TECHNICAL EXPERT WITNESS INVOLVEMENT IN CIS AND CEE OIL AND GAS ARBITRATIONS

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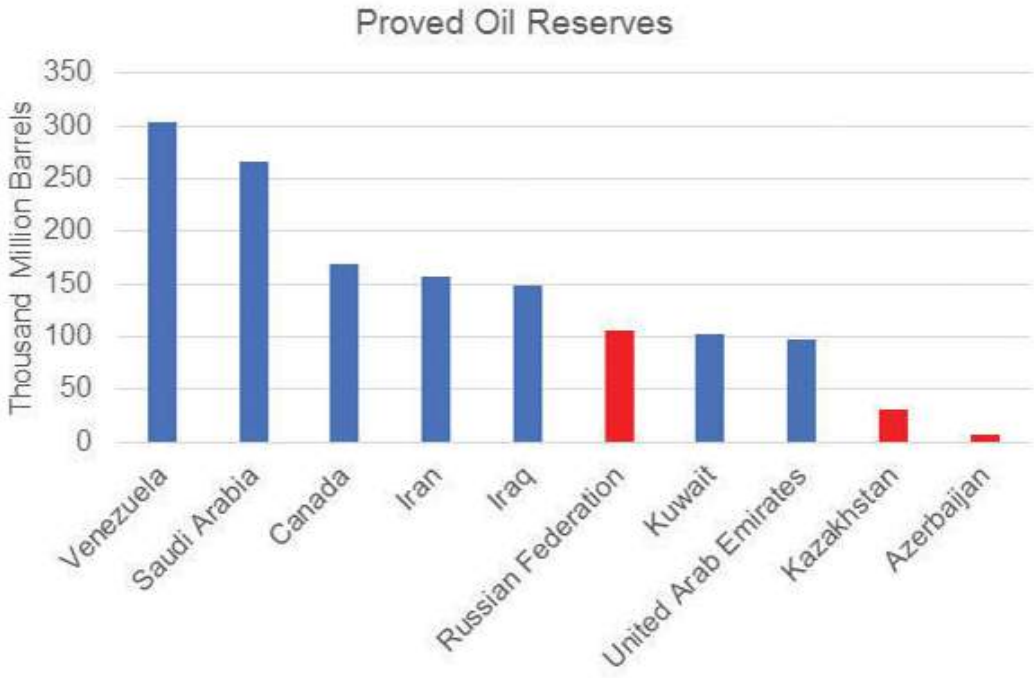
Introduction

It is hardly surprising that there are a significant number of arbitrations for oil-related matters, particularly in CIS countries. This stems from the fact that the Russian Federation, Kazakhstan and Azerbaijan have large volumes of proven oil reserves. Typically, technical experts are involved in assessing the reserves and resources for oil and gas exploration in the context of arbitration investment disputes.

In the case of gas reserves, the CIS countries are even more important, as in oil volumes. The Russian Federation has the largest gas reserves in the world and those for Turkmenistan as also sizeable. The largest source of disputes for gas involves gas pricing and the experts for this are usually economists rather than technical experts. However, technical experts are involved in gas disputes typically looking at gas supply and demand or gas/liquefied natural gas plant construction disputes.



Source: BP Statistical Review, June 2018

The only CEE country that has material proven reserves of oil and gas is Romania.

Stockholm Chamber of Commerce

The use of the Stockholm Chamber of Commerce to carry out UNCITRAL arbitrations between the Soviet Union and US companies was agreed in a 1977 agreement between the USSR Chamber of Commerce and Industry and the American Arbitration Association. This has been proven to be a popular option and many of the oil and gas licences awarded by CIS countries included the provision of arbitration at the Stockholm Chamber of Commerce.

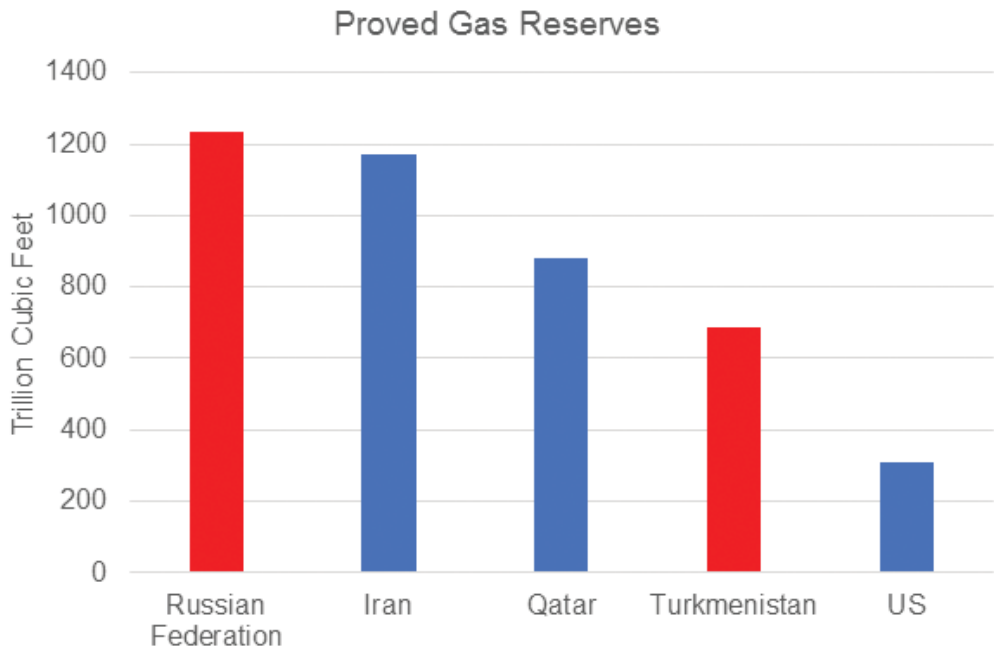
In fact, the Stockholm Chamber of Commerce continues to play an important role in international arbitration. The Arbitration Institute of the Chamber of Commerce publishes figures on the nationality of the parties in its cases. Although the Arbitration Institute has a large number of cases involving domestic Swedish parties (137) the next largest number is from Russia (29).

One of the earliest cases that involved oil and gas was the arbitration between the Republic of Kazakhstan and Bidermann International, which took place at the Arbitration Institute in 1999. The claim was for the potential loss of profits from the Kenbai field which was on a licence that had been revoked by the Republic of Kazakhstan. Petroleum Development Consultants (PDC) acted as an expert witness for the Republic of Kazakhstan and demonstrated that the field was sub-economic based on the oil price assumptions used by the expert employed by Bidermann International.

The arbitration was confidential, but a summary of the results is provided[1] by UNCTAD (United Nations Conference on Trade and Development). This indicated that the complaint against the Republic was upheld but that the award was US$8.9 million, which represented the investor's expenditure, but did not allow for any loss of profits.

The Arbitration Institute continues to play an important role in the CIS oil and gas industry. An award by the Arbitration Institute on February 28, 2018, was made to Naftogaz of Ukraine against

[1] http://investmentpolicyhub.unctad.org/ISDS/Details/9



Source: BP Statistical Review, June 2018

Gazprom of Russia in connection with the gas transit contract through Ukraine. The Svea Court of Appeal in Sweden made an order[2] on June 13, 2018, to suspend the implementation of the award.

The international workload of the Arbitration Institute typically involves 90-100 cases in the period 2009-2017.

Examples of Technical Expert Involvement

Many tribunal cases are confidential, but four have been selected as the award is publicly available. The award also gives details of the technical expert work in the tribunal. The cases that I have considered are:

- Mohammad Ammar Al-Bahloul v. the Republic of Tajikistan
- Stati, Ascom Group and Terra Raf Trans v. the Republic of Kazakhstan
- The Republic of Croatia v. MOL Hungarian Oil and Gas PLC
- Caratube International and Devincci Salah Hourani v. the Republic of Kazakhstan

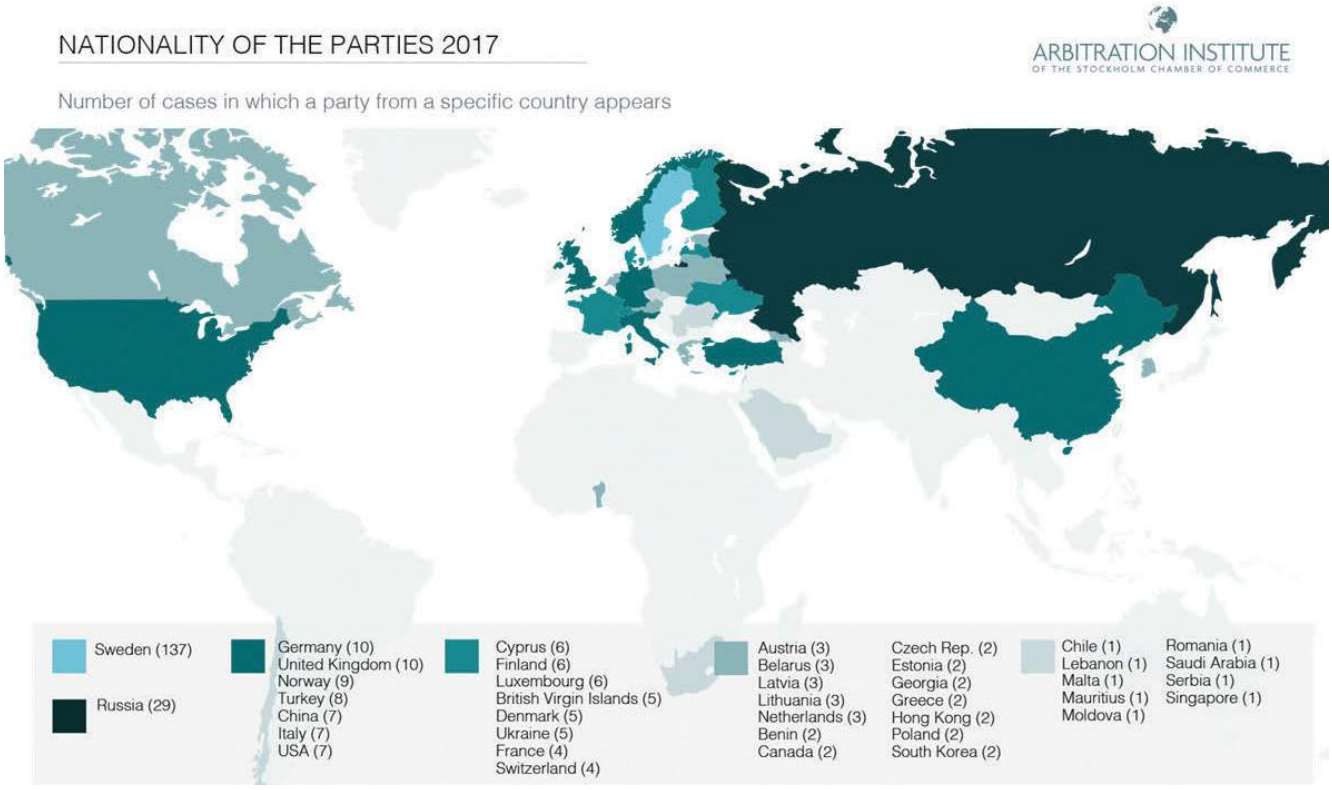
Mohammad Ammar Al-Bahloul v. the Republic of Tajikistan

The abitration was conducted by the Arbitral Tribunal of the Stockholm Chamber of Commerce, in June 2010.[3] The case involved four areas in Tajikistan that were the subject of agreements between the Claimant and the Republic of Tajikistan. The Republic of Tajikistan did not attend the tribunal. The case was held under the Energy Charter Treaty which specifies arbitration at the Stockholm Chamber of Commerce. Three of the licences were re-awarded to Gazprom, and the fourth to Tethys Petroleum.

The claim for compensation was based on the value the licences would have had without the breach and assuming that the licences had been issued in 2001, and the value that they would have had in 2009, assuming that the licences were issued to the Claimant by the Republic.

The technical expert in this case was Mr

[2] https://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/OGZD/13681299.html
[3] https://www.italaw.com/sites/default/files/case-documents/ita0024_0.pdf



Arbitration Institute of the Stockholm Chamber of Commerce

Gustavson, of Gustavson Associates. He prepared a valuation of the Expected Valuation (EV) of the licences. The EV was defined as a Net Present Value (NPV) multiplied by the Probability of Success (PoS) less the NPV of its failure multiplied by 1-PoS. Mr Gustavson calculated a PoS for three of the areas in the range 13-19% and the fourth at 51%. For the one area with a higher PoS, Mr Gustavson testified that the internal rate of return was particularly low and might render the licence unattractive.

The Tribunal considered that there were four steps to pass before applying a DCF (Discounted Cash Flow). These involved the following questions;

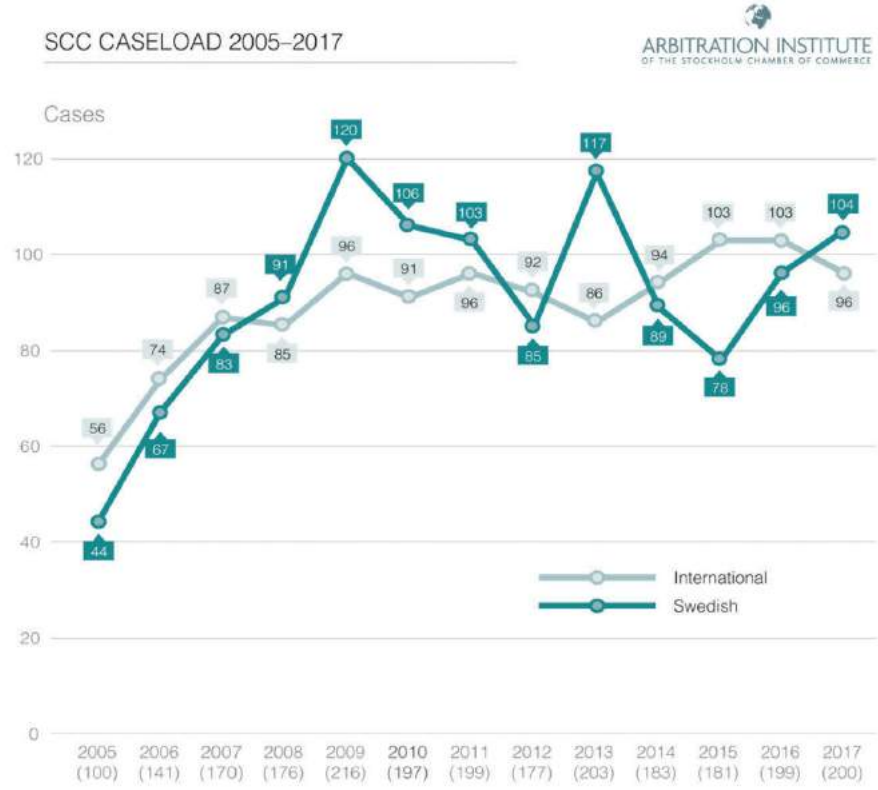
1. Was Claimant able to finance the exploration for hydrocarbons?
2. Would the exploration have been successful i.e. Claimant found oil and gas reserves which could be exploited
3. Would Claimant have been able to finance and perform the exploitation of any hydrocarbon reserves found?
4. Would it have been possible to sell any hydrocarbons produced?

The Tribunal found that there were too many unsubstantiated assumptions to justify the application of the DCF method. It did not support, therefore, the Claimant's claims.

Stati, Ascom Group and Terra Raf Trans v. the Republic of Kazakhstan

A tribunal under the Arbitral Institute of the Stockholm Chamber of Commerce considered this dispute which was about the alleged appropriation by Kazakhstan of certain oil and gas licences in Kazakhstan for which the Tribunal made its award on December 19, 2013, with the amount of damages being nearly $500 million.[4] This award was upheld in the Swedish appeal court in its judgement of December 12, 2016. The Claimant is currently attempting to sequester Kazakh financial resources from several

[4] https://www.italaw.com/sites/default/files/case-documents/italaw3083.pdf



Arbitration Institute of the Stockholm Chamber of Commerce

sources including a London branch of a U.S. bank.

Technical experts appeared both for the Claimant (Stati, Ascom Group and Terra Raf Trans) and the Respondent. For the Claimant, the technical expert was Ryder Scott, working with FTI as the quantum expert. For the Respondent (the Republic of Kazakhstan), the technical expert was Gaffney Cline and Associates (GCA), working with Deloitte as the quantum expert.

The arbitration concerned the valuation of two oil and gas producing fields (Borankol field and Tolkyn field), an exploration licence and an uncompleted LPG plant. According to the award, Ryder Scott's fees and expenses amounted to $877,458.14, and GCA fees and expenses were $1,277,255.67.

The experts were subject to attack at the tribunal. The Claimant suggested that GCA and Deloitte work was "utterly unreliable." The Claimant stated that the documents that GCA produced were nearly all created by someone else — either Ryder Scott or state institutes. The Respondent claimed that "Ryder Scott has proven to be a partisan instrument of Claimants, rather than independent experts."

A significant issue that is shared by many other of these types of arbitration was the determination of the valuation date. The fact that the oil price has varied in the last few years, together with oil price forecasts, means that the NPV can critically be determined by the valuation date and hence the oil price forecast at that valuation date.

The Claimant and its experts used a different valuation date than that of the Respondent and its experts. The Tribunal came to a different view on the valuation date and this may have influenced its approach in deciding how to calculate damages. An approach which utilised the valuation being based on a bid for the assets rather than an NPV calculation was used.

Borankol and Tolkyn Fields

The amount of damages calculated by the Parties for the expropriation of the Borankol and Tolkyn fields are shown in the table below.

Field	Claimant Valuation Date	Claimant Valuation ($ million)	Respondent Valuation Date	Respondent Valuation ($ million)
Borankol	October 14, 2008	197.0	July 21, 2010	62.8
Tolkyn	October 14, 2008	478.9	July 21, 2010	123.2
Total		675.9		
	186.0			

An earlier study that involved the use of another technical consultant (Miller and Lents) determined that the valuation for the two fields as of October 1, 2009, was $546 million in the base case. In a case assuming a higher gas price, this was increased to $784 million.

The reserve analysis carried out by the two Parties' experts does differ. Ryder Scott estimated that reserves at the two fields as of October 14, 2008, were 18.8 Million Barrels of oil and condensate. GCA calculated that as of July 21, 2010, the reserves were 8.65 Million Barrels. There was 2.3 Million Barrels of production between these two dates so that the difference was 7.05 Million Barrels. This difference was probably due to varying views on the number and effectiveness of well recompletions. The difference in valuation was likely to be mainly due to having different views on the gas price, and whether the gas price to be used would be a domestic lower Kazakh price or a higher gas export price.

The Tribunal determined that the valuation date should be April 30, 2009, which meant that neither of the two calculations could be applied. As an alternative, the Tribunal used the comparable transactions prepared by Deloitte, which resulted in a total asset value for the two fields of $227.8 million. No details are provided of the comparative transactions, but it is noticeable that the Tribunal decided on a valuation much nearer to that of the Respondent than the Claimant. The Tribunal stated that the Ryder Scott reserve estimates were "convincing in their approach". However, the Tribunal also noted that the FTI calculations provided by the Claimant were "less convincing" and were "considerably overstated".

Exploration Licence

There was considerable uncertainty about the valuation of the exploration licence (Contract 302). The licence was to expire in March, 2009. The Claimant was in the process of drilling an exploration well, which was stopped because a rig with a higher-pressure rating was required. The Tribunal decided that valuation of the licence was not possible, and awarded the Claimant damages of $33.33 million to cover its expenses, excluding the cost of the well.

LPG Plant

The technical experts had no part in the valuation of the LPG plant. The Tribunal decided that an offer made to buy the plant by the state-owned oil and gas company in September, 2008, of $199 million, should be used to determine damages.

The Republic of Croatia v. MOL Hungarian Oil and Gas PLC

The Final Award of an UNCITRAL arbitration between the Republic of Croatia and MOL Hungarian

Oil and Gas PLC was made on December 23, 2016.[5] The arbitration concerned the Shareholders agreement between the Republic and MOL relating to INA, the integrated oil and gas company in Croatia. A further arbitration which has not been concluded is under ICSID rules and involves arbitration under the Energy Charter Treaty.

Much of the UNCITRAL arbitration concerned an allegation that MOL had bribed the Croatian president, and that as a consequence, the First Amendment to the Shareholder's Agreement and the Gas Master Agreement should be rendered null and void. A further allegation was that the First Amendment to the Shareholder's Agreement was null and void under Croatian corporate law. The Tribunal concluded that the Republic had failed to establish that MOL had bribed the Croatian President. The Tribunal also concluded that the First Amendment to the Shareholder's Agreement was not contrary to Croatian corporate law.

A further part of the arbitration concerned the allegation that MOL had failed to support the INA business in exploration and production, refining and wholesaling, and retailing oil and gas and their products. PDC was the technical expert for MOL, with Mr Anthony Way being the technical expert for the Republic.

Mr Way was criticised by the Tribunal for using a local consultant who was frequently used by the Republic. Also, one of the directors of this consultant was a former manager of INA who had publicly criticised MOL's management of INA. The Tribunal stated, that insofar as Mr Way relied uncritically on the local consultant, the Tribunal would treat that evidence with caution. The Tribunal also concluded that having considered most carefully the cross-examination of Mr Way "that his evidence was not persuasive." The Tribunal rejected Croatia's assertion that MOL had breached its obligations under the Shareholder's Agreement when managing INA's refineries.

Croatia's claim regarding an alleged breach of the Shareholder's Agreement to expand exploration was "heavily dependent on the expert testimony of Mr Anthony Way." The Tribunal stated that the contentions of the breach were "neither sufficiently articulated nor accompanied with relevant evidence." The Tribunal stated that the only evidence was Mr Way's expert testimony which the Tribunal described as "not convincing."

Croatia claimed that MOL had breached its best efforts obligation to assist INA in maintaining its downstream market in Croatia and adjacent markets. PDC showed in its Second Expert Report that INA's loss of retail market was entirely consistent with the loss of market share by similar state oil companies in Romania, Hungary and Slovakia under market liberalisation. The Tribunal concluded that it could not say that MOL had failed in its best efforts obligations to assist INA in maintaining its downstream share in Croatia and expanding its regional markets.

Caratube International and Devincci Salah Hourani v. the Republic of Kazakhstan

The first ICSID arbitration resulted in an award of June 5, 2012.[6] The case involved the alleged appropriation by the Republic of Kazakhstan of a licence held by Caratube International. The case was heard under the bilateral investment treaty between Kazakhstan and the United States. The tribunal dismissed the case as it found that there was a lack of jurisdiction.

The second ICSID arbitration resulted in an award of September 27, 2017.[7] This second case relied on the arbitration clause in the exploration and production contract, and Kazakhstan's Foreign Investment Law, which includes substantive protections.

This second case rested on the expert evidence of Mr Sven Tiefenthal, who prepared an indicative development plan that the quantum expert Grant Thornton used to develop its claim of lost profits. The claim by the Claimant involved $647.57 million as at January 31, 2008, to cover the alleged reserves and $298.72 million for contingent and prospective resources.

[5] https://www.italaw.com/sites/default/files/case-documents/italaw94016.pdf
[6] https://www.italaw.com/sites/default/files/case-documents/italaw1100.pdf
[7] https://www.italaw.com/sites/default/files/case-documents/italaw9324.pdf

Many of the issues are not provided in the published information, but it does appear that Caratube concentrated on a period of trial production rather than carrying out a 3D seismic survey and a deep exploration well as they were required to do under the exploration licence. The second tribunal in a majority opinion decided that Caratube had not done enough work to support the indicative Tiefenthal development plan. Therefore, the tribunal determined that the only damages that would be allowed were the out of pocket expense of Caratube amounting to $39.2 million.

Current Trends

Current trends are reviewed in the following areas:

- The extent to which oil and gas arbitrations will increase in number
- The extent to which oil and gas arbitrations will increase in number in CIS and CEE
- The role of oil and gas technical experts
- The potential role for CIS arbitration institutes in oil and gas

The extent to which oil and gas arbitrations will increase in number

The current level of international oil and gas activity is still quite low. This applies both to exploration and development activities. However, there are several new discoveries in countries such as Uganda, Kenya and Guyana. The lack of experience in these countries in handling large-scale oil and gas developments means that there are almost bound to be disputes. In the case of Uganda, the sales of Heritage's interest in licences to Tullow resulted in an UNCITRAL arbitration between Uganda and Heritage regarding capital gains tax.

Apart from disputes that relate to oil and gas licences, it is expected that disputes will increasingly occur in complex oil and gas construction cases. Generally, contractors are only marginally profitable now, which contrasts with increasing oil company profitability. The accentuated competition for large oil and gas construction jobs means construction companies are likely to bid low and hope to improve their financial position through change order procedures. If these procedures are not actioned properly through the construction period, they may well lead to further arbitrations.

Therefore, the combination of new countries' involvement in oil and gas and the increased competition for major oil and gas construction jobs suggests that oil and gas arbitrations internationally will increase.

The extent to which oil and gas arbitrations will increase in number in CIS and CEE

Several of the early CIS oil and gas arbitrations reflected the lack of experience of the host countries. Many of the early licensees did not have the organisation or financial capacity to carry out the exploration and development activities that their licences entailed. This experience has now been gained, and it is no surprise that arbitration institutes are being developed in Russia and Kazakhstan,

However, for the international oil and gas industry, the CIS region is not as attractive as it was in the past. Faced with difficulties for the oil industry to be working in the Middle East, the CIS region was appealing particularly as it appeared to be so prospective. Since that time, however, other areas such as Iraq, East Africa, East Mediterranean and the Caribbean have come to the forefront, making the CIS region less important to the international oil and gas industry.

It remains to be seen how much Russia needs to have Western technology and therefore be involved in joint operations. Whilst Russia is strong in conventional land production, it is weak in deep-water technology, Arctic technology and shale gas development. These are areas that are subject to current sanctions.

The extent to which oil and gas arbitrations increase in number in CIS and CEE countries depends specifically on the level of activity in these countries. For CEE countries that are within the European Union, the recent Achema judgement of the European Court of Judgement will mean that arbitration under the Energy Charter Treaty may

no longer be possible for intra-EU disputes. A new licence round is expected in Kazakhstan and it is likely to increase the number of oil and gas arbitrations. There may be licence rounds in other CIS countries, but at the moment this is unlikely to include Russia.

Overall, considering overall activity in the CIS and CEE countries, one would expect a modest increase in oil and gas arbitrations in the near future.

The role of oil and gas technical experts

Disputes involving oil and gas are often technically complicated. Upstream disputes involving exploration, development and production of oil and gas are particularly complicated. This is because the outcome of oil and gas development is not finally known until the field ceases production. For this reason, there are always elements of uncertainty in production profile and investments, not to mention the variability of oil and gas prices. These uncertainties have a major impact on the NPV calculations and therefore the claim for damages.

In the US, for example, it is quite simple to evaluate damages using similar transactions. In view of the small number of such transactions in the CIS and CEE countries, this may be a much more difficult process. This could potentially mean that the NPV approach may be more appropriate. However, this approach is technically complex and is highly influenced (primarily due to varying oil and gas prices) by the valuation date. Most arbitrations appear to involve the Claimant and Respondent having different valuation dates. If the arbitration tribunal chooses an arbitration date that is different to that used by the Claimant and the Respondent, it is unable to carry out an NPV calculation and has to resort to other simpler methods such as relevant transactions. It might make for sense for a tribunal to determine a valuation date before the Claimant and Respondent make their damage claim evaluations.

The other area that is likely to involve technical experts is the downstream sector. This is particularly important for the design and construction of LNG (liquefied natural gas) liquefaction and regasification plants. There is currently a dispute involving the construction of the Polskie LNG regasification plant. PDC was involved recently as an expert witness in a construction dispute regarding a North Africa liquefaction plant. Technical experts could also be involved in construction disputes for new refineries or modification of existing refineries.

Tribunal members consist almost entirely of lawyers and there appears to be a real gap in their understanding of complex technical issues. A good technical expert has to recognise these limitations and provide reports and tribunal appearances that take this into account. The best technical experts combine technical excellence with good communication skills. They also need to fully understand the arbitration process and how the role of a technical expert fits in this process.

The potential role for CIS arbitration institutes in oil and gas

The International Commercial Arbitration Court at the Chamber of Commerce and Industry of the Russian Federation is an independent permanent arbitration institution located in Moscow. Kazakhstan also has ambitions to carry out arbitrations. The Astana based International Arbitration Center was launched in 2018. It is based at the Astana International Finance Center which is being modelled on the Dubai International Financial Center, with which it has a consultancy agreement.

It is expected that the institutes in Russia and Kazakhstan will handle small non-oil and gas related cases. For oil and gas, the disputes are likely to be between investors and the governments of Russia and Kazakhstan. Whilst these governments may wish to include their local dispute procedures in oil and gas licences, it is unlikely that investors will accept this. For this reason, at least in the short-term, there is likely to be a limited role for these CIS arbitration institutes in international oil and gas disputes. However, it remains to be seen if the CIS institutions have a role in domestic oil and gas disputes.