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Ukraine and Russia: a hindered rapprochement

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The policy of rapprochement with Russia that President Victor Yanukovych and his entourage had been actively promoting in the first months of his presidency has slowed down notably. One of the reasons for this lowered pace is that current talks between Russia and Ukraine concern the spheres in which Kyiv is not ready to make concessions to Russia. Despite numerous top-level meetings, recent months have failed to bring a breakthrough in energy issues of key importance. First of all, no compromise was reached in gas issues where the divergence of interests is particularly large and where Ukraine has adopted a tough stance to negotiate the best conditions possible. Even though some agreements were signed during the October session of the inter-governmental committee presided over by the prime ministers (the agreement on linking the two states' aircraft production and on the joint construction of a nuclear fuel production plant), these resulted from prior agreements.

Economic negotiations will continue in the coming months but the observed deadlock is not likely to be broken any time soon. The results of these talks are likely to reflect the interests of both Russia and Ukraine, as well as the competition among Ukrainian business groups, some of which opt for closer cooperation with their Eastern neighbour.

Ukraine's consent to send oil to Belarus along the Odessa-Brody pipeline shows that the government in Kyiv is ready to engage in projects they consider profitable, even those that run counter to Russian interests. Ukraine's adoption of this stance may trigger irritation in Moscow and lead to a cooling in bilateral relations.

1. Previous agreements

Since the presidential elections in February 2010, the Ukrainian government has concluded a number of agreements that met Russia's expectations, starting with the ‚fleet for gas' agreement. Ukraine agreed to extend the stationing of the Russian Black Sea Fleet in Crimea for 25 years, i.e. until 2042, in return for a 30-percent discount on the high price of Russian gas, included in the gas contract signed by the previous government. This discount will be

calculated as a reduction in Ukraine's debt (from 2017, this debt will be go down in line with Russia's successive payments for stationing the fleet).
The ‚fleet for gas' deal has provided the Ukrainian government with short-term benefits. It saves Ukraine some $4 billion a year (provided that gas prices are kept at current levels). A lower gas price enabled the adoption of a budget with a deficit of less than 6%, which in turn enabled the resumption of cooperation with the International Monetary Fund and improved the condition of Ukraine's chemical and metallurgical industries. The extension of the stationing of the fleet has also reduced tension in Crimea and decreased the popularity of pro-Russian parties in this region. Nevertheless, this deal can hardly be considered as a success for Ukraine since certain unfavourable provisions in the gas contract have not been lifted. First of all, the price formula has not been changed which means that Ukraine will continue to pay relatively high rates. Also, except for 2010, the volume of gas contracted remains unchanged (52 billion m^3, with the possibility to reduce it by 20%) with Ukraine not allowed to re-export the excess gas. Ukraine will hardly be able to use so much gas, moreover, this will impede its attempts to introduce energy-saving technologies (Ukraine's is one of the most energy-intensive economies in the world). Kyiv has also failed to make Russia guarantee a specific volume of gas transferred via Ukrainian territory and to include it in the contract.

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Kyiv's concessions resulted from decisions made by the previous government who signed an 11-year gas contract that was unfavourable to Ukraine; it did so under international pressure when gas supplies to Ukraine were withheld in January 2009 as a result of the, gas war'. It seems that regardless of who would become president in 2010, this contract would have needed to be renegotiated. The Party of Regions considers the ‚discount for the further stationing of Black Sea Fleet' deal the lowest price Ukraine could pay, and the withdrawal of the fleet in 2017 was, furthermore, widely regarded as unrealistic.

So far, Ukraine and Russia have fortified their cooperation in two spheres of the economy: nuclear energy and the aircraft industry. In the first case, Ukraine has accepted Russia's monopoly on nuclear fuel supplies and the modernisation of power plants. In the second case, major Ukrainian aircraft factories were merged with Russian ones to form a Russian-Ukrainian joint venture.

The agreement between Ukraine's Antonov State Aeronautic Concern and Russia's United Aircraft Corporation (OAK) to establish a joint venture means that the Ukrainian corporation will be merged with a part of OAK. Both sides saw the merger as advantageous, but its importance is much greater for Ukraine. The merger will revive the Ukrainian aircraft industry and increase its profitability; currently this industry is in crisis as the market for its production has shrunk and funding for production has been insufficient. Antonov tried in vain to enter the EU and US markets, but they preferred to support their domestic aircraft corporations. In July 2010, Antonov participated in a tender organised by the US Department of Defence concerning the supplies of air tankers, but its application was rejected for formal reasons. Given this situation, a merger with a Russian corporation was their only chance to survive. Cooperation with Russia will help Antonov to win contracts in the Russian market and in third markets, and will allow it to resume the serial production of such aircraft as An-124 Ruslan and An-225 Mriya, and to increase the sales of An-140 and An-70.

In June 2010, an intergovernmental agreement was signed to complete the construction of two reactors at the nuclear power plant in Khmelnitsky, for which Russia provided a low-interest loan of $2 billion, and an agreement on the supplies of nuclear fuel. Moreover, in October the Ukrainian State Company ‚Nuclear Fuel' and Russia's TVEL concluded an agreement providing that Russians would construct a plant producing nuclear fuel on Ukrainian territory. The agreement states that Ukraine will hold a controlling stake in this plant. It cannot be ruled out that this investment will be delayed as it is not favourable for TVEL (the Russian corporation currently has a total monopoly on supplies to Ukraine). The deals signed mean that Ukraine has given up its plans to diversify supplies and has become fully dependent on Russian nuclear fuel. Earlier Ukraine had held talks with America's Westinghouse corporation on the supplies of fuel, but Russia warned that it would withdraw its security guarantees for Soviet and Russian reactors if fuel from other sources was used there. However, Russia has so far failed to achieve its main goal, i.e. to establish a joint nuclear corporation that would group machinery plants, production and sales of energy from nuclear power plants, uranium mining and the production of nuclear fuel (should that happen, it would give Russia total control over the Ukrainian nuclear sector). As such, Ukraine's decision to give up its search for diversification of fuel supplies brings it some profits (American fuel would have been more expensive) and does not affect the interests of Ukrainian big business. What Ukraine clearly wants to avoid is completely losing control over the nuclear energy area, especially by allowing Russia to engage in electricity sales.

2. Key sticking points

Extensive bilateral economic negotiations have been ongoing simultaneously since spring 2010, both on a government level and on the level of individual companies. The talks concerned different sectors of the economy, above all the energy sector. Information on these negotiations has been very scarce. Moreover, messages coming from the two sides are often contradictory, which makes it hard to assess how advanced the talks are and what their result may be. A number of issues are being discussed simultaneously, so there may be agreements wherein one partner's concessions in one sector are compensated by benefits in other areas.

2.1. Gas issues

Despite the discount received in April 2010, Ukraine is still paying a relatively high price for gas ($252 for 1,000 m^3 in the 4^{th} quarter of 2010; by comparison, Belarus pays $194). Among those who are most interested in a reduction in the gas price there are representatives of a group in the Party of Regions associated with the oligarch Dmytro Firtash, the co-owner of RosUkrEnergo (minister of energy Yuri Boyko and head of the Presidential Administration Serhiy Lovochkin belong to this group). Firtash's activity is concentrated in the gas sector and chemical industry (where natural gas is used as a resource). He is vitally interested in a further reduction of the gas price. His group has significantly strengthened its position following Yanukovych's election, and its representatives opt for closer cooperation with Russia.

It is completely unlikely that Ukraine will agree to merge Naftohaz with Gazprom, as was suggested by Prime Minister Vladimir Putin in May 2010. A solution preferable to Kyiv would be to establish a tripartite consortium (the EU, Ukraine and Russia) that would manage the pipelines but not own them.

In its negotiations with Russia, the government is seeking to reduce the gas price by renegotiating the price formula that Ukraine deems unfavourable and by getting access to Russian gas deposits. Another objective is to maintain Ukraine's position as the main transit country for Russian gas and to guarantee that the current level of transit is sustained (for Russia this would have to mean giving up its plans to construct the South Stream pipeline). A further objective Ukraine has is to get assistance in the modernisation of its pipeline system, preferably with the participation of the EU.

Russia for its part is seeking to take over control of the pipeline system, to strengthen its position on the Ukrainian gas market and to participate in gas extraction in Ukraine. Control over pipelines could be acquired by merging Naftohaz with Gazprom or by establishing a joint venture that would own the Ukrainian pipeline system. However, it is completely unlikely that Ukraine will agree to merge Naftohaz with Gazprom, as was suggested by Prime Minister Vladimir Putin in May 2010. A solution preferable to Kyiv would be to establish a tripartite consortium (the EU, Ukraine and Russia) that would manage the pipelines but not own them. What is also possible is the establishment of a joint venture of Naftohaz and Gazprom that would deal with the extraction and sales of gas on the Ukrainian market and would modernise the pipelines. Russia suggested that the joint venture could receive some gas deposits located in the Yamal Peninsula and in the region of Astrakhan, which attracted Ukraine's interest. For Russia, the creation of a joint venture, even though considered a half-solution, would still enable it to strengthen its position on the Ukrainian market and to gradually take over some assets.

In October 2010 it was announced that the gas contract would be signed by July 2011, which suggests that neither side envisages reaching a prompt agreement. Ukraine is seeking to reduce the gas price, although this need is no longer urgent, as the industry proved able to operate even when paying current rates. It cannot be ruled out, however, that the representatives of Ukrainian business who opt for closer cooperation with Russia will succeed in pushing through a decision that will reduce the gas price and give them a share in gas export revenue in return for establishing a joint venture.

2.2. Oil transit

By late November 2010, Ukraine and Russia had signed the intergovernmental agreement on the transit of oil in 2011, wherein Russia has pledged to send 17 million tonnes of oil via Ukrainian territory. However, according to the information available (the contract has not been made public), no sanctions are provided should Russia fail to comply with these terms. This in fact means that the current principles of transit will be sustained. It can be regarded as a defeat for Ukraine, since its declared objective was to sign a 5-year transit agreement that would define a minimum volume of oil transferred. Current principles (no minimal volumes guaranteed) are good for Russia, as it plans to activate the first branch of the BTS-2 oil pipeline in 2011, which will allow it to diversify its oil supplies to Europe, e.g. by sea from the Ust-Luga port on the Baltic Sea.

Ukraine's important objective is to get profits from transit fees. When Russia proved unable to provide the appropriate volumes of transit, Kyiv did not hesitate to look for other partners.

However, Moscow gave up its earlier plans to block the use of the Odessa-Brody pipeline in the direction of Brody (the contract initialled in October had provided that Russians would continue to use the pipeline). Russia had used the pipeline to send only small amounts of oil and completely stopped transit in November 2010, probably due to shortages of oil.

While negotiating with Russia, Kyiv simultaneously held talks with Belarus concerning the use of this pipeline (Belarus was searching for oil supplies alternative to Russian). Not having reached any agreement with Russia, Ukraine chose to use the pipeline to send oil to Belarus. On 1 November a ministerial agreement between Ukraine and Belarus was signed, providing that in 2011 8 million tons of oil would be transmitted from the port of Odessa to the Mazyr refinery along the Odessa-Brody pipeline and the southern branch of the Druzhba pipeline. Reversing the Odessa-Brody pipeline in the Belarusian direction will be a proof that Kyiv is ready to participate in projects that undermine Russia's interests. Ukraine's important objective is to get profits from transit fees. When Russia proved unable to provide the appropriate volumes of transit, Kyiv did not hesitate to look for other partners.

2.3. Cooperation in the electric energy sector

During the October session of the intergovernmental committee, Ukraine and Russia settled that an agreement on the parallel operation of the electric energy systems of the two countries would be prepared by the end of the year. This declaration meets Russia's needs. Up till now, Ukraine has expressed interest in linking the systems to exchange energy in cases of increased demand, but it consistently opposed Russian energy being exported via its networks, as Kyiv itself has significant exporting potential in this branch (according to some estimates, Ukraine uses only half of its production capacity). By signing the agreement with Russia, Ukraine would contradict the commitments it took when joining the Energy Community. One of the commitments was to unite its energy network with the European UCTE system (the Union for the Coordination of Transmission of Electricity) which would enable Ukrainian electric energy to be exported to the EU. If the Ukrainian and Russian networks are linked, the main exporter will be Russia which produces cheaper energy, and Ukraine's role will amount to its being a transit country.

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The agreement as proposed by Russia would in fact prevent Ukraine from exporting its electric energy to the EU, therefore it seems that Ukraine would conclude this agreement only if Russia makes serious concessions in other areas, especially in connection with gas. If Ukraine agrees to do so, it would seriously affect Ukraine's richest businessman Rinat Akhmetov, associated with the Party of Regions, who has made large investments in the electric energy sector and is vitally interested in exporting energy to the West. On the other hand, this solution may be lobbied for by the Firtash group which is competing with the Akhmetov faction and is seeking to weaken the latter's position.

3. Hindered rapprochement

Despite numerous top-level bilateral meetings conducted in recent months, the results of the talks proved to be unimpressive, as illustrated by Prime Minister Vladimir Putin's last visit to Kyiv in late October. During this visit, Russia and Ukraine did sign two important economic agreements, but the decision to do so had been made back in the summer. No agreement was reached in the area of gas, contrary to earlier announcements. Moreover, the atmosphere of Putin's visit was clearly less favourable than during previous meetings. Equally unproductive was the session of the interstate commission on 26 November with the participation of Presidents Yanukovych and Medvedev. An agreement on oil transport was signed, which did not take into account Ukraine's demands, but no progress was made in gas talks.

One of the greatest obstacles in negotiating with Moscow are the concerns Ukrainian oligarchs have that Russian businesses would expand in the branches they consider their exclusive domains. Moreover, the government is unwilling to make concessions without being certain that it will receive adequate compensation. Finally, a gradual improvement of Ukraine's economic situation allows Kyiv to be more assertive in its talks with Moscow, which has led to an apparent slow-down in negotiations.
The government in Kyiv firmly supports the businesses of Ukrainian oligarchs whenever they compete with Russians. For example, Russia's attempt to take over Ukraine's largest metallurgical plant, Ilyich, in Mariupol was blocked by Mykola Azarov's government, because Rinat Akhmetov was also interested in acquiring the plant. Similarly, Kyiv Commercial Court overruled the purchase of the Luhansk Locomotive-Building Factory by Russia's Bryansk Engineering Plant.

4. Conclusions

The slowdown in Russian-Ukrainian economic negotiations shows that the government in Kyiv has become extremely cautious about the presence of Russian business in Ukraine. Whenever the interests of business groups associated with the Party of Regions and Russian interests clash, Ukraine does not hesitate to oppose Moscow.
The scope and details of possible bilateral agreements now seem difficult to predict. It seems, however, that any agreement that would be harmful to certain sectors of the Ukrainian economy would only be possible if counterbalanced by Russia's concessions in other areas. Existing agreements (such as the contract on the transit of oil) show that Russia is not ready to make such concessions. There is a possibility that the groups in Ukraine (mainly in the gas sector) who opt for closer cooperation with Russia may successfully lobby for some concessions to Russia.

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Existing economic agreements (with the exception of the, fleet for gas' contract that was concluded under time pressure) cannot be considered as harmful for Ukraine. Cooperation with Russia is often a cheaper and a more beneficial option (as in the case of nuclear fuel supplies) if not the only one possible (aircraft industry). However, this closer cooperation does strengthen Russia's position in Ukraine, which can (and will) be used by Moscow in the future.
At the moment, the greatest importance is attached to negotiations in the energy sphere, including the gas sector and cooperation in the area of electric energy. Considering how divergent the interests of the two parties are, prompt agreement should not be expected.

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