OSW COMMENTARY
ISSUE 81 | 20.06.2012 | CENTRE FOR EASTERN STUDIES

# An inexhaustible source of income? The significance of Belarusian refineries and the outlook for the future

Kamil Kłysiński, Wojciech Konończuk

**Belarus generated a surplus at US$1.9 billion in foreign trade in goods and services in the first four months of 2012 as compared to a deficit of US$2.8 billion for the same timeframe a year earlier. Minsk owes this, its highest positive trade balance since 1991, mainly to a significant increase in exports of petroleum products manufactured by the refineries in Navapolatsk and Mazyr. This is a consequence of the favourable contract for supplies of Russian oil until 2015 which Belarus signed in December last year. This contract has resulted in a *de facto* resumption of Russia subsidising Belarus. The favourable conditions of Russian oil supplies will allow the Belarusian refineries to remain the driving force of the country's economy, and the Belarusian government will not allow them to be privatised, which Russia has been seeking for years. The two refineries initiated an ambitious modernisation programme, which is aimed at increasing their output and improving the quality of their production. Owing to this, their share in the market of petroleum products in the region, including on the Polish market, may grow within the next few years.**

## The Belarusian oil sector

There are two oil refineries in operation in Belarus. They were built in several stages in the 1960s and 1970s as a component of Soviet heavy industry. One of them, Naftan, is located in the northern part of the country, in Navapolatsk; the other is in the south, in Mazyr. The two refineries have a similar capacity, currently at 11 million and 12 million tonnes of oil per year respectively. Both are state-controlled: Naftan to 100%, and the Mazyr refinery to 55%[1], both belonging to the state-owned corporation, Belneftekhim.

Almost all of the petroleum processed at the two refineries originates from Russia and is supplied via the Druzhba pipeline or, to a lesser extent, by rail (15.1 million tonnes and 3 million tonnes last year, respectively). Although the Belarusian government ensured oil supplies from Venezuela and Azerbaijan in 2010 while in dispute with Moscow[2], the high prices and logistic problems caused Minsk abandon the alternative supply sources (approximately 2 million tonnes last year). Furthermore, the state-controlled company, Belarusneft, produces small amounts of oil in Belarus. Over the past few years, its annual production has ranged between 1.5 and 1.7 million tonnes, and almost all of it has been exported[3].

## The significance of the refineries for the Belarusian economy

The refineries in Mazyr and Navapolatsk are among the companies of crucial significance for the running of the Belarusian economy. According to data from the state-controlled operator in the oil sector, the Belarusian Oil Company, production and trade in this sector generate

[1] The second largest shareholder is Russia's Slavneft (which is controlled by Gazprom Neft and TNK-BP), which holds a 42.6% stake. The remaining 2.4% of the shares are held by private investors.

[2] Oil supplies from Azerbaijan were linked to a swap contract as part of oil co-operation with Venezuela. In addition to that, Belarus also imported oil directly from Venezuela.

[3] In 2011, Belarus exported 1.55 million tonnes of oil for a price of US$1.3 billion. All of this was supplied to Germany via the Druzhba pipeline.

up to 30% of the revenues of the Belarusian state budget. The two refineries are also among the country's key exporters. In 2011, the value of petroleum products sold to foreign markets reached US$12.5 billion, which accounted for 34.3% of total Belarusian exports. The share of petroleum products in exports in preceding years was at a similar level (see Appendix). For this reason, the refineries – in addition to the potassium company, Belkali – are the main source of hard currency for the Belarusian economy and budget.

The significance of the Belarusian refineries is increased further due to the government's application of 'cross-subsidising', i.e. supporting low-performance or unprofitable sectors (such as the agricultural sector or light industry) using the profits generated by the key contributors to the state budget. One of the forms this aid takes is a compulsory contributions (which also apply to the petrochemical sector) to the 'national innovation funds', linked either to particular ministries or operating separately. Furthermore, one important and widely used solution (brought in a modified form from Soviet times) is the imposition of the obligation on companies to ensure sophisticated welfare programmes for their employees and their families; this is expected to maintain social stability in Belarus. Thus the condition of the refineries in Mazyr and Navapolatsk not only has a direct impact on state finances but – due to their significant participation in the complex system of subsidies, tax allowances and benefits – it is also among the key factors able to maintain the stability of the Belarusian command-and-distribution model.

**The refineries in Mazyr and Navapolatsk are the main source of hard currency for the Belarusian economy and budget. They also play a key role in maintaining the stability of the Belarusian command-and-distribution economic model.**

## The modernisation challenge

In 2010, Belarusian refineries embarked upon a modernisation programme, scheduled to be completed by 2015, aimed at improving the efficiency of petroleum processing from the present average rate of 72% to 92%. The Nelson Index[4], which at present is 4.6 in the case of the Mazyr refinery, and 7.7 in the case of Navapolatsk's Naftan, is to rise to 11.8[5]. Following the modernisation, the two refineries will increase their production of petrol by 45% and of diesel oil by 50% (for more details see Appendix 2). Additionally, the output of the Mazyr refinery will increase to 12 million tonnes annually. In effect, the greater part of the production of these two plants will meet the Euro-5 standard, and their management expects that their rate of return will rise by approximately 10%, which will reduce Belarusian petrochemical sector's dependence on the preferential prices of Russian oil. Given the fact that the financial situation of the Belarusian refineries is directly dependent on the conditions of supply and processing of crude oil from Russia, the implementation of this task is of paramount significance for Belarus.

**Given the fact that the financial situation of the Belarusian refineries is directly dependent on the conditions of supply and processing of crude oil from Russia, the plan for improving the refineries' performance, which is to be implemented within the timeframe between 2010 and 2015, is of paramount significance for Belarus.**

However, the most serious problem is the cost of the modernisation of the Belarusian refineries which, according to estimates, will range between US$2 and 2.5 billion. In turn, the creditworthiness of Belarus is adversely affected to a great extent by the high level of the

[4] This is a rate which reflects the technological complexity of a given refinery and its ability to manufacture highly processed petroleum products.

[5] For comparison, the Nelson Index for the refinery in Plock is 9.5, and for the refinery in Mazeikiai is 10.3. Data quoted from: www.orlen.pl/EN/InvestorRelations/Documents/Company_overview_EN_March_2011.pdf

country's foreign debt, which has already exceeded 60% of its GDP, and its bad relations with the West. Western banks and international financial institutions are unwilling to take the risk of financing any companies in a country on which economic sanctions have been imposed, also including on the oil sector[6]. At the same time, the possibilities of allocating such amounts of money from the country's own funds are rather limited. Although the central bank's foreign currency reserves this year reached a record-high level of approximately US$8 billion, they will be used primarily to repay Belarus's foreign debt, and the instalments due in 2013–2014 will reach approximately US$6 billion (only public debt). It appears that the best-available variant of foreign credit for Minsk at present could be to obtain support from Russian oil companies. However, it is very unlikely that these companies will be willing to provide funds for the modernisation of Belarusian refineries without being allowed to purchase control stakes in them at the same time.

## The orientation towards exports

A distinctive feature of Belarusian refineries is the fact that they are export-oriented. In 2011, Mazyr and Naftan exported a total of 15.6 million tonnes of petroleum products, worth US$12.5 billion. The key purchasers of their production are EU member states, which last year accounted for 83.5% of total sales. The main recipient in the EU is Holland (44% of total exports of petroleum products), which is mainly owing to its role as an agent in the further sale of these products on the Amsterdam exchange. Another major recipient is Latvia, with a share of 13%. Other purchasers include Estonia (3.2%), Italy (3%), the United Kingdom (3%), Poland (2.2%) and Lithuania (2%). Such a significant share of petroleum products in Belarusian exports last year allowed Belarus to reach a positive balance at US$7 billion in trade with the EU. From among the non-EU member states, the most important market is Ukraine (22.5%), which is a consequence of a long-standing crisis in the Ukrainian refinery sector[7].

The entity in charge of exporting the production of the Mazyr and Naftan refineries is the Belarusian Oil Company, which was established in 2007 and which last year sold 12.7 million tonnes of petroleum products (an 81.5% share in total sales of petroleum products). The remaining deals are effected by private Belarusian firms owned by entrepreneurs linked to aides of President Alyaksandr Lukashenka[8].

**If the product pipeline was built, this would cause an increase in the share of Belarusian diesel oil on the Polish market, and thus the position of Orlen and Lotos in eastern Poland would be challenged.**

The planned modernisation of the Belarusian refineries may lead to an increase in the value of exports of petroleum products to the EU market owing to a significant improvement in their quality, i.e. mainly the production of petrol and diesel oil at the expense of low-processed heavy fuel oil (mazut). The consequences of this may include a weakening of the position of the Mažeikiai refinery in the region and an increase in the share of Belarusian petroleum products, mainly diesel oil, on the Polish market. The planned project of building a product pipeline from Belarus to Poland, which is set to be implemented by a private company, Energopol Warszawa, could also contribute to this. According to initial plans, this project was to be launched already in 2012; however it still does not have all the permits required in Poland. If the product pipeline was built, this would cause an increase in the present 3% share[9] of Belarusian production in the Polish diesel oil market (0.5 million $m^3$), and thus the position of Orlen and Lotos in eastern Poland would be challenged[10].

[6] In 2007, the USA in response to the violations of human rights in Belarus imposed sanctions on Belneftekhim, including a ban on exports and contacts with US companies. In turn, the EU sanctions, in force since March 2012, are of a limited nature due to opposition from some of the member states, and apply only to selected private entities owned by three businessmen, who provide the financial base for the regime. Two of these businessmen are active in the oil sector.

[7] Since no import duty is imposed on petroleum products in Ukraine, it is more profitable to import these products from Belarus, Russia or Lithuania than to manufacture them at Ukrainian refineries. This has led to the winding up of most Ukrainian refineries.

[8] Such exporters include the entities controlled by the corporation Triple owned by Yuri Chizh and the corporation Univest owned by Anatol Tarnausky. The EU sanctions have been imposed on both of them.

[9] Oil industry and trade in 2011, www.popihn.pl/download.php?s=1&id=749

[10] At present, Belarusian petroleum products are carried to Poland by rail. The product pipeline would essentially cut their transport costs.

## The external environment for the operation of the refineries

Since the beginning of their existence the Belarusian refineries have been processing Russian oil almost exclusively. For this reason, conditions of oil supply have a decisive impact on the financial situation of the two Belarusian refineries and – given their significance – also on the economy of Belarus. In December 2011, Belarus and Moscow signed a new contract on supplies of Russian oil in 2012–2015. Pursuant to this contract, oil will be supplied to the Belarusian refineries without export duty being imposed and sold at a discount of US$3.7 per tonne in comparison to the oil price at the Rotterdam exchange. The relinquishing of the bonuses charged by Russian suppliers on each tonne of oil was an important concession from Moscow – the value of such bonuses could reach even US$45, which significantly affected the profitability of processing last year. In turn, oil companies from Russia were allowed to receive for their own needs products manufactured from up to 50% of oil supplied by them to Mazyr and Navapolatsk ('tolling'). At the same time, the agreements state that if Belarus exports petroleum products made from Russian oil to countries which do not belong to the Customs Union, Minsk will have to pay export duty to Moscow at the same rate as paid by Russian exporters.

While operating according to the old rules in 2011, the Belarusian refineries were unprofitable and managed to improve their situation only in the last quarter of last year, which allowed them to close the year with a small profit (approximately US$16 million). This was the worst result achieved by the Belarusian petrochemical sector in the past few years.

The new rules of Russian oil supply are much more beneficial than those in force after 2007, when Russia changed the oil supply model which had been applied for many years. This significantly reduced the level of its subsidies for the Belarusian economy[11]. The new four-year contract concerning Russian oil imports means that there has been a partial resumption of Russian subsidies. The average price per barrel paid by Belarusian refineries in the first quarter this year reached US$61 while at the same time the Russian oil Urals cost on average US$115 per barrel on the EU market. The government in Minsk estimates that, owing to the preferential conditions, Belarus has gained between US$0.7 billion and US$1 billion annually. It is still unclear how the need to guarantee that 50% of oil supplied will be processed for the Russian suppliers' own needs will affect the situation of the refineries in Mazyr and Navapolatsk in the longer term. In the first quarter of this year, 30% of oil supplied was processed according to the tolling rule for the needs of oil companies from Russia.

At the same time, everything seems to indicate that the Belarusian government has been abusing the oil preferences obtained from Russia. In 2011, Belarusian exports of solvents and thinners increased several times, and their value reached US$1.5 billion (the main recipient was Latvia). This could not be explained by a sudden increase in the demand for these chemical products, and therefore it was probably an effect of Minsk's forgery of customs documentation, and the 'solvents and thinners' were in fact petroleum products on which Belarus does not need to pay export duty to the Russian budget[12]. This practice has continued this year – according to official data for the first quarter, exports of these substances increased twelve-fold. The Russian government turned a blind eye to this problem for a long time, which may prove that the Russian oil sector also benefited from this scheme. It was only in the past few weeks that the Prime Minister Dmitry Medvedev ordered that actions aimed at clearing up this issue be taken.

**Owing to the preferential conditions, Belarus has gained between US$0.7 billion and US$1 billion annually. At the same time, everything seems to indicate that the Belarusian government has been abusing the oil preferences obtained from Russia and has been forging export documentation to evade the payment of export duty to Russia.**

[11] Before 2007, Russia not only sold oil to Belarus with no customs duty imposed, but also all the export duty imposed on Belarusian petroleum products went to the Belarusian budget. The rules of Russian oil supplies changed several times in 2007–2011, depending on the state of political relations between Minsk and Moscow.

[12] See: Y. Romanchuk, Krizis. Belarus kak territoriya neftebaronov, 29 February 2012, http://naviny.by/rubrics/opinion/2012/02/29/ic_articles_410_177018/

## Possible future developments – is there an alternative to Russian investments?

Maintaining control of the Belarusian oil sector will have a strategic significance for the Belarusian government. It may thus be expected that the privatisation of the two refineries – Russian companies have been seeking for this for years – will still be held back. This will give rise to tension in relations with Russia, the only realistic investor and the sole oil supplier. The scale of such bilateral disputes and their frequency will depend on the political situation in Russia and its priorities in foreign policy. At present, the integration of part of the post-Soviet area is among the main goals of President Putin. Therefore, at least in the next few months, tension is unlikely to be escalated in the main disputes in relations between Russia and Belarus, including regarding the privatisation of the refineries. This also means that the preferential conditions of Russian oil supplies will be maintained (at least in the short term) and that Moscow will continue to tolerate what is most likely the large scale forgery of Belarusian customs documentation. At the same time, despite its criticism of the Belarusian regime for the violation of human rights and the rules of democracy, the EU will not be able to decide to impose a complete ban on imports of petroleum products from Belarus. Given this situation, it may be expected that the present good situation in exports of Belarusian petroleum products to the EU market will continue for a long time. As a result, the Belarusian government will in all likelihood be able to generate the funds necessary to complete the modernisation of the Belarusian refineries. Owing to this, the Belarusian oil sector will have the opportunity to reduce its reliance on Russian preferences, and its production will become more competitive on Western markets.

## APPENDIX

### 1. The share of petroleum products in total Belarusian exports (2005–2011)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|
| Total exports (US$ billion) | 15.9 | 19.7 | 24.3 | 32.5 | 21.3 | 25.2 | 40.2 |
| Exports of petroleum products and oil (US$ billion) | 4.8 | 6.7 | 8.1 | 11.9 | 7.8 | 6.7 | 13.8 |
| % | 24.6 | 34 | 33 | 36.6 | 36.6 | 26.1 | 34.3 |

*Data: Belstat*

### 2. The output of the refineries in Mazyr and Navapolatsk before and after modernisation (millions of tonnes)

| | Mazyr | | Navapolatsk | |
|---|---|---|---|---|
| | 2011 | 2015 | 2011 | 2015 |
| Petrol | 2.16 | 3.0 | 0.96 | 1.7 |
| Diesel oil | 2.75 | 4.7 | 3.9 | 5.2 |
| Heating oil | 2.93 | 0.7 | 2.16 | 0.6 |
| VGO (vacuum gas oil) | 0.21 | 1.1 | 0.52 | 1.12 |

*Data: Argus FSU Energy, 19 April 2012*

OSW
**Centre for Eastern Studies**
Koszykowa 6A,
00-564 Warsaw
e-mail: info@osw.waw.pl

**The Centre for Eastern Studies (CES)** was established in 1990. CES is financed from the budget. The Centre monitors and analyses the political, economic and social situation in Russia, Central and Eastern European countries, the Balkans, the Caucasus and the Central Asia.

**CES focuses** on the key political, economic and security issues, such as internal situations and stability of the mentioned countries, the systems of power, relations between political centres, foreign policies, issues related to NATO and EU enlargement, energy supply security, existing and potential conflicts, among other issues.

**The views expressed by the authors of the papers do not necessarily reflect the opinion of Polish authorities.**



Editors: Adam Eberhardt, Wojciech Konończuk
Katarzyna Kazimierska
Anna Łabuszewska
Translation: Ilona Duchnowicz
Cooperation: Nicholas Furnival
DTP: Bohdan Wędrychowski