

Energy sectors of former Soviet countries covered by the ENP

'Gas sector in Ukraine is a magnet for corruption'¹.
World Bank Report

'...this key sector is the most criminalised,
according to the opinion of all experts. It is also too politicised'².
President Leonid Kuchma

Dependency on supplies from Russia

The lack of diversification of gas and crude oil supplies is one of the most important reasons for the politico-economic problems of Ukraine, Moldova and Belarus with Russia. Gas and oil imported from Russia or, as in the case of gas for Ukraine, via Russia from Central Asian countries through the intermediary of Russian corporations, satisfies a huge part of demand for these resources.

Of the three countries, only Ukraine has gas deposits that satisfy part of its demand for gas (19.1 billion m³ of the 66.4 billion m³ consumed in 2006). Ukraine and Belarus also extract small quantities of the crude oil they need

¹ *Ukraine: Challenges facing the gas sector*, World Bank, September 2003, <http://siteresources.world-bank.org/INTECAREGTOPENERGY/34004325-1112025344408/20772948/ukrainegassector.pdf>

² Quoted in: *It's a Gas. Funny Business In the Turkmen-Ukraine Gas Trade*, 'Global Witness', April 2006, p. 22, http://www.globalwitness.org/media_library_get.php/296/its_a_gas_april_2006_lowres.pdf

(3 million tonnes and 1.8 million tonnes, respectively). Moldova does not have its own resources. Hence, most of these countries' gas and oil must be imported from or via Russia (see Table 1).

Table 1. Gas and crude oil consumption in Belarus, Ukraine and Moldova (2006).

	Gas (billion m³)	Crude oil (millions of tonnes)
Belarus	19.6	8.0*
Ukraine	66.4	15.0
Moldova**	2.68	0.67

*It should be stressed that in its refineries Belarus processes almost 20 million tonnes annually, exports most oil products and only about 1/3 of the oil is used domestically.

** 2005

Data from: *BP Statistical Review of World Energy 2007, International Energy Agency.*

Dependency on Russia is heightened by the fact that natural gas and, to a lesser extent, crude oil, are basic resources in the energy balance of each of those countries (see Table 2).

Table 2. Energy balance of Belarus, Ukraine and Moldova (2004).

%	Crude oil	Natural gas	Coal	Nuclear energy	Electric energy (import)
Belarus	31.9	64.7	2.3	0	1.1
Ukraine	12.8	47.2	23.7	16.3	0
Moldova	20	67.7	2.5	0	7.5

Data: International Energy Agency.

Gas has a special place in the energy balance of each of those countries: it is used to generate 67.7%, almost 65% and 47% of all energy in Moldova,

Belarus and Ukraine, respectively. This goes a long way to explaining why the issue of resources in Ukraine's, Moldova's and Belarus' relations with Russia is not so much an economic problem as a political one.

Despite their high dependency on Russian supplies of energy resources, Ukraine and Belarus can at least partly counterbalance this dependency thanks to the control they have over the pipelines transporting Russian gas and oil to the West. Ukraine and Belarus are crucial to the transport of Russian gas because almost all gas exported from Russia to the EU – 25% of the gas consumed in the EU³ – travels through their territory. The most important route for the transport of Russian oil to the EU – the Druzhba pipeline – also crosses Ukraine and Belarus. Moreover, some Russian oil is transported via oil terminals at sea ports in Ukraine (mainly Odessa, Pivdenniy and Theodosia).

Dependency on oil and gas supplies from Russia is a throwback to the time those countries were part of the USSR and hence part of the internal energy market of the Soviet empire. When referring to the high degree of dependency on Russian supplies of resources, it is worth pointing out that some of the member states of the EU are in a similar situation, especially those that were part of the USSR, such as Lithuania, Latvia and Estonia, or that depended on the USSR, such as Poland, the Czech Republic, Slovakia, Hungary, Romania and Bulgaria.

High level of energy consumption and inefficiency

For Ukraine, Belarus and Moldova, Russian gas and oil have strategic significance; their economies, which have high levels of energy consumption, depend on them. The natural gas consumption per capita in Ukraine and Belarus is among the highest in the world. The principal gas consumers are enterprises with strategic significance to the economy that account for

³ Of those EU states that use Russian gas, only Finland, Estonia and Latvia do not import it through Belarus, Ukraine or Moldova.

a large part of GDP and export revenues. Gas consumption in the metallurgical and chemical sectors, key sectors of the Ukrainian economy, is 25–30% higher than the average in the EU, according to World Bank estimates. The very low efficiency of the Belarusian, Ukrainian and Moldovan economies makes them less competitive. At the end of the 1990s, 25% of the costs of manufacturing a product in Ukraine were represented by the price of energy, which was eight times higher than in France⁴. To date, those figures have not appreciably changed. All three countries are forced to bear the consequences of lack of reforms in the most important sectors of their economies and the effects of failing to introduce market prices in the 1990s, like Central Europe did.

Households are also major gas consumers. For example, in Ukraine they consume 20 billion cubic meters annually, which accounts for ¼ of the country's gas consumption. Gas consumption there is much higher than it could be because of the very high losses of energy, for example in the heating of buildings. In all three countries, modern energy-saving technologies are still rarely used in households. The result of the lack of energy efficiency is easy to foresee. Any increases in the prices of gas and oil must severely affect the economies of these countries and could each lead to an economic crisis.

Political and financial significance

The energy sectors of former Soviet countries are also typically politicised and corrupt because no other sector of the economy provided such a rapid route to wealth as energy. In the case of Belarus, where the state has retained its dominant role, supplies of oil and gas from Russia ensured huge profits for Lukashenka's regime and this has become a foundation of the stability of his authority, especially in recent years, because the Belarusian

⁴ M. Balmaceda, *Explaining the management of energy dependency in Ukraine: possibilities and limits of a domestic-centered perspectives*, Mannheimer Zentrum für Europäische Sozialforschung, 'Working papers', no. 79, 2004.

regime earned high revenues from processing oil imported from Russia at well below world prices, and then exporting it to the countries of the EU (as oil products) at market prices.

In the case of Ukraine, the exploitation of vague rules on trading in energy resources led to the creation of powerful oligarchic groups with political ambitions. According to Ihor Bakay, the first chairman of Naftohaz, ‘everyone who is rich in Ukraine became rich by trading in gas’. Even if his opinion is exaggerated, to a certain degree it still reflects the reality of independent Ukraine. Wealth through trading in gas was made possible by the theft of huge quantities of gas from the transit pipeline (this underhand trade, estimated at 6–7% of Ukraine’s then GDP, did not cease until 2000⁵) and the result of using barter schemes to pay for Russian and Central Asian gas to avoid paying of taxes⁶. The ease with which high profits were made by trading in energy resources means politicians became dependent on the energy business.

The best example of the interdependence of the energy business and politics is former Ukrainian Prime Minister Pavlo Lazarenko, who in 1999, two years after his resignation, was arrested in the USA and accused of laundering money originating, in part, from gas trading. Yulia Tymoshenko, former Ukrainian Prime Minister and currently leader of the strongest opposition party, also traded in Russian gas in dealings that remain unclear. In turn, in 2000 Ihor Bakay was dismissed under suspicion of corruption, but shortly thereafter he was appointed to an important post in President Kuchma’s administration. In 2004, after proceedings were brought against him, he left for Russia, where he obtained citizenship ‘for services to Russian culture and art’. Individual politicians and political groups in Ukraine greatly benefited from the continued depend-

⁵ See: *Economic Reform in Ukraine: The Unfinished Agenda*, <http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=228>

⁶ J. Dodsworth, P. Mathieu, C. Shiells, *Cross-Border Issues in Energy Trade in the CIS Countries*, ‘IMF Discussion Paper’, Washington 2002, p. 13, <http://www.imf.org/external/pubs/ft/pdp/2002/pdp13.pdf>

ency on Russia for energy and so they were interested in retaining the status quo. The most recent example of ambiguous conduct is Ukrainian fuel and energy minister Yuri Boyko (in 2002–2005 he was chairman of Naftohaz). He is considered a ‘lobbyist’ for the interests of RosUkrEnergo, and the gas agreements he signed are considered controversial and to Ukraine’s disadvantage.

Lack of transparency

The desire to earn undisclosed amounts of income by trading in gas and oil with Russia has led to the creation of a system whose basic feature is lack of transparency. In the case of Belarus this is understandable, bearing in mind its authoritarian regime, which attempts to conceal its revenue. Yet lack of transparency is also a problem in Ukraine and is caused, among others, by insufficient information on the ownership structures of the companies involved in the import of energy resources. Almost from the beginning of Ukraine’s independence, supplies of gas from Russia and Central Asia were handled by companies acting as intermediaries in the transactions, with little known about their owners. The first intermediary (from 1994) was Itera. In 2003, it was replaced by Eural Transgas, and in 2006 – under the Russian-Ukrainian gas agreement – by RosUkrEnergo⁷.

It is unclear why Gazprom decided to supply gas to Ukraine for many years through intermediaries when it has its own subsidiary that usually handles this (Gazpromexport). It seems that the intermediary companies enable representatives of the political and business elites of both sides to benefit financially. Current intermediary RosUkrEnergo is most certainly a link necessary for ensuring supplies of gas to Ukraine. When in March 2007, the Ukrainian opposition attempted to remove the company, its man-

⁷ After the Ukrainian-Russian gas contract of 4 January 2006 was signed, President Yushchenko, asked what he knew about RosUkrEnergo’s shareholders, stated on television ‘The founders of RosUkrEnergo could have been anybody ... anybody’. *It’s a Gas...*, *op. cit.*, p.58

agement issued a statement that ‘the stability of gas supplies to Ukraine depend on RosUkrEnergo’⁸.

The gas agreements signed with Russia are also obscure. Unfortunately, neither the Orange Revolution nor the pro-Western policy of the Moldovan authorities has altered negative practices. Lack of transparency continues.

Need for a purge

The lack of transparency of Ukraine’s, Moldova’s and Belarus’ fuel sectors is a serious obstacle in the modernisation of these countries. Unfortunately, consecutive Ukrainian and Moldovan governments, and in particular Lukashenko’s regime, have done nothing to alter the vague relationships or to ensure greater efficiency in energy consumption. Even after the Orange Revolution, the new Ukrainian authorities soon gave up revising gas and oil trading schemes⁹. Basically, without a thorough purge in the energy sector of each of these countries and changes to how they import Russian resources (especially gas), no reform of their economies will be possible. Ukraine, Moldova and Belarus should first of all decrease the high level of their industries’ energy consumption. This could be achieved through energy-saving programmes and more efficient energy consumption. Making their economies dependent on supplies of resources at ‘concessionary prices’ has meant that they remain partially dependent on Russia and vulnerable to Russia’s blackmail in energy issues.

8 Yulia Tymoshenko *ispytyvayet koalitsiyu na razryv kontraktov s RosUkrEnergo*, ‘Kommersant – Ukraina’, 13.03.2007.

9 In June 2005, an investigation of RosUkrEnergo began in Ukraine. Yulia Tymoshenko, then Prime Minister, publicly stated that the company was ‘a criminal enterprise’ and called for President Yushchenko’s faction not to replace the old energy trading schemes of Kuchma’s era with new ones that would not, in fact, differ from the old ones. After the dismissal of Tymoshenko’s government in September 2005, the investigation of RUE was closed. R. Kupchinsky, *Ukraine: A Conflict Over Gas And Power*, ‘RFE/RL’, 12.09.2005.

Ukraine could also increase the quantities of gas extracted from its own deposits. In February 2006, the then Prime Minister Yuri Yehanurov announced that Ukrainian companies were capable of extracting up to 30 billion cubic meters of gas annually (compared to approx. 19,000 million m³ currently extracted). These plans seem realistic because Ukraine has significant stocks of gas, estimated at 1.2–1.5 billion cubic meters, which at the current level of consumption would be sufficient for 20 years.

Paradoxically, Russia's systematic move towards market prices could be an advantage, because it would lessen the opportunities for Moscow to exploit the resources to achieve its political aims. In the case of Ukraine, it would also lessen the oligarchic effect on politics and the economy.