

## **Polish-Russian Relations: Bones of Contention Piling Up**

**The following is a summary of an article by Adam Grzeszak, featured in "Polityka".**

Both in their economic and political dimension, the relations between Poland and Russia are gradually worsening. The ban on Polish foods exports and the dispute over the Vistula Spit were recently followed by problems concerning oil supplies to the Mazeikiu refinery and gas trade. In such conditions, it is better not to think what the future might have in store.

According to official statements, there is no conflict, only certain hardships which need to be overcome. After all, each of the problems can be rationally justified in one way or another. The blockade of the port in Elblag is tied to expiry of the Polish-Russian maritime agreement, whereas the ban on Polish food products was introduced after the Russian customs services discovered cases of veterinary and phytosanitary document forgery by certain domestic exporters. In turn, suspending oil supplies to Mazeikiu resulted from the damage of the Northern section of the Druzhba pipeline, while the gas trade problems are in fact price negotiations, which is a normal thing in business. - The food ban mystery

However, everybody seems to be aware that in reality the situation is far from normal. The Russian ban on Polish foods was a hard blow for the domestic agricultural and food industry, which in the last few years has been developing rapidly, also due to the growing volume of exports to Russia. A number of Polish companies representing the sector set up its branch offices in the country and corrected their development strategies in order to better adapt to the needs of the local market.

Shortly after the meat products ban was introduced, it seemed that the problem could soon be solved. The irregularities discovered by the Russian customs services were swiftly corrected. However, during subsequent talks Russia put forward new demands concerning issues lying in the competence of the European Commission (EC). As a result, the ban was not lifted, but extended over several other agricultural products, such as fruit, vegetables, flowers and even wood. To make matters worse, as a result of Russian pressure the ban on Polish meat was also introduced by Ukraine, which found itself in a tough spot after Russia threatened to apply economic sanctions against the country if it did not take measures to exclude the possibility of Polish meat being smuggled through its borders. In consequence, exports of Polish meat and agricultural products fell by over 10 percent and 24 percent, respectively, with losses reaching several hundred million dollars.

"We are still hoping that the ban will soon be lifted and are holding negotiations regarding the issue. However, we are not sufficiently supported by the politicians, whose anti-Russian statements are not helping the situation," says head of Polish Meat Union Witold Choinski. The declarations made by Brussels concerning support for the Polish meat industry also proved to be empty. Apparently, it decided that the issue should be straightened out by Poland and Russia themselves. Moreover, the gap created by removing Polish exporters from the Russian market has already been filled by meat producers from other EU member states. - No escape from Russian gas

Nonetheless, there are serious indications that in reality Russia is much more concerned with energy issues than with the food market, given that its relations with Poland in this crucial domain have always been tense. Poland imports over 90 percent of oil and 60 percent of gas from Russia. In the latter case, the matter is particularly complicated, as a part of the remaining share of gas imports is supplied to Poland by Central Asian Post-Soviet Republics, which remain strongly dependent on Russia and its gas giant Gazprom. Therefore, while officially the gas is not purchased from Russia, this is not so obvious in reality. Additionally, the acquired gas is transported to Poland via Russian pipelines, which only strengthens Poland's fears and feeling of dependency.

Meanwhile, Russia does not hide the fact that it intends not only to remain our main oil and gas supplier, but also to enter the Polish fuel and energy market. Kremlin has similar plans regarding a number of other EU member states, which raises justified fears, given that the Russian authorities do not deny that they are planning to use their raw material power to regain political superpower status. In Poland, these fears often result in hysterical reactions of leading politicians. On the one hand, their aim is to purchase oil and gas at the lowest possible prices, which can only be offered by Russia. On the other hand, however, they would prefer to acquire these raw materials from some other country. Thus, a vicious circle is formed.

As a result of these complications, the issue of gas supplies in 2007 remains unresolved until this day. Out of the total 14 billion cubic metres needed, around 7 billion will be purchased from Russia according to the long-term "Yamal contract". However, the Russian side demands that the pricing rules be changed, which the Polish side refuses to accept. This dispute does not bode well for the future.

The remaining 7 billion have to be found elsewhere, also because the regulations adopted by Polish gas monopoly PGNiG state clearly that gas supplies from Russia cannot exceed 60 percent of total volume needed. For this reason, it has recently been agreed that 1 billion cubic metres of gas will be purchased from Germany. Another 3 to 4 billion will come from Polish gas deposits. Therefore, over 2 billion cubic metres of gas will have to be acquired through spot contracts and then transported to Poland. The latter task may prove especially troublesome. Representatives of PGNiG maintain that talks regarding the issue are already underway and that with the amount of time remaining until the end of the year there is no need to be concerned by the situation. They may be right, as in 2005 the final spot contracts were signed just before Christmas. However, they may also be wrong, given that a few years ago one such contract was eventually not completed after Gazprom stated it was unable to carry out the operation due to technical reasons. - Poland surrounded by enemies?

Taking the above into consideration, it turns out that it is because of the pipeline network, not the gas, that Poland remains dependent on Russia and that its energy security is constantly threatened. If the Russian authorities decided to cut supplies to a particular country, such as the case was in February 2004 with Ukraine, the move would affect the energy security of Poland as well. Therefore, it would seem logical that in order to prevent such situations from taking place in the future the authorities should make efforts to extend one of the Western European pipelines to Poland. However, when such solution was proposed a few years ago by domestic entrepreneur Aleksander Gudzowaty, it was immediately rejected. His opponents argued that Gudzowaty's real aim was to disrupt the idea of building an extension of the Norwegian-Swedish pipeline in order to be able to smuggle Russian gas to Poland from Western Europe. Nonetheless, much to everybody's surprise, in 2005 it was announced that the interconnector will finally be built. The project was to be carried out by PGNiG and German company VNG. However, following changes in the Polish gas monopoly's top brass, which were made after the victory of Law and Justice (PiS) in the parliamentary election, the plan was eventually abandoned. It turned out that the new government is equally distrustful of Germany and of Russia.

"There are justified fears that the interconnector could be used by our German partner to expand into the Polish market. At present, the Polish industry is not yet ready to face competition from such a powerful company," says one top PGNiG executive. He uses the same arguments to explain the reasons of blocking the entry of foreign gas suppliers on the domestic market. While most of them are EU companies, in some cases they are supported by Russian capital and thus perceived as a potential threat.

"While conspiracy theories have never been my cup of tea, it sometimes occurs to me that the construction of the Polish-German interconnector may have been disrupted by Russia," says former PGNiG CEO Marek Kossowski, who advocated for carrying out the project. He recalls strange obstacles which had to be overcome since the idea first came about.

Meanwhile, an article recently featured in National Security quarterly, which represents the views of the presidential National Security Bureau (BBN), calls for integration of the Polish gas system with the EU system. In the opinion of its author, at present such option remains the best solution of ensuring Poland's energy security. The article also suggests that Poland should change its attitude towards the North European Gas Pipeline (NEPG) project, which some time ago was compared by Defence Minister Radoslaw Sikorski to the Ribbentrop-Molotov Pact. Given that these views can hardly be reconciled with the official guidelines of Polish foreign policy, it is not surprising that the sections of the article which contained them were removed from the Internet edition of the quarterly.

In the opinion of the authorities, Poland should reply to the construction of the NEPG by building the extension of the Norwegian-Swedish pipeline and constructing a liquefied natural gas (LNG) terminal. These projects are presented as the only way of reducing our dependency on Russia in the sphere of energy policy. Both, however, have shaky economic foundations and probably cannot be carried out at the same time. Moreover, given that both facilities are to annually supply Poland with 5 billion of cubic metres of gas each, the government will have to deal with oversupply of expensive Norwegian gas. - Orlen adds fuel to flames

As if the relations between Warsaw and Moscow were not tense enough, the recent months have seen the emergence of a yet another contentious issue. After winning rivalry with several Russian enterprises, Polish fuel corporation PKN Orlen acquired the Lithuanian refinery Mazeikiu. The facility, which until recently has been controlled by Russia's Yukos, will cost PKN Orlen \$2.5bn. When the transaction was about to be completed, all of a sudden oil supplies to Mazeikiu, so far carried out through the Northern section of the Druzhba pipeline, were suspended. To make matters worse, it is not known whether they will ever be continued. Reportedly, the pipeline is seriously damaged and may no longer be functional.

It seems evident to one and all that in reality the supply have been withheld by Kremlin in order to manifest its disappointment with the outcome of the tender for Mazeikiu and, if possible, to force PKN Orlen to withdraw from the transaction. While it is no secret that the Russian pipelines breakdown every now and then, they are usually quickly repaired. For example, one could not imagine that if a similar damage occurred to the main section of the pipeline, it was not mended on the spot, as the pipeline annually transports around 50 million tonnes of Russian oil to a number of European countries and its functionality is therefore of crucial importance to Russian oil corporations.

Many commentators warned that Russia may use different tricks to complicate things for Orlen. Nonetheless, the corporation's CEO Igor Chalupiec firmly stated that in his opinion Kremlin would not risk taking such measures in the present situation. As he argued, such move would discredit Russian authorities in the eyes of the Western world and additionally lead to a conflict with an enterprise purchasing 15 percent of Russian oil. However, shortly after the head of PKN Orlen was proven painfully wrong.

"Given that the transaction has not yet been completed, the problem does not concern us, but the Lithuanian government and the Mazeikiu refinery," states the Polish corporation's spokesperson Dawid Piekarz. He goes on to say that the situation did not surprise Orlen, which devised an emergency plan in case any trouble was experienced. The enterprise is determined to acquire Mazeikiu and pay the agreed price. At present, oil is supplied to the refinery by the sea, which reportedly does not seriously affect the facility's profitability.

In an interview for Forbes, Chalupiec maintains that by purchasing Mazeikiu he struck a great deal and that it is the Russians who have got themselves into trouble by cutting supplies to the refinery. According to Orlen's CEO, the corporation intends to purchase the Latvian oil terminal in Ventspils, which for a long time has been experiencing the same problems as Mazeikiu. It is difficult to understand the logic behind these plans.

In its confrontation with the Russian oil industry, Orlen surely does not look to be the stronger side. Having no deposits of its own, it will have to purchase oil in order to supply it to the acquired refinery by sea, which is going to significantly increase the corporation's operating costs. Moreover, it will have to compete with Russian fuel companies, as a large part of Mazeikiu's production output will have to be shipped to receivers by sea, in which Orlen has no experience at all. Keeping the above in mind, its critics, who have already announced that the corporation paid \$2.5bn for a heap of scrap, begin to sound anxiously convincing. Meanwhile, Russia does not seem to be worried one bit by the consequences of suspending oil supplies to the Lithuanian refinery.

"The demand for oil is higher than ever and Russia remains the most stable country rich in oil deposits in the world. The malfunction of the Druzhba pipeline enabled Russian oil producers to increase supplies by sea using the port in Primorsk, which turned out to be even more profitable than the solutions used so far," explains fuel industry expert Andrzej Szczesniak, adding that Russian oil giant Lukoil intends to build a powerful refinery near the city, whose production output would be entirely exported. If these plans take shape, Orlen may have an even tougher nut to crack.

The worst thing the Polish authorities could do in the present situation is continue to make irresponsible and offending statements towards Russia. Instead of engaging in a war of words, they should look for allies willing to establish joint projects in the sphere of energy security. Consistent privatisation and liberalisation of the Polish market may prove to be a more efficient means of achieving this goal than implementation of projects based solely on political assumptions and thus having little in common with the reality.

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