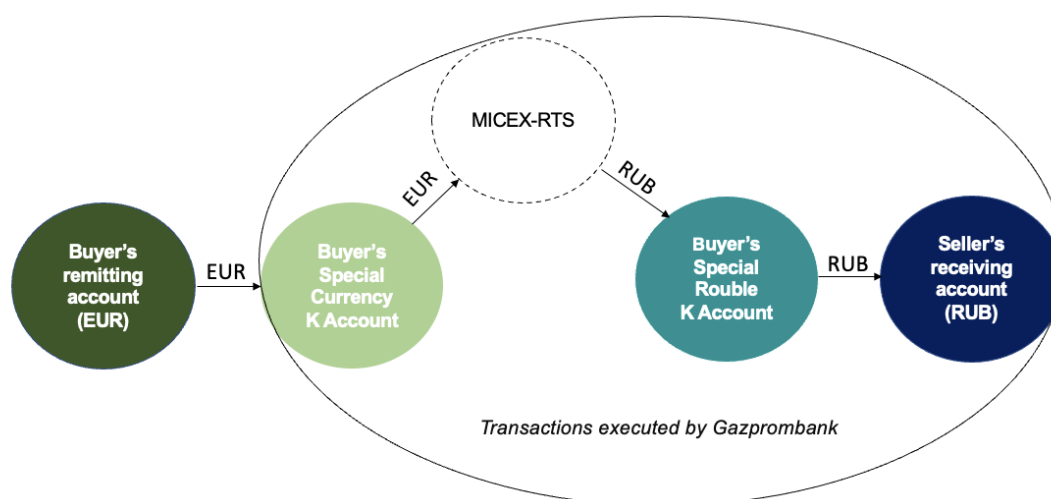
5.3 Payment mechanism

The Decree requires that the buyer applies to open two special accounts (‘K type’) with an authorised bank (Gazprombank).

The payment process as such involves four steps:

1. The buyer transfers funds into the special currency ‘K’ account in foreign currency
2. Gazprombank sells the foreign currency at the ‘Moscow Exchange MICEX – RTS’
3. Gazprombank transfers the rouble proceeds to the buyer’s rouble-denominated ‘K’ account
4. Gazprombank transfers the rouble funds from the buyer’s account to Gazprom’s account in Gazprombank

This sequence can be illustrated as follows:



⁴ The list of ‘unfriendly’ countries corresponds to those that imposed sanctions on Russia and includes EU Member States, the US, UK, Japan, Canada, Norway, Singapore, South Korea, Switzerland and Ukraine.

⁵ <https://www.reuters.com/business/energy/putin-says-russia-will-start-selling-gas-unfriendly-countries-roubles-2022-03-23/>

As the next step, the Russian Government, Central Bank, Federal Customs Service, and Gazprombank, need to put in place the procedures for the implementation of the Decree.

6. Implications

The Decree has clarified the mode of execution by which Russia will demand a rouble payment mechanism for its gas sales. It was published a day after President Putin told German Chancellor Scholz that ‘nothing would change for European partners’⁶ under the Decree. Nonetheless, the wording of the Decree speaks to the contrary.

6.1 Payment for gas in roubles

The Decree introduces a new payment mechanism, which is intended to apply to multiple gas supply contracts. From a legal point of view, the new payment rules would need to be measured against, and potentially reconciled with, the earlier arrangements in the relevant GSAs. This is a case-specific exercise, but it is apparent that the new mechanism differs from the most basic (and common) payment mechanism in a GSA involving one simple transfer of funds from the buyer’s bank account to the seller’s.

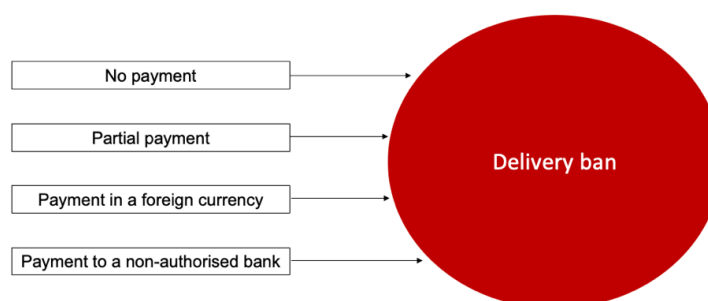
Instead, the Decree introduces a multi-step, and multi-stakeholder, process, which requires both buyer and seller to take certain actions but, generally, shifts the ‘heavy lifting’ for the completion of the process to Gazprombank (and, to a limited extent, involves the Moscow Exchange). The complexity of this mechanism has a clear objective of facilitating the exchange of foreign contract currency into roubles.

This approach appears at first to acknowledge the position of a buyer unwilling to pay for gas in roubles since it allows for the first transfer to be made by the buyer in a foreign currency. However, as soon as the funds are credited to the buyer’s first (foreign currency) ‘K’ account, the subsequent transactions are executed by Gazprombank. This, in turn, translates into various risks for the buyer, including its exposure with respect to the fulfillment of its payment obligation.

With the first transfer in euros or dollars, the buyer does not pay for gas. The buyer’s payment obligation is fulfilled only with the last transfer when the rouble funds are credited to Gazprom’s account. As a result, the complex process under the Decree leading to the fulfillment of the buyer’s payment obligation will have been executed beyond the buyer’s control. Effectively, the Decree forces the buyer to transfer its obligation to pay to another person (Gazprombank).

6.2 Suspension of deliveries and force majeure

The Decree establishes a delivery prohibition mechanism and empowers a ‘*customs authority*’ to ‘*ban*’ the delivery of gas if one or more of the following four circumstances occur when the payment is due:



⁶ <https://www.reuters.com/world/europe/germanys-scholz-did-not-agree-with-putin-rouble-energy-payments-spokesperson-2022-03-30/>

The timeline for a decision of the customs authority and particularities of a potential delivery ban are not stated in the Decree but it is plausible that the new mechanism established under the Decree differs from the earlier contractual arrangements of the parties for a 'payment failure' under the relevant GSA.

A potential supply halt has been a lead theme in the discussion of Russia's demands for the currency switch. Despite the lack of clarity as to the valid contractual ground for this move (but also comments that such a move for Russia would be 'like shooting itself in the foot'⁷), a threat of supply disruption has been reiterated by several Russian officials and remained central to President Putin's televised remarks introducing the Decree.

The Decree potentially changes the tone of the discussion since it effectively transfers the decision on the potential supply halt from Gazprom (as a seller exercising its rights under the relevant GSA) to the customs authority (under the Decree). This maneuver could have several implications and potentially prepare the ground for a potential Gazprom force majeure case.

Force majeure, broadly speaking, refers to unexpected external circumstances that impede performance under a contract. If the customs authority bans the delivery of gas to a certain buyer, Gazprom could file a notice of force majeure under the relevant GSA, claiming that the delivery ban had been imposed by an act of government. In this way, Gazprom could seek to be excused from liability for non-performance of its obligations under a GSA.

6.3 The Decree as a test for unity among EU importers

As of 2 April 2022, the affected (mainly EU) buyers and governments are reportedly in the process of analysing the Decree and are yet to formulate their response.

The first reports that emerged after the publication of the decree suggested that the mechanism proposed by Moscow was welcomed with relief in Europe. Italy's Ecology Transition Minister Cingolani was quoted as saying that the Decree does not seem to alter things that much since '*Putin could show that the Europeans ... could pay in euros.*'⁸ This statement was echoed by French Ecology Transition Minister Pompili, who reportedly said that '*[since] companies pay in euros, the contracts are respected.*'⁹

Meanwhile, French and German Economy Ministers reportedly rejected the demand as '*blackmail*', with French Minister La Maire stating during a visit in Berlin that both nations are '*preparing for the possibility there is no longer any Russian gas.*'¹⁰ On 2 April 2022, referring to '*Russia's energy blackmail in Europe*', the Lithuanian Energy Ministry announced that Lithuania has '*completely abandoned*' Russian gas (adding that this makes Russia's demand to pay for gas in roubles meaningless since Lithuania no longer plans to order and pay for Russian gas.)¹¹

This limited sample mirrors the range of responses that have been delivered by politicians from EU Member States within the week between President's Putin initial remarks on the change of payment currency and the Decree. As the dependence on Russian gas varies across the EU and other political considerations come into play, the EU itself has not issued any formal document that would establish EU-wide guidance for the response (or be akin to the rejection of that demand by G7).¹²

⁷ <https://www.reuters.com/business/energy/russia-europe-gas-standoff-both-sides-lose-2022-04-01/>.

⁸ <https://www.reuters.com/business/energy/russia-gas-payment-decree-does-not-change-much-italy-minister-2022-04-01/>

⁹ https://www.bfmtv.com/economie/entreprises/energie/pourquoi-le-gaz-russe-ne-devrait-pas-etre-coupe-malgre-le-refus-des-europeens-de-payer-en-roubles_AV-202204010289.html

¹⁰ <https://www.france24.com/en/europe/20220331-france-germany-reject-putin-demands-for-gas-payments-in-roubles-as-blackmail>.

¹¹ <https://enmin.lrv.lt/en/news/lithuania-completely-abandons-russian-gas-imports>.

¹² On 28 March 2022, the energy ministers of G7 countries issued a Joint Statement rejecting Russian demands for gas deliveries to be paid in roubles and calling on the companies based in G7 countries not to accede to such demand.

As the EU ‘signals unity’¹³, it remains to be seen how the EU will respond to the new payment mechanism, which has been put in writing (and is no longer subject to speculation as to its mode of execution) and imposes obligations on EU importers that need to be assessed and fulfilled on short notice under the threat of supply disruption.

Notably, the Decree creates scope for cracks in any attempt for a unified response since it allows for exemptions from the Decree. Specifically, at section 9, it stipulates that the Russian Commission for the Control of Foreign Investments is granted the authority to issue ‘permits’ for foreign buyers allowing them to fulfil their obligations under the Decree without observing the procedure established by this Decree. The conditions and process for obtaining permits are not stated in the Decree.

7. Conclusions

With the new payment mechanism, Russia has rectified an obvious weakness of its earlier case for a currency switch in gas supply agreements (which had been strongly opposed by various stakeholders as a ‘breach of contract.’) The new payment mechanism leads to the same result – payment for gas in roubles – but it is a more nuanced strategy which does not require any change in the currency of the contract price and could prove more difficult to navigate for the buyers.

The context of Russia’s demand is key. What could have been understood as a purely technical change to the payment mode under ordinary circumstances (and agreed by the parties in negotiations for the sake of a good business relationship) is unilaterally imposed by Russia on multiple foreign buyers through a domestic legal act that stipulates a severe sanction for non-compliance (namely, a delivery ban).

As a forced solution, the Decree completely ignores the contractual context and potentially interferes with the rights and obligations of the parties under gas supply contracts. In that regard, the Decree is not a step back from the earlier demands for the currency switch since any change to contractual provisions – whether it is a major change in the contract currency or a minor modification in bank transfer rules – must be agreed upon by the parties in accordance with the process prescribed by the relevant contract.

Clearly, the Decree transforms an ordinary contract adjustment issue into a political test, where the threat of a delivery ban could serve as a strong incentive for some buyers to agree to the new payment mechanism. Delivering a set of instructions that must be implemented on short notice (but also leaving scope for individual exemptions), the Decree discourages the re-opening of gas supply agreements with Gazprom where EU buyers might have some demands of their own, mainly with respect to volume provisions, as they prepare to address EU plans to make Europe independent from Russian energy. The related objective of reducing Russian gas imports by two-thirds by the end of 2022 leaves ‘a substantial gap’ (according to a recent OIES analysis¹⁴) between the target import level and contractual take-or-pay levels and therefore puts pressure on the take-or-pay position of EU buyers of Russian gas.

The new rouble payment mechanism is an even more urgent challenge for the buyers and is in itself a ‘take-or-pay’ proposition, where the buyer, in any event, would need to bear the cost consequence. Various considerations (financial, operational, political, and reputational) are at stake, which suggests that the response to the new payment mechanism under the Decree is unlikely to be a smooth exercise. A supply disruption in response to the perceived failure to comply with the rules under the Decree as early as May (when payments for gas delivered in April are due) is, therefore, an eminently plausible outcome.

¹³ <https://www.reuters.com/business/energy/gas-still-flows-russia-europe-buyers-navigate-putins-rouble-order-2022-04-01/>

¹⁴ <https://www.oxfordenergy.org/publications/the-eu-plan-to-reduce-russian-gas-imports-by-two-thirds-by-the-end-of-2022-practical-realities-and-implications/>

Appendix

Decree on the special procedure for the fulfilment by foreign buyers of obligations to Russian natural gas suppliers (unofficial translation).¹⁵

I decree:

1. Establish that from April 1, 2022:
 - a) payment for supplies of natural gas in a gaseous state (hereinafter referred to as natural gas) carried out after April 1, 2022 by residents participating in foreign economic activity who, in accordance with Federal Law No. 117–FZ of July 18, 2006 "On Gas Export", have the exclusive right to export natural gas in a gaseous state (hereinafter referred to as Russian suppliers), produced in roubles:
 - under foreign trade contracts for the supply of natural gas (hereinafter referred to as contracts for the supply of natural gas) concluded with foreign persons, if the supply of natural gas is carried out to foreign states that commit unfriendly actions against the Russian Federation, Russian legal entities and individuals;
 - under contracts for the supply of natural gas concluded with foreign persons whose place of registration is foreign states that commit unfriendly actions against the Russian Federation, Russian legal entities and individuals;
 - b) the further supply of natural gas by a Russian supplier to foreign persons named in paragraphs two and three of subparagraph "a" of this paragraph is prohibited (hereinafter – foreign buyers), under a contract for the supply of natural gas, if the payment period for the gas supplied under this contract has come, the payment has not been made by the foreign buyer or made in foreign currency, and (or) not in full, and (or) to an account with a bank that is not an authorized bank in accordance with paragraph 2 of this Decree, and such delivery is carried out to foreign states that commit unfriendly actions against the Russian Federation, Russian legal entities and individuals. Information on compliance with the procedure established by this Decree for payment for the supply of natural gas is submitted to the customs authority. When the customs authority receives information about a violation of this procedure, the customs authority decides to ban such delivery.
2. Gazprombank Joint Stock Company, which is an authorized bank for the purposes of this Decree (hereinafter referred to as the authorized bank), opens special rouble accounts of the "K" type and special currency accounts of the "K" type for payments for supplied natural gas on the basis of applications from foreign buyers.
3. The authorized bank has the right to open special rouble accounts of type "K" and special currency accounts of type "K" without the personal presence of a representative of a foreign buyer. The authorized bank carries out identification of a new client – a foreign buyer, his representative, beneficiary, beneficial owner in accordance with the requirements of the Federal Law of August 7, 2001. No. 115-FZ "On Countering the Legalization (Laundering) of Proceeds from Crime and the Financing of Terrorism" and regulatory acts of the Central Bank of the Russian Federation adopted in accordance with it on the basis of documents and information about these persons available in the circumstances no later than 45 days after the date of opening a special rouble account of the "K" type to such a client" and a special currency account of type "K".
4. Until amendments are made to the Tax Code of the Russian Federation and other federal laws, special rouble accounts of the "K" type and special currency accounts of the "K" type are not subject to paragraph 12 of Article 76, paragraph 1 of Article 86 of Part one of the Tax Code of the Russian Federation and part 27 of Article 77 of the Federal Law of August 3, 2018. No.

¹⁵ Source: <https://www.reuters.com/article/ukraine-crisis-russia-gas-putin-decree-idUSL5N2VY5U7>



289-FZ "On Customs Regulation in the Russian Federation and on Amendments to Certain Legislative Acts of the Russian Federation".

5. It is not allowed to suspend operations on a special rouble account of type "K" and a special currency account of type "K", to seize or write off funds held on these accounts as part of the fulfilment of obligations of a foreign buyer not related to payment under a contract for the supply of natural gas.
6. A foreign buyer transfers funds to a special currency account of type "K" in the foreign currency specified in the contract for the supply of natural gas, and an authorized bank, on the basis of an order from a foreign buyer received in accordance with the rules of an authorized bank, sells foreign currency received from a foreign buyer to such an account at organized auctions, conducted by the public joint Stock Company "Moscow Exchange MICEX – RTS", transfers the proceeds in roubles to a special rouble account of type "K" of this foreign buyer and transfers the credited funds in roubles to a rouble account opened by a Russian supplier in an authorized bank.
7. The obligation to pay for natural gas supplies by a foreign buyer in accordance with subparagraph "a" of paragraph 1 of this Decree is considered fulfilled from the moment the funds received from the sale of foreign currency carried out in accordance with paragraph 6 or subparagraph "a" of paragraph 10 of this Decree are credited to the rouble account opened by the Russian supplier in an authorized bank.
8. If a foreign buyer has transferred the obligation to pay for the supply of natural gas to another person, it fulfils this obligation in accordance with the procedure established by this Decree.
9. Grant the Government Commission for the Control of Foreign Investments in the Russian Federation the authority to issue permits for foreign buyers to fulfil obligations to Russian suppliers to pay for natural gas supplies without observing the procedure established by this Decree.
10. Grant the following powers to the Board of Directors of the Central Bank of the Russian Federation:
 - a) determine a procedure for the sale of foreign currency other than that provided for in paragraph 6 of this Decree;
 - b) establish the regime of a special rouble account of the "K" type and the regime of a special currency account of the "K" type.
11. Within 10 days, the Government of the Russian Federation shall approve the procedure for issuing permits provided for in paragraph 9 of this Decree by the Government Commission for the Control of Foreign Investment in the Russian Federation.
12. The Board of Directors of the Central Bank of the Russian Federation shall, within 10 days, make decisions necessary for the exercise of the powers provided for in subparagraph "b" of paragraph 10 of this Decree.
13. The decisions of the Board of Directors of the Central Bank of the Russian Federation provided for by this Decree are subject to official publication in accordance with Article 7 of Federal Law No. 86-FZ of July 10, 2002 "On the Central Bank of the Russian Federation (Bank of Russia)".
14. Grant the Central Bank of the Russian Federation the right to give official explanations on the application of this Decree.
15. The Federal Customs Service, in coordination with the Central Bank of the Russian Federation and with the participation of an authorized bank, within 10 days to approve the procedure for submitting, in accordance with subparagraph "b" of paragraph 1 of this Decree, information to the customs authority on compliance with the procedure for payment for natural gas supplies.



16. Recommend to the authorized bank to determine the rules in accordance with paragraph 6 of this Decree within 10 days.
17. This Decree comes into force from the date of its official publication.