

RUSSIA-BELARUS STANDOFF MAY BEGIN AFFECTING OIL SUPPLIES TO EUROPE

January 9, 2007

by Vladimir Socor

Deliveries of Russian oil via Belarus to points West suffered several brief interruptions during January 5 through 8, causing a slight decrease in the volumes scheduled for delivery to Poland and Germany. The problem has arisen following Minsk's introduction of a transit charge for Russian oil through Belarusian pipelines, as a compensatory response to Moscow's introduction of customs duties on oil supplies to Belarus (see EDM, January 8).

Confusion prevails regarding the responsibility for these delivery interruptions. On January 8, European Energy Commissioner Andris Piebalgs and the relevant ministries in the Polish and German governments issued statements noting a deficit of information from the Russian and the Belarus sides. The statements call on both sides to provide detailed and prompt information and abide by their commercial commitments regarding oil supply and transit, respectively.

The position of Belarus is set down in a January 5 explanatory note by the government to foreign governments, a January 8 Ministry of Foreign Affairs statement, and follow-up media interviews by Belarus oil transit officials. According to them, Belarus has not interrupted the oil flow to third countries and will not do so. As owner of the pipelines, Belarus has introduced a transit charge -- not customs duty -- on Russian oil en route via Belarus territory to third countries. The transit tax reciprocates for Russia's sharp hike of the cost of oil supplies to Belarus through the introduction of customs duties on those supplies.

Moreover, effective January 1, the state oil-refining enterprise BelNaftakhim has suspended for the months of January the supply contracts for Russian crude oil to be refined in Belarus. In a December 30 letter notifying Russia's Transneft company of Minsk's decision, BelNaftakhim complained that Russia's customs duty on crude oil deliveries to Belarus has heavily hit the latter's oil refining industry. According to BelNaftakhim and the Minsk government, purchases of Russian crude in this situation would force the Belarus refineries to become loss-making. Existing crude oil stocks would enable Belarus refineries to function at 60% to 65% of their normal operating capacities for several weeks while fuel oil consumption in the country remains relatively low thanks to the mild winter.

The Minsk government hopes to resolve the differences with Russia through negotiations within the next few weeks while its stocks last. It proposes a mutual cancellation of Russia's customs duty on oil supplies to Belarus and of the Belarus transit tax on Russian oil en route to third countries.

According to Belarus pipeline-operator Homel-Transnafta chief Alyaksey Kastsyuchenka and the Belarus ambassador in Warsaw, Pavel Latushka, the oil flow through the Russian

pipeline was briefly halted three times on January 8 in Russia, before reaching the point of entry into Belarus.

Moscow's position is set out in media statements mostly by second-tier officials, while the top-level ones are on leave during Orthodox Christmas. State Secretary and Deputy Minister of Economic Development and Trade Andrei Sharonov seems to coordinate positions for the officials on hand. Moscow is serving notice that it will plead force-majeure, citing circumstances beyond Russia's control, in the event of any shortfalls in oil deliveries to European countries.

While blaming Belarus, Sharonov admits that *Russia itself stopped deliveries from Russian territory to Belarus because the transit had become impossible.* According to him, Belarus Customs has warned Russia's Transneft pipeline monopoly in a letter that Belarus would impound certain volumes of Russian oil in the event that Russia does not pay the transit charge (Interfax, January 8).

Unnecessary confusion stems from repeated accusations that BelNaftakhim *ordered a halt to the transit* of Russian oil to points West. In fact, BelNaftakhim only suspended deliveries of oil for refining in Belarus.

Russian officials systematically mis-describe the transport tax introduced by Belarus as a customs duty and term it illegitimate, inasmuch as customs duties cannot apply to transit. However, the tax in question is specifically for transit, such as Russia pays to other transit countries and charges itself on its territory. Transneft president Semyon Vainshtok and vice-president Sergei Grigoriev are publicly holding out the possibility of negotiating with Belarus for mutually acceptable transit charges on that country's territory. But they underscore that the negotiations would be a lengthy process, pending which Belarus should continue providing the transit service on the previous terms -- that is, gratis.

The officials in Moscow are accusing Belarus of *siphoning off* Russian oil destined for European Union countries from the transit pipeline. This accusation may be a preemptive one designed to discourage Belarus from resorting to this practice if the standoff continues.

Moscow calls for negotiations, on the condition that Belarus first cancels its transit tax. Moreover, Sharonov and other officials are highlighting Minsk's heavy dependence on the Russian market for Belarus exports, openly warning that Russia may close its market to certain Belarus products. Sharonov and the Duma's International Relations committee chairman Konstantin Kosachev are even warning of a *trade war* and implying that Russia could only win such a war.

(Interfax, RIA Novosti, NTV Mir, Belapan, Belarus radio and television, January 6-8)

BELARUS OIL TRANSIT TAX RETALIATES TO RUSSIAN OIL COST HIKE

by Vladimir Socor

Effective January 1, the Russian government has introduced a heavily-hitting export duty of \$181 per ton of crude oil delivered to Belarus. Those deliveries had been duty-free until now. Signed by Prime Minister Mikhail Fradkov on December 8, 2006, the decision places oil deliveries to Belarus under the same customs regime as the deliveries to countries that are not members of the CIS Customs Union/Eurasian Economic Community (EurAsEc, which includes Belarus). If those organizations have existed largely on paper until now, they may begin losing even their paper existence as a result of such Russian measures.

By raising the cost of oil supplies to Belarus sharply at one stroke, this measure severely hurts Belarus, but also slashes the profits of Russian oil-producing companies that refine their oil in that country.

On January 3, the Belarus government retaliated by introducing a customs tax of \$45 per ton on Russian crude oil in transit to the West through Belarus pipelines, effective also from January 1. The transit had been tax-free until now. President Alexander Lukashenka authorized the introduction of the tax during a cabinet meeting he chaired that same day, shown on state television. Denouncing "the Russian Federation's extremely unfriendly steps," Lukashenka remarked, "They are choking on petrodollars, but they have decided to hit at Belarus" (Belarus Television, January 3).

Belarus transited an estimated 80 million tons of Russian oil to European Union territory in 2006, down by some 10% on the 2005 figure, but still more than a third of Russia's crude oil exports to EU countries in 2006. A switch of some Russian oil export volumes to Primorsk and the deliberate cessation of Russian deliveries to Lithuania since mid-2006 (and earlier to Latvia) account for the decline in the transit through Belarus in the year just past.

The Belarus Ministry of Foreign Affairs has given public assurances that the tax will not physically affect the transit of Russian oil to EU countries. The EU Commission's spokesman has taken note of those assurances.

The Soviet-era Druzhba pipeline system remains critical to Europe's oil supplies in the absence of a diversification strategy. The mainline originating in Russia is branching off in three directions from Belarus: one branch northward to Lithuania and Latvia, another westward to Poland and onward to Germany, and another branch across western Ukraine to Hungary, Slovakia, and the Czech Republic.

According to the management of Russia's pipeline monopoly Transneft, which operates the Druzhba system in Russia, the transit tax just imposed by Belarus is to be levied on Russian oil-producing companies. However, the Belarus Customs Committee on January 6 launched a court case against Transneft for failing to declare goods in transit to third countries and failing to pay customs tax on those goods -- that is, the oil being pumped

from the Russian into the Belarus sections of Druzhba. The Belarus Customs Committee has summoned Transneft president Semyon Vainshtok to appear in the Homel court within 48 hours (Belapan, Interfax, January 6).

Russian oil-producing companies supplied Belarus itself with more than 20 million tons of crude oil in 2006 (some 17.5 million in the first three quarters of the year), topping the 2005 figure of 19.3 million tons. The leading suppliers in 2006 were Surgutneftegaz with some 30% of the total deliveries to Belarus, Rosneft with 25%, Sibneft (acquired by Gazprom during 2006) with 13%, Lukoil with 11%, Slavneft with 10%, and smaller companies delivering the remainder (Interfax, December 14). Those volumes are traditionally destined for processing at the Mozyr and Navapolatsk refineries in Belarus, substantially exceeding the internal demand in Belarus for refined products.

This arrangement has long proven highly lucrative both for Russian oil-producing companies and for Belarus. The Russian companies, taking advantage of the duty-free export, sent low-priced volumes of crude oil for refining in Belarus, which in turn exported the refined products to Europe at market prices, with high profit margins for the Russian suppliers and the Belarus refineries. Moreover, Belarus charged export duties on the refined products, thus earning big revenues for its state budget. Even so, the Belarus export duties on various types of refined products were all along far lower than Russia's export duties for the same types of products refined in Russia.

With Russia chronically short of in-country refining capacities, it is logical for Russian producers to use the refineries in Belarus. The hitherto-existing customs and tax arrangements made this practice particularly profitable. According to Russian Industry and Energy Minister Viktor Khristenko, Russian oil-producing companies were *scrambling and elbowing each other in order to use this tax shelter* in Belarus (Interfax, December 12). For its part, the Russian government claims to have been losing \$4 billion per year in 2005-2006 in tax and customs revenue to the state budget.

Minsk has notified Moscow on January 3 and repeatedly thereafter that Belarus would revoke the oil transit tax if Russia revokes the oil export duty. Minsk calls for resuming negotiations (interrupted since last November) on sharing the proceeds from the Belarus export duty on the oil derivatives refined in Belarus. It calls for sharing those proceeds on a 50% to 50% basis and for completing the negotiations within this month.

For its part, Russia wants Belarus to raise its export duties on the refined products to the level charged by Russia and to pay 85% of the proceeds into the Russian state budget. Such a move could be devastating to Belarus, particularly in conjunction with the doubling of the price for Russian gas to Belarus on January 1.

(Interfax, Belapan, NTV, Belarus TV, January 1-7; see EDM, November 2, 14, 2006.)

OIL SUPPLY CUTBACK TO EUROPE SHAKES RUSSIA'S RELIABLE-SUPPLIER IMAGE

January 10, 2007

by Vladimir Socor

Conclusive evidence emerged on January 9 that Russia halted oil exports to European Union countries via Belarus during the night of January 7-8. Moscow seeks to force Belarus to accept Russian-imposed terms for oil supplies to Belarus itself as well as for transit of Russian oil to Europe (see EDM, January 8, 9). Russia briefly interrupted the deliveries to EU countries via the Belarus Druzhba pipeline several times between January 5 and January 7 before halting them completely. Moscow did not inform the EU customer countries about its intentions and has left them guessing about Russia's ongoing moves.

On January 9 Moscow threatened to turn its dispute with Belarus into a dispute between Russia and the EU. Probably for the first time ever, Moscow officially warned that it might have to reduce oil exports in the short term by cutting back on oil extraction in Russia itself. The excuse is that Belarus makes it impossible for Russia to fully carry out its oil export commitments. This and other warnings authorized by President Vladimir Putin on January 9 are inspiring the European Union -- also for the first time -- to openly question the postulate about Russia as a *reliable energy supplier.*

Russian oil exports to Europe via Belarus are estimated at nearly 80 million tons for 2006, amounting to more than one-third of Russia's total deliveries to EU countries. In addition, Russia supplies crude oil to Belarus refineries for exports of refined products to European countries.

Chairing a government session on January 9, Putin ordered the government to work out a set of possible measures, which he listed in the following order on live television: Reduce oil extraction in Russia, hold talks with Belarus, satisfy the interests of Western consumer countries, and satisfy as well the interests of Russian oil companies by minimizing their losses.

Industry and Energy Minister Viktor Khristenko and Economic Development and Trade Minister German Gref elaborated on these ideas during news conferences the same day. Russia, they said, can use railroad and sea tanker transportation to Europe in order to re-direct some crude oil volumes that normally reach Europe through the Belarus Druzhba pipeline. However, such alternative spare capacities are limited at present, and cannot any time soon be expanded to accommodate the full volume of crude that has hitherto been exported to Europe through the Druzhba system. Thus, apart from developing those alternative transport capacities for crude, Russia needs to increase in-country refining capacities, of which Russia is short. Pending those measures, the Russian government would discuss with the oil companies short-term cutbacks in production, the ministers said.

The warnings aim at far more than just pressuring Belarus to accept Russian-imposed terms for oil supplies and transit. They appear designed to foster nervousness on European energy markets and set the stage for manipulating oil prices. While almost certainly a bluff, such warnings can potentially cause short-term disruptions. From Russia's own standpoint, these warnings are also mutually contradictory to some extent. Thus, while urging Russian companies to quickly increase refining, the Russian government has just introduced an oil export duty heavily hitting Russian oil producing companies that refine their crude in Belarus.

German Chancellor Angela Merkel, meeting with European Commission President Manuel Barroso on January 9 in Berlin, struck a new and far more realistic tone than had hitherto been the case in Berlin on energy relations with Russia. Asked about Russia's reliability as a supplier, Merkel replied that Moscow's failure to consult [with EU countries] is unacceptable, it repeatedly destroys confidence; you can't build cooperation based on real mutual trust in this way. Merkel strongly called for diversifying Europe's energy mix and reducing dependence on a supplier country.

In a similar vein, EU Energy Commissioner Andris Piebalgs declared, Failure to inform the [EU] partners is unacceptable. The European Commission (the EU's executive body) underscored that the situation negatively reflects on the two countries' perceived reliability as energy partners [to the EU]." With this, the EC equalized Russia and Belarus in terms of reputation as economic partners.

The situation highlights the risks of dependence on Russia for crude oil deliveries in addition to gas. It shows that the January 2006 gas crisis over Ukraine and the oil supply cutoff to Lithuania (a move hostile to Poland as well) in July 2006 are far from exceptions, but rather recurring crises affecting the EU as such. Such recurrence shatters the view of Russia as a reliable supplier even in some West European circles that have been clinging to this view.

(Interfax, Russian TV Channel One, NTV Mir, Belapan, Belarus Television, January 9)