Russia and Poland Settle Their Natural Gas Dispute©

It is reported that on Thursday (23 January), in Moscow, the vice prime ministers of Poland and Russia (Marek Pol and Victor Christienko) signed a preliminary protocol to modify the basic gas supply agreement between Russia and Poland originally signed in September 1996. The new agreement changes the delivery quantities under the contract, and clears up some financial problems so that the first phase of the new ("Yamal") pipeline could be completed.

The original agreement called for Poland to buy (take or pay basis) 240 billion (1,000 million) cubic meters[i] ("bcm") of natural gas by 2020. Press reports vary on what the actual, annual take or pay commitment was, but it worked out to about 10 bcm per year. In February 2002, Pan EurAsian published an article (available from our archives) in which we pointed out that Poland had over-estimated substantially the growth in demand for natural gas. For about a year now, Polish Oil & Gas Company ("PGNiG") has been trying to negotiate a new gas supply agreement with Gazprom more in line with likely demand. After much discussion, it seems that a settlement has been reached.

According to one press report following the meeting on 23 January between the two vice prime ministers, the following has been agreed:

- Poland's obligation to buy gas will be reduced to the level of 6.6 bcm per year from this year until 2010;
- From 2010 until 2020, the amount may increase, not specified in one report, or 'about 8 bcm per year' in another;
- For 2021 and 2022, the amount will be 9 bcm per year (thus extending the original contract by two years).

However, other press reports indicate that the total amount of remaining deliveries under the contract have been reduced from 218 bcm to 161 bcm for the period from now until 2022. Adjusting for the 9 bcm per year for the last two years of the new contract, the interim take (2010 to 2020) works out to over 9 bcm per year. These conflicts in the data will need to await resolution until more details are published by the governments, if they ever are.

It is worth noting here that neither the price of the gas, nor the indexation formula for adjusting the price of the gas, has been mentioned. These are important issues that have been significant commercial obstacles to expanding the use of gas in Poland, especially for power generation. The difference between gas price and coal price is still so much in favor of coal that natural gas is "out of market." Furthermore, the indexation of natural gas to world oil prices has been an unrealistic commercial proposition in Poland for development of gas-fired, independent power generation. Electricity prices in Poland are sensitive to coal prices, not oil prices.[ii]

While this agreement is being presented in Poland as a major, positive change, we believe it may not be. The quantities involved seem only to reflect the reality that Poland's demand for natural gas has not grown over the last 11 years, so the change only adjusts to meet reality. The Poles will be disappointed that the reduction in fact leaves no room for diversification from a primary reliance upon Gazprom for gas supplies. The lack of change in the price and indexation arrangements mean that gas remains considerably more expensive than it is, for example, in Ukraine and Belarus just across the border. Poland continues to pay the "European price" for natural gas, a luxury we are not sure it should wish to support.

It makes sense that Gazprom (and the Russian government) would have been willing to concede a *de facto* reduction in sales volume while protecting the high price that Gazprom gets, and needs to continue to get to subsidize the very low price realized in the domestic, Russian market. It also would seem that the reduction in volume was just enough to accommodate the present reality, but not enough for foreign competitors (such as Statoil) to get a toehold in the Polish market.

Also at issue for Gazprom was completion of the first phase (first pipe) of the so-called "Yamal Pipeline." The original plan, agreed to in 1995, was for a two-phase construction of a new transit gas pipeline crossing Poland from the Belarusian border to the German border to carry as much as 60 bcm per year, of which Poland would ultimately take 14 bcm per year.

The first phase has been partially completed, one pipe with two compressor stations in Poland, delivering about 20 bcm per year across Poland. The plan was to have three more compressor stations completed, boosting capacity to 30 bcm per year by the end of 2001. The increase in capacity to 30 bcm has not been completed. Gazprom has been eager to complete this first phase, while PGNiG has not. The new agreement now clears the way to complete the first phase.

The main problem was financial. Gazprom and PGNiG set up a company, EuRoPol Gas, to build, own and operate the "Yamal Pipeline" in Poland. In order to construct the pipeline portion already built, EuRoPol borrowed $100 million from PGNiG and $412 million from Gazprom, which has not been repaid. The agreement reached between Ministers Pol and Christienko provides for an extension of the deadline to repay the loans.

The agreement also provides for an increase from $1.40 to $2.70 per 1,000 m^3/100 km as a transit fee for gas crossing Poland. This is an increase of about $100 million per year[iii] in transit fees to the benefit of EuRoPol, which (we presume) has been ear-marked to repay the PGNiG and Gazprom debts and finance the completion of Phase 1. This is good news for both Gazprom and PGNiG. It is bad news for German customers who will pay the increased transit fees.

This agreement needs to be ratified by the prime ministers of both Russia and Poland, and may require ratification, or acceptance, by the boards of both PGNiG and Gazprom.

It is not clear what impact this new agreement will have on the actual balance of gas that Poland takes from the Yamal Pipeline versus that which it takes from the old pipeline that transits Ukraine. We understand that Gazprom would prefer that Poland take 100% of its deliveries by the new pipeline. However, PGNiG maintains that there are technical problems with doing that, and wishes to take deliveries through the three pipelines that cross into Poland from Belarus and Ukraine.

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[i] Conversion: 1 m^3 = 35.31 ft^3

[ii] It is worth noting that only two gas-fired power plants of significance are currently operating in Poland: Gorzów and Enron's Nowa Sarzyna. Both are based on long term contracts with the Polish Power Grid in which the Grid takes gas price risk. Such contracts are no longer possible in Poland.

[iii] We estimate that, at the present capacity of 20 bcm per year, about 14 bcm per year crosses Poland; the distance across Poland is about 600 km. The result is $1.30 x 6 x 14,000,000 = $109.2 million. An increase to 30 bcm per year will increase the benefit to EuRoPol, however, there are the additional costs of building the three additional compressor stations to be taken into consideration.