

## *Chapter Thirteen*

# **Transatlantic Energy Security and Ukraine: Politics, Corruption and National Interests**

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Ukrainian energy policies during the last two decades of Ukrainian independence are closely tied to the country's evolving domestic politics and foreign policy. Four Ukrainian presidents<sup>1</sup> and twelve (of fifteen) governments have not dismantled the system in place, which draws high rents from the energy sector. As Chatham House's James Sherr states, no Ukrainian government has sought to break the pattern of dependency, opacity, rent seeking and preferential pricing, since any such effort would have broken the close ties between big business and power.<sup>2</sup>

The three governments that were the exception to this rule were Viktor Yushchenko in 2000-2001, where Yulia Tymoshenko was Deputy Prime Minister with responsibility for energy; and two governments headed by Prime Minister Tymoshenko in 2005 and 2007-2010. The Yushchenko government cancelled 250 government resolutions that provided subsidies to companies on energy, many of whom operated in Ukraine's large shadow economy.<sup>3</sup> The anti-corruption crusader Prime Minister Yushchenko proved to be very different to

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<sup>1</sup> Leonid Kravchuk (1991-1994), Leonid Kuchma (1994-2004), Viktor Yushchenko (2005-2010) and Viktor Yanukovich (2010-).

<sup>2</sup> James Sherr, *The Mortgaging of Ukraine's Independence* (London: Royal Institute International Affairs, August 2010).

<sup>3</sup> Oleh Rybachuk, head of the presidential secretariat in 2005-2006, is cited in "17 myt-tyevostey vesniy 2001-ho," by *Istorychna Pravda*, 29 April 2011. Ukraine's shadow economy is estimated by the government and World Bank to account for 40-50 percent of GDP. See Taras Kuzio, "Political Culture and Democracy: Ukraine as an Immobile State," *East European Politics and Society*, vol.25, no.1 (February 2011), pp. 88-113.

President Yushchenko, who was a defender of opaque gas intermediaries. President Yushchenko blocked Tymoshenko's attempts to remove the gas intermediary RosUkrEnergo.<sup>4</sup>

Ukraine's energy sector has been the source of the greatest degree of corruption in the country and the extraction of rents from this sector have taken priority over the country's energy independence, national security and efficiency. The declared national interest of energy independence from Russia has often been defined as a key strategic goal in Ukrainian legislation and by experts, but has never become a priority for Ukrainian leaders.

With short-term frames of reference, Ukraine's elites have preferred to cooperate with Russia in opaque gas schemes rather than investing in domestic oil and gas production or reducing gas consumption through greater energy efficiency. Ukraine, which was an exporter of gas until the 1970s, has sufficient reserves to produce up to 80% of its gas needs, up from 20% currently. But investment in greater domestic production would require Ukrainian leaders with vision who are ready to implement market economic reforms and prioritize the national interest. Such leaders have yet to materialize. As Margarita Balmaceda writes, control over key aspects of Ukraine's energy policy "was actually given to economic actors with a clear interest in the maintenance of Ukraine's energy dependency status quo."<sup>5</sup>

This chapter discusses four ways in which high levels of corruption in Ukraine's energy sector have ramifications upon transatlantic and European security. First, it leads to the prioritization of corruption and short term interests over reforms. Second, corruption is exported to western European NATO and EU members. Third, instability in energy relations between Russia and Ukraine could lead to a repeat of the 2006 and 2009 crisis crises. Fourth, prioritization of personal over national interests, as seen in the imprisonment of Julia Tymoshenko, derails Ukraine's European integration and leads to its possible geopolitical re-orientation towards Russia and the CIS.

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<sup>4</sup> RosUkrEnergo was established by Presidents Vladimir Putin and Kuchma at a July 2004 Yalta meeting to replace Eural-Trans Gas, established in 2002.

<sup>5</sup> Margarita M. Balmaceda, *Energy Dependency, Politics and Corruption in the Former Soviet Union* (Abingdon and New York: Routledge, 2008), p. 76.

## **It's a Gas**

Ukraine remains the seventh largest gas consumer in the world because gas consumption is highly inefficient and Ukraine's energy intensity is 2-2.5 times higher than EU levels. Around one-third is produced domestically with the remainder imported from Russia and Central Asia. Consumption of gas did not significantly decrease during the economic depression of the 1990s (when Ukraine suffered one of the highest declines in GDP in the former USSR) because a large proportion of the imported gas was re-exported. Re-export of gas brought huge profits for a large proportion of Ukraine's elites. Annual consumption of 75-78 bcm of gas remained consistent throughout the first two decades of Ukrainian independence with only the U.S. and Russia, both of whom have far larger populations and economies, consuming more gas. Following the 2004 Orange Revolution and Viktor Yushchenko's election as president of Ukraine, Russia massively increased the price of gas edging it towards "market levels" that Ukraine pays since 2010. The increase in imported gas prices has led to a halving of Ukraine's gas consumption to 35-40 bcm.

Ukrainian gas trader Ihor Bakay, in exile in Russia since the 2004 Orange Revolution, once famously said that most Ukrainian oligarchs made their initial capital on the re-export of Russian gas. Ukraine's private gas debts to Russia were passed to the Ukrainian state. Contracts "were most often with offshore companies of dubious provenance and involved the transfer of highly profitable areas of activity to them at the expense of state income and state decision-making power."<sup>6</sup> The Ukrainian state and taxpayers were lumbered with debts incurred from corrupt energy deals.

High gas dependency upon Russian energy supplies and a close corrupt relationship between Russian and Ukrainian elites in the energy sector has stymied Ukraine's Euro-Atlantic integration throughout the last two decades. From May 1997, when an agreement on the Black Sea Fleet was signed with Russia, until 2009 Ukraine was "paid" a paltry \$100 million annual rent for the Sevastopol Black Sea Fleet naval base. Ukraine never received any of this rent because it was used to pay off gas debts accumulated by private traders and oligarchs

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<sup>6</sup> Balmaceda, p. 73.

who had passed their debts to the Ukrainian state. The Black Sea Fleet has therefore been a hostage to Ukraine's energy dependency and corruption. The April 2010 "Kharkiv accords" extended the Sevastopol base until 2042-2047 in exchange for a mythical "thirty percent discount" on gas import prices. The Black Sea Fleet has de facto obtained a permanent naval base that, as in the case of Georgia during the 2008 war with Russia, could be used to promote separatism and block Ukraine's Euro-Atlantic integration.<sup>7</sup>

As Balmaceda points out, energy became both a "bottleneck in the country's economic development and Ukraine's Achilles Heel in its relations with Russia" that has led to multi-vector and muddled foreign policies that have balanced between the CIS and Europe. Dependency has led to "increased pressure for closer economic and political integration with Russia" and thereby increased Ukraine's vulnerability and reduced its ability to negotiate from a strong position.<sup>8</sup> Russian-Ukrainian energy corruption undermined rhetoric in favor of Euro-Atlantic integration by Presidents Kuchma and Yushchenko.

Russia has always controlled the narcotics fix that Ukraine, a "gas junky," has needed. Rising energy prices have forced some business owners to restructure Ukrainian industry, and Ukrainian companies have substituted the use of natural gas with more efficient technology, including the use of pulverised coal that requires no inputs of gas (Ukraine has the 9th largest coal deposits in the world). Nonetheless, Ukraine remains one of the top five world consumers of gas and Ukraine's big business continues to prefer Yanukovich's willingness to trade sovereignty for "cheaper" Russian gas (for example, through the 2010 extension of the Black Sea Fleet base). As with all Ukraine's gas contracts, the touted benefits of "discounted gas" were illusory except for a small group of corrupt elites and oligarchs.

As Roman Kupchinsky has pointed out, Ukraine is one of the most energy wasteful countries in the world. It consumes more natural gas—74 billion cubic meters in 2003—than Poland, Hungary, the Czech Republic, and Slovakia combined. Despite the huge amount of

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<sup>7</sup> See T.Kuzio, *The Crimea: Europe's Next Flashpoint?* (Washington DC: The Jamestown Foundation, November 2010).

<sup>8</sup> Balmaceda, p. 77.

energy Ukraine consumes—1.5% of the world's total energy consumption according to the U.S. Energy Information Administration (EIA)—Ukraine's GDP of \$300 billion in 2004 was far below Poland's figure of \$463 billion.<sup>9</sup>

Households also benefitted, as Ukraine had one of the highest subsidized utility prices in the former USSR. There were no price increases of household utilities from 1998 until Russia dramatically increased gas prices following Yushchenko's election in December 2004. In 2006 Ukrainian households paid less for utilities than households in Belarus, or approximately twenty percent of the real cost of imported gas. The huge subsidy was passed to the state-owned Naftohaz Ukrainy gas company that made it perennially close to bankruptcy and added two percent to the state's budget deficit.

A condition of the 2008 and 2010 IMF agreements with the Tymoshenko and Nikolai Azarov governments respectively was the removal of subsidies to household utilities (and thereby reducing the budget deficit and transforming Naftohaz Ukrainy into a solvent entity). The Tymoshenko government ignored the IMF demand in the midst of the 2008-2010 global financial crisis and on the eve of January 2010 presidential elections. The Azarov government went half way and increased household utilities by fifty percent in August 2010 but then retreated and did not implement the second fifty percent increase, fearful of the consequences of public disapproval for the Party of Regions ahead of the October 2012 parliamentary elections.<sup>10</sup> The Azarov government has instead gone the traditional Ukrainian route of seeking cheaper below market Russian gas at the expense of national interests such as giving up control over its gas pipelines.

## **Energy Corruption**

Every gas contract signed by Ukraine has been opaque and corrupt, benefitting Ukrainian elites rather than the state.<sup>11</sup> Balmaceda writes,

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<sup>9</sup> Roman Kupchinsky, "Ukraine: An Unrepentant Gas Junkie," *RFERL Commentary*, 17 January 2006.

<sup>10</sup>See Roman Olearchyk, "Ukraine: time to call the IMF?" *Financial Times*, 3 October 2011.

<sup>11</sup>Balmaceda, p. 76.

“neither democrat nor oligarch, nationalist or friend of Russia seemed to be able to resist the temptation of its embrace or, perhaps, the fear of violent retribution reserved by the ultimate organizers of energy corruption for those who might seek to dismantle their profitable schemes.”<sup>12</sup> Nationalists in the Yushchenko team were as willing to participate in energy corruption as pro-Russian politicians in the Kuchma or Yanukovych administrations. Retribution for not playing by the rules set out by elites has been tough against politicians such as Tymoshenko who has twice been imprisoned for seeking to dismantle schemes that provide energy rents.

Edward Chow,<sup>13</sup> Senior Fellow in the National Security Program at Washington’s Center for Strategic and International Studies, believes Ukrainians successfully established one of the most efficient schemes in the world for extracting corrupt rents from the energy sector:

*“If you set out to design a gas sector that is optimised for corruption, it might look very much like Ukraine’s. You would have at its centre a wholly state-owned company that is not accountable to anyone other than the head of the country who appoints its management. It would operate non-transparently without discipline by either shareholders (who might demand legal rights as owners) or capital markets (since there is an implicit sovereign guarantee behind the company’s borrowings). Domestic production would be priced artificially low, ostensibly for social reasons, leading to a large grey market on domestic gas supply that is allocated by privileged access rather than by price.”*

Chow continues:

*“As a result, consumers who have access to a cheap supply of gas use it in a wasteful manner and those who do not suffer shortages. Low gas prices suppress domestic gas production and energy efficiency, thereby necessitating the import of large volumes of gas which ‘coincidentally’ is controlled by the same state monopoly. Even though the state company buys gas from another state monopoly*

<sup>12</sup>Balmaceda, p. 137.

<sup>13</sup>Interview with Edward Chow, Washington DC, June 2, 2011. E. Chow’s biography can be found here: <http://csis.org/expert/edward-c-chow>.

*from a neighbouring country, more frequently than not it utilises a middleman who has no discernible capabilities to import gas. The opaque middleman is paid handsomely in-kind, rather than with money, and in turn resells the gas to a higher-value market beyond the country's borders."*

Finally, Chow believes:

*"Foreign investment in the gas sector is discouraged since this would highlight the failings of the state company and force market-clearing domestic pricing, which would spoil the whole corruption optimisation scheme that you have set up. The game itself is ultimately unsustainable and highly costly to the country, but it is also high rewarding to insiders in the game."*

Ukraine has utilized opaque gas intermediaries since the mid 1990s: Itera (1995-2001), Eural-Trans Gas (2002-2004) and RosUkrEnergo (2005-2009). President Putin, according to Balmaceda, proposed the replacement of Eural Trans Gas with RosUkrEnergo in July 2004 because he wanted to utilize it for geopolitical purposes to export greater volumes of gas to the EU. Dmitriy Medvedev, then Gazprom Chairman, became together with Putin major beneficiaries of the new gas intermediary.

On the Ukrainian side RosUkrEnergo was established by President Kuchma, Prime Minister Yanukovych and Naftohaz Ukrainy CEO Yuriy Boyko. Boyko is named on a document dated July 2004 as a member of RosUkrEnergo's key management committee.<sup>14</sup> In March 2010, Global Witness, a British NGO, raised concerns that Boyko had returned as Minister of Energy and Coal in the Nikolai Azariev government.<sup>15</sup> With the Kuchma era coming to a close and the likelihood of Yushchenko being elected Ukraine's elites needed to ensure their survival in the new era. Boyko established the Republican Party (RPU) that, after a brief existence, merged with the Party of Regions

<sup>14</sup>See "It's a Gas It's a Gas. Funny Business in the Turkmen-Ukraine Gas Trade" (London: Global Witness, July 25, 2006), available at: <http://www.globalwitness.org/library/its-gas-funny-business-turkmen-ukraine-gas-trade>.

<sup>15</sup><http://www.globalwitness.org/library/global-witness-concerned-choice-new-ukraine-energy-minister>.

in 2006. Then Foreign Minister Konstantyn Gryshchenko joined the RPU and continued in government service under Yushchenko as deputy head of the National Security and Defence Council and Ambassador to Russia. The Azarov government returned him as Foreign Minister, a position which he has used to support criminal charges against Tymoshenko. Tymoshenko, he alleges, is supported by Russia and the EU because the 2009 gas crisis was beneficial to them—but not to Ukraine.<sup>16</sup>

The Ukrainian side was interested in extracting greater energy rents—not in geopolitics or the national interest. This was clearly seen in the decision by President Kuchma to not accept the Russian proposal that RosUkrEnergo be a joint venture of two state-owned gas companies: Gazprom and Naftohaz Ukrainy. The Ukrainian side instead opted to include two individuals—Dmitriy Firtash and Ivan Fursin—as owners of 45 and 5 percent respectively of RosUkrEnergo with Gazprom owning the remaining 50 percent. Ukrainian Prime Ministers Yuriy Yekhanurov (2005-2006) and Viktor Yanukovych (2006-2007) supported the structure of RosUkrEnergo and ruled out Naftohaz Ukrainy buying out Firtash and Fursin.<sup>17</sup> Billions of dollars that could have potentially been earned annually in gas transit to Ukraine and the EU would have ensured that Naftohaz Ukrainy would never be close to bankruptcy. These profits were instead diverted to oligarchs and senior Ukrainian officials.

Global Witness, a London-based NGO, commented:

*“Naftohaz Ukrainy, as the state gas company of Ukraine, has a clear role to play in the Ukrainian gas market. Gazprom, as a supplier of gas, has a commercial interest in this market too. But what is the commercial rationale for involving RosUkrEnergo, a company with no track record in the gas industry? What service does RosUkrEnergo provide to the gas trade that cannot be provided by Naftohaz Ukrainy?”*

Global Witness continued:

<sup>16</sup>Interview with Konstantyn Gryshchenko in *Ukrayinska Pravda*, 28 September 2011.

<sup>17</sup>Balmaceda, p. 134. See also R. Kupchinsky, *Gazprom's European Web*, Jamestown Foundation special report, February 2009. [www.jamestown.org](http://www.jamestown.org).

*“RosUkrEnergo made profits of over US\$700 million in 2005. Meanwhile, Naftohaz Ukrainy has accrued debts of over US\$500 million, mostly to RosUkrEnergo. Is it in Ukraine’s benefit for Naftohaz to be so indebted to this private company, or for Ukraine to cede half of its domestic market to RosUkrEnergo via the new joint venture UkrGazEnergo?”*<sup>18</sup>

The pro-Western Yushchenko did not increase transparency in Ukraine’s energy sector or ensure that energy policy began to serve the national interest. The 2006 gas contract, signed following the first of two major gas crises with Russia during his presidency, maintained the RosUkrEnergo intermediary in Ukraine’s gas relationship with Russia. The 2006 contract, “hints of a personal interest in the agreements” as Yushchenko, “not only knew of the real owners behind RosUkrEnergo but may have received important benefits from them.”<sup>19</sup> The Ukrainian delegation did not follow instructions from the Ministry Foreign Affairs or the government (Prime Minister Yekhanurov was excluded from the negotiation) but from Firtash and Naftohaz Ukrainy Deputy Chairman Oleh Voronin.

Ukrainian Centre for Economic and Political Studies expert Valeriy Chaly, Deputy Foreign Minister under Yushchenko, described the 2006 gas contract as Ukrainian diplomacy’s “Pearl Harbor.” The gas price remained unstable, transit fees were set for five years, a non-transparent pricing mechanism was put in place which did not foresee an increase to market prices, and the right to re-export gas was taken from Naftohaz Ukrainy and given to RosUkrEnergo. Re-export of gas is a lucrative business and RosUkrEnergo again diverted potential profits away from Ukraine’s state gas company that was saddled with supplying the unprofitable housing market. The profitable distribution of gas to Ukrainian industry was given to a newly established company UkrHazEnergo, a joint venture between Gazprom and RosUkrEnergo.

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<sup>18</sup> “New Ukrainian administration must answer key questions about Naftohaz Ukrainy and RosUkrEnergo,” *Global Witness*, 25 July 2006. See <http://www.globalwitness.org/library/new-ukrainian-administration-must-answer-key-questions-about-naftohaz-ukrainy-and>

<sup>19</sup>Balmaceda, p. 128.

In winter 2008-2009 the second gas crisis lasted longer, seventeen days, during a bitterly cold winter. Although Europeans welcomed the gas contract concluded between Prime Ministers Tymoshenko and Putin, the negotiations were not transparent and it has therefore remained unclear why Tymoshenko agreed to some of its terms. On the positive side the contract removed RosUkrEnergo and thus for the first time Ukraine-Russia traded gas on a bilateral level without the use of opaque intermediaries. The contract also agreed to introduce the principle, for the first time, of gradually increasing gas prices to market levels—although unexplainably transit fees were not to grow to market levels.

On the negative side, “[t]he deal imposed a very high base price for gas of \$450 per thousand cubic meters; a strict payment regime, which following any default could force Ukraine to pay for gas in advance; very high take-or-pay clauses that forced Ukraine to pay for gas it could not possibly use; and no ship-or-pay obligations on Gazprom (hence Gazprom, without penalty, could reduce shipments to Ukraine).”<sup>20</sup> These aspects of the 2009 gas crisis have led to criminal charges launched against Tymoshenko.

Why did Tymoshenko agree to these terms? As gas negotiations between Ukraine-Russia have never been transparent we will never know the answer to this question. Tymoshenko was under intense pressure from Yushchenko (who lobbied for RosUkrEnergo to remain in place) and the EU (to end the 17 day gas cut off). The EU therefore would have welcomed any deal that was made. Speculation has suggested Tymoshenko agreed to the terms in exchange for Putin agreeing to remove RosUkrEnergo. Yushchenko and Yanukovych have alleged that Tymoshenko agreed to the terms in exchange for Putin’s support in the 2010 elections and after agreeing to extend the agreement for the Sevastopol Black Sea Fleet base. Tymoshenko may have been seeking to score a double strike against Yanukovych ahead of the presidential elections by eliminating a major source of funding from the gas lobby and Putin’s support.

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<sup>20</sup>Alan Riley, “Corruption in Kiev and an E.U. Trade Pact,” *The New York Times*, October 4, 2011.

The criminal charge against Tymoshenko for abuse of office under a 1962 Soviet criminal code is a charge that is tantamount to having taken the wrong political decision in the 2009 gas contract. Such a criminal article or charge would not take place in any democratic country with the rule of law (see below). There would be as much grounds for applying the same criminal charges against those who signed the 2006 gas contract (“Ukrainian diplomacy’s Pearl Harbor”) as that of the 2009 contract. The 2010 “Kharkiv Accords” and the decision made by Ukraine to establish a gas consortium over Ukraine’s pipelines with Russia (60%), a German company with ties to Gazprom (20%) and Ukraine with the remaining 20%, that would bring Naftohaz Ukrainy under greater influence of Gazprom, will also be construed as a bad political decision by the opposition. To establish a consortium, parliament will have to change the February 2007 law that prevents the sale, lease, or rent of the pipelines. The law was lobbied by then opposition leader Tymoshenko and voted through by a massive majority of 430 deputies (out of 450)—including by the Party of Regions—although opposed by the Yanukovich government.<sup>21</sup>

## **Western Ukrainians and Energy**

Firtash, although a Hungarian name, grew up in the Bukovina city of Chernivtsi and is Ukraine’s only western Ukrainian oligarch. Firtash has never provided much information about his rise to the senior levels of Ukrainian business and politics. A U.S. Embassy cable from Kyiv following a December 2008 meeting between Firtash and U.S. Ambassador William Taylor revealed interesting details about his early life and how he entered business. In addition to Firtash, present at the meeting were consultant and AmCit Zev Furst, and Andras Knopp, the Hungarian-born number two at RosUkrEnergo.

Firtash, according to the U.S. diplomatic cable, “acknowledged ties to Russian organized crime figure Seymon Mogilevich, stating he needed Mogilevich’s approval to get into business in the first place. He was adamant that he had not committed a single crime when building his business empire, and argued that outsiders still failed to under-

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<sup>21</sup>Pavel Korduban, “Ukraine and Russia Prepare New Gas Agreement,” *Eurasia Daily Monitor*, vol. 8 Issue: 178 (28 September 2011).

stand the period of lawlessness that reigned in Ukraine after the collapse of the Soviet Union.”<sup>22</sup> Ties between organized crime and the energy sector in the former USSR had long been written about in Western specialist publications but these had always been the brunt of legal proceedings from oligarchs keen to whitewash their images.<sup>23</sup>

Western Ukrainians have played a prominent role in Ukraine’s corrupt energy sector. These have included Congress of Ukrainian Nationalists (KUN) leader Oleksiy Ivchenko who was based in Turkmenistan in the 1990s and worked with Bakay in the Itera gas intermediary. Ivchenko headed Naftohaz Ukrainy in 2005–2006 and KUN was a member of Yushchenko’s Our Ukraine bloc in the 2002 and 2006 elections. Ivchenko’s gas business partner Bakai financed the 2000–2001 coalition of national democratic and centrist factions that backed the Yushchenko government.

Firtash had seen the writing on the wall after the second round of the 2004 elections on 21 November when the Orange Revolution derailed plans to install Yanukovich as president. Firtash became an important financial backer for Yushchenko’s election campaign following a December 2004 meeting between them and Serhiy Levochkin, a senior adviser to President Kuchma. Yushchenko reached agreement with the energy lobby in his first year in office and supported RosUkrEnergo throughout his presidency. In summer 2005 the presidential secretariat ordered a halt to the pending arrest of former Naftohaz Ukrainy CEO Boyko by Security Service (SBU) Chairman Oleksandr Turchynov, Prime Minister Tymoshenko’s right-hand man.<sup>24</sup> As Global Witness asked, “And what of the criminal investigation concerning RUE, launched by former Ukrainian State Security chief Aleksandr Turchynov in 2005? Why was this investigation never completed, and why does the office of the current SBU chief deny that an investigation ever took place?”<sup>25</sup>

<sup>22</sup>[www.guardian.co.uk/world/us-embassy-cables-documents/182121](http://www.guardian.co.uk/world/us-embassy-cables-documents/182121)

<sup>23</sup>Jane’s Information Group and Radio Free Europe–Radio Liberty were forced to retract articles on Eural Trans Gas and remove them from their web sites.

<sup>24</sup>Balmaceda, pp. 123–124.

<sup>25</sup>“New Ukrainian administration must answer key questions about Naftohaz Ukrainy and RosUkrEnergo,” *Global Witness*, 25 July 2006. See <http://www.globalwitness.org/library/new-ukrainian-administration-must-answer-key-questions-about-naftohaz-ukrainy-and>.

Firtash, like all Ukrainian oligarchs, is a pragmatist with no ideology and can therefore cooperate with all political groups if they do not intervene in his business affairs. In Ukraine all members of the establishment have been willing to cooperate with Firtash except Tymoshenko who has not been willing to play by their rules. Firtash and Yushchenko had close relations throughout his presidency and Firtash invested in many cultural and educational projects that the president supported. In February 2009 Firtash was awarded a state medal in gratitude for his financial donations.<sup>26</sup>

At the December 2008 meeting between Firtash and U.S. Ambassador Taylor:

*“Firtash admitted that he has “loyally served” as an unofficial advisor to President Yushchenko during tense gas negotiations with Russia and political crises dating back to the Orange Revolution in 2004. He reported that he met with the Yushchenko at his dacha (cottage residence) three times in the last week at the President’s request. He described himself as a close friend and confidante of the President—someone the President can trust totally.”*<sup>27</sup>

While maintaining a cooperative relationship with President Yushchenko at the parliamentary level, Firtash supported Yanukovych and the Party of Regions, becoming an alternative source of funding to established Donetsk oligarchs such as Rinat Akhmetov. Firtash, Yushchenko and Yanukovych had a common interest in their contempt for Tymoshenko and worked together to prevent her election in 2010. Firtash thereby “strengthened the position of those wanting a closer relationship with Russia.”<sup>28</sup> The gas lobby elbowed aside Donetsk oligarchs, such as Akhmetov, and established a commanding influence over the Party of Regions.

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<sup>26</sup>Firtash invested in the re-building of Cossack encampments, such as Baturyn, and donated a large endowment to Lviv’s Ukrainian Catholic University. Firtash provided \$7 million for the launch of a Ukrainian cultural program at Britain’s Cambridge University. On Firtash’s funding see the *Kyiv Post*, 24 September 2010 and 19 May 2011.

<sup>27</sup>[www.guardian.co.uk/world/us-embassy-cables-documents/182121](http://www.guardian.co.uk/world/us-embassy-cables-documents/182121).

<sup>28</sup>Balmaceda, p. 136.

This strategy enabled the gas lobby to come to power with Yanukovich in 2010 when its representatives received key appointments in the Yanukovich administration. Party of Regions deputy Nestor Shufrych confirmed that the RosUkrEnergo gas lobby, within which he includes Levochkin, controlled the Yanukovich administration.<sup>29</sup> Levochkin became head of the Presidential Administration, Valeriy Khoroshkovsky was promoted from First Deputy Chairman (a position he received from Yushchenko) to Chairman of the SBU, and Boyko was appointed Minister for Fuel and Coal. Khoroshkovsky ordered the SBU's Alpha anti-terrorist special forces to storm Naftohaz Ukrainy offices in retaliation for the elimination of RosUkrEnergo from the 2009 gas contract. Firtash revealed his contempt for Tymoshenko to U.S. Ambassador Taylor at the December 2008 meeting and, together with Khoroshkovsky, was able to take revenge against Tymoshenko after Yanukovich came to power—even at the cost of possibly undermining Ukraine's European integration.<sup>30</sup> Firtash and Khoroshkovsky are partners on Inter, Ukraine's most popular television channel, an important resource during elections as its main audience is in Russian-speaking eastern Ukraine.

### **Tymoshenko and Selective Use of Justice: The Gas Connection**

Tymoshenko had participated in opaque gas schemes during the 1990s when she was CEO of United Energy Systems. But, after Tymoshenko was appointed Deputy Prime Minister in the Yushchenko government and twice Prime Minister during Yushchenko's presidency, she worked to close gas intermediaries. Among Ukraine's politicians only Tymoshenko has sought to remove gas intermediaries and battle corruption in the energy sector, and in retaliation the establishment has twice imprisoned her in 2001 and 2011.

Tymoshenko was imprisoned in January-February 2001 on charges related to her position as CEO of United Energy Systems in the 1990s. United Energy Systems operated with Itera and her political sponsor was Prime Minister Pavlo Lazaenko. In 1998 Tymoshenko

<sup>29</sup>Interview with Nestor Shufrych in *Segodnya*, July 13, 2011.

<sup>30</sup>[www.guardian.co.uk/world/us-embassy-cables-documents/182121](http://www.guardian.co.uk/world/us-embassy-cables-documents/182121)

entered parliament in Hromada (Community), a political party established by Lazarenko. A year later, Lazarenko's parliamentary immunity was removed and he fled abroad, eventually seeking diplomatic asylum in the U.S., which put him on trial for money laundering. In 2006 Lazarenko was sentenced to nine years in prison by a U.S. court for extortion, money-laundering through American banks and fraud. In 1999 Tymoshenko launched her own political party, *Batkivshchina* (Fatherland), becoming the main political party in the Tymoshenko bloc in the 2002, 2006 and 2007 elections. *Batkivshchina* is an associate member of the center-right European People's Party which has been vocal in condemning in the European Parliament democratic regression in Ukraine under Yanukovych and selective use of justice against Tymoshenko.

The arrest of Tymoshenko on August 5, 2011 was tied to the authorities' fear that they were losing control of the trial in three ways. Firstly, they did not see the outcome they had planned for, namely, daily proceedings pointing to alleged guilt on Tymoshenko's part. Evidence provided by witnesses for the prosecution during the trial was neutral or even supportive of Tymoshenko's innocence, as in the case of testimony by *Naftohaz Ukrainy* CEO Oleh Dubyna. This is because, Oleksiy Krasnopyorov believes, "the instinct of self-preservation amongst the 'political class' has come to the fore."<sup>31</sup> Secondly, the trial proceedings had degenerated into what former Ambassador to Ukraine Steven Pifer described as a "farce."<sup>32</sup> Other Western figures pointed to how the authorities were desperate to find any charge that would "stick." Thirdly, and most importantly, live proceedings from the court room and intense questioning of witnesses by Tymoshenko began to publicly reveal too many details of the inner corrupt workings of the Yushchenko and Yanukovych administrations.

The first witness to be called who was interrogated about RosUkrEnergo was former Prime Minister and Our Ukraine leader Yekhanurov who has always had an image of a center-right reformer loyal to Yushchenko. Yekhanurov's replies about RosUkrEnergo showed him to be disinterested in questions of corruption, market pricing or national security—three issues that the gas intermediary

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<sup>31</sup>*Ukrayinska Pravda*, August 2, 2011.

<sup>32</sup>Steven Pifer, "Undemocratic values will isolate Ukraine," *Kyiv Post*, July 2, 2011.

had greatest influence over. In a lengthy interview Yekhanurov said the “Problem of RosUkrEnergo is thought up, it is the basis of business conflicts between two gas traders.”<sup>33</sup> For Yekhanurov the only important factor in his decisions as prime minister was the lower price of gas offered by RosUkrEnergo. The Russian demand in 2006 for Ukraine to pay \$230 per 1000 cu m. was “unacceptable” and the Yekhanurov government therefore agreed to RosUkrEnergo’s proposal of \$95. Yekhanurov said: “Before me was a price of \$230 from Gazprom and \$95 from RUE. Therefore I chose 95.” After his court interrogation, Yekhanurov repeated, “What difference does it make who will be selling the gas? As long as this gas is delivered to Ukraine.” “I believe that Ukraine would agree (to use RosUkrEnergo) today if the gas price was not as bad as the one that exists today.”<sup>34</sup>

The choice was in fact a non-choice as Yekhanurov should have asked his advisers and SBU how it was possible for RosUkrEnergo to offer a price that was 2.5 times cheaper unless there the pricing formula was not transparent. Yekhanurov chose a non-market pricing formula that was opaque and never questioned how RosUkrEnergo—with a statutory fund of only \$US20,000—could be involved in gas trading in a business that had an annual turnover of billions of dollars.

One of the most damning witnesses in the Tymoshenko trial proved to be Dubyna, CEO of Naftohaz Ukrainy during the 2007-2010 Tymoshenko government. His testimony was not always favorable to Tymoshenko but was startling for his revelations about RosUkrEnergo’s links to President Yushchenko whom, he argued, lobbied its interests during the 2008-2009 gas negotiations with Russia. As part of this lobbying effort, President Yushchenko and RosUkrEnergo sabotaged the negotiations Tymoshenko was conducting towards a lower gas price. Dubyna testified that he was called back to Kyiv on December 31, 2008 by President Yushchenko to prevent the signing of a cheaper price gas deal. Asked during his testimony if he had contact with RosUkrEnergo’s founders and managers, Dubyna replied: “Yes. I met with them only in the presidential administration. Three times in Viktor [Yushchenko]’s office, twice in the office of [Viktor] Baloga,” who was then chief of staff. Baloga resigned from the position of head

<sup>33</sup>Interview with Yuriy Yekhanurov in *Ukrayinska Pravda*, July 14, 2011.

<sup>34</sup>Ibid.

of the presidential secretariat in May 2009 and worked for Yanukovich's election campaign. Trans-Carpathia, Baloga's home region, was the only western Ukrainian region which voted for Yanukovich in the 2010 elections. Baloga was rewarded with the position of Minister of Emergency Situations in the Azarov government.

Political analyst Viktor Nebozhenko pointed out that Tymoshenko's arrest on August 5, 2011, which damaged negotiations towards, and future ratification of, a Deep Comprehensive Free Trade Agreement between Ukraine and the EU, coincided with the approaching interrogation of former President Yushchenko. "I believe these two events are inter-dependent," he said.<sup>35</sup> Mustafa Nayem in a lengthy analysis of Yushchenko's place in the trial wrote how testimony given at the trial had revealed concrete facts, "that confirm ties between the ex-president with the gas intermediary and the role these ties played in the 2009 gas crisis."<sup>36</sup> Yushchenko's testimony to the Tymoshenko trial supported the charges laid against her.

Dubyn revealed that up to December 31, 2008 Ukraine could have signed a contract with a price of \$235 per 1000 cu.m. and gas transit prices of \$1.8 which he believed were a good deal for Ukraine. But President Yushchenko forbade him from signing this favorably priced contract. Gazprom head Alexey Miller told his Ukrainian counterpart, Naftohaz Ukrainy head Dubyn: "I have a letter from RosUkrEnergo that they are ready to pay 295 for all the gas. This is backed by Yushchenko's word."<sup>37</sup> Investigative journalist Nayem concluded that this testimony will enter "the handbooks on questions of corruption in the highest levels of state officials."

Tymoshenko was first arrested on August 5, 2011 for "contempt of court" and sentenced on October 11, 2011 to seven years imprisonment, a three year ban from political life and fine of 1.5 billion *hryvnia* (approximately \$200 million) The "7+3" charges ban Tymoshenko from the next two presidential and three parliamentary elections, conveniently removing her from politics during two potential presidential

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<sup>35</sup>Viktor Nebozhenko cited on [www.politdumka.kiev.ua](http://www.politdumka.kiev.ua), August 5, 2011.

<sup>36</sup>Mustafa Nayem, "Sud nad Yuliyu Tymoshenko: na arenu vykhodyt Viktor Yushchenko," *Ukrayinska Pravda*, August 1, 2011.

<sup>37</sup>*Ukrayinska Pravda*, August 1, 2011.

terms for Yanukovich up to 2020. The sentence, refusal to heed the flood of Western criticism and new charges against Tymoshenko led the EU to cancel the October 20, 2011 Brussels visit by Yanukovich, where he was to finalize negotiations on the Association Agreement ahead if its signing in December 2011 at the EU-Ukraine summit in Kyiv.

To add oil to the fire, the Security Service (SBU) launched two additional criminal charges against Tymoshenko related to when she was CEO of United Energy Systems in 1995-1997 and the assassination of Viktor Yushchenko's protégé, banker Vadym Hetman in 1998. Both charges are linked to former Prime Minister Pavlo Lazarenko, who was sentenced in August 2006 by the U.S. to nine years imprisonment on money laundering charges.

SBU Chairman Valeriy Khoroshkovsky's intervention was the latest in a number of similar steps that all had the objective of damaging Ukraine's European integration. Khoroshkovsky was promoted to the position of First Deputy Chairman of the SBU by President Yushchenko in January 2009 and became its Chairman in March 2010. His interventions have led Ukrainian experts to conclude, as one of four members of the pro-Russian gas lobby, that he heads a pro-Russian group within the Yanukovich administration with the strategic objective of integrating Ukraine into the CIS Customs Union. Khoroshkovsky and Firtash jointly own Inter, Ukraine's most popular television channel, that is mainly watched in eastern-southern Ukraine, the voter base for the Party of Regions.

Tymoshenko's trial descended into what former U.S. Ambassadors to Ukraine Steven Pifer and William Taylor described as a "farce." Taylor described criminal prosecution of the opposition as a "bad precedent" and "madness", telling Radio Svoboda, Radio Liberty's Ukrainian language service, "It's hard to understand why criminal charges are brought against the political decisions of the previous administration" because it "is a very bad precedent for future governments." This is because "The next government may start judging the current one."<sup>38</sup>

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<sup>38</sup>Ex-US ambassador calls Yanukovich's policy 'madness,' *Interfax-Ukraine*, August 29, 2011, Steven Pifer, "Undemocratic Values will isolate Ukraine," and "Does Yanukovich get it?" *Kyiv Post*, July 28 and September 20, 2011.

The trial was viewed as a “farce” because Tymoshenko was sentenced under article 365 for abuse of office” which first was introduced in the 1962 criminal code when Nikita Khrushchev was Soviet leader. The article remained in Ukraine’s criminal code that was adopted in 2001. No similar article exists in any rule of law-based European or U.S. democracy, as it punishes politicians for undertaking the “wrong” decision, a very subjective charge that is open to high degrees of political manipulation by those who are in power.

The criminal charge opens up a Pandora’s box of counter-charges if the Yanukovich team is voted out of office, a threat that could make Yanukovich seek to hold on to power indefinitely. This, in turn, makes the likelihood of free elections in Ukraine in the near future a remote possibility.<sup>39</sup> The OSCE cannot recognize elections as having been held in “accordance with democratic values” if opposition leaders sit in jail. The sentencing of Tymoshenko and unwillingness to heed Western demands has placed the Association Agreement in jeopardy; even if it were to be signed there is no likelihood of the Agreement being ratified by the European Parliament and the parliaments of 27 EU members.

### **Ramifications for Transatlantic and European Security**

High levels of corruption in Ukraine’s energy sector have ramifications upon transatlantic and European security in four ways. First, the temptation of drawing high levels of rents from the energy sector has made Ukrainian elites prioritize short-term gain over the medium-long term benefits of reforms. Ukrainian elites have paid lip service to support for reforms throughout the last two decades and have failed to fulfil the demands placed upon them by the IMF and EU. Second, the inefficiency of Ukraine’s energy sector, lack of modernization and corruption has external ramifications. Corruption and a poor business environment have made foreign investors wary of investing in Ukraine’s energy sector and pipelines. Much of the corrupt proceeds from Ukraine’s energy sector are exported to western European EU and NATO members. Offshore zones Cyprus and the British Virgin

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<sup>39</sup>See T.Kuzio, “Can Ukraine Hold Free Elections Next Year?” *Eurasia Daily Monitor*, Volume: 8, Issue: 191 (October 18, 2011).

Islands are the first and fifth largest foreign investors in Ukraine. London and Britain have received a huge injection of finances from Ukraine, Russia and the CIS. Ukrainian oligarchs Renat Akhmetov and Viktor Pinchuk bought two of the most expensive properties in British history in 2009–2011 for a combined total of US\$400mn.

Third, unstable energy relations between Ukraine and Russia could lead to further gas crises as took place in 2006 and 2009. As Ukraine is a major transit route for Russian and Central Asian gas to NATO and EU members, gas crises can lead to major security threats, as seen in the seventeen-day cut off in January 2009. Fourth, personal and business interests are of greater importance than the national interests of Ukraine which can derail Ukraine's integration into Europe and change the balance of power by leading to Kyiv's reorientation towards Russia and the CIS Customs Union. Revenge against Tymoshenko for removing the opaque gas intermediary RosUkrEnergo from the 2009 gas contract with Russia is more important in the eyes of Ukraine's elites than European integration. The signing of an Association Agreement (which includes a Visa Free Regime and a Deep and Comprehensive Free Trade Agreement) with the EU is far less important than personal revenge or enrichment—even though it would benefit the country and its citizens.

## Conclusions

After two decades of Ukraine as an independent state, corruption has become an integral part of Ukrainian society, business and politics. Corruption emerged in the 1990s transition to a market economy and has never been tackled by any Ukrainian president. The energy sector has been the most tempting for corrupt elites from all political groups and regions as the greatest rents can be extracted from it that give incumbents greater advantage in politics. Western Ukrainians have played a prominent role in gas corruption and Ukrainian nationalist party leaders have dropped their anti-Russian rhetoric when travelling to Moscow to negotiate corrupt energy deals.

What continues to remain unclear is why Prime Minister Yushchenko supported Tymoshenko's policies to reduce energy corruption while President Yushchenko blocked both Tymoshenko gov-

ernments' attempts to undertake similar policies. President Yushchenko continued the state and executive's involvement in corruption that he had opposed as prime minister. Energy corruption was a major factor in bringing about the failure of Yushchenko's presidency and the Orange Revolution and thereby facilitated the coming to power of Yanukovych and the gas lobby.

Ukraine's mismanaged energy policy and high level corruption in the energy sector has four ramifications for transatlantic and European security. First, it leads to vacuous rhetoric about reforms and a failure to fulfil demands to reform sectors of the economy, finances, rule of law and corruption that are placed upon Ukraine by the IMF and EU. Second, it leads to the export of corruption to western European members of NATO and the EU. Third, unstable relations with Russia could lead to further gas crises as shook NATO and EU members in 2006 and 2009. Finally, the domination of personal over national interests, as seen in the revenge undertaken by the Yanukovych administration against Tymoshenko for successfully removing RosUkrEnergo, can change the balance of power in Europe. The imprisonment of Tymoshenko was strongly condemned by the EU, US and Canada and will lead to the European Parliament and 27 EU members failing to ratify the Association Agreement. If European integration is blocked, Kyiv has threatened to join the CIS Customs Union, which would establish a second 'Belarus' on the eastern borders of NATO and the EU.<sup>40</sup>

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<sup>40</sup>See T.Kuzio, "Surreal Eastern Partnership Summit: EU Gives Ukraine Last Red Card," *Eurasia Daily Monitor* Volume: 8 Issue: 185 (October 7, 2011).

