SVEA COURT OF APPEAL
Division 02
Bench 020104

JUDGMENT
2 July 2012
Stockholm

Case no. T 611-11

CLAIMANT
National Joint-Stock Company "Naftogaz of Ukraine" (Naftogaz)
6 B Khmelnitskogo Street
01001 Kiev
Ukraine

Counsel: *Advokat* Bengt Åke Johnsson and *Advokat* Ola Nilsson and *jur.kand*. Linda Kahver
White & Case Advokataktiebolag
Box 5573
114 85 Stockholm

DEFENDANT
Italia Ukraina Gas S.P.A. (IUGAS)
Via Leopoldo Micucci 23
00173 Rome
Italy

Counsel: *Advokat* Harald Nordenson and *Advokat* Christina Waering
Setterwalls Advokatbyrå AB
Box 1050
101 39 Stockholm

THE MATTER
Invalidity and challenge of arbitral award

THE AWARD
Separate award issued in Stockholm 19 October 2010 in arbitration proceedings V 007/2008 before the Arbitration Institute of the Stockholm Chamber of Commerce (see appendix A)

JUDGMENT OF THE COURT OF APPEAL

1. The Court of Appeal dismisses Naftogaz's claims.

2. Naftogaz is ordered to pay compensation to IUGAS for its litigation costs in the Court of Appeal in the amount of SEK 2,719,709 and USD 72,457, of which SEK 2,600,000 relates to counsel fees. In addition, interest is payable on the amounts of SEK 2,719,709 and USD 72,457 pursuant to section 6 of the Swedish Interest Act commencing on the date of the Court of Appeal's judgment until payment is made.

Postal address Box 2290 103 17 Stockholm
Street Address Birger Jarls Torg 16
Telephone +46 (0)8-561 670 00 +46 (0)8-561 672 50
Fax +46 (0)8-561 675 09
Office Hours Monday - Friday 9 am – 3 pm
E-mail: svea.avd2@dom.se
www.svea.se

THE PARTIES' AGREEMENT

Naftogaz is a limited liability company wholly-owned by the Ukrainian state. Naftogaz is the leading company in the oil and gas industry in Ukraine. IUGAS is an Italian limited liability company. IUGAS is owned by two companies in the Italian corporate group F.I.S.I., which is a group of companies active in the energy market.

In December 2003, Naftogaz and IUGAS entered into an agreement designated the *Natural Gas Supply Agreement from 2004 to 2013*. When the Court of Appeal writes "the agreement" below, it is this agreement between Naftogaz and IUGAS which is referred to, unless otherwise apparent. Naftogaz is of the opinion that the agreement never became binding between the parties. However, that question was decided by the arbitral tribunal and shall not be readjudicated by the Court of Appeal.

The provisions of the agreement are cited in selected portions in the appended arbitral award. The main aspects of the agreement are as follows.

The agreement has a term running from 1 January 2004 up to and including 31 December 2013. The main import of the agreement is that Naftogaz will sell natural gas originating from Turkmenistan, Kazakhstan, and Uzbekistan and/or Ukraine to IUGAS. The gas is to be delivered by Naftogaz to gas meter stations at the border between Ukraine and Slovakia, where it is received by IUGAS. The volume of the delivery is determined monthly based upon a written order by IUGAS prior to the relevant delivery month, but is limited to a maximum of 1.3 billion m³ per month and a maximum total of 13 billion m³ for the entire contract term. A price for the gas (USD 110 per 1,000 m³ natural gas) is set forth in an appendix to the agreement. The agreement also prescribes that the parties must agree on a mechanism for changing the price through supplemental agreements in the event of a significant change in the price of gas on the European market.

In a section governing the parties' liability, there are provisions regarding damages and liquidated damages. This section prescribes, *inter alia*, that Naftogaz shall pay liquidated damages to IUGAS in a particular manner if the quantity of natural gas delivered is less than the stated quantity in IUGAS' written order for delivery. Correspondingly, there is a provision that IUGAS must pay liquidated damages to Naftogaz if IUGAS fails to take receipt of the agreed volume of gas.

The provisions of the agreement governing dispute resolution state, briefly, that a dispute that cannot be resolved through negotiations shall be decided by the Arbitration Institute of the Stockholm Chamber of Commerce and that the arbitral tribunal shall consist of three arbitrators. The arbitration provision contains a reference to Swedish substantive law. In another section of the agreement, there is also a separate provision that the agreement is governed by Swedish substantive law.

Commencing in May of 2007, IUGAS made written orders for the delivery of gas. No gas deliveries under the agreement have been made thus far.

THE ARBITRATION DISPUTE

Set forth here is a summary of the arbitration dispute in those parts that are of greatest relevance to the case before the Court of Appeal. For a complete report of the parties' claims and the conclusions of the arbitral tribunal, reference is made to the arbitral award in English (appended without the pleadings designated *Pre-trial Statements* which are appended to the arbitral award). In reporting information from the arbitral award, the Court of Appeal has used a translation of the award into Swedish, which was submitted by Naftogaz.

IUGAS requested arbitration proceedings against Naftogaz in January 2008. In its statement of claim, IUGAS moved that the arbitral tribunal hold that the agreement is valid and that Naftogaz is obligated to supply natural gas to IUGAS in accordance with the terms and conditions of the agreement. IUGAS also moved that Naftogaz be ordered to deliver approximately 1.3 million m³ of natural gas and pay liquidated damages of slightly more than USD 80,000,000 to IUGAS. For its part, Naftogaz moved that the arbitral tribunal dismiss IUGAS' cause of action and hold that the agreement is invalid and that no rights or obligations exist under the agreement.

In a joint brief submitted to the arbitral tribunal following deliberations, the parties requested that the arbitral tribunal divide up the proceedings into two parts, where the first phase would result in a separate award, which would then be followed by a final award. The arbitral tribunal ordered proceedings in accordance with the parties' agreement.

The more specific meaning of this bifurcation was that the arbitral tribunal, in a separate award, would determine whether the agreement is valid and in force and whether the arbitral tribunal has jurisdiction to adjudicate the dispute, and whether Naftogaz, in such case, is obligated to supply natural gas to IUGAS in accordance with the terms and conditions of the agreement. Based upon this conclusion, it

would also be determined whether Naftogaz is obligated to pay liquidated damages to IUGAS for unperformed deliveries and is obligated to pay damages to IUGAS. If Naftogaz prevailed in its objections, the proceedings would be terminated following the first phase through a final award. In the event the arbitral tribunal held that the agreement is valid and in force and that Naftogaz is obligated to supply gas and/or pay liquidated damages and/or damages to IUGAS, the proceedings would move on to the second phase where the arbitral tribunal would establish the quantum of such liquidated damages and/or damages in a final award.

During the first phase of the arbitration proceedings, Naftogaz raised a number of different objections to IUGAS' claim, *inter alia* that the agreement was not a binding agreement, that no valid agreement ever arose between the parties, and that the agreement, in any event, ceased to apply or, for various reasons, nonetheless cannot be enforced against Naftogaz. In the latter respect, Naftogaz claimed, *inter alia*, that Naftogaz must be released from its contractual obligations since performance of the agreement is impossible due to Ukrainian legislation. In addition, Naftogaz stated that performance of the agreement would contravene Ukrainian public policy (*ordre public*). Naftogaz also had several objections to Naftogaz being liable to pay liquidated damages and damages, *inter alia*, that IUGAS had failed to give due notice of non-delivery. Other objections included that the liquidated damages provision is unreasonable and must be set aside or adjusted pursuant to section 36 of the Swedish Contracts Act and that liquidated damages cannot be calculated, as IUGAS claimed, on the maximum amounts of gas deliveries stated in the agreement.

In the separate award, which is thus the decision subject to the Court of Appeal's adjudication, the arbitral tribunal's conclusion was that the agreement is valid and that performance of the agreement is not prevented by any of the circumstances argued by Naftogaz. Naftogaz was therefore held to be liable to supply gas to IUGAS in accordance with the terms conditions of the agreement (see the summary on page 86 of the award).

It can be added that it is apparent from the award that the tribunal was of the opinion that Naftogaz was not obligated to perform the agreement until after the close of 2006 (arbitral award, page 69). The reason for this was the extreme circumstances prevailing at the time of the execution of the so-called three party agreement (see more on this agreement below in the description of the Ukrainian gas market).

On the question regarding liquidated damages, the arbitral tribunal held that IUGAS had forfeited its right to liquidated damages regarding the first and second order for delivery in May and July 2007 due

to the late notices of breach. With respect to other ordered deliveries, there was a right to liquidated damages. The arbitral tribunal found that the calculation of the liquidated damages must be based upon the volume of gas that was actually ordered and not based upon the maximum volumes of gas stated in the agreement. In addition, the arbitral tribunal found that Naftogaz is not obligated to pay damages on any of the grounds argued by IUGAS.

It is stated, *inter alia*, in the ruling in the award that the agreement is valid and in force (section 2), that Naftogaz is obligated to supply natural gas to IUGAS in accordance with the terms and conditions of the agreement (section 3) and that Naftogaz is obligated to pay liquidated damages pursuant to the agreement to IUGAS for ordered, but not performed, deliveries of gas from 1 September 2008 until the final award was issued (section 4).

It is apparent from the award that the arbitral tribunal, in the second phase of the arbitration proceedings, will deal with the quantum of liquidated damages awarded to IUGAS and the cost for the arbitration proceedings (pages 92 and 99). That portion of the arbitration proceedings is still pending.

MOTIONS IN THE COURT OF APPEAL

Naftogaz has moved that the Court of Appeal, firstly, declare the arbitral award invalid with respect to sections 2, 3 and 4 of the award and, secondly, set aside the same sections of the award.

IUGAS has contested the motions.

The parties have requested compensation for their litigation costs in the Court of Appeal.

NAFTOGAZ 'S CLAIMS IN THE COURT OF APPEAL

The invalidity claim

The arbitral tribunal has, firstly, ordered Naftogaz, or declared that Naftogaz is obligated, to in fact perform the deliveries of gas to IUGAS despite the fact that Naftogaz is legally prohibited from doing so and that such performance is subject to penal sanctions. Since 2006, Ukrainian law has prohibited the exportation of gas of Ukrainian origin and the re-exportation of gas originating from Central Asia. Any person violating the provisions is subject to a lengthy term of imprisonment.

There are exceptions to the provisions in certain cases where the exporter, in an individual case, has obtained export approval (replaced by a quota system on 1 January 2012) and possesses a license for export, or a specific permit for re-exports. Despite the fact that Naftogaz has made inquiries regarding export approval and export licenses and re-export permits and thus taken the measures possible, such approvals and licenses and permits have not been granted by the Ukrainian authorities.

The Ukrainian legislation regarding export prohibitions and provisions against re-exporting of gas are, as is the case with Ukrainian customs legislation, mandatory and sanctioned by criminal penalties. These legal rules have been adopted in the furtherance of societal interests and for the protection of the fundamental public interest of ensuring the gas needs of the population and society, which are necessary for fundamental societal functions and the fundamental needs and rights of the population.

The arbitral tribunal has, secondly, ordered Naftogaz, or declared that Naftogaz is obligated, to pay liquidated damages as a sanction for Naftogaz having failed to supply gas in contravention of prohibitions set forth in the law and as pressure in order to induce Naftogaz to perform the gas deliveries in contravention of these prohibitions.

The arbitral award obligates Naftogaz, in contravention of the criminally sanctioned prohibitions set forth in the law, to supply gas and, as a consequence thereof, pay liquidated damages. Both the award and the grounds for the award require that performance is made that is prohibited by law. The arbitral award is thus obviously incompatible with the fundamental basis of the Swedish legal system as well as the Ukrainian legal system. The arbitral award is incompatible with mandatory legal rules under Ukrainian law regarding export and re-export prohibitions adopted in the furtherance of societal interests. The arbitral award must therefore, with respect to sections 2, 3 and 4 of the award, be declared invalid pursuant to section 33, first paragraph, subsection 2 of the Swedish Arbitration Act (SFS 1999:116) (hereinafter "SAA").

The challenge

Naftogaz claimed in the arbitration that it was legally prohibited from delivering gas to IUGAS of either Ukrainian or Central Asian origin. The arbitral tribunal found that Naftogaz is clearly prevented from supplying gas, but found - without adjudicating Naftogaz's objections to the claim (its legal grounds) - that Naftogaz is nonetheless obligated to supply gas.

The arbitral tribunal has not adjudicated Naftogaz's claim that, as a consequence of legislation in Ukraine, it was prohibited from supplying gas to IUGAS of Central Asian origin. Thus, through no fault of Naftogaz, such a defect has arisen in the proceedings which affected the outcome of the award. In the alternative, Naftogaz argues that the grounds for challenge invoked, from a legal perspective, entail that the arbitral tribunal exceeded its mandate. The award must therefore be set aside with respect to sections 2, 3, and 4 of the award in accordance with section 34, first paragraph, subsection 6 of the SAA, or in the alternative section 34, first paragraph, subsection 2 of the SAA.

IUGAS' REBUTTAL OF THE CLAIM

The claim of invalidity

The arbitral tribunal has not ordered Naftogaz to supply gas to IUGAS.

Instead, the arbitral tribunal declared Naftogaz's contractual obligations to supply gas to IUGAS in accordance with the terms and conditions of the agreement.

Naftogaz is not legally prohibited from supplying gas to IUGAS. Ever since 2006, Ukrainian law has not had a prohibition against the exporting of gas of Ukrainian origin and the re-exporting of gas of Central Asian origin. The granting of an export license cannot be described as an exception from a general export prohibition under Ukrainian law. The Ukrainian regulatory system governing gas exports expresses the idea that satisfying the gas needs of the Ukrainian population must be the first priority.

Naftogaz's inquiries regarding export licenses and export approval directed to the Ukrainian authorities cannot constitute support for Naftogaz's claim that it is legally prohibited from supplying gas. Naftogaz had possibilities to acquire licenses or permits for gas exports to IUGAS during the period 2007 – 2010. For the period 2011 and 2012, Naftogaz can also obtain licenses or permits for gas exports when the annual gas balances are established. It is stipulated that the Ukrainian regulatory system for gas exports went from a licensing system to a quota system on 1 January 2012.

It is correct that there are criminal sanctions in Ukraine where gas exports take place without the necessary licenses or permits. However, this fact lacks relevance in the case since the arbitral award does not obligate Naftogaz to export gas in contravention of the Ukrainian regulatory system.

The arbitral tribunal has not ordered Naftogaz to pay liquidated damages. Nor has the arbitral tribunal ordered Naftogaz to pay liquidated damages as a penalty or pressure to induce Naftogaz to perform gas deliveries in contravention of Ukrainian export rules. Instead, the arbitral tribunal has established Naftogaz's contractual obligation to pay liquidated damages upon non-delivery.

The award does not obligate Naftogaz, in contravention of criminally sanctioned legal prohibitions, to supply gas and, as a consequence thereof, pay liquidated damages. Neither the ruling in the award nor the grounds for the ruling in the award require that performance be made that is prohibited by law. The arbitral award is not incompatible with mandatory legal rules under Ukrainian law with respect to export and re-export prohibitions enacted for the protection of societal interests.

The arbitral award is not obviously incompatible with the fundamental basis of the Swedish and Ukrainian legal systems and must not be declared invalid.

The challenge

The arbitral tribunal has not found that Naftogaz is clearly prevented from supplying gas. Nor has the arbitral tribunal found, without adjudication of Naftogaz’s rebuttal, that Naftogaz is obligated to supply gas.

It is correct that, in the arbitration case, Naftogaz has claimed that it was legally prohibited from supplying gas of Central Asian origin to IUGAS. The arbitral tribunal has adjudicated Naftogaz's claims in this respect as well. There have not been any errors in the adjudication, without the fault of Naftogaz, that have affected the outcome of the case. Nor has the arbitral tribunal exceeded its mandate. Therefore, the arbitral award must not be set aside.

MORE SPECIFIC COMMENTS BY THE PARTIES REGARDING THE CLAIMS IN OTHER RESPECTS

In addition to the summaries above, the parties' more specific comments regarding the claims in the Court of Appeal have primarily consisted of their reporting their respective positions regarding the regulation of the gas market in Ukraine and the meaning of the arbitral award, and based upon this, arguing their legal positions. In the reasoning of the Court of Appeal set forth below, there is a separate section regarding the regulation of the gas market in Ukraine. In the reasoning in other

respects, the Court of Appeal goes into more detail regarding portions of the award and the parties' argumentation to the extent this is justified.

THE EVIDENCE IN THE COURT OF APPEAL

The parties have offered extensive written evidence. At the request of Naftogaz, the witnesses A.M., P.A., Y.A.S., and O.B. and expert witness I.P. have testified in the case. At the request of IUGAS, expert witness O.M. has testified.

THE REASONING OF THE COURT OF APPEAL

The regulation of the gas market in Ukraine

The parties have offered evidence regarding the regulation of the gas market in Ukraine from the time of the execution of the agreement and forward, *inter alia*, in the form of legal opinions and the testimony of expert witnesses. In this section, the Court of Appeal provides an overall summary of that which has been adduced from the evidence in this respect. It can initially be stated that the parties are in agreement in most respects regarding which rules have applied. However, they have differing opinions regarding the meaning of the regulatory system and its effect on Naftogaz's possibilities and obligations to perform the agreement with IUGAS.

However, to provide a background to the regulatory system for gas exports, some comments should first be provided about the general developments on the Ukrainian gas market during the decade following 2000.

At the time of the parties' agreement, there was a plentiful supply of natural gas in Ukraine. One reason for this was an agreement from 2002 between Naftogaz and the Russian state gas company Gazprom. According to the agreement, Gazprom paid for the transit of Russian gas through Ukraine in the form of gas deliveries to Naftogaz which thus obtained access to cheap natural gas. During 2005, the conditions were changed and at the end of that year Gazprom demanded a significant increase in the price for gas, which was not accepted by Naftogaz. The situation developed into a gas war in the beginning of January 2006 when Gazprom stopped deliveries of gas to Ukraine. Naftogaz then entered into the so-called three party agreement with Gazprom and the Swiss company RosUkrEnergo. According to the three party agreement, it was RosUkrEnergo that would be the supplier of natural gas to Ukraine. The agreement states that, commencing 1 January 2006, Gazprom shall not deliver

Russian natural gas to Ukraine and that natural gas that comes from the Russian Federation shall not be exported from Ukraine by Naftogaz. Naftogaz has argued that the agreement was extremely disadvantageous and that the arbitral tribunal, in the separate award, has concluded that Naftogaz entered into the three party agreement under duress.

In October 2008, a treaty was entered into between Russia and Ukraine which, *inter alia*, stated that the parties' intention was that Naftogaz would be the sole importer of all natural gas to Ukraine. RosUkrEnergo's role as supplier terminated after this. Following an additional gas crisis, the three party agreement was replaced by a new trade agreement for natural gas between Naftogaz and Gazprom commencing January 2009. The agreement contains a provision stating that the natural gas that is delivered according to the agreement is intended for Ukrainian users and that Naftogaz is not entitled to sell such gas outside of Ukraine's borders.

With respect to the Ukrainian regulatory system for the gas market, in summary, the following has been adduced in the case.

When Naftogaz and IUGAS entered into their agreement in December 2003, there were no lawful restrictions in Ukraine for the exporting of any type of natural gas.

After the gas crisis in the beginning of 2006, restrictions were enacted under Ukrainian law for exporting domestically produced Ukrainian gas and for re-exporting imported gas. At this time, provisions were introduced pursuant to which gas that is extracted by state-owned companies in Ukraine must firstly be used in order to satisfy the Ukrainian population's needs and Ukrainian gas may not be exported without an export license. Application for such a license is made to the Ukrainian Ministry of Finance, which may only grant an export license following the approval for export from the Ministry for the Energy and Coal Industry. Correspondingly, at the same time, a requirement for a permit for re-exporting imported gas was also introduced. Such a permit may be granted by the Ministry of Finance upon application.

A further condition for a permit to export domestic or imported gas is that there is scope for this in the Ukrainian gas forecast. The annual gas forecasts, which are ultimately established by the Ukrainian government, state, among other things, which volumes of gas will be produced, imported, used and exported during the next year. Naftogaz participates in producing the gas forecasts. The parties are in disagreement as to what extent Naftogaz can impact the contents of these forecasts. In the gas forecasts established during the years 2007 – 2010, the annual volume of gas for export was only

between 5 and 9 million m³. As far as has been shown, that export related to a Ukrainian undertaking regarding the supply of gas to a small Polish town near the Ukrainian border. The gas forecasts have not yet been established for the years 2011 and 2012.

Naftogaz has reported a number of criminal law sanctions that may be triggered if gas is exported without the necessary licenses and permits. The parties are in agreement that such exports can lead to criminal liability for smuggling, since customs clearance cannot be obtained without licenses and permits.

The licensing and permits system described above for exporting gas has applied in largely unchanged form since 2006, with the exception that, starting in January 2012, the requirement of export approval by the Ministry for the Energy and Coal Industry for exports of Ukrainian gas was replaced by a quota system. In addition to that system, Naftogaz has stated that Ukrainian law sets up additional obstacles to the exportation of domestic and imported gas.

In July 2010, law 2467 *On the Fundamentals of Natural Gas Market Operation* was adopted, which prescribes, *inter alia*, that state companies must sell all natural gas they have produced in Ukraine to a body which is appointed by the government and that the people's need for natural gas must, firstly, be satisfied through the gas (see appendix 11 to I.P.'s legal opinion of 16 April 2012). The parties have differing opinions regarding the law. Naftogaz's position is that the law constitutes an absolute prohibition on the exportation of gas of Ukrainian origin, without any lawful possibility to obtain an export license. According to Naftogaz, it was not until July 2011, through an amendment to the law which was made in order for Ukraine to be able to perform its undertakings regarding gas supplied to Poland, that it was once again possible to grant export licenses. IUGAS is claiming that the law has never constituted an absolute prohibition against exports and has not stipulated that the express possibility for exporting, which Naftogaz claims was introduced in July 2011, did not apply earlier.

The expert witnesses who have testified in the case have had differing opinions on the question and, in the opinion of the Court of Appeal, no certain conclusions can be drawn from their information or from the correspondence from various governmental authorities offered by Naftogaz. Even taking into consideration the fact that the cited *Explanatory Note*, which addresses the background of the relevant amendment to the law, to some extent favors Naftogaz's interpretation of the legal rules, for its part the Court of Appeal cannot glean any export prohibition from the relevant legislation (see the explanatory note in appendix 15 to I.P.'s legal opinion of 16 April 2012). Thus, the conclusion of the Court of Appeal is that nothing has been adduced showing that law 2467 constituted an absolute export

prohibition on gas of Ukrainian origin during the period July 2010 – July 2011, as claimed by Naftogaz.

With respect to imported gas, Naftogaz has argued that, in parallel with the requirement of a license for re-export, and in line with the three party agreement, a prohibition was introduced banning re-export of Central Asian gas from Ukraine through resolution 163 *On Sale of Imported Natural Gas on the Territory of Ukraine*. This law states, *inter alia*, that Central Asian natural gas that enters Ukraine from RosUkrEnergo may only be used to satisfy the needs of the Ukrainian users within the volumes established in the gas forecast and that imported gas must be sold by Naftogaz and its subsidiaries (see appendix 22 to I.P.'s legal opinion of 16 April 2012). The parties and their respective experts have differing opinions on the question of whether this resolution entails an absolute prohibition against re-exporting Central Asian gas from Ukraine. Also on the question of these provisions, the Court of Appeal is not of the opinion that the wording of the resolution, together with the evidence otherwise, leads to the conclusion that an absolute prohibition on exports, in this case for Central Asian gas, applied.

As is apparent from the summary of the parties' cases, Naftogaz's opinion is that the Ukrainian regulatory system, taken as a whole, means that Ukrainian law, since 2006, prohibits the export of gas of Ukrainian origin and the re-exporting of gas of Central Asian origin and that Naftogaz is legally prohibited from performing deliveries of gas to IUGAS. According to Naftogaz, it has not been possible for Naftogaz to obtain the necessary licenses and permits for export.

On the contrary, IUGAS argues, in line with the conclusion of the arbitral tribunal, that Naftogaz is not legally prevented from supplying gas to IUGAS since Ukrainian law does not establish any prohibitions against the exportation of gas. According to IUGAS, the Ukrainian regulatory system only states that the gas needs of the Ukrainian population must be satisfied first. IUGAS also claims that Naftogaz had the possibility, and still has the possibility, to obtain a license or permit for the exportation of gas to IUGAS.

In summary, the Court of Appeal draws the following conclusions regarding the Ukrainian regulatory system for the exporting of gas. From the evidence in the case, nothing has been shown other than that the exportation of both domestic and imported gas in the period starting in 2006 and going forward was permitted provided that necessary licenses and permits were granted, which in turn presupposes that the scope for such exportation has been established in the gas forecast. The Court of Appeal's position is thus that Ukrainian law has not contained, nor does it contain, any total prohibition against

the exportation of natural gas, irrespective of the origin of the gas. As has already been set forth, the parties are in disagreement regarding the question of whether Naftogaz actually had, and has, the possibility to obtain a license or permit for the exportation of gas to IUGAS. It is not necessary for the assessment which the Court of Appeal must make in this case to take a position on this question. However, the Court of Appeal notes that, to the extent such a permit could not be obtained, this was not, as the arbitral tribunal has also stated (page 75 of the award) a consequence of any permanent prohibition under Ukrainian law but rather on a lack of access to gas. In the next section, the Court of Appeal will address how the legal situation described above must be assessed from a public policy perspective.

Does the award contravene public policy?

According to Naftogaz, the award is invalid since it is obviously incompatible with the grounds of the Swedish legal system (*ordre public*).

The following, among other things, is stated in the legislative history underlying the provision set forth in section 33, first paragraph, subsection 2 of the SAA to the effect that an arbitral award is invalid if it is obviously incompatible with the fundamental grounds for the legal system in Sweden (Government Bill 1998/99:35, page 141, et seq. and 234). The concept "*ordre public*" covers only highly objectionable cases. The rule focuses on arbitral awards where elementary legal principles of a substantive or procedural nature have been circumvented. In Sweden, out of custom, public policy rules are given a narrow application and this ground for invalidity is probably therefore very seldom relevant. Examples of arbitral awards which may conceivably contravene Swedish public policy include awards that relate to claims based on gambling or criminal acts or where a party is obligated to render performance which is prohibited by law. An arbitral award can also be of a nature of a criminal penalty such that it cannot be deemed acceptable. One can also conceive of cases where an arbitral award is deemed to contravene public policy where the arbiters determined the dispute without taking into consideration a legal rule which is mandatory based on a third-party or public interest.

As is apparent from the wording of section 33, first paragraph, subsection 2 of the SAA, the invalidity ground focuses on the Swedish legal system. Since this case involves an international arbitration dispute, there is also cause to address public policy from an international perspective (for this report, see Redfern and Hunter *On International Arbitration*, student version, fifth edition, page 614, et seq. and 656 et seq.). Since the view of public policy varies between various countries, there is a risk that, citing public policy, a country will not recognize arbitral awards that other countries deemed to be

valid. It may also occur that the courts of individual countries will employ public policy arguments in order, in reality, to disregard arbitral awards on substantive grounds. In order to combat a situation where international arbitral awards are not recognized solely on the grounds that they contravene a domestic approach, a doctrine has been developed regarding international public policy, which can be said to be a narrower concept than the national equivalent.

In an attempt to harmonize the application of public policy in international arbitration disputes, the International Law Association has adopted recommendations regarding this (ILA resolution 2/2002). The following is stated in article 1(d):

> The international public policy of any State includes: (i) fundamental principles, pertaining to justice or morality, that the State wishes to protect even when it is not directly concerned (ii) rules designed to serve the essential political, social or economic interests of the State, these being known as "*lois de police*" or "public policy rules" and (iii) the duty of the State to respect its obligations towards other states or international organisations.

A few examples of unacceptable activities that have been mentioned in this context are corruption, the narcotics trade, smuggling and terrorism (see ILA Interim Report on Public Policy 2000, page 7 and ILA Final Report on Public Policy 2002, page 7).

In an assessment of whether an arbitral award contravenes public policy, the legal impact of the award must be analyzed. Naftogaz has claimed, by way of summary, that the arbitral award obligates Naftogaz, in contravention of criminally sanctioned legal prohibitions, to supply gas and, as a consequence thereof, to pay liquidated damages. According to Naftogaz, both the ruling in the award as well as the grounds for the ruling in the arbitral award require that performance be rendered that is prohibited by law. IUGAS's position is that the arbitral tribunal has not ordered Naftogaz to perform deliveries of gas or to pay liquidated damages to IUGAS. According to IUGAS, the arbitral tribunal has instead established Naftogaz's contractual obligations to supply gas and to pay liquidated damages in the event of non-delivery.

In order to understand what the award means, the bifurcation of the arbitration proceedings into two phases is of interest. As the Court of Appeal has reported under the heading *The Arbitration Dispute*, IUGAS moved in the statement of claim, *inter alia*, that Naftogaz be ordered to deliver a certain volume of natural gas and pay liquidated damages in a particular amount to IUGAS. As a consequence of the bifurcation which was subsequently decided, the arbitral tribunal adjudicated in a first phase whether the agreement is valid, whether Naftogaz is obligated to supply natural gas to IUGAS in accordance with the terms and conditions of the agreement, and whether Naftogaz is obligated to pay

liquidated damages and damages to IUGAS. Given the conclusions that were made, it remains for the arbitral tribunal in the second phase of the arbitration proceedings to address the amount of liquidated damages to be awarded IUGAS and the costs for the arbitration proceedings (award, page 99).

According to the Court of Appeal, through the separate award, the arbitral tribunal adjudicated whether Naftogaz is to be released from its contractual obligation to supply gas on the basis of the objections raised by Naftogaz. In this context, the arbitral tribunal has held that Naftogaz's obligation to supply gas to IUGAS according to the agreement applies (see section 3 of the tribunal's reasoning). This does not mean that the award orders Naftogaz to actually supply gas to IUGAS. With respect to the liquidated damages, the arbitral tribunal, as far as the Court of Appeal understands the award, has held that Naftogaz is obligated to pay liquidated damages to IUGAS for certain periods and also established several principles for how the liquidated damages are to be calculated. However, the tribunal did not determine which amounts are to be paid. From the information in the award regarding the second phase of the arbitration proceedings, it is also apparent that it will also not be relevant in the final award to order Naftogaz to perform deliveries of gas. It involves instead determining the amount of the liquidated damages to be awarded to IUGAS.

This means that Naftogaz can never be forced to supply gas on the basis of the arbitral award. In the event Naftogaz is unable to perform its obligation to supply gas according to the agreement, Naftogaz may be liable for this by paying liquidated damages. Therefore, the award does not order Naftogaz to take any unlawful act, such as for example smuggling, and for this reason can therefore not be deemed to contravene public policy.

The question is then whether it nonetheless contravenes public policy to hold that Naftogaz is obligated to supply gas and pay liquidated damages, considering the legal situation which has existed, and continues to exist, on the gas market in Ukraine and which, according to Naftogaz, entails a prohibition on the exporting of gas. According to Naftogaz, the obligation to pay liquidated damages becomes a type of penalty for Naftogaz not having supplied gas in contravention of legal prohibitions and constitutes pressure to induce Naftogaz to perform gas deliveries in contravention of legal prohibitions.

As set forth above in the section regarding the regulation of the gas market in Ukraine, however, the Court of Appeal's position is that Ukrainian law during the time from 2006 onwards did not contain a total prohibition against exporting natural gas. Instead, exporting both domestic and imported gas was permissible provided the necessary licenses and permits were granted. To the extent Naftogaz has been

unable to perform the agreement, this was instead a consequence of a lack of access to gas. The arbitration dispute can therefore be described such that the main issue dealt with determining which of the parties should bear the risk of the situation on the gas market developing in the manner which it did after the parties entered into the agreement and whether the shortage of gas which arose gives cause to release Naftogaz from its contractual obligations. The substantive issue has been decided by the arbitral tribunal and will not be re-adjudicated by the Court of Appeal in this case.

Given these circumstances, the Court of Appeal is of the opinion that it cannot be deemed to contravene public policy in the traditional national sense, or as the doctrine of international public policy has been developed, to hold that Naftogaz is obligated to supply gas to IUGAS in accordance with the agreement. Given this approach, it also does not violate public policy for Naftogaz to pay liquidated damages for non-delivery. It can be added that contractual liquidated damages cannot be equated with punitive damages as they exist in the United States, which a few courts in other countries have held, in certain cases, contravene public policy. Nor has any particular reason been presented or adduced otherwise in the case for holding that the arbitral award contravenes public policy with respect to section 2 of the ruling that the agreement is valid and in force.

Accordingly, the conclusion of the Court of Appeal is that the arbitral award is not obviously incompatible with the fundamental basis of the Swedish legal system.

The challenge

Naftogaz has stated that the arbitral tribunal did not consider the claim that, as a consequence of legislation in Ukraine, Naftogaz was prohibited from supplying gas to IUGAS of Central Asian origin. According to IUGAS, the arbitral tribunal considered Naftogaz's claim in this respect as well. IUGAS has also argued that the alleged error cannot have affected the outcome.

The relevant ground is related to section 10 of the arbitral award which is headed "*Is performance of the Agreement impossible*?" Following an initial general section, Naftogaz's claims regarding the impossibility of performance of the agreement are addressed in two different sections. The central section for the Court of Appeal's consideration is section 10.2 which is headed "*Is performance of the Agreement impossible as a consequence of Ukrainian legislation?*"

It is stated in the report of Naftogaz's statement of particulars of its claim in section 10.2.1 of the award that Ukrainian law establishes a prohibition against exporting of gas of Ukrainian origin.

However, nothing is mentioned here regarding a prohibition against exporting Central Asian gas. In light of the fact that the parties are in agreement in the Court of Appeal that Naftogaz argued, in the arbitration proceedings, that Ukrainian law prohibits the exporting of Central Asian gas as well, Naftogaz's cause of action in this respect must be deemed to have been incompletely reported by the arbitral tribunal. At the same time, it can be noted that the arbitral tribunal includes a summary of Naftogaz's statement of particulars of its claims also in its introductory general section in section 10. In this section, Naftogaz's position is reported, *inter alia*, that, as a consequence of the three party agreement and Ukrainian legislation that prohibits exporting and re-exporting gas, it is still impossible to perform the agreement (award, page 58). Thus, the relevant claim by Naftogaz is more completely restated there.

However, the decisive question is not how Naftogaz's grounds have been restated in the award, but rather whether the fact was considered and adjudicated by the arbitral tribunal or whether the arbitral tribunal disregarded the grounds in its adjudication. In order to decide that question, that which is otherwise addressed in section 10.2 of the award must be considered.

To begin with, it can be noted that the arbitral tribunal restated that IUGAS, in stating the particulars of its claims, has argued in respect of the export rules for gas of both Ukrainian and non-Ukrainian origin (award, page 69 et seq.).

In addition, in its reporting of the evidence in this section, the arbitral tribunal has addressed exports of both Ukrainian and imported gas. For example, it is stated that T.S. has stated that, beginning in 2006, Naftogaz was continuously prohibited from exporting gas which had been imported from, *inter alia* Turkmenistan, Kazakhstan, or Uzbekistan. It is also reported that O.M. has stated that Ukrainian legislation does not prohibit the re-exporting of gas but rather establishes separate legal rules for such re-exporting. The arbitral tribunal also reports correspondence from the Ukrainian Chamber of Commerce which, among other things, states that, beginning in January 2006 and continuing until now, Naftogaz has been prohibited from re-exporting gas from Turkmenistan and/or Kazakhstan and/or Uzbekistan. Finally, correspondence from the Ukrainian Ministry of Finance is cited according to which gas from Russia, Kazakhstan, Uzbekistan and Turkmenistan may not be exported outside of Ukraine's borders. It is thus apparent that the arbitral tribunal believed that it was relevant in this section to report evidence regarding export prohibitions on Central Asian gas, which would hardly have been the case if the tribunal had not believed that Naftogaz had argued that Ukrainian law prohibits the exporting of such gas.

With respect to the arbitral tribunal's own conclusions on this question, the arbitral tribunal in its assessment touches upon the re-export prohibition in the three party agreement on page 74, fourth paragraph, of the award. Thereafter, in the fifth paragraph, there is a discussion regarding how the provisions have been incorporated into Ukrainian legislation, whereupon the significance of resolution number 163 is addressed. The arbitral tribunal states, *inter alia*, that the resolution was not an independent regulatory system which prevented Naftogaz from re-exporting gas and then draws the conclusion that the resolution lost its effect when the three party agreement ceased to apply. In the opinion of the Court of Appeal, it is clear through this that the arbitral tribunal has adjudicated the claim that Naftogaz, as a consequence of legislation in Ukraine, was prohibited from supplying gas of Central Asian origin to IUGAS. The arbitral tribunal states on page 75 of the award that, even if Naftogaz were at least temporarily prevented from exporting the volume of gas required in order to perform the agreement, this was not a consequence of any permanent prohibition under Ukrainian law but rather on a lack of access to gas. In the opinion of the Court of Appeal, this statement covers the question of a prohibition under Ukrainian law against exports of both Ukrainian as well as Central Asian gas.

In this context, Naftogaz has argued in respect of the conclusion on page 76 of the award where the Swedish translation states that the tribunal by way of summary is of the opinion that Naftogaz was clearly prevented by legislation in Ukraine but that Naftogaz nonetheless may have had certain possibilities to export gas in order to perform the agreement. According to Naftogaz, the arbitral tribunal's statement appears contradictory and indicates that the arbitral tribunal only adjudicated the export prohibition regarding gas of Ukrainian origin. It is the opinion of IUGAS that the arbitral tribunal did not find that Naftogaz is clearly prevented from supplying gas, but that the tribunal's conclusion is that, despite significant legislative limitations, there were certain possibilities to export gas in order to perform the agreement.

The Court of Appeal wishes here to emphasize that the language in the arbitration proceedings is English and that the Swedish version of the award is thus a translation. The English original text in this section states: "*In conclusion, the tribunal considers that Naftogaz was clearly prejudiced by the legislation of Ukraine but may nevertheless have had some possibilities to export gas for the fulfilment of the contract*". It can be noted that the word "prejudiced" also is found in the sentence "*The Tribunal finds it obvious that Naftogaz's situation was dramatically prejudiced by the TPA*" on page 66 of the award which, in the Swedish version, has been translated to "*Nämnden finner det uppenbart att Naftogaz situation kraftigt påverkades av TPA*" (TPA stands for three party agreement).

The Court of Appeal is of the opinion that the arbitral tribunal's statement regarding legislation on page 76 means that the legislation in Ukraine clearly affected Naftogaz's possibilities to export gas (negatively) but that some possibilities nonetheless existed. According to the Court of Appeal, the statement does not provide any support for the position that the tribunal has only considered the export prohibition regarding gas of Ukrainian origin. Instead, it must be understood such that it deals with the Ukrainian legislation regarding the exporting of all types of gas covered by the agreement.

Naftogaz has also claimed that the arbitral tribunal failed to consider the claim regarding a legal prohibition against exporting Central Asian gas in its adjudication of whether performance of the gas supply agreement contravenes public policy in Ukraine which, according to Naftogaz, affected the outcome in this respect. The question of whether performance of the gas supply agreement contravenes public policy in Ukraine is addressed in section 13 of the award. In its consideration there, the arbitral tribunal refers back to its earlier conclusion in section 10.2 that Naftogaz is not prohibited from performing the agreement as a consequence of Ukrainian legislation. As set forth above, the Court of Appeal has found that the adjudication in section 10 includes Naftogaz's claim regarding a legal prohibition against the exporting of Central Asian gas. This means that the circumstances must be deemed to have been taken into consideration even in the arbitral tribunal's assessment of the public policy issue. The arbitral tribunal has also stated that, in any event, an award that orders Naftogaz to perform the agreement would not contravene Ukrainian public policy.

The Court of Appeal's conclusion is that the arbitral tribunal has considered the claim that, as a consequence of legislation in Ukraine, Naftogaz was prohibited from supplying Central Asian gas to IUGAS. Accordingly, no procedural error has been committed in this respect. There can thus also not be any question of any excess of mandate.

Summary of the outcome of the substantive aspects of the case

The arbitral award is obviously not incompatible with the fundamental basis of the Swedish legal system. There is therefore no cause to declare the award invalid. The arbitral tribunal has not failed to consider the claim that, as a consequence of legislation in Ukraine, Naftogaz was prevented from supplying gas to IUGAS of Central Asian origin. Accordingly, no procedural error was committed nor was there any excess of mandate which gives cause to set aside the award. Therefore, Naftogaz's cause of action is dismissed in its entirety.

Litigation costs

Given the outcome of the case, Naftogaz is ordered to compensate IUGAS for its litigation costs in the Court of Appeal. Naftogaz has approved the amount requested.

APPEAL

Pursuant to section 43, second paragraph, of the SAA, the Court of Appeal's judgment may be appealed only where the Court of Appeal is of the opinion that it is important for guidance in the application of the law that an appeal be heard by the Supreme Court. The Court of Appeal is of the opinion that no such cause exists in this case and does not permit an appeal of the judgment.

Justice of Appeal and Head of Division C.R. and Justices of Appeal M.E. and U.S.G., reporting, participated in the judgment. Unanimous.