

THE FINLANDIZATION OF UKRAINE

30th June 2010

www.kas.de

www.kas.de/moskau

New developments in the relationship between Russia and Ukraine: a challenge for the EU?

The deal struck between the new Ukrainian President Viktor Yanukovich and his Russian counterpart Dmitry Medvedev on a new gas contract and a longer lease of a Russian naval base in the Black Sea port of Sevastopol on Wednesday 22 April 2010 reinvigorates the relationship between the two countries whose past disputes on gas contracts disrupted the energy supply to European countries. Implemented by both the Ukrainian and Russian parliament, the agreement increases Russia's influence in the former Soviet republic and also implicates a significant shift from a former pro-west oriented Ukraine towards Russia. Moscow has been keen in the past to show its disagreement about Western influence in Ukraine by flexing its muscles in energy issues and to highlight its will to preserve a 'sphere of privileged interests' in its 'near abroad'.

The deal would open up new opportunities for Russian state energy companies and postpone a solution to the so-called 'frozen conflict' in the Crimean peninsula. Although the improved relationship between Russia and Ukraine would reduce the possibility of any further disruptions of energy supply to Europe, the EU would find itself in a less influential position and would have to cope with a more ambiguous Ukraine. Moreover, the move made by Yanukovich could further split the country by inciting pro-western forces against pro-Russian supporters, thus deepening the political divide within Ukraine. The debate in the Ukrainian

parliament over the extension of the Russian naval fleet degenerated and parliamentarians of the opposition threw eggs at the parliaments' speaker and started brawling. However, the lease extension was ratified by 236 out of 450 members of the chamber. Meanwhile, the Russian lower house of Parliament, the Duma, duly approved the deal without any opposing views.

This paper deals with the relation between Ukraine and Russia in particular and the possible effects it will have on the EU. It first sketches out the difficult relationship between Russia and Ukraine in the past taking into account the political contrasts, the disputes on energy issues as well as the 'frozen conflict' on the Crimean peninsula. Furthermore this paper will then analyze the change in character of the Russian-Ukrainian relationship under the new Ukrainian president and if we currently witness a 'Finlandization' of Ukraine benefiting Russian security interests. Finally it will focus on the subject of energy security and neighbourhood policy and how Europe might be affected by a tighter bond between Russia and Ukraine.

KEY WORDS: Russia, Ukraine, EU, energy, pipelines, Yanukovich, Crimea, Finlandization, Gazprom.

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT
JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

THE FINLANDIZATION OF UKRAINE

To better understand the rehabilitated relationship between Ukraine and Russia, it is useful to take into consideration the theory of "Finlandization". The term derives its name from the agreement made by Finland and the Soviet Union in 1948 that secured Finland an autonomous status due to its promise not to participate in any activity or alliance that would harm the Soviet Union's interests. In return, Moscow would respect Finland's sovereignty and democratic system. The difference between a "satellite state" and a Finlandized one is that the latter can make strategic concessions to its bigger neighbour while the former does not have the power to make such voluntary choices. These concessions are based on the interests of a Finlandized regime whose ultimate goal is not to stir up tensions with a superpower next door but to stay neutral and avoid any conflict. The Finlandized state cannot escape the influence of its much bigger neighbour though due to their geographic proximity as well as their cultural and historic bonds. The economic prowess and occasional threats from the superpower generate enough fungible power to change the Finlandized state's policies in a way it otherwise might not do. The choices of the Finlandized state are thus made on the basis of a rationale with regard to its long-term interests and its motivation to keep its sovereignty while following a policy of appeasement and neutrality towards its bigger neighbour.

Hence, one has to view the current Russian-Ukrainian relationship in this way. The pragmatic decision by President Yanukovich to consolidate parts of the Ukrainian economy with the Russian one clearly provides insight into this way of thinking. The refusal of giving up the Ukrainian state oil company Naftogaz due to national security reasons and threat to its national sovereignty is also best explained by this attempt to finlandize Ukraine. Like Finland, Ukraine likens itself to being an interlocutor between the EU and Russia and thus benefit from this in-between position. The Ukrainian government knows that it could serve as much as a bridge between Russia and the EU as

Finland did with the Helsinki accords in the 1970s.

The analogy bears a few differences though. While Finland has been separate in cultural as well as social terms from the Soviet Union, Ukraine and Russia have been one state for over two centuries before the break-up of the Soviet Union. While Finland has its own distinctive language, large parts of the Ukrainian population speak Russian. Due to their common Orthodox religion as well as their origins in the Kievan Rus, Ukraine and Russia both constitute a much tighter bond that would not have been possible with Finland. Therefore, Ukraine is much more valuable to Russia than Finland, both in economic and cultural/historic terms. The strategic concession of Yanukovich to extend the lease on the naval base of the Russian fleet in Sevastopol was obviously part of an appeasement policy. The Finlandization analogy also differs here since the bigger neighbour does not respect fully Ukraine's sovereignty by leaving its military base on such a strategic peninsula as the Crimea. This could be seen as an attempt to stop NATO advancement.

The strategic goal of Russia seems to Finlandize Ukraine not by turning it into a sub-state but by turning it into a country whose foreign policy would not challenge Russia's interests. The economic interdependence currently developing should also help to extend Russia's influence on Ukraine, thus reversing the Finlandization process in the long term and bringing Ukraine back under the political influence of Moscow.

THE RUSSIAN – UKRAINIAN RELATIONSHIP: POLITICS

Why is Ukraine of so much interest to Russia? For two centuries Ukraine and today's Russia were one state. Ukraine still has a huge Russian speaking population and both countries are bound by their East Slavic origins and Orthodox religion. They both trace their origins to the Kievan Rus a thousand years ago. Moreover, "loosing" Ukraine to

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT

JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

the EU and NATO would mean putting the “West’s” frontier to Russia as Ukraine currently acts as a buffer state between the “West” and Russia.

After the collapse of the Soviet Union in 1991 Ukraine became independent. While the eastern part of Ukraine is looking to its big eastern neighbour Russia due to long historic bonds, the western part of Ukraine is closer to its Western European neighbours. In recent years the Ukrainian government was looking for closer integration with the EU, a process seen with unease by Russia.

The Russian-Ukrainian relationship went off to a difficult start when Viktor Yushchenko became the elected President of Ukraine in 2004. Russia backed Viktor Yanukovych who was seen as pro-Russia and a fierce opponent of NATO membership. Yushchenko wanted to steer Ukraine into the EU and towards NATO membership. While the majority of the population is in favour of integration into the EU, NATO membership is too closely related to American military leadership and thus heavily opposed by large parts of the Ukrainian people.¹ Yushchenko thus deepened the divide of the Ukrainian people by pursuing the interests of the Western part of the Ukraine while disregarding the interests of the Eastern part.

In the aftermath of the “Orange Revolution” Yushchenko appointed Yulia Tymoshenko, the other opposition figure, as prime minister supported by an overwhelming majority of the parliament. In the 1990s Ukraine had a strongly presidential system which was then changed after the Orange Revolution in 2004 giving the parliament more rights. This constitutional change was not clear cut though thus creating a situation where both

the competencies of the President and the Parliament were such convoluted laying ground for future complications. When Tymoshenko and Yushchenko fell out with each other, the defeated presidential candidate of 2004, Viktor Yanukovych, became prime minister in the 2006 parliamentary elections.

The undefined competencies among the parliament and the president as well as a constitutional court unable to make a lasting decision in how to split the tasks of both the President and the Parliament led to a constitutional conflict between the President Yushchenko and his opponent and Prime Minister Yanukovych. As a consequence, Yulia Tymoshenko was reelected prime minister. The relationship between the two leaders of the Orange Revolution soon deteriorated and they became bitter rivals, paralyzing the country by blocking necessary political and economic reforms due to personal animosities. This political deadlock could not be resolved.

The country itself was severely hit by the global economic and financial recession. Domestic politics remained blocked though and important economic reforms could not be passed in the lower house of parliament. The International Monetary Fund (IMF) therefore retained the further disbursement of the rescue package of \$16.5 billion to Ukraine on the grounds that its conditions such as a balanced national budget would not be met. Meanwhile, the political crisis aggravated and President Yushchenko, Prime Minister Tymoshenko and opposition leader Yanukovych were all but unwilling to constructively work together to steer Ukraine out of its economic and political slump.

Although the EU is Ukraine’s biggest trading partner, Ukraine heavily depends on Russian gas imports. A dispute over gas prices led Russia to briefly stop all gas imports to Ukraine in 2006. Only when Ukraine agreed to pay twice as much the former price, Russia continued to send gas to Ukraine. Prices for gas increased again in 2007, stirring emotions in the Ukrainian government towards Russia. While the Ukrainian side

¹ Ukraine-Analysen 39/08, S. 7, <http://www.laender-ana-lysen.de/ukraine/pdf/UkraineAnalysen39.pdf>

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT

JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

blamed Russia using its power over the gas imports to press Ukraine on political matters such as impeding its pursue of further Western integration, Russia cited purely commercial matters. Former US President George W. Bush supported strongly Ukraine's bid for NATO and WTO membership at the time.²

In June 2008 Russian President Medvedev warned the Ukrainian leadership of "serious consequences" if it continued its pursuit for NATO membership. He also withdrew the Russian ambassador to Ukraine as a clear sign that relations between the countries had turned sour. When the Russian-Georgian conflict broke out in August 2008, Russia used its naval base on the Crimean peninsula in Sevastopol to send war vessels to Georgia. In September, the coalition government of Timoshenko and Yushchenko broke apart due to different opinions in how to respond to Russia's use of military force against Georgia. President Yushchenko threatened to block the return of the Russian war vessels to the Crimea. Moreover, he directly supported Georgia during the war by sending missiles to combat Russia. Moscow complained, stating that Ukraine even sent soldiers to Georgia during the Russian-Georgian conflict and that Ukraine also "expelled alleged Russian security officers".³ Russia's response to Ukrainian policies was the same as in South Ossetia and Abkhazia providing ethnic Russians in Ukraine with Russian passports.

At the presidential election of February 2010 Yanukovich came out slightly ahead of his rival Timoshenko and thus ended the political deadlock. Former President Yushchenko did not even make it to the second round receiving only 5.45% of the total vote. Yanukovich dissolved the parliament and appointed his running mate Azarov as prime minister. Yanukovich announced a balanced relationship with both the EU and Russia. His first trip abroad was to Brussels

which should calm European fears that he was taking the country back under the Russian orbit. His encounter with President Medvedev and the quick deal made on the gas prices and the Crimea pointed to a much closer relationship with Russia though.

THE RUSSIAN – UKRAINIAN RELATIONSHIP: ENERGY

Ukraine is one of the biggest Russian gas importers. Ukraine is also the biggest transit country for Russian gas exports towards the European Union (EU), estimated to be as vast as 80% of all Russian gas transported to Europe.⁴ Russia stopped gas exports to Ukraine several times due to quarrels about late payments and allegations towards Ukraine of illegally abstracting gas from Russian pipelines. Russia strongly disapproved with the former President Yushchenko and his attempt at NATO membership. Russia has been claiming a "sphere of privileged interests" in the Commonwealth of Independent States (CIS). After the conflict with Georgia in August 2008, Russia made clear that it would not tolerate NATO membership of CIS countries sharing a common border with Russia and seems to use its energy dominance to accomplish its political goals such as in the case of Ukraine. Russia never said so publicly, claiming that the difficulties with Ukraine resulted purely from commercial interests.

The global economic and financial crisis forced Ukraine in a very difficult position since Ukraine has been hit harder than other countries due to its dependence on commodities exports. The state heavily subsidized gas prices for private consumers. Therefore higher gas prices would have put the government in an awkward situation because due to its deteriorating financial position it would have had to pass higher

² See also Peter Baker, 'Bush promises more Help to Ukraine, *The Washington Post*, Tuesday, April 5, 2005, p. A02

³ Anders Aslund, "Crimea and Punishment", *Foreign Policy*, January/February 2010

⁴ RIANOVOSTI, *Russian, Ukrainian presidents to discuss gas, navy, border cooperation*, <http://en.rian.ru/world/20100421/158676570-print.html>, last accessed May 1st, 2010.

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT

JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

prices on to consumers which in turn might have resulted in a public outcry and the possible ousting of the government. This situation has now completely changed with the election of President Yanukovych who is not favouring NATO membership and more likely to look for a balanced partnership with both Russia and the EU, thus reducing any future conflicts between Ukraine and Russia.

After a meeting between Russian PM Vladimir Putin and Chancellor Angela Merkel in January 2009 in Berlin and a subsequent meeting of Ukrainian PM Yulia Tymoshenko and Putin in Moscow two days later, a solution to the gas conflict could be found. As a result, instead of a bunch of different contracts with various distributors, only two separate contracts dealt with Ukraine as a transit country for Russian gas and Ukrainian gas imports from Russia. These contracts expire in 2019. The Ukrainian import and transit prices were coupled to the oil price. There were no distributors anymore which should result in a stable long-term regulation of the gas trade. Though due to their track records it is still possible that further conflicts could erupt under a new Ukrainian government once Ukraine is again not able to pay its gas bills to Russia or policy tensions between the two countries are rising that could again lead to further escalations.

By signing the new contract, Ukraine could improve its relative position in terms of the new regulation of transit tariff rates but Russian state company Gazprom came ultimately out as the big winner. Even low long-term oil prices would guarantee high gas prices in the Ukraine which would result in bigger profits for Gazprom. Furthermore, Naftogaz, the Ukrainian energy state company, overtook all debts of the distributor company RosUkrEnergo (which was equally owned 50% by Gazprom and 50% by two Ukrainian oligarchs and which formerly exported oil and gas from Turkmenistan to Ukraine via Russia). Since higher gas prices could not be passed on to consumers, Naftogaz had to take transit tariffs to reduce its outstanding debts. If Ukraine goes bankrupt, Gazprom could pressure Ukraine to sell its transit pipelines to the Russian

energy company, something Gazprom had longed for some time.

The Russian energy giant Gazprom is highly interested in acquiring Ukrainian pipelines to better control the transit of its energy exports to the EU, and particularly to Germany, and thus reduce transit costs. Almost 20% of Europe's energy needs go through Ukraine. With the onset of the Ukrainian "Orange Revolution" Gazprom looked for alternative routes of gas supply to Europe and started developing the South Stream and North Stream pipelines to reduce Ukraine's position in controlling the transit of Russian gas. However, until now all political factions in Ukraine (including the Party of Regions of the newly elected President Yanukovich) have not been willing to cede any transit pipelines to Gazprom by citing national security reasons. This could change though once Ukraine is not able to pay its debts back. This could certainly be the case if Russia is able to reduce sharply its gas transits through Ukraine and instead choose to boost gas transits via the North and South Stream pipelines in the future. Since Naftogaz derives most of its revenues from transit tariffs, it could soon become even less profitable than now opening up the possibility of being merged with or acquired by Gazprom.

Ukraine needed capital to approve the budget for 2010. The International Monetary Fund (IMF) has put on hold a \$16.5 billion programme to help Ukraine financing its debts until the Ukrainian government can provide a credible budget that underlines its financial discipline.

Thus the offer of the Russian side to lower the gas price by 30% saving the Ukrainian state \$40 billion over ten years was too good to be rejected by Yanukovych and might in part explain the surprisingly quick completion of that deal. The lower gas price is combined within the same contract to a longer lease for the Russian naval base on the Crimean peninsula. The Russian side did not try to hide the political motives behind the offer for lower gas prices. Should the

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT
JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

Ukrainian parliament had refused the Crimea deal, it would have been left without the much needed financial injection to please the IMF presenting a balanced budget and thus receiving further money from the IMF rescue package.

THE RUSSIAN – UKRAINIAN RELATIONSHIP: CRIMEA

Some commentators asked the question why Russia has been so keen to prolong its naval base on the Crimea when it could instead have built a much better and new one on Russian territory on the Black Sea coast?⁵

For Russia, the reasons for prolonging the contract are pretty straightforward. Contrary to the former gas disputes with Ukraine, this time Russia did not mention commercial interests but simply stated that the lower gas price was a political concession in return for the extension of the Russian naval base. Furthermore, with a Russian fleet on Ukrainian territory until 2042-47, all NATO membership dreams still around in Ukrainian opposition circles ended up in smoke. Therefore, Russia is simply following its goal to stop any further eastward advancement of NATO. It is important to point to the fact that Russia's President Dmitrij Medvedev is never tired to stress the importance of a common security strategy "from Vladivostok to Vancouver". This new security framework would also deal with the Crimea question being based on a common ground where both the West's interests and those of Russia could co-exist. Russia looks at NATO with caution and prejudices. During the Georgian conflict Russia felt reinforced by its prejudices towards NATO when NATO unilaterally decided to suspend the NATO-Russia Council (NRC). With hindsight this was later seen by NATO General Anders Fogh Rasmussen as a huge mistake since the NRC should exactly work as an instrument to keep diplo-

matic relations functioning, especially in difficult times. Even though the NRC was then again reinvigorated four months later, the rupture was not without consequences for Russia's mindset.

The Russian naval base on the Crimea is in no good condition though and a much needed modernization is not even planned yet. Instead, Russian Prime Minister Vladimir Putin pushed for the ongoing construction of a new \$3 billion naval base on Russian territory near Novorossiisk on the Black Sea coast which will be able to host as many as 80 warships in 2020. This will enlarge the number of warships to a great extent as there are currently already 52 warships deployed in Sevastopol. The construction of the new naval base started in 2005 when Yushchenko became Ukrainian president opposing any further extension of the Russian naval base in Sevastopol which were due to expire in 2019. With Putin insisting on the completion of the new naval base in Novorossiisk the Russian leadership seems to take into consideration a possible future change of political wind in Ukraine after Yanukovych. A new political leadership in Ukraine could indeed opt for declaring the naval base contract as unconstitutional and thus forcing Russia to leave the Crimea after 2019. Otherwise, experts point out, building the new naval base would make no sense.⁶ Indeed, the majority of the population in the Western part of Ukraine is against the longer lease. The political opposition in parliament spoke of an act against the sovereignty and the national interests of Ukraine, promising to annul the contract once it regained power.

There could be three motives for Ukraine for the extension of the Russian naval base. First, Ukrainian President Viktor Yanukovych wanted to show his more balanced policy towards Russia by offering something valuable to Russia in return for the cheaper gas price. Yanukovych has always been a keen supporter of the extension as are most of

⁵ Yevgeny Kiselyov, 'A New Lease on a Fleet and a new Lease on Life', *The Moscow Times*, Thursday, April 29, 2010, p.9

⁶ Anatoly Medetsky, 'Putin Throws Weight Behind Rival Black Sea Base', *The Moscow Times*, Monday, May 10, 2010.

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT

JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

his supporters on the Crimea peninsula that voted for Yanukovych.⁷

Second, the non-extension of the naval base could have been a huge stumbling bloc in Ukrainian-Russian relations. The naval base is more of a historic symbol to Russia and its past then a significant military base harbouring only old vessels designed to fight the US during the cold war.⁸ The withdrawal from the Crimea would thus have been more of some sort of humiliation of the Russian population at home and the Russian speaking population of the Crimea.

To fully understand the circumstances, one has to go back in history. In 1954 Nikita Khrushchev "offered" the Crimea to Ukraine as a present. It was a decision based on administrative grounds without consulting the population. Historically, Ukraine and Russia are bound by their language, religion, as well as Russia-Ukrainian intermarriages. About one million Ukrainians live in Russia. In 1989, 1.600.000 million Russians and about 630.000 Ukrainians lived on the Crimea. The Crimea has always been a primary target for Russians in terms of human relations as well as cultural relations.

The goal of former Ukrainian President Yushchenko to make his country a member of NATO could ultimately have brought more instability or would at least have made it more difficult to reach stability by not including Russia in this decision process. While there has been a strong separation movement in the Baltic states grown from the very basis of the societies during the break-up of the Soviet Union, the Ukrainian split from Russia was due to a decision made by bureaucrats of the Communist Party without the consent of the Ukrainian and Russian population.

Third, and the most likely reason, has been the inclusion of the Crimea question tied to

a lower gas price. No naval base for Moscow, no lower gas prices for Kiev. Yanukovych is backed by the billionaire oligarchs who control large parts of the steel and chemical industries which suffered big blows during the financial crisis and in times of higher gas prices. Lower gas prices would give them a better opportunity to cope with the current economic situation. In addition, Yanukovych urgently needed capital to present a national budget and thus qualify for the resuming of money flowing from the IMF to Kiev's debt loaded coffers. The removal of state subsidies of domestic gas prices is politically not feasible. With state coffers being empty, Yanukovych can now reduce the budget deficit without scaring off his supporters.

CHANGE IN RELATIONSHIP, BIG TIME?

Comparing the rather tumultuous years under Yushchenko towards Russia and the occasionally occurring disputes between the two countries with the swift rehabilitation of the relationship now under President Yanukovych, it becomes clear that both countries pressed the 'reset button'. Yanukovych has always been a staunch supporter of Russia and his return to power also signalled a closer relationship with Russia. His difficult task though is to unite both the pro-Western part and the pro-Russia part of the Ukrainian population in order not to split the country and prevent further political turmoil.

In economic terms, Ukraine is already under the orbit of the EU since most of its trade goes there. Hence Yanukovych visited first Brussels before going to Moscow. Even though he was reluctant to work with the EU before, he cannot disregard reality now. Turning his back on the EU would mean losing its most important economic trading partner hampering Ukraine's economy. By turning its back on Russia, Ukraine would lack the necessary energy resources that drive its economy. So the difficulty lies in balancing the relationship towards both the EU and Russia. Ukraine has a vested interest in having again a stable and balanced

⁷ The Economist states that almost 60% of Ukrainians support the new extension of the Russian fleet. See 'Ukraine and Russia – A Normal day's debate in Kiev', *The Economist*, May 1st 2010, p.29

⁸ ibidem

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT
JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

relationship with Russia without jeopardizing its relations with the EU.

The former government was unable to reform the economy making it more competitive and reducing its dependence on Russian gas. The new deal with Russia will not solve this situation. Rather, it will bind Ukraine to Russia and its interests. Next to the lease agreement and the lower gas prices Russia also put forward cooperation initiatives in the nuclear energy, aviation and shipbuilding industries. The consolidation of these industries, respectively, is in both countries' interests since either of them alone would be too weak to compete against each other in the same market.⁹ In terms of nuclear business, the deal with Ukraine would boost Russia's power nuclear industry monopoly in the region. Under the envisioned deal Russian nuclear companies would build two new reactors in Ukraine and would further keep its role as the main nuclear fuel provider.¹⁰ A new agreement with Syria and Turkey on the development of nuclear energy plants in May 2010 made clear that Russia is trying to carve out a bigger role in the international market for nuclear energy.

Russian Prime Minister Vladimir Putin surprised his Ukrainian counterpart Nikolai Azarov on April 30 by proposing to merge Russian state company Gazprom with the Ukrainian state company Naftogaz. Despite all the euphoria on both government sides on the rehabilitation of the countries' relations, the Ukrainian response to this proposal was rather cool. Ukrainian President Yanukovich cited national security reasons for not submitting Naftogaz to Gazprom under the current proposals, and instead preferred an international consortium including Ukraine, Russia and the European Union (EU) that should take part in any future merger talks. A merger between the two gas monopolies would indeed mean a de

facto takeover by the Russian state company Gazprom, giving it full control of Ukrainian transit routes and gasholders. Naftogaz is Ukraine's biggest employer with 170,000 employees. It derives most of its revenues from transit tariffs of Russian gas to Europe. Russia's possible threat to immensely reduce the flow of gas through Ukraine and instead opt for the North and South Stream pipelines as alternatives in the future, will increase the pressure on Naftogaz.¹¹ Therefore, Russia's offer to overtake Naftogaz could again become a hotly debated issue in the coming years. Gazprom would indeed have to modernize Ukraine's pipeline system. But this would then give Gazprom the chance to abandon the South Stream project altogether since modernizing the pipeline system in Ukraine would be economically more viable than having to deal with all the political implications of the South Stream pipeline and the construction of completely new transit routes. But for now, the South Stream pipeline project goes ahead nevertheless in order to show Russia's will to move on.

The possible extraction of shale gas throughout Europe as well as the recent fall in gas prices depressed Gazprom's profits. To sweeten the deal, Gazprom allows from now on that Ukraine would not be punished if it bought less gas than initially it had asked for and that Kiev could also re-export Russian gas to Europe. Ukraine promised in return to increase gas imports from Russia by 10 percent.¹² The brunt of the fiscal burden lowering the gas price for Ukraine will not be met by Gazprom itself but by the Russian taxpayers as the reduced price will be levied by a cut in export duties usually paid by Gazprom (state company) to the Russian state.¹³

Politically, both sides agreed to closer cooperation between the two countries. The

⁹ Vladislav Inozemtsev, 'Moscow's New Best Friend', *The Moscow Times*, 5 May 2010.

¹⁰ Roman Olearchyk and Stefan Wagstyl, 'Russia and Ukraine set for gas price deal in exchange for navy base pledge', *Financial Times*, Thursday, 22 April 2010, front page.

¹¹ Konrad Schuller, 'Putins Angebot', *Frankfurter Allgemeine Zeitung*, 3 May 2010.

¹² Anatoly Medetsky, 'Deal Struck on Gas, Black Sea Fleet', *The Moscow Times*, 22 April 2010.

¹³ See 'Ukraine and Russia – A Normal day's debate in Kiev', *The Economist*, May 1st 2010, p.29

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT
JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

Russian ambassador returned to Kiev shortly after the election of Yanukovich. Russian President Medvedev met his counterpart Yanukovich already 7 times since March 2010 which should by definition describe the new relationship between the two countries as excellent. But there is more than the simple exchange of friendly words. On his first visit to Kiev President Medvedev signed agreements on border demarcation and interbank cooperation.¹⁴

A closer relationship between Russia and Ukraine would allow Russia to keep its power in the Black Sea region. Medvedev already pronounced a non-attacking contract with all Black Sea coast states in order to diffuse any anxieties coming up in the neighbouring countries regarding its naval fleet on the Crimea.

Russia's ultimate goal seems to bind CIS countries economically to Russia to create economic interdependence that later can then be turned into political influence.

IS THIS DEVELOPMENT GOOD OR BAD FOR THE EU?

The EU has missed a huge opportunity in not assisting Ukraine becoming a Europeanized state. Indeed, the EU largely stood by when Ukraine's elite blocked itself. One has to ask though what would have happened if the EU had been more actively involved? If the EU had been successful in integrating Ukraine, could there have been internal political turbulences due to the missing reconciliation with Russia? The short answer is: yes. The current trend brings ultimately more stability to the country because of its better relations with Russia.

The Orange Revolution was turned upside down since its leader and former President Yushchenko did not follow up on his promises to reform the country but was instead wound up in a personal battle against his

rivals. This laid the ground for a come-back of Yanukovich and former bureaucrats whose difficult task is to implement the structural reforms asked for by the IMF. Now the EU has to deal with a Ukrainian government which obviously seeks a closer relationship with Russia. The EU should not dismiss this as a one-way decision though but should listen instead to the strong signals sent out by Kiev also wanting to strengthen its relations with the EU.

What does this mean to the EU in terms of energy security and neighbourhood policy? Regarding energy security, the closer relationship between Russia and Ukraine would firstly relieve the EU from future gas shortages or shut-offs from Russia since disputes over gas prices would not hinder the supply of gas to Europe. Second, the proposed merger by Putin of the Russian and Ukrainian gas state companies, Gazprom and Naftogaz, would make the South Stream pipeline obsolete because Russia could then fully control the transit routes through Ukraine without fearing interferences from Ukraine. This in turn would mean that the Nabucco pipeline would become economically viable since South Stream until now constituted a huge stumbling bloc to the realisation of the Nabucco pipeline. A takeover of the Ukrainian state company would also be another reason for the EU to seek diversion of its energy resources since Russia could be then in a more powerful position to use energy as a fungible power to press Europe over other issues. At the same time though Russia would have to invest big sums into the old pipeline system of Ukraine which would make only sense if Russia was interested in securing gas over the long-term to Europe.

So the result is a mixed one. Russia would extend its regional monopoly on gas supplies and the EU would still depend on Russian energy. A consortium as proposed by Yanukovich consisting of the EU, Russia and Ukraine would indeed help to keep disputes at bay and guarantee Ukraine transit tariffs on which Ukraine would lose out if it gave in to Russian's quest for merging its state oil company Naftogaz with the giant Russian state oil company Gazprom. The EU

¹⁴ 'Ukraine Rules Out Energy Deals With Russia', *The Moscow Times*, 13 May 2010.

Konrad-Adenauer-Stiftung e.V.

RUSSIAN FEDERATION

DR. LARS PETER SCHMIDT

JOHAN BÖLTS

30th June 2010

www.kas.de

www.kas.de/moskau

though seems not to support such a consortium calling instead on the IMF to press for reforms in opening up the Ukrainian energy market and decrease state energy subsidies to households. Such reforms had been avoided by previous governments which feared a political backlash. Insisting on the reforms could lead to further frustration over the EU thus tilting Ukraine more towards Russia.¹⁵

The neighbourhood policy of the EU (ENP) is deeply affected by Ukraine's eastward swing. Once designed to facilitate economic integration with non-EU countries to be later followed up by political integration, some of the EU-Ukraine Association Agenda priorities for 2010¹⁶ will most probably not be fulfilled. With Yanukovich's team being in full control of executive and legislative levers of power, the team around Yanukovich can now fully concentrate on implementing those reforms. The powerful Ukrainian oligarchs pragmatically side with Yanukovich preferring a rapprochement with Russia. If Russia will overtake the EU as Ukraine's most important trading partner, the EU would lose its most powerful incentive for EU accession since opening the doors to its vast economic market has always been the

EU's best appeal for other countries to join the EU.

However, as seen in the past years, the political mood in Ukraine can always change bringing once again the opposition back to power. That could again change fundamentally the relationship between Ukraine and Russia turning the country more towards the EU. To prevent this outcome from happening, the Russian government designed an economic and political agenda which binds Ukraine to Russia without disrupting though the (weak) Ukrainian-EU bonds, even though Brussels should have no illusions about further EU-accession with Ukraine in the near to mid-term future. Instead, the EU would have to deal with a finlandized Ukraine. A common security framework as foreseen by Russia could be the basis for a rethinking of the old security structures in Brussels as well as in Moscow to come to common terms over how to deal with the challenges of the 21st century leaving the debates about cold war rivalries behind.

¹⁵ Roman Olearchyk, 'Unbalanced between east and west', Ukraine, Special Report, *Financial Times*, Wednesday, June 2 2010.

¹⁶ Such as to „work towards rapid accession of Ukraine to the Energy Community Treaty" (32), "continue reform of electricity tariff and gas pricing and measures to ensure full payments for providing electricity and gas" (34) or to "fully implement the Joint Declaration of the investment conference on the rehabilitation and modernisation of the Ukrainian gas transit network of 23 March 2009" (36) as formulated in the LIST of the EU-Ukraine Association Agenda priorities for 2010, January 2010, at http://ec.europa.eu/external_relations/ukraine/docs/2010_association_agenda_priorities_en.pdf