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THE 2007 RUSSIA-BELARUS GAS AGREEMENT

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Gazprom's press-release: 1 January 2007, 1:41 Moscow time

On 31 December 2006, late at night (reportedly at 23:58), Belarus and Gazprom signed a 5-year supply and transit contract according to which Belarus will buy gas from Gazprom in 2007 at $100 instead of $46.68 per thousand cubic metres (mcm) previously. The press-release states that starting from 1 January 2008, the gas price will correspond to a percentage of the price at which Gazprom exports its gas to Europe - 67%, 80% and 90% for 2008, 2009 and 2010 respectively.[1] Starting from 2011 Belarus will have to pay the full European gas price. The issue which may cause difficulty later on is that it is not clear at which point in time, and at which location in Europe, Gazprom is going to calculate this price. The transit fee via the Beltransgaz (Northern Lights) pipelines has been increased from $0.75 to $1.45 per mcm/100km. The press-release does not mention the volumes of gas to be delivered, but Interfax quotes the Belarusian First Deputy Energy Minister as saying that 21.2 Bcm will be delivered in 2007 with the possibility of a further 0.6 Bcm if conditions allow (a significant increase from the 20.5 Bcm received in 2006).[2] The press-release also states that Gazprom will buy 50% of Beltransgaz assets for $2.5 bn, making four equal payments during the period of 2007-2010.[3] Importantly, it is envisaged that all payments are to be made in cash.

The Belarusian view

The Belarusian first deputy-minister Semashko, who held a press-conference on 2 January 2007 stated that in each of the four year starting in 2007, Gazprom will pay Belarus $625 m representing 12.5% of Beltransgaz's shares. Thus by 1 June 2010, Gazprom will become an owner of 50% of Beltransgaz's shares, having paid $2.5 bn; the first tranche is due in May 2007. [4] As regards transit fees, Semashko noted that according to the contract, these will increase in line with gas price increases. This is,

[1] The press release, which is only available on the Russian language version of the Gazprom site as this article is being written, has the hallmark of a document written late at night by somebody rushing to leave for their holiday. It is open to a number of different interpretations. http://www.gazprom.ru/news/2007/01/010141_22165.shtml

[2] Belarus to receive Russian gas at $100 in 2007, *Interfax Oil and Gas Weekly*, 28/12/2006-10/1/2007, p.6.

[3] http://www.gazprom.ru/news/2007/01/010141_22165.shtml

[4] In May 2007 Gazprom must transfer $625m as a payment for 12.5% of Beltransgaz's shares, *Economy and Business*, cited on www.tut.by, 3 January 2007, translated by the author, http://news.tut.by/economics/80033.html

in our view, potentially the most contentious point of the agreement keeping in mind the aforementioned uncertainty regarding Gazprom's calculations of the European gas price and hence the resulting uncertainty regarding transit fees.

Russian-Belarusian gas relations since 2002

Since the break-up of the USSR, Gazprom has been a major supplier of gas to Belarus, providing it with some 60-70% of its gas needs, with independent Russian gas companies covering the rest of the demand. Starting from July 2002, Belarus bought gas from Gazprom at the Russian domestic price in line with the 1995 Customs Union agreement, according to which all supplies (including energy) were to be traded at the domestic prices of the manufacturing country. However, according to the Russian-Belarusian Intergovernmental Agreement, Belarus was supposed to privatise its gas transit and transmission network, Beltransgaz, and create a 50/50 joint venture (JV) with Gazprom. Gas would continue to flow to Belarus at Russian domestic prices only if this were established. When in September 2002 Gazprom discovered that Beltransgaz was still on the national list of strategic companies that could not be privatised, it threatened Belarus with the suspension of its gas deliveries and price increases. This had the desired effect and by April 2003, Beltransgaz had become a joint stock company. However the government later declared that Gazprom's proposed valuation was too low - $500-600 m against Belarus' estimates of $5-6 bn. Gazprom replied that if the venture was not formed then the new price for Belarus starting from 2004 would increase from $30/mcm to $50/mcm.

When Belarus refused to sign the 2004 contract on these terms Gazprom stopped shipping gas to Belarus via Beltransgaz's Northern Lights pipeline on January 1, letting independents – Itera, SIBUR and TransNafta - supply at a price averaging $46.68/mcm under short-term contracts. When the last short-term contract expired, and the independents refused to conclude a new contract, Belarus undertook unauthorized gas offtakes from the Yamal-Europe pipeline, intended solely for deliveries to Europe.[5] In response, despite Yamal's handling around 16% of its exports to Europe, Gazprom cut off gas flows via this route as well. Less than a day after the cut off, Beltransgaz signed a new short-term supply contract with TransNafta.

Belarus was supplied by independents until mid-2004 while it continued difficult negotiations with Gazprom. Only in mid-June 2004 was a new contract finally signed to ensure Gazprom's gas supplies to Belarus for the remainder of 2004 with 10.2 bcm at a higher price of $46.68/mcm and at a higher transit rate of $0.75/mcm/00km, instead of $0.53/mcm/00km via the Northern Lights and 0.46 per mcm/100 km via Yamal-Europe. [6]

[5] In 2004 23-24 bcm of gas was transited to Europe via Yamal-Europe and 7-9 bcm via the Belarus-owned Northern Lights. In 2006, 30 bcm via Yamal and around 14 bcm via Northern Lights

[6] For a detailed account of these events see Chloe Bruce, *Fraternal Friction or Fraternal Fiction? The Gas Factor in Russian-Belarusian Relations*. OIES: 2005, http://www.oxfordenergy.org/pdfs/NG8.pdf

In trying to resolve the JV issue, Deloitte & Touche were appointed to value Beltransgaz's assets. The valuation was meant to be completed by the end of 2004 with a view to establishing the venture just before the 2004 contract expired, but it is unclear whether the valuation was completed. The talks between Belarus and Gazprom regarding the 2005 gas contract were no less difficult than for 2004, but eventually a contract was signed in time and on exactly the same terms. The story was repeated when the same terms were agreed for 2006. In the meantime, the two sides appointed ABN Amro to value the Beltransgaz assets. According to *Kommersant*, ABN Amro suggested four possible valuations, the highest of which was $5 bn.[7] Gazprom accepted this figure and officially confirmed that it was prepared to buy 50% of Beltransgaz's shares at $2.5 bn.

In 2006, in line with its new policy according to which all CIS importers are required to pay European prices for gas irrespectively of their 'alliance' status vis-à-vis Russia, Gazprom suggested that Belarus should pay $200/mcm. This led the Belarusian president, who never made a secret of his view that the value of Beltransgaz should be proportional to the gas price, to declare that 'a fair price' for Betransgaz in this case would be around $17 bn irrespective of the ABN Amro valuation.[8] He then suggested that Belarus would be ready to exchange half of Beltransgaz for the right to produce 10 bcm of gas annually in Russia.

During the subsequent rounds of negotiations, Gazprom lowered its price from $200 to $170, to $110 and then to $105/mcm. According to *Kommersant*, $105/mcm comprised $75 to be paid in cash ($1.5 bn) and the remaining $30 in shares of Beltransgaz ($0.6 bn), provided that supply volumes achieve a level of 20 bcm[9]. Starting from 2008 Gazprom wanted Belarus to pay $105 per mcm, all of it in cash. Belarus insisted that this would be a violation of the Customs Union Agreement according to which Belarus should receive gas at Russian domestic prices. However in November 2006 it was agreed in Russia that domestic gas prices would be raised to 'European levels' by 2011. Thus there would be no contradiction if the price to Belarus increased along similar lines. Neither the Russian government nor Gazprom would accept Belarus paying a lower price for gas than Russian domestic customers.

Until the very end of 2006, Belarus refused to sign the 2007 supply contract on such terms. It further stated that it would also refuse to sign a 2007 transit contract until a supply contract was signed, and threatened that an increase in transit fees from $0.75 to at least $1.6 mcm/100km would be necessary. The Belarusian government then stated that the 44 bcm of gas that Gazprom intended to transit via Belarus in 2007 could not flow in the absence of a transit contract. Gazprom interpreted this statement as a thinly veiled intention to take gas from the transit pipelines should Gazprom cut

[7] *Kommersant,*27December,2006,
http://www.kommersant.ru/doc.html?DocID=733457&IssueId=30288.
According to the Belarusian energy minister, one of ABN Amro valuation was $5.3 bn and Belarus later agreed to lower it to $5 bn, cited on tut.by, http://news.tut.by/politics/79742.html. Interestingly, the same price at which Belarus agreed to establish the venture with Gazprom in 2004.

[8] In support of his argument he stated that the Czech transportation network Transgas, which half the length of Beltransgaz, was sold at around €4.1 bn ($5.5 bn), *Kommersant*, 14 November, 2006, http://www.kommersant.ru/doc.html?DocID=721579&IssueId=30251

[9] *www.rian.ru*, 27 December 2006

off its supplies, and warned Belarus that in the absence of a supply contract, any offtakes of transit gas would be unlawful. Gazprom threatened that it would stop supplies to Belarus on 1 January 2007 at 10:00, but promised to do its best to protect European consumers from shortfalls, it discussed with the Ukrainian energy minister the possibility of diverting up to 10 bcm of transit flows from Belarus to Ukraine in 2007.[10]

Alternative supplies – were there other options?

With the hindsight, it seems that Belarus did not have much choice but to sign the contract on these terms since it is difficult to imagine where alternative – and cheaper - deliveries could have come from. Indeed, in a sharp contrast with the 2004 January crisis, when Gazprom cut off all gas flows via Belarus for a brief period, when Belarus was supplied by a range of Russian independent gas traders and producers, such an arrangement would not be possible in 2007 because of the 2006 law awarding monopoly export rights to Gazprom. In addition, Itera - one of the major suppliers of gas to Belarus in 2004 - has since sold many of its production assets to Gazprom. Three years ago, Itera and TransNafta were 'allowed' by Gazprom to take over supplies to Belarus because Gazprom, then limited by the recommendations of the Federal Energy Commission, could not make a profit from selling gas at subsidised prices. After the Russian Duma voted in mid-2005 that CIS countries should pay European prices for Russian gas, that situation changed enabling Gazprom to make a profit from sales to Belarus.

There was some speculation in the press that Belarus might be able to buy some gas from UkrGazEnergo which, in turn, is buying its gas from RusUkrEnergo (RUE)[11]. Any gas which in theory could have been made available for Belarus by UkrGazEnergo, could only be gas that RUE would have been buying from Gazprom in 2007. Such re-export would however need to be sanctioned by Gazexport, since according to the 2006 framework Russian gas could only be re-exported in a joint programme with Gazexport. But since this gas is already priced at $230 per mcm then – even if it were technically possible[12]– this would have been less favourable than the initial proposal made to Belarus by Gazprom, i.e. buying gas at $200 per mcm unless Belarus was prepared to sell at least a half share in its network.

Another possibility could have been that UkrGazEnergo, which does not sell gas to distribution companies supplying households (because of payment problems), and reportedly halted gas supplies even to some Ukrainian industrial users in November, could have been tempted to sell some of its imported gas to Belarusian industries had

[10] In 2005 Gazprom transited via Ukraine around 123.4 bcm of gas

[11] *Kommersant*, 24 October, 2006, http://www.kommersant.ru/doc.html?DocID=715797&IssueId=30233

[12] According to Gazprom this would not be technically possible since the same pipeline (Ivtatsevichi-Dolina, with around 8 bcm of gas flow in 2003) is already being used for delivering Russian exports to Europe and a reverse flow, which would be required for gas coming from Ukraine to Belarus, is thus impossible. However, as Russian *Kommersant* notes, when Yamal-Europe will have achieved its projected capacity of 33 bcm, reverse flow would become technically possible, *Kommersant*, 30 October, 2006, http://www.kommersant.ru/doc.html?DocID=717483&IssueId=30238

they been able to pay more than their Ukrainian counterparts – i.e., more than $108/mcm. But again the prohibition on re-export would have prevented UkrGazEnergo from selling to Belarus. The only, albeit theoretical, possibility to overcome a clause prohibiting re-export would be if Naftogaz Ukrainy and some Ukrainian traders who control domestic production would have sold Ukrainian indigenous gas to Belarus. This would however mean that Naftogaz Ukrainy would not have had enough gas to cover the needs of the Ukrainian public sector, the heating and power complex and residential customers. It could have bought gas from UkrGazEnergo to cover the deficit, but since this gas is more expensive, Naftogaz then would not have been able to make any profit in Ukraine since gas prices in the aforementioned sectors are subsidised[13]. This analysis suggests that there was no realistic possibility for Belarus to get a better deal than that which it accepted just before midnight on 31 December 2006.

Will Belarusian industry be able to survive higher prices?

The Belarusian economy is highly dependent on gas. The country has almost no indigenous production (0.25 bcm in 2005[14]) or underground gas storage and imports around 98.7% of its gas needs. In the power sector gas accounts for more than 80% of fuel used in centralised power generation, and 42% of district heat and electricity.[15] The corresponding shares are 29.5% in industry, where major gas consumers in the industrial sector are chemicals/petrochemicals and non-metallic minerals, which generate a proportion of the country's export revenues. The share of gas in the residential sector is more than 22% , though its use in the commercial sector is negligible (0.4%). In 2002 the share of gas in total energy consumption in all stationary sectors amounted to 50%, which is the same as Ukraine (although the latter has a lower share in the power sector but higher residential, commercial and industrial penetration).[16]

It remains to be seen how well the Belarusian industrial sector will be able to adapt to the new reality of $150/mcm gas[17]. There may be a parallel with Ukraine here where it was widely believed that the effect of dramatically increased gas prices in 2006 would have a devastating effect on the Ukrainian economy. In the event, with the exception of ammonia, fertiliser and petrochemicals, Ukrainian industry, which had to pay around $108-110 per mcm, has proved to be surprisingly resilent.[18] Whether the Belarusian industries will be similarly resilient at higher prices is difficult to predict.

[13] Allegedly, Naftogaz has already used more expensive imported gas to supply the population, which partially explains its mounting debt to RUE. Ukraine's gas sector becomes the field for political infighting, *Gas Matters*, December, 2006, pp. 17-19.
[14] *Trends & Figures in 2005, Natural Gas in the World,* Cedigaz, 2006
[15] Figures in this paragraph are for 2002.
[16] Calculated from *Energy Balances of Non-OECD Countries*, 2001-2002, 2004 edition, IEA, 2004
[17] Price of gas for consumers in 2007 will go up to more than $150 per mcm, *Economy and Business*, cited on tut.by, 3 January, 2007, translated by the author, http://news.tut.by/economics/80031.html
[18] Ukraine's gas industry restructures while industry absorbs prices increases, *Gas Matters*, November, 2006, pp. 11-16.

What does the new agreement mean for Gazprom and its 'transit avoidance strategy'?

The new contract is beneficial for Gazprom, mostly because the latter finally is getting a half share in the Belarusian transit network – an aim that Gazprom has pursued since as early as 2000. The new arrangements also make it easier for Gazprom to negate criticisms that its gas pricing policy towards CIS countries – backed by the Russian government - is politically motivated. Indeed, in the case of Belarus, Gazprom will be able to claim that a lower price for Belarus is justified by the fact that Gazprom will be getting ownership rights over its transit network. At the same time it will be able to point out that despite the establishment of a joint venture, the Belarus price nonetheless increased two-fold. Importantly, under this agreement, by 2011 Belarus – like all other CIS and Russian customers – will be paying "European" prices. By that date, with the completion of the Nord Stream pipeline, Gazprom will have much more flexibility regarding its export routes to Europe. In our view, the only reason Gazprom did not seek to achieve a similar arrangement with Belarus a year ago, was that it did not want a confrontation with its two major transit countries - Ukraine and Belarus – simultaneously, and decided to deal initially with the much larger problem of Ukraine.
Furthermore, this time the negotiations with Belarus have been made easier for Gazprom by the fact that since it had already cut off supplies to its most important transit country to force through a price increase, there was little doubt that it would not have hesitated to do the same in respect to Belarus. At the same time Gazprom was prepared to make, and in the event made, some important concessions to Belarus in order to avoid cutting supplies and sustaining further reputational damage in Europe, following the disastrous January 2006 Russia-Ukraine gas crisis.

No matter how good the new contract might be for Gazprom, the past few weeks have further confirmed to its management the correctness of the company's "transit avoidance strategy" and the need to develop new routes such as Nord Stream as quickly as possible. A major part of Gazprom's future export strategy is about minimising its dependence on transit countries, and particularly on Ukraine and Belarus. But this will take a great deal of both time and money and the question of whether this really is the best way to proceed, will depend on how smoothly the type of deal signed on December 31 operates over the next few years.

Economics, Politics and the Future

With no realistic alternatives to buy cheaper gas – or indeed any gas - elsewhere, Belarus seems to have secured a very good deal. Perhaps even too good for its longevity! Belarus will still be buying gas at a lower price than any other Gazprom customer (apart from the Russian domestic market) although at a substantially higher price than $46.68/mcm that it paid previously. An increase in transit volumes via the Northern Lights pipeline from 14 to 15.7 bcm will provide Belarus with additional revenues, especially keeping in mind the increase in transit fees. Furthermore, having secured its share in the Beltransgaz's ownership, Gazprom might be more willing to invest in the refurbishment of the Northern Lights pipelines as well as bringing the Yamal-Europe pipeline to its full projected capacity of 33 bcm.

The main potential problem that raises questions about the durability of the agreement is the fact that, whereas the price for 2007 is fixed, the prices for 2008-2010 are not.

Although the agreement lays out *the principle* of how these prices are to be calculated – as a percentage of the European export price – it does not spell out how Gazprom will calculate the latter. While this lack of clarity may give both sides more room for manoeuvre in the future, the danger is that it could lead to a situation that when the time comes to announce a new price for 2008, Belarus might raise objections to the new figure due to a different interpretation of "European export prices".

Another problem is that Gazprom and Belarus do not seem to have a common understanding of the relationship between prices and transit fees envisaged in the agreement. While Belarus believes that if gas prices go up, transit fees should also increase, Gazprom's press-release makes no mention of any such mechanism.

In the second week of 2007 as this article was being completed, Belarus imposed an additional $45/ton tariff on Russian oil supplies in transit to Poland and Germany through the Druzhba pipeline, followed by alleged illegal siphoning of oil from that pipeline by Belarus, causing the Russian pipeline company Transneft to cut supplies for two days until a telephone call between the Russian and Belarusian presidents resolved the dispute.[19] The additional oil transit tariff appears to have been imposed as retaliation against the imposition on January 1 of $180/ton export duty on Russian oil sold to Belarus, with little mention of the gas price increase as a possible motivation**.**[20] The disruption, while it caused barely discernible inconvenience to European oil supply, was met by a storm of political protest and caused additional damage to Russia's reputation as a secure supplier of energy to Europe.[21]

The gas contract negotiations and the oil transit episode were both bilateral Russian-Belarusian economic, rather than political, issues. As far as oil and gas is concerned – and despite the tone of most European press commentary – both of these episodes have been based much more on economic pragmatism rather than on geopolitical considerations. The overwhelming evidence is that, with subsidised oil and gas deliveries costing Russia many billions of dollars per year, geo-economics has prevailed – and will continue to prevail - over geopolitics. Both episodes were milestones in the unravelling legacy of Soviet-era energy relationships. Because this legacy has taken longer, and been extremely painful, for all sides to deal with, the Russia-Belarus gas agreement should probably be regarded as less of a finished contract and more of a "work in progress" which can be expected to evolve over time.

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[19] Oil supplies were suspended on January 8 and restored on January 10, Belarus climbs down over tariffs as Russia turns off oil and threatens trade war, *Interfax Oil and Gas Weekly*, 28/12/2006-10/1/2007, pp. 3-4.

[20] An agreement whereby Russian oil was sold to Belarus free of duty for refining and sales to Europe, with 85% of the resulting profits intended for Russia, had not been respected by Belarus for more than 10 years; hence the imposition of the duty. Belarus to receive Russian gas at $100 in 2007, *Interfax Oil and Gas Weekly*, 28/12/2006-10/1/2007, p.6.

[21] EU demands supply line is restored, *Financial Times*, January 9, 2007; EU furious at Putin's defiance on Belarus oil, *Financial Times*, January 10, 2007.

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