PP/04/04

Seminar on Gas Transit: Key Findings

1. Introduction

On March 10, 2004 the German Economic Team in Belarus and the Research Center of the Institute for Privatization and Management jointly hosted a seminar, entitled: *Belarus as a Gas Transit Country*. The seminar brought together international experts and business representatives as well as government officials. The objective of the seminar was to provide information about expected developments of the European gas market and their consequences for gas producing- and transiting countries. Based on these expectations, participants discussed a strategy of how to include Belarus as a reliable partner within the increasingly interconnected network of gas consumers, gas producers and transit countries.

In particular, seminar participants discussed future developments on the Western European market, Russia's strategy of dealing with changes on the European market as well as the reaction of Ukraine as Belarus' most important transit competitor with the largest capacity. The main conclusion of the seminar is that in the increasingly competition-oriented gas business the two main determinants of competitiveness are low costs and high security of supply. Since Russian gas transit through Belarus has the lowest supply costs on the European market, the country has a clear advantage. However, in order to utilize it, Belarus should concentrate its efforts on ensuring security of transit supply. If it succeeds in doing so, Belarus has the promising long-term perspective of receiving higher transit profits from additional investments into pipeline capacity. Furthermore, a stronger inclusion of Belarus in the gas transit network would help avoiding negative incidents such as the recent interruptions of Russian gas deliveries to Belarus with their corresponding negative consequences for Belarus' reputation as a reliable transit partner.

The remaining sections of this paper summarize the viewpoint of the German Economic Team and its policy recommendations, taking into consideration the conclusions of seminar presentations and discussions. In line with the structure of the seminar, it first summarizes the key developments on the EU gas market (section 2) as well as its implications for Russia (section 3) and Ukraine (section 4). In the last section, we summarize the relevant conclusions for Belarus. In addition, the German Economic Team in Belarus also provides a policy paper that elaborates the content of the seminar in more detail (PP/03/04).

2. The EU gas market

***Finding 1*:**
Consumption of natural gas in Western Europe will continue its strong growth during the next decades

Annual consumption of natural gas in the 22 European OECD countries is projected to increase from 524 bcm in 2000 to 800-830 bcm in 2020 and to up to 940 bcm in 2030. The main driving forces for this development are the substitution of carbon fuels – in particular coal – in favor of gas due to the introduction of a trading scheme for greenhouse gas emission rights as well as the politically-determined decision to reduce the share of nuclear power in Europe's energy mix. Since gas reserves within the EU are limited, most of this additional demand will have to be satisfied by increased imports of natural gas.

Finding 2:
Liberalization of the gas market in the EU will strengthen competition between gas-exporting countries such as Russia, Algeria or Norway with both supply security as well as supply costs being the main determinants of competitiveness

Liberalization is designed to replace the existing structure of regional monopolies on the EU market. Instead, equal access rights to network infrastructure is expected to allow for flexible, price- and cost-oriented competition between European gas traders. Consequently, also the typical long-term contracts between gas-supplying countries and traders will be substituted by short-term or spot market transactions that allow for more flexibility. Such an environment will also strengthen competition between gas-exporting countries, in particular Russia, Norway and Algeria. In addition, it is expected that technological progress will soon allow trading of Liquefied Natural Gas (LNG) at costs comparable with those of pipeline imports, which will enable even more countries, e.g. from the Middle East, to supply gas to the growing Western European market. Under such conditions, the main determinants of the competitiveness of exporting countries will be security of gas deliveries as well as the corresponding costs of supply. The latter aspect is especially problematic for Russian gas exports, which currently account for almost 50% of gas imports of Western Europe despite their relatively high supply costs (Table 1).

Table 1. Costs of gas supply to EU 15 for incremental supply volumes (Long Run Marginal Costs in USD per tcm)

Exporting country	Russia (NadymPurTaz) via		Algeria	Norway
	Ukraine	Belarus		
- Extraction	14.3	14.3	16.1	44.6
- Transport	75.4	61.4	28.5	30.4
- Transit fees	10.0	5.7	3.9	
Total	**99.6**	**81.4**	**48.0**	**75.0**

Source: Assessment of Internal and External Gas Supply Options for the EU. Observatoire Mediterraneen de L'energie.

3. Russia / Gazprom

Finding 3:
Adjusting to the challenges of increased competition in Europe forces Russia to increase supply security and to reduce supply costs. For this, Russia has two options: intensifying cooperation with transit countries or investing in new transit capacity to bypass transit countries

Russia, more precisely Gazprom, faces the need of adjusting to the new challenges. However, Gazprom lacks the financial means for large-scale transit projects since it also needs to finance large investments in its own production and transportation infrastructure. On the other hand, given its disadvantage in supply costs vis-à-vis Norway and Algeria (Table 1), action is necessary. In this situation, Gazprom seeks to reduce costs wherever possible. Furthermore, it tries to compensate its cost-based disadvantage by increased supply security. To realize both intentions, Gazprom tries to expand its control over the existing gas pipelines in Ukraine and Belarus in order to control transit fees and to separate transit from regional infrastructure. In addition, Gazprom is currently negotiating with Western European partners about financing new projects to diversify supply routes.

4. Ukraine

Finding 4:
Ukraine has understood the changing environment and is currently considering various options of optimizing pipeline management and operation

Ukraine also needs to attract funds for substantial investments in its transit system. It is rather unlikely that such investments can by financed from domestic sources. Thus, Ukraine faces the need to present favorable conditions for a joint cooperation in pipeline operation with international partners. As a first step, Ukraine and Russia agreed to establish a joint consortium with the possibility to further include Western European investors. Moreover, Ukraine is currently reviewing various options of optimizing pipeline management and operation. Among them, privatization or a concession contract appear to be the most likely alternatives. In addition, Ukraine is seriously considering the construction of new transit capacity.

5. Belarus

Finding 5:
The low cost of Belarus' gas transit system are a clear advantage. Hence, the country's strategy should focus on attracting new investments for increasing capacity rather than on increasing current transit fees. This would raise profits from gas transit for Belarus in a sustainable manner. In addition, it would also be rational for international investors provided that security of supply can be credibly ensured

Belarus should realize that it is in competition with other transit countries in a changing environment and should put its efforts on optimizing its competitive position rather than reducing it. More concrete, this means that creating insecurity of current transit as well as increasing current transit fees might –in the medium and long term – direct transit volume away from Belarus. In particular, this will be an additional stimulus for the construction of a pipeline from Russia to Germany through the Baltic Sea. For Gazprom as well as for its Western consumers completion of this pipeline project would increase supply security because it bypasses all transit countries. However, realization of the proposed project will be rather costly. Belarus, on the other hand, might be an interesting alternative for additional investment since it offers a supply route for Russian gas to Europe at low costs. Consequently, abandoning plans to build an expensive pipeline through the Baltic Sea and instead installing the necessary capacity as a second trunk line through Belarus would be an economically rational choice for both Gazprom as well as western investors, if only supply security at low cost could be credibly ensured. If this were possible, it would be a win-win-win situation for all parties involved. For Gazprom as well as its European customers it would provide sufficient capacity at a reasonable price and for Belarus it would mean additional income from higher transit volumes. However, crucial pre-conditions for this investment are, first, keeping transit fees at low levels and, second, allowing for reliable cooperation between producers, the providers of transit services and consumers.

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