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**Explaining the Management of Energy  
Dependency in Ukraine**

Possibilities and Limits of a Domestic-Centered Perspective

Juli 2004

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## ABSTRACT

This paper explores the issue of policy choices in the context of post-Soviet transformation processes and, in particular, why have various post-Soviet bloc states dealt with their economic dependency on Russia in different ways. The question is analyzed through an examination of the management of energy dependency on Russia, one of the most crucial issues in the domestic and foreign policy situation of the East Central European transformation states. Using Ukraine in the 1995-2004 period as case study, the connection between, on the one hand, ways of managing energy dependency and, on the other, the domestic system of power is analyzed. The basic hypothesis is that the nature of the political system/arrangements in various Central-East European countries will affect the management of energy dependency in general and, more concretely, the management of energy relations with the largest partner (Russia). The link between the domestic system of power and the management of energy dependency is analyzed through a discussion of the following issues:

- (1) what the continued prevalence of non-transparent markets in countries such as Ukraine means for Russia's ability to play a role in these markets;
- (2) through the issue of a country's ability to decide upon and implement a coherent, proactive energy policy;
- (3) through the issue of where are energy policy decisions made: in the open, democratic political realm, or in informal deals between regime and interest articulators;
- (4) through the issue of how political leaders are constrained by domestic political factors in their energy negotiations with Russia;
- (5) through the issue of interest groups and how states and regimes help mediate between them; and,
- (6) through the issue of the profits and rents that can be made out of a situation of dependency and how are they extracted, accessed, and distributed.

Through the analysis of these factors, insights are provided into larger theoretical issues concerning the relationship between institutions, economic policy and foreign relations in transition countries in general.

## I INTRODUCTION

This paper explores the issue of policy choices in the context of post-Soviet transformation processes.<sup>1</sup> It is related to a larger question: how can we explain the fact that various post-Soviet bloc states have dealt with their economic dependency on Russia in different ways? Which factors may help us explain those differences? As a way of gaining insight into this larger question, we look specifically at the issue of energy dependency and its management. A focus on energy is warranted for two reasons. First, energy is one of the most crucial issues in the domestic and foreign policy situation of the East Central European transformation states, most of which have been chronically energy-dependent since the 1950's. Second, looking at the management of energy dependency can offer some new insights into larger theoretical issues concerning the relationship between institutions, economic policy and foreign relations in transition countries in general.

The larger framing project to which this paper is related<sup>2</sup> looks at the comparative management of energy dependency in Central and Eastern Europe by analyzing the Ukrainian case alongside those of other post-Soviet states. While an analysis of the Ukrainian case alone cannot answer these larger questions, it can provide important insights into the role of domestic factors in policy-making and the management of energy dependency.

### Ukraine as a case study

In this particular contribution we focus specifically on the case of Ukraine. A focus on Ukraine is merited because, of all the transition states, it is the one where, arguably, energy issues play the largest role in the country's daily economic and political life.<sup>3</sup> Unstable energy supplies are Ukraine's number one problem, in terms of effects on the economy,<sup>4</sup> political instability, and relations with Russia. Energy is also central to Ukraine's relations with international financial institutions, the European Union and the GUUAM (Georgia-Ukraine-Uzbekistan-Azerbaijan-Moldova) grouping, an informal foreign policy alliance created in 1997 to promote an alternative to Russian hegemony in the region.

For the purposes of this paper, we will concentrate on the issue of the *management* of Ukraine's energy dependency relationship with Russia. While the complexity of this relationship cannot be fully captured by the word "dependency" (see below), we start from the assumption that Ukraine will remain largely dependent on Russian energy for decades to

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1 I would like to thank Sabine Fischer, Astrid Sahm and Susan Stewart for their comments on previous versions of this paper, and Maren Jochimsen for her ideas and suggestions on the framework project.

2 The project as a whole ("Energy and Foreign Policies in Central-East Europe") offers a comparative analysis of the connection between energy, domestic and foreign policies in Central and Eastern Europe in the period 1991-2003. The overall project includes the cases of Ukraine, Belarus, Hungary, Poland and Slovakia, and their energy relationship with Russia.

3 While Belarus' and Moldova's level of energy dependency are higher than Ukraine's, on the basis of its effects on the economy, political instability, and foreign relations (with Russia, other former Soviet states and international financial institutions), energy issues have been more central in the case of Ukraine. This has to do not with the percentage of total energy dependency, but with the way in which the energy issue and profits from less-than-transparent energy business (the so-called "rents of dependency") have been incorporated into the political system. In the case of Ukraine, due to the particularities of its political system, energy capital actually created (or strengthened) political actors, who later used that strength to influence the political system and get access to the policy-making and licensing process with the goal of securing continued access to even more rents of dependency, in this way distorting the political game. On rents of dependency see p. 22 below.

4 See Vlasov, Peter 1999. "Bednie Liudi: Bor'ba za kontrol nad gazovym rynkom – vazhneishii element vnutripoliticheskoi zhizni Ukraini," Ekspert No. 20 (31 May 1999).

come. While this dependency may not be able to be eradicated in the short term, it may be managed in more or less successful ways.

A central question this paper will analyze is: why has Ukraine managed its energy dependency the way it has? Which factors and theoretical approaches may help explain this? Realist, international political economy and constructivist approaches have sought to answer the question of policy choices, with mixed results. We believe a modified institutional approach can provide the most productive means of understanding Ukraine's policy wavering in the post-Soviet period.

In order to answer this question, we will proceed as follows. Part I of the paper provides some basic background information on Ukraine's energy situation, both in terms of where it stands on the basis of important indicators, and in terms of several larger energy trends and issues facing the country. Part II of the paper presents several key aspects of Ukraine's actual track record concerning the *management* of its energy dependency on Russia. Part III presents various theoretical approaches which could be used for understanding the sources of Ukraine's energy policy in the post-independence period. We conclude (Part IV) with a discussion of how a domestic-centered perspective can be applied to analyze Ukrainian responses to its energy dependency. The goal of this paper is not to develop a comprehensive theory explaining all policy-making in transformation states, but to present some insights into how an understanding of domestic factors may help us understand Ukraine's management of its energy dependency situation.

### *Some Preliminary Caveats and Qualifications*

#### What do we mean by "energy dependency"?

When we refer to Ukraine as energy dependent and to its energy relationship with Russia as one of dependency, we are not denying the fact that their relationship is also characterized by elements of asymmetrical interdependence between both sides.<sup>5</sup> Some elements of this interdependence are: the control that can be potentially exerted by countries such as Ukraine or Belarus on Russian export pipelines going through their territories,<sup>6,7</sup> the influence they have as large sale markets, and the influence they may have as recipients of important investments by Russian energy companies. These are elements of power these countries can use in formal or informal negotiations with Russia, and in the management of their energy dependency more generally. At the same time, the existence of elements of interdependence does not change the basic fact of Ukraine's energy dependency on Russia, but only qualifies it and makes it more complex.

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5 While there is no single internationally recognized definition of energy dependency, for the purposes of this paper, by "energy dependency" we mean a situation where a) more than one-third of a country's total energy consumption comes from foreign sources; or b) more than fifty percent of a country's annual consumption of a major energy source for that country (a source providing 30% of that country's Total Primary Energy Supply, in the case of Ukraine, oil or gas) comes from foreign sources. One factor exacerbating the situation of energy dependency is a situation in which a country depends on a single external provider for more than 60 % of its imports of a major energy source for that country (in the case of Ukraine, oil or gas) or 45 % of its consumption of that energy source.

6 Especially important in cases where the country has a monopoly on export routes for Russian gas or oil, making the threat of transit disruption an available weapon in the relationship. However, the importance of this weapon has decreased as Russia has developed additional oil and gas export routes in the last years.

7 See Astrid Sahn and Kirsten Westphal, "Power and the Yamal Pipeline," in Margarita M. Balmaceda, James Clem and Lisbeth Tarlow (eds.) *The Belarus Factor: Implications for Central-East Europe, Russia and the West* (Cambridge: HURI/Davis Center for Russian Studies: distributed by Harvard University Press, 2002).

## What do we mean by “management of energy dependency”?

By “management of energy dependency,” we do not imply a normative stance in the sense of considering only *good* management of energy dependency management overall. By “management of energy dependency,” we mean a sub-set of the larger universe of management of energy issues in general. In particular, we are referring to ways of going about (regardless of whether these are proactive or just passive) energy issues in a situation of dependency. In particular, we are referring to the following three areas. First, ways of going about the direct *management of energy supply diversification issues*, for example: issues related to the establishment and carrying through of a national energy policy and strategy, the development of energy supply plans, the discussion and implementation of diversified, alternative energy supplies (in a geographical, an energy-source and a contractual sense), the role of the state in the organization and financing of energy imports, policies of promoting energy self-sufficiency, the use of alternative energy and energy efficiency programs, policies about access to pipeline networks, and the role of private and particularistic<sup>8</sup> interests as opposed to general national ones in determining ways of dealing with these issues. Second, we are referring to ways of going about issues having to do with the *organization of energy trade* with the main current supplier on which the country is still dependent (in the case of Ukraine, Russia), issues such as a) how the financing of this trade will be organized, b) who will organize these imports and who will profit or sustain losses from them, c) who will guarantee these imports. Third, we are referring to ways of going about more general energy issues, *in those of their aspects related to and having implications for energy dependency issues*.<sup>9</sup>

## **II BACKGROUND: A SNAPSHOT OF UKRAINE’S ENERGY SITUATION AND TRAJECTORY SINCE INDEPENDENCE**

Ukraine’s energy situation since independence has been characterized first and foremost by two elements: first, the country’s dependency on imported energy sources – especially on Russian ones – and, second, its low levels of energy efficiency.

### ***High Levels of Dependency on Imported Energy***

Ukraine’s total energy dependency is one of the highest in the Central-East European (CEE) region (see Table 1). This is the result of declining domestic production and inefficient energy use, among other factors. According to a study by the Ukrainian Centre for Economic and Political Studies, should current trends continue, Ukraine’s total energy import dependency could rise to 65-70% by 2020.<sup>10</sup>

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8 For the purposes of this paper, we define particularistic interests as those interests of specific groups or elites which are defined in exclusive terms and without regard for the interests of larger groups or society or general national interest.

9 For example, the domestic distribution of energy imports, policies about differential rates for industrial, residential or state sector users and how they will be financed, policies about subsidies for particular types of users and how they will be financed, and policies about foreign investments in the energy area.

10 Ukrainian Centre for Economic and Political Studies, “Concept of the State Energy Policy of Ukraine through 2020” National Security and Defense No. 2 (2001), p. 19.

**Table 1: Ukraine's Total Energy Import Dependency in Comparative Perspective (in percentages)**

	1990	1995	1996	1997	1998	2000	2001
<b>Ukraine</b>	<b>47.4</b>	<b>49.9</b>	<b>N/A</b>	<b>45.9</b>	<b>43.7</b>	<b>43.7</b>	<b>41</b>
<b>Czech Republic</b>	<b>11.9</b>	<b>N/A</b>	<b>22.5</b>	<b>24</b>	<b>25.7</b>	<b>23.3</b>	<b>25.77</b>
<b>Estonia</b>	<b>41.8</b>	<b>N/A</b>	<b>36.0<sup>a</sup></b>	<b>31.2</b>	<b>41</b>	<b>37.3</b>	<b>36.1</b>
<b>Hungary</b>	<b>49.8</b>	<b>N/A</b>	<b>52.7</b>	<b>51.8</b>	<b>56</b>	<b>56</b>	<b>54.4</b>
<b>Poland</b>	<b>2.0</b>	<b>N/A</b>	<b>5.2</b>	<b>7.8</b>	<b>9.6</b>	<b>10.7</b>	<b>10.5</b>
<b>Slovakia</b>	<b>77.0</b>	<b>N/A</b>	<b>73.8</b>	<b>72.9</b>	<b>70.3</b>	<b>66.1</b>	<b>61.6</b>
<b>Belarus</b>	<b>N/A</b>	<b>87</b>	<b>N/A</b>	<b>N/A</b>	<b>86</b>	<b>86.1</b>	<b>85.4</b>
<b>Moldova</b>	<b>N/A</b>	<b>99</b>	<b>N/A</b>	<b>N/A</b>	<b>95.8</b>	<b>97.9</b>	<b>98</b>

*Source: European Commission (EC) "Energy in Europe – 2000 Annual Energy Review." Special Issue of Energy in Europe (Brussels, 2001), and International Energy Agency Key World Energy Indicators, 2000, 2001 and 2003, available at [www.iea.org/statist/key2003.pdf](http://www.iea.org/statist/key2003.pdf). Energy dependency is defined as Net Imports/Total Domestic Consumption.*

Although at first glance these figures would seem to present a view of decreasing energy import dependency in Ukraine as compared to an increasing trend in the ECE states, the situation is more complex than it appears at first. Ukraine's declining trend must be seen in the context of the sharp fall in the country's economic activity and GDP in the first decade after independence (between 1991 and 1999, Ukraine's GDP fell by almost 60%;<sup>11</sup> Ukraine's GDP started to grow again in 2000-2001) (see Tables 2 and 6 below). With a return to pre-crisis levels of economic activity, energy consumption and energy dependency will rise. In the case of the Central European states,<sup>12</sup> both the GDP decline and its recovery took place earlier than in Ukraine, leading to increased energy consumption and dependency as well. In addition, if nuclear energy were not to be counted as domestic production – given the fact that its raw materials (fuel cells or nuclear fuel) are almost exclusively imported from Russia, which also provides 85% of the nuclear power plant equipment – then the figure for Ukraine's total energy dependency would rise significantly, to around 70-75%.<sup>13</sup>

The situation looks clearer when we look at Ukraine's total energy consumption and imports and compare the change in energy dependency with changes in energy consumption. So, we can see that energy dependency fell only slightly or remained constant, while energy consumption fell significantly. (See Tables 3, 4 and 5 below.)

11 See World Bank, Statistical Yearbook for Ukraine and Hans van Zon, *The Political Economy of Ukraine* (London: MacMillan, 2000), p. 76.

12 The Czech Republic, Slovakia, and Hungary.

13 Christian von Hirschhausen and Volkhart Vincentz, "Energy Policy and Structural Reform," in *Eastern European Economics* vol. 38 no. 1 January-February 2000, p. 63.

**Table 2: Ukraine's Total Energy Imports and Total Energy Consumption (Total Primary Energy Supply) in Million Tons of Energy Equivalent (Mtoe)**

	1990	1991	1992	1993	1994	1995	1997	1999	2000	2001
<b>Total net imports of energy</b>	119.79	132.52	107.77	89.93	75.25	82.50	N/A	59.86	57.69	58.15
<b>TPES</b>	252.63	250.57	219.90	193.66	165.13	165.52	153.3 <sup>a</sup>	140.21	139.21	141.58

Source: IEA, *Energy Balances of Non-OECD Countries 2000-2001 (2003 Edition)* and IEA, *Energy Policies of Ukraine-1996 Survey (Paris: 1996)*  
*a Estimated from Boris Kostiukskii, "Enerhetichna kriza v Ukraini," Energetichna Politika Ukraini 2000 No. 4 (April 2000), pp. 46-50*  
*b Calculated from www.iaea.org/Textbase/stats/PDF\_graphs/UATPES.pdf and http://www.unece.org/env/epr/studies/ukraine/annex1.pdf*

**Table 3: Changes in Ukraine's Energy Import Dependency as Compared to Decreases in Energy Consumption**

	1990-1995	1995-2001	1990-2001
<b>Decrease/Increase in Energy Consumption (TPES) (in %)</b>	-34.48%	-14.46%	-43.95%
<b>Decrease/Increase in Energy Import Dependency (in % of earlier level)</b>	+5.27%	-17.83%	-13.5

Source: calculated on the basis of International Energy Agency Key World Energy Indicators, 2000, 2001 and 2003, IEA, *Energy Balances of Non-OECD Countries 2000-2001 (2003 Edition)* and IEA, *Energy Policies of Ukraine-1996 Survey (Paris: 1996)*.

### ***Inefficient Energy Production System and High Energy Intensity***

Both Ukraine's energy production system and its economy as a whole are sorely outdated. Fifty-four percent of Ukraine's pipelines – built for a normal exploitation period of 25 years – are twenty-one years old or older,<sup>14</sup> and their state of disrepair increases the possibility of accidents. Moreover, pipeline gas pumping units are in particularly bad condition, which means increasing amounts of gas are needed to pump gas through the pipelines. (In 2001 almost ten percent of Ukraine's yearly gas consumption was used for this purpose.)

Ukraine's outdated energy system has also contributed to the fall in gas and oil production since 1990 (See Table 4).<sup>15</sup> Despite the recent discovery of several gas fields, official Ukrainian sources estimate that oil and gas condensate reserves will be exhausted between 2025 and 2030, and natural gas reserves by 2032.<sup>16</sup>

14 Ukrainian Centre for Economic and Political Studies, "The EU-Ukraine-Russia 'Gas Triangle,'" National Security and Defense 2002 No. 3, p. 31.

15 This should be seen in the context of the fact that during the Soviet period oil and gas reserves were exploited in ways that quickly and seemingly inexpensively got the gas and oil located in easy-to-reach parts of deposits, but which actually made it much more difficult -- and expensive -- to get at the remaining parts of these deposits later on.

16 Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy of Ukraine through 2020," op. cit., p. 10.

**Table 4: Ukrainian Gas Production and Consumption, 1992-2001, in Trillion Cubic Feet**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<b>Consumption</b>	N/A	N/A	3.50	3.87	3.33	2.97	2.93	2.83	2.61	2.75	2.78	2.61
<b>Production</b>	0.99	0.83	0.74	0.68	0.64	0.62	0.64	0.64	0.64	0.63	0.64	0.64

Source: U. S. Energy Information Administration, available at [www.eia.doe.gov/emeu](http://www.eia.doe.gov/emeu) (Total oil supply) and Boris Kostiukovskii, "Enerhetichna kriza v Ukraini," *Energetichna Politika Ukraini* 2000 No. 4 (April 2000), pp. 46-50 (for 1990 and 1991 data)

**Table 5: Ukrainian Oil Production and Consumption, 1992-2001, in Thousand Barrels per day (TB/d)**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<b>Consumption</b>	N/A	N/A	813	570	495	484	388	363	384	374	264	290
<b>Production</b>	110	98	95	87	85	85	81	85	82	98	88	86

Source: U. S. Energy Information Administration, available at [www.eia.doe.gov/emeu](http://www.eia.doe.gov/emeu) (Total oil supply) and Boris Kostiukovskii, "Enerhetichna kriza v Ukraini," *Energetichna Politika Ukraini* 2000 No. 4 (April 2000), pp. 46-50 (for 1990 and 1991 data)

In addition, Ukraine exhibits very low levels of energy efficiency (see Table 6 and Figure 1 below). Not only does Ukraine have one of the highest levels of energy intensity (energy consumption per unit of GDP) in the world, but it actually increased by almost 50% from 1991 to 1999. Although the validity of this calculation has been challenged by those arguing GDP produced in the hidden economy needs to be included in the equation, the existence itself of high levels of energy intensity has not been challenged.<sup>17</sup> As a result, despite having a population of only 48 million, Ukraine is the seventh largest gas consumer in the world, with a yearly consumption of 75-78 billion cubic meters (bcm) per year.<sup>18</sup>

Low energy efficiency also affects Ukraine's exports, lowering their competitiveness in the long term. The share of energy in the cost structure of Ukrainian goods was 25% in the late 1990s, 8.3 times higher than in France and 4 times higher than in the US.<sup>19</sup> The other side of the coin is that energy subsidies are a way of subsidizing this inefficient production, with a doubly negative effect: the incentive for increasing efficiency is lost, and the state as a whole

17 Energy intensity is defined as the amount of energy needed to produce a fixed amount of GDP. A qualification often made to energy intensity calculations for Ukraine is that they are not fully correct because they are based only on official GDP figures, ignoring the shadow economy that by 1999 accounted for up to 50% of economic activity. This view is supported by the fact that, indeed, one of the ways to measure the shadow economy is by looking at electricity consumption. From this perspective, it could be said that, if calculations were made on the basis of the economy as a whole (shadow as well as non-shadow), as opposed to just the official economy, the increase in energy intensity would not look as large, because energy consumption has grown together with total (shadow and non-shadow) GDP. At the same time, including the shadow economy in energy intensity calculations fails to fully disqualify the increase in energy intensity argument. This is so because "a large part of the shadow economy consists of trade with little energy intensity" and because data on single industries as well "show a high and increasing energy consumption that cannot be attributed to the shadow economy". (See von Hirschhausen and Vincentz, op. cit., p. 64. See also International Energy Agency, *Energy Policies of Ukraine 1996 Survey* (Paris: OECD/IEA, 1996), pp. 73-75.)

18 See Energy Information Administration, available at <http://www.eia.doe.gov/emeu>. See also Ivan Dyak, head of the Subcommittee on Gas Industry at the Verkhovna Rada Committee on the Fuel Complex, in Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy of Ukraine through 2020," op. cit., pp. 67-68.

19 Sergey Tulub, Ukraine's Minister of Fuel and Energy, in Black Sea Regional Energy Centre, *Black Sea Energy Review: Ukraine* (Sofia, July 2000), p. 9. For comparison, the share of energy in total manufacturing costs in the late 1990s was 6-9% in Russia. International Energy Agency, *Energy Policies of the Russian Federation* (Paris, IEA/OECD, 1995), p. 40.

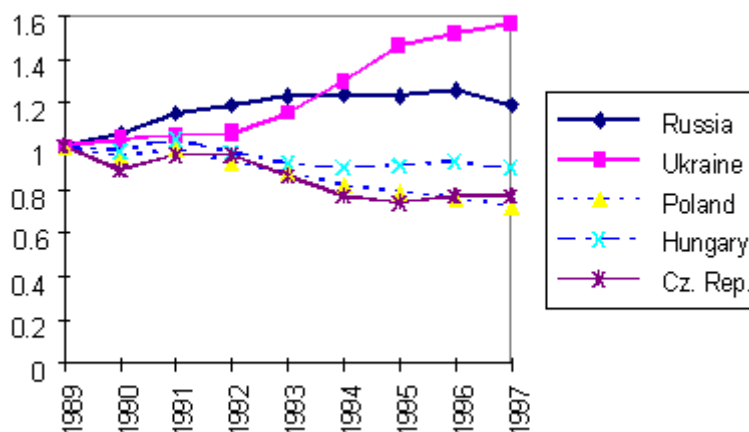
must carry the costs of such subsidization. Because Ukraine did not introduce market prices for energy in the first years after independence, neither were individual consumers pushed to reduce consumption, nor the country as a whole to abandon an energy-intensive production mix in favor of a more efficient one.<sup>20</sup>

**Table 6: GDP, Energy Usage and Energy Intensity in Ukraine, 1990-2002**

	1990	1995	1999	2000	2001	2002
<b>GDP, billion hryvna (at 2000 prices)</b>	399.3	187.9	160.6	170.1	185.7	195.4
<b>GDP as percentage of 1990 GDP</b>	100	47.1	40.2	42.6	46.5	48.9
<b>Energy use (in million tons of fuel equivalent)</b>	353	226.3	191.1	191.7	192.9	198.7
<b>Energy use as percentage of 1990 use</b>	100	64.1	54.1	54.3	54.6	56.3
<b>Energy intensity in kg of fuel equivalent/ thousand hryvna GDP</b>	0.88	1.199	1.184	1.127	1.039	1.017
<b>Energy intensity as percentage of 1990 energy intensity</b>	100	136.3	134.5	128.1	118.1	115.6

Source: Boris Kostiukovskii, "Energetichna kriza v Ukraini," *Energetichna Politika Ukraini* 2000 No. 4 (April 2000), pp. 46-50, and Boris Kostiukovskii, *Institute of General Energy Problems, Kyiv*.

**Figure 1: Ukraine's GDP energy intensity trends by international comparison (1989 =100)**



Source: HELIO International Sustainable Energy Watch Report for Ukraine, available at [www.helio-international.org](http://www.helio-international.org), citing data from the German Advisory Group in Ukraine

20 Hermann Clement, "Economic Aspects of Ukrainian-Russian Relations," in Kurt R. Spillman, Andreas Wenger and Derek Mueller, *Between Russia and the West: Foreign and Security Policy of Independent Ukraine* (Bern and New York: Peter Lang, 1999), p. 296.

### III MANAGEMENT OF ENERGY DEPENDENCY: THE TRACK RECORD

Having been handed a difficult energy situation at independence, how has Ukraine managed it? Two elements are especially important: the fact that no real diversification of energy supplies has taken place, and the lack of a clear and proactive energy policy.

#### *Ukraine's Lack of Progress in Energy Diversification*

Ukraine's high levels of energy import dependency are made worse by its problems in energy supply diversification. It is generally accepted that energy diversification is guaranteed by receiving significant energy supplies from at least three different geographical sources. Ukraine is far from this situation, as an overwhelming share of its energy imports comes from Russia. Imports from the only other significant source (gas imports from Turkmenistan) have remained erratic – at times amounting to half of total gas imports, but often interrupted by lack of payments or other factors.

Although in 2003 gas imports from Turkmenistan amounted to 42% of Ukraine's gas use,<sup>21</sup> they do not seem to be assured in the long term, and involve several controversial elements.<sup>22</sup> Contracts between Ukraine and Turkmenistan are often affected by Turkmenistan's other relationships, both with Russia and with Russian-controlled companies such as Itera, which has been an important intermediary in the sale of Turkmenistan gas to Ukraine.<sup>23</sup> Imports from Turkmenistan remain subject to Russian influence, as they must be transported through Russian pipelines. Moreover, the long-term continuation of these deliveries seemed to come under question in April 2003 as Turkmenistan signed a long-term gas delivery contract with Russia which, from 2007 on, would sell to Gazprom almost the entire Turkmenistan gas production,<sup>24</sup> leaving little free capacity for exports to Ukraine or putting this capacity under Gazprom's control.<sup>25</sup>

#### *Lack of a Proactive Energy Policy*

The track record since independence is also one of a lack of a clear, proactive and widely accepted energy policy. This refers to both rules for the day-to-day organization of the sector, and to a more long-term energy policy. Unpredictable and often-changing rules for the organization of the energy market<sup>26</sup> (and the gas market in particular) have made it difficult for medium- or long-term planning to take place, for the system to work smoothly or for serious investors to take an interest in the market.

The various actors which could play a role in the open determination of a coherent energy policy are weak; moreover, little effective formal coordination exists between them. These weak formal actors such as, for example, various ministries *as institutional actors* (as opposed to individual members of interest groups holding important positions in these

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21 See Ganna Liuta, "Eto vam ne 'vedrami gaz' prodavat'," *Zerkalo Nedeli* No. 15(490), 17 April 2004, pp. 1, 10.

22 Such as, for example, the scandals around the use of questionable companies as intermediaries in the importation of Turkmen gas to Ukraine at a significant cost to the state and astronomic profits to the middleman company. See Roman Olearchyk, "Gazprom, Naftogaz Ukrainy Replace Itera with new firm", *Kyiv Post* 6 March 2003, p. 1.

23 On the difference between contracted gas supplies from Turkmenistan and actual supplies delivered, see IEA, *Energy Policies of Ukraine-1996 Survey* (Paris: 1996).

24 60-70 bcm of gas per year. The deal also assumes highly increased gas production in Turkmenistan. See Tatiana Vysotskaya, "Tseny na gaz budut rasti," *Delovaia Nedelia* (Kyiv) No. 15 (129), 8-14 May 2003.

25 See Vladimir Saprykyn, "Uzkie mesta gazovogo sektora stran Tsentralnoi Azii" *Energeticheskaya Politika Ukraini*, 2004 No. 5 (May 2004).

26 On changes in the organization of the domestic energy market, von Hirschhausen and Vincentz, *op. cit.*

ministries), research institutes, etc., are juxtaposed to a variety of strong unofficial actors: not only companies operating largely in the “gray market,” but also state companies whose property structure and chain of command is unclear (and whose top positions are held by individuals often more linked to private than to general interests), such as Naftohaz Ukraina (the near-monopoly gas and oil operator) and Ukrtransnafta (the state-owned oil transit company). In some cases, the divisions between business-administrative groups (“clans”)<sup>27</sup> run inside state companies as well, with unpredictable consequences given the lack of clear corporate governance rules.<sup>28</sup>

The Ministry of Fuel and Energy, despite having (on paper) a research division, in reality lacks it, as most of its cadres are used for administrative duties.<sup>29</sup> With few exceptions, other energy-related institutes, both within the Ukrainian Academy of Sciences and beyond, receive only nominal funding, and lack some of the basic material conditions needed for effective work. Due to virtually non-existing funding, preliminary work for the drafting of a new Energy Policy of Ukraine to 2020 has been stalled and so far has occurred only in piecemeal fashion and without a strong coordinating center.

### The example of policy-making around a possible reversal of the Odessa-Brody oil pipeline

Ukraine’s lack of a clear energy policy also affects its role as an energy transit route. A number of factors make Ukraine a potentially crucial player in European energy transit: its strategic location between the main gas producers (Russia and the Caspian Sea area) and consumers (Western Europe) in the Eurasian region, the fact that it possesses Europe’s second largest gas transit network (after Russia’s) and the availability of significant underground gas storage capacities, something other transit countries lack. But in order for these positive factors to be put to use fully, a strong and proactive state policy is needed.

Ukraine’s indecision in energy policy makes it more difficult for herself as well as for other states in the region to have access to more diversified energy supplies. The history of the Odessa-Brody pipeline exemplifies some of these problems.<sup>30</sup> The pipeline, originally envisioned with the goal of helping foster Ukraine’s energy supply diversification and to help put the country on the map as a transit corridor for Caspian oil to Europe by building a link between the Caspian-near Odessa port and Poland, has in reality turned out to be a clear example of Ukraine’s problems in developing and following a clear energy policy. At first, the completion itself of the project, originally envisioned in the mid-1990s, was delayed for a number of years. When the Odessa-Brody segment (reaching up to near the Polish border) was finally completed in 2002, it became clear little business planning had been completed beforehand, and no Caspian oil was ready to flow through it, which called forth Polish reservations on building the connecting segment from Brody to Plotsk. While one can point to policy indecisiveness on the part of Ukraine as one of the reasons for the delay in the project, Poland’s role should not be neglected. Despite publicly taking upon itself the role of Ukraine’s strategic partner and advocate vis-à-vis the West, and despite the 1999 agreement between both countries to complete a pipeline extension linking Brody and Gdansk, when concrete Polish support was needed for the building of the Brody-Plotsk-Gdansk segment,

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27 The term “business-administrative group” is used to denote the fact that these groups combine both economic resources and decision-making power.

28 This has been especially evident in the battle for control of oil transit monopolist Ukrtransnafta in 2003-2004. See Aleksandr Vladimirov, “Vozmozhnost porulit nefetranstportnooi systeme budorazhit donetskikh oligarkhov,” *Delovaia Stolitsa* No. 17, 26 April 2004.

29 Personal consultations, Ukrainian Center for Economic and Political Studies, Kyiv, 2003 and School of Political Analysis, Kyiv-Mohyla Academy, 2004.

30 On the history of the Odessa-Brody pipeline, see Sergei Tsokolenko, “Gde nachinaetsia neft, tam zakanchivaiutsia natsional’nie interesy,?” *Zerkalo Nedeli* 2000 No. 19 (13-19 March 2000).

crucial for its commercial exploitation, Poland failed to provide funds for it, citing the lack of a business plan for the project.

In early 2003 the Ukrainian side responded to the absence of offers of Caspian oil to be shipped north through the pipeline by temporarily “reversing” the flow of a fifty-two kilometer segment of the pipeline, using it to transport Russian oil south to the Odessa port, for further transport by tanker to Western Europe. In the Spring of 2003, rumors started to flow to the effect that Ukraine was planning to accept a Russian proposal for a “full reversal” of the pipeline, i.e., to transit Russian oil (belonging to TNK, the Tuimenskaya Neftenaya Kompania) from Brody in the north to Odessa in the south (to be shipped further West by tanker), that is, in the opposite direction as the pipeline was originally intended. Soon after that, a protocol for the full reversal of the pipeline, signed by the Ukrainian state oil company Neftehaz Ukraini, Russia’s Transneft and TNK was leaked to the press.<sup>31</sup>

This proposal took place in the context of the acute lack of free export capacity in the Russian pipeline system at a time when the difference between domestic and export prices was especially large. Nevertheless, given the fact that those Russian oil exports to Western Europe could be shipped through another existing Ukrainian pipeline (the Transdnister Pipeline System, which could also transit Russian oil south for further shipment through Odessa), many argued that the reversal proposal was a targeted Russian attempt to torpedo Ukraine’s new transit role and the export of Caspian oil to Western Europe.<sup>32</sup> At the same time, the Russian companies pushing for the reversal and most likely to benefit from the proposal found ready Ukrainian partners – not only individuals well-connected in the energy area, such as President Kuchma’s son-in-law Viktor Pinchuk, but even important players within the state company Ukrtransnafta, Ukraine’s monopoly oil transit operator.

Although the immediate economic benefit of using the Odessa-Brody pipeline in a reverse direction seemed obvious (immediate cash payments and higher transit fees than those Russia would pay for transit in the same direction through the Transdnister Pipeline System), a reversal would have a number of negative short- and medium-term implications that would result from such a decision. First, it would affect Ukraine’s agreements concerning a link between the Druzhba and Adria pipelines to transit Russian oil to the Croatian port of Omisalj, agreements that were reached after lengthy negotiations with Russia, Slovakia, Hungary and Croatia.<sup>33</sup> Most importantly, the implications for Ukraine’s energy security are also clear: were Ukraine to abandon the original purpose of the pipeline, it would close one possible source of energy diversification for the country and become even more dependent on Russian oil. Similarly, Poland, Slovakia, the Czech Republic and Germany would be deprived of an additional possibility to increase their import diversification. The shelving of the original Odessa-Brody project would also have important ecological implications for the Southern European region, as oil transit to Europe through the pipeline (instead of by tanker) would have reduced transit through the ecologically-sensitive Bosphorus straits, already in environmental danger due to the high volume of tanker transit and the possibility of oil spills.

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31 Published in *Den* (Kyiv), 27 May 2003.

32 “K ‘Uyzhnomu’ khochet prichalit Yukos,” Ukrainian Gas and Oil Report (NefteRynok) June 30, 2003.

33 The Druzhba-Adria project would be affected because the capacity of the Druzhba pipeline in the Ukrainian segment up to Brody is only 9 million Tons per year; if some or all of that capacity were to be taken up by TNK oil to be later transported through Odessa-Brody to Odessa, then very little or no capacity would be left there for other oil -- which happens to belong to TNK’s competitor Yukos -- to be transported through the new Druzhba-Adria system. The Druzhba-Adria project was voted down by the Ukrainian Parliament in late 2003, which many saw as retaliation for the further failure of its Odessa-Brody reverse project. After being stalled on several occasions, the project was finally ratified in February 2004. See Denis Petrov, “Chastnaya Ekspansia. Vneshneekonomicheskaya deyatel’nost rossiskikh kompanii poka ne nakhodit dolzhnoi podderzhki gosudarstva,” *Nezavimaya Gazeta*, 17 October 2000, p. 4, and Oles M. Smolasky, “Ukraine and Russia: an Evolving Marriage of Inconvenience,” *Orbis* 48 No. 1 (Winter 2004).

On the other hand, the Russian proposal offers the temptation of immediate revenue and an end to the unseemly picture of an expensive, brand-new pipeline standing idle.

The floundering of the original Odessa-Brody project would also have implications for the building of alternative, non-Russian-centered political groupings in the post-Soviet area. One of these groups, the Georgia-Ukraine-Uzbekistan-Azerbaijan-Moldova (GUUAM) affiliation, could be especially affected. Established in 1997 as a counterweight to Russian-led attempts at regional integration in the post-Soviet area, it has had an important energy component, as it is composed of countries which could benefit from an alternative, non-Russian-controlled system of energy transit and supplies from the Caspian and Central Asian area, of which the Odessa-Brody pipeline would be the central element. Already weakened due to a variety of factors, the demise of the original pipeline project would further weaken this potentially important organization.

Debate on the Odessa-Brody pipeline has been going on since April 2003, and has been characterized by contradictory statements on the issue by government officials (including President Leonid Kuchma himself), and by a fierce behind-the-scenes battle between pro- and anti-reversal interest articulators and business-administrative groups represented in state institutions and state energy companies. Despite an early February 2004 decision of Ukraine's Cabinet of Ministers declaring the pipeline should be used in its original direction, the question seems all but closed, as continued discussions on the possibility of giving the pipeline in concession to a Russian company renewed fears that the pipeline would be used to transport Russian oil south rather than Caspian oil north.

### *How Energy Policy Problems Hurt Ukraine*

Taken together, the lack of a clear diversification policy and of a consistent energy policy in general, exemplified by the case of the Odessa-Brody pipeline, contributes to creating a situation where Ukraine has problems meeting its energy needs, and where the necessary mechanisms for the effective and economically efficient functioning of its energy system are not present. Ukraine's energy problems have a variety of implications and consequences for the country's broader domestic political and economic situation, as well as for its international relationships and regional stability.

### *Domestic Consequences*

As a result of the way Ukraine's energy policy-making system has worked, many costs are shifted, in a non-transparent manner, to the state. This has been the case, for example, when the state has assumed the debts of energy traders, or when it absorbs losses related to energy waste. As a result, the state is robbed of valuable resources it could use in other areas. The state becomes further weakened, which, in a vicious circle, makes it less able to get a grip on the energy system and its problems. Energy problems and the lack of proactive approaches to them also create dissatisfaction in the population and increased political apathy, further weakening Ukraine's still unstable democracy.<sup>34</sup> This became especially clear in the winter of 1993-1994, when energy supply problems and an "energy war" with Russia led to freezing home temperatures: when the state cannot provide basic services such as heating and electricity, people often lose confidence in their leaders, leading to apathy.

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34 There is an active scholarly debate on whether and why some hardship situations and loss of confidence in leaders will lead to apathy or protest. For a discussion of this issue in a Central and Eastern European context, see Béla Greskovits, *The Political Economy of Protest and Patience: East European and Latin American Transformations Compared* (Budapest and New York: Central European University Press, 1998), and Debra Javeline, *Protest and the Politics of Blame: the Russian Response to Unpaid Wages* (Ann Arbor: University of Michigan Press, 2003).

### *Consequences in Terms of the Relationship with Russia*

Ukraine's blatant energy dependency on Russia, together with the government's inability to take a strong policy stance on energy issues, makes the country especially vulnerable to price fluctuations and dependency on Russia<sup>35</sup> and further complicates both countries' already difficult relationship. Energy remains both a bottleneck in the country's economic development and Ukraine's Achilles' heel in its relationship with Russia, a relationship which, in a reflection of Ukraine's own foreign policy wavering between Russia and the West, remains a highly ambiguous one at the political, military and economic levels. In the context of Ukraine's currently strained relationships with other foreign partners, such dependency leads to increased pressure for closer economic and political integration with Russia, as evidenced by Ukraine's signing of the treaty on a Common Economic Space with Russia, Belarus and Kazakhstan in September 2003.<sup>36</sup> Energy dependency also increases Ukraine's weakness in negotiations with Russia and its vulnerability vis-à-vis its largest trading partner.

## **IV POSSIBLE THEORETICAL APPROACHES TO UKRAINE'S ENERGY SITUATION**

How can various theoretical approaches in International Relations help us get closer to understanding Ukraine's responses to its energy situation? How can we best make sense of Ukraine's inability to develop a decisive, long-term and consistent energy policy?

Realist approaches see the state as the main decision-maker, emphasizing it above the level of domestic actors, and emphasize states' selection of trade policies on the basis of the strategic opportunities open to them.<sup>37</sup> In terms of trade, this would mean that countries will act proactively and seek to "create conditions which make the interruption of trade of much graver concern to its trading partners than to itself."<sup>38</sup> From this perspective, achieving and maintaining energy independence would be part of a state's desire to increase its power and maintain independence more generally. Thus, states such as Ukraine would be assumed to want to minimize their dependency on Russia – including energy dependency – at almost any cost. Yet the record of Ukrainian energy policy seems to counter these realist expectations. The reason realist explanations are insufficient to explain Ukraine's management of its energy situation is because attention to domestic considerations is largely missing from this perspective.

Two literatures within the Political Economy tradition do pay attention to such domestic considerations: the so-called "rentier state" literature, and the literature on the international political economy of trade policy-making.

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35 Ukrainian Centre for Economic and Political Studies, "Concept of the State Energy Policy of Ukraine through 2020" op. cit., p. 19.

36 Ratified by the Verkhovna Rada in April 2004.

37 Strategic opportunities which are, in turn, based on the state's capabilities and the existing international power configurations. See Stephen Krasner, "State Power and the Structure of International Trade" and Stephen Krasner, "Oil is the Exception," in Jeffrey A. Frieden and David A. Lake, *International Political Economy: Perspectives on Global Power and Wealth*, 4th Edition, (New York: Bedford/St. Martin's Press, 2000).

38 See Albert O. Hirschman, *State Power and the Structure of Foreign Trade* (Berkeley: U. of California Press, 1980) [originally published in 1945], chapter 2. See also the discussion of Hirschman in D'Anieri, op. cit., pp. 13-16.

The “rentier state” literature<sup>39</sup> offers interesting insights into the domestic politics side of trade policy by analyzing the effects of high external (resource) rents – such as rents generated by oil exports – on political systems. It suggests that an overabundance of external rents leads to a situation where the state – liberated from the need to extract income from the domestic economy – becomes more interested in spending than on promoting growth; real taxation becoming minimal, citizens and other political actors lose their sense of “ownership” and connection with the political system,<sup>40</sup> leading to weakened governance. Yet this focus on the negative effects of high external rents is problematic in terms of its implications for energy-poor states such as Ukraine. If we were to take this perspective a step further, it would lead us to believe that – in contrast to the negative political effects of external rent abundance – a situation of natural resource want would make a country pool its strength and lead to states’ more concentrated efforts at economic development and, by extension, at overcoming energy dependence. Yet the Ukrainian record does not support this expectation.

The constructivist approach, with its emphasis on how issues of national identity and their contestation can affect foreign and trade policy, can also be used to analyze the case of Ukrainian policy-making.<sup>41</sup> While this approach cannot explain all aspects of policy-making in transformation states, some of its insights can enrich other approaches, in particular an institutional approach.<sup>42</sup> In particular, the emphasis on how the “identities states create between them”<sup>43</sup> play a role in trade policy-making and on how a state’s international behavior may be intended more to attain symbolic benefits in advancing a particular notion of identity than to attain material benefits, can provide important insights for our project.<sup>44</sup> Constructivism can also contribute to a broader and more nuanced understanding of institutions.<sup>45</sup> (See p. 20 below.)

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39 See Douglas A. Yates, *The Rentier State in Africa: Oil Rent Dependency and Neocolonialism in the Republic of Gabon* (Trenton and Asmara: Africa World Press, 1996), Hazem Beblawy and Giacomo Luciani (Eds.) *The Rentier State, Vol 2, Nation, State and Integration in the Arab World* (London: Croom Helm, 1987), Cyrus Bina, "Theories of Rent and Their Critique: The Development of a Theory of Oil Rent," in *Economics of the Oil Crisis, Oil Rent and Internationalization of Capital in the Oil Industry* (New York: St. Martin's Press, 1985), Hossein Mahdavy, "The Pattern and Problems of Economic Development in Rentier States: The Case of Iran," in *Studies in the Economic History of the Middle East* (Oxford: Oxford U. Press, 1970), and Richard M. Auty, "Natural resources, the state and development strategy," *Journal of International Development* 9. (1997).

40 See Beblawi and Luciani, and Jacques Delacroix, "The Distributive State in the World System," *Comparative International Development* Vol. 13 No. 3 (1980), pp. 3-20.

41 Some main constructivist works are: Alexander Wendt, "The Structure-Agent Problem in International Politics," *International Organization* 41 no. 3 (1987), pp. 335-370, Martha Finnemore, *National Interests in International Society* (Ithaca, N.Y.: Cornell U. Press, 1996), Peter Katzenstein (ed.) *The Culture of National Security* (New York, Columbia U. Press, 1996) and Alexander Wendt, *Social Theory of International Politics* (N.Y., Cambridge U. Press, 1999). See also Peter Katzenstein, *Cultural Norms and National Security* (Ithaca: Cornell U. Press, 1996). For applications of this perspective to CEE and post-Soviet cases see for example Paul D'Anieri, "Constructionist Theory and Ukrainian Foreign Policy," in Jennifer P. Moroney et. al., *Ukrainian Foreign and Security Policy: Theoretical and Comparative Perspective* (Westport: Praeger, 2002), pp. 37-55, and Rawi Abdelal, *National Purpose in the World Economy: Post Soviet States in Comparative Perspective* (Ithaca and London: Cornell U. Press, 2001).

42 Despite its value in bringing to the IR debate issues previously relegated to the margins of this debate, neither national identity nor foreign policy orientation can explain everything: looking at other domestic factors is still important.

43 Paul D'Anieri, "Constructionist Theory and Ukrainian Foreign Policy," in Jennifer D. P. Moroney et. al., *Ukrainian Foreign and Security Policy: Theoretical and Comparative Perspectives* (Westport: Praeger, 2002), p. 40.

44 See Paul D'Anieri, "Constructionist Theory and Ukrainian Foreign Policy," in Jennifer D. P. Moroney et. al., *Ukrainian Foreign and Security Policy: Theoretical and Comparative Perspectives* (Westport: Praeger, 2002), p. 43.

45 Sometimes it is difficult to differentiate between the effects of national-identity and interest-group factors because they often seem to point in the same direction. In the case of Ukraine, mighty divisions on national identity and the relationship with Russia overlap at times with institutional and interest articulation factors.

While realist and “resource wealth” approaches focus on the external side of the equation,<sup>46</sup> and constructivist approaches on identity issues, the International Political Economy (IPE) literature specifically looks at the link between external and internal factors. It does so by looking at how changes in the global economic environment differentially affect various domestic sectors or actors and, thus, may make some groups – and not others – push for specific policies.<sup>47</sup> In doing so, the institutional approach is rooted in a liberal view of International Relations, emphasizing the role of domestic actors and interest articulators.<sup>48 49</sup> The institutionalist approach within this literature emphasizes the role of institutions in “translating” international changes to domestic groups, and possibly isolating the country (or sectors within it) from changes in the international economic environment.<sup>50</sup>

## V OUR APPROACH: A FOCUS ON INSTITUTIONS AND DOMESTIC FACTORS

We believe a modified institutional approach can provide the most productive means of understanding Ukraine’s policy wavering in the post-Soviet period. In this section we explain our interpretation and modification of the institutionalist approach. In the next and final section, we discuss how this approach can be useful for understanding the Ukrainian case.

### *Usefulness of an Institutional Perspective for Understanding the Ukrainian Case*

Several important reasons make an institutionalist approach especially useful for dealing with the post-Soviet cases, including Ukraine. The first reason has to do with the huge role played before 1991 by institutions specifically aimed at isolating COMECON<sup>51</sup> states from the international economy. In the pre-1991 period, three main institutions fulfilled this role, two of them directly related to energy trade: first, the system of energy supplies provided on “soft” terms of trade, which made it possible for the Soviet and CEE states to become relatively isolated from competitive world markets as long as the center was willing to accept “soft,”

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While a constructivist approach can provide a framework to understand the general dilemmas facing a country such as Ukraine, an interest-articulation approach can help us understand the more specific ways in which decisions are reached, something a constructivist approach, taken by itself, cannot do.

46 Realism by looking at the state as a unitary actor affected by external factors and the resource wealth approach by focusing on the impact of external rents on the domestic political system.

47 While most of the literature focuses on why some groups -- and not others -- push specifically for protectionist industrial policies, the approach can be extended to analyze other policies as well. These differential effects of international changes are analyzed on the basis of factors such as each sector’s level of exposure to the international economy, economies of scale, the “specificity” of its assets (whether sectors are characterized by assets that cannot be easily "moved" but are rather "stuck" with an activity and, thus, will be more motivated to influence policy toward their industries) and whether a sector (or concrete firm) is closer to the country’s international comparative advantage. On asset specificity see Jeffrey A. Frieden, *Debt, Development and Democracy* (Princeton: Princeton U. Press, 1991) esp. pp. 20 ff.

48 For an example of this approach as related to the process of European integration, see Andrew Moravcsik, *The Choice for Europe* (Ithaca and London: Cornell University Press, 1998).

49 For the purposes of this paper, and when a more precise definition would be out of place, various entities seeking to articulate their interests through state policy will be defined collectively as interest articulators. For our purposes, this concept includes lobbies, interest groups, and interest associations, as well as other more informal arrangements.

50 Following North and the “new institutionalism” literature, for the purpose of this paper we take a broad view of institutions, defining them as formal or informal constraints that help structure human interaction and facilitate coordination between actors. See Douglas C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge, Cambridge U. Press, 1990).

51 Council of Mutual Economic Assistance.

uncompetitive goods as payment for energy supplies.<sup>52</sup> <sup>53</sup> Second, the institutionalized system of implicit subsidies to energy-intensive industries, which isolated these countries from changes in world energy supplies.<sup>54</sup> Third, the decoupling by foreign trade institutions of prices paid *to* exporting enterprises from the actual international prices paid *by* the buyer to the foreign trade authority. The second reason why an institutionalist approach makes sense for understanding the Ukrainian and other post-Soviet cases has to do with the strong institutional legacies left by the Soviet system. Looking at these legacies, their lingering impact, and the way they have been reflected in new institutions developed since 1991 is crucial for understanding these cases better. In fact, some of these legacies continue to go strong in the post-1991 period.

### ***Building upon and Enlarging an Institutional Perspective: A Sharpened Focus on Domestic Practices and Institutions***

A modified IPE-institutionalist approach may yield promising results in terms of helping us understand the link between Ukraine's domestic situation and its management of its energy situation. By looking at the ways in which domestic institutions mediate how changes in the international economy affect domestic groups, the institutionalist IPE literature can help us make the connection between the type of political/institutional system and styles of management of energy dependency.

However, the institutionalist perspective may be enriched by a rethinking of some of the concepts included in the analysis. First, the traditional IPE concentration on "sectors" of the domestic economy needs to be reassessed. At least in the post-Soviet states where the institutional framework is in great flux and informal but strong business-administrative groupings are very important, the emphasis on "sectors" needs to be more nuanced – here we need to look not just at sectors or branches of the economy, but also at a variety of interest articulators, including specific companies, business-administrative conglomerates, and regional-based "clans."

Secondly, there needs to be a fuller incorporation of *formal and informal political institutions* into the IPE approach. We do this by extending our concept of institutions and emphasizing three elements in our understanding of them: (1) the role of the *absence* of (formal) institutions able to mediate between interest articulators and the state; (2) the importance of informal as well as formal institutions; and (3) the role of broader institutions in mediating between interest articulators and policy-making, and between particular and general interests.

Absent institutions and preference-setting. Sometimes the *absence* of institutions is as important as existing institutions, in that it also contributes to creating a particular institutional environment and promotes certain forms of interest articulation.

Formal and informal institutions. In their role in helping shape preferences, we can talk not only about concrete legal institutions (such as foreign trade institutions and formal constitutional politico-institutional arrangements), but also, following Zisk, about broader, more informal and culturally defined institutions having to do with culture, informal social

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52 See John M. Kramer, *The Energy Gap in Eastern Europe* (Lexington, MA: Lexington Books, 1990), p. 132.

53 Although the short-term effect was to cushion these countries from changes in international energy markets, the medium-term effect of these distortions was that these countries' entire economies became geared towards the production of non-competitive goods, which has made their adaptation to competitive world markets more difficult.

54 By, for example, not fully passing on the 1973-1974 increases in world oil prices. Georges de Ménéil, "From Hyperinflation to Stagnation," in Anders Aslund and Georges de Ménéil, *Economic Reform in Ukraine. The Unfinished Agenda*, (Armonk, N.Y.: M. E. Sharpe, 2000). pp. 50-51.

norms, and expectations about roles,<sup>55</sup> which have important effects in terms of helping actors shape their preferences and expectations. Here some of the insights of the constructivist literature, such as its accent on cultural and identity issues and on how structures and agents mutually define each other, can be very valuable in building a broader, more inclusive understanding of institutions. Thus, we need to look not just at the formal domestic political system, but at the informal distribution of political power and economic resources,<sup>56</sup> and at the more or less informal institutional arrangements *as they really work*.

The most important area where the institutionalist approach needs to be expanded concerns the role of broader institutions in affecting interest articulation and the relationship between “particular” and “general” interests. When analyzing how a country’s institutional arrangements (both formal and informal) will affect how various domestic groups will be differently affected by external economic pressures, it is not enough to think about institutions’ role as channels through which societal actors “mobilize and apply power,”<sup>57</sup> or to think in terms of the factors traditionally emphasized by institutionalist IPE approaches, such as each sector’s level of exposure to the international economy, economies of scale, “specificity” of assets, and closeness to the country’s comparative advantage. It is also essential to look at the broader role of institutions in affecting the interest intermediation relationship between various groups and the state and at the ways in which the larger political-institutional arrangements may favor particular sectors or groups and influence the process of interest articulation between them and the state. Here we are talking about *de facto* systems of power and interest articulation.

For example, in a pluralist and transparent system of interest intermediation, by and large, no single group should have “greater access to and influence over the state than (...) representatives of other interests.”<sup>58</sup> In such a situation, the state has more of a chance to develop preferences that are independent from those of the main interest groups and, therefore, more of a chance to represent “general” as opposed to “particular” interests. In a situation where interest articulators have little independent power (Belarus, for example) or too much power (Ukraine), the state’s ability to develop and implement democratically regulated and controlled policies will be limited.<sup>59</sup>

So from this third (interest representation and political systems as institutions) perspective, a country’s *de facto* system of interest representation will have important effects in terms of that country’s ability to manage its energy dependency and, in particular, its energy dependency on the most significant external player (in this case, Russia). The *de facto* system of power and interest articulation can affect the management of energy dependency in a variety of ways, for example through the ways in which it affects (a) the transparency or non-transparency of energy markets; (b) the country’s ability to develop and pursue a clear and consistent energy policy; (c) the existence or absence of a transparent, democratically controlled energy policy; (d) the institutional space given to the executive by the political

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55 Zisk, *op. cit.*, p. 141. See also Gerner Grabher and David Stark, “Organizing Diversity: Evolutionary Theory, network analysis and post-socialism” (pp. 54-75) in John Pickles and Adrian Smith (Eds.), *Theorising Transition: the Political Economy of Post-communist Transformations* (London: Routledge, 1998).

56 See Juan Linz, “Introduction: Some Thoughts on Presidentialism in Post-Communist Europe,” in Ray Taras (ed.), *Postcommunist Presidents* (Cambridge: Cambridge U. Press, 1997).

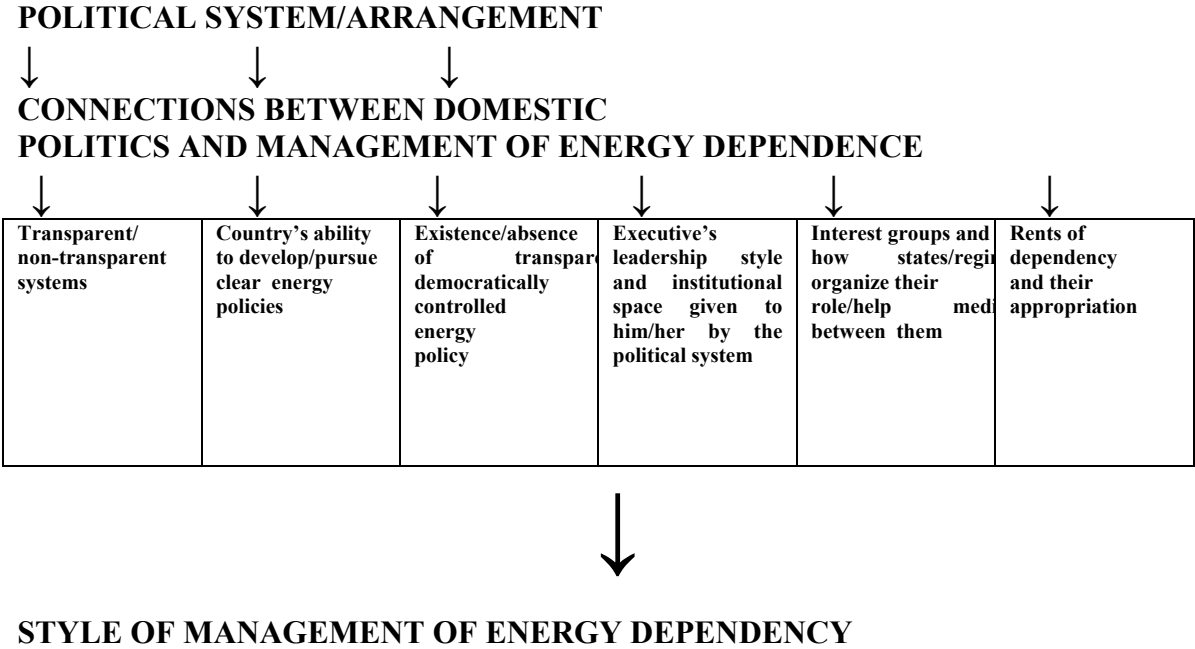
57 See Gourevitch, (1986), p. 33.

58 Michael McFaul, “State Power, Institutional Change, and the Politics of Privatization in Russia,” *World Politics* 47 (January 1995), p. 240.

59 By “developing and implementing democratically regulated and controlled policies” we refer to a situation where the state has both the ability and the power to conceptualize and carry through policies, but this is done not in an authoritarian manner, but in a way that is transparent and represents the democratically expressed interests of the population.

system and domestic factors constraining leaders’ negotiating space; (e) the system of interest articulation; and (f) access to and use of rents of dependency. (See Figure 1 below.)

**Figure 1: Intervening factors between political systems and management of energy dependency**



a. Transparency. Whether or not the political and economic system is characterized by transparency will matter because non-transparent systems offer fertile ground for corruption and for the appropriation of significant “rents of dependency” (see p. 22 below) at the expense of the state as a whole. In addition, non-transparent systems will tend to cooperate with each other, with consequences for trade policy-making.

b. Clear and consistent energy policies. Whether the system in place allows for the development of consistent, long-term energy policies will matter because, in cases where following an energy diversification policy will entail significant initial costs, such diversification only has a chance to succeed if it is part of a long-term, consistent energy policy.

c. Democratically-controlled energy policies. The management of energy dependency is also affected by the question of *where* energy policy decisions are made: in the open political realm, or in under-the-table deals between regime and interest articulators? Whether there is a democratically controlled energy policy will matter because democratically controlled policies have more of a chance to represent national as opposed to particularistic interests. Moreover, only democratically controlled and generally accepted energy policies can survive contestation in the long term.

d. Executive’s leadership style and institutional space given to him/her by the political system. Leaders with little legitimacy at home will have a diminished ability to pursue their country’s energy interests internationally. Moreover, leaders with few allies will be tempted to seek support from other possible partners at all costs, restricting their policy-making sovereignty in energy issues.

e. Patterns of interest articulation. Larger interest articulation patterns will affect how de facto policy is made (including energy policy). These patterns will also affect whether and to what extent the abuse of office and the misuse of (nominal or real) energy policy-making institutions for the benefit of private, particularistic interests will be encouraged. The system of interest representation will also affect whose group interests gain the upper hand and, thus, will also affect energy diversification policies.

f. Rents of dependency. Larger interest articulation patterns will also affect whether certain groups can benefit from the situation of dependency, privately appropriating its “benefits” while shifting the costs to the state and the society as a whole. We refer to these benefits as “rents of dependency” – the significant windfall profits that, under some circumstances, can be made out of a situation of energy dependency, often through illegal or semi-legal means.<sup>60</sup> They will also affect the management of energy dependency through the issue of whether or not, and how, these “rents of dependency” largely related to untransparent systems will be able to be extracted and incorporated into these systems.<sup>61</sup> How various groups will benefit from the rents of dependency will affect whether they will want to draw out this situation of dependency (in general, or with respect to a specific partner).

## VI APPLYING OUR FRAMEWORK TO THE CASE OF UKRAINE

In this section, we seek to apply this framework to an understanding of the Ukrainian case.

### *General Political System*

Ukraine’s post-independence political system (in particular that in place in the period 1995-2004<sup>62</sup>) is a semi-authoritarian system following the letter if not always the spirit of democracy.<sup>63 64</sup> While somewhat different energy policies were followed in 1991-1995<sup>65</sup> and 2000-2001, the basic characteristics of the Ukrainian system of power have not changed since 1995.<sup>66</sup> It is characterized by a system of informal balances between strong business-

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60 For example, through indirect and often murky energy trade means involving barter and a variety of grey market mechanisms such as the mutual offsetting of loans and the resale of discounted IOUs, bills of exchange and tax arrears scrip.

61 This is not to deny that in some cases “rents of dependency” actually may have to do more with external than with internal factors, or at least the confluence of the two, for example in the case of the energy benefits received by Belarus from Russia in exchange for political support.

62 We take as a starting point the Constitutional Agreement of 1995. The Agreement greatly strengthened the role of the executive, opening the door for the current system of interest representation.

63 See Steven Levitsky and Lucan A. Way, “The Rise of Competitive Authoritarianism,” *Journal of Democracy* 13 no. 2 (April 2002): 51-63.

64 As of mid-2004, the system is composed of three larger groups (the so-called “Donetsk,” “Dnepropetrovsk” and “Medvedchuk” groups, with a number of smaller groups (Lugansk, etc.) at the margins.

65 Ukraine’s system of interest representation in the 1991-1995 period differed from the current one in that after 1996 (1) regional and business-administrative “clans” -- as opposed to the importance of state enterprise directors in the immediate post-independence period -- became more influential in state policy; (2) the central cleavage changed from one between state enterprise managers (“red directors”) and private property owners to one among various business-administrative groups; and, (3) the President acquired significant new powers allowing him to play a “balancing” role among these. However, we have chosen not to consider the pre-1996 Ukrainian system as a separate case, as it was rather a transitional and often disorganized, “spontaneous” arrangement.

66 The period encompassing Viktor Yushenko’s tenure as PM and Yulia Tymoshenko’s work as First Vice Prime Minister for Energy issues in 2000-2001 was characterized by a strong push for increased transparency and accountability in energy policy. However, interest groups turned out to be more powerful

administrative groups (“clans”), with President Kuchma playing an important balancing role for purposes of remaining in power.<sup>67</sup> This “balancing” has economic as well as political aspects: central to it is the executive’s allocation of patronage appointments, administrative benefits and licensing rights that allow these groups to enrich themselves, in exchange for returning a portion of the profits, recycled by the executive into regime-maintenance and election-preparation activities.

In the Ukrainian case we see a situation where strong interest articulators have great power and have taken over state policies in many areas, with the autonomy of the state limited by this power. At the same time the executive acts as “balancer” among various interest groups<sup>68</sup> (we refer to this as an “executive-as-balancer” system). While the strength of some interest articulators reminds us of Hellman’s concept of “state capture,”<sup>69</sup> what sets the 1995-2004 Ukrainian case apart is the role of the executive in this system. The executive’s maintaining of a “balance” among the various groups prevents any one group from gaining total power, but also prevents two or more groups from joining together to challenge the president. At the same time, President Kuchma has developed a closer group of associates or “inner group” and placed them at the helm of state companies strategically located in the chain of access to financial resources, in particular natural monopolies in energy and raw materials sectors. Independent of the main business-administrative groups and loyal only to Kuchma, members of this “inner group” have the task of securing direct access to constantly renewed financial resources through strategically located and nominally state-owned companies, a source of funding that complements the more indirect (and relatively unstable) flow of income through business-administrative groups (Table 7 places the Ukrainian case in a comparative Central East European perspective).

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than the reform team, which was removed from office in 2001. However, some of the reforms introduced during that period (especially concerning payment discipline in the energy sector) have remained in place. The survival of some of these policies is explained by some by the fact that increased payment discipline was now desirable by the largest participants in the energy market. See Olexander Babanin, Vladimir Dubrovskiy, and Olexyi Ivaschenk, Ukraine: The Lost Decade and the Coming Boom (Kyiv: CASE Ukraine, 2002).

67 Kubicek uses the concept of “residual corporatism” in reference to Ukraine. However, this approach is not appropriate for our inquiry as it focuses mainly on formal interest associations as opposed to a broader range of economic and interest groups. See Paul Kubicek, Unbroken Ties: the state, interest associations and corporatism in post-Soviet Ukraine (Ann Arbor: University of Michigan Press, 2000).

68 On this balancing, see Oleh Protsyk and Andrew Wilson, “Centre Politics in Russia and Ukraine: Patronage, Power and Virtuality,” *Party Politics* Vol. 9 No. 6 (2003), pp. 703-727.

69 In Hellman’s view of “captured state,” particularistic actors gained great power within the state, to the point that they can use its institutions and resources for their own goals as opposed to general interests. See Joel S. Hellman and Mark Schankerman, “Intervention, Corruption and State Capture: The Nexus Between Enterprises and the State,” in *Economics of Transition* 2000 No. 3, pp. 545-567, and Joel S. Hellman, “Winners take all: The Politics of Partial Reform in the Postcommunist Transition,” *World Politics* 1998 No. 1, pp. 203-234. For the World Bank definition of state capture, see World Bank, *Anticorruption in Transition: A Contribution to the Policy Debate* (Washington, DC: World Bank, 2000).

**Table 7: Ukraine’s system of power and interest articulation (1995-2004) in a comparative Central East European perspective**

Domestic Interest Representation Arrangements	Formal Political System	Transparency	Open Competition Between Elites	Alternative [Non-system] Economic Elites Independent of Executive or Balancing/Clientelistic System	Alternative Elites Having Access to Own Sources of Income and Size	Alternative Elites Having Own Parties	Alternative Elites Having Own Media
Centralized: few interest groups, executive/ruling party as monopolist <b>Belarus</b>	Super-presidentialist	Low	No	None/minimal	None/minimal	Yes, but small, heavily persecuted and having minimal access/impact	No/minimal
Executive-as-balancer: strong interest groups, unclear rules of the game, executive plays “balancing” role for own benefit <b>Ukraine</b>	Semi-presidentialist. Up to 2004 change in the law. Rada elected according to single-mandate districts, allowing local elites to control the result, and in turn Kuchma to control the Rada	Low	Yes, strong regional element	Few, most important elites included in president’s “balancing”/clientelistic system	Some	Yes	Yes
Limited-clientelistic <b>Slovakia 1993-1999</b>	Parliamentary	Medium-Low	Yes	Some, “balancing”/clientelistic system was not able to control most of economy	Yes	Yes	Yes
Transparent: active interest groups constrained by clear rules <b>Poland Hungary Slovakia 1999+</b>	[Premier-presidential semi-presidentialism <sup>70</sup> ] Parliamentary Parliamentary	Medium-High	Yes	Plural elites	Yes	Yes	Yes

70 In a “Premier-presidential” model the power of cabinet dismissal rests with the parliament but not the president. Protsyk, “Troubled Semi-Presidentialism,” p. 1084.

What are some implications of this situation for the policy-making process? First, the fact that policy-making institutions are often misused or sidestepped for the benefit of particularistic interests, including the executive. Second, that there is a good chance “rents” of dependency can be appropriated by particularistic interests, affecting their role in the policy process. Third, the fact that policy decisions (including energy policy decisions) are often the result of non-transparent negotiations among various well-placed groups – and arbitrated by the President – with various results depending how the rent-seeking interests of the various groups involved are “balanced” in each case. In terms of energy policy, sometimes these results will promote energy diversification, and sometimes they will lead to an entrenchment of energy dependency. The central factor here is not general national interest nor long-term national energy policy, but the short-term rent-seeking perspectives opened by each policy alternative to specific groups and how they affect the “balance” among the various groups. From the point of view of the logic of the system in terms of regime maintenance, energy policy is just another field in which the “balancing” of various business-administrative groups by the executive takes place, with policies used as “coin change” in a larger system of “balancing” and where actual questions of energy policy often play only a secondary role.

In the case of Ukraine, the absence of a clear policy has left real policy-making to well-connected actors, to the detriment of general interests. Let us see how the larger system of power and interest articulation in place in Ukraine has affected energy policy-making through its effects on the six elements discussed above.

a. Transparency. The general system of power in Ukraine has affected the issue of transparency through the fact that real policy-making often takes place not through elected representative institutions, but through informal networks reminiscent of patron-client relationships.<sup>71</sup>

Lack of transparency in the Ukrainian energy markets not only creates opportunities for corruption and abuse of power, but actually invites corruption by creating opportunities for quick enrichment through shady energy deals. Non-transparent systems also offer fertile ground for the appropriation of significant “rents of dependency” at the expense of the state as a whole. Because of the centrality of the energy sector for Ukraine’s economy as a whole, such trends, once started in the energy sector, spread easily to the rest of the economy.<sup>72</sup> The extensive barterization of the energy economy has also contributed to the growth of the shadow economy, as barter deals are harder to control and tax than money transactions.

The widespread prevalence of corruption, taken together with the lack of clearly institutionalized energy policy-making process, and the large discretionary power of regulatory officials, increases the temptation to engage in bribe-taking. Perhaps the best example is provided by former Prime Minister Pavlo Lazarenko, ousted in 1997 and now on trial in California, but corruption continues at all levels.<sup>73</sup> Having a vested interest in delaying reform, corrupt officials and business-administrative groups associated with them seek to delay reform in the energy sector, making the country less resilient to Russian pressure. Corruption and the general lack of transparency in the system also keep Western investors away, creating a situation that makes Ukraine more open to Russian economic penetration and influence. Actors benefiting from lack of transparency will also tend to cooperate with each

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71 See Oleksander Fisun, “Developing Democracy or Competitive Neo-Patrimonialism,” paper presented at the Centre for Russian and East European Studies, University of Toronto, 24 October 2003, p. 4.

72 As was the case, for example, with the “barterization” of the economy and decline in monetary transactions in the early 1990s. Yuri Savka, “Vzaemozalik iak sposib zhittia,” (“Mutual-offset” operations as a way of life”), *Enerhetychna Politika Ukraini* 2000 No. 6 (June 2000), pp. 30-34.

73 Pavlo Lazarenko is accused of stealing and “laundering” over a hundred million dollars in energy-related corruption deals during his tenure as Ukraine’s PM in 1995-1997. These came mainly from multiple multi-million bribes demanded by Lazarenko from regional gas companies as a condition for granting them distribution rights in their respective regions.

other, and will be more willing to work with countries where similarly low levels of transparency are generally accepted. They will also be less willing to work with partners where a higher level of transparency can be expected. Thus, these less-than-transparent links are more likely to be with Russia than with Western partners, probably pushing the country towards the continuation of energy dependency, not challenging it.

b. Clear and consistent energy policies. Whether the system in place allows for the development of consistent, long-term energy policies will affect diversification issues because, given the high cost of and other difficulties involved in following an energy diversification policy (given the strength of Soviet legacies and of structural factors such as Russian-centered oil and gas pipeline systems<sup>74</sup>), such diversification only has a chance if it is part of a long-term, consistent energy policy.

The general system of power in Ukraine has affected the system's ability to pursue clear and consistent energy policies through two elements. First, through the widespread "capture" of state companies and institutions by particularistic interests. Second, through the constant "balancing" needed to keep the system in place from the president's perspective, which gets in the way of the development of clear and consistent national policies. One of the reasons, if not the main reason, Ukraine has been unable to develop clear and consistent national policies is that this has not been a priority of President Kuchma, with regime-maintenance "balancing" a more important goal for the leadership.

At a more general societal level, three additional factors can help us understand the lack of a domestic consensus on the need for energy diversification. First of all, the fact that many in Ukraine do not instinctively think in terms of a Ukrainian "national interest" nor see a Ukrainian national interest as a priori separate from Russian national interest and rather instinctively think in terms of common interests with Russia.<sup>75</sup> Second, the fact that many people do not see the point of an energy diversification policy based solely on political independence goals *as a value in itself*, so they are ready to support diversification initiatives only if they are also economically advantageous in the short term.<sup>76</sup> Third, the fact that some individuals and economic groups draw considerable benefits from the continuation of the energy dependency relationship *with Russia* – due to their interest in specific contracts, but also because dealings with Russian and CIS companies allow for greater freedom of action in terms of non-transparent deals than could be provided by Western partners. Understanding the selective domestic redistributive implications of the energy relationship with Russia and how they are made possible by the Ukrainian political system is essential for understanding

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74 This is not to say that energy diversification is an easy task. In addition to Ukrainian policy wavering, diversification has been made difficult by a variety of factors, both structural/historical and political. At the level of international relationships, both the Russian government and Russian companies have repeatedly created hurdles on the path of Ukraine's energy diversification plans, as exemplified by Russian pressures for the possible reversal of the Odessa-Brody oil pipeline. At the structural level, Ukraine remains tied to a Russia-centered energy infrastructure developed during the Soviet period, which means that the actual pipelines needed to receive oil and gas from non-Russian sources simply are not there. Because of the high cost of building new oil and gas pipelines or securing other transportation options, alternative oil and gas supplies would initially be significantly more expensive than Russian ones. Such initial difference in costs reduces the attractiveness of diversification in the short term, and makes diversification initiatives difficult to push through unless there is significant domestic consensus on the issue. It is exactly because of these external constraints that the development of a consistent and proactive energy policy is so important for countries such as Ukraine.

75 As put by James Mace, the issue of the Odessa-Brody is another manifestation of Ukraine's problems in "defining its national interests in the context of Russian-Ukrainian relations." See James Mace, "Neftianna Geopolitika," *Den'* (Kyiv) 8 April 2003. Translation mine.

76 For a representative view, see Vladimir Golovko, "Vliianie vneshnikh faktorov na strategiu energeticheskoi politiki Ukraini," *Energeticheskaya Politika Ukraini* 2003 No. 2 (February 2003), pp. 8-11.

Ukraine's energy policy and its weakness in negotiations with Russia and Russian energy companies, and also to dispel any illusions of a victimized Ukraine united in the face of Russian pressure.

As a result of these factors, the current system in place in Ukraine does not foster the development of consistent long-term energy policies.

How does the example of Odessa-Brody relate to larger questions concerning the possibilities for the development of clear and consistent energy policies? First, because of the lack of a clear business plan accompanying the project and repeated delays in its completion. While the lack of a clear business plan in the development of public policy projects is hardly a monopoly of Ukraine, this does not make this factor less important for understanding problems and issues around the Odessa-Brody pipeline. Both the planning and building, and now the implementation of the pipeline, were not carried out at the level of national policy (as a project of this magnitude and geopolitical significance may warrant), but at the level of specific state companies, which carried most of the financial weight of the project.

Second, the issue of the development of clear and consistent energy policies comes in through the issue of President Leonid Kuchma's reaction to proposals for the reversal of the pipeline. From the very beginning, President Kuchma's response to the discussions and debates around the pipeline was characterized by wavering and the lack of a clear position.<sup>77</sup>

c. Democratically controlled energy policies. The general system of power in Ukraine has affected the issue of democratic control over energy policy through the fact that de facto policy decisions are often made not through elected representative institutions, but through informal networks. What are some of the effects of this on energy policy? This lack of a democratically controlled energy policy process makes actual energy policies easy prey for political and social contestation. It also creates important hurdles on the way to energy diversification, because only a democratic and generally accepted energy diversification policy has the chance to be followed despite the hardship involved in its implementation, as is often the case in the former Soviet area.

d. Executive's leadership style and institutional space given to him/her by the political system. The general system of power in Ukraine has affected President Kuchma's leadership style and the domestic constraints on his international behavior by giving the executive significant formal and informal powers, which make possible a certain system of "balancing," with important effects on the country's ability to pursue a clear and consistent energy policy.

#### *President Kuchma's Leadership Style*

President Kuchma's style of political manoeuvring limits Ukraine's field of action in energy policy. In the first place, because of his style of managing interest representation. For example, President Kuchma's cadre policy based on frequent rotation – essential for his "balancing" of various business-administrative groups to work out – has hindered the development of a clear national energy policy, as well as a clear line on the use of the Odessa-Brody pipeline.

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77 Two recurring comments by President Kuchma are representative of his wavering on Odessa-Brody. First, his declared insistence that the pipeline will not be reversed, and, simultaneously, his veiled (or not-so-veiled) accusation that the West was acting hypocritically towards Ukraine, proclaiming the importance of and political support for the Odessa-Brody project, while failing to provide any concrete material support. (See for example his declarations at the VI Ukrainian-Polish Economic Forum, Odessa, 24 June 2003, arguing that Ukraine will indeed use the pipeline in reverse, unless the EU goes beyond declarations and takes concrete steps in support of the Odessa-Brody use of the pipeline. See Ukrainian Gas and Oil Report (NefteRynok) July 7, 2003.) Gradually, his declarations turned more and more in support of the reverse use of the pipeline.

This style of balancing (in reality the opposite of what is usually understood as a balance of executive, legislative and judicial powers) is based not on consensus-building, the development of a pluralist interest representation system, or the institutionalized balancing of social political and economic groups with equivalent access to interest articulation possibilities, but on the “balancing” among various business-administrative groups. President Kuchma has sought to play the role of “balancer” among various interest articulators, playing various interest groups and clans against each other, and not stopping at blackmail when he has seen this to be necessary. This style was recently manifested through Kuchma’s cadre policies during the debate on the possible reverse use of the Odessa-Brody pipeline, by promoting “pro-reversal” Neftegaz Ukraini head Yurii Boiko from Vice-State Secretary of the Ministry of Fuel Energy to First Vice-Minister, thus greatly increasing his power vis-a-vis Energy and Fuel Minister Ermilov, who opposed the reversal.<sup>78</sup> By creating the conditions for a confrontation between both, such promotion fits well with Kuchma’s role as partial “balancer” among various interest groups by seeking to make them “fight it out among themselves”. Yet such a leadership style further reduces the predictability of Ukraine’s policies, and does little to attract foreign confidence in dealing with Ukraine.<sup>79</sup>

President Kuchma has also used energy policy as a balancing tool in his relationship with Moscow. Kuchma’s often repressive and intransparent domestic and international policies<sup>80</sup> have led to his becoming more and more internationally isolated. This puts the president in a situation where, on the one hand, he becomes increasingly dependent on Russian support and, on the other, his weakness vis-à-vis Moscow also weakens his ability to stand up to it in terms of energy issues. With few reserves of legitimacy at home<sup>81</sup> or allies abroad, Kuchma has had little alternative but to comply with Russian wishes and requests, including in the area of energy policy. Combined with the traditional weaknesses of Ukrainian energy policy-making, this means Kuchma has little of a clear, legitimate and well-supported national energy policy to oppose to Moscow’s ideas and pressure.

Different interests exist within any country, but President Kuchma’s way of dealing with these conflicting interests, within the context of the absence of well-institutionalized mechanisms for interest articulation, has only exacerbated Ukraine’s energy problems. His personal motives also emerged as an interesting factor in relation to the issue of the creation of an international consortium for the operation of Ukraine’s gas transit system and his tacit support for an intransparent and far from perfect Russian proposal in 2003.<sup>82 83</sup> Many asked themselves: why would President Kuchma support such a vision of the consortium which

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78 See Elena Brodskaya, “V UKRTATNAFTE – dvoevlastie,” Infobank Oil and Gas Monitor (Lviv), August 25, 2003.

79 On this way of managing interests, see Elena Brodskaya, “V UKRTATNAFTE – dvoevlastie,” Infobank Oil and Gas Monitor (Lviv), August 25, 2003.

80 Exemplified, among others, by his purported role in the disappearance and assassination of journalist Heorhii Gongadze in September 2000, the “Kuchmagate” scandal involving self-incriminatory tapes later that year, and the scandal involving the possible secret sale of Kolchuga radars to Irak in 2002. See the transcripts available at [www.oneworld.org/index\\_oc/news/ukraine1210101.html](http://www.oneworld.org/index_oc/news/ukraine1210101.html).

81 Domestically, Kuchma seems to compensate for his lack of legitimacy by strategically using the support of various influential individuals and “clans,” which he manipulates by selectively giving support to (and seeking support from) them and by playing them selectively against one another.

82 What we call here a “far from perfect” Russian proposal concerned the counting of Ukrainian debt to Gazprom as Gazprom’s capital contribution to the gas consortium project, the easing out of German participants from the consortium, and general lack of transparency in discussions of the project. See the special issue on the international gas consortium project, *Natsionalna bezpeka i oborona* (Kiev), 2004 No.1. The creation of a full-scale international gas consortium was delayed in 2004 due to the need to modify a number of Ukrainian laws to permit its functioning.

83 President Kuchma’s declarations on the consortium have been contradictory, but he is generally believed to want to drag out the process of formation of the consortium as a way to remain needed as intermediary, and thus increase his chances of winning immunity from criminal prosecution after he leaves office.

seems to have more minuses than pluses? Kuchma can benefit from it because he urgently needs Russia's support, and, thus, is more ready to come to agreements and compromises with Gazprom than if he were not so dependent on this support.

### *Institutional Space Given by the Political System to the Executive*

It is clear that President Kuchma's domestic weakness, lack of legitimacy, and his leadership style are some of the factors driving Ukraine's specific management of its energy relationship with Russia. But up to which point is this just an exception having to do only with the current president, and up to which point is it a reflection of wider, more stable trends in the Ukrainian political system as it has developed since independence? It could be argued that the Ukrainian political system gives the president significant informal power, which he can then use for his own personal needs.<sup>84</sup>

It could be argued that certain characteristics of Ukraine's constitutional framework (especially after the 1995 Constitutional Agreement) create the framework conditions for a de facto system of power that allows the president's leadership style to play too much of a decisive role, and fosters a system in which the president, not transparent institutions, is the ultimate "balancer" among various informal interest articulators.

In particular, three characteristics of the Ukrainian political system foster this situation: the president's range of powers, the electoral system for election to the national parliament (Rada), and the Rada's own internal regulations. Concerning the president's powers, these increased significantly as a result of the 1995 Constitutional Agreement. In particular, the president's significant appointment (including patronage appointment) and dismissal powers play an important role. The president's appointment powers and ability to change rules means he has resources that can in turn be used by the various parties to strengthen their own clientelistic networks, which in turn fosters the development of a clientelistically structured party system.<sup>85</sup> The president's power to dismiss the Prime Minister gives the latter an incentive to work with the president, helping shape Cabinet of Ministers decisions too.<sup>86</sup> The fact that in the 1995-2004 period the dominant electoral system has been one based on single-mandate districts has contributed to local elites' ability to control the results, and in turn, through clientelistic linkages, to strengthening the president's control of the Rada. The existence of low electoral thresholds for the party-list portion of Rada seats<sup>87</sup> and of low faction recognition thresholds<sup>88</sup> has contributed to fragmentation in the Rada, allowing the president to more easily play a "balancing" role. The fact that Rada itself is not structured along party lines, but on the basis of "factions" (once elected to the Rada, each MP can choose to join a number of "factions," and can change factions at his pleasure) also means the

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84 See Paul D'Anieri, "Leonid Kuchma and the Personalization of the Ukrainian Presidency," *Problems of Post-Communism* Vol. 50 No. 5 (September-October 2003), pp. 58-65. For the argument that regimes such as that of Ukraine should be considered actual regimes rather than just temporary transitional arrangements, see Steven Levitsky and Lucan A. Way, "The Rise of Competitive Authoritarianism," *Journal of Democracy* 13 no. 2 (April 2002): 51-63.

85 See Oleh Protsyk and Andrew Wilson, "Centre Politics in Russia and Ukraine: Patronage, Power and Virtuality," *Party Politics* Vol. 9 No. 6 (2003), pp. 703-727, here p. 707.

86 See also Oleh Protsyk, "Troubled Semi-Presidentialism: Stability of the Constitutional System and Cabinet in Ukraine," *Europe-Asia Studies* Vol. 55 No. 7 (2003), pp. 1077-1095.

87 Until 2004, in order to be represented in the Rada, a party had to reach the 4% threshold.

88 There is currently no law forcing Rada MPs to adhere to a certain voting discipline vis-à-vis their party. Most importantly, although candidates may campaign for election to the Rada as members of specific parties, the Rada itself is not structured along party lines, but on the basis of "factions." Once elected to the Rada, each MP can choose to join a number of "factions," and can change factions at his pleasure. A law passed in 2004 introduced modifications which will come into force in the next parliamentary cycle.

president will have more of a chance to use divide-and-rule tactics to influence voting in the Rada.

In addition, the country's structure plays an important role: the existence of a unitary system and the appointment of regional governors by the president mean regional governors (1) are more independent of the local electorate than if they were elected; (2) have at their disposal a significant amount of resources from Kyiv (access to appointed and patronage positions, etc.) which they can use to further build their clientelistic networks and support preferred parties in the elections; and (3) are also tied to the president by clientelistic links (since they are appointed and dismissed by the president); thus, in order to keep their jobs they need to be able to "mobilize" votes for the president, strengthening "party of power" clientelistic structures.<sup>89</sup> The fact that the Ukrainian political system gives the president significant informal powers, which he can then use for his own personal needs,<sup>90</sup> "multiplies" the de facto significance of these powers.

e. Patterns of interest articulation. In many ways, patterns of interest articulation affect all other connections between political systems and the management of energy dependency. The general system of power in Ukraine has led to a situation where de facto interest articulation takes place not through elected institutions but through the informal "balancing" of business-administrative groups described above.

Even in the context of the most clearly institutionalized and transparent political system, Ukraine's energy dependency on Russia would be a problem. Kuchma's ability to build a strategy based on playing certain interests against each other could not succeed if these conflicting interests did not exist. Indeed, differing and often conflicting interests exist everywhere, but the issue is whether a sufficiently developed institutional system exists which is able to moderate these differences and guarantee that general interest prevails over particular sectoral interests. Such a system does not exist in Ukraine,<sup>91</sup> and its absence means increased freedom for the executive to engage in back-room dealings with various political and economic groupings, making it much more difficult for the country to adopt a proactive and long-term energy policy in tune with the needs of the country as a whole and not only those of some political and economic groups.

Absent institutions and preference-setting. Similarly, the lack of institutionalized and transparent mechanisms of interest articulation changes the calculations of the various actors in the system. For example, if part of the standard Western definition of "interest groups" is that they "do not in themselves seek to occupy the position of authority,"<sup>92</sup> in the case of many post-Soviet states the specific institutional situation, in particular the absence of working mediating institutions,<sup>93</sup> means that economic groups will indeed see it in their interest to *pursue power itself* in order to attain certain policy goals. In this case, the institutional situation (actually, the *absence* of working mediating institutions) affects actors' preferences – they react by preferring to *have* power because "just influencing power" is

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89 See K. Matsuzato, "From Communist Boss Politics to Post-Communist Caciquismo – the Meso-Elite and Meso-Governments in Post-Communist Countries," Communist and Post-Communist Studies Vol. 34, No. 2 (2001), pp. 175-201, here p. 189.

90 See for example see Paul D'Anieri, "Leonid Kuchma and the Personalization of the Ukrainian Presidency," Problems of Post-Communism Vol. 50 No. 5 (September-October 2003), pp. 58-65.

91 On this lack of organized lobbying see article on lobbying see Tatiana Zolotareva, "Lobbizma u nas net," Kontrakti, (Lviv) No. 16 (April 19, 2004).

92 See Jerry Richardson, Pressure Groups (Oxford: Oxford U. Press, 1993), p. 1.

93 Such as independent trade associations, but also policy-making institutions able to make policy on the basis of democratic control and independent expertise and not personal connections or the misuse of office for personal goals. On trade associations in Ukraine, see Paul Kubicek, Unbroken Ties: the state, interest associations and corporatism in post-Soviet Ukraine (Ann Arbor: University of Michigan Press, 2000) and Paul Kubicek, "Variations on a Corporatist Theme: Interest Associations in Post-Soviet Ukraine and Russia," Europe-Asia Studies Vol. 48 No. 1, 1996.

simply not a viable option. Also, in cases such as that of Ukraine, the absence of such institutions able to mediate between private and general interests has left real decision-making to whatever actor might be stronger or command better contacts with policy-makers, rather than to representative institutions.<sup>94</sup>

In Ukraine, the missing formal and transparent interest representation system has been largely replaced by informal arrangements, bringing us back to the question of formal and informal institutions. To understand the Ukrainian situation, it is necessary to look not just at the formal domestic political system, but also at the more or less informal institutional arrangements *as they really work*. In the case of Ukraine, for example, we can talk about corruption and institutionalized non-transparent ways of policy-making as informal institutions playing an important role. Interest articulation arrangements are an example of informal institutions but also of an area where the formal (political and constitutional) and informal arrangements (de facto systems of power) interact closely. Different formal political and constitutional arrangements (presidential vs. parliamentary systems, for example) can promote or hinder various forms of de facto interest articulation.

f. Rents of dependency. The general system of power in Ukraine has affected the issue of rents of dependency through the way in which various participants in the system are allocated access rights to and are expected to subsequently share significant rents, in particular “rents of dependency” drawn from energy transactions.

In post-1996 Ukraine, various interest articulators have been the main recipients of these “rents,” which they then use in a complex way to support the president (or, less frequently, other political forces), and where the president does not control but somehow keeps a balance among these groups by various means, including the allocation of licensing rights that allow them to continue participation in the energy market in such a way that they can continue extracting “rents of dependency”.<sup>95</sup>

At the same time, President Kuchma has developed an “inner group” of associates, which he has placed at the helm of state companies strategically located in the chain of access to financial resources, and which have the task of securing direct access to constantly renewed financial resources through strategically located and nominally state-owned companies. The logic of this system and President Kuchma’s efforts to gain and solidify direct control over energy-related financial streams explains some of the changes and constant reorganization of the Ukrainian energy sector in the last years, in particular the creation of special companies consolidating state shares in the oil (Naftohaz Ukraini, established in 1998), atomic energy (Energoatom, established 1996), electricity (Enerhetichna Kompania Ukraini, established 2004) and coal (announced 2004) subsectors. This trend is also significant because it places significant areas of energy policy, previously dealt with by the Ministry of Fuel and Energy, away from the normal policy-making chain and in a non-transparent sphere, where “commercial secrets” can always be called upon as a justification for the lack of transparency.

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94 As noted by Fisun, in the case of Ukraine and a number of other post-Soviet states, formal democratic institutions exist, but these institutions are tied together “not by modern, rational-legal civil relations, but by patron-client relationships”. Oleksander Fisun, “Developing Democracy or Competitive Neo-Patrimonialism,” paper presented at the Centre for Russian and East European Studies, University of Toronto, 24 October 2003, p. 4.

95 This view is consistent with analyses of [center] parties in Ukraine as clientelistically structured in the sense that they are structured around the exchange of votes for access to executive decision-making, which becomes especially important given the executive’s role as 1) having resources that can in turn be used by the various parties to strengthen their own clientelistic networks (through patronage appointments, spending, ability to change rules) (Oleh Protsyk and Andrew Wilson, “Centre Politics in Russia and Ukraine: Patronage, Power and Virtuality,” *Party Politics* Vol. 9 No. 6 (2003), pp. 703-727, p. 707.) and 2) acting as a guarantor of “balance” in the system due to the ability to change rules. If we substitute “clan” for party, this characterization would apply as well.

Another side of the “rents of dependency” question has to do with the role of institutions in cushioning certain domestic actors from the full impact of negative changes in the international economy, such as the energy price increases that followed the dissolution of COMECON and the USSR in 1991. In the same way as the Soviet system of foreign trade institutions gave enterprises little incentive to export because no matter how much world prices for their products would increase, they would still be paid the domestic price and the additional profits go to the state budget,<sup>96</sup> in countries such as post-Soviet Ukraine the institutional framework has cushioned some economic actors from the full impact of worsening energy terms of trade with Russia. For example, in post-1991 Ukraine, energy dealers and users have often had little incentive to save energy, because the institutional framework resulted in a situation where they would see little difference in doing so – the losses related to energy waste have often been transferred to the state (through energy subsidies and through the state assuming responsibility for private energy debt). Similarly, the fact that until 2003 Ukraine largely bartered transit services for gas supplies from Russia (not having to pay in cash for a significant part of its gas imports) partially sheltered Ukraine from developments in international gas markets, whether favorable or not.<sup>97</sup> Furthermore, Ukraine’s institutional framework has not only softened the blow received by some sectors due to worsened conditions, but has actually created a situation where many economic players could benefit from the country’s energy dependency (for example, through state policy on guarantees for energy imports from Russia, in place for parts of the period since 1991) and from non-transparent ways of conducting energy trade. So in the case of Ukraine, for example, both *institutionalized policies* and *institutionalized non-transparent ways of dealing with energy issues* have cushioned energy dealers and some consumers from the increase in energy prices – by shifting the cost to the state as a whole.

## VII CONCLUSIONS

What have we learned from the Ukrainian case? First, institutions matter. The way Ukraine has been affected by changes in the international energy environment and in its energy relationship with Russia cannot be explained simply by looking at the state-to-state relationship between both actors. Rather, the relationship is mediated by Ukraine’s domestic institutional environment, which largely determines how energy policy is made, and how and whether various domestic actors will attain economic gains from the energy dependency relationship with Russia. This highlights the importance not only of domestic interest articulators, but also of the institutional framework in which they interact.

Second, institutions matter not only in terms of their formal characteristics, but also in terms of their informal ones. In the case of Ukraine, some informal institutions – such as the system of informal balances among strong but informal business-administrative groups, the importance of informal networks in policy-making and the institutionalized corruption and lack of transparency that have made it possible for some economic actors to make a considerable profit out of Ukraine’s energy dependency on Russia – are often more important in the actual management of energy dependency than formal, official ones.

Third, how formal and informal institutions interact, and whether they mutually reinforce each other, is also important. For example, the significant informal powers given by the Ukrainian Constitution to the President reinforce his formal ones, “multiplying” their de facto significance and making it possible for Leonid Kuchma as executive to play the role of

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96 See Evangelista (1996), p. 167.

97 In 2003 Gazprom announced that it would reduce the percentage of transit fees that it pays Ukraine through barter arrangements. On barter and isolation from international price trends, see Clement, op. cit., p. 297.

“balancer” in a largely informal system of power. This comes to affect energy policy which, de facto made as a by-product of this larger “balancing,” never acquires the contours of a clear, consistent and long-term policy line.

A final word on the limits of a domestic-oriented institutionalist approach. In this study, we have focused on the domestic management of a country’s energy dependency. This does not imply, however, that all outcomes will be determined solely by the domestic management of dependency, or that energy dependency and its negative consequences can be surmounted by simply pursuing the “right” style of managing this dependency. No matter what the management of energy dependency will be, other factors – legacies and path dependencies created by the Soviet system, cultural factors, international price dynamics, and international political relationships – will play an important role in the determination of energy outcomes.

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