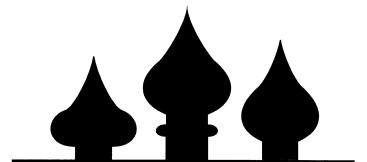




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# Occasional Paper #291 Ukraine's Energy Policy and U.S. Strategic Interests in Eurasia

Margarita M. Balmaceda



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Occasional Paper #291  
Ukraine's Energy Policy  
and U.S. Strategic  
Interests in Eurasia

Margarita M. Balmaceda

## **Ukraine's Energy Policy and U.S. Strategic Interests in Eurasia** **by Margarita M. Balmaceda**

Ukraine's strategic location between the main energy producers (Russia and the Caspian Sea area) and consumers in the Eurasian region, its large transit network, and its available underground gas storage capacities make the country a potentially crucial player in European energy transit. The country's importance is likely to grow as Western European demands for Russian and Caspian gas and oil continue to increase.

Yet because of Ukraine's domestic political inefficiency and its complicated relationship with Russia, it has been unable to fully capitalize on this potential. The case of the Odesa–Brody pipeline, which was originally envisioned with the goal of fostering Ukraine's energy supply diversification and to help put the country on the map as a transit corridor for Caspian oil to Europe but is now in danger of being put to “reverse” use for the transit of Russian oil to Odesa, exemplifies some of these perils. Moreover, the lack of a clear and proactive energy policy, together with continued pressure from Russia, have led to a situation where Ukraine continues to be overwhelmingly dependent on Russian energy imports and has failed to develop transparent and effective energy markets.

This situation has clear negative implications for Ukraine's domestic political situation, its foreign relationships, and its ability to play a leading role in Central and Eastern Europe. Energy problems and the lack of proactive approaches to their resolu-

tion create dissatisfaction and apathy in the population, further weakening Ukraine's still unstable democracy. Energy dependence also increases the country's weakness and vulnerability in negotiations with Russia.

Ukraine's current energy situation and its handling also have important negative implications for U.S. strategy in the region. They complicate U.S. efforts at helping consolidate Ukraine as a viable democratic state and a regional leader. Moreover, Ukraine's lack of a clear energy policy strategy complicates the U.S. strategy of supporting multiple pipeline routes on the East–West axis as a way of helping promote a more pluralistic system in the region as an alternative to continued Russian hegemony.

### **THE PROBLEM**

Twelve years after achieving independence, Ukraine seems unable to find a way to break away from its energy dependency on Russia, or to find viable ways of managing it. On the contrary, Ukraine's energy dependency seems to call into question the country's political independence as much today as it did in 1991. As stated by Oles Smolansky in 1995, “the proclamation of independence, the adoption of state symbols and a national anthem, the establishment of armed forces ... and even the presence on Ukrainian territory of nuclear missiles—all important elements of independent statehood—amount little if another power, Russia, controls access to fuel

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**Table 1. Ukraine's Total Energy Import Dependency in Comparative Perspective**  
(percent)

<i>Country</i>	<i>1990</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>2000</i>	<i>2001</i>
Ukraine	47.4	49.9	N/A	45.9	43.7	43.7	41.0
Czech Republic	11.9	N/A	22.5	24.0	25.7	23.3	25.8
Estonia	41.8	36.0	N/A	31.2	41.0	37.3	36.1
Hungary	49.8	N/A	52.7	51.8	56.0	56.0	54.4
Poland	2.0	N/A	5.2	7.8	9.6	10.7	10.5
Slovakia	77.0	N/A	73.8	72.9	70.3	66.1	61.6
Belarus	N/A	87.0	N/A	N/A	86.0	86.1	85.4
Moldova	N/A	99.0	N/A	N/A	95.8	97.9	98.0

Note: N/A = not available. Energy dependency is defined as net imports / total domestic consumption.  
Sources: European Commission, *Energy in Europe: 2000 Annual Energy Review, Special Issue of Energy in Europe* (Brussels: European Commission, 2001); and International Energy Agency, *Key World Energy Indicators, 2000, 2001, and 2003*, available at [www.iea.org/statist/key2003.pdf](http://www.iea.org/statist/key2003.pdf).

**Table 2. Ukraine's Total Energy Import Dependency as Compared with that of EU Candidates' Group** (percent)

<i>Country or Group</i>	<i>1990</i>	<i>1995</i>	<i>1997</i>	<i>1998</i>	<i>1999 (estimated)</i>
Ukraine	47.4	49.9	45.9	43.7	43.7
EU candidate countries <sup>a</sup>	28.1	26.1	35.2	36.3	39.1

<sup>a</sup>EU candidate countries group includes Bulgaria, Cyprus, Czech Republic, Hungary, Poland, Latvia, Lithuania, Malta, Romania, and Slovakia.

Source: European Commission, *Energy in Europe: 2000 Annual Energy Review, Special Issue of Energy in Europe* (Brussels: European Commission, 2001).

without which Ukraine cannot survive economically.”<sup>1</sup>

We can identify five main aspects of the problem: first, Ukraine's dependency on imported energy sources; second, the country's lack of progress in terms of energy diversification; third, the low levels of energy efficiency; fourth, lack of transparency in energy markets; and fifth, the country's apparent inability to adopt a coherent and proactive energy policy.

### **Ukraine's Large Dependency on Imported Energy**

Ukraine's total energy dependency is one of the highest in Central and Eastern Europe

(see tables 1 and 2). This is the result of declining domestic production and inefficient energy use, among other factors. According to a study by the Ukrainian Center for Economic and Political Studies, if current trends continue, Ukraine's total energy import dependency could rise to 65 to 70 percent in 2020, leaving the country even more vulnerable to price fluctuations and dependence on Russia.<sup>2</sup>

Although, at first glance, these figures would seem to present a view of decreasing energy import dependency in Ukraine as compared with an increasing trend in Central and Eastern Europe and the EU candidate countries, the situation is more complex. Ukraine's declining trend must be seen in the

context of the sharp fall in the country's economic activity and gross domestic product (GDP) (between 1991 and 1999, Ukraine's GDP fell by almost 60 percent<sup>3</sup>). With a return to precrisis economic activity, energy consumption and energy dependency are expected to rise. In the Central and Eastern European states, both the GDP decline and its recovery took place earlier than in Ukraine, leading to increased energy dependency numbers earlier as well.

### Ukraine's Lack of Progress in Energy Diversification

Ukraine's high levels of energy import dependency are made worse by its lack of progress in diversifying its sources of energy supply. It is generally accepted that energy diversification is guaranteed by receiving energy supplies from at least three different geographical sources. Ukraine is far from this situation, because the overwhelming share of

its energy imports comes from Russia. Imports from the only significant alternative source (gas imports from Turkmenistan) have remained erratic—at times amounting to up to 40 percent of Ukraine's gas imports, but often interrupted by lack of payments or other factors. Moreover, gas imports from Turkmenistan remain subject to Russian influence, because they must be transported through Russian pipelines. Contracts between Ukraine and Turkmenistan also are often affected by Turkmenistan's other relationships, both with Russia and with Russian-controlled companies such as Itera, which has been an important intermediary in the sale of Turkmenistan gas to Ukraine.

Such a lack of progress in diversification can be explained by a variety of factors, both structural/historical and political. At the structural level, Ukraine remains tied to a Russia-centered energy infrastructure developed during the Soviet period, which means that the actual pipelines needed to receive oil and gas from non-Russian sources simply are

**Table 3. Ukrainian Gas Production and Consumption, 1992–2001**  
(trillions of cubic feet)

Measure	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Consumption	N/A	N/A	3.50	3.87	3.33	2.97	2.93	2.83	2.61	2.75	2.78	2.61
Production	0.99	0.83	0.74	0.68	0.64	0.62	0.64	0.64	0.64	0.63	0.64	0.64

Note: N/A = not available.

Sources: U.S. Energy Information Administration, available at [www.eia.doe.gov/emeu](http://www.eia.doe.gov/emeu) (for total oil supply); and Boris Kostiukovskii, "Enerhetichna kriza v Ukraini," *Enerhetichna Politika Ukraini*, no. 4 (April 2000): 46–50 (for 1990 and 1991 data).

**Table 4. Ukrainian Oil Production and Consumption, 1992–2001**  
(thousands of barrels per day)

Measure	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Consumption	N/A	N/A	813	570	495	484	388	363	384	374	264	290
Production	110	98	95	87	85	85	81	85	82	98	88	86

Note: N/A = not available.

Sources: U.S. Energy Information Administration, available at [www.eia.doe.gov/emeu](http://www.eia.doe.gov/emeu) (for total oil supply); and Boris Kostiukovskii, "Enerhetichna kriza v Ukraini," *Enerhetichna Politika Ukraini*, no. 4 (April 2000): 46–50 (for 1990 and 1991 data).

not there. Because of the high cost of constructing new oil and gas pipelines or securing other transportation options, alternative oil and gas supplies would initially be significantly more expensive than Russian ones. Such an initial difference in costs reduces the attractiveness of diversification in the short term, an especially important consideration given the lack of a widely shared domestic commitment to this goal. At the level of international relations, both the Russian government and Russian companies have repeatedly created hurdles on the way of Ukraine's energy diversification plans, as exemplified by the possible reversal of the Odesa–Brody oil pipeline (see below).

Actual diversification initiatives may also complicate relations with Russia, a country on which Ukraine is bound to remain largely energy dependent in the long term, no matter what other diversification initiatives are undertaken. At the level of Ukrainian policymaking, it has been argued that, despite repeated governmental declarations about the priority of diversification, Ukraine has failed to take aggressive steps to improve its energy diversification options, such as establishing a real system of incentives (tax, customs and credit preferences; insurance of risks related to project implementation) and providing the level of political and diplomatic support (e.g., in the search for appropriate foreign partners) adequate to the importance of the goal.<sup>4</sup>

### **Inefficient Energy Production System and High Energy Intensity**

Both Ukraine's energy production system and its economy as a whole are sorely outdated. Fifty-four percent of Ukraine's pipelines—built for a normal exploitation period of twenty-five years—are twenty-one years old or older,<sup>5</sup> and their state of disre-

pair (thinning walls and inadequate anti-rust protection, among other problems) increases the possibility of accidents. Moreover, gas-pumping units are in particularly bad condition, which means more gas needs to be expended to pump gas through the pipeline. (In 2001, almost 10 percent of Ukraine's yearly gas consumption was used for this purpose.)

Ukraine's outdated energy system has also contributed to the fact that gas and oil production has been falling since 1990 (see tables 3 and 4).<sup>6</sup> Despite the recent discovery of some gas fields, Ukraine's natural endowment is not of much help here; official Ukrainian sources estimate that oil and gas condensate reserves will be exhausted between 2025 and 2030, and natural gas reserves by 2032.<sup>7</sup>

In addition, Ukraine exhibits very low levels of energy efficiency. Not only does Ukraine have one of the highest levels of energy intensity in Europe and the world, but its energy intensity (measured as its energy consumption per unit of GDP) actually increased by about 50 percent from 1991 to 1999.<sup>8</sup> As a result, despite having a population of only 48 million, Ukraine is the sixth largest gas consumer in the world, with a yearly consumption of 75–78 billion cubic meters per year.<sup>9</sup>

Ukraine's low energy efficiency also affects its exports, lowering their competitiveness in the long term. For example, the share of energy in the cost structure of Ukrainian goods was 25 percent in the late 1990s, 8.3 times more than in France and 4 times more than in the United States.<sup>10</sup> The other side of the coin is that energy subsidies are a way of subsidizing this inefficient production, with dual negative effects: The incentive for increasing efficiency is lost, and the state as a whole must carry the costs of such subsidization. Because Ukraine did not



introduce market prices for energy in the first years after gaining its independence, individual consumers were not pushed to reduce consumption, nor was the country as a whole spurred to abandon an energy-intensive production mix in favor of a less energy-intensive one.<sup>11</sup>

### **Lack of Transparency and Corruption in Energy Markets**

The lack of transparency in the Ukrainian energy markets not only creates opportunities for corruption but actually invites corruption and abuse of power by creating opportunities for quick enrichment through shady energy deals. Because of the centrality of the energy sector for Ukraine's economy as a whole, such trends, once started in the energy sector, spread easily to the rest of the economy (e.g., the "barterization" of the economy and decline in monetary transactions in the early 1990s).<sup>12</sup> The extensive barterization of the energy economy has also contributed to the growth of the shadow economy, because barter deals are harder to control and tax than money transactions.

The widespread prevalence of corruption, together with the lack of clear institutionalization of energy policymaking and the large discretionary power of regulatory officials, increases the temptation to engage in bribe taking. Perhaps the best example is provided by former prime minister Pavlo Lazarenko, who was ousted in 1997 and is now under trial in California on charges of laundering of \$114 million in receipts from gas-related corruption through U.S. banks. Yet corruption at all levels continues. Because they have a vested interest in delaying reform, corrupt officials and the oligarchic groups associated with them make Ukraine delay reform of the sector, making the country less resilient to Russian pressure.

Corruption and the general lack of transparency in the system also keep Western investors away, creating a situation that makes Ukraine more open to Russian economic penetration and influence.

In addition, the predominance of non-cash payments (through barter and a variety of grey market mechanisms, e.g., the resale of discounted IOUs and the mutual offsetting of loans) and the existence of large payments arrears in the Ukrainian energy market as a whole—an especially large problem until 1998 but continuing in a somewhat lesser form today—have contributed to lack of transparency in the market and to the weeding out of possible foreign partners. Such circumstances have made possible Western partners seek to avoid the Ukrainian markets but have given Russian companies a comparative advantage, for it is mainly Russian companies that have the gray-market "expertise" required to work profitably (if not necessarily wholly legally) in these markets.

### **Ukraine's Inability to Develop a Coherent and Proactive Energy Policy**

The lack of a clear and generally accepted and respected energy policy is a serious hurdle in Ukraine's ability to improve its energy situation. This refers to both rules for the day-to-day organization of the sector and also to a more long-term energy policy. Unpredictable and often-changing rules for the organization of the energy market (and the gas market in particular) have made it difficult for medium- or long-term planning to take place, for the system to work smoothly, or for serious investors to take an interest in the market.

The various actors that could play a role in the determination of a coherent energy policy are weak; moreover, little effective formal coordination exists between them. The Energy Ministry, despite having (on

paper) a research division, in reality lacks it, because most of its cadre is used for administrative duties. The energy-related institutes of the Ukrainian Academy of Sciences receive only nominal funding and lack some of the basic material conditions needed for effective work, such as access to high-quality trade publications and Internet resources. Other, non-Academy of Sciences research and policy institutes dealing directly or indirectly with energy issues are often in only a slightly better situation. Some of them are fledgling operations that precariously tide themselves over from one project or commissioned article to the next, compromising their ability to deal with energy issues in a continuous manner.<sup>13</sup>

Other institutes, such as the Ukrainian Center for Political and Economic Studies (“Razumkov Center”) and the Institute for Economic Research and Policy Analysis, which thanks to foreign support have well-functioning and well-respected operations, lack sufficient personnel to play a larger policy role, as well as for fulfilling a coordination function among all organizations dealing with energy policy issues. Due to virtually nonexistent funding, preliminary work for the drafting of a new Energy Policy of Ukraine to 2030 was stalled and as of this writing had occurred only in piecemeal fashion and without a strong coordinating center. The implementation of adopted energy policies has also been a major problem, which has been made worse by the power and policy interference of Ukraine’s strong economic interest groups.

Ukraine’s lack of a clear energy policy also affects its role as the provider of an energy transit route. A number of factors make Ukraine a potentially crucial player in European energy transit: its strategic location between the main producers (Russia and the Caspian Sea area) and consumers of gas in

the Eurasian region; the fact that it possesses Europe’s second largest gas transit network (after Russia’s); and the availability of significant underground gas storage capacities, something other transit-oriented countries lack. Moreover, as demand for gas and oil continues to increase in Western Europe and North Sea supplies are depleted, Ukraine’s importance as a transit-oriented country for Russian, Caspian, and Central Asian energy production will continue to increase. But for these positive factors to be fully put to use, a strong and proactive state policy is needed.

### **Complicating Domestic Factors**

Even taken by itself and in the context of the most transparent political system, Ukraine’s energy dependency on Russia would be a problem. But Ukraine’s lack of a transparent policymaking system simply makes it much more difficult for the country to adopt a proactive and long-term energy policy that is in tune with the needs of the country as a whole and not only those of some political and economic groups. Similarly, President Leonid Kuchma’s leadership style complicates attempts at dealing proactively with Ukraine’s energy situation.

For example, the lack of well-institutionalized policymaking and interest representation mechanisms means increased freedom for the current president to engage in backroom dealings with various political and economic groupings, which, together with his questionable human rights record, weakens his legitimacy. This, in turn, weakens his ability to negotiate with Russia. Kuchma—domestically and internationally isolated and increasingly personally dependent on support from Russia—finds himself in a situation where he is increasingly willing to leave Ukraine’s interests at the door and acquiesce to Russian demands in order to receive this support.

President Kuchma's style of political maneuvering limits Ukraine's field of action in energy policy. Kuchma's often repressive and nontransparent domestic and international policies (exemplified, among others, by his purported role in the disappearance and assassination of journalist Heorhii Gongadze in September 2000,<sup>14</sup> the "Kuchmagate" scandal involving self-incriminatory tapes later that year, and the scandal involving the possible secret sale of "Kolchuga" radar to Iraq in 2002) have led to his becoming more and more internationally isolated.

This puts the president in a situation where, on the one hand, he becomes increasingly dependent on Russian support and where, on the other, his weakness vis-à-vis Moscow also weakens his ability to stand up to Moscow on energy issues. With few reserves of legitimacy at home<sup>15</sup> or allies abroad, Kuchma has had little alternative but to comply with Russian wishes and requests, including in the area of energy policy. In combination with the traditional weaknesses of Ukrainian energy policymaking, this means Kuchma has little of a clear, legitimate, and well-supported national energy policy to oppose to Moscow's ideas and pressure.

Different interests exist within any country, but President Kuchma's way of dealing with these conflicting interests have not contributed to solve Ukraine's energy problems. For example, his personal motives also emerged as an interesting factor in relation to the issue of the creation of an international consortium for the operation of Ukraine's gas transit system and his tacit support for a non-transparent and far from perfect Russian proposal in 2003. Many asked themselves: Why would President Kuchma support such a vision of the consortium that seems to have more minuses than pluses? Kuchma can benefit from it because he urgently needs

Russia's support, and, thus, is more ready to come to agreements and compromises with Gazprom than if he were not so dependent on this support.

Kuchma's ability to build a strategy based on playing certain interests against each other could not succeed if these conflicting interests did not exist. Certainly, differing and often conflicting interests exist everywhere, but the issue is whether a sufficiently developed institutional system exists that is able to moderate these differences and guarantee that general interest prevails over particular sectoral interests. Understanding these domestic divisions and struggles, and the way they are dealt with by the Ukrainian political system, is essential for understanding Ukraine's weakness in negotiations with Russia and Russian energy companies, and also to dispel any illusions of a victimized Ukraine united in the face of Russian pressure. Instead, the real picture is one of "competing internal and foreign interest groups, all trying to make a profit out of this situation of dependency."<sup>16</sup>

## **WHY SHOULD WE CARE? THE DOMESTIC, REGIONAL, AND INTERNATIONAL IMPLICATIONS OF UKRAINE'S ENERGY SITUATION**

Ukraine's energy and energy policy problems have a variety of implications and consequences for the country's broader domestic political and economic situation, as well as for its international relationships and for the stability of the region. In this way, they also affect the United States's relationship with Ukraine and its strategy in Central and Eastern Europe as a whole.

### **Domestic Consequences**

As a result of the way Ukraine's energy poli-

cymaking system has worked, many costs are shifted, in a nontransparent manner, to the state. As a result, the state is robbed of valuable resources it could use in other areas. The state becomes further weakened, which, in a vicious circle, makes it less able to get a grip on the energy system and its problems. Energy problems and the lack of proactive approaches to these also create dissatisfaction in the population (e.g., in the winter of 1994, when energy supply problems led to freezing home temperatures) and increased political apathy, thus further weakening Ukraine's still unstable democracy.

### **Consequences for Ukraine's Relationship with Russia**

Ukraine's blatant energy dependency on Russia, together with the government's inability to take a strong policy stance on energy issues, further complicates an already difficult relationship. In the context of Ukraine's currently strained relationships with other foreign partners, this dependency leads to increased pressure for closer economic and political integration with Russia, as evidenced by Ukraine's signing of the treaty on a Common Economic Space with Russia, Belarus, and Kazakhstan in September 2003. It also increases Ukraine's weakness in negotiations with Russia and its vulnerability vis-à-vis its largest trading partner.

### **Regional Consequences**

Whether divided from its Western neighbors by a wall separating it from new NATO and EU members or tied to them through a variety of economic and political agreements, Ukraine plays a central role in Central and Eastern Europe's regional security.<sup>17</sup> And it is especially worrisome that Ukraine, of all countries in the region, is the most vulnera-

ble in its energy security and security in general. Ukraine's own energy security problems and its wavering on energy policy issues have negatively affected the whole region's security.

Ukraine's indecision in energy policy makes it more difficult for other states in the region to have access to more diversified energy resources. The case of the Odesa–Brody pipeline exemplifies some of these dangers. The pipeline originally envisioned with the goal of fostering Ukraine's energy supply diversification and to help put the country in the map as a transit corridor for Caspian oil to Europe, has in reality turned out to be a clear example of Ukraine's inability to develop and follow a clear energy policy. At first, the completion of the project, originally envisioned in the mid-1990s, was delayed for a number of years.

When the Odesa–Brody segment was finally completed in 2002, it turned out that little business planning had been done in connection with the project, and no Caspian oil was ready to flow through it, which called for Polish reservations on building the connecting segment to Plotsk. In early 2003, the Ukrainian side responded to the absence of offers of Caspian oil to be shipped North through the pipeline by temporarily “reversing” the flow of a 52-kilometer segment of the pipeline, using it to transport Russian oil through the Odessa port to Western Europe.

As summer approached, the issue gained momentum and became the center of daily rumors, assertions, and counterassertions. Rumors started to flow to the effect that Ukraine was planning to accept a Russian proposal for a “full reversal” of the pipeline, that is, to transport Russian oil (belonging to TNK, the Tiumenskaya Neftenaya Kompania) from Brody in the North to Odesa in the South (to be shipped further West by tanker)—that is, in the oppo-

site direction from the pipeline as originally intended. This proposal takes place in the context of the acute lack of free export capacity in Russian pipelines system at a time when the difference between domestic and export prices is especially large.

The issue gained international exposure in early April 2003, when the German, Polish, and U.S. ambassadors responded to the idea of a reversal with a front-page editorial in one of Ukraine's leading newspapers, strongly condemning the idea. Soon after that, a protocol for the full reversal of the pipeline, signed by the Ukrainian state oil company Neftegaz Ukraini, Russia's Transneft, and TNK was leaked to the press. After that, a number of domestic and foreign actors quickly started to mobilize either for or against the project.

At this point, it is important to note that the controversy around the future of the Odesa–Brody pipeline is not only an issue of Ukrainian versus Russian interests. The Russian companies pushing for the reversal and most likely to benefit from the proposal have found ready Ukrainian partners—not only individuals who are well connected in the energy area, such as President Kuchma's son-in-law Viktor Pinchuk, but even the state company Ukrtransnafta. Indeed, all the major oligarchic groups presently active in Ukraine have important energy interests. Moreover, the struggle on the future of the Odesa–Brody pipeline is but one manifestation of the struggle of different clans and interests groups within Ukraine. This has been manifested by the contradictory positions on the future of the pipeline held by former Fuel and Energy Minister Serhii Ermilov, who has opposed the reversal of the pipeline, and Neftegaz Ukraini head Yurii Boiko.

This conflict flared again in October 2003, when the supervisory board of Ukrtransnafta (a company that is 100 percent owned by Naftohaz Ukraini) announced its

decision to fill the pipeline with Russian oil (a step widely seen as clearly leading to a reversal of the pipeline), to be quickly rebuffed by former Energy Minister Ermilov, who argued that a decision on the purchase of oil for the pipeline was the sole prerogative of the Cabinet of Ministers.<sup>18</sup> Although an early February 2004 decision of the Cabinet of Ministers declared the pipeline should be used in its original direction, the question may not be closed, as discussions on possibly giving the pipeline in concession to a Russian company have renewed fears that the pipeline will be used to transport Russian gas South rather than Caspian gas North.

Although the immediate economic benefit of using the Odesa–Brody pipeline in a reverse direction seemed obvious (immediate cash payments and higher transit fees than those Russia would pay for transit in the same direction through the Transdnister pipelines, which reportedly could also move Russian oil south for further shipment through Odesa<sup>19</sup>), there are also a number of short- and medium-term implications that would result from such a decision. First, it must be emphasized that the TNK–BP proposal was only for a three-year contract for the reverse use of the pipeline. Second, a reversal of the pipeline would affect Ukraine's agreements concerning a link between the Druzhba and Adria pipelines to move Russian oil to the Croatian port of Omisalj for further shipment west, agreements that were reached after lengthy negotiations with Croatia, Hungary, Russia, and Slovakia. The Druzhba–Adria project would be affected because the capacity of the Druzhba pipeline in the Ukrainian segment up to Brody is only 9 million tons a year. If some or all of that capacity is taken up by TNK oil to be later transported through Odesa–Brody to Odesa, then very little or no capacity is left there for other oil (which

happens to belong to TNK's competitor Yukos) to be transported through the new Druzhba–Adria system.

The implications for Ukraine's energy security are also clear. If Ukraine were to abandon the original purpose of the pipeline, it would close one possible source of energy diversification for the country and actually become even more dependent on Russian oil. Similarly, the Czech Republic, Germany, Poland, and Slovakia would be deprived of an additional possibility to increase their import diversification. Conversely, the Russian proposal offers the temptation of immediate revenue and an end to the unseemly picture of an expensive, brand-new pipeline standing idle. The shelving of the original Odesa–Brody project would also have important ecological implications for Southern Europe, because oil transit to Europe through the pipeline (instead of by tanker) would have reduced movement through the ecologically sensitive Bosphorus Straits, an issue about which NATO member Greece has been particularly sensitive.

The floundering of the Odesa–Brody project would also have implications for the building of alternative, non-Russian-centered political groupings in the post-Soviet area. One of these groups, the Georgia-Ukraine-Uzbekistan-Azerbaijan-Moldova (GUUAM) affiliation, could be especially affected. GUUAM, which was established in 1997 as a counterweight to Russian-led attempts at regional integration in the post-Soviet area, has had an important energy component, for it is composed of countries that could benefit from an alternative, non-Russian-controlled system of energy transit and supplies from the Caspian and Central Asian area, of which the Odesa–Brody pipeline would be the central element. The demise of the original pipeline project—which had already been weakened due to a variety of factors—would

further weaken this potentially important organization.

### **Consequences for U.S. Strategy in the Region**

The success of the Odesa–Brody project would greatly support U.S. strategy in Central and Eastern Europe and beyond, for two reasons. First, it fits within the broader U.S. policy of supporting the development of multiple pipelines on the East–West axis. Second, routing Caspian oil supplies through the Odesa–Brody pipeline to Western Europe would help guarantee the oil diversification and energy security of the United States's Western European allies, a long-standing American aim.

At the same time, Ukraine's current energy situation and its handling create difficulties in the U.S. strategy of helping consolidate Ukraine as a viable state and a democracy as a way of helping contain Russian influence in the region.<sup>20</sup> A Ukraine that is weak, lacks transparent governance, and is overwhelmingly dependent on Russia for its energy needs cannot be a strong independent state able to put a stop to possible hegemonic designs in the region. Moreover, such a state cannot be the basis of strong regional cooperation movements, which could both facilitate Ukraine's ties to its Western neighbors soon to join the European Union and the development of alternatives to Russian-centered regional integration initiatives.

### **RECOMMENDATIONS FOR U.S. POLICY**

The foregoing analysis leads to four proposals. These proposals are based on a realistic assessment of political and economic realities in the post-Soviet region, as well as on an awareness of the political sensitivity that sur-

rounds both the energy issue and relations with the West in Ukraine.

### **Proposal 1: Give Ukraine Concrete Material Support to Increase Its Energy Diversification**

*Provide concrete support.* The United States has made clear the importance of Ukraine's energy situation for its future development and for its ability to safeguard both its political and economic independence. This stance was made especially clear during Carlos Pascual's tenure as U.S. ambassador in Ukraine (2000–3).<sup>21</sup> The United States, though the programs of the Agency for International Development and other federal agencies, has provided significant material and technical support for projects focusing on issues such as energy efficiency, the creation of a wholesale electric energy market, and local environmental management. Such programs should continue to be strengthened. However, the United States needs to take a stronger stance concerning Ukraine's energy diversification situation by providing more concrete support for initiatives such as the Odesa–Brody pipeline.

Although the official U.S. policy has been not to provide direct economic support for such projects and to leave such decisions to private companies, there are a variety of ways in which the United States may support the project, for example, through loan guarantees and through its influence in multilateral organizations able to provide financing for such projects, such as the European Bank for Reconstruction and Development, which has played a major role in financing other pipeline projects, such as the Baku–Ceyhan pipeline.

*Do not give ammunition to accusations that the West is acting hypocritically.* From the very beginning, President Kuchma's response

to the discussions and debates around the Odesa–Brody pipeline (and about Ukraine's economic integration into the West more generally) gave prominence to the veiled (or not-so-veiled) accusation that the West was acting hypocritically towards Ukraine, proclaiming the importance of and political support for the Odesa–Brody project, but failing to provide any real material support.<sup>22</sup>

It is hard to deny that there has been a significant gap between Western formal support for the pipeline (in the form of political declarations and discussions) and actual Western investment in the project. Although full implementation of the project would probably benefit U.S. companies such as Chevron working in Kazakhstan (it has been argued that the future of the project lies with the transport of Kazakh, rather than Azeri oil), the United States has provided only limited economic support for the project. Similarly, the European Union, although giving Ukraine an important place in discussions about a future European–Asian Transport Corridor, has so far provided only 2 million euros for a feasibility study. The West expects Ukraine to make a political decision to support the project economically, when it itself seems not to be fully prepared to do this. But perhaps this should not surprise us, given the history of the Western relationship with Ukraine: Although committed to supporting Ukraine's independence, countries such as the United States have been repeatedly disappointed by the current Ukrainian government's lack of commitment to human rights, wavering international alliances, and lukewarm respect for transparent rules in tenders involving Western companies.

Yet EU and American policy toward Ukraine's energy projects should make an effort to both move toward clearer and substantial support for concrete projects, and

reach and engage local public opinion in such a way as to make clear the seriousness of that commitment. The United States should also be careful in the timing and form of engagement of the local media. The use of the local media around the Odesa–Brody controversy may be a good example of the possibilities as well as challenges opened by direct access to it. On the one hand, the appearance of a front-page editorial by the German, Polish, and U.S. ambassadors in one of Ukraine’s leading newspapers in April 2003<sup>23</sup> immediately raised the issue of a possible reversal of the Odesa–Brody pipeline to national prominence, and indirectly led to the disclosure of a secret protocol providing for the full reversal of the pipeline.<sup>24</sup> On the other hand, some in Ukraine found the idea of foreign diplomats appealing directly to the public a good reason to complain about foreign interference in Ukraine’s internal affairs.

### **Proposal 2: Support the Work of the Energy Charter Treaty**

The Energy Charter—which was first signed in 1994 and aimed to facilitate trade and cooperation between the Western European, former Soviet, and Eastern European energy sectors<sup>25</sup>—had the basic thrust that energy trade should be governed by World Trade Organization rules, and that investment, exploration, production, and transportation policy should be nondiscriminatory. As a transit-oriented country largely dependent on transit revenue for the satisfaction of its own energy needs, Ukraine stands to benefit greatly from the full application of the Energy Charter in Eurasia. (Although Ukraine has ratified the treaty, Russia, by far the area’s most important energy actor, has not, casting uncertainty over its application in the region.)

Ukraine stands to benefit in a variety of

ways from the full application of the Energy Charter, both in its relationship with Russia and in its broader energy relationships. The charter seeks to protect transit from political disputes, a main problem in the Ukrainian–Russian relationship. In addition, the charter’s Protocol on Transit—which is currently under discussion and whose successful negotiation is seen as essential for Russian ratification—can be very important for Ukraine, because it would regulate not only the transit of energy resources that cross at least two national borders but also the establishment of a system for transit tariff setting and for preventing illegal siphoning during transit, both of which are issues whose regulation is essential for Ukraine to be able to safeguard and strengthen its role as an energy transit state. This is especially important considering the steady decline in gas transit through Ukraine; from 139.9 billion cubic meters per year in 1996 to 124.4 in 2001.<sup>26</sup>

The Energy Charter also has important implications for Ukraine through the issue of the transit of Central Asian oil and gas. Ukraine has repeatedly tried to lessen its dependency on Russia by acquiring gas supplies from Turkmenistan. Leaving aside the fact that these deliveries have been hindered again and again by Ukraine’s payments arrears, the issue of transit has also created obstacles because, in the absence of other pipelines, supplies from Turkmenistan have to go through Russian pipelines. Gazprom has sometimes opposed providing access to this transit, has imposed punitive transit fees, or has otherwise subjected this transit to political manipulation.<sup>27</sup>

### **Proposal 3: Help Ukraine Move toward a Clear Energy Policy Concept**

The lack of a clear, effective and enforceable



energy policy is a serious hurdle in Ukraine's ability to improve its energy situation. Two concrete proposals can be offered to help deal with this situation and to tap into the varied energy expertise that does exist in Ukraine.

First, additional funding can be provided to one of the well-established institutes conducting energy research (possibly the "Razumkov Center," because it is the one most financially independent from the state), with the explicit mandate to play a coordinating role between the various institutes involved in policy research and to organize monthly roundtables which will lead to a clearer, shared vision of future energy policy. Second, medium-sized grants can be given to other institutes engaged in energy policy research to support continuous monitoring of the energy situation and uninterrupted work on energy issues. Before Ukraine decides where it wants to go—in its energy strategy, but also in its foreign policy generally—it will be very difficult for the country to capitalize on its geographical position as a transit corridor. The United States should support an open and earnest debate on Ukraine's future energy policy.

#### **Proposal 4: Support Transparency in Policymaking at All Levels**

Many of Ukraine's energy problems have to do with lack of transparency in policymaking, and with power structures that privilege private as opposed to general national interests. To be able to adopt a proactive energy policy, Ukraine needs to move toward more transparent policymaking at all levels. In the medium and long terms, this will be essential, especially concerning energy privatization issues, where shadowy deals and a lack of transparency have created serious problems. Yet here the United States walks a tightrope in designing a proactive and effec-

tive policy vis-à-vis Ukraine: how to put pressure on the Ukrainian government to adopt a more transparent and democratic policymaking style, without alienating it into falling further into the Russian embrace. Or, to put it differently, to make it clear to Ukraine and its political leaders that the United States is its friend, without falling into condoning (or making them believe the United States condones) corrupt, repressive, and undemocratic practices.

Yet the United States can support increased transparency in a variety of ways. First, it can help the Ukrainian public receive objective information about events in the energy area that are not always fully covered in a press that is increasingly controlled by the government and the oligarchic groups close to it. Here, support for continued and extended service by Radio Liberty, as well as other independent media, is essential. In addition, the United States can support the work of nongovernmental organizations that act as watchdogs for transparent policymaking.

#### **THE COSTS OF INACTION: WHAT WILL HAPPEN IF NOTHING IS DONE**

Energy is the Achilles' Heel of the Ukrainian economy, and also the basic element of its relationship with Russia. Because of these factors, inaction in the energy arena can lead to even more serious problems than those seen today. If the United States does not adopt a proactive policy, it risks increased problems in several areas, ranging from the domestic to the international.

#### **Increased Vulnerability vis-à-vis Russia**

In a situation where it is dangerously dependent on Russian energy and without a tight grip on its energy situation, Ukraine

continues to be extremely vulnerable to pressure from Russia. The huge domestic costs of such vulnerability have become evident from two examples from the past. First, the virtual oil embargo imposed by Russia in early 2000 as a way of putting pressure on Ukraine to stop the “unsanctioned taking” of gas from the pipeline to Western Europe and adopting a transit fee policy more favorable to Russia in the arranging of oil transit to the port of Omisalj through the Druzhba–Adria connection. More recently, Russia’s summer 2003 delay in signing a long-negotiated oil transit agreement with Ukraine as a way of putting pressure on Ukraine to acquiesce to the reverse use of the Odesa–Brody pipeline also showed that such methods are not part of the past.

### **Increased Weakness in Negotiations with Russia**

In a situation of not only external but also domestic vulnerability, Ukraine becomes weakened in its negotiating capacity vis-à-vis Russia. A clear example of this was seen in 1999–2000, when Ukraine—heavily indebted to Russia due to previous energy shipments, and unable to secure alternative oil supplies—was pressured into debt-for-shares agreements with Russia, which by 2002 had given Russian companies virtual control over Ukrainian oil refineries. In the future, this weakness vis-à-vis Moscow will also mean a weakness in Ukraine’s ability to stand up to Moscow to defend its energy interests.

### **Ukraine May Lose Its Chance to Become a Central Player in the Transit of Caspian Oil to Western Marke**

Unless Ukraine adopts a proactive, long-term-oriented energy policy, it may lose the chance to become increasingly integrated into the European economy through its

potential role as an important energy transit country. President Kuchma’s position on the use of the pipeline has focused on the possible short-term financial gain that could be accrued from the use of the Odesa–Brody pipeline for the transit of Russian oil from Brody to Odesa. At the same time, his argument has been that there is nothing wrong with a temporary reversal, and that, after a few years, when Caspian oil becomes widely available and demand for it increases, the pipeline could be reversed again.

This argument was based on the assumption that the international configuration of alternate transport routes for Caspian oil would remain “frozen,” and that Ukraine, after a few years and a second reversal, could just go back to developing its hoped-for role as an important transit route for Caspian oil to Western Europe. Yet there are good reasons to believe that the world will not “wait” for Ukraine. If Ukraine drags its feet, other competing plans for the transit of Caspian oil to Western Europe (e.g., the Burgas, Bulgaria–Alexandropoulos pipeline project) will gain ground, and Ukraine may lose a unique chance, in which it has already invested hundreds of millions of dollars.<sup>28</sup>

### **Increased Pressure for Closer Economic (and Political) Integration with Russia**

As long as Ukraine does not get a grip on its energy situation, this puts pressure on the country to increase its economic integration with Russia (and Russian-dominated trade groups) as a way to try to ameliorate its energy dilemma through short- or medium-term measures. For example, one recurring problem in Ukraine’s energy relationship with Russia has been the discriminatory treatment the country has faced. Ukraine is the only country in the region where Russian oil exported to it is subject both to

value-added tax (VAT) and export duties, while, in the case of other states, only one of the two (either VAT or an export duty) is levied, depending on whether they are members of the Customs Union or not.<sup>29</sup> This discriminatory treatment has actually served to pressure Ukraine to join Russia in closer forms of economic integration, in the hope of resolving this situation. However, the Russian government has not provided guarantees that such discriminatory treatment would end should Ukraine ratify the Single Economic Space agreements proposed by Russia and signed on September 18, 2003.<sup>30</sup>

In turn, this apparent absence of economic integration alternatives strengthens the opinion of those who believe that Ukraine's future lies firmly in integration with a Russian-led block. This has serious political implications, for it strengthens those groups within Ukraine that favor closer political relations with Russia as well. This is especially dangerous given the divided nature of Ukrainian society, significant segments of which have strong moods in favor of reintegration with Russia. Similarly, increased pressure for integration with Russia would significantly reduce Ukrainian involvement in groupings such as GUUAM. Without such involvement, the chances of success for this and other, non-Russian-centered regional groupings would be severely limited, and an important counterweight to the growing role of Russian-centered integration projects in the region would be lost.

## **CONCLUSION**

Ukraine finds itself at a crossroads in both its political and economic development. Because of their centrality both economically and politically, how energy issues are dealt with will have a significant impact on the country's domestic political development and

international relationships. Ukraine's dependency on energy imports creates a source of weakness, while its current and potential role as an important transit country for Russian, Caspian, and Central Asian energy production opens new possibilities. How Ukraine balances these two elements and how it will be able to use these possibilities will depend to a large extent on its ability to develop proactive energy policies, and on the Western help it receives in reaching this goal.

## NOTES

- <sup>1</sup> Oles M. Smolansky, "Ukraine's Quest for Independence: The Fuel Factor," *Europe-Asia Studies* 47, no. 1 (1995): 85.
- <sup>2</sup> Ukrainian Center for Economic and Political Studies, *Concept of the State Energy Policy of Ukraine through 2020*, National Security and Defense 2 (Kyiv: Ukrainian Center for Economic and Political Studies, 2001), 19.
- <sup>3</sup> World Bank, *Statistical Yearbook for Ukraine* (Washington, D.C.: World Bank, various years), and Hans van Zon, *The Political Economy of Ukraine* (London: Macmillan, 2000), 76.
- <sup>4</sup> See Ukrainian Center for Economic and Political Studies, *Concept of the State Energy Policy*, 36.
- <sup>5</sup> Ukrainian Center for Economic and Political Studies, *The EU-Ukraine-Russia "Gas Triangle,"* National Security and Defense 3 (Kyiv: Ukrainian Center for Economic and Political Studies, 2002), 31.
- <sup>6</sup> This should be seen in the context of the fact that during the Soviet period oil and gas reserves were exploited in ways that quickly and seemingly inexpensively got the gas and oil located in easy-to-reach parts of deposits, but which actually made it much more difficult—and expensive—to get at the remaining parts of these deposits later on.
- <sup>7</sup> Ukrainian Center for Economic and Political Studies, *Concept of the State Energy Policy*, 10.
- <sup>8</sup> A qualification often made to this calculation is that this data are not completely correct because they measure only the official gross national product, ignoring the shadow economy that by 1999 accounted for up to 50 percent of economic activity. This view is supported by the fact that, indeed, one of the ways to measure the shadow economy is by looking at electricity consumption; Christian von Hirschhausen and Volkhart Vincentz, "Energy Policy and Structural Reform," *Eastern European Economics* 38, no. 1 (January–February 2000): 64. So from this perspective, it could be said that, if calculations were made on the basis of the economy as a whole

(shadow as well as official), as opposed to just the official economy, the increase in energy intensity would not look as large, because energy consumption has grown together with total (shadow and nonshadow) GDP. At the same time, including the shadow economy in energy-intensity calculations fails to fully disqualify the increase in the energy-intensity argument. This is so because "a large part of the shadow economy consists of trade with little energy intensity" and because data on single industries as well "show a high and increasing energy consumption that cannot be attributed to the shadow economy"; von Hirschhausen and Vincentz, "Energy Policy," 64. See also International Energy Agency, *Energy Policies of Ukraine 1996 Survey* (Paris: Organization for Economic Cooperation and Development and International Energy Agency, 1996), 73–5.

- <sup>9</sup> Ivan Dyak, head of the Subcommittee on Gas Industry at the Verkhovna Rada Committee on the Fuel Complex, in Ukrainian Center for Economic and Political Studies, *Concept of the State Energy Policy*, 67–8.
- <sup>10</sup> Sergey Tulub, minister of fuel and energy, in "Black Sea Regional Energy Center," *Black Sea Energy Review: Ukraine* (Sofia: Black Sea Regional Energy Center, 2000), 9.
- <sup>11</sup> Hermann Clement, "Economic Aspects of Ukrainian-Russian Relations," in *Between Russia and the West: Foreign and Security Policy of Independent Ukraine*, ed. Kurt R. Spillman, Andreas Wenger, and Derek Mueller (Bern and New York: Peter Lang, 1999), 296.
- <sup>12</sup> Yuri Savka, "Vzaemozalik iak sposib zhittia," *Enerhetichna Politika Ukraini*, no. 6 (June 2000): 30–4.
- <sup>13</sup> E.g., the research centers Sofia and Strategia-I, and the International Comparative Analysis Institute.
- <sup>14</sup> See Melnichenko Tapes Project, available at [www.wcfia.harvard.edu/academy/melnynchenko](http://www.wcfia.harvard.edu/academy/melnynchenko).
- <sup>15</sup> Domestically, Kuchma seems to compensate for his lack of legitimacy by strategically using the support of various influential individuals and "clans," which he manipulates by selectively giving support to (and seeking support from), and

playing them selectively against one another.

<sup>16</sup> See M. Balmaceda, "Gas, Oil and the Linkages Between Domestic and Foreign Policies: the Case of Ukraine," *Europe-Asia Studies* 50, no. 2 (March 1998), p. 283.

<sup>17</sup> See Margarita M. Balmaceda, ed., *On the Edge: The Ukrainian–Central European–Russian Security Triangle* (Budapest: Central European University Press, 2000).

<sup>18</sup> See *Ukrainian News–Oil and Gas Week*, October 12, 2003.

<sup>19</sup> "K 'Uyzhnomu' khochet prichalit Yukos", *Ukrainian Gas and Oil Report* (NefteRynok), June 30, 2003.

<sup>20</sup> As famously noted by Zbigniew Brzezinski, "Without Ukraine, Russia cannot really be an empire." See also Sherman Garnett, *Keystone in the Arch: Ukraine in the Emerging Security Environment of Central and Eastern Europe* (Washington, D.C.: Carnegie Endowment for International Peace, 1997).

<sup>21</sup> See, e.g., Carlos Pascual, "Ukraine: Energy Hub of Europe," Second International Oil and Gas Conference: Energy Forum Ukraine— 2002, 21 May 2002; available at [www.usinfo.usemb.kiev.ua/files/pascual\\_energy-forum\\_5-21-02\\_eng.html](http://www.usinfo.usemb.kiev.ua/files/pascual_energy-forum_5-21-02_eng.html).

<sup>22</sup> See, e.g., his declarations at the VI Ukrainian–Polish Economic Forum, Odesa, 24 June 2003, arguing that Ukraine will indeed use the pipeline in reverse, unless the European Union goes beyond declarations and takes concrete steps in support of the Odesa–Brody use of the pipeline. See *Ukrainian Gas and Oil Report* (NefteRynok), July 7, 2003.

<sup>23</sup> See Carlos Pascual, Ditmer Studemann and Marel Ziukovskii, "Dvukhmyslenii revers: Neft i evroatlantskii shans Ukraini," *Den'* (Kyiv), 3 April 2003, p. 1.

<sup>24</sup> Tatiana Vysotskaya, "'Nefte haz Ukraini' i 'Ukrtransnafta' sporiat o budushem proekta Odesa–Brody" *Delovaya Nedelia* (Kyiv), 2003 No. 18 (132), May 29–June 4, 2003, 2.

<sup>25</sup> See Bryan Clark, "Transit and the Energy Charter Treaty: Rhetoric and Reality," published

in *Web Journal of Current Legal Issues* (1998) in association with Blackstone Press Ltd.; available at [www.webjcli.ncl.ac.uk/1998/issue5/clarck5.html](http://www.webjcli.ncl.ac.uk/1998/issue5/clarck5.html).

<sup>26</sup> Ukrainian Center for Economic and Political Studies, *EU–Ukraine–Russia "Gas Triangle,"* 32.

<sup>27</sup> An example of this kind of behavior comes from fall of 2000 when, in the midst of Ukrainian–Russian negotiations on the gas debt, Russian vice premier Viktor Khristenko made the following veiled threat: Ukraine should choose: either Turkmen gas, or Russian gas, but not both. Aleksandr Bekker, "Polufinal. Rossia i Ukraina pochtii dogovorilis" *Vedomosti*, November 2000, A4. After further negotiations, the threat was not put into effect; Viktor Yadukha, "Bolshoi gazovyi secret" *Segodnia*, November 20 2000, 2.

<sup>28</sup> See Pascual, Studemann, and Ziukovskii, "Dvukhmyslenii revers."

<sup>29</sup> Pavel Miroshnikov, "Neftiannaia zavisimost'" *Delovaya Nedelia* (Kyiv), no. 8 (March 13–19, 2003): 1.

<sup>30</sup> Miroshnikov, "Neftiannaia zavisimost'." Moreover, less than a week after the signing of the Common Economic Space agreements in September 2003, Russia's ambassador to Ukraine, Viktor Chernomyrdin, declared that the agreement did not mean that Russia would reduce prices for its oil and gas supplied to Ukraine. Interfax Ukraine, September 26, 2003; available at: [www.interfax.com?item=Ukr&pg=0&id=5660683&req=](http://www.interfax.com?item=Ukr&pg=0&id=5660683&req=).