

Baltic Pipe – Is it Real?[©]

The Russian proposal to build a natural gas pipeline from Russia, under the Baltic to serve Western Europe has been around for a while. There has been for some time a question in our minds as to whether that was a real proposal or a negotiating stratagem. The recent (October 9, 2003) declarations by President Putin and Chancellor Schroeder that Baltic Pipe would be built (at an estimated cost of €6 billion) in the near future raise the stakes in the guessing game. It now seems that Baltic Pipe may get built.

The latest version of Baltic Pipe seems to be based on a venture including Gazprom, Ruhrgas, and Wintershall. That is an odd family to start with. If memory serves us correctly, Gazprom teamed up with Wintershall in the early 1990s because Ruhrgas would not give Gazprom access to the German wholesale gas market as part of a package to build the Trans-Poland pipeline. Then, Ruhrgas and Gazprom reached some working agreements that seemed to leave Wintershall behind. Now, the three are cooperating, but it still looks like an awkward arrangement.

The fundamental pressures are clear. Germany is highly dependent on Russian gas. The German markets have not been open for external TPA, and Gazprom would like downstream market access. Since Germany wants to increase its assurance of supply, Gazprom seems to have wrung concessions from Germany and is gradually getting access to the German markets.

But why build Baltic Pipe? Why not double up, as originally planned, on the recently-built Trans-Poland pipeline bringing another 20 billion cubic meters of gas into the market that way?

We suspect the answer there is Russian frustration and impatience. Russia, Gazprom specifically, is frustrated and impatient with both Poland and Belarus.

Belarus is a political thorn in Russia's side. Gazprom has been having problems with getting paid by Belarus for gas supplies. Recently, the Russians have signaled further frustration by decontrolling the price of gas at which Gazprom sells gas to Belarus. This means, we believe, that Belarus will no longer get treated like a domestic gas consumer, but will be treated like a non-CIS gas consumer, increasing substantially the cost of gas in Belarus. Bypassing Belarus is probably a large part of the rationale to build the Baltic Pipe rather than to finish the Trans-Poland pipeline.

There is also frustration and impatience with Poland. While Poland has a far better payment record with Gazprom than Belarus has had, there have been issues. More important than payment, however, would seem to be Poland's lack of performance on the original gas supply agreement that served as part of the basis to build the first tranche of the Trans-Poland pipeline.

In about 1994, Poland agreed to a "take or pay" arrangement for long term gas supplies from Russia. These commitments were unreasonable in hindsight and even questionable at the time.

(For more information about that, Pan EurAsian published in a Platt's *Power in East Europe* in February 2002 an article entitled "**Confusion about Natural Gas Supplies for Poland.**" This article is also available on our website at www.paneurasian.com/gas.pdf)

One big problem in Poland is protection of the coal industry. A forecast by the Polish Academy of Science (upon which the original plan for the Trans-Poland pipeline was justified) predicted gas consumption in Poland would grow from essentially 10 billion cubic meters per year in 1993 to around 20 bcm per year by 2010. The first half of the Trans-Poland pipeline was completed

and now operates at around 20 bcm per yearⁱ. But, gas consumption in Poland remains at about 10 bcm per year, just as it was in 1994 when the commitments were made to build the pipeline. Poland failed to meet its take or pay commitments up to 2001 and has been forced by circumstances to ask Gazprom to renegotiate the original contract and reduce its commitments to buy gas.

While it may be that Russia is now just starting to grapple with reform of energy prices and structures and will find it no easier to accomplish than Poland has, there is no denying that Poland's progress in energy reform since 1990 has been far short of early promises. The coal industry still provides most of the fuel for power generation. Most of power generation is still in the hands of the State, and very little use of gas in power generation has materialized. The prices for energy still remain below full economic cost, especially for coal. Yet, Poland pays the nearly the same price for imported gas that Germany pays where prices for energy are generally at economic full cost levels (so-called "world prices"). In short, Poland could not afford to comply with the terms of the original Gazprom contract and had to renegotiate that contract. The process was painful and slow. The result was that Gazprom would like to avoid Poland if it can.

Making things worse, Poland and Russia had an unpleasant argument in 2001 about the second phase of the Trans-Poland pipeline (see update in Note i at the end of this article). Gazprom had apparently concluded that the market in Germany was not ready for the second phase, but that southern Europe was. They asked the Poles to consider a diversion from the original route through Poland that would go into the Czech Republic instead of Germany. That was seen in Poland at the time as an effort to punish Ukraine for its theft of gas and its non-payment for gas. Perhaps that's what it was. Poland took offense at Gazprom's suggestion and, for whatever reason, stoutly rejected Gazprom's requests. This probably added to Gazprom's incentive to avoid Poland.

The present, and main, route for Russian gas to Germany (and the rest of western Europe) is via the Ukraine, Slovakia, and the Czech Republic. But, given the payment and theft of gas problems Gazprom had with the Ukraine, and the deteriorating condition of the pipeline through the Ukraine, it is no surprise that Gazprom wishes to avoid the Ukraine for incremental new deliveries.

Finally, there was some discussion of building a pipeline from Russia through Finland and Sweden into western Europe. That proved too difficult, or expensive, and the plans were evidently given up.

The result is Baltic Pipe.

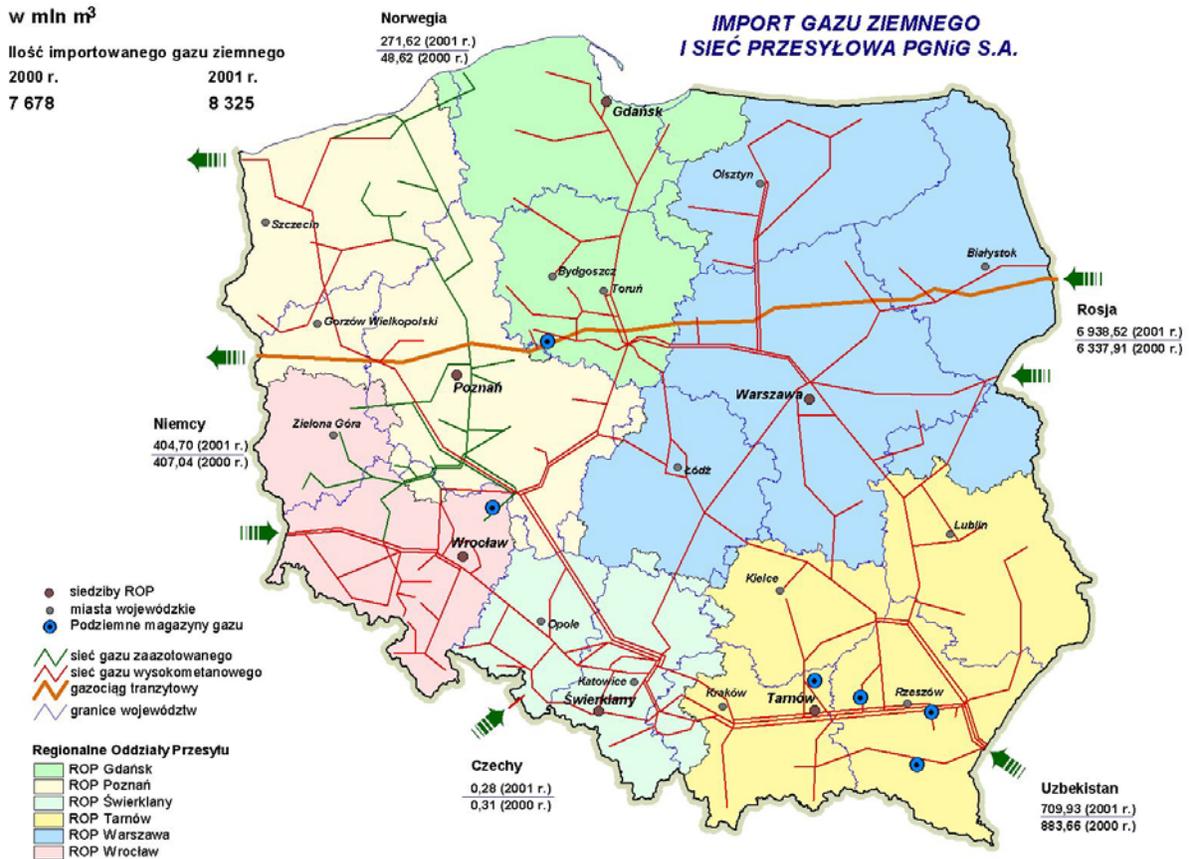
The lurking question in our minds, until recently, was whether Baltic Pipe was simply a bargaining stratagem to get Poland to make concessions. Perhaps a transit fee reduction was the target.

But, it would appear Poland was in no position to make concessions. The recent, ugly, demonstrations in Warsaw by the coal miners show that Poland still has problems with restructuring the coal mines. Poland is still a long way from the kind of conversion to gas for power generation that it would take to impel an increase in gas consumption from 10 bcm per year to 20 bcm. Since any conversion would be at the expense of the coal industry, the government has covertly, if not overtly, blocked it.

So, it would appear that Baltic Pipe may happen. We still think it is Gazprom's second choice. The weakness of Baltic Pipe is its lack of flexibility. When Poland finally does follow the rest of Europe in phasing out, or down, coal as a primary fuel there will be pressures on the existing pipelines. Implementing the original Trans-Poland pipeline plan would allow for deliveries in Poland or onward to southern destinations, which Baltic Pipe cannot do. But Gazprom wants to consolidate its position in Germany now, not later when Poland might be ready. So, Baltic Pipe is the compromise with reality that now looks likely to get built.

But, we would not be surprised to see some last minute concessions, or even incentives, offered by the Poles that would result in doubling up on the Trans-Poland pipeline.

For those who may be curious about the Polish gas transportation system, we show on the following page a map of the Polish gas infrastructure.



Source: Polish Oil & Gas Company

Explanations:

This map shows two points of import of gas into Poland from Russia on the eastern border of Poland, one point of import (marked “Uzbekistan”) on the Polish-Ukrainian border, one small point on the Czech border, and one point on the German border marked “Niemcy.”

The northernmost entry from Russia on the eastern border is the new Trans-Poland pipeline that crosses the country and enters Germany near Frankfurt-on-Oder. The gas connection south of that from Russia has a capacity, we understand, of around 2 bcm per year and has not been fully utilized.

The gas pipeline from “Uzbekistan” is the main, traditional means of importing gas from Gazprom via the Ukraine. Polish Oil & Gas Company’s representation that this route now is limited to bringing gas from Uzbekistan was a surprise to us. We believe that, actually, some of the gas shown coming into Poland from Gazprom, shown coming in from the Northern connection on the Trans-Poland pipeline actually still comes in via the Ukraine.

Transit quantities are not shown on this map.

The imports from Czech Republic are negligible. The imports shown as coming from Germany (“Niemcy”) are possibly Gazprom gas and the small quantity of Norwegian gas shown at the Northern margin. The capacity of that interconnection with Germany is reported to be about 2 bcm per year and is reversible.

The export connection with Germany shown at the uppermost northwestern corner of Poland is, we believe, negligible.

ⁱ Note on the Jamal, or Trans-Poland pipeline.

During the mid-1990s Gazprom and Polish Oil & Gas Company (“PGNiG”) formed a jointly owned company known as EuRoPol. That company was to build a dual gas pipeline from the eastern border of Poland with Belarus to the German border near Frankfurt-on-Oder. Due to lack of demand on both the Polish and German markets only one of the two planned pipelines was laid, and only two of five planned compressor stations were built. That gave the pipeline only 20 billion cubic meters of gas a year capacity versus the 64 bcm per year included in the original plan.

Increasing the pipeline’s capacity has been a source of friction between Gazprom and PGNiG since then. We believe, as stated in this article, that part of the impetus to build the Baltic Pipe stems from this frustration.

During the week of October 13 the supervisory board of EuRoPol made a decision to build more compression capacity, bringing the capacity of the line from the present 20 bcm per year to 33. This decision to add 13 bcm per year of capacity may delay a decision to build the Baltic Pipe.

(updated October 20, 2003)