From the SelectedWorks of Aleksander Kotlowski

May 2009

Russian Energy Strategy and Transit Routes in Eastern Europe

Contact Author

Start Your Own SelectedWorks

Notify Me of New Work

Available at: http://works.bepress.com/aleksander_kotlowski/2

Russian Energy Strategy and Transit Routes in Eastern Europe - a view from Warsaw

by Alexander Kotlowski [1]

Abstract

The article considers perceptions of the new Russian energy policy in the oil and gas sector in Eastern Europe with a particular focus on the Polish perspective. The paper explains the regional reservations in Poland, Ukraine, Belarus, and the Baltic States to the Russo-German cooperation on the Nord Stream Pipeline project. Then, it summarises the view of the Russian-Ukrainian gas disputes and regional consequences of the disruptions in gas supply. The paper discusses Poland's energy security policy and conflicting expectations concerning the Yamal-Europe Gas Pipeline. The implications of Russian plans to reduce importance of the Druzhba oil pipeline are considered. Attempts to develop new energy alliances and a regional energy security policy towards Russia are further presented together with the joint energy projects in Eastern Europe such as Odessa-Brody, Amber Stream, Skanled and Baltic Pipe, as well as Mazeikiu Refinery or Ignalin nuclear plant.

Keywords: energy security, Yamal gas pipeline, gas disputes, Polish energy policy

JEL Classifications: Q49, L95, L98, L52, H17

Suggested Citation: The working version of this article was published in Oil, Gas & Energy Law Intelligence special issue on EU Russia relations, Vol. 7, No. 2, 2009 and the final version was published as a book chapter: Alexander Kotlowski "Russian Energy Strategy and Transit Routes in Eastern Europe - a view from Warsaw" in Piero L Fratini, Michael Hunt and Kim Talus (eds.), "EU - Russia Relations" Euroconfidentiel (Bruxelles 2009).

[1] Alexander Kotlowski is a DPhil research fellow at the Faculty of Law, University of Oxford and Advisor in the Polish Government.

1. Introduction[2]

The fundamental problem of the new Russian energy policy is at the forefront of public discussions in Eastern Europe. Poland and other Eastern European countries feel threatened by what is often perceived as Russian 'great-power anti-status quo resentment' embodied in the Russian-Georgian war and the gas disputes between Russia and Ukraine.[3] Then again, there are serious endeavours to attain political rapprochement and to increase energy cooperation with Russia.

German, Italian and other Western European energy companies emphasize the need to increase supplies and are primarily interested in economic aspects of the new transit projects from Russia. On the other hand, Poland, the Baltic States and Ukraine want to reduce their overdependence on Russian energy and Gazprom's dominant pricing power. They focus on the negative economic and political consequences of the new projects.

Thus, this article considers perceptions of the new Russian energy policy in Eastern Europe with a particular focus on the Polish perspective. The paper discusses Poland's energy security policy and conflicting expectations concerning the Yamal-Europe Gas Pipeline. The article explains the regional reservations to Russo-German cooperation on the Nord Stream Pipeline project. Then, it summarises the view of the Russian-Ukrainian gas disputes. Almost a year after the gas supplies were disrupted, Moscow and Warsaw did not reach agreement on transit issues and Gazprom's supplies to Poland from Ukraine were still not restored.

The paper presents the attempts to develop new energy alliances and a regional energy security policy towards Russia, in the context of Russian plans to reduce importance of the Druzhba oil pipeline. The joint energy projects in Eastern Europe, for which Poland acts as a political facilitator, such as Odessa-Brody, Amber Stream, Skanled and Baltic Pipe, as well as Mazeikiu Refinery or Ignalin nuclear plant, are further presented.

---

[2] The content of this paper is the author's sole responsibility and does not represent official views of any Polish public bodies or companies.

[3] For a detailed account see Simon Pirani, Jonathan Stern, Katya Yamfimava "The Russo-Ukrainian Gas Dispute of January 2009: a comprehensive assessment" Oxford Institute for Energy Studies, February 2009.

2. Poland's Energy Policy

A. *Poland's Energy Security*

Policy makers in Poland believe that Polish relative energy security, growing trade relations with Russia, a voice in the EU coupled with the membership in the International Energy Agency impose a special responsibility to represent regional concerns in Moscow and in Brussels. Warsaw embraces a view that the region and the EU should pursue a common energy policy integrating both the security of supply issues and the external political agenda.

Russian-Polish relations deteriorated rapidly in 2004, when the then Polish president Kwasniewski actively supported Ukrainian Orange Revolution. Notwithstanding the harsh rhetoric that has blown up during the two years of Mr. Kaczynski's conservative government in Warsaw, Poland does not have serious social or political conflicts with Russia, such as those which define Russia's relations with the Baltic States and Ukraine. Poland, with €19 bn bilateral trade, is the fourth largest Russian trading partner in Europe. Unlike Ukraine or Belarus, Poland has never been accused of disrupting or 'stealing' Russian transit gas supplies. Russian-Polish economic relations are much better than they were at the time of the 'Polish meat' trade war of 2006. However, various oil and gas disputes remain unresolved.

The new liberal government under Mr. Tusk is determined to relieve tensions with Moscow without provoking political outrage from the populist opposition. Warsaw has turned down its support for Georgia, Chechnya, and Ukraine, and wants to return to more pragmatic 'business as usual' energy cooperation. Considering the new political mood in Poland, one that is exemplified by unenthusiastic reactions to the American antimissile project, Warsaw believes in a possible rapprochement with Russia. The Prime Minister's Putin high profile visit in Poland in September 2009 to mark the 70th anniversary of the start of World War II, and a conciliatory letter he wrote to a leading Polish newspaper[4] were clearly aimed to ameliorate Kremlin's strained relationship with Warsaw. Nevertheless, despite symbolic gestures, the expected new intergovernmental agreement on energy had not been signed.

In contrast to its neighbours, Poland enjoys a relatively secure energy position and can withstand various political pressures. Nine-tenths of Poland's national energy demand is satisfied by the Polish coal industry producing 90 mt of hard coal and 60 mt of lignite annually. There are no commercial power plants or combined heat/power generating plants fuelled by gas or by oil. The

[4] Vladimir Putin "List do Polaków" Gazeta Wyborcza 31 08 2009.

mining industry, though considerably underinvested and inefficient, has 42 bt of hard coal and 14 bt of lignite in documented reserves for the decades to come.[5]

Demand for gas in Poland comes primarily from industrial chemical plants. The coal based economy consumes only 14.4 bcm of natural gas, of which 5.2 bcm are extracted locally by Polish Oil and Gas Mining company PGNiG. Poland expects to increase its gas output to 6.2 bcm by 2015. The remaining 9 bcm gas is imported from Gazprom, mainly from the Yamal-Europe pipeline. Poland has natural gas reserves of 143 bcm, equivalent to ten years of national consumption. The government, with the desire to produce cleaner energy than that which is produced through the burning of coal, wants to increase gas consumption while maintaining base load coal capacity. As a result, Poland can supply household consumers with great flexibility and sustain mid-term gas shortages.

Poland is also relatively comfortable with Russian oil supplies. Poland receives most of its crude oil, 18 mt, from the northern stretch of the Druzhba (Friendship) pipeline, which has operated without major controversies for forty years. The pipeline, constructed in 1964 to supply Soviet western satellites, starts in Siberia and runs through Samara, Briansk in Russia, Belarus and Poland until it reaches Leipzig in Germany. The pipeline is operated by Transnieft in Russia and by a state-owned company PERN in Poland.[6] The southern stretch of Druzhba goes through Ukraine and subdivides into two pipelines, one leading to Slovakia and the Czech Republic and the other to Hungary and the Adriatic coast in Croatia. The Druzhba pipeline transports 66 mt of crude oil annually, out of which a substantial 49 mt goes through the northern stretch and supplies the Orlen and Lotos refineries in Poland as well as the Schwedt, Mider Spergau and Leuna refineries in Germany. In anticipation of possible disruptions, a new oil terminal Naftoport was constructed in Gdansk in 1991 on the Baltic Sea. The Naftoport Gdansk terminal is connected to the PERN network and provides Polish oil refineries with a strategic alternative to crude supplies from Druzhba. However, taking into account Russian plans to phase out the northern stretch of the pipeline going through Poland, the long-term harmonious cooperation on the Druzhba pipeline may be tested in the forthcoming years.

The government in Warsaw decided to further increase energy security in Poland, with the construction of a new LNG import facility in the Baltic port Swinoujscie. The Polish chemical industry; the major gas consumer in the country, expressed doubts as to whether the expensive LNG gas supplies would ever provide economically viable alternative to Russian gas supplies

[5] Polish Central Statistical Office "Statistical Yearbook 2008".

[6] PERN website at www.pern.com.pl

through land pipelines. In the midst of highly politicised disputes concerning security of supply, the LNG project gained political support and government guarantees. The LNG terminal will have an initial 2.5 bcm capacity by 2013, which is projected to be expanded to 7.5 bcm by 2020. PGNiG made some preliminary arrangements for LNG supplies from Qatargas. Despite the expected cost of approximately USD 1bn and the weak economics of the projects, Mr Tusk's government continues to support the LNG terminal plans. This strategy is coupled with an extensive investment program to expand underground gas storage capacity. In 2009, PGNiG signed a new contract to expand its gas storage capacity to 4bcm in 2015.[7]

Concurrently, despite pressures from the coalmining lobby, the Polish government adopted a national framework program for the development of nuclear energy.[8] At present, there are no nuclear power plants in Poland. The long-term nuclear development plan comprises four stages and aims for an initial construction of two nuclear plants. In the first phase until 2010, a comprehensive national nuclear energy program and an accompanying regulatory framework is to be prepared. It will provide an analysis of the social costs, assess the economic impact of the nuclear program and the accompanying infrastructure. The program will indicate possible number, size, and locations for the nuclear plants. At this stage, investor/project manager, PGE SA is expected to form a consortium for the development of the first nuclear plant and to prepare investment analysis. At the second stage, in 2010-2013, the investors shall choose the location, the technology provider and arrange financing. The construction contracts for the first nuclear plant are to be signed. In 2014-2015, technical construction designs will be prepared and approved. Finally, in 2016 the construction of the first plant should start with the expected completion by 2020.

B. *Tensions on the Yamal-Europe Gas Pipeline*

The major energy issue facing the Polish government and the gas company PGNiG is the impact of the Nord Stream project on the future of the Yamal-Europe pipeline. There are some doubts as to whether there will still be sufficient supplies with the Nord Stream project to fill the existing Yamal-Europe pipeline.[9] Some pipelines from Western Siberia are already not used at full capacity, as Yuzhno Russkoe's reserves were overestimated, and Shtokman field in the

[7] PGNIG Press Release 05 04 2009.

[8] Polish Ministry of Economy Press Release at www.mg.gov.pl 11 08 2009.

[9] Michael Fredholm "Gazprom in Crisis" UK Defence Academy 2006.

Barents Sea will not be operational until 2015[10] or even 2035.[11] Gazprom admitted that the key project the Bovanenkovo field on the Yamal Peninsula could be delayed.[12]

The Yamal-Europe transit pipeline was designed in 1992 as a major gas corridor to supply new demand in Germany and Western Europe as well as to be the primary source of increased gas supplies to Poland. It was strongly supported by the governments of Russia, Germany and Poland. For the Polish government, the reason for the investment was to satisfy the increased demand for gas from the Polish chemical industry in the 1990s, as well as to strengthen Poland's role as a reliable partner for Russia and Germany.[13] The gas pipeline project was financed by Europolgaz; a Russian-Polish joint venture. The Yamal-Europe transit pipeline, through which a fifth of Russian gas reaches Western Europe, has been in operation without disruption since 1999, and for the last ten years has fulfilled these expectations.

The Yamal-Europe gas corridor was one of the largest infrastructure projects since the collapse of the Soviet Union. The 4,000 km high pressure transit pipeline, with a dedicated 2,000 km stretch through Russia, Belarus and Poland, links gas deposits in Nadym fields in Tyumen and prospective fields in Yamal peninsula with customers in Germany and Western Europe. The state-of-the-art pipeline passes through hundreds of rivers, streams and railroads, and finally secures safe passage through urbanized territories in Poland and Germany. The 680 km Polish stretch of the pipeline was constructed and operated by Europolgaz, a joint venture between Gazprom and the Polish national gas network operator PGNIG.[14] The Belarusian stretch of the pipeline belongs to Gazprom. The existing Yamal-Europe pipeline has a significant 33 bcm annual transit capacity. The long-term 7 bcm annual contract from the pipeline satisfies most of the import needs and half of Polish gas consumption. The remaining 26 bcm is destined for Germany and other Western European markets.

When the first Yamal pipeline was constructed, many technical solutions were immediately planned for the second stretch to be constructed when the abundant Bovanenkovskoe fields in Yamal peninsula reached sufficient production levels. With the planned second line, the Yamal-

---

[10] Susanne Nies "Oil and Gas Delivery to Europe - An Overview of Existing and Planned Infrastructures" p 71 French Institute for International Relations and OGEL 3 2008.

[11] Bellona Foundation in "Shtokman won't be on stream until 2035" Upstream Online 17 04 2007.

[12] Financial Times 16 06 2009.

[13] David Victor "Bypassing Ukraine: Exporting Russian Gas to Poland and Germany" in David Victor, Amy Jaffe and Mark Hayes (eds.) "Natural Gas and Geopolitics. From 1970 to 2040" Cambridge University Press Cambridge 2006.

[14] Europolgaz website at www.europolgaz.com.pl

Europe project was to reach 66 bcm total annual capacity and possibly more. Respectively, the second stream of the Yamal-Europe gas pipeline could satisfy the planned transit capacity of the first twin-pipeline of the Nord Stream project (27 bcm). Initially the construction of the second Yamal stream was planned for 2001. However, since the change of government in Moscow in 2000 and growing politicization of energy infrastructure investments,[15] the development of the Yamal-Europe project is in a stalemate. In 2003, the Russian and Polish governments agreed to speed up the project until 2010, but due to Russian involvement in Nord Stream, the second pipeline project has been stopped in the design stage.

For years, in the context of political tensions surrounding Russian investments,[16] the consecutive governments in Warsaw were quite reluctant to demonstrate active support for the second Yamal pipeline. Despite arguments that Warsaw is primarily preoccupied with losing transit revenues, reality of the situation is that transit tariffs for Russian gas have always been minimal; for years, the transit tariffs have been less than half of those in Western Europe. Since Poland joined the EU, the tariffs are strictly regulated and cannot be a source of any extraordinary income. The joint-venture transit company Europolgaz is highly leveraged, and in the years to come, any limited income from transit operations will return to its financing institutions affiliated with Gazprom. As a result, Poland gains limited economic or political benefits from being a transit country or from developing the second stretch.

However, the plans for the Nord Stream pipeline change the role of the Yamal-Europe pipeline and shake up the relative stability of the current Russian Polish energy arrangements. PGNiG perceives the risk that the new supplies from Shtokman or the Yamal peninsula developed after 2015 will end up in the Nord Stream or as LNG exports[17], while existing Tyumen gas supplies will be slowly reduced.

As a result, the Polish government wants to revive the second stretch of the Yamal-Europe project. Warsaw believes that expanding the overland Yamal pipeline in Poland is the second best alternative to increased Russian transit via Ukraine. Warsaw persuades Gazprom that expanding the existing overland Yamal-Europe gas corridor is viable, technically easier, substantially cheaper, and much safer for the environment than the proposed Nord Stream project. The

[15] Andrei Belyi "International Energy Security Viewed by Russia" OGEL 4 2007.

[16] Andrey Illarionov "Russia Inc." The New York Times 04 01 2006.

[17] The 2004 Gazprom's demission to use the Shtokman field gas for LNG exports seems to be reversed.

strategy to develop the overland Yamal transit pipeline complements Polish attempts to bring Belarus closer to Europe. [18]

C. *Russian Polish Transit Disputes in Europolgaz*

Following years of quiet cooperation, Europolgaz a company that owns the Polish stretch of the Yamal-Europe gas pipeline, has been shaken by shareholders' conflicts. Despite prolonged negotiations and high expectation, the disparities were not solved during Prime Minister's Putin Visit to Poland in 2009. The conflict emerged in the context of the Russian-Ukrainian gas disputes, disrupted gas supplies to Poland, and the planned construction of the competing Nord Stream gas transit pipeline. Europolgaz was created as a result of the 1993 Russian-Polish intergovernmental agreement on gas transit. The company is owned by Gazprom 48%, PGNiG 48%, and 4% Gas-Trading.[19] The insertion of Gas-Trading as a third shareholder[20] was sometimes perceived as an attempt to strengthen Russian control in Europolgaz but in effect, in the following years, it gave PGNiG a stronger position in the pipeline operator.[21] Consequently, in the recent years, the Polish shareholders exercised their control over Europolgaz and the company adopted some tariff decisions that were opposed by Gazprom.

At present, Gazprom demands more control over the transit of Russian gas to Germany through Poland and wants to modify the long-standing arrangement between the Europolgaz shareholders in a new intergovernmental agreement. The existing arrangement emerged from the intergovernmental agreement and long-term commercial contracts between Gazprom, PGNiG, and Europolgaz. Gazprom wants to eliminate Gas-Trading and impose shareholders unanimity in all company matters. In fact, it would provide Gazprom with a much wanted right to veto all

---

[18] For detailed account see Katja Yafimava "Post-Soviet Russian–Belarussian Relationships: the Role of Gas Transit Pipelines" Ibidem-Verlag Stuttgart 2007.

[19] Gas-Trading is controlled by PGNiG which owns 43,4% of the company, while 16% belongs to Gazprom and 36% to a private Polish company. The then Gazprom's chairman Mr. Vyakhirev became the first chairman of Gas-Trading.

[20] Polish corporate regulations at the time required at least three shareholders to form a joint stock company. For discussion of political problems surrounding Europolgaz in the 1990's see Anita Orban "Power, Energy, And the New Russian Imperialism" Praeger Security International 2008.

[21] Most of Europolgaz management decisions are taken unanimously by directors nominated by Gazprom and by PGNiG, however the president nominated by PGNiG has a prevailing voice in case of irreconcilable differences.

decisions concerning gas transit tariff in Poland.[22] In this respect, Gazprom maintains a persistent regional strategy; more gas supply flexibility in exchange for control over the transit routes.

Moreover, Gazprom wants to reduce significantly the transit tariffs charged by Europolgaz. The current tariffs were proposed by Europolgaz and approved by the Polish National Energy Regulation Agency URE. The transit tariffs remain in the European lower range and are already lower than Ukrainian transit fees that have far greater publicity. Nevertheless, Gazprom rejects the existing tariffs and insists on operating Europolgaz on a strictly non-profit basis. As a result of the tariff disagreement, Gazprom pays Europolgaz only a reduced tariff calculated according to Gazprom's own estimates, just enough to allow Europolgaz to repay its construction debts. Following two international arbitrary disputes in Moscow, in 2009 Gazprom was prompted to pay USD 20 million, in order to cover the full tariff charged by Europolgaz.[23] Apart from that, Gazprom wants Europolgaz to be granted an extraordinary exemption that would allow the company to introduce new tariffs without the need to seek approval from the Polish regulator. Pursuant to the EU Gas Directive, Polish Energy Law requires all tariffs, including those charged by Europolgaz, to be approved by the Regulator. So, the Gazprom's proposal to apply tariff exemptions originally designed to encourage new investments to the existing Yamal-Europe pipeline would require the EU Commission's approval. This is in line with Russian fundamental problem to accept the Energy Charter Treaty and the EU competition rules.[24]

PGNiG and the Polish government are not willing to change the existing arrangements without tangible concessions from Russia. The current arrangements prevent Europolgaz from receiving any extraordinary gains from transit. In the past, the reduction of transit tariffs has led the operator to serious financial problems. Following the recent fluctuations in exchange rates and gas prices, Europolgaz already closed the 2008 fiscal year with a significant loss. The government in Warsaw is worried that complying with Gazprom's demands would further diminish the network operator's income and undermine its financial stability. In this case, Europolgaz may be taken over by its financing institutions which are affiliated with Gazprom. Gazprom would then gain control over the Polish domestic gas market.

The Polish government provisionally agreed to modify the shareholders' agreement allowing Gazprom to impose lower tariffs. Warsaw would like to see possible changes in Europolgaz in the context of the construction of the second stretch of the Yamal-Europe project. In the wake of the

[22] This was confirmed by Prime Minister Putin during his visit in Poland in 2009.

[23] Gazeta Wyborcza 01 07 2009.

[24] For the account of Russian reservations see Sergey S Selivestrov "Energy Security of Russia and the EU: Current Legal Problems" OGEL 2 2009.

negotiations concerning gas transit and in contrast to former energy policy, Polish Deputy Prime Minister Pawlak, who is responsible for economic policy, explicitly stated that the strengthened security of supply that will result from Poland's participation in new transit projects is more important than the diversification of gas supplies. The negotiations between Poland and Russia are conducted in the context of disrupted gas supplies from Gazprom's Ukrainian intermediary RosUkrEnergo (2.5 bcm of annual supplies), which was eliminated from the market following the 2009 Russian-Ukrainian gas dispute.

3. Poland's Perceptions of the Russian Energy Policy

A. *Perceptions of the Russian-Ukrainian Gas Disputes*

Most of Eastern European countries recognize that the emerging balance of power in Ukraine will have a direct effect on their energy security and geo-political position of the region. For the last several years, the Kremlin under Mr. Putin has openly embraced Gazprom as a dependable instrument of foreign policy.[25] Indeed, political commentators in Eastern Europe recognize in Russian foreign policy a persistent pattern of coercion and intimidation apparent during previous gas conflicts in Ukraine,[26] Belarus, the small Republic of Moldova, Armenia and recently in Georgia.[27]

As a result, the political elites in Poland, Lithuania, Latvia, Estonia, Slovakia, Czech Republic and to some degree in Hungary[28] believe that they must actively support Ukrainian and Belarusian sovereign ambitions in order to politically stabilize the region and increase security

[25] Andrei Denisov "The Gains and Failures of the Energy Superpower" Russia in Global Affairs No. 2 2008.

[26] Jonathan Stern "The Russian–Ukrainian Gas Crisis of 2006" Oxford Institute for Energy Studies, January 2006.

[27] For an overview of Russian foreign policy see Edward Lucas "The New Cold War: Putin's Russia and the Threat to the West" 2ed Palgrave Macmillan 2009; Peter Baker and Susan Glasser "Kremlin Rising: Vladimir Putin's Russia and the End of Revolution" Potomac Books 2007; Andrei Piontkovsky "Another Look into Putin's Soul" Hudson Institute 2006; and Yuri Zarakhovich "Q&A with Andrei Illarionov: Putin's Critical Adviser" Time 31 12 2005.

[28] "The Position of Fidesz - Hungarian Civic Union on the Agreement between the Hungarian and Russian Governments concerning South Stream Pipeline" www.fidesz.hu 07 03 2008.

and diversity of energy supplies.[29] They understand that, if Ukraine becomes truly sovereign in her attempts to construct new oil and gas pipelines directly from Central Asia, then Russia risks losing not only her highly lucrative transit business from Asia, but primarily her ability to dictate gas prices on the Eastern European gas market.

Support for the economic and political independence of Ukraine has become a principle of Polish foreign policy. Despite economic incentives, decision makers in Warsaw have believed that instead of using Poland's geographical position and trying to strike an independent deal with Russia and its Belarusian affiliates, Warsaw must create a comprehensive gas system that includes Ukraine. It was recognized that a new project bypassing Ukraine and decreasing Kiev's bargaining power with Moscow would eventually backfire on Warsaw. Even though political developments in Kiev resulted, with Gazprom's acquiescence, in a transit arrangement with a non-transparent company RosUkrEnergo, PGNiG was still willing to buy one fourth of its gas imports through Ukraine rather than directly from Russia through the Yamal-Europe pipeline.[30]

The 2009 Russian-Ukrainian gas dispute has shaken the relative stability of Russian-Polish gas transit arrangements. Ten months after the gas crisis, Poland remained the only EU country where the supplies of Russian gas had not been fully restored.[31] Because of the crisis, RosUkrEnergo, an opaque Swiss intermediary half owned by Gazprom and partly owned by two controversial Ukrainian businessmen, has been eliminated from the transit market.[32] PGNiG has not received 2.5 bcm gas, a quarter of its supplies, contracted from RosUkrEnergo. PGNiG has managed to sustain the prolonged pressure resulting from the disruption in supply only due to its domestic reserves.

PGNiG wants Gazprom to take responsibility for the broken supply chain to Poland from Gazprom's Ukrainian affiliate. However, Gazprom does not agree to deliver the supplies contracted to Poland through Ukraine, nor through the Yamal-Europe pipeline unless Poland consents to modifying the long-term Yamal gas contract and give up control over Europolgaz. Prime Minister Putin during his visit to Poland stressed that Russia does not take responsibility

---

[29] Polish President Kwasniewski and later President Kaczynski were active in supporting the Ukrainian Orange Revolution and democratic movements and during the Russian Georgian conflict President Kaczynski organized a support rally of Presidents and PMs of Lithuania, Latvia, Estonia and Ukraine in Tbilisi.

[30] Platts Commodity News 15 09 2009.

[31] Polish Oil and Gas company PGNiG website at www.pgnig.pl

[32] Roman Kupchinsky "Gazprom's European Web" The Jamestown Foundation Report 18 01 2009; and Roman Kupchinsky "The Gazprom-Hungarian Gas Scam" Eurasia Daily Monitor Volume 6 Issue 126 01 06 2009.

for disrupted RosUkrEnergo supplies, despite the fact that he openly negotiates with Ms Timoshenko on behalf of the Gazprom subsidiary. The Kremlin uses the disruptions to demand changes in the intergovernmental agreement that would transfer to Gazprom control over Europolgaz and transit tariffs. Otherwise the disrupted gas supplies will not be restored.[33] Moreover, Gazprom agrees to compensate for the breakdown in supplies only if Poland permanently increases the Russian imports to 10 bcm until 2022, or even until 2035. This new long-term commitment would completely cover Polish gas demand, increase Gazprom's dominance on the Polish market, and effectively block diversification plans concerning Swinoujscie LNG terminal, Amber Stream or the Baltic Pipe project from Denmark. Following protracted negotiations, PGNiG signed a short-term contract with Gazprom for the supply of an additional 1bcm of gas for 2009[34] but the government in Warsaw wants to increase the delivery of Russian gas for 2010-2013, corresponding to the volume contracted with RosUkrEnergo.[35] If talks with Russians end in a failure, PGNiG considers spot purchases of Russian gas from Ruhrgas or GDF Suez, which receive gas from Gazprom in Drozdowicze on the Polish-Ukrainian border.[36] The Polish government also considers building an interconnector to the Czech gas system near Cieszyn. The link would allow PGNiG to purchase gas on the secondary European spot market. However, these arrangements, possible due to global recession and temporarily falling demand in Western Europe, cannot provide a permanent cost-effective solution.

In Poland, Russian-Ukrainian gas disputes are perceived as political rather than commercial. Though not played with military instruments they are often seen as part of the same Russian revisionist politics to regain influence with and, where possible, dominance over her neighbour states.[37] Russian diplomacy has stressed that the Ukrainian ruling elite entangled in domestic power struggles cannot be relied on to guarantee secure transit to Europe. Through Gazprom it exposed that Ukraine with its pro-Western ambitions is fully dependent on Moscow. The Polish government believes that allowing the Kremlin such a degree of leverage is not good for the

[33] This position has been explicitly confirmed by Mr Pieskov; PM Putin's spokesman in Ekho Moskvy 09 09 2009.

[34] PAP 01 07 2009.

[35] PAP 09 08 2009.

[36] The possibility was confirmed by the Polish Prime Minister's advisor on energy Mr Maciej Wozniak in an interview for PAP 09 08 2009.

[37] Ariel Cohen and Owen Graham "European Security and Russia's Natural Gas Supply Disruption" Heritage WebMemo No 2194, 08 01 2009.

region. Warsaw assumes that, despite domestic political instability, no real separatism exists in Ukraine,[38] and the country must be helped in its sovereign ambitions.

In 2007, Polish and Lithuanian vocal opposition to the new Russian energy policy resulted in the stalemate of EU-Russian negotiations of the Partnership and Cooperation Agreement. In 2009, the famed European solidarity was missing in terms of a unified response to gas cut-offs.[39] Nevertheless, Eastern European governments were not willing to leave Ukraine to stand alone in its struggle to pay the gas bills. During the crisis, President Kaczynski organized a joint meeting with President Yuszczenko of Ukraine and the Czech Prime Minister Topolanek, who headed the EU Presidency in order to give Ukraine some political support.

Warsaw wants to engage the Commission on an ongoing basis and move the discussion of the transit system for Russian gas to the EU level as part of the External Relations and European Neighbourhood Policy.[40] Polish diplomacy initiated the EU Eastern Partnership program with Eastern European countries and shares the view that security of supply issues should be part of the EU development policy.[41] The Czech Presidency put much effort into allocating €4bn of the European Energy Programme for Recovery funds to be used for gas and electricity infrastructure projects strengthening the regional security[42] and supported negotiations on Ukraine's accession to the Energy Community Treaty. Both Czech Republic and Poland pushed for a mutual EU-Ukraine framework declaration enumerating terms of EU support for the modernisation of Ukrainian gas infrastructure.[43] The declaration of European support was criticized in the Kremlin as unfeasible. Moscow warned that it might withdraw from currently negotiated Russian financing for Ukraine. Subsequently, Chancellor Merkel of Germany undermined the Eastern

[38] Anders Aslund "How Ukraine Became a Market Economy and Democracy" Peterson Institute for International Economics 2009.

[39] Similarly in "Interview with Claude Mandil: Energy solidarity 'still just words' " Euroactv.com 09 02 2009.

[40] Similarly Benita Ferrero-Waldner European Commissioner for "EU-Ukraine: Partners for securing gas to Europe" EU Press Release 23 03 2009.

[41] Piero L Fratini "Internal Energy Market, Security of Supply and Development Cooperation: Aspects of the Same Policy?" OGEL 2 2007.

[42] EU Press Release 16 04 2009.

[43] Joint Declaration of the Joint EU-Ukraine International Investment Conference on The Modernisation of Ukraine's Gas Transit System Brussels 23 03 2009.

European diplomatic efforts and reassured President Miedviediev that all energy projects with Ukraine would have to be approved by Russia.[44]

The gas disputes as well as undermining Russia's reputation as a reliable energy supplier have damaged the position of Ukraine as a transit country. PGNiG was particularly displeased with the handling by the Ukrainian government of the struggles to take over the RosUkrEnergo gas supplies intended for Poland. In addition, contrary to intergovernmental agreements with Poland to build a joint project through Ukraine and Poland to Slovakia, Prime Minister Timoshenko's government started negotiations with Gazprom to construct a southern stretch of the Yamal gas interconnector from the existing Yamal–Europe pipeline to Slovakia straight through Ukraine. This was particularly disappointing for PGNiG, as the company had previously rejected Gazprom's offer to bypass Ukraine and construct the interconnector to Slovakia directly via Poland.

In the European Commission and the European Parliament elected in 2009 and presided over by a former Polish Prime Minister Buzek, energy security and Eastern Partnership are high on agenda. Although it is impossible for the EU to solve Ukrainian structural problems and directly meet the €2.9bn in credits to finance gas consumption, the European Commission took active role in preventing escalation of gas disputes[45] and works on political agreement to support gas sector reform in Ukraine through some USD 1.7 bn financing from EBRD, EBI, and IMF.[46] The financial assistance package could also help Ukraine to refill the 26 -28 bcm underground reserves, which are traditionally used to fill peak gas demand in Europe during winter. Some Polish politicians believe that, as part of the gas sector reform, Ukraine may adopt by 2011 the European regulations on unbundling and third party access. Then, European utilities could buy gas from Gazprom on the Russian-Ukrainian border. This could strengthen Ukrainian gas sector by much needed direct investments in the network. Therefore, Gazprom should be less inclined to suspend gas transit through Ukraine to Europe because of disagreements with Kiev.

B. *Perceptions of the Russian-German energy cooperation*

The interlocking of German and Russian interests on an economic and political level is profoundly unsettling in Poland, Ukraine, the Baltic States, and some other Eastern European

[44] Interfax 01 04 2009.

[45] EU Press Release "The Commission adopts new rules to prevent and deal with gas supply crises" IP/09/1153 16 07 2009.

[46] EU Press Release "Commission and International Financial Institutions reach agreement with Ukraine on reform of the Ukrainian gas sector" IP/09/1218 31 07 2009.

countries.[47] Moscow, strengthened by a decade of energy windfall profits, unequivocally pushes for alternative gas passage to Western Europe via the Baltic Sea and the Black Sea, thus bypassing the increasingly independent transit countries.

The crucial element of Gazprom's plan is the Nord Stream twin gas pipeline on the Baltic seabed.[48] Regardless of general public reservations vis-à-vis Russian investments,[49] the German energy conglomerates involved in the Nord Stream consortium[50] are - not surprisingly - motivated primarily by the economic aspects of the pipeline and have complete disregard for the political consequences of the project. Nevertheless, the active role of the German government in securing financing for the Gazprom joint venture, combined with the engagement of the former German Chancellor Gerhard Schroeder (who made his preferences to Russia clear) as a Gazprom representative on the Nord Steam Board of Directors, accentuated the political rather than the purely commercial dimensions of the project.

The enthusiastic German support for the Nord Steam Project is coupled with criticism of the Nabucco pipeline by Chancellor Merkel who wanted to block EU funding for the project,[51] just before the decisive intergovernmental agreement was signed.[52] The Russian desire to bypass Belarus, Ukraine, Poland and Slovakia altogether and reach its Western customers directly is not a new concept. Moscow had already decided to circumvent Poland as a "possible source of dissension" in the late 1970s.[53] However, the perceived shift in German politics and support for the Nord Stream project is new. Germany has accepted the Russian argument that Ukraine, Poland and the Baltic States cannot be relied on as transit countries and therefore, an alternative transit rout under the Baltic Sea must be constructed. Berlin has embraced *Realpolitik* and, in choosing to ignore any spirit of EU solidarity in energy security matters, is now dealing directly

---

[47] Germany, which already depends on Gazprom gas for 40% of its 100 bcm consumption, and also relies on Russia for almost 40 % of its crude oil imports.

[48] The 55 bcm pipeline would completely satisfy the current German consumption requirements of Russian gas. Nord Stream consortium website at www.nord-stream.com

[49] FT/Harris poll in John Thornhill "Western fears on Russian Energy" Financial Times 02 18 2008.

[50] Nord Stream consortium is formed by Gazprom (51%), German BASF Wintershall (20%), E.ON (20%) and Dutch Gasunie (9%).

[51] Reuters 30 01 2009.

[52] EU Press Release "Signature of Nabucco Intergovernmental Agreement marks new era in EU energy" ISEC/09/85 10 07 2009.

[53] Jean-Marie Chevalier and Joseph Stanislaw "Les grandes batailles de l'énergie" p 276 Gallimard Paris 2004.

with Moscow over the heads of these countries. The governments in Warsaw, Kiev and the Baltic States fear that Germany has allowed itself to be manoeuvred into a situation of overdependence on Russian gas. The Kremlin had already made clear that new Russian investments and possible lucrative LNG tanker construction contracts from Gazprom for the ailing German shipyards in Rostock and Wizmar, which are already controlled by a Russian investor, depend on Ms Merkel's continuous political support for the Nord Stream project.[54]

The Nord Stream gas pipeline is not intended to supply Poland, Ukraine, or the Baltic States. In this context, it is sometimes questioned why consecutive Polish governments are opposed to the project that will provide the badly needed new supplies to Germany and does not directly concern Poland. However, it is exactly the fact that the Nord Stream project bypasses Poland, despite the country's geographical location between Russia and Germany that cause serious concerns in Warsaw. The project is widely perceived as intentionally designed to exclude Poland and other less docile Eastern European countries from the new gas transit system for Europe.[55]

The Nord Stream pipeline may have significant negative economic consequences for the region. Political commentators in Warsaw are concerned that Gazprom's privileged relationship with Germany resulting in new long-term supply arrangements could effectively petrify Gazprom's dominant position in what Russia perceives as a "privileged" sphere of influence in Eastern Europe and thereby jeopardize efforts to create an open energy market in Europe. This is especially true considering that the Nord Stream consortium has already applied for third party access exemptions on the new overland pipelines to be constructed for the Nord Stream gas supplies. The German National Regulatory Agency Bundesnetz Agentur did not agree to limit competition on the westward NEL stretch of the overland gas pipeline. On the other hand, the German agency has agreed to limit third party access on the newly planned OPAL pipeline to the Czech Republic.[56] The new eastwards OPAL pipeline to be constructed alongside the Polish border would allow Gazprom to supply Czech Republic with Russian gas from the West, rather than from the East, contrary to geography. Wingas, the majority shareholder in the OPAL project, has already agreed to reserve its pipeline capacity for Gazprom.[57]

---

[54] Kommiersant 12 08 2009.

[55] It inspired petitions to the European Parliament supported by almost 30 000 EU citizens, expressing concern at the planned construction of the gas pipeline.

[56] Bundesnetz Agentur "Federal network Agency grants partial exemption for OPAL pipeline" Press Release 25 02 2009.

[57] Kommiersant 13 03 2009.

The decision of the German regulator to exempt OPAL project from third party access rights,[58] if approved by the EU Commission, will effectively block the possibility for Poland to receive any significant gas supplies from the Nord Stream pipeline.[59] Even without formal exemption of the Nord Stream pipeline from competition, the prospects of viable gas supplies of Russian gas from Germany would be very limited. PGNiG, the Polish transmission system operator, is afraid that the new Russo-German arrangement effectively excludes Poland and the Baltic States from the nascent internal European gas market. The project petrifies fragmentation of the EU gas market and gives Gazprom an unprecedented pricing power and an undisputed monopoly and in Eastern Europe through 2035.

Foremost, the Eastern European governments are worried that the Nord Stream pipeline will shift the regional balance of power. Despite Prime Minister Putin's reassurances that energy is just about business and not politics[60] the project is seen as inherently political. The government in Warsaw is afraid that Russia will be more willing to pressurise Poland and the Baltic States and suspend supplies through the Yamal-Europe pipeline. Following construction of the Nord Stream, Russia will have a free hand to execute and prolong punitive political cut-offs in Ukraine, Belarus and other countries, without endangering its business with customers in Western Europe. This would expose Poland to severe gas problems that could not be mitigated with domestic supplies. Declarations by the Russian Navy that it wants to protect the pipeline have further aggravated fear and suspicion.

Consequently, Berlin's support for Gazprom in its efforts to bypass the transit countries would inevitably weaken their ability to stand up to economic and political pressure from Moscow. The disregard for smaller countries was widely perceived as being in the worst tradition of the Russo-German handling of the region. For the conservative government in Warsaw in 2006, German support for the Nord Stream project, at the time of gas tensions in the region, gave the impression that both the SPD and CDU-CSU governments would not hesitate to push Ukraine and Belarus into the Russian sphere of dominance. The sentiment of disappointment was also prevalent in the Baltic States. There is a growing recognition that Russian strategy to involve

---

[58] For an analysis of the third party access concept see Alexander Kotlowski "Third-Party Access Rights in the Energy Sector: A Competition Law Perspective' 16 (3) Utilities Law Review 2007; and Alexander Kotlowski "Access Rights to European Energy Networks – a Construction Site Revisited" in Bram Delvaux, Michael Hunt and Kim Talus (eds.), "EU Energy Law and Policy Issues - ELRF Collection" 2nd ed. Euroconfidentiel 2009.

[59] An idea proposed by Claude Mandil in "Sécurité énergétique et Union Européenne Propositions pour la présidence française" p 15, 21 08 2008.

[60] Mary Dejevsky "Putin Promises Russia Will Not Act Like an Energy Superpower" The Independent 11 09 2006.

major European energy players in the Nord Stream project, coupled with courting the political elites, pays off.

The liberal government under Mr. Tusk, with its strong pro-European stance, which took off in 2007, was determined to ameliorate relations with Germany and with Russia. Mr. Tusk's government acknowledges the German preoccupation with reliable gas supplies from Russia. Warsaw, however, does not understand why expansion of European network capacity is planned in a way that is contrary to the crucial political and economic interests of the Eastern European transit countries. Apart from the political concerns, Warsaw points out that the Nord Stream project is already substantially more expensive than land based pipelines such as extension of the Yamal-Europe project and that the costs of building the pipeline are likely to grow.[61] Therefore, both German and Eastern European markets will remain substantially closed to competition and consumers or possibly even the shareholders will have to bear the increased costs. Regardless of the internal energy market legislation, which creates a new structure of cooperation between network operators, isolated Eastern European markets with only one source of gas will remain more vulnerable to supply disruptions and dominant pricing than well integrated markets with gas supply from different sources. The arrival of expensive Nord Stream gas, which cannot easily compete with land based and already amortised pipelines, may put on the EU and the German government a strong pressure to delay market liberalisation.[62] However, German government remains dedicated to the project despite existence of economically more effective alternatives and some evidence that the costs of the expensive Russian export infrastructure are unlikely to be recoverable.[63] Despite the exemplary German-Polish relations in the years preceding the expansions of the EU, Mr. Tusk has already confirmed that his government would oppose financing of the Nord Stream project by the European Investment Bank. There may also be a strong opposition for the European Commission clearing any possible German state aid for the project.

Warsaw opposes Moscow's tactics of dealing with 'old' EU member states on issues of concern to 'new' EU countries by going over their heads, and thus it seeks to discuss the gas transit issues within the EU. Whereas the politics surrounding Nord Stream are complicated, the environmental language is the one that Brussels understands. Although Finland's Uusimaa

[61] Frank Umbach "Europe's Next Cold War: The European Union Needs a Plan to Secure its Energy Supply" DG GAP IP 2006.

[62] Alan Riley "Nordstream: An Economic and Market Analysis of the North European Pipeline Project" Centre for European Policy Studies 2008.

[63] Ibid.

regional authority has already approved the pipeline,[64] Poland and Lithuania alongside Scandinavian countries frame their opposition in environmental terms[65] and emphasize the preoccupation with environmental consequences of the project and problems with weapons at the bottom of the Baltic Sea.[66] Warsaw hopes that Brussels will eventually reject Nord Stream's environmental impact assessment and that in an extreme case the European Court of Justice will halt the project.

The German-Polish intergovernmental energy consultation group initiated in 2007 by Chancellor Merkel and Prime Minister Tusk to solve the discrepancies did not bring any tangible results. Germany, assured of its increased security of supply resulting from the new pipelines from Russia, is reluctant to agree for new European anti-crisis arrangements prepared by the Commission, which would allow less prepared countries in Eastern Europe to call for emergency solidarity supplies from the German system. German gas companies argued that Poland, as well as other Eastern European countries should not be allowed free riding on the German investments in the security of supply, without themselves committing to serious infrastructure investments. The government in Warsaw believes that, this otherwise reasonable requirement was a bit cynical when addressed to the countries bypassed by an explicitly excluded from the major planned pipelines such as the Nord Stream. In this context, the government in Warsaw promotes construction of an additional interconnector that would allow small-scale 'reverse' flows of Russian gas from Germany to Poland. The reverse interconnector (Pieremyczka) was already discussed in the 1990s with the German company VNG. Surprisingly, at that time it was promoted by Gazprom as an alternative to connecting the Polish system to the Scandinavian network. PGNiG, the dominant Polish gas company, did not want to invest in the bypass, as it rightly realised that it was not leading to real diversification. Today, PGNiG believes that the project can provide some additional security and emergency supplies to Poland in case direct Russian supplies are ever again disrupted. Though the gas would still come from Russia, the interconnector would introduce the possibility of 'indirect' small-scale balancing flows from Germany, that are not contracted from Gazprom; this would at least partly mitigate any possible disruptions. The likely proposed solution is a Bernau-Szczecin 50 km 'reverse' pipeline close to a large chemical facility or a direct technical solution on the Yamal pipeline in Germany that would allow reverse gas flows.

---

[64] Associated Press 01 07 2009.

[65] Urmas Lips "Possible Environmental Impacts of the Nordstream Project" Presentation at the Nordstream Project Conference Vilnius 2007.

[66] Marcin Libicki "Report on the environmental impact of the planned gas pipeline in the Baltic Sea to link up Russian and Germany" European Parliament Petitions 0614/2007 0952/2007 2007/2118 INI 2007.

4. New Energy Alliances in Eastern Europe

The developments in the German-Russian relationship and the quest for political balance and regional energy security motivate Poland and other Eastern European countries to coordinate their energy policies and to initiate projects aimed at diminishing their dependence on Russian energy.[67] However, this strategy has its limitations as individual countries have conflicting interests and incentives to strike independent deals with Gazprom.

A. *Amber Stream*

The government in Warsaw put all its weight into developing alternative plans to the Nord Stream that could still be beneficial for Gazprom and acceptable to its Western consumers. The possible alternative is the Amber Stream overland pipeline that would offer Russian gas a route to Germany via Estonia, Latvia, Lithuania and Poland, and further to the Netherlands, and the UK. Warsaw emphasises that the Amber Stream would run through stable EU countries that have consistent and reliable transit records and that have never 'stolen' gas or run late with payments. The Amber Project would cost only 20-30% of the seabed option, and the overland pipeline is far better suited for containing the impact of accidents, which could turn into catastrophes if they were to occur on the seabed.[68] The Amber overland pipeline, by integrating the new member countries, would have advanced the EU's goal of an integrated Internal Energy Market.[69] Nevertheless, the Kremlin is not interested in developing the Amber project and building energy partnerships with Baltic States, which some in Moscow often perceive as Russo-phobic troublemakers.[70]

B. *Baltic Pipe*

The previous conservative government in Poland was preoccupied with limiting Poland's energy dependence on Russia and focused on creating new energy alliances in order to diversify energy supplies. The Skanled submarine Baltic gas pipeline was seen as the last chance to get supplies

[67] Keith C Smith "Russian Energy Politics in the Baltics, Poland, and Ukraine" Center for Strategic and International Studies Press 2004.

[68] Polish Ministry of Economy "Preliminary Amber Pipeline feasibility study" 2008.

[69] Ryan R Miller "Germany's Baltic Betrayal" Central Europe Digest 16 07 2008.

[70] Reuters 14 08 2008.

from Norway and to diversify gas supplies to Poland and possibly to the Baltic States.[71] The Skanled gas pipeline probably the last big new Norwegian pipeline to Europe, is designed to supply 6-8bcm of Norwegian gas from Karsto to Scandinavian industrial sites in eastern Norway, Sweden, Denmark and further to Poland.[72] In 2007, the Polish gas company PGNiG acquired an interest in the Skanled consortium led by Gassco.[73]

At the same time, PGNiG and Danish Energinet.dk revived their long-standing plans to construct the Baltic Pipe interconnector to Denmark and link the Scandinavian natural gas systems with the Polish system allowing gas imports from Norway.[74] The planned 230-km Baltic Pipe would connect Redvig in Denmark and Niechorze in Poland. The pipeline capacity was planned for 5 bcm of gas annually.[75] The estimated €350 million financing for the project would have to be provided by PGNiG, which would initially own the project. The EU has indicated that it could support the Skanled project and the onward link from Denmark to Poland with €150 million. The Baltic Pipe could operate in both directions and, depending on gas market conditions, provide Denmark with Russian gas via Poland.[76] Nevertheless, both Scandinavian projects had been struggling to find enough buyers.[77] In May 2009, participants in Skanled, which now involves major Nord Stream shareholders (E.ON, VNG and Gasunie), suspended the project.[78]

C. *Developments on the Druzhba Pipeline*

Following the Russian-Belarusian oil disagreements in January 2007[79] and just before the Russian-Ukrainian gas dispute in December 2008, Prime Minister Putin signed a decree to construct the Baltic Pipeline System 2 (BTS-2). The €4 bn Baltic Pipeline System is designed as

---

[71] Derek Brower "Laying the pipes" Petroleum Economist October 2007.

[72] Energinet.dk "Information concerning the planning of Skanled gas pipeline" Press Release 22 06 2007.

[73] PGNIG Press Release 22 06 2007.

[74] Energinet.dk Press Release "Denmark and Poland look into gas pipeline" 03 05 2007.

[75] "One Step Closer to Diversification" Warsaw Voice 24 06 2001.

[76] "Denmark and Poland considering gas pipeline" Energy Business Review 03 05 2007.

[77] Reuters 17 03 2009.

[78] Norwegian Ministry of Petroleum and Energy Press Release 29 04 2009.

[79] Russia cut off supplies to Europe for four days via the Druzhba pipeline after Belarus refused to let Russian oil pass through the country without payment of a transit duty.

an alternative to the Druzhba oil pipeline. Moscow made it clear that, in line with the Russian gas strategy, it wants to tighten control over oil transit and cut Belarus and Poland from the overland oil supply route to Western Europe. Furthermore, the new BTS-2 pipeline with target capacity of 50 mt of oil annually would allow Russian exporters to avoid shipping oil through the Baltic States as well as give to the Kremlin the option to divert oil flows from Ukraine. Despite increasing tanker traffic on the Baltic, Moscow is determined to send oil directly to ports in Germany. German Baltic ports have already undertaken preparations to expand their oil import capacity.

The Russian pipeline monopolist Transnieft launched the construction in June 2009 and the pipeline is to be operational by 2011. The 1170-km new pipeline will connect to the existing Druzhba pipeline in Unecha in Bryansk Oblast near the Belarusian and Ukrainian borders, and divert supplies to the new Ust-Luga terminal on the Gulf of Finland, 110 km from St Petersburg.[80] A branch will connect the pipeline to the Kirishi oil processing facility in northwest Russia. The BTS-2 pipeline will be constructed alongside the existing BTS-1 route transporting 75 mt of west Siberian oil to the nearby Baltic terminal in Primorsk.

Warsaw is concerned that, with diminishing Russian crude output, it will not be possible to fill both the 80 mt Druzhba and the 30-50 mt BTS-2 oil pipelines at the same time. Moscow will probably want to keep operating the southern Druzhba in order to preserve its dominant oil position in Slovakia, Czech Republic, and Hungary; however it may diminish supplies through Belarus and Poland. It is expected that the BTS-2 pipeline will be filled with diverted supplies form Ukrainian ports in Odessa and Yuzhny on the Black Sea (18mt), as well as from the Baltic oil terminals in Latvia and Lithuania (12mt), Naftoport in Poland (7mt) and oil transport by train through Belarus (2mt). Moscow already invited Kazakhstan to join the project and fill the remaining capacity (initially 10mt). Kazakh participation in the Baltic Pipeline System may further discourage European-backed projects to transport Kazakh oil directly to world markets without Russian intermediaries. The loss of oil transit and limited ability to set the transit fees would be particularly significant for Belarus, which has no independent import facility. Warsaw rests assured that it is cable to use its buying power to secure supplies from Russia and get the necessary imports by sea. Nevertheless, there are concerns that diminishing supplies from the Druzhba pipeline, the major oil import route in the country, may shake the long-established cooperation and disrupt supplies.

As there is no new oil output in Russia to fill the new pipelines, there is apparently no immediate economic need for this new expensive project. In Poland, the Baltic States, Belarus and Ukraine, the BTS project is generally perceived as politically, not economically, motivated. It exemplifies

[80] The Ust-Luga terminal is to be constructed by Transnieft and possibly by Gunvor.

Russian willingness to politicise trade relations with the neighbouring markets and strategically diminish regional security of supply, rather than sustain long-term energy cooperation in the region.

D. *Odessa-Brody Oil Pipeline*

In light of the Russian strategy to restructure the oil pipeline system, one of the persistent concerns in Warsaw is that the Polish Orlen and Lotos refineries will have to face diminishing oil supplies from the less-used Druzhba pipeline. Russia plans to replace the Druzhba oil pipeline with a new connector to the Russian Baltic port in Primorsk.[81]

In recent years, Poland and the Baltic States inspired and supported Ukrainian plans to construct a new Odessa-Brody oil pipeline. The pipeline was planned from the Privdenny oil terminal in Odessa on the Black Sea to Brody near the Polish border, and further to the Polish Orlen refinery in Plock and to the Naftoport Gas terminal in Gdansk. The Odessa-Brody pipeline has considerable geopolitical significance, as it potentially allows direct transport of Caspian oil from the Black Sea to Polish, German and Czech refineries and Baltic export terminals, without usage of the Russian transit system. Kiev believed that the pipeline would significantly strengthen the foundations of Ukrainian economic independence.

The 675 km oil Odessa-Brody pipeline was constructed in 2002. Nevertheless, Russian companies used their buying power and dissuaded their Caspian partners from selling oil to Odessa. With a new oil transit pricing through the existing Russian pipelines, the alternative tanker supplies from the Black Sea turned unattractive. Due to lack of agreement for viable oil supplies from Central Asia, the Odessa-Brody pipeline remained unused for two years. In 2004, the Ukrainian government, faced with unused capacity, accepted Russian TNK-BP's proposal to utilize the pipeline for transports in the opposite direction: to supply Russian oil from the Druzhba pipeline southwards to Odessa to be shipped further to the Mediterranean. The shorter Polish stretch of the pipeline was never completed and the project was running at a loss. Following the success of the Orange Revolution in 2004, Ukrainian President Yushchenko returned to plans originally intended for the pipeline. With significant public interest in the project, this idea has been upheld by the succeeding Ukrainian government of Mr. Yanukovych. In 2007 the presidents of Poland, Ukraine, Lithuania, Georgia, and Azerbaijan, and the special envoy of the president of Kazakhstan, agreed at a meeting in Krakow to proceed with the oil

[81] For an account of Russian oil policy see Shamil Yenikeyeff "The Battle for Russian Oil Corporations, Regions, and the State" Oxford Institute of Energy Studies 2010.

pipeline bypassing Russia and linking the existing pipeline with Gdansk. The agreement expanding an international pipeline consortium, Sarmatia, was signed by the presidents at the energy security conference in Vilnius in October 2007.

Polish and Ukrainian plans to diversify oil supplies strained Polish-Russian cooperation on the Druzhba pipeline. The newly constructed Polish terminal Naftoport on the Baltic Sea with its strategic import capabilities currently serves as a key export terminal for Russian and Kazakh oil. The new Russian energy policy, however, assumes that all oil exports, in line with gas transit, should bypass selected Eastern European countries. In December 2008, Transnieft, which manages Russian crude exports, announced that in 2009 it would reduce by half and by 2012 possibly would stop all exports from the Polish and Lithuanian Baltic ports and from the Ukrainian Odessa terminal on the Black Sea. It stated that all exports were to be diverted to newly constructed terminals in Primorsk in the Gulf of Finland and to Novorossiysk on the Black Sea, which were operated by Gazpromnieft, a Gazprom oil company formed in partnership with some Cypriot entities. With the new Baltic Pipeline System BTS-2 to be constructed by 2012, Moscow may want to reduce overland supplies to Poland from the Druzhba pipeline and withdraw completely from Naftoport terminal on the Baltic Sea. A reduction of Russian oil imports to Poland through Belarus from the Druzhba pipeline would possibly require switching Naftoport terminal from export to import facility. Although Poland has the strategic crude import capacity to support the national demand in Naftoport in Gdansk, the terminal would not be able to export Caspian oil coming through the Odessa-Brody pipeline; as originally intended by the Polish and Ukrainian governments.

Russia used a similar retaliatory method in 2004, when the Latvian government refused political pressure to sell its largest Latvian port in Ventspils to Russian investors. Despite chronic shortages in export capacities, Transnieft stopped oil exports from the Latvian port, which for preceding years served as the largest export facility for Russian oil. Latvian attempts to engage the EU in solving the issue did not succeed.

E. *Mazeikiu Refinery*

The consecutive governments in Warsaw and Vilnius encouraged Polish oil and gas companies to secure supplies through new energy alliances. In 2006, the Polish petrochemical company Orlen, in fierce competition with Lukoil, TNK-BP, and KazMunaiGaz, a Kazakh company linked to Gazprom, acquired a 54% controlling stake in Rafinerii Mazeikiu Nafta in Lithuania from the bankrupt Yukos.[82] The Lithuanian government, with the remaining 40% in the refinery, was

[82] Orlen Press Release 14 12 2006.

determined not to let Russian companies take over the strategic energy infrastructure. Mazeikiu refinery is often regarded as the most important enterprise in the Baltic republic and control over it carries political clout. The USD 2.3 bn acquisition finalised in 2007 was the largest foreign acquisition by a Polish company. At the time, the acquisition had a strong support from the Polish President Kaczynski and the then conservative government.

Mr. Kosachov, the chairman of the Duma's foreign committee, stated openly during his visit in Vilnius that Lithuania had chosen the wrong investor and would be punished for that.[83] Just before the transaction, a gigantic fire destroyed part of the refinery. As soon as the transaction was finalised, Transnieft, the Russian oil pipeline monopolist, halted oil supplies to Lithuania on technical and ecological grounds. Despite personal pledges by the Lithuanian Prime Minister Kirkilas, the country was left without a vital source of crude and had to resort to tanker supplies by sea to the Butynga oil terminal.

With the concurrent takeover in 2004 of 63 % of Unipetrol, the leading refinery in the Czech Republic, Orlen formed the largest petrochemical group in Central Eastern Europe, with a total annual deep processing capacity of 31.7 million tonnes. On the other hand, Czech energy concern CEZ has recently signalled interest in acquiring Polish electricity companies such as Tauron, ENEA, ZE PAK, and a coalmine Bogdanka.[84] The possible sale of Orlen's stake in Mazeikiu to the Russian Transnieft, following the Russian boycott and the disappointing results of the now partly dysfunctional Lithuanian refinery, caused a serious commotion in Lithuania in the spring of 2009. The Polish president felt obliged to reassure the Lithuanians that Poland is committed to the energy partnership between the two countries.[85]

Arguably, Orlen's expansion to Lithuania has not achieved its initial goals to reduce regional dependence on Kremlin politics. The expensive acquisition has shaken the financial stability of the Polish company and significantly increased its borrowing costs. Following the market meltdown, Orlen reduced by one third the valuation of its stake in the now partly dysfunctional and loss making Mazeikiu refinery. There are no immediate prospects to restore pipeline crude supplies from Russia. Moreover, the high-priced supplies by sea to the Lithuanian refinery have been dominated by Gunvor; a Kremlin-favoured oil trading intermediary.[86]

---

[83] Gazeta Wyborcza 02 11 2006.

[84] Poland pursues a €7 bn privatisation program in the energy sector until 2010.

[85] Rzeczpospolita 07 04 2009.

[86] Gunvor which has risen from niche player in 2003 to become the world's third-largest oil trader is owned by Mr. Timczenko; purportedly Mr. Putin's judo instructor. Financial Times 14.05.2009

Apart from the cooperation in oil refining, the governments in Warsaw and Vilnius plan to connect the Baltic States to Poland's gas systems, giving them a backup in case direct supplies from Russia are ever disrupted. Lithuania also plans to build a new LNG terminal by 2013, for which it got initial support from the US Trade and Development Agency and from the International Energy Agency.[87] The 1.5 - 2.0 bcm facility would be 80 % state-owned, with the rest taken by AB Achema, a private chemical company and a major Lithuanian partner of Gazprom. The Lithuanian LNG project competes to a certain degree with Polish plans to construct a new LNG terminal in Swinoujscie.

F. *Ignalin Nuclear Plant*

In 2007 Polish electricity operator PSE, Lietuvos Energjjos, Latvenergo and Eesti Energia agreed on a joint €5 bn project to construct a new nuclear plant in Lithuania by 2015.[88] The 3200 MW nuclear power plant in Visaginas near Ignalin will replace the old Chernobyl-type reactor, which supplied from 70% to 90 % of Lithuania's electricity consumption.[89] Lithuania has agreed in the EU Accession Treaty to close the obsolete plant by 2009. The phase-out of the old Ignalin reactor leaves the Baltic republics utterly dependent on electricity and gas supplies from Russia. When Belarus demanded exorbitant transit charges for Ukrainian energy supplies, the Lithuanian energy company ERC had to sign a 10-year 2.5 bn KWh power supply contract with the Russian company Inter RAO.[90] It is also hoped that the Ignalin project will allow for construction of the €500 m Elk – Alytus electricity interconnector which is designed to link the Lithuanian and Latvian grids via northern Poland to the European UCTE system by 2013 as well as to allow electricity exports to Poland. Warsaw expects that the interconnector will also add to the now suspended project to create a Baltic energy market with Nord Pool.[91]

However, the Ignalin nuclear project will have to compete with a newly announced 2400MW Baltic Nuclear Power Plant planned by Rosatom/Energoatom to be build adjacent to the Lithuanian border in Neman, in the Russian enclave in Kaliningrad.[92] The Rosatom facility, with

[87] USDA Press Release 15 09 2008.

[88] PAP 03 03 2007.

[89] Ignalin Nuclear Power Plant www.iae.lt

[90] Reuters 06 03 2009.

[91] The rather volatile Baltic energy policy provoked the Nordic electricity exchange Nord Pool to close its Tallinn office in 2009. As a result, Estlink 2 the second undersea cable between Estonia and Finland may be delayed for another few years.

[92] "Kaliningrad plan for Baltic States market" World Nuclear News 17 04 2008.

its capacity being excessive for the sparsely populated Kaliningrad region, is explicitly planed to produce electricity for exports to the Baltic States and to Poland. The Lithuanian nuclear power project will also compete with a recently planned nuclear power plant in Ostrovetskaya, which will be constructed by the Russians near Grodno in Belarus close to the Lithuanian border by 2016.[93] Furthermore, contrary to the expectations of other Baltic States, Russia repeatedly suggested that Lithuania should participate as a partner in the Baltic power plant and give up the Ignalin project.[94] The Russian plant, if completed before the Ignalin plant, may undermine the economics of the Lithuanian project. Delays over the Ignalin project provoked bitter comments from the Estonian Prime Minister Ansip and motivated Estonia to participate in a small-scale IRIS nuclear plant development project with the American company Westinghouse.[95] Both the Polish and the Estonian prime ministers stressed that plans for new domestic nuclear power plants do not undermine their commitment to the Lithuanian project.[96]. The status of the Lithuanian strategic investor LEO LT is subject of political and legal quarrels[97] but the government in Vilnius confirms plans to build the Ignalin reactor by 2015 - 2018.[98] Nevertheless, the new Lithuanian President Grybauskaite admitted that the deep economic crisis puts pressure on Lithuania to revaluate Vilnius' commitment to nuclear energy.[99] At the same time, Lithuanian gas company Lietuvos Dujos, where Gazprom holds a 39 % minority stake, develops a second stretch of the 140 km 2.5 bcm gas pipeline from Minsk in Belarus, through Vilnius to Kaliningrad. Gazprom plans to build there a large gas fuelled power plant and supply electricity to Lithuania and possibly to Poland.

Delays over the Lithuanian nuclear power plant prompted Russian Rosatom to speed up construction of the Baltic Nuclear Plant in Kaliningrad. The Kaliningrad power plant would be capable to export 70% of its electricity output to Lithuania and Poland, and possibly to Germany. Furthermore, Rosatom expressed interest in selling up to 49% of the Baltic Nuclear Plant operator to foreign investors from Poland and Lithuania.[100] The Russian state-owned

[93] Grodno Oblast Executive Press Release 20 12 2008.

[94] Regnum.ru News 08 04 2009.

[95] Gazeta Wyborcza 18 04 2009.

[96] PAP 16 04 2009.

[97] The Lithuanian Government owns 62% of LEO LT and the remaining shares belong to a private investor NDX Energia.

[98] Vilniaus Diena 06 08 2009.

[99] PAP 27 07 2009.

[100] Czech CEZ and Spanish Iberdrola also expressed interest in the Kaliningrad project.

company argues that in this scenario, "the power to switch off" electricity in Lithuania would remain with the jointly controlled operator. The Baltic States, preoccupied with the security of supply, realise that switching off a nuclear reactor is more complicated than political manipulations with oil and gas deliveries. Rosatom also wants to discuss with Polish electricity operator PSE, a construction of a high-voltage electricity transmission corridor from Kaliningrad to Germany through Poland. This is presented as an alternative to a rather theoretical electricity interconnector with Germany put on the Baltic seabed, alongside the Nord Stream Pipeline.[101] The governments in Warsaw and in Vilnius did not give up the Ignalin project but they perceive the nuclear plant in Kaliningrad as a possible alternative. Although electricity imports from Kaliningrad would increase Lithuanian and Latvian dependency on Russian energy, they would also allow for construction of the planned Elk – Alytus electricity connector to Poland, giving the Baltic States much-needed interconnection with the European UCTE system. Participation in the Kaliningrad project may increase know-how transfers to The Baltic States expect that the Swedish EU presidency will support the plans to reduce their energy dependence on Russia with new electricity interconnectors to Sweden, Finland, and Poland.

5. Conclusions

The new energy order in the EU emerges as a result of conflicting national interests. Russia actively strengthens her political influence in the transit countries and promotes new alternative transit routes. On the other hand, Ukraine, Poland, Belarus, and the Baltic States, in fear of Russian economic and political dominance, seek new energy alliances.

Post-Soviet gas pricing and complicated political barter arrangements are unsustainable. Sooner rather than later, Ukraine and Belarus will have to face market prices for Russian gas. Commercialization of gas consumption may eventually help establish regular business relations in the region and increase political stability. However, this will never happen if Ukraine and Belarus lose their only bargaining position as major transit countries. Should Ukraine, Belarus and other Eastern European countries live under permanent danger of punitive gas cut-offs, the market for gas and transit services, as well as sound economic relations between the countries, will never develop.

This security of supply issue is high on the political agenda in Poland neighbouring States. Although a lot of criticism towards Russo-German cooperation is marked by populist rhetoric, the Nord Stream and the South Stream projects nevertheless create serious detrimental effects and political tensions that can only be resolved at the EU level. Therefore, there is a need for a

[101] Litovskij Kurier 06 08 2009.

comprehensive European energy policy towards Russia that will take into account political and not just economic consequences of the new arrangements. The European Union, founded on principles of fair competition, should not allow the strategic part of the Internal Market to be dominated by particular interests and Gazprom's political ambitions. The dominant view in Eastern Europe is that short-term economic gains offered to German and Italian companies can hardly balance the long-term security consequences that Europe will have to bear if it lets a whole neighbouring region slip into economic and political dependence.

* * *

Table of Contents OGEL special issue on EU - Russia relations

OGEL 2 (2009) OGEL special issue on EU - Russia relations

- EU-Russia Energy Relations: Common Goals and Concerns **A. Piebalgs**, EU Commissioner for Energy, European Commission
- EU-Russia Energy Dialog at the Origin of the European Foreign Energy Policy **F. Tarradellas Espuny**, European Commission
- The Transition from Communism: A Diagrammatic Exposition of Obstacles to the Demand for the Rule of Law K. Hoff, World Bank, **Joseph E. Stiglitz**, Columbia University
- Enforcement of Foreign Arbitral Awards in Russia: Improving, But Still Uncertain C.M. Baker, Fulbright & Jaworski L.L.P.
  J. Sutcliffe, Fulbright & Jaworski International LLP
  K. Wilson, Fulbright & Jaworski
  K.H. Romman, Fulbright & Jaworski
- Russian Energy Strategy and Transit Routes in Eastern Europe - A View from Warsaw **A. Kotlowski**, Faculty of Law, University of Oxford,
- Arbitrating Disputes under the Energy Charter Treaty **K. Hobér**, Mannheimer Swartling Advokatbyrå
- A Common Russia-EU Energy Space (The new EU-Russia Partnership Agreement, acquis communautaire, the Energy Charter and the new Russian initiative) **A.A. Konoplyanik**,
- Energy charter and the Russian initiative - Future prospects of the legal base of international cooperation A.A. Konoplyanik,
- A New Energy Charter: Myth or Reality? **A.V. Belyi**, Higher School of Economics
  S. Nappert, 3 Verulam Buildings
- The Politics of EU-Russia Energy Relations **F. Cameron**, EU-Russia Centre
- EU-Russia Relations in the Energy Field: The Continuing Role of International Law **S. Nappert**, 3 Verulam Buildings
- The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment **J. Stern**, Oxford Institute for Energy Studies
  S. Pirani, Oxford Institute for Energy Studies (OIES)
  K. Yafimava, Oxford Institute for Energy Studies (OIES)
- Russia-Ukraine Gas Dispute: Soft and Hard Security Issues - A View from Russia **A.V. Belyi**, Higher School of Economics
- 2009 Gas Conflict and its Consequences for the European Energy Security **M. Gonchar**, Centre for Global Studies "Strategy XXI"
  V. Martyniuk, Centre for Global Studies "Strategy XXI"
  O. Prystayko, EU-Russia Centre
- The Impact of the Russia-Ukraine Gas Crisis in South Eastern Europe **A. Kovacevic**

- Current Stay of Play in EU-Russian Energy Relations **C. Filis**, IIR Russia and Eurasia Centre (CERE)
- The Relevance of a Triangular Approach to the Issue of Energy Security in Europe: Russian Case as an Example **S.S. Haghighi**, ECONGAS
- Can Nordstream and Southstream Survive in a Changing European Gas Market? **A. Riley**, City University London
- EU-Russian Energy Relations is Not a Zero-Sum Game: It is Beholden on Brussels Needs to Educate the Russian Elite Before it is too Late **E.S. Burger**, Esq., Georgetown University Law Center
- Russian Energy Strategy: Does BP-TNK Represent a Valuable Case Study? E.S. Burger, Esq., Georgetown University Law Center
- The Effect of the EC-Russia Partnership Agreement in Community Law: Lessons Learned From the Soccer World **D. Buschle**, Energy Community Secretariat
- The Long-Term Capacity Agreements, Third Party Access and EU-Russia Relations **K. Talus**, University of Helsinki
  M. Hunt, CMS DeBacker
- The New EU Energy Policy and Implications for Former Soviet Union Natural Gas Suppliers **D. Volkov**, Center for Energy Economics, BEG/UT-Austin
  G. Gülen, Center for Energy Economics, BEG/UT-Austin
  M. Michot Foss, Center for Energy Economics, BEG/UT-Austin
- Unbundling As a Defence Mechanism Against Russia: Is the EU Missing the Point? **A.R. Willems**, Sidley Austin LLP
  J. Sul, Sidley Austin LLP
  Y. Benizri, Sidley Austin LLP
- Improving the Climate for European Investments in the Russian Electricity Production Sector: (I) the Role of Investment Protection Law **A.J.R.T. Boute**, Groningen Centre of Energy Law,
- Improving the Climate for European Investments in the Russian Electricity Production Sector: (II) the Role of Regulatory Convergence A.J.R.T. Boute, Groningen Centre of Energy Law,
- A Formula Approach May be the Only Option for Guaranteeing Pricing Predictability and Transparency Between Gazprom and Naftogaz of Ukraine (interview) **A.A. Konoplyanik**,
- The Gas Transportation System of Ukraine and Russia Has Always Been Unified (Interview) A.A. Konoplyanik,
- Modernization and Expansion of the Gas Transportation System Will Create Positive Macroeconomic Effects for Ukraine (interview) A.A. Konoplyanik,
- Energy Security of Russia and the EU: Current Legal Problems **S.S Seliverstov**, Sokolov, Maslov and Partners.