

# Ukraine: Lynchpin for European Energy Security

## FRIDE Democracy Backgrounders

Democracy Backgrounders provide factual information relevant to topical international challenges related to democratisation, and analyse policy implications for the international community.

## About FRIDE

FRIDE is an independent think-tank based in Madrid, focused on issues related to democracy and human rights; peace and security; and humanitarian action and development. FRIDE attempts to influence policy-making and inform public opinion, through its research in these areas.

A 2006 dispute between Russia and Ukraine over gas prices cast a sobering shadow over EU energy security and galvanised new European energy initiatives. Energy-related tension between Russia and Ukraine has continued since that time with periodic flare-ups. This Backgrounder highlights the importance of Ukraine to EU energy security and explains how Ukraine's complex internal energy politics and equally complex relationship with Russia affect European interests.

Ukraine's soviet past has burdened its energy policy. Following the collapse of the Soviet Union in 1991, Ukraine's economy was one of the most energy-intensive in the world with most of its energy imported from its northern neighbour, Russia, and Central Asia. At the same time, Russia used Ukraine's energy dependence to keep the newly independent state within the Russian sphere of geopolitical interest. The energy sector reforms of the 1990s were stillborn as true incentives for sector reform were overshadowed by low gas prices and rent-seeking by Ukrainian political and business elites. The 2004 Orange Revolution, which brought Viktor Yushchenko to power, boosted political and economic competition. This competition, combined with a liberalisation of imported gas prices, created opportunities for needed reforms to the energy sector. However,

Ukraine continues to be known more for its questionable Russian gas deals and for high labour mortality in its coal mines than as a case study for energy sector restructuring. While the European Union's initial interest in its neighbour's energy policy was motivated by a desire to secure European energy needs, the European Union might nonetheless play a transformative role, assisting Ukraine in moving beyond its rentier-state past.

## Ukraine's Energy Importance

\* *Ukraine is the world's top transit country.* While not energy-rich itself, Ukraine is strategically located between gas and oil producers in Asia and a growing consumer base in Europe. This makes Ukraine one of the world's primary energy transit countries. Approximately 80 percent of Russian gas and between 14 and 17 percent of Russian oil pass through Ukraine en route to European consumers. About 40 percent of gas imported by the European Union travels through Ukraine. In addition to an extensive system of gas pipelines, thirteen underground gas storage tanks with a total capacity of 32bn cubic metres provide Ukraine with a unique advantage over alternate gas transportation systems.

\* *An energy-intensive and energy-inefficient economy.* Ukraine is one of the most energy-intensive and inefficient countries in the region. The energy intensity of Ukraine's GDP is higher than that of resource-rich Russia and more than three times higher than the average energy intensity of the EU.<sup>1</sup> In 1990 Ukraine was the third largest gas consumer in the world after the US and the Russian Federation. Over the next fifteen years gas consumption dropped, but in 2005 Ukraine continued to consume an amount of gas similar to that consumed in such countries as Japan,

Italy or Saudi Arabia or in the entire continent of Africa.<sup>2</sup>

This amount of gas usage is the largest in total final energy consumption, accounting for about 40 percent and making Ukraine one of the world's most gas-intensive economies.<sup>3</sup> Moreover, gas consumption grew from 31 percent to 42 percent between 1994 and 2004.<sup>4</sup> Only about 25 percent of the country's demand is supplied by domestic production: the rest is imported from Russia and Central Asia.

\* *Cheap energy consumption.* One of the main reasons for such high energy consumption is that Ukraine has benefited from one of the lowest pricing structures for imported gas in the region. Between 1998 and 2005 Ukraine paid US\$50 per 1,000 cubic metres of gas imported from Russia, while the average export price for Europe grew steadily over the period reaching US\$192 in 2005. Until 2006 Ukraine supplied its domestic consumers with imported gas. Even with price increases Ukrainian residential and public sector consumers pay well below the government's cost-coverage level.

## Ukraine's Resource Curse

Newly independent Ukraine inherited an economy dependent on intensive energy consumption. At the same time Ukraine's vast transmission infrastructure, while not an energy resource in and of itself, has served as a source of gas supply for Ukraine's economy. Low prices for imported gas perpetuated the Ukrainian economy's energy inefficiency.

<sup>2</sup> Pirani., Simon, *Ukraine's Gas Sector*, Oxford Institute for Energy Studies, June 2007, p. 11.

<sup>3</sup> Tsarenko., Anna, *Overview of Gas Market in Ukraine*, Kyiv: CASE Ukraine, 2007, p. 5, <http://www.case-ukraine.com.ua/u/publications/64647c5562749d05c7529cc4f0a59cad.pdf> (accessed 1 June, 2008)

<sup>4</sup>International Energy Agency, p67.

<sup>1</sup> International Energy Agency, *Ukraine: Energy Policy Review 2006*, OECD/IEA 2006, p. 80.

Relying on Ukraine's competitive advantage due to inexpensive gas, Ukrainian business groups focused on the development of resource-dependent industries with high export potential — steel, chemicals, machinery, energy and agriculture. In 2003, these sectors accounted for approximately 95 percent of industrial production, while information technology, software, electronics, telecommunications, information services and biotechnology accounted for only five percent of production.<sup>5</sup> As a result, Ukraine's economic growth since 2000 has been largely export-driven and dependent upon energy-intensive industries with a limited value-added factor, making it extremely vulnerable to natural resource (especially metals) price volatility.

It can be argued that although Ukraine is a country with the "resource curse",<sup>6</sup> it has suffered also from the typical economic, social and political consequences of resource-led development. Ukraine developed as a rent-seeking state, where "economic influence and political power are especially concentrated, the lines between public and private are very blurred, and rent seeking as a strategy for wealth creation is rampant".<sup>7</sup> Indeed, starting from late 1990s the President has played a crucial role in the distribution of rents through such methods as privatising state assets for less than fair market value, maintaining state control over energy resources, and providing subsidies and protection to loyal businesses. At the same time, there is limited rule of law and a limited system of property rights, such that every change of political power leads to a redistribution of economic assets.<sup>8</sup> Furthermore, the political regime

has sought to maintain the *status quo*, suppressing economic and political competition and thereby leading to the development of authoritarian rule.

External factors have also contributed to the continuation of Ukraine's rentier state status. Russia, Ukraine's northern neighbour, is interested in keeping "managed democracy" in Ukraine by continuing economic penetration and constraining Ukraine's integration into the European and Euro-Atlantic communities. Russian political and economic support of President Kuchma's regime, in the form of low gas prices, guaranteed the *status quo*.

What are the other consequences of Ukraine's resource-based development and rent-seeking economy? Ukraine suffers from widespread corruption — it is in 118<sup>th</sup> place on Transparency International's Corruption Perception Index in 2007. Furthermore, Ukraine's economic growth (largely based on its Soviet-era industrial capacities) is forecast to be almost two times slower than its potential based on its competitive advantages<sup>9</sup>. Also, Ukraine has poor social welfare performance and is ranked 76<sup>th</sup> on UNDP's Human Development Index - the lowest-ranking European country. Ukraine is also beset by public health problems including the fastest growing HIV/AIDS epidemic in Europe, the spread of social diseases such as tuberculosis and high levels of environmental pollution.

Rent seeking in Ukraine was challenged both by reforms imposed by international financial institutions in late 1990s and by the Orange Revolution. Reforms introduced by the Yushchenko-Tymoshenko government, particularly a ban on tolling schemes, had a positive impact on Ukraine's economy, strengthening the financial position of the energy sector in particular while improving public finance and increasing household incomes. The Orange Revolution and associated political changes in 2004 also brought about democratisation of the political system with

<sup>5</sup> World Bank, *Ukrayina: Formuvannia dlya stabil'noho zrostantia. Memorandum pro ekonomichni rozvytok*, Vol.2, Kyiv: "Kozaky", 2004, p 367-368.

<sup>6</sup> Primarily the resource curse refers to countries overwhelmingly dependent on oil revenues. See Karl, Terry Lynn, *Oil-led Development: Social, Political and Economic Consequences*, Stanford University, p. 4, [http://iis-db.stanford.edu/pubs/21537/No\\_80\\_Terry\\_Karl\\_-\\_Effects\\_of\\_Oil\\_Development.pdf](http://iis-db.stanford.edu/pubs/21537/No_80_Terry_Karl_-_Effects_of_Oil_Development.pdf) (accessed 1 June, 2008)

<sup>7</sup> Karl, Terry Lynn, "Understanding the Resource Curse", in Tsalik., Svetlana, and Schiffrin., Anya, ed., *Covering Oil. A Reporter's Guide to Energy and Development*, Revenue Watch Open Society Institute, p. 25.

<sup>8</sup> See Dubrovskiy, Vladimir (et al.), *Ukraina do i posle "Oranzhevoy revoliutsii": politekonomiya nezhelannykh reform*, Presentation, Kyiv: CASE Ukraine, 2007, <http://www.case-ukraine.com.ua/u/publications/0414eeddf91265d84bce22a6af0fb4b.ppt> (accessed 1 June, 2008)

<sup>9</sup> See *Majbutnie ekonomiky Ukrayiny* (Future of economy of Ukraine), Kyiv: International Centre for Policy Studies, 2007, p. 22-23.

fairer elections, political competition and media freedom. At the same time, constitutional reforms strengthened the role of Ukraine's parliament. Ukraine also accelerated accession talks with the WTO and the European Union. An opening up of the Ukrainian economy and an improved internal regulatory environment resulted in an increase of foreign direct investment to record levels as well as record domestic market growth. Lastly, prices for imported gas in Ukraine have risen since 2006 spurring energy conservation and modernisation of the economy.

## Decay of the Rentier State

\* *Russia increases gas prices In the early 1990s.* Russia continued providing energy at low prices to countries such as Ukraine and Belarus in order to keep them on a re-integration path within the Community of Independent States. Starting in the mid-1990s Russia has used its energy supplies to penetrate economic systems of post-soviet countries, taking control of the principal GDP-contributing industries as well as strategic assets, such as pipelines. This has been accomplished primarily through privatisation or debt repayment schemes.

In 2005, after presidential elections in Ukraine that did not deliver the kind of results Moscow might have hoped for, Russia declared a nearly five-fold price increase on gas exported to Ukraine (from \$50 per 1,000 cubic metres in 2005 to \$230 in 2006). Negotiations between the two countries resulted in more gradual price hikes but at the expense of Russian energy giant Gazprom's takeover of Ukraine's gas market<sup>10</sup>.

<sup>10</sup> The Ukrainian state monopoly NaftoGaz Ukrainy has lost control over delivery of gas to its domestic customers, management of the country's underground storage tanks, distribution of natural gas on Ukrainian territory, and re-exportation of it. A new monopoly was created on the Ukrainian natural gas market, UkrGazEnergo, a 50–50 joint venture between NaftoGaz Ukrainy and RosUkrEnergo, an offshore commercial company. RosUkrEnergo also obtained exclusive rights to conduct re-exporting activities.

The immediate positive effect of this new gas deal was price liberalisation for gas supplies to Ukraine. Since 2006 the price Ukraine has been paying for gas imported from Russia has been growing, from \$130 in 2007 to \$179.50 in 2008 with further increases projected to between \$250 and \$270 in 2009 and to between \$290 and \$320 in 2010.<sup>11</sup> As a result, Ukrainian businesses have started to seek competitive advantages other than low-cost energy supplies and to modernise their existing energy intensive enterprises.

\* *Ukraine starts thinking about energy efficiency.* Spurred on by the Ukraine-Russia gas conflict, the Ukrainian government approved the "Energy Strategy of Ukraine to 2030". This new energy strategy was also motivated by stagnation in the energy sector in 2004 and 2005 when the state put the privatisation of the power sector on hold, decreased public investment, and disallowed increases in regulated rates.<sup>12</sup>

The Energy Strategy envisages the Ukrainian fuel and energy complex's greater reliance on domestic energy resources through development of the coal and atomic energy industries. The strategy also stresses the importance of increased energy efficiency in order to reduce dependence on Russia. The economy's energy intensity is expected to be halved through increased energy conservation in the most energy intensive sectors - metals, chemicals, utilities and power. The authors of the strategy argue that greater efficiency and structural changes in the use of energy will make it possible to reduce the level of Ukraine's external energy dependence from 54.8 percent to 11.7 percent by 2030. According to the plan, gas use will be cut by 36 percent, with accompanying slight increases in oil, coal and power use.<sup>13</sup> An estimated investment of \$6 billion (six percent of Ukraine's 2006 GDP) through 2010 will be required to implement the Ministry of Fuel and Energy's plans.<sup>14</sup>

<sup>11</sup> Forecast is made by the International Centre for Policy Studies. *Quarterly Predictions* No 41, Fourth Quarter 2007, p.31.

<sup>12</sup> International Centre for Policy Studies, *Political Commentary* No 34, April 2006, p15 - 16.

<sup>13</sup> Ibidem.

<sup>14</sup> International Monetary Fund, *Ukraine: Selected issues*, Country Report No. 07/47, February 2007, p.7.

\* *Europe includes Ukraine in its external energy policy.* Gas cut-offs to Europe in the heat of the Ukraine-Russia gas dispute triggered EU concerns about security of gas deliveries. The EU has sought to enhance its energy security through the extension of its energy market rules into neighbouring countries. Since 2005, the energy component has become a key element in Ukraine-EU cooperation. Energy-related objectives have also appeared in the European Neighbourhood Policy Action Plan between the EU and Ukraine. In December 2005, Ukraine and the EU agreed a Memorandum of Understanding (MOU) on cooperation in energy matters<sup>15</sup>. In the MOU the parties recognised that the “gradual convergence of Ukraine’s energy sector with the EU’s internal energy market, aiming ultimately at its integration, remains a shared priority for the EU and Ukraine”. The MOU developed a road-map in four areas: (i) nuclear safety; (ii) integration of electricity and gas markets; (iii) enhancing the security of energy supplies and the transit of hydrocarbons; and (iv) structural reform and enhanced safety and environmental standards in the coal sector. The MOU contemplates a comprehensive dialogue between the EU and Ukraine on energy issues as well as the promotion of energy related legislative reform (e.g., a draft law on gas transit to secure transparency and accountability of transit deals).

In November 2006 Ukraine acquired “observer status” in the EU’s Energy Community; however, full accession to the Community is conditioned upon a satisfactory assessment of safety levels in all of Ukraine’s operational nuclear power plants. The worst nuclear power plant accident in history occurred in 1986 at Chernobyl in the then soviet republic of Ukraine. Accession to the Energy Community will require an alignment of Ukrainian and EU laws related to energy.

In furtherance of the MOU the EU has been providing technical assistance under both TACIS and, since

2007, the European Neighbourhood and Partnership Instrument<sup>16</sup>. Also since 2007, a new Instrument for Nuclear Safety Cooperation provides for Ukraine to continue with safety improvements to nuclear plants and increase regulation of the nuclear energy sector. The European Investment Bank’s credit lines have included the energy sector as a priority and both the World Bank and the European Bank for Reconstruction and Development have increased their investment in energy saving projects in Ukraine.

\* *The gas agreement with Russia reflects Ukraine’s rentier state heritage.* While gas price liberalisation will stimulate energy conservation and modernisation of the economy and has the potential to trigger reforms in the energy sector, Ukraine’s 2006 gas agreement with Russia evinced the continuation of rent seeking in the Ukraine. Caving in to business pressure to keep production costs low, the government negotiated for lower gas prices at the expense of strategic energy interests. The agreement perpetuated Ukraine’s reputation for opaque gas trading schemes which use seemingly corrupt intermediaries. Moreover, the agreement allowed Russian energy giant Gazprom to enter Ukraine’s gas market without establishing any rules to prevent the resulting monopoly from abusing its substantial power.

In contrast to pre-Orange Revolution gas deals, these recent deals received unprecedented media and public scrutiny, largely due to greater freedom of speech. The opposition released secret protocols signed with the 2006 agreement. The press subsequently revealed the names of two Ukrainian owners of a 50 percent share in RosUkrEnergo, which fuelled accusations that some of Ukraine’s most powerful politicians are participating in the corrupt gas schemes.

Successive governments have negotiated more favourable prices for imported gas but have not otherwise challenged the opaque trading scheme. Despite Prime Minister Yulia Tymoshenko’s electoral

<sup>15</sup> Memorandum of Understanding on cooperation in the field of energy between Ukraine and the European Union, <http://www.ukraine-eu.mfa.gov.ua/eu/en/publication/content/6936.htm> (accessed May 29, 2008)

<sup>16</sup> 197.6 million euros is to be allocated to Ukraine in 2007–10 as support for infrastructural development, including the energy sector.

promise to get rid of the intermediaries, her most recent talks with Moscow indicate this goal is being held hostage to avoid increases in gas prices over the next two to three years.

Ukraine's government seems unwilling to increase gas prices for residential consumers as it would likely have a negative impact at polls. In fact, the Ukrainian government has subsidised residential gas and electricity rates, keeping them below-cost as a substitute for social security programmes. Today, industrial users pay two or three times more than households for gas and electricity.<sup>17</sup>

Such a policy does not stimulate energy conservation. A transparent and market-based system of establishing prices for energy supplies for final consumers is key to achieving the goal of energy efficiency and implementing other policy priorities, such as the reform of the communal services sector, which is in deep crisis, and the reform of the social security system. By subsidising energy costs the government promotes a culture of rent seeking and takes away incentives for citizen participation in public policy making and, as a result, diminishes state accountability.

In May 2006 for the first time in seven years the government increased energy rates for households by 25 percent. The second increase from 25 percent to 100 percent had been planned for the second half of the year and by 2008 the Government planned for rates to cover costs fully. However, it has proved difficult to implement these plans as the regulatory authority responsible for energy price setting (the National Electricity Regulatory Commission) is subordinated to the political priorities of the Government. Some legislative changes aiming to depoliticise the rate-setting process for natural monopolies in the energy sector were approved in 2007, but rates policy is still influenced by the Cabinet

<sup>17</sup> In developed countries, it is generally the opposite: residential users tend to pay about 20 percent more than other users. This is based on economies of scale: the cost of delivery to small scale users (individual residences) is higher than delivery to large users (major industries).

of Ministers and dependent on those persons who head regulatory bodies and institute legislation<sup>18</sup>.

### Main barriers to reforms in the energy sector

The rentier state heritage	Implications for the energy sector
Absence of rule of law, no stable property rights	There are no stable rules of the game in the sector: a legislative base is underdeveloped. Redistribution of energy assets occurs with each change of political power. Privatisation processes lack transparency and the results appear unfair.
Concentration of economic influence and political power, state capture by powerful, self-interested economic actors	Government interests are substituted by business interests. The government focuses on keeping prices low and rapidly privatising state assets at the expense of rule making and enhanced transparency.
No transparent governance, corruption	Structure of ownership and management of state assets is opaque. Payment schemes and budgets of public enterprises lack transparency.
Ability to generate wealth is limited, due to discouragement of economic competition	A limited number of actors compete in the market. Access to foreign investors is limited.
Weak public administration	Low level of implementation of approved decisions

The experiences of Central European countries show that corporate restructuring, price liberalisation and privatisation, which send positive messages to business and individual consumers, are the main factors in improving energy efficiency<sup>19</sup>. In the immediate pre- and post-millennium period, the Ukrainian government promoted energy-sector privatisation and liberalization policies. The government then abruptly shifted to a policy of state consolidation of the energy market. The post-Orange Revolution government's re-launch of energy-sector reforms has been slow due to political instability, weak public administration and

<sup>18</sup> International Centre for Policy Studies, *Political Commentary* No 44, February 2007, p. 18-20.

<sup>19</sup> Kolesnichenko., Anna, and Tsarenko., Anna, *Overview of Implementation of Effective Energy-Saving Policy in the EU and Opportunities for Ukraine*, Kyiv: Case Ukraine, 2007, p.19.

state capture by powerful, self-interested economic actors.

\* *The government fails to adopt clear and transparent rules for privatisation.* Privatisation policy in Ukraine has been politically driven with different political actors giving preference to the business groups they favour. One well-known example is the largest power generating operator in Eastern Ukraine, Dniproenergo, which changes ownership with each change of government.<sup>20</sup> Ukraine's privatisation programme has become a battleground between competing political actors with divergent interests.

Despite the coal sector's recognised strategic importance to Ukraine's pursuit of energy independence, the government's failure to restructure the sector has resulted in continued poor financial performance and record rates of employee mortality. In 2005, only seven percent of mines were private, but these mines produced 40 percent of Ukrainian coal, and *de facto* control of large parts of the coal industry lies with certain groups of major industrial consumers.<sup>21</sup>

Despite a number of policy initiatives aimed at reforming the coal industry, the most recent adopted in July 2005, the government has failed to close unprofitable and dangerous mines. In addition to political considerations – a decision to close a mine is always difficult in electoral terms – there are strong public and private lobbies to maintain the *status quo*. Continued operation of unprofitable and dangerous mines bring profits, in the form of subsidies, to state managers or private operators. Even though 93

percent of mines are state-owned, they are under the *de facto* control of industrial groups which dominate both the distribution and purchase of coking coal. As a result, they use sole-source, non-competitive contracts to buy coal from state-owned mines at 20 to 40 percent below fair market value.<sup>22</sup> Losses at state-owned enterprises are covered by the State's General Budget through the subsidisation programme. This creates what is known by the Razumkov Centre as a "corruption tax" on Ukrainian citizens.<sup>23</sup>

This form of corruption keeps coal prices artificially low and the cost of extraction high, also creating a mechanism for the funneling of public funds (intended as subsidies to a troubled sector) into the hands of private companies controlled by already wealthy industrialists.<sup>24</sup>

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## Implications for the European Union

Ukraine's energy policy is driven by business interests represented by competing political parties and the short-term concerns of political elites worried that reforms might cost electoral support. This has resulted in a lack of reform-minded measures in the energy field. There have been no reforms in the energy sector since 2000. Only the gas sector has experienced transformation, albeit limited, and this is due more to the external factors previously discussed than to an actual desire for change.

The energy sector in Ukraine continues to suffer from a lack of stable and clear regulation, a lack of transparency in decision-making and public finance, discouraged economic competition and poor implementation of adopted initiatives. The breaking

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<sup>20</sup> In August 2007 the Victor Yanukovich's government enabled further privatisation of Dniproenergo by another Party of Regions leader Rinat Akhmetov's Donbass Fuel-Energy Company (DTEK). When the government of Yulia Tymoshenko returned to power, it announced re-privatisation of Dniproenergo blaming the previous sale as undervalued and corrupted. The analysts said that apart from state interest, there were business interests defining the position of BYT government: a competing business group "Privat" which is considered as a financier of BYT's electoral campaign aspires to privatise Dniproenergo. President Victor Yushchenko supported DTEK's position and blocked the government's plan to privatise state power generating companies calling for more transparency in privatisation competition and investment of obtained revenues in research and development projects.

<sup>21</sup> International Energy Agency, p. 251.

<sup>22</sup> International Energy Agency, p. 253-254.

<sup>23</sup> Razumkov Centre, "Ukraine's Coal Industry: Its State and Trends Against the Background of Restructuring", National Security and Defence, No. 9 (44) 2003, Kyiv: Ukrainian Centre for Economic and Social Studies after Razumkov.

<sup>24</sup> *Ibidem*, p.255.

point for reforms might be 2011-2012, when the process of transition comes to an end and residential consumers will be paying market level prices. At this point, the government might have more incentive to restructure the energy sector.

Russia will likely continue to dominate Ukraine's energy sector. Ukraine remains highly energy dependent on Russia and energy efficiency and diversification reforms to eliminate this dependence are being implemented slowly. Russian companies dominate the oil market<sup>25</sup> and control a significant share of the gas market in Ukraine. Gazprom, directly or through intermediaries, will likely expand its position in Ukraine's gas market through gas trade deals or participation in local gas distribution companies. It would thus be in Ukraine's best interest to adopt regulations limiting monopoly power and obliging

Gazprom to adhere to rules applicable to domestic and other foreign investors.

The Free Trade Agreement currently being negotiated by the European Union and Ukraine will have a lasting impact, changing Ukraine's economy and energy sector in particular. The Agreement will require regulatory reform, including reform of public subsidies and governance of state-owned entities. Cooperation in the energy field will be one of the key priorities in the Agreement. The EU is keen to extend EU energy rules and standards to Ukraine and to include the country in the emerging EU energy market through the Energy Community. By 2011-2012, when the Agreement is to enter into force and gas prices are to be fully liberalised, the environment will be much better for successful implementation of energy sector reforms.

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