

Oligarchy 2.0: Rebuilding the Ukrainian Economy and Ensuring Energy Security

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Oligarchs have ruled Ukraine since independence, playing a significant role in the incoherent energy security policy that contributed to the Russo-Ukrainian gas crises of 2006 and 2009. Since the Maidan Revolution and the war in Eastern Ukraine, Kiev and the West have argued that Ukraine can only succeed by completely destroying the class of tycoons that rule the country's most profitable sectors including energy. But ridding the state of the oligarchy is impossible and would hamper efforts at rebuilding the war-torn industrial regions in the East. One option for Kiev that enables it to regain control over its own energy security while supporting much needed reconstruction is to bring the oligarchs under government control. Making reforms to regulation, subsidies and the tax system that enriches the oligarchs will not marginalize them altogether, but will wrest control over the energy policymaking agenda back into the hands of the government.

Ukraine's Devastating Energy Collapse

Decreasing dependence on Russian commodities has been at the top of the Western agenda for years, even before the devastating gas crises in 2006 and 2009 that left Ukraine and much of Eastern Europe without gas supplies during the dead of winter. Ukraine was always especially insecure, as it had an extremely energy intensive economy yet relied on a supplier, with whom it had a contentious relationship for the bulk of its crucial energy supplies. Despite numerous attempts by the European Union to induce Ukraine to implement a coherent energy security policy, Ukraine continued to increase its dependence on Russian commodities even after the gas crises.

Part of the reason for this was the presence of powerful oligarchs who gained veto power over energy policy but had little interest in the energy security of the state. As a result, Ukrainian oligarchs with links to Moscow like [Dmitry Firtash](#) made exorbitant profits off the energy trade by profiting off inefficiencies in the system and passing on the losses to the Ukrainian state. Public dissatisfaction with rampant corruption around the energy sector and the political system was part of the reason for the Maidan Revolution in 2014 and subsequent protracted civil war.

Now, after almost two years of fighting in Eastern Ukraine, it seems as if Ukraine has solved its problem of Russian energy dependence. In 2015 Ukraine doubled its gas imports from Europe and halved its imports from Russia. In [2016](#) Ukraine did not import any gas from Russia at all.



Source: Own graphic, from data via Ukrtransgaz.

But these figures are misleading: although Ukraine stopped importing gas directly from Russia, they are still relying on Russian gas supplies sent via “reverse flow” from Europe. Moreover, part of the reason for Ukraine’s decrease in reliance on Russian imports stems from the fact that industrial production in the war-torn eastern regions has collapsed. In the first quarter of 2015 alone, Ukraine experienced a [17.6% decline](#) in economic output while industrial production declined more than 20%. European reverse flow imports are not only more expensive than Russian pipeline gas, but will not be enough to meet the needs of a rebuilt industrial sector.

While Moscow may have political motivations for supporting the Ukrainian rebels and keeping the conflict simmering, as the war drags on it has become clear that everyone is a loser. The European Union has inherited the responsibility of subsidizing the collapsing Ukrainian state, Russia lost a once important market for its commodities and the preferential transit tariffs for transporting its gas across Ukraine to its crucial European market, and Ukraine itself has broken apart. Although Moscow has long demonstrated its preference for putting politics above the commercial interests of its energy sector, the realities of the [global market](#) and the Russian economy make this policy unsustainable.

But despite the collapse of the Ukrainian state and energy industry, Kiev has made only limited inroads into addressing the institutional shortcomings that caused the problem in the first place. The Ukrainian political system remains divisive, venal and contentious and the so-called “war on corruption” is unwinnable when those in power are part of the problem. While Ukraine’s leaders have expressed continued support for democracy, rule of law and transparency, entirely ridding the country of corruption, especially in its most notoriously corrupt sectors like energy, is unlikely in the near future.

How can Ukraine rebuild its energy sector and ensure energy security in the future?

The Problem with Destroying the Oligarchy

In recent years Ukraine has made strides towards implementing a cohesive energy policy and in June of 2015 adopted a Law on the Gas Sector that is fully compliant with the European Union's Third Energy Package. Negotiated in talks with the European Union, the IMF and the Ukrainian government, the law bases the functioning of the gas market on free-competition, consumer protection and security of supply. But Ukraine has made such legislative efforts before, and complying with the Third Energy Package will be incredibly difficult given Naftogaz's monopoly on the market and its precarious supply situation.

The real problem rests in how to bring transparency to the most notoriously corrupt sector of Ukraine's economy. Kiev instituted the National Anti-Corruption Bureau in December of 2015 but although it was a noble start, it is grossly inadequate and is hampered by the fact that Ukraine's current leaders have an incentive to prevent the agency from doing its job. Although parliament approved a law stipulating that Ukraine would comply with the standards of the Extractive Industry Transparency Initiative (EITI), reducing the power of the oligarchs by legislative action is unlikely. First, President Poroshenko himself is an oligarch who has proved unwilling to completely divest his own numerous assets and who has been accused of targeting only select oligarchs that align with his interests. The problem with Ukraine is that however flawed, oligarchy is one of the only functioning institutions and destroying it altogether is both impossible and misguided. Second, if Ukraine is to rebuild as unified country after the end of fighting, then the government will have to rely on the oligarchs that control the heavy industries of regions like Donetsk to bring these important commercial interests back on line. Ukraine cannot rely on [IMF bailouts](#) forever, and how quickly Ukraine's economy can recover depends largely on repairing damaged industry and infrastructure.

Access to energy supplies is crucial to powering the energy intensive industries on which Ukraine's economy is based. Currently the central government controls only one third of the country's important electricity generating coalmines. If Kiev can exert control over rebel held areas they will need the aid of the local oligarchs that control commercial interests and the labor market to ensure production comes back online quickly. Another problem however, rests in securing the natural gas supplies that power most eastern industry. While in 2016 Ukraine imported no gas from Russia, this is both an inefficient and unsustainable option. If Russia and Ukraine can agree on a gas supply arrangement based on commercial interests alone, both parties would benefit. Ukraine would have access to cheaper Russian pipeline gas subsidized by transit fees and Russia could resume sales to Ukraine. Currently Gazprom and Naftogaz are locked in a bitter arbitration feud over [\\$70 billion](#) and the 2009 gas contract. Getting the two parties back to the bargaining table may require some of the oligarchic deal makers that made this possible during other low points in diplomatic relations.

Oligarchy and the State: Bringing them back into the fold

However distasteful the prospect to the West, the most prudent policy option rests not in completely marginalizing the oligarchy, but bringing them under state control. Although Ukraine's oligarchy contributed to the crumbling of the Ukrainian state, the oligarchs and the state are mutually dependent. The oligarchs need to rebuild their commercial interests to

make a profit, and to do that they need a more or less functional Ukrainian state. Kiev needs the help of the oligarchs to rebuild infrastructure, industry and get the devastated populations of eastern Ukraine back to work. For years the oligarchs profited off of the Ukrainian state with little regard for outcomes. They should now see that this was unsustainable. Kiev should abandon impossible efforts to rid the country of oligarchs. Instead, Kiev should try to incorporate these actors into the state apparatus.

This will of course require immense economic restructuring and will not be easy. But there are several steps the government can take to start the process. First, Kiev should eliminate the [state subsidies](#) on which most of the oligarchs rely to extract rents. The most notorious of these are in the energy sector. For years the state has been subsidizing energy, rendering efficiency and cost saving measures impossible because citizens did not know the real cost of it. The oligarchs profited by importing huge amounts of energy and passing the losses onto the state. By eliminating these subsidies the government can increase tax revenues and finally gain the political will to make painful reforms around its grossly inefficient energy use in the residential and industrial sectors. Second, the government must embark on a major simplification of Ukraine's convoluted set of regulations and taxes. Current rules are so complex that only oligarchs know how to circumvent them, which prevents any competition in favored industries. Streamlining regulations and the Byzantine tax system will not only increase government revenues, but will also encourage economic development across sectors.

These reforms will weaken the power of the oligarchs, but it will not eliminate them. Powerful actors in Ukraine should be aware that if reform succeeds, Ukraine has enormous economic potential. It is a huge market with numerous advantages including a favored geographic position for transit from East to West, cheap labor, 30% of the [world's richest soil](#) for agriculture and of course, mineral deposits. To tap into this potential Ukraine needs Western investment and the only way to attract it is to reform the economy and combat corruption. Even if the state blocks some of their revenue streams, the oligarchs still have the potential to make enormous profits. If the state can oversee this process and tax it properly, then everyone wins.

There is another benefit to reforming rather than destroying the oligarchy: Ukraine's tycoons have a wealth of experience and could be invited to provide advice in a consultative body to the Ukrainian government. Further, despite the collapse of the economy, most of Ukraine's oligarchs are still immensely rich and could make financial contributions to some of the hardest hit areas by the war. Oligarchs could be called upon to promote national causes and unity. The ill-advised decision to [destroy](#) the empire of Igor Kolomoisky, an oligarch who had used his influence to quell separatism in Dnipropetrovsk, shows the shortsighted nature of such policies.

Given the dire state of relations between Russia and Ukraine, it is unlikely that Moscow would look favorably upon Kiev reducing the power of oligarchs who are their economic fifth column. But Moscow should recognize that subsidizing a protracted conflict in Ukraine is not in its economic best interest—not only is war expensive, but it has also resulted in the loss of a once important market for its commodities. Gazprom's Alexei Miller has expressed the desire to [bypass Ukraine](#) entirely for its gas transit to Europe when its transit contract with Ukraine expires in 2019. But even if the European Commission does approve the

highly controversial Nord Stream 2 pipeline, which would double capacity of the pipeline linking Russia and Germany, the commercial viability of the pipeline remains questionable. Gazprom has already begun much needed internal reform by prioritizing commercial interests over politics, and should continue that process here.

Russia and the European Union should recognize that Ukraine has an interest in maintaining a foothold in both East and West, and should not try to force it to choose one over the other. Doing so has already led to disastrous consequences for all parties involved, most of all Ukraine. All parties involved should recognize that a stable and prosperous Ukraine is in the best interest of both East and West. To bring its economy back from its current state of collapse will require rebuilding its devastated industrial sector and infrastructure, both of which require access to energy supplies. Ukraine is right to diversify and ensure that it can access Western European gas in case of emergency, but any forward thinking economic plan requires Russian commodities.

Now more than ever Ukraine needs the expertise of its oligarchy working for the interests of the state rather than against it. Doing so will increase much needed technical capacity in strategic sectors and may increase bargaining leverage against Russia when they finally make it back to the negotiating table. The only way to achieve this practically is not by marginalizing the oligarchy altogether, but by bringing them under central control and inducing them to help the Ukrainian state profit, rather than profit off of the state.