Energy Dependency, Politics and Corruption in the Former Soviet Union

Russia's power, oligarchs' profits and Ukraine's missing energy policy, 1995–2006

Margarita M. Balmaceda

Routledge
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Energy Dependency, Politics, and Corruption in the Former Soviet Union

> Margarita Balmaceda has done pioneering research into the development of energy trade in Eurasia since the collapse of communism. This book is a major contribution to our understanding of the ways in which the energy relations of the post-Soviet states have enriched elites in both energy-producing and energy-consuming countries at the expense of transparency and balanced economic growth. It highlights how the energy magnates in Russia and Ukraine are interconnected in ways that defy conventional concepts of national interest and sovereignty and suggests that we re-examine our understanding of energy security in this strategic part of the world.
>
> (Angela Stent, Director, Center for Eurasian, Russian and East European Studies, Georgetown University)

Energy has become a major element to Russia's attempts, under Putin, to restore its influence over former Soviet territories and reaffirm itself as the dominant regional power. This book investigates how Russia has manipulated its neighbors' dependency on Russian energy supplies to achieve its own foreign policy goals, focusing in particular on relations with Ukraine. Based on a multitude of primary Ukrainian and Russian sources until now not brought to the attention of Western readers, it examines important events such as Russia's January 2006 suspension of gas supplies to Ukraine, and the implications for Ukraine's "Orange Revolution," other post-Soviet states and Western Europe. The case of Ukraine provides a taste of what might be in the horizon for other European states given Russia's ability and renewed willingness to use the energy weapon. However, the book goes further in showing how domestic political conditions in the post-Soviet states may facilitate Russia's use of energy as a foreign policy weapon, investigating the local groups that often receive significant profits from allowing Russia to control energy markets and energy transit possibilities. With European countries becoming more dependent upon Russian energy, this book will be of interest not only to Russian studies and Eastern European studies experts, but to scholars of international relations and European politics.

Margarita M. Balmaceda is Associate Professor in the John C. Whitehead School of Diplomacy and International Relations, Seton Hall University, and an Associate of the Harvard Ukrainian Research Institute and of the Davis Center for Russian and Eurasian Studies at Harvard University. Her publications on Russian, post-Soviet and East European politics, include, as editor, *On the Edge: the Ukrainian-Central European-Russian Security Triangle* (2000) and *Independent Belarus: Domestic Determinants, Regional Dynamics and Implications for the West* (2002). She has taught and conducted research extensively in the Central-East European region, including through Fulbright, Humboldt Foundation, and other grants in Russia, Ukraine, Belarus, Hungary, and Lithuania.

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2008
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Simultaneously published in the USA and Canada
by Routledge
270 Madison Ave, New York, NY 10016

This edition published in the Taylor & Francis e-Library, 2007.

"To purchase your own copy of this or any of Taylor & Francis or Routledge's
collection of thousands of eBooks please go to www.eBookstore.tandf.co.uk."

Routledge is an imprint of the Taylor & Francis Group,
an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available
from the British Library

Library of Congress Cataloging in Publication Data
Balmaceda, Margarita Mercedes, 1965–
Energy dependency, politics and corruption in the former Soviet
Union : Russia's power, oligarchs' profits and Ukraine's missing energy
policy, 1995–2006 / Margarita M. Balmaceda.
p. cm.—(Basees / Routledge series on Russian and East European
studies ; 37)
Includes bibliographical references and index.
1. Energy policy—Russia (Federation) 2. Energy policy—Ukraine.
3. Russia (Federation)—Foreign relations—Ukraine. 4. Ukraine—
Foreign relations—Russia (Federation) I. Title.

HD9502.R82B36 2007
333.790947'090511—dc22 2007013949

ISBN 0-203-93434-2 Master e-book ISBN

ISBN10: 0–415–43779–2 (hbk)
ISBN10: 0–203–93434–2 (ebk)

ISBN13: 978–0–415–43779–0 (hbk)
ISBN13: 978–0–203–93434–0 (ebk)

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Acknowledgments

Work on this book was conducted in the United States, Germany, and Ukraine, and I owe a great debt of gratitude to the many colleagues and institutions in these three countries which made this work possible. This project would have been impossible without the support of the John C. Whitehead School of Diplomacy and International Relations at Seton Hall University, the Davis Center for Russian and Eurasian Studies at Harvard University and the Harvard Ukrainian Research Institute (HURI). The Whitehead School, my academic home, has provided a supportive and free atmosphere for the development of my work, and I thank my colleagues for their generous support over the last seven years. I am specially grateful to my colleague Courtney Smith, Associate Dean for Academic Affairs, and to Deans Paul Holmes and John Menzies, as well as to Robert De Martino of the Office of Grants and Research Services for their support and understanding of the importance of field research in Eastern Europe. Our secretary Susan Malcolm's great skill in diffusing many a day-to-day crisis helped me return promptly to the writing table. Many of the ideas developed in this book were discussed in a spring 2006 graduate seminar on Foreign Policies of Russia and the Post-Soviet States at the Whitehead School, and I remain indebted to our students for providing a critical forum for their discussion. At Harvard, the Davis Center and the Ukrainian Research Institute have been central to my work, and I thank their directors Timothy Colton (Davis Center), Roman Szporluk, and Michael Flyer (HURI) for their warm welcome throughout my years as Associate at both institutes. Lubomyr Hajda of HURI and Lisbeth Tarlow of the Davis Center deserve special thanks for their friendship, long-term support, and crucial advice at critical moments. The participants of the Workshop on Post-Communist Politics and Economics at the Davis Center, and, in particular, Yoshiko Herrera, Jeronim Perović, Oxana Shevel, and Benjamin Smith, provided insightful comments on two papers related to this book project. I also thank Yaryna Yakubyak for copyediting the Ukrainian and Russian portions of the manuscript, and Scott Walker, Digital Carthographer at the Harvard Map Collection for his many hours of work in creating the maps for this book. Angela Stent, Director of the Center for Eurasian, Russian, and East European Studies at Georgetown University graciously agreed to read and comment on the whole manuscript.

The International Research and Exchanges Board (under Title VIII funding from the US Department of State) and the Fulbright-Hays program of the

US Department of Education provided crucial support for field research in Ukraine. Research for this book was also supported by the Title VIII Combined Research and Language Training Program, which is funded by the US State Department and administered by the American Councils for International Education: ACTR/ACCELS. The opinions expressed herein are the author's own and do not necessarily express the views of any of the funding organizations.

The Ukrainian Center for Economic and Political Studies (Razumkov Center) in Kyiv, where I spent nine months of field research, deserves special recognition. In Kyiv, Volodymyr Dubrovs´ky, Volodymyr Kulyk, Volodymyr Saprykin, and Olena Viter provided invaluable help and enlightening discussions. I am especially indebted to Volodymyr Saprykin, Director of the Razumkov's Center Energy Program, who offered very insightful advice throughout my work in Kyiv, and read and commented on Chapters 1 through 7 and an earlier version of Chapter 8. Ulrike Straka's multifaceted help during my stay in Kyiv greatly contributed to its success. Valentyna Nevoit of Kyiv University, who quickly understood my thirst for "all energy, all Ukrainian, all the time," helped me to become fluent enough in Ukrainian as to prepare my first energy paper presentation without fear, and remains the best language teacher I have ever had.

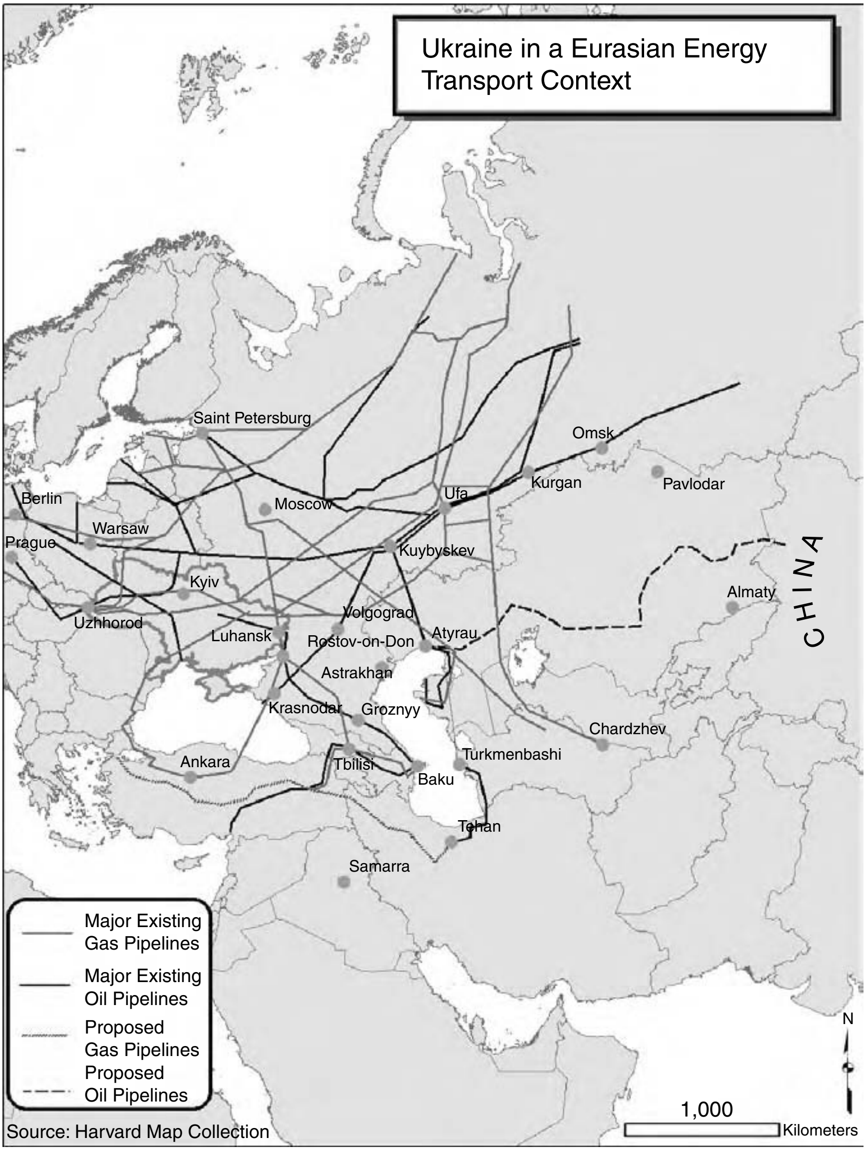
The actual writing of this book was made possible by a Fellowship from the Alexander von Humboldt Stiftung in Germany and conducted at the Justus-Liebig-Universität Gießen and the Deutsche Gesellschaft für Auswärtige Politik (DGAP) in Berlin. (An earlier version of the analytical framework was developed during a previous visit as Guest Scholar at the Mannheimer Zentrum für Europäische Sozialforschung, Universität Mannheim, for whose generous support I remain deeply indebted.) I thank my German colleagues Sabine Fischer of the Stiftung Wissenschaft und Politik and the Institute for Security Studies of the European Union, Astrid Sahm of the Internationale Bildungs-und-Begegnungsstätte "Johannes Rau" (IBB) in Minsk, Manfred Sapper and Volker Weichsel, editors of the journal *Osteuropa*, Susan Stewart of the Stiftung Wissenschaft und Politik, and Kirsten Westphal of the Universität Gießen—where she also excelled as my host—for making my stays in Germany productive and interesting ones, and for countless interesting discussions and useful comments. Seminar presentations at a number of German universities, but especially at the Interdisciplinary Research Group on Transition and Transformation (IRTT) organized by Kirsten Westphal at Gießen and at the Forschungsstelle Osteuropa at the Universität Bremen, organized by Heiko Pleines, greatly helped me clarify my perspective on the main issues of the book. Heike Zanzig and Alexander Rahr made possible six weeks of very interesting work at the DGAP in Berlin. I thank Egbert Jahn, Professor Emeritus of Political Science at the Universität Mannheim, and Reimund Seidelmann, Professor of Political Science at the Justus-Liebig-Universität Gießen, for their support of my project, and for opening the doors of their universities as hosts for my Mannheim and Humboldt Foundation fellowships, respectively.

I am greatly indebted to my friends and family for their support. Srinivas Gandhi and Luis Girón provided invaluable help in streamlining a summary of the argument. Marianne Sághy kept me informed at the most critical points in Ukrainian-Russian energy relations while I was half-way across the world. My parents'—Eudoro Balmaceda and Margarita Sastre de Balmaceda—unwavering belief in the importance of advanced training in Eastern European languages is the basis without which this project could not have emerged.

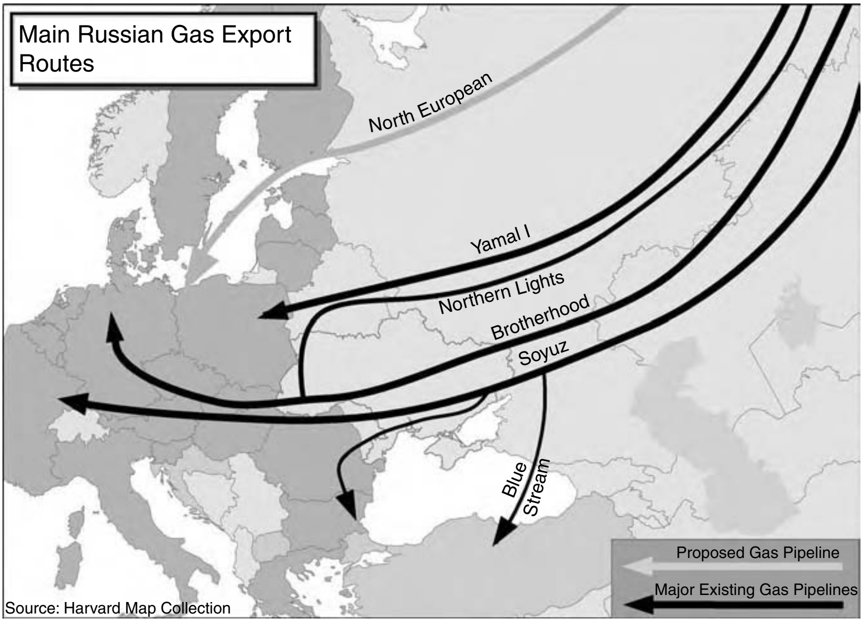
Last but not least, it is no exaggeration to say that this book would never have come to be without the steadfast help, support, and advice of Maren A. Jochimsen, whose own commitment to her work devoted to unveiling the economic aspects of caring activities and their impact on economics, and to the advancement of women scholars has been a great inspiration. From our first conversations at Harvard in 1997, to memorable energy-and-french-fries discussions against the backdrop of the Zeebrugge gas terminal in Belgium, to the day-long breakfast at Gießen where the work plan for this book was born, she has never been afraid to ask the toughest questions, and has been a constant source of energy, good humor, and very practical support in all my work. This book is no exception, though all responsibility for errors remains my own.

Note on transliterations

Transliteration of Russian- and Ukrainian-language materials was done using the US Library of Congress transliteration system. For the few words for which there is a standard English-language usage (Yeltsyn, RosUkrEnergo, among others), this has been used, instead of the Library of Congress transliteration system. As personal names are spelled differently in Russian and Ukrainian, for persons whose names appear both in Ukrainian and Russian in the book, after the first usage of the name, any other name associated with that person is added in parenthesis.



Map 1 Ukraine in a Eurasian energy transportation context.



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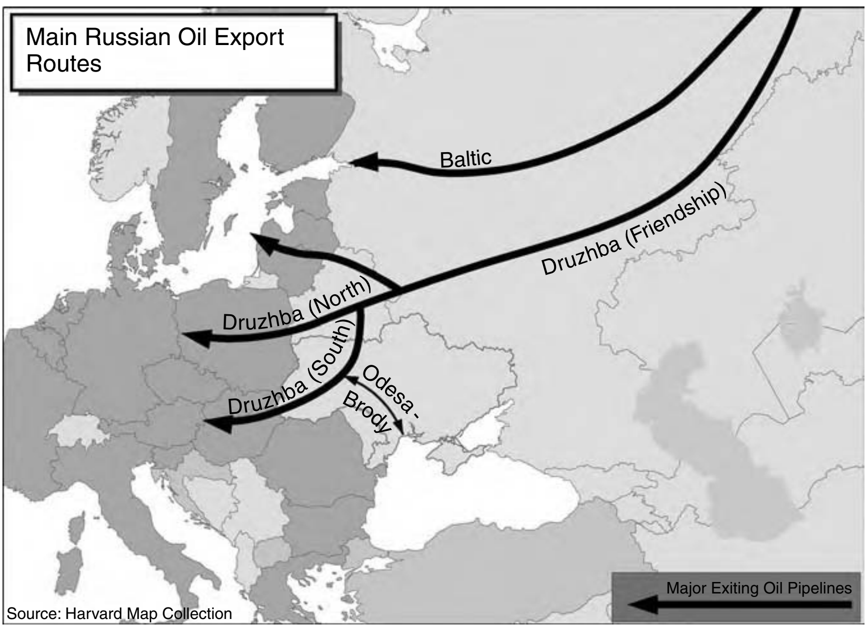

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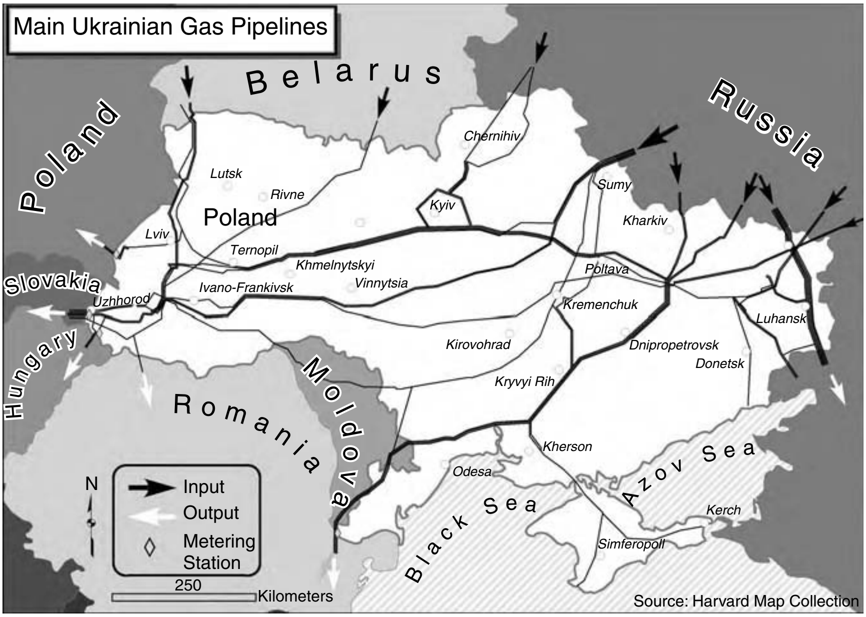

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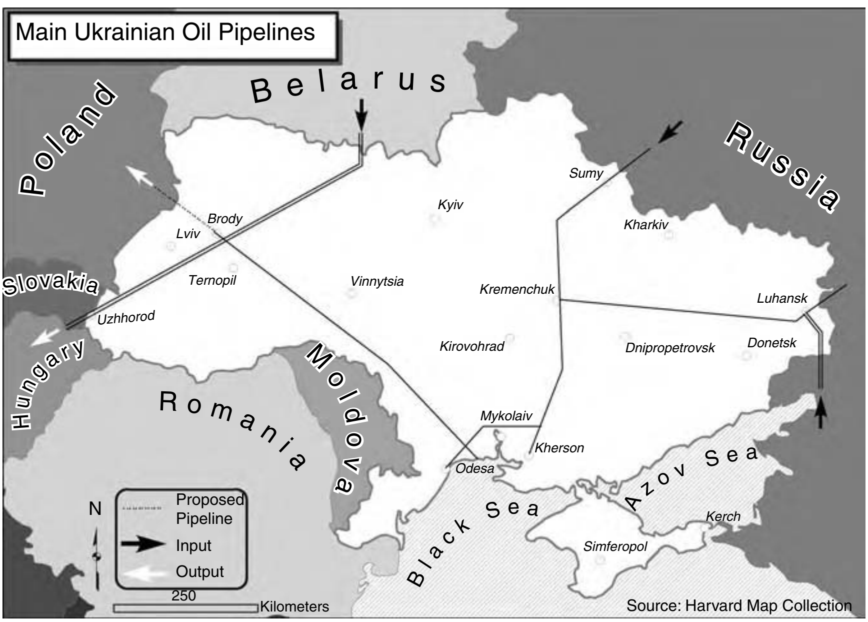

Map 5 Main Ukrainian oil pipelines.

1 Introduction

Energy, integration and disintegration in the former USSR

The post-Soviet context

Cheap and abundant energy supplies were like a bonding agent that kept the Soviet Union together; energy supplies and interdependencies have also been central to the processes of both separation from the center and reintegration in the former USSR.

In the last years, much Western attention paid to the international relations of Central-East Europe (CEE) and the Former Soviet Union (FSU) has concentrated on strategic and military issues. Yet such emphasis has underestimated the importance of economic relationships between Russia and its former allies. Nowhere is this importance as clear as in the energy area. If we look only at NATO expansion, we may think Russia is "retreating" from the Central-East European area. Yet from the Baltic ports in the North to Bulgaria in the South, Russian energy supplies and Russian energy companies are making their presence felt in ways that can have a deep impact on the local economies. Nothing made this as patently clear as Russia's January 2006 suspension of gas supplies to Ukraine, which also affected gas supplies to Europe and left European Union (EU) states wondering whether Russia's dominance of energy markets in the former USSR had not gone too far and could come to threaten their economic security as well. In January of 2007, a three-day interruption of Russian oil supplies to Hungary, the Czech Republic, Slovakia, and parts of Germany, resulting from Russia's stoppage of shipments via Belarus in the wake of a confrontation with that country on transit duties and fees, made Europe realize even more fully the vulnerabilities created by the lack of energy imports diversification.

For many of the former Soviet republics, the energy issue is literally the number one question—it directly affects their daily economic situation, their domestic politics, and their relationship with their main international partners. This is especially so for those eight energy-poor states which remain largely dependent on imports from Russia: Belarus, the three Baltic States, Moldova, Armenia, Georgia, and last but not least, Ukraine.[1] Thus, energy dependency emerges as a central reality in the lives of most post-Soviet states. The question is: how do these states manage and deal with it? This is the main topic of this book—how domestic political circumstances affect the management of energy dependencies. As will be seen throughout this book, domestic processes have been central to facilitating Russia's use of energy for foreign policy purposes through the maintenance of old dependencies and establishment of new ones.

Energy issues have been central both for conflict in the former USSR, and for Russian-led reintegration attempts. In the post-Soviet region, energy issues have been closely related to conflict at both the inter-state and domestic levels: conflicts over access to oil and gas markets and supplies; conflicts over energy transit; and conflicts over the distribution of economic gains—and, conversely, the apportionment of losses—from energy trade, transit, and domestic sales. These are important conflicts with not only considerable strategic and international relations implications, but also conflicts that cannot be understood by looking only at the level of state-to-state relations—in many of the post-Soviet states what we see is not national states domestically united in fighting to overcome their energy dependency on Russia, but a multiplicity of competing interest groups, both domestic and foreign, all trying to make a profit out of this situation of dependency.

Of all the issues related to energy in the post-Soviet dissolution-and-reintegration dance, three have been especially important for the energy-dependent states: First, Russia's ability to create new dependencies in addition to the infrastructural dependencies inherited from the Soviet Union by being able to control, not only the sales of its own gas and oil, but, increasingly, transit services and also the sale of Central Asian gas to these countries. Second, Russia's manipulation of post-Soviet energy dependencies for the pursuit of foreign policy goals. And, third, the effects of domestic conditions (first and foremost corruption) on the post-Soviet states' ability to manage their energy dependencies.

Creating new energy dependencies

The post-Soviet states inherited from the Soviet energy system a number of features that would significantly affect their ability to deal proactively with energy issues after independence. While the most obvious of these dependencies are infrastructural (the system of oil and gas pipelines centered on Russia and the fact that the energy-poor states lack direct energy transport connections with non-Russian energy producers, so that, even when able to buy oil and gas from other suppliers, those would most likely need to go through Russian pipelines), these are not the only ones. Other important legacies have to do with the fact that some oil and gas reserves located outside Russia were not developed, the fact that the republics had little control over the oil and gas infrastructure within their borders[2] (infrastructure which was controlled directly by ministries in Moscow), and the fact that their overall development strategy was based on an assumption of energy-abundance—reflected in heavy energy subsidies and unrealistically low energy prices that had little to do with real production and recovery costs—that privileged inefficient energy-intensive industries, industries which have little chance of survival under energy-poverty and market economy conditions.[3] To these dependencies Russia has been able to add new ones in the post-Soviet period, sometimes with the help of domestic players in the energy-poor countries themselves. The clearest examples of these new types of dependencies have to do with the issue of market control and of contractual diversification, and control over transit infrastructure.

Russia's role as monopsonist and its effects on contractual diversification

Ukraine and other energy-poor FSU states have sought to diversify their energy supplies, especially through the buying of oil and gas from Central Asia (CA) and the Caspian area. But geographical diversification per se has little meaning if contracts are monopolized by a single company. Indeed, Russia's role in hindering contractual diversification brings to the fore the importance of distinguishing between the various components of energy diversification—energy source diversification, geographical diversification, and contractual diversification.[4] In the last years, Russia has been increasingly using Central Asian gas to compensate for its own dwindling gas production, so that it can fulfill its contracts with Western Europe, in the process buying up or controlling the marketing of most of the CA states' gas exports.[5] In doing so, Russia is strengthening its role as both monopolist seller (in the sale of gas to Ukraine, the Baltics, Belarus, and Armenia among others) and monopsonist (in the purchase of gas from Turkmenistan and other CA states; in January 2006, Gazprom, Russia's giant gas monopolist producer, marketer and exporter began purchasing the totality of Turkmenistan's gas exports, much of which is re-sold to Ukraine). What these new roles mean is that when Ukraine buys gas "from Turkmenistan," the gas may have been produced in Turkmenistan, but its marketing has been controlled by Gazprom.[6] This largely neutralizes the positive effects of geographic diversification.

A short excursus is needed on Russia's role as a near-monopsonist buyer of Central Asian gas, a topic that has received little attention in the West. By involving states such as Turkmenistan and Uzbekistan in contracts by which they sell to Russia most if not all of their exportable production,[7] Russia is simultaneously pursuing three goals: First and most importantly, to prevent competition from Central Asian gas in Western European markets by marketing this gas itself, while receiving the additional benefit of using CA gas to compensate for missing Russian supplies necessary to fulfill contracts with Western European partners. Second, to delay and counteract the building of new pipelines that would allow the CA states to sell their energy directly in Western markets.[8] Third, to prevent states such as Ukraine from truly diversifying their energy supplies. Russia's role as a monopsonist buyer of Central Asian gas also involves domestic factors and political interdependencies; indeed, one of the reasons Russia has been able to secure these contracts, and at favorable prices, has been not only CA's lack of alternative export pipelines bypassing Russia, but also the fact that the Russian government has provided significant political support to these regimes despite their poor human rights records.[9] Although beneficial to Gazprom in the short term, the personalization of the gas trade relationship around concrete leaders such as Turkmenistan's President

Saparmurad Niyiazov (Turkmenbashi) leads to unpredictability in the medium and long-term, as was seen clearly through the instability created by Niyiazov's death in December 2006.

Transit infrastructure

A second area where new dependencies are emerging has to do with control over transit infrastructure. A Russian-centered pipeline infrastructure was one of the most important legacies of the Soviet period, and the fact that most oil and gas pipelines cross Russian territory gives Moscow significant power. Russia has refused to ratify the Energy Charter Treaty[10] providing for negotiated third-party access to pipelines, and has not been shy to use its control over pipelines crossing its territory, as when it refused Ukraine the transit of Central Asian gas in 2000, or refused to transit Kazakh oil to Georgia in 2005.

After the dissolution of the USSR, each new state gained ownership over the pipelines crossing its territory, which, while not eliminating their dependency on pipelines crossing Russia, gives transit states such as Ukraine, Belarus, and Moldova the possibility of affecting Russia's gas and oil exports, and thus provides them with a means of counteracting Russia's own flexing of its pipeline muscle. Because energy exports are so important and profitable for Russia, it has tried to counter this trend, and has sought to take control of the oil and gas transport infrastructure located in the former Soviet republics. In the cases of Moldova and Armenia, Gazprom has already been able to gain significant control over these countries' gas transit systems.[11] Similarly, after Gazprom threatened to sharply increase gas prices to Armenia in 2006, one of its demands in order to limit the new price to $110 per 1,000 cm (cubic meters) was giving the company significant control over the construction of a gas pipeline from Iran, a cause of concern for Russia as it could reduce not only Armenia's, but also Georgia's and Ukraine's dependence on Russian gas and create competition for Russian—or Russian-marketed—gas in Europe.[12] In November 2006, Armenia and Gazprom reached an agreement increasing the latter's share in ArmRosGazprom, the pipeline's operator, to 58 percent.[13]

Even in the case of the Baltic states, which like no others have embraced political and economic reform and Western institutions, Russian oil companies and Gazprom retain important positions, with most of the area's oil and all of its gas imports still coming from Russia.[14] As of 2006, Gazprom owned 37 percent of shares of the fully privatized Estonian national gas company AS Eesti Gaas (which owns the country's gas transportation system), 34 percent of Latvia's Latvijas Gaze,[15] and 37.1 percent of Lithuania's Lietuvos Dujos.[16]

But even in the cases where it has not been able to gain control of the transit infrastructure per se, Russia has been able to partially compensate for this by gaining control of important transit infrastructure in a piecemeal but not insignificant fashion by using intermediary firms to gain control of important transit activities (such as port services and the building of new pipelines that would not be part of state-owned gas and oil transit networks[17]), and to control the sale of third-party gas to energy-dependent states.

What is especially interesting about these new dependencies is that they have often been facilitated by the participation of local partners in the countries involved. This raises the question of how domestic conditions affect the management of the energy dependency relationship with Russia, a topic we return to after a brief discussion of Russia's new energy assertiveness.

Exploiting interdependency: Moscow's growing control of energy industries and Russia's use of energy as a foreign policy tool

Energy issues play an overwhelming role in all the post-Soviet states' relationships with Russia, and energy dependency has often been used—directly or indirectly—by Russia as a foreign policy tool in those relationships. By keeping these states tied to Russia, energy dependency has also helped maintain a number of other dependencies on Russia that have often hindered the development of broader relationships with Western institutions.

Throughout the post-Soviet area, we see important interdependencies affecting the energy relationship with Russia. In some cases, these interdependencies have to do mainly with energy transit (as in the case of Ukraine, Belarus and, to a lesser extent, the Baltics and Moldova); in other cases, these have to do more with political (Belarus, Moldova) and strategic (Belarus, Georgia, Armenia) factors. In all these areas, the energy relationship with Russia has been both—depending on the occasion—moderated and/or exacerbated by these larger interdependencies.

At the level of political and broader economic interdependencies, the best example is provided by Belarus, where Russia has been supplying gas at lower than market average prices[18] in exchange for political loyalty in a context where Belarus remains one of Russia's few remaining allies in the wake of NATO and EU expansion.[19] Russian energy subsidies account not only for President Aliaksandr Lukashenka's political survival, but for the very survival of the unreformed Belarusan economy.

With or without energy subsidies, Russia remains an important economic player in the region, be it through its importance as a market, as a provider of imports and investments, or through the stabilizing role played by labor migration to Russia, as worker remittances make an important contribution to many cash-strapped post-Soviet economies.[20] Georgia's economic dependence on Russia as a market became painfully clear in 2006, when a politically motivated Russian ban on the importation of Georgian wine and mineral water, two of the country's largest exports, dealt a major blow to the local economy.[21]

Strategic interdependencies also complicate post-Soviet energy relationships. We should not forget that many in Russia see Ukraine as a "buffer" between an expanding NATO and Russia, and that many in Ukraine itself (especially in Eastern Ukraine and Crimea) see a strong relationship with Russia as essential for balancing-out what they perceive as a growing encroachment by NATO and the

West. Although moving toward a pro-Western foreign policy course since 2003, Moldova is almost totally dependent on Russian energy, and also politically linked to Russia through the latter's role as supporter of the unrecognized Transdniester republic and possible intermediary in the conflict. Armenia's interdependency relationship with Russia goes well beyond energy and into strategic issues, as Russia's main ally in the volatile Caucasus region. For Armenia, economically exhausted from the protracted conflict with Azerbaijan over Nagornyi Karabakh and long under an economic blockade from its oil-rich neighbor, military support from Russia is essential. While on much more conflictual terms with Russia since 2003's "Rose Revolution," Georgia is strategically important to Russia due to its proximity to Chechnia and its possible use as base by Chechen insurgents.

At the level of energy transit interdependencies, Russia depends on transit through Ukraine and Belarus for the profitable export of most of its oil and gas to Western European markets, which provides Russia with its largest source of foreign currency income. Although much less significant in absolute terms, transit through Moldova plays a central role in Russia's gas exports to Romania, Bulgaria, and Greece.[22] Before Russia's oil pipeline monopolist Transneft stopped shipping oil for export by pipeline through the Latvian port of Ventspils in 2003, Latvia derived significant revenues from this transit role; although the port sought to regain market share by shifting to shipments of oil and oil products to it by railway freight, Transneft's termination of oil shipments made the port lose two-thirds of its business, and deprived the country of significant income.[23] Despite the Ventspils blockade, the transit of Russian oil and oil products by rail was reported to bring Latvia \$1.7 billion in annual income by 2005, equivalent to 30 percent of its annual budget.[24]

At the same time, transit is an important factor moderating the relationship of energy dependency on Russia, as transit countries could—at least theoretically—make use of the threat of transit disruption as an instrument of pressure on Russia. It is not surprising, thus, that since the mid-1990s Russia has sought to build additional pipelines bypassing states considered as troublesome transit partners, be it Ukraine or, more recently, also Belarus and Poland.[25] These interdependencies, however, do not change the fact of these states' energy dependency on Russia, a dependency that exists at the contractual, energy source,[26] as well as at the specifically geographical level.

Changes in Russian domestic as well as foreign policies since Vladimir Putin's coming to power in 2000 have once again brought to the fore the question of Russia's use of energy as a foreign policy tool and, more specifically, as a means for post-Soviet (re)integration on Moscow's terms. The dramatic changes in Russia's domestic energy landscape since 2000, taking place against the backdrop of rapidly rising world oil and gas prices,[27] have strengthened the Russian government's ability to use oil and gas deliveries as instruments of political pressure.[28] While the energy-poor states continue to be internally divided, Russia has become increasingly centralized in energy matters. If by 1996 Russia's energy sector had emerged from the privatization process with the former oil monopolist largely privatized and divided among around ten partially privatized companies, and with the former

Ministry of Gas Production, now reshaped as AO Gazprom, retaining its monopoly but with only a plurality of state-owned shares, ten years later the situation had changed drastically.[29] Nothing served as a clearer sign of these changes as the arrest of Yukos'—until then Russia's largest oil company—CEO Mikhail Khodorkovskii in October 2003. By December of 2004 Yukos had been largely destroyed, with much of its property passing to state hands. In September 2005, one of the few remaining Russian oligarchs, Roman Abramovich, under pressure from the Kremlin, sold a majority stake in Sibneft′, Russia's fifth-largest oil producer, to Gazprom. Also in the gas sector the trend toward increased state control—or at least toward more direct control by President Putin—has been clear. In 2001, Gazprom's longstanding CEO Rem Viakhirev was replaced by Aleksei Miller, closely related to Putin's "St Petersburg group." If throughout most of the last decade state ownership of Gazprom's shares had oscillated around 38 percent, by 2005 this had increased to just over 50 percent. Most importantly, Gazprom's acquisition of Sibneft′ broke the administrative division between oil and gas, and the road seemed to be paved for the eventual establishment of a powerful state-controlled *kontsern* encompassing both oil and gas assets, which could become a mighty instrument for the pursuit of foreign policy goals. The December 2006 retreat of foreign investors (the Royal Dutch Shell-led consortium also including Mitsui and Mitsubishi) from the multi-billion dollar Sakhalin II oil and gas development project after strong pressure from Gazprom and the Russian government was a clear signal of the Russian government's desire to keep foreign companies at bay in major projects.

These changes have greatly increased President Putin's ability to use energy as a means of political pressure both within and outside the FSU. This ability comes together with a new will to use energy for domestic and foreign policy goals.[30] In the FSU, the best examples come from Moldova, Georgia, Belarus, the Baltics (discussed earlier in this chapter), and Ukraine, which we discuss below.

At the same time, when thinking about Russia's use of energy for foreign policy purposes, we should keep in mind that this is not only a issue of a monolithic Russian state using energy to pursue an equally monolithic national interest. Despite widespread coverage of Putin as "bringing the state back in," it is still unclear how much of what is being presented as "state interests" in the battle against anti-Putin oligarchs actually concerns the private interests of Putin's close associates.[31] A multiplicity of interests (state, corporate, and private-interests-within-the-corporation interests) de facto still coexist in Russia's energy sector and also in its largest, state-controlled corporations.[32] In particular, it is important to keep in mind not only companies' corporate interests and whether or not they may coincide with those of the Russian state, but also those of their high management ("private interests within the corporation"), which have often been pursued separately from the companies' "corporate" interests.[33]

The 2006 gas crises

When Russia suspended gas supplies to Ukraine in January 2006, the repercussions went well beyond Ukraine. While it was Ukraine that received most coverage, the events of early 2006 can be seen as a coordinated Russian offensive vis-á-vis some of its major gas customers in the FSU. Moldova was left without gas supplies from Russia for two weeks, in part as a result of Gazprom's suspension of supplies to Ukraine, but also of Gazprom's own attempt to raise prices to Moldova and use this to pressure it into giving Gazprom a larger share in the MoldovaGaz gas transit company than the 50 percent (plus one share) it held since the company's establishment in 1999. Indeed, one of the conditions for limiting the new gas price to \$110 per 1,000 cubic meters (cm) (as opposed to the \$160 Gazprom demanded) was the increase in Gazprom's share in Moldovagaz, the country's gas transit system, to 64 percent.[34] Despite these concessions, effective July 2006, Russia increased gas prices to \$160/1,000 cm, and, effective January 1, 2007, to \$170/ 1,000 cm. In the case of Georgia, Russian energy and general economic pressure in early 2006 led to speculation about the possibility of privatizing Georgia's state-owned gas transit system to Gazprom.

This cursory look at the role of Russia's energy companies in the post-Soviet area makes it hard to disagree with the interpretation that the Russian government is using energy dependencies for political purposes, in order to pressure former Soviet republics into not pursuing "too close" relations with the West and into agreeing to Russian-led integration initiatives and otherwise following policies considered desirable by the Russian leadership. The alternative explanation that Gazprom is simply moving to commercially based "world prices" in its gas trade with all former Soviet states loses much of its explanatory power against the evidence that, as of January 1, 2007, various post-Soviet states were paying different prices, from \$100/1,000 cm for Belarus, to \$235 for Georgia.[35] This book takes Russia's use of energy for foreign policy purposes as a given, although it does not in any way justify it. We seek to go beyond this question, however, by looking at how domestic conditions in the non-Russian states can affect Russia's ability to use energy as a foreign policy tool.

The new dependencies just discussed—Russia's role as a monopsonist buyer, and control of transit infrastructure—also have in common and highlight the participation of local partners in the countries involved, who often receive significant profits from the relationship with Russia. This brings to the fore the question of rents of energy dependency and their impact on the energy relationship between Russia and the energy-poor former Soviet republics.

Dealing with energy dependency on Russia: the role of domestic conditions and rents of energy dependency

Moldova, Georgia, Belarus, the Baltics, and Ukraine provide important examples of how domestic conditions—and especially the existence of significant rents of energy dependency that can be appropriated by various domestic actors—can play an important role in the energy relationship with Russia.

Much of this book is devoted to the competition and struggle between economic groups over energy business and over the distribution of economic gains (and losses) from energy trade, transit, and domestic sales. Here the real picture is less often one of clear national interests as of a variety of interested actors, both domestic and foreign, sometimes competing and sometimes coalescing, while all trying to make an economic and political profit out of this situation of dependency.

But, why so much competition over energy business in energy-poor states? That large profits can be made in the energy sector may seem obvious in the case of an energy-rich country such as Russia, but counter-intuitive in situations of energy dependency. It is here where the concept of rents of energy dependency comes in. Energy can be, indeed, a very lucrative business in some of the energy-dependent states of the former USSR. The apparent paradox of energy rents in a situation of energy dependency is explained not only by the role of economic intermediary groups in the energy-importing countries, but also through the fact that in many post-Soviet transition countries the energy import, distribution and re-export business has been a center of corruption activities. (While not limited to corruption gains, these compose a significant part of rents of energy dependency.)

By rents of energy dependency we are referring to whatever unearned benefits an economic group within a country (or, for that matter, a regime or a country as a whole) may receive from the continuation of energy dependency relationships, especially with longstanding partners, in this case Russia. Such rents of dependency can take a variety of forms: from, on the one hand, the subsidy effect experienced by a whole economy (such as in the case of Belarus) to, on the other, the concrete benefits received by specific economic groups.[36] Legal, semi-legal, or illegal businesses with privileged access to insider information and political networks have been able to take advantage of the profitable arbitrage possibilities created by a situation in which the energy market has not been liberalized and where differences between domestic, "near abroad" and export prices continue to be significant despite the gradual move to market-based trade relations.[37,38] For the purposes of this book, we will focus on the rents of energy dependency accrued by economic groups, of which the best example is provided by the Ukrainian case in the post-independence period.

Understanding rents of energy dependency is central for understanding politics and policy-making in the energy-dependent post-Soviet states. This is so at two levels. At a first level, each of the various rent-seeking schemes associated with the energy sector can have and has had a direct effect on the management of energy dependency. How various groups will benefit from the rents of dependency will affect whether they will want to prolong this situation of dependency (in general, or in respect to a specific partner). At a second and more general level such rent-seeking system can have broader effects on a country's ultimate ability to define and implement a national energy policy, and on the overall development of its political system.

Although Moldova, Georgia, and Latvia also provide good examples of this situation, it is in the case of Ukraine, due to its dual role as both a large energy consumer and important transit country, that we see the largest number of potential rent-acquisition opportunities in the energy trade area, and the largest revenue potential in rent-seeking. The next section presents the Ukrainian case as exemplary of the energy policy challenges facing the post-Soviet states.

Ukraine as case study of post-Soviet interdependencies

The energy interdependence issues discussed earlier are richly illustrated by the case of Ukraine. While Ukraine is not the only energy-dependent post-Soviet state, it presents a uniquely relevant case study of the relationship between domestic and external factors on energy issues. If on the one hand the Ukrainian case reflects all of the main problems faced by other post-Soviet energy-dependent states, a number of factors make Ukraine's case especially important.

First, because of Ukraine's importance as a transit state for Russian oil and gas to Western Europe—80 percent of Russia's gas exports to Western Europe go through Ukraine—nowhere are the broader international implications of the energy relationship with Russia as clear as in this case. This was made evident by the effects on Western Europe of the January 2006 gas crisis, which caused shock in European markets and prompted a substantial debate in the EU, not only about its energy relationship with Russia, but also about its energy security more generally and about the very need for a single EU energy policy.[39]

Second, Ukraine is representative of the types of energy dependencies tying the energy-poor states to Russia. Although Ukraine's absolute level of energy dependency (45.82 percent of total consumption in 2004[40]) is not unusually high in terms of the energy-poor post-Soviet states, if we include nuclear energy in this picture, its situation of energy dependency becomes more alarming. If nuclear energy were not to be counted as domestic production—given the fact that its raw materials (fuel cells or nuclear fuel) are almost exclusively imported from Russia, which also provides 85 percent of the nuclear power plant equipment—then the figure for Ukraine's total energy dependency would rise significantly, to around 70–75 percent.[41] As will be discussed later, however, Ukraine's energy dependency is also moderated by elements of asymmetrical interdependence between itself and Russia.

Third, Ukraine presents the most powerful example of Russia's use of the energy weapon as a means to influence the foreign policy orientation of a post-Soviet state, and as "testing ground" for Russia's possible use of energy as a foreign policy weapon elsewhere in the former USSR and beyond. This became especially clear in December 2005 as the Putin government sought to use the threat of rising prices to punish President Yushchenko for following a pro-Western foreign policy line, and to pressure Ukraine to join a pro-Russian economic, political, and military bloc.

Finally, it is in the case of Ukraine that some of the domestic struggles for the control of energy-related profits have been most keen, and have had the clearest repercussions throughout state and society. Because of its importance as both an important energy market and energy transit country, several billion $ dollars (estimated at $3.1 billion in 2005 and nearly $4.9 billion in 2006 in gas trade alone[42]) of energy-related real or virtual money changes hands in Ukraine yearly,

Table 1.1 Post-Soviet States' energy import dependency in comparative perspective (in percentages), as of 2004

	2004
Ukraine	43.01
Belarus	87.26
Moldova	97.33
Georgia	54.41
Armenia	64.78
Estonia	32.49
Latvia	66.52
Lithuania	46.06

Source: IEA, IEA, Key World Energy Statistics 2006, available at www.iea.org/textbase/ nppdf/free/2006/key 2006.pdf (accessed January 15, 2007). Energy dependency is defined as "Net Imports/Total Primary Energy Supply."

and it is in Ukraine that that we see the largest number of potential rent-acquisition opportunities in the energy trade area, and the largest revenue potential in energy rent-seeking. In the Ukrainian case, the possibilities for profit-making in conditions of energy dependency have been plentiful—from opportunities created by barter and other deals used to pay for imports of Russian energy, to energy companies (both local and Russian) using energy debt to gain control over forced-to-become-insolvent companies unable to pay their energy bills, to the state assuming responsibility for private traders' unpaid energy debts vis-á-vis Russia, to non-transparent privatization deals, to outright stealing from the state. We discuss these in detail in Chapter 7.

Focus of the book

Ever since its independence in 1991, Ukraine has been pulled between, on the one hand, the desire for sovereignty, and, on the other, its longstanding dependencies on Russia. Nowhere is this dependency as deep as in the case of energy, to the point that, looking at Ukraine, some have questioned the meaning of formal statehood when a state lacks control of the basic resources needed by its economy to function.[43]

Most discussions of the Ukrainian-Russian energy relationship have focused on the international relations and strategic aspects of the issue, posing the question as one of a confrontation between Russian versus Ukrainian national policies and interests. While such factors are important, they are not sufficient to explain Ukraine's management of its energy dependency relationship with Russia and lack of resolve in pursuing its energy interests vis-á-vis its foreign partners. What is missing in this picture is an assessment of the impact of domestic

Ukrainian political factors in Ukraine's management of its energy dependency relationship with Russia.

The purpose of this book is to seek to understand the domestic factors that stand behind Ukraine's continued energy dependency on Russia and its apparent inability to escape it. Why is it that, 16 years after independence, Ukraine has not been able to take decisive measures to break its extreme energy dependency on Russia, even when such dependency threatens the very essence of its independence? How did and do domestic factors affect Russia's ability to use energy as a foreign policy tool vis-á-vis Ukraine? This book addresses these questions by analyzing the management of energy dependency in Ukraine during the Kuchma (1995–2004) and early Yushchenko (2005–2006) presidencies. The end point is August 2006 with the formation of the first government after the March 2006 parliamentary elections and the entrance into force of the Constitutional Agreement limiting presidential power and Viktor Yanukovych's return to power as Prime Minister. Due to their overwhelming importance both in Ukraine's energy balance and in trade with Russia, our analysis concentrates on gas and oil; other sources of energy are discussed only when relevant, and in less detail.

The Ukrainian case and debates on state-business relations and policy-making in post-Soviet development

The Ukrainian case, with its rich examples of the complex connections between politics and energy policy, can help us shed light on a number of debates on the role of business and the state in post-Soviet societies. A first debate relates to the power of the state: are we seeing a situation where the power of the state is increasing, and this predatory or "grabbing state"[44] is using economic actors to pursue its interests, or, instead, are we seeing a situation where the state is captured by economic interests? As this study will show, although there is much to be said for the state capture hypothesis, the Ukrainian case adds important nuances to the equation, for example, the fact that various economic interests may control separate areas of the state, and the role of the president as "arbiter" in this system. Most importantly, the complexity of the Ukrainian case tells us that it is not sufficient to look at the situation in terms of "state" versus "private" interests, but that it is important to recognize the role of other actors and interests created by the specific nature of the post-Soviet transition, such as the separate corporate interests of state-owned companies, and the private interests that may be located within these, which do not necessarily coincide.

The case of Ukrainian energy policy is also central to the debate on the sources of public policy in the post-Soviet states, especially in terms of the relationship with Russia. Realist and constructivist approaches have sought to answer the question of policy choices, with mixed results. Realist approaches see the state as the main decision-maker and most important level of analysis, emphasizing it above the level of domestic actors. They emphasize states' choosing their trade policies on the basis of the strategic opportunities open to them (strategic opportunities which are, in turn, based on the state's capabilities and the existing international power configurations).[45] From this perspective, achieving and maintaining energy independence would be part of a state's desire to increase its power and maintain independence more generally. In terms of trade, this would mean that countries will try precisely to "create conditions which make the interruption of trade of much graver concern to its trading partners than to itself."[46]

Yet realist explanations, centered on state power, are insufficient to explain why independent Ukraine has been unable to adopt a consequent and proactive energy policy, despite the obvious importance of doing so for geopolitical reasons. The reason a realist approach cannot explain these issues satisfactorily is because attention to domestic considerations—concerning both political culture factors and the domestic institutional structure—is missing from this perspective. Energy relationships in the post-Soviet area include multiple actors with a variety of often murky relationships to state policy, making the question very difficult to tackle using only a state-as-actor perspective, or posing it as one of, first and foremost, a confrontation between Russian versus Ukrainian national policies and interests.

Looking more specifically at the post-Soviet world, constructivist-inspired authors such as Rawi Abdelal and Andrei Tsygankov have stressed the role of national identity in the making of foreign economic policy, and have argued that national identity issues have significantly affected the way post-Soviet states have developed economic and trade relations with Russia in the post-Soviet period.[47] One weakness of this approach, however, is that it runs the risk of overseeing the real differences existing within a single society, as well as the economic interests associated with these, as shown by the case of Ukraine.

The modified institutional approach used here

We believe a modified institutional approach, supplemented with significant detailed research on the actual workings of the system, can provide the most productive means of understanding Ukraine's policy wavering in the post-Soviet period. Such an approach allows us to look closely at the domestic institutions that have facilitated certain types of behavior by interest groups, and at the behavior of these interest groups. In doing so, analyzing the case of Ukraine will help us generate hypotheses that could be later tested on the cases of other energy-dependent post-Soviet states as well.

Understanding the nature of domestic interest groups, how Ukraine's energy dependency has affected them differentially, and how various ways of managing this dependency have different effects on them is essential for understanding Ukraine's convoluted energy policies since independence. Most importantly, these institutional factors and the economic and political-economic interests of the various groups involved may lead specific groups to favor—or oppose—a continuation of the energy dependency relationship with Russia. The basic starting point here is the question of how changes in the global economic environment (changes in relative energy prices, for example) differentially affect various domestic sectors or actors and, thus, may make some groups—and not others—push for specific policies.[48]

Framing factors in Ukraine's energy relationship with Russia

Ukraine's energy dependency on Russia must be understood within the context of two important framing factors: the elements of asymmetrical interdependence existing in the Russian-Ukrainian relationship, and Ukraine's relationship with other energy suppliers, especially Turkmenistan.

Asymmetrical interdependence

When we refer to Ukraine as energy dependent and to its energy relationship with Russia as one of dependency, we are not denying the fact that this relationship is also characterized by elements of asymmetrical interdependence between both sides. Some elements of this interdependence are the control that can be potentially exerted by Ukraine on Russian export pipelines going through its territory, the influence it has as a large and potentially lucrative sales market, and its indirect influence as recipient of important investments by Russian energy companies. These are elements of power Ukraine can use in formal or informal negotiations with Russia, and in the management of its energy dependency more generally.

In terms of Ukraine's possible importance as a market, it is important to note that with the overall improvement of the economy after 2000, Ukraine has become an important market for Russian oil and oil products, both largely being purchased at world market prices. With gas prices paid by Ukraine also moving toward average Western European levels, it is clearly important for Russian producers to maintain Ukraine, the world's fifth largest importer of gas, as a sales market for Russian suppliers.

In terms of investments, it is important to note the strong Russian interest in all areas of Ukraine's energy sector—not only oil and gas, but also electricity generation and distribution. Investments in Ukraine have played an important role for concrete Russian oil companies, as refining in Ukraine has been used by them as part of a larger strategy of maximizing the export of refined oil products to Western Europe while minimizing taxes and the impact of Russian export restrictions and pipeline capacity shortages.

Most important among these interdependence factors is Ukraine's important role in the transit of Russian gas to Western Europe. As of 2006, about 80 percent[49] of Russian gas exports—themselves providing nearly 55 percent of Russia's export revenues[50] and more than a quarter of the state budget—went through Ukraine, a very significant amount considering Gazprom's concentrated efforts since 1995 to become less dependent on Ukraine as a transit country and to bypass Ukrainian gas pipelines through new pipeline projects such as the Yamal Pipeline via Belarus. Similarly, Ukraine's role in the transit of Russian oil is very important, as about 30 percent of Russian oil exports to Western Europe transit through Ukraine. While the importance of transit as a defense against Russia's own use of energy as a pressure tool is bound to decrease as Russia continues to develop additional export routes bypassing Ukraine, transit continues to be an important factor moderating the relationship, as Ukraine could—at least theoretically—make use of the threat of transit disruption as an instrument of pressure in the relationship. Due to Ukraine's well-developed gas pipeline network and the fact that its capacity can be significantly expanded (from its current 130 bcm per year to 200 bcm) at a relatively low cost, transit via Ukraine remains highly competitive despite the growing use of liquefied natural gas (LNG) technologies making possible the shipping of gas overseas via tankers, and despite Russia's announcement that it will start building a Northern European Gas Pipeline linking Russia and Germany directly. Thus, in a mid-term perspective, Ukraine is poised to remain Russia's most important gas transit partner.[51] Similarly, Gazprom's gas export strategy requires access to Ukraine's gas storage facilities, as it allows adjustment for seasonal gas demands and maximization of profits.[52]

At the same time, the existence of elements of interdependence does not change the reality of Ukraine's energy dependency, it only qualifies it and makes it more complex.

Ukraine's energy purchases from Turkmenistan and the question of energy dependency on Russia

A second qualification has to do with Ukraine's energy relationship with Turkmenistan, Central Asia's largest gas producer, from which Ukraine has been purchasing relatively large amounts of gas since before independence.[53] What does this mean in terms of our very conceptualization of Ukraine's energy dependency on Russia? Does this mean Ukraine is no longer "energy dependent" on Russia? In the same way as energy diversification has to do not only with the physical diversification of supplies but also with contractual diversification, energy dependency has to do not only with the physical origin of supplies, but also with control over its transportation and over the contractual forms these imports take. The case of Ukraine's energy relationship with Turkmenistan and other Central Asian states once again highlights the importance of distinguishing between the various components of energy diversification—energy source diversification, geographical diversification, and contractual diversification. Ukraine's growing imports from Turkmenistan have not amounted to real diversification, as control over these contracts (contractual diversification), as well as over transportation, has remained outside Ukraine's hands. More specifically, imports from Central Asia have not amounted to real diversification because, due to the legacy of Soviet-era pipelines, gas supplies have currently no alternative but to go through Russia.[54] As Russia has not ratified the Energy Charter Treaty, and has not hesitated to deny transit rights over its territory when it has seen fit to do so, gas transit from Turkmenistan (as well as other potential Central Asian suppliers) remains firmly in Russia's hands. In terms of the contracts involved, since the mid-1990s the importation of Turkmenistan gas has not taken place directly but through a series of intermediaries, either controlled directly by Russia,[55] or by non-transparent structures, in each case making a significant profit out of the relationship and having murky connections to the management of Ukraine's state-owned energy companies. The concrete mechanisms used for the importation of Turkmenistan gas are discussed in Chapters 7 and 8.

Central concepts discussed

In this section, we define central concepts to be used throughout the book, as well as some limits and caveats to their application.

Energy dependency

We do not see energy dependency as an absolute, but as something that can take a variety of intermediate values. However, for the purposes of this book, by "energy dependency" we mean a situation where

a more than one-third of a country's total energy supply comes from foreign sources;
b more than 50 percent of a country's annual consumption of a single major energy source (in most of the CEE states, oil or gas) come from foreign sources or
c a country depends on a single external provider for more than 60 percent of its imports of a major energy source for that country or 45 percent of its consumption of that energy source. Ukraine clearly fulfills these conditions.

Management of energy dependency

By "management of energy dependency," we are referring to ways of going about energy issues in a situation of dependency, regardless of whether these are proactive or just passive. In particular, we are referring to three main issue areas. First, ways of going about the direct management of energy supply diversification issues. Second, ways of going about the organization of energy trade with the main current supplier(s) on which the country is still dependent (in the post-Soviet cases, Russia). Third, we are referring to ways of going about more general energy issues, in those of their aspects related to and having implications for energy dependency issues, in particular the structure of policy-making in the energy sphere, subsidies for particular types of users, and policies about foreign investments in the energy area.

By "management of energy dependency," we do not imply a normative stance in the sense of considering only *good* management of energy dependency management at all. Rather, energy dependency can be managed (a) in more or less transparent ways, running the spectrum from transparent to non-transparent; (b) in ways that predominantly reflect the interests of particularistic interests, or national interests as a whole, running the spectrum from particularistic to non-particularistic, and; (c) in ways that run the spectrum between fostering the continuation of the energy dependency relationship and, conversely, fostering growing energy independence and diversification.

How countries manage their energy dependencies will have an important impact on their domestic and foreign policies. The domestic impact is a result of the fact that, even in conditions of energy dependency, energy can be a very profitable business and, as such, is at the center of conflicts over the distribution of significant economic gains and losses. At the same time, there are limits to the management of energy dependency in the sense that, no matter what the management of energy dependency will be, other factors—structural legacies and path dependencies created by the Soviet system, cultural factors, international price dynamics, and international political relationships—will play important roles in the determination of energy outcomes.

Interest groups, "clans," and Business-Administrative Groups

One of the elements that makes the Ukrainian case especially rich is the prominent role of economic groups in energy policy. Here it is essential to note that these are not "simply" economic groups, but that their strength is very much related to the combination of political and economic power they were able to acquire in the years following independence. While these groups are commonly referred to as "clans," the term "Business-Administrative Groups" (BAGs) better captures their essence and role.[56] The term is used to denote the fact that these groups combine both economic resources and administrative decision-making power. In fact, their distinguishing feature is the "unification of business and political (decision-making) assets under control of a narrow circle of the group's leaders."[57] Indeed, as will be discussed in Chapters 3 and 4 , it is exactly this feature which made their role so significant in Ukraine, and which allowed them to move beyond their original roles as regional players and into the very core of national policy-making. While economic interests have played an important role in all the post-Soviet states, having a multitude of strong economic groups with significant administrative power is a feature not shared by all post-Soviet states, first and foremost Belarus with its centralized system of power under Lukashenka.

The Ukrainian economy since independence: major trends and landmarks

Ukraine's energy policy did not take place in a vacuum, but was influenced by changes in the country's overall economic situation since independence. We can identify five main periods in Ukraine's economic history since independence. The first period, encompassing the first five years after independence, was characterized by chronic inflation (reaching its high point in 1993 at over 10,000 percent per year), currency instability, and industrial collapse. Hyper-inflation, due largely to cheap state credits and other deficit-creating subsidies, led to a crisis of liquidity, which, together with the fall in foreign-currency reserves as a result of the Soviet collapse, led to a significant increase in barter transactions at all levels. From 1991 to 1998, Ukraine's real GDP declined cumulatively by over 62 percent (a decline second only to Turkmenistan's in the former USSR[58]), much of it the result of the collapse in intra-USSR trade. For the first five years following independence Ukraine did not have its own currency, but used hastily printed and quickly depreciated *Kupony* and *Karbovantsi*, which came to personify the instability of the economy as a whole.

The introduction of the *Hryvnia* in September 1996 was a major achievement which set into motion a more general stabilization of the economy and for the first time created the possibility of implementing President Kuchma's October 1994 "Program of Radical Economic Reform." Although the movement toward stabilization continued, Kuchma's reforms remained haphazard and contradictory, largely as the result of the lack of a clear reform coalition in the Verkhovna Rada (Rada) and among the major Ukrainian interest groups. As GDP and living standards continued to fall and the economic costs of even limited reforms became clear, many in the population started to turn away from the idea of reforms at all.

Privatization of large-scale firms—including major oil refineries—which until then had remained limited, started to take off in 1999; much of it, however, was conducted with little transparency and reeked of crony dealings between President Kuchma and some of the main clans close to him. Viktor Yushchenko's appointment as prime minister (PM) in December 1999 (and that of Yuliia Tymoshenko as first Vice PM for energy issues shortly thereafter) inaugurated a period of relatively bold reforms, especially in terms of decreasing the role of the state in the economy, fighting corruption, and reducing barter transactions and arrears, especially in the energy sector. These reforms largely stalled, however, with Yushchenko's removal as PM in April 2001.

In 2000, the Ukrainian economy started to grow again—GDP grew by almost 6 percent in 2000, continued to grow throughout the early 2000s, and reached 12 percent annual growth in 2004.[59] After a slowdown in 2005, growth rebounded to an estimated 6.3 percent in 2006.[60] Many saw this recovery not only as a sign that the post-Soviet recession had reached its low point in the late 1990s, but also as a delayed result of the reforms introduced by Yushchenko as Prime Minister. Yet this period of growth was not accompanied by a renewed commitment to economic reform—in fact, the years between Yushchenko's dismissal as PM and his return to power as president in 2005 can be characterized as a period of "frozen transition"[61] in which Ukraine remained "stuck between the plan and the market" in something approaching "a semi-permanent stage of 'near-transition.'"[62] While the Orange Revolution represented a political watershed, it is still to be seen whether the impasse over real economic reform has been broken for good.

These economic changes—such as the crisis of liquidity and the generalized use of barter in the first years after independence—had important effects on the situation of Ukraine's energy sector, and on her energy relationship with Russia. Moreover, they also limited the range of choices available to Ukrainian actors in terms of energy policy, and also affected the types of energy-related rents available to Ukrainian and Russian actors in Ukraine. Although energy-related rents were important throughout the post-independence period, the ways in which they could be accessed changed in accordance with changes in Ukraine's broader economic situation. Thus, for example, some kinds of rent-extraction schemes that can make sense in a situation of lack of liquidity and generalized barter no longer make sense once the situation has stabilized, opening the door for other types of rent-extraction deals. We discuss this in Chapter 7.

Chapter overview

This book is divided into three parts. Part 1 presents the context in which the management of Ukraine's energy dependency takes place. Chapter 2, "The Energy-Foreign Policy Nexus," analyzes the role played by energy in Ukraine's relations with its main partners, including Russia, the EU, and international financial institutions. Chapter 3 looks at the nature of the Ukrainian political system under Kuchma, in order to analyze how its specific features—in particular the emergence of the president as a powerful "balancer" between various interest groups—affected energy policy-making. Chapter 4 provides a historical overview of the development of Ukraine's energy markets and policies in the period from independence to 2004.

Part 2 of the book looks at the interrelationship between domestic politics and energy policy during the Kuchma period (1994–2004). Chapter 5 analyzes the extent to which the energy diversification slogans proclaimed by every Ukrainian government after 1991 were reflected in actual policy. Chapter 6 discusses how domestic institutions—both formal and informal—affected Ukraine's management of its energy dependency between 1995 and 2004 and helped transform declared diversification goals into non-diversification policies and results. Chapter 7 discusses in detail the main ways in which the rents of energy dependency system worked during the 1995–2004 period, how it evolved with time, and how it related to President Kuchma's role as "arbiter" between BAGs.

Part 3 of the book looks at energy policy and energy dependency after the Orange Revolution. Chapter 8 asks whether there has been a significant change in energy policy following Yushchenko's coming to power in early 2005, in particular in terms of energy diversification policies, the functioning of the energy rents system, and the fight against corruption. Chapter 9 concludes by asking how the easy availability of energy-related corruption funds has affected political and economic reform in post-Soviet Ukraine, and how domestic political and rent-seeking games in post-Soviet states affect Russia's ability to use energy as a foreign policy tool in Ukraine and beyond.

Part 1

Frame of reference and context of the energy question

2 The energy-foreign policy nexus

This chapter analyzes the role played by energy in Ukraine's foreign relations with its main partners, including Russia, the EU, and international financial institutions. It looks at both the effects of pre-existing energy dependencies on foreign policy relationships, and at the effect of political relationships on the maintenance or overcoming of energy dependencies. After looking at the foreign policy, state-to-state level of the issue in this chapter, we turn to the domestic side of this question in the remaining chapters of the book.

To a great extent, the history of Ukraine's foreign relations since independence has been the history of its policy wavering between Russia and Euro-Atlantic structures such as NATO and the EU. Although often presented by President Kuchma during his presidency (1994–2004[1]) as a conscious policy choice in the form of a "multi-vector policy," such wavering was, in reality, most often the result of the lack of clear policies, of the struggle between various interests within Ukraine itself, and, especially during 1999–2004, of the use of foreign policy for the pursuit of Kuchma's own interests and those of his close associates.[2,3]

Whatever their sources, these two relationships have been central for Ukraine's management of its energy dependencies. Part 1 of this chapter looks at the role of energy in the broader Russian-Ukrainian relationship, after which we turn to the Western side of the equation.

Energy and the Ukrainian-Russian relationship

Introduction: the international context of the Russian-Ukrainian energy relationship

Sixteen years after independence, Ukraine remains highly dependent on Russia, and their energy relationship takes place in the context of a broader political and economic relationship marked by strong dependencies and interdependencies. The two economies remain closely connected, especially in areas such as metallurgy and machine-building. Although exports to Russia declined dramatically in the 1990s (from 34.8 percent Ukraine's total exports in 1993 to 18.7 percent in 2003), imports from Russia (also declining, but at a much more slower pace) still constituted 37.6 percent of Ukraine's imports in 2003, largely as a result of energy imports.[4] Despite the fact that Russian investments have lagged behind those from Western Europe and the US,[5] Russia continues to be Ukraine's main creditor and one of its main markets, especially for metals, pipes, chemical industry products, military and high-technology exports, and, last but not least, agricultural products, where Russia remains the main market. Such dependencies make the Ukrainian economy very vulnerable to the ups and downs of the relationship with Russia, as was shown during the so-called trade wars of 1997, 1999–2000, 2002, and 2006.[6] As discussed in Chapter 1, this relationship also includes elements of asymmetrical interdependence, with Russia relying on Ukraine not only for energy transit, but also for joint projects, especially in the military area, where both countries' military-industrial complexes developed in a closely intertwined way during the Soviet period. The closeness of the overall economic link with Russia means that, no matter what Ukraine's official foreign policies may be, Russia will continue to hold significant bargaining chips in the relationship in the near future.

There is some debate about how Russia has responded to these dependencies. While some have argued that from the very beginning Russia tried to use Ukraine's dependencies to (re)establish control over Ukraine, others, such as Tor Bukkvoll, maintain that, especially before Putin's coming to power in 2000, Russia lacked a clear strategy toward Ukraine.[7] Given a lack of clear policy guidelines the role of economic actors such as Gazprom and other energy companies becomes even more important, as "[i]n this institutional vacuum the activism of non-state actors often moved alongside and supplemented the ambivalent messages coming from foreign policy agencies."[8] This raises the question of how to understand the relationship between business and the state in Russian foreign policy. Without doubt, this multi-faceted and evolving relationship plays an important role in Russian-Ukrainian relations, but it would be inaccurate to speak simply of the state "using energy companies" for its own foreign policy goals as an all-explanatory element. Especially when looking at the case of a large and complex company such as Gazprom, we need to look not only at its possible role as an instrument of Russian state goals, but at the multiplicity of interests (state, corporate, and private-interests-within-the-corporation) coexisting within it. In particular, it is important to keep in mind not only companies' corporate interests and whether or not they may coincide with those of the Russian state, but also the interests of their high management ("private-interests-within-the-corporation"), which have often been pursued separately from the company's "corporate" interests. As will be discussed in Chapters 7 and 8, the Ukrainian case provides ample examples of such a situation, with the added twist that top managers on both sides of the border often found a common language through corruption and other non-transparent deals.

In addition, the interrelationship between state, corporate, and private-interests-within-the-corporation (such as those of Gazprom and NAK Naftohaz Ukrainy managers) has changed with time and in accordance with shifting political circumstances. If from 2001 on (with the replacement of Rem Viakhirev as Gazprom's CEO by Putin associate Aleksei Miller) we can talk of a stronger role of the state in

Gazprom, we need to keep in mind that in the mid-2000s—as the January 2006 gas crisis made clear—some of the private-interests-within-the-corporation schemes continued in place, but now connected not only to individual managers, but possibly also to higher levels in the state machinery, and bringing together personal and foreign policy interests.

In the following sections, we analyze the main turning points in Ukrainian-Russian relations in the 1995–2006 period from the perspective of energy policy. In doing so, we aim to show both the ways in which energy was used by Russia to attain broader foreign policy goals involving Ukraine and, similarly, the way in which other aspects of the bilateral relationship were used by both sides to attain desired outcomes in the energy area.

Energy and Russian–Ukrainian relations in the first years after Ukraine's independence

Not all of Russia's energy-related behavior toward Ukraine has been politically motivated, especially in the very initial period. During the first months and years following independence in 1991, although the Russian state still had a large degree of direct control over energy companies (energy privatization had barely begun), the increased prices charged by Russia to Ukraine were more the result of domestic changes in the Russian economy (the domestic price liberalization needed to set economic reform in swing) than of policies specifically aimed at Ukraine.[9]

By 1993–1994, however, it had become clear that Russia was willing to use energy as an instrument for the pursuit of broader policy objectives in Ukraine, in particular to make Ukrainians "rethink the wisdom of their sharp break with Russia."[10] During this period and that immediately following it, Russia was able to use energy as a tool of its foreign policy vis-á-vis Ukraine in three main ways.

First, through the threat of a cut-off in supplies,[11] which was raised in a variety of occasions, as will be discussed later.

Second, through the issue of Ukraine's large energy debt, which gave Russia indirect leverage over the Ukrainian economy. By 1994, this debt amounted to *c.* $2 billion, which was later converted into Ukrainian state debt toward Russia.[12] Indeed, it could be said that the Russian state, despite complaining loudly about Ukraine's rapidly growing debt, in reality welcomed this, as this debt provided Russia with a kind of "rain-check" it could make use of when necessary, to be exchanged for political or economic concessions, not only at the level of bilateral relations broadly understood, but also at the more concrete level of issues such as control over the Black Sea Fleet, the future of Ukraine's nuclear weapons, and control over its gas transit system.

Third, by continuing to provide Ukraine with energy on relatively favorable conditions[13] (through lower than world prices, credits, and barter deals, for example), Russia insured that Ukraine would remain dependent on it, as opposed to a situation where Russia would have drastically increased prices and the Ukrainian economy would have suffered but ultimately adapted, moving away from near-exclusive dependence on Russian energy in the process. By continuing to offer relatively favorable conditions, which, moreover, were tied to various schemes involving and benefitting its local partners, Russia created for itself mighty Ukrainian allies of convenience more interested in maintaining their profitable schemes than in Ukraine's energy security.

These three elements were used together in variations of a "carrot-and-stick" approach. The use of such an approach was exemplified by Russian behavior during and immediately preceding the early September 1993 Massandra summit between presidents Yeltsin and Kravchuk, where the fate of the Black Sea Fleet and of Ukraine's nuclear weapons was to be discussed. A week before the summit, citing lack of payment, Gazprom reduced gas supplies to Ukraine by about 25 percent[14] as a way of letting Ukraine know what could be the consequences of not complying with Moscow's requests. During the summit, Russia offered Ukraine a "zero option" agreement that would have erased Ukraine's gas debts in exchange for giving Russia full control of the Black Sea Fleet, surrendering its nuclear weapons, and signing the Nuclear Non-Proliferation Treaty.[15,16] Although President Leonid Kravchuk initially agreed to the deal, furious uproar in the Ukrainian parliament precluded ratification of the agreements, and Russian retribution followed. Although gas supplies were not cut completely, the actual amount of gas supplied to Ukraine during fall and winter 1993–1994 declined considerably, leaving many public buildings unheated, many streets in the dark, and many citizens wondering whether the price paid for independence was not, indeed, too high.

Was this pressure "successful?" Russia's success was limited if one defines success as getting Ukraine to relinquish its quest for independence and sovereignty. Yet two clarifications are in order. The first concerns the "disposability" of the energy weapon. Russia refused to use an all-out energy embargo against Ukraine, in part because it could have endangered the transit of Russian gas to Europe via Ukraine and ongoing discussions between Russia, the EU, and the US about Ukraine's nuclear disarmament, but also, D'Anieri argues, because Russia was unwilling to use the "ultimate weapon" (an all-out embargo against Ukraine) which, he argues, can, almost by definition, only be used once.[17] It is worth emphasizing that one characteristic feature of the way in which Russia has used the energy "weapon" in its relationship with Ukraine has been (in addition to the "carrot-and-stick approach" and the ability to incorporate local partners in the relationship) the conscious use of the energy weapon in a relatively limited form, that is, not cutting off supplies totally or engaging in actions that would leave Ukraine no option but to adapt to world market prices in a harsh, one-time shock and reorienting its energy imports toward non-Russian sources. Rather, in every occasion, a "solution" was found, which—together with the interests of important Ukrainian Business-Administrative Groups (BAGs)—helped weaken Ukraine's resolve to take the painful measures needed to reduce its energy dependency on Russia.[18]

The second clarification concerns the very definition of success. Although Russia was not successful in getting Ukraine to relinquish its quest for independence and sovereignty, to a certain degree the realization of Ukraine's energy dependency on Russia took the wind out of the sails of militant nationalism.[19]

Similarly, energy pressure may have prompted Ukraine to sign the January 1994 agreement giving up its nuclear weapons and signing the Non-proliferation Treaty. (Although the agreement does not seem to have been reached as a result of direct energy blackmail by Russia, it is likely that the reduction of supplies in fall 1993 and promises of low prices "played a significant, if not crucial part, in that deal."[20]) Most importantly from the point of view of the argument of this book, throughout the early and mid-1990s, Russia was able to tie important Ukrainian interest groups to a view of energy security that was less based on Ukraine's national interests than on a de facto joint view of energy security and on successful (from the point of view of individual participants) "joint business" with Russia, a reality that was to have long-term effects on Ukraine's energy policy.

Energy and foreign relations in Kuchma's first presidency, 1994–1999

Around 1994 we start to see a double change in Russia's use of energy issues in the relationship with Ukraine, affecting both the goals of its use and the means through which these were pursued. If in the period 1993–1994 Russia tried to use energy as a foreign policy tool vis-á-vis Ukraine rather directly, after receiving no direct positive outcome in this quest, it turned to more indirect methods (and methods that also involved local partners) after that. The goals also started to change. In 1994 Russia seemed to move away from using the energy weapon for political concessions, and into more concrete goals related to control over energy transit infrastructure and economic integration in the CIS. In 1994–1995 Russia sought to use the imposition of an excise duty on oil exported to Ukraine as a way to pressure Ukraine to join the CIS Customs Union.[21] In the mid-1990s, Gazprom also used energy pressure to seek to gain control over Ukraine's gas pipelines, which, if realized, would have left Ukraine with no control over transit going through its territory and, thus, no way to counter Russia's pressure by threatening to cut-off supplies to Western Europe. Despite Russia continuing to exert pressure for a deal giving it control of the pipelines,[22] the deal failed due to strong opposition in Ukraine, especially in the Verkhovna Rada, which responded by outlawing the privatization of all "strategic" enterprises, including the oil and gas industries.[23] The energy war ebbed in the fall of 1994, in part because now, having received support from international financial institutions, Ukraine started to be much more proactive in terms of paying its gas debts on time.[24]

The 1997 agreements on the Black Sea Fleet—which had been a major bone of contention between Russia and Ukraine since independence—provide an additional example of the variety of ways in which energy concessions were used to deal with political issues. It is not clear where the idea of "compensating" Ukraine for giving up its part of the Fleet through reducing its gas debt came from, but we know that, already in 1995, Russia's President Yeltsin had been linking negotiations on the Black Sea Fleet to Ukraine paying back its debt to Russia.[25] Similarly, during the Yeltsyn-Kuchma negotiations in Sochi in June 1995, the idea of paying for Russia's leasing of the Sevastopol base in the form of energy supplies and forgiveness of Ukraine's debt came up and was agreed to in principle,[26] although never implemented due to very strong domestic opposition in Ukraine.

The 1997 agreements included a significant energy component. In the agreements, as compensation for the reduced-rate rent agreed to in the 20-year lease given to Russia for the Black Sea Fleet bases in Crimea, Russia would credit Ukraine's debt to Gazprom $526 million, and a further $200 million for the 1992 transfer of nuclear weapons. Other parts of the package agreement included both countries dividing the Black Sea Fleet on a 50–50 percent basis, and Russia leasing the ports in and around Sevastopol for twenty years at $97.75 million per year.[27] Ukraine subsequently agreed to a division giving Russia 81.5 percent of the Fleet in exchange for additional energy debt relief.[28] This agreement was to have long-term consequences, as, for example, when Russia raised gas prices charged to Ukraine in January 2006, Ukraine responded by arguing that it would also raise the rent charged to Russia to market prices.

The Black Sea Fleet agreements opened the door for other important agreements between Russia and Ukraine. The 1997 Russian-Ukrainian Treaty on Friendship, Cooperation, and Partnership (ratified in 1999) that accompanied the agreements on the Black Sea Fleet had broad repercussions for Ukrainian-Russian relations, as it finally established official Russian recognition of Ukraine's sovereignty and international borders. Thus, it established the base without which closer cooperation would have been unthinkable. In February 1998 Ukraine and Russia signed a large-scale Treaty on Economic Cooperation for the Period 1998–2007, which officially opened Ukrainian privatization to Russian investors, and signaled the beginning of large-scale Russian investments in all areas of the Ukrainian economy.[29] Russia's recovery from the 1998 crisis and the rise of powerful economic conglomerates in Russia also promoted this trend.

How did these processes fit in—or did not fit in—within larger trends in Ukraine's foreign policy during this period, and how did they influence Ukraine's response to Russia's energy overtures? If the image of Ukraine's wavering between Russia and the West is largely valid for the whole post-Soviet period, there were important differences between Kuchma's first and second presidential periods.

During his first term in office, between 1994 and 1999, several factors made it difficult for President Kuchma to follow an openly pro-Russian foreign policy. Some of these factors were the following: First, the considerable nationalist opposition to such a rapprochement, a stance which was made easier by Russia's foot-dragging in recognizing Ukraine's sovereignty as an independent state.[30] Second, the fact that the West was still keenly interested in Ukraine, and economic and political support for the country provided Ukraine with an important counterweight to Russia.[31] Third, during Kuchma's first term in office he had to rely on the moderate nationalist national democrats for political support; in Kuchma's second term, these became sidelined as potentially more pro-Russian oligarchic groups gained a greater role as Kuchma's allies and developed a strong political base as "centrist" parties in the Verkhovna Rada.

Energy and Russian-Ukrainian relations in the second Kuchma presidency, 1999–2004

If at the time of his re-election in 1999 President Kuchma promised to engage in a “multi-vector” foreign policy of strategic partnerships with both Russia and the US, a number of domestic developments very soon put an end to this plan and started to push Ukraine closer and closer to Russia. In the early 2000s two scandals rocked Ukraine, both with important implications for Ukrainian-Russian energy relations. The first concerned the September 2000 disappearance and assassination of investigative journalist Heorhii Gongadze (whose focus on corruption, including energy corruption, had put him out of favor with the government[32]); President Kuchma was indirectly implicated in the disappearance through comments allegedly made and recorded in his office. The second scandal (the so-called Kolchugate) flared up when Kuchma’s plan to secretly sell Kolchuga passive radar systems to Irak was unveiled. (Paradoxically, the political crisis unleashed by the Gongadze scandal also swept with it the government of PM Viktor Yushchenko, who since 1999 had been seeking to introduce a measure of real reforms.)

These scandals had important implications for Ukraine’s relationship with Russia, as they (and, in general, Kuchma’s increasingly non-transparent domestic and international policies during his second administration) led to his becoming more and more internationally isolated. This put the president in a situation where, on the one hand, he became increasingly dependent on Russian support and, on the other, his weakness vis-á-vis Moscow also weakened his ability to stand up to it in terms of energy issues.[33] With few reserves of legitimacy at home[34] or allies abroad, Kuchma had little alternative but to comply with Russian wishes and requests, including in the area of energy policy. The growing orientation toward Russia was reflected in a number of Ukrainian-Russian bilateral agreements and programs of coordination in foreign policy and defense enterprises, including the February 2001 agreements on linking both countries’ energy grids. (Indeed, the period immediately following the bursting out of the Gongadze case saw a flurry of activity in Ukrainian-Russian relations, with both presidents meeting a record eighteen times in 2000–2001.[35]) Most importantly, a series of Ukrainian-Russian energy agreements were signed in the period 2000–2004. Among these the most talked about—although ultimately unimplemented—was the October 7, 2002 agreement for the creation of an Ukrainian-Russian gas transit consortium which would have de facto given Russia a veto power in Ukrainian gas transit policy and transit relations with the West.[36] Ultimately more important, however, were the series of lower-level energy agreements by which, one by one, Ukraine gave Russian or Russian-dominated companies control over significant portions of Ukraine’s gas and oil transit.[37]

This growing role of Russia in Ukraine’s energy policy was supported by larger trends in Kuchma’s second term in the direction of more pro-Russian policies. In addition to Kuchma’s growing isolation, discussed earlier, a number of other factors were moving Ukraine in a more pro-Russian direction. Domestically, Ukrainian economic groups with important connections to Russia were becoming increasingly important, both in terms of their economic weight, and of their weight in the Verkhovna Rada and the Kuchma coalition.[38]

Internationally, two other circumstances coincided to facilitate Russia's increased control over Ukraine's energy policies. First, Vladimir Putin's accession to the Russian presidency in 2000, which marked the beginning of a much more assertive policy toward former Soviet republics, and the West's growing disillusionment with Ukraine.[39] Taken together with the negative developments taking place within Ukraine itself, these tendencies contributed to Ukraine's moving closer to Moscow. This does not mean, however, that, that there were not important limits to economic cooperation with Russia. At a more general level, as stated by Kuzio, "Just as he [Kuchma] and his advisers were not interested in sharing power domestically with the opposition, so too did they oppose integration eastwards or westwards, as this would have entailed a threat to their total monopolization of power."[40] More specifically, the system of connections between BAGs (often referred to as "clans") and political power meant that businesses lacking a "roof" of clan protection—including many Russian businesses—had little chance of success in the Ukrainian market.[41]

Second, Ukraine's growing rapprochement with Russia also had effects on energy policy through the issue of GUAM. One of the few means Ukraine had of counterbalancing Russia's hegemonic control of the post-Soviet space was through its participation in—and, by 2001, de facto leadership of—the informal alliance GUAM, created by Georgia, Ukraine, Azerbaijan, and Moldova in 1997 (and later joined, for a time, by Uzbekistan) as an attempt to develop an alternative to Moscow-centered integration plans in the post-Soviet area. But even this organization, which had a strong potential in the energy area through its ability to promote the development of non-Russian-centered energy transit structures (in particular the Baltic-Black Sea link that could have been pivotal in helping these countries' break their energy dependence on Russia) seemed to fall victim to Ukraine's closer relationship with Russia. Under likely pressure from Russia, Ukrainian support for GUAM started to dwindle even before Yushchenko's dismissal as Prime Minister in 2001, and the very idea of working toward Euro-Atlantic integration was removed from the agenda of the day.[42]

In many ways it could be said that these foreign and energy policy changes were the price Ukraine had to pay for Moscow's support of the embattled President Kuchma.[43] But while the benefits of Russian support could only be reaped by Kuchma and his associates, the "price" of this support had to be paid by society as a whole, including giving up a significant degree of sovereignty in energy policy.[44]

The year 2000 marked the beginning of large-scale Russian investments in Ukraine's energy sector, especially refineries.[45] In 2000, Russia's Tiumen′ Oil Company acquired 67 percent of the Linos refinery,[46] LUKoil and Sintez Oil acquired a controlling package of shares in the Odesa refinery,[47] and a number of Russian companies, led by Tatneft, acquired 57 percent of shares in the Kremenchuk refinery.[48] By 2002, Russian companies had acquired control over the most important four of Ukraine's six oil refineries. Gazprom, which since 1995 had pushed for conversion of some of Ukraine's debts with the company into shares in strategic industries,[49] also sought to take advantage of this wave of investments to acquire control over Ukraine's gas transit system, although strong opposition in the Verkhovna Rada once again precluded this from happening. The energy offensive went beyond the oil and gas sectors, however, with Russia's United Energy Systems (RAO-UES, led by Anatolii Chubais) showing a strong interest in regional power companies (oblenerhos) in Ukraine.[50]

Energy issues and Russia's attempt to get Ukraine to join a Russian-dominated economic bloc

The Ukrainian-Russian relationship takes place in the context of Russian attempts to build a closer relationship—economic and political—with former Soviet republics.[51] What Russia expected from Ukraine in exchange for support of the Kuchma regime went beyond the purely bilateral relationship and also involved Russia's plans to beef-up economic integration plans—first under the name of "Eurasian Economic Community" (EEC) and later that of "Single Economic Space" (SES)—in the former Soviet space.[52] Here the role of Ukraine was seen as crucial, not only because of its economic importance, but because of its ability to attract other post-Soviet states to the enterprise. Yet, despite Russian pressure, Ukraine failed to adopt a consequent policy on the issue. If in March 2002 Kuchma spoke of full membership in the EEC, after facing strong protests at home he changed to proposing associate membership and, by December 2002, to rejecting membership altogether. In a new reversal, in February 2003 Kuchma declared Ukraine's readiness to join the organization while continuing negotiations to join the World Trade Organization (WTO).[53] In September, 2003—despite the objections of several ministers—Kuchma, together with the presidents of Russia, Kazakhstan, and Belarus, signed an agreement (ratified in April 2004) on the later establishment of a SES including a free-trade zone and a customs union. Yet problems with ratification by parliament meant the agreements remained unlikely to be implemented. Many saw Kuchma's support of the SES proposal as, first and foremost, a way to support Viktor Yanukovych in the 2004 presidential elections, both in a broader political sense and in terms of assuring Russian economic support for Yanukovych's candidacy. The energy component here was twofold. On the one hand, Russian-Ukrainian cooperation in a Single Economic Area signaled a willingness to also cooperate in other areas, for example, in the management of Ukraine's gas transport system, and, in connection with this, Russia's willingness to abandon the idea of building new pipelines around Ukraine.[54] In addition, Ukraine joining a post-Soviet free-trade zone seemed to bring with it the hope (never officially corroborated by Moscow) that energy prices may be lower for SES states.

Russian energy pressure under Yushchenko

As things worked out, even with mighty Russian support, President Kuchma was not able to secure a Yanukovych victory in 2004. Viktor Yushchenko's arrival to power in early 2005 opened—or at least so it seemed at the time—a new era in Ukrainian foreign policy, characterized by a clear Ukrainian striving for membership in NATO and the EU. Such an approach was not welcomed by Moscow. As shown by the events of fall 2005, Russia not only used the threat of rising gas prices as a way to punish President Yushchenko for following a pro-Western foreign policy line, but also to seek to persuade Ukraine to join a pro-Russian economic, political and military bloc—already including Belarus—which could serve as the basis for a larger reintegration process sellable to other post-Soviet states as an alternative to NATO and the EU. This attempt ended in the Ukrainian gas crisis of January 2006, the cut-off of gas supplies by Russia, and their resumption after the signing of a highly questionable gas supply agreement, all of which are discussed in Chapter 8.

So far we have discussed Russia's use of energy pressure to attain broader foreign policy goals vis-á-vis Ukraine. But Russia did not hesitate to apply pressure in other policy areas to attain desired outcomes in the energy sphere. In late January–February 2006, for example, when public outcry mounted in Ukraine over the January gas agreements with Russia, and these agreements seemed under threat of being canceled, Russia put pressure on Ukraine through other policy areas—for example, by provoking a confrontation on the use of a lighthouse in the Crimea area leased by the Russian Black Sea Fleet, and banning the importation of Ukrainian meat and milk products. This is interesting because it shows how other aspects of the bilateral relationship have been used to attain desired outcomes in the energy area.

Energy and Ukraine's relations with Western states and financial institutions

Chornobyl, energy policy and relations with the West

If Ukraine appeared in the Western energy map—and, some would say, in the Western map altogether—it was first and foremost because of the Chornobyl nuclear reactor accident of April 26, 1986. Thus, nuclear energy and Chornobyl damage-control emerged as an important area of Western policy toward Ukraine, with important implications for Ukraine's diversification possibilities. After the Chornobyl accident, one unit of the damaged reactor continued in use, creating tensions with the international community. In 1995 Ukraine and the G-7 group signed an agreement on the closing of the Chornobyl nuclear power plant by the end of 1999 in exchange for financial support for the modernization of Ukraine's energy system and the building of a sarcophagus to limit radiation leaking from the original reactor.

What followed, however, has been a rather tense relationship in which, especially during the Kuchma presidency, the Ukrainian side has repeatedly accused the EU of not fulfilling its 1995 commitments.[55] Under both the Kuchma and Yushchenko presidencies, Ukraine has insisted on a return to an increased use of nuclear energy, seen by many as especially urgent given Ukraine's dependency on Russian gas and oil. (As of 2004, nuclear energy provided 16.2 percent of Ukraine's Primary Energy Supply, including 40 percent of Ukraine's electricity production.)[56] The issue of whether Ukraine should continue to depend largely on gas for its energy needs came to the fore again after Ukraine decided to finally close down the Chornobyl nuclear power plant on December 15, 2000 and the issue of how to replace that lost capacity had to be grappled with. (The government's plan has been to replace this lost capacity with two new nuclear power plants, Rivne and Khmelnystkyi, which were 80 percent complete in 2000.) In August 2004, President Kuchma reopened the second block of the Khmelnytskyi nuclear power plant. However, as Ukraine depends on Russia for nuclear fuel, increased nuclear power production does not in and of itself resolve the question of energy dependency on Russia.

Ukraine's energy dependency and its relationship with Western partners and institutions

In general, Ukraine's energy dependency on Russia has affected its relationship with the West in the sense that this energy dependence is part of the larger set of dependencies and interdependencies that keep the Ukrainian economy tied to Russia's and, thus, have contributed to Ukraine's foreign policy wavering between East and West for most of the post-independence period. At a more specific level, energy dependency on Russia brings to the fore the role of Ukrainian economic groups in the relationship with Russia. Although there is some debate as to whether and to what extent Ukraine's main oligarchic groups supported economic integration with Russia,[57] Ukraine's energy dependency on Russia under its particular post-independence political conditions set into motion a number of processes involving BAGs and their interests, processes which, as discussed in Chapter 7, worked to strengthen Ukraine's dependency on Russia. These mutually reinforcing processes in turn made it difficult for Ukraine to build closer relations with the West. Moreover, the corruption and lack of transparency that have characterized much of Russian-Ukrainian energy trade since 1991 contributed to Ukraine's image as a country with which it is difficult to do business, and where it is not safe to invest. Ukraine's chronic dependency on Russian energy and chronic inability to pay for it also contributed to the ballooning of Ukraine's external debt, which from $8.42 billion in 1995 had soared to $23.88 billion by 2005.[58] In fact, Ukraine was borrowing from the West to pay its energy debts to Russia, as payment due for yearly energy imports amounted to a significant portion of Ukraine's export revenues, making it necessary for Ukraine to either borrow from abroad (from Russia or the West) or enter into often murky barter and other deals in order to keep gas supplies flowing.

Ukraine's energy situation has also affected the relationship with its Western partners through issues such as energy intensity and energy subsidization. While low energy efficiency (discussed in Chapter 5) lowers the competitiveness of Ukrainian exports in the long term, the other side of the coin is that energy subsidies have been a way of subsidizing this inefficient production and promoting Ukrainian exports. Indeed, it is Ukraine's most energy-intensive industries (metallurgy, and to a certain extent petrochemical industries) that have generated the most exports since 1991. This means that "part of the higher energy consumption resulting from the biased industrial structure is paid for by increased exports."[59] But at the same time, the relative success of these energy-intensive exports to Western Europe, the US, and the Far East[60] during a good part of the 1990s kept Ukraine tied to an unconstructive energy use model. Yet, it was exactly this subsidization through subsidized energy prices that made some Western partners, in particular the EU, suspicious of possible Ukrainian dumping in steel production and other exports.

How Ukraine's relationship with Western partners and institutions affected its energy relationship with Russia

Ukraine's relationship with Western institutions had a variety of effects on Ukraine's energy dependency on Russia. Yet the effects have not been clear-cut, with some of the policies supporting Ukraine's energy diversification, and others indirectly contributing to a continuation of the status quo.

A number of Western initiatives have been directed at helping Ukraine diversify its energy resources and diminish its energy dependency on Russia. Several Western countries (in particular the US and Germany) have established programs to help Ukraine increase its energy efficiency. At the level of the EU in general, programs such as TRASECA[61]—devoted to creating a variety of transportation links between Caspian and Black Sea area countries and Western Europe—have been very important. Indeed, it was in the context of TRASECA that the building of the Odesa-Brody pipeline intended to diversify Ukraine's oil supplies took place.[62]

While many of the EU's energy-related regulations affecting the Central European former candidate states do not affect Ukraine because Ukraine is not a candidate for membership,[63] some of its indirect initiatives could affect Ukraine's situation as an important consumer and transit state. Of these, the most important is the Energy Charter Treaty (ECT), intended to provide a comprehensive approach to deal with energy investment, exploration, production, and transportation policy, based on World Trade Organization rules, non-discrimination, and Third-Party Access to pipelines.[64] Russia's refusal to ratify the Charter has created serious obstacles for its implementation. However, the treaty still has important political effects. For a large consumer and transit country such as Ukraine, the most important contribution of the Energy Charter lies in the fact that it could protect transit from political disputes, which would increase transit revenues by increasing security. According to experts such as Opitz and von Hirschhausen, this could significantly increase Ukraine's transit revenues, especially when combined with an international concession-based management of its pipeline system.[65] Moreover, full implementation of the Energy Charter could mean that Ukraine could have access to Central Asian gas—even through Russian pipelines—without Russia being able to forbid its transit at will.[66]

Despite their support for Ukrainian independence, Western institutions were not able or willing to provide Ukraine with decisive help to break its energy dependency on Russia. This had to do with several factors. First, Ukraine's energy dependency problem is too large, and too chronically embedded in the country's whole political and economic system to be able to be solved easily from the outside. Second, Western institutions such as the EU had their own interests and perceptions of energy security, interests and perceptions that focused mainly on Russia as supplier and that did not give much importance to the development of alternative gas pipelines linking new Central Asian gas suppliers with Ukraine and Europe by-passing Russia. Ukraine has been relatively neglected in a EU policy that clearly privileges the relationship with Russia, especially in the energy area. Indeed, many of the smaller countries of the region have shown apprehension that the EU's "energy dialogue" in regard to Russia may not consider their interests. This refers not only to the possibility of rising prices, but also to fears that, in the rush to increase imports from Russia, their transit interests may be ignored; for example, that the EU may not take into account Ukraine's interests in deciding about new transit routes for gas. But other parts of the "energy dialogue" could also have far-reaching implications for the CEE countries dependent on Russian oil and gas, for example, the call for the demonopolization of Russia's domestic gas market and export system, something Gazprom has opposed, but which, if ever implemented, could create real competition from which large consumers such as Ukraine could benefit.[67]

Finally, the EU's ability to help Ukraine was severely limited by the fact that in Ukraine itself there was limited interest at best in both a significantly closer relationship with the EU and in real energy diversification, especially among important interest groups. The Kuchma leadership did not seem to be, beyond the rhetoric, particularly interested in actual integration with Western institutions. In fact, as time passed, even the rhetoric became less pro-Western, with constantly pushed back target deadlines and presidential statements such as "[h]aste is absolutely not required" setting the tone.[68] In fact, it seemed that by the last year of the Kuchma presidency, important Ukrainian political actors were intent on sabotaging whatever was left of Ukraine's "pro-European" vector. This was seen clearly in the energy area around the Odesa-Brody oil pipeline (discussed in Chapter 6), a major diversification project that seemed to be torpedoed from within the Ukrainian side itself.

By 2001–2002 the West was losing both interest and patience in Ukraine, partially as a result of its deteriorating domestic dynamics—which robbed Ukraine of credibility as an EU candidate—but also of changing international circumstances. As noted by Kuzio, after the September 2001 terrorist attacks the

US started to concentrate much more on Russia as a strategic partner in the fight against global terrorism, which took much attention away from the US-Ukrainian partnership started under President Clinton.[69]

The retreat of Western institutions and Western interest meant increased opportunities for Russia in Ukraine. In many ways, in building closer relations with Ukraine (including in the energy area during 1999–2004), Russian President Putin was taking advantage of opportunities created by the lack of a sufficiently strong and decisive EU energy policy vis-á-vis Ukraine, and vis-á-vis the development of an energy security strategy looking beyond Russia to other important regional producers such as Central Asia.

Western institutions and the management of Ukrainian–Russian energy relations

In the final analysis the strongest impact of Western institutions on Ukrainian energy policy was not direct—by either radically increasing or decreasing the country's energy dependence—but indirect, by helping Ukraine moderate and manage its continuing energy relationship with Russia. For example, Western mediation helped Ukraine restructure its energy debts with Russia in 1995 by, among other things, putting pressure on Russia, making an agreement on debt with Ukraine an indirect condition for granting Russia a large stand-by credit.[70] The role of Western-led international financial institutions was essential at another important turning point in Russian–Ukrainian energy relations, namely the large-scale entrance of Russian capital into Ukraine's oil refining sector in the late 1990s. Having shown unimpressive macroeconomic improvements in the last years, Ukraine's prospects of acquiring new loans from international financial institutions stood at a low point, and these started to put pressure on Ukraine to relax restrictions on large-scale privatization.[71,72]

Conclusion

This chapter analyzed the foreign policy, state-to-state level of the energy question, including Russia's use of energy as a foreign policy tool. Having looked at this question, in the following chapters of the book we look behind this state-to-state picture to show how, given this external situation, Ukraine's domestic conditions made a difference in terms of its way of dealing with its energy dependency situation.

3 De facto policy-making system and energy policy

The Ukrainian political system under Kuchma and beyond

Introduction

A central argument of this book is that the nature of its political arrangements affected Ukraine's management of its energy dependency and its ability to develop a consistent energy policy, as well as the opportunities available for the realization of Russian energy interests in the country. To analyze this, a first step involves characterizing the political system and its implications in terms of establishing certain patterns of interest articulation and policy-making. In this chapter, we analyze the general aspects of this question, that is, how Ukraine's political system under President Kuchma affected policy-making in general; Chapter 6 discusses the system of energy policy-making more specifically. Here, we look at the nature of the Ukrainian political system between 1995 and 2004, and trace how its specific features affected interest articulation and policy-making. We look at three important elements of this system—the de facto system of interest articulation, the role of the executive, and the role of the parliament—whose interaction largely determined the way politics and policy-making were de facto conducted in Ukraine.

Our discussion of the Ukrainian political system here focuses on the 1995–2004 period. Although Leonid Kuchma was sworn into office in 1994, we have chosen 1995 as the starting point for the analysis due to the importance of the 1995 Constitutional Agreement in shaping some central features of Kuchma's "system."[1] As will be discussed in Chapter 4, by the mid-1990s the main cleavage had already started to shift from one between state enterprise managers ("red directors") and private property owners to one between various regional Business-Administrative Groups (BAGs), and the 1995 Constitutional Agreement serves as a landmark representing the beginnings of the new system. The Agreement greatly strengthened the role of the president, giving him significant new powers allowing him to play a balancing role between various groups.[2] The system described here comes to a tentative end with the October 2004 presidential elections and the concomitant crisis of the Kuchma system.

In most general terms the Kuchma regime can be characterized as a semi-authoritarian system following the letter if not always the spirit of democracy.[3] Some have characterized it as "electoral authoritarianism"[4] or a "hybrid state" combining elements of democracy and authoritarianism.[5] Within the "hybrid state" framework, some have described Kuchma's regime as "competitive authoritarianism"[6] where, despite the existence of democratic institutions and their survival as real mechanisms of political competition, they are systematically manipulated by the regime through bribery, co-optation, and other informal means that nevertheless often fall short of a clear violation of existing laws. Looking at some of its more specific features, some have described the Ukrainian system under Kuchma as semi-presidentialist (emphasizing the president and prime minister as "dual executive") or as presidential-parliamentary.[7]

Regardless of the specific way the Kuchma regime may be characterized, there is agreement that one of its central features was the ambiguous demarcation of powers between the president, the parliament, and the government (the Cabinet of Ministers system). This ambiguity was compounded by ambiguity in the rule-making authority within government institutions themselves, with ministries and other agencies able to "issue instructions which are akin to presidential and cabinet decrees."[8] With the lack of viable majorities and other bottlenecks making legislation increasingly hard to pass in the Verkhovna Rada, such quasi-legislative instruments became increasingly important and provided the president with an additional opportunity to wield his significant informal powers.

Clans, interest groups, and "balancing"

Some have characterized post-independence Ukraine as a "captured state," in the sense of particular actors gaining great power within the state, to the point that they can use its institutions and resources for their own goals as opposed to general interests.[9] While we leave a detailed discussion of the applicability of this model to Ukraine for Chapter 6, it suffices to note here that the Ukrainian system under Kuchma was characterized by strong interest articulators having significant power and having taken over state policies in many areas, with the autonomy of the state limited by this power.[10]

By 1995, regionally based (or originally regionally based) interest groups started to emerge as the most important interest articulators active in the system; their economic power was further strengthened as a result of large-scale privatization in the late 1990s. These groups could be further divided into "in-system" and "non-system" interest articulators. Our discussion here focuses on the role of in-system BAGs (clans) that is, those groups that participated in the president-centered system of "balancing" and exchange of economic favors for political support, which we discuss below.[11] As will be discussed in Chapter 4, each BAG's level of influence fluctuated in the period under our consideration; here we concentrate on the general aspects of their role in politics and policy-making.

By the late 1990s the Dnipropetrovsk, Donetsk, and Kyiv clans had emerged as Ukraine's main BAGs.[12] These in-system interest articulators were strong, had access to their own media outlets, regional leaders, and political parties, and competed both in the Verkhovna Rada (discussed below) and in more informal policy-making arenas.[13] At the same time, as noted by Bukkvoll, we should not assume that these BAGs were fully cohesive, or free of internal conflict.[14]

Although competition between BAGs was often open, the means by which it took place were not transparent to the general population. To the public, they were best known through their main oligarchs-turned-politicians: Andrii Derkach and Serhii Tyhypko of the Dnipropetrovsk BAG (Working Ukraine Party), Viktor Yanukovych, Rinat Akhmetov of the Donetsk BAG (Party of Regions), and Viktor Medvedchuk, Hryhorii Surkis, and Leonid Kravchuk of the Kyiv BAG (Social Democratic Party of Ukraine (United), SDPU(o)). Each of these main BAGs and their main players also had important energy-related interests. While these BAGs competed for control over policies and related economic benefits, they had a common interest in the maintenance of the general system of interest articulation as such and of a presidential "balancing" between them.[15] As put by a Ukrainian journalist: "the only thing that brought together Ukrainian oligarchs was the 'roof' [system of protection]—on 11 Bankivska Street, where the President's Administration is located."[16] Indeed, it has been argued that the 1996 Constitution strengthening the role of the president represented BAG's recognition of their "need of a strong president as a means of [regulating] their influence on each other."[17]

The role of the executive

The role of the executive was central in this system. While authors such as Prostyk have referred to the Ukrainian system under Kuchma as "semi-presidential," with the president and prime minister effectively constituting a "dual executive,"[18] when it comes to the "balancing" system of interest articulation, the system centered around the president. Thus, we use the term "executive" to denote the president.

Role of the president as "arbiter" and interest articulator

A central feature of the Ukrainian system under Kuchma was the coexistence of strong interest articulators and a strong president. It was characterized by a system of informal balances between these strong BAGs with President Kuchma playing an important balancing role between them. Thus, we refer to this as a "president-as-balancer" system. While the strength of some interest articulators reminds us of Hellman's concept of "state capture," what sets the 1995–2004 Ukrainian case apart is the role of the executive in this system. Although strong interest articulators were able to take over state policies in many areas, limiting the autonomy of the state, the president acted as a powerful "balancer" between them, playing the role of informal arbiter while pursuing his own economic and political interests. The president's ability to play the arbiter in this system was a result of his formal and informal powers, as well as of other features of Ukraine's constitutional system.

The president as "balancer" and "arbiter"—cooptation, negative retribution, and blackmail

The president—as political actor and not necessarily as representative of a single state interest—played a complex role in this system, moving between his role as arbiter within various interest groups and as representative of his own interests. Yet the president was far from being an uninterested arbiter in this system, as he often represented his own economic interests and those of his close associates.

The means through which the president played the role of arbiter were closely related to his own electoral ambitions and desire to stay in power, and this role had economic as well as political aspects. On the economic side, central to this system was the executive's allocation of preferential treatment with potentially high economic value (patronage appointments, administrative benefits, and licensing rights) in exchange for the informal sharing of some profits, recycled into regime-maintenance and election-preparation activities, or more general financial and media-coverage contributions.[19] On the political side, the manipulation of Rada deputies and coalitions (discussed below) was essential. By helping maintain a balance between the various groups, the president not only prevented any one group from gaining total power, but also prevented two or more groups from joining together to challenge him. This "balancing" could be accomplished by, on the one hand, playing various interest groups and clans against each other—seeking to make them "fight it out among themselves," not stopping at blackmailing when necessary[20]—and, on the other hand, by keeping this conflict under control by, among other means, establishing a measure of predictability in the system of access to governmental positions[21] and state-related rents by the various BAGs.[22]

Formal and informal powers

Undoubtedly, some of Kuchma's ways of doing policy may have had to do overwhelmingly with his personal style, but these could not have come to the surface nor have had so much of an effect had it not been for the institutional system that made them possible. Thus, important clues for understanding Ukraine's way of managing its energy dependency are to be found in the system of powers afforded the president, especially the combination of formal and informal powers he had access to. Indeed, it is impossible to understand the real system of power in place in Ukraine under Kuchma without looking, not just at the formal domestic political system, but also at the more or less informal institutional arrangements as they really worked, including the informal powers held by the president. In terms of formal powers, it is important to note the president's significant appointment and dismissal powers, including not only the power to appoint the government, but also lower-level functionaries and the heads of state companies, not an irrelevant prerogative given the fact that the chairmanship of state-owned NAK Naftohaz Ukrainy (NAK NU) was widely seen as being worth "a whole wagon-load of ministerial posts."[23] The 1996 Constitution, by strengthening presidential appointment powers, provided the president with additional means of offering economically relevant preferential treatment to his allies, putting them in a position to access important sources of income. The presidential power to appoint the government (subject to approval by the Rada), for example, put important limits on the potential independence of the Cabinet of Ministers.[24] In addition, the country's unitary system and the appointment of regional governors further strengthened the president's power as "arbiter" in the system, as it gave regional governors more independence from local electorates than if they were elected, and put at their disposal a significant amount of resources from Kyiv (e.g. access to by-appointment patronage positions) which they could use to further build their clientelistic networks and support preferred parties in the elections. Because regional governors were appointed and dismissed by the president, this strengthened their clientelistic links with the president (with the practical implication that, in order to keep their jobs, they would need to be able to mobilize votes for the president, strengthening "party of power" clientelistic structures).[25]

The president also had important informal powers at his disposal, including through the selective application of administrative regulations, through the politicization of the government bureaucracy, law enforcement agencies, and the tax administration, and through his informal control over the media, electoral and patronage-for-votes processes, and of choice real estate holdings through the presidential administration.[26]

Such informal powers allowed the president to use the state machinery to both prosecute opponents and provide allies with preferential access to profitable contracts and rent-access opportunities. In these areas, the president was able to use formal rules and informal power in a mutually reinforcing way—using formal rules to exercise informal power, using this informal power to give himself more formal power, and in turn using these new "formal powers to gain additional informal powers, and so on in a self-reinforcing cycle."[27]

These informal powers contributed to what van Zon calls Kuchma's imposition of "strong presidential rule by stealth."[28] Understanding the president's informal powers also helps us understand his strength vis-á-vis the prime minister, with whom he was often in a situation of competition and open or veiled confrontation.[29] Such competition often led to instability in the cabinet, which, together with the general ambiguity of policy-making powers, encouraged the development of "alternative arenas for decision making" such as various presidential councils and corporatist bodies[30] and, most importantly, of the Presidential Administration as "the second centre of executive power."[31]

Using these powers, President Kuchma and his Presidential Administration were able to increasingly sideline the government in major foreign policy decisions, as was the case with Single Economic Space agreements in 2003. Despite the fact that according to Ukrainian law all international agreements need to be discussed by the Cabinet of Ministers, which then forwards its non-binding recommendation to the president, the fact that the government depended on the president for its survival de facto limited this power.

The role of the parliament (Verkhovna Rada)

The nature of political relations in the parliament (Verkhovna Rada) also fostered the president's strong role in the system. As discussed above, in the period 1995–2004 (and especially 1999–2004), Ukraine's three main BAGs were able to build their own parties and representation in the Verkhovna Rada. The Dnipropetrovsk BAG had control over the Labor Ukraine (Trudova Ukraina) Party, Donetsk over the Party of Regions (Partiia Rehioniv), and the Kyiv BAG over the Social Democratic Party of Ukraine (United) (SDPU(o)). Both internal and external laws and regulations affecting the work of the Rada helped BAGs to translate their economic into political power, as they helped inter-party competition proceed mainly along "clientelistic rather than ideological lines."[32] Some of the elements contributing to this situation were the nature of Ukraine's party system, electoral laws and regulations, and the Rada's internal rules and regulations.[33]

General nature of the party system

Some features of the Ukrainian party system, such as the fact that parties were mainly brought together by important personalities and not a shared ideology, and the fluidity of party divisions and affiliations, contributed to making parties especially vulnerable to pressure from interest groups and the president. This overlapped with Ukraine's regional cleavages to create a situation where no single party or orientation (left, right, or center) ever had a "natural" majority. However, the situation was not simply one where parties happened to lack a strong ideological basis, but one where parties were often artificially created (or taken over) by BAGs for their own purposes.[34] Compounded with internal Rada regulations, this would hinder the formation of stable parliamentary coalitions. For example, the fact that the Rada itself is not structured along party lines, but on the basis of "factions" (in the system in place until 2005, once elected to the Rada, each MP could choose to join a number of "factions," and could change factions at will) also means the president will have more of a chance to use divide-and-rule tactics to influence voting in the Rada. As noted by Dubrovs´ky, Graves *et al*, the lack of development of a strong party system also played a role: "Without strong political parties that would be politically accountable and would control the Cabinet, the underlying logic of political struggle is the competition of BAGs for the rent."[35]

The electoral system

Until 1998, Ukraine used an exclusively single-mandate district (SMD) system of representation. Effective in the 1998 elections, it moved to a mixed system (with half of the deputies chosen on a SMD and half on a proportional representation basis) and, effective in 2006, to an exclusively proportional representation system.[36] While the gradual introduction of this system gave more of a chance to politicians without state connections to win seats, the single-mandate district system partially or fully in force until 2005 fostered competition between individual candidates, not parties, and "favored individual politicians who were government office-holders and were able to command significant material and organizational resources in order to win majority SMD districts,"[37] fostering electoral clientelism.[38] SMD districts also encouraged the election of a large number of deputies formally unaffiliated with any party (in the 1998–2002 Ukrainian parliament, 136 out of 450 deputies[39]) available to be later recruited for membership in various party and non-party caucuses (factions) as well as change factions at will—most often in one of the centrist factions close to the president—as part of their participation in the system of potential clientelistic rewards. Indeed, it was mainly in the Rada that much of clan-controlled party activity concentrated. As noted by Whitmore, the role of economic interests and patronage was reinforced by the growing role of entrepreneurs elected to the Rada as these not only brought with them their own economic interests, but also "provided a reservoir of potential clients for presidential co-optation."[40] That a variety of entrepreneurs at different levels of the transparency scale were attracted to the Rada in a period characterized by both selective law enforcement and large-scale corruption is not surprising, as one of the main "perks" coveted by oligarchs—highly prized parliamentary immunity from criminal prosecution—was available only through the Rada.

Although this situation did not lead to a strong and stable presidential majority in the Rada (see below), it created a pool of ideologically and otherwise unattached "centrist"[41] deputies ready to be tapped into (through different configurations) by the president for the formation of situational coalitions and majorities.[42]

Rada rules and regulations

In addition, institutional factors such as Rada regulations setting a low threshold for the formation of new factions (for the 1998–2002 Rada, a minimum of 25 deputies), allowing individual deputies to change factions, and providing no incentives for building larger factions[43] promoted the development of a multitude of small caucuses, and made it easier for deputies to change from one to another based on opportunistic clientelistic considerations. At the same time, the constitution, "by limiting the Rada's role in government formation and survival, did not provide sufficient incentives for majority formation."[44] It must be noted, however, that the lack of a viable majority in the Rada was not only the result of institutional factors such as the electoral system, but of the very reality of regional divisions and fragmented elites.[45]

How did this fragmentation of the Rada, especially of its "center," affect Kuchma's ability to play the arbiter? For much of 1999–2004 there was no clear presidential majority,[46] but also no clear opposition majority, in part due to opposition factions' inability to form durable alliances.[47,48] However, as stated above, there were many ways for President Kuchma to build situational, *ad hoc* pro-government majorities when needed (e.g. as in 2000–2001 and 2002–2004). Echoing his more general way of dealing with various BAGs, President Kuchma was able to exploit fragmentation in the Rada using negative retribution and blackmail to pursue his own objectives.[49] Another effect of this fragmentation was that it often took protracted bickering, including vetoes and their overriding, to pass important legislation.[50]

Conclusion: impact on policy-making

The implications of this situation for the policy-making process were clear: first, the ambiguous separation of powers, together with the use of legislative institutions for clientelistic purposes gave the president increased opportunities to use his significant informal powers for the pursuit of "balancing" between BAGs. This created a situation where it was easy for policy-making institutions to be misused or ignored for the benefit of particular interests, including those of the executive. At the same time, in this system various elites (even when dependent on the system of favors presided over by President Kuchma) were rather strong, and, thus, were able—to a certain extent—to create competition in energy policy.

If it could be said that in its classic form the Kuchma "system" of clan balancing ended with the Orange Revolution in 2004, the outcome is far from certain. Chapter 8 discusses how Viktor Yushchenko's coming to power in 2005 affected this policy-making system, both as an effect of the institutional changes resulting from the amendments to the Constitution agreed to in December 2004 (and which came into force on January 1, 2006) significantly reducing in the power of the president, and of the more general changes in the country's political life brought about by the Orange Revolution.

4 Politics and economics in the development of the Ukrainian energy markets, 1995–2004

"[The rules for the organization of the Ukrainian energy market have been so changing and complicated]... like a soap opera with [too] many plots."

(Hanna Liuta)[1]

Introduction

We complete Part I of this book with an overview of the development of Ukraine's energy markets and policies in the period from independence to 2004. This chapter seeks to answer the question of how did changes in domestic political conditions and the "balancing" between various Business-Administrative Groups (BAGs) affect the development of Ukraine's energy markets between 1995 and 2004. In doing so, we aim to provide a context for the more focused analysis of the role of energy rents in Ukrainian energy policy in Part II of the book.

Situation at time of independence

Structural and political factors defined Ukraine's energy situation at the time of independence and the period immediately following it. Ukraine acquired independence in 1991 in a situation of enormous energy dependency on the rest of the Soviet Union: 89 percent of its oil needs and 56 percent of its gas needs were covered by imports, mainly from Russia.[2] This dependency encompassed both structural as well as mental elements. It had to do not only with "pure" dependency on energy supplies and the lack of infrastructure needed for alternative imports, but with an economy organized in ways that depended on the industrial infrastructure of the rest of the USSR—especially in areas such as refining, metallurgy, and heavy machine-building—and even the way in which the Ukrainian political and economic elites lacked a Ukraine-centered concept of energy security, as apposed to one based on a common balance of energy supplies and expenditures with Russia.

The political aspect—more precisely, the way in which Ukraine acquired independence—reinforced this dependency. The fact that Ukraine acquired independence as a result of a "bargain" in which independence was accepted by the old elites but these remained in power meant that, despite many declarations to the contrary from all sides of the political spectrum, many old ways of looking at energy issues remained in place. Ukrainian elites did not come to terms with the reality of energy scarcity. Second, the fact that the old Communist Party of Ukraine elites' support for independence was based on an implicit bargain: trading their support for Ukrainian independence in exchange for maintaining the highest possible degree of influence[3] (which could, in hindsight, not only be easily translated into freedom from the Soviet Union, but also freedom to steal). In other words, as stated by van Zon, "[W]hen Ukraine became independent, loyalty of the elite to the state was promoted by the fact that the state was the most lucrative feeding ground and it gave elites the opportunity for career advancement and self-enrichment."[4] As we will see throughout this book, the combination of these two factors (old ways of looking at energy dependency and new or newly articulated interests) would turn out to be decisive for the way Ukraine would come to deal with its energy dependency in the next 15 years.

1991–1994: Heyday of the "red directors"

The first years after independence clearly show the lasting effects of Soviet-era legacies and Soviet-era ways of looking at energy issues. Indeed, in the first years after independence, we see a situation where structural factors—the continuation of very cheap energy deliveries by Russia throughout at least 1993 and the short-term survival of giant Soviet-era industries—combine to contribute to the rise of state-owned companies' managers as important factors of power and keepers of a certain approach to energy issues. The fact that many parts of Ukraine had been heavily industrialized during the Soviet period almost automatically made this group one of the most important political players in the first years after independence.[5] Many of the so-called red directors were directors of huge Soviet-era factories characterized by their high energy intensity, energy inefficiency, and, thus, dependency on cheap supplies of Russian energy. The "red directors" also carried with them Soviet-era ways of looking at the question of energy independence, in the sense of looking at a Soviet-wide energy balance, not a specifically Ukrainian one, and, thus, of seeing energy inputs as basically unlimited and only a soft constraint on their production cycle. In other words, they still felt as if they lived in an energy-rich state. Moreover, because energy prices for Ukraine did not increase immediately after independence, enterprise directors did not feel the full economic shock of changed external conditions.

The large role of the "red directors" in the Ukrainian political system during the first years of independence coincided in time with the centralized system of gas purchases from Russia (through the state company Ukrhazprom), and the two reinforced each other. Managers also had the full support of conservative state officials "strongly inclined toward maintaining the volumes of production and preserving the existing entities along with existing cadres by the means of their habitual resource-oriented policy."[6] The huge role of the industrial sector in Ukraine′s total energy consumption (61 percent in 1998) magnified the impact of such policies and attitudes on Ukraine′s overall energy situation.[7]

1993: Energy prices increase, but enterprise directors spared

Starting in 1993, energy prices for Ukraine start to rise,[8] but the directors' way of looking at energy questions in Soviet-size terms did not change, because they were cushioned from the full impact of external changes by domestic institutional arrangements, in particular the system of soft credits made available by the Ukrainian state at this time.[9] As a result of these soft credits[10]—which later contributed to increasing Ukraine's state foreign debt—the most energy-intensive sectors of the Ukrainian economy not only survived, but actually grew during this period, making Ukraine even more dependent on energy imports from Russia.[11] Indeed, Ukraine presents a fascinating case of what happens when a state suddenly changes from being an energy-rich country to an energy-poor one, but the elites fail—at least in the short term—to change their behavior as a response, and, moreover, try to influence institutions (in this case, the system of soft credits) in order to keep the status quo, or even to seek a profit out of this situation.

1994–1997: From red directors to oligarchs

The influence of Soviet-era industries and their directors during the early years of independence was reflected in the general structure of power in Ukraine at the time. Together with the agrarian lobby, the former CPSU nomenklatura and—to a lesser extent—the new businesses started after 1991, the "red directors" composed the main interest articulators in the first post-independence years. Significantly, during this early period these main interest groups and the cleavages among them were based on each group's position in the economic structure (and, to a lesser extent, on sectoral interests[12]) and not so much on regional relationships. (As most heavy industry was concentrated in Eastern Ukraine, however, the "red directors" power base was also concentrated there.) Moreover, each of these groups did not seem to have at its disposal the variety of resources (own media, political parties, and so on) we would later associate with Ukrainian regional clans. This situation was to change after 1994 with the entrance of BAGs (or clans) into the scene.

Kuchma's access to the prime minister's post under President Leonid Kravchuk in October 1992 coincided in time with the timid beginnings of a new system of interest articulation. First, through the process of nomenklatura privatization, many enterprise directors became owners or acquired de facto control over state property. Second, the "red directors," Kuchma's original power base, start to forge links and merge their interests with new economic structures, thus starting to combine policy-making and economic resources, and leading to the beginning of the development of the so-called clan system.[13] Later on, in the mid-1990s, various groups and alliances within the "party of power"[14] formed more rigid structures and eventually became known as clans. These structures combined business and political (access to decision-making) assets under the control of a narrow circle of leaders.[15] Thus, the main difference between interest articulators before and after 1994 was that before, the main groups were created on the basis of their position in the economic structure; after 1995, it was increasingly on the basis of regional clans.[16]

The kind of clan system we see under Kuchma did not exist under President Kravchuk. Indeed, the Ukrainian system we characterize as a "president-as-balancer" system can be seen as Kuchma's creation ("his contribution to state building," in a kind of ironic sense), but a creation that could not have been possible without these preceding changes. By the time Kuchma becomes president in 1994, BAGs are in full development, first and foremost that established around his own power base, Dnipropetrovsk, and start to acquire important positions in both state and rent-seeking structures locally and in the capital, largely dominating politics for the next two years. Indeed, it is estimated that over 200 officials moved from Dnipropetrovsk to Kyiv following Kuchma's election.[17] A later but no less significant arrival from Dnipropetrovsk was Pavlo Lazarenko, whose influence and wealth started to grow immediately after being named Vice Prime Minister in September 1995 and whose role in the restructuring of energy markets will be discussed below.

Energy money and the formation of the post-1991 Ukrainian political system

The rise of gas traders and Lazarenko

If in the early 1990s industrial enterprises and their directors could access rents stemming from subsidized energy imports from Russia and their subsequent re-export at near-Western prices, when heavily subsidized imports stop in 1994 this "true" source of rents becomes replaced by a "virtual" one—payments to Russia for gas stopped almost totally, with the debt most often eventually taken over by the state.[18] In other words, the external source of rents represented by the subsidized gas prices becomes replaced by an internal one—the simple shifting of the costs to other internal sources, first and foremost the state.

The shift of costs to the state took place in the context of serious liquidity problems and general economic instability, exemplified by hyper-inflation, workers going unpaid for months at a time, and currency depreciation. The lack of cash for payments—magnified by the increase in energy prices—largely contributed to the rise of the so-called gas traders (*hazotreidery*) during this period. Gas traders were able to solve some of the problems created by the generalized lack of liquidity by carrying through flexible payment schemes through barter operations and through the restructuring of non-performing gas loans.[19] Indeed, the 1995–1996 reorganization of the gas import system—from a centralized system based on Ukrhazprom to a "decentralized" one—was based on the premise that private gas traders would be more flexible in dealing with Gazprom, that they would help increase collection rates by being more willing than the state to cut off non-paying customers, and that this would help move to a system where market forces—and not a state organization—would determine gas demand and import requirements.[20] The *hazotreidery* engaged in a whole array of creative deal-making to overcome liquidity problems. Particularly notorious were their complex barter deals (trading goods, IOUs and even tax scrip for gas), through which traders were not only able to guarantee gas supplies to enterprises and residential consumers, but to amass considerable fortunes through legal and illegal means. (We discuss this at length in Chapter 7.) It was also at this time, 1994, that the gas trading company ITERA starts to enter the Ukrainian market, with the active support of Gazprom's management, which gave it some of its contracts and later offered it preferential access to its pipelines for the transit of Turkmenistan gas to Ukraine.[21] ITERA's growing role in Ukraine must be seen in the context of its relationship with Gazprom; it has been estimated that, between 1996 and 2002, Gazprom handed ITERA more than 50 percent of its gas markets in the former Soviet Union.[22] In Ukraine itself, ITERA's rise was greatly supported by PM Pavlo Lazarenko, who in early 1996 gave the company permission to import *c*. 18 bcm of gas from Turkmenistan to Ukraine.[23]

While the *hazotreidery* system sounded good on paper, in reality it led to chaos in the gas market, with a multiplicity of suppliers, prices, and deals going on simultaneously in any given area of the country. This rather chaotic situation gave rise to an attempt to put it under control, an attempt which eventually ended getting out of hand. Private intermediaries (wholesale importers) were given regional monopolies to buy gas from Russia and Turkmenistan and to enter into barter contracts with factories in their regions, with the state (through Gosneftehazprom, the State Oil and Gas Industry Committee) playing a regulating role, including the territorial division of the market between wholesale gas importers, something that would lead to significant problems. While giving the profitable industrial contracts to well-connected *hazotreidery*, the state itself kept the contracts with the largely insolvent residential customers, often unable to pay.[24] One can make sense of this seemingly irrational situation by looking at it in terms of the capture of state companies by various economic interests, and by the exchange of preferential regulatory treatment for political and economic support, discussed in Chapter 7.

Significant problems arose when one of these regional supply groups, Dnipropetrovsk's Iedyni Enerhetychni Systemy Ukrainy (United Energy Systems, IESU), started to acquire power and influence well beyond its original area, and its economic power started to synergize with its growing political power in a way that threatened the balance established at the time. PM Lazarenko's heavy involvement with IESU led to corruption and political infighting—indeed, Lazarenko as PM carried out a radical restructuring of the gas sector (see below) specifically to benefit IESU. If in early 1996 eight independent wholesale importers were granted regional monopolies to buy gas from Russia and Turkmenistan and to establish barter contracts with factories in their regions, soon afterwards the number of licensed companies was reduced to two, prompting speculation about government favoritism and the use of illegal methods of privatization.[25] Following this, IESU, linked to Lazarenko, expanded rapidly, including into the traditionally rival Donetsk region.

Estimates vary, but the *New York Times* estimated that Lazarenko personally netted around $200 million a year in oil and gas deals.[26] The territorial division of the market meant industries had no choice but to buy from the dealer given monopoly rights in each region, which created large profits for the gas traders—for example, traders often imported gas from Russia at effective prices of $40 or $50 per 1,000 cm but sold it to "captive industrial consumers for $80."[27] Those factories unable to pay were subject to bankruptcy procedures and takeover by the gas suppliers themselves in profitable forced bankruptcy schemes.

Based in Dnipropetrovsk (hometown of both President Kuchma and PM Lazarenko), IESU quickly grew to supply half the natural gas traded in Ukraine. IESU's establishment of a near-monopoly on gas supplies also threatened to disrupt the "balancing" system between various BAGs. The lack of strong institutions able to limit the misuse of power at the highest levels heightened the influence of Lazarenko and his Dnipropetrovsk clan, magnifying the impact of his use of political power for personal enrichment.

PM Lazarenko's heavy-handed tactics in supporting IESU's expansion into rival territories threatened to plunge Ukraine into a cycle of mafia-like violence unacceptable even for the low standards of the day. A murky assassination attempt on Lazarenko in the summer of 1996, followed by a widespread campaign of official intimidation against Donetsk businessmen (accused of participation in the attempt on Lazarenko) fueled speculation about a new battle over the division of Ukraine's gas markets, perhaps with the acquiescence of the highest echelons of power, and led to fears that Lazarenko's reprieve against Donetsk was getting out of hand. The November 1996 gangster-style assassination of Yevhen Shcherban′, a prominent Donetsk businessman and leader of the Liberal Party of Ukraine, was widely believed to be related to struggle between the Donetsk and Dnipropetrovsk clans for control of the gas market;[28] many saw it as Lazarenko's response to Shcherban′'s call for resistance to IESU's growing power.[29] (The so-called Dnipropetrovsk clan, which controlled United Energy Systems, was associated with Lazarenko; Shcherban′ was associated with a rival company, Aton, and the "Donetsk group".)

Lazarenko's fall and a new division of the gas market

As Lazarenko starts to gain de facto control over the Cabinet of Ministers,[30] pursuing policies independent of President Kuchma and even heading a movement against him, the confrontation between interest groups starts turning into a confrontation between different groups in the executive power and between different parts (pro-president and anti-president) of the Dnipropetrovsk clan itself. Lazarenko's use of gas rents to build his own political movement and challenge Kuchma's power was the final straw for Kuchma. So, after having turned a blind eye to Lazarenko's misdeeds while he supported him, the President now denounced him. Moreover, the Parliament started a special investigation into the division of the country's gas market.[31] Pressure from all these factors finally led to Lazarenko's resignation in June 1997.

Lazarenko's resignation led to an open division of the Dnipropetrovsk clan between its pro-Kuchma and pro-Lazarenko factions, the latter becoming organized around the "Hromada" (Unity) party. Lazarenko was replaced as PM by Valerii Pustovoitenko, associated with the pro-presidential wing of the Dnipropetrovsk group, which quickly found a base in the newly created Popular Democratic Party, which also incorporated many economic interests related to the energy sector.[32] Lazarenko remained close to the Hromada party, formed in summer 1997 around IESU head Yuliia Tymoshenko. Since its very inception, Hromada launched a virulent campaign against Pustovoitenko, Lazarenko's successor as PM, accusing him, among other things, of "open administrative terror" against the country's industrialists and energy sector corporations[33] such as IESU, that is, of exactly the same abuse of power Lazarenko had himself conducted until a few months before.

Prime Minister Pustovoitenko reacted to Lazarenko's "too quick and too loud" political comeback by taking measures to curtail IESU's business interests. For example, a successful bid by IESU to buy up shares in Ukraine's largest manufacturer of petroleum and gas pipelines was reversed by the government.[34] New rules for the division of the gas market, adopted in the wake of the non-payments crisis of summer 1997—when Russian supplies were reduced due to lack of payment—also negatively affected IESU's interests.[35] By 1998, IESU had lost its gas trading license and its customers had been redistributed to rival companies. The brunt of the attack on Yuliia Tymoshenko, now head of the company, came from rival gas-related oligarchic structures (especially the gas company Interhaz then headed by Ihor Bakai and Hryhorii Surkis), something she did not forget by the time she became first Vice PM for energy issues in 2000. Despite Lazarenko's fall from power, the deals made by IESU continued to have an impact on Ukrainian-Russian relations. After IESU lost most of its costumers, it still owed Gazprom several hundred million US dollars for imported gas, a debt Gazprom argued should be taken over by the Ukrainian state.[36]

Indeed, the government's measures against IESU seemed to go beyond a simple return to normalcy. Deprived of President Kuchma's support, the company was basically ousted from the market, but other Kuchma associates continued to control the gas market. The Popular Democratic Party, Kuchma's new base, was successful in winning 28 seats in the Rada elected in 1998. But "controversies over the redistribution of gas contracts" led twenty-three of its deputies to eventually abandon the faction[37] to join Working Ukraine or the Party of National Revival.

The system of balances between various BAGs only came into full swing after 1995 and especially after 1997 following the defeat of Pavlo Lazarenko's attempt to give one clan overwhelming control over the Ukrainian economy. At the same time, parallel to the eradication of IESU's power, a new process was gaining strength which in many ways represented a response to the uncontrolled growth of IESU's and Lazarenko's power. IESU's uncontrolled growth had deeply frightened President Kuchma. First, because the power of Lazarenko's sub-clan was growing, taking over more and more positions outside its original geographical area, and this threatened the nascent "balancing" system Kuchma was putting in place.

And, second, because of Lazarenko's direct challenge to the president. The lesson was clear: never again allow one clan to acquire so much power as to threaten the system and Kuchma's power in it. Kuchma's response was to develop a two-track strategy: while seeking to safeguard and perfect the balancing system, he simultaneously sought to promote a set of cadre—first and foremost in the energy area—that would be accountable only to him.[38] Indeed, it has been argued that President Kuchma needed to create NAK Naftohaz Ukrainy (thereafter Naftohaz) to gain some independence from the various clans.[39] "After the experience with Pavlo Lazarenko, Kuchma does not trust anyone in the energy sector, he does not 'trust it' to either his PM nor the First Deputy PM in charge of energy, therefore he tries to control the sector directly."[40] This may explain, for example, the close relationship he established with Ihor Bakai, since the mid-1990s involved in gas trading through the companies Respublika and Interhaz. Bakai was named chairman of the State Committee for Gas and Oil Industry (1997) and first head (1998–2000) of Naftohaz Ukrainy. Ironically, only four years earlier, in 1994, Kuchma had ordered an inquiry into Bakai's Respublika barter deals with Turkmenistan.[41] It appears, however, that, with time, Kuchma understood that it was much more advantageous to use Bakai's contacts and "business savvy" for his own goals, than to oppose him. Because this was not just about having a devoted cadre but about having personal access to the rents system, it became necessary to create new structures and institutions. NAK Naftohaz Ukrainy was the most significant of them.

NAK NU's establishment and development

Chapter 7 discusses in detail the role of NAK Naftohaz Ukrainy (NAK NU); here we highlight only the most important aspects. The company was established in May, 1998, and started to work in full about a year later, concentrating under it practically all state companies dealing with the oil and gas area.

The amount of resources gathered under NAK NU can barely be underestimated, as the company came to nearly monopolize Ukraine's multi-billion yearly gas trade with Russia. NAK Naftohaz Ukrainy's efforts to push out remaining gas traders from Ukraine's gas market[42] and to concentrate virtually all "gas monies" through Naftohaz's subdivision Haz Ukrainy[43] fitted in well with President Kuchma's desire to acquire centralized control over energy-related money flows. This allowed the president to put important financial flows, especially those in the rent-rich energy area, under his direct control, giving him more independence vis-á-vis the various BAGs, while making it possible for him to continue to play the role of "arbiter" between them. In terms of the relationship with Russia, this increase in NAK Naftohaz Ukrainy's control basically transformed the Ukrainian-Russian energy relationship into, as noted by Shiells, a "bilateral monopoly," with Gazprom and NAK Naftohaz Ukrainy as monopolists in the Russian and Ukrainian sides respectively.[44]

Energy, "balancing," and the 1999 elections

Such direct control over important financial resources came especially handy in preparation for the 1999 presidential elections, as it allowed President Kuchma more independence from the various BAGs he sought to balance. At the same time, Kuchma's preparation for the 1999 presidential elections showed the system of "balancing" and exchange of economic favors for political support in full force. For example, both Oleksandr Volkov and Viktor Pinchuk of the Dnipropetrovsk BAG gave significant monetary support to Kuchma's re-election campaign, "and to compensate the first [Volkov] it was necessary [to give him control over] several newspapers and TV channels, and to compensate the second [Pinchuk] [it was necessary to give him control over] several metallurgical complexes and oil and gas companies."[45,46]

Although Kuchma had relied on support from the Popular Democratic Party and the SDPU(o), in the months before the election the signal was sent that business support for his re-election would be welcomed (and, one would assume, also rewarded) regardless of political affiliation.[47] As a result, various informal business holdings were established to support Kuchma's re-election bid, although in many cases these, in a similar way to the situational coalitions of the Verkhovna Rada discussed in Chapter 3, were temporary collections of differing interests, and thus inherently unstable.

Kuchma's November 1999 re-election was in large part made possible by the financial support of energy traders making significant profits from barter operations, in particular the gas trading company Interhaz and its head Ihor Bakai. Interhaz, arch-rival to Lazarenko and Tymoshenko's IESU, gained the support of the state, and was de facto "brought into" NAK Naftohaz Ukrainy, with Interhaz head and Kuchma associate Ihor Bakai promoted to head of the company, which he led until March of 2000, when he was forced to resign in the wake of corruption allegations. Interhaz was granted exclusive rights to sell gas imported from Russia to Ukraine's three hundred largest companies, and was able to accrue large profits out of this; in addition, a variety of deals were used by the company to finance both Kuchma's 1999 campaign and provide for Mr Bakai's own personal profit.[48]

Therefore, it is not hard to understand why, when energy reforms were started in 2000, those energy traders that had supported Kuchma's 1999 re-election turned resolutely against them.

Understanding the Yushchenko/Tymoshenko reforms of 2000–2001

Largely under pressure from the IMF and the World Bank, President Kuchma decided to name a reformist, Viktor Yushchenko, as PM in December 1999. A month later, Yuliia Tymoshenko was named Vice PM for energy issues. Her accession to this post reflected both President Kuchma's needs at the moment as well as her political path since 1998. If in the first months after Lazarenko's resignation she had defended IESU's interests through the Hromada party, after Lazarenko's February 1999 arrest in the United States, the Hromada fraction in the Rada largely dissolved, and Yuliia Tymoshenko decided to lead her own political party, Bat'kivshchyna (Fatherland), considered by some Ukraine's "first dissident oligarchs' party."[49]

Pressure on Kuchma from the international community was compounded by the weight of objective factors precipitated by the Russian 1998 crisis, first and foremost the Russian government's increased pressure on Gazprom to deliver revenue, forcing it to demand cash payments from Ukraine.[50] Indeed, the naming of a reformist PM was preceded by a worsening of trade relations between Ukraine and Russia—the so-called trade wars of 1999[51]—and a number of energy supply reductions, of which the most significant was Russia's oil embargo of winter 1999, justified on the Russian side by Ukraine's alleged illegal re-export and stealing of gas, and foot-dragging on its gas debt to Russia. In what some called "the first full scale oil war between Ukraine and Russia,"[52] Russia suspended oil supplies to Ukraine in December 1999-January 2000, thus raising the threat of a possible energy shortage that would continue to disrupt agricultural work.

Russia's oil blockade, compounded with Western urging, pressured Ukraine to put its house in order in the energy area. Moreover, as noted by Dubrovs´ky *et al*, the uncontrolled "overfishing" for rents was threatening the stability and viability of the system as a whole.[53]

The Yushchenko-Tymoshenko reforms of 2000–2001: sources and limits

MAIN REFORMS

The period encompassing Viktor Yushchenko's tenure as PM and Yuliia Tymoshenko's work as Vice PM for energy issues in 2000–2001 was characterized by a push for increased transparency and accountability in energy policy. Soon after taking office, Yushchenko and Tymoshenko declared a three-month "state of emergency in the energy sector" in January 2000 and embarked on an important reform program. Its main goal was to reduce the role of non-monetary payments (i.e. barter and other similar constructions) and non-payments (unpaid bills and credits) in Ukraine's energy sector. Some of the main achievements of these reforms involved the move away from barter, the establishment of oil auctions, and the re-establishment of some degree of state control over gas purchases from Turkmenistan. Cash payments for energy were promoted—barter trade was outlawed, and settlement of gas payments limited to that done through special accounts in the Oshchadbank (Savings Bank).

The attempt to eliminate oil traders was an important goal, which Yushchenko and Tymoshenko pursued through the establishment of oil auctions, and made them compulsory for the sale of a certain percentage of oil produced in Ukraine. Another important goal of the oil auctions was putting an end to the "administrative distribution" (de facto heavily subsidized distribution) of fuel, especially to the agricultural sector and its replacement by sales through auctions. This was significant because the auctions slowed down or stopped the state's wholesale granting of oil credits (which were often not repaid) to the agricultural sector at the cost of domestic producers and refineries (who were often subject to confiscation of their oil products for these to be delivered to the agricultural sector).[54] Despite a number of problems, the central achievement of oil (and gas[55]) auctions was their contribution to making oil trade operations more transparent, and, hindering, in particular, the continuation of sweetheart deals that often led to the sale of domestic oil at prices too low to make domestic production profitable.

In addition, Tymoshenko was able to reach an agreement with Turkmenistan on the continuation of gas supplies to Ukraine—which had been periodically suspended in the 1990s—but now with direct sales to a wholesaler's market under the control of the Cabinet of Ministers, instead of through intermediaries.[56]

Eliminating barter trade in the energy sector threatened to eliminate one of the main sources of unregulated rents in the Ukrainian system. More specifically, Tymoshenko's reforms threatened the rent-seeking ability of the dominant groups in each of the four main energy areas: coal, electricity, oil, and gas. In the coal sector, Tymoshenko's desire to establish open auctions for the sale of some types of coal threatened the profits of not only the most important members of the Donetsk group (the Industrial′na Spilka Donbasu, ISD), but, indirectly, also the interests of Viktor Pinchuk's (Dnipropetrovsk) group. Concerning the oblenerho (regional electricity distributors) system, Tymoshenko's attempt to make the conditions of privatization tenders more open and transparent, to allow electricity prices to increase, and to eliminate non-monetary payments in order to attract Western investors, threatened Ukrainian oligarchs' control of the area. All of this did not bode well for Hryhorii Surkis and Konstantin Grigorishin's plans for taking over Ukraine's oblenerhos, where they had already made significant inroads. In terms of the oil market, oil auctions threatened to disrupt the cozy non-market division of the oil market (and especially of domestically produced oil) among associates "at a price three times lower than its market price,"[57] making domestic production unprofitable. Moreover, the ending of state oil credits to the agricultural sector threatened their use as a currency of favors in clientelistic relationships. Tymoshenko's gas sector policies were the most problematic, and we discuss them separately below.

GAS MARKET POLICIES AND THE ATTACK ON NAK NAFTOHAZ UKRAINY

Even more problematic and controversial was Tymoshenko's attack on NAK Naftohaz Ukrainy; in order to understand it we need to keep in mind both the objective and subjective reasons for the onslaught. Among the objective reasons were the need to impose payment discipline in the Ukrainian energy market, to end the cycle of non-payments, and to deal with some of the underlying factors that were worsening the already thorny energy relationship with Russia. Among the subjective reasons, the most important was Tymoshenko's desire to exact revenge on Hryhorii Surkis and Ihor Bakai, her main opponents of the late IESU period and mainly responsible for the virtual destruction of the company, and for the state's refusal to take over some of IESU's debts vis-á-vis the Russian Ministry of Defense.[58]

In early March 2000, Tymoshenko announced a new concept for the organization of the gas market, based on the breaking of Naftohaz Ukrainy's monopoly on the purchase, transport, and distribution of gas.[59] This would have not only meant breaking one of the biggest sources of politically related rents, one of the most important sources of income for the Interhaz-Bakai group, but also one of the main sources of unregulated income for President Kuchma's use in coalition maintenance and electoral activities (according to Tymoshenko, Ukrainian oligarchs lost up to UAH 9 billion ($1.8 billion) in foregone rents due to her policies[60]).

In Ukrainian energy issues the domestic is never far away from the foreign, and it should come as no surprise that the confrontation between Tymoshenko and Bakai quickly moved to the level of relations with Russia and, more specifically, to the level of debt negotiations with Gazprom.[61] Negotiations on Ukraine's debt to Gazprom had been going on for years, and had been complicated by issues of state responsibility for private debts, non-repayment of previously restructured debt, and accusations of unsanctioned taking of gas from the pipeline and illegal re-exports.[62] Since about 1999, Naftohaz and Gazprom had been in conflict as to the real amount owed by NAK Naftohaz Ukrainy to Gazprom, with the Naftohaz management arguing that the debt amounted to less than $1 billion, while Gazprom used a figure closer to $2 billion. Then, during her visit to Moscow in January 2000, Tymoshenko made the sensational announcement that NAK's debt to Gazpom actually amounted to over $2 billion.[63]

How was NAK affected by the new figures unveiled by Tymoshenko? First, because unclear debt amounts, together with lack of clarity about the exact gas amounts supplied by Gazprom seemed to be part of an "unclear numbers game" that benefited top managers at both NAK and Gazprom. Second, because Tymoshenko used the new debt figures as an opportunity to accuse NAK NU of continued stealing of Russian gas, something that not only threatened managers' own deals and access to rent-seeking opportunities, but also dealt a huge public blow to their reputation. In accusing NAK NU of theft and mismanagement of its debt to Gazprom, Tymoshenko was not only seeking to "exact revenge" on Bakai, but preparing the ground for a new carving of the Ukrainian gas market and perhaps also for the finding of a negotiated solution to the problem of IESU's $350 million debt to the Russian government, which her opponents argued she was trying to add to NAK Naftohaz Ukrainy's debt to Gazprom.[64]

In their confrontation, Tymoshenko and Bakai relied on allies within Gazprom. While at first glance it could be assumed Gazprom would be happy to see a higher debt recognized by Ukraine, it should be noted that much of NAK Naftohaz Ukrainy's non-transparent business (not mainly but also including the manipulation of debt figures, as discussed in Chapter 7) was done with the knowledge and acquiescence of at least part of Gazprom's top management. At the same time, it seems as if Tymoshenko tried to use ITERA—suspected of ties with the top Gazprom management under Viakhirev—as a weapon in the confrontation with Bakai.[65] Since spring 1999 most of the Russian gas sold to Ukraine was going through ITERA; in 2000 Tymoshenko proposed a gas market restructuring plan involving the creation of an ITERA-NAK Naftohaz Ukrainy joint venture to handle all gas imports,[66] and allowing Russian companies to participate in competitive bids for regional gas distribution (monopoly) licenses issued by the JV.[67] Later that year Tymoshenko proposed dividing the market, with ITERA supplying industrial consumers and NAK Naftohaz Ukrainy residential consumers and budget organizations, an arrangement suspiciously reminiscent of the division of the gas market under Lazarenko, where privileged companies were given the contracts with the able-to-pay industrial customers, and the non-privileged with less able-to-pay residential customers.

This brings to the fore the question of whether the Yushchenko-Tymoshenko reforms may be automatically equated with an across-the-board attempt at "defending Ukrainian interests" vis-á-vis "Russian interests." In addition to Tymoshenko's good relationship with ITERA at the time,[68] it should not be forgotten that the years of the Yushchenko-Tymoshenko reforms were also the years of massive entrance of Russian capital into the Ukrainian oil refining sector. Indeed, it has been argued that fostering the entrance of Russian capital into the Ukrainian refining sector may have been a way to play Russian oligarchs (and also ITERA) against those Ukrainian ones Tymoshenko was battling against, first and foremost Boiko and Surkis.[69]

The answer from Boiko and his associates was clear. Even after pressure from Tymoshenko and "blackmail from above"[70] forced him to resign as head of NAK Naftohaz Ukrainy in March 2000, Boiko and his associates continued the battle against Tymoshenko's reforms. In a first step, they sought to bog down and "neutralize" these reforms. This was not difficult to do given the fact that many of these policies had significant shortcomings and could be seriously criticized.

Almost from her first day in office, Tymoshenko found herself in conflict with Minister of Fuel and Energy Serhii Tulub, who is said to have been given the position in an attempt by Kuchma and associated oligarchs to "balance" Tymoshenko.[71] Moreover, not only were big-name energy oligarchs against these reforms, but also were many members of parliament directly or indirectly deriving profits from energy trade.[72] As a result, the reforms were quickly mired down in political infighting and opposition to them in the parliament and the presidential administration.

The state machinery failed to fully support Tymoshenko's policies. The government remained divided on issues such as the extent to which energy corruption should be prosecuted, and on whether private energy debts should be taken over by the state.[73] In many cases the judiciary failed to fully tackle energy corruption cases.[74] In great part due to pressure from powerful energy traders, in July 2000 President Kuchma signed a decree providing for the state indirectly to take over energy debts,[75] which greatly contradicted the gist of the Yushchenko-Tymoshenko reforms.

In a second step, the oligarchs took the offensive and sought to push Tymoshenko and Yushchenko out of power. The conflict with Ihor Didenko (temporary head of NAK Naftohaz Ukrainy after Bakai's resignation in March 2000) proved greatly instrumental in this. In May 2000 Didenko openly accused Tymoshenko of making false allegations against Naftohaz Ukrainy,[76] and argued this was Tymoshenko's way of "getting even" with Naftohaz Ukrainy after the company had refused to take over some IESU's debts to the Russian Ministry of Defense. Didenko was dismissed by Tymoshenko a month later, only to challenge this in court and be reinstated in September 2000, in a clear blow to her authority.[77]

Energy policies after Yushchenko-Tymoshenko

By summer 2000 the political atmosphere had taken a clear anti-Tymoshenko slant, with daily rumors of her impending removal.[78] Indeed, some argued that the reason she had not been removed already had to do with Kuchma's own political calculations and the demands of the "balancing" system: Kuchma decided to wait some time before firing Tymoshenko because he could not lead the constitutional reform to completion without the support of 23 deputies in Tymoshenko's Rada group Bat'kivshchyna.[79] Moreover, another reason Kuchma waited was because he did not want to give the job of Vice PM to either the Kyiv or the Donetsk groups, the groups that had suffered the most from Tymoshenko's reforms.[80,81]

Tymoshenko was removed in January, and Yushchenko in April 2001, brought down by a parliamentary coalition of Communists and parties related to the main in-system BAG's (USDP(o), Trudova Ukraina, Rehiony Ukrainy, Democratic Union, and Yabluko), "united in criticizing the increased liberalization of the Ukrainian economy"[82] and brought together by Kyiv's Viktor Medvedchuk, whose rising influence started to become clear at this time, and who was named head of the Presidential Administration in May 2002. The rising Kyiv clan was soon joined in power by the Donetsk BAG, whose "return" to Kyiv became clear with the naming of Viktor Yanukovych as PM in November 2002. From this moment on, the three main clans started to fully flex their muscles in terms of influence, leading in some cases to protracted indecision, as with Donetsk's Serhii Yermilov's replacement as energy minister in March 2004, which took over five weeks—during which the important post remained vacant—as the various groups negotiated among themselves.[83]

Tymoshenko was replaced by Oleh Dubin, a representative of the metallurgical lobby,[84] who declared that the war against non-payments and non-monetary payments would continue. In reality, however, after Tymoshenko's dismissal, many oligarchs who had been against her forced the approval of new laws, decrees and edicts watering down the effect of Tymoshenko's original ones. In a signal of the change in the general mood concerning energy reform, soon after Yushchenko was sacked, Kuchma declared a moratorium on oblenerho privatization.[85]

Although interest groups turned out to be more powerful than the reform team, some of the reforms introduced during the Tymoshenko-Yushchenko period (especially those concerning payment discipline in the energy sector) remained in place. The survival of some of these policies is explained by some through the fact that increased payment discipline, although at first not welcome or not feasible, was now desirable for the largest participants in the energy market.[86]

A balance of Tymoshenko's reforms

Do the Yushchenko-Tymoshenko reforms of 2000–2001 and the move toward a more transparent system (and thus their difference from the non-transparent policies most commonly associated with the Kuchma period) invalidate our analysis and our characterization of Kuchma's "balancing" system?

Indeed, during this period we see a change in Ukraine's de facto management of its energy dependency—a move toward greater transparency and an attempt to bring some of the gas import operations from Turkmenistan more firmly under the control of the state by limiting barter operations. But these reforms nonetheless fit well with the balancing model in the sense that what brought the changes was exactly the domestic-political infighting and "balancing" characteristic of the 1995–2004 period. Indeed, the naming of Tymoshenko as Vice PM—one of the reasons why Kuchma did not outright oppose her reforms, at least openly—may have been partially related to Kuchma's own desire to maintain the system of balances among BAGs, by using Tymoshenko and her energy-sector reform policies as a way of "balancing," not only the growing power of the left (Communist Party) in the Rada,[87] but also that of Ihor Bakai, whose role as head of NAK Naftohaz Ukrainy gave him access to significant cash flows.

So, what remained of the Tymoshenko-Yushchenko reforms in the energy sector? Despite her loud confrontation with Bakai and NAK Naftohaz Ukrainy, Tymoshenko's challenge to the company was not successful, and she was not able to fully reform the gas supply system. Concerning the tug-of-war issues of NAK NU's debt to Gazprom and state guarantees for energy debt, when an agreement on Ukraine's debt to Gazprom was finally reached in 2001, the debt was converted into Naftohaz Ukrainy bonds with the provision that, should Naftohaz Ukrainy go bankrupt or be liquidated, the debt would be converted into state debt.[88] In reality, however, the question remained unregulated until August 2004, as Gazprom (ostensibly due to tax liability reasons) refused to accept NAK's corporate bonds deposited in the Bank of New York.[89] Yet one important element of the 2001 debt agreement becomes clear when compared with the 2004 agreements reached during the last days of the Kuchma regime—the fact that in the 2001 agreements Ukraine would pay back the debt in cash, and in the 2004 agreements it would pay in gas, "returning" to Gazprom 5 bcm of gas yearly from the amount received in lieu of payment for transit.[90]

Tymoshenko's reforms of the electricity system were more successful, despite the fact that some of them were canceled or watered down after her dismissal. Yet the area where reforms were able to have the most significant long-term effects was in the area of increasing cash payments to NAK NU (which went from 15.8 percent in 1999 to 87 percent in 2001[91]) and reducing the role of barter in energy trade. Although it was not only Tymoshenko but also Gazprom who were interested in increasing cash payments and reducing barter transactions, the long-term positive significance of these changes for Ukraine should not be underestimated.

Most importantly, Tymoshenko's reforms proved monetary payments "to be possible and efficient."[92] Despite the stalling of other reforms, the move away from barter and other non-monetary payments proved to be very significant. It set a trend that continued to develop after Tymoshenko's dismissal and set a new standard—and limits—for the work of energy-related BAGs which, despite continuing to extract energy rents in a variety of ways, no longer "dared" (nor found it profitable) to return to the widespread use of barter schemes in the energy sector.[93]

The development of energy markets from Yushchenko's dismissal to the 2004 elections

The development of Ukraine's energy sector from Tymoshenko's dismissal in 2001 to the 2004 presidential elections was affected by five important processes: the move away from barter, the further pushing out of private gas traders and ITERA from the Ukrainian market, the growing role of Russian capital, and the further consolidation of an Ukrainian economic elite with its own interests despite the continued strength of BAGs.

In the first place, the move away from barter and toward a higher degree of cash payments in the energy economy continued to develop, with consequences for the whole energy sector. This contributed to the further pushing away of *hazotreidery* from the market—a process already begun by NAK Naftohaz Ukrainy in 1998—because, with liquidity problems on the wane, companies such as NAK Naftohaz Ukrainy no longer needed them to secure payments.[94] A third trend was the easing away of ITERA as a player in the Ukrainian market, a process driven by the growing control of Gazprom by the Russian state.[95]

At the same time, the role of Russian energy capital grew significantly. This was to a significant extent a delayed effect of the legacies of the Soviet system[96] and of the challenges posed by its dissolution—the severing of many links with other parts of the once-Soviet energy complex, chaos in the oil supply chain, and lack of investments paralyzed the Ukrainian refining sector after independence. By 1999, this crisis had made Ukraine especially receptive to Russian oil companies' offers to take over Ukrainian refineries in debt-for-shares deals.[97] In the course of six months in 2000, Russian companies took over more than half of the Ukrainian petroleum market, controlling supplies to most refineries.[98] The massive Russian investments of 2000–2001 and the associated revival of the refining sector had a significant stabilizing effect on the Ukrainian oil refining sector. If in 1998 Ukrainian refineries were working at a fraction of their capacity, by 2002 they were much closer to reaching full capacity. By 2002, the largest six of the eight Ukrainian refineries, as well as several important aluminum plants, were under Russian oil companies' control; by 2003, 90 percent of refining was done by Russian companies, with 86.6 percent of Ukrainian oil supplies being provided by Russian companies as well.[99] Control over refineries was especially significant as this allowed Russian oil companies in Ukraine to develop vertically integrated production and distribution chains (from the import of crude oil to refining to sale and export of oil products), to increase their weight in the Ukrainian energy market, and to participate in it as independent actors.[100]

This period also saw the consolidation of an Ukrainian “national economic elite,” which became reflected in ever more self-confident BAGs—whose influence in energy policy remained strong—and which some authors (Puglisi) have associated with the emergence of a “militant nationalist agenda” in part of this elite.

The strengthening of Ukrainian economic groups coincided in time with the large-scale entrance of Russian capital into the Ukrainian energy sector. In pondering this coincidence, what at first appear to be two contradictory views of this relationship emerge. On the one hand, a view based on the idea that it was in the economic interest of many Ukrainian oligarchs to coalesce with Russian economic actors such as Gazprom—or private actors within it—even when this would threaten Ukraine’s energy security. On the other hand, the view that many Ukrainian oligarchs did not want to “share” with Russian economic actors the benefits they had received in Ukraine in exchange for political support for President Kuchma. Yet this apparent contradiction fades away upon a closer look: in both cases, the central initiators of the process are domestic Ukrainian oligarchic groups and the opportunities afforded them by domestic Ukrainian processes, which led them to either “coalesce” with Russian oligarchs when this allowed them to increase their rents, or move against them when they threatened their direct control of some areas of the economy (as in the case of the Kryvorizhstal’ steel mill, for example[101]). As we will see in the next section of the book, the impact of these domestic factors in the actual conduct of energy dependency-management would turn out to be decisive.

Part 2

Rents of dependency and the Russian factor in Ukrainian energy policy under Kuchma, 1995–2004

5 Ukraine’s management of its energy dependency relationship with Russia: the track record 1995–2004

Introduction

In the last chapter, we provided an historical overview of how Ukraine’s energy markets developed in the first decade after independence, and of how they interrelated with the political battles and developments going on in the country. In this chapter, we ask ourselves: how did these developments reflect themselves in the management of energy dependency? To what extent were the energy diversification slogans proclaimed by every Ukrainian government after 1991 reflected in actual policy? To what extent did these slogans reflect actual intentions? Did these policies produce the intended results?

Ukraine’s energy situation at the time of independence was characterized by three elements: high dependency on Russian energy supplies, dependence on Russian pipelines for the transit of Central Asian energy, and high levels of energy inefficiency. In 1991, 47.4 percent of Ukraine’s energy needs—and 89 percent of its oil needs and 56 percent of its gas needs, vital for important sectors of the economy—were covered by imports, mainly from Russia.[1]

How did the Ukrainian government deal with these legacies? We can look at the Kuchma regime’s track record in the management of energy dependency in terms of three issue areas: the direct management of energy supply diversification, the organization of energy trade, and other aspects of energy policy having implications for energy dependency issues. After looking at each of these areas, we will look at the direction the management of energy dependency took during this period, in terms of transparency, the role of particular interests, and the creation of synergies in favor of or against the continuation of energy dependency.

Management of energy supply diversification issues[2]

Domestic diversification: energy diversification via energy savings, energy efficiency and increased production

The first and most obvious way of offsetting external energy dependencies is by dealing with the domestic side of the question: reducing demand through increasing efficiency, reducing consumption without increasing efficiency (by increasing prices or rationing, for example), increasing domestic production, and/or changing the energy mix in favor of fuels produced domestically.

Energy savings and energy efficiency programs

As a result of both pre-1991 legacies and post-1991 developments, Ukraine's levels of energy efficiency remained very low throughout the Kuchma period (see Table 5.1 and Figure 5.1). In Ukraine, energy loss measured in terms of the difference between the Total Primary Energy Supply (TPES) and final consumption is one of the highest in the world, with TPES exceeding consumption by 71 percent in 2005.[3]

Not only does Ukraine have one of the highest levels of energy intensity (energy consumption per unit of GDP) in the world, but energy intensity actually increased significantly from 1991 to 1999.[4] (Although the validity of this calculation has been challenged by those arguing that GDP produced in the hidden economy needs to be included in the equation, the existence itself of high levels of energy intensity has not been challenged.[5]) Even after decreases in the early 2000s, by 2004 Ukraine retained high levels of energy intensity (see Table 5.1) and remained the most inefficient energy user in Europe, including Russia.[6] Despite having a population of only 48 million, by the early 2000s Ukraine was the seventh largest gas consumer in the world, with a yearly consumption of 75–78 bcm per year.[7]

Throughout the mid-1990s and early 2000s, the Ukrainian government launched a number of energy efficiency initiatives.[8] While limited-scale projects produced positive results (e.g. programs aimed at increasing energy efficiency in public buildings), the magnitude of the obstacles on the way to improving energy efficiency on a larger scale should not be underestimated. By 2005, more than half of the households did not have gas meters, and were charged for gas on the basis of flat-rate calculations, discouraging gas conservation.[9]

Many of Ukraine´s power stations are old and use outdated technology difficult to modify without significant investments. While this makes potential energy savings significant, it also makes system-wide changes especially expensive.

Moreover, many of the energy efficiency measures implemented at the local and regional level were largely canceled by some of the more general trends taking place in the country since 1991, in particular budget problems, often contradictory legislation, the continued influence of large, energy-intensive industries, and the general problems of abuse of influence and corruption.[10] Because Ukraine did not introduce market prices for energy in the first years after independence, neither were individual consumers pushed to reduce consumption, nor the country as a whole to abandon an energy-intensive production mix in favor of a more efficient one.[11] In fact, before they were raised by the Yushchenko government in 2006, Ukrainian residential gas and electricity prices were some of the lowest in the former USSR, at $35.2 per 1,000 cm, lower than in energy-rich Russia ($44.3) or highly Russian-subsidized Belarus ($52.8);[12] they had remained unchanged since

Table 5.1 GDP, energy usage and energy intensity in Ukraine, 1990–2005[1]

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005 est.*
GDP, in billion U$D at 2000 prices and exchange rates[2]	72.00	65.90	59.50	51.00	39.30	34.50	31.10	30.20	29.60	29.50	31.30	34.10	35.90	39.30	44.00	45.20
GDP, in U$D at 2000 prices and purchasing power parities[3]	441.00	404.70	373.40	327.90	248.20	220.00	197.40	191.50	189.20	190.30	202.00	217.80	228.40	249.20	278.80	286.70
GDP as percentage of 1990 GDP (PPP)	100	91.77	84.67	76.62	56.28	49.89	44.76	43.42	42.97	43.15	45.80	49.38	51.79	56.51	63.22	65.16
TPES, in mtoe[4]	253.00	250.60	219.90	189.00	160.00	160.00	151.00	141.00	134.00	133.50	132.00	132.00	135.50	141.50	141.00	N/A
Energy use as percentage of 1990 use	100	98.81	86.91	74.70	63.24	63.24	59.68	55.73	52.96	52.76	52.17	52.17	53.35	55.92	55.73	N/A
Energy intensity (unit of fuel equivalent per unit of GDP) (@PPP)	0.63	0.62	0.59	0.58	0.64	0.73	0.76	0.74	0.71	0.70	0.65	0.61	0.59	0.57	0.51	N/A

Notes

1 Preparing time series tables for the Ukrainian case is not an easy endeavor—most Ukrainian publications give only current snapshot information, while international sources (the most exhaustive being the IEA, World Bank, and US Department of Energy) often use different base years and different measuring units, and most often have a three-year delay. While conversions to common units have been carefully performed, there is a small margin of error possible, as some of the "original" units may have been themselves arrived at through conversion from another measuring unit.

2 IEA 2006, p. 33; data for 1990 and 1991 World Bank Estimates, United Nations Statistics Division, Available at http://mdgs.un.org/unsd/cdb/cdb_da_itypes_cr.asp?country_code=804 (last accessed on August 31, 2007). Data for 2005 is an estimate.

3 Source: World Development Index Online, available at http://ddp-ext.worldbank.org/ext/DDPQQ/report.do?method=showReport (last accessed on April 20, 2007).

4 In million tons of oil equivalent (mtoe). Data for 1993–2004 from IEA, International Energy Agency, *Ukraine Energy Policy Review 2006*, p. 76. Data for 1990–1992 estimated from IEA, *Energy Policies of Ukraine. 1996 Survey*, pp. 45, 50, 52. Data for 1991 labeled in IEA source table as "Total Primary Energy Demand," but assumed to refer to Total Primary Energy Supply, as figures for both for 1990 are identical in the source (see pp. 45 and 52).

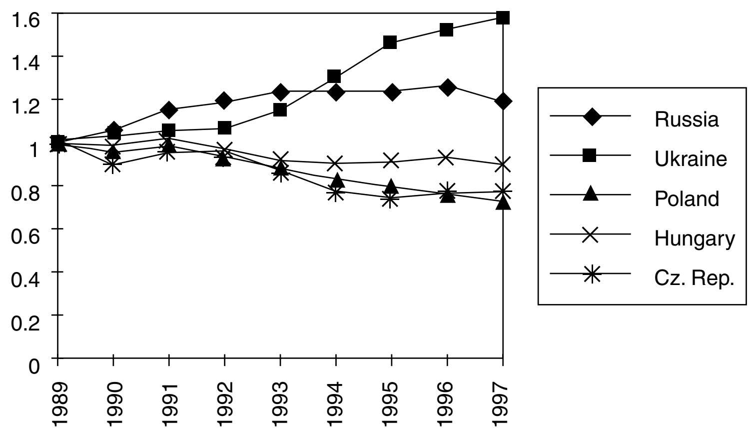

Figure 5.1 Ukraine's GDP energy intensity trends in international comparison, 1989–1997 (1989 = 100).

Source: HELIO International Sustainable Energy Watch Report for Ukraine, available at www.helio-international.org, citing data from the German Advisory Group in Ukraine.

1998, and, in fact, had declined in real terms.[13] Low residential prices isolated Ukrainian consumers from the worst effects of energy dependency on Russia and made diversification policies, more expensive in the short term, hard to sell politically; in other words, by keeping residential energy prices low, the government basically deprived the proponents of diversification of political support among the population, and made the continuation of energy dependency on Russia seem palatable to broad sectors of the population. But there is no such thing as a free lunch—the higher costs for gas were paid indirectly by the population, in the form of inflation and higher foreign indebtedness. The share of energy in the cost structure of Ukrainian goods was 25 percent in the late 1990s, 8.3 times higher than in France and four times higher than in the US.[14] This inefficient production continued to be subsidized, with a doubly negative effect: the incentive for increasing efficiency was lost, and the state budget had to carry the costs of such subsidization. At the same time, the relative success of energy-intensive metallurgical exports to Western Europe, the US, and the Far East[15] to a certain extent "paid" for "part of the higher energy consumption resulting from the biased industrial structure,"[16] thus contributing to keeping Ukraine tied to an energy-intensive industrial model. Because those most energy-intensive industries (energy, metallurgy, and to a certain extent petrochemical industries) "declined less than industry as a whole,"[17] their impact on overall energy intensity increased. This seems to explain the difference between energy intensity development patterns in Ukraine, Russia, and, in particular, the Central European early reformers, where decreases in energy intensity were observable since 1991 (see Figure 5.1).

Energy mix diversification

Energy imports can also be reduced through energy mix diversification, that is, by switching to fuels more commonly available domestically. As of 2004, 47 percent of Ukraine's Total Primary Energy Supply (including electricity generation) was covered by gas, one of the highest levels in the world; the share of gas in Ukraine's total energy supply has increased by over 10 percent since the early 1990s, making the country increasingly gas-dependent on Russia.[18] (At the same time, oil consumption has decreased dramatically since 1991, from 813 thousand barrels per day, to 370 in 2004.)

Gas was followed by coal (23.6 percent), oil (12.7 percent), and nuclear energy (16.2 percent).[19] Of these, only coal and nuclear energy have been real alternatives to imported gas, but political, economic, and environmental issues have stood in the way of either becoming a long-term substitute. In the case of coal, the poor quality of the local coal sorts, low labor productivity, the manipulation of prices by BAGs,[20] and the de facto bankruptcy situation of most mines (which makes them dependent on heavy state subsidies) have been major factors preventing coal from becoming a real alternative.[21] Moreover, the political decision to keep coal mines active despite their low rentability was not accompanied by any clear strategy to convert electricity generating plans to coal from gas, diminishing the chance that domestically produced coal could be used to partially replace the import of oil and gas from Russia.[22]

Diversification through the increased use of nuclear energy was also problematic. Although the last reactor in the Chornobyl complex was shut-down in 2000, in defiance of tacit Chornobyl-related agreements with the European Bank for Reconstruction and Development, Ukraine put into operation two new nuclear power units in 2004.[23] However, nuclear energy is not a reliable diversification solution for Ukraine given the significant domestic (opposition from environmental groups) and foreign (tensions with the EU and international financial organizations) political dangers involved, as well as the fact that nuclear fuel needed for the type of reactors in use in Ukraine needs to be imported from Russia, thus minimizing the geographical diversification effect of an increased use of nuclear power.[24] In terms of renewable resources, both the 1996 National Power Energy Program and the 2001 Alternative Energy Resources bill aimed to develop alternative and renewable sources of energy (such as hydroelectric, solar, and wind power), but these still represent a small amount (0.9 percent in 2005) of TPES.[25]

Increased domestic production

Ukraine's energy production and distribution[26] system is sorely outdated, leading to significant energy losses and limiting the growth of domestic production. Ukraine's gas pipeline system is outdated and in a poor state; this contributed to the fall in gas and oil production since 1990 (see Table 5.4).[27] Corruption and complex, investor-unfriendly rules also hindered the entrance of foreign investors (especially Western ones) into oil production areas in Ukraine, which could have helped Ukraine increase domestic production (see Tables 5.2 and 5.3).[28] Despite

Table 5.2 Ukrainian gas consumption and production, 1990–2005, in trillion cubic feet (1990–2005)

Year	*Consumption*	*Production*
1990	N/A	0.99
1991	N/A	0.83
1992	3.50	0.74
1993	3.87	0.68
1994	3.33	0.64
1995	2.97	0.62
1996	2.94	0.64
1997	2.83	0.64
1998	2.61	0.64
1999	2.76	0.63
2000	2.78	0.64
2001	2.62	0.64
2002	2.78	0.65
2003	3.02	0.69
2004	3.05	0.68
2005 (est.)	3.20	0.68

Sources: Gas production: US Energy Information Administration, available at www.eia.doe.gov/pub/international/iealf/ table13.xls (Total gas consumption; table posted May 31, 2006) and (for 2005) estimated from IEA, International Energy Agency, *Ukraine Energy Policy Review 2006*, p. 173. Gas consumption: www.eia.doe.gov/pub/international/iealf/ table24.xls (gas production; table posted May 31, 2006); Borys Kostiukovs′kyi, "Enerhetychna kryza v Ukraini," *Enerhetychna Polityka Ukrainy* 2000 No. 4, April 2000, pp. 46–50 (for 1990 and 1991 data); and (for 2005) estimated from US Department of Energy, Energy Information Administration, Country Analyses Briefs, Ukraine, available at www. eia.doe.gov/emeu/cabs/Ukraine/Full.html (accessed June 15, 2006).

the recent discovery of several gas fields, official Ukrainian sources estimate that oil and gas condensate reserves will be exhausted between 2025 and 2030, and natural gas reserves by 2032.[29]

External diversification

Geographic diversification: the declarative level

It was in the area of geographical diversification that the biggest contradictions could be observed between official declarations and practice during the Kuchma period. At the level of declarations, great attention was paid to diversification.[30] (It should be kept in mind, however, that, as discussed in Chapter 4, there was no real consensus in the Ukrainian political and economic elite about the need for diversification as a goal in itself or on whether to give primacy to a Ukraine-centered view of energy security. Actually, if there was a de facto—not just declarative—elite consensus, it was rather in the direction of a common energy balance with Russia.)

Table 5.3 Ukrainian oil consumption and production, 1990–2005, in thousand barrels per day (TB/d)

	Consumption	*Production*
1990	N/A	110.0
1991	N/A	98.0
1992	812.7	80.7
1993	569.6	79.2
1994	495.3	81.9
1995	484.4	82.0
1996	393.0	81.0
1997	372.5	86.2
1998	365.9	83.7
1999	288.5	100.9
2000	260.1	91.2
2001	304.5	90.2
2002	308.0	85.9
2003	338.5	85.9
2004	370.0	85.1
2005 (est.)	370.0	85.1

Source: US Energy Information Administration, available at www.eia.doe.gov/pub/international/iealf/table12.xls (Total oil consumption; Table posted June 5, 2006); www.eia.doe.gov/ pub/international/iealf/tableg2.xls (Oil Production; Table updated June 19, 2006) and (for 2005) estimated from US Department of Energy, Energy Information Administration, Country Analyses Briefs, Ukraine, available at www.eia.doe.gov/emeu/cabs/Ukraine/ Full.html (accessed June 15, 2006) and Borys Kostiukovs´kyi, "Enerhetychna kryza v Ukraini," *Enerhetychna Polityka Ukrainy* 2000 No. 4 (April 2000), pp. 46–50 (for 1990 and 1991 data).

Already in 1996 a "Concept for the Diversification of Gas and Oil Supplies" (Kontseptsiia dyversyfikatsii dzherel postavok hazu ta nafty v Ukrainu) was adopted by the Ukrainian government. It included proposals for increased energy diversification through imports from Turkmenistan, Iran, Uzbekistan, and the Near and Middle East. The "Concept" also supported the building of a pipeline which could transit Caspian oil to Ukraine (the Odesa-Brody pipeline). The 1997 National Security Doctrine adopted by the Rada also emphasized the problems created by Ukraine's dependence on Russian oil and gas.[31]

A second wave of diversification proposals came in 2000 during the government of PM Yushchenko. A 2000 update of the 1996 "Concept" (the document had to be "corrected" in 2000 because the goals assigned in 1996 had not been reached by 2000) called the import of more than 30 percent of gas from a single source "economically unsafe" for the state,[32] implying that supplies from a single source should be limited to less than 30 percent of total supplies. It was also during this time that Ukraine adopted the "State Concept (*Kontseptsiia*) for the Development of Ukraine's Oil Pipeline Transport System," in line with the TRASECA (Euro-Asian Oil Transit Corridor) program sponsored by the EU stressing the importance of supplies from the Caspian area. Yushchenko and Vice PM Tymoshenko also supported the idea of building a gas pipeline from Turkmenistan to Western Europe via Ukraine bypassing Russia.

In addition, a number of diversification initiatives were announced by President Kuchma each time there would be a gas or oil supply crisis with Russia, for example during the oil blockade of early 2000 and the oil supply crises of May–June 2004.

Diversification: the de facto level

Despite support for diversification at the declarative level, the de facto diversification policies followed by the Kuchma regime were often haphazard and contradictory.

GEOGRAPHIC DIVERSIFICATION: TURKMENISTAN

Although Ukraine has been receiving gas from Turkmenistan since before independence and in 2004 gas imports from Turkmenistan amounted to 42 percent of Ukraine's gas imports,[33] they never were managed in such a way as to create a real guarantee of decreasing energy dependency on Russia. These imports lacked long-term guarantees, were often affected by Turkmenistan's other relationships (both with Russia and with Russian-controlled intermediary companies such as ITERA), and remained subject to Russian influence, as they had to be transported through Russian pipelines. Moreover, the long-term continuation of these deliveries seemed to come under question in April 2003 as Turkmenistan signed a long-term gas delivery contract with Russia which, from 2007 on, would sell to Gazprom almost the entire Turkmenistan gas production, putting these capacities under Gazprom's control and leaving little free capacity for exports to Ukraine.[34] As will be discussed in Chapter 8, imports from Turkmenistan did not become a more reliable source of real diversification after 2005.

Even before the problem of Turkmenistan committing the near totality of its gas production to Russia appeared, however, other problems clouded the Turkmen-Ukrainian energy relationship, first and foremost frequent payment arrears and complications created by the large role of barter in these relations which, on the one hand, allowed Ukrainian traders to make large profits, but which, on the other hand, led to significant lack of transparency in pricing, delays in the supply of the agreed commodities, and frequent irritation on the Turkmenistan side.[35] During her time as Vice PM, Tymoshenko tried to put Ukrainian-Turkmen gas relations on a firmer footing by eliminating barter transactions in the area. However, President Kuchma often vetoed her initiatives. For example, when Tymoshenko traveled to Turkmenistan in July 2000 seeking to restart the gas import contracts with Turkmenistan (which had been frozen by the Turkmenistani side), President Kuchma did not seem to support her initiative, referring to the delegation, despite the importance of the mission, as a "so-called government delegation."[36] Also in 2000, when Tymoshenko was about to reach an agreement with Turkmenistan establishing that gas purchases would be paid in monetary form only, President Kuchma intervened to make sure the final agreement included provisions on a 50 percent payment in bartered goods and services.[37]

GEOGRAPHIC DIVERSIFICATION: ODESA-BRODY

Ukraine's track record in energy diversification during the Kuchma regime is well-exemplified by the case of the Odesa-Brody pipeline. The pipeline started to be discussed in the early to mid-1990s as a way of fostering Ukraine's energy supply diversification and helping put the country on the map as a transit corridor for Caspian oil to Europe. Delayed by a variety of problems, when the project was completed in 2002, it turned out—or so at least was the official version offered by the government—that no sellers of Caspian oil were available to supply oil to the pipeline at an economically viable price, and no buyers (refineries in Central and Western Europe) were ready to sign import contracts committing themselves to buy the oil to be supplied through the pipeline. By July 2004 the Ukrainian government had agreed to a Russian proposal for the reversal of the pipeline, that is, to transit Russian oil from Brody in the North to Odesa in the South (to be shipped further West by tanker), that is, in the opposite direction from the one originally intended. We return to this case in Chapter 6, but for now it suffices to highlight that the pipeline, from its original conception as a pro-diversification measure, to its eventual use in an anti-diversification direction, clearly exemplifies the distance between theory and practice in Ukrainian diversification policy. This problem was compounded by the fact that, despite the policy initiatives unveiled in 1998, 2001, and 2004 at the time of each major oil supply crisis,[38] by 2006 Ukraine had not taken steps to develop a 90-day reserve of oil and oil products to help stabilize the market and act as a buffer in case of interruptions in the supply of Russian oil; by 2006 Ukraine's oil storage amounted to only a minimal portion of its yearly needs.

CONTRACTUAL DIVERSIFICATION

In contrast with geographical diversification, contractual diversification is first and foremost about developing a variety of contractual relationships both in terms of companies and type of contracts (short-term, long-term, and so on), even when the energy originates from a single country. In this area, Ukraine's track record during the Kuchma regime was rather negative. If there were some aspects of contractual diversification that fell beyond the control of the Ukrainian side (the fact that no alternative Russian gas exporter to Gazprom was available, for example), in other areas the Ukrainian side consciously entered into unfavorable contracts with various Russian companies, contracts that took away income, diversification options, and decision-making power from the Ukrainian side. These contracts, which will be discussed in more detail in Chapter 7 were most often with offshore companies of dubious provenance and involved the transfer of highly profitable areas of activity to them at the expense of state income and state decision-making power,[39] for example, in the case of contracts with the offshore company Collide for the management of the Odesa (Pivdennyi) oil terminal.[40]

ORGANIZATION OF ENERGY TRADE WITH MAIN CURRENT SUPPLIER(S)

In the area of contractual organization of energy trade with Russia, the track record is one of non-transparent organization of the sector, and the use—at least until 2001—of ways of organizing payments and financing (such as barter deals, unclear credits and accounting, and so on) which actually permitted the gains from this trade to accrue to politically well-connected groups, while the losses were shifted to the state. This has been the case, for example, when the state has assumed the debts of energy traders, or when it absorbs losses related to energy waste.

WAYS OF GOING ABOUT MORE GENERAL ENERGY ISSUES, IN ASPECTS RELATED TO AND HAVING IMPLICATIONS FOR ENERGY DEPENDENCY ISSUES[41]

In this area, the track record of the Kuchma period is one characterized by the lack of institutionalization in the energy policy-making sphere, and dubious allocation of domestic gas and electricity distribution licenses which in turn created plenty of opportunities for the exchange of distribution rights for political favors. We discuss these issues in detail in Chapter 7.

The medium-term results of these factors in terms of Ukraine's energy dependency and diversification are discussed below.

Outcomes

Ukraine's total energy dependency is one of the highest in the Central-East European (CEE) region (see Table 5.4). What in this table appears as a declining trend in Ukraine's energy dependency must also be seen in the context of the sharp fall in the country's economic activity and GDP in the first decade after independence (between 1991 and 1999, Ukraine's GDP fell by almost 60 percent).[42] In the case of the Central European

Table 5.4 Ukraine's total energy import dependency in comparative perspective, selected years 1990–2004 (in percentages)

	1990	*1995*	*2000*	*2001*	*2003*	*2004*
Ukraine	47.4	49.9	43.7	41.00	43.01	43.01
Belarus	N/A	87.0	86.1	85.40	85.78	87.26
Moldova	N/A	99.0	97.9	98.00	98.78	97.33
Estonia	41.8	N/A	37.3	36.10	29.73	32.49
Latvia	N/A	N/A	N/A	59.30	61.18	66.52
Lithuania	N/A	N/A	N/A	46.88	44.23	46.06
Hungary	49.8	N/A	56.0	54.40	62.07	60.73
Czech Republic	11.9	N/A	23.3	25.77	25.09	25.71
Poland	2.0	N/A	10.7	10.50	14.63	14.75
Slovakia	77.0	N/A	66.1	61.60	64.79	67.07

Source: Calculated from European Commission (EC) "Energy in Europe—2000 Annual Energy Review." Special Issue of *Energy in Europe* (Brussels, 2001), International Energy Agency, *Key World Energy Indicators*, 2000, 2001, and 2003, available at www.iea.org/statist/key2003.pdf (last accessed on December 10, 2006) and International Energy Agency, *Key World Energy Statistics 2005*, available at www.iea.org/dbtw-wpd/Textbase/nppdf/free/2005/key2005.pdf (last accessed on August 31, 2007) and International Energy Agency, *Key World Energy Statistics 2006*, available at www.iea.org/textbase/nppdf/free/2006/key2006.pdf (accessed January 15, 2007). Energy dependency is defined as Net Imports/Total Domestic Consumption or Total Primary Energy Supply.

states,[43] in contrast, both the GDP decline and its recovery took place earlier than in Ukraine, leading to increased energy consumption and dependency as well. Ukraine's GDP started to grow again in 2000–2001 (see Tables 5.2 and 5.6). With a return to pre-crisis levels of economic activity, energy consumption increased, but at a more moderate tempo than economic growth, leading to slightly decreased energy intensity.

At the same time, the percentage of energy dependency, in and of itself, may not be enough to provide a full picture. Looking at gas and oil vulnerability—net imports of gas or oil (measured in oil equivalent) per unit of GDP—may provide an important additional perspective. From this perspective, Ukraine's situation emerges as especially worrisome: if not as energy dependent as some other states in the region, its high energy intensity (amount of energy needed to produce a certain amount of GDP) makes it one of the most energy-vulnerable countries in Europe. Thus, for example, while Germany imports around 78 percent of the gas it consumes, a similar ratio as Ukraine's, its gas vulnerability index is only 0.06, as compared to Ukraines' 0.35.[44]

The situation looks clearer from the viewpoint of Ukraine's total energy consumption and imports, comparing the change in energy dependency with changes in energy consumption. So, we can see that throughout the 1990s energy dependency fell only slightly or remained constant, while energy consumption fell significantly (see Tables 5.5 and 5.6). This is the result of declining domestic production and inefficient energy use, among other factors. According to a study by the Ukrainian Centre for Economic and Political Studies, should current trends

Table 5.5 Ukraine's total energy imports and total energy consumption (TPES) in million tons of oil equivalent (Mtoe), 1990–2004

Year	*Total net imports of energy*	*Total primary energy supply*
1990	119.79	252.63
1991	132.52	250.57
1992	107.77	219.90
1993	89.50	193.66
1994	75.25	165.13
1995	82.50	165.53
1997	N/A	141.00[a]
1999	59.86	140.21
2000	57.69	139.21
2001	58.15	141.58
2003	57.02	132.56
2004	64.30	140.33

Sources: IEA, *Energy Balances of Non-OECD Countries 2000–2001* (2003 Edition) and IEA, *Energy Policies of Ukraine. 1996 Survey* (Paris: 1996), and (for 2002–2003) www.eia.doe.gov/ pub/international/iealf/tablee1.xls (last accessed on August 31, 2007) and (for 2004). International Energy Agency, *Key World Energy Statistics 2006*, available at www.iea.org/textbase/nppdf/free/2006/key2006.pdf (accessed January 15, 2007). For a table of Ukraine's TPES from 1991 to 2003 in Quadrillion BTU's, see www.eia.doe.gov/pub/international/iealf/tablee1.xls.

Note
a IEA, *Ukraine Energy Policy Review 2006*, p. 76.

Table 5.6 Changes in Ukraine's energy import dependency as compared to decreases in energy consumption

	1990–1995	*1990–2003*
Decrease/Increase in energy consumption (TPES) (in %)	−34.48	−52.4
Decrease/Increase in energy import dependency (in % of earlier level)	+5.27	−9.28

Source: Calculated on the basis of International Energy Agency, *Key World Energy Indicators*, 2000, 2001, and 2003, IEA, *Key World Energy Statistics*, 2005, IEA, *Energy Balances of Non-OECD Countries 2000–2001* (2003 Edition) and IEA, *Energy Policies of Ukraine. 1996 Survey* (Paris: 1996).

continue, Ukraine's total energy import dependency could rise to 65–70 percent by 2020.[45]

Direction of the management of the energy dependency relationship

What does the track record in each of these areas tell us about the direction of the management of energy dependency under Kuchma? As discussed earlier, energy dependency relationships can be managed in a variety of ways having to do with the following issues: (a) transparency of management, running the spectrum from transparent to non-transparent; (b) whether it predominantly reflects the interests of particular interests, or national interests as a whole, running the spectrum from particular to non-particular, and; (c) whether it is managed in ways that foster the continuation of the energy dependency relationship or, conversely, foster growing energy independence and diversification.

In terms of the spectrum from transparent to non-transparent, the management of Ukraine's energy relationships during the Kuchma period was characterized by very low levels of transparency. In terms of reflecting the interests of particular interests or national interests, particular interests clearly had the upper hand, with the added twist that the particular groups whose interests came to be reflected in policy changed regularly as a result of President Kuchma's "balancing" strategy. In terms of the spectrum between fostering the continuation of the energy dependency relationship and proactively fostering growing energy independence and diversification, during the Kuchma period the contractual aspects of energy diversification were managed in such a way as to weaken diversification—control over important areas of energy policy was actually given to economic actors with a clear interest in the maintenance of Ukraine's energy dependency status quo.

Conclusion

Domestic and international consequences

Ukraine's energy dependency and vulnerability had a variety of domestic consequences—the state was robbed of valuable resources it could have used in other areas, and became further weakened, which, in a vicious circle, made it less able to get a grip on the energy system and its problems. Energy problems and the lack of proactive approaches to these also created dissatisfaction in the population and increased political apathy, further weakening Ukraine's still unstable democracy.[46]

The international implications are no less important. Ukraine's blatant energy dependency on Russia, together with the government's inability to take a strong policy stance on energy issues, made the country especially vulnerable to price fluctuations in Russia[47] and further complicated both countries' already difficult relationship. Energy remains both a bottleneck in the country's economic development and Ukraine's Achilles' Heel in its relationship with Russia, a relationship which, in a reflection of Ukraine's own foreign policy wavering between Russia and the West, remains a highly ambiguous one at the political, military, and economic levels. In the context of Ukraine's strained relationships with other foreign partners during the Kuchma period, such dependency led to increased pressure for closer economic and political integration with Russia, and increased Ukraine's weakness and vulnerability in negotiations with its most important partner.

6 Domestic institutions and Ukraine's responses to energy dependency

Introduction: intervening institutions and the management of energy dependency in Kuchma's Ukraine

As discussed in Chapters 4 and 5, there were significant differences between Ukraine's declared energy diversification goals and actual pro-diversification policies. The main argument of this chapter is that it was to a great extent the nature of domestic institutions which transformed declared diversification goals into non-diversification policies and results. In Chapter 3 we discussed Ukraine's political system under Kuchma and how it affected policy-making in general. This chapter discusses how broader domestic institutions—both formal and informal—affected Ukraine's management of its energy dependency between 1995 and 2004.

In the case of Ukraine under Kuchma, domestic institutions affected the management of energy dependency through (a) the system of energy market organization and its level of transparency; (b) the general system of interest articulation; (c) the de facto system of energy policy-making, including the system of presidential powers; (d) the de facto system of access to and use of rents of dependency. These institutions came—black-box like—between the declarative and real levels in Ukraine's management of its energy dependency, especially in terms of diversification initiatives. In Chapter 7 we will deal specifically with the system of access to rents of energy dependency; this chapter considers the first three institutional factors.

System of market organization: transparent or non-transparent

The level of transparency in Ukrainian markets had important effects on Ukraine's way of managing its energy dependency. By transparency, we mean not only transparency in the sense of public access to information about the functioning of various companies, but also the existence of the regulatory and institutional means of securing and guaranteeing that openness, for example, through clear property rights legislation and corporate governance rules.

Clear and strong property rights, in turn, play a role in moderating competing interests, as they help regulate the relationship between various economic actors and prevent the over-appropriation of rent resources ("overfishing"). At the same time, in a situation of weak property rights, an actual "arbiter"[1] (such as, many would argue, President Kuchma between 1995 and 2004) can compensate for the missing institutional framework, using his power to coordinate (or "balance," as in the case of Kuchma's Ukraine) interests and prevent the over-appropriation of rents.[2] As seen in Table 6.1 below, property rights in Ukraine remained weak throughout the Kuchma period.

In terms of corporate governance, throughout 1995–2004, general levels of corporate governance in Ukraine remained below par due to low disclosure levels of financial and ownership structure information, lack of clearly codified and implementable guarantees of minority shareholders' rights, manipulations with dividend payments, and the widespread occurrence of asset dilution and asset stripping.[3] In addition, the generally low levels of freedom of the press, control of the press by the main Business-Administrative Groups (BAGs), and intimidation of independent journalists made it virtually impossible for the real extent of corruption in the energy sector to be discussed openly in the wide-circulation media (see Table 6.2).

In the Heritage Foundation/Wall Street Journal Index of Economic Freedom and Index of Corruption by Transparency International, Kuchma-period Ukraine received consistently low grades, but with some improvement starting at the time of Viktor Yushchenko's tenure as prime minister in December 1999; the comparisons with Slovakia and Poland further highlight the Ukrainian results. Although we lack specific rankings for the energy sector, a variety of Ukrainian and Western sources have referred to it as the most corrupt, criminalized and non-transparent part of the Ukrainian economy.[4]

These low levels of transparency were related to the nature of the political system under Kuchma, as well as to some factors specifically associated with the transition period, such as the demise of the old and need to build new political and economic institutions. In Ukraine, as in much of the former USSR, chronic payments arrears and the resulting increase in barter and other non-cash means of trade in the early and mid-1990s also contributed to the growth of the shadow economy, as barter deals are harder to control and tax than money transactions.

The fact that real policy-making during the Kuchma period often took place not through elected representative institutions, but through informal networks evocative of patron-client relationships[5] contributed to decreased transparency in policy-making. This lack of transparency, in turn, played a crucial role in the de facto system of energy policy-making under Kuchma. On the one hand, lack of transparency (and the related system of widespread and selectively prosecuted corruption) was part of the "balancing" system in the sense that it was always advantageous for the president to have available some kind of evidence of corruption and tax evasion he could use to pressure a company into providing contributions for electoral and coalition-maintenance purposes. The existence of such evidence and the possibility of using it for blackmail was also part of the

Table 6.1 Levels of economic freedom in Ukraine (1995–2006), Slovakia (1995 and 2006), and Poland (1995 and 2006) according to the Wall Street Journal/Heritage Foundation[1] Index of Economic Freedom (1 = free, 6 = not free)

Year[a]	*Ukraine*												*Slovakia*		*Poland*	
	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*1995*	*2006*	*1995*	*2006*
Overall index	4.05	3.75	3.83	3.83	3.75	3.75	3.88	3.84	3.59	3.49	3.21	3.24	2.88	2.35	3.46	2.49
Sub-indicators:																
Ownership (Property) Rights[b]	4.00	4.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	2.00	3.00	3.00	3.00
Regulation[c]	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	2.00	3.00	3.00	3.00
Black (Informal) Market/ Corruption Perceptions[d]	5.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	3.00	3.50	3.00	3.50

Notes

1 See www.heritage.org/research/features/index/pastscores.cfm (last accessed on December 10, 2006). While the Index of Economic Freedom does not seek to measure transparency per se but the level of economic freedom, it can provide important cues as to the relative level of transparency through the data on black market and ownership rights, for example.

a According to the index's website, scores for each year are *generally* based on data covering the second half of the preceding year and the first half of the preceding year. However, the scores for 2005 do not seem to reflect this rule, as they seem to reflect events in the second part of 2004, not 2003.

b The score on Ownership/Property Rights primarily reflects the degree to which laws protecting private property rights exist and are enforced. It also considers the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts.

c The score on Regulation analyses primarily the degree of difficulty in opening a business, but also considers, among other factors, the level of transparency and uniformity with which regulations are imposed on various businesses, and the extent of government corruption.

d The score on Black (Informal) Markets is based on Transparency International's Corruption Perceptions Index. Another way of measuring corruption is through the "corruption tax" equivalent calculated by the World Bank. See "Dazhe nesyrevye strani SNG zavisiat ot dinamiki neftegazovykh tsen," *Kommersant*, September 21, 2006.

Table 6.2 Levels of political freedom and rule of law in Ukraine (1997–2006), Slovakia (1997–98 and 2006) and Poland (1997–98 and 2006) on the basis of the Freedom House's Index of Political Freedom[1] (1 = highest level of democratic development, 7 = lowest)

Year[e]	*Ukraine*									*Slovakia*		*Poland*	
	1997	*1998*	*1999–2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*1997–1998*	*2006*	*1997–1998*	*2006*
Independent media[a]	4.50	4.75	5.00	5.25	5.50	5.50	5.50	4.75	3.75	4.00	2.25	1.50	1.75
Governance and public administration[b]	4.50	4.75	4.75	4.75	5.00	5.00	5.25	5.00	4.50	3.75	2.00	1.75	2.75
Constitutional, legislative and judicial framework[c]	3.75	4.00	4.50	4.50	4.75	4.50	4.75	4.25	4.25	4.00	2.00	1.50	2.25
Corruption[d]	N/A	N/A	6.00	6.00	6.00	5.75	5.75	5.75	5.75	N/A	3.00	N/A	3.25

Notes

1 Source: Nations in Transit, available at www.freedomhouse.org (accessed January 15, 2007).

a Sub-part of the "Democratization" index.

b Sub-part of the "Democratization" index. In 2005 this category was divided into "national" and "local" subcategories. The 2005 and 2006 ratings used here are for the "national" sub-category. The Governance score includes consideration of the level of transparency in the work of executive and legislative bodies.

c Sub-part of the "Rule of Law" index. In 2005 this category changed its name to "Judicial Framework and Independence." The index considers the level of impartiality and independence of the judicial system, and whether courts are free of political interference.

d Sub-part of the "Rule of Law" index. The Corruption index includes consideration of ties between top policy-makers and business, and the existence and implementation of laws disallowing conflict of interest and requiring financial disclosure by public officials.

e According to the index's website, scores for each year are *generally* based on data from January 1 through December 31 of the previous year.

"system" of haphazard responses to recurring oil and oil products supply crises, as it allowed the president to pressure individual companies into providing fuel to the agricultural sector at times of energy crises. In this way, the state would receive free or low price supplies in exchange for closing its eyes to financial irregularities. This actually put non-corrupt companies at a disadvantage, as they also had to "pay the price" of lack of transparency (government manipulation of oil companies), without being able to profit from it.[6]

Effects of lack of transparency on the management of energy dependency

Transparency levels affect both the external and domestic aspects of the management of energy dependency. On the external side of the question, low levels of transparency helped keep Western investors away, making Ukraine more open to Russian economic penetration and influence. Low levels of transparency also gave an advantage to Russian companies working in the Ukrainian market—actors benefiting from lack of transparency will tend to cooperate with each other, and will be more willing to work with countries where similarly low levels of transparency are generally accepted than with partners where a higher level of transparency can be expected.[7] Low transparency levels in Ukraine also provided Russian companies with an important comparative advantage, as it is mainly Russian companies which possess the post-Soviet gray-market "expertise" and contacts required to work profitably (if not necessarily wholly legally) in these markets.[8] Thus, the lack of transparency—together with complex rules hindering the entrance of foreign investors, especially Western ones—fostered links with Russia as opposed to Western partners, likely pushing the country toward the continuation of energy dependency, not challenging it.[9]

The effects of low transparency on the domestic front reinforced those it had on the external front. Domestically, less transparent systems offer fertile ground for corruption and for the appropriation of significant rents of dependency, the availability of which has been a major factor in making continued energy dependency on Russia attractive to major economic actors in Ukraine. As will be discussed in Chapter 7, lack of transparency in the Ukrainian energy markets not only created opportunities for corruption and abuse of power, but actually invited corruption by creating opportunities for quick enrichment through energy deals and bribe-taking. Perhaps the best example is provided by former Prime Minister (1996–1997) Pavlo Lazarenko, but corruption at all levels continued well beyond him.[10] Having a vested interest in delaying reform, corrupt officials, and BAGs associated with them sought to delay reform in the energy sector, making the country less resilient to Russian pressure.

The confluence of non-transparencies between Ukrainian and Russian energy markets and actors provided an opening for the Russian government to take advantage of Ukraine's energy dependency for the pursuit of its own foreign policy goals. Indeed, the Russian leadership, especially under Putin, has preferred to deal with less transparent Russian companies on which power and influence may be easier to exert, and which may be more pliable as instruments of state policy in the former USSR. (The fact that it was exactly Yukos, widely considered to be the most transparent Russian energy company, that was targeted for destruction by the Kremlin is symptomatic of these changes.[11]) Similarly, it was in Russia's advantage to foster corruption in the Ukrainian energy sector, as it clearly weakened Ukraine's resolve to deal with its energy dependency.[12]

Lack of transparency also affected direct instances of Russian-Ukrainian energy interactions, as was seen in the case of the gas consortium agreement signed in October 2001 between Russia and Ukraine. From the very beginning, Energy Minister Haiduk kept details of the agreement secret,[13] and silence and misinformation dominated the progress of further negotiations, especially concerning the gradual easing away of the German side of the consortium and the fact that it seems to have been kept in the dark about the course of events.[14,15] This continued lack of transparency reduces the chances that the gas consortium could become the basis of a stable, sustainable, and non-Russian-controlled gas transit system in Ukraine in the near future.[16]

The system of interest articulation

Energy is an area that mobilizes powerful domestic and foreign interest groups. This is so because of the prospects for large profits that are associated with energy trade worldwide, and—despite its energy scarcity—notably so in the case of Ukraine, as will be discussed in the next chapter. While it is true that scarce and in-high-demand commodities will always mobilize interest groups, the specific characteristics of the de facto system of interest representation in each case will play a large role in determining how competition between interest groups will take place, and how and to what extent these interest groups will affect state energy policy.

In Chapter 3, we introduced the system of presidential balancing between BAGs. In this section, we look further into this question within the context of the larger institutional and interest representation system in Ukraine. The informal "balancing" of BAGs that characterized the system under Kuchma steered interest articulation away from elected institutions and other institutionalized means and into more informal kinds of relationships. So instead of an institutionalized system of interest representation and competition between interest groups, what we see is a situation where "competition does not occur in the open economic or political market, but at the (. . .) 'market' of personal or family relations (. . .)."[17]

Absent institutions and preference-setting

Energy policy-making took place in the context of relatively strong informal interest groups and BAGs but weak formal business associations (such as the USPP, the Ukrainian Association of Industrialists and Entrepreneurs). Indeed, the prevalence of more informal relationships also had to do with the lack of strong, well-institutionalized and transparent mechanisms of interest articulation.

As noted by Puglisi and Kubicek, although formal business associations did exist, they failed to play an important role in interest representation under Kuchma due to their weakness and lack of unity,[18] as well as to the fact that many of them (such as the USPP) “were not fully independent, as many of the enterprises in it received subsidies.”[19] With few strong institutions or clear rules of the game moderating their behavior, BAGs continued to have a very strong impact on policy-making, with the executive’s balancing role partially replacing these absent institutions and rules of the game.

This raises the question of absent institutions and the development of policy preferences by interest groups. If part of the standard Western definition of “interest groups” is that they “do not in themselves seek to occupy the position of authority”[20] but rather seek to influence power, in the case of many post-Soviet states, including Ukraine, the absence of working mediating institutions[21] means that economic groups will indeed see it in their interest to pursue power itself in order to attain certain policy goals. In this case, the absence of working mediating institutions affected actors’ preferences—they reacted by preferring to have power because “just influencing power” was simply not a viable option. In turn, the absence of a clear policy consensus and policy line (discussed later) further promoted this trend by making it easier for well-connected actors to “take over” policy in many areas, to the detriment of general interests.

In the specific case of Ukraine, the de facto system of interest representation affected the management of energy dependence in three major ways. First, the lack of institutionalized means of interest representation affected not only the strategies followed by various interest groups, but also the constraints and possibilities open to the president himself. In other words, the lack of well-institutionalized interest representation mechanisms meant increased freedom for the executive to engage in back-room dealings with various political and economic groupings and thus facilitated his use of energy policy for non-energy policy purposes—that is, for the balancing of various interests.[22] So we see a chain of mutual reinforcement between the “balancing” system, the weakness of formal interest representation institutions, and the further strengthening of the “balancing” system. Second, the system led to a situation where the power of BAGs was so large and unconstrained that they were often capable of formally capturing state institutions in charge of energy policy, including energy companies. Third, the fact that interest intermediation largely took place away from the public eye and in the less transparent realm of presidential politics meant that there was much less possibility for societal control of these policies. These general features of the system of interest representation in turn affected the de facto system of energy policy-making. We discuss this system next.

The system of energy policy-making

Ukraine’s de facto political system affected the country’s ability to pursue clear and consequent energy policies through two elements. First, through the constant “balancing” needed to keep the system in place from the president’s perspective, which got in the way of the development of clear and consequent national policies. In Kuchma's system, "balancing" the various BAGs and their demands was often more important than democratic control and institutionalized means of policy-making. Such a system of power affects the possibility of developing and pursuing clear policies (including energy policies) because the central policy-making criterion was often not the value of various policy options per se, but "how does this policy affect the 'balance' between the various Business-Administrative Groups?" Second, through the largely institutionally unconstrained (only "balance"-constrained) power of BAGs, which meant that actual policy was often chiefly a reflection of the policy preferences of whatever group happened to have the upper hand at a particular time.[23] Policy-making, thus, becomes "based not on (. . .) the institutionalized balancing of social, political and economic groups with equivalent access to interest articulation possibilities, but on the 'balancing' between various financial-administrative groups,"[24] with the spoils going to various interest groups. Here lies one of the main reasons why Ukraine has been unable to develop clear and consequent national policies.

Role of various actors in the policy-making system

Cabinet of Ministers and individual ministries

In the case of Ukraine the relative weight of various actors has been different than one would expect in a more institutionalized system. While various ministries and the Verkhovna Rada as institutional actors remained weak, a variety of unofficial actors turned out to be much stronger: not only private companies (many of which operated largely in the gray-market), but also state companies whose property structure and chain of command remained unclear and which had been captured by various economic groups or individuals.

The ministries' weakness as institutional actors was aggravated by some of President Kuchma's policies taking away power from them, such as the creation of National Shareholding Companies (NAKs) which would take over—with monopoly or near-monopoly powers—whole areas of activity from various ministries, first and foremost the Ministry of Fuel and Energy. While the history of these NAKs will be discussed in more detail in the next chapter, it is important to highlight that this process significantly reduced the competencies of the Ministry of Fuel and Energy, transferring them to institutional forms that were even less transparent and even more prone to direct control by the president. The weakness of the Cabinet of Ministers was not limited to energy policy, however, as there is evidence that the government was sidelined from other important negotiations, such as those on joining a Single Economic Space (SES) in 2002–2003.[25]

The Verkhovna Rada

In saying that real policy-making during the Kuchma period took place much more through informal discussions and negotiations than through more institutionalized means, we are not denying the role of representative institutions such as the Verkhovna Rada.[26] Indeed, some of the legislation passed by the Rada has had pivotal effects on energy policy, as was the case with the 1995 vote where, in reaction to the first attempt to create a joint Russian-Ukrainian gas transit joint venture ("Gaztranzit"), it voted to add the gas transit system to the list of strategic objects barred from privatization, a decision which has limited the possibilities for Russian participation in a Ukrainian gas transit consortium to our day. Similarly, it was Rada opposition in 1998 that prevented NAK Naftohaz Ukraini (NAK NU) from incorporating oil refineries into its holdings, which would have given the company an even higher degree of control over financial resources than the high one it actually received.[27] Similarly, the Law on Oil and Gas passed by the Rada in July 2001, after serious confrontation with the president, limited private ownership of pipelines to new ones built on the money of these private parties.[28] It was exactly because of this law that the Ukrainian-Russian gas consortium created in 2001 could not legally acquire control of Ukraine's entire gas transit system, as it had originally hoped, and had to limit itself to ownership of a small pipeline built entirely by the consortium.[29] Yushchenko's dismissal as PM in April 2001, with all its implications, came at the initiative of the Rada (more specifically, a Rada coalition of communists and oligarchs).

At the same time, the role of the Rada in energy policy-making was limited by two circumstances: First, by the fact that, as discussed in Chapter 3, due to the nature of the Ukrainian party and political system, the Rada's capacity for real policy-making was limited; instead, the Rada was to a large extent a battleground for the confrontation between various BAGs, around which the main parties were formed. Second, the fact that, due to its internal dynamics, the Rada was much more effective as a place where negative legislation (prohibiting certain things) could be passed than as a place where positive, proactive legislation could be approved. (Indeed, if we look at some of the main energy legislation passed by the Rada, discussed earlier, it is indeed legislation prohibiting something and not so much setting proactive policy initiatives.)

The president and the Presidential Administration

Although much interest representation and interest intermediation took place in the relatively open-to-the media context of the Verkhovna Rada, the much less transparent Presidential Administration remained the main focus of lobbying—and possibly of de facto foreign policy-making as well—throughout the Kuchma period. The Rada's lack of strong policy-making capacity and expediency made it comparatively less attractive as a place to promote one's economic interests than the Presidential Administration, which, due to its ability to deliver favors and "provide immediate protection for individual interests," remained more attractive as a "focus of business lobbying."[30]

The Presidential Administration started acquiring more muscle as well. It has been reported that in 2001, "the presidential administration was expanded to include a shadow cabinet that had the power to overrule government [Cabinet of Ministers] decisions,"[31] with a November 2003 presidential decree moving additional foreign policy authority from the Foreign Ministry to the Presidential Administration.[32] By the end of 2004, the administration had grown into an apparatus of almost 2,000 civil servants.[33] This allowed the president not only to manipulate and sideline parliament, but also the government.[34]

The president's formal and informal powers—discussed in Chapter 3—affected the management of energy dependency, first, through the fact that they provided him with sufficient power and leeway to use energy policy for non-energy purposes. This further reduced policy predictability, and did little to attract foreign confidence and investments. These same informal powers also allowed Kuchma to engage in the kind of abuse of power that reduced his domestic legitimacy, increased his dependency on Russia and limited his ability to manage the energy relationship in a proactive way, both in terms of his ability to foster a strong national policy consensus on energy policy issues and in terms of being able to forcefully negotiate and defend this policy consensus vis-á-vis Russia.[35]

The use of energy policy as an adjustment mechanism in Kuchma's own relationship with Moscow also affected energy policy, as seen in the case of Kuchma's management of the proposed Ukrainian-Russian-German gas transit consortium unveiled in 2002. Kuchma's acquiescence to a Russian proposal including highly problematic points such as the counting of Ukrainian debt to Gazprom as Gazprom's capital contribution to the consortium, the easing out of its German participant (Ruhrgas),[36] and general lack of transparency in the consortium's proceedings[37] may be explained by Kuchma's urgent need for Russian support at the time the project was unveiled, which made him more open to agreements and compromises with Gazprom than if he were not so dependent on this support.[38]

Similarly, Kuchma's personal political indebtedness to Moscow—combined with his own economic interests—restrained him from fully pursuing some of the energy diversification possibilities that were open to Ukraine during this period, for example, a more active participation in a possible Baltic-Black Sea energy alliance, the possible building of a gas pipeline from Turkmenistan to Ukraine lobbied by Tymoshenko during her tenure as Vice PM, or participation in the building of a 1,680 km "Trans-Afghan Pipeline" to bring Turkmenistan gas to India.[39]

Kuchma's domestic weakness meant he had little leeway to promote a separate Ukrainian vision of the energy relationship with Russia. This made even worse a situation already characterized by the lack of a clear, legitimate, and well-supported national energy policy to oppose to Moscow's ideas and pressure. Paradoxically, it was exactly the lack of constraints on the president's domestic power that led to increased constraints on his ability to defend Ukraine's energy interests vis-á-vis Russia.

Effects on policy

Democratic control, attitudes to energy diversification, and consequent policies

A policy-making system in effect taken over by BAGs and presidential "balancing" between them leaves little space for democratically controlled policy-making (if we understand democratically controlled policy-making as a situation where there is a real debate on an issue, followed by a real closing of ranks behind the chosen position). Ukrainian energy policies were only partially democratically controlled, as real policy-making was concentrated in the presidential administration, the NAKs, and informal bargaining structures that remained outside the realm of control by the electorate.[40] In the day-to-day managing of the energy sector, so-called manual steering by top policy-makers (in Lazarenko's period the PM himself, later the Vice PM for energy to the extent that he or she possessed real policy-making power at any given moment) prevailed.

The lack of a clearly institutionalized system, of a democratically controlled policy-process, and of consequent long-term policies are clearly related. Energy policies do not necessarily need to be democratic in order to be consequent, but lack of democratic control hinders the development of clear, well-institutionalized, and consequent policies. Moreover, the lack of a democratically controlled energy policy will matter for the management of energy dependency because only a democratic and generally accepted energy policy can survive contestation in the long-term and has the chance to be followed despite the short-term hardship involved in its implementation, as has most often been the case with diversification policies in the former Soviet area.[41]

The lack of a democratically controlled energy policy is an especially significant problem for Ukraine given the lack of a basic consensus on how to conceptualize the country's energy security and, thus, on what should be the goals of its energy policy. Path dependencies and identity issues are important for understanding the lack of a domestic consensus on the need for energy diversification. Many in Ukraine—especially in the first years after independence—did not instinctively think in terms of a Ukrainian "national interest" separate from Russian national interest but rather thought in terms of common interests with Russia.[42] Second, many did not see the point of an energy diversification policy based solely on political and energy independence goals as a value in itself, so they were ready to support diversification initiatives only if they were also economically advantageous in the short term.[43] At the same time, the fact that some individuals and economic groups benefited from the continuation of the energy dependency relationship with Russia helped solidify a non-Ukraine-based concept of energy security. It is exactly this lack of an obvious consensus that makes a democratically controlled policy-making system especially important—given the difficulties involved in pursuing energy diversification due to the strength of structural and mental legacies and the power of interest groups, diversification policies only have a chance to succeed if they are part of a generally accepted and well-legitimized energy policy. As soon as there are any reasons to start contesting the validity of these policies, their chance of being implemented in a consequent manner becomes much smaller. In Chapter 8 we discuss whether these mental legacies and ways of looking at Ukraine's energy interests have changed after the Orange Revolution.

How the policy-making system affected the management of energy dependence: examples

How did the system of policy-making affect the management of the energy dependency relationship with Russia? It did so mainly by facilitating the capture of state institutions and through the rapid organizational and cadre turnover it fostered. We provide some examples below.

Capture of state institutions

The first obvious way in which the de facto system of policy-making affected the management of energy dependency was through the widespread capture of state institutions by BAGs, facilitated by the lack of clear policy-making procedures, and the weakness of formal policy-making institutions.[44] This capture—often with the blessing of the executive—played an important role in the "balancing" system: control over various organizations could be used as a kind of "currency of exchange" between the executive and the various clans, in the sense that temporary control over state enterprises or over some of the rent-making activities associated with them could be temporarily turned over to one or another clan in exchange for political and economic support.[45] Regulatory organs were also available for capture; one important feature that facilitated rent-creating schemes was the frequent absence of a distinction between regulatory organs and the companies they were supposed to regulate. Indeed, regulatory powers were often just another policy field that could be "given out" on the basis of the general rules of the game that characterized the "balancing" system.[46] (We should not forget, however, that this capture, taking place within the context of the general "balancing" system in place in Ukraine during the Kuchma period, was also subject to the same instability as other parts of the policy-making system.)

Capture of state institutions was often preferred by corrupt players to full property rights. As noted by Dubrovs′ky, Graves *et al*, corrupt managers often preferred this kind of arrangement (not full-fledged private property, but their full control rights over a state-owned enterprise) because it allowed them to "get the rents in full, but pass losses to the rest of population."[47] In some cases the president as an individual actor has preferred such an arrangement over privatization, as he might have felt privatization could have limited his possibilities for access to rents for electoral and coalition-maintenance purposes.[48]

In captured state companies, top positions are often held by individuals more linked to private than to state interests, affecting these companies' behavior. The best examples are provided by state-owned Naftohaz Ukrainy (the near-monopoly gas and oil operator) and Ukrtransnafta (the state-owned oil transit company),[49] cases where a de facto privatization of state property took place. In some cases, the managers in question had a close relationship with a particular BAG or economic group (as in the case of Ukrtransnafta controlled by the Pryvatbank subdivision of the Dnipropetrovsk group and later Economics Minister Serhii Tihipko and Ihor

Kolomoisky in the early 2000s, for example); on other occasions, they were acting more independently or through a direct link with the president.

The capture of state companies had a strong impact on the management of energy dependency, as shown by the case of NAK Naftohaz Ukrainy. As will be discussed in Chapter 7 on rents of dependency, the company's "capture" by private economic actors such as Ihor Bakai led the company to support a variety of deals highly dubious from the point of view of Ukraine's energy security or even of NAK Naftohaz Ukrainy's corporate interests.

Similar trends took place in oil operations controlled by oil transit monopolist Ukrtransnafta (100 percent owned by NAK Naftohaz Ukrainy). While remaining formally state-owned, the company became largely controlled by the Pryvatbank group in 2000 (and indirectly by 2002–2004 NAK head Yurii Boiko), facilitating the company's anti-diversification agenda and its support for the reversal of the Odesa-Brody pipeline in 2004.[50]

While capture-related economic deals did not benefit either Ukraine or even its main trade partner Gazprom as a corporation, they had the potential to benefit well-connected individuals at both the government and the company levels and were often carried out in coordination with corrupt managers on the other side of the border.

Moreover, the capture of Ukrainian energy companies by local groups whose economic interests at least in the short term coincided with the continuation of Ukraine's energy dependency on Russia led to a situation where Ukraine's energy policy was silently steered in the direction of relinquishing control over its oil and gas transit system to Russian private or state companies. As a result of little-publicized agreements with oil companies[51] as well official agreements with Gazprom,[52] and Transneft,[53] by 2004 Russian oil and gas companies actually had control over most of Ukraine's oil and gas trade and export business and infrastructure.

Cadre and organizational turnover

As discussed earlier, during the Kuchma period, energy policy decisions were often taken more on the basis of the "balancing" needs of the president at each time than of an agreed long-term policy.[54] One of the most obvious ways in which this happened had to do with personnel and organization decisions—the naming of top managers and policy-makers was most often done in such a way as to maintain the balance between the various BAG's. Because being able to take money flows out of control from one group and giving it temporarily to another group—preventing any one group from feeling too comfortable in its position—was essential for the functioning of the "balancing" system, constant reorganization in the energy area was needed.

The clearest examples of such reshuffling include not only to the repeated reorganization of the gas markets in the mid-to-late 1990s discussed in Chapter 4, but the institutional changes happening in and around the Ministry of Fuel and Energy, in particular the repeated changes in its regulatory responsibilities throughout the 1990s and early 2000s. The creation of National Shareholding

Companies (NAKs) under the more direct control of the president is another important example of this situation. This constant cadre and organizational turnover hindered the development of a clear and consequent energy policy.

Another way in which "balancing" policy-making affected the management of energy dependency was through the way in which it affected responses to the periodic fuel shortage crises faced by the country for much of the post-independence period. Such crises came regularly—almost every spring at the beginning of the planting season (where lack of fuel for agricultural work led to fuel hoarding and consequent shortages) and fall at the beginning of the winter heating season (where a near-crisis situation was faced until sufficient energy supplies would be "found" to get through the winter[55]). Because these crises were often dealt with on the basis of "balancing" principles and not of a consequent policy, the underlying problems were seldom dealt with, and short-term "solutions" had to be found anew every year.

Inability to develop a clear and consequent energy policy

How is this related to the larger political process? The various formal actors which could play a role in the determination of a coherent energy policy were weak; moreover, little effective formal coordination existed between them. The Ministry of Fuel and Energy, despite having (on paper) a research division, in reality could not use it to its full potential, as most of its cadre were needed for administrative duties. Energy-related institutes of the Ukrainian Academy of Sciences received very limited funding, and lacked some of the basic material resources needed for effective work. Other, non-Academy of Sciences research and policy institutes dealing directly or indirectly with energy issues were in only a slightly better situation.[56] Due to nearly non-existing funding, work on a new Energy Policy of Ukraine to 2030 occurred only in piecemeal fashion, without a strong coordinating center, and with major delays.[57] Implementation of adopted energy policies was also a problem, made worse by the power and policy interference of Ukraine's strong economic interest groups. This is seen clearly in the cases of missed opportunities concerning gas (imports from Turkmenistan) and oil (imports from the Caspian area) diversification.

Inability to develop a clear and consequent energy policy: the case of diversification possibilities through gas imports from Turkmenistan

One area where the lack of a clear and consequently adopted energy policy was especially clear was diversification. Despite repeated declarations on the importance of diversification, in particular the 1996 "Concept for the Diversification of Gas and Oil Supplies" approved by the government, these diversification initiatives were watered down and ultimately sunk by lack of interest on the part of the leading in-system economic elites and by their misuse for corruption and domestic political purposes.

This was seen clearly in the case of gas purchases from Turkmenistan. The use of gas purchases from Turkmenistan to achieve real diversification away from Russia was weakened by the fact that the actual organization of imports and/or their transportation was given to intermediary companies that were either highly non-transparent or where the Ukrainian state had little say,[58] and by corruption, which led to repeated payment difficulties and the suspension of supplies in March 1997 (resumed only in January 1999), May 1999, and January 2005.[59] This in turn reinforced the already problematic fact that supplies from Turkmenistan had to go through Russian pipelines to reach Ukraine. In exchange for their "transit services," these intermediary companies received from 37.5 (RosUkrEnergo) to 41 percent (ITERA) of the supplied gas,[60] leading to multi-billion profits. As a result of these factors, even accounting for the percentage given to the transit company, the gas volumes actually received from Turkmenistan were often lower than those originally contracted, with actual deliveries amounting to between 60 and 94 percent of contracted amounts,[61] and Turkmenistan's role in Ukraine's energy diversification remained smaller than potentially possible. Similarly, the idea of building a gas pipeline from Turkmenistan to Western Europe through Ukraine without crossing Russian territory (i.e. via the Caspian Sea), advocated by Vice PM Tymoshenko in 2000, never got off the ground due to financing problems, strong opposition from Russia, and, last but not least, the general uncertainty in the Turkmenistan-Ukraine energy relationship and the Ukrainian government's lack of strong commitment to the idea. By the time President Kuchma took up the idea again during an April 2002 visit to Turkmenistan, it had been heavily watered down, to a version involving transit through Southern Russia toward the Donbas.[62] Similarly, despite official declarations, President Kuchma opposed attempts to increase transparency in gas relations with Turkmenistan.[63]

Inability to develop a clear and consequent energy policy: the case of diversification possibilities through the Odesa-Brody pipeline

The case of Caspian oil supplies—and especially of the Odesa-Brody pipeline—provides another example of how the policy-making system in Kuchma's Ukraine helped hinder Ukraine's ability to develop a clear and consequent energy diversification policy. The possibility of using Caspian supplies for diversification purposes was weakened by the power of influential financial groups and the lack of a generally accepted and consequently applied energy policy, which, together with Russian pressure, led to the torpedoing of the project in 2004.

Originally envisioned in the early 1990s as a way of fostering Ukraine's energy supply diversification, reducing its dependency on Russia, and making it an important player in the transit of Caspian oil to Europe, problems followed the Odesa-Brody project from the very beginning. Completion of the project, originally envisioned for the mid-1990s, was repeatedly delayed.[64] The building of the Pivdennyi (Yuzhnyi) oil terminal in Odesa, essential for the functioning of the pipeline, was subject to similar fits and starts—it was started in May 1994, suspended from 1998 to 2000 due to organizational and financial problems, political infighting[65] and the opposition of ecological organizations,[66] and finally completed in 2001.

Policy indecision and the lack of coordination between various participants in the Odesa-Brody project contributed to these delays. From the very beginning, there was no clear business plan for the project. Both the planning, building, and putting into operation of the pipeline were not carried out at the level of national policy (as a project of this magnitude and geopolitical significance would warrant), but at the level of specific state companies, which carried most of the financial weight of the project. While the Odesa oil terminal (intended to receive Caspian oil to be transported North-West through the Odesa-Brody pipeline) was built using budget funds, the pipeline project itself was largely carried out on the basis of the Druzhba Pipeline System, making the project largely dependent on the enterprise's financial situation (in 2000 alone the company invested $40 million in the pipeline[67]), its relationship with Ukraine's other major pipeline system (the Transdniester Pipeline System[68]), and the political fortunes of Druzhba's head and Odesa-Brody's "father" Liubomyr Buniak, in particular his confrontation with head of the National Security and Defense Council (2000–2001) Yevhen Marchuk.[69]

The piecemeal approach followed in the building of the Odesa-Brody pipeline was also reflected in the fact that pipeline policy was not coordinated with refinery policy— neither with refinery privatization policy in order to promote diversified ownership of Ukraine's refineries so that their interests would be less tied to receiving oil supplies specifically from Russia, nor with the promotion of the building or modernization of refineries so that they would be able to refine the light Caspian oil set to come through Odesa-Brody in addition to the heavier Russian "Urals" blend.[70] On the contrary, when controlling packages of shares in most Ukrainian refineries were sold to Russian investors in 2000 and 2001, the commitments imposed by the state on the new owners did not include bringing in oil from a variety of geographical sources nor being able to refine lighter Caspian oil in addition to heavier Russian oil. Rather, the new owners were asked to make commitments on only one issue: the physical volume of crude oil supplies to their refineries.[71]

When the pipeline was completed in 2002, it turned out little business planning had been done in advance, and no Caspian oil was ready to flow through it, which called for Polish reservations on building the connecting segment to Plotsk, essential for the pipeline to serve not only to diversify Ukraine's oil supply, but also as a transit route for Caspian oil to reach Western Europe independently of Russia.[72] While the negative impact of Polish reservations should not be underestimated, it must be acknowledged that these reservations were partially a response to the lack of clear Ukrainian policy position on the project.

ROLE OF RUSSIAN AND UKRAINIAN INTEREST GROUPS

Despite the clear Russian desire to torpedo the Odesa-Brody project,[73] the controversy around its future was—and continues to be—much more than an issue of Ukrainian versus Russian interests. Rather, domestic confrontations about a possible reversal of the Odesa-Brody pipeline took place at the level of state companies, political elites, and BAGs. The role of Russian companies and interests was not simply that of creating conflict in Ukrainian energy policy, but of exacerbating and taking advantage of previously existing or latent conflicts.

Nothing exposed conflicting Ukrainian interests around Odesa-Brody as clearly as the TNK's (Tiumenskaia Neftianaia Kompaniia[74]) 2003 proposal for a reversal of the pipeline, that is, to transit Russian (TNK) oil from Brody in the North to Odesa in the South to be shipped further West by tanker, that is, in the opposite direction from which the pipeline was originally intended. At the level of Ukrainian companies, the TNK proposal fostered conflict between those who supported the as-intended use of the pipeline and proponents of its reverse use, even in the midst of single state companies such as Ukrtransnafta, where battles around the pipeline mirrored internal power struggles (e.g. the conflicts between Yevhen Marchuk and Liubomyr Buniak in 1999–2001, and between then formal head of Ukrtransnafta Oleksandr Todiichuk and Chairman of the Board Stanislav Vasylenko in 2003–2004) and took place in the context of larger battles on the relative role of the company vis-á-vis other energy policy-making institutions (such as the Ministry of Fuel and Energy headed by anti-reversal Serhii Yermilov) going on at the time the final decision was made in 2004.[75] Yermilov's position in favor of the as-intended use of the pipeline, in turn, reflected that of the Donetsk group and the Industrial′na Spilka Donbasu (ISD), one of whose goals was to have good relations with the EU in order to secure access to Western European markets for its metallurgical products and participate in privatization projects in EU states.[76] Yermilov's position put him at odds with NAK Naftohaz Ukrainy, the country's largest energy company, and its head Yurii Boiko, who conducted a fierce public relations campaign claiming support for the project but arguing its short-term impossibility due to the lack of available Caspian oil. Similarly, it has been argued that Ukrtransnafta (under the control of a pro-reverse faction loyal to Boiko in competition with an anti-reversal group led by Todiichuk, at that time still formal head of the company) did everything it could to torpedo negotiations with possible suppliers of Caspian oil—including a concrete proposal by Tengizshevroil[77]—while conducting a sophisticated public relations campaign aimed at convincing the public that no interested suppliers were available, and that it would be more profitable to use the pipeline in reverse direction to transit Russian oil from Brody to Odesa.[78]

As a result of these contradictions, between 2003 and 2004, Ukraine repeatedly changed its policy concerning the Odesa-Brody pipeline, and constant speculation about whether the oil would finally flow West or East became a painful reminder of Ukraine's own foreign policy indecision since independence. In early 2003, the Ukrainian side responded to the absence of offers of Caspian oil to be shipped North-West through the pipeline by temporarily "reversing" the flow of a 52 km segment of the pipeline, using it to transport Russian oil through the Odesa port on the way to Western Europe. As summer 2003 approached, the issue gained momentum and became the center of daily assertions and counter-assertions to the effect that Ukraine was planning to accept a Russian proposal for a "full reversal."[79] This proposal took place in the context of—and was justified by TNK on this basis—the acute lack of available export capacity in Russian pipelines at a time when the difference between domestic and export prices was especially large. The conflict flared again in October 2003, when Ukrtransnafta's supervisory board announced its decision to fill the pipeline with Russian "technical oil"[80] (a step widely seen as clearly leading to a reversal of the pipeline), only to be quickly rebuffed by Energy Minister Yermilov, who argued that a decision on the purchase of oil for the pipeline was the sole prerogative of the Cabinet of Ministers.[81] Although a February 4, 2004 decision (*Postanova*) of the Cabinet of Ministers declared the pipeline should be used in its original direction, the question was far from closed. The fact that the position of Minister of Fuel and Energy remained unfilled a month after Yermilov's dismissal on March 5, 2004 was a further sign of the existence of high-level disagreements on the future of the pipeline, as well as of the need to reach an agreement between the major BAGs.

Yet at the end of the day it was President Kuchma's and son-in-law Pinchuk's role as translators of Russian interests that prevailed, and in late 2003-early 2004 they prepared the ground for a possible reversal of the pipeline by removing from office several key anti-reversal players: Vice PM Vitalii Haiduk (December 2003), Energy and Fuel minister Serhii Yermilov (March 2004), head of Ukrtransnafta Oleksandr Todiichuk (May 2004), as well as eliminating the position of plenipotentiary envoy for the Euro-Asian Oil Transit Corridor (also in May 2004) held by Oleksandr Todiichuk. In July 2004, the Ukrainian government decided to agree to TNK's reversal proposal, initially for a three-year period.[82]

Although the immediate economic benefit of using the Odesa-Brody pipeline in a reverse direction seemed obvious (immediate cash payments and higher transit fees than those Russian companies would pay for transit in the same direction through the Transdniester pipelines, which could also transit Russian oil South for further shipment through Odesa[83]), such a decision would also have very serious long-term implications both in terms of Ukraine's energy security, other energy transit commitments,[84] and broader relationships with both Russia and Western institutions.[85] Indeed, if looked at from the perspective of Ukraine's total oil transit revenue (including other transit commitments) and not narrowly Odesa-Brody, reversing the pipeline makes little economic sense.[86] The fact that short-term interests won out over longer-term ones tells much not only about the power of interest groups in Ukraine, but about the lack of a strong national policy capable of overcoming these differences.

Conclusion

How did the domestic institutions discussed in this chapter affect Ukraine's management of its energy dependency? The system of energy policy-making affected the actual management of energy dependency through its role in hindering the development and application of clear and consequent energy policies. As discussed earlier in this book, the period 1995–2004 saw a number of declarations concerning energy policy initiatives, but little in the form of a clear energy policy coordinating its various sub-sectors. And what had been agreed on was seldom implemented in a consequent manner.

As shown by the examples of gas supplies from Turkmenistan and oil supplies from the Caspian area, Ukraine's two most serious attempts to diversify its energy supplies were hindered by Russian interference, lack of interest among Ukraine's major economic players, and by the lack of a clear and consequent energy policy. As we will see in the next chapter, diversification initiatives were also hindered by the fact that, for many Ukrainian political and economic actors, the system of gas and oil supplies from Russia—directly or indirectly controlled by Russian actors—as it became organized during the Kuchma period, provided multiple opportunities for rent-creation and rent-access, opportunities that were just "too good" to sacrifice for the sake of the rather abstract goal of energy supply diversification. The central factors were the short-term rent-seeking perspectives opened by each policy alternative to specific groups and how these affected the "balance" between them. We turn to this question in our next chapter, where we introduce the rent-seeking perspective as a crucial element for understanding Ukraine's energy policy since independence.

7 Rents of dependency and the problem of energy dependency

Introduction

Definition of rents of energy dependency

In our last chapter, we discussed the systems of market organization, interest articulation, and energy policy-making as important institutions affecting Ukraine's management of its energy dependency.

But it was a fourth mechanism which was perhaps most decisive as a means through which the Ukrainian political system affected the management of the country's energy dependence—the system of access to and use of rents of energy dependency. By "rents of energy dependency" we refer to the windfall profits that, under some circumstances, can be made out of a situation of energy dependency, profits received without the creation of value added.[1] This apparent paradox can be explained not only through the role of intermediaries in the energy-importing country, but also through the fact that in transition countries such as Ukraine much of the energy import and distribution business is often transacted through illegal or semi-legal means. Taken together with the existence of preferential or subsidized pricing schemes for supplies from Russia, this environment provided excellent legal and illegal opportunities for manipulating price, tax, and trade regulations for the extraction of significant rents. (Many of these opportunities, however, may be available only to those with the needed connections and contacts.) This situation means certain groups are able to benefit greatly from the situation of dependency, privately appropriating its "benefits" while shifting the costs to the state and society as a whole.

This chapter provides an overview of the main ways in which the system of access to and use of rents of dependency worked during Leonid Kuchma's presidency, and how it has affected Ukraine's management of its energy situation. Its purpose is not to unveil and document each instance of rents of dependency and corruption in Ukraine's energy sector, but to point to main trends in the area.[2]

Relationship with the political system

The role of energy rents in the political system has been especially significant in the case of Ukraine, to the point of being "Ukraine's specific feature, which hardly can be found elsewhere."[3] This is in great part due to the sheer size of the energy trade (Ukraine is the world's fifth largest gas importer) and to the overwhelming role of energy-intensive industries—an important legacy of the Soviet period—in the economy, but the nature of Ukraine's post-independence political system also contributed to this situation. Indeed, one of the features of the 1995–2004 Ukrainian system was the fact that the rents of energy dependency were distributed among all major in-system groups, with the president-as-arbiter playing a role in distributing possibilities for access to these rents, for example, through providing political protection (*"krysha"*) and turning a blind eye to illegal deals, as well as through the allocation of licenses and contracts making possible profitable energy deals. In exchange, the various groups would also "pass on" some of their profits for the financing of presidential electoral and coalition-maintenance activities. Domestic institutions come into play as they affect the rules of the game under which these rents are accessible to various groups and are subsequently "recycled" into the larger political process.

In 1995–2004 Ukraine, various interest articulators were the main recipients of these rents which they then used in a complex way to support the president (or, less frequently, other political forces), and where the president did not control but kept a balance between these groups by various means, including the selective allocation of licensing rights allowing continued access to these rents.[4] While the main recipients of energy rents were what we would call "in-system" Business-Administrative Groups (BAGs) (the Donetsk, Dnipropetrovsk, and Kyiv clans), some members of the opposition—including groups that would later come to be associated with Yushchenko's Nasha Ukraina system[5]—were also able to extract significant benefits from the system, especially through their involvement in the oil refining sector, an area of activity where significant rents could be accessed through the re-export of Russian oil and schemes involving tax and VAT evasion.

Institutional context and historical development of the system of rents of dependency

Prehistory: institutions' role in moderating the impact of external changes

In seeking to understand the role of domestic institutions in the rents of dependency system we first need to understand the "pre-history" of these institutions' role. In particular, this has to do with the preceding (and prerequisite) role played by institutions in cushioning certain domestic actors from the full impact of negative changes in the international economy, such as the energy price increases that followed the dissolution of the USSR in 1991. For example, in post-1991 Ukraine, the system of energy subsidies and frequent state guarantees of private energy debt gave energy dealers and consumers little incentive to save energy, as they would see little difference in doing so—the losses related to energy waste were often transferred to the state. Credits provided on very generous conditions ("soft credits") to energy-intensive industries served to cushion these from the impact of higher energy prices as these started to increase in 1994, shifting the costs to the state, as private debt was later converted into international debt owed by the state.[6] Similarly, the widespread availability of barter—until 2003 Ukraine largely bartered transit services for gas supplies from Russia, not having to pay in cash for a significant part of its gas imports—partially sheltered Ukraine from developments in international gas markets, whether favorable or not.[7] As we will see below, some of the same institutions that first served to moderate the impact of external economic changes on domestic actors would later provide opportunities for rent-seeking and rent-getting. In both cases, the cost of this cushioning (or, actually, rent-creation) was shifted to the state as a whole.

Institutions' role in translating external changes into rent-creation opportunities

There were two major ways in which rents of dependency worked during the Kuchma period. The first type of rents of dependency were those accessed by individual BAGs with the help of preferences given by those writing the rules, in exchange for direct and indirect paybacks, paybacks which were in turn used for electoral and coalition-maintenance purposes. This first type, in various modifications, was basically the only one available during the first seven years of independence. The second type, which became more popular in the late 1990s and 2000s, had to do with President Kuchma's attempt to access energy rents in a more direct and centralized way, especially through the establishment of so-called National Shareholding Companies (*Natsional′ni Aktsionerni Kompanii*).

Our discussion below is structured along the lines of these two main forms of access to rents of dependency. Among each of these two types, we further distinguish between those involving gas and oil, allowing us to compare the various rent-access opportunities available in an area where a supply monopoly virtually existed (gas purchases from Russia and Turkmenistan for example) and where a variety of suppliers coexisted (case of oil supplies from Russia).

Rents of dependency extracted by BAGs as part of the "balancing" system

This type of rents of dependency was accessed by individual BAGs with the help of preferences given them by those in positions of power, in exchange for direct and indirect paybacks, compensations which were in turn used for electoral and coalition-maintenance purposes. Although the basic framework remained, the relationship between this type of rent-access and political power evolved in time: if in the early 1990s such rent-appropriation schemes were taken advantage of by various groups in a more or less spontaneous way, and during 1996–1997 had become nearly monopolized by the dominant BAG of the time (Lazarenko's Dnipropetrovsk clan), by 1998 it had become more institutionalized as part of the larger "balancing" system.

BAGs rents of dependency schemes related to the gas sector

Re-export of low-cost Russian gas

The re-export of low-cost Russian gas was one of the main sources of private rent in the first years of Ukraine's independence, and also one of the simplest to operate. The scheme functioned as follows: a gas distributor would buy Russian gas at low, special-for-Ukraine prices, but would later re-export that gas to Central and Western European countries (where Gazprom sold gas at much higher prices) at a significant profit. In other cases, gas illegally siphoned from the exports pipeline was re-exported. In either case, the profits were not accrued by the state as a whole, but by specific groups or individuals within Ukraine. Combined with access to selectively granted state guarantees for gas imports (which, as discussed later, often covered unpaid contracts), such operations could yield billion-dollar profits. It has been estimated that between 2001 and 2004 alone, gas re-exports brought groups within Ukraine "up to $1.5 billion in net profits."[8]

While during the first years after independence the issue of re-exports remained largely unregulated in contracts with Gazprom—actually, some degree of re-exports to Central European states was even foreseen by the Yamburg agreements of 1985[9]—such re-exports were later explicitly forbidden by the Russian side.[10,11] After 2001, re-export quotas were jointly agreed between NAK NU and Gazprom's daughter company Gazėksport on the basis of a jointly agreed gas balance[12] and Ukraine's level of domestic production,[13] before re-exports were banned again by the Tymoshenko government in June 2005.[14]

Although instances of illegal re-export of Russian gas took place throughout the whole 1995–2004 period, it was most often prevalent in the mid- and late 1990s. Some of the best-known instances are from 2000, when Gazprom accused Ukraine of illegally re-exporting 10 bcm of Russian gas, mainly to Poland and Hungary.[15]

How did Ukraine's illegal re-export of Russian gas affect the management of its energy dependency? While at first glance this could be seen—as has indeed been seen by some Western commentators—as a means used by an energy dependent country to increase revenues and be able to afford energy imports, this perception ignores the important role of corruption and private interests. Once these factors are taken into account, a more nuanced story emerges, involving private-interests-within the corporation on both sides of the border, working together in a way that guaranteed profits to both, but contributing neither to their companies' corporate interests nor to Ukraine's energy security.

Ukraine's illegal re-export of Russian gas, especially in the late 1990s, was a major irritant in the energy relationship with Gazprom, with short- and medium-term implications. In the short-term, Gazprom's frustration about Ukraine's gas re-exports and the losses associated with them led to some especially harsh conditions for Ukraine in its 2000 agreements with Russia, in particular concerning the punitively high export duty[16] Ukraine was pressured into applying to all gas exports in order to make the re-export of Russian gas practically impossible.[17] In the medium term, frustration with Ukraine's gas re-exports was one contributing factor in Gazprom's search for new transit routes bypassing Ukraine and an excuse for disseminating the view of Ukraine as an unreliable partner. These were official reactions at the level of Gazprom as a corporation, presented to the press regardless of whatever actual role individuals related to the company may have actually played in the stealing, in collusion with actors on the Ukrainian side of the border.[18]

Selective payments for gas from the state budget: private companies paid, public companies not paid

Throughout a significant part of the mid-1990s, one important source of rents was the profits made by well-connected private gas distribution companies, which were paid by the state for the gas they supplied, while state companies were often not paid. This, together with the selective allocation of the most lucrative contracts, meant that well-connected energy actors could make significant profits, while the country as a whole could barely afford to pay for its energy supplies. Such situation was especially clear during Pavlo Lazarenko's tenure as PM, where IESU, due to its privileged position, was one of the few companies paid in full and on time by the state, while debts to other companies—including national gas producing companies—increased rapidly.[19]

One important aspect of the "balancing" system that became apparent through the case of privileged contracts and selective payments was the fact that privileged companies themselves were often given licensing powers over their own areas of activity—the right to regulate themselves, as well as the right to allocate contracts. Indeed, in a development that is also related to the capture of state institutions more generally, there was often little distinction between regulatory organs and the companies they were expected to regulate. While this situation was most scandalously evident at the time of Pavlo Lazarenko's tenure as PM from May 1996 to June 1997, it continued later in somewhat milder form.

The selective payment of gas supplies to private companies while domestic producers were not paid had important implications for Ukraine's energy situation because domestic gas-producing companies, nearly insolvent due to unpaid contracts, had no means to maintain their domestic extraction and transportation infrastructure,[20] thus reducing Ukraine's chances of becoming more energy self-sufficient. In addition, the unpaid debts accumulated by state companies eventually had to be carried by the budget,[21] contributing to inflationary pressures and to the increase of Ukraine's foreign debt. Once again, profits were appropriated by well-connected private actors, and the losses passed on to the state.

Selective allocation of most lucrative gas distribution contracts

Even in the most difficult years for Ukraine's energy situation, such as 1996–1998, some gas distribution companies were able to make significant profits due to the selective allocation of profitable gas distribution contracts by Ukraine's Cabinet of Ministers and other responsible organs in exchange for political loyalty or other paybacks.[22] (It should be noted, however, that, in a manner in tune with the “balancing” system, these contracts were frequently redistributed.[23])

These contracts had to do with especially profitable barter arrangements and with the right to supply the most payment-able customers under monopoly conditions, giving them little choice but to comply with whatever conditions the gas-supplying company dictated.[24] In many cases, this monopoly power was misused by the gas suppliers in order to force extremely onerous deals on the company buying the energy, deals that did not limit themselves to the high prices but were part of further commercial and rent extraction deals involving barter, bills of exchange, and privatization. In some cases, farming enterprises were left with no option but to buy gas and petrochemicals in exchange for future crops at terms very unfavorable for them; the resulting crops (corn, wheat, and sugar) were then exported by the gas traders at much higher prices.[25] While not in themselves illegal, the fact that these contracts were adjudicated in a non-transparent way and were often accompanied by monopoly powers limited their de facto legality.

These monopoly contracts allowed gas distributors to enter another very profitable area of activity: by forcing exorbitantly high gas prices on enterprises, gas distributors could artificially drive such enterprises to bankruptcy, in order to acquire them at very low prices. Instances of this were seen especially in energy-intensive industries such as metallurgy and machine-building.[26] Similar attempts were also made with electricity-generating companies.[27]

This selective allocation of the most lucrative contracts and customers to certain companies meant that well-connected private energy actors could make significant profits, while the country as a whole could barely afford to pay for its energy supplies.

Manipulation of gas prices and reporting artificially high prices for gas imports through barter and other non-transparent forms of energy trade

For much of 1995–2004, gas prices officially paid to Gazprom were higher than those charged to customers in Ukraine, at times significantly so.[28] While at first this may seem an example of the largesse of companies such as NAK Naftohaz Ukrainy for the benefit of national consumers, what often stood behind these inconsistencies was the widely reported fact of Ukrainian companies and gas traders using artificially high prices to calculate their payments to Gazprom, while in reality paying much lower prices. This kind of manipulation was made possible by largely non-transparent contracts and by the predominance of barter and discounted bills of exchange arrangements in them, which allowed for the manipulation of real prices through a variety of discounts.[29]

As has been stated by a number of Ukrainian observers, such manipulation of prices would not have been possible without the acquiescence and collusion of high-level policy-makers on both the Ukrainian and Russian sides.[30] This benefited gas traders and NAK Naftohaz Ukrainy (not necessarily as a corporation but individual officials within it) because, through such arrangements, they could charge higher prices to consumers than those warranted by the prices actually paid to Gazprom.[31] Similar schemes were also used by companies importing gas from Turkmenistan through barter arrangements, companies that often received these contracts in exchange for political favors or other contributions.

Such price manipulations, however, had very negative effects in terms of Ukraine's management of its energy situation. First, because these artificially inflated prices were later used for calculating NAK Naftohaz Ukrainy's and Ukraine's debt to Gazprom, in turn leading to an increase in Ukraine's state debt vis-á-vis Gazprom, a debt that would later be used by Gazprom to pressure for acquiring shares in Ukrainian energy-related enterprises.[32] Moreover, the "over-availability" of rent-seeking opportunities had a variety of negative implications in the energy area and beyond.[33] For example, as various Ukrainian BAGs threw themselves at the possibility of easy rent-making in barter deals with Turkmenistan, Ukraine actually found itself having more gas than it could handle.[34] Such gas surplus, although looking like a good thing at first glance, actually created problems, because, in the absence of sufficient underground gas deposits, unused gas supplies would probably be re-exported, something Gazprom strongly opposed, thus leading to renewed confrontations with the Russian company. Moreover, the free-for-all of price manipulations could not last forever, as shown by the example of Turkmenistan which, tired of being deceived through doctored barter deals, repeatedly suspended or canceled gas supply agreements with Ukraine citing irregularities, only to restart them a few months or years later.[35] So it could be said that the great availability of rent-seeking opportunities in the Ukrainian market, together with corruption at the highest levels of the state, has not only led to non-rational energy supply policies, but also to worsened relations with the major suppliers.

A related scheme was the fictional importation of gas from Western Europe: importing gas from Russia, but accounting for it as if it was higher-price gas imported for hard currency, a transaction that could not be carried out without the active cooperation of Russian partners. This would allow the importer to "pay" for the imports in hard currency and to wire the money to its own accounts abroad, thus contributing to capital drain.[36]

Transferring the liability of non-payments to the state

One important way in which *hazotreidery* were able to make a profit had to do with the selective transferring of payment liabilities to the state. This was made possible by the state selectively providing guarantees for gas purchases, taking over responsibility for payments in case the original firm would be unable to do so. In the majority of cases, this meant the conversion of private debt—from companies declaring themselves bankrupt—into Ukraine's state debt vis-á-vis Gazprom. The selective provision of state guarantees was doubly related to the "balancing" system not only because which companies were chosen to receive state guarantees was related to political loyalty, but also because many of these companies were the same that had been selected to receive the most lucrative domestic contracts in the first place.[37] This was beneficial for the companies concerned, as they could receive at least partial payment from industrial users (which were often the most payment-able consumers, as discussed earlier), neglect to pay Gazprom themselves (while most often depositing the money abroad), declare bankruptcy, and soon afterwards resume work under a new name.

In addition to IESU's debts from the mid-to-late 1990s, some of the most important examples of profit-making through access to state guarantees involved gas imports from Turkmenistan, where private corporations—most notably Ihor Bakai's corporation "Respublika," which reportedly passed on a $350 million debt to the state in the mid-1990s—received state guarantees for the import and transit of Turkmenistan gas.[38] While extremely profitable for the individuals involved, the preferential granting of state guarantees was seriously damaging to Ukraine's energy interests. The companies' sending of their receipts abroad contributed to capital flight and divestment in the local economy.[39] At the same time, the increase in unpaid state debt to Gazprom was not only a major complicating factor in the relationship, but would later provide Gazprom with a means for acquiring strategic Ukrainian energy assets through debt-for-shares swaps,[40] also leading to a loss of economic sovereignty in the form of Russian control of strategic companies. The provision of state guarantees for gas imports was one of the central Russian demands at the time of the signing of state-to-state agreements, for example in the 2000 negotiations.[41]

Stealing Gazprom gas from the pipelines

Throughout the 1990s and early 2000s, one of the most controversial issues in the Ukrainian-Russian energy relationship and one of the most embarrassing spots in Ukraine's international reputation was the repeated stealing of Gazprom-owned gas (intended for export to Western Europe) from the pipelines crossing Ukraine.[42] This stealing has been discussed repeatedly at various levels, and often taken as a given by both the media and policy-making circles. In 1999, for example, Gazprom accused Ukraine of having stolen over $88 million dollars worth of gas from the transit pipeline; accusations continued even after Vice PM Tymoshenko's official 2000 acknowledgment that stealing had taken place.

Yet there are many indications that the stealing was not carried out unilaterally by the Ukrainian side. Rather, it can be seen as an example of the confluence of private-interests-within-corporations on both the Ukrainian (NAK Naftohaz Ukrainy and its predecessor, Ukrhazprom) and Russian sides (Gazprom)[43] within the context of a "balancing" system. While neither NAK Naftohaz Ukrainy as a corporation nor Ukraine as a state benefited from these deals, there is good reason to believe that a significant part of the benefits accrued from the "illegal siphoning of gas" were recycled to President Kuchma for coalition-maintenance and electoral purposes.[44]

The calculations on Gazprom's side were more complicated. While some individual Gazprom managers most likely benefited from these deals, up to a certain extent it could be said that Gazprom as a corporation also benefited, as the "stolen" gas could be calculated as part of Ukraine's debt to Gazprom, and later be used to acquire assets in Ukraine's energy sector, which in turn dovetailed with Gazprom's and the Russian leadership's interest in securing the stable and low-priced transit of Russian oil and gas through Ukraine and preventing Ukraine's full integration into Western institutions.

The stealing of Gazprom's gas from Ukraine's pipelines had a variety of effects. On the one hand, it provided multi-million profits to its organizers, especially when—as seems to have often been the case—this gas was subsequently sold to Central and Western European markets at European prices. Yet it also had a variety of negative effects on Ukraine's ability to manage its energy situation. At the level of Ukrainian-Russian relations, the repeated gas stealing gave impetus—or at least official justification—to Russia's decision to impose an oil embargo on Ukraine in early 2000.[45] It also contributed to—or at the very least helped justify—Russia's decision to start building new pipelines around Ukraine.[46] Gas "stealing" was also one of the reasons for Russia's pushing for the development of a gas consortium on its own terms for the operation of Ukraine's gas transit system. At an international level, the situation significantly damaged Ukraine's international reputation as a reliable gas transit partner—not only due to the direct damage caused by the stealing itself, but also by the loss of pipeline pressure caused by it, which endangered the functioning of the pipeline as a whole. Considering Ukraine's potential role as an important transit route for Eurasian and Caspian energy to Western Europe and the fact that this transit provides Ukraine with one of the few viable ways of compensating for its lack of domestic energy resources, this reputational damage carried with it a very high cost.

Rent-creation through discounted bills of exchange and barter operations in gas trade

Discounted bills of exchange operations (*zaliky* in Ukrainian) provided another important means for the extraction of significant profits from energy trade. Like barter, bills of exchange became especially popular in the early and mid-1990s, when they emerged as one of the ways for coping with the extreme lack of market liquidity at the time.[47] Basically, bills of exchange or IOUs formalized a barter-like chain of exchange, where, for example, a gas distributor would supply gas to a company and would be paid partially in bills of exchange, which it in turn could use to partially cancel its tax liabilities vis-á-vis the state.[48] Bills of exchange operations could be used to finance both energy purchases from Russia and sales within Ukraine.

The key to understanding rent-creation through this mechanism is the "discount" part of bills of exchange—bills were seldom traded at face value, but various levels of discount were applied to them depending on the level of risk.[49] By manipulating or at least taking advantage of differences in the level of discount at various stages in the chain of payments through bills of exchange, a significant profit could be made. Because the crucial value of the discount in specific bills of exchange operations was set by state officials,[50] this made the system especially amenable for the exchange of access to rents privileges for political and economic support that was central to the "balancing" system. In the case of manipulated bill of exchange operations involving Russia, they were often conducted with the cooperation of partners on the Russian side.[51]

Manipulated barter operations worked in a similar manner. In this case, essential in the chain of "value-adding" (rent-adding) were the prices assigned to the various goods bartered. (Gas and oil were bartered for almost any imaginable product sold domestically or abroad and—through bills of exchange operations—even for tax and other future obligations.) An added appeal of barter and bills of exchange operations was the additional opportunities they provided for tax evasion, as they are more difficult to oversee than monetary operations. At the same time, this, of course, meant lost tax income for the state.

Use of subsidized energy in production of goods later to be exported at world prices

Ukraine inherited from the Soviet period an economy dominated by energy-intensive industries. The fact that some of these industries' products (first and foremost metallurgical products) could be exported at world-market prices while the price of some of its main inputs (electricity as well as oil, gas, and gasoline) was well below market prices led to the possibility of enormous profits through these exports. In reality, these profits had to do with a revenue transfer or, as put by Dubrovs´ky *et al*, with the generation of micro rents "at the expense of wasting macro rents."[52] Most often, the revenue flew from the state (which in many instances imported gas at higher prices but sold it to domestic enterprises at lower ones) to the energy-intensive industries.[53]

Although this method of rent-creation continued throughout the Kuchma period, it was especially important during the first years after Ukraine's independence, when the difference between world and Ukrainian energy prices was largest, and was also magnified by the further price manipulations that could be accomplished through the barter arrangements especially common during those years. The availability of these rents[54] played a key role in the creation of new fortunes in Ukraine. Who would be able to tap into this source of revenue was not impervious to political factors, as accessing the necessary raw materials was easier done with political connections than without, and selling these products abroad required a variety of permits granted by regulatory organs, and which could be distributed on an exchange-of-favors basis.

As shown by the above examples, gas trading provided unique opportunities for rent seeking and rapid enrichment. As famously noted by Ihor Bakai, head of Naftohaz Ukrainy (1998–2000) and who must have known from his own experience, all major political fortunes in post-independence Ukraine were made on the basis of Russian oil and gas.[55] Due to these factors, energy trade capital and energy rents actually created (or strengthened) Ukraine's most important political actors of the post-Soviet period.

BAGs rents of dependency schemes related to the oil sector

Although less generous than the rents available through gas, the oil trade also provided significant opportunities for rent-seeking.

Re-export of low-cost Russian oil and schemes involving tax and VAT evasion

Taking advantage of imperfect tax and custom laws, oil importers and refineries could access important rents through various manipulations related to Value Added Tax (VAT) and oil re-exports.[56] Indeed, the issue of VAT and other taxes levied on oil products has been an important issue not only in terms of relations with Russia but also in terms of the opportunities the VAT system opened for tax-evasion and economic foul play, in particular for oil importers and refineries. For example, instead of paying VAT immediately at the moment of import, an oil importer could get an extension until the oil products refined from that oil were actually sold. This opened the door to many irregularities, as, for example, the firm (or fictitious companies working with it) could sell the oil products refined from that oil at a very low official price, thus significantly reducing the amount of VAT paid.[57] Two additional means of avoiding taxes were available to refineries: illegally re-exporting oil earmarked for Ukrainian refineries and often imported at lower than world prices,[58] or, conversely, for export purposes, declaring the exported Russian oil as Ukrainian-produced for VAT-avoidance purposes.

Tax exemptions given to well-connected oil products importing companies

Tax exemptions granted to individual companies or types of companies by the Rada or the Cabinet of Ministers were an important part of the Ukrainian energy landscape. Although the granting of such exceptions (especially VAT exemptions) to well-connected companies affected both the gas and oil sectors, its best-known examples come from so-called enterprises with foreign investment (EFIs) involved in the import of oil products and collectively known in the media and the popular imagination as “bisons” after the “Bizon” company, one of the first to benefit from the tax advantages.

The “Law on Foreign Investments” (1992) gave enterprises with foreign investments established during a short period in 1992 special tax benefits; however, these benefits were debated, fought about, and repeatedly canceled and reinstated throughout the following ten years. Heavily represented among the benefited companies were those involved in the import of oil and oil products, an area where significant supply bottlenecks arose in the first years following independence. If during the early 1990s crisis of the Ukrainian refining sector the granting of special privileges to promote oil products imports seemed to be clearly justified, the situation started to change radically around 2000 when massive Russian investments revitalized Ukraine’s refineries and their profitable functioning started to be hindered by competition and downward price pressure from cheap tax-free imports. Thus, this led to a situation where some clearly differing interests emerged between those Ukrainian oligarchs benefiting from the EFI schemes and those benefiting from the entrance of Russian capital, and also some differing interests between Ukrainian oligarchs involved in EFIs and those Russian ones involved in the purchase of refineries in the late 1990s.

It is exactly around this time that the real battles around these privileges start in the Rada and other policy-making forums. While the intricacies of these battles are too complex to discuss in full here,[59] it is important to note the role of these tax privileges in the "balancing" system, and their implications for Ukraine's management of its energy dependency.

Although the Law on Foreign Investments stems from before the Kuchma period, its role in the 1995–2004 "balancing" system is important, as the very fact that the benefited interest groups were able to maintain their privileges despite significant opposition tells us something about their closeness to power during the Kuchma period.[60] Moreover, there are strong indications that not all companies theoretically entitled to these benefits actually were able to use them, but only those which had "paid their dues" in terms of supporting the needed political lobbying.[61,62] Moreover, companies close to President Kuchma and the "Party of Power" were able to gain disproportional benefits from the tax exemptions, for example, the Slavutich group associated with the Kyiv (SDPU(o)) clan of Hryhorii Surkis and Viktor Medvedchuk, especially in 1996–1998.

The tax advantages given to oil products importing companies had a variety of effects on Ukraine's ability to manage its energy dependency. In the first place, they had a heavy cost for the state—it is estimated that in 1999 alone the state lost $275–300 million in taxes through these exemptions. Moreover, the flooding of the market with tax-free oil products significantly contributed to the worsening situation of Ukrainian refineries, a weakness that was later used by Russian companies to buy-out most Russian refineries at low prices starting in 2000.

Rents of dependency accessed centrally through NAK NU and other NAK-type companies

While the granting of access to rents of dependency to private groups in exchange for political or other contributions may fit best with the "balancing" model, under certain circumstances more direct mechanisms were favored by the executive. (Who, it should not be forgotten, despite his role of arbiter in the system, also had his own economic interests.) In certain cases, state control of energy companies in a situation of murky property relationships could provide the executive with more direct means to extract and use energy rents for electoral and coalition-maintenance purposes than those provided by BAG balancing. This is related to the broader political atmosphere in Ukraine at the time, in the sense that, it has been argued, after his re-election in 1999 Kuchma "turned to the security apparatus and alienated the oligarchs."[63] The fact that the main BAGs were not able to "deliver" good results in the 2002 Rada election (where the pro-Kuchma bloc received only 11.8 percent of the votes) was a further incentive for seeking more direct access to election-time resources.[64]

This search for a more direct way of gaining access to rents of dependency was characterized by two elements. First, the establishment of a number of "National Shareholding Companies" (NAKs), especially in the energy sector, concentrating state shares, and playing a monopoly role in various areas of activity. Second, the desire to achieve a more direct access to rents by relying on people who, while not free of their own economic interests, would be more dependent on—and more responsive to—the president than to one or another BAG. In fact, the beginning of this more direct system of access to rents of dependency dates to the creation of NAK Naftohaz Ukrainy in 1998, exactly in the wake of the major shock dealt to the Ukrainian political system by PM Pavlo Lazarenko and the near-monopolization of power by his Dnipropetrovsk clan. President Kuchma emerged deeply scared from this experience, and according to many analysts, with the firm resolution to prevent the monopolization of power by a single clan. On the one hand this required a strengthening of the "balancing" system; on the other, the development of some cadre directly responsive to him and not to one or another clan.

The first NAK, NAK Naftohaz Ukrainy, was established in May, 1998, and became fully operational about a year later.[65] It was followed by the creation of other NAKs or NAK-like organizations in the atomic energy (Enerhoatom, established 1996), electricity (Enerhetychna Kompaniia Ukrainy, established 2004), and coal (existing 1998–2001 under the name Vuhil´ Ukrainy, and whose re-establishment was announced in 2004) areas. By taking important areas of activity away from the Fuel and Energy Ministry's control, the establishment of these companies had important institutional implications, as they significantly reduced the ministry's power and competencies with the separation of gas, atomic energy, and planned separation of electricity and coal "ministries." The role of NAK Naftohaz Ukrainy as a more direct means for access to energy rents for the executive was confirmed by the granting of a special status to the company, where it was subordinated not to the Ministry of Fuel and Energy, but directly to the Cabinet of Ministers.[66] This gave NAK Naftohaz Ukrainy heads direct access to President Kuchma[67] but also gave the president, unencumbered by the institutional structures of the ministry, more freedom in dealing with the company, as well as more direct control over it as well. NAK Naftohaz Ukrainy (and, through it, largely the Presidential Administration) acquired control over gas payment money transfers, Ukraine's pipeline system, the licensing process for gas imports, and gas barter operations, including control over the gas supplied by Gazprom as payment for gas transit (around 30 bcm per year). Especially important was NAK Naftohaz Ukrainy's control over the fall 1998 "barter deal of the century" by which Ukraine would pay $1 billion of its gas debt to Russia through food and industrial supplies for organizations belonging to the Russian government, opening the door for the kind of manipulations associated with barter deals.

The BAG-focused and centralized (NAK) systems of access to rents coexisted in time. On some occasions, the more centralized system of access to rents seemed to be compatible with the system of BAGs' access to rents, as the ability to temporarily turn over control of one or another NAK to various clans or groups played a role in Kuchma's "balancing" system. On other occasions, however, the attempt to create a more centralized system encroached into previously established rent systems involving well-connected political actors. This was the case, for example, with the Enerhetychna Kompaniia Ukrainy, a NAK-like organization created in early 2004 to bring together state packages of shares in the regional electricity distributors (oblenerhos), some electricity generators, and Ukraine's electricity export monopolist Ukrinterenerho. This gave the Enerhetychna Kompaniia Ukrainy control over significant financial flows, as, taken together, these companies amount to about 60 percent of electricity deliveries, and about 40 percent of electricity production in Ukraine.[68] While this meant a more direct access to rents for the president for the financing of the October 2004 presidential elections, it also encroached into the regional oblenerho rent "feeding fields"[69] and into control over financial flows until then enjoyed by Oblderzhadministratsii regional administration heads.[70] Moreover, the plan also encroached upon the ambitions of those Ukrainian financial-industrial groups involved in energy-intensive production, for example, heavy metallurgy and pipe production, which were also interested in gaining ownership over the oblenerhos.[71] According to some observers, this desire to keep the "balancing" system in place while ensuring a more direct access to energy rents explains the naming of Serhii Tulub as Energy Minister in April 2004, as someone who, while acceptable to all clans, would also be able to guarantee the president direct access to energy rents for the upcoming presidential elections.[72]

General characteristics of NAK and NAK-like organizations

Before discussing the concrete mechanisms for "rents of dependency" extraction through NAK and NAK-like organizations, some general comments are in order. While they are based mainly on examples from NAK Naftohaz Ukrainy, the points are applicable to the other NAKs as well.

Timing. The timing of the establishment of the various NAKs seemed to be tied to approaching elections, and to the executive's electoral needs, as evidenced by the creation of NAK Naftohaz Ukrainy right in time to help with the financing of the 1998 Rada and 1999 presidential elections.[73] Similarly, as stated by Ukrainian energy analysts, Kuchma's goal in naming Yurii Boiko as head of NAK Naftohaz Ukrainy in 2002 was to develop "a profitable company (. . .) which should be a reliable financial contributor not only to the budget, but to 'adminresursy.' "[74] Similarly, there were numerous allegations that the creation of the Enerhetychna Kompaniia Ukrainy in February 2004 was a means for the Kuchma regime to place under its control important electricity-related money sources for the "financing" of the October 2004 presidential election.[75] This timing also evidences the fact that—despite official declarations to the contrary—the various NAKs and NAK-like organizations were created with little coordination with Ukraine's broader energy and energy-diversification policy, further demonstrating Ukraine's lack of a consequent energy policy under Kuchma.[76]

NAKs and private-interests-within-the-corporation

Many signs lead to the belief that NAK Naftohaz Ukrainy, for example, worked not so much for the advancement of Ukraine's national interests or of NAK Naftohaz Ukrainy's corporate ones, but for those of its top managers and President Kuchma himself. While from the point of view of the executive NAK Naftohaz Ukrainy's main appeal was its ability to allow him direct access to resources, private-interests-within the corporation existed within NAKs as well, and top NAK managers are reported to have extracted significant economic benefits through the rent-extraction schemes discussed above. NAK Naftohaz Ukrainy's role in the illicit enrichment of its first chairman Ihor Bakai was widely discussed well before he was presented with criminal charges, flew to Russia, and was put on the Interpol search list in spring 2005.[77] Some of the (still not authenticated) Mel′nychenko tapes record a conversation between head of tax police Mykola Azarov and Kuchma implicating the tax police in wrongdoing at NAK, and claiming Azarov knew Bakai had stolen at least $100 million from the company.[78] (Perhaps it is this concentration on private economic gains what kept Bakai from being able to fulfill Kuchma's expectations in terms of financial contributions to the 1998 and 1999 elections, which many saw as the reason for his forced resignation in 2000.[79]) Thus, when in January 2002 Kuchma named Yurii Boiko head of the company, what seemed to be at stake was not only or not so much the appropriate functioning of the company, but having someone who, as head of the company, would be most useful in terms of keeping Naftohaz Ukrainy's cash resources flowing to Kuchma's electoral campaign. At the same time, we should not forget the role of NAK managers in simply and openly pursuing personal and political profits at the expense of the corporation, despite their attempt to present their organizations as dynamic global players active in defense of Ukraine's energy supply stability, for example, through the pursuit of oil production possibilities in Libya and elsewhere.[80]

Centralized rents of dependency schemes related to the gas sector

Manipulation of gas prices

Barter deals and the reporting of artificially high import prices were rent-access means frequently used by private gas traders and their related BAGs, especially in the early and mid-1990s. Yet such manipulation of gas prices was also an important rent-acquisition means for actors associated with NAK Naftohaz Ukrainy, especially after the company's acquisition of a near monopoly on gas imports as a result of the gradual sweeping away of private gas traders in the late 1990s. The manipulation of gas prices by NAK Naftohaz Ukrainy was made possible by the lack of transparency in the sector and in NAK Naftohaz Ukrainy's bookkeeping in particular,[81] but also by more mundane factors such as the intricate nature of arrangements between Gazprom and NAK Naftohaz Ukrainy. Every year, complex agreements had to be signed between both sides, involving both multiple issues (such as supply volumes, prices, transit fees, and "treatment of existing and new debt") as well as multiple actors on both the Ukrainian and Russian sides.[82] With so many elements involved, it should not come as a surprise that plenty of opportunities for manipulation would be available. In particular, the fact that for much of the period starting in 1995 at least half of the gas imported by NAK Naftohaz Ukrainy from Gazprom was received as barter payment for transit services using a negotiated accounting price[83] is likely to have provided additional opportunities for such manipulation. Indeed, it has been argued that a significant part of the revenue received for the transit of Gazprom gas through Ukrainian pipelines did not accrue to NAK Naftohaz Ukrainy or to the Ukrainian government, but to private economic actors.[84]

Giving advantages to private gas-related firms associated with the firm's management

As in the case of oil contracts, being able to provide advantageous contracts to preferred companies was a major advantage of NAK and NAK-like companies. In contrast with the more decentralized system associated with the BAG system and the adjudication of the most profitable ("plum") gas distribution contracts to specific gas dealers, the NAK system offered the advantage (from a rent-extraction perspective) of being able to consolidate in one place access to large-scale gas contracts (e.g. the whole of Ukraine's purchases from Turkmenistan), thus multiplying the amount of easily accessed rents. Ukraine's gas purchases from Turkmenistan turned out to be, indeed, one of the major sources of rents of energy dependency, thanks to the proliferation of advantageous contracts to preferred companies. Indeed, the case of gas purchases from Turkmenistan and Russia provides rich examples of the role of private-interests-within corporations in the energy realm, as is shown by the cases of ITERA, Eural Trans Gas, and RosUkrEnergo.

ITERA was an important intermediary in the sale of Turkmenistan gas to Ukraine from the late 1990s and up to 2001, and was able to skim a significant profit out of the relationship by overcharging Ukraine and underpaying Gazprom (the owner of the pipelines) for transportation and other services.[85] Despite the well-known shake-up of Gazprom in June 2001 and despite the new management's attempt to avoid middlemen in gas and oil exports, similar trends continued, but with easily recognized ITERA now being replaced by new, less-known companies.[86] In 2002, Gazprom "replaced" ITERA with a small firm registered in Hungary (Eural Trans Gas) for the transportation of gas from Turkmenistan to Ukraine, a deal that led to Gazprom losing between \$130 million and \$1 billion in payment for services it could have provided itself.[87] The deals were made possible by barter operations, where the favored companies would be paid for their services in gas, which they would later export to Western Europe at higher prices.[88] While such a deal did not benefit NAK NU or Gazprom, it could benefit well-connected individuals at both the government and the NAK levels and often did so in coordination with equally corrupt managers on the other side. It has been reported that preparing the smooth entrance of Eural Trans Gas into the Ukrainian gas imports system was one of the tasks specifically entrusted by President Kuchma to Yurii Boiko upon his becoming head of NAK Naftohaz Ukrainy in 2002.[89]

"Deals" such as these clearly reduced Ukraine's ability to control its energy situation; moreover, they increased the already high cost of energy dependency by facilitating tax evasion through barter operations, as well as diverting resources that should have gone to NAK Naftohaz Ukrainy as a corporation.

Centralized rents of dependency schemes related to the oil sector

Giving advantages to private oil-related firms associated with the NAK NU's management

In the same way as private firms were provided with privileged contracts in the organization and transit of gas imports from Turkmenistan, privileged private oil firms also received specially profitable contracts at the expense of NAK Naftohaz Ukrainy as a whole. In the oil area, this occurred not so much through the actual organization of imports but in more constrained areas such as oil transit and loading.

In 2003, NAK Naftohaz Ukrainy's daughter company Ukrtransnafta, together with Russia's Transneft, chose a new operator for the Pivdennyi/Yuzhnyi oil terminal in Odesa. (The completion of this terminal in 2001 was considered a main achievement along the road to Ukrainian energy independence, as it would allow Ukraine to receive Caspian oil by tanker, thus breaking Ukraine's dependence on pipeline supplies from Russia.) Yet the new terminal's usefulness was limited by the way in which advantageous contracts were given to private firms reportedly associated with the firm's management. The offshore company Collide, incorporated in 2003 in the British Virgin Islands, was made the operator and given significant policy-making control over the Pidvennyi (Odesa) oil terminal, with the result that Ukraine "in fact lost its ability to manage the Pivdennyi oil terminal."[90] This has implications for Ukraine's management of its energy dependency because Collide overcharged for services provided at the terminal, thus "scaring away oil traders planning to ship their oil via the Odesa-Brody pipeline to Europe."[91] Moreover, of the $14 charged per ton of oil transported through the terminal, only 25 percent went to Ukrtransnafta.[92] According to Ukrainian observers, the profits generated were shared, including in the form of bribes "to anybody one would need to pay bribes to," including Transneft[93] executives.[94]

To these more specific means of rent-creation could also be added rents and profits acquired by oil and gas companies and/or their executives through much more pedestrian forms of corruption, such as the purchasing of machinery and other goods and services from related companies at artificially high prices.

What have rents of dependency told us about the larger Ukrainian and post-Soviet cases?

Rents of energy dependency or rents of energy trade?

It could be argued that some of the rents discussed in this section—for example, those where monetary advantage was derived from manipulations of price differences or from taking advantage of loopholes in tax regulations—were not so much rents of energy dependency as rents of energy trade. Yet, although some of the means of accessing rents in the energy sector were not directly related to energy dependency per se, they all took place within the general context of Ukraine's energy dependence, in particular vis-á-vis Russia. Most importantly, the availability of these schemes had the effect of encouraging the maintenance of dependency patterns on Russia, and of ways of dealing with energy policy (first and foremost lack of transparency) that hindered the development of clear and consequent energy policies.

Rents of dependency, corporate interests, and private-interests-within-the-corporation

One central aspect of the way the system of access to and use of rents of energy dependency worked in Ukraine had to do with the interrelationship between state, corporate, and private-interests-within the corporation in the activity of Ukraine's major energy players. Very often NAK Naftohaz Ukrainy managers acted not as managers of state companies, but as de facto representatives of private interests. Corporations and private energy actors within corporations on both sides of the Russian-Ukrainian border were able to find common interests through the access to and appropriation of rents of dependency. Indeed, this joint access to rents of dependency has been one of the most important mechanisms bringing together Russian and Ukrainian energy elites. It has thus played an important role in the country's management of its energy dependency on Russia, hindering the articulation and implementation of Ukraine's national interests. While in the case of Gazprom as well private actors within the corporation were able to accrue private profits in exchange for revenue for the corporation as a whole, Ukraine's greater energy vulnerability means the role of private actors had a much more significant effect on Ukraine's national energy situation than on Russia's.

Gas versus oil in the creation of and access to rents of dependency

The different organizational structures in the oil and gas sectors in the main supplying markets (Russia and Turkmenistan for gas, Russia for oil) also affected the various possibilities for access to rents of dependency in Ukraine. Gas exports from Russia and Turkmenistan remained largely monopolized, while the oil sector in Russia had been largely de-monopolized and farther from state control, at least until the destruction of Yukos in 2003–2004.

Rents of dependency deals seemed more common in the gas than in the oil sector, which may have had to do with the structural differences between the two sectors, including differences in transportation possibilities, as well as differences between sectors in the supply (mainly Russian) side of the equation in terms of market structure and structure of ownership.[95] In terms of transportation possibilities, the fact that gas can only be transported economically through pipelines[96] makes the pipeline a location for both highly concentrated revenue accumulation and rent-seeking opportunities; oil, in contrast, can be transported by a variety of means, spreading out transit income and rent-seeking opportunities.

In terms of market structure, the fact that in the oil sector there was not a single monopoly exporter but a number of competing suppliers may have had the effect of limiting the use of these corporations for private-within-the corporation enrichment schemes, as competition—and the related reduction of profit margins—may limit the leeway for private deal-making within these corporations.[97] In terms of ownership structure, the fact that the main Russian oil exporting companies were privately owned—at least until 2004—as opposed to largely state-owned Gazprom, probably also had the effect of limiting the possibilities for individual managers' pursuit of private-interests-within the corporation. Finally, the fact that oil purchases by Ukraine have since 2001 or so been largely carried out at world-market prices also reduced the possibilities for price manipulations and the associated rent-creation and rent-access. In other words, the fact that the Ukrainian side was not buying oil from a single, mainly or totally state-owned monopoly oil exporter also played a role. Rent-creation and rent-accessing deals did exist in the oil sector as well, but they seemed to be more concentrated in areas such as transit and loading services.

Rents of dependency and political and economic reform

The availability of large energy rents during the first, formative years of Ukrainian statehood had an important impact on its development. Considering the vast amount of rents that could be accessed through various energy-related schemes, it is not surprising that both managers of energy-intensive industries and emerging oligarchs would find a common interest in freezing real economic and energy reforms for the simple reason that it was in their interest to maintain a system that allowed them to amass vast riches—legal and illegal—in record time. The fact that the winners of the first stage of what could with some largesse be called "reforms" had a vested interest in the maintenance of an energy-intensive system could not but contribute to its maintenance despite Ukraine's reality of lack of energy sources. In other words, the fact that some groups were sheltered from the full shock of the increase in energy prices meant that they had little interest in moving to policies more in tune with Ukraine's reality of energy scarcity. So in this case the institutional structure (the system of exchange of access to rents privileges for political and economic support) was crucial for the "conversion of macro-rents into micro-rents," and also for the maintenance of energy-rich-country policies in a situation of energy poverty.[98]

Easy-to-access energy rents were simply "too good to give up," and seemed to benefit the short-term interests of most political and economic actors with a voice in Ukraine's political system. The fact that Ukraine's long-term national interests or those of the population as a whole were not considered seemed to raise few alarms, as the political system gave ordinary people little voice in the policy-making system. At the same time, the over-availability of rent-seeking opportunities (and, in a certain way, the political system's need to provide these rent opportunities in order to keep all members of the "balancing" system content and in turn financing electoral and coalition-maintenance activities) created broader problems for the political system, as it led to not just corruption, but also to serious inefficiencies in the long term; the related possible "overfishing" of these rents could lead to their depletion in the long run.[99] Although the Kuchma system tried to deal with this by his playing the role of arbiter (and allocator of "rent-fishing" rights) in the system, the basic problem remained, threatening stability.

What have we learned that can help us understand Ukraine beyond Kuchma?

In this chapter, we have analyzed the main rents of dependency possibilities available during the Kuchma period, as well as the ways in which these possibilities were used. While it is clear why understanding the way rents of dependency worked in the Kuchma system is essential for understanding how that system worked, the answer as to why this can provide us with an important insight into the post-Kuchma system may not be as obvious. Yet it is no less important: while the political regime and the policy prerogatives of president and prime minister may have changed, if the opportunities for access to rents of dependency do not change, not only will the structure of incentives for maintaining energy dependency on Russia be unlikely to change, but also the very nature of the political system. We turn to this question in our next chapter.

Part 3

Energy policy and energy dependency under Yushchenko

8 Energy and the rise and fall of the Orange Revolution

If you can't stop a booze-up, then you should lead it.[1]

Introduction

This chapter asks whether the coming to power of Viktor Yushchenko in the wake of 2004s Orange Revolution brought about significant changes in energy policy and the role of energy rents in the Ukrainian political system. In analyzing this issue, it considers three main questions: First, up to which point were there significant changes in Ukraine's energy policy under the new government? Second, how has the change of political elites—to the extent that this has really happened—affected the functioning of the energy rents system? Third, was there a serious attempt to dismantle the energy corruption system? We will look at these questions through the prism of the Yushchenko government's energy policies in the first year and a half after coming to power in January 2005, and of the gas supply agreements signed with Russia on January 4, 2006.[2] The way these questions are answered provides important clues for understanding why the era of the Orange Revolution lasted for as short a time as it did, and why it did not live to realize its dream of a freer, less corrupt Ukraine. We take as the end point of our analysis Viktor Yanukovych's return to power as prime minister on August 4, 2006; we also discuss selected events of the post-August 2006 period as relevent.

The first part of the chapter looks at the interplay between old and new elites in Yushchenko's Ukraine, the second part at energy corruption and anti-corruption initiatives, and the third part at the January 4, 2006 agreements and their meaning in the context of Ukrainian politics and Russia's new foreign and energy policy priorities. The chapter concludes with an analysis of the role of energy issues in Viktor Yanukovych's return to the post of prime minister in August, 2006.

The Yushchenko presidency: the energy record to August, 2006

Yushchenko's energy policy record in the first 18 months of his presidency remains mixed. The Yushchenko period—especially during its first seven months with Yuliia Tymoshenko as PM—was characterized by ambitious declarations about energy diversification initiatives. These included, among others, the idea of building a gas pipeline from Turkmenistan to Ukraine bypassing Russia,[3] planned investments abroad by NAK Naftohaz Ukrainy, which would allow the company to produce oil and gas in Russia and other foreign countries, and a strategic gas and oil transit partnership with Iran.[4] In February 2006, in the aftermath of the January gas crisis with Russia, a new round of energy diversification declarations took place, but the implementation of actual diversification policies was bogged-down by the general political crisis that paralyzed Ukraine from January to August 2006.

If, on the one hand many initiatives concerning the geographical diversification of energy supplies remained on paper, two important steps in favor of energy diversification and energy savings were taken. First, the long-overdue step of increasing energy (gas and electricity) prices for end-consumers, very important as residential prices had not been increased since 1998.[5] Although the increases were largely eaten up by the higher gas prices charged Ukraine starting January 2006, it was a positive step in the sense of breaking the populist vicious circle of low end-consumer prices for energy (often not sufficient to cover the cost of imports) and consequent lack of incentives for energy saving.[6]

A second important step concerned the Odesa-Brody oil pipeline. In early July 2006, an agreement of principle was reached with Poland, the Czech Republic, and Slovakia for the extension of the pipeline to Plotsk in Poland;[7] around the same time, Odesa-Brody operator Ukrtransnafta announced that, following its pay-back of a debt owed Russia, it would now be free to decide independently on the future of the pipeline.[8]

Yushchenko's first year and half in power was not very different from the Kuchma period, in the sense that it was characterized by the lack of a clear, long-term energy policy. The Energy Strategy of Ukraine to 2030,[9] finally passed in March 2006, turned out to be rather weak (as discussed in Chapter 6, Ukraine had been struggling with a new energy policy strategy document for years). The document has been criticized for including contradictory goals, such as, for example, reducing emissions, while at the same time calling for an increased use of coal.[10] In addition, in calculating Ukraine's expected degree of energy dependency in 2030, the document counts the gas and oil "produced by Ukrainian companies abroad" as equivalent to domestic production, when in reality that oil and gas would most likely still need to pay all regular taxes and duties and be subject to regular import procedures.[11] Many referred to the document as more a declaration of wishes and intentions than a clear strategic policy plan.[12]

In addition, from the very beginning there seemed to be serious divisions within the government, both in terms of interests and of policy preferences. Policy differences between Yushchenko and Tymoshenko were evident from the very beginning, and became most clear around the handling of the oil products supply crisis in May 2005,[13] where Tymoshenko was accused of using heavy-handed "manual control" methods and of exacerbating relations with Russia by accusing Russian oil traders in Ukraine of a complot against the new government.[14] Tymoshenko's main policy response to the crisis was to remove import duties on oil products, with disastrous effects on Ukrainian refineries, two of which —the Odesa and Kherson refineries— remained largely idle for the following thirteen months.

The January 4, 2006 agreements are discussed separately in the third part of this chapter; for now, however, it suffices to say that, rather than opening new energy diversification perspectives, they led Ukraine into new and additional forms of energy dependency.

New political elites and the energy rents system

Old and new elites and the Yushchenko presidency: confrontation or accommodation?

How did the change of political elites and the rise to power of "second-level oligarchs" associated with Yushchenko, such as Petro Poroshenko, affect the functioning of the energy rents system? Have the new oligarchs been able to tap into the old system to become the beneficiaries of rents of dependency schemes inherited from the Kuchma period?

In order to answer this question, we first need to look at the question of accommodation and confrontation between new and old elites in Yushchenko's Ukraine. Although later on in 2005 we would see confrontations (not so much with Yushchenko as with PM Yuliia Tymoshenko) between the new government and important economic groups around the issue of reprivatization,[15] from the beginning a desire by many economic groups to find an accommodation with the new government could be observed. The apparent lack of opposition in the first weeks after Yushchenko's coming to power (reflected, for example, in the unanimous—not counting abstentions—vote for Tymoshenko on February 4, 2005) provided a hint about pro-Kuchma groups wanting to ingratiate themselves with the new government.[16] As we will see through this chapter, it did not take long for the new power to seek accommodation with previous ways of doing business and politics.

Energy business continued to be a prime bone of contention and competition between Business-Administrative Groups (BAGs)—both within and outside the Orange coalition—during the Yushchenko period. The very first two scandals in the Yushchenko presidency (on oil shipments and re-exports involving Justice Minister Roman Zvarych and Rada Deputy—and protégé of Volodymyr Lytvyn—Ihor Yeremieiev[17] and on using state power to redistribute ownership shares in oblenerhos[18]) were related to energy issues and the distribution of energy profits. These early scandals are significant because they clearly showed, only a few weeks after the inauguration of the Yushchenko regime, that important differences in economic interests existed within the coalition, and also the fact that business and "power" had not been totally separated as Yushchenko had promised to do "within seven to ten days" after coming to power.

One important difference with the Kuchma period, however, is the change in relative power between various BAGs (a decline in the "Kyiv group's" power and an increase in the "Donetsk group's"[19]). Most importantly, however, had been changes in the formal and informal role of the president. President Yushchenko was not and is not willing nor able to play the role of "balancer" between various BAGs as President Kuchma did in the past. This trend was further solidified as a result of the constitutional changes that came into force in January 2006 reducing presidential policy-making powers.

Old and new elites and the Yushchenko presidency: confrontation or accommodation?: a look at NAK Naftohaz Ukrainy

The nominations made at the country's most important energy enterprise, NAK Naftohaz Ukrainy, after Yushchenko's coming to power speak volumes about the accommodation between old and new elites. The fact that the Orange Revolution of fall 2004 ended in a pact between some of the previously existing elites and not an all-out confrontation means that, although often in new positions and with new party affiliations, many figures from the previous regime would continue to play important roles. The energy area was no exception to this trend.

Although Oleksii Ivchenko, named as head of NAK in March 2005, would at first glance seem to be a person far removed from the energy sphere (one of his main qualifications for the position was his being head of the Congress of Ukrainian Nationalists), he had a long history of involvement in energy business together with some of the main actors of the Kuchma era—as business partner of Ihor Bakai in "Interhaz"[20] in the gas chaos and corruption-ridden period of the mid-1990s, and as ITERA's Russian and Turkmenistan gas business representative in Kyiv from 1994 to 1998.[21] Also interesting is the timing and the means by which the appointment was made. Despite PM Tymoshenko's public statement that the position of head of NAK would be filled "through an open competition" (*konkurs*), this did not happen in practice. The timing of the appointment was also at issue—NAK head Yurii Boiko was the last of the "non-Orange" top managers to be dismissed, only on March 3, 2005. Why did it take so long to dismiss Boiko and name a successor? The delay has been explained by the fact that, given the amount of money circulating through NAK NU, it was essential for Yushchenko to have in that position not only an energy specialist, but "his own man," to prevent the company's money from being used to support "any political group" in advance of the 2006 Rada elections.[22] (A less generous interpretation would put the importance of having a close associate in this position as being related to gaining access to these resources, rather than preventing their use for political purposes.) Stanislav Vasylenko, head of Ukrtransnafta and main advocate of the reversal of Odesa-Brody, also remained in his post until May of 2005.

Moreover, if we look at the names and biographies of those making energy policy behind the scenes, we will see that not so much changed with Yushchenko's coming to power. Among those named (or renamed) to second-line posts at NAK NU, many old names could be found, such as Serhii Pereloma, a close collaborator of Yurii Boiko, as first deputy head of the NAK Naftohaz Ukrainy's Board of Directors.[23] Yurii Boiko himself, despite his dismissal from NAK NU, continued to wield significant influence, not only through his newly founded Republican Party, but through his behind the scenes role, for example, in the 2005 gas negotiations with Russia, discussed later.[24] Other important players holding no official positions, such as Dmytro Firtash (also discussed later) continued to wield great influence in energy policy.

Energy corruption, anti-corruption measures and the Yushchenko presidency

The Yushchenko-Tymoshenko coalition came to power on an anti-corruption platform, which it used to gain broad support in the December 2004 elections. Because energy-related corruption was so essential for the functioning of the corrupt Kuchma regime, it is natural that many of the new government's initiatives in terms of the fight against corruption would have important repercussions in the energy area, and also that this would have been an uphill battle. In March 2005, the government started to put pressure on NAK Naftohaz Ukrainy to pay its full tax burden,[25] and started to investigate corruption in government monopolies (including NAK Naftohaz Ukrainy, Ukrtelekom, railroad operator Ukrzaliznytsia, and others), but there was significant opposition, especially within NAK NU. The inquiry moved slowly, with Naftohaz providing little help with the investigations and often blocking access outright. Nevertheless, the investigation seemed to reach a high point in June, when the State Security Service (SBU) let it be known that an inquiry would be started on companies acting as intermediaries in Ukraine's gas purchases from Turkmenistan, especially RosUkrEnergo (suspected by SBU head Oleksandr Turchynov of siphoning $1 billion from state coffers),[26] as well as on Eural Trans Gas, the transit intermediary until 2004. On August 12, 2005, the SBU conducted a search of NAK NU's office looking for materials on possible links with RosUkrEnergo. A Ukrainian delegation was preparing to travel to Moscow in mid-August to, among other things, work on the case, but the trip was postponed until at least August 23.[27] It is not clear whether the visit ever took place.

Energy and the unraveling of the Orange coalition, act I: Tymoshenko's dismissal (September 2005)

NAK's investigation came to a halt in mid-August 2005.[28] The order came from the very top: at some point in summer 2005, President Yushchenko seems to have warned SBU head Turchynov to "leave my boys in peace."[29] After Yuliia Tymoshenko was dismissed as PM on September 8, 2005, the investigation came to a full stop; Turchynov resigned immediately after Tymoshenko's dismissal. Indeed, there is good reason to believe that her dismissal was to a large extent motivated by the "need" to stop the investigations of corrupt practices in NAK NU and beyond.

This raises the question of the fate of energy-related corruption schemes in Yushchenko's presidency. Were the "new" oligarchs associated with Nasha Ukraina able to tap into the old system to become the beneficiaries of rents of dependency schemes inherited from the Kuchma period? According to Turchynov and other Tymoshenko associates, the answer is positive; in a tumultuous press conference on September 15, Turchynov discussed evidence of certain persons in the Yushchenko entourage (in particular Security Council head Petro Poroshenko) being involved in high-level energy corruption, and spoke of "an international criminal system, with the participation of members of the Ukrainian government, living off Ukrainian gas consumption."[30] Yushschenko's answer was to dismiss both Poroshenko and Tymoshenko and—following his first "agreement" with the Party of Regions[31]—appointing Yurii Yekhanurov as PM.

The missing link seems to have been provided by Dmytro Firtash, who—as it came to light in April 2006—was the main Ukrainian figure in RosUkrEnergo, the gas imports operator.[32] While little information is available on Firtash, he is believed to have been an important financial backer of the Yushchenko campaign.[33] Throughout the 1990s, Firtash developed good relations with both Yurii Boiko (head of NAK Naftohaz Ukrainy from 2002 to 2005) and his predecessor Ihor Bakai, who was Firtash's business partner in the mid-1990s.[34] According to some sources, Firtash and his business partner Ivan Fursin had good relations with, and may have also been acting as a cover for Serhii L′ovochkin, former vice-head of administration in Leonid Kuchma's presidential administration,[35] as well as other well-connected players in Russia and Ukraine. It has been argued that it was exactly through L′ovochkin that ex-president Kuchma became involved in gas-related business, and that L′ovochkin, through Fursin, kept the Ukrainian side of RosUkrEnergo under his control.[36] In December 2004, a meeting was organized by Mykhailo Doroshenko (a childhood friend of Yushchenko's) between Firtash and Yushchenko, starting a mutually beneficial relationship that involved support for both Nasha Ukraina[37] and for Yushchenko's social programs more generally. The exact nature of the relationship between senior Ukrainian officials—both pre- and post-Orange Revolution— and RosUkrEnergo remains a mystery, however.

The attempt of the newly in-power economic groups to tap into old energy schemes was accompanied by a muted battle between different groups interested in taking over or at least sharing in these schemes. Indeed, comments by Yushchenko made shortly after the January 2006 gas crisis indirectly pointed to the possibility of another major group seeking to take over RosUkrEnergo's intermediary role: seeking to defend the January 2006 deal (discussed later), Yushchenko discussed the possibility of "other political forces" wanting to appropriate the same intermediary role, but for their own purposes: "I am certain that this rumor [against RosUkrEnergo] has been launched for one reason—to bring the structure you are interested in, you need to compromise the structure that is currently involved in these operations. (. . .) I reiterate that this has been a hook for the sake of one thing—to bring in one of the companies which could finance the party of one political force ahead of the election."[38] According to Roman Kupchinsky, Yushchenko was talking about "ITERA and Yuliia Tymoshenko's alleged attempts to replace RosUkrEnergo with this Russian company."[39] This, of course, is quite reminiscent of the 1999–2000 battles discussed in Chapter 4, when ITERA- and Bakai-related gas trade operations competed in the Ukrainian market and this competition set the background for the fierce animosity between Bakai and Tymoshenko during her tenure as First Deputy PM in 2000–2001.

Other sources argued that Viktor Pinchuk and Rinat Akhmetov may have been involved in RosUkrEnergo. (In the course of the June 2005 investigation into RosUkrEnergo, then SBU head Turchynov stated that the non-Russian shares of RosUkrEnergo were controlled personally by former President Kuchma and PM Yanukovych and that "the managers of the shares were, respectively, Pinchuk and Akhmetov. (...) Turchynov later said that Kuchma and Yanukovych had resold their shares to Gazprom, but that these shares were again resold to their managers [Pinchuk and Akhmetov] through Cypriot, Hungarian, and Swiss offshore entities."[40]

The story of Firtash's role in RosUkrEnergo tells us much about the ability of the orange "powers that be" to find a place in previously existing gas trade rent-seeking schemes. There are important reasons to believe the new NAK leadership (Oleksii Ivchenko, who became head of NAK NU in March 2005) may have found an accommodation with the old schemes. As discussed before, it was very important for Yushchenko to have "his own man," in charge of NAK Naftohaz Ukrainy and its related cash-flow.[41] In addition to the scandal around RosUkrEnergo, there have been accusations of other types of corruption taking place both within and outside NAK Naftohaz Ukrainy.

In particular, the increase in gas prices changed the structure of incentives for various types of rent-seeking, and increased the attractiveness of financial manipulations around domestically produced gas, including manipulations by NAK NU itself. Some of these manipulations—as was unveiled by a Rada investigation—involved the adding of fictional or uncorroborated costs to the price calculation for domestically produced gas to increase prices and NAK's profits, which in any case did not prevent the company from going into the red in 2005.[42] On late November 2006, the Attorney-General's office opened criminal proceedings against Ivchenko. The accusations against Ivchenko were many, and ranged from incompetence to the intentional attempt to bankrupt the company, including accusations of purchasing inputs at artificially high prices, and the fictional renting—at a $2 million cost—of non-existent buildings.[43]

Outside NAK NU, there were allegations of corruption in the National Commission for the Regulation of Electric Energy (NKRE),[44] as well as in the allocation of oil-prospecting contracts.[45]

The January 4, 2006 agreements: Ukraine's energy policy weakness meets Russia's new use of energy for political purposes

Background to the agreements

Despite the existence of a valid contract for the supply of part of Ukraine's gas needs in exchange for transit services signed in 2001,[46] in the summer of 2005 Gazprom, increasingly under Kremlin control, proposed a more than threefold increase in prices, as well as payment in cash only; by December, the price requested had climbed to $230 per 1,000 cm. Gazprom had actually taken the hint from Ukraine, which in spring 2005 had played with the idea of ending the payment of gas supplies through the barter of gas transit services and moving to exclusively cash payments.[47] When negotiations broke down in December, Gazprom vowed to stop supplies unless a contract was signed; on January 1, 2006, supplies were stopped. With the chance of receiving alternative supplies from Turkmenistan very small due to tensions in the relationship with that country and Moscow's growing control over Turkmenistan's gas exports,[48] Ukraine found itself in dire straits. On January 4, after three days of no gas supplies to Ukraine and Moldova and partially interrupted supplies to Western Europe, an agreement was signed between NAK Naftohaz Ukrainy, Gazprom, and intermediary company RosUkrEnergo providing for continued gas supplies. Short-sightedly, Western Europe sighed in relief. As will be discussed below, the agreements provided a stop-gap, short-term solution, but turned out to be deeply flawed constructions with a variety of negative long-term effects for Ukraine and beyond.

A snapshot of the January 4, 2006 agreements

The core of the January 4 agreements is that Ukraine is offered a relatively moderate gas price, in exchange for giving up the exact determination of these imports to the trading company RosUkrEnergo. Former Minister of European Integration Oleksandr Chalyi called the agreements a "Pearl Harbor" for Ukrainian diplomacy.[49] Although the agreement, with its gas price set at $95/1,000 cm, was presented as a victory by Ukraine, Russian gas (as opposed to the mixture of gases sold for $95/1,000 cm) would still cost Ukraine $230/1,000 cm, the price originally demanded by Gazprom. Moreover, the $95/1,000 cm price for the mixture of gases seemed to be valid only for the first six months of the contract. Given the fact that most of the gas actually delivered to Ukraine in the first six months of 2006 seems to have come from Central Asia, what this means is not Russian gas at a "reduced" price of $95 per 1,000 cm, but Central Asian gas at much higher prices than those contracted directly between Ukraine and Turkmenistan.[50] While the new and higher prices charged Ukraine had no guarantee of stability, fees paid to Ukraine for transit services would remain constant for five years. Moreover, and despite Russian assertions to the contrary, the non-transparent price-setting mechanisms included in the agreements did not necessarily bring Ukrainian gas imports closer to market price-formation mechanisms.[51] Most important, however, is the question of contractual diversification and the fact that Ukraine becomes contractually tied to a single supplier tied to Russia. If there is a small element of geographical diversification here, it has to do with the fact that—at least on paper—RosUkrEnergo would provide gas produced, not only in Turkmenistan, but also in Kazakhstan and Uzbekistan, countries from which Ukraine had imported very little or no gas in the past.

Although this is not the first time that intermediaries have been used in Ukrainian-Central Asian gas trade, there are important qualitative differences between their role before and after the January 4, 2006 agreements. As discussed in Chapter 7, intermediaries have been part of Ukrainian-Turkmenistan gas trade since the mid-1990s, when Ihor Bakai's Respublika started to tap into the highly lucrative business of gas-for-goods barter. The basic difference, however, between the role played by these other intermediary companies and that given RosUkrEnergo in the January 2006 agreements is that previous agreements paid (excessively for that matter, but that is not the main point here) these companies to organize the transport of CA gas to Ukraine; under the new agreements, after 2006, RosUkrEnergo becomes not just the transporter, but also the operator of Ukrainian gas imports from CA and Russia, giving the company much more power in the relationship. In one additional point, part of the "secret" portion of the January 4 agreements that only came to light later, NAK Naftohaz Ukrainy agreed to sell to RosUkrEnergo, at the Turkmen-Uzbek border, 40 bcm of Turkmen gas (already contracted for purchase by Ukraine under the direct Turkmenistan-Ukraine agreements of December 2005) at \$50/1,000 cm, and to then buy 25 bcm of this same gas from RosUkrEnergo, but at \$80/1,000 cm. The other 15 bcm remain with RosUkrEnergo as payment for transit—effectively, 37.5 percent of the purchased gas.[52]

Two additional elements of the agreements directly threaten NAK NU's ability to do business profitably. The right to re-export gas, until then held jointly by NAK and Gazprom's Gazėksport, was given over to RosUkrEnergo. (Despite some restrictions on gas re-exports set by the Ukrainian and Russian governments, in 2005 NAK made about \$600 million dollars in profits through re-exports.[53]) Finally, a later agreement (of February 2, 2006) gives a newly formed JV, UkrHaz-Enerho (owned in equal parts by Gazprom and RosUkrEnergo) the right to distribute gas directly to industrial users in Ukraine, the most profitable domestic consumers, as these are often the only consumers able to pay regularly (and at higher prices than those charged to residential customers) for their gas.[54] Thus, we are speaking of a three-level monopolization of the gas trade: the monopolization of Turkmenistan's exports by Gazprom, the monopolization of sales to Ukraine by RosUkrEnergo, and the monopolization of domestic sales to industrial consumers by RosUkrEnergo's creation UkrHazEnerho.[55]

According to Ukrainian sources, Ukraine was basically forced by Gazprom and RosUkrEnergo to accept UkrHazEnerho as virtual domestic monopolist.[56] The scheme is not new—as discussed in Chapter 7, one of the most common gas schemes in the 1990s was the selective allocation of most lucrative gas distribution contracts, with the less payment-able customers left to state companies. The loss of these two business opportunities is extremely significant, as it has been mainly through these additional activities that NAK NU has been able to make up the losses created by selling gas to the population at prices lower than those paid by NAK NU for imports.

What the agreements (and how they were reached) say about transparency

The way in which the January 4 agreements were reached tell us that lack of transparency continues to be a major problem in Ukrainian-Russian energy relations. The negotiations were conducted in an atmosphere of high secrecy[57] and lack of transparency, although the activism of the press was very high—incomparably higher than that during the Kuchma period, where few dared to write about the possibility of corruption in RosUkrEnergo.[58] It is hard to avoid a certain impression of chaos during the negotiations, as it was not clear who was in charge. Moreover, it has been argued that several ministers—according to some, even Prime Minister Yekhanurov himself—were largely kept out of the negotiations.[59]

What kind of leadership did President Yushchenko exhibit during the negotiations? Not much—he kept a low profile and, according to a number of observers, seemed far from understanding the gravity of the situation.[60] There have been various interpretations of this role and of Yushchenko's level of knowledge of what was going on. Some have argued that Yushchenko was fully informed, and that his keeping a low profile was rather related to his personal interest in the issue. Despite his cryptic declarations and apparent ignorance of what was going on, the picture that eventually emerges is that of someone who was both much more informed than may have seemed at first glance, and who remained "the country's main gas person"[61] as many believed President Kuchma was before him.

The fact that Yushchenko knew what was going on or may have been personally involved is reflected in the fact that, despite repeated calls to dismiss him and ample evidence of his inept leadership of the company presented by the press in the wake of the agreements, Yushchenko decided to keep Oleksii Ivchenko as head of NAK Naftohaz Ukrainy.[62] Yushchenko's apparent connection with Dmytro Firtash also hints of a personal interest in the agreements.[63] Despite Yushchenko's ambiguous declarations (such as stating that he did not know of any Ukrainian state participation in RosUkrEnergo), it became rather clear that he not only knew of the real owners behind RosUkrEnergo, but may have received important benefits from them.[64]

As would later become apparent, Dmytro Firtash, RosUkrEnergo's main Ukrainian owner, was likely present in the negotiations, and the Ukrainian delegation followed "not the instructions of the Ministry of Foreign Affairs and the Ministry of Economics, but those of Firtash and Voronin."[65] MP Yekhanurov explained that Firtash and Voronin were given the right to be present at the NAK NU-RosUkrEnergo coordination committee by NAK Naftohaz's board of directors.[66] It is also suspected that Yurii Boiko may (indirectly) be a shareholder in Centragas, which owns 50 percent of UkrHazEnerho.[67] The conflict of interest was clear—Ihor Voronin, a very important figure in the NAK NU hierarchy, remained until at least October 2006 simultaneously acting head of de facto competitor UkrHazĖnergo,[68] and is considered by some to be the main person involved in coordinating RosUkrEnergos's work at NAK NU.[69]

Leaving aside the question of transparency, the Ukrainian negotiating team did not seem to have been fully prepared for the task at hand. From our discussion of the 1994–2005 period in the previous chapters of this book, we know Ukraine was not well prepared for Gazprom's onslaught. However, lack of coordination and transparency in the fall of 2005 seemed to have been extreme.[70] Despite the fact that already from spring 2005 Ukraine knew that Russia was trying to impose higher prices, Ukraine failed to prepare consequently for the upcoming negotiations. Moreover, already in the spring of 2005 the Ukrainian side had proposed to Gazprom moving away from barter payments.[71] Maybe the government thought it could change this but still keep in force other parts of the contract, for example, the old prices? At the time, energy experts such as Volodymyr Saprykin had warned against tweaking with the old contract, arguing that it could lead to an increase in prices.

During the negotiations, Ukraine did not a act as a united and professional actor while, some would argue, Russia was planning even the smallest details of its "attack" on Ukraine.[72] This difference could also be seen as a reflection of the different structure of ownership in the Ukrainian and Russian "parts" of RosUkrEnergo, the intermediary company key to the agreements—while the Russian part of the company was owned by Gazprom,[73] the Ukrainian side was held by private individuals, whose names did not become known until April of 2006. When the names of the real owners were made public, it was not by the Ukrainian side, but as a result of a calculated decision by the Gazprom-controlled newspaper *Izvestia*.[74]

Part of the lack of planning on the Ukrainian side had to do with failing to pay attention to alternative suppliers from Central Asia, first and foremost Turkmenistan. While in theory Ukraine's agreements with Turkmenistan[75] remained in force despite the agreement with RosUkrEnergo, by July 2006 Ukraine had not received any directly contracted gas from that country.[76] The interruption had to do with, above all, some of the longstanding problems that have plagued the Ukrainian-Turkmenistan gas relationship, in particular allegations of unpaid debts and unfulfilled barter contracts.[77] But there is an additional problem: while Ukraine still has the right to import Turkmenistan gas directly, even if Turkmenistan could produce enough gas, the transport infrastructure is not there that would allow it to fulfill both of these contracts: while Ukraine's 2006 contract was to purchase 40 bcm of gas, and Gazprom's to purchase 30 bcm, the transit capacity of the Central Asian pipelines is only 45–50 bcm per year.[78] Given this over-commitment, it is likely, then, that it will be price considerations and informal power relations that will decide who Turkmenistan will sell to. At the time of the agreements, Turkmenistan sold gas to Gazprom at $65/1,000 cm, which re-sold it to RosUkrEnergo, which then sold it to Ukraine at a much higher price. Yet these are mute questions if, as discussed earlier in this chapter, the NAK NU management itself is not interested in making use of the direct contract, and prefers to re-sell and re-purchase this directly contracted gas to and from RosUkrEnergo, at a great profit to RosUkrEnergo and at a loss to the Ukrainian state.[79]

The difficulties with Turkmenistan—compounded with Russia's growing gas role in the CA region discussed in Chapter 1 of this book—meant not only that Ukraine was having trouble accessing gas volumes already contracted for 2006, but that the prospect of signing a new agreement for 2007 (when the current agreement with Turkmenistan would end) and later was becoming less and less realistic. While in 2006 Ukraine—at least in theory—still had a direct contract with Turkmenistan to "balance" its dependency on RosUkrEnergo with, if there is no direct contract reached for 2007–2011, Ukraine will be left in a situation where the state will be left out of any gas supply negotiations, and with only very indirect ways of influencing gas monopolists such as RosUkrEnergo.[80]

What the agreements say about corruption

Why was NAK NU so clearly unprepared for the negotiations? Perhaps its leaders were too busy protecting their information from state investigations of corruption started by Yuliia Tymoshenko's team. Even more disturbingly, the possibility that the crisis itself could have been expected and "prepared" by both sides cannot be excluded.

Credits and a possible NAK NU bankruptcy

The January 4 agreements tell us that energy corruption is alive and well in Ukraine,[81] and that energy-sector transactions continue to be one of the most important sources of both corruption opportunities and corruption funds in the country. In addition to the question of RosUkrEnergo's gains, even more troublesome is the question of NAK Naftohaz's losses and their future impact. In addition to its estimated $500 million debt to RosUkrEnergo, by July 1, 2006, the company also had accumulated a $200 million debt vis-á-vis its partner UkrHazEnerho.[82] Keeping in mind NAK NU's losses as a result of the agreements, as well as its new and large indebtedness, it cannot be excluded that one of the purposes of the agreements would be a "forced bankruptcy" of the company (possibly with inside knowledge) and possible sale at a low price, with important implications in terms of loss of Ukrainian control of its energy infrastructure.[83] Tellingly, 2006 saw renewed discussion about a possible Russian participation in an international consortium to run Ukraine's gas transit system.[84]

Although most discussions of a possible "intentional" bankruptcy of NAK NU came in the wake of the January 4 agreements with RosUkrEnergo,[85] doubts about the way NAK NU has been managed had existed for a long time, including under the helm of Yushchenko appointee Oleksii Ivchenko. During the period between his appointment in March 2005 and mid-February 2006, the company had taken more than a billion US dollars in credits, arguing these were for special investment projects, but used them for general expenses and for the payment of overdue taxes.[86] In connection with the $2 billion line of credit given by Deutsche Bank to NAK Naftohaz in 2005, some look with suspicion at the fact that no concrete goal was given for the loan.[87] Some of the loans are serviced by Gazprombank, or were immediately sold to Gazprom-affiliated structures, giving increased weight to the "forced bankruptcy" hypotheses.[88] In this scenario, under the threat of a new winter gas supply crisis in the near future, and with the company in poor financial health, the Ukrainian government may feel compelled, in exchange for continued gas supplies, to compromise and give Gazprom control of the company, whose activities guarantee its loans.[89] Contributing to a possible NAK NU bankruptcy is the fact that, as noted earlier, the company has given up to RosUkrEnergo and affiliated UkrHazEnerho gas re-export rights and a monopoly of domestic sales to industrial customers, its two most profitable areas of activity. With little of a working, legitimate Ukrainian government to speak of from January (and especially since the 26 March elections) to early August 2006, it was basically impossible for these problems to be dealt with in a proactive way.[90]

The January 4, 2006 agreements and Russia's new use of energy for political purposes

Three readings of the January 4, agreements

What started as a straight story of Ukraine's state interest versus Russia's use of energy for profit-making or foreign policy purposes quickly turned into a much more complex story, a story involving many more actors and interests than one would normally consider. Ukraine, which until January 3 seemed to be united in its resistance to Russian pressure, emerged from the long Christmas holiday slumber on January 10 in a serious constitutional crisis.[91] And President Yushchenko, only a few days before calling for Ukrainians to unite against the Russian threat, emerged accused of betraying national interest, and with little chance of a Nasha Ukraina victory in the March parliamentary elections.

The state interests story

A first account of the events reads like a classical state interest-versus-state interest story. On the morning of January 1, 2006, Russia stopped gas deliveries to Ukraine, threatening to bring the Ukrainian economy to a standstill and laying bare its continued economic dependency on Russia despite fourteen years of independence. One year after Viktor Yushchenko's victory in the Orange Revolution, Ukraine's future was being decided, not on Kyiv's Maidan made famous by the Revolution, but in the Gazprom boardroom and in the Kremlin.

At issue was, officially, the price paid by Ukraine for Russian gas, discussed earlier in this chapter. The reality, however, went well beyond prices. If there was any doubt that Russia was ready and willing to use energy for foreign policy purposes, the events of January 1 seemed to have set these doubts aside. The ultimatum reflected Russia's growing assertiveness in using energy in the post-Soviet area to reward allies (such as authoritarian Belarus, with which Russia had just signed a contract maintaining low gas prices of $46.80 per 1,000 cm in exchange for political loyalty and promises of joint control over the country's pipeline system) and punish those following a pro-Western foreign policy line, such as Yushchenko's Ukraine.[92] The goal seemed to be to get Ukraine to join a pro-Russian economic, political, and military bloc—already including Belarus—which could serve as the basis for a larger reintegration process sellable to other post-Soviet states as an alternative to NATO and the EU, and to consolidate Gazprom's ownership over pipelines on post-Soviet territory carrying Russian gas to highly profitable Western European markets. Later developments in Belarus and Georgia, discussed in Chapter 1, support the validity of this perspective.

The private interests story

The story that emerged after 4 January is a much more complex one, and one that seemed to counter both Ukraine-as-victim/Ukraine-as-hero narratives and realist views of international affairs that see the state as the central actor and one whose actions are based on the pursuit of a maximum of independence for the state.

Again, Ukraine's future was being decided, not on Independence Square, but elsewhere. Not necessarily in the Kremlin or at Gazprom's headquarters, but somewhere "under the table," between Moscow, Kyiv, Vienna, and Switzerland,[93] under a table whose "support legs" are the profits and rents of energy dependency that can be made from Ukraine's situation of dearth of both energy resources and policy resolve.

It is not difficult to see how the January 4 agreements are negative for Ukraine but can bring large profits to private actors. Leaving aside the price issue—a very problematic one indeed—there are three main ways in which the January 4, 2006 agreements significantly worsen Ukraine's energy policy sovereignty. The first way has do with the fact that this is a private document (and not a state-to-state agreement), which has specific implications in terms of how it can be applied, and how disputes between the sides can be resolved.[94] Moving the contracts to a private company, Russia moves away from legal responsibility for the gas supply agreements it signed with Ukraine in 2001. Given the fact that the intermediary company RosUkrEnergo is estimated to have a basic capital of only $37,000, if there was a grievance against it, its responsibility would be limited to this amount.[95] The second way has to do with the size of RosUkrEnergo's influence: as a result of the new agreement RosUkrEnergo becomes the operator, not only of gas purchases from Turkmenistan, but of all gas purchases, including those from Russia itself, an important departure from its previous role. The third way has to do with the fact that, in the new agreement, Central Asian and Russian gas become mixed, further reducing Ukraine's contractual diversification, with the implication that gas from Central Asia will be able to play an even smaller role as a real diversification alternative than before. If before the agreement the situation with contractual diversification was far from good, as gas from Turkmenistan had to go through Russian pipelines and an intermediary company, now the situation is even worse because all gas from all sources becomes contractually undistinguishable.

As it became clear in the fall of 2006, the system put in place through the January 4, 2006 agreements had a number of other negative effects on Ukraine. First of all, the virtual monopoly on domestic gas supplies to industrial enterprises given to UkrHazEnerho gave the company the power, if it wanted, to lead companies to bankruptcy by sharply increasing prices, or simply stopping supplies. Thus, in November of 2006 UkrHazEnerho stopped gas supplies to sixteen factories, largely belonging to the Privat Group and Ihor Kolomoisky that competed with Firtash-owned companies.[96] In a related development, the company used the threat of disrupting supplies to seek to gain control over a number of regional gas distributors (oblhazi), many of which, such as Zakarpathaz and L'vovhaz, were controlled by former Nasha Ukraina deputy Ihor Yeremieiev. Both economic (UkrHazEnerho refusing to supply gas) and administrative pressure (in the form of frequent police controls and so on) was exercised against those oblhazi that refused to sell.[97] More generally, the move to control domestic-transmission gas pipelines could be a way of circumventing legislation prohibiting strategic objects (including transit pipelines) from being privatized.

It could be argued that the far-from-transparent agreement of January 4, 2006 was the alternative to succumbing to Russian pressure (using the threat of higher gas prices) for further integration into a Russian-dominated Single Economic Space (SES). It is clear, however, that the agreement did not strengthen Ukrainian sovereignty vis-á-vis Russia, but weakened it in many ways. Thus, the after January 4 story is a story of Ukrainian and Russian groups—possibly including groups close to the leadership of NAK Naftohaz Ukrainy and Gazprom—benefiting from the agreements, even when these create serious threats to Ukraine's future energy security. The contract reflects not only a non-Ukrainian-based view of energy security, but the fact that important actors continue to make a profit out of Ukraine's energy dependence. While the agreement is hardly beneficial to Ukraine, it provides substantial profits to RosUkrEnergo owners and to those behind them. It is estimated that in 2005 alone—that is before the increased profit stemming from the 2006 agreements—RosUkrEnergo made a profit of over $500 million, of which half went to the Ukrainian owners of the company.[98]

The private-interests-for-political purposes story

As events continued to unfold, a third reading started to gain plausibility. As domestic uproar over the faulty January 4 agreements grew, and as the possibility for the ratification of the agreements (and creation of UkrHazEnergo, a gas distribution joint venture) started to be called into question, Russia (and Gazprom) started to put pressure on Ukraine not to cancel the agreements. It has been argued (by *Dzerkalo Tyzhnia* journalist Alla Yer´omenko) that the January 4 "solution" was not a compromise, but a scenario Gazprom had been preparing months in advance.[99] Declarations by Ukrainian PM Yekhanurov seemed to point in the same direction: "The whole of the pipeline from the Turkmen-Uzbek to the Russian-Ukrainian border is filled by Gazprom's contractor RosUkrEnergo. We were offered a choice: either this, or to ship gas by train. Thus, we had no choice."[100] The fact that later in January, once Ukraine started to slow down the process of creating a JV with RosUkrEnergo, Gazprom reacted with strong accusations of Ukraine "taking more gas than it was supposed to" and the Russian government started a new "trade war" against Ukraine were unmistakable signs of growing pressure on Ukraine to continue supporting less-than transparent trading schemes.[101]

Indeed, some additional problems started to come up right when the agreements were to be ratified in late January, 2006. It emerged that the Russian side had been speaking about the creation of a JV also for the distribution of gas inside Ukraine, while the Ukrainian side seemed to be talking only about a JV to bring gas to the Ukrainian border.[102] RosUkrEnergo insisted that the domestic gas sales JV should be created with NAK Naftohaz Ukrainy, and not with its daughter company Haz Ukrainy.[103] These conflicts about control of domestic gas distribution are significant, as the domestic gas distribution business in gas-importing countries can be even more profitable than that of gas imports.[104] The Ukrainian side agreed, and a few weeks later UkrHazEnerho received official permission from the Antimonopoly Committee to distribute gas in Ukraine, albeit, as noted earlier, with a limit of 5.04 bcm per year.

Vladimir Putin's private interest in the agreement remains unclear. A variety of sources tell us that Putin was behind the liquidation of Eural Trans Gas, the operator of the previous gas transportation agreement between Ukraine and Turkmenistan, because its profits were not controlled by the Russian state, and because of the negative public relations created by its alleged connection with underworld figure Semėn Mogilevich.[105] Was Putin, however, for RosUkrEnergo? As shown by Roman Kupchinsky and Global Witness, and by documents made public in Ukraine in late 2006,[106] there are indeed important links between Eural Trans Gas and RosUkrEnergo, so the break with Eural Trans Gas—and, therefore, with all persons related to it—was clearly not as clear-cut as may have seemed at first glance. The fact that Russian citizenship was conferred on Ihor Bakai—who flew to Moscow and has been sought by the Ukrainian police and the Interpol since 2005—specifically thanks to a presidential decree by President Putin[107] tells us that he may have some important reasons to be grateful to Bakai—for example, that Putin and his circle may also have benefited from the gas trade schemes put in place by Bakai.

Could the crisis be seen as a set-up to move Ukraine to strengthen murky agreements where Putin himself, and his inner group, can benefit?[108] Yuliia Mostova calls attention to the fact that the very way in which the Russian side was able to manipulate the ownership structures linked to its part of RusUkrEnergo (through the company Arosgas, which owns 50 percent of RosUkrEnergo) speaks of the fact that, for the Russian side, the company is not only a means of accruing significant profits, but of supporting the expansion of Russian gas business in Europe and of hindering other players' access to Turkmenistan gas. Mostova contrasts this with the Ukrainian approach, where the very structure of ownership of the Ukrainian part of RosUkrEnergo (through the company Centragas) speaks of the predominance of private economic interests over larger national ones.

The picture that slowly emerges is that of a situation where Russia—Putin's group at least—may consciously use corrupt and half-underworld mechanisms not only to accrue profit (in turn used to strengthen Putin's faction), but also to pursue certain political and geopolitical goals in Ukraine. This is a new and powerful combination which, taken together with Russia's new role as largely monopsonist energy buyer in Central Asia, can have important long-term effects.

Changes in Russia's energy role

The new dependencies Ukraine finds itself in as a result of the January 4, 2006 agreements would not have been possible without important qualitative changes in the Russian side as well. Here three main issues come to mind: the Russian government's increased willingness to use energy as a foreign policy tool (as evidenced in Russia's new Energy Strategy to 2020[109]), the new boldness facilitated by its large energy-related income, and, especially important, Russia's new role as de facto (near) monopolist buyer and marketer of CA gas, which it uses to compensate for its own dwindling production. In January 2006, Gazprom (including RosUkrEnergo) began purchasing the totality of Turkmenistan's gas exports, much of which is re-sold to Ukraine. In seeking to control the marketing of Central Asian gas, Russia is simultaneously seeking to prevent competition from Central Asian gas in Western European markets by marketing this gas itself, to counteract the building of new pipelines that would allow the CA states to sell their energy directly in Western markets,[110] and, third, to prevent states such as Ukraine from truly diversifying their energy supplies, an essential precondition for diversifying their foreign policy options as well.

As stated by deputy foreign minister Anatolii Buteiko, Ukraine is the first state to experience on itself the effects of this new role played by Russia.[111] Its new power vis-á-vis Ukraine may be a warning of what is to come for other post-Soviet and neighboring states.

Energy and Yanukovych's comeback

By August 2006, the situation had gone full circle: from the original uproar over the January 4 agreements as a sell-out of Ukrainian sovereignty to Russia, to the return to power of exactly those political actors—personified by Viktor Yanukovych, elected as PM on August 4, 2006[112]—wanting a closer relationship with Russia. What happened in these seven months? How to explain this paradoxical outcome? In the following few paragraphs, we briefly discuss some ways in which the energy rents issue discussed throughout this book made possible Yanukovych's return to power in August 2006.

Energy and the unraveling of the Orange coalition, act II: Coalition-building chaos and Yanukovych's revenge (January–August 2006)

The battle around the January 4 agreements

In the same way as it did not seem like all members of the government were fully aware of what was going on at the time of the signing of the January 4 agreements,[113] in the following weeks these not only became the opposition's main argument to call for a vote of no-confidence in the government, but also were interpreted differently by different members of the government. On January 10, 2006 the Rada, in uproar, declared a vote of no-confidence in the government. Later, on February 14, 2006 it dismissed "for the second time" energy minister Ivan Plachkov[114] and repeatedly declared its non-confidence in NAK NU chief Ivchenko. While a few government officials defended the agreements—especially before information about secret clauses came to light—others, both in and outside the government, started to call for their denunciation.[115] Their strongest voice was Yuliia Tymoshenko, whose popularity grew as a result of her vocal opposition to the agreements, winning her a strong showing in the March Rada elections, at least in contrast with Nasha Ukraina's results.[116] This, in turn, gave her the chance to build a new ruling coalition with Yushchenko's Nasha Ukraina, a process that was discussed from March to July of 2006.

President Yushchenko argued there were no Ukrainian "official organizations" among RosUkrEnergo's shareholders. The government created a special commission (headed by RNBO head Anatolii Kinakh) to clarify the situation. The Rada also created, on 10 January, a "temporary investigation commission" to study NAK NU and the gas issue. Its report, however, had only limited weight, as it was not approved by any of the economics-area ministers, who disagreed with its contents.[117]

There was also significant disagreement and lack of clarity about the issue of who exactly had pushed for RosUkrEnergo to become Ukraine's gas supply intermediary, with members of the Ukrainian government declaring it had been the Russian side which pushed for the use of that company, and the Russian government, including President Putin himself, saying it had been the Ukrainian side. Within the Ukrainian government itself, contradictory voices could be heard on whether the government would buy the Ukrainian 50 percent of RosUkrEnergo. In February, the Russian side argued NAK NU should participate directly in RosUkrEnergo, but PM Yekhanurov made clear that that the company lacked the financial means to buy the Ukrainian part of RosUkrEnergo.[118]

The agreements and the March 2006 Rada elections

The chaos and exchange of accusations following the January agreements not only reflected the deep divisions—based on interests as well as policy preferences—existing within the Orange coalition, but seriously discredited the Nasha Ukraina movement, already mired in allegations of corruption related to the gas deal, as disorganized and unable to run a government. The fact that seven of Nasha Ukraina's nineteen months in office (up to Yanukovych's return to the post of prime minister in August 2006) were characterized by a significant vacuum of power and legitimacy was directly related to energy issues, and did little to increase Nasha Ukraina's popularity.

The January 4 agreements with Gazprom not only led to the plummeting of Nasha Ukraina's ratings, but also strengthened the position of those wanting a closer relationship with Russia, and who (such as extreme pro-Russian politician Nataliia Vitrenko but also the Party of Regions), proposed to solve the question through joining the SES "and then getting domestic gas prices, maximum \$65/1,000," as Vitrenko argued.[119]

Seven months passed between the dubious agreements of January 4 and the formation of a new government, seven months in which Ukraine remained without a working government. It is not too far-sighted to speculate that both issues are related—that is, that much of the negotiation about the future shape of the government was also a negotiation about the future of energy rents, the complex battles for which have already brought so much trouble to Ukraine in the past. If in the previous years the nature of the political system led to lack of proactivity in energy policy, by 2006 the energy rents field had gotten so complicated, that it contributed significantly to the bogging-down of political negotiations, and to virtual immobility in the political system and the lack of a workable government for months.

One important reason for the final triumph of an arrangement with Yanukovych's Party of Regions was that, simply, too many important actors both in Ukraine and Russia were afraid of what Yuliia Tymoshenko's coming to power could mean in terms of the revision of the gas agreements signed on January 4, 2006, and of the far-reaching consequences this revision could have.[120] Tymoshenko never concealed that her number one task as prime minister would be to review the agreements, and the coalition agreements of June 22, in discussion until July 6,[121] would have given her wide powers to do this.[122]

A second important issue concerns the common interests between the partners in the new arrangement between the Party of Regions and Nasha Ukraina. In the same way that important actors within Ukraine and Russia found a "common language" through the agreements of January 4, 2006, so the Nasha Ukraina and Party of Regions bloc found a way to reach an agreement through the unspoken—or at least not publicized—agreement to continue the non-transparent, but far too profitable for far too many people[123] gas trade practices enshrined in the January 4 RosUkrEnergo agreements.[124,125] Interestingly, despite the generalized uproar at the agreements, President Yuschenko never denounced them fully.[126] Yanukovych, for his part, despite having criticized the agreements strongly in January and February of 2006, ceased his criticisms upon regaining the PM post, and started to refer to RosUkrEnergo as a reality that could not be changed, at least in the short-term.[127]

Conclusion

In the first year and a half of the Yushchenko presidency, the connection between politics and energy policy turned out to be no less strong than during the Kuchma period. If the Orange Revolution is over, it is in great part due to the great attraction exercised by energy rents, and to their "swamp" effects—neither democrat nor oligarch, nationalist nor friend of Russia seemed to be able to resist the temptation of its embrace or, perhaps, the fear of violent retribution reserved by the ultimate organizers of energy corruption for those who might seek to dismantle their profitable schemes. Only one source of power proved to be stronger than the Orange Revolution—not (former) PM Viktor Yanukovych, nor Russia, but the power of energy-related interests.

If there is a main difference in the relationship between politics and energy policy in the Kuchma and Yushchenko periods it is that now there is true freedom of the press, and the details of energy trade deals are coming to public attention. This is an important difference that may have important implications for the future. It is still not clear, however, whether this will make a difference under conditions where the Ukrainian public—tired after multiple installments of the "coalition-forming saga," "speaker-election saga," "Rada blockade saga," and "Yanukovych vs. Yushchenko competition for power saga" in 2006 and beyond—is disillusioned and increasingly apathetic, and where real policy decisions continue to be made behind closed doors and without much real input from the electorate.

9 Conclusion

Ukraine, energy, and Russia's new power

Although exceptional because of its richness, the Ukrainian case analyzed in this book is not an isolated case of misuse of public policy for private benefit. It exists in the context of, and reflects two important trends coexisting in the post-Soviet world: on the one hand, the unique opportunities for enrichment created by the post-Soviet transition, and, on the other, the way in which post-Soviet Russia is using both old (structural dependencies inherited from the Soviet Union) and new dependencies to reassert a hegemonic position in the former Soviet bloc.

Summing up: what have we learned about the Ukrainian case?

Energy rents and the shaping of the Ukrainian political system

This book has focused on the effects of the political system on the management of Ukraine's energy situation. At the same time, the very availability of large, relatively easy to access (for those with the right connections) energy rents had a very significant impact on the development of the Ukrainian political system more generally. This impact took place at both the more general and more specific levels. At a more specific level, money from energy rents, energy corruption and energy companies more generally played a very important role in all Ukrainian national elections since 1994. Direct and indirect contributions from Russian energy companies were very important, but "domestic" energy money also played a major role, as, for example, funds accessed through NAK Naftohaz Ukrainy and other energy traders in the 1999 and 2004 elections. At a more general level, the impact of energy corruption went well beyond the energy sector. Because of the centrality of the energy sector for Ukraine's economy as a whole, trends related to corruption and lack of transparency, once started in the energy sector, spread easily to the rest of the economy.[1] A World Bank study aptly described Ukraine's gas sector as a "magnet for corruption."[2]

The impact of such a large influx of energy rents money into the Ukrainian political system can hardly be overestimated, and here we see the mutually reinforcing effects of political system, energy dependency and rents of dependency at work. On the one hand, the political system created certain "windows of opportunity" for access to energy rents, influenced those who had access to these rents, and also how these rents would be recycled into the political system. This led to the strengthening of certain political actors with an interest in maintaining both certain "bad institutions" (institutions permitting widespread corruption and lack of transparency) and a situation of energy dependency through which their access to energy rents could be most easily guaranteed.[3]

The wide availability of energy-related rent-seeking opportunities exactly during the first, formative years of Ukrainian statehood left an important imprint on its development. Access to these energy rents made it possible for managers of energy-intensive industries and emerging oligarchs to find a common interest in opposing real economic reforms, as such reforms may have threatened the continuation of a system that allowed them to amass vast riches—legal and illegal—in record time.

Competition or collusion?

This book started under the assumption that "the competition and struggle between economic groups over energy business and over the distribution of economic gains (and losses) from energy trade" has played a central role in influencing political events in Ukraine. Without doubt, the Ukrainian case has provided ample evidence of this, especially concerning the impact of energy-related competition between economic and political groups on the country's political development.[4] But the Ukrainian evidence, especially from the period after 2004, leads to the conclusion that the system of energy corruption and rents of energy dependency carried within it, not only the basis for conflict, but also for accommodation between elites and energy groups inside and outside Ukraine's borders, who were often able to find a common language through the shared appropriation of energy rents—indeed, one of the most important mechanisms bringing together Russian and Ukrainian energy elites.

Three examples support this conclusion. First, the tacit agreement between some Russian and Ukrainian actors to allow the "unsanctioned taking of gas" from the pipeline carrying Russian gas to Europe and the sharing of resulting profits. A second example is provided by the Russian-Ukrainian gas trade agreements of January 4, 2006, where the conflict between both countries was quickly put aside once a way was found (through giving the company RosUkrEnergo a highly profitable role) to provide important players in both Ukraine and Russia important profits, even at the expense of the Ukrainian and Russian budgets. Similarly, common fear of what a revision of the January 4, 2006 gas agreements with Russia would have meant for many Ukrainian political and economic actors was an important basis for the Nasha Ukraina arrangement with its former arch-rival Party of Regions, paving the way for Viktor Yanukovych's return to power as PM in August of 2006.

This sharing of corruption-related energy trade profits often came at the expense of the state budget (which was often the ultimate source of many of the acquired rents) and of the population at large. At a broader level, these shared interests among elites often had very negative consequences for Ukraine's energy development, as most important energy actors found it advantageous to continue a system of subsidized energy prices, at the expense of the state budget and of Ukraine's ability to break away from its energy dependency on Russia. In this situation, important economic elites found common interests not on a positive basis, but on the basis of the common plundering—direct or indirect—of their own state. This proved not to be a solid basis on which to start building a state after independence from the Soviet Union.

What have we learned about the post-Soviet world?

The nature of interest representation in the post-Soviet world

The Ukrainian case has made evident that energy relationships in the post-Soviet area include multiple actors with a variety of often murky relationships to state policy, on the one hand making the question very difficult to tackle using only a state-as-actor perspective, and, on the other, asking us to rethink our view of both interest representation and policy-making in the post-Soviet area.

One conclusion that emerges clearly from the analysis of the Ukrainian case is that we are hardly talking about traditional interest groups in the sectoral sense of the term. In post-independence Ukraine, sectoral groups were soon largely replaced as main actors by sectorally more heterogeneous Business-Administrative Groups (BAGs). In addition, the complex role played by formally state-owned companies such as NAK Naftohaz Ukrainy highlights the fact that it is not sufficient to look at policy-making in terms of "state" versus "private" interests, but that other actors and interests created by the specific nature of the post-Soviet transition may also play an important role. The Ukrainian case has also taught us that there may be important differences between the separate corporate interests of (state-owned) companies and the private interests that may be located within these.

As investigations on the real owners and widespread political contacts of very important energy policy-making organizations such as RosUkrEnergo continue, it becomes clear that a variety of other actors may also have an important say and important vested interests in energy policy: not only sectoral interest groups, state and other companies with their corporate interests and "private-interests-within the corporation," but also individual politicians and organized crime. Against these strong actors, official energy policy-making institutions played a clearly secondary role. This multiplicity of often hard-to-track actors, and the murky distinctions between state and private interests presents important challenges to scholars seeking to understand the nature of interest representation in the post-Soviet world. It also calls for a new approach to policy-making, that is, one less fixed on official policy-making institutions and more attentive to policy-making wherever it may take place.

Oil, gas, rents of energy dependency and corruption

The evidence presented by the Ukrainian case highlights the need to pay particular attention to what the differences between oil and gas mean for both the domestic political implications of energy development, and for the international trade relationships involved. Some of these differences have to do with how the different organizational structures in the oil and gas sectors in the main supplying markets (Russia and Turkmenistan for gas, Russia for oil) affect the various possibilities for access to energy rents. Differences in terms of access to rents of dependency may also have to do with the structural differences between both sectors, including differences in transportation possibilities, as well as differences between the oil and gas sectors in the supply (mainly Russian) side of the equation in terms of market structure and structure of ownership. Understanding these differences, including their effects in terms of facilitating or hindering various types of corruption, is essential for developing both proactive energy policies and effective corruption-fighting strategies in the post-Soviet area.

Who "captures" whom?

In the complex interplay of power and influence that characterized the Kuchma period, it is still not fully clear who had the upper hand, the president or the various BAGs that participated in the system. Thus, it is still unclear: who "captured" whom? The executive the BAGs, or the BAGs the executive? While we may never get a straight answer to this question, the Ukrainian case may be useful in terms of making clear the limits of both "captured state" (where economic actors use the state to pursue their own economic intezests[5]) and "grabbing state" (whare the state seeks to control economic activity[6]) perspectives, as none of them seems able to fully explain the Ukrainian case.

Implications for policy

Energy corruption and energy dependency

The case analyzed in this book has important implications for the fight against corruption in the former Soviet area and beyond. One clear conclusion is that energy corruption and Ukraine's energy dependency are closely related. In this case, the private profits that could be accrued from non-transparent energy trade, even when these condemned Ukraine to continued dependency on Russia and low levels of energy efficiency, were too large for any important players to gain a real interest in moving toward greater energy independence. Conversely, the energy corruption system was so widespread, that the possible private costs of engaging in corrupt deals (and being caught) were seldom high enough to serve as a deterrent.[7]

If the international community is serious about helping Ukraine move toward greater energy independence, it cannot look at the problem simply in terms of "Ukraine" versus "Russia." As long as widespread corruption continues, and as long as trade in energy remains non-transparent and an easy source of corruption rents, Ukraine will have little chance to achieve greater energy independence and of managing its energy dependency in a proactive, positive way. One possible option would be to eliminate some of the features that make the energy sector such a potent magnet of corruption as it is now, first and foremost the attractive arbitrage opportunities still built-in in much of post-Soviet gas trade, and made possible not only by the continuing differences between domestic, "near abroad," and export prices, but also by the fact that most energy markets in the region have not been liberalized. Russia's refusal to ratify the Energy Charter Treaty, as well as recent measures strengthening state control over gas exports (such as the July 2006 law establishing that all exports of Russian gas have to go through state structures, i.e. Gazprom) spell bad news in this area.

The battle against energy corruption will not be an easy one, as energy corruption often involves a multiplicity of important actors across the political spectrum with little interest in abandoning profitable rent-seeking schemes. Moreover, with an extremely non-transparent country such as Turkmenistan as one of its main trade partners, it may be difficult for Ukraine to fully eliminate gas trade corruption schemes until the situation improves there as well. Further, the cessation of barter trade (as shown by the January 4, 2006 agreements), has proven not to be a guarantee against corruption.

It could be argued that the only guarantee against arbitrage gains and the corruption opportunities opened by them is the move to full market prices, and that this could be lethal for the Ukrainian economy. Yet gas prices close to average Western European ones will eventually come to Ukraine, with or without Viktor Yanukovych at the helm of the state; Ukraine has been paying world (or near-world) oil prices for years already. The issue is whether these changes in pricing will be implemented gradually, and whether Ukraine will be able to use the transition period to prepare its economy for these. If these two conditions are met, the move to more market-oriented prices may actually turn out to be a blessing in disguise for the Ukrainian economy. As stated by many experts, "low" energy prices[8] have been one of the main reasons why Ukraine, the world's fifth largest gas importer, has remained tied to an energy-intensive industrial model, and has not been able to take resolute measures to increase its energy efficiency.

Energy corruption, new dependencies, and Russia's new power

At the same time as it is not enough to see Ukraine as simply a victim of Russia's energy blackmail, it is important to understand the links between domestic politics (and, in particular, corruption) and Russia's ability to take advantage of new types of energy dependencies taking shape in the former Soviet area, in particular those created by Russia's role as a monopsonist buyer in Central Asia, and by its increased control of energy transit infrastructure in the post-Soviet area. These new dependencies have in common and highlight the participation of local partners in the countries involved, who often receive significant profits from the relationship with Russia. This question concerns not only Ukraine, as energy corruption is a serious problem in many post-Soviet states.

Energy corruption and freedom of the press

The non-transparent energy deals put in place by the January 4, 2006 agreements are nothing new. In one way or another, they have all been rehearsed and tried in Ukraine between 1995 and 2004; many of them are described in Chapter 7 analyzing the main means of energy rent-seeking during the Kuchma era. Unfortunately, due to the formal and informal censorship characteristic of the Kuchma era, such information was not easily available to the wide Ukrainian public.[9] This brings to the fore the tremendous importance of freedom of the press, and the role of foreign actors in supporting it—perhaps, if more of the schemes tried between 1994 and 2004 had been brought to public attention, the public would have been warned, and it would have been easier to prevent the kinds of deals represented by the 4 January agreements. Certainly, there are limits to what the press can do, especially when it is given no access to government information and when investigative journalism can be a very dangerous profession, as witnessed by Heorhii Gongadze's assassination in 2000. Nevertheless, press organs such as *Dzerkalo Tyzhnia*, to which Ukraine has to thank the unveiling of the real nature of Ukrainian-Russian energy corruption, deserve to be supported generously, both to make sure they can maintain their print and internet presence, and to help them withstand pressure from the state or private actors for whom its reporting may be highly inconvenient.

Looking ahead

Even with Yanukovych back in power, there is no automatic return to the Kuchma days, if only because a much more vigilant press is active. But, regardless of who may come to power in the next few years, the energy rent-seeking schemes discussed in this book will most likely continue to be in place and create the context for any government's energy policy. What we have learned about how energy rents functioned in the Kuchma period, and how they were able to adapt to the new conditions created by the Orange Revolution will provide important clues for understanding the making of politics and policy in this new period as well. As this book goes to press, a new cycle of Ukrainian politics has been completed and restarted with the contested dismissal of the Verkhovna Rada in April of 2007, the strong showing of the Bloc Yuliia Tymoshenko in the September Rada elections, and the fits-and-starts shaping of a coalition agreement between Tymoshenko and Nasha Ukraina forces. The fate of this coalition, and whether it will be able to revive the hope of the Orange Revolution, will to a large extent depend on how the affected parties will deal with the question of energy rents, and on whether Ukraine's political future will be allowed, once again, to be hijacked by these.

As shown by the role of energy rents in bringing down the promise of the Orange Revolution, energy rents, energy policy and democracy continue to be closely related in Ukraine. Until the Ukrainian population is able to regain faith in its government and political elites, and until a democratically controlled policy process is put in place, there will be little chance for Ukraine to develop consequent long-term energy policies, including energy diversification policies. Given the structural legacies from the Soviet period and the dearth of pipelines linking Ukraine to alternative suppliers, there will be an inevitable short-term hardship involved in the implementation of real energy diversification measures; only democratic and openly discussed energy policies put in place by governments widely seen as legitimate have the chance of succeeding in spite of these challenges.

At the same time, the answer to the question of energy and politics is crucial, not only for Ukraine's ability to move away from energy dependency on Russia, but for the future of Ukrainian democracy as well. The ability to reform corrupt relationships in the important energy area represents a litmus test of whether any of the changes heralded by the Orange Revolution are for real and will have a real impact on the way Ukrainian politics is conducted. Energy-related corruption and energy-related political capitals were so essential for the development of the only limitedly democratic political system in Ukraine under Kuchma that, unless that source of corruption money is eliminated, the chances for real reform—not only in terms of energy efficiency and economic reform, but also political reform—in Ukraine will remain next to nil.

Notes

1 Introduction: energy, integration and disintegration in the former USSR

1 Two additional states, Kyrgystan and Tadzhikistan, are energy poor, but draw largely on supplies from their Central Asian neighbors. Despite having very significant gas reserves, Azerbaijan has been slow to bring these to market due to lack of infrastructure, and covers roughly half its gas needs with supplies from Russia.

2 In the case of some of the energy-dependent post-Soviet states, this infrastructure simply does not exist within the borders of the state. For example, as of 2006, there were no gas counters on Ukrainian territory measuring the volume of gas incoming from Russia. See Vitalii Kachanov, "Resursy liubiat uchët," *Ėnergobiznes*, July 10, 2006. Accessed through the ISI Emerging Markets portal, available at www.securities.com (thereafter noted as "via ISI"). *Ėnergobiznes* is listed in the ISI portal under the English name "Energobusiness Magazine." See also Map 4 in this book.

3 On the energy legacies of the Soviet Union, see Margarita M. Balmaceda, "Der Weg in die Abhängigkeit: Ostmitteleuropa am Energietropf der UdSSR," special issue on *Europa Unter Spannung: Energiepolitik Zwischen Ost und West*, *Osteuropa* 54, Nos 9–10, 2004, pp. 162–179.

4 Geographical diversification refers to importing energy from several countries and/or geographical areas. Energy source diversification refers to making a country less dependent on one single energy source (oil, gas, and so on) in favor of a broader basket of energy sources. Contractual diversification refers to developing a variety of contractual relationships both in terms of companies and of type of contracts (short-term, long-term, and so on) even when the energy originates from a single country.

5 On gas cooperation with Turkmenistan, Uzbekistan, and Kazakhstan, see Martha Brill Olcott, "International Gas Trade in Central Asia: Turkmenistan, Iran, Russia and Afghanistan," Program on Energy and Sustainable Development, Rice University, Working Paper No. 28 (May 2004), p. 33; available at http://pesd.stanford.edu/publications/international_gas_in_central_asia_Turkmenistan_iran_russia_and_afghanistan (accessed June 21, 2006).

6 In January 2006, control over gas supplies to Ukraine was given to the Russian-Ukrainian-Austrian firm RosUkrEnergo, discussed in detail in Chapter 8.

7 See US Department of Energy, Energy Information Administration, Country Analyses Briefs, Central Asia, available at www.eia.doe.gov/emeu/cabs/ Centasia/Background.html (accessed June 21, 2006).

8 Such as the Baku-Ceyhan oil pipeline inaugurated in 2005.

9 This is evidenced most clearly in the case of Uzbekistan, where President Islam Karimov's displeasure at Western criticism of his human rights record led not only to the closing of a US base in 2005, but to the signing of ambitious energy cooperation agreements with Russia starting in 2004.

10 The Energy Charter Treaty was first signed in 1994 as the European Energy Charter and later extended to include a growing number of non-European participants. A basic premise of the Charter is non-discrimination in energy transit, so that "all the signatories must allow the transit of energy from third parties, and must not disrupt this in the event of a conflict with one of the parties." Janne Haaland Matlary, *Energy Policies in the European Union*, New York: St. Martin's Press, 1997, p. 76.
11 In 1999, in addition to its de facto takeover of the Transdniester region's gas transit system, Gazprom gained control of 50 percent (plus one) of shares in Moldova's gas transit company MoldovaGaz. A few hours before midnight on December 31, 2006, and under threat of a total stoppage of gas supplies from Russia, Belarus agreed to sell to Gazprom 50 percent of gas transit company Beltransgas, after 10 years of difficult negotiations. In addition, Gazprom has been keen to gain control of the gas transit systems in other post-Soviet states. The latest attempts to gain control of the post-Soviet gas transit system come in the wake of and dovetail nicely with Russia's majority state-owned electricity near-monopolist RAO-UES' successes in gaining significant ownership in the post-Soviet states' energy grids, also important for transit purposes, as RAO-UES sees electricity exports to former Soviet republics and other neighboring states as a priority and an important source of revenue.
12 See Reinhard Veser, "Armenische Abhängigkeiten," *Frankfurter Allgemaine Zeitung*, April 11, 2006, p. 7.
13 See Vladimir Socor, "Russia Cements Control of Armenia's Energy System," *Eurasia Daily Monitor* 3, No. 204, November 3, 2006, available at http://jamestown.org/edm/article.php?article_id=2371612 (accessed January 13, 2007).
14 US Department of Energy, "Country Analysis Briefs, Baltic Sea Region," available at www.eia.doe.gov/emeu/cabs/Baltic/Full.html (accessed June 24, 2006). On gas see Austrian Energy Agency, "Energy Profile Estonia," "Energy Profile Latvia," and "Energy Profile Lithuania," available at www.energyagency.at/enercee/ (accessed June 24, 2006).
15 Latvijas Gaze website, www.lg.lv/pub/default.php?lapa=3&oid=3 (accessed January 11, 2007).
16 Lietuvos Dujos website, www.dujos.lt/en.php/company/shareholders/146 (accessed January 11, 2007).
17 While these specific illustrations come from the Ukrainian case, a variety of examples can also be found in the other energy-dependent post-Soviet states.
18 While there is no quotable "world gas market price" as there is in the case of oil (this is because gas markets are much more fragmented than oil markets, preventing the establishment of a single price), one can talk of European average prices for gas supplied by pipeline, in 2007 hovering around $250 per 1,000 cm. Shorter transit distances from Russia mean that final prices for Ukraine or Belarus should normally be lower than for Western European markets because of the lower transport costs. More generally, any discussion of "market energy prices" in the former USSR should be taken with a grain of salt, as a market is usually understood to exist where several sources of supply and demand meet, which is seldom the case in former Soviet area gas and oil trade.
19 While Belarus often presents itself as "Russia's last ally" and has provided it with important military access, serious contradictions have plagued the relationship since 1996. See Margarita M. Balmaceda, *Belarus: Oil, Gas, Transit Pipelines and Russian Foreign Energy Policy*, London: GMB Publishing, 2006, and Margarita M. Balmaceda, "Myth and Reality in the Belarusian-Russian Relationship: What the West Should Know," *Problems of Post-Communism* 46, No. 3, 1999, pp. 3–14.
20 Russia, suffering from chronic labor shortages, also benefits from this labor migration.
21 The Russian government used the thinly veiled excuse of non-conformity with Russian sanitary standards.

22 Moldova transits *c*. 20 bcm of gas to Romania, Bulgaria, and the Balkans per year.

23 See US Department of Energy, Energy Information Administration, Country Analyses Briefs, Baltic Sea Region. Although Transneft presented the cessation of pipeline oil supplies to Ventspils as resulting from its shifting exports to the Russian port of Murmansk, many saw the oil stoppage as a means of forcing Ventspils into bankruptcy so that Transneft or another Russian company could acquire it at a bargain prices, and as retaliation against Latvia's domestic and foreign policies, often perceived by Moscow as anti-Russian. Already in 1998, Russia had cut oil exports through Latvia in a dispute over alleged discrimination against ethnic Russians. See Anna Ferus, "Latvia and Russia Oil Dispute," Trade and Environment Database Case Study No. 505, available at www.american.edu/ted/latviaoil.htm (accessed June 21, 2006). A similar strategy was pursued toward the Lithuanian refinery Mazeikiu Nafta (an indirect re-exporter of Russian oil) in 2006.

24 The $1.7 billion figure is from Simon Araloff, "Russia Prepares for the Economic Conquest of the Baltic Countries," Axis Information and Analysis, available at www.axisglobe.com/article.asp?article=300 (accessed June 27, 2006).

25 The most important of these bypass pipelines are the Yamal pipeline through Belarus and Poland (intended to bypass Ukraine) and, more recently, the Northern European Gas Pipeline (intended to bypass Belarus, Ukraine, and Poland) with a direct link to Germany under the Baltic Sea, the construction of which started in late 2005.

26 Most post-Soviet states are overwhelmingly dependent on gas, an energy source where Russia is one of a few providers in Europe.

27 Between 1998 and 2005, world oil prices increased sixfold, from $10 to $64 per barrel, boosting Russia's foreign-currency earnings.

28 While Russia's large gas (where it is the world's largest producer and exporter) and oil (where its production and exports are second only to Saudi Arabia's) resources give the country a strong basis for international leverage, we should not forget that significant domestic problems (declining gas production, creeping Dutch disease, an outdated and poorly managed energy infrastructure, and over-dependency on volatile energy revenues) may make Russia an energy giant with feet of clay. On some of the challenges faced specifically by the gas sector, see Jonathan P. Stern, *The Future of Russian Gas and Gazprom*, Oxford and New York: Oxford University Press, 2005.

29 On this transformation see, among others, Stephen Fortescue, *Russia's Oil Barons and Metal Magnates: Oligarchs and the State in Transition*, Basingstoke, Hampshire: Palgrave MacMillan, 2007.

30 See *Ėnergeticheskaia strategiia Rossii na period do 2020 goda* (Russia's Energy Strategy up to 2020), Moscow, September 2003. Full text in Russian available at www.gazprom.ru/articles/article4951.shtml (accessed June 21, 2006).

31 See Vladimir Milov, "Russian Energy Policy in a Broader Context," presentation at the American Enterprise Institute, Washington, DC, March 16, 2006, power-point presentation available at www.energypolicy.ru/files/March16–2006.ppt (accessed June 25, 2006). See also Konstantin Simonov, *Russkaia neft': poslednii peredel*, Moscow: Ėksmo, Algoritm, 2005.

32 For a detailed discussion of this topic, see Margarita M. Balmaceda, "Russian Energy Companies in the New Eastern Europe: the Cases of Ukraine and Belarus," in Andreas Wenger, Jeronim Perovic, and Robert W. Orttung, eds, *Russian Business Power: The Role of Russian Business in Foreign and Security Policy*, London: Routledge Curzon, 2006, pp. 67–87.

33 As has often been the case within Gazprom, especially under the leadership of Rem Viakhirev (1992–2001).

34 Radio Free Europe/Radio Liberty, "EU Lauds Temporary Resolution of Moldova-Russia Gas Dispute," RFE/RL Research Report 8, No. 3, January 24, 2006, available at www.rferl.org/reports/pbureport/2006/01/3–240106.asp (accessed January 11, 2007).

35 In addition, according to the agreements in force as of January 1, 2007, Armenia will pay $110/1,000 cm, Ukraine $130/1,000 cm, and Moldova $170/1,000 cm.

36 In a related argument, Volodymyr Dubrovskyi (Volodymyr Dubrovs′ky, Vladimir Dubrovskyi) *et al* refer to these as "macro-rents" and "micro-rents," respectively. See Olexander Babanin, Volodymyr Dubrovskyi, and Oleksii Ivashchenko, *Ukraine: The Lost Decade… and the Coming Boom?*, Kyiv: CASE Ukraine, 2002, p. 12.

37 Arbitrage refers to the possibility of making a profit out of manipulating price differentials for the same good between various markets or within sectors of the same market.

38 Despite pressure for reducing such differences coming from the WTO-accession process among other sources, price differentials between domestic, "near abroad" and export prices continue to be an important characteristic of trade between post-Soviet states.

39 A direct result of this rethinking was the new draft Energy Policy for Europe presented by the EU on January 10, 2007 emphasizing the need for increased energy efficiency and a reduction of energy supply dependency. See "Communication from the European Commission to the European Council and the European Parliament (provisional)," available at http://ec.europa.eu/energy/ energy_policy/doc/01_energy_policy_for_europe_en.pdf (accessed January 11, 2007).

40 Not including imported nuclear fuels needed for nuclear energy production. Source: International Energy Agency, *Key World Energy Statistics 2006*, available at www.iea.org/textbase/nppdf/free/2006/key2006.pdf (accessed January 15, 2007).

41 Christian von Hirschhausen and Volkhart Vincentz, "Energy Policy and Structural Reform," in *Eastern European Economics* 38, No. 1, 2000, p. 63.

42 The 2005 calculation is based on imports of 37 bcm of gas from Turkmenistan at $44 per 1,000 cm and 30 bcm of Russian gas at $50 per 1,000 cm (data from Ferdinand Pavel, German Institute for Economic Research, presentation on "The Ukrainian-Russian Gas Agreement: Analysis and Alternatives," Conference on The Ukrainian-Russian Gas Crisis and Its Aftermath: Economic, Political and International Ramifications, Harvard University, February 5–6, 2006, streaming video available at www.huri.harvard.edu/na/na_gas_conf_2006.html (accessed June 15, 2006)). The 2006 estimate is based on 37 bcm of directly contracted gas from Turkmenistan at $55 per 1,000 cm, plus 30 bcm of RosUkrEnergo gas at $95 per 1,000 cm.

43 See Oles M. Smolansky, "Ukraine's Quest for Independence: The Fuel Factor," *Europe-Asia Studies* 47, No. 1, 1995, p. 85.

44 See Tymothy Frye and Andrei Schleifer, "The Invisible Hand and the Grabbing State Hand," *American Economic Review Proceedings and Papers* 87, No. 2, pp. 354–358, and Timothy Frye, "Capture or Exchange: Business Lobbying in Russia," *Europe-Asia Studies* 54, No. 7, 2000.

45 See Stephen Krasner, "State Power and the Structure of International Trade," *World Politics* 28, No. 3, 1976, pp. 317–348 and Stephen Krasner, "Oil is the Exception," *Foreign Policy*, No. 14, 1974, pp. 68–84.

46 See Albert O. Hirschman, *State Power and the Structure of Foreign Trade*, Berkeley: University of California Press, 1980 [originally published in 1945], Chapter 2. See also the discussion of Hirschman in Paul D'Anieri, *Economic Interdependence in Ukrainian-Russian Relations*, Albany: SUNY Press, 1999, pp. 13–16.

47 See Rawi Abdelal, *National Purpose in the World Economy: Post Soviet States in Comparative Perspective*, Ithaca and London: Cornell University Press, 2001, and Andrei P. Tsygankov, *Pathways after Empire: National Identity and Foreign Economic Policy in the Post-Soviet World*, Lanham, MD: Rowman and Littlefield, 2001.

48 While most of the International Political Economy literature on trade policy-making (see for example Helen Milner, *Resisting Protectionism: Global Industries and the Politics of International Trade*, Princeton: Princeton University Press, 1988) focuses

on why some groups—and not others—push specifically for *protectionist* industrial policies, the approach can be extended to analyze other policies as well.

49 As of 2005, about 115 bcm or almost 72 percent of the 160 bcm of gas exported by Russia (including that provided to Ukraine in lieu for transit services) transited through Ukraine. If we substract from the equation the gas staying in Ukraine, then 115 bcm amounts to almost 81 percent of Russia's gas exports to Western Europe.

50 In 2005, 63.3 percent of Russia's export revenues originated from oil, fuel, and gas exports. The Economist Intelligence Unit Country Risk Service Russia, available at http://store.eiu.com/index.asp?layout=show_sample&product_id=60000206&country_id=RU (accessed January 11, 2007).

51 Christian von Hirschhausen, "The Globalization of Natural Gas Markets: Implications for Ukraine," paper presented at the Ukrainian Research Institute, Harvard University, April 6, 2006.

52 See World Bank (written by Mark Davis, Ruslan Piontkivsky *et al*), "Ukraine: the Impact of Higher Natural Oil and Gas Prices," December 2005, available at http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/UKRAINEEXTN/0,,contentMDK:20774978~pagePK:141137~piPK:141127~theSitePK:328533,00.html (accessed June 1, 2006), p. 8.

53 Turkmenistan supplied 42 percent of Ukraine's gas imports in 2003, and *c*. 50 percent in 2006.

54 See Yurii Aks′onov (Yurii Aksënov), "Mrii ta real′nist′ dyversyfikatsii hazozabezpechennia Ukrainy," *Enerhetychna Polityka Ukrainy*, No. 6, 2000, pp. 14–23, here p. 17. Since 2006, the EU agreed on building the 3300 km Nabucco pipeline that would bring 30 bcm of Caspian and Middle Eastern gas to the EU yearly, through Turkey and the Balkans, thus bypassing Russia.

55 July 2004 agreements between Ukraine and Russia stated control over the purchases of Turkmenistan gas by Ukraine starting 2007 would be given to a Russian-controlled company, RosUkrEnergoprom, with no Ukrainian participation. In the January 2006 Ukrainian-Russian gas supply agreements control over gas supplies is given to the company RosUkrEnergo, whose ownership and beneficiaries are not fully known, but which was suspected of links with individual managers at both Ukraine's NAK Naftohaz Ukrainy and Russia's Gazprom.

56 Throughout this book, both terms are used interchangeably.

57 V. Dubrovskyi, W. Graves, Y. Holovakha, O. Haran′, R. Pavlenko, and J. Szymer, "The Reform Driving Forces in a Captured State: lessons from the Ukrainian Case," first draft of the Understanding Reform Project, Kyiv, mimeo, 2003, p. 60. See also Ibid., p. 67.

58 Robert Kravchuk, *Ukrainian Political Economy*, New York: Palgrave McMillan, 2002, p. 13.

59 Data for 2000–2003 from The Economist Intelligence Unit, Country Reports: Ukraine, available at www.economist.com/countries/Ukraine/profile. cfm?folder=Profile-Economic%20Data (accessed October 15, 2005).

60 Institute of Economic Research and Policy Consulting, Macroeconomic Forecast Ukraine No. 10, October 2006, available at www.ier.kiev.ua/English/mfu_eng.cgi/ (accessed December 1, 2006).

61 Oleh Havrylyshyn, *Divergent Paths in Post-Communist Transformation*, Basingstoke, Hampshire: Palgrave McMillan, 2006, p. 239. See also chapter 8, "Future Prospects for Captured States."

62 Robert Kravchuk, *Ukrainian Political Economy*, New York: Palgrave McMillan, 2002, pp. 6, 7–8.

2 The energy-foreign policy nexus

1 Although Leonid Kuchma technically remained president until January 23, 2005, his real power ended with the elections of December 26, 2004. Thus, we use 1999–2004 as the years of the second Kuchma presidency.

2 Taras Kuzio, "Neither East Nor West: Ukraine's Security Policy Under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 59–68, here p. 61.

3 In fact, it could be argued that, given Kyiv's weakness vis-á-vis Moscow and its need to have strong Western allies as a counterweight to this, Ukraine's "only choice" is to have a multi-polar diplomacy encompassing both Russia and the West as important partners. See Igor Torbakov, "Apart from Russia or part of Russia: A sad saga of Ukrainiain-Russian relations," *Demokratizatsiia* 9, No. 4, 2001, pp. 588–602.

4 The Word Bank, *Ukraine Trade Policy Study* (Report No 29684-UA) (November 16, 2004), available at http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/UKRAINEEXTN/0,,contentMDK:20555497~pagePK:141137~piPK:141127~theSitePK:328533,00.html (accessed February 1, 2005).

5 It is difficult to estimate the real extent of Russian investments in Ukraine, as much Russian capital has entered the country through Russian-controlled companies officially registered abroad (in 2004 Cyprus and the British Virgin Islands, for example, accounted for 12.7 and 7.8 percent of total foreign investment in Ukraine, while the Russian Federation accounted for only 5.8 percent) and affiliated resident companies. Data on foreign investment from the Ukrainian Embassy in the US, available at www.ukraineinfo.us/business/investment.html (accessed January 15, 2007).

6 The 1997 "trade war" concerned Russian customs duties on Ukrainian sugar and the imposition of VAT on imports from Ukraine. The 1999–2000 and 2002 trade confrontations were motivated by the Russian government's decision to start a dumping investigation against, and later introduction of limits on imports of, Ukraine's pipe-building industry (a very damaging move for Ukraine considering large-diameter pipe was one of the barter items traditionally used by Ukraine to pay for Russian gas), to which Ukraine responded by blocking imports of Russian cement and other commodities. See Mykhailo Pashkov and Valerii Chalyi, "Zovnishnia polityka vnutrishn´oho vykorystannia," *Dzerkalo Tyzhnia*, No. 45/420, November 23, 2002, available at www.dt.ua/1000/1600/36837/ (accessed July 30, 2007). On January 20, 2006, the Russian government prohibited the importation of dairy and meat products from Ukraine, leading to a monthly loss of over sixty million dollars for Ukrainian producers. See Vitalii Kuksa, "Napugat´ ëzhika," *Zerkalo Nedeli*, No. 13/592, April 8–14, 2006, available at www.zerkalo-nedeli.com/ie/show/592/53105/. (accessed April 16, 2006).

7 See Tor Bukkvoll, "Off the Cuff Politics: Explaining Russia's Lack of a Ukraine Strategy," *Europe-Asia Studies* 53, No. 8, 2001, pp. 1141–1157.

8 Rosaria Puglisi, "Clashing Agendas? Economic Interests, Elite Coalitions, and Prospects for Co-operation between Russia and Ukraine," *Europe-Asia Studies* 55, No. 6, 2003, pp. 827–845, here p. 840.

9 On January 1, 1993, Gazprom introduced so-called world market prices for the sale of gas to CIS states. The implementation of these measures, however, was not immediate.

10 Paul D'Anieri, *Economic Interdependence in Ukrainian-Russian Relations*, Albany: SUNY Press, 1999, p. 74.

11 For a detailed discussion of this topic, see D'Anieri, *Economic Interdependence*, ch. 4 (pp. 69–98).

12 Ibid., p. 74.

13 Whether these conditions were favorable for Ukrainian society as a whole is a separate question, due to the fact that—as will be discussed in Chapter 4—in many cases during this period it was the Ukrainian state that ended up subsidizing these imports. Moreover, many have argued that low energy prices did a disservice to Ukraine by taking the urgency away from possible energy-saving measures.

14 D'Anieri, *Economic Interdependence*, pp. 74, 78.

15 D'Anieri, *Economic Interdependence*, p. 77.

16 This offer took place in the context of a similar agreement signed between Russia and Belarus in 1996, by which Belarus was pardoned its gas debt accrued vis-á-vis Russia up to that date, in exchange for leasing to Russia, free of charge, two military telecommunications objects. See Margarita M. Balmaceda, *Belarus: Oil, Gas, Transit Pipelines and Russian Foreign Energy Policy*, London: GMB Publishing, 2006, p. 8.
17 D'Anieri, *Economic Interdependence*, pp. 70, 87.
18 Despite the very different political relationship between Ukraine and Russia as compared to Belarus and Russia, a somewhat similar trend can be observed in Belarus, where, every time Belarusian-Russian gas relations are about to go truly sour, the Russian government seems to find sufficient strategic arguments to step in, provide continued support in the form of credits or other concessions, and keep the relationship going. See Balmaceda, *Belarus: Oil, Gas, Transit Pipelines*.
19 See D'Anieri*, Economic Interdependence*, p. 74.
20 See John Loyd, "Ukrainian Offered Debt Swap for Nuclear Deal," *Financial Times*, January 13, 1994, p. 2 and "Rosiis'ki eksportery hazu vymahaiut´ rozrakhunku za svoi postavky," *Post-Postup*, February 17–23, 1994, p. B5, cited in D'Anieri, *Economic Interdependence*, p. 81.
21 See Oles M. Smolansky, "Ukraine and the Fuel Problem: Recent Developments," *The Ukrainian Quarterly*, LII, No. 2–3, 1996, p. 144. See also Konstantin Levin, *Kommersant-Daily*, 26 July 1995, in FBIS/SOV July 27, 1995 and "State Committee…" in FBIS/SOV October 10, 1995 (Supplement).
22 In March 1994, Gazprom made clear its intention and resolve to cut supplies on April 10, 1994 if by that date no payments on Ukraine's gas debt had been made; however, it is assumed that the real demand was acceptance of Gazprom taking control over Ukraine's gas transit system. See Hanna Liuta (Ganna Liuta), "Vyrishennia Problemy Hazozabezpechennia Ukrainy Lezhyt' u Politychnii Ploshchyni," *Post-Postup*, March 17–24, 1994, p. 1, quoted in D'Anieri, *Economic Interdependence*, p. 82.
23 The resolution, passed in November 1995, took away the possibility that Gazprom could buy any shares in Ukraine's gas transit system. Moreover, as many of the entities in play had not even been privatized themselves, it would have been very difficult to sell them to Gazprom.
24 This improvement turned out to be temporary, as by 1997 Ukraine started to accumulate new debts vis-á-vis Gazprom.
25 Will Englund, "Clinton Heads for Bright Spot—Ukraine," *The Baltimore Sun*, May 11, 1995, cited in Tyler Felgenhauer, "Ukraine, Russia, and the Black Sea Accords," WWS Case Study 2/99, available at www.wws.princeton.edu/cases/papers/ukraine.html, p. 19 (accessed April 30, 2006).
26 Felgenhauer, "Ukraine, Russia, and the Black Sea Accords," p. 19.
27 "Russian Friendship Treaty Signed; Other Developments," *Facts on File World News Digest* (5/6/97), p. 400 G3, cited in Felgenhauer, "Ukraine, Russia, and the Black Sea Accords." In January 1994, Ukraine, Russia and the US signed a Trilateral Agreement providing for Ukraine's transferring its nuclear weapons to Russia for destruction in exchange for security guarantees for Ukraine. The transfer took place in 1996.
28 See Alyson J. K. Balies, Oleksyi Melnik, and Ian Anthony, "Relics of Cold War: Europe's Challenge, Ukraine's Experience," SIPRI Policy Paper No. 6 (Stockholm, November 2003), p. 39, available at http://editors.sipri.se/pubs/RAPPORT_RELICSOFCOLDWAR.pdf (accessed May 5, 2006) and Mikhail A. Molchanov, *Political Culture and National Identity in Russian-Ukrainian Relations*, College Station, TX: Texas A&M University Press, 2002, pp. 232–233.
29 See Puglisi, "Clashing Agendas," p. 833.
30 See also Kuzio, "Neither East Nor West," p. 64.

31 For much of the 1990s Ukraine was the third largest recipient of US aid, after Israel and Egypt. See Taras Kuzio, "Ukraine's Relations with the West: Disinterest, Partnership, Disillusionment," *European Security* 12, No. 2, 2003, pp. 21–44.
32 See Simon Pirani, "Gas, Guns, and Gongadze: Practicing Journalism is Lethal in Ukraine," (no date), available at http://media.gn.apc.org/gongadze/pirani.html (accessed June 15, 2006).
33 Leaving aside for a moment the possibility that President Kuchma or his entourage might have had a personal interest in the continuation of the energy dependency relationship with Russia.
34 Kuchma's popular support ratings plummeted after the exposure of the Gongadze scandal in late 2000, reaching 11.4 percent in February–March 2001. Poll conducted by the Center for Economic and Political Studies (Tsentr Razumkova), in *RFE/RL Poland, Belarus, and Ukraine Report*, No. 3, 2001, p. 10. Domestically, Kuchma sought to compensate for his lack of legitimacy by strategically using the support of various influential individuals and clans, which he manipulated by selectively giving support to (and seeking support from), and playing them selectively against one another.
35 Puglisi, "Clashing Agendas," p. 840.
36 Germany, significantly involved in the original negotiations for the consortium, was expected to become a third member. Its participation, however, was gradually sidelined by Gazprom.
37 Some of these companies were "shell companies" involving corrupt Ukrainian officials as well, as will be discussed in more detail in Chapter 7.
38 See Chapter 3, and Tor Bukkvoll, "Private Interests, Public Policy: Ukraine and the Common Economic Space Agreements," *Problems of Post-Communism* 51, No. 5, 2004, pp. 11–22, especially pp. 14–15.
39 This growing disillusionment happened to be accompanied with a reduction in the means available to the West to influence Ukraine as, as noted by van Zon, "Western influence [on Ukraine] through the institutions of global governance dwindled, because Ukraine was able to manage its debt from 2001 onwards." Hans van Zon, "Political Culture and Neo-Patrimonialism under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 12–22, here p. 14.
40 See Kuzio, "Neither East Nor West," pp. 59–68, here pp. 62, 63. See also Bukkvoll, "Private Interests, Public Policy," pp. 11–22, especially pp. 17–18.
41 This was seen clearly around the privatization issue, where local insiders clearly had the upper hand and were able to acquire important assets at well below market price, as was the case around the privatization of the Kryvorizhstal′ steel mill in 2004, where Russian bidder Severstal′ was defeated despite the fact that it had offered a much higher price than the Ukrainian competitor, an alliance between clan leaders Rinat Akhmetov (Donetsk) and Viktor Pinchuk (Dnipropetrovsk).
42 As noted by Borys Tarasiuk, who was dismissed as Minister of Foreign Affairs in 2000 in the wave of closer relations with Russia: "It is precisely because of pressure from Russia that there has been a change in Ukraine's strategic course. We no longer use the term 'Euro-Atlantic integration.' " *Ukraina Moloda*, 21 February 2001, cited in Tammy Lynch, "Kuchmagate's Collateral Damage," Institute for the Study of Conflict, Ideology and Policy, available at www.bu.edu/iscip/vol111/lynch.html (accessed June 1, 2006).
43 Russian support came in a variety of ways, many of which were symbolic in nature, such as Putin's "effusive" pre-election visit to Kyiv in October 5, 2004, where he supported Kuchma's presidential candidate Viktor Yanukovych, as well as his proposal that Kuchma be elected head of the Council of Presidents of CIS member states. Vladimir Socor, "Putin, Gazprom Seek Control of Ukraine's Gas Pipelines to Europe," *IASP Policy Briefings: Oil in Geostrategic Perspective*, No. 3, October 27,

2002, available at www.iasps.org/strategic/socor9.htm. This offer was especially significant given that Ukraine had not yet ratified the CIS Charter at that time. Oleksii Haran´ and Rostyslav Pavlenko, "The Paradoxes of Kuchma's Foreign Policy," written for the Program in New Approaches to Russian Foreign Policy (PONARS), 2003, available at www.iasps.org/strategic/socor9.htm (accessed January 30, 2007).

44 See Pashkov and Chalyi, "Zovnishnia polityka vnutrishn´oho vykorystannia."

45 In addition to investments in the energy sector, Russian companies actively acquired shares in the automotive, chemical, and metallurgical sectors, among others.

46 See Torbakov, "Apart from Russia or part of Russia," pp. 588–602.

47 Charles Clover, "Ukraine Looks East," *Financial Times*, January 21, 2001, cited in Torbakov, "Apart from Russia or part of Russia," pp. 588–602.

48 Puglisi, "Clashing Agendas?," p. 839.

49 In 1995 Gazprom presented to the Ukrainian side a list of fifteen enterprises where it could "claim" a 30–50 percent share on the basis of Ukraine's by then $1.5 billion debt to Gazprom. *OMRI Daily Digest*, March 14, 1995, cited in Puglisi, "Clashing Agendas?," p. 832. Although the plan was never approved by the Ukrainian government due to political opposition, in reality results were rather similar, as share sales took place as part of the overall privatization program. See Charles Clover, "Russia Steps Up Battle over Ukraine Debt," *Financial Times*, March 6, 2000 and "Ukraine's Shriveling Economy Weakens Its Independence," in Stratfor.com, April 4, 2000 (reprinted in UKL (The Ukraine List) No. 80, 2000, no date).

50 Puglisi, "Clashing Agendas?," p. 839. This plan did not progress as hoped by Chubais, however, because of opposition from Hryhorii Surkis of the SDPU(o) and the Kyiv clan, who had their own interests in oblenerho privatization.

51 See Bukkvoll, "Private Interests, Public Policy," pp. 11–22.

52 Although "packaged" under different names, the Eurasian Economic Community and the Single Economic Space refer to basically similar organizations. Haran´ and Pavlenko, "The Paradoxes of Kuchma's Foreign Policy."

53 Joining the SES would negatively affect Ukraine's bid for WTO membership by making it, at the very least, dependent on close coordination with Russia and other SES members.

54 In 2001–2002 the main idea being discussed in this area was that of building a so-called Yamal II gas pipeline connection going through Slovakia and Poland, which would have allowed a significant part of the gas transited through Ukraine to bypass that country. Gazprom abandoned the idea in the fall of 2002.

55 After the original 1995 agreement pledged support for the completion of two unfinished nuclear reactors in Khmelnytskyi and Rivne, the G-7 retracted support after an international panel casted doubts on this being the most efficient way for Ukraine to ensure its energy security after the closing of the Chornobyl nuclear power plant. BBC News Europe, June 5, 2000, available at www.news.bbc.co.uk/1/hi/world/europe/778626.stm. (accessed June 30, 2005).

56 International Energy Agency (IEA), *Ukraine Energy Policy Review 2006*, Paris: OECD/IEA, 2006, p. 77. Figures are for 2004. Some Ukrainian groups as well argued that increasing energy efficiency would be a much cheaper and safer way to reduce Ukraine's energy dependency on Russia. See Mark Hopkins and Mykola Raptsun, "Save energy, save Ukraine," *Kyiv Post*, 16 October 1998.

57 See for example Bukkvoll, "Private Interests, Public Policy," and Puglisi, "Clashing Agendas?."

58 Data from The Economist Intelligence Unit, available at wwwa4.secure.alacra.com.ezp2.harvard.edu/cgi-bin/eiusite.exe.

59 Christian von Hirschhausen and Volkhart Vincentz, "Energy Policy and Structural Reform," in *Eastern European Economics* 38, No. 1, 2000, p. 65.

60 See Hermann Clement, "Economic Aspects of Ukrainian-Russian Relations," in Kurt R. Spillman, Andreas Wenger and Derek Mueller, *Between Russia and the West: Foreign*

and Security Policy of Independent Ukraine, Bern and New York: Peter Lang, 1999, pp. 287–288.

61 The Transport Corridor Europe-Caucasus-Asia being developed by the European Union. See www.traceca-org.org/.

62 The Odesa-Brody pipeline is discussed at length in Chapter 6.

63 On these more direct initiatives, see Margarita B. Balmaceda, "EU Energy Policy and Future European Energy Markets: Consequences for the Central and East European States," *Mannheimer Zentrum für Europäische Sozialforschung (MZES) Working Papers*, Arbeitspapiere 42, Mannheim: MZES, 2002.

64 See Bryan Clark, "Transit and the Energy Charter Treaty: Rhetoric and Reality," published in Web Journal of Current Legal Issues (1998) in association with Blackstone Press Ltd., available at www.webjcli.ncl.ac.uk/1998/issue5/clarck5.html (accessed May 30, 2001).

65 See Petra Opitz and Christian von Hirschhausen, "Ukraine as the Gas Bridge to Europe?: Economic and Geopolitical Considerations," Institute for Economic Research and Policy Consulting Working Paper No. 3, October, 2000, available at www.ier.Kyiv.ua/Eng/WP/WP3Eng.htm. Others (Watin Grais and Kangbin Zheng, "Strategic Interdependence in European East-West Gas Trade: A Hierarchical Stackelberg Game Approach," *Energy Journal* 17, No. 3, 1996) have also argued that even a small increase in security of transit and thus a reduction of fixed transit costs (a 10 percent reduction) could generate about $35 million in extra profit for Ukraine yearly.

66 Current Energy Charter negotiations do not call for unlimited Third Party Access, but negotiated Third Party Access.

67 See Balmaceda, "EU Energy Policy."

68 *Ukrains'ka Pravda* (April 26, 2004), cited by Taras Kuzio, "Neither East Nor West: Ukraine's Security Policy Under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 59–68, here p. 63.

69 Kuzio, "Neither East Nor West," p. 64.

70 See *The Economist*, May 6, 2000. According to the agreement, Ukraine would pay its $2.5 billion debt to Russia over twelve years (starting in 1997), with no interest charged on most of the debt between 1995 and 1997. See Margarita M. Balmaceda, "Gas, Oil and the Linkages Between Domestic and Foreign Policies: the Case of Ukraine," *Europe-Asia Studies* 50, No. 2, 1998, pp. 257–286, here p. 282. This did not seem to help much, as by early 2000 new energy debt had reached $1.4 billion, and $2.9 billion by then end of the year.

71 Puglisi, "Clashing Agendas?," p. 838.

72 It was, indeed, due to the poor reputation earned by Ukraine in the mid-1990s that, when the State Property Fund finally launched the privatization of large packages of state-owned shares in major companies, "Russian companies proved the only ones able and willing to participate in the competitive bids." See Ibid.

3 De facto policy-making system and energy policy: the Ukrainian political system under Kuchma and beyond

1 While the organization of both Ukraine's interest representation system and of its energy markets changed significantly from the time of independence in 1991 to Kuchma's consolidation of power in 1995, we have chosen not to consider the pre-1995 situation as a separate "system" as it lacked a clear organizing principle and, thus, was rather a transitional and often disorganized arrangement. Chapter 4 analyzes some aspects of the politics-energy policy link in the period 1991–1994.

2 On the 1995 Constitutional Agreement and 1996 Constitution, see Kataryna Wolczuk, *The Moulding of Ukraine: the Constitutional Politics of State Formation*, Budapest: Central European University Press, 2002.

3 Other authors have focused on specific but less central aspects of the system. Hans van Zon, for example, has characterized the Ukrainian system as a "neo-patrimonial state in which each civil servant has his own fief" and where "the state apparatus resembles a mosaic of separate institutions more concerned with safeguarding their own privileges than with serving society." Hans van Zon, "Political Culture and Neo-Patrimonialism under Kuchma," *Problems of Post-Communism* 52, No. 5, September–October 2005, pp. 12–22, here p. 14. Van Zon further defines the main characteristics of a neo-patrimonial state as "an intertwining of polity and economy, sharp separation of state and society, a cult of power, and the absence of rule of law." Ibid., p. 19. Kubicek uses the concept of "residual corporatism" in reference to Ukraine. However, this approach is of only limited use for our inquiry as it focuses mainly on formal interest associations—which were not so powerful in any case—as opposed to a broader range of economic and interest groups. See Paul Kubicek, *Unbroken Ties: the State, Interest Associations and Corporatism in Post-Soviet Ukraine*, Ann Arbor: University of Michigan Press, 2000.

4 See Paul D'Anieri, "Democracy Unfulfilled: The Establishment of Electoral Authoritarianism in Ukraine," *Journal of Ukrainian Studies* 26, No. 1, 2001, pp. 13–35.

5 Some of such hybrid systems could be relatively stable over time. Oleh Havrylyshyn analyzes the economic aspects of this stability (under the concept of "transition frozen") in *Divergent Paths in Post-Communist Transformation*, Baskingstoke Hampshire, Palgrave McMillan, 2006, especially Chapter 8.

6 See Steven Levitsky and Lucan A. Way, "The Rise of Competitive Authoritarianism," *Journal of Democracy* 13, No. 2, 2002, pp. 51–63, especially p. 52.

7 Oleh Protsyk, "Troubled Semi-Presidentialism: Stability and the Constitutional System in Ukraine," *Europe-Asia Studies* 55, No. 7, 2003, pp. 1077–1095, p. 1077.

8 Hans van Zon, *The Political Economy of Independent Ukraine*, New York: St. Martin's Press, 2000, p. 25.

9 See Joel S. Hellman and Mark Schankerman, "Intervention, Corruption and State Capture: The Nexus Between Enterprises and the State," in *Economics of Transition* No. 3, 2000, pp. 545–567, and Joel S. Hellman, "Winners take all: The Politics of Partial Reform in the Postcommunist Transition," *World Politics*, No. 1, 1998, pp. 203–234. For the World Bank definition of state capture, see World Bank, "Anticorruption in Transition: A Contribution to the Policy Debate," Washington, DC: World Bank, 2000.

10 Anders Aslund's 2003 comment captures the power of these groups: "No post-communist state today is more oligarchic [than Ukraine]." Anders Aslund, "Left Behind: Ukraine's Uncertain Transformation," *National Interest*, No. 14, 2003, p. 109, cited in Tor Bukkvoll, "Private Interests, Public Policy: Ukraine and the Common Economic Space Agreements," *Problems of Post-Communism* 51, No. 5, 2004, p. 14. According to Bukkvoll, one of the elements that made the Ukrainian oligarchs (the BAGs) especially strong—in contrast with Russia, for example—was their ability to control the state's security agencies. Ibid., p. 14.

11 At the same time, smaller, "non-system" groups also existed, many of them former members of the main in-system groups which had grown dissatisfied by the system, and had "defected" from the Kuchma camp, taking their capital with them (e.g. former Deputy head of the SDPU(o) Oleksandr Zinchenko, "sweets baron" Petro Poroshenko, and Kyiv major Oleksandr Omel´chenko). While these non-system elites had a much smaller access to the system of rents in exchange for political favors, they had access to their own sources of income, much of which was deposited or invested abroad, outside the control of the Kuchma regime. Moreover, they had their own party structures (after 2002, Yushchenko's Nasha Ukraina) and control over some (although not significant) media, for example the Channel Five TV channel inaugurated in 2003.

12 These were the largest groups, with a number of smaller groups (Kharkiv and Luhansk, among others) at the margins.
13 On access to regional leaders see Bukkvoll, "Private Interests, Public Policy," p. 14.
14 Bukkvoll writes about the clans: "They are clusters of businessmen, bureaucrats, and politicians who have certain common interests and an allegiance to one another. This does not mean that there is no competition or conflict among members of the same clan, but such conflicts coexist with a readiness to defend fellow clan member [sic] when they are in competition with members of other clans and to seek support first from within one's own clan." Ibid., p. 21 note 21. For a detailed analysis of some of the main subdivisions within the largest clans, see Kost' Bondarenko, "Khto i chym volodiie v Ukraini," *L′vivs′ka Hazeta* July 17, 2003 (reprinted in *Ukrains′ka Pravda*, available at http://pravda.com.ua/news/2003/7/17/29375.htm (accessed May 25, 2005).
15 As opposed to the "wild" and often excessively violent system of competition in the mid-1990s, discussed in Chapter 4.
16 "Starye pesni o glavnom," *Gaz i neft′. Ėnergeticheskii biulleten′*, December 23, 1999 (via ISI). *Gaz i neft′. Ėnergeticheskii biulleten′* is listed in the ISI portal under the English name "Infobank Oil & Gas Monitor."
17 V. Dubrovskyi, W. Graves, Y. Holovakha, O. Haran′, R. Pavlenko, and J. Szymer, "The Reform Driving Forces in a Captured State: Lessons from the Ukrainian Case," first draft of the Understanding Reform Project, Kyiv, mimeo, 2003, p. 92.
18 See Oleh Protsyk, "Troubled Semi-Presidentialism: Stability and the Constitutional System in Ukraine," *Europe-Asia Studies* 55, No. 7, 2003, pp. 1077–1095, here p. 1078. I do not contest the usefulness of this perspective for understanding the particular relationship between the president and the prime minister.
19 Later on in the period under our consideration, President Kuchma started to move away from predominant reliance on a "balancing" system and started to develop a closer group of associates, which he placed at the head of strategically important state companies. Independent of the main BAGs and loyal only to Kuchma, members of this "inner group" had the task of securing direct access to constantly renewed financial resources through strategically located and nominally state-owned companies, a source of funding that complemented the more indirect (and relatively unstable) flow of income through BAGs. We discuss this in more detail in Chapter 7.
20 See Keith A. Darden, "Blackmail as a Tool of State Domination: Ukraine Under Kuchma," *Eastern European Constitutional Review* 10, Nos. 2/3, 2001, pp. 67–71.
21 The balancing principle in the distribution of high governmental appointments was clearly reflected in the system of "quotas" for ministerial appointments agreed to between the pro-government parties when their coalition agreement was signed in the fall of 2002. At least in theory, this system translated each party's electoral weight into an "influence coefficient," which was then paired up with a ministerial position, the nomination for which would be the prerogative of that party. The party had the power to propose a candidate for minister, which the president could then approve or not. Author's interviews, Kyiv-Mohyla Academy, Kyiv, March 23, 2004.
22 One example of balancing in terms of access to rents comes from the area of privatization. As noted by van Zon, "privatization tenders were formulated in such a way that only a specific clan had the chance to win and to get state property on the cheap." Van Zon, "Political Culture," p. 14.
23 "Khto stane nastupnym holovoiu Naftohazu Ukrainy?," *Ukrains′ka Pravda*, May 17, 2006, available at www.pravda.com.ua/news/2006/5/17/41816.htm (accessed May 26, 2006).
24 Tor Bukkvoll, "Private Interests, Public Policy: Ukraine and the Common Economic Space Agreements," *Problems of Post-Communism* 51, No. 5, 2004, pp. 11–22, here p. 13.

25 See Kimitaka Matsuzato, "From Communist Boss Politics to Post-Communist Caciquismo—the Meso-Elites and Meso-Governments in Post-Communist Countries," *Communist and Post-Communist Studies* 34, No. 2, 2001, p. 189, cited in Kerstin Zimmer, "Khoziaistvenniki and Political Machines in Donetsk: Economic and Political Regionalism in Ukraine," paper prepared for ECPR Conference 2003, Marburg, Germany, September 18–21, 2003, p. 9.
26 Paul D'Anieri, "Leonid Kuchma and the Personalization of the Ukrainian Presidency," *Problems of Post-Communism* 50, No. 5, 2003, p. 62.
27 Ibid., p. 60.
28 Van Zon, "Political Culture," p. 13.
29 The best but not only example of such confrontation was PM Lazarenko's challenge to Kuchma's power in 1996–1997, discussed in Chapter 4.
30 See Mykola Tomenko, "Formal´ni ta neformal´ni mekhanizmy vplyvu na pryiniattia derzhavnykh rishen´," *Politychnyi Kalendar* 5, 1999, pp. 20–35, cited in Protsyk, "Troubled Semi-Presidentialism," p. 1085.
31 Protsyk, "Troubled Semi-Presidentialism," p. 1085.
32 Ibid, p. 1079.
33 On these issues, see also Paul D'Anieri, *Understanding Ukrainian Politics: Power, Politics, and Institutional Design*, Armonk, NY: M.E. Sharpe, 2007.
34 For example, the Kyiv clan's and Hryhorii Surkis' 1996 "takeover" of the SDPU(o). See Yurii Aksënov and Igor´ Guzhva, "Deti gaza i stali," *Ėkspert*, October 11, 2004, reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, October 14, 2004 (via ISI). *TEK i Pressa. Ezhednevnyi obzor* is listed in the ISI portal under the English name "Fuel and Energetical Complex—Monitoring of the Ukrainian Press."
35 Dubrovskyi *et al*, "The Reform Driving Forces," p. 74.
36 The threshold for parliamentary representation changed as well, from 4 percent for the 1998 and 2002 elections, to 3 percent effective the 2006 elections. The 1994 elections used the Soviet-era system of a majoritarian double-ballot, with the added stipulation that "majority in any constituency required both a 50 percent vote and a 50 percent turnout," with the result that 8 percent of seats remained empty at the end of the legislative period four years later. Andrew Wilson and Sarah Birch, "Voting Stability, Political Gridlock: Ukraine's 1988 Parliamentary Elections," *Europe-Asia Studies* 51, No. 6, 1999, pp. 1039–1068, here pp. 1039, 1041.
37 Oleh Protsyk and Andrew Wilson, "Centre Politics in Russia and Ukraine: Patronage, Power and Virtuality," *Party Politics* 9, No. 6, 2003, pp. 703–727, here p. 712.
38 See Sarah Birch, "Nomenklatura democratization, electoral clientelism and party formation in post-Soviet Ukraine," *Democratization* 4, No. 4, pp. 40–62.
39 Protsyk and Wilson, "Centre Politics," p. 712.
40 Sarah Whitmore, "State and Institution Building Under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 3–11, here p. 9.
41 See Protsyk and Wilson, "Centre Politics," p. 716.
42 On the importance of situational majorities in the absence of "natural majorities" in the Rada, see Sarah Whitmore, "State and Institution Building Under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 3–11, here p. 9.
43 Protsyk and Wilson, "Centre Politics," p. 716.
44 Whitmore, "State and Institution Building," p. 9.
45 See Taras Kuzio, "Regime Type and Politics in Ukraine under Kuchma," *Communist and Post-Communist Studies* 38, No. 2, 2005, pp. 167–190, here p. 178.
46 If between 1994 and 1999 it was possible to speak of the People's Democratic Power (PDP) as the "Party of Power," from Kuchma's re-election in 1999 onwards this coalition became so weak as to lose any meaning. Van Zon, "Political Culture," p. 14.

47 Ibid.
48 This was all the more telling after the 2002 Rada elections where, despite getting almost 60 percent of the votes in contrast with the pro-presidential party's 18 percent, opposition parties were not able to form a stable majority coalition.
49 See Whitmore, "State and Institution Building," p. 9. On blackmail tactics see Keith A. Darden, "Blackmail as a Tool of State Domination," pp. 67–71.
50 Van Zon's description of the usual pattern in the period 1996–2000 as one in which there is typically "a battle between president and parliament in which the parliament vetoes draft laws passed by the government and the president vetoes legislation passed by the parliament, while the legislative threatens to impeach the executive" may have been slightly overemphasized, but is not far from the reality of the law-making process in Ukraine. Van Zon, *The Political Economy*, p. 24.

4 Politics and economics in the development of the Ukrainian energy markets, 1995–2004

1 Ganna Liuta, "Vozvrashchaiutsia vse, krome tekh, kto nuzhnei," *Zerkalo Nedeli*, No. 35/152, August 30, 1997, p. 2.
2 See Karen Dawisha and Bruce Parrott, *Russia and the New States of Eurasia*, Cambridge: Cambridge University Press, 1994, cited in Rawi Abdelal, "Interpreting Interdependence: Energy and Security in Ukraine and Belarus," PONARS Working Paper No. 20 (2002), p. 18, available at www.csis.org/ruseura/ponars/workingpapers/ (accessed October 10, 2006).
3 See Taras Kuzio and Andrew Wilson, *Ukraine: Perestroika to Independence*, London: McMillan, 1994.
4 Hans van Zon, *The Political Economy of Independent Ukraine*, New York: St. Martin's Press, 1994, p. 44.
5 Indeed, Oleksandr Babanin, Volodymyr Dubrovs´kyi, and Oleksii Ivashchenko argue that "(. . .) the most harmful institutional consequence of the overindustrialization in Ukraine was the creation of the powerful industrial lobby that, together with their agrarian colleagues, since the very beginning of transition started to extort resources from the rest of the economy." Oleksandr Babanin, Volodymyr Dubrovskyi, and Oleksii Ivashchenko, *Ukraine: The Lost Decade . . . and the Coming Boom?*, Kyiv: CASE Ukraine, 2002, p. 40.
6 Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 40.
7 Source: U.S. Department of Energy, Energy Information Administration, Ukraine Country Analysis Brief (updated January 26, 2005), available at US Department of Energy, Energy Information Administration, Country Analyses Briefs, Ukraine, Available at www.eia.doe.gov/emeu/cabs/Ukraine/Full.html (accessed June 15, 2006).
8 According to calculations by Krasnov and Brada, in 1993 Ukraine paid considerably more for Russian oil and gas than in 1992. If in 1992 the average price of oil imported from Russia was $42.20 per ton, by 1993 this had risen to $80.00. In the case of gas, the increase was even more significant, with average prices jumping from $9.30 per 1,000 cm to $49.80. Gregory V. Krasnov and Josef C. Brada, "Implicit Subsidies in Russian-Ukrainian Energy Trade" *Europe-Asia Studies* 49, No. 5, 1997, pp. 825–844, here p. 830, Table 1. At the same time, any discussion of Russian gas prices to Ukraine must include two caveats. First, official prices may underestimate the price paid by Ukraine, because agreements to supply to Ukraine at below market prices were accompanied by provisions for Russia to transport oil and gas across Ukraine at below market prices as well (Paul D'Anieri, *Economic Interdependence in Ukrainian-Russian Relations*, Albany: SUNY Press, 1999,

pp. 84–85). Second, as will be discussed in Chapter 7, barter transactions allowed prices to be heavily manipulated.

9 Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 6. From the point of view of President Kravchuk (1991–1994), the rationality of these policies had to do with the desire to avoid the negative social and political consequences of massive industrial closings.

10 For part of the early 1990s, credits to enterprises were provided at low interest rates (20 percent), while the overall inflation rate was running at over 10,000 percent, amounting to de facto free money. See Rosaria Puglisi, “The Rise of the Ukrainian Oligarchs,” *Democratization* 10, No. 3, 2003, pp. 99–123, here p. 104.

11 Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 6. Between 1990 and 1996, Ukraine’s energy dependency increased from 47.4 to 49.9 percent of total consumption. It must be noted, however, that in 1994 both GDP and total energy consumption start to fall sharply (although GDP started to decrease in 1991, the decline between 1993 and 1994 was the most significant).

12 On sectoral interests during the 1994–1999 period, see Tor Bukkvoll, “Private Interests, Public Policy: Ukraine and the Common Economic Space Agreements, *Problems of Post-Communism* 51, No. 5, 2004, pp. 11–22, here p. 18, and Tor Bukkvoll, “Defining a Ukrainian Foreign Policy Identity: Business Interests and Geopolitics in the Formulation of Ukrainian Foreign Policy 1994–1999,” in Jennifer D. P. Moroney *et al*, *Ukrainian Foreign and Security Policy*, Westport: Praeger, 2002, pp. 131–153.

13 Author’s interviews, School of Political Analysis, Kyiv-Mohyla Academy, Kyiv, March 23, 2004. Loosely formed regional clans also existed in Soviet-period Ukraine, with some, such as the Dnipropetrovsk clan, enjoying wide influence throughout the Soviet political apparatus.

14 By “Party of Power” in the Ukrainian case it is understood the former top *nomenklatura* supporting Kuchma’s regime, but organized not in a single political organization but active in a number of different parties. See Taras Kuzio, *Ukraine: Perestroika to Independence*, London: McMillan, 2000, pp. 21–22 and 154.

15 V. Dubrovskyi, W. Graves, Y. Holovakha, O. Haran´, R. Pavlenko, and J. Szymer “The Reform in a Captured State: lessons from the Ukrainian Case,” first draft, Understanding Reform Project, Kyiv, mimeo, 2003, p. 60.

16 Author’s interviews, School of Political Analysis, Kyiv-Mohyla Academy, Kyiv, March 23, 2004.

17 See Rosaria Puglisi, “The Rise of the Ukrainian Oligarchs.”

18 Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 47.

19 V. Khmurych and T. Tkachenko, “Opportunities for Corruption in the Ukrainian Gas Market,” Eurasia Foundation 1999. Available at: www.eurasia.org/programs/eerc/Kyiv/papers/khtk.htm (accessed May 1, 2004).

20 See International Energy Agency, *Energy Policies of Ukraine. 1996 Survey*, Paris: OECD/IEA, 1996, p. 140.

21 See Jerome Guillet, “Gazprom’s got West Europeans Over a Barrel,” *The Wall Street Journal*, November 8, 2002.

22 Hermitage Capital Management, “How should Gazprom be managed in Russia’s national interests and the interests of its shareholders?,” (Moscow, June 2005), p. 4, cited in Global Witness “It’s a Gas—Funny Business in Turkmen-Ukraine Gas Trade,” April 2006, available at www.globalwitness.org/reports/show.php/en.00088.html, p. 35.

23 Global Witness “It’s a Gas,” p. 22.

24 Bohdan Kliuk [CEO of Ukrhazprom], “U nas gaz potrebliaiut, slovno nazlo vragam,” (interview) in *Zerkalo Nedeli*, No. 33/50, August 16, 1997, p. 9. While the state assigned the lucrative contracts for gas provision to solvent companies to selected

"gas traders," this did not bring much profit to the country as a whole. On the contrary, these companies made money by paying gas producers such as Gazprom much less than they collected (this was possible because, through barter manipulations, the prices officially stated as being paid to Gazprom were often much higher than those actually paid) but having the consumer bill or the debt calculated on the basis of the higher price. We discuss this in detail in Chapter 7.

25 Matthew Kaminsky, "Ukraine held hostage by the clash of its clans," *Financial Times*, August 7, 1996. The scandal reached Parliament, but the procurator-general's office found only minor infractions, and none involving Lazarenko. Not surprisingly, Ukraine's procurator-general at the time, Hryhorii Vorsinov, also came from Dnipropetrovsk.

26 Raymond Bonner, "Ukraine Staggers in the Path to the Free Market," *The New York Times*, April 9, 1997.

27 Laszlo Lovei and Alastair McKechnie, "The Costs of Corruption for the Poor – The Energy Sector," World Bank Note No. 207, 2000, p. 5 available at http://rru.worldbank.org/ Documents/PublicPolicyJournal/207lovei.pdf (accessed May 30, 2006).

28 *IntelNews Weekly Digest*, November 11, 1996, p. 9.

29 No court of law has established Lazarenko's responsibility for the murder.

30 V. Dubrovskyi, W. Graves, Y. Holovakha, O. Haran´, R. Pavlenko, and J. Szymer, "The Reform Driving Forces in a Captured State: Lessons from the Ukrainian Case," first draft of the Understanding Reform Project, Kyiv, mimeo, 2003, p. 113.

31 For details see Alla Yer´omenko (Alla Erëmenko), "Esli ne mozhesh´ pobedit´ kartel´, obnimi ego," *Zerkalo Nedeli*, No. 11/128, March 15, 1997, pp. 1, 9.

32 See Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," p. 113.

33 Statement of the all-Ukrainian association "Hromada," Interfax-Moscow, August 22, 1997, in FBIS-SOV-97–234.

34 "Lazarenko as Lazarus: Comeback of the Year," *The Rukh Insider* 3, No. 8, September 4, 1997, available at www.freenet.kiev.ua/ISD/RUKHINSD/tri indx.htm (accessed December 10, 1997).

35 Not having received Russian gas in the previous weeks, IESU was replaced by six other companies as provider of gas to the population and state organizations. See Ganna Liuta, "Vozvrashchaiutsia vse, krome tekh, kto nuzhnei," *Zerkalo Nedeli*, No. 35/152, August 30, 1997, p. 2.

36 Lovei and McKechnie, "The Costs of Corruption for the Poor – The Energy Sector."

37 S. Belashko, "Partiia, Vlast´, i Biznes," *Kompan´ion*, No. 48, 1998, pp. 8–11, cited in Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," p. 113.

38 As noted by a Ukrainian analyst, Kuchma wanted to create a "system of checks and balances in which he alone could decide over the fate of various oligarchs." Pëtr Burkovskii, "Rozhdënnaia ėvoliutsiei," *Kompan´ion*, No. 14/374, April 16–22, 2004, pp. 45–47, here p. 46. Translation mine.

39 Author's interview, Kyiv, 2004.

40 Author's interviews, Kyiv, July 2004.

41 See Global Witness, "It's a Gas—Funny Business in Turkmen-Ukraine Gas Trade."

42 If in 2003 *hazotreidery* sold 10–15 percent of all the gas sold in Ukraine, in 2004–2005 they sold only about 1 bcm (less than 2 percent). See Alla Yer´omenko, "Buvaie i take. Ta i tse—ne bida," *Dzerkalo Tyzhnia*, No. 10/589, March 18–24, 2006, available at www.zn.kiev.ua/nn/show/589/52897/ (accessed June 1, 2006).

43 See Pëtr Vlasov, "Bednie Liudi: Bor'ba za kontrol nad gazovym rynkom—vazhneishii element vnutripoliticheskoi zhizni Ukraini," *Ėkspert* 20, May 31, 1999, pp. 22–24.

44 Clinton R. Shiells, "VAT Design and Energy Trade: The Case of Russia and Ukraine," *IMF Staff Papers* 52, No. 1, 2005, pp. 103–119, here p. 109. While this accurately describes the official side of the relationship, it must be kept in mind that the de facto relationship was significantly complicated by the existence of strong

private interests-within-the-corporation on both sides. We discuss these in Chapter 7.

45 "Starye pesni o glavnom," *Gaz i neft´. Ėnergeticheskii biulleten´*, December 23, 1999 (via ISI). Translation mine.

46 The story seemed to repeat itself in 2004, as Viktor Pinchuk established a temporary coalition with Rinat Akhmetov in order to jointly privatize the Kryvorizhstal´ steel mill; it has been argued they were allowed to privatize Kryvorizhstal´ under especially favorable conditions in exchange for supporting Kuchma in the 2004 presidential elections. See Kost´ Bondarenko, "Igra po-krupnomy," *Delovaia Nedelia*, No. 22/182, June 10–16, 2004, p. 3.

47 Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," p. 114.

48 For a discussion of the issue as revealed through the Mel´nychenko secret recordings of President Kuchma, see Patrick E. Tyler, "From Under a Couch, an Effort to Stop Corruption in Ukraine," *The New York Times*, February 26, 2001 available at http://s95451559.onlinehome.us/1a/couch.doc (accessed May 30, 2006).

49 Andrew Wilson, *Ukraine's Orange Revolution*, New Haven: Yale University Press, 2005, p. 21.

50 See Dubrovskyi *et al*, "The Reform Driving Forces," p. 116.

51 Involving a Russian price dumping investigation on Ukraine's pipe-building industry producing high diameter pipe, one of Ukraine's traditional export and barter items to Russia.

52 *NefteRynok*, March 5, 2000 (via ISI). Translation mine. *NefteRynok* is listed in the ISI portal under the English name *Oil Market Weekly/Ukrainain Oil and Gas Report.*

53 See Dubrovskiy *et al*, "The Reform Driving Forces."

54 See "Kuda postavit´ pristavku 'ėks,' " *NefteRynok*, December 25, 2000 (via ISI).

55 In 1998, under IMF pressure, the government declared that, in order to create a market system, all gas either produced domestically or received as payment for transit and remaining after gas was sold to households and the public sector should be auctioned. However, the first auctions were hardly successful, and were opposed by ITERA and Gazprom.

56 Pëtr Burkovskii, "Rozhdënnaia ėvoliutsiei," p. 46.

57 Yuliia Tymoshenko (Yuliia Timoshenko), as quoted in *Gaz i neft´. Ėnergeticheskii biulleten´*, January 17, 2001 (via ISI).

58 The debt had been accrued in the mid-1990s as IESU did not fulfill its contract to supply goods (furniture) in exchange for Russian gas. See Vlad Trifonov, "Delo Yulii Timoshenko otpravilos´ na dorabotku," *Kommersant*, February 3, 2005, reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, February 3, 2005 (via ISI).

59 *Gaz i neft´. Ėnergeticheskii biulleten´*, June 20, 2000 (via ISI) and Yuliia Tymoshenko's interview in *Den´*, May 13, 2000.

60 Dubrovskyi *et al*, "The Reform Driving Forces," p. 84.

61 This confrontation on the debt issue came in the wake of a number of previous—but never fully implemented—agreements, for example the 1995 agreement in which Russia and Ukraine agreed to restructure the latter's debt. "For two years, Ukraine paid on time, but, in 1997, all payments stopped." Oles M. Smolansky, "Ukraine and Russia: a Marriage of Inconvenience," paper presented at the Johns Hopkins University School of Advanced International Studies, October 26, 2001, p. 6. Available at www.sais-jhu.edu/programs/res/papers/Smolansky_paper_web.pdf (accessed May 30, 2006).

62 These accusations are discussed in detail in Chapter 7 of this book.

63 Some sources put the amount at $2.233 (Nataliia Zinets, "Ukraine Calls State of Emergency for Energy Sector," *Reuters*, January 12, 2000), others at $2.8 billion (Viktor Yadukha, "Carve-up of gas market looming in Ukraine—'gas princess' brings new debts back from Moscow," *Segodnia*, January 13, 2000).

64 See “Dolg IESU pered gosudarstvom ne budet gosudarstvennim,” *Gaz i neft′. Ėnergeticheskii biulleten′*, May 17, 2001 (via ISI).

65 By 1999, ITERA’s role in the Ukrainian market had grown significantly. Indeed, in 1999 Gazprom basically turned its Ukrainian business over to “competitor” ITERA, and in 2000, Ukraine imported more gas from ITERA (32.2 bcm) than from Gazprom (*c.* 28 bcm). The *Financial Times* reports that in 2000 ITERA was granted “the exclusive right to sell gas to Ukraine’s power generators, at a price considered high in the former Soviet Union, around Dollars 45 per 1,000 cms;” that same year, the Ukrains′ka Spilka Promyslovtsiv ta Pidpryiemtsiv (USPP) (and in 2001 the “Yabluko” Party) asked President Kuchma to take measures to stop ITERA’s “monopolization” of the Ukrainian gas supply market and forced bankrupting of electricity generating plants and wholesale gas purchasers, in order to later buy them. (Charles Clover, “Sharp whiff on corruption threatens Ukraine sell-off,” *Financial Times*, October 20, 2000, p. 9; see also “Ėnergeticheskaia bezopasnost′ Ukrainy stala zalozhnitsei kompanii ITERA, schitaet partiia ‘Yabluko,” *Gaz i neft′. Ėnergeticheskii biulleten′*, April 12, 2001 (via ISI)). When ITERA was eased out of the Ukrainian market, however, it was not due to Kuchma’s efforts, but to Vladimir Putin’s initiative and as a by-product of the Russian president’s desire to bring Gazprom back into the more direct control of the state. After Rem Viakhirev is replaced as Gazprom chairman by Putin protégé Aleksei Miller, the company starts a campaign to expel ITERA from CIS markets, canceling the preferential contracts earlier signed with the company. This coincided with objective factors (the growing monetarization of the Ukrainian economy and thus the reduced need for the type of barter deals widely used by ITERA) and the interests of NAK Naftohaz Ukrainy’s management, leading to ITERA’s being eased out of the Ukrainian market.

66 *Gaz i neft′. Ėnergeticheskii biulleten′*, April 17, 2000 (via ISI).

67 The plan was not implemented due to strong opposition from NAK Naftohaz Ukrainy’s management, which saw the plan as a means of weakening its position in the Ukrainian gas market with the help of Russian capital.

68 Some Ukrainian observers have explained Tymoshenko’s survival in office despite strong attacks from NAK Naftohaz Ukrainy to the intervention of then Gazprom head Rem Viakhirev, who, knowing he would have to leave Gazprom in the next year or so, may have wanted to transfer all of Ukraine’s payments to Gazprom to ITERA, as a way of maintaining control over these. *Gaz i neft′. Ėnergeticheskii biulleten′*, August 1, 2000 (via ISI).

69 Indeed, we should not forget that some Ukrainian BAGs, although first and foremost feeling threatened by Western business methods, as they threaten profitable non-transparent ways of doing business, sometimes have perceived Russian capital as a threat, as it could threaten the “balance” of power and favoritism between well-connected local groups.

70 Ihor Bakai, quoted in *NefteRynok*, April 2, 2000 (via ISI).

71 See *NefteRynok*, June 25, 2002 (via ISI) and *Gaz i neft′. Ė nergeticheskii biulleten′*, December 1, 2000 (via ISI). Tulub resigned on June 15, 2000, citing an “aggressive atmosphere” in the Cabinet and the fact that proposals made by the ministry to take the country out of the energy crisis were ignored, and in protest against the “administrative methods” used by Yuliia Tymoshenko. *NefteRynok*, June 25, 2002 (via ISI).

72 Hans van Zon, “The Reform of Ukraine’s energy complex as a precondition for eliminating Ukraine’s energy dependence,” paper presented at the conference “Confronting Change: North East England and East European Coal Fields,” November 12–13, 2001, available at www.suderland.ac.uk/~os)hva/zon.htm (accessed June 15, 2004), p. 19.

73 Some Ukrainian analysts consider the main cause of the defeat of Tymoshenko’ reforms not so much “opposition from the oligarchs,” but the lack of a “single, unified

view in the government and not enough support for reforms from other branches of power." Vladimir Saprykin, "Ėnergorazrukha," *Zerkalo Nedeli* No. 23/296, June 10–16, 2000, available at www.zerkalo-nedeli.com/nn/show/296/27403/ (accessed January 31, 2006).

74 This was Tymoshenko's accusation. See van Zon, "The Reform of Ukraine's Energy Complex," p. 19.

75 The gist of the decree was as follows: if budget organizations owed money to energy companies, the state would "pay" these energy companies by offsetting them through the debts these companies had vis-á-vis the state. See Ibid.

76 To the effect that NAK Naftohaz Ukrainy had conducted illegal, non-market price and bill of exchange operations with the company Dniproenerho.

77 In May 2006, Didenko tried to use this judicial decision to return to his post at NAK Naftohaz.

78 In fact, it has been argued that, when Tymoshenko's husband was arrested on August 18, 2000 for alleged gas smuggling, the government was hoping Tymoshenko would resign voluntarily, in exchange for his freedom. But she did not. "Delo muzha," *Gaz i neft′. Ėnergeticheskii biulleten′*, January 17, 2001 (via ISI).

79 In April 2000, a referendum was held on a constitutional reform reducing the power of the parliament and increasing that of the president. Although the proposal was approved in the referendum (which was seen as largely manipulated), the proposals were not implemented, as in 2002 President Kuchma, aware that his days in office were counted, changed his tactic and sought to introduce a new reform weakening the power of the president.

80 See Burkovskii, "Rozhdënnaia ėvoliutsiei," p. 47.

81 It has also been argued that one of the reasons why Tymoshenko was able to survive in her position for as long as she did was because of Rem Viakhirev's intervention and his being "always able to produce some weighty counter-arguments to Leonid Kuchma." *Gaz i neft′. Ėnergeticheskii biulleten′*, August 1, 2000 (via ISI). Translation mine. The connection could be speculated to be related to Tymoshenko's and Viakhirev's common sympathy for ITERA.

82 Rosaria Puglisi, "Clashing Agendas? Economic Interests, Elite Coalitions and Prospects for Co-operation between Russia and Ukraine," *Europe-Asia Studies* 55, No. 6, 2003, pp. 827–845, here p. 840

83 See Tat′iana Vysotskaia, "Promezhutochnaia Pobeda," *Delovaia Nedelia*, No. 9/169, March 11–17, 2004, p. 3.

84 See Oles′ Tyshchuk, "Ruki-proch′," *Gaz i neft′. Ėnergeticheskii biulleten′*, January 17, 2001 (via ISI).

85 The moratorium seems to have been applied selectively, as there were two exceptions: the privatizations of Donbasenerho (eventually going to Rinat Akhmetov) and of the Luhansk electricity grid (to Viktor Pinchuk). Yurii Aksënov and Igor′ Guzhva, "Deti gaza i stali," *Ėkspert*, October 11, 2004, in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, October 14, 2004 (via ISI).

86 See Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*.

87 By December 2000, the Communist fraction was the largest in the Rada, controlling 111 out of 449 seats.

88 See Oles′ Tyshchuk, "Nestroinoe 'no pasaran,'" *Gaz i neft′. Ėnergeticheskii biulleten′*, December 13, 2001 (via ISI).

89 In August 2004, Gazprom and NAK Naftohaz Ukrainy agreed that NAK would pay the debt through a system of mutual offset payments—NAK would be paid partially in advance for gas transit services to be provided 2005–2009 ($1.25 billion), and these same monies would go to pay back the debt. NAK would transfer the money to Vneshėkonombank, which earlier had gotten from Gazprom the right to collect debt payments from Ukraine. See Vitalii Kniazhans′kyi, "Kinets′ hazovoho borhu. Pochatok hazovoho defitsytu," *Den′*, August 12, 2004, p. 5. It is unclear whether the agreement was fully implemented.

90 See interview with Yuliia Tymoshenko, "Ėto monopol′naia vlast′ v rukakh trёkh-chetyrёkh chelovek," *Kommersant-Ukraina*, August 10, 2005, reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, August 12, 2005 (via ISI). The essence of the 2004 agreements is that "NAK will be paid partially in advance by Gazprom for gas transit services 2005–2009 ($1.25 billion), and these same monies will go to pay back the debt," with the effect that it will receive less gas in exchange for providing transit services. Vitalii Kniazhans′kyi, "Kinets′ hazovoho borhu," p. 5.

91 Source: Naftohaz Ukrainy, quoted in World Bank, "Ukraine: Challenges Facing the Gas Sector" (September 2003), p. 10, available at www.siteresources.worldbank.org/INTECAREGTOPENENERGY/1112025344408/20772948/ukrainegassector.pdf (accessed June 2, 2006).

92 See Volodymyr Dubrovskyi, Janusz Szymer, and William Graves "The Driving Forces for Unwanted Reforms: The Case of Ukraine" (manuscript, 2004) and Dubrovskyi *et al*, "The Reform Driving Forces," p. 122.

93 See Ibid.

94 See Interview with A. Kysel′ov, general director of Haz Ukrainy in Alla Yer′omenko, "'Rozvytok biznesu v interesakh derzhavy—osnovne zavdannia NAKu,' vvazhaie heneral′nyi dyrektor DK 'Haz Ukrainy' Oleksandr Kysel′ov," *Dzerkalo Tyzhnia*, No. 30/405, August 10–16, 2002 available at www.dt.ua/2000/2229/35746 (accessed July 31, 2007).

95 See " 'Gazprom' reshil prekratit′ postavku gaza 'Itere' v Ukrainu," *Ukrainskaia investitsionnaia gazeta*, No. 4, 2003, pp. 17, 23.

96 During the Soviet period, some of the largest and most important refineries in the USSR were established in Ukraine (and Belarus), but these refineries could only work profitably as part of a larger, union-wide market guaranteeing regular crude oil supplies and access to markets throughout the former USSR.

97 The possibility of a large-scale Russian participation in Ukrainian privatization was opened by the ten-year Agreement on Economic Cooperation between Russia and Ukraine signed in February 1998, as well as by pressure on Ukraine by the International Monetary Fund to start large-scale privatization. This proved to be perfect timing for Russian oil companies, as it was only by the late 1990s that they—having spent the first years after the dissolution of the USSR busily dividing among themselves the Russian market—were ready to turn their attention to the Ukrainian market. While never fully absent from the Ukrainian market, from 1991 to 1999 they mostly limited their participation in the Ukrainian market to import-export operations.

98 See Puglisi, "Clashing Agendas?," p. 839.

99 www.oilua.com, January 30, 2004 (accessed June 1, 2004), quoted by Olena Viter, "Analitychna zapyska shchodo roli ta mistsia rosiis′kykh naftovykh ta hazovykh kompanii v Ukraini," June 11, 2004, unpublished paper, p. 1.

100 See Ibid.

101 The Kryvorizhstal′ steel mill was privatized in 2004 to a Ukrainian holding headed by Viktor Pinchuk and Rinat Akhmetov despite much higher bids by Russian and other foreign companies.

5 Ukraine's management of its energy dependency relationship with Russia: the track record 1995–2004

1 See Karen Dawisha and Bruce Parrott, *Russia and the New States of Eurasia*, Cambridge: Cambridge University Press, 1994, cited in Rawi Abdelal, "Interpreting Interdependence: Energy and Security in Ukraine and Belarus," PONARS Working Paper No. 20 (2002), p. 18, available at www.csis.org/ruseura/ponars/workingpapers/ (accessed October 10, 2006).

2 This includes the establishment of and carrying through of a national energy policy and strategy, the development of energy supply plans, the discussion and implementation of energy supply diversification plans (both in a geographical, an energy-source,

and a contractual sense), as well as other policies concerning the promotion of energy self-sufficiency.

3 This indicator is much higher in Ukraine than in other areas, not only the EU (where TPES exceeds final energy consumption by 41 percent), buy also Russia (50 percent). See World Bank (written by Mark Davis, Ruslan Piontkivsky *et al*), "Ukraine: the Impact of Higher Natural Oil and Gas Prices," December 2005, available at http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/UKRAINEEXTN/0,,contentMDK:20774978~pagePK:141137~piPK:141127~theSitePK:328533,00.html p. 4 (accessed June 1, 2006).

4 The extent of the increase reported depends on the unit of GDP measurement used and other factors. The HELIO International Sustainable Energy Watch Report for Ukraine, available at www.helio-international.org (accessed June 15, 2004), citing data from the German Advisory Group in Ukraine, reports a 50 percent increase between 1991 and 1999 or 60 percent between 1989 and 1997 (see Figure 5.1). The IEA (*Ukraine Energy Policy Review 2006*, p. 118), using Purchasing Power Parity (PPP) GDP data, reports a 30 percent increase between 1991 and 1995, and gradual declines since then.

5 Energy intensity is defined as the amount of energy needed to produce a fixed amount of GDP (either nominal GDP or GDP calculated on a PPP basis). A qualification often made to energy intensity calculations for Ukraine is that they are not fully correct because they are based only on official GDP figures, ignoring the shadow economy that by 1999 was estimated to account for up to 50 percent of economic activity. This view is supported by the fact that, indeed, one of the ways to measure the shadow economy is by looking at electricity consumption. From this perspective, it could be said that, if calculations were made on the basis of the economy as a whole (shadow as well as non-shadow), as opposed to just the official economy, the increase in energy intensity would not look as large, because energy consumption has grown together with total (shadow and non-shadow) GDP. At the same time, including the shadow economy in energy intensity calculations fails to fully disqualify the increase in energy intensity argument. This is so because "a large part of the shadow economy consists of trade with little energy intensity" and because data on single industries as well "show a high and increasing energy consumption that cannot be attributed to the shadow economy." (Christian von Hirschhausen and Volkhart Vincentz, "Energy Policy and Structural Reform," in *Eastern European Economics* 38, No. 1, 2000, p. 64; see also International Energy Agency, *Energy Policies of Ukraine. 1996 Survey*, Paris: OECD/IEA, 1996, pp. 73–75.) A further issue concerns calculating energy intensity on a nominal or PPP basis; most of the calculations for Ukraine are based on nominal calculations. Calculations based on PPP GDP show a sharp increase in energy intensity from between 1992 and 1995, followed by a gradual decline (see Table 1). The use of PPP calculations, however, does not change Ukraine's status as Europe's most energy-intensive economy. An energy intensity time series figure based on PPP GDP calculations is available at US Energy Information Administration, "Ukraine Country Analysis Brief" (last updated March 2006), available at www.eia.doe.gov/emeu/cabs/Ukraine/Full.html (accessed June 8, 2006).

6 Ferdinand Pavel, German Institute for Economic Research, presentation on "The Ukrainian-Russian Gas Agreement: Analysis and Alternatives," Conference on The Ukrainian-Russian Gas Crisis and Its Aftermath: Economic, Political and International Ramifications, Harvard University, February 5–6, 2006 (streaming video available at www.huri.harvard.edu/na/na_gas_conf_2006.html) (accessed June 15, 2006).

7 See Energy Information Administration, available at www.eia.doe.gov/emeu (accessed June 1, 2004). See also Ivan Diak, head of the Subcommittee on Gas Industry at the Verkhovna Rada Committee on the Fuel Complex, in Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy of Ukraine through 2020," *National Security and Defense*, No. 2, 2001, pp. 67–68.

8 These included the Law on Energy Conservation (1994), the Comprehensive National Program on Energy Conservation (1996), and a 1999 presidential decree emphasizing energy savings in the public administration sector.

9 See Oles´ Tyshchuk, "Kholodnyi dush," *Gaz i neft´. Ėnergeticheskii biulleten´*, June 25, 2006 (via ISI).

10 It has been argued, for example, that some of Ukraine's initiatives in the area of wind energy were held back by the use of outdated technologies (e.g. the adoption of a 1970s model of wind electricity generating equipment because of the producing company's, Yuzhmash's, political clout and close connections with President Kuchma), as well as by the attempt of "corrupt Ukrainian oligarchic clans" to get involved into a 2003 German-financed project for the building of a wind electricity generation station, forcing the German government to suspend the project. Aleksei Onipko and Boris Korobko, "Vozmozhnye sostavliaiushchie ėnergonezavisimosti Ukrainy," *Zerkalo Nedeli*, No. 4/583, February 4–11, 2006, available at www.zerkalo-nedeli.com/nn/show/583/52491/ (accessed January 22, 2007). It has also been argued that President Kuchma vetoed any possibility of attaching financial incentives to a law supporting the development of renewable energy in 2001–2002, due to his connections with and desire to support the nuclear energy industry. See Vladimir Kosterin (Charmain of the Board of Overseers, Institute of Sustainable Development), "Vozobnovliaemaia ėnergetika kak lekarstvo ot 'gazovoi nedostatochnosti,' " *Zerkalo Nedeli*, No. 6/585, February 18–24, 2006, available at www.zerkalo-nedeli.com/ie/show/585/52626/ (accessed March 1, 2006).

11 Hermann Clement, "Economic Aspects of Ukrainian-Russian Relations," in Kurt R. Spillman, Andreas Wenger and Derek Mueller, *Between Russia and the West: Foreign and Security Policy of Independent Ukraine*, Bern and New York: Peter Lang, 1999, p. 296.

12 Ukraine figures are for 2005–2006. Belarus and Russia figures are for 2004–2005. On Belarus see Valerii F. Dashkevich, *Ėnergeticheskaia zavisimost´ Belarusi: posledstviia dlia ėkonomiki i obshchestva*, Minsk: Lovginov/ Fond imeni Fridrikha Eberta, 2005. The IEA reports households with meters were charged $35/1,000 cm, and households without meters $38. IEA, *Ukraine Energy Policy Review 2006*, p. 183.

13 While inflation in the 2000–2004 period was 47 percent, the increase in combined energy prices (electricity, natural gas, and heating) for the same period was only 22 percent. IEA, *Ukraine Energy Policy Review 2006*, p. 45.

14 Serhii Tulub, Ukraine's Minister of Fuel and Energy, in Black Sea Regional Energy Centre, *Black Sea Energy Review: Ukraine*, Sofia, July 2000, p. 9. For comparison, in late 1990s Russia the share of energy in total manufacturing costs was 6–9 percent. International Energy Agency, *Energy Policies of the Russian Federation*, Paris, IEA/OECD, 1995, p. 40.

15 See Hermann Clement, "Economic Aspects of Ukrainian-Russian Relations," in Kurt R. Spillman, Andreas Wenger and Derek Mueller, *Between Russia and the West: Foreign and Security Policy of Independent Ukraine*, Bern and New York: Peter Lang, 1999, pp. 287–288. In 2004 alone, Ukraine's metal exports grew by 10 percent in terms of volume, and by *c.* 60 percent in price. Source: Metaly Ukrainy, available at www.business.dp.ua/me/data/0801.htm (accessed June 15, 2006). Ukraine's metallurgical production is significantly more energy-intensive than that in the US, Western Europe or Japan—if in these countries by the late 1990s the share of energy in production prices was *c.* 12 percent, in Ukraine even by 2005 it was 40 percent. Viktor Zhovtianskii and Boris Stognii, "Ėnergosberezhenie: moment istiny?," *Zerkalo Nedeli*, 22/601, June 10–16, 2006, available at www.zerkalo-nedeli.com/ie/show/601/53619/ (accessed June 20, 2006).

16 Von Hirschhausen and Vincentz, "Energy Policy and Structural Reform," p. 65.

17 Ibid., p. 64.

18 International Energy Agency (IEA), *Ukraine Energy Policy Review 2006*, Paris: OECD/IEA, 2006, p. 75. See also US Department of Energy, "Country Analyses Briefs, Ukraine" (updated March, 2006), available at www.eia.doe.gov/emeu/cabs/Ukraine/Full.html (accessed January 22, 2007).

19 IEA, *Ukraine Energy Policy Review 2006*, p. 77. Figures are for 2004.

20 The prices of domestically produced coal have been widely manipulated, often by crafty intermediaries working for the major BAGs, with the effect that coal has often been sold at prices well below production costs, further worsening the financial situation of Ukranian mines, already in dire straits and highly dependent on government subsidies. On the manipulation of coal prices, see Roman Olearchyk and Stephan Ladanaj, "State seeks control over energy sector," *Kyiv Post*, April 22, 2004, p. 15B. According to Dubrovskyi *et al*, for much of the 1990s coal was sold at a negative profit of *c.* 50 percent. Oleksandr Babanin, Volodymyr Dubrovskyi, and Oleksii Ivashchenko, *Ukraine: The Lost Decade…and the Coming Boom?* Kyiv: CASE Ukraine, 2002, p. 18.

21 See Volodymyr Saprykin, "Restructuring Ukraine´s Coal Industry: Key Problems and Priority Measures," *National Security and Defence*, No. 11, 2004, pp. 2–9.

22 See Saprykin, "Restructuring Ukraine´s Coal Industry," p. 5.

23 The Khmelnytskyi Unit no. 2 and the Rivne Unit no. 4.

24 Ukrainian government sources calculate imported uranium as being equivalent to a further 11.7 percent of Ukraine's energy consumption. As a result, these sources put Ukraine's energy dependency index at 54.5 percent, higher than the IEA's 43.1 percent. See *Enerhetychna Stratehiia Ukrainy na period do 2030 roku*, Kyiv, Ministerstvo Palyva ta Enerhetyky, March 2006, Section II, p. 14, available at http://mpe.kmu.gov.ua/control/uk/archive/docview;jsessionid=3C2134CB829F6B49B827B34128BA604F?typeId=36172&sortType=4&page=0 (accessed June 3, 2006). In a display of Ukraine's vulnerability in this area, in 1994 Russia cut off nuclear fuel deliveries to the Ukraine for a brief period. UT-1 Television Network, January 28, 1994, translated in FBIS-SOV-94-020, January 31, 1994, p. 43, cited in Paul D'Anieri, *Economic Interdependence in Ukrainian-Russian Relations*, Albany: SUNY Press, 1999, pp. 85–86.

25 IEA, *Ukraine Energy Policy Review 2006*, p. 333. Ukrainian sources, using a broader definition of "alternative energy," put the figure at 3.6 percent of TPES. Ibid.

26 In terms of energy distribution, it is important to note that pipeline gas pumping units are in particularly bad condition, which means increasing amounts of gas are needed to pump gas through the pipelines. (In 2001 almost ten percent of Ukraine's yearly gas consumption was used for this purpose.) Similarly, losses in electricity transmission have increased, to the point that in 2000 the planned losses amounted to a loss coefficient of 22.2 percent, equivalent to $1.2 billion, which is more than the value of technical aid and loans Ukraine annually receives from international financial institutions. Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 54. (Under "losses of electricity" the authors understand transportation costs [losses], stealing of electricity, "ecological consumption of electricity" and subsidies to the population and producers.)

27 This fall in production should also be seen in the context of the fact that during the Soviet period oil and gas reserves were exploited in ways that quickly and seemingly inexpensively got the gas and oil located in easy-to-reach parts of deposits, but which actually made it is much more difficult—and expensive—to get at the remaining parts of these deposits later on.

28 Despite the passing of Production Sharing Agreement (1999) and Oil and Gas (2001) laws "intended to simplify the procedure of obtaining licenses for oil and gas exploration and extraction and [to] provide for certain benefits for the investors," enforcement and corruption continued to be an important problem, and many foreign oil and gas companies did not feel safe to engage in significant investments in Ukraine; others

left the country after negative experiences with the Ukrainian bureaucracy and corruption. See US and Foreign Commercial Service, "Ukraine Oil and Gas Resources and Production Report," 2004.

29 Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy," p. 10.

30 However, it is impossible to ascertain with certitude up to which point pro-diversification declarations were made sincerely and up to which point were simply intended to strengthen Ukraine's freedom of choice in its "multi-vector" foreign policy by reassuring the West of its desire to strengthen its economic independence from Russia.

31 See Oles M. Smolansky, "Fuel, Credit, and Trade: Ukraine's Economic Dependence on Russia," *Problems of Post-Communism* 46, No. 2, 1999, pp. 49–58. The text of the National Security Doctrine can be found in *Uriadovyi Kur'ier*, February 4, 1997, pp. 5–6.

32 Yurii Aks´onov, "Mrii ta real´nist´ dyversyfikatsii hazozabezpechennia Ukrainy," *Enerhetychna Polityka Ukrainy* 2000, No. 6, 2000, pp. 14–23, here p. 21.

33 See Ferdinand Pavel, "The Ukrainian-Russian Gas Agreement."

34 Turkmenistan would sell to Gazprom 60 to 70 bcm of gas per year. The deal also assumes highly increased gas production in Turkmenistan. See Tat´iana Vysotskaia, "Tseny na gaz budut rasti," *Delovaia Nedelia*, (Kyiv) No. 15/129, May 8–14, 2003, and Vladimir Saprykin, "Uzkie mesta gazovogo sektora stran tsentral´noi Azii," *Ėnergeticheskaia Politika Ukrainy*, 2004, No. 5, May 2004.

35 See Roman Olearchyk, "Gazprom, Naftohaz Ukrainy Replace ITERA with new firm," *Kyiv Post*, March 6, 2003, p. 1.

36 See Alla Yer´omenko, "Dviiko b'iet´sia, a 'Gazprom' smiiet´sia," *Dzerkalo Tyzhnia*, No. 30/303, July 29–August 4, 2000, available at www.zerkalo-nedeli.com/ie/show/303/27977 (accessed June 1, 2003). See also *Gaz i neft´. Ėnergeticheskii biulleten´*, June 15, 2001 (via ISI).

37 See Oleksandr Babanin, Volodymyr Dubrovskyi, and Oleksii Ivashchenko, *Ukraine: The Lost Decade*, pp. 74–75.

38 Igor Petrov, "Sozdanie strategichekikh zapasov nefteproduktov ne provalilo, a vsego lish otsrochilo na god," *Delovaya Stolitsa*, No. 47, November 22, 2004, available at www.dsnews.com.ua/archive/index.php?action = article&r_id = 22&article_id = 17663&arc_num = 192 (accessed July 31, 2007).

39 This is no outsourcing in the traditional sense of the word where the main purpose of transferring the service to an outside provider is cost savings.

40 Vitaly Kniazhanskii (Vitalii Kniazhans´kyi), "Comrade Reverse" *The Day*, March 16, 2004, p. 3; originally published in Ukrainian in *Den´*, March 12, 2004, p. 4. *The Day* is the weekly English-language edition of *Den´*.

41 This includes issues such as the structure of policy-making in the energy sphere, the domestic distribution of energy imports, policies about differential rates for industrial, residential or state sector users and how they will be financed, policies about subsidies for particular types of users and how they will be financed, and policies about foreign investments in the energy area.

42 See World Bank, Statistical Yearbook for Ukraine and Hans van Zon, *The Political Economy of Ukraine*, London: MacMillan, 2000, p. 76.

43 The Czech Republic, Slovakia, Hungary and the Czech Republic.

44 World Bank (written by Mark Davis, Ruslan Piontkivsky *et al*), "Ukraine: the Impact of Higher Natural Oil and Gas Prices," December 2005, available at http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/UKRAINEEXTN/0,,contentMDK:20774978~pagePK:141137~piPK:141127~theSitePK:328533,00.html (accessed June 1, 2006), p. 10. Data on German gas imports is from the IEA, available at www.iea.org/textbase/speech/2003/mandil/kolncm.pdf (accessed June 1, 2006).

45 Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy," p. 19.

46 When the state is unable to provide basic services such as heating and electricity, people often lose confidence in their leaders, leading to apathy. This became especially clear in the winter of 1993–1994, when energy supply problems and an "energy war" with Russia led to freezing home temperatures.
47 Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy," p. 19.

6 Domestic institutions and Ukraine's responses to energy dependency

1 See the discussion of Olson's "stationary bandit" in Volodymyr Dubrovskyi, Janusz Szymer, and William Graves, "The Driving Forces for Unwanted Reforms: The Case of Ukraine" ("Draft version of the work in progress, 2005"), p. 1. See also Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, New York: Basic Books, 2000.
2 Dubrovskyi, Szymer, and Graves, "The Driving Forces," p. 1.
3 These factors have been adapted from Andreas Heinrich, "Internationalization and Corporate Governance. Case Study: Hungary," paper presented at the VII World Congress of the International Council for Central and East European Studies, Berlin, July 25–30, 2005. For a discussion of one Ukrainian case see Aleksandra Lis and Heiko Pleines, "The Global Impact of Corporate Governance. Case Study of Ukrnafta (Ukraine)," paper presented at the VII World Congress of the International Council for Central and East European Studies, Berlin, July 25–30, 2005. See also J. C. Brada and I. Singh, *Corporate Governance in Central Eastern Europe*, New York; M. E. Sharpe, 1999.
4 Ukraine's Tax Police officially considered the energy sector as Ukraine's most corrupt one. See *Gaz i neft´. Ėnergeticheskii biulleten´*, August 22, 2001 (via ISI). On World Bank views see *Gaz i neft´. Ėnergeticheskii biulleten´*, May 23, 2000 (via ISI).
5 As noted by Fisun, in the case of Ukraine and a number of other post-Soviet states, formal democratic institutions exist, but these institutions are tied together "not by modern, rational-legal civil relations, but by patron-client relationships." Oleksandr Fisun, "Developing Democracy or Competitive Neo-Patrimonialism," paper presented at the Centre for Russian and East European Studies, University of Toronto, October 24, 2003, p. 4.
6 See *NefteRynok*, November 12, 2000 (via ISI).
7 Most Russian energy companies do not follow current international business accounting standards, nor make their books available to public scrutiny as most Western firms do. See Keith C. Smith, "Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?," Washington: Center for Strategic and International Studies Report, 2004, p. 7. At the same time, we should not forget the fact that, at times, it has been their association with Western companies that has provided corrupt Russian-Ukrainian deals the cover of respectability (such as in the case of Raiffessen Invest in Austria and its relationship with the company RosUkrEnergo, discussed in Chapters 7 and 8). In other occasions, it has been offshore companies registered in Western countries that have done the "dirty work" for Russian-Ukrainian corrupt outfits, and have helped to launder the proceeds afterwards.
8 On Russian companies' advantages in terms of access to domestic interest groups in Ukraine, see Vadym Karas´ov, (Director, Institute of Global Strategy, Kyiv), interview in *Profil´-Ukraina*, No. 8/23, March 1, 2004, pp. 30–32.
9 Indeed, the prevalence of non-transparency is one explanation (in addition to the fact that most Ukrainian refineries, being Russian-owned, preferred to receive supplies from their own mother companies) for the lack of interest in the purchase of Caspian oil, which

could be obtained mainly only by transparent means (such as tenders and auctions), which made it impossible to avoid paying taxes or minimizing them, as was often the case in deals between refineries and their mother companies in Russia. According to some authors, this is the reason why many in Ukraine could see the Odesa-Brody pipeline exclusively as a *transit* pipeline and not one that could really supply Ukrainian refineries, because these are often dependent on working within the framework of state-to-state agreements on fuel supplies, or direct supplies by their mother companies, but are not able to work in the free market. "Given the existence of these other 'deals,' it is de facto unprofitable [for these refineries] to buy alternative (non-Russian) oil, even when at times the price of Russian oil supplied to Ukraine is higher than the average price of oil in the European market." Oleg Dorozhovets, "Fliuger-truba-2," *Gaz i neft´. Ėnergeticheskii biulleten´*, March 25, 2005 (via ISI). Translation mine.

10 Pavlo Lazarenko is accused of stealing and laundering over a hundred million dollars in energy-related corruption deals during his tenure as PM of Ukraine in 1996–1997. These came from multiple multi-million bribes received from regional gas companies as condition for granting them distribution rights in their respective regions. He was arrested in Switzerland in December 1998 and in the US in February 1999, after which he applied for political asylum. He was tried and convicted in Switzerland (in absentia) on money-laundering charges and in the US on charges of money-laundering, wire fraud and interstate transportation of stolen property. Although he was convicted of 29 charges by a US court in 2005, most of the charges related to his role in Ukrainian energy corruption were thrown out; in August 2006, he was condemned to nine years in prison and fined $10 million for money laundering, wire fraud, and interstate transportation of stolen goods.

11 See Yuliia Latinina, "Oligarchs Trade Davos Forum for Courcheval Frolic," *St. Petersburg Times*, February 3, 2004, available at sptimes.ru, quoted in Smith, "Russian Energy Politics," p. 25.

12 See Margarita M. Balmaceda, "Energy Business and Foreign Policies in Belarus and Ukraine," presentation at the conference on "Economic Interests and Foreign Policy Choices: the Case of Slavic Triangle," University of Toronto, January 26–27, 2006, and Paul D'Anieri, "Ukrainian-Russian Relations: Beyond the Gas," presentation at the conference on "The Ukrainian-Russian Gas Crisis and its Fallout: Domestic and International Implications," Harvard University, February 5–6, 2006 (streaming video available at www.huri.harvard.edu/na/ na_gas_conf_ 2006.html) www. huri.harvard.edu/na/na_gas_conf_2006.html (accessed June 15, 2006).

13 The agreement was signed in haste in Chisinau, Moldova, on October 18, 2001, intentionally away from the prying eyes of the Ukrainian press.

14 The exclusion of the German side was not a coincidence, as keeping the consortium a bilateral affair would strengthen the Russian side's power vis-á-vis weaker Ukraine.

15 For a full discussion of the consortium, see *Natsional´na bezpeka i oborona*, 2004, No. 1. The same issue includes a short but rather aggressive reaction by NAK Naftohaz Ukrainy to accusations of lack of transparency.

16 The project was basically frozen from 2001 to 2006 due to its collision with Ukrainian legislation prohibiting foreign ownership of previously built strategic objects, lack of transparency, and the Russian attempt to use the idea of an Ukrainian-Russian-German consortium for public relations reasons, while in reality seeking to keep the German side away from the negotiating table.

17 V. Dubrovskyi, W. Graves, Y. Holovakha, O. Haran´, R. Pavlenko, and J. Szymer, "The Reform Driving Forces in a Captured State: Lessons from the Ukrainian Case," first draft of the Understanding Reform Project, Kyiv, mimeo, 2003, p. 17.

18 As argued by Puglisi: "Business associations, which could play a crucial role in mediating between the state and entrepreneurs, were weak, very numerous, and

scarcely significant on the political scene." Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," *Democratization* 10, No. 3, 2003, pp. 99–123, here 107.

19 See Paul Kubicek, "Post-Soviet Ukraine: in Search of a Constituency of Reform," *Journal of Communist Studies and Transition Politics* 13, No. 3, 1997, p. 112.

20 See Jerry Richardson, *Pressure Groups* (Oxford: Oxford University Press, 1993), p. 1.

21 Such as independent trade associations, but also policy-making institutions able to make policy on the basis of democratic control and independent expertise and not personal connections or the misuse of office for personal gain. On trade associations in Ukraine, see Paul Kubicek, *Unbroken Ties: the State, Interest Associations and Corporatism in post-Soviet Ukraine*, Ann Arbor: University of Michigan Press, 2000 and Paul Kubicek, "Variations on a Corporatist Theme: Interest Associations in Post-Soviet Ukraine and Russia," *Europe-Asia Studies* 48, No. 1, 1996.

22 On this lack of organized lobbying see Tat´iana Zolotarëva, "Lobbizma u nas net," *Galitskie Kontrakty*, No. 16, April 19, 2004, available at www.kontrakty.com.ua/show/rus/article/4/1620042411.html (accessed July 31, 2007).

23 As put by Puglisi, "the permeability of national institutions (. . .) meant that the one elite coalition that acquired control over the centre of policy-making could impose its policy preferences over the national interest." Rosaria Puglisi, "Clashing Agendas? Economic Interests, Elite Coalitions and Prospects for Co-operation between Russia and Ukraine," *Europe-Asia Studies* 55, No. 6, September 2003, pp. 827–845, here p. 842.

24 Margarita M. Balmaceda, "Explaining the Management of Energy Dependency in Ukraine: Possibilities and Limits of a Domestic-Centered Perspective" Mannheimer Zentrum für Europäische Sozialforschung (MZES) Arbeitspapiere/Working Papers, May 2004, p. 36, available at www.mzes.uni-mannheim.de/publications/wp/wp-79.pdf (accessed June 6, 2006).

25 Tor Bukkvoll, "Private Interests, Public Policy: Ukraine and the Common Economic Space Agreements," *Problems of Post-Communism* 51, No. 5, 2004, pp. 11–22, here p. 13.

26 On the Rada's ability to maintain a degree of autonomy despite encroachment and manipulation by President Kuchma, see Sarah Whitmore, "State and Institution Building Under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 3–11, here p. 9.

27 See Alla Erëmenko, "'Naftohaz Ukrainy': kratkaia istoriia v sobytiiakh i litsakh," *Zerkalo Nedeli*, No. 19/444, May 24–30, 2003, available at www.zn.ua/2000/2200/38608/ (accessed July 31, 2007).

28 *Gaz i neft´. Ėnergeticheskii biulleten´*, August 23, 2000 (via ISI).

29 The 600 km long Aleksandrov Gai—Novopskov pipeline, due to be extended to Uzhhorod.

30 Puglisi, "The Rise of the Ukrainian Oligarchs," p. 114.

31 *Ukrains´ka Pravda*, February 16, 2005, cited in Hans von Zon, "Political Culture and Neo-Patrimonialism under Kuchma," *Problems of Post-Communism* 52, No. 5, 2005, pp. 12–22, here p. 14.

32 Tor Bukkvoll, "Private Interests, Public Policy," p. 15. See also Taras Kuzio, "Neither East nor West: Ukraine's Security Policy Under Kuchma," *Problems of Post-Communism* 52, No. 5, September/October 2005, pp. 59–68, here p. 63.

33 *Ukrains´ka Pravda*, February 16, 2005, cited in van Zon, "Political Culture," p. 14.

34 Ibid.

35 This is not to say, however, that, had it not been for these constraints, President Kuchma would have pursued a more proactive energy policy vis-á-vis Moscow—despite his role as "arbiter," Kuchma had his own interests, including in the energy area (interests which most often were carried into practice by the Kyiv clan associated with his

son-in-law Viktor Pinchuk), and these undoubtedly also affected his energy transactions with Russia.

36 The gas transit consortium had been originally proposed at a meeting between Presidents Putin, Kuchma and Chancellor Schroeder in June 2002, and it was announced as a trilateral project where German companies would play an important role. Looking at the situation in hindsight after Gerhard Shroeder's leaving the position of Chancellor and taking a high-paying position at Gazprom's planned Northern European Gas Pipeline in the fall of 2005 after having forcefully lobbied the project while in office, it does not seem unreasonable to speculate on Schroeder's true motives in seeking to lend legitimacy to the Ukrainian-Russian agreement of 2001.

37 See special issue on the international gas consortium project, *Natsional′na bezpeka i oborona*, No. 1, 2004. The creation of a full-scale international gas consortium was delayed in 2004 due to the need to modify a number of Ukrainian laws to permit its functioning.

38 Throughout 2003 and 2004, President Kuchma's declarations on the Consortium were rather contradictory, but he is generally believed to have wanted to drag out the process of formation of the consortium as a way to remain needed as intermediary, and thus increase his chances of winning immunity from criminal prosecution after leaving office.

39 See Ivan Petrov, "Islamabad daët poslednii shans," *Delovaia Stolitsa*, No. 5 January 31, 2005, available at www.dsnews.com.ua/archive/index.php?action=article&r_id=22&article_id=18613&arc_num=201 (accessed July 31, 2007).

40 This is not to say, however, that elected institutions such as the Verkhovna Rada were a model of democratic control. As noted earlier, the Rada was often more an arena of clientelistic negotiation and horse-trading between BAGs than a forum for policy debate guided by voters' ideas and interests.

41 As seen throughout this book, because of Soviet structural and mental legacies as well as the interests of important economic interest groups, energy diversification as a value in itself was not an important shared goal for Ukrainian elites between 1991 and 2004. The situation in the post-2004 period remains unclear.

42 James Mace referred to this reality when emphasizing the debate about the use of the Odesa-Brody oil pipeline as manifestation of Ukraine's problems in "defining its national interests in the context of Russian-Ukrainian relations." See James Mace, "Neftiannaia Geopolitika," *Den′* (Russian-language edition) April 8, 2003. Translation mine.

43 For a representative view, see Vladimir Golovko, "Vliianie vneshnikh faktorov na strategiiu ėnergeticheskoi politiki Ukrainy," *Ėnergeticheskaia Politika Ukrainy*, No. 2, 2003, pp. 8–11.

44 In Hellman *et al*'s 2000 Index of State Capture covering twenty-two post-Communist states, Ukraine is classified as a "high state capture" case, occupying the third place (tied with Russia) after Azerbaijan and Moldova. Joel S. Hellman, Geraint Jones, and Daniel Kaufmann, "Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition," World Bank Policy Research Working Paper No. 2444 (September 2000), p. 9, available at www.colbud.hu/honesty-trust/hellman/pub01.PDF (accessed June 7, 2006).

45 Thus the appropriateness of the expression *kormushka* or "feeding ground."

46 This is a situation we saw in repeated occasions, most clearly during Pavlo Lazarenko's tenure as PM in 1996–1997, but also later. For example, when on April 2000 President Kuchma vetoed the Verkhovna Rada's version of the Law on Natural Monopolies and signed his own version of the law, the main difference and point of contention was that in the Rada's version the "National Commissions for Regulation of Natural Monopolies" were independent non-agency state organs subordinated to the president but accountable to the Rada; in the president's version, the commissions are organs of the executive branch, and he has the right to independently create and

liquidate such commissions, making them directly dependent on the executive. See *Gaz i neft´. Ėnergeticheskii biulleten´*, June 20, 2000 (via ISI).

47 Dubrovskyi *et al*, "The Reform Driving Forces," p. 94. See also Aleksandr Pashkaver, as cited in Ibid.

48 For some examples of how this took place in the oil-refining sector, see Oleg Gavrish, "Neftegazovye skhemy prezidenta. Chast' 1. Neft,' " available at www.pravda.com.ua/news/2005/3/30/2992.htm (accessed January 31, 2007).

49 In this and other cases, the de facto (if not legal) privatization of formally state property has been compounded by the fact that, in some cases, the divisions between BAGs (clans) run between state companies, between daughter and mother companies of the same state concern, or within these as well, with unpredictable consequences given the lack of clear corporate governance rules. This has been especially evident in the battle for the control the oil transit monopolist Ukrtransnafta in 2003–2004. See Aleksandr Vladimirov, "Vozmozhnost´ porulit´ neftetransportnoi sistemoi budorazhit donetskikh oligarkhov," *Delovaia Stolitsa*, No. 17, April 26, 2004, available at www.dsnews.com.ua/archive/index.php?action=article&r_id=22&article_id=14128&arc_num=155 (accessed July 30, 2007).

50 See Serhii Yermilov (Sergei Ermilov) [Minister of Fuel and Energy in 2000 and 2003–2004], "Vysoka napruha," interview in *Den´*, February 26, 2004, p. 4.

51 For example, the 2003 agreement with the offshore company Collide for operation of the Odesa oil terminal. Vitaly Kniazhanskii (Vitalii Kniazhans´kyi), "Comrade Reverse," *The Day*, March 16, 2004, p. 3. Originally published in Ukrainian in *Den´*, March 12, 2004, p. 4.

52 As a result of the August 2004 agreements with Gazprom, Ukraine loses control over the transit of gas through its territory and the revenue flow associated with it, as well as of gas imports from Turkmenistan, putting these under the control of Gazprom and the Russian-Ukrainian-Austrian company RosUkrEnergo. See Oles´ Tyshchuk, "Vlast´: Igra v poddavki," *Gaz i neft´. Ėnergeticheskii biulleten´*, August 25, 2004 (via ISI) and Nataliia Nagornaia, "Ukraina poteriala kontrol´ nad sobstvennoi gazotranzitnoi sferoi," *Delovaia Nedelia*, No. 30–31/190–191, August 12–18, 2004, p. 5.

53 As a result of the 15-year agreement on oil transit signed with Russia on August 18, 2004, Ukraine gave Transneft the right to set most terms and conditions relative to oil transit through Ukraine, including volumes. *Dzerkalo Tyzhnia* journalist Ivan Honta (Ivan Gonta), writing in 2006, characterized the role of *de jure* Ukrainain oil transit monopolist Ukrtransnafta after the 2004 agreements as "a de facto branch of Moscow's [Russian oil transit monopolist] Transneft." Ivan Honta, "Khto v Ukraini i na shcho spodivaiet´sia?," *Dzerkalo Tyzhnia*, No. 23/602, June 17–23, 2006, available at www.zn.Kyiv.ua/ie/razdel/602/2233/ (accessed June 25, 2006).

54 See also Dubrovskyi, Szymer, and Graves, "The Driving Forces," p. 114.

55 Thus the image of the state acting as a "*pozhezhna bryhada*" (fire brigade) every year. Author's consultations, Kyiv, March 25, 2003.

56 Some of them were fledging operations precariously tiding themselves over from one special grant-financed project to the next, compromising their ability to deal with energy issues in a continuous manner. Other institutes, such as the Ukrainian Centre for Political and Economic Studies ("Razumkov Center") and the Institute for Economic Research and Policy Analysis, which thanks to a first-rate staff and foreign support had well-functioning and well-respected operations, lacked sufficient personnel to play a larger policy role, as well as for fulfilling a coordination function among all organizations dealing with energy policy issues.

57 Completion of the Strategy, originally planned for December 2002, was postponed twice, and had not been completed by the December 2004 elections. See Volodymyr Saprykin, "Restructuring Ukraine´s Coal Industry: Key Problems and Priority Measures," *National Security and Defence*, No. 11, 2004, pp. 2–9, here p. 5. For a chronology of work on an Energy Policy of Ukraine see Verkhovna Rada Ukrainy,

Enerhetychna stratehiia Ukrainy: realii ta perspektyvy. Materialy kruhloho stolu, Kyiv, 2003, pp. 6–7. The fate of the Strategy under the Yushchenko government will be discussed in Chapter 8.

58 The companies were Respublika, led by later NAK Naftohaz Ukrainy head Ihor Bakai, ITERA, Eural Trans Gas, and, after 2004, RosUkrEnergo. These offshore companies either did not have an official Ukrainian connection or were controlled by figures close to the national oil and gas monopolist, but acting in their own personal interest. In the case of Respublika, Bakai's personal connections allowed the debts incurred by the company to be guaranteed as state debt, resulting in a $350 million debt liability being transferred to the state. Alla Yer´omenko, "Politychnyi hazovyi pres," *Dzerkalo Tyzhnia*, No. 23/551, June 18–24, 2005, available at www.zn.kiev.ua/nn/show/551/50353/ (accessed January 31, 2007). See also Alla Erëmenko, "Restrukturizatsii ukrainskikh 'gazovykh' dolgov: za i protiv," *Zerkalo Nedeli*, No. 49/364, October 13–19, 2004, available at www.zerkalo-nedeli.com.ie/show/364/32542/ (accessed October 20, 2006).

59 See Nikolai Ivanov, "Ukraina otkazalas´ ot Turkmenskogo gaza," *Segodnia*, April 1, 1999, p. 1. Some of the corruption-related problems that led to the suspension of supplies were related to barter operations (as when Ihor Bakai's firm Respublika sold rain boots to chronically draught-prone Turkmenistan), as well as those related to the provision of services, for example the building of bridges. Indeed, Bakai's Respublika was the first company to use barter schemes to pay for natural gas imports, which gave Bakai enough profits as to become an oligarch on his own right. Oles´ Tyshchuk and Kost´ Bondarenko, "Geometriia ot Bakaia," *Gaz i neft´. Ėnergeticheskii biulleten´*, June 15, 2001 (via ISI).

60 Oleksandr Ivchenko (head of NAK NU in 2005), cited in Oksana Liven´, "Kreditnaia dobycha," *Ėnergobiznes*, September 19, 2005 (via ISI), accessed October 21, 2005. Eural Trans Gas received 38 percent of the gas for its services.

61 In 1995, Ukraine received 12.1 bcm of Turkmenistan gas instead of the contracted 20, in 2003 34 bcm instead of the agreed 40, and in 2004 33.6 bcm were received despite a contracted 36 bcm. Source for 1995 (estimated data): International Energy Agency, *Energy Policies of Ukraine. 1996 Survey*, Paris: International Energy Agency/OECD, 1996, pp. 144, 146; source for 2003–2004: "Z hazu na haz," *Biznes*, No. 1–2, January 17, 2005, based on www.energobussines.Kyiv.ua. The phrase "transit services" needs to be taken with a grain of salt here, as most of the involved companies had minimal staff and did not seem to engage in any real work besides assuring the necessary transit permissions were granted by Russia and other pipeline operators.

62 See Andrei Didyk, "Khot´ Kaspiiskoe, khot´ Indiiskii okean," *Gaz i neft´. Ėnergeticheskii biulleten´*, May 15, 2002 (via ISI). See also Boris Vinogradov, "Ochen´ slezotochivyi gaz," *Izvestiia*, October 12, 2000, p. 3 and Viktor Timoshenko and Liudmila Romanova, "Vsia pogoda delaet´sia v Kremle," *Nezavisimaia Gazeta*, October 17, 2000, p. 1.

63 As shown by his lack of support for PM Tymoshenko´s proposal to end barter operations for the purchase of Turkmen gas. Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, pp. 74–75, and Alla Yer´omenko, "Dviiko b'iet´sia, a 'Gazprom' smiiet´sia," *Dzerkalo Tyzhnia*, No. 30/303, July 29–August 4, 2000, available at www.zerkalo-nedeli.com/ie/show/303/27977 (accessed June 1, 2003).

64 The 667 km long Odesa-Brody pipeline took much longer to build (almost 10 years) than comparable Soviet-built pipelines (the 686.5 km long Druzhba pipeline was built in four years, from 1970 to 1974). See S. I. Pirozhkov, *Zabezpechennia enerhetychnoi bezpeky Ukrainy*, Kyiv, 2003, p. 178, quoted in Olena Viter, "Analitychna zapyska shchodo problem zapusku naftoprovodu Odesa–Brody," unpublished paper, 29 June 2004, p. 1.

65 For example, when construction was halted in 1999, the nationalist Rukh party accused Deputy PM Anatolii Holubchenko of acting independently in ordering that construction be halted, in order to protect his own financial gain as he was "making substantial

personal gains from the resale of Russian oil in Ukraine and feared the Odesa–Brody pipeline would diminish the size of the trade." (Kuchma removed Holubchenko and "Kuchma's foreign policy advisor, Yurii Shcherbak, later confirmed that the pipeline project had been almost terminated because certain civil servants had had private interests in this situation.") But the project continued only slowly; around 2000 Ihor Bakai was suspected of obstructing the project, for the same reason as Holubchenko earlier had been. Tor Bukkvoll, "Defining a Ukrainian Foreign Policy Identity: Business Interests and Geopolitics in the Formulation of Ukrainian Foreign Policy 1994–1999," in Jennifer D. P. Moroney *et al*, *Ukrainian Foreign and Security Policy: Theoretical and Comparative Perspectives*, Westport: Praeger, 2002, p. 147, and (on Holubchenko) Yurii Shcherbak, "Vybor Tseli," *Stolichnye Novosti*, February 22–27, 2000, quoted in Tor Bukkvoll, "Defining a Ukrainian Foreign Policy Identity," p. 147.

66 Some suspected Odesa's Sotsial′no-Ekolohichna Spilka (Social-Ecological Union) and other groups opposing the building of the Pivdennyi terminal of being used by Russian interests to delay the completion of the terminal.

67 See R. Kravtsev, "Zolotoi styk," *Kyivs′kyi Telehraf*, No. 54, January 19–25, 2001, cited in Olena Viter, "Analitychna zapyska shchodo problem zapusku naftoprovodu Odesa-Brody," unpublished paper, June 29, 2004, p. 3.

68 As a legacy of the Soviet system, where energy-related infrastructure was controlled by Moscow and not by the republican capitals, both pipeline systems remained independent until 2001.

69 Although he ran against Kuchma in the first round of the 1999 presidential elections, Marchuk moved to the pro-Kuchma camp in the second round and was named head of the National Security and Defense Council (RNPO) in 2000, a position he held until 2001. After becoming head of the RNPO, Marchuk, who had his own oil interests, argued—among others in an official note to President Kuchma of April 27, 2000—that state investments in Odesa-Brody should be frozen due to poor planning, which he indirectly blamed on Buniak. But after the state company Ukrtransnafta was created in June 2001 and Oleksandr Todiichuk (actively supported by Marchuk) was named its president, Marchuk toned down his opposition to state involvement in the project, and by November 2002 this critique had disappeared. Although on the surface the differences seemed to be about the sources of financing for the pipeline (with Marchuk favoring the establishment of an international consortium and Buniak "building it on one's one"), what seemed to be at play at a deeper level was a difference in economic interests between Buniak and Marchuk concerning the extension of the pipeline to Poland. Whereas Marchuk supported the company Golden Gate and the creation of an international consortium and extending the Brody pipeline up to Plotsk, Buniak opposed the establishment of a consortium, and supported building a connection pipeline to the Druzhba pipeline with the company Przyjazn and the Polish state company PERN. After Ukrtransnafta was created and Marchuk-supported Todiichuk was hired to head it, Buniak was de facto removed from the building of the pipeline, and the project continued, but without him. (Indeed, some have argued that the very creation of Ukrtransnafta was an attempt to take power away from "Druzhba" and Buniak. The argument goes that Marchuk sought to hinder the building of the Odesa–Brody pipeline as long as the process was under Buniak's control, but had no reason to oppose it after it came under his indirect control with the establishment of Ukrtransnafta in 2001 and the naming of Todiichuk as its head.) See Kost′ Bondarenko, "Khto i chym volodiie v Ukraini," *L′vivs′ka Hazeta*, July 17, 2003 (reprinted in Ukrains′ka Pravda at www.pravda.com.ua), p. 13 of internet version, *NefteRynok*, July 8, 2001 (via ISI), Sergei Tsokolenko, "Gde nachinaetsia neft′, tam zakanchivaiutsia natsional′nye interesy?," *Zerkalo Nedeli*, No. 19/292, March 13–19, 2000, available at www.zn.ua/2000/2229/27046 (accessed August 14, 2007), Bogdan Golobud, "Ne vsë zoloto, chto blestit," *Gaz i neft′. Ėnergeticheskii biulleten′*, November 5, 2002 (via ISI), Kost′ Bondarenko, "V nemetskom plenu," *Gaz i neft′. Ėnergeticheskii*

biulleten´, August 22, 2001 (via ISI) and Valerii Tikhonov, "Chinovniki Evrosoiuza namereny finansirovat´ issledovanie neosushchestvimogo proekta," Oligarh.net, February 2, 2005, reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, February 3, 2005 (via ISI). On tensions between Golden Gate and "Druzhba" (Buniak), see *NefteRyno*k, November 26, 2000 (via ISI).

70 Leonid Nester (Head of the International Co-operation Division at AOA Ukrtransnafta), "Khrushenie khrustal´noi mechty, ili neskol´ko slov o mifakh i realiiakh kaspiiskoi nefti," *Zerkalo nedeli*, No. 42/517, October 16, 2004, p. 8.

71 Ibid.

72 In November 2003 Poland and Ukraine finally signed an agreement on the intention to build the extension to Plotsk, which many observers saw as purely symbolic or "declarative." See for example Elena Dem'ianenko, "Po proektu Odesa-Brody naiden kompromis," *Delovaia Nedelia-FT*, January 28, 2004 (via ISI).

73 The fact that Russia was looking for much more than an inexpensive way to bring its oil to Western markets—and namely seeking to torpedo Ukraine's energy diversification and the Caspian states' energy export diversification as well—is shown by the fact that in 2003 the Russian side rejected a less expensive proposal that would have allowed the same oil intended for transit through a reversed Odesa-Brody pipeline to be transported by the already existing Transdniester Pipeline System (Prydnistrovs´ki Mahistral´ni Hazoprovody) to Odesa.

74 Since 2003 joined with British Petroleum as TNK-BP.

75 For example, in February 2004 Minister of Fuel and Energy Yermilov requested PM Viktor Yanukovych to fire Ukrtransnafta head Stanislav Vasylenko for "sabotaging state decisions concerning the Odesa-Brody pipeline." *Profil´-Ukraina*, No. 6/21, February 16, 2004, p. 6. Translation mine.

76 See Dem'ianenko, "Po proektu Odesa-Brody." ISD's enthusiasm for European integration and for Odesa-Brody was temporarily dampened by the February 2004 Polish rejection of ISD's bid for the privatization of the Huta Czestochowa steel mill.

77 See Dorozhovets, "Fliuger-truba-2."

78 See also Vitalii Kniazhans´kyi, "Truba bez nefti," *Den´* (Russian-language edition), June 30, 2004, p. 5, Garik Churilov, "Yanukovich v Moskve 'pridumal,' kak napolnit´ nefteprovod 'Odesa-Brody,'" obkom.net.ua, July 5, 2004, in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, July 6, 2004 (via ISI), Tat´iana Vysotskaia and Yurii Lukashin, "Mozhet, po krugu. Ukraina ofitsial´no podderzhala i revers, i avers 'Odesa-Brody,'" *Ėkonomicheskie Izvestiia*, No. 26, July 9, 2004, in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, July 6, 2004 (via ISI), and Vitalii Kniazhanskii, "Rasshifrovka signala,' *Den´* (Russian-language edition), July 14, 2004, p. 1.

79 The issue gained international exposure in early April 2003 when the US, German and Polish ambassadors responded to the idea of a reversal with a front-page op-ed article in one of Ukraine's leading newspapers, strongly condemning the idea. (See Carlos Pascual, Ditmer Stüdemann and Marek Ziolkowski, "Dvukhsmyslennyi revers: Neft´ i evroatlanticheskii shans Ukrainy," *Den´* (Russian-language edition), April 3, 2003, p. 1.) Soon after that, a protocol for the full reversal of the pipeline, signed by the Ukrainian state oil company Naftohaz Ukrainy, Russia's Transneft and TNK was leaked to the press. (The first discussion of the protocol in the Ukrainian press was in Vitalii Kniazhanskii, "Protokoly neftegazovykh mudretsov: Pravda? Vymysel?," *Den´* (Russian-language edition), May 24, 2003, pp. 1, 2.) After that, a number of domestic and foreign actors quickly started to mobilize either for or against the project.

80 Purportedly for pipeline maintenance purposes.

81 See *NefteGazNedelia*, October 12, 2003. Accessed through the ISI Emerging Markets portal, available at www.securities.com (thereafter noted as "via ISI"). *NefteGazNedelia* is listed in the ISI portal under the English name *Ukrainian News—Oil & Gas Week.*

82 That then PM Yanukovych played a role in this decision, as well as the fact that Russian oil companies saw their interests in Ukraine (including the reverse use of the Odesa-Brody pipeline) better guaranteed by a Yanukovych than by a Yushchenko presidency was shown by the fact that, of the $300 million in Russian contributions (of a total of $600 million) PM Yanukovych spent on the 2004 presidential campaign, the largest share is reported to have come from energy companies. "Russia & the 2004 Presidential Elections," Global Security.org, available at www.globalsecurity.org/military/world/ukraine/election-2004-r.htm (accessed January 23, 2007).

83 "K 'Yuzhnomu' khochet prichalit′ Yukos," *NefteRynok*, June 30, 2003 (via ISI).

84 A reversal of the Odesa-Brody pipeline can affect Ukraine's agreements concerning a possible link between the Druzhba and Adria pipelines (and a reversal of the Adria pipeline originally flowing northward) to transit Russian oil to the Croatian port of Omisalj for further shipment West. These agreements were ratified in February 2004 after lengthy negotiations both with the other project partners (Russia, Slovakia, Hungary and Croatia) and within Ukraine (where ratification was delayed by fears that it would give Russia too much monopoly control over oil transit through Ukraine and finally achieved in 2004). The Druzhba-Adria project would be affected because the capacity of the Druzhba pipeline in the Ukrainian segment up to Brody is only 9 million Tons per year; if some or all of that that capacity were to be taken up by TNK oil to be later transported through Odesa-Brody to Odesa, then very little or no capacity would be left there for other oil to be transported to the Druzhba-Adria system in planning. Despite recent problems with the implementation of the project, its possible significance remains high. Thus, if looked at from the perspective of Ukraine's total oil transit revenue and not narrowly Odesa-Brody, reversing the pipeline would make little economic sense. On the debates about the Druzhba-Adria project, see "Transport 'Druzhba'-'Adria': poka nestykovka," *Gaz i neft′. Ėnergeticheskii biulleten′*, December 25, 2003 (via ISI).

85 Were Ukraine to abandon the original purpose of the pipeline, it would close one possible source of energy diversification for the country and become even more dependent on Russian oil. Similarly, Poland, Slovakia, the Czech Republic, and Germany would be deprived of an additional possibility to increase their import diversification. The shelving of the original Odesa-Brody project would also have important ecological implications for the Southern European region, as oil transit to Europe through the pipeline (instead of by tanker) would have reduced transit through the ecologically sensitive Bosphorus straits, an issue about which NATO-member Greece has been particularly sensitive. The floundering of the Odesa-Brody project would also have implications for the building of alternative, non-Russian-centered political groupings in the post-Soviet area. One of these, the Georgia-Ukraine-Azerbaijan-Moldova (GUAM) group, could be especially affected. Established in 1997 as a counterweight to Russian-led attempts at regional integration in the post-Soviet area, it has had an important energy component, as it is composed of countries which could benefit from an alternative, non-Russian controlled system of energy transit and supplies from the Caspian and Central Asian area, of which the Odesa-Brody pipeline would be the central element. Already weakened due to a variety of factors, the demise of the original pipeline project would further weaken this potentially important organization.

86 The TNK-BP proposal accepted in July 2004 was only for a three-year contract for the reverse use of the pipeline, and, as of 2005, only a fraction of the pipeline's capacity was used, with the respectively reduced revenue.

7 Rents of dependency and the problem of energy dependency

1 Rents are defined as revenue appropriated "without the input of any [of one's own] factors of production, or without the direct performance of any service in return."

Claudia Schmid, *Das Konzept des Rentier-Staates. Ein sozialwissenschaftliches Paradigma zur Analyse von Entwicklungsgesellschaften und seine Bedeutung fur den Vorderen Orient* (Munster and Hamburg: Lit Verlag, 1991), p. 78, quoted in Ulrich G. Wurzel, "Natural Resources, Geostrategic Interests and the Necessity of a New Economic Policy for Kazakstan," The Columbia Caspian Project (1999), available at www.sipa.columbia.edu/RESOURCES/CASPIAN/ked_p13.html#21 (accessed February 18, 2006).

2 Unveiling the whole picture of untransparent transactions in Ukraine's energy sector would be almost impossible to do anyway, even for the Ukrainian government itself: after taking office in 2005, the Yushchenko government sought to make a review of NAK Naftohaz Ukrainy's energy activities in the previous years, only to be prevented from doing so by the company's security service. See " 'Gosudarstvennye kholdingi zhili v svoë udovol´stvie,' govorit predsedatel´ Glav KRU Nikolai Sibul´skii (Interview with Nikolai Sibul´skii)," *Ukrainskaia Investitsionnaia Gazeta*, June 21, 2005 (via ISI, accessed June 25, 2005). Similarly, in August 2005 NAK Naftohaz Ukrainy denied representatives of the tax police access to important company documents.

3 Oleksandr Babanin, Volodymyr Dubrovskyi, and Oleksii Ivashchenko, *Ukraine: The Lost Decade... and the Coming Boom?* Kyiv: CASE Ukraine, 2002, p. 9.

4 This view is consistent with analyses of center parties in Ukraine as clientelistically structured in the sense that they are structured around the exchange of votes for access to executive decision making, which becomes especially important given the executive's role as, first, having resources that can in turn be used by the various parties to strengthen their own clientelistic networks (through patronage appointments, spending, and the ability to change rules) (Oleh Protsyk and Andrew Wilson, "Centre Politics in Russia and Ukraine: Patronage, Power and Virtuality," *Party Politics* 9, No. 6, 2003, pp. 703–727, p. 707) and, second, acting as a guarantor of "balance" in the system due to the ability to change rules. If we substitute clan for party, this characterization would apply as well.

5 In particular individuals such as Petro Dymins´kyi and Ihor Yeremeiev associated with the Halychyna Refinery in the Carpathian region.

6 Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 6.

7 In 2003 Gazprom announced that it would reduce the percentage of transit fees that it pays Ukraine trough barter arrangements. On barter and isolation from international price trends, see Hermann Clement, "Economic Aspects of Ukrainian-Russian Relations," in Kurt R. Spillman, Andreas Wenger and Derek Mueller, *Between Russia and the West: Foreign and Security Policy of Independent Ukraine*, Bern and New York: Peter Lang, 1999, p. 297.

8 "Yuri Boiko vyshel na okhranu granitsi," *Kommersant-Ukraina*, September 27, 2006, reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnii obzor*, September 27, 2006 (via ISI).

9 See Oles´ Tyshchuk, "Restrukturatsii restrukturizirovanno," *Gaz i neft´. Ėnergeticheskii biulleten´*, October 16, 2001 (via ISI).

10 Article 7 of the 1999 gas supply agreement between Gazprom and Ukraine explicitly banned the re-export of Russian gas. See Ganna Liuta, "Kazhdoi vetvi vlasti—po gazotreideru," *Zerkalo Nedeli*, No. 48/218, December 5–11, 1998, available at www.zn.ua/200/19152 (accessed July 30, 2007). The fact that this ban was seldom observed by Ukraine was a major contributing factor to Gazprom´s insistance (in its 2001 agreements with Ukraine) on the imposition of punitive export taxes on all gas exported from Ukraine as a way of discouraging re-exports.

11 While Gazprom has been especially vehement in its opposition to Ukraine and Belarus re-exporting gas purchased from it at "lower than world market prices," it has also opposed re-exports in its contracts with other European costumers. This banning of re-exports (also known as "redestination clauses") has been a strong point of contention between Gazprom and the European Union.

12 I.e. the amount of gas Ukraine is expected to use, import, and produce in a given year.

13 See Ivan Honta, "Borh za rosiis′kyi haz bude restrukturyzovano na 12 rokiv," *Dzerkalo Tyzhnia*, No. 39/363, October 6–12, 2001, and Alla Yer′omenko, "Politychnyi hazovyi pres," *Dzerkalo Tyzhnia*, No. 23/555, June 18–24, 2005 (via ISI), accessed June 25, 2005. Between late June and September 2005, gas re-exports were banned by the Ukrainian government. Interfax Russia & CIS Oil and Gas Weekly. September 21, 2005, available at www.accessmylibrary.com/coms2/summary_0286–9744458_ITM (accessed January 23, 2007).
14 IEA, *Ukraine Energy Policy Review 2006*, p. 172.
15 *Gaz i neft′. Ėnergeticheskii biulleten′*, March 15, 2000 (via ISI).
16 The export duty applied would be "at least equal to the difference between contract and world prices" (in 2000, $18–22 per 1,000 cm). Aleksandr Bekker, "Polufinal. Rossiia i Ukraina pochti dogovorilis′," *Vedomosti*, November 20, 2000, p. A4.
17 As noted by Russian Vice PM Viktor Khristenko: "this automatically precludes exports from Ukraine, regardless of whether this is Russian gas, Turkmen gas, or Ukrainian gas." *Gaz i neft′. Ėnergeticheskii biulleten′*, December 1, 2000 (via ISI).
18 Ukraine's top energy experts, as well as a number of Kuchma-era politicians, have been largely unanimous in confirming the existence of this type of arrangements. See for example Oleksandr Moroz (leader of Ukraine's Socialist Party) quoted in *Gaz i neft′. Ėnergeticheskii biulleten′*, February 13, 2002 (via ISI), Volodymyr Saprykin, interview in Radio Svoboda Ukrainian service "Priamyi Efir," April 12, 2005 17:00 UTC, text available at www.radiosvoboda.org/article/2005/04/69d7a9c5-6fdb-489e-9075 c4ed57a3c7bb9.html (accessed April 14, 2005), Dmytro Vydrin (Director, European Institute of Integration and Development, Kyiv) quoted in "Gazovyi kontsortsium. Otsenki ėkspertov," *Gaz i neft′. Ėnergeticheskii biulleten′*, July 16, 2002 (via ISI), Dmytro Vydrin, interview in *Nezavisimaia Gazeta*, November 16, 2000, p. 5, and Yevhen Marchuk, interview in *The Day*, No. 32, November 7, 2000, available at www.day.kiev.ua/266656/(accessed July 30, 2007).
19 V. Khmurych and T. Tkachenko, "Opportunities for Corruption in the Ukrainian Gas Market," Eurasia Foundation 1999. Available at: www.eurasia.org/programs/eerc/Kyiv/papers/khtk.htm (accessed May 1, 2004).
20 See Ibid.
21 Ibid., p. 5.
22 Such as in the case of contracts allocated by PM Pavlo Lazarenko in the mid-1990s and by Luhansk governor Oleksandr Yefremov in the late 1990s. On the accusations against Yefremov, see Andrei Stepankov, "Komu nuzhen korrumpirovanii gubernator," *Zerkalo Nedeli*, No. 43/316, November 4, 2000, available at www.zerkalo nedeli.com/ie/show/316/28942/ (accessed January 29, 2007).
23 See Khmurych and Tkachenko, "Opportunities for Corruption," p. 2.
24 On this topic, see also Hans von Zon, "The Reform of Ukraine's energy complex as a precondition for eliminating Ukraine's energy dependence," paper presented at the conference "Confronting Change: North East England and East European Coal Fields," November 12–13, 2001, available at www.suderland.ac.uk/~os)hva/zon.htm (accessed June 15, 2004), pp. 6–7.
25 See "Gazprom Muscles into Ukraine," *The Russia Journal* 2, No. 15, May 9–16, 1999 (via ISI).
26 See also Pëtr Burkovskii, "Rozhdënnaia ėvoliutsiei," *Kompan′ion*, No. 14/374, April 16–22, 2004, pp. 45–47, here p. 45.
27 In 2000–2001, the Ukrains′ka Spilka Promyslovtsiv ta Pidpryiemtsiv (USPP), and the "Yabluko" Party appealed publicly to President Kuchma to stop ITERA's monopolization of the Ukrainian gas market and its alleged attempts at artificially driving to bankruptcy gas-dependent electricity generating companies with the purpose of acquiring them at low prices. See "Ėnergeticheskaia Bezopasnost′ Ukrainy stala zalozhnitsei kompanii ITERA, schitaet partiia 'Yabluko,' " *Gaz i neft′. Ėnergeticheskii biulleten′*, April 12, 2001 (via ISI).

28 For example, according to the December 1999 contracts between NAK Naftohaz Ukrainy and Gazprom the purchase price for gas was $103 per 1,000 cm, while it was sold for domestic distribution for about a third of this price. Igor´ Maskalevich, "A teper´ sushite sukhari," *Zerkalo Nedeli*, No. 36/309, September 16–22, 2000, internet version available at www.zerkalo-nedeli.com/nn/show/309/28437/ (accessed June 15, 2003). During some periods, the official prices paid by Ukraine were also higher than those paid by Western European importers.

29 Ihor Maskalevych, "Minus 'Iteryzatsiia' vsiiei krainy," *Dzerkalo Tyzhnia*, No. 21/446, June 7, 2003, p. 9. On the manipulation of official prices see also Alla Erëmenko, "Treideram sovetuem sobrat´sia ili, na vybor, razdumat´sia, prignut´sia, prognut´sia—na rynok gaza vykhodit NAK," *Zerkalo Nedeli*, No. 36/205, September 5–11, 1998. On the connection between lack of transparency and prices see also Hermann Clement, "Economic Aspects," p. 298. We discuss discounted bills of exchange in more detail below.

30 See Charles Clover, "Sharp whiff on corruption threatens Ukraine sell-off," *Financial Times*, October 20, 2000, p. 9.

31 See declarations of Kostiantyn Hryhoryshyn, deputy director of the Ukrainian state-owned electrical company Enerhorynok in interview with Charles Clover, where Hryhoryshyn describes this scheme as follows: "At the same time that Russia was agreed to sell Europe gas as Dollars 60 per 1,000 cm, Ukraine for some reason agreed to buy it for Dollars 80, even though transport to Europe is far more expensive than transport to Ukraine. (. . .) the reason was that you could charge Dollars 80 cash in Ukraine, and pay Russia with, say, Dollars 40 worth of barter goods which you would value at Dollars 80, and the difference would find its way somewhere else." Kostiantyn Hryhoryshyn, interview with Charles Clover, Ibid, p. 9.

32 Between the approximate dates of 1993 and 2000, Ukraine purchased gas from Gazprom at the official price of $80 per 1,000 cm, while the prices charged by Gazprom to Western European states were often lower. Aleksandr Chalyi, "Ėnergeticheskaia diplomatiia Ukrainy—plan deistvii dlia G-8," *Zerkalo Nedeli*, No. 26/605, July 8–14, 2006, available at available at www.zerkalo-nedeli.com/ie/show/605/53900/ (accessed July 12, 2006).

33 According to Dubrovskyi *et al*, this "overfishing" for rents got out of control even from the perspective of President Kuchma himself (who, for all his centrality to the "balancing" system, could not remain aloof to the general economic health of the country), leaving his regime no choice but to initiate reforms, thus explaining the naming of Viktor Yushchenko as PM in December 1999. See Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, pp. 80 ff.

34 For example, when rights for the import of 20 bcm of gas from Turkmenistan in 1999 were given to the company Ukrinvesthaz, Ukraine had already signed agreements for the supply of 30 bcm by Gazprom as payment for transit, 25 bcm supplied by Gazprom through ITERA, and 17 bcm domestic production. The new contracts through Ukrinvesthaz would raise total supplies to 92 bcm, while Ukraine's 1999 gas consumption was not expected to exceed 80 bcm, which would lead to about 10 bcm of surplus gas in 1999. See *NefteRynok*, December 9, 1998 (via ISI).

35 Ukrainian companies involved in barter with Turkmenistan regularly overcharged for the products being bartered, for example selling them at 200 percent above the average world prices, or sneaked into the barter agreements overpriced and little-needed products, of which rain boots bartered in the mid-1990s to chronically dry Turkmenistan were the clearest example. See "Gazprom Muscles into Ukraine," *The Russia Journal* 2, No. 15, May 9–16, 1999 (via ISI).

36 One of the accusations made against Yuliia Tymoshenko was that she had been involved in smuggling, processing 445 million Hryvnias (*c.* $243 million calculated at the exchange rate of 1.8295 Hryvnia/$ valid for 1996) worth of Russian (Gazprom)

gas as if it was British gas in 1996. See "Delo Lazarenko," *Gaz i neft´. Ėnergeticheskii biulleten´*, January 17, 2001 (via ISI).

37 It could also be argued that these companies' inability to pay their gas bills was related to the fact that they had been chosen on the basis of political criteria and not on their own merits.

38 See "Postanova Kabinetu Ministriv 'Pro postavky Turkmens´koho hazu v Ukrainu v 1999 rotsi," 1998, cited in Liuta, "Kazhdoi vetvi vlasti—po gazotreideru." In many of these cases, although the state was the official signatory of the gas import agreements, due to its inability to carry these out, it empowered private companies such as Respublika, ITERA and others to carry out the agreements.

39 According to some estimates, between 1992 and 1999 some $25–40 billion (generated through imports-exports and other types of rents) flew outside of Ukraine through the use of fake companies and contracts. Oxford Analytica Brief, May 9, 2000, cited by Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 44.

40 See Khmurych and Tkachenko, "Opportunities for Corruption."

41 See Vremia, ORT TV, October 16, 2000 21:00 Moscow Time, Viktor Timoshenko and Liudmila Romanova, "Vsia pogoda delaet´sia v Kremle," *Nezavisimaia Gazeta*, October 17, 2000, p. 1, and *Gaz i neft´. Ėnergeticheskii biulleten´*, August 1, 2000 (via ISI).

42 The stealing accusations gave Ukraine much negative public relations attention, the most damaging of which probably being Gazprom's 2000 suit (through its insurer Monegasque de Reassurances of Monaco) at the International Commercial Arbitration Court, which ordered Naftohaz Ukrainy to pay for $88,256,704 worth of stolen gas. See Jan Adams, "Russia's Gas Diplomacy," *Problems of Post-Communism* 49, No. 3, 2002, pp. 17–18, and *Gaz i neft´. Ėnergeticheskii biulleten´*, June 15, 2001 (via ISI).

43 Ukraine's top energy experts, as well as a number of Kuchma-era politicians, have been largely unanimous in their assessment of the question. See note 18 above.

44 In 2000, Russia's *Nezavisimaia Gazeta* "accused the Ukrainian Ministry of Energy of actually issuing secret instructions" regulating the amount of gas to be diverted. Oles M. Smolansky, "Ukraine and Russia: a Marriage of Inconvenience," paper presented at the John Hopkins University School of Advanced International Studies, October 26, 2001. Available at www.sais-jhu.edu/programs/res/papers/Smolansky_paper_web.pdf (accessed May 30, 2006), pp. 6–7, citing Denis Petrov in *Nezavisimaia Gazeta*, October 17, 2000, and Jan Maksymiuk, "Russia's Double Bypass," *RFE/RL Newsline* 4, No. 206, part I (October 24, 2000) and 5, No. 125, part II (July 2001).

45 The fact that it was exactly an oil embargo that was used by Russia to put pressure on Ukraine to stop the "unsanctioned taking" of *gas* from the pipeline and to reduce gas transit fees is especially interesting from the point of view of the Russian state's continued ability to put pressure on Russian oil companies (an area where at the time state control was minimal in comparison with the gas sector) to intervene regarding a non-oil related issue. At the same time, the Russian state's control of the Transneft oil transit monopolist gave it a continued lever of influence on oil companies.

46 For example, the so-called Southern branch Yamal project (Yamal II) that would have connected with the Druzhba pipeline in Belarus and run through Poland and Slovakia, bypassing Ukraine. After much discussion in 2000 and 2001 the project was shelved in fall 2002 after Gazprom´s relations with Ukraine improved. In 2003 Gazprom and Naftohaz Ukrainy signed a 10-year gas transit agreement according to which Gazprom would transit to Western Europe through Ukraine no less than 110 bcm of gas per year.

47 Bills of exchange came increasingly into disuse after 2000 as a result of the increase in cash payments and general improvement of the Ukrainian economy, as well as of Gazprom's crackdown on barter and bill of exchange operations.

48 On bills of exchange operations, see Yurii Savka, "Vzaiemozalik iak sposib zhyttia," *Enerhetychna Polityka Ukrainy*, No. 6, 2000, pp. 30–34.
49 See also Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs* 77, No. 5, 1998, pp. 53–68.
50 Khmurych and Tkachenko, "Opportunities for Corruption," p. 5.
51 See for example "Rossiiskoe delo," *Gaz i neft′. Ėnergeticheskii biulleten′*, January 17, 2001 (via ISI).
52 See Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 50.
53 The importance of state-regulated energy and other utility prices in the relationship between the government and various BAG's became clear once again in 2005 when the Yushchenko-Tymoshenko government "declared war" on the main Ukrainian BAGs involved in heavy metallurgy by significantly increasing the price of rail freight services.
54 Babanin, Dubrovskyi *et al* estimate that in 1992 alone total rents related to exports amounted to $4.1 billion, or 20 percent of GDP, as domestic prices for many export goods were ten times lower than market ones. Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 50.
55 See Bakai's quotation in *The Warsaw Voice*, April 8, 2001, available at www.warsaw.voice/pl/v650/News12.html (accessed April 25, 2003). Given the enormous role played by Turkmenistan-related gas trade deals in the acquisition of energy rents, however, the statement should be amended to read "all political fortunes in Ukraine were made on the basis of Russian *and Turkmen* gas."
56 The taxation of Ukraine's oil and gas trade with Russia has been subject to a variety of complex and changing regulations involving country-of-origin or country-of destination application of VAT by Russia and Ukraine, export and excise taxes. See Clinton R. Shiells, "Optimal Taxation of Energy Trade: the Case of Russia and Ukraine," pp. 2–6, available at www.etsg.org/ETSG2005/papers/shiells.pdf (accessed June 28, 2006), and Clinton R. Shiells, "VAT Design and Energy Trade: The Case of Russia and Ukraine," *IMF Staff Papers* 52, No. 1, 2005, pp. 103–119. While it is impossible to fully trace the changing regulations here, it is worth noting that the very complexity of these regulations facilitated their manipulation for both tax-evasion and political purposes.
57 See Yevhen Martsenko and Pavlo Boruta, "Osoblyvosti proiavu orhanizovanoi zlochynnosti v PEK Ukrainy," *Enerhetychna Polityka Ukrainy*, No. 11, 2001, pp. 62–68. See also Sergei Kuiun, "Svobodnyi benzin," *Zerkalo Nedeli*, No. 12/591, April 1–7, 2006, available at www.zerkalo-nedeli.com/nn/show/591/53014/ (accessed April 10, 2006).
58 Oil imports at lower than world prices were available until the early 2000s, in part through the use of intra-corporate pricing for the supply of oil from Russian mother companies to their subsidiary refineries in Ukraine. But because such arrangements could no longer be used as these Russian-owned refineries acquired a legally more independent status in the 2000s, by 2002 Ukraine was largely paying world (European) prices for oil imported from Russia.
59 The tax benefits given to the enterprises with foreign investment (EFIs) went largely uncontested until 1999, when they began to be challenged in the Rada and elsewhere, fueled by the revival of Ukrainian refineries. In March 1999 the refinery side scored a partial victory when EFIs tax-free foreign trade operations were suspended by a resolution of the Cabinet of Ministers, but in July they were reinstated by a Rada resolution ("Kto v 2000-y?," *NefteRynok*, December 20, 1999 (via ISI); see also *NefteRynok*, October 8, 1999 (via ISI)). The issue went to Ukraine's Constitutional Court, and on August 14, 1999 the Cabinet of Ministers reinstated the validity of the tax breaks; according to some, not only because of the "need" to raise contributions for the 1999 election campaign (*NefteRynok*, January 23, 2000 (via ISI)), but also because of pressure: in a show of their strength, EFIs had responded to the March

suspension of their tax breaks by boycotting the import of oil products (gasoline) to Ukraine, with the result that gasoline imports for the whole spring 1999 were lower than the import for a single week in 1998 (*NefteRynok*, December 6, 1999 (via ISI)). The confrontation continued throughout Yuliia Tymoshenko's tenure as Vice PM; although the decision on EFIs was subsequently changed several times, the taking away of these privileges is considered one of Tymoshenko's successes as Vice PM for energy (Burkovskii, "Rozhdënnaia ėvoliutsiei," p. 46). The breaks were suspended and restored repeatedly over the next two years, and in many occasions the suspensions were challenged in court by the EFIs involved, who sued to have the taxes paid returned to them. In February 2001 the Council of National Security and Defense passed a resolution condemning the tax breaks, as a result of which President Kuchma had to sign an Ukase stopping the tax breaks ("Antologiia 'Bizonov,'" *NefteRynok*, March 25, 2001 (via ISI)). After negotiations and counter-negotiations that drew on for years, on June 7, 2001, the Rada canceled the tax benefits for the import of diesel during the agricultural season, and the tax breaks ended definitively on January 1, 2002 ("'Peniat′ bol′she ne na kogo," *NefteRynok*, June 17, 2001 (via ISI)).

60 While this statement accurately reflects the overall situation, the history of tax breaks for EFIs and the attempt to eliminate them is so long and convoluted that many instances can also be found where the Kuchma government sought to eliminate the tax privileges.

61 See "Antologiia 'Bizonov.'"

62 As stated by Dubrovskyi, Graves, *et al*: "it was just impossible to register such a firm unless having a top-level patron." V. Dubrovskyi, W. Graves, Y. Holovakha, O. Haran′, R. Pavlenko, and J. Szymer, "The Reform Driving Forces in a Captured State: Lessons from the Ukrainian Case," first draft of the Understanding Reform Project, Kyiv, mimeo, 2003, p. 26.

63 Anders Aslund, in "Kuchmagate: Political Crisis in Ukraine," *Meeting Report* 3, No. 3, February 14, 2001, Carnegie Endowment for International Peace, available at www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=274 (accessed May 28, 2006).

64 The pro-Kuchma United Ukraine bloc included parties related to the Donetsk and Dnipropetrovsk clans, such as the Party of Regions and Working Ukraine. See Tor Bukkvoll, "Private Interests, Public Policy: Ukraine and the Common Economic Space Agreements," *Problems of Post-Communism* 51, No. 5, 2004, pp. 11–22, here p. 15.

65 The delay in the setting-up of the company was related to strong opposition in the Rada. Many Rada deputies tried to block NAK Naftohaz Ukrainy's establishment because they believed the Cabinet of Ministers had overstepped its competencies in establishing the company (Alla Erëmenko, "'Naftohaz Ukrainy': Kratkaia Istoriia v Sobytiiakh i litsakh," *Zerkalo Nedeli*, No. 19/444, May 24–30, 2003, available at www.zn.ua/2000/2200/38608/ (accessed July 31, 2007)), but mainly because many believed the establishment of a single company covering both the oil and gas areas would be a mechanism for collecting money for the 1998 Rada elections and the 1999 presidential elections (*NefteRynok*, April 2, 2002 (via ISI)). This opposition was only partially successful—although the establishment of NAK Nafthohaz Ukrainy could not be stopped, it was slowed somewhat, and the company did not succeed in adding oil refineries to its holdings.

66 The issue of which state organ should NAK Naftohaz Ukrainy be subordinated to (and, thus, what degree of freedom would it enjoy) would become a major issue of contention in late 2003 as the Donetsk group put pressure for the company to be subordinated to the Ministry of Energy, which would have made it possible for the Donetsk group to control the company better, given the fact that it controlled the ministerial position through the "quota system" for the allocation of ministerial posts. The change did not take place, however, as President Kuchma annulled a decree to this effect.

67 See “A teper′-revoliutsiia,” *Vlast′ deneg*, March 12, 2005.

68 The decision to create the Enerhetychna Kompaniia Ukrainy seemed to have been related to larger trends in the battle for Ukraine’s electricity sector and the relationship between Ukrainian and Russian oligarchs—it has been argued that the establishment of the company was a response to Russia’s Anatolii Chubais announcement of his company’s (RAO-UES) plans to become a shareholder in 10 Ukrainian oblenerhos and participate in the further privatization of the in Ukraine’s electricity sector. See Nataliia Kobel′chuk, “Vlast′ forsiruet sozdanie NAK ‘Ėnergeticheskaia kompaniia Ukrainy,’ ” *Delovaia Nedelia* 6, No. 166, February 19–25, 2004, p. 4.

69 Also referred to as “rent swamps.” See Margarita M. Balmaceda, “Some Thoughts on Rents of Energy Dependency, ‘Rent-seeking Swamps,’ and Political Development: the Ukrainian Case in Comparative Perspective,” circulated for discussion at the Workshop on Post-Communist Politics and Economics, Harvard University, March 13, 2006, available at www.fas.harvard.edu/%7Epostcomm/papers/2005–06/Balmaceda.pdf (accessed May 25, 2006).

70 See Oleksii Haran′, cited in Ilona Zaets and Sergei Kiselëv, “Kontrol′ vysokogo napriazheniia,” *Kompan′ion*, No. 4/364, February 6–12, 2004, p. 8.

71 See Ibid.

72 See editorial comments and interview with Petro Oliinyk, (MP from Nasha Ukraina), member of Rada Committee on energy, *Postup-tyzhnevyk*, April 15–21, 2004, p. 7. Nasha Ukraina MP Mykhailo Volynets′ commented on Tulub upon his appointment: “He is someone who convinced the Presidential Administration that he will ‘guarantee’ in the energy sector all needed conditions so that the results of the presidential elections are in accordance with the ‘power that be’s’ needs.” Mykhailo Volynets′, quoted in *Postup-tyzhnevyk*, April 15–21, 2004, p. 7. See also comments by Kost′ Bondarenko and Yuliia Tymoshenko, quoted in “Svoi Tulub blizhe k telu,” *Ukrainskaia Pravda*, at www.pravda.com.ua. (originally published on April 13, 2004, 21:46). Translation mine.

73 See for example *NefteRynok*, April 2, 2002 (via ISI).

74 Oles′ Tyshchuk and Taras Smakula, “Boiko s vertikal′nym vzlëtom,” *Gaz i neft′. Ėnergeticheskii biulleten′*, March 14, 2002 (via ISI). By *adminresursy* or administrative resources is usually meant the funds operated directly by the president for political goals, as well as the possibility of using state resources for his own political purposes.

75 See Oleksii Haran′, cited in Zaets and Kiselëv, “Kontrol′ vysokogo napriazheniia,” p. 8, and Aleksandr Gudima, quoted in *Gaz i neft′. Ėnergeticheskii biulleten′*, June 25, 2003 (via ISI).

76 On the lack of public discussion and coordination with other parts of Ukrainian energy policy in plans for the (re)creation of a “coal NAK” (Vuhil′ Ukrainy) in 2004, see Oleg Kil′nitskii, “V ozhidanii ‘Toplivo-ėnergeticheskoi kompanii,” *Kievskie Vedomosti*, April 22, 2004 (via ISI).

77 As noted by a Ukrainian trade publication: “Ihor Bakai built that pyramid [NAK Naftohaz Ukrainy] around himself, and its function was to make money not only for the state, and possibly, not mainly for the state.” Oles′ Tyshchuk and Kost′ Bondarenko, “Geometriia ot Bakaia,” *Gaz i neft′. Ėnergeticheskii biulleten′*, June 15, 2001 (via ISI). Translation mine.

78 Tyshchuk and Bondarenko, “Geometriia ot Bakaia.” A transcription of part of the Mel′nychenko tapes implicating Azarov and NAK NU is included in the article.

79 On the expectation of financial contributions, see Oles′ Tyshchuk and Taras Smakula, “Boiko s vertikal′nym vzlëtom,” *Gaz i neft′. Ė nergeticheskii biulleten′*, March 14, 2002 (via ISI). This view is also confirmed by still unauthenticated recordings of conversations between President Kuchma and Ihor Bakai and Kuchma and Mykola Azarov, head of the Tax Administration. These alleged conversations were made public in the course of the “Gongadze affair” and are discussed in Global Witness “It’s a Gas—Funny Business in Turkmen-Ukraine Gas Trade” (April 2006), available at www.globalwitness.org/reports/show.php/en.00088.html (accessed May 15, 2006), p. 28.

80 Yurii Boiko (head of NAK Naftohaz Ukrainy 2002–2005) in particular was able to build the reputation of a proactive and entrepreneurial manager, which he used to start his own political party (Republican Party) after his dismissal in 2005 following the Orange Revolution.

81 Between its establishment in 1998 and 2006, NAK Naftohaz Ukrainy had "never been subjected to a consolidated, financial audit by an independent auditor." IEA, *Ukraine Energy Policy Review 2006*, p. 161. See also Alla Erëmenko, "Aleksei Ivchenko: 'Menia nikto ne snimal, ne snimaet i snimat′ ne budet,' " *Zerkalo Nedeli*, No. 15/594, April 22–28, 2006, available at www.zerkalo-nedeli.com/ie/show/594/53234/ (accessed April 30, 2006).

82 Jonathan P. Stern, "Soviet and Russian Gas: the Origins and Evolution of Gazprom's Export Strategy," in Robert Mabro and Ian Wybrew-Bond, *Gas to Europe: The Strategies of Four Major Suppliers*, Oxford: Oxford University Press/Oxford Institute of Energy Studies, 1999, p. 158.

83 By "negotiated accounting price" we mean a price that is both "negotiated" between both sides (i.e. not necessarily a market price) and calculated for accounting purposes, as for example when barter operations are expressed in money terms for accounting purposes, but without actual money exchanging hands.

84 Commenting in 2002, Volodymyr Dubrovskyi of CASE Ukraine argued that, of the 1.5 to 2 billion $ dollars that should accrue to the state yearly from gas transit fees, the state received only a small portion not exceeding 20 percent. Volodymyr Dubrovskyi (CASE Ukraine), quoted in "Gazovyi konsortsium. Otsenki ėkspertov," *Gaz i neft′. Ėnergeticheskii biulleten′*, July 16, 2002 (via ISI).

85 During the mid-1990s (1995–1996), imports of gas from Turkmenistan were organized by the company TurkmenRosGaz, a joint venture owned by the Turkmenistan government (51 percent), Gazprom (45 percent) and ITERA (4 percent).

86 After Rem Viakhirev's removal as head of Gazprom and its replacement by Putin ally Aleksei Miller in June 2001, the company tried to recover some of the assets ITERA had taken from it.

87 See Catherine Belton, "Suspicions Raised by Gas Giant's New Deal," *The St. Petersburg Times*, February 28, 2003, available at www.sptimes.ru/ index.php?action_id=2&story_id=9440 (accessed June 28, 2006), as well as additional materials from Jane's Intelligence Digest, Radio Free Europe/Radio Liberty, and the early March 2003 Moscow press. In 2005, the company was replaced by RosUkrEnergo, a JV of Gazprom and Austrian and Ukrainian partners. It has been argued that the change was due to Gazprom's pressure to acquire 50 percent ownership in the intermediary company, so as to receive half of the profits, as Eural Trans Gas was controlled mainly by Ukrainians.

88 The way this was reportedly organized is as follows: Eural Trans gas would arrange the transit and supply to Naftohaz Ukrainy of 36 bcm of gas in 2003–2006. Eural Trans Gas would pay Gazprom $470 million in transit fees per year for the use of its pipelines, and Ukraine would pay Eural Trans Gas 13.7 bcm of gas, which would be worth between $600 million (if sold in CIS markets) and $1.5 billon (in Western European markets), thus generating between $130 million and $1 billion in profits for the company. See Roman Kupchinsky, "Naftohaz Ukrainy: A Study in State-Sponsored Corruption," (Parts I and II) Radio Liberty/Radio Free Europe Corruption Watch 3, No. 25, available at www.rferl.org/corruptionwatch/archives.asp and www.uanews.tv/archives/rferl/cct/cct037.htm (accessed August 25, 2003). See also press conference of Oleksandr Turchynov, former head of Ukraine's Security Service (SBU) during the Yushchenko government in 2005, in www.pravda.com.ua, Global Witness, "It's a Gas," and Roman Kupchinsky, "The Unexpected Guest: RosUkrEnergo," paper presented at the Conference on The Ukrainian-Russian Gas Crisis and Its Aftermath: Economic, Political and International Ramifications, Harvard University, February 5–6, 2006, streaming video available at www.huri.harvard.edu/na/na_gas_conf_2006.html (accessed June 15, 2006).

89 See “A teper′—revoliutsiia,” *Vlast′ deneg*, March 12, 2005.
90 Vitalii Kniazhans′kyi, “Comrade Reverse,” *The Day* (Kyiv), March 16, 2004, p. 3; originally published in Ukrainian in *Den′*, March 12, 2004, p. 4.
91 Ibid.
92 Ibid.
93 The Russian oil transit monopolist.
94 Consultation with former high manager of a Ukrainian oil company, Kyiv, July 2004.
95 This section has focused on joint rent-extraction deals between Ukrainian and Russian energy managers, but has said little about schemes involving Turkmen energy managers or corporations. Given the fact that Turkmenistan has become an increasingly important gas supplier for Ukraine, such connections deserve to be analyzed. We have not done so in this book, however, because of our focus on the energy dependency relationship with Russia and because of the difficulties involved in gaining any insight into inner-company politics in a near-totalitarian state such as Turkmenistan. It could be assumed, however, that President Saparmurat Niyazov (1991–2006) kept close personal control over energy rents. See also Global Witness, “It’s a Gas—Funny Business in Turkmen-Ukraine Gas Trade” (April 2006), available at www.globalwitness.org/reports/show.php/en.00088.html (accessed May 15, 2006).
96 Improvements in LNG technology only partially change this situation, as transit by pipeline will continue to be the main means of gas transport in the European region.
97 The degree of actual competition between Russian oil companies in supplies to the post-Soviet area needs to be qualified, however, as various companies may have an especially high market share in particular areas.
98 See Babanin, Dubrovskyi, and Ivashchenko, *Ukraine: The Lost Decade*, p. 50.
99 See Dubrovskyi *et al*, “The Reform Driving Forces,” pp. 9–10.

8 Energy and the rise and fall of the Orange Revolution

1 Popular saying of the late Soviet era.
2 With the powers of the Prime Minister substantially increased as a result of the Constitutional Reform that came into effect on January 1, 2006, it is appropriate to consider the post-August 2006 as Yanukovych’s, not Yushchenko’s, era.
3 “Konflikt Interesov,” *Galitskie Kontrakty*, May 2, 2005 (via ISI).
4 See declarations by Petro Poroshenko, interview in BBC Rankova Prohrama, July 12, 2005 07:00 am Kyiv time (0400 UTC), heard live on www.bbc.co.uk/ukrainian/index.shtml.
5 On May 1, 2006, residential gas prices were raised by 25 percent, and, effective July 1, by an additional 85 percent.
6 For years, international organizations have recommended Ukraine a move to higher end-consumer energy prices, accompanied by targeted subsidies for the most vulnerable parts of the population.
7 BBC Rankova Prohrama, July 4, 2006, 07:00 am Kyiv time (0400 UTC), heard live on www.bbc.co.uk/ukrainian/index.shtml.
8 On July 19, 2006, Ukrtransnafta paid, ahead of schedule, its $107.5 million debt to Scilton Ltd., which it had taken in July 2004 to pay for “technical oil” for the pipeline; one of the conditions for the credit was the reverse use of the pipeline. Having paid off the debt, Ukrtransnafta returns to itself the right to make independent decisions about the future of the pipeline.
9 The text of the Strategy is available at the Ministry of Fuel and Energy’s Website, www.mpe.kmu.gov.ua/control/uk/archive/docview?typeId=36172 (accessed May 5, 2006).
10 Sergei Ermilov [former minister of energy], “Zametki k programme Partii Ėkologicheskogo Spaseniia ‘EKO+25%,’ ” (paid political advertising) *Zerkalo Nedeli*, No. 5/584 (February 11–17, 2006), available at www.zerkalo-nedeli.com/nn/show/584/52569/

(accessed March 1, 2006). For additional comments on the Strategy, see *Ėnergeticheskaia Politika Ukrainy*, No. 3, March 2006.

11 The IEA states: "even if Ukrainian companies actually start producing hydrocarbons abroad, it is doubtful that this will result in actual gas deliveries to Ukraine." IEA, *Ukraine Energy Policy Review 2006*, p. 171.

12 The International Energy Agency referred to the projections contained in the document as "based not on economic analysis, but on policy goals" and "government aspirations" more than "real projections." IEA, *Ukraine Energy Policy Review 2006*, p. 81.

13 In May 2005, as gasoline prices started to increase rapidly, the government responded by setting mandatory price limits, and serious shortages followed.

14 President Yushchenko's attempt to save the relationship with the Russian traders by personally apologizing to Russian oil company CEO's for Tymoshenko's handling of the situation marked a first crisis in their relationship. It is widely believed that, following the oil crisis, Tymoshenko was not allowed to have a real impact on energy policy decisions.

15 PM Tymoshenko's original threat to review up to three thousand Kuchma-era privation agreements created panic among investors.

16 Socialist deputy Yosyp Vins´kyi's words on this issue, pronounced just days after Yushchenko taking the oath of office, turned out to be prophetic: "Business will not be in the opposition, it will seek contacts with the new power, because our business [in Ukraine] is based on the stealing away of state moneys, and, obviously, today they [business] have hope, and to keep what they have, they have to establish contacts. I believe (...) this could be the end of the new power. The new power [government] needs to be careful about such demonstrations of love. (...) All vote for the boss." Rada MP Yosyp Vins´kyi. (Socialist Party), interview in Radio Svoboda, February 4, 2005, 18:00 UTC, www.radiosvoboda.org (accessed February 5, 2005). Translation mine.

17 Justice Minister Zvarych refused to sign a governmental decree prohibiting oil re-exports, a bill he considered unconstitutional, but which also made impossible a large-scale oil re-exports operation brokered by his wife, who works in an oil trading company. Zvarych rebuked accusations of personal interest by in turn accusing another Nasha Ukraina deputy, Ihor Yeremeiev, of trying to pressure his wife's company into an illegal oil re-exports scheme involving the Halychyna refinery, where Yeremeiev has an important interest, and which would have costed the state millions of dollars in lost tax revenue. See also Alla Erëmenko, "Cherchez Le Petrol," *Zerkalo Nedeli*, No. 6/534, February 19–25, 2005, available at www.zerkalo-nedeli.com/ie/print/49288 (accessed February 26, 2006).

18 On February 17–18, 2005, armed individuals occupied the offices of the Ivano-Frankivsk and Poltava oblenerhos, where a property conflict between Hryhoriy Surkis and Kostiantyn Hryhoryshyn had been simmering for years. Hryhoryshyn, emboldened by Surkis' "defeat" in the Orange Revolution, was seeking to re-establish control over five Ukrainian oblenerhos.

19 By the fall of 2006, after Yanukovych's return to the post of PM, representatives of the Donetsk area had virtually taken control over important policy areas, with Vitalii Haiduk named head of the RNBO (National Security and Defense Council). Their increased power was also reflected in an increase in the power of Donestk representatives (mainly representatives of Akhmetov-rival Industrial Union of Donbass) within Nasha Ukraina and Viktor Yushchenko's inner circle.

20 *Ukrains´ka Investytsiina Hazeta*, No. 9, March 9, 2005 (via ISI).

21 Tat´iana Vysotskaia, "Neftegazovyi KUNak," *Ėkonomicheskie Izvestiia*, No. 30, March 4, 2005 (via ISI).

22 Vitalii Kachanov, "Tochki nad I," *Ėnergobiznes*, May 15, 2006 (via ISI).

23 MP Oleksandr Hudyma, quoted in Oleg Gavrish, "Za TEK vzialis′ vser′ëz," Ukrains′ka Pravda website, September 15, 2006, available at Pravda.com.ua. Reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, March 4, 2005 (via ISI).

24 Boiko did not remain out power for long, however: in August 2006, he was named Minister of Fuel and Energy by PM Yanukovych.

25 In 2005 NAK Naftohaz Ukrainy paid twice as much taxes and in the previous year, making a significant contribution to the budget. Much of that income was used to finance social programs (increasing pensions, salaries, child allowances, and so on) that, it was hoped, would bring victory to Nasha Ukraina in the March 2006 Rada elections. By 2006, the company it was in tax arrears again. Oles′ Tyshchuk, "Na gazovom pole—kak na futbole," *Gaz i neft′. Ėnergeticheskii biulleten′*, June 25, 2006 (via ISI).

26 Roman Olearchyk, "SBU to investigate gas siphoning," *Kyiv Post*, June 23, 2005 p. 14.

27 Radio Svoboda, Ukraina i Svit program to Ukraine, August 15, 2005, 18:00, available at www.radiosvoboda.org. See also materials posted in the Ukrains′ka Pravda website (www.pravda.com.ua), August 13–15, 2005.

28 Tatiana Serafim, "Ukrainian Billionaires May Be Behind Murky Gas Deal," Forbes.com, January 13, 2006.

29 Yuliia Mostovaia, "O butonakh, tsvetochkakh i iagodkakh," *Zerkalo Nedeli*, No. 2/581, January 21–27, 2006, available at www.zn.kiev.ua/ie/index/581/ (accessed January 21, 2006).

30 Turchynov's press conference, September 15, 2005, as transcribed by the Ukrains′ka Pravda website, available at www.pravda.com.ua/ru/news/2005/9/15/32610.htm (accessed October 1, 2005). Translation mine.

31 The agreement ("Memorandum of Understanding Between the Government and Opposition"), seen by many as a major betrayal of the Orange Revolution, was signed on September 22 as a condition for Party of Regions deputies' support for the candidacy of Yurii Yekhanurov as PM. One of its clauses provides amnesty from criminal prosecution for those accused of committing election fraud in the 2004 presidential elections.

32 As made public in late April 2006, RosUkrEnergo is owned in equal parts by Arosgas Beteiligungs Holding AG (in turn owned by Gazprom), and by Centragas Beteiligungs Holding AG, in turn owned by Ukrainian citizens Dmytro Firtash (90 percent) and Ivan Fursin (10 percent).

33 See Alla Yer′omenko, "Shalom Hazavat, slov'iany," *Dzerkalo Tyzhnia*, No. 1/580, January 14, 2006.

34 "Ukrainskie deti Gazproma," *Korrespondent*, May 6, 2006 (reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, May 10, 2006 (via ISI)). Firtash has also been suspected of being connected to underworld figure Semën Mogilevich. Yuliia Mostova, "Hazova Firtashka," *Dzerkalo Tyzhnia*, No. 17/596, April 29–May 12, 2006, available at www.zn.kiev.ua/ie/show/596/53328/ (accessed May 15, 2006), and Global Witness "It's a Gas—Funny Business in Turkmen-Ukraine Gas Trade," April 2006, available at www.globalwitness.org/reports/show.php/en.00088.html (accessed May 15, 2006), p. 57. In December of 2006, *The Wall Street Journal* reported on a US investigation on RosUkrEnergo's suspected links with organized crime. See Glenn R. Simpson, "U.S. Probes Possible Crime Links To Russian Natural-Gas Deals," *The Wall Street Journal*, December 22, 2006.

35 One element of L′ovochkin's biography ties him to Kuchma's search for energy players not under the control of any of the main BAG's to administer his NAK Naftohaz-centered deals, discussed in Chapter 7: "although he came from the Donetsk region, he is not under the control of any of the local business groups." Yurii Feofantov, "Firtash, utrativshii nevinnost′," *Gaz i neft′. Ėnergeticheskii biulleten′*, May 25, 2006 (via ISI).

36 Ibid. The fact that Fursin owns only 10 percent of Centragas shares, as opposed to Firtash's 90 percent, would seem to counter this argument, however.

37 According to Yuliia Mostova, Firtash gave a "seven-figure" election contribution to Yushchenko, "three times smaller than Borys Berezovs´kyi's" contribution to Yushchenko's 2004 campaign, estimated at $15 million. If one accepts these assumptions, Firtash's contribution could be estimated at around $5 million. Mostova, "Hazova Firtashka."

38 Viktor Yushchenko, interview with Ukrinform, January 12, 2006, printed in *The Action Ukraine Report* (AUR), No. 642, January 16, 2006.

39 Roman Kupchinsky, "Letter to the Editor," *The Action Ukraine Report* (AUR), No. 642, January 16, 2006. See also Vitalii Kachanov, "Gazovaia demokratiia," *Ėnergobiznes*, May 8, 2006 (via ISI). See also *Robitnycha Hazeta*, January 25, 2006, cited in www.BBCUkrainian.com, and (on Tymoshenko's interest in the RosUkrEnergo contract) Vladimir Milov, "Popytki sdelat nas imperiei ia schitaiu sdledstvem kakikh-to kompleksov," Utro.ru, August 9, 2006, available at www.milov.info/articles.php?id=225 (accessed January 15, 2007).

40 Tatiana Serafin, "Ukrainian Billionaires May Be Behind Murky Gas Deal," www.Forbes.com, January 13, 2006, available at www.forbes.com/business/2006/01/13/ukraine-gazprom-billionaires-cz_ts_0113autofacescan09.html (accessed January 31, 2007).

41 See Kachanov, "Tochki nad I."

42 See Artem Bobrov, "Konets 'tenevoi renti' NAK," *Kievskii Telegraf*, October 2, 2006, reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, October 2, 2006 (via ISI). The add-on increased the price of domestically produced gas from the 140 Hryvnia (*c.* $30) per 1,000 cm paid by NAK NU to producers to 414 (*c.* $83) charged by the company to consumers. Ibid.

43 See the interviews of Rada deputy and member of the Rada Ad Hoc Commission for on the Supply of Natural Gas (created in 2006) Vladmir Sivkovich, with the newspaper *Delo* (cited in Oles' Tyshchuk, "Boikovshchina. Respublika sredi regionov," *Gaz i neft´. Ėnergeticheskii biulleten´*, August 25, 2006 (via ISI) and in "Milliardi Neftegaza," *Kievskii Telegraf*, October 2, 2006, excerpts reprinted in Ėnergobiznes, *TEK i Pressa. Ezhednevnyi obzor*, October 2, 2006.

44 In late February 2006, Yurii Kiiashko resigned as member of the NKRE after accusing the head of the organization, Valerii Kal´chenko, of overstepping the organization's mandate (setting electricity prices), getting the NKRE involved in property disputes between energy companies, and of illegally approving a Cabinet of Ministers resolution without following existing regulations, an important issue as the NKRE is supposed to be an independent regulator. See Alla Yer´omenko, "Regulatori Capture, abo zakhoplennia orhanu rehuliuvannia hrupamy interesiv" (interview with Yurii Kiiashko), *Dzerkalo Tyzhnia*, No. 8/587, March 4–10, 2006, available at www.zerkalo-nedeli.com/ie/show/587/52789/ (accessed October 1, 2006).

45 For a discussion of irregularities in the adjudication of an oil exploration and production contract to Shell, see Ganna Liuta, "Shellovlivyi kontrakt," *Zerkalo Nedeli*, No. 27/606, July 15–21, 2006, available at www.zn.kiev.ua/ie/show/587/52789/ (accessed July 17, 2006).

46 On the validity of the 2001 contracts see Oleksandr Chalyi, "Ukrains´ko-Rosiis´ka hazova uhoda: dorohovkaz do suprotyvu," *Dzerkalo Tyzhnia*, No. 1/580, January 14–20, 2006, available at www.zn.kiev.ua/ie/show/580/52316/, (accessed January 25, 2006). See also Aleksandr Chalyi, "Korporativnye gazovye dogovorënnosti: slovo za sudom," *Zerkalo Nedeli*, No. 593, April 15–21, 2006, available at www.zerlako-nedeli.com/ie/show/593/53163/ (accessed July 12, 2006).

47 In the arrangements in force until 2005, Ukraine's gas imports from Russia were largely payments in kind for the transit of Russian gas to EU markets. A nominal gas import price of $50/1,000 cm and a nominal transit fee of $109 per 1,000 cm

and 100 km were stated, resulting in total transit costs being equal to the total costs of gas imports from Russia. Imports from Turkmenistan were governed by separate agreements, where Ukraine purchased gas directly from Turkmenistan at $68/1,000 cm (payable in a mixture of cash and barter) but a significant percentage of this gas (*c.* 38 percent, equivalent to *c.* $1.8 billion if sold in the Western European markets or 88 percent of the cost of Turkmenistan gas to Ukraine) was given over to an intermediary transit company (RosUkrEnergo in 2005), in payment for transit services to the Ukrainian border. See Ferdinand Pavel, German Institute for Economic Research, presentation on "The Ukrainian-Russian Gas Agreement: Analysis and Alternatives," Conference on The Ukrainian-Russian Gas Crisis and Its Aftermath: Economic, Political and International Ramifications, Harvard University, February 5–6, 2006, streaming video available at www.huri.harvard.edu/na/na_gas_conf_2006.html (accessed June 15, 2006).

48 On Russia's influence on Turkmenistan gas exports, see Vladimir Socor, "Kremlin has upper hand: gas negotiations with Ukraine," in *Eurasia Daily Monitor* 2, Issue 230, December 12, 2005, available at www.jamestown.org/edm/article.php?article_id=2370590 (accessed July 31, 2007).

49 Chalyi, "Ukrains´ko-Rosiis´ka hazova uhoda."

50 In the first six months after the signing of the agreements with RosUkrEnergo, Ukraine received 50 percent of its gas needs from Turkmenistan, 20 percent from Russia, and approximately 5 percent each from Kazakhstan and Uzbekistan. Ekaterina Malofeeva, Renessans-Capital, cited in "Gaz dlia Ukraini," 16 August 2006, available at www.svobodanews.ru (accessed December 1, 2006).

51 See comments by Oleksandr Bolkisiev, head of the NAK NU daughter company "Haz Ukrainy," in *Gas Matters*, cited in the Ukrains´ka Pravda website, May 17, 2006, available at http://193.178.146.18/news/2006/5/17/41816.htm (accessed August 15, 2006), and Ferdinand Pavel, German Institute for Economic Research, presentation on "The Ukrainian-Russian Gas Agreement: Analysis and Alternatives."

52 Yuliia Mostovaia and Alla Erëmenko, "Sovershite vy massu otkrytii (inogda ne zhelaia togo)," *Zerkalo Nedeli*, No. 4/583, February 4–10, 2006, available at www.zn.ua/1000/1030/52513/ (accessed July 30, 2007). See also Oles´ Tyshchuk, "Sovinaia Bolezn´," *Gaz i neft´. Ėnergeticheskii biulleten´*, February 25, 2006 (via ISI).

53 See Tyshchuk, "Sovinaia Bolezn´."

54 Although the NKRE gave UkrHazEnerho a sales quota of only 5.04 bcm (in contrast with the 32 bcm of gas the company has available), it was expected by many that the company would find a way to overcome this limitation, for example, through reselling some of the additional gas to local gas traders for further distribution; in late May an agreement was reached with gas traders providing for the sale of 4 bcm of gas to them for resale (albeit at low profit margins, given gas price limit set at $110), especially to small and medium enterprises. See Vitalii Kachanov, "Khoziain gazovogo rynka," *Ėnergobiznes*, April 10, 2006 (via ISI). This would give gas traders 7 percent of the Ukrainian gas market, that is, a significant increase from the market share of *c.* 2 percent they held in the last years, which was mostly accounted to by trade in gas produced in Ukraine (1.5 bcm).

55 See Vladimir Socor, "Gazprom Targeting Ukrainian Infrastructure for Hostile Takeovers," *Eurasia Daily Monitor*, November 13, 2006, available at www.jamestown.org/edm/article.php?volume_id=414&issue_id=3921&article_id=2371640 (accessed January 24, 2007).

56 Oksana Mar´ianenko, "UKRGAZ-ĖNERGO urezali ambitsii," *Gaz i neft´. Ėnergeticheskii biulleten´*, March 25, 2006 (via ISI).

57 The following incident is anecdotal but no less telling. It has been reported that on the day when the contracts were actually signed, as a way of avoiding questions from the press, NAK NU head Ivchenko concealed himself in a bathroom stall, where he received any papers that needed to be signed, as a way of avoiding attention.

58 An even higher level of journalistic activism is evident in flagship publications such as *Dzerkalo Tyzhnia*.
59 Yuliia Mostovaia, "Ėto po-vashemu- Van Gog, a po-nashemu- Gogen," *Zerkalo Nedeli*, No. 3/582, January 28–February 3, 2006, available at www.zn.ua/1000/52447/ (accessed July 30, 2007). Former Energy Minister Yermilov spoke of the government wanting to temporarily "free itself" from "inconvenient" members of cabinet by sending them on business trips and placing them on sick leave.
60 See Yuliia Mostovaia "Protivogaz—odin na vsekh . . . ," *Zerkalo Nedeli*, No. 49/577, December 17–23, 2005, available at www.zn.ua/1000/1030/52117/ (accessed July 30, 2007).
61 Rada deputy Vira Ul′ianchenko, cited in Yuliia Mostovaia, "Ėto po-vashemu- Van Gog."
62 See Alla Erëmenko, "Aleksei Ivchenko: 'Menia nikto ne snimal, ne snimaet i snimat′ ne budet,' " *Zerkalo Nedeli*, No. 15/594, April 22–28, 2006, available at www.zerkalonedeli.com/ie/show/594/53234/ (accessed April 30, 2006).
63 Criminal responsibility can only be ascertained by a court of law, however.
64 See "Ukrainskie deti Gazproma."
65 Mostova, "Hazova Firtashka." Similarly, former head of NAK Naftohaz Ukrainy Ihor Bakai (since March 2005 on an Interpol warrant) declared in a March 2006 TV interview that that he had talked with a number of senior Ukrainian politicians during the winter 2005–2006 gas negotiations with Russia. See Yuliia Mostova and Yurii Butusov, "Yurii Lutsenko: 'meni pryiemno, shcho Bakai postupovo zvykaie do zvertannia 'hromadianyne nachal′nyku,' " (interview with Yurii Lutsenko) *Dzerkalo Tyzhnia*, No. 8/587, March 4–10, 2006, available at www.zn.kiev.ua/ie/index/587 (accessed May 15, 2006).
66 Mostova, "Hazova Firtashka."
67 Mostova, "Hazova Firtashka."
68 See Tyshchuk, "Sovinaia bolezn′," and Yuliia Mostovaia, "Osada zamknutogo kruga," *Zerkalo Nedeli*, No. 19/598, May 20–26, 2006, available at www.zerkalo-nedeli.com/ie/show/598/53426/ (accessed June 1, 2006) and Vitalii Haiduk, interview with Yuliia Mostova, in *Dzerkalo Tyzhnia*, No. 41/620, October 28–November 3, 2006, available at www.zn.kiev.ua/ie/show/620/54930/ (accessed January 27, 2007). Voronin was dismissed as deputy chairman of NAK NU by the Cabinet of Ministers in late June 2005, a dismissal confirmed by NAK head Ivchenko late September. On October 2005 he was reinstated by order of the Cabinet of Ministers. (See Artëm Bobrov and Aleksandr Kolotilo, "Prinuditel'naia Fiksatsiia," *Kievskii Telegraf*, February 10–16, 2006, available at www.versii.com/telegraf/arhiv.php (accessed January 24, 2007).
69 *Ukrains′ka Pravda*, "Khto stane nastupnym holovoiu 'Naftohazu Ukrainy?" Available at www.pravda.com.ua/news/2006/5/17/41816.htm (accessed May 26, 2006).
70 It is possible that such levels of transparency are similarly low to those in previous gas negotiations, but that only now the public became fully aware of them due to greatly increased freedom of the press following the Orange Revolution.
71 Yuliia Mostovaia "Protivogaz—odin na vsekh . . . ," *Zerkalo Nedeli*, No. 49/577, December 17–23, 2005.
72 Mostovaia "Protivogaz."
73 At the time of the January 2006 agreement, the Russian 50 percent of RosUkrEnergo's shares was owned by Gazprombank; on February 26, 2006, Gazprom's Board of Directors agreed that the company buy these shares from Gazprombank. For full details, see Mostovaia, "Protivogaz." It seems the original Russian owner of the 50 percent Russian share, Arosgas, was controlled by high managers of Gazprombank and Gazprom; as the Russian government tried to take more direct control of the company (and of the associated tax income), it sought to transfer ownership shares to Gazprombank, and then to Gazprom itself.

74 See *Izvestiia*, April 26, 2006.

75 In December 2005, NAK Naftohaz Ukrainy and Turkmenistan's state company Turkmengaz signed an agreement for the supply to Ukraine of 40 bcm of gas in 2006, at \$50/ 1,000 cm in the first part of 2006, and \$60/ 1,000 cm in the second part of 2006, with the gas being supplied up to the Turkmen-Uzbek border. See Ivan Gonta, "Kto v Ukraine i na chto nadeetsia?," *Zerkalo Nedeli*, No. 23/602, June 17–23, 2006, available at www.zerkalo-nedeli.com/show/602/53684/. (accessed June 25, 2006).

76 Alla Yer´omenko, " 'Til´ky chomus´ poky shcho nemaie pys´movoi propozytsii vid Turkmens´koi storony," *Dzerkalo Tyzhnia*, No. 7/586, February 25–March 3, 2006, available at www.zn.kiev.ua/ie/show/586/52699/ (accessed June 1, 2006).

77 In February 2006, President Niyazov argued Ukraine owed Turkmenistan \$158.9 million for gas deliveries, including \$143.3 million for 2005 alone. Vitalii Kachanov, "Nedelia 'bol´shogo gaza," *Ėnergobiznes*, February 20, 2006 (via ISI). There is some debate as to these numbers, as the Ukrainian side has argued these are not debts but accounting inaccuracies concerning barter arrangements. Foreign Minister Tarasiuk went so far as to argue that the Turkmen accusations concerning unpaid gas debts were simply an excuse for not fulfilling Turkmenistan's contractual oblications vis-á-vis Ukraine (in order to sell the same gas to RosUkrEnergo). See Borys Tarasiuk, quoted in Yer´omenko, " 'Til´ky chomus´."

78 Vitalii Kachanov, "Teatr dvukh aktërov," *Ėnergobiznes*, February 7, 2006 (via ISI).

79 Mostovaia and Erëmenko, "Sovershite."

80 One remaining means of influencing the gas monopolist would be by limiting domestic gas sale prices and through the National Commission for the Regulation of Electric Energy (NKRE). Vitalii Bernadskii, "Tsena gaza," *Ėnergobiznes*, May 29, 2005 (via ISI). On February 2006, for example, economics minister Arsen Yatseniuk passed a resolution limiting the price that could be charged to industrial gas consumers to \$110/1,000 cm plus transport costs, making it impossible for UkrHazEnerho to sell this gas domestically for \$160, as it had originally hoped. Alla Erëmenko, "'Agentstvo po Bankrotstvu ukrainskoi ėkonomiki' poka ne sozdano," *Zerkalo Nedeli*, No. 5/584, February 11–17, 2006, available at www.zerkalo-nedeli.com/nn/show/584/52573/ (accessed February 18, 2006).

81 See also Serhii Rakhmanin, " 'Volodymyr Lytvyn: 'Ia perekonanyi, shcho v hazovii uhodi ne obiishlosia bez koruptsii,' " (Interview with Volodymyr Lytvyn), *Dzerkalo Tyzhnia*, No. 21/600, June 3–9, 2006, available at www.dt.ua/1000/1030/53563/ (accessed July 31, 2007).

82 On the debt to RosUkrEnergo, see Channel 5 TV (P'iatyi Kanal), at http://5tv.com.ua/eng/newsline/ 186/0/27899/. On the debt to UkrHazEnerho, see Vitalii Bernadskii, "Neudachnoe znakomstvo," *Ėnergobiznes*, July 10, 2006 (via ISI). See also Alla Erëmenko, "Novyi glava 'Naftohazu' protiv posrednichestva 'RosUkrEnergo,' " *Zerkalo Nedeli*, July 15–21, 2006, available at www.zerkalo-nedeli.com/nn/show/606/53974/ (accessed January 31, 2007). Some, such as Ihor Franchuk (between 2001 and 2006 head of Chornomornaftohaz, owned by NAK NU) went so far as to imply that Boiko is Moscow's agent infiltrated into Ukraine to bankrupt NAK NU and free market space for Russian Gazprom-affiliated companies. See interview with Ihor Franchuk, " 'NAK' Naftohaz Ukraini u stani bankrovstvo," *Dzerkalo Tizhnia*, No. 40/619, October 21, 2006, available at www.zn.kiev.ua/ie/show/619/54863/ (accessed January 24, 2007).

83 See Mostovaia and Erëmenko, "Sovershite."

84 As discussed in Chapter 6 earlier, similar discussions in 2001–2003 were soon cut short by the fact that Ukrainian legislation prohibited such consortium from taking ownership of existing pipelines, limiting its area of possible action to new pipelines built by the consortium itself.

85 For example, in mid-January 2006 the rating agency Fitch reduced NAK's rating from "stable" to "negative," arguing the hardships created by the new higher price for gas. Yurii Skolotianyi and Alla Erëmenko, "Kto i chem otvetit po kreditam NAK 'Naftohaz Ukrainy,?'" *Zerkalo Nedeli*, No. 6/585, February 18–24, 2006, available at www.zn.ua/2000/2200/52633/ (accessed July 1, 2007).

86 Ibid.

87 Ibid.

88 Ibid.

89 Alla Erëmenko, "Aleksei Ivchenko: 'Menia nikto ne snimal, ne snimaet i snimat′ ne budet,'" *Zerkalo Nedeli*, No. 15/594, April 22–28, 2006, available at www.zerkalo-nedeli.com/ie/show/594/53234/ (accessed April 30, 2006).

90 This problem was temporarily exacerbated in mid-May 2006 by the fact that it was not clear who was officially at the head of NAK Naftohaz Ukrainy, with at least three people having some claim to the post: Ivchenko (who was asked to resign by the Rada, took a leave of absence and later resigned to take up his seat as Rada deputy), Ihor Didenko (who had been head of the company in 2000 before being dismissed by then Deputy PM Tymoshenko, and had won a judicial decision to come back to his old position, which he formally did for a few days in May 2006), and Oleksandr Volkisiev (who was appointed head of the company on May 12 but left the position again upon Ivchenko's return from his leave of absence).

91 On January 10, 2006, the Rada presented the government a vote of non-confidence.

92 Subsequently, in April 2006, Gazprom demanded significant price increases from Belarus (effective 2007); for the rest of the year, both sides found themselves in a battle of wills involving prices and control over the Belarusan transit monopolist Beltransgas. See Margarita M. Balmaceda, *Belarus: Oil, Gas, Transit Pipelines and Russian Foreign Energy Policy*, London: GMB Publishing, 2006.

93 RosUkrEnergo is registered in Zug, Switzerland, and has an important partner in Raiffeisen Investment AG, an Austrian corporate finance advisory firm (a subsidiary of Raiffeisen Centrobank), which manages the Ukrainian shares of the company.

94 See Yer′omenko, "Shalom Hazavat."

95 See Ibid.

96 Thus, argues Tyschuk, "UkrHazEnerho can be seen as a powerful raiding instrument in the hands of Dmitrii Firtash." Oles Tyschuk, "Treider-reider," *Gaz i neft′. Ėnergeticheskii biulleten′*, November 25, 2006. Tyschuk mentions that one of the companies affected, soda-producing Lisichanskaya Soda, is the only Ukrainian company competing with the Krimskii Sodovyi Zavod controlled by Firtash. Ibid. UkrHazEnerho justified the cut-offs by pointing to the fact that these companies had their own gas reserves in underground storage, with the implication that they may be involved in gas trading themselves. Ibid. The interest in the oblhazi despite their being technically unprofitable is explained by the fact that in reality large profits can be made through the gas-supplied oblenerhos through various schemes.

97 See Alla Erëmenko, "Kontsessiia, konsortsium plius RUĖ i izhe s nei," *Zerkalo Nedeli,* No. 48/627, December 16, 2006, reprinted in Ėnergobiznes, *TĖK i Pressa. Ezhednevnyi obzor*, December 15, 2006 (via ISI). Administrative pressure (frequent police and tax controls, for example) could also be used as a way of gathering negative information on Ivchenko and Yushchenko's brother Petro, as a way of having a means to potentially blackmail or pressure Viktor Yushchenko himself.

98 According to a Gazprom report cited in Mostova, "Hazova Firtashka." See also "Ukrainskie deti Gazproma."

99 Yer′omenko, "Shalom Hazavat."

100 PM Yurii Yekhanurov, interview in Ukrainian TV, no date given, quoted in Vladimir Socor, "Yushchenko Swears by Russian Gas Deal While Yekhanurov Spills the Beans," *Eurasia Daily Monitor* 3, No. 9 (Jamestown Foundation Washington, DC, January 16, 2006), available at www.jamestown.org/edm/article.

php?volume_id=414&issue_id=3584&article_id=237066 (accessed January 25, 2007). "Shipping gas by train" is a technical near-impossibility given the high volume occupied by gas.

101 On January 20, 2006, Russia banned the importation of Ukrainian meat and dairy products due to alleged non-compliance with Russian sanitary standards. On January 26, Gazprom accused Ukraine of stealing, between January 19 and 25, of 80 million cm of Gazprom gas in transit to Western Europe. See www.finanznachrichten.de/nachrichten-2006-01/artikel-2010944.asp.

102 Anastasiia Zanuda, "Uhodu s Hazpromom i RosUkrEnerho vidkladeno," January 25, 2006, www.BBCUkrainian.com (accessed February 1, 2006).

103 Ibid.

104 That this has not escaped the Russian side is made evident not only by the UkrHazEnerho agreements, but by Gazprom's continued interest in joining the downstream gas distribution business in Western Europe through joint ventures with Ruhrgas and other Western companies.

105 See Roman Kupchinsky, "The Unexpected Guest: RosUkrEnergo," Conference on "The Ukrainian-Russian Gas Crisis and its Fallout: Domestic and International Implications," Harvard University, February 5–6, 2006, streaming video available at www.huri.harvard.edu/na/na_gas_conf_2006.html (accessed June 15, 2006) and Global Witness "It's a Gas," pp. 54–56.

106 See Ibid., Global Witness "It's a Gas," pp. 54–56, and Vladislav Vetrov "'RosUkrEnergo': kto komu 'papa,'"? *Glavred*, December 27, 2006, available at www.glavred.info/print.php?article=/archive/2006/12/27/172203–4.html (accessed January 13, 2007).

107 Statements of Interior Minister Yurii Lutsenko, in Roman Kupchinsky , "Ukraine: Battle Against Corruption Grinds to a Halt," Radio Free Europe/Radio Liberty Feature Article, September 26, 2005, available at www.rferl.org/featuresarticle/2005/09/0df313c3–32fd-4b91-b524–0d022f46f2c2.html (accessed October 1, 2006).

108 See declarations by Stanislav Belkovskii, Director, Russian Institute of National Strategy, cited in "Ukrainskie deti Gazproma."

109 See *Ėnergeticheskaia Strategiia Rossii na period do 2020 goda* (Russia's Energy Strategy up to 2020), Moscow, September 2003. Full text in Russian available at www.gazprom.ru/articles/article4951.shtml (accessed June 21, 2006).

110 Such as the Baku-Ceyhan oil pipeline inaugurated in 2005 and the Nabucco gas pipeline planned by the EU.

111 See Buteiko's interview in BBC Rankova Prohrama, June 29, 2006, 7:00 Kyiv time (04:00 UTC), heard live on www.bbc.co.uk/ukrainian/index.shtml.

112 Following the signing of the "Universal" Declaration on National Unity on August 2, a joint declaration of intentions between Nasha Ukraina, Yanukovych's forces, the Socialist and Communist Parties.

113 For at least a month after the signing of the agreements, the members of cabinet had not received a full copy of the agreements signed on January 4. Alla Erëmenko, "Agentstvo po Bankrotstvu."

114 Plachkov's first dismissal came on January 10, 2006. He continued to hold the appointment on a caretaker basis.

115 Some members of the Cabinet refused to approve the contracts (perhaps wanting to avoid personal responsibility, NAK NU's head Ivchenko tried to get the agreement approved by the cabinet as a whole). According to the *Dzerkalo Tyzhnia*, besides Energy minister Plachkov, no other high government official spoke positively about the agreements. Mostovaia and Erëmenko, "Sovershite."

116 In the March 26, 2006 Rada elections, Yanukovych's Party of Regions received 32 percent of the votes, the Bloc of Yuliia Tymoshenko 22, and Yushchenko's Nasha Ukraina nearly 14 percent.

117 Erëmenko, "'Agentstvo po Bankrotstvu.'"

118 Vitalii Kachanov, "Tema nedeli: Nedelia 'bol′shogo gaza,' " *Ėnergobiznes*, February 20, 2006 (via ISI).

119 Channel 5 TV (P'iatyi Kanal), Prohrama "Chas," January 5, 2006 (21:00 local time Kyiv). Yevhen Kushnar′ov, head of the Partia Regioniv electoral campaign, argued that with Ukraine's entry into the Single Economic Space "the [gas supply] questions would be solved automatically." Vitalii Vernadskii, "Turkmenskii siurpriz," *Ėnergobiznes*, April 3, 2006 (via ISI).

120 It must be made clear, however, that the Yushchenko-Yanukovych coalition agreement was the result not only of common interests in the acquisition of energy rents, but to Yushchenko's frustration after repeated attempts to form a coalition with Tymoshenko.

121 On July 6, 2006 Oleksandr Moroz accepted the position of Speaker of the Rada in a back-door agreement with Yanukovych's Party of Regions, de facto disbanding the "Orange" Nasha Ukraina-Bloc Yuliia Tymoshenko-Socialist Party coalition, and opening the door for a new coalition by the Party of Regions, Socialist Party, and Communist Party.

122 In the coalition agreement reached on June 22, 2006, Tymoshenko's bloc was to get control of 13 portfolios, including the Energy Ministry and the energy-relevant Finance Ministry. Given Tymoshenko's own history of involvement in gas deals in the 1990s, and her past collaboration with ITERA, her own personal interest in the energy issue cannot be excluded.

123 An analysis of the composition Verkhovna Rada elected on March 26, 2006 confirms that Ihor Bakai's famous statement "all political fortunes in Ukraine were made on the basis of Russian gas" continues to be true in today's Ukraine. Deputies with current or past energy-sector business interests are found in all parties and blocs (perhaps with the exception of Nataliia Vitrenko's bloc), and in significant numbers. It is also interesting to note that in the official election documents they are usually listed, not under their current or past energy-related affiliations, but under other titles. For a discussion of energy-related deputies in the new Rada, see Mariia Rozhdestvenskaia, "Ėnergetichnye deputaty," *Ėnergobiznes*, May 22, 2006 (via ISI), and Yurii Feofantov, "Neftegazovoe lobby- 2006: popytka kollektivnogo portreta," *Gaz i neft′. Ėnergeticheskii biulleten′*, January 25, 2006 (via ISI).

124 Although after the August 2006 agreement tensions between Yushchenko and Yanukovych have greatly increased, these have not been mainly about energy policy.

125 At the same time, the increase in gas prices experienced by Ukraine in 2006 may help bring out a new diversity of interests in energy policy, as some economic actors (e.g. metallurgical companies able to incorporate energy-saving technologies) may be better able to adapt to higher energy prices and may ultimately support the move to a non-subsidized, more transparent system.

126 When Yushchenko did come out against RosUkrEnergo in October of 2006, it was mainly because of its attempted take-over of other domestic companies, and not because of its monopoly of gas supplies to Ukraine.

127 See "RosUkrEnergo—forever,?" *Zerkalo Nedeli*, No. 43/622, November 11, 2006, available at www.zerkalo-nedeli.com/ie/show/622/55080/ (accessed January 15, 2007).

9 Conclusion: Ukraine, energy, and Russia's new power

1 As was the case, for example, with the "barterization" of the economy and decline in monetary transactions in the early 1990s, both of which started in the energy sector. Yurii Savka, "Vzaiemozalik iak sposib zhyttia," *Enerhetychna Polityka Ukrainy*, No. 6, June 2000, pp. 30–34.

2 World Bank, "Ukraine: Challenges Facing the Gas Sector," (September 2003), available at http://siteresources.worldbank.org/INTECAREGTOPENERGY/34004325-1112025344408/20772948/ukrainegassector.pdf#search=%22Challenges%20Facing%20the%20Gas%20Sector%22 (accessed June 2, 2006).

3 On "bad institutions," see Konstantin Sonin, "Why the Rich May Favor Poor Protection of Property Rights," William Davison Institute (University of Michigan) Working Papers Series No. 544, December 2002.

4 As seen most clearly in the confrontation between Pavlo Lazarenko and Leonid Kuchma in the mid-1990s.

5 See Joel S. Hellman and Mark Schankerman, "Intervention, Corruption and State Capture: The Nexus Between Enterprises and the State," in *Economics of Transition*, No. 3, 2000, pp. 545–567.

6 See Timothy Frye, "Capture or Exchange: Business Lobbying in Russia," *Europe-Asia Studies* 54, No. 7, 2000.

7 It could be argued that these "costs" were very high during the period of confrontation between Pavlo Lazarenko and President Kuchma (1996–1997), with IESU's "being caught" leading to the disappearance of the company. But in this case IESU was not so much punished because of its corrupt practices, but because it and Lazarenko fell out of grace with President Kuchma.

8 While Ukrainian energy prices between 1994 and mid-2006 may have been low for final consumers, as seen throughout this book, they were not so for the state budget, which had to pay for these prices in a variety of ways, from loss of transit revenue, to growing inflation and external indebtedness, to outright subsidization.

9 While little accurate information on the real mechanisms of energy policy-making was available in mass-circulation newspapers and magazines, more information was available for reduced groups, through specialized, costly and low-circulation per-subscription-only energy business publications such as *Ėnergobiznes, Gaz i neft′. Ėnergeticheskii biulleten′, NefteRynok*, and *NefteGazNedelia.*

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