Summary: Reforming Ukraine's energy sector is vital for the future of Ukraine's economy and security. Ukraine narrowly averted national bankruptcy following the global financial crisis. But Ukraine's economic recovery depends on reforming the energy sector, which has suffered severe politicization since the 1990s leading to non-transparent business operations and mega-corruption.

European concerns about secure gas supplies from Russia, via Ukraine, have become the overarching policy matter on the current EU-Ukraine agenda. To strengthen Ukraine's energy sector, the new Ukrainian president should start abandoning domestic subsidies for oil and gas prices and let the price reach global market levels. The energy sector must also improve its business transparency significantly in order to encourage foreign capital investment.

More than any other issue, energy security will determine Ukraine's future. Energy is the driving force in Ukraine's relations with Russia and with the European Union. And it is the reform of the energy sector that will decide the success of urgent domestic political and economic reforms.

The global financial crisis hit Ukraine harder than almost any other country of the former Soviet Union. After years of growth rates as high as 10 percent, Ukraine's GDP has declined by 15 percent since October 2008, the Hryvnia (Ukraine's national currency) has lost 60 percent of its value, and bankruptcy of the country could only be averted by an emergency stand-by credit facility from the International Monetary Fund. Economic reform can only succeed, however, if the new Ukrainian president reforms the energy sector.

Ukraine is blessed by its geography: it has generous hydrocarbon resources and is strategically well positioned between Russia, the world's largest gas producer, and the European Union, Russia's main gas customer (the EU receives 25 percent of its gas needs from Russia, and 80 percent of that gas is transported via Ukraine).

In spite of often loud Russian rhetoric about its future gas sales to China, Europe will remain Russia's main market for a long time, if not indefinitely; therefore, Ukraine's favorable strategic location will not change. Even the North Stream pipeline project, an alternative Russian route that circumvents Ukraine, will not seriously affect this strategic position since it will not be completed until 2015 at the earliest. Furthermore, the pipeline's projected annual gas volumes will divert only about a third of European gas imports from Russia that currently traverse Ukraine while European demand for Russian gas continues to grow.

Nonetheless, since the early 1990's, Ukraine has been struggling with energy security due to the almost complete politicization of the Ukrainian energy sector. This politicization leads to entirely opaque, non-transparent business structures and revenue sources—and mega-corruption. The Ukrainian energy sector is not governed by business economics but by politicians and their parties. They often use their positions to extract revenues and to choose commercial winners and losers for their personal—private or political—convenience.

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Control over the energy sector is a major prize in the political contest; indeed, seizing that control is what makes the political competition in Ukraine so fierce. Other countries debate economic stimulus packages, bail-out measures or other policy actions to limit the economic crisis. Ukraine, however, has been stuck for more than a year in the deadlock of the personal competition between the President, the Prime Minister, and the head of the Party of the Regions for the presidential election. Ukraine’s political system with its independent media and free elections is different from the Russian model. But its non-transparent and policy-controlled energy sector is altogether too similar.

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Ukraine’s energy industry, weakened by the political party rivalries, opened an ideal playing field for Russian political interference. Russian Prime Minister Vladimir Putin inserted himself by doing a favor for his Ukrainian counterpart when he agreed with Prime Minister Yulya Tymoshenko on November 19, 2009, to release Ukraine from fines that it owed Russia for failure to buy the amount of gas that it had committed to. As a consequence of illegal Ukrainian gas siphoning in January 2009, Russia’s cut-off of gas supplies to Ukraine and Europe not only undermined European confidence in Russia’s credibility as a reliable gas supplier, but also Ukraine’s reliability as a gas transporter. Although this winter’s energy supply disputes seem to involve Belarus, not Ukraine, European concerns about a secure gas supply via Ukraine have become the overarching matter on the current EU-Ukraine policy agenda. Indeed, it overshadows progress achieved in negotiations of the EU-Ukraine Association Agreement, previously planned to be concluded by the end of 2009. Neither the overwhelming majority of the Ukrainian people nor Russia’s leadership is fundamentally against Ukraine’s EU accession—in contrast to the broad rejection to an accession of Ukraine to NATO. On the other hand, in their national electorate only a few European leaders presently find support for giving Ukraine a clear EU-membership prospective. It is more important to offer Ukraine pragmatic ways toward EU integration. If an EU free trade agreement with Ukraine could be concluded in 2010, it would offer the country a sales market of almost 500 million customers and the potential for European integration of the Ukrainian economy.

In spite of all political difficulties in dealing with Ukraine, the European Union has to keep in mind that a geopolitical vacuum in its Eastern neighborhood will not exist: if the EU doesn’t act, Russia will do so and increase its efforts to undermine Ukraine’s European integration process. But Ukraine has to contribute constructively to this integration process.

To translate the potential of Ukraine’s energy sector into a strength that contributes to the long-term economic and political stabilization of the country, two major transformations have to be pursued after a new president is elected:

First, the new Ukrainian president needs to start abandoning domestic subsidies for the oil and gas prices for private households and let the price reach global market price levels. This will have profound consequences for other sectors and domestic industries, but is an indispensable step in a transformation at the end of which business and market economics matter more than political control. Ukraine’s energy intensity is twice as high—or twice as inefficient—as neighboring Poland. This potential to use energy more efficiently can only be explored by lifting domestic subsidies for energy prices.

Second, the energy sector has to improve its business transparency significantly, otherwise, urgently needed foreign capital will shy away from investments into the modernization of the energy infrastructure and new production fields on and off-shore in the Black Sea.

This is not about broad political EU accession but about pragmatic European energy integration, the same way the European Union itself was built up. Even if the EU’s readiness to offer Ukraine a clear EU membership prospective exists, only in the distant future can the EU play a decisive role in the
modernization of Ukraine’s energy sector and the improvement of its transparency. Last July, for the first time, the EU offered credit to Ukraine to enable Naftogaz, the national Ukrainian gas transporter, to pay its monthly bill to Gazprom. But more than this: the EU should think about buying into or leasing stakes in Naftogaz by the European Bank for Reconstruction and Development (EBRD) or other international financial institutions. Such an EU investment touches Ukrainian sensitivities about its sovereignty, because gas pipelines and storage capacities are perceived as assets of Ukraine’s sovereignty. But the EU stakeholdership should also be seen as strengthening Ukraine’s negotiating position with Gazprom. The European Union as a stakeholder could then enforce the transparency of Naftogaz and Ukraine’s energy sector—and that would unblock Ukraine’s political and economic transformation.

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