



Ukraine Analyst

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Presidential Candidates 5: Anatoliy Grytsenko

Anatoliy Grytsenko is one of a number of offshoots from the former pro-presidential Our Ukraine-People's Self Defence bloc (NU-NS). Grytsenko is a member of the rising wing of alternative (but not young) politicians in Ukraine whose popularity is growing at a time when the established politicians have become discredited over the course of the Viktor Yushchenko presidency.

Grytsenko, like Serhiy Tyhipko, belong to the so-called 'second tier' presidential candidates who are unlikely to enter the second round, where Viktor Yanukovych is most likely to face Yulia Tymoshenko. Grytsenko and Tyhipko are very likely to squeeze Arseniy Yatseniuk's third place position and may even replace him. Much of Yatseniuk's support is soft and a protest "vote" in many public opinion polls and, therefore, is unlikely to hold up during the three month election campaign. Polls and elections are two very different things: Tymoshenko/BYuT always receives higher support in elections than the pre-election polls suggest she would have.

Western Trained Academic

Grytsenko is unique in Ukrainian politics as he hails from a long military background, has attended Western training courses and fellowships, speaks English (still relatively uncommon for Ukrainians of his 40s generation), and has published in Ukraine and abroad. Grytsenko has combined a military and political background with 15 years of analysis and research in the Ministry of Defence, National Security and Defence Council (NRBO) and Kyiv's leading think tank, the Razumkov Centre for Economic and Political Studies.

Grytsenko's research and analysis in Ukraine and abroad has focused on democratic (civil) control over the armed forces, an area of research that he pioneered in Ukraine. In 1996, he published one of the first studies of civil-military relations in Ukraine while he was a visiting fellow in The Netherlands. He followed this with a more extensive study four years later as a NATO-EAPC (Euro-Atlantic Partnership Council) fellow. Grytsenko has also written on military reform in Ukraine.

During the 2004 presidential elections, Grytsenko, then head of the Razumkov Centre, headed the Yushchenko campaign's research-analytical department. The President of the Razumkov Centre, Mykola Martynenko, is head of Kyiv's Our Ukraine branch and head of the NU-NS faction in parliament. After taking the NU-NS faction over from Vyacheslav Kyrylenko, Grytsenko moved it into supporting Tymoshenko and the democratic parliamentary coalition. Kyrylenko is one of a small and dwindling group of staunchly pro-Yushchenko deputies remaining in NU-NS.

Minister of Defence

Grytsenko remained Minister of Defence under two orange coalitions and the Yanukovych government (2005-2007), but fell out of favour with presidential secretariat head Viktor Baloga over land corruption. Baloga's cronies had sought access to Ministry of Defence land. As a result, Grytsenko was not submitted as the president's candidate for Defence Minister in the Tymoshenko government.

As Minister of Defence, Grytsenko implemented military reforms with a view to building a professional structure and was instrumental in the preparation of the State Programme for the Development of the Armed Forces of Ukraine for the 2006-2011 period. He was seen in Brussels and Washington as one of a few non-corrupt, pro-Western Ukrainian politicians. Western and Ukrainian commentators began to doubt President Yushchenko's commitment to NATO membership after he replaced him with Yuriy Yekhanurov, who had no military experience.

Three other areas Grytsenko focused on while he was Defence Minister included adaptation of NATO practices to the Ukrainian Armed Forces education, training and readiness, strengthening Ukrainian military ethos and patriotism and streamlining the system of command and control. The latter especially related to the creation of a Joint Operational Command and transformation of military logistics towards modern economic and market standards.

Presidential Candidate

Grytsenko's popularity has grown in line with other politicians from the former orange camp stamping their mark in the January 2010 elections. Tyhipko was not seen as a competitor as it was thought he would focus on Eastern Ukraine to take votes from Yanukovych. Tyhipko is associated with one wing of the Dnipropetrovsk clan's Labour Party (as is Viktor Pinchuk) and would be naturally disposed to competing for the Russophone vote.



The other wing of the Dnipropetrovsk clan is led by Igor Kolomoysky and the Pryvat group which aligned with Yushchenko and Our Ukraine, providing funds for their 2006 and 2007 election campaigns. Tyhipko left politics in 2005 and only returned as an adviser to Prime Minister

Tymoshenko; hence, his depiction as "Tymoshenko's technical candidate".

Competition Among Former 'Orange' Politicians



Grytsenko and Yatseniuk will be competing for the disillusioned former "orange" vote in western Ukraine, but

they have four different characteristics and strategies.

Firstly, Grytsenko established a civil society organisation (Civic Platform) and desists from launching a political party. This step flows from the understanding that Ukraine already has too many parties (167) most of which are virtual (including the nine that established the NU-NS bloc) and his emphasis on civil society flows from his former career as head of a think tank.

Secondly, Grytsenko has a lot of hidden support from those who like him but don't believe he has the money or charisma to win. Together with Tyhipko, he does have a realistic chance of knocking Yatseniuk from third place in the elections. Grytsenko therefore could become the kingmaker in the second round following in former Security Service chairman Yevhen Marchuk's footsteps, who also ran as the strongman candidate in the 1999 presidential elections and came third in the first round winning support from national democratic and nationalistic voters.

Thirdly, Grytsenko is a critic of the president, whereas Yatseniuk was close to Yushchenko and was his, and the First Lady's, prodigy. Grytsenko has refused to join any government while Yushchenko remains president. Grytsenko has ruled out creating a joint bloc with Yatseniuk and the only partner that has been publicly aired is former boxer, Vitaliy Klychko, who is a deputy in the Kyiv city council. Civic Platform will only, "choose people who are able to walk with a straight spine and be not influenced by foreign forces", a reference to when Yatseniuk was parliamentary speaker and how he was manipulated by the presidential secretariat.

Fourthly, Grytsenko is in a minority among parliamentary deputies in supporting a return to a presidential constitution where the government would return to the president, as it

was in the 1996-2005 semi-presidential constitution. Within parliament's five factions, only pro-presidential deputies within NU-NS support a return to a presidential constitution; Interior Minister Yuriy Lutsenko's Self Defence party is, for example, opposed. Grytsenko is therefore ironically of the same opinion as Yushchenko who unveiled, typically many years late, his draft constitution in March of this year.

Will 2010 Be A Repeat the 1999 Elections?

In the second round of the 1999 elections, Marchuk gave his support to Kuchma in exchange for the position of NRBO secretary. This scenario had already been played out in Russia three years earlier when Aleksandr Lebed came third and offered his support to Borys Yeltsin in exchange for the position of National Security Council secretary.

Grytsenko would be an excellent NRBO secretary following in the footsteps of Volodymyr Horbulin in the 1990s. Yushchenko has severely undermined the NRBO as an institution by appointing four political secretaries (Petro Poroshenko, Anatoliy Kinakh, Ivan Plyushch, Raisa Bohatyriova) to use the NRBO to undermine the government. The NRBO in effect became the presidents vehicle to by-pass the 2006 constitutional reforms that transferred the government to parliamentary control; a step that Yushchenko has never been able to reconcile himself with. This had more to do with power for power's sake, without any vision as to what to do with the power.

1957	Born in Cherkasy <i>oblast</i> .
1979	Awarded an MBS, Air Force Institute, Kyiv.
1984	Awarded a PhD in technical sciences, Air Force Institute, Kyiv.
1981-1996	Held various positions in the Soviet and Ukrainian military, including senior research and analysis positions in the Main Education Directorate, General Staff, and the National Research Centre for Defence Technologies and Military Security, all in the Ministry of Defence.
1993	Attended the Defense Language Institute, Lackland AFB, Texas, and the International Officer School, Maxwell AFB, Alabama, USA.
1994	Attended the Air War College, Maxwell AFB, Alabama, USA.
1996	A Fellow at the Center for European Security Studies, University of Groningen, the Netherlands.
1997-1999	Director of research, National Security and Defence Council (NRBO).
1999-2005	Head of the Razumkov Ukrainian Centre for Economic and Political Studies. In 2004, the Centre acted as the research-analytical wing of the Yushchenko election campaign.
2000	NATO-EAPC Research Fellow.
2005-2007	Minister of Defence under the Tymoshenko, Yekhanurov, and Yanukovich governments.
2007	Elected to parliament within the NU-NS bloc. Appointed chairman of parliaments Committee on National Security and Defence.
2008	Elected Chairman at the inaugural congress of Civic Platform NGO.

Ideological Platform

Grytsenko is critical of the abuse of both the NRBO and the presidential secretariat as counter 'governments' that the president has used to undermine the two Tymoshenko and Yanukovich governments. Grytsenko believes that support for parliamentarism, particularly within the Yulia Tymoshenko bloc (BYuT), has grown in response to a president who has infringed the constitution and legislation and blocked the government and parliament. With one 'government', not 'three', there would be only one person – the president – responsible for implementing his election programme through his control of the government. Grytsenko is critical of the lack of implementation by Yushchenko of his 2004 election programme and his unwillingness to be held accountable for his actions.

Grytsenko believes that Ukrainian politicians will only become accountable once some of them go to jail. He is right. The fact that not a single Ukrainian politician has ever been criminally charged is an indictment of the system that has emerged. "Bandits did not go to jail," but instead to medal awarding ceremonies put on by the president.

Grytsenko's support for strong presidential authority stems not only from his military background, but also from observing the lack of leadership by Yushchenko. Grytsenko emphasises the need for there to be a single person who takes upon himself responsibility for the

government. Opinion polls back up Grytsenko on this question. 2007 became the first year since Ukraine became

an independent state that a majority of Ukrainians saw their state and its nefarious elite's as a bigger threat than NATO or Russia (depending on whether you live in Eastern or Western Ukraine respectively). This craving for a strong leader is also evident in opinion polls that indicate that 60 percent of Ukrainians having a positive view of Vladimir Putin; not because they want to ditch democracy for authoritarianism but because they desire their country to have a leader. Both polls are a damning indictment of Yushchenko's record in office.

Grytsenko is careful to not equate strong leadership with authoritarianism. He described the possible creation of the BYuT-Party of Regions grand coalition in September 2008 and Spring 2009 as a 'bulldozer' which, although beneficial in breaking the logjam in parliament and government, could also be a threat to democracy.

In his parliamentary role, Grytsenko has blocked authoritarian tendencies in a president who has sought to concentrate all security forces in his own hands, including transferring military hardware to the presidential guard and re-establishing a National Guard under the president's sole control. The National Guard was under joint parliamentary-presidential control between 1991-1999 until it was disbanded and transferred back to the Interior Ministry. Both Kuchma and Yushchenko had been unwilling to share control over a National Guard with parliament.

Grytsenko is critical of the continued 'politicisation' of the Security Service (SBU), which

Presidential Election Timetable

20 October-6 November: Candidate registration. The Central Election Commission (CVK) is obliged to register or refuse registration within five days of the submission of documents. Within three days following registration the CVK is obliged to submit a registration document to the candidate. Within three days of the registration *Holos Ukrainy* (Parliamentary newspaper) and *Uriadovyi Kurier* (Government newspaper) are to publish the financial accounts and assets of the candidate.

13 November: Candidate registration is closed.

Registration-15 January: Candidates can undertake their official election campaigns. Within ten days of registration candidates should open their election campaign fund.

27 November: Final deadline for establishment of territorial election commissions.

21 December: Final deadline for establishment of district and special election commissions.

25 December: Final deadline for creation of election bulletin for election day.

27 December: Final deadline for transfer of voting lists to district election commissions.

1 January: Final deadline for each voter to receive invitation to vote in elections.

13 January: Final deadline for transfer of voting lists to territorial election commissions.

17 January: Election day voting takes place between 8-20.00 hours.

27 January: Deadline for publication of official results which are published within three days in *Holos Ukrainy* and *Uriadovyi Kurier*.

7 February: Second round of the elections.

devotes its greatest attention on the president's opponents. The SBU has continued to spy on the president's political opponents, a practice that re-emerged under Kuchma and was thought would end following the Orange Revolution. Grytsenko has strongly criticised the lack of separation of business and politics, as seen in the appointment of millionaire and Valeriy Khoroshkovsky to the position of first deputy SBU chairman. It is extremely unusual for such a wealthy person to have a high ranking position in the intelligence services. Khoroshkovsky was appointed by Yushchenko for one reason only: he was seen as an ally against Prime Minister Tymoshenko. One of Khoroshkovsky's first steps was to send SBU special force Alpha troops to raid Naftogaz Ukraine, which comes under the government's jurisdiction, in March; a step dictated by his close business ties to RosUkrEnergo co-owner Dmytro Firtash.

Civic Initiative

Civic Initiative has expressed its intention to contest local and national elections in 2012, especially if Grytsenko is successful in reaching third place in this year's presidential elections. If Tymoshenko were to seek his support in round two in exchange for the position of NRBO secretary, she would do so in the firm knowledge that Grytsenko would become her challenger in the 2015 presidential elections.

Civic Initiative's strategy, influenced by Grytsenko's leadership of the Razumkov Centre, aims to build up a cohort of 100 leading activists who could

enter senior government, parliamentary, and presidential positions. A second aim is to use the three years until the parliamentary elections to build up a minimum membership of 10,000 activists who could be elected to local councils.

Civic Initiative supports continued use of the proportional system in national elections (used in 2006 and 2007 elections) but returning to majoritarian elections at the local level. Local state administrations, currently controlled by governors who are appointed by the president, should be liquidated, Grytsenko believes as they merely duplicate local centres of power.

Conclusion

Grytsenko is a representative of a new generation of pro-Western politicians who supported the Orange Revolution, but are now disillusioned with establishment politicians. Grytsenko's civil society strategy will be more successful than that of launching another party, especially a top down organisation, as in Yatseniuk's Front for Choice. Moreover, his desire for strong presidential authority, built on democratic principles, will be popular after years of absent leadership of the country and numerous political crises during a deep global financial crisis that has badly affected Ukraine.

Tymoshenko, Yushchenko, and NATO

by Taras Kuzio

The publication of the draft Agreement for the Establishment of a Union of Parties 'For a Powerful Ukraine!' as Yulia Tymoshenko's election campaign alliance (*Ukrayinska Pravda*, 7 October) is an important milestone for Ukraine. If it is adopted as it stands, it will be the first election programme in Ukraine that mentions NATO in anyway whatsoever - and even more so it directly indicates a candidate's support for Ukraine seeking NATO membership.

A second factor that stems from this development is the degree to which President Viktor Yushchenko has lost the support of his own faction, Our Ukraine-People's Self Defence (NU-NS), that entered parliament in the September 2007 pre-term elections. Of the original nine

parties in the bloc, only one – his own People's Union-Our Ukraine – still supports him. Eight parties from the NU-NS bloc will join Tymoshenko's election campaign 'For a Powerful Ukraine!'

New parties and budding parties established since 2007 - Anatoliy Grytsenko's Civic Initiative, Arseniy Yatseniuk's Front for Change, Viktor Baloga's United Center - also do not support Yushchenko's candidacy. Put in another way, the number of parties and budding parties in NS-NS has grown from 9 to 14 since 2007 and of these only 1 supports Yushchenko's candidacy. This development is testimony to President Yushchenko having become a participant in inter-elite squabbles rather than staying above them.

Rukh in the 1998 elections, and the Our Ukraine bloc in the 2002, 2006, and 2007 elections never mentioned NATO in their election programmes. Neither did the Yulia Tymoshenko bloc mention NATO in any election programme. The January 2010 elections would be the first

time national democratic and 'Orange' parties and leaders would mention NATO in an election programme.

Viktor Yushchenko never mentioned NATO or even the European Union in his 2004 election programme. The tenth of his 'Ten Steps' programme merely stated that if elected he would 'Conduct Foreign Policy that Benefits the Ukrainian People'. His eleventh of fourteen draft decrees that he would issue after being elected President was even more banal, stating that he would 'Ensure the Basis for Good Relations with Russia and Belarus'. Why with only Russia and Belarus – what about Europe and the US another of Ukraine's key strategic partners?

Accusations in 2008-2009 by President Yushchenko and his secretariat staff that Tymoshenko was moving away from seeking NATO membership was therefore hypocritical, as neither Our Ukraine nor Yushchenko had ever had the courage or honesty to include NATO in their election programmes. In fact only Arseniy Yatseniuk has removed his signature from the January 2008 letter (signed with Yushchenko and Tymoshenko) to NATO requesting that it grant Ukraine a Membership Action Plan at its Bucharest summit.

The establishment of 'For a Powerful Ukraine!' is a sign that within the former 'orange' camp, only Tymoshenko has the courage and honesty to face voters with a

programme that openly declares NATO membership as a goal. If Tymoshenko wins the presidency, she will therefore possess a popular mandate to pursue Trans-Atlantic integration that Yushchenko never had from Ukrainian voters when he was elected five years ago.

Relations with Russia, Gas and all That Jazz

By Tim Ash

In many respects after the January and April gas price and supply agreements, there has been something of a lull in battles over gas supply and pricing. Russia appears content with the gas price agreement that it secured, which in effect moves Ukraine to 'market' prices for gas by the end of 2009, fixes gas transit prices at US \$1.7 per 1,000 cu metres (tcm) of gas per 100km, and also obliges Ukraine to purchase 42 billion cu metres (bcm) of gas annually from Russia.

On this latter note, Russia has not kept Ukraine to the contract in 2009, allowing Ukraine to import lower quantities of gas, reflective of a marked reduction in consumption of gas in Ukraine as the economy has slowed (consumption has likely reduced to 55 bcm, from ~ 72 bcm annually in recent years). It was suggested to Royal Bank of Scotland (RBS) in Moscow that Russia's own economic problems mean that it is eager to avoid a repeat of the European gas crisis which affected Europe in January, assuring instead a supply of gas and hence gas export receipts. Gazprom itself is working on the assumption that gas export volumes will slow to around 142 bcm in 2009, from 156 bcm planned earlier. Some two thirds of these were planned to be transited through Ukraine, albeit in the year to date gas transit through Ukraine is down by around 60 percent.

Russian Energy Geopolitics

Nevertheless, Russia still has the ability to destabilise Ukraine through its right to demand that Ukraine sticks to the requirement to purchase 42 bcm of gas in 2009, as contracted. Given Ukraine's, and indeed Naftohaz's (Ukraine's gas transit company) perilous financial state, the demand to buy an additional 10-12 bcm of gas in 2009 could potentially provide the proverbial straw that broke the camels' back, requiring Naftohaz to find an additional US\$2-2.5bn in gas import finance by the end of 2009.

Gas supply is linked to the broader issue of Russian-Ukrainian relations and Russia's willingness to exert

leverage over the domestic political process in Ukraine itself, and perhaps more widely to extract political capital from a regional and global context of energy security. Russia clearly has an interest in bringing Ukraine more closely within its sphere of influence, both for business and geopolitical reasons, therein weakening Ukraine's capacity for Euro-Atlantic integration. This policy has thus far proved relatively successful, with Prime Minister Yulia Tymoshenko taking a noticeably more pragmatic approach towards Russia during her second term in government than during her first stint as Prime Minister between February-September 2005. The January-April gas price agreements were clear evidence herein.

The bottom line is that Russia continues to show much more interest in Ukraine than either the EU or US, and this is beginning to sway politicians such as Tymoshenko.

EU Apathy

Russia's drive to bring Ukraine back within its sphere of influence has certainly been assisted by the West's lack of real and meaningful engagement with Ukraine. The EU has, for example, consistently failed to give Ukraine a clear perspective for EU membership and prefers to keep Ukraine in something of a twilight zone, which itself has undoubtedly contributed to policy inertia in Ukraine (we would argue that it was only the clear timetable towards EU membership, with benchmarked decision dates, which drove forward reform in Central and Eastern Europe after the Copenhagen summit set the date of the first wave of enlargement in May 2004). Ukraine lacks this membership perspective and hence lacks the key reform anchor which its Central and East European neighbours benefited from in the decade up to 2004. Explanations for this real lack of engagement of Ukraine by the EU probably come down to Russia's own success in driving divisions within the EU over strategy to Ukraine; key EU powers such as Germany, Italy, and France thus appear to value the relationship with Russia far more highly than that with Ukraine, and herein have exercised an effective veto on deepening Ukraine's EU perspective. In any event, this lack of EU perspective for Ukraine has served to undermine the position of Europhiles within successive Ukrainian presidential administrations. The bottom line is that Russia continues to show much more interest in Ukraine than either the EU or US, and this is beginning to sway Ukrainian politicians, such as Tymoshenko.

Russia's New Strategy

While Russia's rough-edged strategy towards Ukraine in the 2004 presidential elections proved entirely counter-productive, since then its much more nuanced strategy, alongside the indecision of the EU and apparent disinterest

of the US in Ukraine is bringing it dividends. (The new Obama administration in the US appears to have set a low priority in terms of relations with Ukraine). This is evidenced by the January-April gas price agreements, and also by the fact that the two key contenders in the 2010 presidential elections, Tymoshenko and Party of Regions leader Viktor Yanukovich, are both now minded to look East, rather than West.

There are concerns that Ukraine's current perilous financial condition could still provoke a repeat of last year's European gas crisis, if it is unable to buy sufficient gas for storage prior to the October-May heating season this year. Herein there have been warnings that Ukraine needs to buy 30 bcm of gas for storage in preparation for the beginning of the heating season and that it will require US \$5-6bn in financing to do this.

Ukraine had already bought 19 bcm of gas for storage, and our understanding is that to maintain a normal supply of gas to Europe through the winter season it needs to have accumulated only 24-25 bcm of gas in storage by the autumn. This suggests a need for only an additional 5-6 bcm of gas, which at current market prices amounts to a cost of only around US\$1.1bn. This seems manageable, given Ukraine's access to official multilateral financing channels, and could likely be financed over the August-September period.

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Restructuring Ukraine's Gas Debts *by Tim Ash*

Naftohaz 09's have been subject to some extreme price movements following a somewhat oblique announcement from the Ukrainian government which suggested that the external liabilities of the company could be restructured as part of an IMF-induced effort to overhaul the company's finances. The bonds, which matured in September, had been trading in the low 90s in mid-July, but dropped to the mid/low 70s, before recovering to trade in the mid-80s as of writing.

Naftohaz is the 100 percent Ukrainian-state owned gas transit and supply company, responsible for the production of gas in Ukraine, the purchase of gas from Russia, and its distribution in Ukraine. It is also responsible for the transit of Russian gas via Ukraine to Western Europe; some two thirds of Russia's gas exports have historically been routed through Ukraine.

The company is often in the headlines given that it is at the centre of political and financial squabbles between Ukraine and Russia over gas pricing and transit. It is also one of the largest companies in Ukraine and the largest single taxpayer. The company is of huge significance domestically in Ukraine as in effect it is responsible for the supply of subsidised gas to the domestic population.

The company's basic problem is that the import price for gas is set by inter-governmental agreements while it sells gas domestically in Ukraine, also mostly at fixed prices. In 2009, for example, the company is set to import gas at an average price of around US\$228 per 1,000 cu metres, while it sells gas to household and municipal users at a price of US\$110-150 per 1,000 cu metres. The company struggles to cover the shortfall through profits on much reduced sales to industrial users and the gas transit fees earned from transporting (much reduced volumes) of Russian gas. In effect, the company is constantly forced to go to the government for bail-outs and subsidies.

Naftohaz Needs Restructuring

The answer to the company's problems lies in hiking domestic gas prices to cost recovery levels, but gas pricing is a hugely charged political issue in Ukraine even though payments for gas make up a relatively small proportion of household bills. With presidential elections due in January, it is thought that the government would be loathed to significantly hike domestic gas prices, before that date. A further complication is that gas pricing of municipal heating companies is not set centrally, but by local municipalities, and hence beyond the remit of central government. Any policy to change gas prices for gas supplied via municipal heating companies would thus require enabling legislation, which could be difficult and time consuming to enact, again especially before presidential elections.

IMF to the Rescue

The IMF understands the importance of Naftohaz to Ukraine. In a press release which accompanied the completion of the second review under the Stand-By Agreement (SBA), in which the IMF mission recommended the disbursement of the latest US\$3.3bn in financing, the IMF noted that: 'To cushion the impact of the sharper economic contraction and to reflect the imbalances of the state gas company, Naftohaz, the revised economic programme targets a broadened fiscal deficit. Corrective fiscal measures and structural reforms are a priority to ensure fiscal sustainability and to avoid crowding out of private sector borrowing'.

In discussions with various IMF officials over a number of years it has not been RBS's impression that the Fund was pressing for the restructuring of the sovereign and quasi sovereign liabilities of the company. Herein it was recognised that, given Ukraine's relatively modest public sector debt:GDP ratio (probably around 20-25 percent at present), Ukraine's problems were not really one of public sector debt sustainability. The assumption was that any restructuring therein would yield limited benefits, in terms of NPV reductions, against the potential downside from securing a default rating loss of market access.

Returning to the government decree published at the end of July, the wording is vague. It speaks of instructing the MOF to address the long term financial feasibility of Naftohaz, and in particular looking at the short term debt service obligations which it argues should be lightened. There appeared to be no indication whether this referred to the US\$500m Eurobond falling due, or the other US\$4.5bn external liabilities of Naftohaz that were outstanding.

Creditors and Restructuring

As part of efforts to ensure that Ukraine has the finances to purchase sufficient gas for storage over the next few months, the government and official creditors are clearly looking at ways to provide new financing and how to reschedule and restructure existing commitments. For the IMF this does not appear to be a prior condition for the release of the next tranche of the SBA, but the above analysis would suggest that the IMF would look favourably on such a development if it proved to be relatively painless and did not unduly undermine Ukraine's broader credit worthiness. Other lenders may, however, be pressing more forcefully for rescheduling and restructuring.

The difficulty for the Tymoshenko government is that it has made numerous commitments to creditors of Naftohaz in the past, in terms of its commitment to support the company. This goes back as far as the eve of Tymoshenko's appointment as Prime Minister in December 2007, when the company was on the brink of a technical default and an agreement appeared to have been concluded with creditors to extend a sovereign guarantee for the company. In the event, the 2008 budget included a provision in the budget to cover the US\$2.7bn outstanding debts (as of then) of the company; albeit the sovereign guarantee was not formalised into law. Creditors have, on numerous occasions in the past, been re-assured that the company is not bankrupt and that the state will stand behind the company. As recently as early July, for example, RBS was re-assured that the company had the resources to meet its external liabilities. After making such promises, and given that the Tymoshenko government is eager to be portrayed as

'investor friendly,' any rescheduling and restructuring seems likely to be voluntary.

An obvious problem with any such deal would be the short period until the bonds matured at the end of September. Securing a deal which could be interesting enough to secure agreement from a quorum of bondholders, without a protracted legal battle, would prove to be difficult. Given that this falls within the upcoming presidential election campaign, presumably the government will not want the issue to be used by the opposition with a stick to beat the government.

Tymoshenko's two main opponents in the presidential campaign (Yanuykovich and Arseniy Yatseniuk) will both likely argue that the company did not default on their watch; herein the question is whether any restructuring could likely result in a default, and then trigger a host of CDS contracts. Tymoshenko's opponents would also argue that a Naftohaz restructuring and default would make it that much more difficult for other Ukrainian companies to secure external financing; if Ukraine's 'most important' company is forced into a restructuring what hope have the rest, they might argue.

Conclusion

These developments could prove extremely unpleasant for the government and more particularly for Tymoshenko in the run up to the president election. Restructuring external liabilities when you cannot pay is one thing, but if this happens when the IMF has just disbursed US\$3.3bn, with a big chunk earmarked for external debt service, is another. In essence this is about willingness, not the ability, to pay.

Meanwhile, all this comes as Ukraine's external credit worthiness seems to be improving, as reflected in the fact that 5Y Ukraine CDS is reported to have pushed back below the 1,000 bps mark, its lowest level since the fall of Lehman. S&P also announced in July that it had moved its admittedly low CCC+ rating on Ukraine onto a positive outlook. A protracted and potentially messy restructuring of Naftohaz liabilities could well negatively impact upon these positive trends.

We sense that the government will want to tread extremely carefully with negotiations with creditors on this issue, and will want to ensure that any restructuring and rescheduling is voluntary, and hence favourable to investors. Ensuring that the balance between making it favourable enough to investors to agree terms, while also not handing her political opponents with the gift of giving cash away to creditors, will be acutely difficult.

