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# **POLICY IMPACT OF THE EASTERN PARTNERSHIP ON UKRAINE**



*trade, energy, and visa dialogue*

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**trade, energy, and visa dialogue**

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**Research Center of the Slovak Foreign Policy Association**

**Bratislava 2012**



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Printed by AEPRESS

Bratislava 2012

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This publication appears thanks to the support of the Friedrich Ebert Foundation.

ISBN 978-80-89645-00-8

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# Preface

This policy paper examines the policy impact of the Eastern Partnership (EaP) on EU–Ukraine cooperation and on reforms in Ukraine within the following three sectors: trade, energy and visa-dialogue. It focuses on identifying those reforms in Ukraine within these three sectors that have been inspired by, and/or have resulted from, the existing institutional framework of the EaP. The examined period starts in 2009 when the EaP was launched; however, the contexts of previous developments are taken into consideration whenever they help to explain the reform processes within the examined period. The main idea of the research is to explore the added value that the EaP has brought to the partner countries, scrutinizing in particular the case of Ukraine. The selection of Ukraine as the research case, along with the impact of the EaP on reforms within the above three sectors, was prompted by the following three factors: first, Ukraine is a pioneer country of the EaP, talks on the Association Agreement included; second, the opening of the EU single market to Ukraine via the Association Agreement with the DCFTA has been the core of the EU offer within the EaP; and third, representatives of both the EU and Ukraine have declared many times and at different levels that energy and visa-dialogue could become the breakthrough sectors of EU–Ukraine cooperation.

This policy paper is the outcome of the research project entitled *Policy impact of the Eastern Partnership: the case of Ukraine*. The project was implemented in 2012 by the Research Center of the Slovak Foreign Policy Association with the support of the Friedrich Ebert Foundation. The preliminary findings of the research were discussed at an international conference on the *Policy impact of the Eastern Partnership on Ukraine: politics, trade, energy, and mobility*, which was held in Bratislava on November 8, 2012.<sup>1</sup>

It should be noted that the project was drafted before the 15<sup>th</sup> EU–Ukraine summit in December 2011, on which occasion it was stated by

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<sup>1</sup> For information about the conference, including its program, visit the website of the Research Center of the Slovak Foreign Policy Association: <http://sfpa.sk/en/podujatia/odborne-podujatia/1081>.

top EU representatives that the EU would postpone completion of the Association Agreement with Ukraine. The reason for the postponement was the growing concern of the EU and its member states about the rule of law in Ukraine, following the sentencing of former Ukrainian Prime Minister Yulia Tymoshenko on October 11, 2011. There were certain hopes entertained in the course of 2012 that the political frost in EU–Ukraine relations might begin to thaw after Ukraine’s parliamentary elections in October 2012, which would allow for a revitalizing of the process of completion of the Association Agreement. However, that did not happen. The way the elections were carried out led the election monitoring and observer missions to conclude that Ukraine had taken a step backwards in regard to international standards for free and fair elections. The combination of the EU’s growing concerns regarding both selective justice and the falling-off of democratic institutions in Ukraine brought bilateral relations to a political standstill. At the moment no one can predict how long the standstill will continue. The fourth and last part of this policy paper looks at the impacts of this “political pause” in EU–Ukraine relations (including the postponement of completion of the Association Agreement) on the further dynamics of the EaP.

This publication is based on previous research carried out by the Research Center of the Slovak Foreign Policy Association with the support of the Friedrich Ebert Foundation within the research project entitled *Regional strategic framework for the European Union’s Eastern policy*. The aim of that project was to search for a comprehensive regional strategy for EU policy toward the region of Eastern Europe, which would attempt to synergize the EU’s neighborhood policy in this region with its policy on Russia. For research outcomes within the above project see the following publications, published by the Research Center of the Slovak Foreign Policy Association: A. Duleba, L. Najšlová, V. Benč, V. Bilčík, *The reform of the European Neighborhood Policy. Tools, institutions and a regional dimension* (2008); A. Duleba, ed., *Searching for new momentum in EU–Russia relations. Agenda, tools and institutions* (2009); A. Duleba, V. Bilčík, *Toward a strategic regional framework for the EU Eastern policy: searching for synergies between the Eastern Partnership and the Partnership for Modernization with Russia* (2010), and *Taking stock of the Eastern Partnership in Ukraine, Moldova, Visegrad Four, and the EU* (2011).

The authors are indebted first of all to Kataryna Wolczuk (Centre for Russian and East European Studies, Birmingham University) who reviewed this policy paper and lent a hand with very useful comments and insights. The authors would like also to thank the following experts who shared with them their expertise and time while they were working on this policy paper: Nat Copsey, Oleksandr Chalyi, Mikhail Gonchar, Jonas Grätz, Grzegorz Gromadzki, Marta Jaroszewicz, Kai-Olaf Lang, Yulia Tyshchenko, and Andriy Yermolayev. The authors, of course, bear sole responsibility for the contents of their contributions. Special thanks for logistical support for the research go to Jitka Ivančíková from SFPA, as well as to Michael Petráš and Stefanie Ricken from the FES offices in Bratislava and Brussels respectively.

# Trade

## Trade and investment

Ukraine has been gradually converging with and coming closer to the EU since 1999 (after ratification of the Partnership and Cooperation Agreement – PCA), especially in the field of trade and investment. It may even be concluded that trade and investment relations are booming, regardless of which political party is in power or how undeveloped the business and investment environment is in Ukraine today. This very positive development could be strongly supported by a unique and very ambitious plan for the signing and ratification of the Association Agreement (AA), at the core of which is the Deep and Comprehensive Free Trade Agreement (DCFTA). One very important fact to bear in mind is that the DCFTA does not only include aspects of the trade of goods and services, but can also be regarded as a “complex commercial policy” that would impose an obligation on Ukraine to harmonize with more than 95 per cent of the EU *acquis* in trade, services and investments. This regulatory approximation could have very a positive impact not only on the economic development of Ukraine, but on the whole of society.

Unfortunately, there are three main obstacles to realizing more of the potential that is the result of cooperation so far. First, the business and investment environment is changing very slowly in Ukraine (albeit in a positive way). There is a need to speed up reforms, and especially to focus on their actual implementation.

Secondly, the crisis year of 2009 demonstrated that mutual trade between the EU and Ukraine is quite vulnerable, because of the narrow focus of this trade. On the one side, there is a big dominance of raw materials and iron (Ukraine’s export), and on the other side a dominance of machine and transport products (EU’s export). However, there is a huge potential for an increase of trade and investment within the other sectors, which would not only increase trade volumes and create more work places, but would also diversify the structure of trade and thus reduce the risk of such shocks.

Thirdly, even though the EU has benefitted more than Ukraine in recent years from a boom in bilateral trade relations, it has begun to link these business relations with strictly political issues (and certain aspects of “values”). In one respect this is positive, because it has brought with it a more comprehensive policy towards Ukraine, but on the other hand this approach has also brought risks. And the Eastern Partnership (EaP) could turn out to be a “victim” of this approach – especially in the area of trade relations – if the development of political relations goes wrong. In addition, the huge concentration of effort on AA and DCFTA negotiations, and comparatively less action “on the ground,” has created a situation in which the EaP is not playing a crucial role in trade and investment development, and is in fact still quite “invisible.” Currently, it amounts more to politics for politicians and oligarchs, than to a real practical policy with clear benefits for ordinary people and SMEs. However, if the AA is signed and implemented, even if provisionally applied, then this could be a really important success from which the whole of EU and Ukrainian society would benefit.

We believe that the PCA that came into force on March 1, 1998 had a very positive impact on bilateral relations, as it initiated cooperation on a broad range of political, economic, trade, and humanitarian issues. This allowed the establishment of a regular bilateral dialogue between Ukraine and the EU at the political and sector levels, the introduction of trade regulations based on the principles of GATT/WTO, and a determination of the priorities of Ukrainian legislation with respect to adapting to European norms and standards within the main sectors of the Ukrainian economy. We believe that such positive impacts will also occur with the ratification of the AA, including the DCFTA. However, there are concerns that this ratification will take a very long time. This could have a very negative impact on bilateral trade and investment relations, as well as on the pace and magnitude of the needed reforms in Ukraine.

Ukraine’s lack of significant structural economic reforms made the Ukrainian economy vulnerable to external shocks, as was evident in 2008–2009. Real GDP growth exceeded 7 per cent in 2006–2007, fuelled, firstly, by high global prices for steel – Ukraine’s top export commodity – and secondly, by strong domestic consumption,

spurred by rising pensions and wages. A drop in steel prices and Ukraine's exposure to the global financial crisis due to aggressive foreign borrowing lowered this growth to 2.3 per cent in 2008. Ukraine needed external help from the IMF in November 2008, in the amount of 16.4 billion US dollars,<sup>2</sup> to deal with the economic crisis; but the agreed anti-crisis program quickly stalled due to the Ukrainian government's lack of progress in implementing reforms. The economy dropped by nearly 15 per cent in 2009, and was among the worst economic performances in the World. In August 2010, Ukraine reached a new agreement with the IMF for a 15.1 billion US dollar<sup>3</sup> loan, in order to put the country on the path to fiscal sustainability, to reform the gas sector, and to shore up the country's banking system. Economic growth resumed in 2010 and 2011, buoyed by exports and domestic consumption.

"The Presidential Program of Economic Reforms for 2010–2014: rich society, competitive economy, and efficient government" contains a large number of positive reforms, but so far its implementation has lagged. Even President Yanukovich's progress evaluation for 2011 was very critical:

The analysis of the current state of performance of the National Target Plan for 2011 shows that many quite achievable tasks have not been implemented... Only about half of the measures have been realized ... and only 25 laws have been adopted within the framework of the National Target Plan.<sup>4</sup>

Included in the action plan for 2011 were such key priorities as ensuring fiscal and monetary stability, deregulation of business, preparing the ground for agricultural land market introduction, continuation of privatization, energy market reform, social benefits reform, and healthcare system reform.

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<sup>2</sup> Average exchange rate in November 2008 was 1 EUR = 1.271746 USD. Source: <http://www.x-rates.com/> (accessed on July 2, 2012).

<sup>3</sup> Average exchange rate in August 2010 was 1 EUR = 1.289676 USD. Source: <http://www.x-rates.com/> (accessed on July 2, 2012).

<sup>4</sup> "President: Some tasks of 2011 National Action Plan have not been performed," official website of Viktor Yanukovich, President of Ukraine, November 2, 2011. Available online: <http://www.president.gov.ua/en/news/22009.html> (accessed on July 2, 2012).

**Table 1.** Key macroeconomic indicators of Ukraine

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F
nominal GDP, UAH billion	345.1	441.5	544.1	720.7	948.1	913.3	1,094.6	1,300.6	1,466.4
real GDP, % change	12.1	2.7	7.3	7.9	2.3	-14.8	4.2	4.5	2.5
consumption, % change	9.7	15.7	12.4	13.6	10.1	-12.2	5.9	8.6	1.0
fixed investment, % change	20.5	3.9	21.2	23.9	1.2	-50.5	4.9	6.7	0.9
export, % change	21.3	-12.2	-5.6	3.3	5.7	-22.0	4.5	4.1	3.8
import, % change	15.5	6.4	6.8	21.5	17.0	38.9	11.1	9.8	1.8
GDP deflator, % change	15.2	24.6	14.8	22.7	28.6	13.0	15.0	13.7	10.0
CPI, % change eop	12.3	10.3	11.6	16.6	22.3	12.3	9.1	5.6	9.4
current account balance, % GDP	10.6	2.9	-1.5	-3.7	-7.0	-1.5	-2.1	-5.4	-4.9
terms of trade, % change	3.5	8.3	4.9	9.8	6.1	-6.8	4.4	0.3	-0.4
budget revenues, % GDP	37.1	41.8	43.7	42.3	44.3	42.3	42.8	42.2	41.3
budget expenditures, % GDP	41.5	44.1	45.1	44.3	47.4	51.0	50.2	46.4	43.8
fiscal balance (with Naftogaz, w/o bank recap), % GDP	-4.4	-2.3	-1.3	-2.0	-3.1	-8.7	-7.4	-4.2	-2.5
external debt, % GDP	47.1	45.3	50.4	58.6	83.6	90.8	85.0	76.7	78.1
public and guaranteed debt, % GDP	24.7	17.7	14.8	12.4	20.0	34.8	39.5	40.8	42.4

Note: F – Forecast

Source: collected from several *World Bank* studies. Available online: <http://www.worldbank.org/en/country/ukraine> (accessed on June 5, 2012).

Some positive signals could be sent to investors by improving VAT refunds, avoiding non-market interventions in the agriculture sector, and reducing the regulatory burden on businesses. However, the fight against corruption is very weak,<sup>5</sup> there are monopolist's trends in several sectors of the economy, and even raider attacks on businesses are witnessed today.<sup>6</sup>

Even though Ukraine was granted a market economy status by the EU in 2005, the key barriers to an increase in productivity in Ukraine are the unresolved problems of a transition economy. Ukraine is still in the process of formation of its basic markets – land, labor, and capital. The infrastructure is worn out and there is a real lack of investment for its upgrade. The heavy burden of the taxation system, obsolete economic legislation, and a weak court system hamper business development. Widespread corruption has long been a part of the system and is perceived by the majority of the population as inevitable. Corruption, the judiciary, administrative barriers, and the tax system were cited by company directors as the key impediments to improvement of the investment climate in Ukraine.<sup>7</sup> High energy dependence and low energy efficiency exacerbate the risks. The education system does not adapt to the requirements of the economy. Deeper fiscal, investment climate, and public sector reforms are needed.

As is generally agreed, Ukraine's economic development agenda should include the following areas of reform:<sup>8</sup>

1. creating the basic elements for a market economy,
2. improving the business environment,
3. developing specific sectors that are structurally vital for the economy.

The main function of the state in relation to business is to establish the fundamental prerequisites for economic growth – the essential elements

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<sup>5</sup> Ukraine is ranked 152<sup>nd</sup> out of 183 countries in the Transparency International Corruption Perception Index (2011). "Corruption by Country: Ukraine," Transparency International, November 10, 2012. Available online: [http://www.transparency.org/country#UKR\\_PublicOpinion](http://www.transparency.org/country#UKR_PublicOpinion) (accessed on August 5, 2012).

<sup>6</sup> V. Makoviy, S. Teren, "A difficult homecoming," *The Ukrainian Week*, No. 15 (38), September 2012, pp. 12–3.

<sup>7</sup> "Investment activity index in Ukraine in April is 4, 23 out of 10," *KyivPost*, April 18, 2012. Available online: <http://www.kyivpost.com/content/business/survey-investment-activity-index-in-ukraine-in-apr-126177.html> (accessed on June 16, 2012).

<sup>8</sup> "Executive summary of Ukraine's economic development agenda," Foundation for Effective Governance, Kiev. Available online: <http://www.feg.org.ua/en/article/4.html> (accessed on July 10, 2012).

of a functioning market economy, such as an effective foreign trade policy, macro-economic stability, effective factor markets (land, workforce and capital), infrastructure, and natural resources (including energy and gas).

The second important area of reform is improvement of the business environment, which consists of two complementary tasks: creating favorable conditions for business development, and ensuring fair competition. Creating a favorable environment means improving tax policy and business legislation, as well as ensuring better protection of investors' rights, a fair and better judicial system, and low administrative barriers. Ensuring fair competition means ensuring effective governance of natural monopolies, encouraging businesses to come out of the "shadow economy" by lowering the tax burden, improving administration, and strengthening the legal and institutional instruments of protection of economic competition (including a more effective governance of state ownership and natural monopolies).

The third important area of reform is the development of sectors that are both strategically important for Ukraine's economy and capable of becoming the "locomotives" of growth: the financial sector, construction, retail, agriculture, and the machine-building and innovation sectors. Industrial policy must focus on removing the typical barriers to growth created by state regulations and the manner in which they are applied. The industrial policy should be executed without any direct state preferences or subsidies, which could weaken competitiveness, distort the market nature of industry development, and jeopardize its sustainability and competitiveness. The main goal of industrial policy must be to ensure a fair competitive environment, to create favorable conditions for business development, and to enable an inflow of the world's best business practices and advanced technologies to Ukraine.

There are not many examples of positive developments within the business environment in Ukraine in recent years. However, we can identify a few positive examples:

- starting a business is now easier, after the elimination of the minimum capital requirement for company incorporation, as well as the requirement to have incorporation documents notarized;
- property transfers are faster, after the introduction of an effective time limit for processing transfer applications at the land cadastre;

- paying taxes is a little easier and less costly for firms, after the revision and unifying of tax legislation, the reduction of corporate income tax rates, and the unifying of social security contributions. Ukraine also made paying taxes easier by implementing electronic filing and payment for medium and large-size enterprises, as well as by introducing and continually enhancing an electronic filing system for value added tax.

On the other hand, there was no reform done to increase the protection of investors. Even though Ukraine has joined the WTO, trading across borders has been made more difficult, at the business level, by the introduction of additional inspections for the customs

**Table 2.** Ukraine's place in the ranking of Doing Business

	<b>Doing Business 2013; countries' ranking</b>	<b>Doing Business 2012; countries' ranking</b>	<b>Doing Business 2011; countries' ranking</b>	<b>Doing Business 2010; countries' ranking</b>
<b>total</b>	<b>137</b>	<b>152</b>	<b>149</b>	<b>142</b>
starting a business	50	116	118	136
obtaining permits for construction	183	182	182	181
getting electricity	166	170	169	
registration of property	149	168	165	160
access to credits	23	23	21	30
protecting investors	117	114	108	108
taxation	165	183	181	181
<i>international trade</i>	<i>145</i>	<i>144</i>	<i>136</i>	<i>139</i>
enforcement of contracts	42	44	44	43
liquidation of enterprises	157	158	158	145

Source: *World Bank Doing Business* reports for 2013, 2012, 2011, and 2010. Available online: <http://www.doingbusiness.org/> (accessed on October 25, 2012).

clearance of imports, and there is still a high administrative burden on Ukraine's international trade.

To support the implementation of the DCFTA, Ukraine needs to improve its business and investment environment, especially in the following areas:

- Stability and transparency: Investors insist that stability and transparency are key factors in attracting their investment. Ukraine needs to improve its fiscal stability, investment and property rights protections, financial markets development, and business deregulation. Investors expect more transparency in Ukraine, especially in terms of reducing corruption, bureaucracy, customs clearance, and pressure from tax and regulatory authorities.
- Ukraine also needs to develop talent and innovation: Ukraine should begin investing in talent and innovation – not only to improve workers' skills and qualifications in order to attract potential investors, but also to compete with the leaders in European FDI by supporting the development of new and emerging economic sectors.

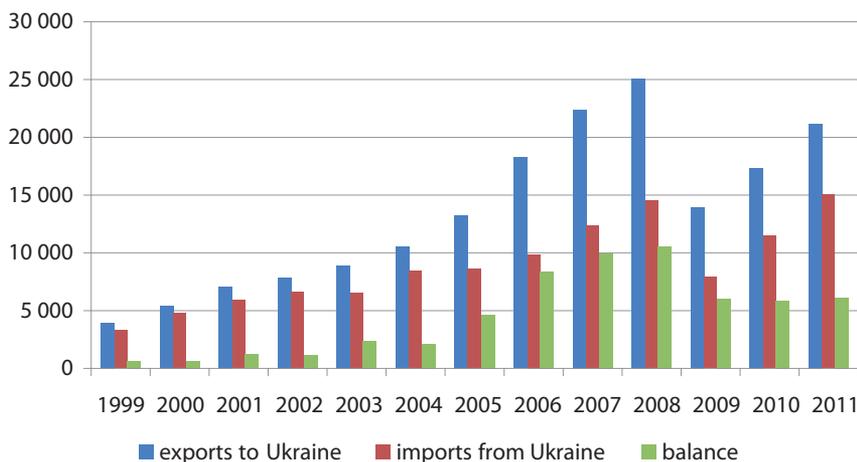
### *Bilateral trade*

In spite of the poor reform and bad investment climate in Ukraine, the trade and investment relations between the EU and Ukraine have boomed in recent years. Since 1999, the volume of trade has increased 500 per cent (five times)! The EU has benefited from these improved trade relations more than Ukraine. Its exports to Ukraine grew by 537 per cent in the last 12 years and the positive trade balance has increased tenfold. However, the economic crisis in 2009 showed just how vulnerable bilateral EU–Ukrainian trade really is. Trade fell by 45 per cent in 2009 as compared with 2008. This vulnerability is caused by the dominance of certain economic sectors in export (machinery and transport equipment in the case of the EU) and import (raw materials and mineral fuels in the case of Ukraine).

**Table 3.** Foreign trade of Ukraine: basic data for 2011

<b>major export markets</b>	CIS countries – 36.9 per cent; EU countries – 28.8 per cent Russian Federation (28.2 per cent), Turkey (6.1 per cent), Italy (5.4 per cent), Poland (4.3 per cent), Belarus (2.9 per cent), China (2.8 per cent), India (2.8 per cent)
<b>export value</b>	82,107.4 million US dollars <sup>9</sup> (2011)
<b>major import sources</b>	CIS countries – 47.6 per cent, EU countries (29 per cent) Russian Federation (39.3 per cent), Germany (7.9 per cent), China (7.1 per cent), Belarus (4.4 per cent), Poland (3.7 per cent), USA (3.3 per cent), Italy (2.2 per cent)
<b>import value</b>	88,854.9 million US dollars (2011)

Source: *Invest Ukraine*. Available online: <http://investukraine.com/> (accessed on September 12, 2012).

**Chart 1.** Trade development between EU and Ukraine 1999–2011

Source: *Eurostat*. Available online: <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/> (accessed on September 10, 2012).

<sup>9</sup> Average exchange rate in December 2011 was 1 EUR = 1.315808 USD. Source: <http://www.x-rates.com/> (accessed on July 2, 2012).

**Table 4.** Trade between EU and Ukraine (billion euro)

<b>year</b>	<b>export</b>	<b>import</b>	<b>balance</b>	<b>volume</b>
1999	3.95	3.30	0.65	7.25
2003	8.94	6.58	2.36	15.52
2006	18.26	9.85	8.41	28.11
2007	22.38	12.42	9.96	34.80
2008	25.09	14.55	10.55	39.64
2009	13.92	7.91	6.02	21.83
2010	17.35	11.47	5.89	28.82
2011	21.20	14.98	6.22	36.17

Source: *Eurostat*. Available online: <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/> (accessed on August 5, 2012).

Ukraine exports mainly steel, coal, fuel and petroleum products, chemicals, machinery and transport equipment, and grains like barley, corn and wheat. Ferrous metals remain the main export commodity. Together with agricultural products, machine-building products, and chemical industry products, they cover more than 80 per cent of Ukraine's entire export. More than 36 per cent of the export goes to other former Soviet Republic countries, with Russia, Kazakhstan and Belarus being the most important. Ukraine imports mostly oil and natural gas, machinery and equipment, and chemicals. Its main import partners are former Soviet Republics (Russia and Belarus being the biggest). Germany, China, and Poland have also been gaining importance in recent years.

Ukraine's primary exports to the EU are iron, steel, mining products, agricultural products, and machinery. EU exports to Ukraine are dominated by machinery, transport equipment, chemicals, and agricultural products. In the last 12 years, The EU's export dominance in machinery and transport equipment has grown. Raw materials and mineral fuels have maintained the same proportion in both export and import. However, Ukraine has increased its export of agricultural products to the EU.

**Table 5.** Share of sectors in total export/import and trade volume in 1999 and 2011

	1999			2011		
	export	import	volume	export	import	volume
food, drinks, tobacco (SITC 0+1)	8.8	3.0	6.2	7.3	8.8	7.9
raw materials (SITC 2+4)	2.7	24.8	12.7	2.3	23.1	11.0
mineral fuels (SITC 3)	4.6	13.4	8.6	6.6	12.3	9.0
chemicals (SITC 5)	14.9	9.4	12.4	18.6	5.8	13.3
machinery and transport equipment (SITC 7)	29.3	7.3	19.3	36.7	9.1	25.2
other manufactured goods (SITC 6+8)	36.7	39.0	37.7	26.0	37.4	30.7

Note: Marked cells describe growth of trade in "sensitive" sectors for both trade partners.

Source: Eurostat. Available online: <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/> (accessed on August 5, 2012).

**Table 6.** EU exports to Ukraine

SITC sections	value (millions of euro)	share of total %
machinery and transport equipment	7,761	36.6
chemicals and related prod, n.e.s.	3,950	18.6
manufactured goods classified chiefly by material	3,431	16.2
miscellaneous, manufactured articles	2,079	9.8
mineral fuels, lubricants and related materials	1,041	6.6
food and live animals	1,328	6.3
crude materials, inedible, except fuels	449	2.1
beverages and tobacco	194	0.9
commodities and transactions n.c.e.	150	0.7
animal and vegetable oils, fats and waxes	43	0.2
total	21,197	100.0

Source: Eurostat. Available online: <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/> (accessed on August 5, 2012).

**Table 7.** EU imports from Ukraine

<b>SITC sections</b>	<b>value (millions of euro)</b>	<b>share of total %</b>
manufactured goods classified chiefly by material	5,027	16.2
crude materials, inedible, except fuels	2,986	19.9
mineral fuels, lubricants and related materials	1,791	12.0
machinery and transport equipment	1,344	9.0
food and live animals	1,292	8.6
chemicals and related prod, n.e.s.	867	5.8
miscellaneous, manufactured articles	604	4.0
animal and vegetable oils, fats and waxes	481	3.2
commodities and transactions n.c.e.	33	0.2
beverages and tobacco	20	0.1
<b>total</b>	<b>14,975</b>	<b>100.0</b>

Source: Eurostat. Available online: <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/> (accessed on August 5, 2012).

### *Investments*

Total FDI to Ukraine has increased since 2004 by 741 per cent. The amount of foreign direct investment in Ukraine at the beginning of 2012 stood at 49.36 billion US dollars, or 1,084.3 US dollars per capita. The growth of foreign direct investment in Ukraine in 2011 was an estimated 4.56 billion US dollars.<sup>10</sup>

The EU is the main investor in Ukraine. Almost 80 per cent of foreign direct investment (FDI) in Ukraine is provided by EU countries. However, the largest investor in Ukraine is Cyprus,<sup>11</sup> whose share of the total investment rose from 22.4 per cent to 25.6 per cent in 2011. Other large investors include Germany (15 per cent), Netherlands (9.8 per cent), Russia (7.3 per cent), Austria (6.9 per cent), United Kingdom (5.1 per cent), and France (4.5 per cent).

<sup>10</sup> Ibid.

<sup>11</sup> Generally, Cyprus is a seat of many companies with Ukrainian and Russian investments, so we assume that Cyprus investment should be considered also at least partly as Ukrainian and Russian.

Financial institutions have accumulated 16.32 billion US dollars (33.1 per cent of the total direct investment in Ukraine), while industrial enterprises have built up 15.24 billion US dollars (30.9 per cent), including 13.06 billion in the processing industry and 1.49 billion in the extractive industry. In particular: the manufacture of basic metals and fabricated metal products obtained 6.08 billion US dollars in direct investment; the production of foods, beverages and tobacco, 2.07 billion; while the chemical and petrochemical industry got 1.38 billion, engineering 1.23 billion, and the manufacture of other non-metallic mineral products 0.89 billion US dollars.

Direct investment in real estate, leasing, and engineering stood at 5.75 billion US dollars (11.6 per cent); while in trade, motor vehicle repair, household appliances and personal items it stood at 5.19 billion US dollars (10.5 per cent).

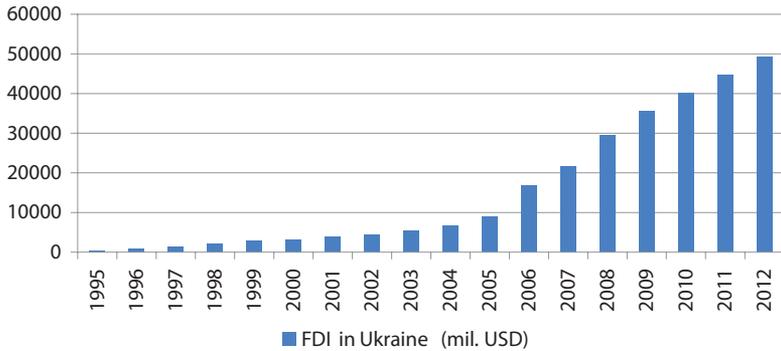
**Table 8.** FDI in Ukraine: basic data for 2011

<b>FDI volume, USD million</b>	49,362.3 (as of December 31, 2011)
<b>FDI per capita, USD</b>	1,084.3
<b>EU countries share in FDI, %</b>	79.9
<b>FDI structure by sector</b>	finance – 33.1 per cent manufacturing – 30.9 per cent, including: metal products – 12.3 per cent foods and beverages – 4.2 per cent chemicals – 2.8 per cent machine building – 2.5 per cent electricity, gas, water – 1.4 per cent real estate – 11.6 per cent retail – 10.5 per cent construction – 6.1 per cent transport and telecoms – 3.8 per cent agriculture – 1.6 per cent hotels and restaurants – 0.9 per cent healthcare – 0.3 per cent other – 1.4 per cent

Source: *Invest Ukraine*. Available online: <http://investukraine.com/> (accessed on September 12, 2012).

**Chart 2.** Ukraine: foreign direct investment  
(at the beginning of 2012; mil. US dollars)

### FDI in Ukraine (mil. USD)



Source: *Invest Ukraine*. Available online: <http://investukraine.com/> (accessed on September 12, 2012).

**Table 9.** Foreign direct investment (equity capital)  
in Ukraine at the end of 2011

	volume of direct investment as of December 31, 2011 (mil. US dollars) <sup>2)</sup>	in % of the total
Cyprus	12,645.5	25.6
Germany	7,386.4	15.0
The Netherlands	4,822.8	9.8
Russian Federation	3,594.5	7.3
Austria	3,423.1	6.9
United Kingdom	2,508.2	5.1
France	2,230.7	4.5
Sweden	1,744.0	3.5
Virgin Islands, British	1,607.0	3.3
USA	1,043.1	2.1
Italy	965.9	2.0
Switzerland	960.3	1.9
Poland	875.5	1.8
Other countries	5,555.3	11.2
<b>Total</b>	<b>49,362.3</b>	<b>100.0</b>

Data are calculated on an accrual basis since the beginning of investments.

Source: *Invest Ukraine*. Available online: <http://investukraine.com/> (accessed on September 12, 2012).

## Impact of the WTO accession

On May 16, 2008, Ukraine became the 152<sup>nd</sup> member country of the World Trade Organization. Ukraine's WTO accession was very important for its trade relations, as well as for its business and investment relations with the rest of the world. The positive decision of Ukraine to join the WTO was later supported by the fact that Russia also joined the WTO on August 22, 2012.<sup>12</sup> So currently, more than 85 per cent of Ukraine's trade is carried out with WTO members.

The effects of WTO accession are unlikely to be significant in the short-term. In the medium to long-term, however, WTO accession has the potential to contribute to faster GDP growth and welfare gains across much of the Ukrainian economy. This potential can be reached by means of accompanying reforms within the domestic economy and business environment. Thus, for WTO accession to have a transformative effect on the Ukrainian economy, it will have to be part of a much broader and ambitious reform package that Ukraine needs to implement.

The positive effect of WTO accession was unfortunately also hampered by the fact that Ukraine joined the WTO during the period of economic crisis, the positive trends that existed before WTO accession being badly hit in 2009:<sup>13</sup>

- the export of goods from Ukraine decreased by 28 per cent, import of goods contracted by 33 per cent, and the negative trade balance decreased by 56 per cent;
- exports decreased mainly owing to a drop of 40 per cent in outbound supplies of ferrous metal products; the lowest decline was seen in agricultural product exports, 17 per cent;
- imports decreased mainly due to a 54 per cent decline in the importation of industrial products (machine-building products and vehicles);

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<sup>12</sup> See the official web page of the World Trade Organization. Available online: [http://www.wto.org/english/thewto\\_e/acc\\_e/a1\\_russie\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/a1_russie_e.htm) (accessed on September 15, 2012).

<sup>13</sup> I. Kobouta, V. Zhygadlo, T. Luzhanska (authors), M. Swiecicki, ed., *Ukraine's second year in WTO: trends in foreign trade in goods, and analysis of compliance with commitments*, Blue Ribbon Analytical and Advisory Centre, Kiev, 2010, p. 78.

- in the geographical structure of the export of goods, one's attention is drawn to a decline in the shares of EU27 countries – from 27 to 24 per cent – whereas the shares of CIS countries and Asia have increased – from 34 to 35 per cent, and from 23 to 28 per cent, respectively;
- in value terms, the decrease in Ukraine's export volume was seen for all regions of the world; the largest supply decline was to the Americas – by 55 per cent – while the lowest decrease was seen in supplies to Asia – by 14 per cent;
- the geographical structure of imports featured an increase in the share of CIS countries – from 39 to 43 per cent; such growth mainly occurred due to declining supplies from Asian countries – from 18 to 15 per cent;
- in value terms, the volume of imports from all regions dropped, most of all from African states – by 50 per cent – least of all from the CIS – by 26 per cent.

The fact that the lowest decline of export supplies from Ukraine was of agricultural products can be explained by the following factors:

- high yields of grain and oil-bearing crops in 2008–2009;
- the favorable pricing environment at global markets;
- the devaluation of the Ukrainian hryvna (UAH) in 2008–2009 also improved the competitiveness of Ukrainian-made agricultural products;
- due to the financial crisis, freight rates became substantially lower than before the crisis;
- the lifting (and non-introduction) by the Ukrainian government of new quantitative export restrictions for agriculture that does not comply with WTO requirements.

After 2009, however, the growth of trade is clearly visible. We believe that WTO membership is helping Ukraine to renew its trade growth after the crisis. Generally, we can see these positive impacts of WTO accession on Ukraine:

- higher integration into the international market economy, including a decrease of tariffs and obstacles for trade;
- the establishing of legal foundations for a stable and predictable business climate;

- the fostering of a favorable climate for foreign investment;
- a wider choice of high quality goods and services for customers;
- a simplification of the procedure for conducting the DCFTA with the EU, as well as for Regional Agreements;
- access to the WTO transparency system and trade dispute settlement mechanism;
- the harmonization of national legislation to international standards.

Further and more successful use of the country's membership status in the WTO requires focusing the efforts of both government and business on the implementation of the following measures:

- taking further measures to promote the export of Ukrainian-made products to foreign markets, drafting a law on financial support for export (export insurance and lending);
- expanding the range of Ukrainian export goods by increasing supplies of hi-tech products;
- establishing a wide-scale information system on foreign trade, and encouraging small and medium-size business to engage in export activities;
- carrying out state monitoring of global prices in certain commodity markets, as well as the monitoring and forecasting of conditions in domestic and foreign markets of industrial and agricultural products, and providing the information to enterprises;
- creating a transparent environment for the providing of services via the Internet, for such entrepreneurial activities as programming, translation, and design; promoting the development of e-commerce using the Internet;
- continuing participation in the Doha Development Round negotiations, first of all to consider national interests, and to obtain separate preferences for the country concerning its commitments;
- ensuring reform of the national system of technical regulation in accordance with WTO and EU requirements;
- increasing the expert level of domestic business associations, and intensifying their participation in WTO activities.

## DCFTA talks: expectations and outcomes

### *Economy versus politics*

There are some positive examples of pre-accession countries that are already converging with the EU during their pre-accession period, and this, within certain sectors, is also true of Ukraine. Trade and investment is one such case. The completion of DCFTA negotiations was also a success for the EU and Ukraine, during a period of growing crisis in their bilateral relations.<sup>14</sup> However, the question of Ukraine's prospects for EU membership remains a contentious and long term issue. Therefore the following question is still on the table: Why not exclude the DCFTA from the Association Agreement, and sign the trade agreement separately? At the moment this is opposed by the EU, but this "take it or leave it" approach may end up undermining the prospects for integrating Ukraine (see more in Chapter 4). A separate agreement could be a beneficial solution for both sides and could bring Ukraine closer to the EU. It could surely have a positive impact on the economy in Europe, and also on bringing Ukraine closer to EU standards; while the improved and enhanced business and trade relations may spur on reform processes within Ukrainian society.

What the DCFTA with Ukraine envisages is not only the liberalization of trade in goods (at least 95 per cent of trade value and tariff lines), but also the freedom to provide services and the free flow of capital and investment, including the free movement of persons (key personnel, self-employed). It also aims at tackling the behind-the-border obstacles to trade through regulatory approximation (standards, conformity evaluation, sanitary and phytosanitary policies, public procurement, etc.).

From a political and also an economic point of view, the separating of the DCFTA from the AA would give Ukraine more space and freedom to maneuver in decreasing the pressure from Russia – for example, the Russian pressure on Ukraine to join its Customs Union, or the Russian pressure in regard to investing (and also privatization)

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<sup>14</sup> T. Iwański, "Completion of Ukraine/EU negotiations on DCFTA," Center for Eastern Studies, *East Week*, October 19, 2011. Available online: <http://www.osw.waw.pl/en/publikacje/eastweek/2011-10-19/completion-ukraine/eu-negotiations-dcfta> (accessed on June 15, 2012).

in Ukraine. Some of Ukraine's oligarchs consider the conclusion of the DCFTA as something positive, since it would enable them to strengthen their position with regard to Moscow. Furthermore, a majority of the oligarchs are opposed to Ukraine's membership in the Customs Union comprising Russia, Belarus and Kazakhstan. This stems from fears that membership in the customs union with Russia will eventually lead to Russian business gaining control of the Ukrainian oligarchs' property.

On the other hand, there are also some Ukrainian politicians and oligarchs that are afraid to support ratification of the DCFTA with the EU. Their reluctance to sign the agreement is caused above all by the fear that it will lead to a fierce conflict with Russia. In addition, none of the groups seems interested in implementing that part of the DCFTA concerned with EU norms and standards. The introduction of free and more transparent competition in the Ukrainian market and the influx of foreign investments would pose a threat to the monopolistic position of some oligarchs, even though some of them are interested in enhanced access to the EU market.

### *Course of the talks*

The negotiations on DCFTA were completed at the technical level (at the level of chief negotiators) on October 19, 2011. In December 2011, at the 15<sup>th</sup> EU-Ukraine Summit, the leaders of the European Union and Ukraine announced that they had finalized negotiations on an AA, aimed at establishing political association and economic integration between the European Union and Ukraine. On March 30, 2012, at the level of Heads of negotiating delegations, the initialization of the Agreement began. For its final signing it will be necessary to implement the EU requirement to have the document translated into all European Union languages. Ratification of the Association Agreement by Ukraine, the European Parliament and all EU member states will follow.

However, at the time of this writing, the negotiated document was not available to the general public.<sup>15</sup> Several studies have tried to evaluate the possible impact of the AA with the DCFTA, however they are based only on the partial information that was provided. So, even

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<sup>15</sup> "Text of association agreement between EU, Ukraine," *Kyiv Post*, December 5, 2012. Available online: [https://docs.google.com/file/d/0B4OpcgGexp\\_ZRVFVZnM1UVFIWUE/edit?pli=1](https://docs.google.com/file/d/0B4OpcgGexp_ZRVFVZnM1UVFIWUE/edit?pli=1) (accessed on December 6, 2012).

until now, we can only assume what the impacts will be, and text of the AA with the DCFTA remains in need of further analysis.

The main problem areas of negotiation included such topics as: trade protection instruments, sanitary and phytosanitary measures, liberalization of tariffs in goods trade, trade aspects of cooperation in the energy sphere, mutual protection of geographical indications, and services trade.

The key negotiation positions were as follows:<sup>16</sup>

1. The EU preferred to maintain import barriers on several agricultural products, while Ukraine was interested in completely eliminating them. As result of the negotiation, Ukraine obtained a full elimination of tariffs for some items (e.g. confectionery and tobacco products), and higher Tariff Rate Quotas (TRQ) for others (such as grain, meat products and fruits) as compared to the initial EU proposal. However, for some products (e.g. vegetables and eggs), the quotas remained low in terms of Ukraine's export potential.
2. The EU wanted both sides to observe their WTO commitments with respect to export subsidies and domestic support of agriculture, while Ukraine (due to insufficient budget resources and stricter WTO commitments than those of the EU) was interested in reducing the level of EU support, including abolishing EU export subsidies.
3. Ukraine wanted to continue import protection (at least temporarily) for "sensitive" industries, especially the car industry. As a compromise, import tariffs for cars will be gradually reduced during a ten year period, and Ukraine will retain the possibility of adopting safeguard measures if car imports increase rapidly.
4. The EU demanded the removal of all export tariffs in Ukraine, while Ukraine was reluctant to remove them. In the end, Ukraine was granted a long transition period (10–15 years) in which export tariffs will be gradually reduced to zero.
5. The EU demanded protection for some 3,000 Geographical Indications (GIs) such as cognac or champagne produced by Ukrainian companies, and a product rebranding if necessary.

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<sup>16</sup> M. Dabrowski, S. Taran, "Is free trade with the EU Good for Ukraine?," *CASE Network E-briefs*, No. 6, 2012. Available online: [http://www.case-research.eu/sites/default/files/publications/2012-06\\_Dabrowski\\_Taran.pdf](http://www.case-research.eu/sites/default/files/publications/2012-06_Dabrowski_Taran.pdf) (accessed on May 6, 2012).

Ukraine wanted to obtain a transition period for such a rebranding and a compensation mechanism for its firms.

6. The trade aspects of cooperation in the energy sector, especially guarantees of the safe and uninterrupted transit of natural gas through Ukraine, were also an issue. As a result of negotiation, Ukraine committed to ensuring that the country's internal legislation would facilitate the free and uninterrupted transit of gas. However, neither the EU nor Ukraine can bear responsibility for actions undertaken by third parties. The EU also expects that domestic energy pricing in Ukraine will be conducted on a market basis.
7. Ukraine wanted free access to the EU market for all types of transportation services for its firms, including the free movement of physical persons to provide these services on EU territory. The EU side was reluctant to grant such access, mostly due to the unfinished process of creating the Single European Market for services. There was also the question of the incompatibility of Ukraine's labor and ecological standards in transportation services with those of the EU. As result, Ukraine will have to rely on bilateral agreements with individual EU member states.

### *Benefits and/or costs*

Generally, free trade offers net benefits for both sides; the potential gains and adjustment costs will be greater for Ukraine as it is the smaller partner with higher initial trade barriers and higher exposure to bilateral trade. However, as mentioned before, the EU has been much more successful in trading with Ukraine over the last 12 years.

We can generally sum up the possible benefits for Ukraine as follows:

- the DCFTA will provide Ukrainian enterprises with better access to the EU market and third-country markets (as a result of harmonization with EU product standards and benefits of scale); it should also help Ukrainian enterprises become part of global production networks by encouraging intra-industry trade;
- the DCFTA will increase competition on the domestic market, leading to better consumer choice;
- the harmonization of Ukrainian standards with those of the EU will also increase the quality and safety of domestically produced and traded goods and services;

- the additional inflow of FDI will contribute to the modernization of Ukraine's economy, enterprise restructuring, job creation, and possibly a greater diversification of its sectoral and product structure; indirectly, it should help reduce its high energy intensity;
- regulatory and institutional harmonization may help to improve the business and investment climate in Ukraine;
- the institutional provisions of the AA with the DCFTA may help to improve the rule of law, domestic policy transparency, and corruption; both agreements will serve as an external anchor to domestic policies and regulations.

Several other studies are not so optimistic. Some argue that the signing of the agreement on DCFTA will not bring any tangible benefits to Ukraine's key areas of export, as the EU market is already relatively open to Ukrainian goods due to the country's WTO membership. Others fear that the practical implementation of the DCFTA will negatively impact the competitiveness of Ukrainian companies, especially in the agricultural sector. However, a study by the World Bank<sup>17</sup> concluded that establishing a free trade agreement between Ukraine and the EU would benefit Ukraine, despite inflicting a sizeable cost on some of Ukraine's key agricultural industries, such as sunflower oil processing and meat processing. Even if the EU excluded some of the key agricultural commodities – such as, for example, wheat, barley, or maize – from the agreement, Ukraine would still benefit from such an arrangement, even though the gains would be significantly lower.

Some Ukrainian analysts argue that the agreement contains just as many disadvantages as advantages for Ukraine. According to a report prepared by the Institute for Economic Research and Policy Consulting,<sup>18</sup> the practical implementation of the DCFTA will negatively impact the competitiveness of Ukrainian companies. The analysts believe this is

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<sup>17</sup> J.P. Chauffour, M. Ivanic, D. Laborde, M. Maliszewska, W. Martin, "Impact of a free trade agreement between Ukraine and the European Union on Ukraine's agricultural sector," Conference paper, 2010, p. 31. Available online: <https://www.gtap.agecon.purdue.edu/resources/download/5394.pdf> (accessed on June 14, 2012).

<sup>18</sup> V. Movchan, ed., "Ukraine's trade policy choice: pros and cons of different regional integration options," Institute for Economic Research and Policy Consulting, 2011, p. 27. Available online: [http://www.ier.com.ua/files/Projects/2010/2010\\_05/trade\\_pros\\_and\\_cons\\_2011-12-08\\_eng.pdf](http://www.ier.com.ua/files/Projects/2010/2010_05/trade_pros_and_cons_2011-12-08_eng.pdf) (accessed on June 14, 2012).

due to the initially high costs of statutory auditing and due diligence checks, as well as the bargaining disadvantage arising from the required disclosure to suppliers and customers. According to the report, companies face the risk that the necessary disclosure standards will be introduced in a quite unstable environment, resulting in with higher numbers of raiding attacks. At the same time, the benefits of the agreement include a greater protection of property rights due to international cooperation, and a chance to avoid litigation due to higher disclosure standards. In general, the report concludes that even though there will be adaptation costs for Ukrainian companies, overall the DCFTA will make them more competitive and the benefits will outweigh the costs.

There are a number of other issues that are a concern to Ukrainian businesses, one of them being the fact that most EU member states tend to subsidize their agricultural sectors. This makes European exporters much more competitive pricewise than Ukrainian businesses. However, if signed, the DCFTA will obligate EU member states to stop subsidizing their own producers should they decide to export their products to Ukraine. Nonetheless, the question of how these measures would be implemented remains.

Given the assumption that DCFTA implementation in its first stages will benefit the EU more than Ukraine, then – in order to support its position on the EU market – Ukraine should:

- respect agreed deals and be more cooperative within international organizations (e.g. Ukraine's current proposals for a renegotiation of their commitments within WTO, which are creating a negative atmosphere);
- remove current obstacles to international trade (especially administrative ones) and not create new ones (such as the current constraints on the car industry);
- take further measures to promote the export of Ukrainian-made products to foreign markets – e.g., establishing a wide-scale information system on foreign trade, and encouraging small and medium-size businesses to engage in export activities;
- carry out state monitoring of global prices in certain commodity markets, as well as monitoring and forecasting of conditions in domestic and foreign markets of industrial and agricultural products, and provide information to enterprises;

- ensure that a reform of the national system of technical regulation takes place, according to the WTO and DCFTA with EU requirements;
- increase the expert level of domestic business associations, and intensify their participation in WTO and DCFTA activities, as well as those of other international trade and business associations, such as Chambers of Commerce; and
- as for the EU, it should support such activities and motivate EU institutions and businesses to undertake joint actions.

Unfortunately, the AA with the DCFTA became publicly available only at the beginning of December 2012, so we could not assess its detailed provisions or potential benefits and costs. Additionally, the text will require extensive analysis in view of the likelihood of Ukraine's legal approximation at the sectoral level, which is beyond the scope of this publication.

## **EU programs and initiatives**

Ukraine has had access to several EU programs and initiatives financed by different instruments since 2007. During the years 2007–2010, the ENPI 1<sup>st</sup> envelope for Ukraine provided an allocation of 494 million euro, with an additional allocation of 28.6 million euro, through the Governance Facility. Additionally, in 2008–2010 the Neighborhood Investment Facility committed 22 million euro to five projects in Ukraine, mainly within the energy sector. Ukraine also benefitted partially from 42 million euro in regional projects approved for the ENP Eastern region.

For the period of 2011–2013, an indicative ENPI 2<sup>nd</sup> envelope of 470.1 million euro was allocated by the European Commission through the new National Indicative Program (NIP) 2011–2013 for Ukraine. This program is geared towards helping to achieve certain key policy objectives as outlined in the EU–Ukraine Association Agenda, and pursues 3 priorities:

1. good governance and the rule of law;
2. facilitating the entry into force of the EU–Ukraine Association Agreement (including a Deep and Comprehensive Free Trade Area (DCFTA)); and
3. sustainable development.

The ENPI Regional East Program Strategy for 2010–2013 includes a new priority area, which is Area 2: Economic development. It includes 3 sub-priorities, namely:

1. support for SME development;
2. territorial cooperation; and
3. transport.

Assistance sub-priority point 1 contributes to the implementation of one of the Eastern Partnership Flagship initiatives, namely the SME Facility. It focuses on improving advisory services to SMEs, to be provided, if feasible, through a dedicated EaP window of the EBRD TAM/BAS program. This complements another project which facilitates investment, trade and the networking of SMEs at both the regional and EaP–EU levels (East Invest). In addition, support for the establishment of the SME finance facility is provided under the inter-regional program.

The key support tools related to the promotion and development of trade and investment relations with Ukraine include:

- National Indicative Program (NIP);
- DCFTA focal sector (specific packages where needed, e.g. for geographical indications);
- ENPI, including Comprehensive Institution Building programs (CIB);
- FVO (EU Food and Veterinary Office) visits and follow-up on SPS (sanitary and phytosanitary standards);
- agriculture dialogue;
- Sector policy support programs (energy, TBT, etc., linked to DCFTA commitments);
- the establishing of Ukraine–EU bilateral institutions envisaged by DCFTA chapter;
- granting the Eurasian oil transportation corridor (EAOTC) the status of priority project of common interest under TEN-E (Trans-European Networks of Energy);
- the financing of a feasibility study on integrating the united power system of Ukraine and Moldova into the central European electricity network (CBC project);
- direct project support for regulatory authorities’ policy making and institutional capacity building;
- support through NIF, EIB and EBRD loans.

In general, ENPI funds have often been assessed as too modest to effectively support ENP objectives in the Eastern neighborhood (even more so under the Eastern Partnership), and such also is the case with Ukraine.<sup>19</sup> However, the level of bilateral support to Ukraine is currently much higher than it was under TACIS, in the 2000–2006 financial perspective, and there are prospects for more resources in the period 2014–2020. The European Commission has proposed a significant increase of ENPI funds for neighbors under the next financial framework, up to 18.182 billion euro.<sup>20</sup> This substantial increase in proposed EU support clearly illustrates the continuity of EU engagement in its neighborhood, and signals a determination to respond to political developments in partner countries, including Ukraine. Nevertheless, this proposed increase appears primarily to be in answer to criticisms expressed over the level of EU support, having been assessed as insufficient to effectively support the reform process in partner countries.

However, the lack of reforms – as well as setbacks – in those ENP partner countries which have benefitted most from EU support, suggest that EU assistance is not a major driving force in the reform process – and the case of Ukraine is an example of this.<sup>21</sup> This raises questions over the effectiveness of EU funds: questions concerning the conditionality of support for a partner country, and also questions regarding the compatibility of intervention priorities with policy objectives and national reform programs.

When comparing Ukraine to other ENP countries, the focal areas of intervention identified in the CSPs and NIPs have been found to be consistent with the objectives and priorities agreed in the PCA and the

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<sup>19</sup> See more in “Evaluation of the European Commission’s cooperation with Ukraine,” European Commission, Vol. 1, December 2010, p. 22. Available online: [http://ec.europa.eu/europeaid/how/evaluation/evaluation\\_reports/2010/1283\\_docs\\_en.htm](http://ec.europa.eu/europeaid/how/evaluation/evaluation_reports/2010/1283_docs_en.htm) (accessed on August 10, 2012).

<sup>20</sup> European Commission news published on February 17, 2012, Available online: [http://ec.europa.eu/europeaid/how/finance/mff/financial\\_framework\\_news\\_en.htm](http://ec.europa.eu/europeaid/how/finance/mff/financial_framework_news_en.htm) (accessed on August 10, 2012).

<sup>21</sup> L. Delcour, “Policy briefing. Improving the EU’s aid to its neighbours: lessons learned from the ENPI, recommendations for the ENI,” European Parliament, 2012. Available online: <http://www.europarl.europa.eu/committees/fr/studiesdownload.html?language=Document=EN&file=79430> (accessed on November 30, 2012).

EU–Ukraine Action Plan, as well as with the principles, objectives and methods of the ENP and the EaP.<sup>22</sup>

On the other hand, in the case of Ukraine there are two key factors limiting the effective use of available EU funds. The first is the Budget support instrument. This instrument has significantly strengthened partner countries' ownership of assistance by shifting the responsibility for fund management to national authorities. However, in the case of Ukraine it has accounted for 70 per cent of ENPI funding during the period 2007–2009. Such reliance upon a single type of assistance is a source of concern, and – as reported by the Court of Auditors<sup>23</sup> – budget support reduces the visibility of EU assistance, and also suffers from problems in partner countries: for example, with respect to the unpreparedness of authorities. The increasing use of budget support also makes EU assistance less targeted, since funds are then used for sector-wide reforms.

The second factor is access of non-state actors (including businesses and civil society) to funds. The ENPI regulations set out a broad list of beneficiaries eligible for funding, including a wide range of non-state actors. Nevertheless, the Commission has focused on cooperation with partner countries' governments, and the bulk of funds has been channeled through partner countries' central authorities via bilateral allocations.<sup>24</sup> Overall, access to funding for non-state actors has been hampered by burdensome procedures and scattered information. For example – to refer again to the above mentioned Budget support instrument – in Ukraine, non-state actors are excluded from the Joint Monitoring Groups, which are set up to track the implementation of budget support projects. These general conclusions fully apply also to the area of trade and investment relations.

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<sup>22</sup> Ibid.

<sup>23</sup> “Is the New European neighbourhood and partnership instrument successfully launched and achieving results in the Southern Caucasus?,” European Court of Auditors *Special Report*, No.13, 2010, p. 17.

<sup>24</sup> R. Sadowski, “The future of the ENPI: towards separate financial instruments for the Union for the Mediterranean and the Eastern Partnership?” *Eastern Partnership Review*, No. 4, 2011, p. 7.

To improve the situation, the following measures need to be implemented:<sup>25</sup>

- tailor the levels and types of support to the reform track record, by combining long-term planning with an earmarking of funds based on effective performance;
- simplify the programming process;
- increase consistency between the EU policy framework and assistance;
- strengthen the performance-based approach (differentiation principle among EaP countries / more-for-more);
- stabilize implementation capacities, and maintain and cultivate institutional memory, by designing an attractive career path at institutions dealing with the EU agenda;
- develop local evaluation expertise in order to build up monitoring capacities;
- encourage participatory policy dialogue, by involving civil society organizations, business representatives, and universities in the programming and monitoring of EU assistance.

## Multilateral dimension of the Eastern Partnership

A similar situation (if not worse) to that of bilateral assistance, is the multilateral dimension of the EaP. The multilateral dimension of the EaP has been neither a visible nor very effective exercise thus far. It has become a bureaucratic discussion forum whose proposals and recommendations are not taken seriously by EaP governments. The visibility of the multilateral dimension is important, since certain thematic platforms deal with issues that are largely domestic, such as public administration reform.<sup>26</sup>

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<sup>25</sup> Some recommendations refer to survey A. Artsiomenka, V. Bayramov, A. Bychenko (et al.), “Effective management of EU assistance by the governments of Eastern Partnership countries: an ECEAP survey report,” Estonian Center of Eastern Partnership, 2012, p. 43.

<sup>26</sup> A. Duleba, V. Bilčík, eds, *Taking stock of the Eastern Partnership in Ukraine, Moldova, Visegrad Four, and the EU*, Bratislava: Research Center of the Slovak Foreign Policy Association, 2011.

Up to now, several macro-economic dialogues have been conducted with the six EaP countries, including Ukraine.<sup>27</sup> This has allowed an exchange to take place on economic developments and policy challenges, including the implications of the sovereign debt crisis in the eurozone for EaP countries. These dialogues have provided an opportunity to review the implementation of the economic reform priorities identified in the ENP Action Plans and the Association Agenda. They have taken into account the ongoing EU macro financial assistance (MFA) programs, which help partner countries to address short-term balance of payment difficulties. The Ukraine program, now in preparation (2012), involves 610 million euro in loans.

Comprehensive Institution Building Programs (CIB), with a total budget of 167.4 million euro, are specifically intended to help partner countries meet the preconditions for negotiating and concluding AAs and DCFTAs, and their related commitments. Technical assistance has been provided to help all partners develop the institutional reform plans for the targeted institutions. At the beginning of 2012, most countries had finalized their reform plans – many of them being formally adopted – thus paving the way for the CIB implementation phase.

Participation of partner countries in EU programs and agencies has been possible since 2011. Protocols allowing for the participation of Ukraine in EU programs entered into force in November 2011. The most visible participation of Ukraine is in the 7<sup>th</sup> Framework Program for Research and Technological Development (FP 7), where Ukraine institutions are participating in several projects. Other areas of cooperation between EU agencies and EaP countries include justice and home affairs, aviation safety (European Aviation Safety Agency), and health (European Centre for Disease Prevention and Control).

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<sup>27</sup> Based on several European Commission documents: “Framework Programme in support of EU–Ukraine agreements,” CRIS: ENPI/2012/23714, Brussels, 2012. Available online: [http://ec.europa.eu/europeaid/documents/aap/2012/af\\_aap\\_2012\\_ukr.pdf](http://ec.europa.eu/europeaid/documents/aap/2012/af_aap_2012_ukr.pdf) (accessed on July 12, 2012); “Implementation of the European Neighbourhood Policy in Ukraine Progress in 2011 and recommendations for action,” SWD(2012) 124 final, Brussels, 2012. Available online: [http://ec.europa.eu/world/enp/docs/2012\\_enp\\_pack/progress\\_report\\_ukraine\\_en.pdf](http://ec.europa.eu/world/enp/docs/2012_enp_pack/progress_report_ukraine_en.pdf) (accessed on July 12, 2012); “Implementation of the European Neighbourhood Policy in 2011 regional report: Eastern Partnership,” SWD(2012) 112 final, Brussels, 2012, Available online: [http://ec.europa.eu/world/enp/docs/2012\\_enp\\_pack/e\\_pship\\_regional\\_report\\_en.pdf](http://ec.europa.eu/world/enp/docs/2012_enp_pack/e_pship_regional_report_en.pdf) (accessed on July 12, 2012).

EaP countries were also invited to share their regional development strategies with the EU and to prepare Pilot regional development programs (PRDPs). The cohesion dimension, i.e. the reducing of social and economic disparities between regions, which is the cornerstone of the PRDPs, was not always properly addressed in the documents presented, and discussions are still ongoing with the partner countries. In addition, given the large budget support programs for regional development which are currently ongoing in Ukraine, it was necessary to define more specifically the added-value of the PRDPs. Within the framework of these programs, complementary specific activities will be identified, to be financed through additional PRDP funds.

The Small and Medium-sized Enterprises (SMEs) flagship initiative was set up to support the needs of SMEs in the EaP countries and to provide an external stimulus to growth and employment, with a total budget of around 34 million euro. It supports initiatives to improve the business climate, extend advisory services to SMEs and establish an SME funding facility.

This flagship initiative includes three components:

1. East-Invest, an investment and trade facilitation project (with a budget of approximately 9 million euro) which provides technical assistance to business support organizations and SMEs from EaP countries. In July, about 40 representatives of business organizations from EaP countries participated in the East-Invest Academy (Irpen, Ukraine). In the spring, two “Train the trainers” seminars were organized in Minsk and Chisinau on the topic of the EU *acquis* and internationalization, for 15 representatives of business organizations. Following these trainings, the trained trainers – together with international trainers – presented four seminars on the same topic. More than 200 SMEs across the region benefited from such trainings on the EU *acquis* and internationalization.
2. The Enterprise Growth Program (EGP) and Business Advisory Services (BAS) (both small business programs) are technical assistance programs, implemented by the European Bank for Reconstruction and Development (EBRD), and funded by the EU (10 million euro for the period of 2010–2014). It aims to support the sustainable development of SMEs in Eastern partner

countries, and to build effective infrastructure of local advisory services. EGP provides the transfer of commercial and technical knowhow from experienced senior managers from EU SMEs, and BAS promotes involvement with local consulting services while supporting the consolidation of local consultancy. Concrete examples in 2011 included: the development of a streamlined organizational structure and strategy, the development of Human Resources policy, new sales and marketing strategy, the development of a management information system, the development of computerized financial management, etc.

3. In 2011, 17 EGP projects were started (with duration of approximately 1 to 1.5 years), as well as 156 BAS projects (shorter projects of approximately four to six months), out of which 79 BAS projects have already been completed throughout the region.

The SMEs Funding Facility Project, with a budget of 15 million euro, is provided by the EU as a risk-sharing cushion to leverage loans for SMEs from European financial institutions, through the intermediation of local financial institutions. To date, several loans for on-lending to SMEs have been signed with local banks, such as ProCredit Bank, Ukrexim in Ukraine, etc.

The regional electricity markets, energy efficiency, and renewable energy sources flagship initiative is focusing on improving the integration of the electricity grid and encouraging sustainable energy, as ways to address the security of energy supply. This flagship initiative is supported, *inter alia*, by the EU's regional energy cooperation program INOGATE. In 2011, INOGATE provided approximately 53 million euro in funding to projects supporting the development of regional energy markets, energy efficiency, and renewable energy sources. Another key activity falling under this flagship initiative is the Covenant of Mayors (CoM), which is currently being extended beyond the EU. Over 40 cities from the EaP region have already joined the CoM, thereby committing themselves to reducing their CO<sub>2</sub> emissions by 20 per cent by 2020.

The first EaP Business Forum that took place in Sopot in September 2011, on the fringes of the second EaP Summit, also constituted positive multilateral activity. The Forum presented the business community's recommendations for further development of the economic aspects of the EaP, including special facilities to help SMEs develop in EaP countries.

Most of these EaP activities are just now being planned and implemented. Generally, it is too early to evaluate Ukraine's participation in the above mentioned programs and projects. However, several challenges may be noted:

- the coordination of a number of initiatives and programs is questionable, and may result in the ineffectiveness of – or even conflict between – programs and projects;
- information available to Ukrainian stakeholders about project possibilities is very limited (and is mostly kept “secret” in Kiev and Brussels). The involvement of more institutions as well as the broader general public is needed;
- the EU and Ukraine should focus more on evaluating the impacts of initiatives, programs and projects; as well as on
- EU *acquis* harmonization in Ukraine – in trade, investment, and regulatory policy.

The AA with the DFCTA will impose on Ukraine a considerable amount of legal adjustment as it adopts large parts of the *acquis communautaire*. It will commit Ukraine to introducing transparent competition, state aid, and public procurement policies, as well as EU company-law regulation. In addition, the essential *acquis* of the internal market will be progressively introduced, to enable Ukrainian producers to participate in the internal market of the EU. But legal harmonization will go beyond product regulation, to include much of the EU's process regulation in areas such as environment, health and safety.

The main challenge to Ukrainian legislation regarding compliance with the *acquis* is not the adoption of new laws, but their proper enforcement. In many areas, the country has relatively new laws, but they are not adequately applied in practice, or are not observed at all. Ukraine needs to resolve many structural problems, including weak government institutions, an extremely outdated legal system, underdeveloped regulatory bodies, and large-scale corruption.

Ukraine needs especially to enhance the following factors which will influence the success of the *acquis* harmonization process:

- Impact assessments: in well-established and efficient administrations, all new policy and legal proposals are automatically evaluated for their impact on the economy, society, and the environment. In

Ukraine, though a considerable amount of discussion about impact assessment appears to have taken place, in reality very little has been done.

- Institutional capacity: institutional reform has been identified as one of the key areas of work in Ukraine, and the EU's Comprehensive Institution Building Program (CIB) will spend a lot of money in Ukraine pursuing this objective. However, this financing will be concentrated in certain key areas (such as SPS), and will leave many areas of administration that are crucial for good implementation without assistance.
- Coordination of work: coordination of the work of the various state institutions in the implementation of the *acquis* is very important, although this has not been fully appreciated by the Ukrainian administration.
- Planning: a detailed National plan for the implementation of AA with the DCFTA, in order to ensure the correct implementation of the *acquis* and of provisions of EU-Ukraine treaties, would be helpful. Such a tool was used in all new member states as they prepared for accession to the European Union, and it proved very helpful to them.

Several positive measures were taken with respect to this in 2011:<sup>28</sup>

- a new composition of the Coordination Council for Approximation of Ukrainian legislation to legislation of the EU, under the chairmanship of the Prime Minister of Ukraine, was approved (governmental decree of March 30, 2011 No. 338);
- the Government's envoy on European Integration was appointed by a Government decision of July 13, 2011 (No. 662);
- the Plan of priority measures as regards Ukraine's integration into the EU was adopted by the Government, in order to speed things up concerning issues related to EU-Ukraine political and sector cooperation (decree of June 29, 2011, No. 612);
- the Department for European Integration was created within the Presidential Administration as a part of its restructuring in April 2011 (decree No. 352 of May 4, 2011), in order to support the carrying out of the President's powers with regards to the European integration policy.

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<sup>28</sup> "Framework Programme in support of EU-Ukraine Agreements," op. cit.

## Conclusions

- It is a very positive sign that the unique and extremely ambitious plan relating to the signing and ratification of the AA, the core of which is the DCFTA, has entered the phase of technical completion. One very important fact to bear in mind is that the DCFTA includes not only aspects of the trade of goods and services, but can also be considered as a “complex commercial policy” obliging Ukraine to harmonize with more than 95 per cent of the EU *acquis* in trade, services and investment. This regulatory approximation could have a very positive impact, not only on the economic development of Ukraine but on the whole of society. It is important that these years of hard work come to a successful conclusion: the signing and ratification (or at least provisional application) of the AA with the DCFTA.
- The EU and Ukraine are gradually converging in trade and investment. Since 1999 trade and investment relations have been booming, even with the slow pace of Ukraine’s “reforms.” However, “political instability” and an “imperfect” business and investment environment are not the best motivations for joint cooperation.
- EU–Ukraine trade is very vulnerable (as the crisis year 2009 showed), because of its narrow commodity structure (steel, raw materials, and mineral oils on the one side, and machine products and transport equipment on the other). Trade needs to be diversified on both sides, and it would also be beneficial to promote trade in other sectors, including trade and investment among small and medium sized enterprises, which are more flexible than large companies. It is great that EaP includes a SME facility, and that SMEs are one of the priority topics. However, action so far has been very limited, and not very visible. More tools and supporting programs are needed.
- Even though in recent years the EU has benefited more than Ukraine from the boom in bilateral trade relations, it began to link more strictly political issues (and aspects of “values”) with these business and trade relations. In one way this is positive, because it has brought a more comprehensive policy towards

Ukraine, but on the other hand this approach has also brought risks. Moreover, the EaP could be a “victim” of this approach – especially in the area of trade relations – if the development of political relations goes wrong. Also, a huge concentration of effort on AA and DCFTA negotiations, and less action “on the ground,” has created a situation in which the EaP is not playing a crucial role in trade and investment development, and is still quite “invisible.” Currently, it amounts more to politics for politicians and oligarchs, than to a real practical policy with clear benefits for ordinary people and SMEs. However, if the AA is signed and implemented, even if provisionally applied, then it could be a really important success from which the whole of EU and Ukrainian society would benefit.

- To make EaP more “visible and citizen oriented,” there is the need for a closer coordination of programs and initiatives, for a more transparent evaluation of programs and projects; and there is also a need for improved awareness – not only of the “big” stakeholders, but also of the wider public – concerning these programs and the possibilities for cooperation (primarily in Ukraine, but also in the EU).
- The membership of Ukraine in the WTO has helped to restore the growth of trade and investment after the crisis of 2009. The DCFTA with the EU may turn out to be another such stimulus. In the event of negative scenarios, caused by potential political controversies between the EU and Ukraine, we believe it is necessary to consider whether or not to exempt the DCFTA from the AA ratification process. A provisional application could be one solution. Economic cooperation should not be hampered by political controversies. Trade and investment could become an ice-breaker for the further convergence of the EU and Ukraine, as many positive examples exist in which FDI not only positively changed the local business environment, but also brought new values to society.
- The AA with the DCFTA will impose on Ukraine a considerable amount of legal adjustment as it adopts large parts of the *acquis communautaire*. New EU member states can share gained experience and know-how of EU *acquis* harmonization – and it would be great

if Ukraine (and also the EU) were to make use of this experience more widely. The EU should also make more of an effort to help Ukraine in building up their capacities (both government and non-government institutions) for developing regulatory bodies, and in fighting large-scale corruption. As long as these problems remain unresolved, Ukraine will not be able to make real progress in observing and implementing the *acquis communautaire*. These activities should be reflected in the EU financial perspective for 2014–2020, and also in Ukraine’s government budget.

The EU should (in order to overcome the period of “possibly long-lasting colder relations,” during the ratification of the AA with the DCFTA):

- consider new supporting programs (a “redefined EaP for 2014–2020” and related tools could be more focused on trade and investment issues), especially for the support of SMEs to develop trade and investment relations with Ukraine;
- use established “dialogue structures” – e.g. specialized dialogues, economic-related expert committees and subcommittees, chambers of commerce networks etc. – to maintain an open and regular dialogue with Ukraine on trade and investment issues, as well as on promoting a better business environment within Ukraine;
- continue reducing obstacles to conducting trade and business with Ukraine – e.g., reducing the administrative burdens related to trade and investment;
- “invest” more into the information campaign for citizens concerning the EaP in general, but also concerning the aims and potential positive impacts of the AA with the DCFTA on the every-day life of citizens.

# Energy

This chapter aims at summing up the impact of EU–Ukraine cooperation on the reforms of the energy sector of Ukraine. It identifies the developments and reforms of the energy sector of Ukraine that have been inspired and/or affected by the existing institutional framework of EU–Ukraine relations, including the Eastern Partnership (EaP). The examined period starts in 2009 when the EaP was launched; however, the contexts of previous developments are taken into consideration whenever they help to explain the developments within the examined period.

This text does not include a full list of new energy legislation adopted within the given period by Ukraine. Rather, it offers an analytical review of the main achievements and failures of Ukraine in relation to agreed goals and commitments under the existing institutional framework of EU–Ukraine relations in the field of energy. Accordingly, this text does not provide a review of the developments in EU–Ukraine cooperation in all segments of Ukraine’s energy sector – rather, it focuses on those specific areas that have been influenced primarily by the harmonization of Ukraine’s national legislation with the EU energy *acquis communautaire*. Seeing that the only binding contractual component of the existing EU–Ukraine institutional framework in the energy sector, as of yet, is the Protocol of Ukraine’s Accession to the Energy Community, this text focuses first of all on the impacts of the EU *acquis* as included in the Protocol on the following segments of Ukraine’s energy: regulatory policy, gas and electricity markets, energy efficiency, and the use of renewables.

Finally, this text includes a brief review of EU–Ukraine cooperation in the field of development of oil transport infrastructure – which, together with cooperation in the field of nuclear power plant operational safety, and in improvement of the institutional and technical standards of the coal sector in Ukraine, may be regarded as the best examples of existing EU–Ukraine cooperation in the field of energy.<sup>29</sup>

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<sup>29</sup> For EU–Ukraine cooperation in the field of nuclear safety and coal sector see – “Sixth joint EU–Ukraine report. Implementation of the EU–Ukraine Memorandum of Understanding on energy cooperation during 2011,” European Commission Energy March 22, 2012. Available online (together with the five previous annual joint reports for the years 2006–2011): [http://ec.europa.eu/energy/international/bilateral\\_cooperation/ukraine\\_en.htm](http://ec.europa.eu/energy/international/bilateral_cooperation/ukraine_en.htm) (accessed on November 19, 2012).

## Legal and institutional framework

The following three bilateral documents present the fundamental legal and institutional framework for the present EU–Ukraine cooperation in the energy sector: the Partnership and Cooperation Agreement (PCA, in force from 1998), the Memorandum of Understanding on cooperation in the field of energy (Memorandum, 2005), and the Protocol concerning the accession of Ukraine to the Treaty establishing the Energy Community (ratified in 2010, in force from 2011).<sup>30</sup>

The PCA refers to provisions of the European Energy Charter as the framework document defining the rules governing EU cooperation with third countries in the field of energy. The Memorandum of Understanding stipulates the ambition of both the EU and Ukraine to upgrade their cooperation in the field of energy, which includes facilitating the integration of Ukrainian electricity and gas markets into the European Union’s internal energy market. For this ambition to be realized, Ukraine must implement key elements of the EU’s *acquis* on energy, environment, competition and renewables. The Memorandum assumes that this goal should be achieved via Ukraine’s accession to the Energy Community.

Ukraine and Moldova became the first EaP countries to engage with the EU’s invitation within the EaP to join the EU Energy Community. Ukraine signed the Protocol concerning its accession to the Energy Community on September 24, 2010, and became a full-fledged member on February 1, 2011. The Protocol includes the list of the energy *acquis* of the EU which Ukraine is obliged to harmonize with, as well as the timeline for its implementation. Ukraine’s obligations in the field of energy as identified by the Protocol will become a separate part of the

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<sup>30</sup> For the texts of the documents see: “Partnership and Cooperation Agreement between the European Communities and their Member States, and Ukraine,” *Official Journal of the European Communities*, L49, February 19, 1998. Available online: <http://ec.europa.eu/world/agreements/downloadFile.do?fullText=yes&treatyTransId=659> (accessed on November 19, 2012); “Memorandum of Understanding on cooperation in the field of energy between the European Union and Ukraine,” European Commission, December 2005. Available online: [http://ec.europa.eu/energy/international/bilateral\\_cooperation/doc/ukraine/2010\\_ukraine\\_mou.pdf](http://ec.europa.eu/energy/international/bilateral_cooperation/doc/ukraine/2010_ukraine_mou.pdf) (accessed on November 19, 2012); “Protocol concerning the accession of Ukraine to the Treaty establishing Energy Community,” Energy Community, September 24, 2010. Available online: <http://www.energy-community.org/pls/portal/docs/728177.PDF> (accessed on November 19, 2012).

Association Agreement (AA) – precisely the chapter on energy, one of the 31 sector chapters of the agreement. The AA, which will replace the PCA, will absorb the provisions of the accession Protocol into the Energy Community once it enters into force.

Altogether, the discussions between the EU and Ukraine concerning the AA, including the Deep and Comprehensive Free Trade Area (DCFTA), have been dragging on for almost 5 years (from March 2007 to October 2011). However, the contractual deal that is expected “to provide one of the most ambitious levels of political association ever between the EU and a foreign country”<sup>31</sup> – quoting the words of the European trade commissioner Karel de Gucht – was achieved during a politically sensitive time, primarily because of the growing political concerns of the EU and its member states over the deteriorating domestic political situation in Ukraine.<sup>32</sup> Even though the EU–Ukraine AA was initiated in technical terms already in March 2012, the prospects for its signature and ratification are still unclear.

Nevertheless, the energy sector does offer a specific field of EU–Ukraine sectoral cooperation in terms of its institutional form, thanks to the Protocol of Ukraine’s Accession to the Energy Community. The PCA provides only for the general framework of EU–Ukraine energy cooperation; it does not include any specific commitments or a schedule for their implementation. The energy chapter of the AA may already be identified as the future “Protocol Plus” – however, it is not yet a reality. Both the Memorandum and the AA (2009) – which is an implementation tool under EaP, and includes bilateral EU–Ukraine cooperation in the energy sector<sup>33</sup> – are merely political documents: they do not have

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<sup>31</sup> K. De Gucht: “EU trade policy looking East,” Speech at the civil society trade seminar, Warsaw, October 3, 2011. Available online: <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/625&format=HTML&aged=0&language=EN&guiLanguage=en> (accessed on November 20, 2012).

<sup>32</sup> For analysis see A. Duleba, V. Bilčík, eds, *op. cit.* In particular see Chapter 3, pp. 196–237.

<sup>33</sup> “EU–Ukraine Association Agenda to prepare and facilitate the implementation of the Association Agreement,” European External Action Service, November 2009. Available online: [http://eeas.europa.eu/ukraine/docs/2010\\_eu\\_ukraine\\_association\\_agenda\\_en.pdf](http://eeas.europa.eu/ukraine/docs/2010_eu_ukraine_association_agenda_en.pdf) (accessed on November 23, 2012). For updates to the priorities of the AA in 2010 and 2011 respectively, including in the energy sector, see the website of the European External Action Service: [http://eeas.europa.eu/ukraine/docs/index\\_en.htm](http://eeas.europa.eu/ukraine/docs/index_en.htm) (accessed on November 23, 2012).

a binding contractual status. The same applies to the “Joint Declaration” adopted at the Joint EU–Ukraine international investment conference on the modernization of Ukraine’s gas transit system (held in Brussels on March 23, 2009),<sup>34</sup> as well as to other respective documents on cooperation in other segments of the energy sector, such as the operational safety of nuclear reactors, and the coal industry. The multilateral platform on energy security within the EaP, of which Ukraine is a part, serves only as the institutionalized forum for consultations on energy security and energy cooperation between the EU and EaP countries.

Thus, the Protocol is the only contractual element of the existing institutional framework of present day EU–Ukraine relations that stipulates – in a binding contractual regime – reforms in the energy sector of Ukraine. In other words, the energy sector could become the first sector within which Ukraine can achieve a real integration with the EU, despite the current low level of compliance. It is the only sector of EU–Ukraine cooperation so far that is being regulated by binding contractual relations between the two parties, with the aim of facilitating the harmonization of Ukraine’s national legislation with the EU energy *acquis*.

## Regulatory policy

The essential content of the EU energy *acquis* deals with regulatory policy, which is the prerequisite for liberalization of the energy market in the field of natural gas and electricity. The central point of the regulatory *acquis* prescribes the norms for the establishment of an independent regulatory authority, which should be observed not only by EU member states, but also by the member states of the Energy Community.

Ukraine has taken some steps towards establishing an independent regulatory authority of the energy sector in line with the EU energy *acquis*. Until November 2011, both the gas and electricity sectors were

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<sup>34</sup> “Joint declaration. Joint EU–Ukraine international investment conference on the modernization of Ukraine’s gas transit system,” European Commission, European Bank for Reconstruction and Investment, European Investment Bank, World Bank, Government of Ukraine, March 23, 2009. Available online: [http://eeas.europa.eu/energy/events/eu\\_ukraine\\_2009/joint\\_declaration\\_en.pdf](http://eeas.europa.eu/energy/events/eu_ukraine_2009/joint_declaration_en.pdf) (accessed on November 22, 2012).

regulated by the National Electricity Regulatory Commission of Ukraine. In November 2011, President Yanukovich issued a decree creating the National Energy Regulation Commission of Ukraine (NERC), which is to take on the role of independent national energy regulator. Some drafts of laws on the regulation of the energy sector, aimed at increasing the independence of a national energy regulatory authority, have been pending in parliament for a couple of years – for example, the Law on the National Electricity Regulatory Commission of Ukraine, and the Law on the regulation of the energy sector of Ukraine. The first one was revoked, and the second has not yet been debated in the parliament.<sup>35</sup>

The adoption of the Law on the principles of the functioning of the natural gas market (July 8, 2010), which provides for a gas market reform similar to the second legislative energy package of the EU, may be regarded as the main achievement of the present EU–Ukraine cooperation. In addition to the liberalization of the gas market, the gas law includes the strengthening of the status of the National Energy Regulatory Commission of Ukraine (NERC) as a regulatory authority for the gas market. The fact that NERC’s status is being established by law at all in Ukraine, and for the first time, is important in its own right. However, by-law acts that would clarify the duties and responsibilities of NERC are still lacking. As a result, NERC is still dependent on the government for making decisions on the tariff regulation of energy markets. For this reason, all of NERC’s actions pertaining to the creation of a new system of energy price regulation through an independent regulatory authority are carried out within the framework of the respective government agencies and actions.<sup>36</sup> In reality, NERC is still subordinated to the Government of Ukraine and does not meet the requirements of the relevant EU *acquis*.

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<sup>35</sup> “Implementation of the Association Agenda energy cooperation priorities, including nuclear issues,” *Report No. 3 on the results of the Civil Society Monitoring of the implementation of the EU–Ukraine Association agenda priorities*, 2010. Available online: [www.ucipr.kiev.ua/files/books/Report3\\_monitoring\\_PDA\\_2010.pdf](http://www.ucipr.kiev.ua/files/books/Report3_monitoring_PDA_2010.pdf) (accessed on November 20, 2012).

<sup>36</sup> “Monitoring: the law of Ukraine on the principles of the natural gas market functioning: Analysis of compliance with the EU law,” Institute for Economic Studies and Political Consultations, July 29, 2010. Available online: <http://www.ucipr.kiev.ua/modules.php?op=modload&name=News&file=article&sid=603277437> (accessed on November 20, 2012). For analysis see also Y. Tyshchenko, “Ukraine,” in A. Duleba, V. Bilčík, op. cit, pp. 10–58.

In other words, Ukraine so far has been not able to establish an independent energy regulatory authority, which is the key provision for the gradual liberalization of the gas and electricity markets – which includes providing for the legal and organizational unbundling of the energy monopolies, ensuring non-discriminatory access to gas and electricity transmission and distribution systems, transparent tariffs, and protection for customers.<sup>37</sup> As a member of the Energy Community, Ukraine in its accession Protocol has committed itself to implementing the third energy package by 2015, including the establishment of an independent energy regulatory authority.

## Natural gas

Within the gas sector, the first reform steps prompted by Ukraine’s Energy Community membership have been undertaken by NERC, which, in February and March 2012, started preparing regulations for defining the status of “eligible customers” (i.e. those that are free to purchase gas from the supplier of their choice). As mentioned above, in the area of approximation of Ukrainian legislation to the EU *acquis*, the most important achievement to date is the Law on the principles of the functioning of the natural gas market. It provides for gas market reform based on the relevant EU directives. This law is vitally important as it contains specific obligations for Ukraine – for example, to ensure that operators and consumers have equal access to various segments of the gas market, thus encouraging market competition; to limit the role of government in terms of exclusive tariff regulation, through the establishment of an independent regulator; and to facilitate attracting investment to the gas sector.<sup>38</sup>

The reform of the gas sector is a precondition for the launch of substantial EU funding for the modernization of the Ukraine GTS (gas

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<sup>37</sup> For analysis see M. Gonchar, A. Duleba, O. Malynovskyi, *Ukraine and Slovakia in a post-crisis architecture of European energy security*, Bratislava, Kiev: Research Center of the Slovak Foreign Policy Association, 2011. See in particular part 2.2., pp. 29–42.

<sup>38</sup> “Monitoring: the law of Ukraine on the principles of the natural gas market functioning: Analysis of compliance with the EU law,” op. cit.

transmission system), which has been agreed by the “Joint declaration” adopted at the Joint EU–Ukraine international investment conference on the modernization of Ukraine’s gas transit system, held in Brussels on March 23, 2009.<sup>39</sup> The EU and Ukraine initiated the project “Preparatory studies for the modernization of Ukraine’s gas transit and storage” on February 18, 2011. This project has been launched within the context of the joint EU–EIB–EBRD–World Bank–Ukraine initiative to modernize Ukraine’s gas transit system. The project, funded by the EU within the framework of the Neighborhood Investment Facility (NIF), is to assist the three international financial institutions in their due diligence, thereby preparing the ground for investment into the Ukrainian gas transit system. The project is managed by the EBRD on behalf of the EU and the three international financial institutions. In this context, it was agreed that the EU will finance a feasibility study as well as environmental and social impact assessments of the modernization of the Ukrainian gas transit system and underground storages, in the amount of up to 2,650,000 euro.<sup>40</sup>

After accession to the Energy Community, Ukrainian authorities announced the restructuring of Naftogaz in order to improve competition in the gas market and to meet the requirements of the third energy legislative package of the EU. However, no measures have been implemented within the year 2011. Finally, in April 2012, the Ukrainian parliament amended the law on pipeline transport, authorizing the government to reorganize Naftogaz in order to fulfill its obligations under the Energy Community Treaty. President Viktor Yanukovich signed the above bill into law on April 28, 2012. Under the bill, the restructuring (merger, acquisition, demerger, spin-off, transfer) of Naftogaz Ukraine will be carried out by the decision of the Ukrainian Cabinet of Ministers, solely for the performance of Ukraine’s obligations under an agreement to join an energy community. At the same time, the law bans the privatization of Naftogaz assets,

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<sup>39</sup> “Joint declaration...” op. cit.

<sup>40</sup> “Archive of news,” Delegation of the European Union to Ukraine, February 18, 2011. Available online: [http://eeas.europa.eu/delegations/ukraine/press\\_corner/all\\_news/news/2011/2011\\_02\\_18\\_02\\_en.htm](http://eeas.europa.eu/delegations/ukraine/press_corner/all_news/news/2011/2011_02_18_02_en.htm) (accessed on November 19, 2012). See also “Sixth joint EU–Ukraine report...” op. cit.

or assets of its gas storage and transit subsidiaries.<sup>41</sup> However, the restructuring of Naftogaz in order that it comply with the unbundling rule of the EU has not yet started.

## Electricity market

Ukrainian authorities took some steps aimed at reforming the electricity market in 2011. In particular, the process of privatization within the sector was intensified, resulting in the privatization of seven regional energy companies in the course of 2011. However, due to the lack of an adequate legal framework for the functioning of the electricity market, this process did not result in improved competition in the electricity market. In fact, it led to the establishment of a dominant position for the DTEC Company, which is controlled by Rinat Akhmetov.<sup>42</sup>

Primary electricity legislation in Ukraine has yet to be upgraded in line with the requirements and principles of the EU Electricity Directive. The existing Ukrainian electricity law does not fully address the requirements and principles of the EU electricity *acquis*. To address this issue (according to information coming from the Energy Ministry), a draft Law on principles of functioning of the electricity market in Ukraine is now being finalized by NERC. The plan has been to submit this draft law to the Verkhovna Rada (Supreme Council of Ukraine – the parliament) within the year 2012.<sup>43</sup>

The Ukrainian electricity market still operates under a “single buyer” model, which does not comply with EU legislation. The Action Plan on Realization of the Provisions of the Concept of Functioning and Development of the Wholesale Electricity Market envisaged a gradual shift to a “bilateral contracts” market model with a balancing mechanism. It was approved by the Cabinet of Ministers of Ukraine in November 2007. However, since that time not much progress has been

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<sup>41</sup> “Yanukovych signs Naftogaz reform bill into law,” *Interfax-Ukraine*, April 28, 2012.

<sup>42</sup> See I. Lyubashenko, “Ukraine’s first year in the Energy Community: restart needed,” Polish Institute of International Affairs, *Policy Paper*; No. 28, April 2012, p. 7.

<sup>43</sup> See T. Tugolukova, “Ukraine’s membership in the Energy Community: one year on. Part I,” *Ukrainian Energy*, May 15, 2012. Available online: [http://ukrainian-energy.com/en/energy\\_legislation/articles/details/259](http://ukrainian-energy.com/en/energy_legislation/articles/details/259) (accessed on September 5, 2012).

achieved in this respect. The elaboration and adoption of a number of relevant regulatory acts in order to ensure progress is still pending.<sup>44</sup>

There are still barriers to the liberalization of the electricity market in Ukraine that should be addressed in line with the EU *acquis*. First, full third party access to regulated tariffs cannot be applied, because of constraints posed by the current “single buyer” model, due to the lack of a clear and detailed procedure for accessing electricity grids, and to technical issues (such as a lack of metering). Second, there are no procedures for the allocation of cross-border transmission capacity, nor are there provisions in Ukrainian legislation for the import, export, and transit of electricity. Third, there is still no definition or clear criteria of an eligible consumer under Ukrainian law. To address this issue, NERC has prepared and published (on April 14, 2012) a draft resolution on the approval of determination criteria for classes of electricity consumers differentiated by voltage type, the adoption of which is still pending. And finally, although non-household customers can choose their electricity supplier, there are no mechanisms in place for such customers to make use of this right. Further elaboration of service provision obligations (e.g. supply quality standards) and consumer protection measures (e.g. support for vulnerable customers) is required.<sup>45</sup>

Ukraine is still in the process of joining the European network of transmission system Operators for Electricity (ENTSO-E). A pre-feasibility study, “Extending the ENTSO-E synchronous zone by the integration of Ukrainian and Moldovan power systems,” has been postponed. It is expected that it will take up to two more years to complete the study.<sup>46</sup>

## Energy efficiency and renewables

In March 2010 the Ukrainian government adopted an Energy Efficiency Program for 2010–2015, aimed at reducing the level of energy consumption

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<sup>44</sup> T. Tugolukova, op. cit. See also I. Kosse, “Prozorist ta ekonomichna obhruntovanist taryfiv na elektroenerhiyu – neobkhidna umova reformy enerhetychnoho sektoru Ukrayiny,” *Cunsultation Working Paper* No. 3, Institute for Economic Research and Policy Consulting, 2012.

<sup>45</sup> Tugolukova, op. cit.

<sup>46</sup> Ibid.

by 20 per cent, decreasing the level of emissions of CO<sub>2</sub> by 15 per cent, and curtailing heating losses in the housing sector by 50 per cent as compared to 2008.<sup>47</sup>

Some positive changes in the field of renewable energy were undertaken in 2011. According to the Energy Community's Annual Report (2011), Ukraine has prepared Action Plans on the implementation of the relevant directives on renewables. Significant investment in the renewables sector resulted in the opening of wind and solar power plants in 2011. Important investments in this field are now foreseen, including the construction of a total of 2000 MW of wind and solar electricity capacity in the Crimea and Zaporizhya regions. The estimated 3 billion euro of investment required is expected to come from private investors. However, the above investments were predominantly driven by already existing legal provisions. In particular, "green tariffs" for electricity generated by "green technologies" were introduced already in 2008. In 2011, the Law on state guarantees to promote the use of renewable energy sources was adopted. On the other hand, the Ukrainian government has not managed to fine-tune the necessary technical regulations on decreasing the amount of sulphur in liquid fuels, in accordance with the Directive on sulphur in liquid fuels.<sup>48</sup> Moreover, a number of Ukrainian energy companies have underlined the need to postpone implementation of the Directive on the limitation of emissions of certain pollutants from large combustion plants until 2028–2030 (instead of 2018, as initially planned).<sup>49</sup>

Important tasks (and their deadlines) which Ukraine has committed itself to implementing, by acceding to the Energy Community Treaty in the area of energy efficiency and renewables, are as follows:

- the preparation of implementation plans by July 1, 2011, regarding the *acquis* on renewable energy sources (RES) – namely, the

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<sup>47</sup> T. Kistynyuk, "Energy efficient Ukraine. Is there a light at the end of the tunnel?" *Global Legal Resources*, HG.org, August 11, 2011. Available online: <http://www.hg.org/article.asp?id=22868> (accessed on September 5, 2012).

<sup>48</sup> "Annual report on the implementation of the *acquis* under the Treaty Establishing the Energy Community," Energy Community Secretariat, September 1, 2011. Available online: <http://www.energy-community.org/pls/portal/docs/1146177.PDF> (accessed on August 10, 2012).

<sup>49</sup> "Archive of news," State Agency on Energy Efficiency and Energy Saving of Ukraine, June 22, 2012. Available online: <http://saece.gov.ua/en/> (accessed on August 10, 2012).

implementation of the directives on the promotion of electricity produced from RES, and the promotion of the use of bio-fuels or other renewable fuels for transport;

- implementation of the EU's 2003 electricity and gas directives and associated regulations, and decisions concerning network access and cross-border exchange, by January 1, 2012;
- implementation of the directives on the security of natural gas supply, and on measures to safeguard the security of electricity supply and infrastructure investment, also by January 1, 2012;
- implementation of the directive relating to the reduction of the sulphur content of certain liquid fuels by January 1, 2012;
- a range of other acts in the environmental field must variously be implemented by January 2013, 2015 and 2018; and
- all non-household electricity and gas customers must become "eligible" from January 1, 2012, and all other customers from January 1, 2015.

However, the session of the DCFTA Working Group of the National Convention on the EU in Ukraine that took place on December 6, 2011 concluded that the target date of January 1, 2012 for implementation of the relevant legislation will not be met by Ukrainian authorities, due to the sluggish legislative process within the Verkhovna Rada of Ukraine.<sup>50</sup> Moreover, the government failed to prepare the National Action Plan on energy efficiency in accordance with the originally planned schedule. Some draft legislation has been drawn up on energy audit, energy efficiency, energy balance, and regulation in the sphere of energy efficiency, but has not yet been adopted by parliament.<sup>51</sup>

In addition, that portion of the business community in Ukraine interested in developing RES complains that the Ukrainian government

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<sup>50</sup> See the official web site of the project National Convention on the EU in Ukraine. Available online: <http://www.euconvention.org.ua/ПГ-II-Сесія-3-06122011> (accessed on November 22, 2012). See also V. Lupatsii, Y. Tyshchenko, eds, *National Convention on the EU in Ukraine. Working Groups Recommendations*, Kiev: National Institute for Strategic Studies, Research Center of the Slovak Foreign Policy Association, Ukrainian Center for Independent Political Research, 2012, pp. 50–3.

<sup>51</sup> See T. Tugolukova, "Ukraine's membership in the Energy Community: one year on. Part III," *Ukrainian Energy*, May 21, 2012. Available online: [http://ukrainian-energy.com/en/energy\\_legislation/articles/details/259](http://ukrainian-energy.com/en/energy_legislation/articles/details/259) (accessed on September 5, 2012).

does not show a willingness to support it. On June 11, 2012, the Ministry of Energy and Coal Industry of Ukraine published the updated draft of the Energy strategy of Ukraine until 2030, in which the requirements imposed on the Energy Community to increase the share of renewable energy in the national energy balance were not taken into account. “Analyzing the Energy strategy, it becomes clear that it aims at the development of traditional energy. In such circumstances renewable energy development is put on the back shelf,” said A. Konechenkov, the Chairman of the Ukrainian Wind Energy Association. The authors of the draft argue that renewable energy is not profitable, and should not be invested in primarily by private business companies. In such a situation the implementation of renewable energy projects needs state financial support.<sup>52</sup>

The key initiative supported by the EU in this area is the Ukraine Energy Efficiency Program (UKEEP). UKEEP is a credit facility developed by the European Bank for Reconstruction and Development (EBRD), targeting Ukrainian private companies in all sectors looking to invest in energy efficiency or renewable energy projects – investments that will decrease energy consumption, increase one’s own energy production, or make energy usage more efficient. UKEEP provides free technical assistance by international energy efficiency experts, for companies with project ideas that are eligible for UKEEP financing. If a project idea is found feasible, UKEEP can provide debt financing for the project.<sup>53</sup>

Regional energy cooperation in EaP countries is supported through the INOGATE program. Energy security and diversification of supply cannot be viewed in isolation; accordingly the INOGATE program links the EaP region to Central Asia. The INOGATE program 2010–2011 includes approximately 32 million euro of ongoing projects in support of regional energy markets, and in particular of the objectives of the EaP Energy Flagship (e.g. energy regulation, harmonization of standards and legislation, but also activities in support of renewable energy and energy efficiency in the building sector).<sup>54</sup>

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<sup>52</sup> “Archive of news,” State Agency on Energy Efficiency and Energy Saving of Ukraine, op. cit.

<sup>53</sup> “Ukraine Energy Efficiency Program.” Available online: <http://www.ukeep.org/> (accessed on August 10, 2012).

<sup>54</sup> For a list of ongoing INOGATE projects see – INOGATE Energy portal. Available online: [http://www1.inogate.org/inogate\\_programme/inogate\\_projects/ongoing-inogate-projects](http://www1.inogate.org/inogate_programme/inogate_projects/ongoing-inogate-projects) (accessed on August 10, 2012).

The most important bilateral initiative to date launched by an EU member state in an EaP country in the area of energy efficiency is the Swedish–Ukrainian Energy Efficiency Business Initiative 2009. The aim of the SUEEB is to support business to business cooperation between Swedish/EU companies and their Ukrainian partners in the implementation of various projects in the area of energy efficiency, including energy supply at the municipal level, energy standards of buildings, and the use of renewable energy sources.<sup>55</sup>

## Oil sector

The development of the oil infrastructure in Ukraine has been one of the most positive examples of EU–Ukraine cooperation in energy matters thus far. This is first of all thanks to the INOGATE program. INOGATE originated in 1995 as an EU support mechanism dealing with Interstate Oil and Gas Transportation to Europe (whence it derived its name as an acronym – INOGATE). It was particularly concerned initially with the oil and gas pipelines running from and through Eastern Europe and the Caucasus to the EU. In 2001, a formal umbrella agreement was signed by 21 countries in Kiev, to cooperate on pipeline development and enhancement (the priorities at that time being the Druzhba pipeline, and the extension of the Odessa–Brody pipeline). It is assisted, via the EU’s EuropeAid program, by a secretariat based in Kiev, Ukraine, with a regional office in Tbilisi, Georgia.<sup>56</sup>

Ukraine’s energy infrastructure has been at the focal point of INOGATE activities from its inception. Ukraine was involved in 16 regional projects implemented in the oil sector, within the INOGATE program, during the period of 1999–2012. The projects that facilitated

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<sup>55</sup> “Project plan for the Swedish–Ukrainian energy efficiency business initiative 2009 (SUEEBI 2009),” Swedish Trade Council, Swedish Energy Agency. Available online: [http://www.swedishtrade.se/PageFiles/160187/Project%20Plan%20Swedish%20Ukrainian%20Energy%20Efficiency%20Initiative%202009%20\\_SUEEBI\\_%20INFO.pdf?epslanguage=sv](http://www.swedishtrade.se/PageFiles/160187/Project%20Plan%20Swedish%20Ukrainian%20Energy%20Efficiency%20Initiative%202009%20_SUEEBI_%20INFO.pdf?epslanguage=sv) (accessed on August 10, 2012).

<sup>56</sup> “INOGATE Programme. Energy Portal. Energy Cooperation between the EU, Eastern Europe, the Caucasus and Central Asia.” Available online: [http://www.inogate.org/index.php?option=com\\_content&view=article&id=46&Itemid=72&lang=en](http://www.inogate.org/index.php?option=com_content&view=article&id=46&Itemid=72&lang=en) (accessed on August 10, 2012).

the construction of the Odessa–Brody pipeline, as well as construction of the Pivdenny oil terminal, included, for example: Priority emergency investments in oil and gas infrastructures – Eastern Europe (Ukraine, Belarus and Moldova) (completed in 2003; 1,000,000 euro); Technical, Economic, Financial and Legal Advisory Support for the Development of the Project Concept for the Odessa–Brody–Plock Oil Transportation System (completed in 2006; 1,999,710 euro); and others. INOGATE supported projects involving Ukraine within the period of 1999–2012 in the amount of approximately 55 million euro.<sup>57</sup> The Odessa–Brody pipeline, including the Pivdenny oil terminal, was built also thanks to EU support in May 2002.

At present, the major INOGATE project “INOGATE Technical Secretariat and integrated program in support of the Baku Initiative and the Eastern Partnership energy objectives” aims at supporting the reduction of participating countries’ dependency on fossil fuels and their imports, improvement of the security of their energy supply, and overall climate change mitigation (project period 2012–2015; 16.6 million euro).<sup>58</sup> The INOGATE program still serves as the instrument for implementing the priorities of EU–Eastern partner countries within the Energy Security multilateral thematic platform, which is one of the four EaP platforms. However, in the case of Ukraine it is difficult to identify any gains in the form of implemented projects resulting from the activities of the EaP multilateral platform on energy security, as the latter serves mostly as a discussion forum.

## Conclusions

- It may be concluded that the reform of Ukraine’s energy sector within the framework of its cooperation with the EU is driven rather by Ukraine’s accession to the European Energy Community than by the EaP framework. The accession Protocol is the only contractual element of the existing institutional framework of

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<sup>57</sup> For a list of INOGATE projects involving the participation of Ukraine (1999–2012) see “INOGATE Programme...” op. cit

<sup>58</sup> Ibid.

present day EU–Ukraine relations that stipulates – in a binding contractual regime – reforms in the energy sector of Ukraine.

- The adoption of the Law on the principles of the functioning of the natural gas market (July 8, 2010), which provides for a gas market reform similar to the second legislative energy package of the EU, may be regarded as the main achievement of the present EU–Ukraine cooperation. In addition to the liberalization of the gas market, the gas law includes the strengthening of the status of the National Electricity Regulatory Commission of Ukraine (NERC) as a regulatory authority for the gas market. However, by-law acts that would clarify the duties and responsibilities of NERC are still lacking. As a result, NERC is still dependent on the government for making decisions on the tariff regulation of energy markets.
- In April 2012, the Ukrainian parliament amended the law on pipeline transport, authorizing the government to reorganize Naftogaz in order to fulfill its obligations under the Energy Community Treaty. Under the bill, the restructuring (merger, acquisition, demerger, spin-off, transfer) of Naftogaz will be carried out by the decision of the Ukrainian Cabinet of Ministers, solely for the performance of Ukraine’s obligations under an agreement to join an energy community. At the same time, the law bans the privatization of Naftogaz assets, or assets of its gas storage and transit subsidiaries.<sup>59</sup> However, the restructuring of Naftogaz in order that it comply with the unbundling rule of the EU has not yet started.
- Ukrainian authorities took some steps aimed at reforming the electricity market. In particular, the process of privatization in the sector was intensified, resulting in the privatization of seven regional energy companies in the course of 2011. However, due to a lack of an adequate legal framework for the functioning of the electricity market, this process did not result in improved competition in the electricity market.
- There are still barriers for the liberalization of the electricity market in Ukraine that should be addressed in line with the EU

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<sup>59</sup> “Yanukovych signs Naftogaz reform bill into law,” *Interfax-Ukraine*, April 28, 2012.

*acquis*. First, full third party access to regulated tariffs cannot be applied, because of constraints posed by the current “single buyer” model, due to the lack of a clear and detailed procedure for accessing electricity grids, and to technical issues (such as a lack of metering). Second, there are no procedures for the allocation of cross-border transmission capacity, nor are there provisions in Ukrainian legislation for the import, export, and transit of electricity. Third, there is still no definition or clear criteria of an eligible consumer under Ukrainian law.

- Ukraine is still in the process of joining the European Network of Transmission System Operators for Electricity (ENTSO-E). A pre-feasibility study “Extending the ENTSO-E synchronous zone by the integration of Ukrainian and Moldovan Power Systems” has been postponed. It is expected that it will take up to two more years to complete the study.
- There has been a certain progress made in the sphere of energy efficiency. However, the National Action Plan on energy efficiency has not been prepared in accordance with the government’s original schedule. Some draft legislation has been drawn up on energy audit, energy efficiency, energy balance, and regulation in the sphere of energy efficiency, but has not yet been adopted by parliament.
- It seems that none of Ukraine’s commitments under the Energy Community Treaty was carried out in full or on time. Implementation of the necessary energy reforms is still a task that must be accomplished. The main challenges and risks for Ukraine in carrying out these commitments to the Energy Community are their restrictive timeframes and the need to invest considerable sums in upgrading its energy generation and distribution capacities.

# Visa dialogue

Although EU–Ukrainian political relations have recently deteriorated, the two sides have made some practical progress in their bilateral visa agenda. There has been a gradual, albeit not uniform, improvement in the process of visa facilitation by EU member states.<sup>60</sup> In short, the growth of the EU’s visa industry in Ukraine has been accompanied by some liberalizing measures and friendlier practices when it comes to issuance of the Schengen visa. At the same time, the goal of visa liberalization remains a long-term issue, which has been affected adversely by increasingly difficult political relations between the EU and Ukraine. So while a full-fledged visa free regime is not in the cards at the moment, a greater facilitation of the existing visa regime is realistic. However, the political situation in Ukraine, combined with a heightened political sensitivity to possible migration into the EU, is likely to slow down further progress on the visa issue. This section briefly reviews the initial positions and expectations of the EU and Ukraine towards the visa agenda. It outlines the current state of play and reviews specific developments in the area of visa facilitation. It concludes with a note of caution on prospects for visa liberalization in light of present political developments.

## Managing expectations

Visa dialogue has been expected to become a “winning area” which could produce positive results for the Eastern Partnership (EaP) by bringing the EU closer to populations of partner countries. The EU had initially asked the governments of partner countries to meet mostly technical criteria that would allow the EU and Schengen countries to liberalize visa regimes for EaP citizens. Many had expected that the

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<sup>60</sup> See I. Sushko, O. Suprunenko, O. Sushko, M. Kuzio, “The EU visa policy in Ukraine. Independent monitoring findings 2012,” *Europe without barriers*. Available online: [http://novisa.com.ua/file/publics/novisa\\_publics1351606401.pdf](http://novisa.com.ua/file/publics/novisa_publics1351606401.pdf) (accessed on November 12, 2012).

progress in visa dialogue might have a spill-over effect on other areas of EU interaction with the partner countries. However, in contrast to such expectations, the visa dialogue so far has brought rather modest outcomes. Despite the fact that the Declaration on the Eastern Partnership promises visa liberalization, there has been little significant progress towards a visa free regime.

Although the EU Warsaw summit in 2011 reaffirmed the launch of dialogues “on visa free regimes with Ukraine and Moldova,” it switched its focus onto the process of visa liberalization itself. The Warsaw summit kept open the ultimate goal of greater mobility by stating the EU’s commitment “towards visa free regimes in due course on a case-by-case basis provided that conditions for a well-managed and secure mobility set out in two-phase action plans for visa liberalization are in place.” The EaP countries must thus deliver on the legislative front, and also enhance the trust of EU member states through practical steps which may be costly at times. Conversely, the EU is in no position to lift its visa requirements at the moment. Rather, it is offering concrete improvements to the visa infrastructure and the procedures being applied in EaP countries.

This shade of grey between a strict visa regime and no visa regime has led to a generally frustrated public and political sentiment in Ukraine. Citizens of Ukraine view the EU visa regime as strict, unfair and unjustified. They see it as another example of the unequal and asymmetric relations between Brussels and Kiev. The Ukrainian discourse has put the primary blame for continued application of the EU visa policy on the lack of political will among EU member states and institutions. Member states are both procedurally rigid and afraid of opening up, according to the Ukrainian public.<sup>61</sup> Perhaps only a handful of Ukraine’s domestic experts recognize the extreme significance of Kiev’s performance in fulfilling the requirements or conditions set out by the EU in order to enable the two sides to come a bit closer to some kind of visa liberalization.

In short, while the European Union has clearly set out its prerequisites for further liberalization of the visa regime, Ukraine has showed limited willingness to adapt to the calls of the facilitation process. Publicly, this

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<sup>61</sup> See V. Bilčík, ed., *Ambitions and expectations of the Eastern Partnership*. Prešov: Research Center of the Slovak Foreign Policy Association, 2011.

“process is one of the highest priority for a Ukrainian society suffering from the phenomenon called ‘The Fortress of Europe,’ which prevents people from travelling abroad in the Western direction.”<sup>62</sup> And past experience tells us that the possibility of traveling freely to Western countries has “contributed significantly to the rise of public demands in favor of modernization and Europeanization.”<sup>63</sup>

However, while the EU has been relatively cautious in its ambitions to liberalize visa policy, Ukraine has produced mixed results in its own attempts to get closer to EU standards. Technically, unless Ukraine settles the matter of document security there will be little progress regarding deeper integration in the field of visa policy. Document security, however, remains a difficult challenge. It is financially demanding and requires political support. Similarly, the question of effective border management remains open, as Ukraine cannot fully guarantee its borders in the East. Nonetheless progress can be observed in the area of border management, as most of the demanded legislation has been implemented, and further changes are planned by 2015. In other related areas, progress in migration management can also be seen after the adoption of the Action Plan on visa liberalization, embodied in the establishment of a National Migration Management Strategy that constitutes an institutional framework for the management of migration.

The main problems, however, are political. Although the European Commission proposed an amendment to the existing visa facilitation agreement in July 2012,<sup>64</sup> the fate of further liberalization depends on internal developments in Ukraine following the parliamentary elections of October 2012, as well as on the EU’s own internal debate on Schengen and visa requirements. The EU assessment of Ukraine’s parliamentary vote in late 2012 will be crucial for any progress in bilateral relations with Ukraine.<sup>65</sup> To enlarge on this difficult political picture, the call by larger EU countries for a reintroduction of the visa regime to applicant

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<sup>62</sup> “Implementation of Action Plan on visa liberalisation: a case of Ukraine,” *Europe without Barriers*, Kiev, 2012, p. 88.

<sup>63</sup> *Ibid.*

<sup>64</sup> “Commission amends visa facilitation agreement for citizens of Ukraine,” European Commission, *Press release*, July 23, 2012. Available online: [http://europa.eu/rapid/press-release\\_IP-12-821\\_en.htm](http://europa.eu/rapid/press-release_IP-12-821_en.htm) (accessed on September 5, 2012).

<sup>65</sup> H. Konstanyan, I. Vorobiov, “Free and fair? A challenge for the EU as Georgia and Ukraine gear up for elections,” *CEPS Commentary*, September 27, 2012.

countries in the Western Balkans could further dampen the mood for visa liberalization elsewhere, and complicate the ratification of the amended visa facilitation agreement with Ukraine.<sup>66</sup>

## Facilitating the EU visa policy

Formal rules are set out by the facilitation agreement and by the EU visa code that sets out all procedures and conditions for issuing “short stay visas” and “airport transit visas.” It also establishes lists of third country nationals who are required to hold “airport transit visas” when passing through the international transit areas of airports situated on the territory of the member states. It covers visas issued for the purpose of “short stays,” i.e. stays not exceeding 90 days in any 180 day period. At the same time, legislation related to the issuance of visas for the purpose of long stays (beyond 90 days) remains in national hands, as do “short stay visas” and “airport transit visas” when issued by EU member states – except the UK and Ireland, which are not in Schengen. Bulgaria, Romania and Cyprus will apply the EU visa code once they become part of the Schengen area without internal borders. The visa code is also applied by those countries that are part of the Schengen area but not EU member states (Iceland, Norway, Switzerland and Lichtenstein).

The visa facilitation agreement softens some of the visa code rules by offering more favorable conditions to Ukrainian citizens (e.g. a 35 euro visa fee instead of 60 euro, broader categories for visa fee waiver, simplification of document requirements, a ten day processing time instead of 15 days). Recent research suggests some degree of improvement lately in the practice of visa policy.<sup>67</sup> The aforementioned amendments to the visa facilitation agreement proposed in July 2012 go several steps further in simplifying visa code rules. If the agreement is adopted, the current visa policy can be facilitated further, with a view to more friendly practices and greater visa accessibility for Ukrainian citizens.

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<sup>66</sup> B. Fox, “Germany and France demand reintroduction of Balkan visas,” *EUobserver*, October 15, 2012. Available online: <http://euobserver.com/justice/117869> (accessed on November 14, 2012).

<sup>67</sup> See I. Sushko, O. Suprunenko, O. Sushko, M. Kuzio, op. cit.

## Liberalizing ambitions

The visa liberalization dialogue started in 2006. The Action Plan on visa liberalization (VLAP) for Ukraine toward the establishment of a visa free regime for short-stay travel was adopted at the Ukraine–EU summit held on November 22, 2010. The Action Plan was divided into two phases – namely, the introduction of a set of legislative acts, and the subsequent implementation of the new legal provisions. At the most recent EaP summit in Warsaw, the EU agreed to abolish its previous formula for liberalization of the visa regime for Ukrainian citizens, which viewed visa liberalization as a long-term process. Ukraine has been seeking concrete conditions that would stipulate the cancellation of the current visa regime with the EU.<sup>68</sup>

The first progress evaluation report was presented to Ukraine in September 2011. It included an assessment of the changes that had occurred in Ukraine within the framework of the EU–Ukraine visa dialogue as of July 8, 2011. The second EU evaluation report, on the implementation by Ukraine of the VLAP, reflected the progress made as of November 2011. According to the European Commission, the progress of Ukraine towards a visa free regime with the EU is uneven and disproportionate. Major legal acts within the VLAP were adopted in May–October 2011, which proved to be the most productive period during the entire first phase of VLAP. Since November 2011, the pace of VLAP implementation has slowed down. We can observe some degree of compliance by Ukraine but there are also certain fundamental deficiencies. Unless the latter are addressed, the progress toward a more liberal regime is going to stall. This is the underlying message of the Commission’s evaluation in February 2012.

The February 2012 report on Ukraine’s implementation of the Schengen *acquis* noted that the legal framework for issuing machine-readable biometric international passports, in full compliance with the highest International Civil Aviation Authority (ICAO) standards regarding secure identity management, had not been completed. Both the action plan, and the

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<sup>68</sup> “Summit EU–Ukraine: visa liberalization progresses,” *PRNewswire*, December 20, 2011. Available online: <http://www.prnewswire.com/news-releases/summit-eu-ukraine-visa-liberalization-progresses-135912173.html> (accessed on August 15, 2012).

program for the complete roll-out of ICAO-compliant biometric passports and the complete phasing out of non-ICAO-compliant passports, have yet to be adopted. The law of Ukraine concerning documents for identifying a person and confirming citizenship – which introduces documents with an electronic chip containing biometric data – was finally signed by the Ukrainian president Viktor Yanukovich at the end of November 2012.<sup>69</sup>

The president's veto on October 22, 2011, of a Law regarding documents identifying a person and confirming Ukraine citizenship, caused the adoption of new measures on document security in Ukraine to be postponed. Certainly one problem was that the adoption of biometric passports is in fact big business, and the various domestic interest groups cannot agree on who is to get the order. At the same time, from the EU's perspective, document security is one of the most important issues for the further development of more liberal arrangements in the area of mobility. The failure to guarantee a sufficient level of security of Ukrainian citizens' documents has constituted an obstacle both to the further facilitation of existing rules and to additional liberalization. Thus, although Yanukovich's signature will be a step in the right direction, financial requirements and further domestic reforms will still be needed. In short, unless Ukraine is able to move ahead in this area, no serious progress in visa liberalization is going to take place.

With regard to migration management, Ukraine has, in a very short time, adopted a legislative framework and established an institutional framework for migration management and for the implementation of migration policy, providing a good foundation for an effective migration management policy. The demand within the Action Plan for the "adoption of a legal framework for migration policy providing an effective institutional structure for migration management, rules for the entry and stay of foreigners, monitoring of migration flows and the fight against illegal migration," became the Law on the legal status of foreigners and status of foreigners and stateless persons, which was successfully adopted on September 22, 2011. Ukraine has very quickly adopted the legislative framework and established the institutional framework for migration

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<sup>69</sup> "Yanukovich signs law on biometric passports," *KyivPost*, November 29, 2012. Available online: <http://www.kyivpost.com/content/ukraine/yanukovich-signs-law-on-biometric-passports-316905.html> (accessed on November 29, 2012).

management. On May 30, 2011, a law establishing a National Migration Management Strategy was adopted by Presidential Decree No. 622/2011.

Ukraine is a major transit country for irregular migrants from Asia, the Arab countries and Africa. The number of such migrants has been increasing gradually. For the purpose of tackling this problem, the State Border Guard Service (SBGS) was established in August 2003.<sup>70</sup> With the help of the European Commission the SBGS continued to implement a strategy of reform aimed at an EU-compliant law enforcement service in 2007. During 2009, there were certain violations of the rights of refugees and asylum seekers, in breach of obligations under international human rights and refugee law. In June 2009, a decree to create the State Migration Service was adopted, but it was vetoed by a Presidential Decree in August 2009. In 2012, the European Commission said that in the area of asylum, Ukraine has a solid legislative basis, mostly in line with European and international standards: "However, some important provisions require modification, and there is a need to align the provisions in other related laws with the new legislation, and to adopt appropriate by-laws."

To sum up, most of the demands concerning border management are now in force. However, they are deemed incomplete, as the plan approved in law contains matters which will not be implemented until 2015. The European Commission Country Report states that "the State Border Guard Service pursued border management reforms in line with the targets of the 2015 plan."<sup>71</sup> As stated in the most recent evaluation of the implementation of the VLAP: "In the area of border management, all the necessary laws are in place along with the institutional framework, including provision of training and ethical codes to fight corruption."<sup>72</sup> More effort is needed to strengthen interagency cooperation in the area of border management.

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<sup>70</sup> Ibid

<sup>71</sup> "Joint staff working paper. Implementation of the European Neighbourhood Policy in 2010. Country Report: Ukraine," European Commission, High Representative of the European Union for Foreign Affairs and Security Policy, SEC(2011) 646, May 25, 2011, p. 15. Available online: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2011:0646:FIN:EN:PDF> (accessed on August 15, 2012).

<sup>72</sup> "Joint staff working document. Second progress report on the implementation by Ukraine of the Action Plan on visa liberalisation," European Commission, High Representative of the European Union for Foreign Affairs and Security Policy, SWD(2012) 10 final, February 9, 2012, p. 4. Available online: [http://ec.europa.eu/home-affairs/news/intro/docs/20120209/UA\\_2nd\\_PR\\_VLAP\\_SWD\\_2012\\_10\\_FINAL.pdf](http://ec.europa.eu/home-affairs/news/intro/docs/20120209/UA_2nd_PR_VLAP_SWD_2012_10_FINAL.pdf) (accessed on August 15, 2012).

In addition, there are two main problems in this area. The first is Ukraine's ability to guarantee its border security towards the East, because there are still many unresolved areas of concern regarding the border with Russia and Moldova (Transnistria). The second problem is the issue of corruption on the Ukrainian borders. Even though many measures have been adopted pertaining to these problems, to what extent they have been carried out in reality is in serious doubt, in light of recent developments with respect to corruption in Ukraine generally.

The 2012 Commission report also notes that Ukraine has made some further progress in the adoption of the required legislative framework in the area of public order and security. The legislative framework on combating organized crime is now in place. Regarding the policy framework, while the strategy was adopted in October 2011, the accompanying action plan is not yet in place. This action plan "should include a realistic timeframe, clearly identified responsible actors, a budget, human resources, performance indicators and a monitoring process including all of the relevant stakeholders," states the report. The Commission also said, however, that limited progress has been made in the fight against corruption.

The last part of the 2012 Commission report, which is dedicated to the issue of external relations and fundamental rights, states that Ukraine "has made some progress." It has drafted and adopted several important amendments to its legislation, aimed at removing unjustified obstacles to freedom of movement within Ukraine. "Further legislative work is required in order to insert effective provisions on human rights and fundamental freedoms into the national legislation. The legal framework also requires revision to ensure respect for the right to fair, impartial and transparent legal proceedings," reads the report.

One outstanding problem is that Ukraine has not yet adopted "comprehensive anti-discrimination legislation in order to ensure effective protection against all forms of discrimination." In this regard, Ukraine is, for instance, lagging behind Moldova, which in technical terms has been faster and more forthcoming in the visa liberalization process.

## **Visa issue and the current political context**

The European Union has committed itself to lifting visa requirements for Ukrainian citizens. It has also made the issuance of the Schengen

visa easier, especially for certain groups of Ukrainian citizens. On the whole, the visa agenda has been a modestly bright spot in the mutual relations between the European Union and Ukraine. However, the political developments of 2012 suggest that there is still a long and twisting road ahead to a visa free regime. The quality of political relations and mutual trust between Kiev and Brussels is crucial for the final abolition of the visa requirement. So while the processes of further visa facilitation and visa dialogue are likely to continue, many EU member states are opposed to a full-fledged visa liberalization. It is therefore important to set realistic expectations with respect to the visa agenda, while at the same time not losing sight of the EU's credible offer to aim for a visa-free regime with Ukraine.

The Danish EU presidency in the first half of 2012 is a good example of the difficulty of balancing between the EU's commitment to greater openness towards Ukraine, and the deteriorating state of Ukraine's democracy. It had planned to conclude the AA with the DCFTA between the EU and Ukraine. Denmark wanted to see Ukraine integrated as far as possible into the EU, including its approximation as far as possible to the EU's economic *aquis*. However, this position became subordinate to the political position of the EU with regard to Ukraine. The EU could not ignore the principles of democracy and the rule of law. Therefore the agreement could not be signed until Ukraine has moved on the Tymoshenko case. However, the Danish Presidency played an important role by assuring a constant focus on political developments.

Moreover, the Danish presidency helped to keep EU-Ukraine relations alive. In the first half of 2012, EU member states agreed to the creation of a pro-democracy fund, the European Endowment for Democracy. This could prove a very useful tool for supporting and promoting democracy, through support at the grass root and NGO levels in Eastern partner countries. An overarching challenge for the EU is how to reach out even further and strengthen EU support for the democratic forces in the East. The challenge is how to reach both governmental and non-governmental forces in partner countries in order to contribute to the establishment of sustainable democracies in the East.

Greater mobility and person-to-person contact represent important catalysts for pro-democratic change. Visa liberalization for Eastern

partners, however, would have important consequences not only for the partners but also for the EU. These issues raise a number of concerns in many EU countries which must be taken into account. Thus Denmark, like other EU states, has advocated an EU policy proceeding towards the long-term goal of visa liberalization for individual partner countries on a case-by-case basis, provided that the conditions for a well-managed and secure mobility are in place. While working on easing visa requirements for Ukrainian citizens, the EU should also be looking at possibilities for strengthening exchange and fellowship programs for students and researchers, among others. It is in the interest of the EU to further highlight and expand the possibilities of these programs. This should be done in close cooperation with the bilateral programs of member states.<sup>73</sup>

On the other hand, moves to re-nationalize Schengen in 2012 did not help the overall state of the EU's visa policy. Ministers voted to change the procedure of co-decision on Schengen matters to a mere consultation procedure – meaning the position of the European Parliament (EP) can now be totally ignored. At a meeting in Luxembourg on June 7, 2012, the EU home affairs ministers agreed on new rules that would allow countries to reintroduce border controls if one state persistently fails to stop illegal migrants from entering Europe's Schengen zone. Such a decision would have to follow a careful monitoring of external borders revealing a “serious threat to public policy or internal security” in the EU. To ensure that the EU's external borders are well protected, the ministers also agreed to step up monitoring of the way checks are conducted. These developments toward greater intergovernmentalism in Schengen issues suggest that in spite of the departure of former French President Nicolas Sarkozy from the political scene, the Schengen reform envisioned by his administration, and underlying the increased role of individual member states, is thriving.

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<sup>73</sup> P.M. Jensen, “The Eastern Partnership and the Danish EU Presidency: caught between realism and disillusion,” *EaPCommunity*, April 11, 2012. Available online: <http://www.easternpartnership.org/publication/politics/2012-04-11/eastern-partnership-and-danish-eu-presidency-caught-between-realism-> (accessed on November 23, 2012).

## Conclusions

- In sum, the road to a visa free regime is going to be slow, and EU benchmarks and action plans are likely to be as important as practical tests of greater openness to and cooperation with the border authorities and security services of individual partner countries. The hardest task for Ukraine will be to meet the EU's expectations regarding values, democracy and the rule of law. Corruption, a weak state, and a lack of standards remain important barriers to Ukraine's development and modernization.<sup>74</sup>
- In this context it is important not to lose sight of some positive results in the facilitating and easing of the existing visa regime. In order to make further progress in the EU's visa policy toward Ukraine, it is essential to keep these two processes (facilitation and liberalization) distinct, and to ratify the amendments to the existing facilitation agreement in the near future.<sup>75</sup>
- Also, the European Union should strive to apply its rules more uniformly across member states when it comes to facilitating the issuance of Schengen visas in different EU consulates.
- While purely political considerations should not override the debate in the European Parliament on the amendments to the visa facilitation agreement with Ukraine, the EU should also more clearly distinguish technical from political benchmarks for progress, in the process of visa liberalization. Although any final decision on lifting the EU's visa requirement is likely to be political and probably demand a very different political leadership in Kiev, Ukrainian citizens should clearly understand what measurable progress there has been on the technical aspects of visa liberalization.

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<sup>74</sup> G. Gotev, "Special report: Ukraine ups ante in EU visa-free travel talks," *EurActiv.com*, September 15, 2011. Available online: <http://www.euractiv.com/specialreport-eu-ukraine-relations/special-report-ukraine-ups-ante-eu-visa-free-travel-talks-news-50> (accessed on August 10, 2012).

<sup>75</sup> I. Solonenko, A. Umland, "What now for EU-Ukraine relations?" *EUobserver*, November 14, 2012. Available online: <http://euobserver.com/opinion/118192> (accessed on November 22, 2012).

- The EU should apply comparable standards when evaluating the progress of different EaP countries, as well as that of Russia, in the process of visa liberalization. While countries like Moldova may be politically and technically further advanced than Ukraine, Russia's progress should not depend primarily on political considerations.
- In the intra-EU debate, it is important to make use of data concerning migration from EaP countries and its potential consequences to the European Union. Further research and new findings<sup>76</sup> may help dispel the continuing myth on the purpose of visa policy and the actual effects of migratory trends from Eastern Europe.

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<sup>76</sup> See, for example, M. Lesinska, E. Matejko, O. Wasilewska, *Migrations from Eastern European countries to the European Union in the context of visa policy*, Warsaw: Stefan Batory Foundation, 2012.

# Impact of EU–Ukraine relations on the Eastern Partnership

The Eastern Partnership (EaP) is a two-sided process. The aim of the final part of this policy paper is to examine the policy impact of present EU–Ukraine relations, as well as the way in which Ukraine is dealing with the EU offer concerning the future dynamics of the EaP.

The research completed within this project allows for some general conclusions that are relevant for a better understanding of both the present and future engagement of the EU with the six East European partner countries, including an understanding of the limits of the EaP. Any projection of the future feasibility of the EU offer to countries within the EaP is impossible without identifying the capacity of the partner countries to absorb it. The research case of Ukraine – which has been the leading partner country since the launch of the EaP in 2009, with talks on the association agreement with the Deep and Comprehensive Free Trade Area (DCFTA) – shows that the existing limits of the EaP have much more to do with the capacity of partner countries to absorb the EU offer, than with the willingness of the EU to make it feasible.

Ukraine has become the leading Eastern partner country for two reasons: First, the EaP per se represents the EU's extending to five additional East European countries (Armenia, Azerbaijan, Belarus, Georgia, and Moldova) an offer to achieve a bilateral institutional arrangement similar to that achieved by the EU in its relations with an "orange" Ukraine during the course of 2008–2009. Second, Ukraine began talks on the association agreement (the core of the EaP offer) all the way back in 2007 (when it was still an "enhanced cooperation agreement," in the jargon of the pre-Eastern Partnership period). Following the recent experience of a three year implementation of the EaP (five years in the case of Ukraine), it is important to reflect on this policy and its success in Ukraine. The critical question might be put as follows: should the EU revise its offer within the EaP if partner countries are not fully ready to engage with it?

From the EU perspective, the fundamental goal of the EaP as designed is to complete the comprehensive association agreements with partner

countries. The remaining EU programs and tools – as applied within the EaP on both bilateral and multilateral levels – are merely supporting instruments aimed at facilitating the completion of association agreements. We argue below in this text that the EU should in fact revise its offer, if none of the six partner countries are able to complete the association agreement by the time of the third EaP summit, scheduled to take place in Vilnius in November 2013. If that happens, it will undermine the future dynamics of the EaP project as a whole. Any policy which cannot achieve the goal it was intended to do should be revised.

The goal of the EaP is to achieve the political association and economic integration of the partner countries with the EU. When it comes to political association, it is still unclear what this means for partner countries in terms of their institutional status with regard to the EU – it is clear, however, that it does not mean their EU membership. The EU does expect that partner countries will share and respect European values, the rule of law, and democratic institutions. When it comes to economic integration, the EU offer to partner countries is both clear and ambitious. The partner countries are offered access to the EU single market via completion of the association agreement, including the DCFTA.

The type of association agreement that the EU has offered to partner countries under the EaP is the third most ambitious type of contractual agreement existing between the EU and third countries (in terms of degree of economic integration via accession to the EU single market), after the European Free Trade Area (EFTA) and European Economic Area (EEA) agreements respectively. The EaP type of association agreement would mean that partner countries adopt about 95 per cent of the EU's existing trade and economic related *acquis communautaire*.<sup>77</sup> Partner countries are offered the benefit of access to the EU single market, provided that they harmonize with the EU trade and economic related *acquis*, and respect European political values. In other words, the EU imposes trade conditions on the six partner countries since political membership is not part of the EaP offer. Whereas the association agreement represents the core of the EaP, the DCFTA might be regarded as the “core of the core” of the EU offer to the six partner countries.

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<sup>77</sup> Authors' interview with the representatives of the DG Trade of the European Commission in Brussels on December 5, 2012.

There is one important difference between EFTA and EEA agreements on the one hand, and EaP association agreements on the other – a difference which has to do with access to EU institutions. Even though the EFTA and EEA countries (Iceland, Lichtenstein, Norway, and Switzerland) are not EU members, they have the right, firstly, to participate in the process of formation of the new EU trade related *acquis*, with the status of observers; and secondly, they can veto a new EU *acquis* through the EU–EFTA Council. (However, it should be pointed out that the EFTA and EEA countries have never made use of this veto right.) The EaP association agreements include neither observer status for partner countries in the formation of a new EU *acquis*, nor a veto right. They can negotiate transitional periods for the transposition of the existing EU *acquis* to their national legislations during discussions on the association agreement, including DCFTA. However, there is no institutional channel through which they can have an impact on the formation of a new EU *acquis*, to which they will be obliged to approximate in the future once they have completed their association agreements.

From this point of view the EaP offer is a step backwards to Romano Prodi's original ENP definition, "we'll give you everything but institutions" (from 2002),<sup>78</sup> as compared with the ENP Plus proposal of the German Foreign Ministry on the eve of the German Presidency of the EU Council in 2007, which included the possibility of Eastern ENP countries having observer status during the formation of a new trade related *acquis*, following the EFTA/EEA model. At the same time, it should also be noted that the EaP as it was developed in the course of 2008–2009 is in fact a step forward as compared with the German ENP Plus proposal, since the latter did not envisage a full-fledged opening of the EU single market for Eastern neighbors via comprehensive association agreements with the DCFTA. The ENP Plus offered a gradual opening of the EU single market (on a sector by sector basis) via sector agreements with Eastern ENP countries, depending on their readiness to comply with the relevant EU sector *acquis*.

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<sup>78</sup> R. Prodi, "A wider Europe – a proximity policy as the key to stability," Speech given at the sixth ECSA World Conference on Peace, Stability and Security in Brussels, December 5, 2002. Available online: [http://ec.europa.eu/comm/external\\_relations/news/prodi/sp02\\_619.htm](http://ec.europa.eu/comm/external_relations/news/prodi/sp02_619.htm) (accessed on June 21, 2012).

Nevertheless, we argue in this text that from the perspective of the recent political pause in EU–Ukraine relations (which led to the postponement of the completion a comprehensive association agreement) – and furthermore, on the proviso that the pause be not settled before the Vilnius EaP summit scheduled for November 2013 – we should not *a priori* exclude a possible combination of the ENP Plus sector-by-sector approach with the existing “one complex agreement” approach under the current EaP. Moreover, the ENP Plus proposal could become a source of renewed inspiration for the EaP and its further upgrade (in order to renew its dynamics) – especially when it comes to ideas for strengthening the institutional affiliation of partner countries with the EU legislation process. In the end, of course, it depends on the willingness of the EU and its member states to achieve the declared policy goals vis-à-vis Eastern partner countries, as well as on the EU’s decidedness to continue with the ENP/EaP normative policy towards the countries of Eastern Europe.

This research on the policy impact of the EaP on Ukraine within the three chosen sectors (trade, energy, and visa dialogue) was undertaken with the aim of assessing the capacity of Ukraine, the pioneer country of the EaP, to respond to the EU offer. The following are the main conclusions that may be drawn from the research, which are relevant also to a discussion of the future dynamics of the EaP.

First, EU–Ukraine foreign trade grew by 500 per cent during the period 1999–2011, and FDI to Ukraine increased by 741 per cent within the years 2004–2011, of which 80 per cent is FDI coming from EU member states. The growing trade and investment between the EU and Ukraine is a matter of fact, regardless of the slow process of reforms in the area of Ukraine’s business environment, which is characterized by a weak rule of law and widespread corruption. The research concludes that the EaP does not as yet play a visible role in trade and investment relations between the EU and Ukraine. This situation could change after the completion of the association agreement with the DCFTA. It would allow for the legal enforcement of reforms in the area of Ukraine’s business environment, as well as a further increase in trade and investment within EU–Ukraine relations. Taking into consideration the positive dynamics in the area of foreign trade and FDI, one can assume that the completion of the association agreement with DCFTA will facilitate an accelerated growth of business between the EU and Ukraine.

Second, the research on energy concludes that the recent reforms in Ukraine's energy sector are driven rather by Ukraine's accession to the European Energy Community than by EaP programs and tools. The Accession Protocol of Ukraine to the European Energy Community is the only contractual element of the existing institutional framework of present day EU-Ukraine relations that stipulates, in a binding contractual regime, reforms in the energy sector of Ukraine. Even though our research finds that none of Ukraine's commitments under the Accession Protocol to the Energy Community Treaty was carried out in full or on time, it does record positive developments, especially in the areas of regulatory policy, liberalization of natural gas and electricity markets, energy efficiency, and the use of renewables.

Third, the research on visa dialogue concludes that the EU and Ukraine have made some practical progress in this area. There has been a gradual, albeit not uniform, improvement in the process of visa facilitation by EU member states. The growth of the EU's visa industry in Ukraine has been accompanied by some liberalizing measures and friendlier practices when it comes to issuance of the Schengen visa. At the same time, the goal of visa liberalization remains a long-term issue, which has been affected adversely by the increasingly difficult political relations between the EU and Ukraine. So while a full-fledged visa free regime is not in the cards at the moment, a greater facilitation of the existing visa regime is realistic.

The EU-Ukraine visa dialogue builds upon the existing visa facilitation agreement as of January 1, 2008. Again, the visa dialogue demonstrates that EU-Ukraine cooperation in sectors that are regulated by sector agreements results in better progress within Ukraine's reform process than cooperation in sectors without such a contractual element. Unlike the Accession Protocol to the European Energy Community, the visa facilitation agreement does not include a list of the relevant EU *acquis* that Ukraine should comply with within a precise given timeframe. Nevertheless, both energy and visa dialogue are the most successful areas of EU-Ukraine cooperation so far, measured in terms of the EU's capacity to stipulate reform processes within Ukraine. The above research finding is of crucial importance for a better understanding of the EU's capacity to support reform processes in partner countries, as well as of the future dynamics of the EaP. This lesson is similar to

another we have learned from previous research on those reforms imposed by the former ENP Action Plan and EaP Association Agenda in Ukraine.<sup>79</sup>

The former EU–Ukraine Action Plan (AP) was endorsed by the EU–Ukraine Cooperation Council on February 21, 2005. It specified 14 priorities for action and 71 goals to be implemented within 6 sector chapters. Subsequently, the Ukrainian government adopted three annual action plans to implement the AP priorities and goals for 2005, 2006 and 2007. The Ukrainian government’s implementation plan for 2005 consisted of 177 actions/measures of a legislative and administrative nature (implemented through 361 tasks for ministries and governmental agencies), 145 actions/measures for 2006, and 133 for 2007. Altogether, Ukraine implemented more than 400 actions over the three years of 2005–2007 with the aim of meeting the goals of the AP. Following the independent monitoring carried out by the Consortium of Analytical Centers in Ukraine in 2010, the Ukrainian government implemented 8 out of a total of 78 priorities agreed with the EU within the Association Agenda. The number of reform actions implemented in Ukraine under the former AP and the number implemented under the present Association Agenda differ considerably. One could argue that this might be explained by a less willing Ukrainian government formed after the presidential elections of 2010, as compared with the previous “orange” one. Additional explanations that should be pointed out are, first, that sector reforms in Ukraine became a sort of “diplomatic hostage” of the DCFTA talks (“let us conclude first, and we will implement reforms afterward”); and second, both the Association Agenda and the former AP are policy documents, they are not binding contractual deals.

The performance of Ukraine under ENP and EaP justifies the following conclusion: the more provisional sector specific agreements the EU concludes with partner countries, the better the outcomes of their reform processes, and the better the capacity of the EU to support them. Policy documents – e.g. AP, Association Agenda (in the case of Ukraine), various sector-focused Memoranda of Understandings, multilateral platforms and panels, etc. – do not deliver when it comes to reforms in partner countries the way sector agreements do. The path towards

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<sup>79</sup> A. Duleba, V. Bilčík, eds, op. cit. See part 3.

the comprehensive Association Agenda is not an easy undertaking for partner countries, nevertheless our research indicates that they perform better under sector agreements than under framework policy documents. Provisional sector agreements do not conflict with the goal of the completion of a comprehensive association agreement, as in the end the latter will absorb all of them.

The general rule that “the more contractual deals, the better for reforms in partner countries” might also be expressed in this way: “the more contractual deals with partner countries, the better for the EU, in terms of its capacity to achieve its normative policy goals within the Eastern Partnership.” The performance of the EU as an international actor in the field of external relations shows two contradictory elements. On the one hand, it is not easy for 27 member states to speak with one voice, due to the different projections of their national interests vis-à-vis third actors, including Eastern European countries (e.g. recent talks on the imposition of economic sanctions against the Lukashenka regime in Belarus, etc.). On the other hand, all 27 member states agree that the EU should export its *acquis communautaire* to third countries whenever possible via legal contractual deals. Portugal and Poland might not agree on various aspects of the EU’s political relations with Ukraine; both Portugal and Poland agree, however, that the export of the EU *acquis* to Ukraine is a good thing from the point of their national interests. The export of the EU *acquis* to partner countries through the comprehensive Association Agreement is the fundamental goal of the EaP, as well as the fundamental background for the consensus of all EU member states to continue in its implementation. Completion of the AA with partner countries, any of them for that matter is of crucial importance for the viability of the EaP as EU policy.

Moreover, the EU aspires to be a normative international actor. Different member states of the EU can disagree on many different aspects of EU external relations with third actors. However, if a policy consensus is to be achieved, in most cases it would include normative policy goals, e.g. advocacy of European values. The experience gained from EU relations with its Eastern and Southern neighbors, including relations with the Western Balkan countries, shows that together with a contractual arrangement for the EU *acquis* export, normative policy goals represent the second pillar of a consensual foreign policy of the

EU. The same experience tells us that the existence of an institutional framework, including a contractual deal with a third actor, which facilitates both the export of the *acquis* and the projection of European values, is a prerequisite for the successful external action of the EU. Should the goal of the EaP become lost (e.g. if there was no AA in place within the foreseeable future), it could undermine the background needed for the EU consensus to proceed with pursuing the EaP as a project.

In addition, there is a real danger that the recent EU debt crisis could not only undermine the funding of the EaP, but could also lead to a diverting of the EU's attention from this initiative. The recent eurozone crisis has prompted a new institutional rearrangement within the EU – which means, in general terms, that for the time being the Union will be less willing to cope with its external agendas. Politically, the EaP enjoys less support across EU member states than in the past, and that's not only because of EU concerns about the deteriorating political situation in Ukraine and some other partner countries, but also because of the eurozone crisis.

Apart from the above dangers, we argue that the future dynamics of the EaP could be undermined if none of the six partner countries is able to conclude talks on the AA and sign it by the time of the Vilnius summit in November 2013. If that becomes a reality, the EaP will gradually start to fade out of view of the EU's external relations. The EaP badly needs a success story by the time of the 2013 Vilnius summit in order to brace itself up. The success of the EaP is of crucial importance both for partner countries and for the EU as well. The EaP represents a feasible chance for partner countries to escape from the post-Soviet marasmus, to complete their post-communist modernization in line with European values, and to restart their economies through economic integration with the EU. On the EU side, the success of the EaP is a vital test for the EU and its capacity to act as a transformative international actor and to include Eastern Europe, together with the Western Balkans, in the European project.

In spite of the recent “political pause” in EU–Ukraine relations, we argue that Ukraine is still the most ready partner country to implement the ambitious association agreement with the EU, including the DCFTA. Moldova and Georgia are moving forward in their association agreement talks with the EU. They have the capacity to proceed relatively smoothly in talks on the sector portions of their future agreements. However, talks on the DCFTA – which include both a harmonization with the EU's cross-

sector *acquis* and specific technical conditions including tariffs and quotas on commodities and services – assume that the governments of partner countries are able to implement agreements within the borders of their states, and that partner countries represent unified customs territories. There are questions about how Moldova can negotiate a free trade agreement with the EU and guarantee its implementation in Transnistria. Georgia finds itself in a similar position in regard to the situation with South Ossetia and Abkhazia. Questions on the ability of Georgia and Moldova to negotiate their respective association agreements with the DCFTA demand some clear answers. It is clear that Chisinau and Tbilisi are harmonizing with the trade related EU *acquis*; however it is unclear how Tiraspol and/or Tskhinvali on their separatist territories will treat goods and services from the EU. How will the governments of Moldova and Georgia ensure implementation of the DCFTA provisions if they do not control the whole customs territories of their own states?

Unless the above questions are given clear answers, we argue that Moldova and Georgia cannot conclude association agreements with the EU that would be comparable to the AA between the EU and Ukraine. The same concerns prospects for the achievement of a visa free regime between the EU and these two partner countries. Would a visa free regime between the EU and these countries mean also a visa free regime for the inhabitants of Transnistria, South Ossetia and Abkhazia, a majority of whom hold passports from the Russian Federation? The outcome of the visa dialogue with Moldova and Georgia, much like their talks on the association agreement, is unclear. In other words, there are limits to the ability of both Moldova and Georgia to engage fully with the EU under the EaP offer.

Armenia is the third partner country that has engaged with the EU in Association Agreement talks, including the DCFTA. Again, how will the EU manage politically vis-à-vis Azerbaijan the potential involvement of the Nagorno–Karabakh in the DCFTA, including access for the businesses of this separatist territory to the EU single market? And this especially given the fact that Azerbaijan is not eligible to negotiate the DCFTA with the EU, as it is not a member of the World Trade Organization (WTO). The same concerns Belarus, since neither is it a WTO member – not to mention, of course, all the political problems in present day EU–Belarus relations. As it is unrealistic to expect that Moldova and Georgia will settle

the problem of their separatist territories within the foreseeable future, much the same can be said for Armenia and Azerbaijan in their bilateral conflict over Nagorno–Karabakh. The EaP does not have so much time on its hands that it can leisurely wait for getting the needed second wind. Therefore we repeatedly argue that Ukraine is still the partner country most ready to implement the ambitious association agreement, including the DCFTA, with the EU – an agreement which represents the core of the EaP. In addition, we argue that the recent “political pause” in EU–Ukraine relations should not mean a “policy pause” for the EU’s Eastern policy. The latter, however, could become the fact of the matter.

If the EU fails to resolve the recent “political pause” in its relations with Ukraine under President Viktor Yanukovich (making impossible the completion of the association agreement), then it should revise its existing offer and rethink the EaP as a policy framework concept. We argue that a postponement of the signing of the AA with Ukraine will undermine the future dynamics of the EaP as such. What follows are several possible basic scenarios for the further development of the EaP (including the Eastern policy of the EU), all of which depend on the capacity of both the EU and Ukraine to restore their relations and regain a measure of political trust.

### *Scenario A (“business as planned”)*

Scenario A would have been unproblematic had the leaders of the EU and Ukraine announced the signing of the association agreement and the start of its ratification process at the EU–Ukraine summit held in Kiev in December 2011. However, that did not happen. The prevailing view among EU institutions, however, is that there is no need as yet to look for a Plan B or Scenario B with regard to the signing of the AA with Ukraine, since it will happen sooner or later anyway – and most probably sooner than later, by the November 2013 Vilnius summit at the latest.<sup>80</sup> However, we argue that Scenario A has already been lost.

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<sup>80</sup> The authors of this paper interviewed a number of EU officials and Members of the European Parliament, including Ukrainian diplomats at EU institutions, on the question of the potential settlement of political concerns in EU–Ukraine relations, including the prospects for the signing and ratification of the association agreement. The interviews were conducted in Brussels at the beginning of December 2012. The majority of the officials, politicians, and experts interviewed expressed optimism

The postponement of the signing of the association agreement, the talks concerning which were already concluded at the technical level in October 2011, has moved EU–Ukraine relations, as well as the EaP, into Scenario B.

### *Scenario B (“settlement of political concerns”)*

On May 14, 2012, the Foreign Affairs Council of the EU encouraged Ukraine to make progress in the following three areas, in order to create the appropriate circumstances for the signing of the association agreement with the DCFTA. The three areas were: (i) progress in addressing the issue of selective justice and preventing its recurrence; (ii) compliance of the 2012 parliamentary elections with international standards; (iii) the implementation of reforms as defined in the jointly agreed Association Agenda.<sup>81</sup>

There were certain hopes during the course of 2012 that the political frost in EU–Ukraine relations might begin to thaw after Ukraine’s parliamentary elections in October 2012, and that this might include a revitalization of the process of completing the AA. However, the way the elections were in fact carried out led the international election monitoring and observer missions to conclude that Ukraine had taken a step backwards with regard to international standards for free and fair elections.<sup>82</sup> The Foreign Affairs Council of the EU at its meeting on

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concerning the restoration of EU–Ukraine relations, including their expectation that this will happen before the Vilnius summit in November 2013. Consequently, in their view, the association agreement with Ukraine will be signed by the time of the Vilnius summit, and afterwards the agreement will begin to be provisionally applied, together with the launch of its ratification process. Many of the officials interviewed made the argument that there is no need to look for a Plan B since things are still developing along the lines of Plan A. However, we argue in this paper that Plan A (along with Scenario A, “business as usual”) had already been lost in December 2011.

<sup>81</sup> “The European Union and Ukraine. Factsheet,” European External Action Service, December 10, 2012. Available online: [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/EN/foraff/134147.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/134147.pdf) (accessed on December 15, 2012).

<sup>82</sup> “Statement of preliminary findings and conclusions. International election observation Ukraine – Parliamentary elections, 28 October 2012,” OSCE Office for Democratic Institutions and Human Rights (OSCE/ODIHR), the OSCE Parliamentary Assembly (OSCE PA), the Parliamentary Assembly of the Council of Europe (PACE), the European Parliament (EP) and the NATO Parliamentary Assembly (NATO PA), Kiev, October 29, 2012. Available online: <http://www.osce.org/odihr/96675> (accessed on November 7,

December 10, 2012 “reaffirmed the EU’s commitment to the signing of the association agreement, as soon as the Ukrainian authorities demonstrate determined action and tangible progress in three areas, possibly by the time of the Eastern Partnership Summit in Vilnius in November 2013.”<sup>83</sup>

In June 2012, the President of the European Parliament Martin Schulz came up with a diplomatic initiative aimed at finding a face-saving solution to the political misunderstandings between the EU and Ukraine. He invited the former President of Poland Alexander Kwasniewski, and the former President of the European Parliament Pat Cox, to monitor the court proceedings involving the imprisoned former Ukrainian Prime Minister Yulia Tymoshenko, on behalf of the European Parliament.<sup>84</sup> The Ukrainian authorities, including President Yanukovich, accepted this Kwasniewski–Cox mission. The mission has been given access to the relevant court materials, including personal contacts with those imprisoned politicians of the former Ukrainian government whose legal cases prompted the EU’s concerns about selective justice in Ukraine. Having been well accepted both by the Ukrainian leadership and the political opposition, the Kwasniewski–Cox mission has expanded its activity in order to address all three EU areas of concern – which include justice reform, as well as the amending of existing election law so that it reflects the recommendations of the OSCE Office for Democratic Institutions and Human Rights (OSCE/ODIHR).<sup>85</sup> In actual fact, the Kwasniewski–Cox mission is a major diplomatic initiative which is

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2012); See also “Post-election interim report 29 October – 6 November 2012,” OSCE Office for Democratic Institutions and Human Rights, Election Observation Mission, Ukraine – Parliamentary Elections on October 28, 2012, November 9, 2012. Available online: <http://www.osce.org/odihr/97077> (accessed on November 22, 2012).

<sup>83</sup> “3209th Council Meeting, Foreign Affairs, Brussels, 10 December 2012,” Council of the European Union, *Press release*, 17438/12, PRESSE 516. Available online: [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/EN/foraff/134152.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/134152.pdf) (accessed on December 11, 2012).

<sup>84</sup> “Cox, Kwasniewski to monitor Tymoshenko appeal on behalf of EP,” European Parliament/The President, *Press release*, June 6, 2012. Available online: [http://www.europarl.europa.eu/the-president/en/press/press\\_release\\_speeches/press\\_release/2012/2012-june/press\\_release-2012-june-3.html](http://www.europarl.europa.eu/the-president/en/press/press_release_speeches/press_release/2012/2012-june/press_release-2012-june-3.html) (accessed on November 21, 2012).

<sup>85</sup> Authors’ interview with the head of the support team of the Kwasniewski – Cox mission, conducted at the European Parliament in Brussels on December 6, 2012.

keeping alive the possibility of resolving the current “political pause” in EU–Ukraine relations within a foreseeable timeframe, e.g. by the time of the Vilnius summit in November 2013.

Scenario B is essentially a “face- and time-saving return” to Scenario A (with some delay of course). It would mean a restarting of the EaP in its existing shape, including the achievement of the core of the EU’s offer by putting into place a comprehensive AA with Ukraine. The outcome of this scenario depends on the success of the Kwasniewski–Cox mission; however, first and foremost it depends on the political will of Ukrainian authorities to comply with the political requirements of the EU.

### *Scenario C (“revision of the offer”)*

The key lesson from Ukraine is the inability of this leading partner country to absorb and comply with the ambitious association agreement. Should Scenario B fail, the EU should revise the EaP by making its offer less ambitious and more absorbable for partner countries. Instead of a comprehensive association agreement with the DCFTA, the focus should be on the development of sector cooperation, including sector based contractual arrangements with partner countries. The ideas of the ENP Plus proposal might serve as good inspiration for such a reform.

The formula of ENP Plus as proposed by the EU in 2006–2007 to ENP partners, who were both ready and willing to go beyond the Action Plan, may be summarized as follows: “a contractual sector-oriented relationship based on two fundamental principles: an obligatory approximation to the relevant EU sector *acquis*, and access to EU sector programs and institutions.” In this way, the EU evolved a new and higher level of ENP which goes beyond the scope of its original definition, “everything but institutions.” The first level of ENP had meant that the EU dialogue with an ENP country on political and sector issues was to follow the Action Plan (and/or the Association Agenda in the case of Ukraine from 2009), which is a political document that has no binding implications, either for the ENP country or the EU. The protocol for a partner country’s accessing a Community program or Agency means that the relevant sector dialogue should be framed by a binding agreement. The expectation of EU institutions and member states has been that both the approximation to the EU *acquis* and access to EU institutions will in the end call into existence a common sector

space between the Union and the partner country – or for the latter, a kind of “sector integration” with the EU, including access to the relevant segments of the EU single market.

In other words, the EU could develop its relations with partner countries following the EFTA model of its relations with the Swiss (sector integration on the basis of sector agreements), however not in line with the EEA model of its relations with Norway, Iceland, and Lichtenstein (a comprehensive agreement with extended access to the single market). There have already been lessons learned from the accession of Moldova and Ukraine to the European Energy Community, which might serve as a model to be applied also to other partner countries and to other relevant sector policies of the EU.

Scenario C would maintain the EU’s capacity to act as a normative actor in its relations with those Eastern partners who are able to promote their systemic modernization pursuant to European values, including their economic integration via a gradual “sector by sector” opening of the single market. Scenario C would keep open the door for the most advanced partner countries to conclude a comprehensive association agreement in the future, including their full access to the single market of the EU. However, that would be a more long-term process which certainly could not be concluded by the time of the Vilnius summit of the EaP in November 2013.

#### *Scenario D (a “new real politics”)*

Developments in the EU’s Eastern neighborhood will divert the transformation track of East European countries away from their modernization in line with European values and institutions. The centralization of political and economic power in hands of the most influential elements of the political and business elite, crony capitalism, ever-present corruption, Soviet style bureaucracy and political culture, a state-dependent judiciary, a media controlled by the state or by state-related business, unfair elections, and weak democratic and social institutions, will become the common features of development within all the Eastern neighbors.

The EU will have to recognize that it does not have the capacity to support reforms and to strengthen democratic institutions in its neighborhood, and herewith it will abandon its normative policy goals.

The EU will be challenged by the need to apply a realistic approach towards its Eastern neighbors, including towards the conducting of business and politics with authoritarian regimes. The EU and its member states will have to give up on their prospects for any ambitious contractual arrangements with Eastern neighbors that would facilitate the export of the European *acquis*. The EU will have to learn a lesson from its unsuccessful ENP and EaP projects, namely that “trade conditionality” simply does not work in relations with East European countries. Any potential talks on trade liberalization with Eastern neighbors will thenceforth be motivated by the need to protect the interests of European businesses in East European markets, no longer by the economic integration of East European countries. EU member states will have to agree to at least a minimal list of their common “security” interests in and towards the region of Eastern Europe, including hard security, combating illegal migration, security of energy supply, etc. Finally, they will have to learn how to speak with one voice with regard to the common promotion of their national interests vis-à-vis Eastern Europe. Under such a “real politics” scenario, Russia will play the dominant role in the EU’s Eastern policy.

The third Eastern Partnership summit, scheduled to be held in Vilnius in November 2013, will be an important milestone with long term consequences for the EU’s Eastern policy. The case of Ukraine provides ample lessons to ensure the effectiveness of this policy. The die has been cast.

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