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Big Business Interconnections in Ukraine-Russia Nexus

***Summary**: Despite the numerous attempts to study, there is no reliable scale assessment of the Russian-Ukrainian joint business as well as Russian economic presence in Ukraine. Political and business elites in Ukraine and Russia do not consider their deep "power-money" merge as the pattern of conflict of interests; therefore have no serious intention to change it substantially. This determines the perception of Russia-Ukraine (mostly energy, but not only) business axis as the most remarkable case of the business-government merge in the entire Black Sea Region.*

Russian big business (mostly controlled by the government) is likely to continue its bid for wider presence and control in the different segments of Ukrainian economy. However this bid will be obviously restricted by the protectionist policies pushed by Ukrainian stakeholders who are rather interested to keep their businesses then to lose them in favor to richer Russian business groups.

Russian and Ukrainian post-soviet political and economic models have been constituted on the strong merge between the state and big business. It is hardly possible to separate business and politics when Ukraine and/or Russia are concerned. The most of large extensive businesses in both countries were built either through political power (access to public resources, biased unfair privatization) or at least with the certain use of political power (protectionism, clientelism). Because of that the notion of "oligarchy" as the definition of specific strata connecting big business and national politics is widely spread in both countries.

At the same time, the nature of "oligarchy" is noticeably different in Russia and Ukraine. In Russia the largest businesses appeared in the natural resources/energy sphere, exploiting public-owned (natural) resources through the direct patronage provided for certain businessmen by the state leadership. In Ukraine the structure of "oligarchy" is more diverse and competitive. While in Russia all the big businesses are fully controlled by the government, Ukraine's order may be rather defined as "pluralistic oligarchy", providing more individual space for the owners of the businesses.

The largest segment of "oligarchic" economy in Ukraine has been built in the metallurgic sector, which delivers about 40% of all export incomes of Ukraine. In this sector the role of politics in the growth of business was principal, as all the assets (factories, plants) in this sector were built before independence, and government-managed privatization played a crucial role in the success of certain business-political groups. By its role in the national economy Ukrainian metallurgic industry is comparable to the role of natural gas/oil industry in Russia.

Common origin, reasonable similarities, and, at the same time, visible asymmetry of Ukrainian and Russian political-economic models provided certain ground for the essential penetration and made it easier to combine political and economic instruments in order to achieve ambitious objectives of "businessmen in power" in both countries. At the same time, economic penetration became an obvious tool of Russian Federation in its attempt to reconstruct the "sphere of influence" in the post-soviet space as soon as Ukraine fails to succeed in its European integration bid.

Despite the numerous attempts to study, there are still neither reliable figures nor qualitative picture of the Russian economic role in Ukraine. Extent of the Russian economic presence in Ukraine is estimated in figures, which vary from 5.2% of the Russian FDI share in total FDI in Ukraine (official Ukraine's statistics - 2010) to exaggerated assumptions, which infer that Russia "controls a half of the Ukrainian economy".

On one hand, Russian capital penetration in Ukraine, as any foreign capital, could be considered as integral process of globalization. On the other hand, due to many essential factors, the Russian economic presence in Ukraine is unique and cannot be compared to any other foreign economic partner.

First of all, the Russian presence, regardless of its scale, plays an important psychological role in Ukraine thus exerting pressure on media, business and political decision making. The discourse on Russian capital and business has become specifically overcharged, where it is portrayed as almighty in any competition either with domestic or other foreign business.

Secondly, the Russian economic presence and Ukraine-Russia "oligarchy axis" is highly politicized. The Russian business is an integral part of the Russian political machine, which explains quite predictable and unilateral policy of such energy giants as, "Gazprom" or "Rosneft'". It makes the Russian economic presence a politically important factor, if the ratio of real presence is high.

Deeply rooted corruption is the third important factor. Russian business traditionally uses all means available for promoting its interests in the world, as have been already felt by governments of Germany, Turkey, Bulgaria and other countries, especially those, where the "Russian money smell with gas". In Ukraine the situation can get even worse as there is a lack of systemic mechanisms to resist corrupt influences and new corrupt "injections" are willingly absorbed. Ukraine's Corruption Perception ranking 134 out of 178 by the Transparency International testifies to the concentration of corrupt practices in the country (1).

The best illustration of non-transparency of the Russian-Ukrainian business connection is the abovementioned lack of information on a real scale of the Russian economic presence in Ukraine, which, in fact, is highly unusual for any healthy economic environment. The fact of continuous and fruitless discussion on this issue, inability to count real volumes of Russian property and Russian investments in Ukraine, detects the substance of this presence better than any, even most reliable figures.

Non-transparency of the Russian property in many economy sectors is sometimes a result of wrong statistical techniques, but more often it is caused by conscious tactics of the owners hiding the businesses' origin. Russian capital in Ukraine arrives through the third countries (predominantly Cyprus, which ranks the first according to official FDI statistics in Ukraine, British Virgin Islands and other offshore territories).

[1] Transparency International – 2010 Corruption Perceptions Index: http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results

Another part of Russian non-transparent assets have formal Ukrainian “identity”: Russian companies are opening subsidiaries which have the same names as their parent companies, but are registered as Ukrainian ones. Sometimes even external (name) features proving the Russian origin of a business are missing to imitate its Ukrainian origin.

Stages and Tendencies of Russian Big Business Penetration in Ukrainian Economy (up to 2009)

According to Andriy Kalynovsky the Russia capital expansion can be approximately divided into 3 main periods:

- 1995-2002 active penetration in energy sector and mass media.
- 2002-2004 the Russian interests entered the machine building, electric power generation and information technologies.
- 2005-2009 interests extended to key sectors of domestic economy: iron and steel industry and financial sphere (2).

Oil refining industry was one of the first sectors, which experienced systemic expansion of Russian big business.

In 1998-2002 Russian investors established control over three biggest and most modern oil refining factories – in Lysychansk, Kherson and Odessa. Kremenchuk Oil Refining Factory was purchased by Russian owners back in 1994.

[2] Andriy Kalynovsky. *Is Russian capital absorbing Ukraine*?, Economichna pravda, 28.08.2009

Russian Capital Penetration in Ukrainian Oil Refining Industry (ORI) (according to A. Kalynovskyi)

ORI	**Industrial production, million tons**	**Russian investor**	**Year of purchasing by Russian investors**
Kremenchuk	18,6	"Tatneft’"	1994
Odessa	3,6	"Lukoil”	1999
Lysychansk	16	TNK	2000
Kherson	8,7	Oil company "Alliance"	2000

In general in 2001-2006 the Russian business controlled more than 90 % of Ukrainian oil industrial production and 85% of oil supply. In 2006-2008 when the owners of Kherson and Kremenchuk Oil Refining Factories were changed, the Russian share in oil refining industry decreased to about 40%.

During the period of 2002-2004 Russian big business was more focused on machine building, electric power generation and information technologies. Transnational integrated production chains were created. At this time Russian business privatized Inguletsk Mining and Processing Enterprise, which was the biggest Ukrainian factory, based on iron-ore concentrate, and set control over flux-dolomite and fireproof production. Mykolaiv Aluminous Factory and Zaporizhzhya Aluminium Integrated Plant were purchased by “Rusal” enterprise.

In the meantime, the Russian business penetrated in a vehicle production sector. It established control over a bus producer – Lviv Bus Factory, the only truck producer – KRAZ (Kremenchuk, Poltava region) and the biggest tire producer “Rosava” Company (Bila Tserkva, Kyiv region).

The largest-scale contract in telecommunication sphere was the purchase of Ukrainian largest GSM-operator “Ukrainian Mobile Communication” (UMC) by Russian MTC Company in 2002. Another

Russian telecommunication group – “Alpha-group” purchased 40,1% of "Kyivstar” mobile operator. As a result, most of service market of mobile communication was shared by two main players, one of them fully and another almost half belonging to Russian investors (3).

A new period started in 2005, after Russia has lost in the struggle for political power in Kyiv. However, it hasn’t got reflected on success of the economic penetration strategy. Moreover, new sectoral priorities appeared and succeeded.

Since 2005 business proxies of the Russian government entered mining and metal sector, where the position of domestic capital was rather strong. In particular, in 2007 Euraz Group bought mining and metal assets of Privat Group, and Russian Smart Holding Company after merging with Metinvest Group became minority shareholder of the biggest metal company of Ukraine, owning its blocking stock (25%+1 share) (4)

And finally, the banking sector became a priority for the Russian capital penetration. If in 2005-2007 Russian investors were not ready for active competition with Western European banks on the Ukrainian market, then in 2008 they substantially strengthened their position. Before the global crisis the share of foreign capital in banking capital exceeded 36%. And at the same time the biggest part belonged to Russian capital – 17,4% (5).

During first six months of 2008 the volume of the Russian capital in the Ukrainian banking sector grew by 2,6 times up to 3,8 billion UAH. In total, in 2007 the Russian capital owned 8 Ukrainian banks, and in 2009 – 12: “Petrokomerts-Ukraine” was controlled by Russian bank Petrokomerts, Alpha-Bank – by Alpha Group Consortium, VTB Bank and Vneshtorgbank Ukraine – by VTB Bank, NRB Bank – by Russian Federation Savings Bank, Energobank – by National Reserve Corporation. Bank Russian Standard belonged to Russian institution of the same name, Radabank was controlled by Kytfinans, BIG Energiya – by Kostyantyn Grygoryshyn, BM Bank – by Moscow Bank, Renaissance Capital Bank – by investment group Renaissance Capital, First

[3] Gylka U.L. the peculiarities of competition on service market of telecommunications // Research notes, Ukrainian Research Institute of Communications, №3(11), 2009, p. 99.
[4] Website of “Smart Holding” Company http://www.smart-holding.ua/fields/list.php?SECTION_ID=17
[5] Andriy Kalynovskyi. Is Russian capital absorbing Ukraine?// Economichna pravda, 28.08.2009

Investment Bank – by VS Energy (6). Two of the abovementioned – Alpha Bank and VTB Bank – are among ten biggest financial institutions of Ukraine.

At the end of 2008 Prominvest Bank, which became one of the first victims of economic crisis in Ukraine, fell under control of Russian state-owned Vneshekonombank.

So, in spite of outwardly unfavorable political situation during 2005-2009, none of political contradictions prevented expansion of the Russian capital on Ukrainian market during this period. In many sectors the penetration was even more successful than during more politically favorable period of 2002-2004. It shows generally low effect of the political situation on the economic penetration.

Dynamics of the Russian Economic Penetration in Ukraine after 2010 Presidential Elections

Expectations of rapid economic expansion of Russia on Ukrainian market have significantly increased after the change of government in Ukraine at the beginning of 2010. Strategic partnership with Russian Federation was proclaimed a priority of new authorities, posing the issue of practical dimension of such partnership.

After Russian part had fulfilled its immediate political and strategic tasks (removal from agenda Ukraine's ambition to join NATO, prolongation of Black Sea Fleet base lease for 25 years, some humanitarian issues), the question about further expansion of economic assets appeared.

In some issues Ukrainian leaders demonstrated readiness to go ahead, in particular, on nuclear energy cooperation and aircraft industry; in other issues like strategic oil/gas transport infrastructure they showed willingness to serious dialogue; while in the issues on metallurgic assets Russian leaders decided to play on their own, using weaknesses of partners in Ukraine.

Gas delivery and gas transportation industry. Regardless of the promising start of a new phase of the energy dialogue in 2010, the

[6] Andriy Kalynovskyi. Is Russian capital absorbing Ukraine?// Economichna pravda, 28.08.2009

Russian side currently remains unsuccessful in gaining direct control over the gas transportation system of Ukraine (the talks on Consortium are going on as of October 2011, their content and outcomes are still uncertain).

At the same time, no deep reforms provided, aiming at reduction corruption and ensuring transparency in the gas market. Gas-related business groups in Ukraine and Russia, despite their certain business disputes, remain the guarantors of status quo which makes the gas market in both countries as well as bilateral gas deals nontransparent and inefficient in terms of public interests.

The period after 2010 presidential elections was indicated by visible return of so-called "Rosukrenergo"[7] group to the top-business stage. Ukrainian Businessman Dmytro Firtash regained the leading positions on gas market which he lost during the previous government while his major partner Yury Boyko was appointed an energy minister of Ukraine. *Rosukrenergo business, strongly connected to Gazprom, taking into account critical dependence of Ukrainian economy form the gas supplies from Russia, constitutes the most remarkable case of the business-government merge in Ukraine-Russia relation, and, possibly, in the entire Black Sea Region.* The reason for that is annual amount of transactions connected with Russian gas delivery to Ukraine which is about $10 bln (in 2010).

High gas prices remain the pressing point pushing Ukrainian government to look for certain solution to reduce price on sustainable basis at least to the average regional level. Kharkiv agreements of April 2010 established a USD 100 discount for each 1000 cubic meters of natural gas provided by Russia according to the 10-years formula-based agreement signed in January 2009 by Prime Ministers Yulia Tymoshenko and Vladimir Putin. This formula is grounded on $450 "basic price" which is substantially higher than in Gazprom's contracts with other major European partners, that leads to overpricing of Russian gas for Ukraine.

This arrangement, exchanging $100 gas "discount" for 25-years additional Black Sea Fleet lease in Crimea, proved to be inefficient, as provided only limited and short-term effects.

[7] "Rosukrenergo AG" is a Swiss-based enterprise co-founded by Gazprom sate-owned company (Russia) and Ukrainian businessmen Dmytro Firtash and Mykhailo Fursin.

During the year 2011 the overpricing of Russian gas in Ukraine became obvious. Temporary benefits provided by Kharkiv Agreements fully exhausted: the price of Russian gas in Ukraine in the 2nd half of 2011 reached the level of gas prices for Germany (with essentially longer transit way and no special arrangement such as Kharkiv Agreement based “discount”).

As Ukraine was looking for re-arrangement of gas agreements, Russia proposed a merger of national gas monopolists Gazprom and Naftogaz as a solution. Such a move could actually have become an intake since Naftogaz market capitalization does not exceed 6-7% of that of Gazprom. Logically, the position of Ukrainian government remains not to accept this approach, continuing to push the idea of “trilateral consortium” involving Russian, Ukrainian and the EU-based companies.

Ukraine’s joining the European Energy Community in October, 2010 was used by the Ukrainian side as an argument not only for revision of the gas agreements concluded by Prime Ministers Tymoshenko and Putin in January 2009 but as a pretext to decline Russia’s claims for the merger and for its attempt to establish control over the gas transportation system in general following the model of Belarus. As Prime Minister Mykola Azarov stated in October, “Market realia have changed, therefore both the basic value and the pricing formula are in need of revision. Ukraine joined the European Energy Charter and adopted the Law “On Gas Market” in June 2010. This means modifications in both the international and internal legal frameworks which are taken into consideration in concluding and implementing gas supply and transportation agreements.” Nonetheless, the Ukrainian government may accept further integration steps in this industry: “Joint venture between Gazprom and Naftogaz may be created, yet on equal grounds only and with no companies’ merger”, Azarov emphasized while receiving no signs of Russia’s enthusiasm in response.

In its turn, the Russian party will not evidently agree to revise even straightforwardly discriminatory gas pricing formula without acquiring benefits in regulation of the gas transportation ownership issue. An idea of consortium that is actively promoted by the Ukrainian party was finding no response in Moscow since consortium suggests no ownership whereas “the common management policy” may be always revised by Kyiv. Only in Autumn 2011 the talks on re-arranging the gas deal between Ukraine and Russia achieved certain progress, however details have not been disclosed yet.

Lack of transparency of the gas market in both Ukraine and Russia, the private interests dominated over the national ones remain the most obvious challenge to the real reforms within the sector on the basis of "common good" principles.

Nuclear power engineering. Ukraine doesn't produce by itself the fuel for nuclear plants, and traditionally was dependent on Russian delivery. During the last three years Ukraine made an attempt to diversify nuclear fuel supply through involving the production of an American company Westinghouse. This fact was undermining long-term monopoly of Russian TVEL Company and it made the Russian part search for new alternatives of influence aiming at re-monopolization of Ukrainian market. The way was found in the project of nuclear fuel factory building of on Ukrainian territory. The project was to be done exclusively with the use of Russian technologies and was conditioned by Westinghouse's removal from the market.

Negotiations lasted for five months and on October, 27-th TVEL and Ukrainian state-owned enterprise "Nuclear Fuel" signed an agreement on joint venture to produce nuclear fuel on the territory of Ukraine with Russian technologies. That could lead to making Ukrainian nuclear energy sector fully dependent on Russian raw materials and technologies (8). The details of the given agreement have been not disclosed yet.

However, developments of next months demonstrated the lack of concrete activity on the field, and as of today Ukrainian government continues its cooperation with Westinghouse, keeping the market of nuclear energy fuel diversified.

Aircraft industry. Foundation of an aircraft-building joint venture was declared in April 2010 (and related documents signed on October 27th). It has been announced that the new enterprise will co-ordinate manufacture and make market promotion of "Antonov" brand aircrafts, such as Antonov-148, Antonov-140, Antonov-70 and Antonov-124. Dmytro Koliesnikov, Minister of Industrial Policy of Ukraine, stated that

[8] BBC, October, 27-th, 2010 . http://www.bbc.co.uk/ukrainian/news/2010/10/101027_putin_visit_rl.shtml

the above-mentioned joint venture should not foresee any transfer of tangible assets. However, since that the deal hasn't moved ahead.

Currently, while manufacture of the medium-range passenger aircraft Antonov-148 has more or less positive prospects, intentions as for the beginning of manufacturing the transport aircraft Antonov-70 and resuming the line Antonov-124 "Ruslan" remain extremely unclear.

Metallurgy. Specific "unilateral" method of Russian expansion may be illustrated by examples of the metallurgical giant "Zaporizhstal" (in the East-Ukrainian city of Zaporizhya) and Illich Mariupol-based Metallurgical Company.

"Zaporizhstal" was finally sold in late May 2010, and the transaction was marked with a rough conflict between the old owners of the enterprise and a SCM (System Capital Management) owner, the richest citizen of Ukraine Rinat Akhmetov (Donetsk, Eastern Ukraine).

Midland Resources Holding Ltd registered in British island Guernsey offshore area has been known to operate as a major shareholder of "Zaporizhstal". Eduard Shyfrin, born in Dnipropetrovsk, Alex Shnider, Canadian citizen, and their partners acted as ultimate owners of the enterprise. They declared intention to sell "Zaporizhstal" in 2010. Rinat Akhmetov did not conceal his interest in this facility. To acquire the association, he created a consortium with a Southern Korea's corporation Posco.

Akhmetov's group enterprises reportedly concluded a purchase and sale contract for "Zaporizhstal". The association owners received $50 million in advance. However, due to later unclear reasons, "Zaporizhstal" owners wanted to pay back the advance of $50 million and terminate the contract with payment of another $50 million of fine.

As it turned out, a Russian purchaser offered a price that allowed "Zaporizhstal" shareholders to acquire still better bargain – even with penalties to be repaid to Akhmetov. The final price of "Zaporizhstal" reached $1.7 billion.

It was an amount for which a contract was concluded with businesses related to the Russian state-owned "Vneshekonombank". As it is known, the head of the Russian Government Volodymyr Putin is in charge of the supervisory board of this bank.

Almost at the same time, in late May, 2010, Russian companies made another attempt to gain control over second largest Ukrainian producer Mariupol-based Metallurgical Association “Illich” Metal factory. Borys Podolsky, representative of a Cypriot company “Formigos Holdings LTD”, told at the press conference that the Russian financial and industrial group (name was not disclosed) purchased 100% of “Illich-Stal” that holds about 90% of shares in the Mariupol-based “Illich” Metallurgical Association.

The roots of this bargain remained unclear. Some sources accused director and owner of the “Illich-Stal” control package Volodymyr Boyko of a deliberate sale of the share package (already in 2009) and later performing a “smoke screen” to hide a deal. Another version attached the key role to certain unnamed top managers who signed the contract without Boyko’s awareness. The latter stated in late June: “We are dealing with a raider attack on behalf of Russian companies. We have taken a whole range of steps to solve the problem. As all government authorities got involved into the matter, I have no doubt that the issue will be solved”. Shortly after that the mass media announced that “Illich-Stal” was negotiating on merger with Akhmetov’s (75%) and Novinsky (25%), “Metinvest Holding” to protect itself against the Russian corporate attack.

This situation illustrates the essence of the matter encountered by the largest Ukrainian metallurgical giants during the “honeymoon” of the new Ukrainian authorities with Russian government. According to some media, it has been these very actions of the Russian party, evidently non-coordinated with Kyiv, that have initiated the end to the “honeymoon” and the beginning of a cooler phase in all trends of the negotiations.

Banking. In 2010 Sberbank Rossii already having its subsidiary in Ukraine, declared its intention to buy one of the first top ten Ukrainian banks. Raiffeisen Bank Aval listed among the top three banks of Ukraine was named as one of the most likely goals. On June 7-th, 2010, the media promulgated announcements on investigation of Raiffeisen Bank Aval’s financial situation by the Ukrainian Subsidiary of Sbierbank within the framework of studying a possibility of the bank’s full repurchase from “Raiffeisen” group.

Andriy Gerus, director of the consulting department of the investment company “Concord Capital”, estimates that the contract value may constitute over 2 billion USD, or 16 billion UAH (UAH 0.55 for one share) based on the fact that the bank value may come up to as much as two balance capitals (7).

Russian bankers expected that due to general restructurisation processes, Swiss owners would be ready to sell their asset at an acceptable price. Although the afore-said acquisition did not take place in October, 2010, entirely state-owned Sberbank Rossii has not abandoned its intentions.

Specifics of the Russian banking expansion are clearly understood not only by political analysts but by bankers as well. Yaroslav Kolesnyk, "Forum" Board of Directors' Head, made the following statement on the subject: "Russian banks are actively penetrating Ukraine. They are willing and planning to influence this market. Their movements reflect a well-thought and thoroughly elaborated national policy of our neighbor (i.e. Russia), which cannot be the case of other (foreign) banks actions that are probing the market or fixing themselves on a given market area rather than pursuing a national strategy" (8).

Analysis of the above-described cases proves the fact of significantly growing appetites of the Russian actors aiming at absorbing Ukrainian assets following the 2010 presidential election that brought to power a part of the Ukrainian political forces sensitive to Moscow needs. The Russian businesses continued expansion on the Ukrainian business area on several parallel tracks. Nevertheless, even under such favourable political and market conditions, by no means all Russian proposals find full-fledged satisfaction as Ukrainian counterparts understand and defend their own business interests.

Conclusions

Big business interconnections continue to play a crucial role in Ukraine-Russia practical agenda.

Political and business elites in Ukraine and Russia do not consider their specific combination of "power-money" merge as the pattern of conflict of interests; therefore have no serious intention to change it substantially.

Gas business (extract, delivery and transit) remains the most essential business nexus between Russia and Ukraine, however its role gradually downgrades due to North Stream (and possibly South Stream) construction.

Current (Autumn 2011) debates over re-arranging of the bilateral gas deal bring no news in terms of substance: the new arrangement, when it appears, may lead to lower price of gas for Ukraine (and cheaper transit for Russia) but will unlikely create more transparent atmosphere and clear regulations for the entire business.

Russian big business is likely to continue its bid for wider presence and control in the different segments of Ukrainian economy. However this bid will be obviously restricted by the protectionist policies pushed by Ukrainian stakeholders who are rather interested to keep their businesses then to sell them to richer Russian business groups.

The overall picture remain ambivalent: on one hand, strong presence in power allow Ukrainian big business actors to pursue protectionist policy defending their businesses from assertive Russian expansion, therefore keeping Ukrainian economy and politics rather independent from Moscow; on the other hand, due to the merge of business and politics Ukraine is unable to combat corruption, ensure rule of law and good governance as well as attract sufficient and diversified foreign investments.