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UKRAINIAN GAS TRADERS, DOMESTIC CLANS AND RUSSIAN FACTORS: A TEST CASE FOR MESO-MEGA AREA DYNAMICS

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Since independence, Ukraine has struggled to consolidate democracy and institute a market economy. Despite its advantageous geopolitical location on the European continent and self-identification as a Central East European Country (CEEC), Ukraine still lags behind its western CEEC neighbors. Its accession to the EU and NATO are distant prospects.¹ Like other CEECs, Ukraine launched neo-liberal reforms guided by the IMF in late 1994, but tangible economic growth was recorded only in 2000, after 10 years of ruinous recession.

On the other hand, the influence of Russia, which shares a common past and similar institutional settings with Ukraine (according to Osamu Ieda, an “institutional identity”), has remained significant in Ukrainian politics and economics. Russia has been the largest trading partner of Ukraine since its independence. In addition, Russia is the de facto largest foreign investor in Ukraine’s economy, whose extremely unpredictable investment climate has made its “older brother” (but not the West) the only investor capable of handling this uncertainty. This situation reminds us of the controversial concept of the “liberal empire,” recently pronounced by A. Chubais, who argues that the Russian government is able to and should encourage Russian entrepreneurs to run businesses and buy stocks in neighboring CIS countries.²

Ukraine, as well as Belarus and Moldova, was neither able to exploit its advantageous geographic location to be quickly accepted by the EU nor to create a meso-area between Europe and Eurasia conducive to indigenous reformism. This chapter tries to elucidate the reasons for

¹ The Ukraine-EU Co-operation Council was established in 1998, but there are neither concrete schedules nor discussions dedicated to Ukraine’s EU accession. Ukraine declared that it intended to gain full EU membership by 2011, but the EU expressed no desire to incorporate Ukraine.

² Anatolii Chubais, “Missiia Rossii v XXI veke,” *Nezavisimaia gazeta*, 1 October 2003.

this failure, based on a case study of Ukrainian gas traders. This topic was chosen since it reveals a specific combination of domestic and international politics. Domestically, Ukraine's system of gas trade was a hotbed of clan politics.³ Internationally, Ukraine has not found any alternative to the old, Soviet unified energy system and it is impossible for this country to ignore Russia's will in this sphere.

The next section explains the significance of this issue and gives a brief overview of the natural gas sector in Ukraine. The following sections examine the chronological development of Ukraine's gas market during 1993-2003. The last section offers tentative conclusions.

WHY DOES NATURAL GAS MATTER?

First of all, natural gas concerns both the IMF and Russia. Natural gas is one of the most necessary commodities in Ukraine. About 40 percent of primary energy consumption comes from natural gas and Ukraine produces only one quarter of its total need (Table 1). Ukraine remains highly dependent on foreign producers for its natural gas supplies and it owes several billion USD in debt to them. For this reason, there is a significant possibility of interference from foreign gas producers, above all Russia's Gazprom, as well as the IMF, which assists Ukraine with its foreign debt problem and advises on economic reforms. The IMF believes that the unreformed gas market was the main source of Ukraine's foreign debts, and that it requires neo-liberal reform of the gas market.

There are numerous state regulations on the gas sector and these regulations attract many people seeking privileges from the state. For this reason, we can identify a patron-client relationship based on the gas business. The dynamics of the gas business have always depended on political patrons who guaranteed favorable business conditions. The natural gas problem involves both internal politics and the IMF and Gazprom's influences. The interaction between external and internal politics has caused the transformation of the gas market in Ukraine.

³ On the clan characteristics of Ukraine's politics, see Kimitaka Matsuzato, "Elite and the Party System of Zakarpattia Oblast: Relations among the Levels of Party Systems in Ukraine," *Europe-Asia Studies* 54:8 (2001), pp. 1265-1299.

TABLE 1. UKRAINE'S DEPENDENCY ON RUSSIAN GAS

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
A. Imported from Russia (bcm)	NA	54.7	56.7	52.8	51.1	57.6	54.9	52.8	39.7	28.7	25.3	26.0
B. Domestic gas production (bcm)	20.9	19.3	18.3	18.2	18.4	18.1	18.0	18.1	17.9	18.3	18.7	19.5
C. Domestic consumption (bcm)	113.4	102.8	92.4	85.4	86.0	81.3	75.6	73.6	73.4	70.5	69.7	76.4
Dependency on Russia (A/C) (%)	NA	53	61	62	59	71	73	72	54	41	36	34
Self sufficiency (B/C) (%)	18	19	20	21	21	22	24	25	24	26	27	26

Source: *Poslannia prezidenta Ukrainy do Verkhovnoi rady Ukrainy: pro vnutrishne i zovnishne stanovyshe Ukrainy u 2002 rotsi*, p. 343; *Statystychnyi shchorichnyk Ukrainy za 2001 rik*, p. 104, Table 6.9; *Statystychnyi shchorichnyk Ukrainy za 2002 rik*, p. 106, Table 6.10; *Rossiiskii statisticheskii ezhegodnik 1993; 1994; 1995; 1996*, p. 355, Table 358; 1997, pp. 590-591, Table 19.10-11; 1998, p. 757, Table 25.14; 1999, pp. 575-576, Table 24.15; 2000, p. 589, Table 24.16; 2001, p. 617, Table 24.17; 2002, p. 627, Table 24.17; *Ministry of Fuel and Energy of Ukraine press release, 20 February 2004*, URL (<http://mpe.energy.gov.ua>)

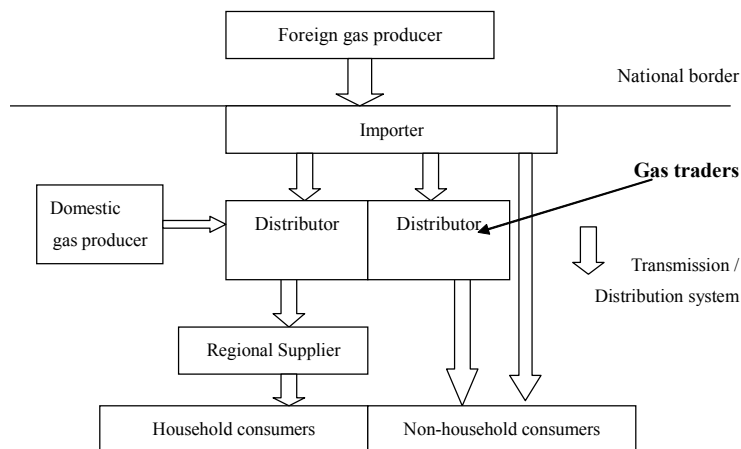
The structure of the natural gas industry in Ukraine is outlined in Figure 1.⁴ In this figure, *foreign gas producer* means a legal person extracting natural gas and exporting it to Ukraine. In Ukraine, because of the absence of a liquid natural gas (LNG) process or alternative gas pipelines, only Russia and the Central Asian republics (Turkmenistan and Uzbekistan) feature as foreign gas producers. The export of Russian gas is carried out by Gazprom itself (Gazeksport, to be precise) and its "mysterious partner" Itera.⁵ Turkmenistan gas reaches Ukraine through Uzbekistan, Kazakhstan, and Russian territory, and this long-distance transport is operated not by Turkmenistan but by various commercial firms, including Itera.

Domestic gas producer means a legal person extracting natural gas in Ukraine. Most of the domestic gas fields are owned and controlled by state companies whose share of output capacity is over 90 percent.

⁴ For each definition, please refer to *Directive 2003/55/EC of the European Parliament and the Council of 26 June 2003*.

⁵ See Petr Vrasov, "Upolnomochennye po delam Sodruzhestva," *Ekspert* 11 (20 March 2000), pp. 26-30.

FIGURE 1. THE NATURAL GAS INDUSTRY IN UKRAINE*



*This figure excludes exports from Ukraine.

Domestic natural gas only covers one quarter of national demand for gas; the gap is filled with imported natural gas. Domestic natural gas is much cheaper than imported gas and is primarily allocated to household consumers.

Gas Importer means a legal person importing natural gas to the territory of Ukraine and selling it to consumers. Importers must be licensed and registered in Ukraine. The state company (Ukrhazprom until 1998, NaftoHaz Ukrainy after 1998), which receives 25-30 billion cubic meters (bcm) of Russian natural gas from Gazprom annually as a transit fee, can also be categorized as an importer.⁶ *Gas Distributor* means a legal person buying natural gas and selling natural gas to consumers. Distributors can be classified into two categories, the first selling natural gas to household consumers through regional gas suppliers (Oblhaz), and the second selling gas to non-household consumers. With very few exceptions, for example Timoshenko's gas trading company, United

⁶ State company means a company, more than 25 percent (a "controlling packet") of whose shares belong to the state.

TABLE 2. THE STRUCTURE OF GAS CONSUMPTION AND DOMESTIC PRODUCTION IN UKRAINE (BCM)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Non-household consumers	914	87.7	81.1	65.2	54.4	45.8	46.5	45.3	34.9	33.2	38.2	34.0	30.9	34.4
Household consumers	213	24.3	26.6	30.2	30.7	31.9	31.3	28.6	33.0	32.9	27.5	29.5	31.5	34.4
Technological needs*	6.1	6.1	5.7	7.4	7.3	7.7	8.2	7.4	7.6	7.5	7.7	7.0	7.4	7.5
Total (A)	118.8	118.1	113.4	102.8	92.4	85.4	86.0	81.3	75.6	75.7	73.4	70.5	69.7	76.4

* Natural gas, which is required for the operation of GTS itself.

Source: Naftohaz Ukrainy HP URL <http://www.ngu.com.ua>, read by author 20 August 2001; Ministry of Fuel and Energy of Ukraine press release, 20 February 2004, URL (<http://mpe.energy.gov.ua>)

Energy Systems of Ukraine (see below), the state companies have monopolized distribution to household consumers.

Regional Supplier (Oblhaz) means a legal person supplying natural gas to household consumers on commission from the distributor. The territories covered by the 55 Oblhaz largely coincide with the administrative districts. They are partially privatized, but the state (or state company) and regional governments retain a large share.⁷ *Regional Suppliers* not only supply natural gas and collect the bills, but are also responsible for the operation, security and maintenance of the regional distribution system (low pressure pipeline networks). *Household consumers* means customers purchasing natural gas for their own household consumption. Also, in the case of Ukraine, we include municipal services and public organizations in this category. *Non-household consumers*, or industrial consumers, means consumers purchasing natural gas not for their own household consumption. Power stations are included in this category.

Gas transmission system (GTS) means the transport of natural gas through a high-pressure pipeline network (35,000 km in total length) and 12 underground gas storage facilities (UGS, 30 bcm in total capacity). This GTS is the most valuable asset in Ukraine and is owned and

⁷ See Irina Dubrova, "Obligazy: Put' k reorganizatsii," *Energeticheskaia politika Ukrainy* (February 2001), pp. 74-76.

operated by the state.⁸ In 2002, the GTS contributed six percent of the state budget. Currently, negotiations are being held between Gazprom and the Ukrainian government to establish common control of the GTS (“Gas consortium”), since the Ukrainian GTS serves as a main gas export route for Gazprom.

In this paper, we focus on the dynamics of importers and distributors to non-household consumers (Table 2) since these categories have been objects of liberalization. In contrast to these, regional supply and GTS are still under state monopoly. A commercial company or non-state company that distributes natural gas to non-household consumers, we define as “gas trader.” In some cases, gas traders have a license to import. What is important is that gas traders have no property, such as gas fields or GTS, but only the license to trade. It is around these licenses that political patron-economic client relations have developed.

HOW TO MAKE PROFITS FROM GAS?

It is well known that distributors to non-household consumers, or gas traders, operate one of the most profitable businesses in Ukraine.⁹ At the same time, Ukrainian gas consumers have been notorious for their low payment rate. How can a high rate of profit be consistent with poor consumers? How could gas traders make a profit in Ukraine? There are several explanations for this paradox. The first reason is the market’s scale. Despite a long economic depression, Ukraine is still highly dependent on gas. As of 2002, the share of natural gas in primary energy consumption was 38 percent.¹⁰ The world’s sixth largest gas consumption market is attractive to gas traders. Moreover, the gas traders only cover non-household, or industrial consumers, which are wealthy in comparison to household consumers.

⁸ In 1995, Arthur D. Little, commissioned by the EBRD, estimated GTS’s value at 22-28.7 billion USD.

⁹ “Vse bogatye liudi Ukrainy zarabotali cvoi kapitally na Rossiiskom gaze,” *Nezavisimaia gazeta*, 16 October 1998.

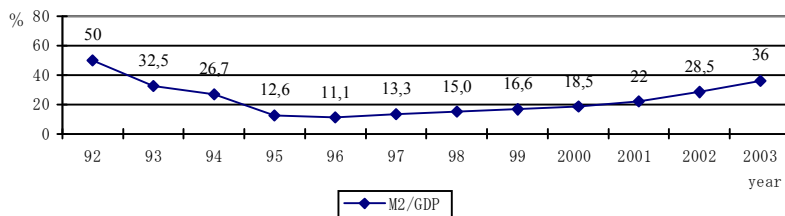
¹⁰ Derzhavnyi komitet statystyky Ukrainy, *Statystychnyi shchorichnyk Ukrainy 2002*, p. 105, Table 6.12.

The second reason is Ukraine's dependency on imported gas. As mentioned above, Ukraine has to import approximately 50-70 bcm of gas annually. This figure includes Russian gas, which the Ukrainian state company receives as a transit fee, amounting to 25-30 bcm. The remaining 25-45 bcm has to be purchased from foreign gas producers. This portion of the gas supply is allocated on the basis of licenses, and provides the business opportunity for the gas traders.

The third reason for the profitability of the gas trade is non-monetary transactions. Ukraine's economy is still subject to de-monetarization. This de-monetarization was led by the tight fiscal monetary policy, which was originally a reaction to the hyperinflation of 1993, and then accelerated under the IMF's guidance (Graph 1). Under these constraints, non-monetary transactions, or payment by barter, debt equity swap and payment in discounted industrial bills of exchange became common between the gas traders and their consumers. These non-monetary transactions gave a great advantage to the gas traders. First, commercial gas traders became more effective than state companies in collecting payments from consumers. It was not a coincidence that gas traders appeared at the moment when the state gas distribution companies proved themselves incapable of collecting on bills from consumers. State companies are bound by the law in their actions, and they are more tolerant of non-paying consumers than commercial companies. The prices achieved by gas traders through non-monetary transactions were two to three times higher than the fixed price, sometimes five to six times higher. Moreover, gas traders could bring companies that were not able to pay for their gas consumption under their control through debt equity swapping and payment in discounted bills of exchange, and these companies' products contributed to the gas traders' further profit.

The fourth reason for the profitability of the gas trade is state protection. The gas traders had to pay the foreign gas producers for their supplies, and the state GTS company for transporting the gas. But their payments fell into arrears. In some cases, gas traders' arrears were covered by the Ukrainian government for diplomatic and political reasons. Also, out of necessity, the government gave a state guarantee on gas traders' imports. And when the gas traders could not pay, the government had to. The gas traders were thus able to make a profit at the government's expense.

GRAPH 1. MONETARIZATION OF THE UKRAINE ECONOMY



M2 means the aggregation of cash currencies, savings, and fixed-time deposits.

Source: National Bank of Ukraine HP URL (<http://www.bank.gov.ua>)

THE BIRTH OF GAS TRADERS (1993-1994)

After the collapse of the Soviet Union, Russia's Gazprom gradually increased its natural gas export price and, from January 1, 1993, introduced the so-called "world market price" for Ukraine. Turkmenistan took a similar step. In May 1993, the then prime-minister Leonid Kuchma declared an "energy crisis," claiming that gas prices had increased 40 times in just four months.¹¹ Ukraine could not adjust its national economy, since its industries and communal services were built on the assumption of cheap natural gas. At that time, Ukrhazprom, which was a state monopoly of all the gas industries from gas extraction to wholesaling, handled the import of gas.¹²

Ukrhazprom's non-payment arrears to foreign gas producers became part of the state debt. To counter Ukraine's arrears, Gazprom and the Turkmenistan government reduced the gas supply to Ukraine. Many households had their gas supply cut off, and central heating stations and plants were blocked out. Under this energy crisis, Donetsk, a coal

¹¹ Prime minister Kuchma's parliamentary speech on May 18, 1993. *Interfax-Ukraine*, 18 May 1993.

¹² Ukrhazprom was founded in 1966; after Ukraine's independence it became a state-owned joint stock company. There was no financial relationship between RAO Gazprom and Ukrhazprom.

rich region, became more prominent in national politics. Backed by a coal miners' strike, Donetsk men replaced Kuchma's cabinet ministers in September 1993. At this critical moment, gas traders were born.

Due to Ukraine's non-payment, in February 1994 the Turkmenistan government totally stopped the gas supply to Ukraine and stated that resumption of supply would be conditional on payment of the debt. In 1993 alone, the Ukraine government owed 671.9 million dollars to the Turkmenistan state gas producer.¹³ To solve this problem, in April 1994 the Ukrainian government designated "Respublika," a commercial corporation established only a few months earlier by the young businessman Ihor Bakai, to pay off the state's gas debt through barter operations. Bakai's company assumed the obligation of mediator in paying off the state gas debt. Furthermore, in agreement with the Turkmenistan government, Ukraine's government gave Respublika a license to import gas from Turkmenistan. Remarkably, the repayment program and the gas imports were state guaranteed, that is, Respublika bore no financial responsibility for either operation. Under these contracts, in 1994 Respublika imported 9.2092 bcm gas from Turkmenistan at the Turkmen-Uzbek border price of 50 USD per 1,000 cm. This privileged agreement was a true product of Bakai's lobbying. Respublika was linked to the then Prime Minister V. Masol; when Respublika did not fulfill its obligations, Masol ordered the state bank to cover Respublika's debts.¹⁴ In the end, this repayment plan only benefited Bakai and further worsened the state's budgetary situation. And when Masol was ousted from the cabinet, Respublika was eliminated from the gas market. Kuchma dismissed Masol from his post.

In October 1994, new President Kuchma declared the beginning of an economic reform backed by the IMF. The accumulation of state gas debts motivated Kuchma to launch the reform. In his address to the parliament (*Verkhovna Rada*), he stressed the necessity of the IMF's help.

¹³ This sum was fixed by a bilateral treaty on 5 November 1994, titled "Uhoda mizh Uriadom Ukrainy ta Uriadom Turkmenystanu pro restrukturyzatsiiu derzhavnoho borhu Ukrainy Tukmenystanu za 1993 rik."

¹⁴ *Rosporiadzhennia vid 13 zhovtnia 1994 (13 October 1994) "Pro nadannia banku 'Ukraina' garantiinykh zobov'iazan' shchodo pohashennia kredytiv, nadanykh korporatsii 'Respublika' dlia oplaty postavok prirrodnogo hazu iz Turkmenystanu."*

Kuchma said, "I want all of you to understand that at the end of this year, more than one billion USD is needed to pay the Russian Federation and Turkmenistan just for gas. We do not have such a sum. So, do think about the outcome if we break off negotiations with international organizations."¹⁵ Thanks to the IMF's support, Russian Gazprom agreed to restructure Ukraine's gas debts through a government bond (*Gazpromovok*) worth 1.4 billion USD in March 1995.¹⁶ This meant two creditors, the IMF and Gazprom, appeared as influential foreign actors with a voice in Ukraine's gas policy. Under this reform program, the import and distribution sector was gradually liberalized and several commercial companies joined this business. Among them were Bakai's new company *Interhaz*, Iu. Tymoshenko and V. Pinchuk's *Spivdruzhnist'*, and Itera's predecessor *Omurania*. They made direct contracts with Gazprom or the Turkmenistan government and sold to non-household consumers.

THE RISE OF THE GAS TRADERS THE EMERGENCE OF A REGIONALLY DIVIDED DISTRIBUTION SYSTEM (1996-1997)

It was Pavlo Lazarenko who institutionalized this liberalization and added a regional aspect to the gas trading business. In 1996, Lazarenko introduced his reform plan, the "regional divided distribution system." However, this was a typical example of "partial reform" and only benefited himself and his client.¹⁷ There were several actors that affected Lazarenko's decision. The first was the IMF. The IMF's main concern was to cut the internal payment arrears in Ukraine, which had

¹⁵ "Obrashchenie presidenta Ukrainy k Verkhovnomu Sovetu," *Golos Ukrainy*, 13 October 1994.

¹⁶ This agreement was a condition imposed by the IMF for granting Russia a large-scale stand-by credit. See Margarita Mercedes Balmaceda, "Gas, Oil and the Linkages between Domestic and Foreign Policies: The Case of Ukraine," *Europe-Asia Studies* 50:2 (1998), p. 262.

¹⁷ Joel S. Hellman, "Winners Take All. The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50 (January 1998), pp. 203-234.

been building up arrears to foreign gas producers and burdening the country with heavy state debts. For this reason, the IMF called for the imposition of tight financial discipline and a gas tariff adjustment. The IMF strongly criticized the state guarantee for the gas traders' import payments, as damaging to the state budget.¹⁸ It also urged a market-oriented reform of the gas sector to lighten the burden on the state.

The second actor that facilitated Lazarenko's reform was Russia's Gazprom, whose main concern was non-payment by Ukrainian importers. Ukrhazprom, a state gas monopoly had poor payment capability due to internal arrears. From this point of view, Gazprom, like the IMF, favored further commercialization of the Ukrainian gas market. Since the gas traders' commitment was limited to non-household consumers, they could be expected to suffer less from internal arrears. Gazprom regarded the gas traders as more capable business partners than Ukrhazprom. And if a gas trader did fall into debt to Gazprom, Gazprom could simply replace it with another.

At the same time, Gazprom used its creditor position to claim not only a property right to the GTS, but also the right to access the Ukrainian gas market to develop its own gas trading business. Gazprom pressured the Ukrainian government to give a large share to its favorite gas trader, the Itera company.¹⁹ Since late 1994, Itera had been handling and supplying Turkmenistan gas to the Ukrainian market through certain Ukrainian gas traders such as *Spivdruzhnist'* and *Omrانيا*, but at that time it had no direct access to Ukraine's consumers. Moreover, in October 1995, Gazprom, preparing for the liberalization of the Ukrainian market, founded the joint venture company "TurkmenRosGaz" to export Turkmenistan gas to Ukraine.²⁰ For these reasons, 1996 was the best time for Gazprom to develop its business in Ukraine.

The third actor facilitating Lazarenko's reform was the new president Kuchma. Having been the general director of the Southern Machinery Factory ("PivdenMash" or "IuzhMash") in Dnipropetrovsk,

¹⁸ Amer Bisat, "Ukraine's Gas Arrears: Issues and Recommendations," *IMF paper on Political Analysis and Assessment*, April 1996.

¹⁹ Pavel Aleksandro, "Bolezn' neplatezhei zagnali vnutr', no ona rvetsia naruzhu," *Kommersant Daily*, 3 April 1996.

²⁰ The Turkmenistan government held a 51 percent stake in this joint venture, while Gazprom had 45 percent and Itera held only four percent.

TABLE 3. NUMBER OF MPs BY FRACTION, AS OF MAY 1995

Fractions	Number of MPs
Communists	90
Agrarians	47
Socialists	27
People's Rukh	28
"State"	28
"Independence"	30
"Center"	30
Unity	31
IDG	30
"Reform"	35
Non-fraction	29
Total	405

Source: O. Haran', O. Maiboroda, eds., *Ukrains'ki liivi: Mizh leninizmom i sotsial-demokratieiu* (Kyiv, 2000), p. 102, Table 10.

Kuchma had weak power bases both in the government and in parliament. In the government, there were many elites from Donets'k who came to Kyiv at the peak of the energy crisis, while the left forces dominated parliament (Table 3). President Kuchma removed the old power structures and brought leaders from his homeland Dnipropetrovs'k to Kyiv. The main target of Kuchma's purge were leaders from Donets'k. In autumn 1993, supported by striking Donbass miners, the then Donets'k city mayor and a coal mine director, Iukhim Zviahil's'kyi, had driven the prime minister Kuchma to resign and took his place. Now it was Kuchma's turn for revenge. During Kuchma's political purge, Zviahil's'kyi was forced to flee to Israel for several years.²¹

In the parliament, Kuchma's faction, the "Interregional Deputies' Group" (*Mizhrehional'na deputats'ka grupa*; IDG), included only 30 parliamentarians, while the Communists, Socialists, and Agrarians had together over 150 parliamentarians and secured the posts of speaker

²¹ Zviahil's'kyi is Jewish.

**TABLE 4. GROUPING BY REGIONS
FOR THE SUPPLY OF NATURAL GAS IN 1996**

Name of Oblast	Name of the Distributor	Annual amount distributed (bcm)	Source (bcm)
Odesa, Kherson, Vinnytsia, Poltava, Zaporizhzhia, Rivne, Khmel'nyts'kyi,	Interhaz	7.8	Gazprom (10.0)
Donets'k, Kharkiv, Mykolaiv, U'viv, Zhytomyr, Kyiv, Ivano-Frankivs'k, Kirovohrad, Luhans'k, City of Kyiv, Crimea, City of Sevastopol'	Itera-Energy	16.8	From Central Asia
Dnipropetrovs'k, Donets'k, Cherkasy	United Energy Systems of Ukraine	25.2 (12.3 for non-household and 12.9 for household consumers)	Gazprom (25.1)
Chernivtsi, Volyn', Poltava, City of Kyiv, Kyiv Oblast	Olhaz	3.5	Gazprom
Motor Sich, Mariupoli Ilich, Azov Stal'	Motor Sich Mriupoli Ilich Azov Stal'	1.0 1.1 1.29	Gazprom
Rest of Oblasts	Ukrhazprom		

Source: Derzhavnyi komitet naftovoi, hazovoi ta naftoperepobnoi promyslovosti Ukrainy "Derzhnaftohazprom," quoted in *Zerkalo nedeli*, 27 January 1996, p. 6.

and first deputy speaker. Kuchma had to cooperate with a pro-presidential fraction, "Unity (*Ednist'*)," led by Pavlo Lazarenko. Lazarenko was the presidential representative in Dnipropetrovs'k Oblast and a strong supporter of Kuchma in the 1994 presidential elections (Table 3). President Kuchma invited him to be the first deputy prime minister in September 1995. After Kuchma removed Marchuk from the premiership in May 1996, Lazarenko succeeded to the post. Charged with Kuchma's authority, Lazarenko launched a partial reform of the gas sector.

In 1996, the government under Lazarenko proposed a policy to reform the system of gas trading. At the beginning, this plan aimed to satisfy the IMF, Gazprom, Kuchma, and every party concerned. As Lazarenko explained it, he aimed to reduce the state company's role and stop the further accumulation of state debts to Russia and Turkmenistan. As a result of Lazarenko's reform, the non-household consumer market was divided along oblast and district lines.²² Each

²² See Lazarenko's interview with *Zerkalo nedeli*. Alla Eremenko, "Avtor pravil igry," *Zerkalo nedeli*, 20 April 1996.

gas trader who received a license covered only specified regions (Table 4). According to Lazarenko, this scheme combined commercial principle with a social safety net. Under the scheme, each commercial gas trader would make profit on a commercial basis, while relatively poor consumers were protected to an extent. Each gas trader had a monopoly of distribution within each "territory," but they had to supply whether their consumers were profitable or not. According to Lazarenko, each region had both rich and poor consumers, so that overall gas traders would be able to make profits. If the gas traders could not turn a profit, the government would replace these gas traders with other gas traders.

The government would control the gas price: inter-governmental negotiation would set import prices and the government would fix transport and storage fees. However, barter operations would easily bypass this price control. Each gas trader made direct purchase agreements with Gazprom. The government did not guarantee their import payment. This non-guarantee policy was the IMF's main concern and Lazarenko himself had on several occasions stressed this principle. However, the non-guarantee policy was frequently ignored at Gazprom's request.

In order to maintain social tranquility, the state company Ukhazprom covered all household consumers, as well as non-household consumers in relatively poor regions. Ukhazprom was able to compensate with its own resources. First, Ukhazprom had the cheapest gas sources, such as the domestic gas fields and Russian gas received as a transport fee from Gazprom. This cheap gas was primarily allocated to household consumers. Second, Ukhazprom received transport fees from the gas traders. Each gas trader contracted with Ukhazprom to transport and store gas. The transport fee and storage fee were fixed at 2 "conditional units"²³/1000 cm and 10 "conditional units"/1000 cm respectively.

The most controversial aspect of Lazarenko's system was which traders were granted the rich regions, namely Dnipropetrovs'k and Donetsk Oblasts (Tables 4 and 5). These two were the largest gas consumers. Also, metallurgy and machine-building enterprises were

²³ In Russia and Ukraine US dollars have been called by this term since the governments have prohibited the settlement of accounts by foreign currencies.

concentrated in these two regions. Having control over these enterprises through gas distribution guaranteed profit.

TABLE 5. GRP AND GAS CONSUMPTION BY REGIONS
(PERCENTAGE OF ALL UKRAINE)

	GRP (in 1996)		Gas consumption (in 1998)	
1	Donets'k	12.3	Donets'k	15.9
2	Dnipropetrovs'k	9.4	Dnipropetrovs'k	13.7
3	Kyiv City	7.4	Kharkiv	6.8
4	Kharkiv	6.3	Luhans'k	6.8
5	Zaporizhzhia	5.4	L'viv	5.7

Source: *Statystychnyi shchorichnyk Ukrainy za 2001 rik* (Kyiv, 2002), p. 47, Table 2.9; *Statystychnyi shchorichnyk Ukrainy za 1998 rik* (Kyiv, 1999), p. 97, Table 5.9.

Lazarenko allocated his home region to Yuliia Tymoshenko's gas trading company, United Energy Systems of Ukraine (*Edyni Enerhetychni Systemy Ukrainy*; UESU). The partnership between Lazarenko and Tymoshenko could be traced to 1992, when Lazarenko was the governor of Dnipropetrovs'k and granted her company the monopoly on gasoline supplies to agro-industrial complexes.²⁴ Unlike other gas traders, UESU had a license to supply household consumers in Dnipropetrovs'k. Why did the UESU want to supply these poor consumers? UESU sold natural gas to household consumers through regional gas suppliers, and could offset any losses with the bills of exchange from the enterprises, which the regional administration collected as tax.²⁵

Donets'k was divided into three sections, and Itera took the largest share.²⁶ Donets'k Oblast' itself asked the Kyiv government to grant the gas trading license. In winter 1995, prior to the introduction of the regionally divided system, Donets'k oblast Rada (regional council) adopted a resolution creating an "Industrial Union of Donbass" (*Industrial'nyi soiuz Donbassa*; IUD), which it was hoped could be the

²⁴ "Yuliia Tymoshenko kak simvol Ukrainskoi revoliutsii," *Nezavisimaia gazeta*, 25 April 2001.

²⁵ V. Khmurych and T. Tkachenko, "Opportunities for Corruption in the Ukrainian Gas Market," *Eurasia Foundation*, 1999. URL (<http://www.eurasia.org/programs/eerc/kyiv/papers/khtk.htm>)

²⁶ See Itera's press release, 7 April 2004.

²⁷ *Biznes*, 25 June 1996.

TABLE 6. GROUPING BY REGIONS FOR THE SUPPLY OF NATURAL GAS IN 1997

Name of Oblast	Name of the Distributor	Annual amount distributed (bcm) (for non-household/ household consumers)	Source (bcm)
Kharkiv, Chernihiv, Crimea, City of Sevastopol', Donets'k	Ukrhazprom, Ukrmafita, Chornomor naftohaz	30.73 (8.83/21.9)	Received from Gazprom as a transit fee (32.0) Domestic production (15.0)
Odesa, Kherson, Vinnytsia, Poltava, Zaporizhzhia, Khmel'nyts'kyi, Kharkiv	Interhaz	8.3 (8.3/ 0)	Gazprom (10.0)
Luhans'k, Ivano-Frankivs'k, Kyiv (Bila Tserkva), L'viv, Mykolaiv, Sumy, Ternopil', Stipol	Itera-Ukraine	11.1 (11.1/ 0)	From Central Asia (11.5)
Dnipropetrovs'k	UESU	15.5 (5.4/ 10.1)	Gazprom (15.5)
Cherkasy, Zhytomyr, Rivne	Ukraine Gas Company	4.0 (4.0/ 0)	From Central Asia (4.0)
Kirovohrad, Dnipropetrovs'k, Zaporizhstal'	Uzbekhazintez	3.0 (3.0/0)	From Central Asia (3.0)
Poltava	Poltava Gazonafta Company	0.3 (0.3/0)	Poltava Gazonafta Company
Donets'k	Ukrainian Gas-resource Company	10.0 (8.0/2.0)	N/a
Total		82.93 (48.93/34.0)	

Source: Derzhavnyi komitet naftovoi, hazovoi ta naftoperepobnoi promyslovosti Ukrainy "Derzhnaftohazprom," *List vid 19 koitnia 1997 roku*, No. 17-174; Postanova KM vid 23 hrudnia 1996 r. (23 December 1996) No. 1539.

exclusive supplier of natural gas to the whole of Donets'k oblast. Donets'k mayor V. Shcherban' pushed Kyiv to grant IUD a license, but Lazarenko rejected his petition as "illegal."²⁷ Eventually, Lazarenko compromised by issuing licenses to two giant metallurgy complexes in Donets'k, as well as to the Zaporizhzhia-based turbine engine manufacturer "MotorShich" and automobile manufacturer "AvtoZaz." These companies obtained the right to contract directly with Gazprom for their own consumption.

The heyday of Lazarenko and Tymoshenko continued into 1997. In addition to Dnipropetrovs'k, they attempted to extend their influence to the Donets'k region. In 1997, Lazarenko took the initiative of creating the "Ukrainian Gas-resource Consortium" (*Ukrains'kyi hazoresursnyi konsortsium*; UGC). Formally, this was a joint venture of UESU and

Ukrhazprom. In practice, however, UGC was under the control of Lazarenko-Tymoshenko since UESU and its related company kept a large portion of the consortium's shares and M.I. Syvul's'kyi, Lazarenko's economic adviser, was appointed as its president. UESU had thus captured two of the most profitable oblasts, Donetsk and Dnipropetrovs'k. Itera lost the lion's share in Donetsk, while Interhaz maintained its share (Table 6).

Lazarenko-Tymoshenko's heyday did not continue long. His system was attacked by President Kuchma and Gazprom, and finally collapsed in the middle of 1997. For Kuchma, Lazarenko was a threat because his sponsorship by UESU meant that he could be a powerful contender in the future presidential elections. Gazprom objected to the fact that UESU together with UGC had eroded Itera's market share.

In July 1997, under pressure from Kuchma, Lazarenko resigned and went back to his hometown. He still held the governor's seat in Dnipropetrovs'k. At the same moment, Gazprom shut off gas supplies to UESU because of its arrears. According to Gazprom, UESU owed 50 million USD as of October 1997. UESU was not the only gas trader in arrears; others were too, including Interhaz. At that that point, Interhaz owed 320 million USD to Gazprom. However, Interhaz found a stronger patron in President Kuchma and the new Prime Minister, Valerii Pustovoitenko. For Kuchma and Pustovoitenko, the enemy of their enemy was their friend. In August 1997, 12 bcm of gas belonging to Interhaz, was accidentally discovered in UGS.²⁸ Thanks to this gas, Interhaz could continue business, while UESU was forced to retreat because of the fall of its political patron.

UESU's share was taken by Interhaz, Itera, IUD and Interpipe. Also, like other gas traders, UESU owed 49 million USD to Ukrhazprom in transit fees (as of August 1997). UESU had to give up its holdings, such as stock in the Khartsiz Tube factory (KhTZ), to offset this debt. And in 1998, UESU failed to renew its license and ceased its gas trading business *de jure*. Bakai's situation contrasted with Tymoshenko's; his company continued business, and in September 1997 he was named first deputy chairman of the State Committee of Oil and Gas.

²⁸ See the trilateral negotiation between Gazprom, Ukrhazprom and Interhaz, reported by *Zerkalo nedeli*, 6 September 1997.

THE DUOPOLY OF ITERA AND NAFTOHAZ UKRAINY (1998-2002)

The experience of Lazarenko's regional distribution system provided costly lessons for the IMF, Gazprom and President Kuchma. The IMF took several occasions to denounce Ukraine's partial reform policies. First, the IMF strongly criticized Ukrhazprom's vertically integrated structure. An IMF paper declared that, "the current vertical integrated structure of Ukrhazprom (production, transmission, and storage by one company) should be broken up."²⁹ Disintegration and privatization of Ukrhazprom were necessary to reduce state interference as well as attract foreign capital, the IMF believed. Second, the strict implementation of the "no guarantee" policy remained the IMF's concern. While Lazarenko stated on several occasions that the government would not guarantee commercial gas traders' gas imports, there were still several cases when the government guaranteed gas import payments, especially in the winter season when the demand peaked. In the close relationship between government officials and the gas traders, the latter easily drew guarantees from the former.

Gazprom was disturbed by the fact that the partial reform did not resolve the payment arrears. Many gas traders accumulated debts. According to Gazprom, UESU and Interhaz had to repay debts in the amount of 400 million USD to Gazprom. The governmental guarantees further complicated collection of the debts, since it was difficult to agree who took responsibility for the debt, the government or the gas traders.

Kuchma and his camp were running for parliamentary election in 1998 and the presidential election in 1999. Pavlo Lazarenko and his client UESU were the main threat to Kuchma's reelection. Kuchma learned the lesson from Lazarenko that a regional distribution system gave an advantage to political patrons. Also, he learned to keep control over the market in order to counter Gazprom-Itera's expansion.

Kuchma's answer was to reverse liberalization. In February 1998, Kuchma ordered the dissolution of Ukrhazprom and the creation of

²⁹ Laszlo Loveu and Konstantin Skorik, "Commercializing Ukraine's Energy Sector" in Peter K. Cornelius and Patrick Lenain, eds., *Ukraine: Accelerating the Transition to Market* (IMF, 19 February 1997), pp. 204-207.

NaftoHaz Ukrainy.³⁰ According to this presidential decree, NaftoHaz Ukrainy was to be a national company in which the government retained 100 percent of the stock, and its purpose was to increase the level of the state's security as well as improve the efficiency and development of the oil and gas complex. The vertically integrated structure of Ukrhazprom was broken up and specialized companies were formed. However, NaftoHaz was able to control these companies because it held the majority of their stock. Unlike Ukrhazprom, NaftoHaz also brought state oil companies such as Ukrnafta (oil production) and Druzhba (oil transport) into affiliation with its structure (Table 7).

TABLE 7. NAFTOHAZ UKRAINY'S VERTICAL INTEGRATION STRUCTURE

	Daughter companies (% of NaftoHaz's shares, as of January 1999)
Production	Chornomor Naftohaz (100%), Ukrnafta (50%+1 stock), Ukrhazvydobuvannia (100 %)
GTS	Ukrtranshaz (100%)
Import	NaftoHaz Ukrainy
Distribution	Haz Ukrainy (100%)

Source: *Biznes*, 1 February 1999, p. 29.

The establishment of NaftoHaz can also be seen as an attempt by President Kuchma to regain control of the whole gas sector. This was the reason why he appointed Ihor Bakai as the first president of NaftoHaz Ukrainy. Bakai had twice bankrupted his companies and damaged the state budget, but Kuchma was less interested in his business ability than in his political loyalty. From the viewpoint of collecting gas payment debts, the creation of NaftoHaz benefited Gazprom, since the government guaranteed NaftoHaz's gas import payments. But Gazprom continued to push Itera into Ukraine's gas market. Gazprom stopped supplying to those gas traders that had non-payment arrears to Gazprom and replaced them with Itera.³¹ By the end of 1998, there were only two gas importers in Ukraine: NaftoHaz and Itera. All other gas traders were limited to gas distribution, purchasing their gas from NaftoHaz or Itera.

³⁰ *Uriadovi kur'ep*, 5 February 1998.

³¹ *Interfax-Ukraine*, 27 November 1998.

RETURN TO THE STATE MONOPOLY THE TWILIGHT OF GAS TRADERS (2002-)

Despite the Ruble Crisis in August 1998 and the default of Ukrainian government bonds in 2000, the year 2000 was the first since Ukraine's independence that the country's economy experienced growth. Although the incumbent Prime Minister V. Yushchenko's reforms certainly contributed to this economic growth, the largest contributor was Russia, Ukraine's biggest trading partner. Even after the ousting of Yushchenko from the government, the National Bank of Ukraine continued to buy US dollars on the inter-bank market to increase the circulation of the Hryvnia and promote further monetarization of the economy, exploiting a positive balance of trade as well as of current account. This monetarization, together with economic recovery, eliminated non-monetary transactions and resolved wage and pension arrears. This led to an improvement of payment discipline as well as an increase in cash payments (Table 8).³² According to Haz Ukrainy, the distribution branch of NaftoHaz, the collection rate was 74.5 percent in 1999, 77 percent in 2000, and 98.0 percent in 2003.³³ Also, the rate of collection in cash rose dramatically from 29.9 percent in 1998 to 90.4 percent in 2003.

TABLE 8. INCREASE IN COLLECTION RATE

	1999	2000	2001	2002	2003
Collection rate (%)	74.5	77	89.4	90.4	98.0
Paid in Cash (%)	29.9	NA	87.0	88.9	90.4

Source: *Energeticheskaia politika Ukrainy*, July 2000, p. 49; *NaftoHaz Ukrainy press release*, 21 January 2004 and 31 January 2003.

The monetarization of the economy had two effects. For the gas traders, the decline of barter transaction was disadvantageous for business. From the gas importers' perspective, the increase in the cash collection rate implied that NaftoHaz and Itera no longer needed gas

³² State pricing policy also contributed to this improvement. Since April 1999, the gas tariff for household consumers has been fixed at 185 UAH per 1,000 cm.

³³ These figures only cover customers of Haz Ukrainy. In 2002, Haz Ukrainy sold 44.4 billion cubic meters, the equivalent of 60 percent of total national gas demand.

traders. Now, the importers could easily overcome payment arrears without the mediation of gas traders.³⁴ As a result, from July 2002, NaftoHaz and Itera moved to the “direct regime,” excluding the middlemen who stood between gas importers and the end consumers.³⁵ At this point, the history of the gas traders seemed to be at an end. But this regime only survived for half a year. Itera suddenly disappeared from the Ukrainian market.

Itera’s ousting was mainly led by Gazprom, or President Putin, who wanted to keep control of Gazprom. Under his Gazprom reform, the “mysterious partnership” between Gazprom and Itera was revoked. Clearly, Gazprom intended to push Itera out of the CIS market. This plan took shape in the winter of 2002. From 25 November 2002, Gazprom started to limit supply to Itera, on the grounds of Itera’s payment arrears in the amount of 30 million USD. On 20 January 2003, Gazprom announced a full halt to gas supplies to Itera, citing non-payment. According to Itera, from the beginning of 2003, Gazprom suddenly insisted on 100 percent pre-payment from Itera, while other companies remained under the previous payment regime.³⁶

At the same time, Gazprom adopted even more blatant means to squeeze Itera. Gazprom offered NaftoHaz a cheaper tariff for the transport of Turkmenistan gas, which was previously operated by Itera. Gazprom’s tariff was 38 percent of the value of the gas that NaftoHaz bought from TurkmenNefteGaz, a state monopoly company, while Itera’s previous tariff was 41 percent. Itera had received gas from NaftoHaz in payment for this transportation and sold it to the Ukrainian market; so the loss of NaftoHaz’s business meant a loss of gas resources for Itera.³⁷ Without Gazprom and Turkmenistan as sources of gas, Itera

³⁴ Interview with A. Kiselev, general director of Haz Ukrainy in Alla Eremenko, “Razvitie biznesa v interesakh gosudarstva – osnovnaia zadacha NAKa,” – schitaet general’nyi direktor DK ‘Gaz Ukrainy’ Aleksandr Kiselev,” *Zerkalo nedeli*, 10-17 August 2002.

³⁵ “Protokol o namerenniakh po itogam rabochii vstrechi rukovodstva NAK ‘Naftogaz Ukrainy’ i MEK ‘Itera’ otnositel’no mekhanizma postavok i realizatsii v Ukraine prirodnogo gaza iz resursov MEK ‘Itera’ vo II polugodnii 2002 g.”; *Press release of Naftohaz Ukrainy* “NAK ‘NaftoHaz Ukrainy’ pereishov na realizatsiiu prirodnogo hazu vykliuchno za priamymy dohovoramy,” Kyiv, 5 July 2002.

³⁶ Itera’s press release, 24 January 2003.

³⁷ “Gazprom’ reshil prekratit’ postavku gaza ‘Itery’ v Ukrainu”, *Ukrainskaia investitsionnaia gazeta* 4 (2003), pp. 17 and 23.

could not supply Ukraine's market, and in January 2003 NaftoHaz agreed to Gazprom's plan to eliminate Itera from both the distribution and import sectors. The Gazprom-NaftoHaz alliance used the same tactics against Itera as Gazprom and Kuchma had used to oust UESU in 1997. Gazprom introduced Itera to Ukraine's gas market and, a decade later, removed it.

CONCLUSIONS

The political and economic realignment of the former socialist space can be understood only with the help of approaches combining analyses of domestic and international affairs. This chapter examined ten years of interactions between Ukraine's domestic clan politics and the Russian factor.

The last decade of development in the gas distribution market is summarized as a cycle of state monopoly, liberalization, and then a new state monopoly. However, the current monopoly is not a simple renewal of the previous one. The former was a residue of the socialist economy; the Ukrainian state simply took over this monopoly from the Soviet regime. As we discussed above, Ukraine could not sustain this remnant of the socialist economy and was forced to launch reforms. On the other hand, natural gas extractive countries, such as Russia and Turkmenistan, or Belarus relying on the gas export countries' mercy, can resist the worldwide trend of neo-liberal reform. Recent conflict between Gazprom and the Lukashenka regime shows that Belarus no longer maintains a system that functions on the assumption of cheap Russian gas. Belarus will have to follow the Ukrainian experience to a certain extent.

In Ukraine, this monopoly was dissolved by the de-monetarization of the economy, by changing political conditions, and above all under pressure from Gazprom and the IMF. Partial reform and political turmoil created a peculiar gas market system, nurturing the gas traders while allowing the penetration of Russian capital.

However, economic recovery and especially monetarization and the consolidation of presidential power removed the spaces in which

gas traders and their patrons operated. The present state monopoly is a result partly of changes in the presidency, partly of the reform of Gazprom, and partly of the progress of monetarization. By comparison with the previous monopoly, it is far more rooted in a money-based economy. As NaftoHaz explained, monopoly was a first step to fundamental reform since monopolization wiped out tax evasion and other aspects of the black market in which some gas traders operated.³⁸

Throughout this decade, the role of the Russian government has been disputable. In September 1995, President Yeltsin issued his decree on the Establishment of the Strategic Course of the Russian Federation with CIS member states in order to accelerate the process of reintegrating former Soviet republics through multilateral and bilateral agreements and institutional arrangements. However, what happened in 1996 was that Russian capitalists pursued their own interests rather than pressure Ukraine into the CIS integration process. And in 2003, in contrast to Chubais's "liberal empire" idea, the Russian government withdrew Russian capital from the Ukrainian gas market. At that moment, Putin's priority was Gazprom's reform rather than the expansion of the Russian capital into Ukraine's market. And, to some extent, the importance of the role of these non-state actors would confirm the development of interdependence between the two countries.

In addition, the role of IMF is less important than previously. Due to the four-year-long stable economic growth, Ukraine no longer relies on the IMF's credit. Since 2002, Ukraine has drawn no credit from the IMF. Moreover, Ukraine concluded a Standby Arrangement with the IMF in March 2004. There are voices arguing that Ukraine should maintain a good relationship with the IMF not for the sake of credit but as a symbol of commitment to economic reform, which helps to attract foreign investment.

Currently, the Ukrainian government plans to reform its gas market and to re-liberalize to harmonize with EU legislation.³⁹ Though Ukraine shares borders with EU member countries and her aspiration

³⁸ "Okonchatel'noe reshenie gazovogo voprosa," *Ukrainskaia investitsionnaia gazeta* 21 (2003).

³⁹ The EU requires member states to open at least 33 percent of the total annual gas consumption to the national gas market. See *Directive 2003/55/EC*, Article 28 (3).

for EU membership is high, there is little momentum from the EU on this matter. Rather, the Russian capitalists would be potential candidates to operate in this re-liberalized market. Putin's Russia will probably advance the presence of Russian capital in Ukraine. However, it is unlikely that Russian capitalists will intrude into Ukraine as actively as in 1996, because Russia's government and Gazprom have less leverage than before. Thanks to stable economic recovery, Ukraine is no longer under pressure from Gazprom or its large shareholder. The Ukrainian government fulfilled its obligations to Gazprom on schedule, and since 2000 Ukraine has paid almost all of its import gas fees. Still, it is uncertain whether Ukraine is on the way to joining its western neighbors, the European mega-area, or, on the contrary, to being re-absorbed by its long time northern economic partner.