

Security of oil supply to Poland

Green College, Oxford
Reuters Foundation Programme
Hilary Term, 2003

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Acknowledgments

Thanks firstly to the British Council and Reuters Foundation Programme for enabling me to come to Oxford and conduct the research. Many thanks to Paddy Coulter and Jenny Darnley for their support and kindness.

I am particularly grateful to Robert Mabro, the director of the Oxford Institute for Energy Studies, who had patience with me and helped me to complete the project. I would like to thank him for the support and encouragement. I would like to thank Jonathan Stern, who kindly agreed to be my supervisor. His comments opened my thinking and did not let my brain remain fixed.

I would like to thank also Jan Krzysztof Bielecki, John Mitchell, Serguei Popov and Taras Sobolev who agreed to provide their knowledge of oil issues.

Many thanks to Rajeev Desphande and Hedwig Kainberger who helped me to polish the language.

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Introduction

As Martin Woolf ¹pointed out – the world’s economy runs on oil and people have a right to fight for stable supplies. This means supplies at reasonable prices, which would guarantee economical performance and prove beneficial for citizens of the world.

Without getting into the question of equitable development, it could be more necessary to answer the question whether the world has changed and stopped being a playground of tensions between groups with different interests. If not, then there remains an ongoing fight for hegemony between some countries and only the fighting tools may be technologically and economically superior.

After the Second World War, the frontier of the conflict was clear: on the one side was the Soviet Union, having “captured” Eastern and South European peoples and then trying to export its ideology and the central-planned economy to other parts of the world. On the other side of the fence was the United States with its alliance with Western Europe representing democracy and market economies. The West which stood for democracy and high living standards, was, however, seen by East Europeans as having “sacrificed” nations and people to the east of the Iron Curtain. This rich Western part of the world got its citizens used to a certain way of political expression, a certain standard of living and values, which all together are more or less a product of technological and economic development of those societies and value systems.

These values were always difficult to give up and a worsening standard of living always meant political troubles. As the world’s economy runs on oil and the resources are unfairly spread among countries it is but natural that oil-importing countries would like to be assured of secure supplies. Reasonable oil price makes business cheaper, which contributes to higher demand for other goods and services, makes financial markets smile, as people have more spare money to invest in successful companies. The economic boom is good for these people because when they retire, they benefit in terms of maintaining high standards of living that they have been used to. Economic boom also makes the job of politicians easier. They do not need to worry how to deal with unemployment and poverty. They do not have headaches how to share the money of a sparse budget. When economy is doing well, western politicians can win elections through giving more privileges and thus satisfy their electorate.

The troubles start when economy is going down or in the case of oil disruption, which, as “ petrol is vital for the functioning of the economy like bread” ²is likely to lead to social demands, if not social conflict.

¹ Martin Woolf’s article in Financial Times, February 2003

² European Commission “Towards a European strategy for the security of energy supply”, November 2000

After the collapse of communism, politicians and nations announced a new order for the world and a new basis for political and economical partnership. Some of former Soviet Union satellites, including Poland, Czech Republic and Hungary became members of NATO, an organization, which was believed to guarantee security in the case of military threat as it had been created after the Second World War in order to “bring the French in, keep the Germans down and keep the Russians out”³. Along with democracy spreading through the former Soviet block, political stability and efficient economies became factors determining membership of the “rich club”.

But those countries, including Poland, which have not forgotten petrol quotas, electricity shortage and the Soviet Union’s domineering threatening attitudes and postures – including the possibility of oil supply cut-offs -- the new realities do not appear so certain. The societies of former Soviet satellites have not forgotten that attempts divert from the imposed political line and command economy resulted in threats. And despite the political situation in the Central and Eastern Europe having drastically changed after the exit of communism, fears of being at the receiving end of an “oil weapon” are still widely shared in the region, including Poland.

A question whether oil supply is secured for countries, which through a historic turn of events face a new future, remains widely relevant. Whether the oil supply security has been significantly enhanced after the changes and whether it will be further enhanced after accession to the European Union still constitute a vital issue. The answers to this debate remain subject to assessments and speculation. This does not reduce the implications of oil security on the unity between eastern and western Europe.

³ Robert Elphic, former BBC correspondent in Moscow

CHAPTER I

Security of oil supply

The definition of security of supply includes: physical security of supply (potential cut offs, or disruption), secure sources of supply with available resources, the infrastructure, and economic security (supply adequate to demand at reasonable prices). However, as oil issues are directly linked to the political constellation which determines the economic system, we can distinguish two types of factors which contribute to the security of oil supplies: external and internal factors.

In the case of Poland the external factors having impact on the security of oil supply include Poland's membership in NATO, perspectives of joining the European Union and the political and economic situation in Russia. Internal factors are : infrastructure, diversification of supply sources, access to own resources, stocks system and market structure.

In the first chapter I will describe the global situation as well as the resources in Russia and the Russian oil supply to Poland during and after the communist era. In the second chapter I will focus on economic issues, including the current situation of oil supply, diversification, prices, and market structure in Poland. In the third chapter I will try to introduce issues linked to the future enlargement of the EU, which may bring advantages to Poland as a transit country or tensions because it might block the expansion of Russian oil exports to the EU.

Political constellations over oil

The end of the Soviet Union and the rhetoric of the "cold war" does not mean the end of the fight for natural resources, above all oil, without which the global economy would suffer. Particularly the ongoing war in Iraq proves that the fight for dominance over natural resources has not ended, as the control over natural resources allows to conduct independent policy and assures economic and social stability. For oil-importing countries the security of oil supply is a matter of belief. It is based on the trust that the exporting country will provide the crude oil in sufficient amount and at reasonable prices in order to match the demand and purchase power of the importing country. The reasonable price is linked to profit expectance for companies refining crude, and the profit for the company means profit for its shareholders, who expect a certain rate of return for their investment.

Even if a political system collapses, like the Soviet Union, the commercial interests remain the same. Robert Mabro says that there is no reason to change the way of policy when a strong commercial interest is involved.⁴ Jonathan Stern,

⁴ Interview with Robert Mabro, the director of Oxford Institute for Energy Studies, March 2003

however, points out the experience of the Communist era is important, not because it says very much how today's Russia may behave but because it influenced the current belief system and therefore current policies of the former Soviet countries like Poland.⁵

Russia entered the world oil market in the early 1960s by undercutting the prices⁶ and thus showing its potential to influence them. Of course Russia does not set international oil prices on its own. But, as the sharp movements of the oil prices depend on politics and geopolitics changes, Russia has good relations with OPEC countries, such as Iran, Libya and Iraq. "Particularly after 1986 price collapse, when it is observed that OPEC member countries have rarely manifested a genuine commitment to a collective production policy one may question the relevance of Saudi Arabia's potential power over supplies"⁷ Not all OPEC members have the same ability to cope with reduced oil revenues. Saudi Arabia, the largest producer, UAE and Kuwait have the greatest ability, while the remaining members have this ability not as well developed. (Oil markets and prices) That creates potential room for outside players like Russia. "The OECD countries, developing nations, the oil and other energy industries and international financial institutions hold Saudi Arabia ultimately responsible whether the price of oil moves sharply and in a destabilizing manner.(...) The official policy (...)since the mid-80s (..) is that Saudi Arabia will never again play this role on its own. It will always require full co-operation from other OPEC member countries and seek that of some non-OPEC producers."⁸

It would be incorrect to question or underestimate Saudi Arabia's power of supply and thus its influence on the prices, but Russia is the largest independent oil producer outside of OPEC and the second largest oil exporter, just behind Saudi Arabia, and it understands itself not just as "an ally" of the US but wants to play a role of an equal partner. Russia does not agree to an "unilateral" position of the US.⁹And Russia's commercial position seems to continue the policy expressed in 1983, summarised after Algerian emissary had visited the Soviet Union to gather informal information about oil volumes and pricing. The main conclusion of the meeting was: "USSR did not intend to agree to any set of rules which would restrain its behaviour to act in what it perceived as its commercial interest".¹⁰

Today an interesting example for Russia's deceptive commitment is the agreement between Russia and OPEC about oil exports cuts in the first half of 2002. "Despite Russia's agreement with OPEC to reduce the country's oil exports by 150.000 bbl/d in the first and the second quarter of 2002, Russia's oil exports actually increased during the first half of 2002"¹¹ When we read that "it is estimated that every \$1 per barrel price increase in the price of Russia's Urals Blend benchmark brings an almost \$1bn in extra earnings",¹² it is easy to understand that the commercial interest of Russian companies was not to give up an advantage of climbing world's oil prices particularly in the second quarter of 2002. Of course one could mention that this shows only a row between the government's attempts and private companies' interest

5 Jonathan Stern, Associated Fellow at the Royal Institute for International Affairs, e-mail April 2003

6 Jonathan Stern "Soviet Oil and Gas Exports, Commercial Transaction or Security Threat"

7 Robert Mabro, Paul Horsnell "Oil markets and prices"

8 Robert Mabro, Paul Horsnell "Oil markets and prices"

9 Andrei Grachev, lecture at St Antony's College, March, 2003

10 Jonathan Stern, "Soviet oil and gas exports, commercial transaction or security threat"

11 EIA website, country's brief - Russia

12 EIA website, country's brief - Russia

and has nothing in common with Russia's policy. One way or another, that may drive further conclusions but they are redundant for this paper purposes.

Oil makes up for 25% of Russian total exports and 40% of government export revenue.¹³ Therefore, Russia is interested in high prices to successfully deal with its budget needs. Moreover, the major part of its oil exports revenue come from the European Union. So retaining a good reputation as a reliable oil supplier should be a crucial factor. But Europe depends on oil imports and its short of own resources, this puts Russia in an advantageous position for the future.¹⁴ High prices maintained for a long time may hamper the expected economic recovery. And that may be harmful particularly for Western, democratic countries used to certain living standard, in which economic troubles cost lose in terms of political support from their citizens. High oil prices are particularly harmful for the US economy, which seeks recovery due to lowering oil prices, among all.¹⁵

However, as Jan Krzysztof Bielecki¹⁶ points out, in a global free market when buying countries can not afford high prices, they will force the oil suppliers to cut them down. He says that currently the global economy is working on its maximum capacity to deal with the prices. The economy will finally result with further shrinking what would contribute to lower demand for oil products and thus giving up high prices. That means necessity for proper ceiling for exporting countries. But, as Taras Sobolev¹⁷ points out, after OPEC crisis in 70s, the prices did not return to the level before the crisis, and economies had to adjust to the new conditions. Since then oil-importing societies have to pay higher prices to the oil-exporting societies, or dictatorships in the Middle East. And the revenues can be spent in the way suitable to their despondent what may mean: either pensions, social support, welfare or military and strengthening a dictator's power.

The development of the situation over Iraq, apart from current political discussions about justification of the war, would also depend on dealing over oil issues between the US and Russia. Due to the split within the EU, the EU's negotiation position over post-war Iraq is certainly weaker. If we look back at the history of the beginning of the 20th century, we will find fight for the oil between Russia, US and the UK, which was attempting to secure its interests in newly-created Iraq. The US was trying to secure its interest over the Caspian region. "Soviet oil men are playing a waiting game in the hope of holding large oil reserves for decades after America and other countries will have exhausted their own supplies" wrote Mr Frederich Kuh, a correspondent of United Press in 1927.¹⁸ "Washington thinks Russia must have large loans which cannot be obtained outside of this country. Some day the Communist dictators will have to compromise with the strongest capitalist government in the world, in the judgment of American officials. Recognition terms, therefore apparently will depend on this race between Russia's need for outside capital, forcing Moscow to compromise, and America's need for Russian oil"¹⁹ When

13 Materials for lecture Oil provinces in post-Soviet Russia, School of Geography and the Environment, Oxford University, February 2003, Alex Kokcharov

14 European Commission, Towards a European strategy for the security of energy supp, November 2000

15 an article in Polish daily "Gazeta Wyborcza" March 2003

16 Interview with Jan Krzysztof Bielecki, former Poland's Prime Minister, currently the board member at the EBRD, March 2003

17 Interview with Taras Sobolev, senior research fellow at Oxford-Analytica

18 Ludwek Denny "We fight for oil"

19 Ludwek Denny "We fight for oil"

we look at Russia's economic trends and recent announcement of repaying foreign debts, we'll see significant change of the situation. And high oil prices contributed to that change. Russia's interest, obvious in Iraq, however is in a strong contradiction to the US and UK interests as all of those countries are striving to get control and cheap oil in the Gulf. The US interest is even more obvious as it is short in reserves. Also, in case of giving up the control and the Gulf, Russia would become the largest oil independent exporter, apart from OPEC countries, what remains in contradiction to US's policy, which would rather avoid oil-dependence on Russia. As the access and control on the oil resources includes also regional influence, the fight over Iraqi oil, and possible compromises linked to the issue between the countries, may result in a new world's order.

Political and economic importance of oil

According to IMF the economy of OECD countries suffered by 2.6% reduction of GDP due to OPEC crisis in 1973-74. And price increases from 1978-1980 accounted for 3.7% of their GDP.²⁰ That may mean higher benefits for societies of oil-producing countries. But it may also benefit dictatorships as budget surplus always can be spent on various things – pensions, environmental protection or military. And the decision depends on values which the authority in a particular oil-producing country subscribes to.

As agreed, that without assured oil supplies, consuming countries would be in trouble. That the highest concentration of the resources are in the Middle East, Russia and the near Caspian Sea region mean that political factors are crucial. In the Gulf region two third of the proved world's oil reserves and 30% of production are located. Russia itself has approximately 48.6bn²¹ barrels of resources accounting for approx 5% of world's reserves according to western sources. Caspian oil reserves could amount to 160-200bn barrels, though the more likely figure is 50-70 bnbls. Caspian region could produce 3% of global oil supply in a long-term.²² According to BP's Statistical Review of World Energy (2001) 38% of global primary energy came from oil alone in 2001, 62% from oil and gas together. "OECD countries, (Poland is a member of OECD) will have to import by the year 2010, 70% of their requirements estimated at 45m barrels per day. (...) This increase was believed to be primarily met by the major Middle East production and Venezuela. But after communism collapse and the end of the Cold War, new territories rich in oil were suddenly and unexpectedly opening up for foreign investors".²³

The world oil demand equals to 78 mb/d, according to IEA. United States is estimated to consume 19.7 MMBD of oil in 2002. The European Union is consuming 19% of the total world's oil demand. Statistics quoted in Financial Times, 2003 following BP statistics said that of total world oil consumption at 75.3mn b/d, a full 21.4% constitutes Europe's share while 26.1% is consumed by the US.²⁴ Both the US and the EU import majority of oil from external sources.

Whether the mentioned above " new territories" are open for investors in real terms or not constitutes a separate issue. But certainly these facts prove the importance of the security of oil supply and show a potential space for political

20 Bernard Mommer "Global oil and the nation state"

21 International Petroleum Encyclopedia

22Terry Adams "Caspian Oil Realities"

23 Bernard Mommer "Global oil and the nation state"

24 Financial Times, February 26

pressure from oil-producing countries on the importers. [There also arises the possibilities of political conflict of interests. This demonstrates mutual dependence between the oil producers and importers, as budget revenue of oil-exporting countries so strongly rely on purchase needs and purchase capacity of oil importers. However, as western countries created market economy and financial markets in order to enable future profits for their citizens, the access to cheap oil determines significant business importance for oil companies.

Shareholders of oil companies have to look in future. The access to cheap resources increases future value of companies and thus investors' confidence to invest in such companies.²⁵ When investors are deciding how to spend their money, they have to be convinced about future profit. Russian and Middle East companies have high replacement ratio for upstream resources while western companies do not have as many options. "Up stream means for a company it can explore and produce oil so for its shareholders the ratio of replacement is a signal whether the company can exist and produce in future. But you can turn that round and say that the annual rate of production is less than 2 or 3% and perhaps less of the stock. In that situation those countries, and usually state-held companies there, are not very interested in new exploration because that oil is not going to be produced for next years. The situation in the US f.e is another extreme where the ratio there is like 10 years and the 10 years is not really long time but, on the other hand, private company does not need 100 years of replacement ratio, as it wants to produce and sell the product. Still the question is whether the western companies can replace resources when they use it."²⁶

That puts on table the issue of access to cheap resources. The production costs in the Middle East are the lowest – between \$1-3 a barrel. In Russia the best companies can extract oil at below \$4 a barrel, while average is \$ 6-7 a barrel. Production costs in Europe equal \$7-11.²⁷ However it does not mean that oil-importing countries would be only interested in low oil prices. Oil-importing countries are interested in stable oil supply at reasonable prices in order to keep their import balance stable. Robert Mabro points out oil prices fluctuate but their jump up is always due political reasons²⁸ and the factors that increase oil security of an importing country are strongly dependent on political conditions. And political conditions often, in the long term, depend on historical and geopolitical natural ties but this may change due to temporarily or short-term interest. "Economics has nothing to say about oil price other than pointing to a.. low cost floor and a.. high price-of substitute ceiling. Price fluctuations are of the market, price altitudes are political variables"²⁹

Conclusion: As oil represents so crucial energy component for economic performance, and it responds in price surge in the face of any conflict or political uncertainty. Thus, stable supplies represent a key factor for stable growth and political stability.

25 Interview with John Mitchell, Associated Fellow at the Royal Institute of International Affairs, March 2003

26 Interview with John Mitchell

27 European Commission and materials of one Russian oil company

28 Interview with Robert Mabro, director of Oxford Institute for Energy Studies

29 Robert Mabro cited in the "New Economy of oil" by John Mitchell, Norman Selley, Koji Morita, Jonathan Stern

Foreign resources - a brief description of Russian resources and production forecast

As “changes in perception of reserves may (...) change today’s prices”,³⁰ the security of oil supply can not be discussed without a broad view on available resources.

According to the International Energy Agency (IEA), technological progress is likely to increase reserves recognized at 1.800 Gb at a starting point to 2.000 – 3.000Gb, though the most likely figure is seen at 2.300 Gb. But there is a lack of consensus in this matter.³¹ The richest in resources is Middle East region with two third of the world’s proven reserves.

Due to its geopolitical location and fact that Poland relies on imports from Russia, the resources situation in this country should be examined at the first place.

In terms of available resources, Russia, according to president of a leading Russian oil company, Yukos, Mikhail Khodorowsky quoting the Society of Petroleum Engineers, Russia’s resources amount to 100-150 bn barrels.³² According to “Russia’s Energy Survey 2002” published by International Energy Agency (IEA), quoting BP Statistical Review of World Energy 2000, the proven reserves amount to approximately 49 bn barrel or 6.7 bn tonnes accounting for 4.7% of the world’s total reserves.³³ Materials prepared for a lecture at School of Geography and Environment at Oxford University estimates Russian oil reserves at 92bn barrels accounting for 10% of the world’s reserves and 25% of the Middle East resources.³⁴ The discussion over which source reflects proper estimates is redundant for this paper’s purposes, but the difference in estimates may be seen as reflecting political approaches. This is because western sources usually are seen by Russian sources as attempting to undermine “real” Russia’s potential.³⁵

One way or another, Russia’s potential in terms of oil reserves is definitely significant. But, as IEA points out “ Russia itself paying less attention to profitability than to technical feasibility, puts its reserves that only 30% of so called >explored reserves< are eligible for development. Analytical documents by the Ministry of Energy state that close to half of Russia’s oil reserves have already been extracted.”³⁶ The perception of potentially available resources in a country and its ability to exploit these and be an oil supplier is important, but not decisive for product purchase availability. However the costs of exploration and then costs of supplies have a significant bearing on being competitive or not on international market.

- Production.

30 John Mitchell, Norman Selley, Koji Morita, Jonathan Stern “The New Economy of Oil”

31 Norman Selley “Changing Oil”

32 Mikhail Khodorowsky, materials based on a speech at conference in Moscow September 2002

33 IEA “Russia Energy Survey 2002”

34 Materials prepared for lecture at School of Geography and Environment at Oxford University, Feb 2003, Alex Kokcharov

35 Mikhail Khodorkovsky, materials based a speech at conference in Moscow September 2002

36 IEA “Russia Energy Survey 2002”

“The current consensus is that the world’s conventional oil production will peak during the 2010-2020 period and inevitably decline thereafter, although some see peak before this date, and others as far away as 2050.”³⁷ However as, Norman Selley points out, the key factors influencing supply-side economics are underlying geological knowledge, how far technology will increase the recovery of discovered oil and aid discovery of further reserves, the extent to which technology and managerial change will continue to decrease the costs associated with exploration, production and transportation; the abundance of unconventional oil, the policy conditions and trends in taxation that increase or reduce the demand for oil, constraints on accessing oil that may lie in environmentally sensitive areas; how the structure of the industry affects investment and the development of supply.³⁸

IEA projects that the Middle East production will not rise above 48m barrels per day (b/d). The current production of the region is at the level of 20m b/d. The production might increase to 40m b/d by 2010 but, as the agency points out, it will depend on investment. According to IEA, OPEC’s share in world’s production will be approaching 50% by 2014. The current share in the world’s production is 30%. The largest oil producer in the world is Saudi Arabia. Russia is the third largest crude oil producer 7.5m b/d in early 2003 and second top crude oil exporter with 5m b/d.³⁹

Still, to develop further oil production and thus tap into resources, Russia needs investment as well as cost calculation. The cost of oil extraction is the lowest in the Middle East and equals \$1-3 a barrel.⁴⁰ According to Yukos, Russia’s oil concern, without taxes, the cost of oil extraction in Russia is equal to the cost of its transport. The transport cost equals \$6-7 for the best companies and averages \$9-10 per barrel. According to other sources providing data for 2001, the cost of oil extraction in Russia for the best companies equalled below \$4 a barrel, while the average was \$7 a barrel.⁴¹

In line with “Energy Strategy of the Russian Federation To The Year 2020” , which extended in 2002 the targets assumed in 2000 in “Main Provisions : <Energy strategy of Russia till 2020”, in favourable scenario, Russia should develop its oil production from the level of 324m tonnes in 2000 to 360-370m tonnes a year in 2005 and further to 405-430m tonnes a year in 2020. In critical scenario, the production may be maintained at the current level but slightly decline after 2010. In favourable scenario, oil and oil products exports should increase to 206.5m tonnes a year in 2005 and after slight decline in 2010, it should increase to 207 and 208.5m tonnes in 2015 and 2020 respectively. In pessimistic scenario, the oil and oil product exports may decline to approximately 175m tonnes in 2020 after having achieved a peak of around 190m tonnes in 2005. The domestic consumption of motor oil in Russia should increase to around 75m tonnes in 2005 and 110m tonnes in 2020 in favourable scenario. The pessimistic one predicts the consumption at 90m tonnes in 2020. The favourable scenario of oil production development is based on oil prices at least at \$27 per barrel in 2010 and \$33/bbl in 2020.⁴² In order to develop production targets stipulated in the “Main Provisions”, thus the level of 335m tonnes in 2010, the

37 Norman Selley “Changing Oil”

38 Norman Selley “Changing Oil”

39 Materials for lecture Oil provinces in post-Soviet Russia, School of Geography and the Environment, Oxford University, February 2003

40 European Commission “Towards a European strategy for the security of energy supply”

41 Mikhail Khodorkovsky, materials based a speech at conference in Moscow September 2002

42 Dr Alexy M. Mastepanov “Energy Strategy of the Russian Federation To The Year 2020”

industry will need to invest approximately \$40-50bn. To reach production level at 360m tonnes by 2020, the country would need further \$70-90bn of investments.⁴³

“Because of the lack of adequate incentives for large-scale foreign investments, the main source may have to be Russian companies’ own funds”. IEA further states “Russian oil companies choosing foreign service companies to enhance oil production would seem to reflect the weakness of Russian service companies created from former geological and geophysical units, received a tremendous boost over 1999-2000 period by the combination of the rouble devaluation and higher oil company investments due to higher international oil prices. Modern technologies, equipment and specialized services will be essential for them to gain and maintain competitive edge”.⁴⁴

Russia’s oil concerns claim sufficient revenues to develop production financed from their own funds.⁴⁵

Conclusion – Geopolitically, Russia is the closest source of crude for Poland. Russia’s potential as the largest independent oil producer apart from OPEC countries is not questionable. The diversity of estimates reflects different basis for calculation of exploration, profitability and then production and potential sales. The uncertainties are linked to investment inflows, which are crucial to develop profitable production at required level. The question whether foreign companies will be interested in investing in Russia, or Russia will be interested in allowing foreign companies to develop its oil industry is too wide to attempt. It is difficult to list all possible factors which may impact the future. Russian companies claim sufficient funds to develop production and also claim profitability.

A separate issue is whether access to resources will be available for oil-importing countries such as Poland. Russian companies claim they do not need foreign investments to boost production. In light of Russia’s low domestic consumption, budget needs and the share of oil export revenue in the GDP, the country is interested in exports and this makes its resources and production potentially available for buyers. The question is on what terms.

Oil supply and political facts during communism era

Poland, as other satellite countries of Soviet Union during communism era, was 100% dependent on Russian crude oil. During that period Soviet Union on a couple of occasions used a verbal threat about cutting off supplies against its artificially created allies.

Jonathan Stern points out examples of Soviet Union attempts to use “oil weapon” for political pressure on countries like Yugoslavia, Czech Republic or Poland. In his view, the acts occurred only to protect SU commercial interest. “(...)although the USSR could not be considered wholly>reliable< in its dealings with other communist countries and allies, its is only when major crisis and rifts with these countries have occurred that it has cut off supplies and shown any tendency towards applying leverage(..)” “It is not correct to construe Soviet pressure to increase prices and/or indirect leverage without detailed analysis of Soviet energy availability (and

43 IEA “Russia Energy Survey 2002”

44 IEA “Russia Energy Survey 2002”

45 Mikhail Khodorkovsky, materials based a speech at conference in Moscow September 2002

costs) as well as the prices of fuels, which these countries (Central and Eastern Europe – przyp MK) would need to import from alternative sources.”⁴⁶

The fact remains, that at the end of communism era Poland had no facility, which could provide alternative supplies. This situation represented a part of Soviet Union policy to link satellite countries with its resources and transport system. This is also true that import from alternative sources would be costly for countries such as Poland due to its geopolitical location and less costly for f.e Yugoslavia. Yugoslavia after having its supplies cut off due to political conflict with Moscow in 1948 was forced to seek for alternative sources and successfully managed to decrease its dependence on Soviet oil. Aside from its geopolitical location, for Poland being a part of the Soviet block and having imposed limits for hard currency earning due to rules applied for RWPG members, contributed to low financial capability to import oil from alternative sources. The question could be whether free foreign trade be determined only by export so that companies' efficiency would lead to acceptance of higher expenditures on oil from alternative sources and whether such diversion would maintain efficient economic performance. As we will see further in the paper, the answer is “not really.” Geopolitical location seems to determine the lack of diversification.

“Although Soviet sources were quoted as saying that >Poland's economy would have been brought to a standstill within two-days without Soviet oil and natural gas and the whole country would freeze< this was an option which was evidently unattractive for Kremlin”, Jonathan Stern points out describing situation at the beginning 1980s. As SU hard currency earnings mostly came from oil and gas exports and it took some time for its companies to break the western market in 1960s, it was not in the commercial interest to loose a good reputation as a stable supplier in the eyes of western European countries. “It is true that in late 50s and early 60s the Soviet did undercut prices in order to gain entry into world oil markets, the practice ceased during 70s and only reappeared sporadically in the 80s as prices fell as a result of a glut of supply. (...)the USSR has become an experienced and very competitive participant. It is important to stress that we are concentrating on Soviet behaviour towards OECD countries“

Conclusion – Even communist Soviet Union appreciated the importance of hard currency earnings and valued high commercial relations with western countries. However crude oil was delivered on partly favourable prices for Soviet Union block countries and in that case the commercial interest was replaced with political one. Still, the commercial interest of Soviet Union in dealings with western countries had a tendency to override the economic interests of satellites countries.

Political security of oil supply of the collapse of communism

After the collapse of communism and the end of the cold war, countries from Central and Eastern Europe region, which led the changes, immediately attempted to re-orient their policies towards the West. Czech Republic, Poland, Hungary started process of joining NATO and preparations to launch negotiations about an access to European Union. And indeed the NATO expanded in 1999 bringing the three countries into the pact. The European Union is to enlarge in May 2004, welcoming 10 new members, including the three leaders of communist system change as well as Slovakia, Lithuania, Latvia, Estonia, Malta, Cyprus and Slovenia. Jonathan Stern's

⁴⁶ Jonathan Stern “Soviet Oil and Gas Exports, Commercial Transaction or Security Threat”

emphasis is that the European Union enlargement will move Poland and other countries in the region into a different status, “which virtually guarantees them protection against any Russian commercial or political threats.” I will develop this in the third chapter.

The first factor that needs to be evaluated in arriving at an assessment of whether a given country is secure in terms of supplies would be “a country’s freedom to practise an independent foreign policy, or, at least to avoid having other countries impose constraints on its foreign policy be threats to deny it energy supplies (...) or to make access to them damagingly expensive (or unprofitable)”.⁴⁷

Political risk of being dependent of outside oil supply, of being at the receiving end of the so-called “oil weapon”, matters in face of a threat of political relations worsening between an oil-importing and oil-exporting country. As a country runs its foreign politics taking into account the history and business relations, the previous relations between Poland and Russia would suggest diversification of oil supply sources. The key question here is: “How much is the country prepared to pay for strategic reserves? Where there is dependence on dedicated supply, as with a pipeline, one has to ask the political question of the probability of war between two countries at either end of the pipeline or along the route”.⁴⁸

The behaviour of Soviet Union influenced the current “belief systems” and therefore current policies of countries in Central and Eastern Europe region, as Jonathan Stern emphasis. This is why after the collapse of communism, Central and Eastern Europe countries immediately attempted to diversify their oil supply. Among the Visegrad group, which includes Poland, Hungary, Czech Republic and Slovakia, only Czech Republic, due to the completion of Mero pipeline in 1996, managed to reduce significantly its reliance on Russian oil. According to data from 1999, the country imports 83% of oil from Russia, while the share was 88% in 1996. Hungary imports small amounts of oil from the Middle East.⁴⁹ The pipeline, which enables import from Italian port of Trieste via the Trans-alpine pipeline network, gives Czech Republic an alternative direction of supply, but due to higher prices Russian oil nevertheless remains dominant. Czech Republic refineries were able though to gain an access to newly developed oil fields in Russia with better qualities of crude oil.⁵⁰

The second Prime Minister of Poland’s independent government, Jan Krzysztof Bielecki said, his government in 1990 decided to build a loading oil terminal Naftoport in Gdansk in order to enable oil import from alternative sources. The facility represents the only one enabling oil import from other direction than Russia. At the beginning of 90s Rafineria Gdanska, the Baltic coast-located refinery and the second largest in Poland, was buying a portion of Brent oil in 1991 and 1992. of 7.6 barrels a day in 1991 and 42.6 b/d in 1992 accounting for 1% of its total production and 5.1% respectively. Currently the company relies on oil from Russia.

The separate issue is whether the diversification of sources was successful in case of Poland. I will describe the issue in the second chapter.

Conclusion- Security of oil supply may be is a situation of regime change accompanied by change in economic postures in Russia that could see dramatic deterioration in relations between the two countries. As after the collapse of communism, Poland became a member of NATO incurring Russian displeasure, any

47 John Mitchell, Norman Selley, Koji Morita, Jonathan Stern “The New Economy of Oil”

48 John Mitchell, Norman Selley, Koji Morita, Jonathan Stern “The New Economy of Oil”

49 Energy Policies of IEA countries-Czech Republic

50 Energy Policies of IEA countries-Czech Republic

deterioration in relations between the US and Russia may also have a similar impact. Good relations between the US and Russia diminish probability of political tensions between Poland and Russia and in case of oil, good political relations are the best preventive against oil shortage.

Country's recognition

The post-communist government in January 2002 introduced to the Lower House of Parliament information about energy security of the country with conclusions that there is no threat for the security at a present stage and in the near future. The information was approved by the parliament, however with negative votes from the parties with post-Solidarity, right-oriented background. Those parties strive for diversification of both natural gas and crude oil supply sources, warning that the dependence on Russia may result in future with the political or economical pressure on Poland.⁵¹

Energy security in Poland is defined as “the stage of the economy which enables the current and the future demand for fuels and electricity in technologically and economically justified way accompanied by environmental protection requirements. Security of supply should be understood as stable, covering the current needs and the demand in a time perspective. The energy security depends on meeting the balance between the demand and the supply, the level of diversification, technological efficiency of the infrastructure, storage capacity and the economic conditions of the industry.”⁵²

Conclusion – As security is a matter of belief and of good political relations with the country selling the oil, the political judgment of security level is based on perception of the parameters of bilateral relations. The approach is determined by political guideline towards a country, which is selling the oil. If oil-importing country predicts worsening of political relations, that may result in different approaches to security issues.

51 Jan Nowak Jezioranski letter cited by MPs Kazimierz Marcinkiewicz

52 Poland's government information about energy security of the country presented to Parliament in January 2002

CHAPTER II

Crude oil supply to Poland

Poland, as natural resources of oil are not fairly spread all over the world, is among the majority group of oil-importing countries. The fact brings certain amount of risks – first of all a political risk, which is linked to a potential disruption in oil supply or an economic risk connected with a jump up of oil prices. The share of crude oil in Poland's energy consumption increased to 22% in 2002 from 13% in 1990, while the share of coal decreased to 51% in 2000 from 64% in 1990. The share of natural gas increased to 10,93% in 2000 from 8,87% in 1990.⁵³ According to the EIA the share of crude oil in Poland's total energy balance is expected to increase by further 50% by 2020.⁵⁴ The average share of oil in the total energy balance in OECD countries is 38-40%, according to IEA reports.

Poland is mostly dependent on crude oil import among other fuels, which constitute the energy balance (natural gas, coal and electricity). The share of imported oil in the 90's exceeded 98% of total oil consumption. The figure declined in 2001 to 94% mainly due to an increase of the domestic exploration. Poland is not so strongly dependent on imports of oil products. Gasoline imports decreased to below 20% of the domestic demand from approximately 30% in the second half of 1990s and the imports of diesel declined to 15% of the domestic demand from over 20% in the first half of the 90s. This was due to necessary investment in local refineries. The investment program resulted in increased processing capacity. It also enhanced the quality of products.⁵⁵

A jump in oil prices by \$10 a barrel hits economic growth by 0.75% in the case of developing country and 0.5% in the case of a developed country.⁵⁶ Economic recession may be seen as particularly harmful for economies in transition, like Poland which need to speed up to meet the western standards. Relatively poor societies may not accept further worsening conditions of living as that might result in political instability and lead to unpredictable consequences of the political system as a whole.

At the same time, Polish analysts claim that Polish economy is not really sensitive to fluctuations of crude oil prices like the US economy. The situation is influenced by the fact that Polish refineries are buying crude in long-term contracts and benefit of being the nearest on the transport chain. There was no available calculation how crude oil prices' increases and the price maintenance at a high level for longer period of time may hit economic growth in Poland. But due to global economy, particularly the US; which is suffering because high oil prices are seen to be blocking the desired recovery, Poland's growth is only impacted indirectly. Poland's economic growth depends on the EU economic performance. Poland is conducting 70% of its trade with EU countries. The EU economy, in turn, eyes the US economic performance. Polish analysts claim, fuels constitute 3.71% in inflation basket in 2002 but the potential price increase for petroleum products is limited due to low demand. So, in summary, the production costs increase but market price does not

⁵³ Poland's government information about energy security of the country presented to the Parliament in January 2002

⁵⁴ EIA website, country's brief - Poland

⁵⁵ Poland's government information about energy security of the country presented to the Parliament in January 2002

⁵⁶ European Commission , Proposals for a new oil stocks directive

necessarily reflect them. In February 2003 the production costs of refineries increased by 7% in comparison to January this year.⁵⁷ That situation may be seen as harmful for oil companies which have to pay more for crude but at the same time have to keep product prices adjusted to the demand and purchase capacity.

Poland imported 17.5 mln tons of crude oil accounting for 128,275 barrels in 2001 (by 0.5 mln tonnes less than in 2000).⁵⁸ The fuel consumption in Poland equalled 9.43m tonnes in 2001 and is expected to increase to 9.7m tonnes in 2002 based on the assumption that the GDP will rise by 1%. Further forecast of oil consumption on assumption of GDP at 3% in 2003, 5% in 2004 and over 5% in 2005, places consumption at 10m tonnes, 10.3m tonnes, 10.6m tonnes respectively.⁵⁹ Data provided by Treasury's Oil and Fuel Company Nafta Polska, which is responsible for the sector restructuring and privatisation states the fuel sales, including gasoline, diesel and heating oil, equalled 13.48m tonnes in 2002. But the sales of gasoline and diesel increased in 2002 to 10.73m tonnes⁶⁰. According to Nafta Polska, cited by brokerage WBK fuels' sales in 2002 declined by further 2.8% after having decreased by 2.3% in 2001. Heating oil consumption equalled 2.787m tonnes in 2002 in comparison to 2.873m in 2001.⁶¹

Diversification

“Diversification is always a matter of costs, “ says Taras Sobolev. “It means a lot in case of political relations worsening, threat of oil disruption or sanctions put on an exporting country from which the dependent one is taking the oil from”.⁶² Being aware that crude oil import dependence may lead to leverage in terms of political relations with the major supplier, after the collapse of communism, Poland immediately attempted to strive for diversification of supply resources in order to reduce its reliance on Russia.

The second Prime Minister of Poland's independent government, Jan Krzysztof Bielecki said, his government in 1990 decided to build a loading oil terminal Naftoport in Gdansk in order to enable oil import from alternative sources. But at present “the decision seems to be economically irrational in terms of oil import possibilities, which turned out to be too expensive via sea, however, from 10-year perspective, it defences itself in terms of exports potential.”⁶³ At the beginning of 90s Rafineria Gdanska, the Baltic coast-located refinery and the second largest in Poland, was buying Brent oil of 7.6 barrels a day in 1991 and 42.6 b/d in 1992 accounting for 1% of its total production and 5.1% respectively.⁶⁴ Currently the company relies on oil from Russia.

But, it has to be mentioned, imports from Russia do not come from one single supplier although it comes from one source. Polish refineries before 2003 were purchasing majority of crude from an intermediary company J&S Service. At the end

57 Mr Kalisz, an analyst of the State Savings Bank

58 Poland's government information about the oil industry, February 2003

59 Polish Chamber of Nefte Industry POPIHN, which associates foreign investors, May 2002

60 own calculation based on brokerage house WBK report on PKN Orlen in March 2003. WBK was citing data of Nafta Polska in a context of PKN Orlen sales in 2002

61 WBK report on PKN Orlen in March 2003. WBK was citing data of Nafta Polska in a context of PKN Orlen sales in 2002

62 An interview with Taras Sobolev, March 2003

63 An interview with Jan Krzysztof Bielecki, March 2003

64 Robert Mabro, Paul Horsnell “Oil Markets and Prices”

of 2001 Russian oil giant Lukoil declared it would like to get rid off intermediaries and provide full supplies to Poland as well as increase its transit.⁶⁵ The response from Orlen was immediate. The company questioned reliability of supplies claiming that in past Lukoil had offered supply but the terms were unacceptable.⁶⁶

Polish companies started though this year purchases of crude oil from another Russian concern Yukos, but did not give up other intermediary companies such as J&S Service, watching the limit of crude from single supplier at 40%.⁶⁷

However, still the question could be why Poland failed to diversify supply sources? Was it purely due to higher costs of alternative oil than Russian, which would be harmful for the industry and the economy performance, or was it due to the fact that economy has just begun transition and restructuring of industries? In general, parties from post-solidarity background feel that diversification is necessary, while those with post-communist background do not see a problem.

However, it would be unfair not to mention that former treasury minister Wieslaw Kaczmarek from the current ruling party SLD, which has communist roots, indicated diversification as a crucial factor determining complete privatisation of Polish oil sector. Kaczmarek stressed the necessity of exchanging Polish outstanding receivables for shares in oilfields or oil supply.⁶⁸ In a context of Iraq war the issue might return, as Iraq owes \$560-700mn to Poland. Having in mind the current ownership structure of Naftoport, a company which runs the oil terminal, the treasury insists on regaining control over it. Naftoport's loading capacity equals 33 mln tons and its ownership structure includes PKN Orlen with 48.71% stake, state-owned Rafineria Gdanska with 25,64%, state-owned pipe operator PERN with 12.82%, state-owned chemical and fuel operator Ciech with 10.26% and Port Polnocny with 3.65% share.⁶⁹ Among Naftoport shareholders is also J&S Service and Investment. According to press article from Polish daily Gazeta Wyborcza from the beginning of April this year, Ukraine is considering the construction of a pipe connecting Turkish Ceyhan and Samsun port on Black Sea.⁷⁰ The pipe could also provide an alternative for Caspian States, which now are left with not much choice, besides Azerbaijan, and have to deal with Russian transport monopoly Transneft. That could give an incentive for Polish companies to eye more carefully the feasibility of extension of the pipe from Ukrainian Brody to Polish Plock and Gdansk. European Commission has officially supported the project.⁷¹

John Mitchell, an expert from Royal Institute for International Affairs, points out that some diversification is always good, as a country can never be sure what will happen. "It is good for both political and commercial reasons, as companies are not dependent on single supplier". Mitchell says.⁷² "As oil is an instrument of political pressure, it is always wise to keep a way opened for alternative supplies." – Taras

65 former Lukoil's, deputy president, Ralif R. Safin, ISBusinessWire news agency, ISI, December 2001

66 statement of PKN Orlen spokesperson, ISBusinesswire news agency, ISI, December 2001

67 PKN Orlen contract, December 2002

68 Kaczmarek statement, September 29, 2002, source ISBusinessWire news agency, ISI

69 Materials of Nafta Polska, Treasury's oil and fuel company responsible for the industry restructuring and privatisation, August 2002

70 an article in Polish daily "Gazeta Wyborcza", April 2003

71 an article in Polish daily "Rzeczpospolita", March 2003

72 Interview with John Mitchell, March 2003

Sobolev says.⁷³ Robert Mabro points out, that the need to diversify supply sources is more important for volume than the price. “If I were Polish government I could sleep at night with high prices but I could not if I had a problem with volumes”. As he notices, if a price is high, it is high everywhere. But still, existence of a facility enabling import from other sources puts importer in a better negotiation position both in terms of price and in terms of volume. It prevents unexpected volume cuts.⁷⁴ Russian companies transport 30% of its exports towards western countries through Poland’s pipe system⁷⁵ what increases security of oil supply and minimizes the risk of cut off but it may create volume problems.

Conclusion- Security of oil supply is a matter of belief that the crude oil will be available in sufficient amounts and at reasonable prices in order to meet the demand. In order to judge the level of security of oil supply today, Poland should answer the question whether it would be in Russian interest to cut off supplies. As long as Poland pays market prices for the oil and Russia wants to continue exports to EU, the cut off seems to be unlikely. But Lithuanian Mazeikiu Nafta case from 2001 should not be missed.

Lithuania cut off

Although it may be argued that the Lithuanian situation differs from Poland because during communism it was a republic of the Soviet Union, while the latter was a Soviet Union satellite country, similar geopolitical location and high costs of alternative supplies may bring in commonalities. Also if we look deeply in the past we will find examples of common history and attitudes towards Russia, as well as examples of Polish costly mistakes in its policy towards Lithuania in 1920.

The Soviet Union attempted to block Lithuania independence in 1990 by instituting oil embargo. In case of Poland’s process of change, the taps were not closed, but, as Jan Krzysztof Bielecki remembers, the fear was widely shared. And the fact brought Poland into negotiations about establishment “RWPG”- bis, freshly after cancelling, in 1991, the treaty binding for this trade organization established during Soviet-era. “I refused to sign the final treaty” – Bielecki says now. “But I remember that many of those days government’s officials were arguing that the refusal will cause taps shut”.⁷⁶ There is no evidence in case of Poland about oil cut off since the system changed apart from the comment of PKN Orlen mentioned above. Czech Republic claims however that until 1996 when Russia was a sole supplier “deliveries of Russian crude oil are not always reliable and the supplies of relatively low quality (..)”⁷⁷

Coming back to Lithuania. The country excluded Russian companies from privatisation of its oil industry and sold 33% stake of the Mazeikiu Nafta refinery to the US firm Williams Oil. Williams apart from operating rights received an option to increase its share in MN to majority. The Americans expressed willingness to deal with Lukoil on long-term supply, but the Russian company refused to conclude the agreement. That resulted in the Lithuanian refinery facing a cash shortage, failure of its modernization plans and losses. “Lukoil’s representatives stressed that the refusal

73 Interview with Taras Sobolev

74 Interview with Robert Mabro, the director of Oxford Institute for Energy Studies, March 2003

75 PERN website

76 Interview with Jan Krzysztof Bielecki, March 2003

77 IEA – Czech Republic

to conclude a long-term supply agreement reflected a business decision, ie that supplying MN was not particularly profitable unless it was linked with other activities. However its periodic supply disruptions and price increases, as well as the restricted general level of supply, could equally be viewed as strong-arm tactics designed to secure a large stake in MN.”⁷⁸

Finally Williams was able to gain supplies from another Russian oil giant Yukos in exchange for enabling the Russian company acquisition of minority stake in MN. The deal was signed without taking the Lithuanian government into confidence and Lithuanian president Valdas Adamkus expressed his concerns about it. ⁷⁹Frictions between the government and American investors as well as losses of the refinery resulted with Williams decision to withdraw from the investment completely. But due to huge losses of the refinery because of oil cut off, Lithuanian government could not afford the buy back, the president signed amendments enabling acquisition of the refinery by Yukos. Russian concern acquired nearly 27% stake in MN in August 2002, and in January 2003 the company doubled its stake to 53.7%.⁸⁰Then Lithuanian government launched negotiations with European Bank for Reconstruction and Development about sale further 15% in MN reportedly in order to decrease Russian influences.⁸¹

Conclusion- Lukoil refusal to supply the Lithuanian refinery and the subsequent tactics of Yukos can not be seen as normal business practises, particularly having in mind the cut off from the beginning of 90s. However currently Yukos claims that the refinery is making profits. The Mazeikiu lesson is particularly important for Poland. Russia’s Lukoil is interested in acquisition Poland’s second largest refinery Rafineria Gdanska Currently the Polish government is thinking hard about the future of the oil industry. Two alternative scenarios are possible – establishing a monopoly or allowing for development of two independent production and distribution centres. I will describe it briefly later in the section about security of oil supply in a context of market structure and the context of transit in the third chapter.

Security of own resources

Poland’s own oil resources equal 115m bbl ⁸² what is approximately 16.4m tonnes. The domestic exploration through Petrobaltic, an offshore company, equalled to 297,100 tonnes, while Polish Oil and Gas Company extracted around 469,000 tonnes of crude oil in 2001. The domestic combined production of Petrobaltic and PGNiG exploration company covers approximately of 7.66% of the domestic demand for oil. According to companies’ planning, both Petrobaltic and PGNiG will attempt to increase domestic exploration to 500.000 tonnes and 1m tonnes respectively in the short-time period.⁸³ Assuming that the demand will be on approximately 10m tonnes a year, the share domestic oil in the total oil consumption could increase to 15%.

78 Oxford-Analytica, November 2001

79 Polish Press Agency PAP, August 2002

80 Polish daily “Gazeta Wyborcza”, September 18, 2002

81 Reuters, January 29, 2003,

82 International Petroleum Encyclopaedia

8312 Internet Securities economic service – ISBusinessWire news agency

Conclusion – Development of own resources, although not huge, could enable to slightly decrease reliance on Russian crude.

Prices

“Oil is not a typical commodity, in that its price is not governed by the cost of marginal supply.(...) There is thus a political as well as market dimension to price setting involving both producing and consuming-country governments.”⁸⁴As Poland and Eastern Europe region have been for over 12 years a part of the international market due to changes of favourable prices of oil⁸⁵ into commercial ones after the collapse of communism, their forecasts should be linked to international market forecast and that is based, first of all, on estimation of available resources for future.

The profitability of extraction relies on technology, fiscal policy and global prices. And we cannot predict political events in future and “we cannot know future prices, so we cannot quantify reserves”.⁸⁶ Economic security of supply would rely on adequate supplies at reasonable prices for oil-importing country, including Poland. The security risk is linked to prices and they depend on situation on global markets. And there is no international agreement in terms of price stability for petroleum like in case of other commodities. “This is a typical risk linked to the situation on global markets. This is a matter of budget planning. If the assumption for oil prices is at average per barrel, the government should predict the chances whether the prices go above a certain threshold or not.”⁸⁷ The prices will go up due to political instability. “That is a guess, what can happen in the market – what happens if supplies will be disrupted due to a crisis in the Middle east or Venezuela and how it will impact the process of oil coming from Russia.”⁸⁸And this strongly relies on political and geopolitical conditions, including relations inside OPEC and relations between OPEC and other oil-producing countries. Russia may also influence prices and volume, which was briefly referred to in the first chapter.

Prices of Russian oil are always adjusted to the tendency on world’s markets. Robert Mabro and Paul Horsnell point out that “Russia prices Urals on dated Brent for term contracts.⁸⁹ Both Urals and Brent markets are closely coordinated, as John Mitchell says,⁹⁰ despite they are competitive at the first place. Brent market also leads the other markets and “what happens in the Brent market directly effects in the pricing of over 50% of world trade in crude oil(...)”⁹¹A different issue is whether Brent could be replaced in future by Urals, as resources of North Sea are limited in time and European Union desperately seeks the other sources of supply. According to Jonathan Stern’s description of commercial behaviour during Soviet period, the Russians were usually the first who were taking an advantage of increasing oil prices. “ That means that where there is advantage to be taken, the Soviet will take it; and this is seen

84 John Mitchell, Norman Selley, Koji Morita, Jonathan Stern “The New Economy of Oil”

85 Jonathan Stern “Soviet Oil and Gas Exports, Commercial Transaction or Security Threat”

86 Norman Selley “Changing Oil”

87 Interview with Robert Mabro

88 Interview with Robert Mabro

89 Robert Mabro, Paul Horsnell “Oil markets and prices”

90 Interview with John Mitchell, March 2003

91 Robert Mabro, Paul Horsnell “Oil markets and prices”

particularly in the 1970s, when Urals crude was usually one of the first to be adjusted upwards as a result of OPEC-determined price increases.”⁹²

In the market economy there is no reason to think that the behaviour would change, as it would be absolutely irrational. However it may raise a question whether the room to play due to world’s price surge is large enough to create possibility to make enhanced profits. This is due to the lack of diversification and the possible quick reactions of refineries to turn for alternative supplies.

As mentioned above, Russia is keen to expand its oil exports towards western markets as accessing these markets is the easiest way to gain revenue. Robert Mabro emphasises “ Russia wants to keep its commercial interest, so it is not interested in playing unfair. If you are seller on international market - you have to have a good name commercially and if you do have it, you do not play politics”.⁹³ Jonathan Stern pointed out that Soviet Union companies used to perform less well in a falling market. “They were slow to adopt to the change from contract to spot pricing, and spot to netback pricing. Perhaps this was because changing in trading practices were required for which the foreign trade organization required permission from higher authorities, and also because market conditions dictated that crude oil be offered at much lower prices”.⁹⁴ That may be another reason why Russia is so strongly interested in long-term contracts. Of course, Russia has been recognized as market economy country, it is negotiating the accession to WTO, and as Jan Krzysztof Bielecki says there must not be an equation between SU and current Russia.⁹⁵ The reorganization of the industry into vertically-integrated concerns which claim being familiar with modern technology and are recognized by financial investors as westernised must have certainly changed the behaviour and ability to run the business. But at the same time the small inflow of foreign capital and obvious distinctions in terms of available resources in Russia make their transparency of operating as an open question.

And, despite that political systems may change, commercial interests remain. And currently, Russia due to its shortage in production of high-valued products and limited access to western markets, sees its advantage in oil and gas exports. Particularly, when there is and is likely to be demand for it in Western Europe.

Conclusion – Economic security is guaranteed as long as Poland is a part of international oil market and its economy can afford paying for oil. Due to close links between economic performance and oil prices, the challenge is to make the economy as efficient as it can be. The important target is also to achieve efficient structure of the oil industry.

Stockpiling

Countries secure oil supplies through maintaining sufficient stocks to meet the demand. In line with International Energy Agency requirements the stocks should reflect 90 days of net import. European Commission requires 90 days of net oil consumption. Poland is not a member of IEA despite of its membership in OECD, but it is aiming to become a member of European Union and thus it will need to increase its stocks by the end of 2008 in line with EU requirements.

92 Jonathan Stern “Soviet Oil and Gas Exports, Commercial Transaction or Security Threat”

93 Interview with Robert Mabro, March 2003

94 Jonathan Stern “Soviet Oil and Gas Exports. Commercial transaction or Security Threat”

95 Interview with Jan Krzysztof Bielecki, March 2003

Fuels storage depots represent part of infrastructure security. The major role in the storage system in Poland is played by Naftobazy, a state-held company whose depots' storage capacity amounts to 1.5m cubic meters. Naftobazy needs approximately PLN 1.5bn investment.⁹⁶ The second largest owner of storage capacity is the leading oil processor in Poland and listed company PKN Orlen. Orlen owns storage at total capacity of 450,000 cubic meters and most of it is used for commercial purposes. The storage capacity of pipe operator PERN amounts to 2,5 mln tonnes. The storage capacity will have to increase in Poland by 3,9 mln cubic meters in order to meet EU criteria to cover net oil consumption for 90 days.⁹⁷

In accordance with the Government information about the energy security of Poland, approved by the Lower House of Parliament in January 2002, the current fuel liquid reserves (excluding coal and gas), including state reserves and compulsory stocks equal 1.5m tons, while commercial reserves equal 2m tonnes. The stockpiles include crude oil, gasoline, diesel oil and jet fuels. The major role in the stocks system in Poland is played by Naftobazy, an operator of strategic liquid fuel reserves as well of compulsory reserves of refineries. The capacity was used in 93% after 10 months of 2001. The second largest owner of the storage is the leading oil processor in Poland and listed company PKN Orlen, in which the treasury holds 28% stake. Orlen owns storage at total capacity of 450,000 cubic meters and most of it is used for commercial purposes. The utilisation level of the capacity after 10 months of 2001 amounted to 85%.⁹⁸ From the beginning of 2002, the all oil processors and importers are required to organize stockpiles. According to PKN Orlen, due to legal obligations, the company is required to hold, in this year, stockpile of 40 days of its sales.⁹⁹ However, in accordance with materials collected by foreign companies chamber in Poland POPIHN, current compulsory stocks in Poland cover 29 days.¹⁰⁰ Companies are responsible for creation and maintenance stocks which is connected with costs and reflected in their balance sheets.

Conclusion – Poland urgently needs to organize its stockpiling system, as current system is not sufficient to cope with potential oil disruption or cut off. That means also that Poland's economy may show significant volatility in case of oil prices continuously register significant increases. Financial condition of oil companies due to high oil prices may also worsen which will contribute to lower efficiency and lower investment capacity.

Infrastructure

Poland, as a former Soviet Union satellite country is underpinned through its pipes to FSU network, the largest integrated system in the world. "It interconnects with 17 countries, including Russia, Azerbaijan, Ukraine, Kazakhstan, Belarus, Lithuania, Latvia, Uzbekistan, Turkmenistan and then East Germany, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Croatia and Serbia. The system also provides access to other international markets via large marine terminals on the Black sea

96 ISBusinessWire news agency

97 Poland's government information about energy security passed to the Parliament in January 2002

98 Poland's government information about energy security passed to the Parliament in January 2002

99 Polish Press Agency, March 2003

100 Polish Chamber of Nefte Industry, materials from May 2002

(Novorossiysk, Tuapse, Odessa) and Baltic Sea (Ventspils, Butinge and Gdansk).”¹⁰¹ According to information from the website of the operator of the pipeline PERN “Przyjazn”, Polish section of the system transports approximately 30% of total Russia’s crude oil exports.¹⁰²

Poland receives 90% of crude oil from Russia through the Druzba pipeline, which crosses Poland’s territory in the middle from east to west. The eastern part of the pipeline from the Belarus border to Plock-based refinery PKN Orlen has a capacity of 42 mln tonnes, while the western section from Plock onwards to the German border carries 27 mln tonnes. The pipeline of capacity at 20m tonnes a year goes from Plock refinery, in central Poland, to the Rafineria Gdanska located on the Baltic Coast. The pipe can carry 30m tonnes of crude from Gdansk to Plock refinery. PERN “Przyjazn”, a state-controlled company, which is not scheduled for privatisation. The company delivers crude oil to Polish refineries PKN Orlen and Rafineria Gdanska, as well as to German refineries, including PCK Raffinerie GmbH Schwedt and Mitteldeutsche Erdoel-Raffinerie GmbH w Spergau. A portion of remaining capacity is used for crude oil transit through the oil sea terminal in Gdansk – Naftoport.¹⁰³ Naftoport was built in 1991 and its capacity was gradually increased to the current level of 33m tonnes a year. PERN is planning to expand the eastern section of Duzba pipe in order to increase transport through the northern part to Rafineria Gdanska and thus boost export via Naftoport.

Conclusion- Poland has sufficient infrastructure to receive crude oil supplies both from Russia and other directions via sea. However oil imports via sea is economically questionable but the facility is being used for exports purposes. The country is also planning to increase capacity of the pipelines to take more advantages from transit opportunities in future.

Market structure

Poland’s state treasury still controls 28 per cent stake in the largest oil processor PKN Orlen after having disbursed the company’s shares to the public. The Government also has significant holdings in three refineries in the South of Poland and storage facilities. Currently, the major decision, which needs to be taken by Polish government, is whether to allow the largest domestic oil processor and largest downstream company in Central and Eastern Europe, PKN Orlen to take over the second largest domestic state-owned refinery, Rafineria Gdanska and on what conditions. The crucial factor for taking the decision seems to be whether to get rid off Britain’s Rotch Energy firm, which has been participating in the privatisation tender from its beginning in 2001 or leave it as an intermediary in the consolidation of the two refineries. After having got rid off Russia’s Lukoil in autumn 2002, Rotch Energy established a consortium with PKN Orlen.¹⁰⁴ Polish media have recently reported that the treasury intends to consolidate the two refineries. However, the treasury insists that PKN Orlen has to relinquish being shareholder in oil terminal Naftoport if it wants to take over Gdansk refinery. PKN Orlen said it could pay a portion for RG’s shares with Naftoport’s shares. After potential consolidation with Rafineria Gdanska, PKN Orlen would control around 80% of wholesale fuel market

101 IEA “Russia Energy Survey 2002”

102 PERN website data

103 PERN website data

104 Press reports, February-March 2003 and ISBusinessWire new agency reports

in Poland. PKN Orlen's share in the fuel wholesale market in Poland equals 60% for the company itself and 69% for its capital group according to data for 2001. According to WBK brokerage house PKN Orlen retained 62% market share in 2002.¹⁰⁵ The market share of RG amounts to 20%.

According to deputy CEO at PKN Orlen Slawomir Golonka, the crude oil cost is crucial for the company operating¹⁰⁶. Orlen has also claimed that its consolidation with RG would increase "negotiating power" in terms of oil purchases.¹⁰⁷ According to the report by brokerage house WBK, the cash inflows of PKN Orlen declined by 38.8% in 2002 resulting in an increased demand for turnover capital due to a surge of oil prices.¹⁰⁸

According to Slawomir Golonka, PKN Orlen after having signed new contracts at the end of 2002, will buy 40% of crude oil from Russian concern Yukos – 20% directly from Yukos and 20% from Yukos subsidiary company. The next 40% comes from intermediary company J&S Service and the remaining 20% is being purchased on spot,¹⁰⁹ what Robert Mabro explains as deliveries based on prices at the spot market. In the past years PKN Orlen purchased 70% of crude oil from J&S Service. Rafineria Gdanska will purchase crude oil in 2003 from J&S Service, B&M, which is believed to be a subsidiary company of Yukos, as well as from the domestic exploration firm Petrobaltic. Golonka said that PKN Orlen receives "discount" in crude oil purchases.¹¹⁰ The discount is factually determined by the nearest location on the pipeline route,¹¹¹ as the prices on Russian border are the same for everyone. That brings certain advantages for Polish companies as they receive the cheapest crude and should increase competitiveness.

Competition or monopoly

European Union, which Poland is aiming to enter, is striving for competition on the markets. It imposes regulations, which are earmarked to increase transparency and enhance the competitiveness of the businesses. John Mitchell points out that for a downstream company the most important factor is free market. "Competition on the market will guarantee that after the enlargement there will be a place in EU for Hungarian or Polish companies,"- Mitchell says.¹¹²

However from the security of supply point of view, competition is not necessary always good, as Robert Mabro says. "America and particularly Europe are obsessive with competition. They say we have to have competition because then the supplies are more secure and this is not true. Competition creates an economic cycle. The problem with competition is that everybody invests at the same time or nobody invests. If I am relying on the belief that competition is 100% guarantee, it is true in terms of current supplies but it is not true if we look in future. Competition will not always give the right amount of investments. Sometimes it can give much more, which lead to collapse. Competition is good for stacking allocation of resources, we stop, we see how resources move. But in a dynamic situation, competition creates a

105 BZ WBK report on PKN Orlen, March 2003

106 ISBusinesswire reports from EGM in August 2002

107 Statement of Krzysztof Rogala, the spokesperson of PKN Orlen in Autumn 2002, ISBusinessWire

108 Bank Zachodni WBK report on PKN Orlen, March 2003

109 Interview with Slawomir Golonka, March 2003

110 Interview with Slawomir Golonka, March 2003

111 Robert Mabro, March 2003

112 Interview with John Mitchell, March 2003

universal cycle. Monopoly is planning, it wants to sell in future. It will always make a judgment about the demand and investment. Of course, sometimes it can judge wrong, but in the long-term monopoly will be less unstable than competition". Mabro says though that before establishing a monopoly, the government should impose a very strong regulatory system in order to prevent uncontrolled price increases, particularly when oil comes from one source. "You should not allow the establishment of a monopoly unless you have a very strong regulating system. Its easier to impose regulations on a Polish owner than one who is simultaneously a foreign owner and the only oil supplier." ¹¹³

Also, as Oxford-Analytica points out, commenting on the creation of a monopoly in Romania in 1996, such a move may discourage foreign confidence in the transition from a command economy. In the longer-term, the industry will remain vulnerable to manipulation.¹¹⁴PKN Orlen is listed on the Warsaw Stock Exchange and London Stock Exchange and the shares are relatively cheap. That may drive a conclusion that potential consolidation could create an opportunity for hostile take over of the full oil market. ¹¹⁵ Russian oil giant Lukoil has sustained its interest in acquisition Rafineria Gdanska. For the time being the company is not saying whether it would be interested in PKN Orlen.

Conclusion- Monopoly is always a threat to economic performance, a monopoly-controlled by a Russian company in the Polish market, particularly before the accession to the European Union and in a stage of poor economic growth which keeps share prices low is not the best from a point of view of economic security of oil supplies. Having in mind potential links between oil prices, volumes and economic performance, as well as being aware of the lack of alternative immediate supply sources, entire market control by a particular oil supplier could lead to Polish economic and political dependence on Russia.

113 Interview with Robert Mabro

114 Oxford-Analytica, daily brief 1996

115 Bartłomiej Sienkiewicz article in "Gazeta Wyborcza", March 2003

CHAPTER III

EU enlargement and security of oil supply to Poland

While EU economic policies are now better able to deal with price volatility, they are still unable to control all the relevant geopolitical and speculative factors, and have little power to determine the future direction of world markets. EU itself has a few resources available for the next 8 years of consumption at the present level. That puts EU into quite urgently attempting to secure its external supplies at an obviously “reasonable price”.¹¹⁶ If Poland and other Eastern European countries join European Union in May 2004, their energy security, thus security of oil supply will be virtually guaranteed by achieving a different status and thus gaining political solidarity against hostile Russian acts¹¹⁷. Poland, which is not a member of IEA could benefit from such a membership. In case of oil shortage, Poland will not participate in IEA sharing, but after the enlargement there will be no mechanism to prevent oil from coming to Poland.¹¹⁸ Robert Mabro says though that even after the enlargement, the best guarantee in the case of a serious oil disruption are Poland’s own oil stocks. In his view, a big disruption in the Middle East could cost countries such as Poland volume problem.¹¹⁹ Jonathan Stern adds that a general crisis in the Middle East, despite the fact that Poland is not importing oil from this region, could cause other problems after the accession.¹²⁰ I will develop this in the next section.

Within European Union the current energy demand is covered by 41% oil, 22% gas, 16% hard coal and 15% nuclear energy and 6% renewables. Without changes the oil share will equal 38% in 2030.¹²¹ And significant changes seem to be unlikely due to high costs of renewables and the slow-going process of giving a green-light to nuclear power. Meanwhile EU as a community seeks diversification in terms of oil supply in order to decrease its reliance on the Middle East. Also, a comprehensive EU energy strategy is unlikely to be formulated in the foreseeable future.¹²² Currently EU imports 90% of its oil by sea. And it wishes to shift towards oil pipes.¹²³ The natural partner for Europe is Russia. The energy dialogue between

116 European Commission “Towards a European strategy for the security of energy supply”, Green Paper November 2000

117 Jonathan Stern, email, April 2003

118 Interview with John Mitchell, March 2003

119 Robert Mabro, the director of Oxford Institute for Energy Studies, April 2003

120 Jonathan Stern, email, April, 2003

121 European Commission “Towards a European strategy for the security of energy supply”, Green Paper November 2000

122 Oxford-Analytica, brief, August 2002

123 European Commission “Towards a European strategy for the security of energy supply”, Green Paper November 2000

Russia and European Union was launched in 2000 and so far has brought no significant progress.

EU wants to convince Russia to give up long-term contracts and open its resources as well as gain access to Caspian basin but on conditions that do not upset Russia. Russia though being used to long-term contracts, is not very keen on establishing a legal framework for foreign companies to extract its crude and gas¹²⁴ and is frankly declaring its cultural, traditional and moral rights to establish a “special relation” with Caspian states.¹²⁵ But at the same time Russia relies on oil revenue and 87% of oil exports go to European Union market.¹²⁶ As the industry brings significant revenue to Russia’s budget, the exports and new emerging markets are crucial for the country. Russian oil sector contributes to 8% of GDP. In 2000 the industry secured 35% of the country’s foreign trade earnings and supplied some 20-25% of federal budget revenues.¹²⁷ “Revenue streams from oil are estimated to account for 16% of Russian GDP in 2002. Russian oil and gas companies have ambitions to raise this.”¹²⁸ Yukos already expressed desire of Russian companies to increase their share in EU market to 25% by 2010 from the current level at 18%.¹²⁹

“Russian government has to look carefully at the price of oil as, according to IMF, for every dollar that the oil price falls, the consolidated Russian budget falls by 0.5% of GDP”.¹³⁰ European Union creates the market, which currently consumes 19% of the total world consumption estimated for 78mn barrels a day.¹³¹ When we look at statistics from 1999, we will find significant increase in oil consumption, which then equalled 73.215m barrels or 3.46bn tonnes. Moreover, of the total consumption at 3.46bn tonnes in 1999, OECD countries consumed 2.17bn tonnes. Europe’s demand equalled 755.2m tonnes, while European Union used itself 632.2m tonnes of oil.¹³² Currently EU imports 76% of oil demand from external sources.

Conclusion- Russia and EU will have to negotiate the oil supply. EU countries interested in getting access to resources as well as in developing Russia’s market may be also keen in granting commissions. For newcomers, including Poland, common negotiations would enhance security of oil supply from Russia due to moving into a new political status, as well as potential benefits from free market functioning. But at the same time the new countries do not create markets with significant importance, at least for the time being. Russia will be interested in keeping its good commercial name as a supplier. Good commercial name and competitive product can guarantee Russia’s success on European market. And Russia needs that success, as it strongly relies on oil exports revenue and most of it comes from the EU.

Oil stocks

124 EIA website, country’s brief - Russia

125 Deputy foreign minister of Russia, Andrei Denisov, speech at Russian Economic Forum in London, April 2003

126 Materials prepared for lecture at School of Geography and Environment at Oxford University, Feb 2003, Alex Kokcharov

127 IEA “Russia Energy Survey 2002”

128 Oxford-Analytica daily brief, March 2003

129 Mikhail Khodorkovsky,, materials based on a speech at conference in Moscow September 2002

130 Oxford-Analytica

131 IEA, outlook, March 2003

132 International Petroleum Encyclopaedia 2001

European Union countries import 45% of their oil from Middle East, which is different from the import structure of Central and Eastern Europe countries due to join the EU in May 2004, including, among all Poland, Czech Republic, Slovakia, Hungary, Lithuania and Latvia. The EU oil dependence is predicted to rise to 90% by 2030 but the enlargement will reinforce the trend by adding to the figure 4%.¹³³ In the case of a big oil disruption in Middle East, there will be smaller amount of volume of oil available globally apart from that the prices will go up. Hence the global oil shortage and countries consuming the largest amount of oil may lose the most. "Some countries may reduce their volumes, as they will not afford paying higher prices, some can try to buy from alternate sources, and some may simply not be able to receive as much as they need. Russia, who may wish to sell more oil for political reasons to some countries, which have lost the most, may make less volume available for others," Robert Mabro says.¹³⁴ Jonathan Stern pointed out that during the communism era, supplies to western Europe should be seen as secure after a judgment "whether the Soviet planners believe that incremental hard-currency earnings from oil sales are more valuable to the Soviet economy than incremental domestic oil consumption and/or exports to Eastern Europe, and that the economic value accorded to hard-currency earnings is sufficient to override political concern about East European economic problems which may arise from cutting back Soviet deliveries to those countries,"¹³⁵ And, as agreed before, there is no need to change the previous policy, as it worked well and particularly because the current situation of Russia in terms of available foreign currencies' earnings does not differ a lot from the previous one. In the case of a big disruption, a chance to benefit more and secure a position for future should be certainly considered. The continuous and increased supplies, in that situation also contribute to maintenance a "good name" on European market. When we see the consumption figures in European Union, it is a commercial interest to increase share in attractive markets of which the crucial ones are Germany, France and Italy. (The UK is a very attractive market but for currently it is an oil-exporter.) Russia, at least for the time being, has to watch its commercial interest carefully due to strong reliance on oil revenue. And Western countries are interested in buying the oil.

In the situation of a big disruption and smaller volume available on global market, the only guarantee to avoid oil shortage for countries, which may face difficulties to receive necessary volumes, is their own stocks. Poland cannot count on sharing either, as it is not a member of International Energy Agency. "IEA membership increases security as it is always a hope to receive some volumes from the other countries. This is like an insurance policy. But in the case of a really big disruption, the security is guaranteed only by sufficient stocks which can be released in the case of volume shortage," Robert Mabro says.¹³⁶

But, apart from Russian dimension to Polish oil security, the new status as a member of the EU could bring also problems purely due to non-sufficient oil stocks. The European Commission claims that IEA mechanisms introduced after crisis in 70s "are no longer suited to the oil market"¹³⁷ and there is a lack of solidarity between

133 European Commission

134 Robert Mabro, April 2003

135 Jonathan Stern "Soviet Oil and Gas Exports, Commercial Transaction or Security Threat"

136 Robert Mabro, April, 2003

137 European Commission proposals to new oil stocks directive

Member States “which is not compatible with the objectives of an internal market, since the energy crisis affect all EU countries.(..). “Current mechanism of stocks release does not guarantee the unity of action and solidarity between the Member States which is necessary for proper functioning of the internal market.”¹³⁸ The European Commission emphasis that provisions put in place by IEA require the unanimity of the 26 participating countries and work only in case of a physical disruption of oil supply, even though there is no legal framework for the coordination of action in the event of a threat of a physical disruption, would increase oil prices beyond what is reasonable. So the European Commission complains that it has nothing to say about oil prices and despite decreased vulnerability to sharp movements thanks to oil stocks, the European Union’s economy is still not capable to properly cope with a surge in prices. ¹³⁹And at the same time EC states “the main risk with regard to energy today is economic”. And its economy suffers because of sharp movements. “The in oil prices since 1999, combined with the fall of euro has already increased Union’s inflation rate by one percentage point. Economic growth seems to be feeling effects but growth in GDP remains around 3%. The current situation is leading to a drop in growth rate:0.3% in 2000 and 0.5% in 2001. Jump up of oil prices increased EU oil bill to EUR 240bn in 1999 from EUR 94bn in 1997.”¹⁴⁰

In order to avoid a critical situation in the oil market in case of a disruption and to enhance the economic security of oil supply, European Commission at the end last year came up with proposals for a new oil stocks directive. The new proposals include increase of oil stocks to 120 days from current level 90 days and implementation of a sharing mechanism between member countries as well as setting a price threshold, which as Robert Mabro says, is targeted to gain an impact on the world’s oil prices. The new directive has not been approved yet and there are many disagreements whether it will or should be adopted.

Jonathan Stern emphasis, that “it is very likely that some kind of sharing of available oil supplies between EU members would be required by Brussels.” In his view Poland, in the case of a general Middle East, crisis, despite it is not taking oil from this region, may be affected. “Even if supplies to Poland are not disrupted, but the EU supplies are, this could have a major impact on Poland apart from that the membership could be good for Polish oil security because of solidarity against potential Russian problems”. ¹⁴¹

John Mitchell points out, the accession to the European Union will anyway enhance Poland’s oil supply security. ”I would guess that the position of Poland is quite advantageous because if there is a crisis and countries do release oil in line with the IEA, the price will be depressed, but there is no way especially when Poland is in the EU, to prevent that oil to go to Poland.” So Poland would not be affected due to a crisis as European refineries will benefit in terms of allocation the oil “Refineries are not going to get anything special but the markets are always going to be there”. Mitchell does not believe that the European Commission attempts to impose price target and implement sharing mechanism within the EU members will work. He agrees that coordination in stocks releasing is important, but also points out that oil market was always free market and the threshold setting will not help EU economies. “It will not work because the market is too big, and the history of agreement shows that having a price target is silly. Even if it worked, who is on another side – OPEC.

138 European Commission proposals to new oil stocks directive

139 Green paper, Towards a European strategy for security of energy supply”, November 2000

140 Green Paper --

141 Jonathan Stern, email, April 2003

When you announce threshold everyone knows how it is.” Mitchell also points out that European Commission does not have a mechanism of sharing the stocks such as International Energy Agency. “In sharing Americans have to be involved”¹⁴²

Conclusion – Poland’s accession to the European Union may enhance the security of oil supply in terms of its new political status, as a country belonging to the community. However, in a scenario of a big oil disruption in the Middle East and Russia aiming to increase its share in the European Union market, may result in volume problems. As Central and Eastern Europe demand tends to contract, while the western European consumption remains challenging and resources are limited. The problem, as far as the western EU is concerned, is prices. In that situation the only security guarantee is the maintenance of oil stocks at sufficient level. Moreover, despite the fact that Poland is not importing oil from the Middle East, in case of disruption the EU accession will also require sufficient stocks, as Poland may be asked to share available oil supply with other EU members. But at the same time the country may benefit from free market if no sharing is implemented within the EU. All possible scenarios highlight the conclusion that the best way to prevent oil shortage is to secure sufficient oil stocks.

Transit

The other way to increase security of oil supply is being an important transit country along with an important domestic market. Europe’s demand equalled 755.2m tonnes, while European Union itself used 632.2m tonnes of oil in 1999. That means that countries outside the EU consumed 123.1m tonnes in 1999 and the demand is contracting further. To recall – The Polish Chamber of Nefte Industry POPIHN, which collates foreign investors forecasts – feels that the gasoline and diesel consumption will gradually increase beginning 2002 after having declined since 1999 to 2001.¹⁴³ The state-held Nafta Polska, which conducts restructuring and privatisation of the oil industry on behalf of the treasury, calculated the fuel sales, including heating oil, declined in 2002. But gasoline and diesel consumption increased in 2002.¹⁴⁴

Russian companies are claiming an interest in Polish thus Central Europe market but when we look at the data, it is obvious that the main target is further. Russian giant Lukoil claims interest to acquire Poland’s number two refinery Rafineria Gdanska and its desire to supply Polish market with petroleum products but exports as well. “We are interested in Rafineria Gdanska and we would need an indiscriminate access to oil terminal Naftoport. That would enable us to provide cheap supplies to Kaliningrad region and would give us export opportunities. We are interested in Polish retail market and RG is important with its 20% share” Serguei Popov, Vice President, Corporate Finance at Lukoil says.¹⁴⁵ Robert Mabro emphasises that security of oil supplies would increase if a refinery were in a supplier’s hands. “A supplier would not be interested in cutting off the

142 Interview with John Mitchell, an associated fellow to the Royal Institute of International Affairs March 2003

143 The Polish Chamber of Nefte Industry POPIHN, which associates foreign investors, materials from May 2002

144 own calculation based on brokerage house WBK report on PKN Orlen in March 2003. WBK was citing data of Nafta Polska in a context of PKN Orlen sales in 2002

145 Interview with Serguei Popov, Vice president, Corporate Finance at Lukoil

supplies as it wants to supply the market and exports but on the other hand there is a risk of monopolisation. So this is a question how to balance the two things.”¹⁴⁶ Jonathan Stern points out¹⁴⁷ that if a country wants to be a transit country and thus increase its security of supplies, it has to consider commercial perspective of a supplier. It is Russian companies view that if they export crude oil via ports or refineries which are on a territory of another country, it would be natural to ensure that they will be getting a share of the profits from those facilities. And that means they are interested in acquiring a share in those facilities. Otherwise the most profitable way to provide exports may be building own facilities or seeking new ways of exports. Russian companies currently are transporting 30% of its exports towards western countries through Poland’s pipe system¹⁴⁸.

“Obviously the nearby location of fields in Kaliningrad is an advantage due to low transportation costs.”¹⁴⁹ “The crude oil price at the border is equal to everyone. Additional transportation fee is added from the border to the final recipient by Polish transportation company, which, we assume is standard for any supplier”.¹⁵⁰

Robert Mabro points out that “pipe belongs to who built it. Transport costs are something different from transit fees which are added due to crossing the land.”¹⁵¹ The near location of Kaliningrad oil shelf would give Lukoil opportunity to avoid potentially costly transport of crude oil from fields located further inside Russia.¹⁵² At the same time the state-owned PERN is planning to expand the eastern section of Duzba pipe in order to increase transport through the northern part to Rafineria Gdanska and thus increase export through Naftoport. The company plans to increase the current capacity of eastern section of the pipe from 42 m tonnes a year to 60mn tonnes a year in 2005 along with an increase of storage capacity.¹⁵³ The processing capacity of the two leading domestic refineries is believed to equal total 24.8m tonnes annually after planned investment programme in Rafineria Gdanska is completed. The current capacity is 17.8 m tonnes for PKN Orlen and 4.5 m tonnes for Rafineria Gdanska. PERN plans that the growth in demand for Russian crude oil, including exports, will equal 10-12m tonnes in the near years. Currently the transport capacity of eastern part is used in 98%, while capacity of the north section of 20m tonnes to Gdansk in 42%. The capacity of north section of 30m tonnes from Gdansk to Plock is used only in 3%. The western section of capacity 27m tonnes was used in 75% in 2001. Gdansk refinery could export petroleum products to European markets after necessary investment to make the refinery compliant with the EU norms. And the forecasts show the demand for petroleum products in the EU markets.¹⁵⁴ But, as Robert Mabro says,¹⁵⁵ products export is not always profitable, as the crude exports.

Conclusion –Poland should be interested in transit as it increases the level of security of oil supplies and brings some revenue but at the same time the country would rather not to give up control on its petroleum market to a one-supply source. Russian

146 Robert Mabro, April 2003

147 Jonathan Stern, email April 2003

148 PERN website

149 Interview with Seguei Popov, March 2003

150 Interview with Serguei Popov, Vice President, Corporate Finance at Lukoil, March 2003

151 Robert Mabro, April 2003

152 Bartlomiej Sienkiewicz article in daily “Gazeta Wyborcza”, March 2003

153 PERN strategy, materials from June 2002

154 Oxford –Analytica daily brief

155 Robert Mabro, March 2003

companies are interested in exports both for Polish and European markets and are interested in acquisition of facilities enabling the exports to the EU. The most important equation is to balance the interests and find a compromise on what conditions and terms the goals of both sides can be achieved.

Conclusions

Oil is a crucial energy component for economic performance, and it responds in price surge in the face of any conflict or political uncertainty. Therefore, stable supplies represent a key factor for economic and political stability.

Geopolitically, Russia is the closest source of crude for Poland. As security is a matter of belief and of good political relations with the country selling the oil, the political judgment of security level is based on the perception of the parameters of bilateral relations. The approach is determined by a political guideline towards a country, which is selling the oil.

Poland's accession to the European Union may enhance the security of oil supply in terms of its new political status, as a country belonging to the community. But, commercial interests remain. The former Soviet Union had a tendency to override the economic interests of its satellite with approval from the Western countries, which needed Russian oil. From the commercial point of view there are no reasons for Russia and the Western European countries to change this behaviour.

Thus, the best guarantee for Poland's security of oil supply is its self-confidence and that means participating in the oil international market, achieving an efficient oil industry, building up sufficient oil stocks and compromising with Russia in terms of transit conditions.

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