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# **The Kharkiv Accords between Ukraine and Russia**

Implications for EU-Ukraine relations

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## Abstract

There has been a step change in Ukraine–Russia relations since the election of Viktor Yanukovych as President in February – seen most obviously in the signing of the Kharkiv Accords with Russia in April 2010.

The key feature of the Kharkiv Accords was an extension of the lease on the Black Sea port of Sebastopol to Russia by an additional 25 years from 2017 to 2042 in exchange for a 30 per cent reduction in the price Ukraine pays for gas between 2010 and 2019, although cooperation has been extended across a range of sectors, as detailed below.

The sense of shock in Ukraine and abroad that greeted the signing of these accords was caused by the manner in which the deals were adopted – very rapidly and with no previous public debate.

Yet Ukraine’s basic security is not compromised by the Kharkiv accords and they will not delay the signing of an Association Agreement with the EU.

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Following the election of Viktor Yanukovich as Ukrainian President earlier this year, there has been a step change in Ukraine–Russia relations, with a clear shift in Ukrainian policy towards a more friendly position on bi-lateral relations. This has been seen most obviously in the signing of the Kharkiv Accords with Russia in April 2010, the key feature of which involved extending the lease to the Russian Federation of the Black Sea port of Sebastopol by an additional 25 years from 2017 to 2042 in exchange for a 30 per cent reduction in the price Ukraine pays for gas between 2010 and 2019. The new warmth in Ukraine–Russia relations is not limited to the Black Sea fleet deal; Presidents Medvedev and Yanukovich met no fewer than seven times between February and May 2010 to discuss cooperation in a very wide range of areas from policy towards Moldova and the Transnistrian question to cooperation in aircraft manufacturing.

An improvement in Ukraine–Russia relations was to be expected in the aftermath of the 2010 Presidential election. Back in 2004, the Kremlin made no secret of the fact that its preferred candidate for the Presidency of Ukraine was Viktor Yanukovich and took his defeat following the events of the Orange Revolution and repeated second round of the election very badly. Bi-lateral relations were poor under President Yushchenko and Prime Minister Yulia Tymoshenko. The Russian government viewed Ukraine’s plans to join the European Union with suspicion and positively detested the Yushchenko administration’s stated ambition of joining Nato. It consequently views the Ukrainian government’s decision to abandon its plan to join Nato – previously seen as stepping stone on the way to full EU membership – very favourably.

Relations with Ukraine’s large neighbour to the north are of course of crucial importance, and it came as scant surprise that Yanukovich placed improving Ukraine–Russia relations so high on his post-election political agenda. What came as more of a shock to Ukraine watchers was the radicalism of Yanukovich’s rupture with the central tenets of Ukraine’s previous foreign policy. It should be borne in mind that the decision not to renew the Russian Black Sea fleet’s lease on Sebastopol beyond 2017 taken by President Yushchenko, was wholly in keeping with Ukraine’s strategy since independence in 1991 of gradually decreasing the level of Russian influence within Ukraine. Moreover, this sense of shock was caused by the manner in which the deals (predominantly the gas/Black Sea Fleet deal) were adopted – with no previous public debate, no independent media at the ceremony of signing the agreement and the press conference, the violent ratification of the agreements in the parliament, and the suppression of street protests by the opposition. The reaction within Ukraine to the accords raised concerns that Ukraine was not just giving a part of its independence to Russia, although this would be bad enough – but even more seriously that the political regime in the country was reverting an authoritarian style of government along the Russian model.

This Working Paper asks what the significance of the Kharkiv Accords is for Ukraine’s European integration agenda in three stages. First, it identifies what has been negotiated and agreed between Russia and Ukraine, also focusing on areas mooted for discussion by either side but where no agreement could be found, such as on Ukraine’s membership of the customs union of Russia, Belarus and Kazakhstan. Second, in the absence of an official explanation from the Ukrainian government as to why it has made these dramatic policy decisions, it puts forward potential explanations that explain this rapid shift in policy on the part of the Ukrainian government. Thirdly, it looks at what the significance of the Kharkiv Accords is for Ukraine’s European integration agenda.

## What are the Kharkiv accords?<sup>1</sup>

The headline grabbing part of the Kharkiv accords was focused on the extension of the lease on the Black Sea fleet base of Sebastopol, but Russia and Ukraine in fact agreed to cooperate in a number of areas, as follows in what perhaps could be regarded as the order of importance:

- A **border demarcation agreement** was signed between Russia and Ukraine, although the issue of the land border was separated from the Russia–Ukraine dispute over the sea border in the Black Sea, which remains unresolved. The land border between the two states is not secure and it is possible to cross from one country to another in many places without passing through proper controls. Given the sheer size of the land border at 1,576 km it will take a while for comprehensive, border controls to be imposed, but the signing of this agreement with Russia is certainly a step in the right direction for Ukraine if it wishes to negotiate a simpler visa regime with the EU with the longer term perspective of visa-free travel between Ukraine and the EU.
- The most sensitive part of the Kharkiv Accords was the commitment of the Ukrainian government to extend the Russian government’s lease on the Black Sea fleet base of **Sebastopol** from 2017 to 2042, by 25 years. This came in exchange for a 30 per cent reduction in the price Ukraine pays for the gas it imports from Russia. This will save the Ukrainian government around \$4 billion annually.
- On May 19, a protocol was signed between the **security services** of Ukraine (SBU) and Russia (FSB). It is believed that this will allow the Russian counter-intelligence service to renew its activities in Crimea.
- The Ukrainian and Russian governments agreed to increase cooperation in a number of sectors where their industries are interlinked, either through a common market or the use of technologies first developed in the Soviet era, such as aviation **or nuclear industry**. Russia has committed between \$2 billion in credits to build the third and the second reactors at the Khmelnytsky nuclear power plant.<sup>2</sup>
- A further \$2 billion in credit was given to Ukraine in June to help **cover the budget deficit**. This enables Ukraine to have some room for manoeuvre since the negotiations on renewing the credit line with the International Monetary Fund have stalled since the Ukrainian government is not ready to fulfill several important IMF demands (e.g. on the size of the budget deficit).
- The Ukrainian and Russian space agencies agreed to cooperate on the GLONASS **satellite navigation system** which Ukraine will now gain access to.
- Two Russian and Ukrainian **state banks**, VTB (Russia) and Ukreximbank (Ukraine) signed a cooperation agreement on treasury operations, investment services, and rouble payments.
- On **education policy**, Ukraine and Russia agreed to support the Ukraine–Russia Joint Commission of historians – this is a perennially hot topic in bi-lateral relations. In spring 2010, in Strasbourg, Viktor Yanukovich controversially made a speech claiming that the Holodomor of the 1930s in Soviet Ukraine was ‘not genocide’ to the consternation of many Ukrainians.
- A vague agreement on priority actions in **science and education** cooperation, in which the parties, *inter alia*, committed to increase student exchanges and promote the study of the Russian language in Ukraine and Ukrainian in Russia, was signed.
- An action plan on **cultural cooperation** in 2010-2014 was signed with a commitment to cultural exchanges and a focus on the needs of the Ukrainian/Russian minorities living in each state.

These official agreements were complemented by three joint statements on cooperation between Russia and Ukraine on regional security issues: in Transnistria/Moldova; in the Black Sea; and in seeking a new architecture for European Security in the 21<sup>st</sup> century. Importantly for Russia, Yanukovich formally ruled out NATO accession for Ukraine through a new law on foreign policy principles. Ukraine, as a European non-aligned state, will continue 'constructive cooperation' with NATO but no longer seeks membership.

Generally, Ukrainian–Russian cooperation at all governmental levels has been reinforced. The work of the main mechanism for bilateral relations, the Inter-state Commission, has been renewed.

*Ukrainian–Russian cooperation at all governmental levels has been reinforced*

A number of other issues were discussed by the Russian and Ukrainian government, including Ukraine's accession to the customs union of Russia, Belarus and Kazakhstan and the Collective Security Treaty Organization

of Russia, Armenia, Belarus, Kyrgyzstan, Kazakhstan and Tajikistan. Both of these were ruled out. Ukraine cannot join the customs union for two reasons: first, because as a member of the WTO it cannot do so unless all the other states of such a customs union decide to join as well; and, second, it would not be able to negotiate and sign a DCFTA with the European Union were it to do so.

Many observers have commented that the conclusion of the Kharkiv accords is just the first step towards a fuller re-integration of Ukraine and Russia as part of the expansionist foreign policy that Prime Minister Putin and President Medvedev have pursued for the past decade.

It has also been argued that the fact that Ukraine has committed itself to buying a larger amount of gas from Russia, 52 billion cubic metres (bcm), considerably more than the 26 bcm that bought in 2009. The first 80 per cent of the 52 bcm is discounted, the remaining 20 per cent must be paid for at the higher world price and will not be discounted. If Ukraine is able to sell on what gas it does not use at a profit, then the deal will be successful – and of course there should be plenty of opportunities for rent-seeking in such an arrangement. If it cannot (and Russia has not committed to transporting a certain amount of gas through Ukraine each year, which the Ukrainians had aimed to negotiate as a means of profiting from the gas trade), then the Ukrainians will have to go to the Russians once again and request a new deal – and here they will once again be in the position of *demandeur*, and in consequence, the Russians may be able to squeeze further concessions.

One key concession that the Russians are believed to have in their sights is the ownership of the Ukrainian gas transportation network. The Ukrainian government ruled out a merger of Naftogas and Gazprom, or rather a takeover by the latter. Loss of control over gas transportation would inevitably compromise Ukraine's capacity to act independently of Russia.

Ukraine's 'no' to (1) a merger of the two states' gas network, (2) the Russia-led Customs Union and (3) the Collective Security Treaty Organization shows the limits of Ukraine–Russia rapprochement. Russia has also demonstrated it will not pay much for the political loyalty of its neighbour. Ukraine did not manage to win concessions on a number of important issues, such as an increase in the transit price for Russian gas, long-term guarantees in transit volumes and in the transit of Central Asian gas that belongs to Ukrainian enterprises through the Russian pipelines.

Despite the concessions made by the new government, the nature of Ukraine's relations with Russia has actually changed rather little. Ukraine and Russia are in an asymmetric relationship where Ukraine is struggling to preserve its sovereignty without undertaking costly reforms, while Russia continues its strategy of attempting a gradual takeover of its former empire. What *has* changed is the general backdrop to bi-lateral relations. Ukraine has emerged battered from the global economic crisis and thus, its position *vis-à-vis* a weakened but still powerful (and solvent) Russia has worsened.

## **Why has Ukraine changed its policy towards Russia so rapidly?**

Following the Presidential election of 2010 and the victory of Viktor Yanukovich, some change in Ukrainian policy towards Russia was to be expected, as a natural compensation for the poor relationship between the two states during the Yushchenko years and reflecting the tendency of the eastern Ukrainian politicians that are now in office to favour better relations with Moscow. What was surprising about the change in foreign policy was the speed with which the new agreements were negotiated (within two months of forming a new coalition) and the wide scope for Ukraine–Russia cooperation that they offer. In the absence of an official Ukrainian explanation for the change in policy, this section puts forward some suggestions that could explain why the new government acted as it did.

### **Financial expediency?**

The new government of Ukraine inherited a financial mess in 2010, and needed to pass a budget for the year as soon as possible. Although Ukraine's budget deficit was relatively small by the standards of developed world economies in 2009 at 6.6% of GDP, it was very difficult to finance. Ukraine's credit rating was very low making it hard to borrow money on world markets and the short-term treasury bills issued by the Ukrainian state paid coupons in excess of 20%.

The only realistic source of short-term funding for the budget deficit in 2010 was the IMF, and the IMF was unwilling to advance any loans unless Ukraine agreed to cut its budget deficit to 5–6% of GDP. This would have been very hard to do since the new Government had already decided to increase welfare payments. One possible way to reduce Government spending would have been to remove subsidies for domestic gas consumers (and the IMF insisted that Ukraine raise its gas prices for domestic consumers to at least cost coverage levels), but this would have been politically very unpopular for the new Government.

The Ukrainian Government did eventually bow to IMF pressure and agreed to increase the cost of gas for domestic consumers by 50% from 1 August 2010, but it is conceivable that the increase in prices for consumers would have been much higher without the gas/Black Sea fleet deal with Russia. Negotiating a cheaper price for fuel saving \$4 billion annually – without having to give the Russians anything they did not already have, given that the lease on the Sebastopol base was due to run until 2017 in any case – was the easiest short-term option for a cash-strapped Ukrainian government and perhaps the only way to ensure that the Ukrainian state actually had a state budget for 2010 at all.

### **Business interests of the Party of Regions?**

According to Ukraine's new foreign policy doctrine, diplomacy will primarily serve the interests of the Ukrainian economy. In practice, this has been narrowly understood to

mean the interests of the Party of Regions' big business supporters. The new president has taken a pro-Russian stance on those issues where he believes business interests will not be prejudiced (such as the Black Sea fleet and the resolution of the Transnistria conflict). Yanukovich has a different understanding of national security than his predecessor Viktor Yushchenko, who saw only the threats posed by Ukraine's northern neighbour.

### **Rent-seeking? Energy politics, power and money in Ukraine**

Seasoned and perhaps more cynical observers of the Ukrainian political scene would observe that the Ukrainian Government of Viktor Yanukovich (in common with his predecessors) had no intention of liberalizing the Ukrainian gas market and moving towards a world price for domestic and industrial consumers. Ukraine's gas industry in general and the notoriously murky Naftogas Ukrainy in particular provide opportunities for rent seeking that no longer exist in the other deregulated parts of the Ukrainian economy. In consequence, the interests of the Ukrainian political elite were best served by a return to the politics of the Kuchma years and a renegotiation of gas prices with Russia in exchange for political concessions.

This strategy ignored the fact that the true gas problem that Ukraine faces is its extraordinary inefficiency. Ukraine has one of the world's most gas-intensive economies in the world, burning its way through \$900 million worth of gas each month in winter, against \$300 million in comparable Poland. Subsidised gas prices remove the incentive for Ukrainian gas consumers to become more energy efficient. Higher levels of energy efficiency would make Ukraine's economy more efficient, improve integration with the European Union and make the IMF more willing to support Ukraine as it emerges from an exceptionally severe economic slump.

### **Ideology?**

Given its historical, linguistic and cultural ties with Russia, Ukraine should pursue a more balanced foreign policy. In the opinion of the president's team, during the past five years Ukraine leaned too far towards the West, but received little in the way of tangible benefits. Nonetheless, there is no ideological unity among Yanukovich's Party of Regions as to what extent Ukraine should lean towards Russia. While some party members promote closer political links with Russia up to a kind of political union, the party line remains that Ukraine has to integrate with the EU but maintain good relations with Russia at the same time. This means Ukraine should pursue a multi-vectored foreign policy – in other words a return to the politics of the Kuchma years.

### **What do the Accords mean for Ukraine's European integration?**

The good news is that short answer to this question is that on the face of it the negotiation of the Association Agreement should not be greatly affected by any of the deals that Ukraine has signed with Russia to date. It is to be stressed that the Ukrainian government has reiterated its commitment to the negotiation of a DCFTA and visa liberalisation (and the border demarcation agreement with Russia is a step towards the latter) in the near future. European integration is the means by which the Ukrainian government will deliver higher living standards for its citizens – a point that has been made by President Yanukovich on several occasions.

*The negotiation of the Association Agreement should not be greatly affected*

Moreover, the new government moves beyond rhetoric and demonstrates its willingness and ability to take at least small steps in this direction. Yanukovich seeks quick, easy 'wins' with the EU, just as he does in relations with Russia. The immediate priorities are a visa-free travel regime (although this is no 'easy win') and signing the Association Agreement by the end of 2010. Ukraine seeks EU financial and political support to preserve its status quo as the main transit route for the Russian gas to the rest of Europe. A new law on the gas market that was required by the EU has been adopted by the government and passed to the parliament for ratification. Moreover, the Parliament has also passed a new public procurement law required by the EU in exchange for a macro-financial aid package of €600 million. Ukraine has also passed the law on personal data protection that is needed for visa liberalisation.

*Ukraine's basic security is not compromised by the Kharkiv accords*

Ukraine's basic security is not compromised by the Kharkiv accords. The continuing presence of the Black Sea fleet in Sebastopol poses no serious military threat to Ukraine or the rest of the region. Much of the fleet is not sea-worthy and it would cost many billions of dollars to modernize the facilities and ships. Russia's desire to retain the base is less strategic than political – retaining control of the port of Sebastopol reflects the politics of identity and nostalgia. To lose the base would be blow to Russia's sense of self and would fly in the face of the politics of restoration pursued by the Kremlin over the last ten years.

It has been argued that the threat to Ukraine that is posed by the continuing retention of the port of Sebastopol provides a jumping off ground for Russian agents to agitate in favour of greater autonomy for Crimea, with the long-term perspective of secession from Ukraine – and some would argue that the presence of a Russian naval base makes it easier, or perhaps even legitimate (in Russia eyes) for Russia to intervene in Ukrainian affairs. It is true that the Russian Black Sea fleet provides comfort

*The real problem lies in the reduction of the gas price*

to Soviet nostalgics in Crimea and the rest of Ukraine. It is also true that it would have been better for the fleet to leave in 2017, but the real problem for Ukraine that results from the Kharkiv accords lies in the reduction of the gas price.

The Kharkiv accords not only do nothing to improve Ukraine's very low level of energy efficiency, but by subsidizing gas prices, they actively discourage the necessary efficiency-booting investments, such as introducing higher prices and metering for domestic heating. This is a major problem. Moreover, most international donors and lenders, such as the EU, IMF or World Bank have placed an energy efficiency condition on their assistance to Ukraine, which will be much harder to meet. It is very hard to see why the EU should finance Ukraine's modernization of its gas transit system if the Ukrainian government appears to be moving in the opposite direction, although its decision to increase gas prices for domestic consumers by 50% from 1 August 2010 is to be welcomed. It is possible that the new government may undertake sufficient reforms to the energy sector to allow for membership of the European Energy Community in the medium term.

## Conclusions

Although the new government of Viktor Yanukovich and Mykola Azarov originally announced that it was firmly committed to a programme of reform that would advance

its European integration agenda, the Kharkiv accords are a step in the opposite direction. It is hard for international donors to provide the funds needed for investment in the modernization of Ukraine's gas transportation network and to reduce domestic demand for energy if the Ukrainian government is pursuing what appear to be contradictory policies. It is also possible (although perhaps a little unfair to suggest so) that the gas price reduction and the commitment to buy a larger amount that Ukraine needs each year was motivated by the rents that could be extracted from international gas sales by the Ukrainian political and economic elite.

It would be sensible to give the new government a longer period of grace before passing judgment on its true motivations and the quality of its reform agenda. There is so much to do in Ukraine: reform of the judiciary, social security and pension reform, improving the business environment, and, of course, tackling Ukraine's woeful energy efficiency record. In a speech that marked his first one hundred days in office, Yanukovich presented an ambitious economic reform plan for the presidential term of 2010-14. This plan envisages comprehensive reform of the economy and the state, including reforms of the tax system, public finances, the financial sector, the budget, healthcare, pensions, social protection and education. It promises measures to improve the business environment and attract foreign investment along with reforms in the energy sector, transport, communications and agriculture. If the new government takes serious action on any of these points it will deserve praise.

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<sup>1</sup> See also the excellent ICPS 'Inside Ukraine' Report No. 8 for May 2010.

<sup>2</sup> [http://www.bellona.org/articles/articles\\_2010/Russia\\_pays\\_for\\_old\\_reactors](http://www.bellona.org/articles/articles_2010/Russia_pays_for_old_reactors).