



## Why Poland's State Treasury ought to maintain its control over the LOTOS Group?

In March 2011 the LOTOS Group completed “Program 10+”, the greatest projects in Polish economy in the years 1990-2010 and worth almost 6 billion PLN. Investments were made in modern technologies, in the installation of a Crude Distillation Unit (CDU) and Vacuum Distillation Unit (VDU), the installation of hydrocracking and hydrodesulphurization of diesel oil, as well as in tools for processing heavy vacuum residue (ROSE). All the investments have also contributed to an increase in the processing capacity of crude oil from 6 to 10.5 million tons annually. Diesel fuel and aviation fuel saw the greatest increase in the capacity of processing and production, almost doubling from 2.52 million tons (before “Program 10+”) to 5.46 million tons (after the program's completion). The execution of “Program 10+” has largely increased LOTOS Group's competitiveness in Europe.

In the current issue of the “Pulaski Policy Papers” our Research Fellow Mariusz Ruszel analyses the importance of the LOTOS Group for Poland. “Considering the balance of potential benefits and threats resulting from the privatization of LOTOS it should be taken into account whether the privatization of a company strategic to national security is worth a one-time inflow of funds to the budget. Analyzing actions of the largest concerns in the world, it can be concluded that these companies, rather than selling their own assets, would prefer to acquire new ones. Is it in the country's interest to lose control over LOTOS? Is the privatization the only solution to realizing the goals of the company more quickly? Might there not be a different way to define strategic partnership with an international energy concern? Couldn't LOTOS use the acquired concessions and its daughter companies to define this strategic partnership? Making the wrong decision here would have serious long-term negative consequences.”

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**Editorial Staff of the “Pulaski Policy Papers”**

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The Casimir Pulaski Foundation is an independent, non-partisan think tank with a mission to promote freedom, equality and democracy, as well as to support actions of strengthening civil society. The foundation carries out such activities as conducting scientific research, preparing publications and analyses, organizing seminars and conferences, providing education and support for leaders in Poland and abroad. The Casimir Pulaski Foundation is one of only two Polish institutions that have a partnership status with the Council of Europe and is a member of the Group Abroad – an umbrella organization of top 40 Polish NGOs working outside of Poland.

## Mariusz Ruszel

### Mariusz Ruszel

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In March 2011 the LOTOS Group completed “Program 10+”, the greatest projects in Polish economy in the years 1990-2010 and worth almost 6 billion PLN. Investments were made in modern technologies, in the installation of a Crude Distillation Unit (CDU) and Vacuum Distillation Unit (VDU), the installation of hydrocracking and hydrodesulphurization of diesel oil, as well as in tools for processing heavy vacuum residue (ROSE). All the investments have also contributed to an increase in the processing capacity of crude oil from 6 to 10.5 million tons annually. Diesel fuel and aviation fuel saw the greatest increase in the capacity of processing and production, almost doubling from 2.52 million tons (before “Program 10+”) to 5.46 million tons (after the program's completion). The execution of “Program 10+” has largely increased LOTOS Group's competitiveness in Europe.

LOTOS is composed of a few, strategically important companies. Among them are: LOTOS Petrobaltic (the only Polish company extracting in the Baltic Sea) and LOTOS Norge Exploration and Production AS with its headquarters in Norway, which searches and extracts in the North Sea (it possesses eight concessions for exploring and one for extraction). The LOTOS Group has also taken over 100 percent of shares of a Lithuanian company AB Geonafta, thanks to which it got access to crude oil located on the Lithuanian territory. Moreover, in 2011 LOTOS signed a letter of intent with the Przedsiębiorstwo Eksploatacji Rurociągów Naftowych (PERN) „Przyjaźń” about a joint construction of underground tanks for crude oil and liquid fuels. The construction of tanks with the volume of 7 million cubic meters (with the possibility of the volume being increased up to 15-20 million cubic meters) is planned to be accomplished by 2020 in Pomerania. This will serve as an important factor in reinforcing the energy security of the countries in the Baltic region. The construction of the caverns will be partially financed from the EU funds. The company is also planning to cooperate with PERN on its investments of joining the pipeline between Małaszewice and Belarus. Małaszewice is an international port of transshipping for the Polish railway company (reload from the trains with the track width of 1520 mm to 1435 mm).

Moreover, LOTOS Petrobaltic possesses seven concessions for exploration and prospecting of crude oil, conventional and unconventional gas. Russian Gazprom and Italian ENI have expressed their interest in taking over these concessions from LOTOS. The concession for production of crude oil and gas from B8 expires only in 2031, whereas B4 and B6 in 2032. LOTOS is interested in other concessions i.e. Słupsk W, Słupsk E, Ustka and Smołdzino.

The development strategy of the LOTOS Group for years 2011-2015 assumes an increase in crude oil extraction to the level of 5 million tons annually, gaining 30 percent share in the domestic oil industry and a 15 percent higher sale than its own production. It is worth underlining here that the LOTOS Group is a major advocator and a founding member of the Central Europe Energy Partners (CEEP) association, which operates in Brussels. LOTOS has also got a few concessions for unconventional exploring of gas in Poland. The company generates an increasing amount of profit which in 2011 is estimated to reach almost one billion PLN. At present, the State Treasury possesses 53.19 percent of shares of the LOTOS Group.

### Who is interested in the privatization of LOTOS?

As recently as 2000 a British company Rotch Energy Ltd was interested in the privatization

of LOTOS (until 2003 LOTOS operated under the name Gdańsk Refinery), and gained exclusive rights to negotiate. Negotiations were completed in September 2001, and the contracts of acquiring shares were initialed. However, the introduction of another industry partner, Lukoil, resulted in the privatization not taking place. The Russian company was interested in gaining full control. In October 2002 Rotch Energy Ltd found another industry partner, PKN Orlen, with which it created a consortium. Finally, in July 2003 the consortium was informed that their offer had been declined. In 2004 Russian Lukoil expressed an interest in the privatization of LOTOS, indicating that it wished to take a controlling stake but leaving the so-called 'golden share' in the hands of the Polish government. Over the next few years LOTOS completed a program of consolidation, entering the stock exchange, and taking over Petrobaltic's shares to raise its initial capital.

At present, companies from all over the world are interested in privatization, amongst them the third biggest fuel concern in Russia TNK-BP. The ownership structure of TNK-BP is as follows: 50 percent belongs to British BP, the remaining 50 percent to Russian companies (25 percent to Alfa Group owned by an oligarch Mikhail Fridman, 12.5 percent to Renova owned by an oligarch Viktor Vekselberg, and 12.5 percent to Access Industries owned by an oligarch, Leonard Blavatnik). The companies most interested in the privatization of the LOTOS Group are as follows: Russian Gazprom Neft, Kazakh KazMunaiGaz, China's National Petroleum Corporation, the American companies ConocoPhillips, Chevron and Exxon Mobil, Hungarian MOL, French Biosyntec, Polish PGNiG, Klesch & Co, a capital fund from London, and private equity funds from the Middle East and the U.S. It is worth noting that private equity funds may place an offer in a consortium where other funds or a company-investor are placed, which makes a clear identification of the actual actors difficult. In June 2011 the Ministry of Treasury chose four investors with whom negotiations will be continued. The final selection will be done at the turn of 2011 and 2012, if the investor meets the requirements imposed by the Ministry of Treasury, and if it gets approval of the Council of Ministers.

### **Why does the Russian Federation want the LOTOS Group?**

Russian concerns have been interested in the privatization of LOTOS for a few years now. There is a certain regularity here: the companies which express interest in gaining LOTOS have good relations with the Kremlin. There are a few reasons for Russia's willingness to take over LOTOS.

First of all, the refinery in Gdańsk enjoys a perfect, strategic location, and due to "Program 10+" it is one of the most modern refineries in Europe with annual output capacity of 10.5 million tons of crude oil. The Russian Federation is in possession of crude oil resources which could be transported to the refinery using the "Przyjaźń" pipeline or by sea using Primorsk oil port.

Secondly, LOTOS takeover is in alignment with the Russian strategy of economic expansion. One should note that Russia is also seeking a takeover of a refinery in Mažeikiai (with an annual output capacity of 10 million tons of crude oil), which it wants to buy from PKN Orlen, and refineries in Belarus. At present, the Russian Slavneft holds 42.5 percent of the shares of a refinery in Mazyr. Russia is seeking to take over the remaining shares of Mazyr refinery and the second largest Belarusian refinery – Naftan in Navapolatsk (with an annual output capacity of 12 million tons of crude oil). At the same time a takeover of refineries in Poland, Lithuania and Belarus may have a negative impact on energy security of Poland and other countries in Central and Eastern Europe.

Thirdly, the LOTOS takeover opens the way to another takeover in the Polish fuel sector – PKN Orlen in Płock. Russia possesses crude oil resources which it can deliver at competitive prices to a newly-acquired refinery and start a 'price fight' on the Polish market

to attract customers. In theory such a situation would benefit future customers due to the lower prices of fuels. Nonetheless, PKN Orlen might be affected in the long run; its shares might fall, consequently worsening its financial standing. A LOTOS takeover would also enable Russia's further expansion in Central and Eastern Europe.

Fourthly, LOTOS takeover would enable fuel to be sold by sea to the markets in Scandinavia, Western Europe and the U.S. More significantly, LOTOS is the only Polish company receiving oil by sea through Naftoport in Gdańsk, i.e. being a monopolist in this respect.

Fifthly, LOTOS holds attractive assets and concessions which are a subject of interest of the Russian Gazprom.

### **What is the point in privatizing LOTOS?**

The privatization of LOTOS is the subject of much political discussion. Opinion is divided over this issue. In April 2011 the Parliamentary Treasury Committee opted for the privatization of LOTOS rejecting one of the opposition parties' proposition to abort this idea. Perhaps it should be asked here: what are the arguments for the company's privatization?

First of all, privatization aims to gain a strategic investor who will ensure the company a competitive development on the national and foreign markets. The company's capital would be increased giving the possibility of a more dynamic development.

Secondly, the State Treasury wants the investor to complete the tasks which result from the company's strategy, i.e. invest in its development as well as in exploration and extraction of crude oil. The realization of these goals without a partner or partners from abroad would be very difficult as it would require substantial financial resources.

Thirdly, competitive firms from oil sector have been developing rapidly, therefore LOTOS, in order not to stay behind, should also complete its strategic goals more quickly.

Fourthly, the shares belonging to the State Treasury are estimated to be worth about 3 billion PLN. Privatization of these assets could give a substantial financial boost to the Polish budget.

### **Summary**

Considering the balance of potential benefits and threats resulting from the privatization of LOTOS it should be taken into account whether the privatization of a company strategic to national security is worth a one-time inflow of funds to the budget. Analyzing actions of the largest concerns in the world, it can be concluded that these companies, rather than selling their own assets, would prefer to acquire new ones. Is it in the country's interest to lose control over LOTOS? Is the privatization the only solution to realizing the goals of the company more quickly? Might there not be a different way to define strategic partnership with an international energy concern? Couldn't LOTOS use the acquired concessions and its daughter companies to define this strategic partnership? Making the wrong decision here would have serious long-term negative consequences.

### **Recommendations for Poland in the case of privatization being aborted**

1. Poland's strategic interest is to maintain control over the LOTOS Group and all the assets belonging to the company.
2. All the daughter companies and acquired concessions for the exploration and extraction of crude oil and natural gas account for company's assets, thus facilitating the development of the right strategic cooperation with an international fuel concern, simultaneously

strengthening LOTOS's position in the region of the Baltic Sea.

3. LOTOS should inspire international cooperation using CEEP base in Brussels, lobbying for acquiring support and financial resources to realize developmental and infrastructural projects in Central and Eastern Europe.

4. LOTOS should form a strategic partnership with an international concern with its primary aim to extract unconventional natural gas from the resources located in the Baltic Sea. Partnership with Great Britain cannot be excluded here (it possesses unconventional natural gas in the North Sea) or with Norway (it possesses extensive experience and technologies). A possible agreement should be accompanied by the signing of appropriate contracts which would guarantee outlets for selling gas in case of its industrial extraction.

5. Further takeovers in Central and Eastern Europe are in LOTOS's interest so that it could strengthen its position in the world markets.

### **Recommendations for Poland in the case of the decision on privatization being made**

1. One should consider whether the present quotation of the value of the company's assets in the situation of financial crisis is optimal. The company has successfully realized the investments of "Program 10+", becoming one of the most modern refineries in Europe, and generating net profits.

2. In the case of privatization, maintaining control over daughter companies should be considered, i.e. Petrobaltic, Norge Exploration and Production AS, AB Geonaftha and Naftoport (8.97 percent of shares belongs to LOTOS; they should then be bought out by PERN). In the case of privatization, withdrawing the assets of these companies from privatization processes should also be considered. In such circumstances the control over concessions belonging to LOTOS should be maintained.

3. It is in Poland's interest to maintain absolute control over energy and logistical infrastructure which belongs to or is dependent on LOTOS (including the planned building of warehouses of liquid fuels in the Pomerania).

4. In the case of privatization, the acquisition of shares of a strategic investor privatizing LOTOS should be considered.

5. Poland should take into account the Russian doctrine of rebuilding influence in Central and Eastern Europe using instruments from the energy sector. Russia's taking over of LOTOS, i.e. increasing its domination in Poland's strategic energy infrastructure would introduce an element of risk in terms of energy security of the country and its political independence. In the case of a takeover by a Russian investor, additional tightening and guarantees should be considered as well as decreasing the number of shares subject to privatization.

6. Before the decision on privatization is made, Poland should aim to reinforce product exchange contracts on the Polish fuel market. This could be done, for example, through the development of logistical infrastructure while maintaining full control.

## The Casimir Pulaski Foundation

is an independent think tank which specializes in foreign policy, with a mission to promote freedom, equality and democracy, as well as to support actions of strengthening civil society. The foundation carries out activities both in Poland and abroad, among others in Central and Eastern Europe and in North America.

The Casimir Pulaski Foundation was founded due to political changes that took place in Poland after 1989. The principal values of Casimir Pulaski (freedom, justice and democracy) are an inspiration for every initiative undertaken by the Foundation. A few of the Foundations activities include: conducting scientific research, preparing publications and analyses, organizing seminars and conferences, providing education and support for leaders ([www.institutprzywodztwa.pl](http://www.institutprzywodztwa.pl)).

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