
Ukraine – A Transit Country in Deadlock?

Four scenarios



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December 2009



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ISBN: 978-2-86592-639-8
ISSN: 1962-610X

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Executive Summary

Should we consider Ukraine a transit country in deadlock, and reduce its energy role just to that of a transit country? Definitely not, because Ukraine is at once a large gas consumer and producer, and possesses massive storage capacity. But the economic and political situation of the country is alarming, even without considering the possibility of another gas crisis. Without such a crisis, however, the event of Ukrainian bankruptcy would attract less broad international attention simply because it would not have direct impact on European gas consumers.

Will there be a new transit crisis this winter? Failure by Ukraine to honor its payment deadlines on the 7th of each month would certainly precipitate it, and that possibility cannot be excluded. Both on the Ukrainian and on the Russian side, a number of factors exist that, combined, could easily trigger a domino effect whereby the situation would become uncontrollable, as was the case in January 2009. Tension has decreased, though, between Russia and Ukraine following the Yalta meeting of CIS prime ministers in mid-November, which is good news. But the risk of a drop of the Hryvnia value and the resulting payment default in January cannot be written off.

Any analysis on Ukraine is a challenge at a moment when information is contradictory and can swing from the assertion of a lull to a red alert in the matter of no time. It is important to highlight the chronic aspects of the Ukrainian situation, which are likely to stay so after the January/February 2010 presidential election: extreme instability, and political and economic volatility and weakness.

Transit has been an acknowledged symbol of Ukrainian identity ever since the country became independent at the end of 1991. It epitomises the position occupied by Ukraine on the European map, at crossroads between Russia and the European Union – a positionning likely to reveal itself as more stable and definitive than might be thought.

The relevance attributed to transit is justified by its impact not just on the European Union but also on Russia and the Central Asian producers. Thus, in its current capacity as an energy bridge –or should we say energy barrier instead?– Ukraine attracts massive international attention, for the good and for the bad. In various senses, the contradictions embodied by this vast country are a fine mirror of European oriental cultures and their history.

Kiev worries its neighbours and the international community because of its random and contradictory governance, its populist policies that prevail over any project formulated by the citizens or the politicians, and its economic collapse linked to the absence of coherent strategies and the constant delay of durable reforms. Ultimately, and regardless of its merits concerning freedom of the press or human rights, the *Orange Revolution* has come to be widely perceived as a failure and a wasted opportunity. On the political and economic fronts, governance has fallen short of the *orange* ambitions; and since 1994, uninterruptedly, the country has been trapped into short-term and clannish approaches.

Such a state of affairs has had direct consequences for the EU as far as energy transit is concerned – a situation that will not change at least for the next five years and then, yet, only provided the will for change exists. A quarter of the gas consumed in the EU comes from Russia and Central Asia, and 80% of that amount passes through Ukraine. Naturally, the EU cannot allow itself to neglect the risk that an amplified Ukrainian crisis would pose on the stability of the Union as a whole, considering the size of the surface and the population of the country.

Quite clearly, the Russian-Ukrainian dispute cannot alone supply all the answers to the question of why the transit crises have taken place – the “small one” in 2006 and then the “big one” in 2009. Western media tend to fixate on the Russian-Ukrainian roots of the crisis and public opinion then finds it easy to condemn one or the other side, according to received wisdom and based on the most convincing arguments. This approach entails the risk of neglecting other fundamental elements that also constitute the background of the crisis.

For a long time, political inefficiency has frustrated reform initiatives and the expectations of Ukraine’s partners, the International Financial Institutions (IFI). The country appears incapable of engagement. Its energy (in)efficiency explains not only its huge gas consumption but also its excessive dependence on Russian and Central Asian supplies. Treaties can be dismissed as soon as they are signed, and daily bargaining among those in office wins the day over the idea of *pacta sunt servanda*. International trust in the reliability and firmness of Ukrainian policy has been dented, and the EU has become weary of the ups and downs of the politicians’ brawls, the quarrels among the former Soviet countries, and blackmail on the lines of “if you guys don’t act now, tomorrow we will be Russian”. On all these issues, a long-term EU vision comes up against a very short-sighted approach that the author suggests calling “spot governance”, the absence of a rule-of-law culture, official unaccountability inherited from 70 years of Soviet experience, and a clannish way of running business to the detriment of the common good.

Acknowledging the responsibility that befalls these Ukrainian downsides should in no way be taken as an invitation to neglect the bilateral nature of the conflict, nor Moscow’s own designs –first and

foremost its quest for control over the Ukrainian gas network— nor even the goals and limits of EU policy. The methodology proposed by the author advocates the necessity to take all of those factors into account in the effort to elucidate Ukraine's current predicament.

The goal of the present study is to highlight Ukraine's role in the landscape of gas transit, while considering and analysing the existing information on fields that are larger than the gas issue, i.e. Ukrainian politics and economy and, above all, the country's energy policy. The study will then review the January 2009 gas crisis and Brussels relations with Kiev. First introduced in a summary fashion, the information will then be analysed. The resulting overall background picture should be a useful tool to help observers and decision-makers find their way through the highly complex context.

The study is structured as follows:

- A first part on the economic and political background introduces the main elements of the current Ukrainian situation;
- the second part is devoted to energy and each one of its variants: mix, oil, coal, and above all, gas;
- the third part develops the January 2009 Russian-Ukrainian conflict; and
- the fourth part concentrates on EU policy towards Ukraine.

The last part presents four scenarios in all of which governance and the gas transport network are the key elements. The decisions taken concerning the future of the transport network will determine the country's chances to modernise, build trust and keep the fortuitous role that the Soviet heritage bestowed upon it. Ukraine has, indeed, the options to stay in chronic deadlock and eventually collapse, enter a multilateral consortium alongside the EU and Russia, hand over the network's governance to the East, or go the Western way. Presented in a nutshell, the last option would entail the introduction of EU conduct codes in the Ukrainian energy sector whereby membership to the Energy Community would be a first step, to be followed by public—and hopefully also private—Western financial contribution to the modernisation task. In the current context, Ukraine's gas policy symbolises –far more than any other national parameter— the stakes laying ahead of the country in a much larger sense.

The author believes that, paradoxically, the current economic situation could play in favour of an important role for Ukraine. European and international gas market prospective studies forecast abundance of supply (IEA 2009, EU Trends towards 2030) and availability of cheap gas – none of which facts is of good omen for the future alternative projects of bypassing the existing Ukrainian route. In the light of this, wouldn't just some political effort from Kiev be enough to allow Ukraine to retain its current position?

The material base for this report comes from the documents and publications listed in the bibliography, as well as from interviews with

EU, Ukrainian and Russian experts and decision-makers. A field mission to Ukraine was undertaken between October 6th and 10th 2009, and meetings were held with representatives of national and international institutions, experts, company officers and researchers. The author is indebted to all her interlocutors –Serhiy Pavlusha, Bogdan Sokolovski, Irina Akimova, Faouzi Bensarsa, Volodomyr Omelchenko, Max Alier, Simon Pirani, Jonathan Stern, Ralf Dickel, Valerij Tsaplin, Olivier Silla, Nico Lange, Slavtcho Neytchev, Kyriakos Morfis, Oleksandr Todiychuk, and Michail Gonchar– for their hospitality, advice and availability. The Ifri energy program colleagues Jacques Lesourne, William C. Ramsay, Maïté Jaureguy-Naudin and Christian Schülke have, as always, supplied good and constructive advice. Marina Gaillard provided efficient reading. The views held in this paper are the sole responsibility of the author.

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December 1st 2009

Introduction

Should we consider Ukraine a transit country in deadlock? Taking into account the political and economic situation, the stakes ahead, the volatility of the Russian-Ukrainian relationship, and the current weakness of EU external energy policy, what are the most pertinent questions to raise, and what the most likely scenarios to envision? Finally, yet, how should the European Union position itself within this context?

At present, the three decisive questions impacting future developments are:

- *The reliability of Ukraine's engagement* in front of European and other IFIs, especially concerning the overhaul of the gas market. In the current context, will it be possible to restructure Naftogas, or will the Russian Moloch succeed in resisting change? Ukraine's reliability will obviously have a decisive impact on the attitude of IFIs on whom Kiev currently depends, especially in the context of a severe economic crisis. Reliability can be the only antidote to the "Ukraine-fatigue" syndrome that has started affecting foreign governments and whose consequences could be devastating for a country so largely dependent on others. The government in office has embarked on a new style of political behavior, the already mentioned "spot governance". However, regardless of the short-term solutions that may indeed be applicable to certain problems, Kiev cannot avoid engaging in a long-term perspective – something that, for all the bad reasons, is already the case if we consider the pyramidal debt inherited from past omissions and poor governance and further fuelled by the economic crisis. On this front, the current situation seems far more dramatic than that of 2006.
- *The likelihood of a new gas cut in the 2009/2010 winter.* Will the situation remain volatile? How explosive could the consequences of calling into question the January 19th contract end up being? Will Naftogas be able to honor Gazprom's monthly bills? A new crisis seemed unlikely back in September and October; but in November, the EU –which had been taken by surprise in 2006 and then again, at least to some extent, in 2009– started sounding the alarm. Outside of Ukraine and Russia the memories of the recent past work as guidelines for analysis and comparisons between the situation in October 2008 and October 2009 are rampant. Observers have not forgotten, for example, that a perfectly cordial relationship between Timoshenko and

Putin in 2008¹ did not prevent the fast deterioration that followed and eventually ended up in the January 2009 crisis. For quite a while now, contradictory messages have been the rule on both sides; President Medvedev did not hesitate, for example, to turn down even the slightest redrafting of the January 19th contract, in stark opposition to the views held by the Russian and Ukrainian prime ministers.² More recently, however, the Russian and Ukrainian prime ministers agreement made in Yalta (November 19th 2009) seems to have been endorsed by the entire Russian leadership: announcements have been made by Gazprom that quantities as well as transit prices will be amended.³ The contradictory style of gestures of this sort –so foreign to the traditional ways of Western politicians and diplomats– adds to the complexity of a situation already marred by a murky line-up of players and a power crisis on the Russian side clearly reinforced by the collapse of the gas prices and demand. The fact that, on numerous occasions, the ultimate, true addressee of some actively publicized messages is no other but the EU, just complicates things further. In the face of recurrent pathological behavior, the EU finds itself in a position where all it can do is to look on in impotence.

- *The result of the presidential elections of January 17th/February 7th 2010 and their impact –or lack thereof– on the geopolitical direction and governance of the country (reforms).*

Four scenarios are here introduced that focus on the Ukrainian alternatives concerning the governance of the country's Gas Transmission System (GTS). Modernisation and a change of management could increase the capacities of the system and reinforce its reliability. The choice to be made bears a strong symbolic weight. "And it will be made soon, one way or the other." (Alier)

¹ October 2008 Putin–Timoshenko Memorandum, cf. analysis in PIRANI 2009:13-14

² AFP, September 6th 2009: "Russian president orders Gazprom CEO Miller not to pay any bill that does not abide by the decisions of the 19th January 2009 contract". http://www.google.com/hostednews/afp/article/ALeqM5iww_EtKh_93Mq9vcVGJPWiBoxPA

³ <http://www.upstreamonline.com/live/article199796.ece>

Four Scenarios

This section strats with a short overview of the key elements in each of the four scenarios.

- *The deadlock scenario:* a continuation of the current situation, with no governance change, more political in-fighting and an always volatile relationship with Russia. Here, short-term piecemeal solutions would reinforce rather than break the present stalemate, a circumstance that would have a very negative impact on the EU as a gas client. The alternative options to Ukrainian transit would then be seen of a kinder eye – a choice all the more preposterous that an important surplus capacity both of gas and transport is to be expected in the years to come.⁴
- *The trilateral consortium scenario:* the acknowledgement of Ukraine's inability to manage the crisis on its own. This scheme postulates the creation of a trilateral consortium that would take out a lease on the Ukrainian gas network in order to prevent its collapse and guarantee investment as well as uninterrupted gas flow. A well-managed consortium alongside with the country's adherence to institutions such as the Energy Community would have a positive impact on Ukraine's overall governance. As a member of the consortium, Russia would have to be watched closely and be effectively discouraged from seeking to take over the Soviet infrastructure. And it goes without saying that the state of EU–Russia relations has an impact on the possibility of such a scenario.
- *The Eastern scenario:* the definitive act of Russia–Ukraine reconciliation. Here, Gazprom and the Kremlin would succeed in their ambition to acquire part of the Ukrainian gas infrastructure in exchange, for example, for Ukrainian credit on Russian gas deposits. In this scenario –which could be implemented by either Timoshenko or Yanukovich, and even by a potential alliance between both– Ukraine would be anchored back into the Russian fold. There is a certain number of rumors and signs pointing at the likelihood of this scenario these days.
- *The Western scenario:* an offspring of the March 23rd 2009 conference on network modernization, and of the late July 2009

⁴ IEA 2009, UE Baseline Scenario 2010 (DG TREN Forecast Unit).

accords between Ukraine and the European and other IFIs. In this case, Ukraine would choose affiliation to the West, adhere to the Energy Community and implement European standards. As opposed to the second and third alternatives, this one does not contemplate either a consortium or a lease but just the financing of the modernization to be executed on a project by project basis. Still slightly reminiscent of the *Orange Revolution* thrust, this scenario appears today as the least likely of the four in the aftermath of the collapse of the “orange spirit” both in Ukraine and in Western Europe.

Next, each of the four scenarios will be described in terms of its historical background, the interests surrounding it, its likelihood, and the arguments in its favor at the present time.

1. Deadlock scenario

Even if we choose to discard the likelihood of a progressive political and economic collapse of Ukraine’s long-term strategic position, the present situation contains at least the germ for the current ills to turn into chronic disease. Stagnation results from continuously muddled policies and from irresponsible populism that tramples the common interest, as will be the case, for example, if Kiev decides not to honor signed agreements or obligations to the IFIs.

If the presidential elections fail to bring about political stability, confidence will not be restored either domestically or internationally. The parliamentary elections will follow and 2010 will be another year of campaigning and populist gestures. International opinion will settle down to the image of Ukraine as a poor-governance country, better to be avoided. The “Ukraine-fatigue” syndrome will continue to gather pace, and those hit by it will close ranks with Russia. Domestic infighting will go on but no longer catch the attention of foreign observers. On matters of energy and the relationship with Russia, Ukraine will continue putting to question the contracts of January 19th 2009 and particularly the transit fees as well as the “Take or Pay” principle. Kiev will win the case but in the end the higher transit fees will further threaten the future of Ukraine as a transit route and, consequently, increase the appeal of other more modern, less expensive and safer routes as possible alternatives. The EU will declare the diversification of routes a priority.

Progressively, Russia’s determination to establish direct links with Europe –its top customer– has concluded in the creation of some connections and a number of alternative projects. Today, the following options exist to bypass Ukraine as a transit country:

- Jamal–Europe: opened in 1999, it crosses Belarus and Poland (the Russian-Belarusian relationships are not at their best at present, though) and has a capacity of 33 bcm per year.

- Blue Stream: opened in 2003 and 2005, it links Russia to Turkey through the Black Sea and handles a current volume of 16 bcm per year. So far, Blue Stream only feeds the Turkish market.

The following alternatives are under consideration and could be operational from 2015 onwards:

- Nord Stream: a direct link via the Baltic Sea connecting Russia to Germany and subsequently to the rest of the European market, with a final volume, for two parallel gas pipelines, of 55 bcm. At present, this project is the one at the most advanced stage: the feasibility studies have been completed, and the countries concerned by the maritime path have given their accord.
- South Stream: a link that will connect Russia to Southeast Europe and then to the EU markets via the Black Sea, bypassing Turkey, with a capacity of 63 bcm. This project will be a competitor to the EU's "Nabucco" link that plans to bypass Russia and establish a direct connection between the Caspian region, Central Asia and the EU.

In this scenario, projects for LNG terminals and pipelines bypassing Ukraine will take shape, pushing the country step by step out of the European energy game. The country will sink deeper into economic and political instability and be further debilitated by the absence of transit fees and growing dependence on its Eastern neighbour. The current economic model will have to be abandoned, and the agricultural and metal sectors, the steel industry, and the financial contribution from millions of emigrants will become critical economic factors.

A new gas cut will occur during the 2009/2010 winter, right ahead of the elections. Other gas crises will ensue between 2011 and 2014, but the EU will, by then, have become better prepared and bypassing routes will be in place and operational by 2015. The 2010 elections will focus on the failures of those presently in charge, i.e. the representatives of the *Orange Revolution*. The Kremlin will try to promote post-Soviet nostalgia and offer better economic perspectives at the price of strengthened cooperation via a customs union. Regardless of who wins the vote, no clear political direction will emerge and the country will continue to look increasingly torn.

The fourth instalment of the IMF loan –initially deferred until December 2009– will be definitively cancelled following default on payment and failure to implement various signed agreements. There will be no reform of the energy and gas markets, and IFIs will size down their contributions and bow to Russia as the only power capable of lending effective guidance and support to Ukraine.

Assessment

It is important to point out that, at any rate, no short-term alternative to Ukrainian transit exists within the next five years. In the meantime, bad

governance and uncertainty of supply would increase “Ukraine-fatigue” within the EU. Scenario 1 could be followed by Scenario 3, but would exclude 2 and 4.

2. Trilateral consortium scenario

The trilateral consortium project plans to include Naftogas, Gazprom and a number of EU companies. Based on a public-private business model, cooperation could be structured according to various contractual options: a management contract, a leasing contract, or even the sale of part of the network. However, Ukraine's objections following the November 2007 law that confirmed national ownership of the gas network are bound to become an obstacle to all options with the only exception of the management contract. Authors Gnedina/Emerson have suggested a 30/30/30/10 consortium with equal splits for Gazprom, Naftogas and the European companies, and 10% for EBRD in the role of arbitrator in charge of ensuring proper governance.

Assessment

A trilateral consortium could be the answer to Ukraine's hesitation between Western or Eastern engagement, simply by allowing the country not to make a choice. At the same time, the complexity of such a group, the potential Russian-Ukrainian conflict and the attempt by each of the two antagonists to involve the EU as arbitrator, could endanger cooperation right from the start. Scenario 2 could turn into Scenario 3 or 4 in a short period of time.

3. Eastern scenario

Ukraine played a fundamental role in the development of the Soviet Union's gas sector, a fact that explains its current key position not just as a transit country but also as a production and storage location. Ukrainian production amounted to 30% of the Soviet Union's in the 60s and then dropped to 12% in the 80s.⁵ The country's gas and even electricity infrastructures exhibit great incoherence as related to consumption areas. Because of this, maintaining the existing structure is not compatible with keeping Russia at bay, as proved to be the case during the January gas crisis when the contradictory pattern of having storage in the West for consumption in the East became a true Achilles' heel for the country. Kiev then found itself faced with the

⁵ For a detailed presentation, cf. PIRANI 2007:17, chapter “Gas in Ukraine”.

dilemma of either cutting transit altogether or renouncing to supply Donbass.

Since the 90s, and even more so after Putin's arrival to power in 2000, Russia has pursued a strategy aimed at poaching the transit networks of the former Soviet republics. As far as Ukraine is concerned, from 1993 onwards, a vast array of swaps have been implemented or at least offered, such as infrastructure against the debt or even the Black Sea fleet or the nuclear weapons. The agreements reached in 1994 concerning the privatisation of the Ukrainian energy sector would have rendered Russia's accession possible, had they not been voided by a parliament fired up by Timoshenko and fear that the infrastructures end up under Russian control.⁶ Considered in itself, Timoshenko's role in the process is rather unclear: the Russian Minister of Energy Shmatko announced to journalists in November 2009 that Russia and Ukraine were working on an intergovernmental agreement about Russian participation in the GTS modernisation.⁷ But it is not clear yet whether this does not just concern the participation of the country along with IFIs, in the modernisation of particular projects.

Through time, Russia's quest for participation in the Ukrainian network has undergone various stages, none of which was crowned by success. In most instances, the attempt to gain control of the network came under the guise of a gas consortium project; such was the case in 2002, when president Kuchma came to an agreement with Putin and Schröder in June that was later ratified by a Russian-Ukrainian accord at prime ministers' level in October of the same year. The consortium was created in November as a Ukrainian legal entity where Naftogas and Gasprom shared ownership, each with 50% of the stake. Negotiations undertaken in April 2003 with the aim to bring Ruhrgas into the partnership did not succeed, the main point of disagreement resulting from Russia's insistence that the consortium take the full lease of the gas transport network – something that Naftogas refused. In 2006, in view of the Russian diversification strategy, Ukrainian president Yushchenko suggested to re-launch talks on a trilateral Russian-German-Ukrainian consortium.⁸ But once again Ukrainian opposition to any project involving Moscow prevailed. In February 2007 it was Putin who came up with a new offer: the consortium would take control of the Ukrainian gas transport network in exchange for which Ukraine would be granted credit to Russian gas deposits. An agreement was reached with the then-Prime Minister Yanukovich⁹ who expected to be allowed to keep gas prices in exchange for Russian participation into the Ukrainian gas network. Immediately, Deputy Yulia

⁶ PIRANI 2007:20

⁷ http://oas.romandie-online.ch/RealMedia/ads/adstream_sx.ads/romandie.com/news/ros/economy/L-29@Bottom1?http://www.romandie.com/infos/news2/091116141930.j52pk521.asp

⁸ PIRANI 2007:87

⁹ DUBIEN 2007:16, "The gas consortium or the eternal return"

Timoshenko submitted to the Rada a draft banning the privatisation of export pipelines. The law was passed on February 6th and since then has become the equivalent to religious dogma.¹⁰

To some extent, all of these projects reveal the will, on both sides, to move away from the situation as it existed following the end of the URSS. Their failure, however, shows at once the extent of Ukrainian reticence and the cultural difficulty to “normalise” relations in that way. In theory, Russian-Ukrainian cooperation in the management of the Ukrainian gas transit network GTN could follow several paths:

- Privatization and subsequent acquisition of part of the stake by Gazprom. Russian-Ukrainian reconciliation, if modeled after the 2006 accord between Russia and Belarus,¹¹ or after the accord between Russia and Armenia, would lead to the privatization of the GTN (a very unlikely possibility).
- Leasing consortium for a limited term, made up 50/50 of Gazprom and Naftogas. As in the past, this option would be likely to encounter historical resistance to any gas network contract viewed as a violation of national ownership.
- A consortium including a minority partner, a German company for example. The presence of a third party might partly reduce the weight of the Russian threat in the minds of the political class and the public opinion, but it would still come up against the imperative of national ownership.

Assessment

The Belarusian example shows that the participation of Gazprom in infrastructure ownership does not guarantee attractive prices in the long term. At present, it looks quite unlikely that Russian accession to the management of the Ukrainian network—if it was to happen—would be carried out through privatisation. It seems more feasible that the move would be accomplished via a consortium and a lease contract for an established term. Once again, however, the economic crisis will

¹⁰ PIRANI 2007:89

¹¹ Belarusian case: this five-year supply and transit agreement postpones the application of the European price to Belarus until 2011. At the same time, the transit price was increased from \$0.75 to \$1.45 per 1,000 m3/100 km, from 2006 to 2007. The most important aspect of the agreement, however, is the sale of half of the Beltransgas network for the price of \$2.5 bn, to be paid by Minsk in four equal cash instalments between 2007 and 2010. Progressively, by steps of 12 % each time, Gazprom will acquire Beltransgas parts and secure, by June 1st 2010, ownership of 50% of the stake. From that moment on, a joint venture will own the Belarusian network and only on that condition will Belarus continue receiving Russian gas at Russian price. The privatisation of Beltransgas was imposed on Minsk by the terms of an intergovernmental accord with Moscow concerning the 1995 customs union, and the delay that followed met with the threat of a supply cut. Beltransgas was privatised in April 2003.

steer the decision-making of the Ukrainian political elites as well as the attitude of the population. Cooperation with Russia –as opposed to any kind of partnership with the EU– would offer Ukraine the advantage of not being immediately forced to change either its economic model, or its energy efficiency pattern, or the existing rules and regulations. Additionally, the country could also choose to set up new nuclear stations in close cooperation with Rosatom, and eventually with Germany (Siemens), and then try, jointly with the latter, to reach out to the European market.

4. Western scenario

In this scenario, specific network modernisation projects will be financed by IFIs and possibly, as a consequence, also by private Western companies. In exchange, Ukraine –the government as well as gas players such as Naftogas and Ukrtransgas– will subject themselves to improved governance. Ukraine will have to join the EU's Energy Community and broadly abide by EU regulations on the subject. Transit will become transmission and gas will be available for purchase either inside Ukraine or on its Eastern or Western borders. Ukraine will become the EU's legal interlocutor concerning gas sales and transit and thus take over the role currently played by Gazprom who, at present, handles all sales to the EU while simultaneously being in charge for the transit agreements with Ukraine on an exclusive basis. During the conference of March 23rd 2009, Ukraine stated its readiness to cooperate with the European and other IFIs, and to reform its gas network in 2010 and 2011 according to a detailed plan based on European legislation, to be submitted by the government by the end of 2009. Also in March 2009, a joint statement stressed the fact that national ownership of the GTN would be respected.

The modernisation program does not contemplate a consortium, but rather the implementation, one by one, of a number of projects summarily described in the master plan. The modernisation effort will especially concern the upgrading and reconstruction of three Western transit corridors (Soyuz, Urengoy-Uzhgorod and Progress), the Southern corridor, two storage sites (Bilche-Volytsko-Ugerske and Bogorodchany), and finally a number of gas measuring stations (Uzhgorod, Berehove, Drozdovychi, Tekovo and Orlivka). A master plan named “Ukrainian Gas Transmission System (UGTS) Priority Objects, Modernisation and Reconstruction”, presented at the March 23rd 2009 conference in Brussels, is available on the site of the European Commission.¹² It forecasts an investment need of about 3 bn

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http://ec.europa.eu/external_relations/energy/events/eu_ukraine_2009/bekker_en.pdf

Euros over seven years and includes an extension of the Ukrainian gas network as well as the increase of its transit capacity of about 60 bcm – especially via the route Novopskov Uzhgorod. The modernisation effort mostly aims at increasing the reliability, efficiency and profitability of the gas transit, tempering the impact on the environment, and reducing risk on the security of supply for European consumers.

The government, Naftogas and the transport network operator Ukrtransgas will be responsible for the projects. In this sense, the Western scenario is clearly distinct from the Eastern one to the extent that it focuses on the introduction of rules of the game and excludes any kind of participation, even a temporary one.

The next stage concerns the creation, inside Naftogas, of a technical unit with the mission to develop a complete master plan for the modernisation and to put forth other relevant technical proposals made by Ukraine upon which a schedule could be planned, to oversee the construction works, and to organise the IFIs cooperation project by project.

The European Commission and the IFIs will be available to provide technical assistance to this Naftogas unit, and the Commission is even ready to assist the Ukrainian government in its task of reforming the gas sector. Following the installation of the technical unit, the private and public participants will specify the nature and extent of their respective roles; additionally, the European Commission will allow Ukraine to benefit from the *Neighbourhood Investment Facility* financial tool. On the occasion of the author's visit to Kiev, interlocutors from the EU and Ukraine both confirmed that the project is on the right track and that delays can be expected to be minimal¹³ – surprising statements considering the significant delays that are noticeable in the sector's reform. The project does not exclude the participation of other parties, Russia among them.

Assessment

Considering that funds for the gas infrastructure projects (new pipelines) will be limited both from the private sector and the IFIs, and that existing long-term gas contracts between Russia and EU enterprises run up to 2025/2030, the succinct calculations of the master plan submitted by the Ukrainian TSO clearly demonstrate that the modernisation of the existing network makes more financial sense than the creation of new pipelines, whether it be Nord Stream (8 bn Euros), South Stream (approximately 20 bn Euros) or Nabucco (about 8 bn Euros). The overall amount required for the modernisation plus the extension of the network, including storage capability, reaches

¹³ For example, PAVLUSHA, Deputy Minister of Fuel and Energy and SOKOLOVSKI, energy advisor to the president, on October 7th and 9th 2009; or Faouzi BENSARSA, DG RELEX, on September 15th 2009.

almost 8 bn Euros, while modernisation alone, no extension considered, would require only 3 bn. Compared to that, new infrastructure for the three pipelines would amount to 36 bn Euros! The extension of the European “regulatory territory” will increase security of supply and stabilise Ukraine as a sustainable transit country, obviously on the condition that the signature of the agreement does not go unheeded and that implementation follows.

The long-term gas demand looks difficult to forecast, and has been estimated downwards by experts from independent institutions and others such as the IEA (2009) or even the EU through its forecasting unit in charge of the “Baseline scenario” to be published in early 2010.

In this context, a conservative strategy seems more adequate than the construction of new pipelines to tackle the risk of surplus supply. The EU’s engagement in Ukraine – whether as transit route or not – becomes a geopolitical duty unless the country is left to fall back into Russia’s lap for good. A positive EU strategy must necessarily include the transit dimension and strive to turn it from a risk into a common advantage. However, any apology of the political and economic rationality of the 4th scenario must be measured against the inherent danger of having to deal with a wily, quite unreliable partner prone to sabotaging one project after another. In the light of this, the more expensive option of building new pipelines might end up being favoured by the EU players who would be ready to settle for a higher price tag in the name of security of supply. This scenario highlights the need for improved governance in order to ensure the country’s political reliability – a measure upon which, ultimately, each of the options will have to be pondered. The 4th scenario would grant Ukraine larger autonomy in the management of the gas network, but simultaneously demand from it rigorous governance and the implementation of EU rules and regulations. The path of “more for more” opens up in this case as much as it does in other instances of the Eastern partnership. The future government will indeed find itself up to a momentous choice.

Conclusion

At present, what is the likelihood of each of the four scenarios?

While we could brush off the trilateral consortium option as highly improbable, the stagnation scenario remains, unfortunately, only too realistic and one that could, in the process, bring along the Eastern scenario while excluding the Western one. The Eastern and Western scenarios could, in turn, constitute the object of a choice for the new government. It is clear, though, that in today's situation –and especially considering the impossibility to circumvent Naftogas and its shadowy management– no investor, including Russia itself, would be ready to put as much as one Euro into the reform of the GTN system.

The author believes that Ukrainian governance is unlikely to change, and that the country will remain dependant on foreign support, whether it is Russian or Western. While, in the first case, bargaining on various other issues –Crimea, political matters, etc.– could result in significant subventions and allow the current model to stay on for a certain time, in the second, the EU and the IFIs would condition their aid to a massive reshuffle of the country's governance. Only a change in the management of the GTN –through lease or sale– would encourage private or public investors to come up with substantial funding. But there, again, reliability and comprehensive Ukrainian governance will be the first conditions for any move.

In his widely influential speech “What is a Nation?”, Ernest Renan summarised his definition of a nation as “the clearly expressed desire to continue a common life.” Looking at Ukraine with the slightly cynical eye of a cold-minded observer, one might be tempted to add to the philosopher's statement: “...and, alongside that shared will, a Nation presupposes as well the existence of a government truly representative of the national interest, capable of raising itself above all individual profits”.

Map1. Overview on the Ukrainian Gas Transmission System