GLOBAL MARKET BRIEFINGS

RUSSIAN FOREIGN ENERGY POLICY

Ukraine: Post-revolution Energy Policy and Relations with Russia

Authors:
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IAGS Institute for the Analysis of Global Security

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GMB Publishing Ltd.
120 Pentonville Road
London N1 9JN
United Kingdom
www.globalmarketbriefings.com

This edition first published 2006 by GMB Publishing Ltd.

Hardcopy ISBN 1-905050-31-3   E-report ISBN 1-905050-77-1

British Library Cataloguing in Publication Data

A CIP record for this book is available from the British Library.

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Introduction: after the Orange Revolution

After Ukraine's Orange Revolution, new state leaders face a great number of problems in the energy sphere. Solving these problems, including the fundamental reconstruction of the energy system's policy in accordance with European principles, is a main assignment of the Ukrainian Government. However, the corrupt energy system has existed for some time and it will be both a time consuming and complicated exercise to dismantle it. The slow progress in solving long-standing problems is preventing the Ukrainian Government from concentrating on its goals for the future.

In a speech to the Ukrainian Government in April 2005, President Viktor Yushchenko stated, 'The main assignment, which I would like to set to the Prime Minister and the Minister of Energy, is establishing the energy independence of Ukraine in the widest sense of the word, starting with the subject of gas balance to oil balance and electro energy.' This principle can be considered the main goal of the Ukrainian Government in implementing its current energy policies. Although the methods employed to achieve this goal have not always been justified, Ukraine can still claim that it is moving steadily, though slowly, towards the assignment set by the president.

The new Cabinet of Ministers of Ukraine (the cabinet) inherited what could be aptly referred to as the 'Augean stables' in regards to the energy sphere. Numerous money laundering schemes were still in existence and a number of managers of energy enterprises were implicitly sabotaging new policy. Clashes, not only between enterprises of the energy sphere, but also between Russian energy 'giant' Gazprom and Ukraine's largest state-owned gas and oil company NJSC Naftohaz Ukrainy, forced the cabinet to review the old agreements and try to settle the misunderstandings rather than form new policies. It took them a long time to understand the real state of the Ukrainian energy sphere.

The oil crisis from April–May 2005 forced the cabinet to examine the current situation and to develop an 'emergency' regime, which led them to react to events rather than direct them. The 'emergency' regime caused internal governmental conflict and misunderstanding – a situation which prevails until now. Having switched to the 'emergency' regime, the government didn't effectively pursue its principal assignment – strategic work in the energy sphere. The long-term goal, 'to bring the Ukrainian energy sphere up to European standards' was moved to the background. The energy strategy has still not been approved (in April 2006), although it was supposed to be presented to the public at the end of April 2005. Even if the strategy had been written, the process would not have met all the demands (public discussion of the strategy, subsequent implementation of the public's response) and it would have been an 'emergency' process. Strategic steps, which the government has now announced (in particular, to develop new projects with Iran and countries of the

European Union) have not been presented as an integral vision of the strategic development of the state.

The government's focus on reaction, but not policy formation has resulted in absence of effective dialogue with the public. Most decisions made by the cabinet regarding the energy sphere have been reported in mass media *post factum*, which has prevented any opportunities to discuss their reasonability. This gap between decision-making and consultation with the public has contributed to a general fall in favour of the new government and given its opposition more reasons for criticism.

In addition to the 'emergency' regime, the 'inheritance' from the former authorities, with which the Ukrainian Government has not got time to deal, caused a number of misunderstandings in energy politics and intensified the already developing crisis. During the first six months of 2005, while the government was examining the situation, inimical structures made attempts to misguide the government. However, today we can say that despite many provocative moments, the cabinet has not allowed the situation to destabilize completely and although the energy market was shaken to some degree, the government managed to help secure its further stable development.

The government's future success in this field will depend on its ability to switch from reactionary policies of prediction and control. Currently European parties have extended a great amount of trust towards Ukraine; some credit lines have already been given to aid the reform of Ukraine's energy sphere and several programmes have been supported. The cabinet will retain this trust if it facilitates close cooperation with other energy ministries and departments dealing with European integration. The next vital step is for the government to initiate new dialogues with Ukrainian and other international energy companies. However, if they allow foreign partners to re-open last year's agreements and contracts, the new Ukrainian authorities may be involved in conflicts, which will slow down the development of the Ukrainian energy sector.

1. Delays in reform

Olena Viter

The old guard

Following the change in the state's leaders (in particular the president and government), representatives of the former authorities retained less important posts for a long time. Their presence demonstrated that the old 'rules of the game' were still in effect and qualitative new decisions in the energy sector were not taken.

During the first two months of the new government's tenure, a representative of the former authorities, Yuriy Boyko, remained head of Naftohaz Ukrainy. Journalists believe he (together with ex-Minister of Transport, Heorhiy Kyrpa) was connected to the funding of the pre-election campaign of Viktor Yanukovych. Prime Minister Yulia Tymoshenko accused Mr Boyko of 'compromising the public interests'[i]. The government's Control and Auditing Department is still investigating Boyko's involvement with money laundering, having estimated the alleged losses of Naftohaz Ukrainy to equal more than 1.5 billion hryvnias (1.5 billion UAH = US $298 million). This investigation might lead to criminal proceedings against Mr Boyko.

Despite accusations concerning Mr Boyko's criminal past, he retained his post for months. According to experts, the delay in a new appointment was due to the importance of the post – too many politicians claimed it, and appointment of any of them would have definitely caused conflicts and resentment. Meanwhile, Naftohaz Ukrainy continued with its old projects and didn't change any of its policies. A number of crucial and radical decisions, which could have been taken in the first months after the regime change, were not made.

Yuriy Boyko's work in the important post delayed reforms in the energy sphere

In particular, in January 2005, during a transition period for Ukraine's top-ranking officials, Boyko made a visit to Turkmenistan and, without agreement from Ukraine's Cabinet of Ministers (as procedure requires), made a contract with the DPT (Democratic Party of Turkmenistan) arranging that they would supply gas to Ukraine at an increased price. This action led to numerous arguments and misunderstandings; in later negotiations with the DPT, the Ukrainian Government attempted to prove the illegality of this step. The problems could have been avoided if the appointment of the head of Naftohaz Ukrainy had been controlled from the start.

New appointments of leaders in the energy sphere only started in March 2005. Since then, the government has developed a new energy policy. Ivan Plachkov, ex-head of the company, Kyivenerho, which supplies Kyiv with heating and electricity, was appointed Minister of Fuel and Energy. Experts considered that this appointment, of a person with no experience in making national decisions, was a signal that in reality Prime Minister Yulia Tymoshenko would manage the energy sphere herself. This was evident by Minister Plachkov's concordance with Yulia Tymoshenko on principal energy issues – in particular, Ukrainian-Russian energy relationships. Having occupied the post of Vice Prime Minister of Fuel and Energy Complex in Viktor Yushchenko's Government (2000–2001), she knew this sector well and has never lost interest in it.

Balance and counterbalance

The principle of 'balance and counterbalance' that President Yushchenko applied to energy sphere management differs from the policy of the former authorities. For instance, in March 2005, President Yushchenko appointed Oleksiy Ivchenko as head of Naftohaz Ukrainy. Mr Ivchenko, an MP, was a leader of the Congress of Ukrainian Nationalists party, chief of the provisory council of the state-funded enterprise Dobromyl-Kyiv in Western Ukraine and was not connected to Yulia Tymoshenko in any way – he was an outsider to the team. Although Oleksiy Ivchenko supported the general principles surrounding the implementation of cabinet's energy policy, as head of Naftohaz Ukrainy (the second-most important position in regards to the state's energy policy) he took an independent stance in managing the company and often did not support the prime minister and cabinet's opinion. This demonstrates how the principle of 'balance and counterbalance' has helped, on the one hand, to make policies less biased, yet on the other hand it has delayed vital decisions due to misunderstandings between decision-makers.

In particular, in May 2005, Oleksiy Ivchenko didn't agree with the government's proposition, supported by Yulia Tymoshenko, to build a new oil-processing plant in Ukraine; in June 2005 he didn't agree with cabinet's proposal to prohibit the re-export of gas; and in spring 2006 he put forward a suggestion to remove Naftohaz Ukrainy from under the control of the Ministry of Fuel and Energy, and to subordinate it to the Cabinet of Ministers of Ukraine directly.

Although Ivchenko and Tymoshenko's differing viewpoints meant the public was privy to the positive and negative sides of each argument, they also prevented efficient implementation of the energy policy. These conflicting relationships caused different speculations in mass media – in particular about the possible impending dismissal of Oleksiy Ivchenko. This information was published with reference to 'a source close to the chiefs of the oil and gas sector of Ukraine'. This method of manipulating public opinion is widely used in Russian and Ukrainian press. Having failed to refute this information[ii], the Prime Minister did not confirm or deny differing speculation that she had appealed to the president requesting the dismissal of Oleksiy Ivchenko. The conflict was developing.

In June, Oleksiy Ivchenko appealed to President Yushchenko in a letter complaining about interference from government representatives regarding issues that were under his competence, and he requested help to enable further independent decision-making. Viktor Yushchenko reacted to the request and demanded that the cabinet 'were not to make unreasoned statements about Naftohaz Ukrainy[iii]; the conflict was suppressed. However, for a month it drew politicians' and the public's attention away from the energy issues and instead to the interpersonal conflicts between Prime Minister Tymoshenko and Oleksiy Ivchenko.

The absence of a unified position on many issues of energy policy has also had the negative effect of politicians making conflicting statements about the same issue. This results in a lack of public awareness regarding the energy sphere. An example of such inconsistency of information is evident in the drafting of an agreement between Ukraine and Gazprom. In July 2005, Oleksiy Ivchenko reported that at the beginning of 2005 the managers of Naftohaz Ukrainy had discovered that the volume of gas available would not meet consumption needs. Therefore, Oleksiy Ivchenko signed a contract for delivery of another eight billion cubic metres of gas. Later, Ivchenko reported that the company had signed a contract for the delivery of another 11 billion cubic metres of gas on favourable terms with independent suppliers, Transneft and the RosUkrEnergo[iv] Company.

The cabinet requested to see documentation confirming that the above-mentioned contracts had been signed. Gazprom joined the conflict making the statement that Gazprom's subsidiary, Gazexport, alone deals with the export of Russian gas and that it had never drafted any of the above-mentioned contracts. This led to Prime Minister Yulia Tymoshenko publicly denying the fact that she had signed the documentation.

In August 2005, Yulia Tymoshenko officially denied the existence of Ivchenko's documents. 'Today there are no signed contracts, about which the chief of Naftohaz Ukrainy spoke[v],' the Prime Minister claimed, adding that a top-level working group had been formed, with participation of the Cabinet of Ministers, to verify the information. Oleksiy Ivchenko, on the contrary, insisted on existence of the documents. However, he never presented them to the government and neither side has refuted their statements yet.

2.
Oil: crisis and stabilization

Olena Viter

Lack of transparency in the oil market

The increase of retail prices for petrol seriously tested the new government's energy policy and revealed a number of serious mistakes. This resulted in a fall in popularity for the government and the president, and provoked criticism from the opposition. Although the price increase was due to reasons beyond the Ukrainian Government's control, if they had combatted such non-transparent schemes earlier, the crisis might have been tempered significantly.

Unreasoned statements by government representatives were another feature of the energy crisis. Their hasty conclusions and accusations that Russian energy companies had been 'plotting for crisis' had the opposite effect. The Russian oil companies that the cabinet was arguing with, responded with numerous legally justifiable arguments, which revealed the government was guilty of causing the crisis. Also, confusion in the decision-makers' public statements and actions led to misinterpretations of their words by the media, adding to uncertainty and triggering criticism both from the Western observers and the opposition.

Annually Ukraine consumes about 18-million tons of oil. Only one-sixth of the required volume is produced in Ukraine; the rest is imported, with Russia supplying 82 per cent. Six ORP (oil-refining plants) are based in Ukraine. Four of them are owned by Russian companies. One is a joint enterprise with Tatneft (Ukrtatnafta), founded on the base of Kremenchuk ORP. TNK-BP controls Lysychansk ORP; Lukoil–Odesa ORP; Alliance group – Kherson ORP. Of the other two ORPs that are not Russian-owned, Nadvirne ORP is controlled by Ukrainian Privat group and headed by Ihor Kolomoiskiy, while Drohobych ORP is believed to be managed by businessman Ihor Yeremeyev. The irregular distribution of control in the ORP field (representative of a strong Russian presence), the virtual absence of government instruments to regulate the market and its non-transparency (part of Kuchma's legacy), brought about the biggest crisis of Ukraine's first six months under the Yushchenko regime.

Fuel crises and price controls

'Fuel crises' take place regularly in Ukraine, at least twice a year – during spring and autumn agricultural seasons, when increased demand for fuel tempts traders to increase prices. This leads the government to make agreements with the oil market traders – firstly, Russian oil companies, seeking possibilities for additional production of petrol or diesel fuel.[vi] Usually these agreements are drafted as contracts for the supply of oil products to agriculturalists in Ukraine. However, in most cases no signed documents (agreements or memorandums) have ever helped to keep the price of petrol down. During the previous years, the opposition (which themselves took power in 2004) used the seasonal crises as an opportunity to criticize the government's energy policy.

Once in power, the new government attempted to prevent a possible crisis. In February 2005, agriculturalists and Ukrainian oil-refining companies drafted an agreement organizing the supply of 600 tons of diesel oil at the price of 2400 hryvnias per ton for the period February–May 2005. The agreement was signed jointly by: Ukrtatnafta (Kremenchuk ORP); TNK-BP Ukraine (Lysychansk ORP); Lukoil-Ukraine (Odesa ORP); Kazakhoil Ukraine (Kherson ORP); ORP-Halychyna (Drohobych ORP); Naftokhimik Prykarpattya (Nadvirne ORP) and NJSC Naftohaz Ukrainy (Shebelyn ORP). However, the signed agreement did little to amend real politics. Due to various reasons petrol prices began to grow.

Between 27 and 30 March 2005 the price for a litre of A-95 petrol at fuel stations increased from 2.80 ($0.56)–3.00 hryvnias ($0.60). This was a substantial increase for Ukrainian citizens who earn, on average, a salary of $100 per month. Experts anticipated further price increases due to additional factors: keen demand due to the bad weather, possible reconstruction of several ORPs and the growth of oil prices in international markets. Another factor contributing to the increase in petrol prices, was that the new government did not liquidate a number of the systemic problems of the oil market; in particular, obscurity of oil acquisition from Russia (companies/owners of ORPs often buy oil from their 'close' Russian companies, so they may overcharge) and lack of transparency in ORPs' expenses (it is not clear what expenses are allocated to oil acquisition or its refinement, and what profit interest is gained).

Causes of conflict

While petrol prices were increasing, in the background a conflict was in progress between the Ukrainian Government and the oil traders. Prime Minister Tymoshenko said at a press conference that the Russian companies wanted to 'make money on the population of Ukraine and its agrarian complex'[vii], and that they had deliberately raised oil prices. On 31 March 2005, Minister of Agrarian Policy, Oleksandr Baranivskiy, made a statement that a secret meeting of managers of ORPs had occurred, where they had agreed to raise prices for fuel. The minister noted that producers had already started to withhold petrol and had even refused to draft the necessary agreements with agriculturalists. According to him, that was the reason for the growth of retail prices for petrol, and that while Russian companies continued to represent most owners of ORPs it took the conflict automatically to the Ukrainian-Russian state level. The companies refused to admit any guilt, indicating objective reasons for the growth of petrol prices, in particular the fact that Russia had raised the export duty for oil internationally.

Russian oil has undergone a record speed in price increase since the beginning of 2005. In Russia, oil prices are based on international levels, which are monitored and change every two months according to international trends. In February 2005, the export duty of Russian oil was $83 per ton. By April, it had increased to $102.60 and in June 2005, the Russian export duty beat its own record, rising to $136. Following monitoring in August 2005, Russian export duty was $140. Taking into account significant fluctuations in the world market, the set level of the duty is definitely not final for the Russian authorities and Russia's influence on the cost of petrol in Ukraine is indisputable for as long as Russian companies continue to constitute the majority of the oil market. However, the Ukrainian petrol crisis is not solely due to the increase of Russian export duty. Between February–March 2005 export duty was lower than the previous month (eg in December–January 2004, export duty was $101 per ton of oil, whereas in February–March 2005 it was $83 per ton of oil).

Denying their connection to the price increases for oil products, Russian oil companies instead drew attention to the difficult terms, which the Ukrainian Government had created for them. Their arguments for the price increase were as follows: introduction of new tax rules by the cabinet (oil traders had to pay VAT for oil supplies to Ukraine with money instead of barter and through customs procedures) and also the introduction of new excise charges for petrol and diesel oil (the amount becomes directly dependent on retail prices for oil products).

The Ukrainian Government opposed their arguments, demonstrating the profitability of the oil industry even on the new terms. It was impossible to decide which side was right – the Ukrainian Government or the Russian oil companies. Due to numerous 'shadow schemes' it was hard to gain a clear perspective on the full circle of oil 'circulation' and, consequently, expenses of petrol producers.

In conclusion, methods of oil purchase and the cost of its refining cycle remained unclear and both parties became mutually offended by the other. The prices for petrol continued to grow in Ukraine, increasing by 10 per cent between March–April 2005.

Non-market regulation

In an attempt to solve the petrol crisis the Ukrainian Government manipulated market regulatory methods. On 14 April 2005, the Ministry of Economy issued a decree instructing that margin prices for diesel oil and petrol were to be decreased at the expense of reduction of trade charge by 13 per cent. Retail prices for petrol were not supposed to exceed 3 hryvnias ($0.60). Only state-controlled companies obeyed the order (Naftohaz Ukrainy and Ukrnafta, which have their own gas stations). The remainder (mostly Russian companies) issued a statement that they had decided not to follow the order of the Ukrainian Ministry of Economy. At most gas stations the situation remained similar to that before the issue of the decree. In accordance with the decree many of them fell under punitive measures. Some companies, for instance TNK-BP, 'responded' to this decree by restricting the supply of oil products to its gas station network. In their statement to the public, TNK-BP explained this decision as their intention 'to prevent possible violation of the legislation[viii]'. President of TNK-BP Ukraine, Alexander Gorodetsky, held a press conference where he made a statement about the illegitimacy of the decree. According to him, 'Taking into account the course declared by Government – to enter the World Trade Organization and … [to be integrated into] the European Union – this decree should not exist.'

Mr Gorodetsky's statement was the start of the oil war, which surpassed the domestic level and affected Ukrainian-Russian relationships. In an attempt to protect themselves from the Ukrainian Government, on

19 April the Russian companies (Lukoil, TNK-BP, Tatneft and Alyans group) appealed to Russia's Prime Minister, Mikhail Fradkov, requesting that he defend their legal interests in Ukraine and add the issue of the 'petrol crisis' to the list of negotiations with the Ukrainian prime minister. In their letter, the companies noted that although they had executed all the terms of the Memorandum, the Ukrainian Government had increased tax pressure on oil refining enterprises and tariffs on transporting. Moreover, they were worried about the possibility that the Ukrainian Government would organize the reprivatization of the plants and manual regulation of the oil products market, without inviting the oil companies to a dialogue. There was no public reaction by Mikhail Fradkov to this letter.

> 'We are not fighting with monopolies – they are fighting with us. They are used to setting any prices, and [expect that] the Government will rectify the situation, [they believe] that money opens any door.'
> Prime Minister of Ukraine Yulia Tymoshenko, May 2005.

At that time (April 2005) the petrol crisis became one of the most popular topics in Ukrainian society. Many experts and journalists criticized the government for 'non-market regulation' actions, a number of critical articles were published in Western publications and Ukrainian opposition forces became active. While the Ukrainian Government was being criticized, nobody focused on the complexity of the real situation – the impossibility to regulate the market, which was monopolized by several energy companies. Three oil refining plants controlled by Russian companies supplied 62 per cent of oil products to the Ukrainian market. The introduction of a competitor could have been a way out from the crisis, but required time and new legislative terms.

Yulia Tymoshenko's government had not had enough time to work out a plan of counteraction. Instead of using, at most, the scarce time it had at the beginning of the year, the cabinet chose to blame the Russians, yet, the latter had not only the market in their hands, but also a good legal base to justify their actions. Thus, bold accusations and administrative measures backfired with accusations of incompetence and authoritarian governing.

Strategic negotiations

Simultaneously with the administrative methods, the Ukrainian Government began negotiating with leaders of the Ukrainian oil market – companies TNK-BP, Lukoil and Alyans group. On 22 April, Tymoshenko agreed with chief of Lukoil, Vagit Alekperov, on a price decrease on oil products imported to Ukraine and a corresponding retail price for petrol. The same negotiations were conducted with TNK-BP. The Prime Minister said that 'The negotiations with TNK and Lukoil are very difficult – they want to leave their hands not on the pulse, but on the throat'.

Having conducted the negotiations, the Prime Minister retained her views regarding the 'conspiracy of the main players of the oil market'. According to Tymoshenko, investigation into the reserves of these two companies showed that they had hundreds of thousands of tons of light mineral oil acquired at previously lower prices. Due to monopolization of the market, not only could the oil companies set the volumes to sell, but also the prices throughout Ukraine.

In addition, the government took steps to decrease dependence on the Russian companies. The Antimonopoly Committee, aided by the SBU (Security Service of Ukraine) announced that they were investigating the issue of overcharging by companies TNK-BP and Lukoil, and also commented that they were going to review their investment obligations, which had been included in the terms of privatization agreements in 1999–2000. According to the Ukrainian Prime Minister, they had to investigate the actions of the organizers of the petrol crisis.

At the same time, on April 19, criminal proceedings for the abuse of a monopoly position in the oil market were brought against TNK-BP. During the petrol war the Antimonopoly Committee tried to use stabilizing measures to maintain set prices for petrol. In particular, it offered to cancel customs duty to the Pension Fund for the period of agricultural works. At the Anti-Monopoly Committee's estimates, an increase in the import of petrol by at least 30 per cent would have covered all possible losses to the budget. As later events demonstrated, the Ukrainian Government only listened to the recommendations of the committee in the most critical situation.

As a possible solution to the monopolistic position of the Russian oil companies, the cabinet started to consider its own presence in the Ukrainian market. At the end of April, the chairman of the board of directors of Naftohaz Ukrainy suggested returning to state ownership the shares of the two biggest oil refining plants – Lysychansk ORP (currently controlled by TNK-BP) and Kremenchuk (Tatarstan, Russia). However, the government turned down this suggestion and decided instead to form a vertically integrated company on the base of the Ukrnafta Company[ix].

According to the plans of the cabinet, the newly founded structure would be a full-fledged player in the oil market and supply 50 per cent of gas stations in Ukraine with petrol at the price of 3 hryvnias per litre. Implementation of the plan began immediately after it had been published. In addition, the Antimonopoly Committee of Ukraine issued permission to the company for the acquisition of an additional 73 gas stations in 13 regions of the country. Another step was the creation of a fuel reserve to maintain set prices for petrol during crises, an activity that has been implemented for a long time by IEA Member states.

Agreements with the major players of the petrol market slowed down the crisis, but failed to stop it. TNK-BP agreed to reduce prices only for the period 22 April–1 May (nine days) and refused to negotiate a longer period. At the end of April, having met with the Minister of Fuel and Energy, Ivan Plachkov, TNK-BP agreed to keep to the set agreements in the future. Lukoil was more responsive – they agreed to reduce their prices to those suggested by the ministry immediately and they did not set any time limits. Vagit Alekperov agreed with the prime minister to form a common working group to work out the price policy for the Ukrainian oil products market.

Successful agreements with the key players of the oil market of Ukraine enabled Yulia Tymoshenko to make an official statement – the crisis in the home oil market had been overcome and the price for petrol had been stabilized. According to the Prime Minister, after the negotiations with the Russian companies, she personally visited all gas stations in Kyiv and the surrounding region and ensured that they set prices recommended by government ($0.60 per litre). However, it was too hasty a statement, which was overridden by the government's next step.

Petrol crisis reignites

The cabinet made a decision to prolong the administrative methods of regulation of the oil market. Minister of Economy, Serhiy Teriokhin, simply explained to the public that monopolization of the oil market still remained and that the cabinet considered that the only possible way to fight it was to keep the players in harsh conditions. Monitoring of prices in the oil market, conducted by the Minister, showed that growth of prices in autumn and spring in Ukraine is absolutely inadequate compared to price fluctuations in neighboring European countries that also consume Russian oil. According to the minister, petrol in Poland and the Czech Republic is more expensive than in Ukraine due to fiscal constituency, and if that is subtracted it turns out that refinement of Russian oil is one-third more expensive than in Ukraine.

Russia started to sell oil to Ukraine at the price of $340 per ton after the export duty was increased in June 2005, while Russian oil was sold to other foreign markets at the price of $318 per ton. Mr Teriokhin also noted that price increases for Ukraine had been timed well – the country did not have its own oil reserves, the Odesa–Brody oil pipeline had not yet been launched. Ukraine depended almost totally on Russian oil and it was a very lucrative thing for Russia to play on.

This immediately caused a new turn in the energy crisis. The Ministry attempted to neutralize the situation, announcing further planned 'market actions' such as developing a plan to link the price of petrol to the world market price of oil. Minister Teriokhin explained that 3 hryvnias per litre of petrol was planned to be the base cost, and later the fixed home price would change in accordance with fluctuations in the world market. He also announced the plan to form a state oil and oil products reserve, which would have a volume equal to 90 days' consumption. However, the country lacked sufficient reservoirs to implement these plans.

As the conflict was unfolding Yulia Tymoshenko tried to demonstrate the firm position of her government, stating that the cabinet was seeking an alternative source of oil supply to Ukraine, in particular from Kazakhstan. These statements had an immediate impact on the unstable energy market. Russian company TNK-BP announced that at the time of international price increases, the company could not trade at the petrol prices set by the Ukrainian Government and as an investor it was 'losing money'. The war continued. Abiding by the government's Memorandum on prices, the oil traders made another move: they caused a shortage of petrol at gas stations.

Official data of the Ministry of Energy shows that 1,934 tons of oil were delivered to ORPs in Ukraine in March 2005, including the following:
228,600 tons – from their own extraction (11.8% of the total volume of supplies);
1.7 million tons – from Russian Federation (88.2% of supplies).
According to the same data, in comparison with March 2004, the volume of oil supply was reduced by 320,200 tons (14.2%).

Under pressure from the oil companies, the ministry raised the margin prices for petrol. By 13 May, the price for A95 had increased by 20 kopeks to 3.20 hryvnias per litre ($0.64). Despite this, quantities of fuel at petrol stations did not increase. The Russian companies denied accusations from the Ukrainian government, stating that they had never terminated supply to gas stations. Instead they explained the decrease of supplies as due to the 'preplanned reconstruction' of Lysychansk and Kherson ORPs. Statistics showed that the companies did not stop supplying oil products, but that refining decreased significantly in May. There were two possible scenarios: either Russia had cut off supplies or the oil companies had decreased their volumes of refinement.

On 14 May the Prime Minister issued another statement about negative tendencies in the energy market. This time the conflict went to the international (Ukrainian-Russian) level again. According to the Prime Minister, Russia had violated the agreements it had signed and terminated the supply of oil to Ukraine for five days.

The Ukrainian Government followed this with the massive import of oil from other state exporters. For instance, it signed a contract for the supply of an additional 300,000–500,000 tons of Kazakh oil and purchased 70,000 tons of petrol from Moldova and Baltic countries. At this stage, President Viktor Yushchenko joined forces with the government and held negotiations with his Polish counterpart Alexander Kwasniewski regarding Poland's support to the Ukrainian oil market. The cabinet made a decision regarding possible reconstruction of the Kremenchuk ORP to increase its output from 600,000 to 900,000 tons per month. Following the propositions of the Anti-Monopoly Committee, the government suggested that parliament

Table 2.1 Oil and oil products refining in April 2005 (thousand of tons)

	April 2005	*% to March 2005*	*January–April 2005*	*% to January–April 2004*
Oil refining:				
Total	1,482.2	76.5	6,627.5	91.5
Ukrtatnafta, Kremenchuk	586.9	96.5	2,243.2	90.6
Odesa ORP	285.3	114.4	790.7	114.3
Lysychansk ORP	166.0	26.1	1,852.0	77.2
Petrol:				
Total	267.7	60.6	1,467.8	88.6
Ukrtatnafta, Kremenchuk	128.8	92.6	506.5	88.0
ORP Halychyna, Drohobych	36.4	105.2	137.6	91.0
Odesa ORP	36.3	103.7	102.6	110.8
Diesel oil:				
Total	457.8	86.1	1,897.8	92.8
Ukrtatnafta, Kremenchuk	181.5	98.1	668.8	91.1
Odesa ORP	77.2	121.2	206.9	109.0
Lysychansk ORP	54.2	36.5	469.2	78.2

Source: Interfax-Ukraine, Ukrainski Novyny pass a bill on the liberalization of the import of oil products to Ukraine. A strategic decision by the cabinet was to construct a new oil refining plant in Odesa within a year and a half. According to the plans, this plant will not be orientated towards Russian oil and it will have a refining depth of 90 per cent unlike most plants, which have a depth of 46–70 per cent.

Since then, other Ukrainian political parties have joined forces with government. In particular, at the request of government, parliament passed a law on 17 May 2005, which reduced excise tax and cancelled the import duty on petrol and diesel oil. As the authors of the bill claimed, this law would open the market for imported oil products and create firm ground for the development of a competitive market. In addition to this, MPs amended the rate of excise tax, decreasing it from 20 per cent on sales turnover to 60 euros per 1000 kilograms. The new rate for diesel oil equalled 30 euros per 1000 kilos (previously it had been 10 per cent of turnover from the sale price).

Stabilization and world prices

President Yushchenko responded with criticism to the energy actions of Government. He opposed the government's non-market regulatory methods, because 'interference in price formation and pressure of non-market methods caused a great number of market participants to regard Ukraine very carefully'. According to the president 'the players did not understand the logic and after-effects of these actions'. He saw that there was only one way out and that was to correspond to world prices, which would enable Ukraine to switch to alternative supply regions. If this step is made, the President said, Ukraine will get Libyan, Caucasian, Kazakh, Russian oil – any oil. Although Viktor Yushchenko did sign the law passed by parliament, he also issued a decree 'On the Measures to Stabilize the Situation in the Oil and Oil Products Market'. It warned the government about the inadmissibility of administrative price regulation and its personal responsibility for the stable workings of the energy market. The decree also stipulated the formation of the state oil reserve, which should be completed by 1 January 2006.

In regards to the Ukrainian-Russian relationship, Viktor Yushchenko declared his will to find common ground with Russia concerning the regulation of oil crises. He expressed his intent to present a clear position regarding the Ukrainian perspective on price formation. The president announced a special session on this issue, with participation of all sides concerned, including the Russian oil companies. After the negotiations, the new maximum for petrol prices was set at 3.2 hryvnias per litre (the price suggested by the Ministry of Economy). President Yushchenko issued several instructions to the government; in particular, to form within a month a vertically integrated scheme for management of state-owned shares in oil and oil refining companies, and to find several sources of oil for Ukraine (for instance Russia, Kazakhstan, Caucasus and Lybia). After the session, the president promised, 'Nobody will ever regulate prices with administrative methods in Ukraine.'

The petrol crisis was over after the meeting of the president with government and representatives of the Council of National Security and Defense. On 25 May, the Ministry of Economy cancelled its decree on the margin wholesale-retail prices, just a day before Lysychansk ORP, which TNK-BP had closed for construction, was launched.

New projects

A number of agreements have been reached which bode well for the oil industry domestically as well as for international investors interested in Ukraine and its export market. Thus, the Kremenchuk ORP is undergoing modernization (an open tender for interested companies was announced, 18 May 2005). There are plans to build two new ORPs in Odesa and/or Crimea (as a part of this project, there is a plan to auction two plants in southern Ukraine – in Odesa and in Feodosiya). The above-mentioned vertically integrated company is still to be founded. It is planned that it will control 35–40 per cent of the oil refining market. These projects are currently at development stage and open for discussion and new propositions.

Control of Russian oil majors

Until her resignation in early September 2005, Prime Minister Tymoshenko did not 'let go' of the Russian oil companies, attempting to control them with 'two hands'. The first 'hand' was the State Consumer Standard Committee (the institution which checks the quality of consumer goods). Immediately after the crisis it announced its plans to check the quality and safety of oil products in Ukraine. During the petrol crisis the products had often been diluted, lessening the quality of petrol and making it dangerous for drivers. Another gross violation was that consumers did not receive all the petrol they paid for. Almost all the oil companies were accused of violations, including the main 'saboteurs', TNK-BP and Lukoil. These conclusions, which comply with the legal demands of the state, provide 'big politics' with the opportunity to find additional instruments of influence over the Russian companies in case of another sabotage.

Yulia Tymoshenko's second 'hand' was the Anti-Monopoly Committee. After conducting the investigation into the monopolist behaviour of TNK-BP and Lukoil, head of the Anti-Monopoly Committee, Oleksiy Kostusev, said that resistance from the Russian companies was so strong that it had led him to initiate another two cases against them, in connection to the non-provision of information and the provision of inadequate information. As a result of these two cases, Anti-Monopoly Committee fined TNK-BP 300,000 hryvnias for the provision of incomplete information and an additional 50,000 hryvnias for violation of competition legislation regarding the provision of inadequate information about business trips by the company's employees.

On 4 July 2005, Anti-Monopoly Committee finalized the inspection. It reported that collectively Ukrtatnafta, Lysychansk ORP and Odesa ORP (Lukoil) constituted more than 50 per cent of national state wholesale petrol and diesel oil markets, demonstrating the presence of a collective monopoly. However, the Anti-Monopoly Committee closed its investigation into the monopolist activities of Lukoil in the oil products market. On the contrary, they declared that there were signs of individual monopoly by TNK-BP over the wholesale petrol market. Anti-Monopoly Committee was planning to make a decision on this issue around the beginning of October 2005, yet never did. For now, Anti-Monopoly Committee has reported the intent to conduct further monitoring of the situation on the oil market to avoid possible conspiracies.

Creating an independent oil products market

Steps taken by the Ukrainian government in the home oil market led to its slow stabilization. Today it has great potential for the development of facilities – both in drilling and refining oil (almost 40 per cent of the facilities in existing oil refineries are not utilized yet). Many companies source their oil from the Ukrainian energy market, however, a great number of them support Russian interests. Ukraine needs European investors to enter their market.

The actions of the new Ukrainian authorities are now supported by some members of the opposition. For instance, ex-head of Naftohaz Ukrainy, Yuriy Boyko, confirmed that Ukraine has been buying oil at world prices for almost a year and that it can choose where to buy oil (in Azerbaijan, Algeria or Saudi Arabia). In August 2005, the Ukrainian Government imported petrol and diesel oil to provide market stability. Not only does the Ukrainian Government understand the future opportunities here, but also Russian business people and politicians do. Today the oil companies adhere to the agreements and the price for retail petrol has not 'soared', even after August 2005, when Russia set another record export duty rate. Moreover, in July 2005, Russian oil companies declared their intent to make massive investments in the region.

The price for petrol is currently growing, however this time experts have objective explanations for this – several ORPs have closed for planned reconstruction and world prices for oil continue to rise. Despite any governmental action, these fluctuations will continue until the oil products reserve is formed (to weaken the influence of the worldwide situation) and enough facilities are acquired to effectively offset the decrease of petrol during reconstruction . It is highly probable that every step the government takes on its way towards diversification will make the oil market more stable and independent from Russian oil policy.

Four important factors are going to influence successful Ukrainian policy in the 'petrol' sphere:

1) quickly implemented reforms;
2) quality and accord in the actions of the decision-making team;
3) reasoned decisions by the Cabinet of Ministers
4) ensuring the public is informed about the oil campaign.

Since the resignation of Tymoshenko's government, the general direction of policy in the energy sphere has continued. The Government sought reforms in all spheres, as identified by experts, in order to create an independent oil products market. However, very soon the Cabinet of Ministers will need to make up a 'list of priorities' as it lacks funds and time.

3. Gas: manipulation and conflict

Olena Viter

Ukraine's energy policy was subject to manipulation and conflict. Inadequate information from previous years, new relationships between Naftohaz Ukrainy and Gazprom, and manipulation of mass media prevented companies from developing transparent relationship policies. Mutual confrontation 'froze' a number of prospective projects between Ukraine and Russia and delayed plans to increase the transit of Russian gas through the territory of Ukraine.

Ukraine consumes more than 70 billion cubic metres of gas annually and exports 5 billion. In 2004, Ukrainian enterprises extracted 19.5 billion cubic metres of gas, but it was not enough for state consumption. Ukraine imports the majority of 'blue fuel' from Turkmenistan. In 2005 it was scheduled to import about 36 billion cubic metres and from 2007 supplies may grow to 60 billion. Gazprom is supplying another 24 billion cubic metres this year. In 2005, 124.9 billion cubic metres of Russian gas will be transited through Ukraine, and Russian Gazprom will supply 112 billion cubic metres to Ukraine as payment.

Having come to power, the new leaders of Ukraine did not start reforming the gas sphere. While representative of the former authorities, Yuriy Boyko, was occupying the post of chief of Naftohaz Ukrainy and groups of new politicians were fighting for this post, the president and the prime minister were developing a 'high-level strategy', in particular on the implementation of a gas-transporting consortium and the possibilities of constructing transit routes that avoided Russia.

Transportation

As promised, Viktor Yushchenko made his first visit as President of Ukraine to Russia. His negotiations with President Vladimir Putin were of a strategic nature. In particular, it was decided that the two countries would continue to cooperate in the gas-transporting sphere.

In Strasbourg, President Yushchenko confirmed plans to develop the gas-transporting consortium, which had been launched by Leonid Kuchma and Vladimir Putin. President Yushchenko reminded the public that the gas-transporting consortium was a model suggested by his government back in 2000. At that time they had planned participation by three sides: 1) Russia extracting the gas; 2) Ukraine transporting it through its pipeline; 3) Europe consuming the gas. According to Yushchenko, he conducted successful negotiations with the European Union in 2000, and now it was necessary to reignite them again.

Immediately after his statement, European firms declared their will to participate in the gas-transporting consortium – French companies

Electricite de France and Gaz de France, and German company Ruhrgas confirmed their intention to start negotiations about participation. Ruhrgas had originally agreed to be a full member of the negotiations at the time the agreement was signed, but had never been involved. According to Ukrainian and Russian officials, when Kuchma was president of Ukraine they had to synchronize their interests, and after that the third party should have been involved. In fact, as Ukrainian energy specialists claimed, the German party had not been admitted to the negotiations due by Russia's demand. The newly elected President Viktor Yushchenko promised to restore the negotiations in full scale.

In early November 2002, Naftohaz Ukrainy and Gazprom signed documentation about the foundation of the International Consortium On Management And Development Of Gas-Transporting Networks Of Ukraine. Later, representatives of Ruhrgas were invited to participate in the negotiations. The consortium's mission was the provision of transportation of Russian gas to Europe and the reliability, safety and stability of Ukraine's gas-transporting system. Between 2002–2004 the negotiation process included only the Ukrainian and Russian parties, which were developing a working scheme for this structure.
Carrying capacity of the gas-transporting system of Ukraine is 287.7 billion cubic metres of gas at entry point and 177.1 billion cubic metres of gas at exit point, including European countries – 141.1 billion cubic metres.

Today the subject of the gas-transporting consortium has moved up another level since the time of Kuchma's presidency. Between 2002–2004, the parties actively discussed the possibility of united management of the Ukrainian pipeline, despite the fact that it belonged to Ukraine. This is now out of the question. On the contrary, the consortium stipulates united management not of the gas-transporting system in general, but of the recently constructed gas pipeline Novopskovsk–Uzhhorod, where both sides participated. The Anti-Monopoly Committee gave its consent that its construction be finalized and gas transit begin.

'I am worried to hear every year that Russia is constructing a pipeline bypassing Ukraine. I want to have a situation with Ukrainian transit interest regulated for dozens of years, and without the risk of dropping volumes of the pumped gas from 106 billion to 70 billion cubic metres annually.'
President of Ukraine Viktor Yushchenko, Strasbourg, 25 January 2005

Over the next several months the Ukrainian Government conducted a number of negotiations with Kazakhstan, Turkmenistan and countries of the European Union about participating in the gas-transporting consortium. However, the relationship with Russia was getting tougher. In June 2005, at negotiations with Naftohaz Ukrainy, head of Russian Gazprom, Aleksei Miller, declared a possible closure of the gas-transporting consortium due to the absence of projects.

The newly constructed pipeline Borodchany–Uzhhorod was only interesting to Russian Gazprom as a first step towards managing the whole gas-transporting system of Ukraine. But Naftohaz Ukrainy argued that the GTS (Gas Transmission System) would remain under state control. Gazprom maintains its position, but the Ukrainian government does not intend to finalize the project. The next negotiations on the further participation of the Russian party in the GTS were to be scheduled for late 2005.

Prices threaten to triple

Another change in the Ukrainian–Russian gas relationship was the transition to a tougher form of gas trading. In particular, at meetings held between Naftohaz Ukrainy and Gazprom, in March 2005, they agreed to review mutual relationships in the natural gas supply and transit sphere. Later, new head of Naftohaz Ukrainy, Oleksiy Ivchenko, claimed it had been Gazprom that had initiated the introduction of the European level of tariffs for transit of Russian gas to Europe. Earlier it had been $1.09 per thousand cubic metres per 100 kilometres; the new proposition was $1.75–2.00 (another initiative was the total cancellation of barter payments). At the same time, Gazprom said that it had been Naftohaz Ukrainy's initiative to change the tariffs, and that Gazprom's further demands were a reaction to the 'impudence' of the Ukrainians.

Gazprom agreed to the new gas-transporting terms and suggested that in exchange for market terms for gas transit, Ukraine had to accept market terms for gas consumption. In particular, Gazprom demanded that prices be raised to the European level – $80 per 1000 cubic metres instead of the previous $50. The new payment level exceeded all previous increases of transit payments. Ukraine agreed to consider this offer on the condition that it would retain its terms regarding the gas balance for Ukraine, in particular supplies from Gazprom of 23 billion cubic metres in 2005. In response, the Russian company guaranteed that it would supply Ukraine with Russian gas completely, not only in 2005, but also in 2006. Ukraine stepped back again while experts considered the suggested terms.

Russia did not intend to abdicate its position. At the next meeting of negotiation in June 2005, chairman of Gazprom, Aleksei Miller, indicated $160 per 1000 cubic metres as a base price for 2006. Gazprom had acted toughly in response to Ukraine's relationships with Turkmenistan and also its negotiations regarding greater participation in transporting gas to Europe. Many experts did not take the new terms of Gazprom seriously. Parliamentary deputy Oleksandr Hudyma, a member of Ukraine's parliamentary Committee on Fuel Energy, said, 'These are emotional statements, which should not be taken seriously'[x]. In his opinion, Gazprom's statement was a reaction to Naftohaz Ukrainy's intention to change the existing format of the two-sided Russian–Ukrainian gas-transporting consortium and invite other European states to participate. Naftohaz Ukrainy also demanded that gas prices be based on 'The agreement about the Transit of Russian Natural Gas Through the Territory of Ukraine to 2013'. In accordance with this, Naftohaz Ukrainy insisted on keeping both the existing tariffs on gas transporting and gas consumption.

At the end of June 2005, Gazprom made a statement concerning all CIS (Commonwealth of Independent States) members. As a result of weakening cooperation from these states and the transition of some of them (in particular Georgia and Ukraine) to democratic regimes, Russia had decided to toughen its energy relationships with them. From 2006 the price of gas would be increased for CIS and Baltic countries and barter payments would be substituted by market mechanisms. According to the Russian gas monopolist's statement, the European market had become a top priority.

The presidents of Ukraine and Russia diffused the situation. At the same time that Gazprom issued its statement, they discussed the possible continuation of a fruitful dialogue. President Yushchenko denied that there were any essential difficulties in the Ukrainian-Russian relationship. At a G8 summit, President Putin agreed to extend the quantity of gas supplies through Ukraine. However, at the same time (in the presence of seven other countries) he accused Ukraine of stealing gas, with no grounds. Today, the question of the price of Russian gas in 2006 is the subject of further negotiations, continued by Prime Minister Yuriy Yekhanurov's government.

Lost gas

In addition to the complicated relationships between Ukraine and Russia regarding price formation, another scandal flared up. At the end of April, head of Gazprom, Aleksei Miller, visited Ukraine to meet with President Yushchenko to discuss the prospects of cooperation in the gas sphere. As part of this dialogue, Aleksei Miller accused Ukraine of misplacing 7.6 billion cubic metres of gas, which were supposed to be kept in local gas reservoirs. According to Gazprom, in the period October 2004–March 2005 Naftohaz Ukrainy refused to execute Gazprom's instruction to pump out this gas, giving different reasons for not doing so, including the absence of the above-mentioned quantity.

The new government rejected all the charges claiming that gas at the cost of $3.5 billion had never left the country. At negotiations in June 2005, Aleksei Miller requested to pay for the above-mentioned gas in exchange for possession of it, but the Ukrainian party refused. A preliminary estimation by experts shows the disputed amount of gas costs around $800–900 million (the price of 3.5 billion cubic metres at the European market plus cost of 4.4 billion at the basic rate for CIS). At the time, Russian and Ukrainian press were covering the scandal and MPs of the Russian State Duma even considered whether Ukraine should be subjected to tougher economic pressure in response to the 'theft'.[xi]

During the debate regarding the missing gas, ex-head of Naftohaz Ukrainy, Yuriy Boyko, and press secretary Kostyantyn Borodin made statements on the situation. According to them, the supposedly missing quantity of gas was in Ukrainian reservoirs and accusations regarding its loss between October 2004–March 2005 were false. The current heads of Naftohaz Ukrainy made similar statements. Later, representatives of Gazprom confirmed this fact. At a company briefing, Deputy Chairman Aleksandr Ryazanov confirmed that gas is kept in Ukrainian underground reservoirs and the problem lies in various technological difficulties, which prevent it from being extracted and utilized. Moreover, according to the representative of Gazprom, gas was 'spoiled' to some extent due to incorrect storage. The negotiations regarding the acquisition of this gas is still in progress – Ukraine did not want to pay the price suggested by the Russian party (about $160 per cubic metre) and did not have a unanimous opinion as to whether Ukraine should buy this gas (it had not been planned for and could upset gas balances of the company).

Without the consent of the Ukrainian party, Gazprom decided to include the mentioned gas commodity as part payment to Ukraine for transporting Russian gas transit through their territory. This initiative caused much critical protest from Naftohaz Ukrainy, with its chief stating that if

Gazprom reckoned unilaterally 7.8 billion cubic metres of gas as payment for Russian gas transit through the territory of Ukraine, Naftohaz Ukrainy would reckon unilaterally this quantity from export of Gazprom to Europe. The Ukrainian party offered a written variant of their payments for gas originating from 1 July 2005 and suggested returning the mentioned gas. If Gazprom did not need it they could re-supply it to Ukraine during the autumn–winter period.

On 1 July 2005, Gazprom officially notified Naftohaz Ukrainy that as a response to it reckoning 7.8 billion cubic metres of gas as payment for gas transit it would supply only 1.1 billion cubic metres of gas to Ukraine by the end of 2005. The statement stipulated that 'Gazprom will execute all obligations on transporting of gas for Ukraine's needs and counts on the execution of obligations on transit by the Ukrainian party'[xii]. Naftohaz Ukrainy responded on the same day, threatening that Gazprom's position would lead to the incomplete delivery of Russian gas to Europe as Ukraine would claim gas in the amount stipulated in the agreements at the beginning of the year.

The parties managed to reach a common agreement only a month later. It was a compromise. Naftohaz Ukrainy bought 2.55 billion cubic metres of gas at the expense of payment of transit services of Russian gas in 2005. Gazprom increased gas transit through the territory of Ukraine by eight billion cubic metres in 2005 and would increase it by 8–11.5 billion cubic metres of gas in 2006 compared to the previously planned quantity. Gazprom sold the other 5.25 billion cubic metres of gas to RosUkrEnergo.

Outcome of the 2006 gas crisis

In autumn 2005, Russia proposed that Ukraine buy Russian gas at $230 per thousand cubic metres. This unrealistic price increase (from $50–$230 – almost five times higher than originally) made Ukraine look like an unreliable partner that couldn't pay for their own gas or transport Russian gas to other European countries. As a result, Naftohaz refused to sign any supply agreements with Gazprom for 2006. Subsequently, Russia threatened to shut off the gas supply.

These unacceptable conditions presented Ukraine with two options. They could 'steal' gas from other European countries in order to avoid an 'Alchevsk' situation throughout Ukraine, but this would mean destroying all positive relationships with Europe during 2005. The second option was to remain honest and do without the supply of Russian gas, but it meant the total loss of the 'Orange authorities' in the parliamentary elections. For Russia both those variants were acceptable.

The Russian scenario was not successfully realized. 'Gas crisis' and related events (for example retirement of the government) raised the rating of Our Ukraine political party almost twice (by different estimations to 18–20 per cent). The European Union in general ignored the conflict and continued to encourage Ukraine to cooperate.

The main loss for Ukraine in this gas conflict concerned agreements with RosUkrEnergo Company about the supply of gas on Ukrainian territory. Non-transparency in the signing of the agreements and the unwillingness of the Ukrainian government to publish documents led to criticism from the Ukrainian public. In the pre-election environment, criticism from the different political parties about the gas conflict became competitive. As a result, the public did not obtain complete information about the strong and weak aspects of the agreements.

RosUkrEnergo AG is a joint venture between Gazprombank and Raiffeisen Investment AG. Since 1 January 2005, the company has acted as an operator of Turkmen natural gas transportation from the border of Turkmenistan and Uzbekistan to the border of Russia and Ukraine. The company has a contract with the Gazprom PC for gas transportation on the territory of Uzbekistan, Kazakhstan and Russia. Naftohaz hands over 37.5% of the volume of gas transported for Naftohaz to the company as services payment. The company sells all gas in European markets.

The responsibility for this loss weighs on the Cabinet of Ministers, who did not reach a common and clear position concerning the gas agreements. The Ukrainian public and experts still have a lot of questions, for example – whether the change in gas prices from Turkmenistan will influence gas prices in Ukraine. The representatives of the RosUkrEnergo Company insist on increasing the cost of gas for Ukraine (based on a set formula). At the same time, the cabinet insisted on maintaining a concrete price on any terms – $95 per 1000 cubic metres.

During this time, Prime Minister Yuriy Yekhanurov, did not demonstrate his confidence in the agreements. His main argument to the public was not about the advantage to Ukraine but, rather, the hopelessness of the situation. Considering the bigger picture, Russia already cannot control multi-variant approaches to its development. RosUkrEnergo was a suitable company for Russia (Gazprom is a 50 per cent shareholder in this company), but in order to demonstrate transparent politics, in February 2006, President Putin loaded all the responsibility for the un-transparent side of this company on to Ukraine. In doing so, Putin reopened to Ukraine the possibility of revising the January agreements. Yuriy Yekhanurov suggested replacing the unreliable partner and finding more transparent ways to cooperate. Russia disagreed. For Russia this step was a serious signal, showing that the situation was already out of its control.

The policy of diversification, which was activated in Europe after the Ukrainian-Russian gas conflict, provides Ukraine with a good opportunity to become a leader in a few strategically important European projects. President Yushchenko has already said that Ukraine is ready to coordinate its strategic energy policy with the greater European policy. Ukraine can be a corridor for many gas transport routes, for example from Iran or Caspian countries.

Today Ukraine has a real chance to play an independent game in the gas sphere. This is the first time Ukraine has been able to develop a realistic possibility of a long-term energy policy and force Russia to be a participant of this, rather than the driver. For this purpose, Ukraine needs to take a fresh look at its strategic documents. Working from a 'bureaucratic scrap of paper' they must develop a real vision for the Ukrainian energy policy, which foresees the achievement of this goal.

Media manipulation

Russia has been conducting an extremely aggressive attack against Ukraine and doing its best to discredit its partner through mass media. Deliberate distortions of Ukraine's image by Russia have been found at least twice.

The first attempt to discredit Ukraine in the West was when the information agency Interfax-Ukraine, referring to Russian mass media, reported that Jochen Weise, a member of the board of directors of EON Ruhrgas, had complained about the deterioration of the regime of gas deliveries through Ukraine. The report stated, 'He did not accuse Ukraine of unsanctioned gas requisitioning, but made it clear that terms of deliveries of Russian gas through Ukraine became worse after Viktor Yushchenko came to power'. However, several hours later, Tetiana Kurganova, a representative of the press centre of the German company, denied this fact.

Another case of inadequate information came from the East. Russian press reported that President of Turkmenistan, Saparmurat Niyazov, had allegedly said on local television that Ukraine had not paid in a timely way for consumed volumes of gas. 'You are fooling us smartly, but you have this money,' he was cited as saying. The Ukrainian Ministry of Foreign Affairs reported that there had not been any statement from the Turkmen party about Ukrainian debts.

Several days later, Oleksiy Ivchenko denied the information published in Russian mass media, stating that 'Turkmenistan has no claims against Ukraine, including the issue of non-payment for natural gas'. At that time, negotiations between the Ukrainian and Tukmen parties were taking place and Niyazov put forward no claims against Ukraine. Niyazov made a statement to the Turkmen press where he said that the published statements were not true. According to the President, the Russian media had quoted statements he had made several years ago.

Again, in October 2005, the media cited Niyazov allegedly protesting against Ukrainian failure to pay for the gas in kind. Ivchenko denied the accusations again, telling the media that he had visited Turkmenistan and presented Niyazov with the facts and figures of the payments. According to Ivchenko, Niyazov had reprimanded his aides for misinforming him.[xiii]

Diversification of supply

Demonstrating the development of a working partnership with Russia, the newly formed Ukrainian government made steps to decrease its dependence on Russia. Already in its first months, gas importation was reduced and home extraction speed was raised. In particular, gas extraction increased by 3.5 per cent in January and import dropped by 1.5 billion cubic metres. This was partly due to a warm winter as well as the policy of the new authorities.

Naftohaz Ukrainy managed to obtain a huge credit from Deutsche Bank (2 billion Euros) for additional gas extraction for domestic use. According to Russian experts, no Russian company has ever received such a sum from any Western structure. The credit (lent for seven years at 8 per cent annual interest) was for modernization of the gas-transporting system of Ukraine and also to support common Ukrainian–German gas projects. Later, chief of Naftohaz Ukrainy, Oleksiy Ivchenko, explained that this money will be directed towards increasing Ukraine's gas extraction by two billion cubic metres annually, leading to a total annual extraction of 30 billion cubic metres of gas in five years.

This was not convenient for Russia. By utilizing gas for its own consumption, Ukraine would minimize its dependence on Russia, meaning it would not be able to 'dangle the gas hook' in front of them in political decision-making. Moreover, the export of Ukrainian gas to Central-Eastern Europe poses competition, though minor, to Russian gas companies (European countries have been searching for additional gas supply sources for a long time as a part of a diversification program). In a conflict between Russia and Turkey, cooperation with Turkey by Naftohaz Ukrainy would be rather dangerous for Russian interests.

As part of the diversification programme, Naftohaz Ukrainy launched negotiations regarding participation in oil/gas projects in Iran, Afghanistan, and Pakistan. They placed special emphasis on cooperation with Iran. At the end of February 2006 the newly appointed Minister of Fuel and Energy, Ivan Plachkov, met with the Iranian ambassador in Ukraine and discussed the possibilities of Iranian gas transit to Ukraine. The minister's initiative was the first in a long chain of Ukrainian–Iranian negotiations. Later, the Secretary of the National Security Council and Defense, Petro Poroshenko, paid a visit to Iran. The negotiations led to the development of an initiative to construct a gas pipeline bypassing Russia on the route Iran–Armenia–Georgia–Ukraine–European Union. After their respective democratic revolutions, Ukraine and Georgia have demonstrated a strong desire to cooperate and this project signals the new state of relationships.

Today, other partners are actively joining the dialogue. Georgia has taken responsibility for negotiations with the Armenian party – Prime Minister of Georgia Zurab Nogaideli has already met with his Armenian counterpart Andranik Markaryan. Both parties decided to focus on the gas-oil issue in further negotiations. At their estimation, the project will cost about $180 billion. Moreover, Iran and Armenia have already begun constructing the gas pipeline, which may later be used for transit and as part of the above-mentioned project.

Another project, suggested by the Ukrainian Government, which will reduce Ukraine's dependence on Russia, is construction of a gas pipeline bypassing Russia through the territory of the Caspian Sea – from Turkmenistan through Azerbaijan, Georgia, and the Black Sea to Ukraine. Simultaneously, an announcement was made about the formation of a new gas-transporting consortium, which could include Turkmenistan, Kazakhstan, Russia and Ukraine. During Viktor Yushchenko's visit to Turkmenistan in March 2005, the Turkmen President Niyazov gave his principle consent to this initiative. Currently the idea is being negotiated. Despite the fact that the President of Ukraine anticipated the project launch within three years, it is unlikely to be operational quickly. However, if it is successfully launched, it will weaken Russia's position significantly, not only on the Ukrainian territory, but also in Europe. Becoming full members of the gas transportation system to the countries of the European Union, Turkmenistan and Kazakhstan will be able to participate in negotiations with the EU, which will have an impact on their Russian colleagues, forcing them to take their interests into account.

The energy opposition

The formation of an 'energy opposition', by representatives of the former administration, is a positive step in the development of Ukraine's energy policy. Yuriy Boyko, today heads a group of politicians who criticize the current energy policy of the Cabinet of Ministers. The new 'energy opposition' also puts forward constructive propositions about the solution of certain issues and problems. Their actions promote a many-sided vision of Ukrainian energy sector development.

Recently Yuriy Boyko has offered a variant of Ukraine's energy strategy development based on seven principles. Mostly they are principles of European energy safety. The first principle, Boyko suggested, is development of three equal gas supply sources to Ukraine – in particular, 30 per cent Ukrainian gas, 30 per cent Russian gas and 30 per cent Central Asian. The current balance does not reflect this proportion to the full extent, therefore a review of several contracts is required, which would shift the balance from Russian supply to the 'Asian way'.

Another principle of the 'energy opposition' is switching to long-term price policies with partner-states in the gas supply sphere. In particular, 18 contracts with Russian companies and 6 with Turkmen companies are mentioned. This principle does not totally correspond to the European market, which works on a long-term 'take and pay' basis. The third element of the oppositional strategy is to increase electricity production in Ukraine and sell it to Europe. Currently Ukraine has the potential to provide this product at a top level.

The fourth step of the strategy is a reform of communal enterprises to ensure efficient energy usage, and the fifth one is implementation of the national energy economy program. In particular, it proposes production and introduction of special electricity counters, mini boiler-houses and a departure from the centralized energy economy system. The direction of the energy economy has been a main priority for Europe and the United States for a long time. Therefore, there are no doubts about the importance of this step. The 'energy opposition's' sixth step is the formation of vertically integrated national companies resembling already existing gas-production ones. In the opinion of the 'energy oppositionists', it will allow the government to effectively react to price fluctuations with market methods and dampen any speculative actions, which players of oil or gas markets might make.

The final vital step is the independent extraction of oil and gas on the home territory of Ukraine. Currently Ukraine has about 600 billion cubic metres of explored gas and about 1.2 trillion of units of standard fuel in the Ukrainian shelf of the Black Sea. It is estimated that with the current speed of gas extraction in Ukraine, there is enough gas for 30 years and, as the opposition claims, selling it to a large investor might pose the risk that 'they will pump everything out' leaving only enough gas for 20 years.

However, the opposition says little about the core reasons that led to the sharp reforms in the energy sector: the non-transparent management schemes, strategic policy-making and removal of excessive administrative barriers for investors. Without solving these problems, any theories concerning the development of the Ukrainian energy sector would be shallow.

4. Ukraine, Turkmenistan and Russia: peculiarities of the triangle

Rostyslav Pavlenko

Competing for Turkmen gas

Prior to Yushchenko taking up office in December 2004, Ukraine was informed by Turkmenistan that it had decided to stop supplying gas to Ukraine and Russia. This decision represented a protest by Saparmurat Niyazov against increased prices for products Turkmenistan received in exchange for gas in barter exchange. The Turkmen party had been required to subsequently increase the volume of gas supplied to Ukraine and Russia. At the beginning of December, Turkmenistan proposed a new price for its supply of natural gas to Russia and Ukraine, stating that in 2005 the price of gas would increase to $60 per thousand cubic metres ($16 higher than in 2004).

After negotiations with a Turkmen delegation, deputy chairman of Gazprom, Aleksandr Ryazanov, reported that Gazprom would not be able to compensate Turkmenistan's obligations on gas supplies to Ukraine. Ukrainian-Turkmen cooperation was jeopardized.

> There is no cheaper gas in the world than Turkmen gas.
> Saparmurat 'Turkmenbashi' Niyazov

This state of events led to Yuriy Boyko (then chief of Naftohaz Ukrainy) visiting Turkmenistan during the period of authoritarian change in Ukraine. As a result of negotiations, a contract was signed that set higher prices for the supply of Turkmen gas to Ukraine – $58 per thousand cubic metres instead of the existing $44. It was planned that Turkmenistan would supply 36 billion cubic metres of gas to Ukraine in 2005, the same quantity as in 2004. Still, according to experts, Mr Boyko exceeded his authority, as he did not coordinate the price with the Ukrainian Cabinet of Ministers (at that time the former authorities were still in office).

According to agreements made in January 2005, Ukraine had to pay half of the value of the gas in dollars and the remainder through goods deliveries and clearing services (the contract stipulates dependence of the price of gas on the value of goods). According to Niyazov, 'The change of prices for metal and other goods, dollar rate, everything is included in the Supplementary Agreement'. It was planned that this agreement would be signed quarterly.

Russia's stance regarding Niyazov's requirement was tougher. Gazprom refused to buy Turkmen gas at the increased price, offering instead to conduct all future payments in dollars instead of barter. However, the

Russian-Turkmen dialogue was actively continued in order to fulfill all long-term agreements between the two states and to increase the volume of gas, which the Russian party may buy in future.

The Ukrainian government copied Russia's example in their dialogue with Turkmenistan. In May 2005, the Turkmen party expressed its discontent with Ukraine's incomplete payment for the supplied gas. Oleksiy Ivchenko, new chief of Naftohaz Ukrainy, urgently flew to Turkmenistan to attend negotiations. In June, the parties signed an agreement which stipulated that from 1 July 2005, Naftohaz Ukrainy would pay for Turkmen 'noninvestment gas' solely in dollars at the price of $44 per thousand cubic metres at the border of Turkmenistan and Uzbekistan. Moreover, they signed supplementary agreements to increase the amount of 'investment gas' supplied in 2005 from the existing 4.5 billion cubic metres to 5 billion cubic metres, and in 2006 to 6 billion cubic metres.

Supply over-promises

Today Ukraine and Russia have to compete for Turkmen gas. Both states realize the importance of purchasing large volumes of gas from Turkmenistan. It is important for Ukraine so that it can diversify its supply sources and reduce its dependence on Russia. For Russia, Turkmen gas is important because it provides it with additional supplies of gas, allowing Russia to increase its presence in the European energy market, and also to prevent states that are energy-dependent on Russia from accessing alternative gas sources.

There is an agreement about strategic cooperation until 2026 between Ukraine and Turkmenistan. According to the signed contracts, the state oil and gas company Turkmenneftegaz is obliged to supply gas to the amount of 50–60 billion cubic metres annually to Ukraine from 2006 to 2026. In turn, in accordance with the existing contract between Russia and Turkmenistan, the latter has to sell Gazprom 60–70 billion cubic metres of gas in 2007, 63–73 billion cubic metres of gas in 2008, and from 2009, 70–80 billion cubic metres of gas. Having been given the opportunity to 'play' in this way, Turkmenistan has taken full advantage of it.

At the same time, statistics show that Niyazov will not be ready to fulfill both of the strategic agreements. According to Russian data, in 2004 Turkmenistan's gas export was 58.5 billion cubic metres and extraction amounts are gradually decreasing. In 2004, gas extraction in Turkmenistan decreased from 59.1 billion cubic metres in 2003 to 58.8 billion cubic metres. In January 2005, gas extraction dropped by 14 percent (to 5.64 billion cubic metres) compared to January 2004. Turkmenneftegaz is not going to ensure provision of both contracts with Russia and Ukraine. And redirection of export from Iran will not help the situation [xiv].

In this context, leaders of Turkmenistan may choose which agreements to adhere to and which to renegotiate the decrease of supply volume giving preference to those agreements with more beneficial terms and extensive prospects for cooperation. As Ukraine has previously not been connected to Turkmenistan by any unique projects, the termination of the contract would come at too high a cost. The formation of a consortium on gas extraction and transportation, which would include Kazakhstan, Uzbekistan, Russia and EU states, could be such a project. Another project between the two countries could be the transportation of Iranian gas and the common construction of an infrastructure in Turkmenistan[xv].

If the assumption of 'Turkmenistan over-estimating its abilities' remains just that, an assumption, and there is enough gas to execute all contracts, cooperation by the countries in more extensive projects will definitely add to stability and predictability of relationships.

Alternative gas pipelines

Currently Gazprom is seeking ways to transport gas to Europe that 'bypass Ukraine'. The NEP (North-European pipeline), which measures 917 kilometres, is being constructed for transportation of 30 billion cubic metres annually. According to Gazprom, fuel consumption will significantly increase in Europe in the next five years.

The NEP project has been underway for nine years (since 1997). Its productivity measures between 19–30 billion cubic metres per year. The first cubic metres of gas are expected to be transported through NEP in 2010. Its cost is estimated at $5.7 billion.[xvi] However, analysts have estimated that the pipeline will not meet necessary requirements. According to Gazprom's press secretary, Olga Moreva, last year Gazprom supplied more than 140.5 cubic metres of gas to the European market. 'On the present contracts our export must be increased to 180 billion cubic metres by 2010,' she said.

'The North-European pipeline is a political statement of Russia – and rather costly statement,' says Jonathan Stern, Director of Gas Research at the Oxford Institute for Energy Studies. 'The pipelines they have are not used at full-load,' he noted. 'New pipelines will be required not earlier than 2013–2015.'[xvii]

Whatever the situation, Russia hopes to launch 'alternative' pipelines in the near future. Ukraine is seeking opportunities to form its own alternative in response – supplying Central Asian gas (as opposed to Russian) to the EU. In particular, during President Yushchenko's visit to Turkmenistan in March 2005, Ukraine proposed a big international gas project to Turkmenistan, arriving at a principal agreement. Ukraine intends to form a gas consortium with Turkmenistan and to invite Kazakhstan and Russia to participate. Kyiv has also agreed with Ashgabat (Turkmenistan's capital) to draft a contract for gas supplies for 20–30 years. The Ukrainian party put forward the initiative to form the gas-transporting consortium on the route Turkmenistan–Aleksandrov Gay–Kazakhstan–Novopskovsk (the border between Ukraine and Russia) – Ukraine.[xviii]

According to Oleksiy Ivchenko, '[The] Russians are considering our proposition, estimating its economic, political, resource reasonability. However, their decision is not principal for us… If they refuse to construct on their territory, we will have grounds for using an alternative way.' But experts note that this project has the same drawbacks as Russia's NEP: a high cost of implementation (in the case of bypassing Russia they will have to lay two pipes on the bottom of the sea) and uncertain prospects of filling the pipes (taking into account the above mentioned difficulties with the Turkmen gas contracts).[xix]

Ukraine's negotiating position

The new Ukrainian authorities have inherited a number of the energy sphere's problems, which may cause crises in home markets (price increases) and make foreign pressure on Ukraine possible.

Firstly, the industry still over consumes energy; energy consumption per unit of production in Ukraine is four–five times more than in the EU states. Ukraine consumes about 75 billion cubic metres of gas per year – one of the highest numbers in relation to GDP in Europe and the world.

Secondly, Ukraine has only one source to transport fuel it needs – through the territory of Russia. Even gas from Turkmenistan is transported through Russian pipelines. On the other hand, 80–85 per cent of Russian gas is transported to the EU through the territory of Ukraine (Ukraine and Poland control practically all export of Russian oil to Europe, which is directed through pipelines). This situation of mutual dependence prevents the parties from taking unreasonable steps. However, at the same time it urges the parties to search for alternative sources of supply and transportation of fuel, which bypass each other.

Thirdly, the low-income level of the population and excessive energy consumption by its industry will make it difficult for Ukraine to switch to 'world prices'. Therefore, energy prices are negotiated with additional terms ranging from goods deliveries as barter instead of money payments, to involving firms, close to some top-ranking officials, in payments. As a result, in exchange for low gas prices, Ukraine risks corruption and is in constant danger that its energy suppliers will review prices on any unexpected pretext.

The energy sector of the Ukrainian economy requires profound reforms directed at the following:

- decreasing industries' energy consumption;
- gradual raising of energy prices to world levels;
- diversification of sources of fuel provision;
- reaching agreements with traditional suppliers regarding maintaining the existing form of supply and transportation of energy sources, and abandoning the practice of their one-sided consideration;
- increasing extraction of Ukraine's energy sources;
- maximizing Ukraine's transit potential, investments in modernization and development of extraction, refining and transportation infrastructure.

As previously mentioned, representatives of the former and new authorities share general approaches to solving the energy sphere's problems. However, there are significant differences of opinion when it comes to priorities. Thus, the current opposition has stressed the importance of maintaining and developing existing sources of fuel supply from Russia, post-Soviet Central Asia (in particular , Turkmenistan). Source diversification focuses primarily on the involvement of Central Asian sources. Broader projects, such as transportation, move to the background.

The opposition has criticized the new authorities' introduction of more transparent money payments for energy sources. They are skeptical about the prospects for developing Ukraine's energy infrastructure (construction of new pipelines, oil-refining plants, etc.). It also regards Western investors with suspicion and does not shy away from using populist arguments about business people who will 'pump out everything'. In general, the opposition supports a scheme of involvement and utilization of energy sources, traditional for Ukraine (taking into account the need for energy preservation, extension of electricity export etc), whose work depends to a great extent on informal agreements with leaders of the Russian Federation and Turkmenistan. From these positions they criticize the actions of the new authorities in the energy sector.

On the contrary, it is dangerous for the new authorities to count on such relationships as 'established' and to be too dependent on the goodwill of foreign officials . As it was stated in Ukrainian mass media, the Ukrainian-Russian relationship has changed from 'inter-elite' (where informal agreements take priority) to 'inter-state' (when rational interest is a key factor). The success of this relationship will depend on the ability of the Ukrainian authorities to prepare long-term projects, directed at the diversification of fuel supply sources, reduction of energy consumption of industry, utilization of state transit facilities, and to attract the interest of international investors.

5. Ukraine, the Caspian and Russian control

Mykhaylo Honchar

The Odesa–Brody pipeline

In 2005, 14 years after becoming independent, Ukraine remains an energy dependent state with a monopolist energy supply from Russia, inherited from the Soviet economy. The beginning of massive oil and gas resources development in the Caspian region, located near Ukraine (at least twice as close than Siberia), in the early 1990s gave Ukraine a unique opportunity to diversify its oil supplies. Unfortunately, it has not taken this opportunity yet. Then Prime Minister Leonid Kuchma, 'godfather' of the sea oil transshipment point Pivdenniy, having signed a decree about its construction in February 1993 and, as President, symbolically welded a golden joint of the Odesa–Brody pipeline in August 2001, appeared a killer of the project of oil independence of Ukraine at the end of his presidency, having supported reverse utilization of it.

Regular supplies of Caspian oil to Ukrainian and European markets via the route: Caspian Sea–Black Sea with further utilization of the oil pipeline Odesa–Brody were supposed to start back in November 2003. That was stipulated in an agreement as of 17 July signed by the Ukrainian pipeline operator Ukrtransnafta PC and Kazakh NK Kazmunaigaz CC. The launch did not take place due to an artificial restriction imposed on Ukraine, about selection of the pipeline functioning direction.

Astana (capital of Kazakhstan) confirmed its intentions in 2004. Kairgeldy Kabyldin, managing director of the oil and gas state company Kazmunaigaz said to Reuters, 'The group of Kazakh oil companies consider the route Odesa–Brody convenient and can start oil supplies with this pipeline in the second half of 2004 – up to six million tons of oil annually – for European states.' Not only does this statement reflect the intentions of working together, but it also demonstrates a genuine will to move in a new direction. Moreover, according to Kabyldin, 'Economic estimates have shown expediency of this route[xx]'.

Two Western-Ukrainian oil refining plants (ORPs) in Drohobych and Nadvirna were ready to receive Caspian oil for refining from Odesa–Brody. ORP Halychyna JSC reported its readiness to refine 500,000 tons of oil in 2003 and 1.5 million tons in 2004. Naftokhimik Prykarpattya added the refining of 1.0–1.5 million tons of oil to its schedule in 2004, with plans to refine 2.0–2.5 million tons of oil in 2005. If the Odesa–Brody system had commenced as described above, Ukraine would not have undergone such a large-scale oil crisis in 2004 and 2005.

However, this scenario did not happen. At the end of September 2004, the Odesa–Brody pipeline was utilized for gas transit at last, but in the opposite direction from originally planned, ie from Brody to the Pivdenniy terminal in Odesa. And it transported Russian oil rather than Caspian oil. Consequences quickly followed. In May 2004 and April 2005, Ukraine was shaken by fuel crises and price fluctuations, there was an absence of fuel at gas stations and oil traders discussed the growth of world prices for oil. So what happened in Ukraine to sabotage this strategically important project?

The Odesa–Brody project was more dead than alive after the welding of the final 'golden joint' in August 2001. The project was besieged by a number of problems:

- There was no demand for the Odesa–Brody pipeline from inside Ukraine, as the privatization of oil refinery in Ukraine was made by a single party – Russia.
- Odesa–Brody was constructed without taking into account the necessity of oil supply diversification and the control of sufficient resources by the government, so that it could retain some influence in the country's oil market.
- The pipeline was constructed in a 'Soviet' way, ie no one worried about its commercial viability and its appeal to potential customers was unclear. Acknowledging the persistence of Lubomyr Buniak, Director of the Druzhba pipeline, in finalizing the construction of Odesa–Brody his certainty that 'as soon as the pipeline was built, they would see a line of oil tankers at the Pivdenniy terminal' proved incorrect.
- International cooperation on the project was undermined already in 2000, as Viktor Yushchenko's government. The government's position was defined by Buniak's approach: 'We will build everything ourselves even as far as to Gdansk. We do not need anyone.'
- Upstream oil exploration in the Caspian region was developing and, simultaneously, the developments of routes for Caspian oil transportation that provided competition to Odesa–Brody, were being planned.

These non-market approaches to Odesa–Brody were only altered by merging the two state oil transportation companies, Druzhba and PDMN, into Ukrtransnafta, and with the introduction of the post of the Special Representative of Ukraine on the EAOTC (Euro-Asian Oil-transporting Corridor), which allowed for the formation of an effective vertically integrated managerial and businesslike approach to the project. In fact, a team, comprised of the Special Representative of Ukraine on EAOTC (Oleksandr Todiychuk), in cooperation with European and American consultants, reinvigorated the project and turned it into a commercially attractive and competitive project, which occupies a unique niche in the European market for oil transportation.

The Odesa–Brody project provides for three major modules for the delivery of low-sulphur Caspian oil to the European market:

1. The 'Western' module runs to Slovakia, the Czech Republic and Southern Germany. It utilizes the existing Druzhba system and the Ingolstadt

(Germany)–Kralupy (Czech Republic) pipeline in reverse.
2. The second or 'Northern-Western' module runs to Plock in Poland exiting at Gdansk through the existing oil pipeline Plock–Gdansk.
3. The third or 'Northern' module runs to Belarus and Baltic countries.

There are also three additional modules – Moldovan, Austrian and Northern-German:

1. The Moldovan module is connected with the construction of a short oil pipeline-spur (80 km) for oil supplies from Odesa–Brody to the projected Moldovan ORP.
2. The Austrian module is connected to the construction of the Bratislava–Vienna (50 km) pipeline, which enables oil supply through the Druzhba system to the only Austrian ORP, Schwehat.
3. The Northern-German module is connected to the construction of the Schwedt–Wilhelmshafen (660 km) pipelines, which enables take off of oil transit volumes at the deep-water German port in the Northern Sea on the route Odesa–Brody–Plock–Schwedt–Wilhelmshafen.

The main part of this project is connected to the Northern-Western module. Construction of the Brody–Plock oil pipeline brings a new aspect to the project in general. The western direction is of equal importance, as here the Druzhba system, which has now been launched, has a facility for additional capacity, sufficient for the first stage of Caspian oil and the ability to successfully pump oil of different grades. This direction module has had some success in negotiations involving Czech and Slovakian companies. Taking into account the Czech Republic and Slovakia's membership in the EU, the Odesa–Brody system uniting Druzhba, is a factor for integrating the Ukrainian pipeline network into the EU system.

In accordance with a business plan, developed by PricewaterhouseCoopers and Channoil, the Odesa–Brody project is designed to maximize oil supplies (from Russia) through the existing Druzhba system and prospectively from the Caspian region through Odesa–Brody and Odesa to Druzhba. This project benefits Ukraine, Slovakia, Czech Republic and Poland as all receive two increasing oil flows, and it increases both transit volumes of oil and diversification of supply. This, in turn, positively influences energy supply security for EU member states and Ukraine. Also, the project integrates Ukraine's pipeline network into the energy system of an extended EU. For Kazakh and American companies developing resources in Central Asia, this route is independent of Moscow in serving the European market.

According to the PwC-Channoil business plan[xxi], three simultaneous phases of the Odesa–Brody project involving the delivery of Caspian and Russian oil to Central and Western Europe markets are anticipated. Each phase is listed below.

1. oil delivery to Kralupy ORP (Czech Republic), Wogburg and Ingolstadt (Germany);
2. oil delivery to Karlsruhe (Germany) and Schwehat (Austria);
3. construction of the Odesa–Brody–Plock (Poland) pipeline with further construction of a Schwedt–Wilhelmshafen (Germany) spur with connection to the deep-water terminal NWO on the North Sea.

As a part of each phase of the project, the supply of Russian oil may be affected.

The new oil pipeline from Schwedt to Wilhelmshafen will enable the supply of Russian oil through Belarus and Poland to Northern-Western Germany. This should decrease tanker supplies of Russian oil to ORPs in this region. This route will further diminish maritime traffic in the Baltic Sea and Danish channels, which have restricted carrying capacity (very similar to the Bosphorus Channel), and decrease ecological risks in this region.

The implementation of the Odesa–Brody pipeline project offers a number of advantages to Russian oil recovery and oil transporting companies as well. These include:

- a direct, economically advantageous oil pipeline route to once inaccessible ORPs in southern Germany, which will result in the increase of oil imports to 5 million tons annually;
- transportation of Russian oil through Ukraine via a cheaper route: Samara–Kremenchuk–Pivdenniy of the declared volume of 9 million tons of oil annually, with the possibility of infrastructure development for transportation of larger volumes in case of the Russian party giving guarantees;
- Russia's participation in the finalization of Brody–Plock oil pipeline construction, including the spur to Wilhelmshafen.

In a letter from the European Commission (13 May 2003) devoted to questions regarding energy policy development in an expanded EU, the EU emphasizes the importance of oil pipeline transport, stating: 'Taking into account increasing frequency of sea shipping in water spaces of [the] EU, it is exceptionally vital to pay more attention, where it is economically and technically possible, to consideration of the alternative way of oil transportation by oil pipelines. It is much safer and provides better environment protection… It is important to achieve such a position so that the existing oil pipelines would be used in full operation, but also plans for the formation of a new pipeline infrastructure would be considered, instead of projects based on oil transporting on sea…. It may be achieved by the following:

- modernization and perfection of the whole Druzhba oil pipeline, in particular in Northern Europe, as an alternative to increasing oil transportation on the Black Sea;
- further construction of the Odesa–Brody pipeline to Plock in order to connect it with the northern route of the Druzhba oil pipeline or the existing line to the Polish port in Gdansk on the Baltic Sea[xxii].'

The Odesa–Brody project has become a top priority for the European Commission. This was confirmed again in Brussels, on 27 May 2003, when a three-part Declaration was approved by Ukraine, Poland and the EU, which committed to their cooperation in its implementation. A Common Working Group was also formed which has an executive-oversight mission.

No other project in the entire history of Ukraine-EU relations has the status of Odesa–Brody. Intensive cooperation between Ukraine, Poland and the European Commission had begun. After signing the Agreement between the governments of Ukraine and Poland about common utilization of Odesa–Brody and its integration with the Polish pipeline network (Brussels, 26 November 2003), it acquired the status of a Ukrainian-Polish project. The foundation of the Ukrainian-Polish 'JV Sarmatia' operation in 2004 was an important step demonstrating the intention to integrate the oil pipeline systems of Ukraine and Poland. As Poland is a full member of the EU, this means Ukrainian oil pipelines will be integrated into the networks of the European Union.

In Ukraine the so-called 'Strategic Five' was formed. It includes the Special Representative of Ukraine on EAOTC, Oleksandr Todiychuk; first Deputy Minister of Foreign Affairs, Oleksandr Chaliy; Minister of Fuel and Energy, Serhiy Yermilov; Deputy Secretary of CNSD, Serhiy Pirozhkov; and Vice Prime Minister, Vitaliy Hayduk. This group's activities brought the project to a pre-launch stage. The successful and dynamic promotion of the Ukrainian project, which some had already considered dead, brought about a deep-seated Russian reaction motivated by non-economic factors.

On 23 April 2003, the Russian companies Transneft and TNK stimulated the signing of a protocol with Naftohaz Ukrainy and Ukrtransnafta in Moscow about their intention to reverse the direction of Odesa–Brody. This step undermined the position of the Strategic Five, as the European Commission was about to make a decision on the importance of Odesa–Brody and sign the three-party declaration Ukraine–Poland – EU about developing the project. Russia appeared to be undermining Odesa–Brody at the exact same time Poland and the EC were signing declarations.

The project's priority status was confirmed on 13 May and the Declaration was signed on 27 May, but Ukraine's partners felt it was playing both sides, allegedly to sell the project to the Russians in the end, at the best price. Doubts about Ukraine's honesty of intentions, reliability and consistency further increased after prepaid advertising about the utilization of the oil pipeline appeared in the region's mass media.

2003 was also a dramatic year for Odesa–Brody. In May, cooperation with Yukos (the second largest Russian oil company) looked possible. Mikhail Khodorkovsky (owner of Yukos) addressed a letter to President Kuchma demonstrating Yukos's desire for partnership in the project. The letter was unanswered, but it activated opponents who discovered its contents after delivery to the Presidential Administration.

A fortnight after the visit of a Kazakh delegation to Ukraine (July 17) and the signing of an agreement about the utilization of Odesa–Brody, a 'coup' took place in Ukrtransnafta. Former chief of Naftohaz Ukrainy, Yuriy Boyko discredited Mr Todiychuk as Chairman of the Board at a shareholders meeting. He appointed Stanislav Vasylenko as General Director, in Todiychuk's place, and he immediately signed the April protocol with Russians on behalf of Ukrtransnafta.

On November 26, in Brussels, Vitaliy Hayduk signed a contract regarding the utilization of the Odesa–Brody system with the Polish Government on behalf of the Ukrainian Government. Returning to Kyiv, he convened a meeting during which he directed Boyko and Vasylenko to provide a report on the availability of funds for the purchase of technological oil for Odesa–Brody. It was discovered that 236 million hryvnias had been spent illogically and, ultimately, the oil was not acquired. The launch of Odesa–Brody with technological oil could not be realized. The reaction to Vitaliy Hayduk's actions was immediate. The Ukrainian President dismissed him from the post of vice prime minister on the evening of the same day.

2004 was no less dramatic. On 4 February, then prime minister Viktor Yanukovych's government issued a decree on the European position on utilization of Odesa–Brody. This decree, according to the prime minister, was final. Concurrent with this, the Governmental Committee on the Efficient Utilization of the Ukrainian Pipeline System continued to receive offers made by foreign oil companies regarding Caspian oil supplies to Ukraine and European markets. Minister of Fuel and Energy, Serhiy Yermilov, tried to resolve the issue of filling the pipeline with technological oil and determine where the funds meant for its purchase had disappeared to. The minister offered to dismiss Vasylenko from the post of General Director of Ukrtransnafta for sabotaging the decree of the Cabinet of Ministers regarding pumping trial oil from Brody to the Kralupy ORP. At the beginning of March, Yermilov was dismissed from his post. It became absolutely clear that the President of Ukraine had sold Odesa–Brody to the Russians and had been playing on their side the entire time.

This fact was proven as a result of the liquidation of the post of the Special representative of Ukraine on EAOTC. This 'gutted' the power, introduced by the decision of the Council of National Security and Defense, of all instruments of influence over the situation. Finally Chaliy (President of Ukrtransnafta) was forced to leave the Ministry of Foreign Affairs thereby dissolving the Strategic Five.

Meanwhile, preparation for the Odesa–Brody reversal was in full progress, although government officials continued to assure Brussels, Washington and Warsaw about the stability of the Ukrainian position. Offers by oil traders about European interest in utilizing Odesa–Brody remained unconsidered. In order to finally persuade the hesitant Ukrainian officials of the necessity and reasonability of reversing Odesa–Brody, Russia and its media used all available methods of lies and misinformation.

For example, at one point TNK PC guaranteed to provide 'a supply of its own and bought oil through the oil pipeline Brody–Odesa in the direction of Pivdenniy port at a quantity not less than 9 million tons annually during the whole term of work of this route (not less than 21 years)'.

On 27 April 2004, Alexander Gorodetsky, an official representative of the TNK-BP group of companies in Ukraine, wrote a letter to Ukrtransnafta stating, 'we are ready to include in the draft of the contract on provision of services of oil transporting, a clause on the payment based on the "ship or pay" principle, in accordance with world practice and on terms, agreed by the parties.' It meant that if for some reason TNK failed to supply the promised 9 million tons of oil, they would have to pay for it at a mutually agreed tariff.

Nothing of this kind was agreed upon. A vague formulation of 'up to 9 million tons', the 'ship or pay' principle was never included. But it helped to prolong a decision about the reversal of the Odesa–Brody until it was legalized in a governmental decree on 5 July 2004.

In March 2005, a year after the reversal, in an issue of *Zerkalo Nedeli*, TNK-BP Ukraine head, Gorodetsky, in response to a question regarding the financial obligations of TNK-BP for the reversal was quoted as saying, 'There is an agreement, which stipulates that TNK-BP will do its best so that all interested Russian oil exporters use this route. Our (TNK-BP) company has never had any other obligations, including financial ones.'

This was a blatant lie. In July 2004, Ukrtransnafta signed a necessary portfolio of five contracts with TNK and its offshore company Skilton. Mass media presented it as a success – the long-suffering oil pipeline was finally going to be used. The president and government, who were concerned with the pre-election period, were not interested in the fact that the oil would travel in the wrong direction and that it would not transport the mentioned nine million tons of oil annually from Brody to Pivdenniy, but only an indefinite 'up to nine million'. No one seemed interested in the fact that the oil pipeline, utilized in this reverse format, had become a mechanism to increase Ukraine's dependence on Russia's oil monopoly.

In September 2004, Brody–Odesa began to transfer oil. Ukrtransnafta, with the double protectorate of Russian Transneft and TNK, received a credit of almost 600 million hryvnias to fund the acquisition of technological oil (Urals grade) while one European oil trader (Baltic Petroleum) was offering Caspian crude oil free of charge on the guarantee that Ukrtransnafta would pump five – seven tons of oil to Brody.

Currently Odesa–Brody is pumping minor quantities of oil under the reverse regime, which fails to even cover transport-related operational costs. According to the signed agreements between Ukrtransnafta and the Cyprus offshore company Skilton (belonging to TNK), the tariff for pumping is sent to the account of Ukrtransnafta in a British bank for credit payment. An offshore company controls the account. Both the government and the public have been deceived: oil is not being transported from Mozyr to Brody and to Pivdenniy, but over the traditional route through Kremenchuk with loading tankers in Pivdenniy. The motive is obvious – it is necessary to show a positive figure by the end of the year and therefore demonstrate that the pipeline reversal has been a success.

The results of 2004 were clear. There has been no promised increase of transit volumes of Russian oil through Ukraine after the launch of the reversal. On the contrary, oil transit volumes decreased from 56.6 m/t in 2003 to 55.3 m/t in 2004. Ukrnafta, to help Yanukovych's pre-election campaign vis-à-vis the Russians, signed a 15-year contract with Transneft, which turned it virtually into an industrial-technological branch of the Russian monopoly. Now Transneft plans to open an office in Ukraine in the near future to allegedly control quantity and quality of Russian producers' oil from all receiving points to destination points, and to provide services for oil shippers. Transneft thereby acts as an operator for oil to final destination points (to the ports of Odesa, Pivdenniy and on the western border of Ukraine), and also as a provider of oil transshipment services. In reality it will mean transfer of control over Ukrtransnafta to a foreign state-owned monopoly and the loss of independence of Kyiv in the oil transporting system of Ukraine. The border of the oil transporting territory of Russia, after signing the 15-year contract, is now on the western border of Ukraine, ie on the former Soviet border.

The politics of energy transit

Russia's policy is directed at creating facilities to bypass traditional transit states; first of all Ukraine, Poland and Baltic states. A shining example concerning the Baltic states in the oil sphere is the Baltic pipeline system, and in the sphere of gas transit – the project of the Northern-European gas pipeline. In the Black Sea region there is the extension of the Novorossiysk oil transport system which bypasses the Bosphorus (Burgas–Aleskandrupolis, Kiyikoy–Ibrikhaba). In the gas sphere there is the Russian–Turkish pipeline 'Blue Stream', which flows under the Black Sea.

In this context, a statement by the head of Transneft, Semyon Weinstock, about Russia's position in relation to the transit issue shows the real state of affairs. 'We must escape transit dependence. Russia has the unique potential to depend on no one for oil transportation. We have our own way to the Pacific, to the Arctic, to the Black Sea and Baltic[xxiii].' Certainly, from Russia's position, this transit policy is rather obvious and logical.

But, Poland, Ukraine and Kazakhstan's defence and promotion of their interests in the energy transit sphere are logical too. There is the prospect of integrating the oil transporting systems of the two neighboring Slavic states (Ukraine and Poland), which control the transit territory from the Black Sea to the Baltic Sea, which in turn evoked Russia's negative reaction. Russia's actions are politically motivated and systematically directed, driven by frustration of this bilateral project. Although it was demonstrated that the Odesa–Brody project could be profitable for Russia and for its companies, Moscow rejected the Ukrainian offer.

The Odesa–Brody oil pipeline gained some significance as a part of the so-called CES (Common Economic Space) in 2004. Belarus decided to diversify its energy sources and transport routes after the events of January 2004 when Russia started to use gas supplies against Belarus in order to force Minsk to privatize its gas transporting system, Beltransgaz, in favor of creating a joint enterprise with Gazprom. Minsk noted the close location of Brody to the ORP in Mozyr. In Minsk in April 2004, Ukrainian, Belarusian and Latvian companies signed a three-sided agreement for transportation of up to 10 million tons of oil from Brody to Belarus and Latvia. Companies working in Kazakhstan expressed their readiness to supply oil to Belarusian ORPs using the Odesa–Brody system. More precisely, this project can be considered a northern module designed for execution within the CES, with participation by Kazakhstan, Ukraine and Belarus. Russia did not accept this approach. It was obvious that cooperation of the three countries would decrease dependence of Kyiv, Minsk and Astana on Moscow. It was also quite clear that all that is acceptable within the CES can only be in realized in accordance with Russia's interests and to the exclusion of Western partners.

There is much misinformation surrounding Odesa–Brody. One of the main arguments is that the project contradicts Russian interests, because it takes Caspian oil to the European market where Russian crude oil dominates. In fact, Caspian oil has already been present on the European market for the last three to four years. Secondly, it comes to Europe not in spite of Russian oil, but as an addition to it. Thirdly, Russian oil does not dominate the European market overall, as OPEC oil does.

What Ukraine offers is a optimal system for transporting oil from the Caspian Sea to Europe, particularly in view of problems associated with the Bosphorus, which have become more acute since autumn 2003. Further to this, Ukraine's interests are national interests as are those of Turkey, Romania, Bulgaria, Greece and especially Russia, who are all actively seeking to direct Caspian oil through their territories.

The reversal of Odesa–Brody may be considered a strategic move by Russia, to the detriment of its competitors. Russia's objective is not to utilize the pipeline in reverse, but to block Caspian oil from accessing the European market. The economics of the Odesa–Brody reversal is extremely unprofitable for Russian traders. 'Supplies on the Odesa–Brody pipeline are considered the least profitable from all possible export pipeline routes for today to foreign countries', the *Weekly Petroleum Argus* reported (September 13, 2004)[xxiv]. The main argument is the fact that the cost of oil transit on the Odesa–Brody reverse route is $3 per ton higher than on any other Ukrainian route.

'The example of the reverse utilization of the Odesa–Brody pipeline demonstrates that Russian oil companies are not eager to pump oil in any direction, just to get it abroad. Some time ago TNK-BP, exploiting this pipe, intended to involve other companies in this project, but none of them has decided to join the project yet,' expressed Aleksandr Blokhin, analyst for Antanta Capital. (RBC Daily, April 12, 2005, http://rbcdaily.ru/news/company/index.shtml?2004/04/12/201313).

There is another vital factor at play as well. This is to maintain the monopolization of Russian companies over the Ukrainian market and to thereby retain the pseudo-competitive environment in Ukraine over which Russia dominates. It is important for Russian traders to prevent non-Russian oil becoming available on the Ukrainian market, as the price dynamics of Russian oil are principally different in diversified versus non-diversified markets. An example of this is illustrated in Table 5.1. This table covers a period of two months – from the middle of March to the middle of May 2005, during the Ukrainian fuel crisis. During this period, prices for Urals crude supplied to Germany, Poland, and the Czech Republic decreased, corresponding to the dynamics of price change on the London Stock Exchange. In contrast, prices for Urals crude supplied to the non-diversified markets of Ukraine and Belarus increased.

Based on absolute price-data from March 2005, the prices of oil to Ukraine were lower than those of Germany and other states of Central Europe. In April there appeared to be some price equilibrium across the region, but in May disequilibrium set in when the price index in Ukraine was higher (by $1.86 per barrel) than prices for the same Urals oil product on the German market. This is in spite of the fact that transport-related expenses for Russian oil exports to Germany are higher than those to Ukraine. In addition, these unaccounted-for price differentials provided the political fodder for Prime Minister Yulia Tymoshenko in her criticism of Russian oil tycoons.

Three main conclusions can be drawn here. The first is that in diversified markets Russian traders cannot overcharge for supplies. Moreover, to maintain their market niche for Urals crude, it must be sold with large discounts compared to other oils with lower sulphur content.

The second conclusion that can be drawn is that in non-diversified markets traders can vary prices as they wish. There is no restricting market factor on price driven by the availability of alternative supplies for either crude or refined products. In the case of Ukraine, the lack of state-controlled oil refining facilities should be added to this composite.

The final conclusion is that in non-diversified markets (primarily Ukrainian) there are compensations for the discounts for Russian supplies, which traders have to give in diversified markets.

In short, the above-mentioned offers a rather tangible set of commercial reasons for Russian opposition to Odesa–Brody. The Kremlin in turn supports its commercial sector from a political standpoint based on the fact that as positive financial flows are formed in non-diversified and pseudo-competitive markets a portion of these funds can be redirected to underwriting a shadow media-related and political infrastructure, which works to promote the interests of both the Russian business and political communities. In turn, these financial flows (which are dependent on market manipulation) lead to a system of corruption where 'oil and gas are exchanged for the loyalty and sovereignty of the Russian state and its interests'.

Returning to the Odesa–Brody transit issue, we should note that the reverse utilization of the oil pipeline gives a time advantage to competitors whose projects have Russian participation. And furthermore reverse loads overloaded Black Sea channels.

Search for alternative routes

A tense situation has arisen in the Bosphorus and Dardanelles regions as a result of the increased oil traffic through the channels. This has stimulated a search for new transportation bypass routes. In 2004, Russia actively promoted the implementation of the Trans-Thracian project in Turkey. A working group was formed, including representatives of Transneft, TNK-BP and Tatneft. The projected pipeline was supposed to go through the European part of Turkey, from the settlement of Kiyikoy on the southwestern coast of the Black Sea to the city of Ibrikhaba on the coast of the Aegean Sea. The estimated quantity of oil pumped was to be 60 million tons annually. The terms of construction stipulated that the project was to be carried out over two years. Investment expenses were estimated at $900 million.

At the same time, the Russian party was actively developing another project: the Bulgarian–Greek–Burgas–Aleksandrupolis route[xxv]. In short, Moscow attempted to put political and psychological pressure on Ankara by forcing them to agree to the Trans-Thracian project. Should Ankara decline, Moscow held out the possibility of dealing with the Burgas–Aleksandrupolis project. The situation was the same with Bulgarians and Greeks; if they did not make a deal, Russia would in turn work with Turkey on the Trans-Thracian project.

This policy brought some success to the Russian party but not in Turkey. President Putin's visit to Turkey at the end of 2004 did not produce the desired result, which was Ankara's

Table 5.1 Price dynamics for Russian export blend, Urals, in different markets (March–May 2005)

Country	Price ($/bar) 10 March	Price ($/bar) 14 April	Price ($/bar) 12 May	Dynamics ($/bar)
Belarus	24.04	27.95	29.04	+5.00 (20.8%)
Czech Republic	46.65	42.75	40.57	–6.08 (13.0%)
Germany	45.80	41.90	39.92	–5.88 (12.8%)
Poland	45.90	41.90	39.92	–5.98 (13.0%)
Ukraine	32.33	40.96	41.78	+9.45 (29.2%)

agreement to the Trans-Thracian project. Certainly, it would not have been logical to expect agreement on the construction of an alternative oil pipeline at the same time the Baku–Tbilisi–Ceyhan project was to be inaugurated.

However, the 'Turkish' factor stimulated the Greek and Bulgarian parties to reach an agreement with the Russians regarding the Burgas–Aleksandrupolis project. The winter period was characterized by a high level of activity between Moscow–Sofia–Athens. As a result, in Sofia on 12 April 2005, the parties signed a memorandum on the project. The length of the pipeline will be 312 kilometres, its capacity will be 35–50 million tons per annum and the cost is estimated at more than $700 million. The Greek party declared its readiness to invest $130 million in the project's implementation.

Meanwhile another competitor of Odesa–Brody, the trans-Balkan project Burgas–Vlera, is underway. An essential agreement at governmental level was signed between Bulgaria, Macedonia and Albania in December 2004, allowing negotiations to move forward[xxvi]. This prompted the Russians and Greeks to reach an agreement on Burgas–Aleksandrupolis that they would not permit the Bulgarians to shift to other competitive projects supported by the interests of some American companies.

At the same time in Russia, TNK-BP was appointed coordinator for a group of companies, including Transneft, Gazprom, the oil companies Rosneft and Lukoil, and others interested in implementing the construction of Burgas–Aleksandrupolis. As well as reaching an agreement to develop a working plan for the project, the companies discussed what their recommendations would be to the Russian, Greek and Bulgarian governments[xxvii].

What is significant about this is the fact that TNK-BP along with Transneft, both initiators of the Odesa–Brody reversal, again demonstrate that the underlying objective of the reversal was to hinder if not eliminate Odesa–Brody as a viable competitor to alternative pipelines and pipeline routes supported by the Russians. On this basis it can be concluded that both political and commercial reasons were at the base of the idea behind the reverse.

Attention should also be paid to the fact that the Russian initiators of the Odesa–Brody reversal regard this development as an unbridled success. The official websites of Transneft and the Ministry of Industry and Energy of the Russian Federation note that in 2004 they 'reached an agreement with the Ukrainian party about reverse utilization of the Odesa–Brody pipeline, and prepared a three-sided memorandum about construction of the Burgas–Aleksandrupolis construction[xxviii,xxix].'

Implications for energy security

It is obvious that the reversal represents a clear obstruction to diversifying Ukraine energy imports and posits the Russian–Bulgarian–Greek project as the principal alternative to fulfilling its niche albeit with Russian versus Central Asian hydrocarbons as the alternative. On an analytical level, the Odesa reversal of Odesa–Brody demonstrates Russian energy policy. The fact is that this is not a new policy; it is the re-emergence of the old Soviet policy, slightly modernized by Putin's establishment, designed at restoring the dominant role of Russia in areas in its proximity with repercussions for Europe as a whole.

If Russia manages to recreate an 'energy empire' to the east of the European Union there will be an energy-transit region with an exclusive decision-making centre in Moscow. This situation presents a real danger for energy security for all states of Central Europe, including Poland, Slovakia, Hungary and the Baltic states. It will be a serious problem for states of the Central Asian region too, as Russia virtually centralizes for itself and its own pipeline infrastructure, supplies of energy resources from the region to world markets. That is what happened to Turkmen gas. That is what Russia is currently trying to do with Kazakh oil.

In April 2004, as part of President Putin's annual message to the Russian Federal Assembly he stated, 'I draw your attention to the fact that implementation of the state goals should be a reason for decision-making, but not interests of separate companies.'[xxx] The obvious deduction from this is that Russian companies, regardless of ownership structure, must now act at the behest of the Kremlin. If not, they run the risk of Yukos' well-known fate.

Russia uses the existing energy dependence of new members of the European Union to its advantage. An example of this is how they shored up Slovakia's dilapidated power base. Despite a tri-party agreement between Ukraine, the Czech Republic and Slovakia, reached in April 2004, regarding the implementation of a trial run to pump light sweet crude from the Ukrainian Brody terminal to the Kralupy ORP in the Czech Republic, the exercise never took place. Russia has blocked the pumping of 20,000 tons of oil intended for the trial run as a result. For more than two years Transneft has blocked oil supplies to Latvia's Ventspils in an effort to leverage the privatization of this transshipment port it seeks to pick up on the cheap.

Former chief of the Polish Intelligence Service, Zbigniew Siemiatkowski, reported to the ad hoc parliamentary committee investigating illegal actions by Russian companies in the oil sector of Poland, that the latter are trying to gain control over their partners in the states of the ex-Soviet Union that are now EU members. 'I agree that we are dealing with an attempt at restoring the Russian Empire by economic means based on the principle "yesterday tanks, today oil",' he said at hearings in the Polish Sejm on 27 October 2004[xxxi].

Confirmation of this evaluation can be found in the 'Russian Energy Strategy to 2020'. This document stipulates 'a consolidation of [Russian] presence in the internal energy markets of foreign countries, co-ownership of sales' networks for energy resources and ownership of the energy infrastructure in these states[xxxii].'

Polish experts note that corruption has also played a factor in jeopardizing the state's national security. The leading Polish newspaper, Rzeczpospolita, has characterized the situation as 'Behind the back of the Union of Leftist Democrats an energy mafia acts, connected to officials of the presidential secretariat, the prime minister's apparatus and even to Russian officials. The mafia gets more than one half of the profits from the sale of oil. Russians have deceived Polish politicians in order to prevent Poland from diversifying its supplies. They [have] discredited the idea of the Norwegian gas pipeline [and have] blocked the project of the Odesa–Brody oil pipeline[xxxiii].'

The constituent actions of Russian oil companies were also noted by former CIA Director George Tenet in a senate testimony on 9 March 2004, when he stated that 'Moscow has become more persistent in its actions with neighbors from the former Soviet

Union, like Georgia, Ukraine and Moldova. Russian companies, following commercial interests, but in accordance with the Kremlin's line, are increasing their presence in the neighboring countries, especially in the energy sector.'[xxxiv]

Ukraine occupies a transit position between the now extended European Union, Russia and the Black Sea region. This location may be considered a system-forming factor of the energy transit potential of the country. The energy strategies of the Russian Federation and the European Union come into definition here. They form a field of new opportunities for energy transit development in both east, west, south and north directions.

For the last 10 years Ukraine has been exemplified by pendulum politics; declaring its European and Euro-Atlantic prospects, it has virtually been moving towards the Western vector of integration. This pendulum however did not facilitate the realization of the energy transit potential of the state. Ukraine, under Kuchma's presidency, surrendered to Russian political pressure, virtually turning itself into a barrier against new energy resources flows from the Caspian region. This was a negative factor for the countries of the South Caucasus and Central Asia. Yet even though Kuchma is gone there has been no *tabula rasa* (fresh start).

The future for diversification

The Odesa–Brody project is economically viable and strategically important for Ukraine and the European Union, especially for its new members, and for Kazakhstan, Moldova and Belarus. The new political leaders in Ukraine, taking into account national interests and principles of the European Economic Charter, must have the political will to pull together the interests of all states and companies in the region in dealing with Russia.

The future of Odesa–Brody depends on the political will of the state's new authorities who faced energy blackmail even during their first 100 days in office (disguised as the reaction to the increase in Russian energy prices relative to the global price for oil). The future of Ukraine's new leadership depends on Odesa–Brody. If it works in the European direction it will extend the space for political maneuvering and level the ambitions of the oil tycoons in Russia.

The fact is that energy diversification can work. The Odesa example of the implementation in 1995 of the pipeline Ingolstadt – (Germany) Kralupy (Czech Republic) enabled the Czech Republic to receive its oil from non-Russian sources through the Italian port of Trieste. While the pipeline is only loaded to 25–30 per cent of capacity, the Czech Republic has fended off, for several years now, Russian interest in reversing the direction of that pipeline to Germany and, in doing so, to fill it to capacity. Despite the commercial attractiveness of the proposal, it has rejected this offer in order to help ensure the energy security through diversification of the state.

The Baltic region is also a good example here, where energy import dependence on Russia is not less than in Ukraine, but where the government has chosen to implement an effective policy, defined by national interests. Ukraine's partners have proven their will to renew cooperation on the issue of Odesa–Brody. At one point they found it encouraging that the management of Naftohaz Ukrainy was changed, but then progress was halted. Few today wish to deal with the management of Ukrtransnafta who have discredited themselves.

If the Ukranian government does not regain control over Ukrtransnafta, the company will remain a decisive instrument of influence in the hands of Russian companies and the state. Furthermore, all steps to impede Odesa–Brody undermine the long-term strategic importance of Ukraine as a transit country. Clearly, interest in Odesa–Brody will not last forever. Speedy construction of the Atasu–Alashankou pipeline by Kazakhstan and China will transport Kazakh oil to the Chinese market in 2006. Kazmunaigaz and American Chevron-Texaco are set to join the Baku-Tbilisi-Ceyhan consortium. They have also been invited to participate in Burgas. All of these efforts complicate an already troubled and indistinct Ukranian energy policy with the result of decreasing the interest of investors in Odesa–Brody. The future of the independence of Ukraine hangs in this delicate energy balance, which is precarious at best.

Notes and references

i In her interview to Radio Liberty Yulia Tymoshenko said in particular, 'For the last two-three years in the system of gas provision of Ukraine, in the system of communication with Russia.... Ukrainian authorities, in particular the ex-President of Ukraine, I mean Kuchma, and chief of Naftohaz Ukrainy Boiko just betrayed national interests of Ukraine.'

ii When asked about possibility of Ivchenko being dismissed on July 2, the Prime Minister answered that "You will get the response after the meeting of Government", where results of work of NJSC Naftohaz Ukrainy were to be discussed.

iii Informational agency UNIAN, 6 July 2005.

iv *Delovaya Nedelia,* 6 July 2005.

v Ukroil's website on 10 August 2005, available at http://www.ukroil.com.ua

vi Prime Minister Viktor Yanukovych initiated signing of the Memorandum with oil-traders, where the minimal price for petrol was stipulated.

vii According to Yulia Tymoshenko, 'Russian owners of Ukrainian ORPs have formed a single monopoly cartel and agreed to make some money on the population of Ukraine and its agrarian complex.' Finmarket information, 11 April 2005, available at www.finmarket.ru

viii Statement of the TNK-BP company, April 18, 2005.

ix The Ukrnafta Company extracts 90% of Ukrainian oil – approximately two billion tons of oil annually. (Ukraine requires about 30 million tons of oil annually).

x The statement was published by the Korrespondent.net agency, 7 June 2005, available at http://www.korrespondent.net

xi MPs-members of Liberal-democratic party, in particular Vladimir Ovsiannikov and Nikolai Kurianovich, put forward these initiatives.

xii *AIA-News,* 1 July 2005.

xiii 'Ivchenko yelled at Niyazov's subordinates in his presence'. See *Ukrainska Pravda,* 18 October 2005.

xiv 'Russia may lose Turkmen gas because of Ukraine'. See *Korrespondent.net,* 14 April 2005.

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xxii 'Communication From The Commission To The Council And The European Parliament On The Development Of Energy Policy For The Enlarged European Union, Its Neighbours And Partner Countries', Com (262), 13 May 2003.

xxiii 'Russia does not need transit through a foreign territory'. 'Interview of correspondent Petr Sapozhnikov with President of Transneft S Weinstock'. *KOMMERSANT* 17 June 2004 at www.transneft.ru

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xxviii 'Major results of actions of the Ministry of Industry and Energy of Russia in 2004 (Part I)', 28 December 2004 (15:14), available at: www.mte.gov.ru

xxix 'The oil pipeline Burgas–Aleksandrupolis project to be discussed in Moscow', *Oil-gas vertical. News line,* 26 January 2005 (15:07), available at: www.ngv.ru xxx 'Nobody will stop Russia on the way to democracy consolidation!' The message of the President of the Russian Federation to the Federal Assembly, 26 May 2004 (14:09), available at http://www.polit.ru/dossie/pv/2004/05/26/putin.html

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xxxii 'Energy strategy of Russia for the period to 2020', available at: www.mte.gov.ru

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Liana Jervalidze has worked with several government and research institutions working on Caspian region energy policy and development. She has advised private sector companies in on the development of east-west energy corridor and Georgia's potential role in regional integration. Since 2003, Ms.Jervalidze has been working on the development of Georgia's gas market. She has spoken on regional energy policy at international conferences in the CIS, Europe and the US. Her analyses have been published in both Georgian and English.

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Gregory Gleason, Ph.D., is an internationally recognized expert in energy policy and international relations. A professor of political science and public administration at the University of New Mexico, Dr. Gleason has extensive field experience in Turkmenistan and the other countries of Eurasia and Central Asia. He has served as a consultant to Lawrence Livermore National Laboratory, Sandia National Laboratories, the Asian Development Bank, and the US Agency for International Development. His research has been sponsored by the National Science Foundation and the National Academy of Sciences as well as other public and private foundations.

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Dr Margarita M Balmaceda

Belarus relies on Russia for about 85% of its total energy needs, while Russia needs Belarus' oil and gas pipelines to export its supplies to Western Europe. How will energy exports from Russia and Belarus' transit capabilities impact Western Europe if this interdependent relationship ends, either through political changes in Belarus or if Russia ends its energy subsidies to Belarus? This report looks at transit, infrastructure and investment issues and analyzes both the state of the current infrastructure, as well as the possibilities this transit opens to Western investors, particularly as the Yamal Pipeline nears completion. In addition, it looks at the current conflict between Belarus and Russian investors for control of the country's gas transit system and oil refineries.

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Hardcopy ISBN 1-905050-34-8
E-report ISBN 1-905050-83-6

'Gazprom and the Russian State'

Dr Kevin Rosner

Gazprom is the world's single largest producer of natural gas, long acknowledged as a state-within-a-state. In 2005 it reached a turning point in its history when the Russian government reasserted its majority stakeholder position, whilst also continuing its own push to gain control over an increasing share of Russia's energy complex overall. This timely report provides answers to questions such as: what do these movements mean for the future of the Russian energy sector? What will be the impact of state control over Gazprom on domestic and foreign shareholders? And what do these changes portend for the future of natural gas exploitation, production, distribution and the ultimate export of Russian gas to downstream consumers? And what will these changes mean to world?

Hardcopy ISBN 1-905050-30-5
E-report ISBN 1-905050-85-2

'Baltic Independence and Russian Foreign Energy Policy'

Dr Harold Elletson

Estonia, Lithuania and Latvia are uniquely dependent on the Russian Federation for energy supplies. The security of energy supplies are national security issues in the three ex-Soviet republics, which are now part of the EU. Increasingly dependent on Russian gas imports and with negligible sources of domestic energy supply, the Baltic countries have been the target of aggressive Russian commercial activity and a sustained attempt to lock them into a long-term reliance on Russia.

Now, as Baltic political leaders, energy specialists and intelligence analysts consider their options, the implications for the security and independence of the three Baltic States are a matter of concern well beyond the Baltic. This important report will be essential reading for anyone with an interest in the future energy supplies of both the Baltic States and eastern Europe.

Dr Harold Elletson leads The New Security Programme, which conducts research into the implications of the new security environment. He was previously Director of the NATO Forum on Business and Security. A former Member of the UK Parliament, he served as Parliamentary Private Secretary to the Secretary of State for Northern Ireland and as a member of the Select Committee on Environment. An international public affairs consultant and a fluent Russian speaker, he has advised many leading companies on aspects of their business in the former Soviet Union, including BP in Azerbaijan and Alstom in Siberia.

Hardcopy ISBN 1-905050-36-4
E-report ISBN 1-905050-89-5

Russo-Chinese Energy Relations: Politics in Command

Dr. Stephen Blank

This report makes the point that in both Russia and China it is politics – and not market or commercial considerations – that largely drive energy relationships with each other and the outside world. For both countries, energy and energy security are regarded as strategic assets and/or objectives that are at risk from outside forces. Moreover, both countries are taking a statist approach to energy issues. Therefore cooperation between Russia and China will be difficult even though Russia wants to sell and China wants to buy.

Russia has blocked Chinese efforts to realize its version of energy security, yet it has not been able to come up either with the resources or means for a coherent policy of supplying China with reliable quantities of energy that would lead China away from Middle Eastern and other producers. Given the political dimension in both countries, the under-fulfilment of the potential for Russia to supply energy to China will continue and remain a source of strain in their relationship.

Stephen Blank is Professor of Russian National Security Studies at the Strategic Studies Institute of the U.S. Army War College. Dr. Blank has been an Associate Professor of National Security Affairs at the Strategic Studies Institute since 1989. In 1998-2001 he was Douglas MacArthur Professor of Research at the War College. Prior to this appointment Dr. Blank was Associate Professor for Soviet Studies at the Center for Aerospace Doctrine, Research, and Education of Air University at Maxwell AFB. Dr. Blank's M.A. and Ph.D. are in Russian History from the University of Chicago.

Hardcopy ISBN 1-905050-43-7
E-report ISBN 1-905050-44-5

Russian-Turkish Energy Contracts: The Case of Blue Stream

Dr. Ahmet K. Han and Dr. Cenk Pala

Throughout negotiations and finalization of the Blue Stream Project, Turkey has encountered every kind of struggle that can be expected in a relationship with the Russian Bear. At a cost of $3.5 billion, the construction of the 1,265km long Blue Stream pipeline will extend 392km beneath the Black Sea at a record breaking depth of 2,140 meters and is aimed to carry annually 16 bcm of Russian natural gas to Turkey in 25 years. Once completed, Blue Stream will symbolize Russia's near monopoly status in the Turkish gas market, probably forcing Turkey to turn off the taps of other possible natural gas transit pipeline projects before they start. With strategic implications like this, the project has been a source of much controversy since its inception. This study attempts to evaluate the negotiation process that led to agreement on Blue Stream while trying to understand

and asses the significance of the project at different levels, including its place in Russian foreign energy policy and global positioning strategy, its importance within the context of the global energy equation and international energy contracts, as well as its effects on Turkish domestic politics.

Dr. Ahmet K. Han is Assistant Professor of International Relations in Istanbul's Kadir Has University's School of Economics and Administrative Sciences. He has 15 years of teaching and research experience in the fields of international relations and economics focusing on issues relating to globalization, energy, world trade and investments, Central Asia, Caucasus and Middle East, strategic thinking and negotiations, Turkish foreign policy and US-Turkish relations. He holds a BA in economics and international relations, an MA in political history and a PhD in international relations from Istanbul University. He regularly appears on major nationwide news TV networks and has written over 120 op-eds and articles for domestic and international press.

Dr. Cenk Pala is the Director of Strategy and Business Development, BOTAS (Turkish Petroleum Pipeline Corporation). He has been directly involved in the realization of Baku-Tbilisi-Ceyhan pipeline project, Turkish Straits By-pass projects, Turkmenistan natural gas pipeline and Nabucco (Turkish-Austrian Natural Gas) projects. He holds a PhD in Economics and authored his doctoral dissertation on "The Importance of Energy in Industrialization". He has published over 45 articles and a book titled *The Triangle: USA, Oil and Dollar*. He is a frequent speaker at national and international conferences on energy issues.