

Chapter VI Ukraine's Status and Role with Reference to Oil and Gas in Central Asia

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Chapter VI

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1. *Ukraine's Position in Relation to the Development of the Caspian Oil and Gas Resources*

Ukraine, the former Soviet republic, with a population of 50 million, is the second largest Slavic country after Russia. Geographically, Ukraine is bordered in the north-east by Russia, in the north by Belarus, in the west by Poland and Slovakia, and in the south-west by Hungary, Romania, and Moldova. It is clear that Ukraine is an important country that holds great influence in the future of the Commonwealth of Independent States (CIS). Ukraine has often been called a "strategic pivot of Europe," and its independence has been seen as a key factor for the future of the CIS. In particular, Ukraine has a decisive influence on the shape of Russia, in the sense that the mutual relations between the two countries have a significant impact on Russia's status within the CIS. At independence, Ukraine remained a nuclear power, along with Russia, Belarus, and Kazakhstan, because of the nuclear weapons which had been deployed there under the Soviet Union. In 1994 it signed an agreement with the United States and Russia, pledging that it would hand over to Russia all its nuclear arsenal for destruction, in return for an assurance of nuclear fuel supplies for nuclear power generation. Ukraine implemented already the agreement.

However, Ukraine's economic reform efforts following independence have faced many difficulties, because conservatives and reformers have maintained parity with each other. Ukraine's former status as one of the key weapons manufacturing bases of the Soviet Union has had a negative effect on its post-independence efforts at economic rehabilitation, pushing its gross domestic product (GDP) down below less than half of what it was before independence. Hard hit has been the country's eastern district, which has a heavy concentration of metal, machinery as well as weapons industries, and the rapid shrinkage of the markets for the weapons industry has brought about a sharp de-

cline in manufacturing production as a whole. It is also important to consider the extremely energy-devouring nature of Ukrainian heavy industry, which is seriously straining the country's supply and demand balance for energy. It is thus imperative for Ukraine to introduce energy-saving technologies and transform its industrial structure as promptly as possible. It should be kept in mind, however, that though the country's economy is currently being afflicted by serious difficulties, it has enormous potential in terms of agricultural and manufacturing production.

It has large coal deposits within its borders and produces 84 million tons of coal a year (as of 1995), as well as limited amounts of oil and natural gas, but these supplies of energy are far from sufficient to meet domestic demand; it thus depends on Russia and Turkmenistan for large portions of its energy supplies. Unlike in the pre-independence days when industrial production was sustained by subsidized low energy prices, energy prices have now approached international levels, dealing a serious blow to its industrial production. Moreover, because of the slow progress in the energy conservation which would be needed to offset the rise in energy prices, firms have fallen into arrears with their payments to other firms, and the country itself has fallen into arrears in paying its bills for the oil and gas imports from Turkmenistan. Ukraine's failure to pay its energy import bills has suppressed the country's nuclear, thermal, and hydroelectric power production.

For Ukraine, reducing its current, excessive dependence on Russia for supplies of nuclear fuel, oil, and natural gas as much as possible is an indispensable prerequisite for pursuing a more autonomous diplomatic policy. In its attempt to diversify the sources of its energy supplies, Ukraine has been closely following the progress of the new oil and gas development projects in Uzbekistan, Azerbaijan, and Kazakhstan. Its international policy stance because of its weight in the CIS will thus have a significant bearing upon the future of the Cauca-

sian and Central Asian countries.

2. *Ukraine's Relationship with Russia and Its Pursuit of Autonomous Diplomacy*

The development of the Caspian oil resources will have impacts on the CIS' unity, as understood not narrowly in terms of whether the Caucasus and Central Asia will remain integral parts of it. Ever since the CIS was established following the dissolution of the Soviet Union, there has been a complex mixture within it of momentum toward its dissolution and opposing momentum toward further unification. For approximately six and a half years (as of this writing) since the proclamation of its independence on August 24, 1991, Ukraine has continued to be affected more seriously by its diplomatic relations with Russia than the other members of the CIS, and to see its diplomacy with Russia affected more seriously by various conflicting factors. The path trodden by Ukraine has been radically different from that followed by Belarus, another Slavic country, which tightened its relations with Russia through the conclusion in March 1997 of an agreement on a customs union, followed by the signing of a Treaty of Customs Union with Russia, Kazakhstan, and Kyrgystan, also during the same month, and by the signing with Russia in April 1998 of a treaty for promoting closer cooperation on matters concerning economic policies and national security. In contrast, during years since independence, Ukraine's relations with Russia had been characterized by a series of conflicts which were far from conducive to improving relations: the dispute over the delivery of its strategic nuclear warhead to Russia; the question of how the Black Sea Fleet should be divided between the two countries; the question of territorial rights over the Crimean Peninsula; and the question concerning natural gas transactions. At long last, however, the signing of an extensive treaty of friendship between the two countries in May 1997 opened the way for improving the bilateral relationship. The trend toward rapprochement suddenly gathered momentum in November 1997, when the two countries agreed to bring their trade war to an end, pledging to lift the value-added taxes which they had been imposing on each others' imports. At that occasion Russia also agreed to open its domestic market to Ukrainian

sugar, and to give Ukraine a grace period for paying US\$100 million of outstanding bills for natural gas imports. It is reported that the trade between the two had been cut back by 20 percent by the value-added taxes, and that Ukraine had been struck especially hard, sustaining a yearly loss in import revenues to the tune of one billion dollars. As such, the value-added taxes were an important cause of its chronic economic crisis. Toward the end of February 1998, the two countries signed an agreement which, with its extensive coverage of matters such as economic cooperation, is expected to help boost Russian investment in Ukraine.

At the beginning of 1997, Russian-Ukrainian ties were strained when the latter signed a contract with Pakistan for the supply of US\$600 million worth of tanks. In the subsequent process of reconciliation, speculation has begun to be voiced in some quarters that Ukraine may sign a treaty with Russia similar to the one concluded by Belarus. Talks about this probability has alarmed Brzezinski and others in the United States who are skeptical of Russia. Ukraine is the third largest recipient of American foreign aid, after Israel and Egypt, but as of late its relations with the West have not been fully amicable. Ukraine has tried to maintain a delicate balance between its ties with Russia and with NATO, by participating, for instance, in a joint military exercise with NATO, while holding a joint naval exercise with Russia.

One central concern for Russia in terms of diplomacy is how it can maintain the CIS in good shape, and maintain or reinforce its leadership role within it. In this regard, the expansion of NATO is a serious challenge. Another no less serious challenge is the possibility that the Caucasian and Central Asian countries may opt to form a bloc outside of its influence, by capitalizing on the powerful leverage of their oil and gas deposits. Russia is concerned about how Ukraine would act in such an eventuality. Ukraine for its part has been cautious about any strengthening of the CIS umbrella in line with Kazakhstan's insistence, because in its opinion this would only end up boosting Russia's influence within the grouping.

As evident from the foregoing observations, the Russian-Ukrainian relationship are far from simple. President Kuchma of Ukraine visited Almaty, Kazakhstan's capital, and met with President Nazarbaev in mid-October 1997, at a time when Kazakhstan's relationships with Russia were re-

ported to have grown sour and strained, most likely because the newly established Russian Ministry of Resources had invited bids in the summer of 1997 for the exploitation of the oil deposits in the northern Caspian Sea, where both Kazakhstan and Russia were claiming territorial rights. Also, more than 10 bilateral treaties for economic cooperation between Ukraine and Kazakhstan were signed immediately after Georgian President Eduard Shevardnadze issued a statement in Tbilisi criticizing Ukraine for pursuing a policy of economic integration with Russia. Seen in this context, Ukraine's rapprochement with Kazakhstan can be interpreted as a manifestation of its effort to assert a degree of independence from Russia within the CIS. Ukraine and Kazakhstan also hinted at the possibility that they might join a four-party free trade treaty (the "New Silk Road Initiative") signed in 1996 by Azerbaijan, Georgia, Uzbekistan, and Turkmenistan. It should be kept in mind, however, that Ukraine and Kazakhstan, which both depend on Russia for more than half of their trade, cannot easily belittle their economic ties with it.

On the other hand, other groupings with overlapping members are also being formed within the CIS. In 1997, for instance, Georgia, Ukraine, Azerbaijan, and Moldova – a group of four countries collectively called the "GUAM coalition" because of their shared interests in promoting intra-regional trade in the Caspian and Black Sea, especially trade in energy resources – took steps to enhance intra-group solidarity.

During his summit meeting in Almaty mentioned earlier, President Kuchma observed: "So long as Ukraine's Achilles heel is its total dependence on Russia for its supplies of oil, natural gas, and nuclear energy, it cannot but be deeply interested in Kazakhstan's oil and gas exports." Kazakhstani President Nazarbaev responded by saying that Kazakhstan, too, was interested in having its oil resources transported to the Caspian Sea, Azerbaijan, the Black Sea, Ukraine's port of Odessa, and further on to European markets. The construction of the southern pipeline outside of Russian control will have the effect of loosening the existing relations of mutual dependence within the CIS. Ukraine, through its support for the pipeline, is trying to switch its energy procurement system to one which is not excessively dependent on Russia.

In an effort to make it possible to import oil from Central Asia and the Middle East, Ukraine is

expanding the oil transshipment facilities in the port of Odessa which faces the Black Sea. This will help Ukraine to reduce its present dependence upon the Druzhba and the Pivdeny pipelines from Russia. For the time being, Ukraine plans to increase the oil handling capacity of the port of Odessa to 12 million tons a year during 1998, and to 40 million tons a year by the year 2000. It has already signed an agreement with Azerbaijan for 700,000 tons of oil imports for fiscal year 1997-98, and hopes that in the future its imports of Caspian crude oil will be transported through the Caucasus to the Black Sea, shipped to the port of Odessa, and then delivered to markets inside Ukraine.

In early 1998, Ukraine concluded a gas supply agreement with Turkmenistan under which it would receive a yearly supply of 20 billion cubic meters of Turkmenistani gas until 2005. Turkmenistan once supplied 20 percent of Ukraine's gas requirements, but the supply was discontinued in March 1997 when the unpaid gas import bills grew to 700 million dollars. During the period between then and leading up to the signing of the new contract, Ukraine experienced a gas shortage that was not filled up by Russia, the country's largest gas supplier, with the result that its total gas supply in 1997 decreased by as much as 10 billion cubic meters, or 15 percent, from the 1996 level. Ukraine relies on gas for half of its energy supply, and 80 percent of the gas is imported. Recently, it struck a contract with Uzbekistan as well for the import of 600 million cubic meters of gas per year. Nonetheless, the fact that Ukraine depends on Russia for half of its gas imports remains basically unchanged. Moreover, in importing Turkmenistan's gas, Ukraine must depend on Russian pipelines, and the considerably high fees charged by Gazprom for the use of its pipelines act as an additional drain upon its strained financial position.

3. The Impacts of the American Containment of Iran on Ukraine

The American policy of containment toward Iran has produced effects that have spread as far as to Ukraine. Because of the strong influence of the Ukrainian lobby in the United States, the country holds third place in receipts of American foreign aid, following Israel and Egypt. Recently, however, the relationship between the United States and

Ukraine has been strained, because Ukraine announced a plan to supply power generation turbines to Iran. This upset the United States, which saw the containment of Iran as a pivot of its policy toward the Persian Gulf and the Middle East. The United States applied pressure on Ukraine for the last one year, by threatening to discontinue its supply of nuclear technologies and nuclear fuel unless and until the latter canceled its deal with Iran.¹ On March 3, 1998, Ukraine acceded to the demand. Iran is now constructing a 1,000-megawatt nuclear power plant in Busher, on the coast of the Persian Gulf, with the construction work worth US\$850 million commissioned to Russian enterprises. However, the turbines necessary for the project were scheduled to be procured from the Ukrainian firm Tsurbo-Atom, and now that Ukraine has succumbed to the American pressure and canceled the deal, it appears that the completion of the power plant will be delayed considerably.

The Clinton administration takes the view that the Iranian nuclear power plant project, which is ostensibly for civilian use, is actually a cloak for Iran's plan to develop nuclear warheads. The United States has been trying to break Russia's monopoly control over nuclear power generation in Ukraine, but the Iranian question has been a major obstacle to this effort. Russia, for its part, had made clear its determination to proceed with the nuclear power plant project, asserting that given the Iranian pledge to subject the nuclear power plant to inspection by the International Atomic Energy Commission (IAEC), the project does not violate international law.²

In December 1997, the United States presented Ukraine with a carrot and stick policy. It

announced that if the Ukraine canceled the turbine sales deal, it would be rewarded with a U.S. aid package, including credits for small-sized firms, Export-Import Bank credits, cooperation in military and aerospace technologies, and an assured supply of nuclear fuel.³ However, it proceeded with the deal, the United States said it was determined to scrap the U.S.-Ukrainian nuclear power agreement. At the same time, the United States also hinted at the possibility of offering technological assistance and loans to help Ukraine complete the construction of its two nuclear power plants. Given the fact that Ukraine has to rely on nuclear power to supply nearly half of its electricity supply, the country faces an important decision in which country — the United States and Russia — it will choose as a partner for its nuclear power policy. Even though Ukraine's exports of turbines to Russia are not subject to American sanctions, it finds itself caught between the United States and Russia, and it being pressed to make one of the hardest choices it has had to face since independence. What is at issue is the question of which of the two countries, the United States and Russia, will supply Ukraine with its nuclear fuel supplies, and which will control the Ukrainian market. U.S. Senator Mitch McConnell of Kentucky, who is known as an influential figure in the Ukrainian lobby in the United States, has warned against pressing Ukraine too hard and driving it toward the Russian camp.⁴

Notes

1. *Financial Times*, February 28-March 1, 1998
2. *Financial Times*, October 15, 1997
3. *International Herald Tribune*, February 9, 1998
4. *Ibid.*