# Doing Business with Russia

*Jonathan Reuvid*
*Marat Terterov,*
*Editors*

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*Consultant Editors:*

*Jonathan Reuvid*
*Marat Terterov*

**Publishers' note**

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# Russian Expo in London: Business-to-Business Relations Consolidating

*Simon Joseph, Director, Russian Economic Forum*

Since its original incarnation in 1998 as "Russia Expo", the Russian Economic Forum has grown rapidly to become the premier international business-to-business event dedicated to exploring Russia's ongoing political realignment with the West and its integration into the global economy. Each spring, the Forum brings hundreds of political leaders, captains of industry, journalists and other opinion formers to London from all around the world. The 6th Annual Russian Economic Forum is being held from 2-4 April 2003.

Organising an event such as this helps to give you an interesting perspective on changes in Russia. In the course of the last 5 years, we have watched old difficulties disappear and new ones materialise. We have watched Russia recover its international reputation as it honours its debt obligations, and important structural reforms like the new tax code begin to take hold, whilst unexpected dangers like the threat to freedom of the press have emerged. We have examined the impact of a variety of historical events, including the war in Chechnya, a change in Presidency and a crippling economic crisis.

We have watched Russia's image soar, and plummet, only to soar again. We have seen the vanguard in a new generation of policy makers and entrepreneurs take the stage, the personalities on whom Russia's future prosperity so sorely depends, the youngest group of people to be running the country in its thousand-year history. Each year has brought fresh faces and new stories, as Russia continues its painful evolution into a modern market-based democracy.

It has been fascinating to gauge the prevailing mood among business people both inside and outside the country. Invariably with Russia, outsiders tend to exaggerate the good and the bad. When the economy is doing well, we often become too bullish, and keen to ignore any problems, whether they be social, political or economic. Conversely, when times are tough, there is a tendency to turn our backs and give up on Russia, as if all our worst suspicions had finally been confirmed.

The truth lies somewhere in between, and one of the secrets to finding it is to communicate with as broad a range of people as possible. In putting together the programme each year, we are always reminded of what a crucial difference individuals can make. As always, the success of your business, whether large or small, will ultimately depend very much on whom you choose as your partners and clients – perhaps more so than almost any country in the world.

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# Foreword

This is the third edition of *Doing Business with Russia* with which the Russo-British Chamber of Commerce has been associated. The first was written following the heady days after the breakdown of the Soviet Union. The second attempted to map out the realities after the 1998 devaluation crisis had subsided. This edition sees Russia in yet another new phase. With several years of solid economic growth, a political climate of strong leadership and, despite differences, a better working relationship between the executive and the Duma, the tone today is one of relative normality for business, though still a challenging and constantly developing environment.

With nearly 150 million well-educated and creative people, Russia is gradually resuming its proper place in the world. It represents huge potential as a consumer, a source of energy and raw materials, and ultimately for profitable domestic and inward investment. This book is designed to update the ground rules for existing players in the Russian market and provide an introduction to the current realities for newcomers. Its contributors, as practitioners, provide realistic and pragmatic advice to both categories of reader.

The Russo-British Chamber of Commerce's history in Russia goes back to 1916 and has seen us survive World Wars, 'Cold War', revolutions and other minor upheavals. We know more than anyone that Russia is a place where a long-term perspective is important and we strive to give practical help to companies, large and small, who understand this and wish to engage with the Russian market. This book will be a valuable additional help in that process and I congratulate those who have had a part in its preparation.

*Sir Norman Wooding CBE*
*President, The Russo-British Chamber of Commerce*

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# Foreword

In the few short years since Vladimir Putin became the second consecutive freely elected President of the Russian Federation in May 2000, Russia has achieved political stability, steady economic growth and substantial structural reform. Relations with the US have improved significantly as the governments of both countries perceive a mutual interest in combating international terrorism and in strengthening ties in such vital economic sectors as energy, forestry, healthcare and information technology. The performances of many American and international companies operating in the Russian marketplace have been consistently strong; annual sales and profit margins continue to grow in a context of increasing consumer spending power and opportunities for export. The Russian operations of a number of blue chip US and global firms outperformed all other units within their respective corporations worldwide in 2001 and 2002. Prospects for continued growth in 2003 are strong.

A core reason for Russia's strong economic performance, particularly notable in light of the prolonged economic downturn in the US and most of the world during the same period, is the remarkable turnaround of Russia's oil companies. Privatized and restructured to streamline operations and improve profitability, Russian oil companies are currently accounting for upwards of 20 per cent of gross domestic product (GDP), primarily through the domestic sale of oil products and the export of crude oil. This figure does not include the huge multiplier effect on GDP of the oil industry which accounts for a significant volume of purchase orders for steel, electricity, telecom, supplies, labour and other sector inputs. While concentration in one sector of such a large share of national wealth suggests the need to develop a more diversified economy, particularly in the domestic manufacturing and financial services sectors, Russian oil companies have been able to exploit to Russia's advantage the substantial rise in oil prices over this period.

A second core reason for Russia's success lies in its disciplined fiscal policy. The government has kept a tight lid on spending and debt levels. As of January 2003 Russia's projected budget surplus for 2002 was 0.7 per cent of GDP; the 2003 budget surplus target is 0.6 per cent of GDP. Taking advantage of the significant tax revenues from oil and gas exports Russia prepaid in late 2001 a not insignificant portion of the external debt inherited from the Yeltsin years, thereby reducing repayments scheduled for 2003 from $19 billion to $17 billion. Moreover the Central Bank's foreign currency reserves have been consistently at or near an all time high of $48 billion as of this writing.

A primary challenge for Russia in 2003 is to reduce administrative barriers to normal business practices. Bureaucratic delay, inconsistent and arbitrary application of regulations and unnecessary rules and procedures burden many sectors of the economy. The American Chamber of Commerce in Russia is working with the Russian government to identify, prioritize and reduce major hindrances to business, submitting in January 2003 to the Prime Minister's office concrete and radical proposals to reduce corruption, facilitate small business growth and improve legal protection of intellectual property rights. The Chamber is also a lead organization of the Russian American Business Dialogue, a process initiated by Presidents Bush and Putin for the private sector to recommend solutions to specific administrative and policy barriers. The Dialogue delivered its first written report to both presidents during the May 2002 Summit in Moscow. Also reflective of the new relationship between the countries is the US-Russia Commercial Energy Dialogue, inaugurated in Moscow in December 2002 with the participation of all the major US and Russian energy companies and co-chaired by the American Chamber of Commerce in Russia and the Russia Union of Industrialists and Entrepreneurs, Russia's largest and most effective private sector business organization. The purpose of the Dialogue is to stimulate closer commercial energy ties between the private sectors of both countries.

Despite remarkable progress in the Putin years, Russia faces major challenges in the years ahead. In this volume you will encounter diversified perspectives on Russia's successes and future direction from business leaders working in the Russian marketplace. We hope that their contributions will serve to stimulate your continuing interest in the enormous opportunities available to American and multinational firms in Russia.

*Andrew B Somers*
*President*
*American Chamber of Commerce in Russia*

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# List of Contributors

**Allen & Overy** is a premier international law firm and was founded in 1930. With over 4,700 staff, including some 420 partners, working in 26 major centres worldwide, they are able to provide effective, co-ordinated and decisive legal advice across three continents. Their clients include some of the world's leading businesses, financial institutions, governments and private individuals. Their aim is to understand business objectives and to be considered a critical arm of any organization they become involved with.

**Eric Zuy, Senior Associate, Allen & Overy Legal Services, Moscow**, has advised major Western banks, financial consortiums and companies on different types of banking transactions, project finance, different financial arrangements with respect to insolvency and securities regulations. Eric's experience also includes advising on various types of secured lending, trade and export finance, financial and commercial transactions. He has broad experience of restructurings and insolvency procedures relating to banks and corporates. Prior to joining Allen & Overy, Eric was heavily involved in legal arrangements of foreign investments in the Russian Federation, transactions involving exchange control regulations, finance, corporate and insolvency matters.

**AmCham Russia** is an impact player in the policymaking arenas of both the US and Russian governments. They have direct and ongoing communication with decision-makers in the State Duma and Congress, ministries and cabinets, and presidential administrations of both countries. The Chamber also benefits from the strong support of the US Ambassador to Russia. With chapters in Moscow and St Petersburg and a representative office in Washington, DC, the Chamber regularly advocates members' interests to Russian and US government officials and provides a forum for dialogue between the American business community and local governments. Their member firms are engaged in the Russian marketplace, penetrating and expanding market segments, and investing in Russia for the long term. Over the course of its eight-year existence, the American Chamber of Commerce in Russia has evolved into the largest and most influential foreign business organization in Russia (www.amcham.ru).

**Andrew B Somers** has been President of the American Chamber of Commerce in Russia since December 2000. He is the American co-chair of the U.S.-Russia Commercial Energy Dialogue and a leader of the Russian-American Business Dialogue. He was Executive Vice President and General Counsel of American Express TRS Company in New York and headed his own consulting firm specializing in real estate and financial transactions in the Russian regions. His wife Marina is a partner in Somers & Cavelier, a Moscow-based executive search firm.

**Aton Capital Group** is a leading Russian investment company offering a full range of services in the securities market, including brokerage services and stock trading, asset management, corporate finance, direct investments, and market research. Aton has its own Internet-based trading system Aton-Line. The managing company Aton Management offers services in asset management of unit investment funds, nongovernmental pension funds, and insurance companies. The company has an excellent business reputation and stable client base in all segments of the stock market. The main counterparties of Aton in Russia and abroad are the largest market players. Aton Capital Group incorporates Aton Securities, Inc. (New York), which holds the license of National Association of Securities Dealers of the U.S.A. (NASD) and operates in the US stock market. Aton maintains conservative policy in risk management. It uses its internally designed methodology to manage credit, market, and liquidity risks. Aton's fundamental financials (capital sufficiency, profitability, and liquidity) are in perfect shape. In financing its operations, Aton Capital Group does not depend on external sources. The Aton Capital Group financial statements are made according to Russian and international standards and available. As of January 1, 2002 the Aton Capital Group equity capital was $67.7mn, assets $130.4mn, and 2001 annual turnover was $4,870mn. Since 1994, PricewaterhouseCoopers has been the auditor of ACG.

**BISNIS** is the US Government's primary market information center for US companies exploring business opportunities in Russia and other Newly Independent States. BISNIS provides US companies with the latest market reports and tips on developments, export and investment leads, and strategies for doing business in the NIS. Since opening in 1992, BISNIS has facilitated more than $3.2 billion worth of U.S. exports and overseas investments. BISNIS has 18 offices in Eurasia and is based at the Dept of Commerce in Washington. **Azim Mamanov** is **BISNIS** Representative for Siberia, located in Novosibirsk, Russia.

The Commercial Section of the **British Consulate Ekaterinburg** was established by the Foreign & Commonwealth Office to promote successful trade relations and investment links between the UK and the Urals region of Russia. It works in close co-operation with the British Trade International to support British trade in the region.

**Cargill in Russia** opened a representative office in Moscow in 1991, although a prior trading relationship dates back some 30 years. In 1993 Cargill opened a wholly-owned Russian subsidiary, Cargill AO, in Moscow with a branch in Krasnadar, now incorporated as Cargill Yug. In 1995 Cargill acquired a majority shareholding in the Efremov wet milling plant, 380km southeast of Moscow. Today Cargill employs more than 1000 people in Russia as a whole. In 2002 new offices were opened in Voronezh (malting, barley, trading) and Kaliningrad (production of cocoa coatings). The Cargill office in Krasnadar, Cargill Yug, is set up to serve farmers in the Russian agricultural belt. The Grain and Oilseed Supply Chain Eastern Europe business unit is active in the region and Cargill holds the majority of shares in a grain elevator at Bryukhavetskiy, in Southern Russia. The company's Russian exports include petroleum products via Petroleum to Western Europe; ferrous products via Cargill Ferrous International to Asia and the US; wheat, sunflower seeds and barley to Europe and the Middle East via Grain and Oilseed Supply Chain Eastern Europe business unit. It imports frozen concentrate orange juice from the Netherlands, via the Orange Juice business unit, bottled vegetable oil from the Netherlands, Belgium and France (AOP), sugar (Sugar), cocoa and cocoa products via the Cocoa business unit, grains via the Grain and Oilseed Supply Chain Eastern Europe business unit, and further processed chicken products via Sun Valley Europe. **Dominique Le Doeuil** joined Cargill in late 1992 at their European Head Office in Cobham and spent a little over 2 years in their Internal Audit Department. He moved to Moscow in December 1998 to become the controller for Cargill's Russian operations. In early 2001, he took on new responsibilities, combining the general management of Cargill's main local investment, the GPK Efremov Corn Mill, and the head of the company's representation in Russia, supervising activities in the Cargill offices of Moscow, Krasnodar, Voronezh, Efremov and Kaliningrad.

**Clyde & Co** is a major commercial law firm with particular experience in international trade and finance, carriage of goods, energy, company and commercial matters, insurance law and commercial litigation. The firm has ten offices around the world, including an associate office in St Petersburg. They advise clients on all aspects of their business transactions in Russia, from setting up local representations or relationships with local companies to resolving disputes if things go wrong. **Trevor Barton** is a partner in Clyde & Co's International Trade, Energy and Finance Group. He specialises in shipping finance and trade related work, and his particular geographical interest is Russia and the former Soviet Union. He worked for six years in St.Petersburg as head of Clyde & Co's representation in Russia. He was also Honorary Legal Adviser to the British Consul-General and, since returning to the UK, has spent fifteen months on secondment to Trade Partners UK as the British Government's Export Promoter for Russia. Before becoming a lawyer he was an officer in the Royal Navy Submarine Service and he maintains a keen interest in a wide range of shipping-related issues.

**CMS Cameron McKenna** is a leading international law firm and a market leader. The firm has been recognized in several prestigious awards including most recently British Consultant of the Year – British Consultants Bureau in 2000 – for work on a water treatment project in Sofia, and the same award in 1999 for work on an airport project in Africa. CMS Cameron McKenna has practices in Central and Eastern Europe with offices in Moscow, Warsaw, Budapest, Prague and Bucharest and affiliated offices in Belgrade and Bratislava. CMS is a transnational legal services organization with member firms in the UK, Germany, France, Austria, Belgium, the Netherlands and Switzerland, and with 44 offices in 19 different countries.

**Control Risks Group** is the leading, specialist, international business risk consultancy. Control Risks Group Moscow was established in early 1994, and offers a full range of consultancy services on the risks associated with doing business in the former Soviet Union. Our dedicated multi-disciplinary team provides a full range of risk identification and mitigation services to our clients. The Russia team has a particularly strong analytical background and specialises in Sector and Market Analysis, Political and Security Risks Analysis, Business Due Diligence, Security Consulting, Information Security, and Crisis Management and Response. **Kate Mallinson,** Russia Analyst, works in Control Risks' political risk analysis team, providing risk assessments and scenario planning to major corporations around the world. She joined Control Risks Group in May 2001 as a political and security risk analyst for Russia. She has worked on various risk assessments including major pre-investment studies for large corporations, analysis of Russian regional politics and scenario planning exercises. She also writes regular analysis for Control Risks' online analysis of security and political risk issues, focusing on Russia. She has worked as a freelance journalist for several publications, including *The Economist* commenting on politics and economic affairs, in the Former Soviet Union. She speaks fluent Russian and basic Farsi. **Steve Lidstone** joined Control Risks in October 2000 as Moscow Representative. Steve has substantial experience as a security manager and of living and working in Russia. Prior to joining Control Risks he served as Security Manager of the Caspian Pipeline Consortium currently constructing the oil pipeline from the Caspian Sea through Russia's troubled southern regions. He also has worked as an investigative analyst in a Moscow-based consultancy firm. Steve served a full career in the British Army Intelligence Corps, specialising in analysis, the Russian language and the former Soviet Army, and has run his own business. He is fluent in Russian.

**Deloitte & Touche CIS** is part of Deloitte Touche Tohmatsu, one of the world's Big Five leading auditing and consulting organizations. More than 92,000 people in over 130 countries serve nearly one-fifth of the world's largest companies as well as large national enterprises, public institutions and successful fast-growing companies. Its internationally experienced professionals deliver seamless, consistent services wherever its clients operate. Deloitte & Touche CIS started its operations in the region in 1988 and opened its first office in Moscow in 1990. It has over 200 local and expatriate professionals working full-time in its offices in CIS countries: in Moscow, St Petersburg, Kyiv, Almaty and Tbilisi. Its local and expatriate professionals work together to provide the right balance of skills. In addition, the CIS firm is able to mobilize specialist support from regional technical centres, as well as DTT member firms internationally. During the decade of its operations in Russia and CIS, Deloitte & Touche has delivered successful projects for banks and other financial institutions, state enterprises, energy producers, extractive, metals and manufacturing plants, fast moving consumer goods and food companies, telecommunications, mass media, retail businesses, hotels, high tech and e-businesses. Deloitte & Touche CIS provide a full range of professional services to both multinational corporations and growth-oriented local firms including assurance and advisory services, management solutions, e-business consultancy and tax and legal advice.

**Dr Maria G Vlasova** has over ten years of experience in business management and communications providing consulting services for top management of multinational companies and U.S. and Russian government agencies. As co-chair of the Healthcare Committee of the American Chamber of Commerce in Russia, she promotes the Committee's objectives of creating better cooperation opportunities and reducing barriers for business and trade through the establishment of the US-Russia Interagency Coordination Council on Reducing Technical Barriers in the Healthcare Sector. During her seven years with Burson-Marsteller, a world's leading public relations consultancy, she was based in Moscow and in the firm's European headquarters in London and advised clients across the entire spectrum of communications disciplines. Dr. Vlasova was a research fellow at Harvard University and is author of publications on international trade, transitional economics, business values and negotiations.

The **International Finance Corporation** (IFC) is a member of the World Bank group and is the world's largest multilateral investor in emerging markets. Since its founding in 1956 through the close of the last fiscal year on June 30, 2002, IFC committed more than $34 billion of its own funds and arranged $21 billion in syndications for 2,825 companies in 140 developing countries. IFC's committed portfolio at the end of FY02 was $15.1 billion for our own account and $6.5 billion held for participants in loan syndications. IFC finances private sector investments in emerging markets, mobilizes capital in the international financial markets, and provides technical assistance and advice to governments and businesses.

IFC made 20 investments totaling $315 million (including syndicated funds) in Russia in 2001. The total project cost of these projects is $741 million. They are spread across many sectors, including leasing, banking, telecommunications, information technology, agribusiness, retail trade, glass production, furniture manufacture, and tile production (see the project list below). Increasing IFC activity reflects the improving investment climate in Russia, greater opportunities in an increasingly broad range of sectors, and a stronger foreign investor interest. Russia currently comprises 2.4 per cent of IFC's global portfolio, and we expect this to increase substantially in the coming years. IFC's advisory projects (currently 15 in Russia) work directly with businesses and government to support the private sector and facilitate investment.

The combination of investment and advisory work has proven to be an effective way for IFC and its investment partners to do business in Russia. Some projects work to improve local companies' capacity to work with large foreign investors, who need reliable and appropriate quality local inputs and services to ensure the success of their operations in Russia. IFC is implementing supply-chain projects in agribusiness, forestry, automotive component production (with Ford Motor Company), mining, and furniture manufacturing (IKEA). Other advisory projects aim to strengthen local banks and leasing companies through advisory work while also providing them with finance. Finally, recently initiated corporate governance work with companies in several regions (St. Petersburg, Samara, Rostov, and Ekaterinburg) will allow IFC to provide investors in these regions with information and contacts of companies with improved corporate governance practices.

**Internet Securities Inc. Emerging Markets Information Service** (ISI) is a Euromoney Institutional Investor company, serves emerging markets specialists at financial institutions and multinational corporations in the United States, Europe, and emerging markets. ISI provides hard-to-get information through its network of 19 offices covering 46 national markets. It aggregates and uploads to www.securities.com a unique content including full-text news articles, financial statements, industry analyses, equity quotes, macroeconomic statistics, and market-specific information. It is derived directly from over 5700 leading sources, local and global, and appears in both English and the local language. **Sergey Korol,** PhD, is a Product manager with responsibilities for Russia and CIS information product covering 10 national markets. His email is as follows: skorol@securities.com.ru

**Jacqueline Coolidge** is the Program Manager for Europe in the Foreign Investment Advisory Service (FIAS), a joint facility of the International Finance Corporation and the World Bank. She has been working in the Russian Federation for the past three years with the Ministry of Anti-Monopoly Policy and Support for Entrepreneurship and several Oblast administrations on removal of administrative barriers to investment. Ms. Coolidge has worked extensively for FIAS in Central and Eastern Europe on improving the environment for foreign direct investment, including investment legislation, tax policy and regulatory reform. FIAS' mandate is to provide advice to governments that want to attract more foreign direct investment. It has worked in over 120 countries over the past 18 years.

**Jones Lang LaSalle** is one of the largest real estate investment and advisory service firms in the world, with 100 offices in 34 countries. Dedicated solely to real estate services, the firm's publicly held international practice shares a centralised code of conduct and ethical standards, with a commitment to client service. Jones Lang LaSalle is a truly international organisation, structured as a single firm operating through strong cohesive regional partnerships, unmatched especially in Moscow with any other leading real estate firms. More than a series of offices or brokerage alliances, the firm is structured to facilitate a continual flow of information regarding international market conditions and sources of capital. As business practices continue to expand into global markets, Jones Lang LaSalle has the advantage of having an established infrastructure with a high degree of penetration in worldwide markets.

Below is presented a brief list of our scope of services provided by the Moscow office:

- Investment Property Sales
- Investment Finance
- Corporate Advisory Services
- Real Estate Consulting
- Valuation and Research
- Asset Management
- Development Consulting
- Leasing Services
- Tenant Representation Services

In Moscow and the CIS Jones Lang LaSalle advised such clients as Aeroflot, AT&T, BNP, Benetton, Deutsche Bank / Deutsche Morgan Grenfell, EBRD, GasProm, OPIC, Stockman, TATI, The World Bank, U.S. State Department, Yves Rocher, shopping centres Smolensky Passage, Ramstore II & III, Atrium, IKEA MEGA, etc.

**The Merchant International Group Limited** (MIG), is an international security and intelligence-gathering group, working across 140 countries. MIG undertakes bespoke project work globally and serves many major international corporate clients. The primary mission of MIG is to identify, quantify and manage the risks associated with overseas investments. MIG looks at the world differently and thereby provides its clients with intelligence and insight expanding the options available to them.

**Pepeliaev, Goltsblat & Partners**, one of the leading full-service Russian law firms, offers a wide spectrum of legal services with particular emphasis on providing tax, legal and IP advice and representing clients in courts of all levels. The clientele of the firm ranges from major Russian companies to well-known multinational corporations from a wide range of industries, including FMCG manufacturers, key players in the automotive, oil and gas industries, energy and natural resources, transport, food and agriculture, utilities, telecommunications, engineering, printing industry, real estate, construction, financial services, service sector, advertising and many other sectors. The clients list includes such companies as Mars, PepsiCo, Harry's/Dan Cake, Frito Lay, McCain Foods, Danone/Bolshevik, METRO Cash & Carry, Motorola, Oriflame, Hewlett Packard, Messe Duesseldorf GmbH, Independent Media, GAZPROM, TRANSNEFT, Russky Aluminiy (Russian Aluminium), ING Bank, Citibank, Westdeutsche Landesbank Vostok and Caterpillar. One of the basic principles of Pepeliaev, Goltsblat & Partners is to bundle services in package focusing on the individual needs of a particular client. Tax, legal and IP services have always been the company's core practice, which is not, however, limited to these particular spheres. Pepeliaev, Goltsblat & Partners lawyers have sufficient experience in providing legal assistance in the areas of corporate law, commercial contracts, labour law, currency transactions, securities, information technologies and communications, natural resources and environment, customs law, antimonopoly legislation, consumer law, advertising legislation, international private law. Pepeliaev, Goltsblat & Partners deals with the most acute issues facing business entities in today's Russia. That is why land and land-related matters form quite a significant part of the firm's practice. Being one of the first in Russia to perform land transactions, including for major foreign investors, *Pepeliaev, Goltsblat &*

*Partners* lawyers now possess expertise-proven practical techniques based on a deep understanding of all the nuances of legal realities in Russia.

**Raiffeisen Bank Austria (Moscow)** is a leader in Russia's financial services market, providing a broad range of commercial, retail, foreign exchange, investment banking and brokerage services to both resident and non-resident corporate and private clients. RBA (Moscow) has been operating in Russia since 1996. A wholly-owned subsidiary of the Raiffeisen Banking Group, it is the first Russian bank with 100 per cent Austrian capital to have been granted a General Licence by the Central Bank of the Russian Federation.

**RMBC** is a part of the Remedium group of companies and is the leader in the field of marketing researches on the Russian pharmaceutical market. The company's key activities are implementation of the full scope of market researches, provision of statistical data on retail sales, hospital purchases and import/export of pharmaceuticals in Russia and information and analytical support of the magazines *Remedium, Rossiyskie Apteki* as well as the medical and pharmaceutical web portal *Remedium.ru*.

**Standard & Poors** was created in 1941 when a merger of Standard Statistics and Poor's Publishing Company took place. It is possible to trace its roots to 1860 when Henry Varnum Poor published his *History of Railroads and Canals of the United States*. Mr Poor was a leader in establishing the financial information industry on the principle of 'the investor's right to know.' Today, more than 140 years later, Standard & Poors is the pre-eminent global provider of independent highly valued investment data, valuation, analysis and opinions and is still delivering on that original mission.

**Tourism Marketing & Intelligence** (TMI) is an integrated marketing company providing market research, marketing strategy & support and PR in the Russian market. The company is active in a number of sectors but specializes in providing services for the travel industry and works with national tourism boards, luxury hotels, airlines and reservation systems. The company opened a representative office in Moscow in 1999.

**Trade Partners UK** is part of British Trade International, the government body with lead responsibility for fostering business competitiveness by helping UK firms secure overseas sales and investments, and for attracting high quality foreign direct investment to the UK. Trade Partners UK offers independent, impartial advice and support to existing exporters and those new to international trade. We work closely with the private sector enabling us to provide essential advice on the most effective means of developing British trade and investment in overseas markets. Our services are available throughout the UK. Trade Partners UK Russia, Ukraine and Belarus Unit is available for consultation on trade and investment matters for British companies interested in more information about doing business with this region.

**United Financial Group** is Russia's leading independent investment bank, providing quality client-driven services based on sound research, sharp analysis and the best mix of Russian and western expertise. UFG offers a broad range of services, including sales and trading, execution of capital market and private equity transactions, advice on mergers and acquisitions, structured products, in-depth research and asset management. UFG was founded in 1994 as a Russian bank independent from any domestic or international financial groups. UFG has consistently been ranked among the top three research houses for coverage in Russia.

**Ilan Rubin** is Research Department editor and insurance analyst for **UFG**. He joined UFG in May 2001, having graduated from Trinity College, Cambridge University, in 1995. He is currently completing a distance-learning MBA at Warwick University Business School.

**Vniki Institute** is an all-Russian market research institute that executes a wide range of professional research and analytical studies and information services to provide with business in Russia and abroad, and offers the following:

- Russian and foreign commodity markets researches;
- working out the programme and conceptual-analytical documents on foreign trade activities and foreign experience application; industry branches, industrial areas, enterprises and companies development strategy;
- execution of feasibility studies for investment projects and business – plans;
- provision of statistical and analytical information on any problems related to business activity in Russia and abroad according to particular requirements of the clients;
- provision of operative information on foreign trade prices on raw materials, pulp and paper, agricultural and industrial goods with respect to export and import deliveries for Russia and foreign countries;
- provision of information on Russian and foreign companies – producers, importers and exporters of different products;

- subscription on electronic versions of *The Bulletin of Foreign Commercial Information* (in Russian), Quarterly Review *Russia: Foreign Economic Relations, Trends and Prospects* (in English);
- some recently fulfilled VNIKI market research studies concerning Russian and foreign commodity markets are available by electronic subscription.

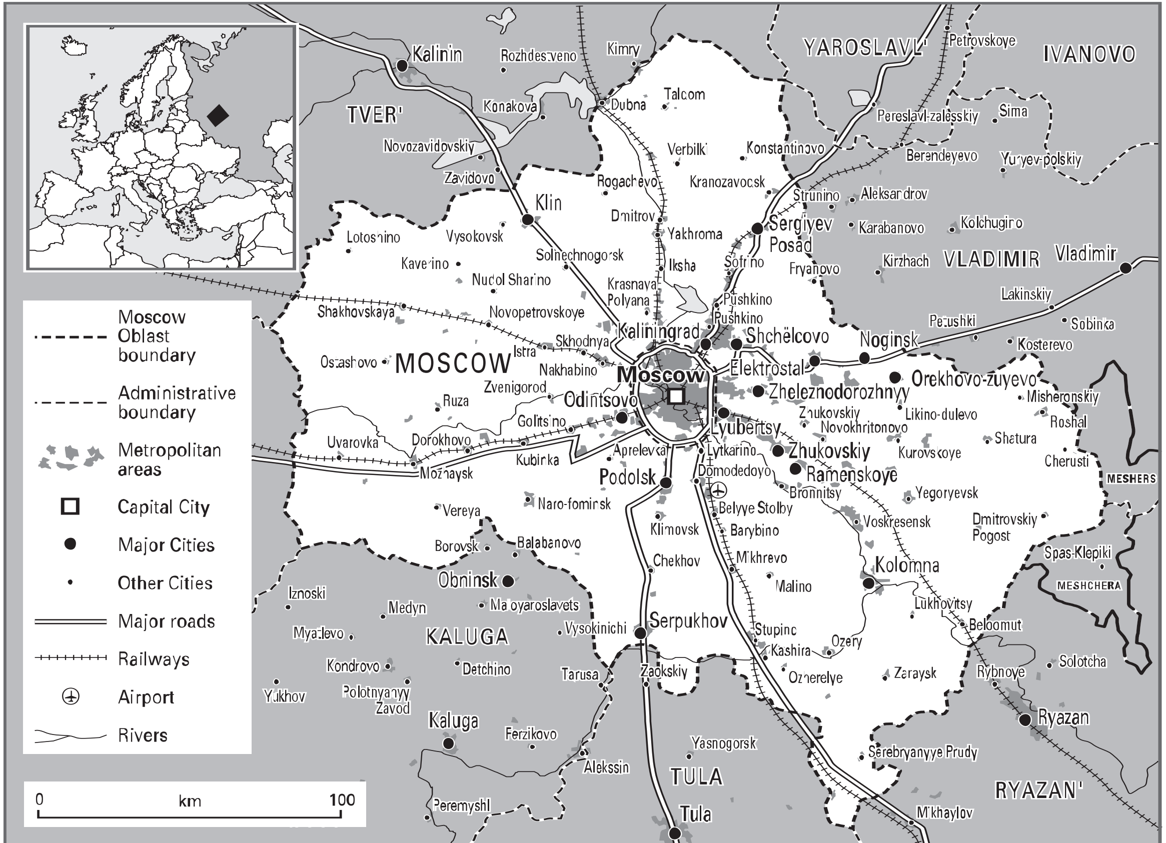
**Victoria Lavrentieva** graduated from the international department of the State Finance Academy under the Government of Russian Federation in 1999. During 1997–1998 she was a mutual funds analyst with Skate financial information agency. In 1998 she joined the local new agency Interfax as a business reporter, covering international financial organizations, including the World Bank, the IMF, the EBRD and the IFC, foreign banks and investment funds. Since October 2001 she has been a staff writer with The Moscow Times business section.

**William Flemming** has been based in Moscow for the past four years, providing analysis of the Russian political scene in a variety of capacities. Prior to moving to Moscow, he was a graduate student of Oxford University doing research on Russian politics. He is currently opinion page editor of The Moscow Times.

**Dr Marat Terterov** is an Australian national resident in Oxford, England, though he is originally from Odessa, Ukraine. He is consultant editor on a number of other publications within the Global Market Briefings series, including Doing Business with Ukraine, Kazakhstan, Georgia, Egypt and Libya. He holds a PhD in politics at Oxford University and is author of a number of academic articles on the Middle East and former Soviet Union. He is a frequent speaker at the Centre for International Briefings, Farnham Castle, near London, and a consultant to US government funded development projects.


**Map 1:** Russia and its Neighbours


**Map 2:** Russia and its Regions




**Map 3:** Moscow and its Boundaries

# Introduction

Russia, a massive heartland stretching across 11 time zones from the Baltic Sea to the Pacific Ocean, is a market that is finally starting to attract positive appraisals internationally. It is evident that during most of the 1990s, the Russian economy performed poorly and Russia's wholesale image abroad was rather negative. The established foreign view of Russian economic and business highlights during the past decade was in fact one of 'low-lights', where production fell drastically in many vital sectors of the economy, foreign and domestic investment has been outstripped by capital outflow, and monetary instability and financial crises have seemed pervasive. Furthermore, the official disbandment of the Soviet Union's institutions and the lack of resources channeled into government agencies has undermined the state's ability to maintain an adequate, secure business environment as is required by foreign and private domestic capital. With the exception of a small number of well-connected, privileged financial-industrial groups that have performed exceptionally well in Russia since the collapse of communism, few private business ventures have been able to assert themselves convincingly amidst the country's economic downturn of the 1990s.

However, perceptions of Russia as a potentially attractive emerging market began to change for the better not long after what seemed to be the decade's ultimate 'low-light', the financial crash of August 1998 and the subsequent devaluation of the Russian currency, the rouble. It is now well established among Russian government sources that the 1998 default was part of the state's explicit economic strategy to stimulate domestic manufacturing in order to make local production more affordable to Russian consumers. Imports were previously dominant in the country's consumer market during the early-to-mid 1990s. While it is debatable whether this was the main objective of Russian policy makers, the Russian economy has been growing since the August 1998 financial crisis, reaching an annual high of 8.3 per cent in 2000. Average annual growth during 2001–2002 was around 4.6 per cent, and, amid the post September 11 downturn in the US, these figures have been well received by many foreign critics.

The West's positive appraisals of Russia's domestic economy and business environment seemingly peaked in mid-2002 when the government of the United States proclaimed Russia to have reached the status of a market economy. The American government decision was based on a ruling from the US Department of Commerce, which carried out an extensive review process and proclaimed that the Russian economy had transformed from its socialist past and was substantially driven by market forces. Also in the summer of 2002, the reputable international credit ratings agency, Standard & Poors, upgraded Russia's rating from B+ to BB- (a rating which Russia last held prior to the August 98 financial crisis), assigning a stable investment outlook and justifying its claim on the basis of continuing economic reforms and improved budgetary discipline. Furthermore, the Russian government and a number of private industry lobby groups have been actively staging numerous international business conferences in Europe and North America promoting Russia as a destination for foreign investors.

Much of Russia's recent economic recovery and enhanced political stability is associated with the dynamic elevation from relative public obscurity of Vladimir Putin to the presidency of the Russian Federation on 1 January 2000. Most foreign observers of Russia during the 1990s will recall the cumbersome – almost comical – position of the once charismatic Boris Yeltsin as the country's first independent President. From roughly the mid-1990s, Yeltsin's presidency was widely associated with an unstable political system where capricious expulsions of prime ministers, frequent changes in federal legislation and bellicose relations between parliament and president occurred frequently. The president himself was often depicted as a rather frail figure, beset by chronic bad health and highly susceptible to the machinations of a narrow group of business oligarchs who captured the majority of the economy's attractive assets. One may also recall that Russia's military intervention in Chechnya did little to improve the country's image as a society at peace with itself, not to mention the overall lack of public confidence in the state to maintain law and order in economic activity, particularly in the vastness of Russia's regions. There was little room for an effective, whole-sale campaign to promote 'Russia the emerging market' to international business while the country was governed in this manner and foreign investment – in the volumes that Russia's policy makers have often advertized that the country needs to attract – largely bypassed the country.

Although in 2003 Russia's economy is still in desperate need of both foreign and domestic capital, three years of a personality shift in the country's supreme political institution combined with the impressive growth figures has led to the widespread perception that Russia is finally on the road to normalization. Instead of the international media depicting an ailing head of state, the world has become accustomed to seeing Putin walk side by side with the US President Bush, or hosting Britain's Prime Minister Tony Blair at St Petersburg's Marinsky Theatre. Long gone are the days of yesteryear's US-Soviet rivalries, and, increasingly, Russia under its new president is presenting itself as an unequivocal friend of the West. Furthermore, while it was widely believed that Yeltsin's presidency was captured by Russia's leading business oligarchs and regional governors, Putin has expelled several of the most notorious business figures from the country. He has also attempted to tame the non-compliant regional bosses and extend federal influence over the country's vast political terrain.

The Kremlin's re-assertion over national politics under Putin has been further reinforced by the continued acceleration of the economic reforms instigated under Yeltsin. The Russian government has advocated its continued commitment encouraging the private sector, reducing bureaucratic controls on commercial activities, encouraging foreign investment and further integrating Russia into the global economy by engaging in continued dialogue over Russia's entry into the World Trade Organisation. A number of laws enhancing the process of economic liberalization have been passed under Putin, including a reduction in the country's tax on incomes to a flat 13 per cent, an overhaul in Russia's land code to one oriented towards private property, simplification in the procedures for the registration of new companies and the introduction of a new labour code for the governing of employer-worker relations. Such reforms, although in their early stage of influencing Russia's overall investment climate, are nevertheless strengthening the country's institutional environment and capturing the attention of foreign investors.

The country's enhanced image among the international community is further reinforced by the emerging confidence of the Russian business community, which, under Putin, is re-investing much of its profit back into the domestic economy. Although without doubt much of the economic growth mentioned earlier has been contributed by Russia's high profile oil and gas industry, a number of domestic enterprises from a diversity of spheres of economic activity are also performing visibly well. Capital flight out of the Russian Federation has been declining noticeably in recent years and the big Russian corporations – in oil and gas, the energy sector, metallurgy, telecoms, and food processing – are now tending to buy up existing assets and enterprises to further expand their business within the country. Major Russian companies such as Lukoil, YUKOS, Gazprom, AvtoVaz, Norilsk Nickel, the electricity giant UES, Severstal, Wimm-Bill-Dann and Sibirsky Aluminium are among the key drivers of the country's improved economic performance. They are also showing a globalist approach to business by increasingly employing graduates from some of the top foreign business schools and universities, using foreign consultants to restructure their enterprises, and seeking to improve their understanding of concepts such as corporate governance. While foreign investment in Russia still remains at relatively low levels compared to some neighbouring emerging markets, the reduction of capital flight and the reinvestment of domestic capital into Russia has provided a substantial boost for the economy and has created many new jobs, particularly in the manufacturing sector.

Russia's over-all improved economic and political performance under Putin, the pro-global economy policies of his government and major Russian corporations, together with the country's seemingly endless supplies of many of the world's most vital natural resources, all make the present time a particularly attractive one for embarking upon business cooperation with this vast country. One can no longer speak of their arrival in major European capitals such as Moscow or St Petersburg as a lawless or exotic experience with early post-Marxist society, since even the first time visitor is likely to be surprised at just how much of 'the West' has now happily settled in present day Russia. All the standard symbols, goods and services found in the most dynamic market economies are likewise found in contemporary Russia. Goods and services of every kind imaginable are both traded between Russia and the outside world, and produced inside the country. Street trading is particularly active in Russia's large, multicultural cities, rekindling memories of Russia's early capitalism in the late 19th and early 20th centuries. Furthermore, many foreign businesses are presently represented in Russia, from veterans such as the Swedish furniture multinational Ikea, which has been in the country for over a decade, to the American giant of the automobile industry, General Motors, which has recently invested heavily in the Russian car industry. Be it from the perspective of international political rhetoric and multinational ratings agencies, or the more practical indicator of typical street life inside the country itself, Russia's image abroad is changing to that of a truelly prospective emerging market.

In this volume, our third attempt at compiling a comprehensive publication on the topic of doing business with Russia, the reader will find over 50 separate chapters covering a wide diversity of business topics relevant to one of the world's most significant countries. Furthermore, in keeping with the Kogan Page tradition of upholding objectivity and a diversity of specialist opinions with regards to a particular country, our 52 chapters are contributed by some 25 different authors, all specialized in their particular aspect of doing business with Russia. In Part One of the book, we present the reader with a comprehensive economic, legislative and political background to the Russian market. Contributors in this section include Austria's Raiffeissen Bank and the international law firm CMS Cameron Mckenna, who focus on the country's economy, foreign policy and federal legislation as it relates to business and investment practices. There are also contributions from the Moscow-based political commentator William Flemming, Professor Oreshkin of the Vniki Institute and the President of the American Chamber of Commerce in Russia, Andrew B Somers, who discuss respectively the Russian political system during the Putin presidency, the country's foreign trade relations, and elaborate upon Russia's new-found status as a market economy.

In Part Two we focus on the Russian financial sector and the foreign investment climate prevailing in the country, and include chapters by the law firm Allen & Overy on banking and insolvency, whilst the International Finance Corporation (IFC) contributes on the Russian leasing market. The IFC also provides a detailed commentary on the latest trends in Russian corporate governance and the Control Risks Group gives a highly objective introduction to the Russian foreign investment climate. While our publication seeks to promote Russia to the potential foreign investor, and we attempt to demonstrate the positive aspects to doing business in the country, we also acknowledge that Russian business practice is often quite different to that prevailing in the reader's home country. It is therefore also one of our objectives to educate the reader about some of the perceived problematics, or rather, cultural differences, to the conduct of business in Russia – be it dealing with rent-seeking elements in the post-Soviet bureaucracy, non-transparent linkages between businessmen and civil servants, or the state's lack of ability to implement some of its legislation designed to ease and facilitate the business process. We thereby include into our publication chapters by well-qualified authors from the Foreign Investment Advisory Service of the World Bank and London's Merchant International Group, who employ their experience with

Russia to insightfully comment on the administrative barriers that new entrants seeking to penetrate the Russian market should be aware of, and the often over-looked 'grey', or non-transparent components of the Russian economy that many less experienced parties may tend to overlook.

Although most goods and services are today readily available in most large Russian centres of population, the country's consumer market is still very under-developed by international standards. Ample opportunity still exists for foreign companies to supply the Russian market. In Part Three therefore, authors from BISNIS in the US Department of Commerce, Am Cham, Deloitte & Touche, the United Financial Group and several other specialist companies review some of the more high profile sectors of the Russian economy, including extraction industries such as oil and gas, gold mining and metallurgy; and other traditionally important sectors such as agriculture, shipping, automobile production, aviation, healthcare and textiles. We also look at some of the newer, dynamic sectors, including mobile telephones, the IT sector, and brewing. In Parts Four and Five our lawyers, accountants, tax specialists, security consultants and real estate practitioners provide an overview of Russia's tax regime, and accounting practices, as well as intellectual property, the new land code, the recent overhaul in the labour code, security for businessmen, and the real estate market. Finally, in Part Six, as was the case with the last edition of *Doing Business with Russia*, we give attention to the Russian regions, this time focusing on the Urals and the Western districts of the enormous Siberian hinterland, particularly the important city of Novosibirsk. The book is also complimented by a number of company case studies and we have included an appendix which we hope the reader will find useful, both in terms of its number of business briefs, some additional statistical information about the Russian market, as well as a collection of internet pages providing further practical information relevant to this once enigmatic country.

*Marat Terterov*
*Oxford, England*
*January 2003*

## Acknowledgements

Although I am now several years more experienced with Russia compared to the time when I first embarked upon the task of compiling the previous edition of the publication, it has proven to be no less an effort to pull together the 500 or so pages of text comprising the current volume. I have become a regular visitor to Russia during 2002, and am particularly grateful to a number of individuals in Moscow who have made my work there far less burdensome than it could have been. In particular, my thanks goes out to Sergey Korol Ph.D, who helped nominate many useful authors for the book and wrote a fine article himself. William Flemming always makes my visits to Moscow well informed, while Ilgar Ibrahimov and Alexander Harlamov make them both interesting and entertaining. We should also acknowledge the role of the Kogan Page editorial staff, in particular Jess Rawlinson, who had to mould the 500 page manuscript into a publication of international calibre.

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# Part One

# Background to the Market

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## 1.1

# Russia: What to Expect – Political and Economic Overview

*Elena Romanova and Christopher Spekhard, Raiffeisen Bank*

### *Highlights*

- The federal election season will shape the political climate in the year ahead. The Kremlin has strategically postponed the main impact of many politically sensitive structural reforms, including adjustment of energy tariffs and communal housing costs, and the further overhaul of Russia's federal system, until after the 2003–2004 election cycle.
- President Putin continues to pursue political and economic integration with the West, and Russia's exclusion from the FATF blacklist represents the latest feather in his cap. At the same time, the momentum has slowed a bit since last spring as Russia and the West move from the realm of political gestures to the 'nitty-gritty' details. WTO negotiations, for example, have stalled on various issues and accession looks more likely in the 2004–2005 timeframe.
- The 'post-crisis' stage of Russia's economic development, marked by devaluation-led growth in domestic industry and a cushion from surging exports, is mostly behind us. In 2003 and beyond, potential for growth will first and foremost depend on sustainable domestic consumption and growth of capital investment. There is good news on this front: the burgeoning corporate bond market and increased corporate lending by banks signal that a new credit cycle is indeed gaining momentum in Russia.
- The main drivers of Russia's economic performance and, correspondingly, the major sources of risk in the year ahead include:
  – Domestic financial stability: strong budgetary discipline and

the further development of the banking sector and capital markets are paramount.
- Global market performance: external stability is essential to maintaining robust external accounts, reducing volatility in asset prices, and promoting foreign investment inflows.

- On the fixed income side, Russian companies will continue to actively tap domestic and international debt markets in 2003. The rouble bond market is growing rapidly, and is diversifying. The stock of sovereign Eurobonds is likely to increase by approximately US$ 2.5 billion next year, including the FTO swap and an expected new issue to refinance the Ministry of Finance redemption. Given overall EMEA market stability, a number of factors should support higher prices, including increased demand from domestic institutional investors, improved sentiment among foreign investors and an anticipated sovereign rating upgrade.

**Table 1.1.1** Economic indicators in Russia 1997–2003

| *Economic indicators* | *1997* | *1998* | *1999* | *2000* | *2001* | *2002e* | *2003f* |
|---|---|---|---|---|---|---|---|
| GDP (per cent, y-o-y) | 0.9 | –4.9 | 3.2 | 8.3 | 5.2 | 4.0 | 3.5 |
| GDP (US$ billion) | 436 | 313 | 182 | 251 | 310 | 352 | 405 |
| Industrial production (per cent, y-o-y) | 2.0 | –5.2 | 8.1 | 9.0 | 4.9 | 4.5 | 4.0 |
| Capital investment (per cent, y-o-y) | -5.0 | –6.7 | 4.5 | 17.7 | 8.7 | 3.5 | 4.0 |
| CPI inflation (per cent, eop) | 11.0 | 84.5 | 36.5 | 20.2 | 18.6 | 15.5 | 14.0 |
| Central budget balance (per cent of GDP) | –7.0 | –5.0 | –1.7 | 2.5 | 2.4 | 1.0 | 0.0 |
| Exports (US$ billion) | 88.9 | 74.8 | 74.7 | 105.6 | 103.5 | 101.0 | 100.0 |
| Imports (US$ billion) | 71.4 | 57.4 | 39.4 | 44.9 | 52.5 | 58.0 | 61.0 |
| Export growth (per cent, y-o-y) | –1.7 | –15.9 | –0.1 | 41.4 | –2.0 | –2.4 | –1.0 |
| Import growth (per cent, y-o-y) | 7.1 | –19.6 | –31.5 | 14.0 | 17.0 | 10.5 | 5.2 |
| Current account (US$ billion) | 3.6 | 2.4 | 25.0 | 46.3 | 34.5 | 27.5 | 22.5 |
| Current account (per cent of GDP) | 0.8 | 0.8 | 13.8 | 18.5 | 11.1 | 7.8 | 5.5 |
| Gross FX reserves (US$ billion) | 17.8 | 12.2 | 12.5 | 28.0 | 36.7 | 48.5 | 54.0 |
| FX rate (rouble/US$ 1, eop) | 6.0 | 21.2 | 27.0 | 28.5 | 30.1 | 32.5 | 34.5.0 |

## Political overview

*Key trends*

The two major events on the domestic political horizon are parliamentary elections in December 2003, followed by presidential elections in the first half of 2004. While this upcoming year promises political mobilization around the country, we do not expect any major surprises: thus far the pro-government centrist majority in parliament looks poised to maintain or even strengthen its position, while parties further right and left – including the Communist opposition – will face a tough struggle just to keep current numbers of seats. In all likelihood, elections should produce another loyal Duma, continuing the current phase of smooth executive–legislative relations that has supported realization of the Kremlin's reform agenda.

Likewise, President Putin's position looks secure through 2008; despite in-fighting among various political and business groupings, the elite remain loosely consolidated around him. The hostage-taking incident in October and Putin's subsequent declaration of Russia's war on terrorism, both at home and abroad, have struck a chord with Russian society and could further boost the President's stature in the short to medium term. Moscow's campaign in Chechnya has got its second wind, though a viable solution to this decade-old quagmire seems more evasive than before.

In terms of domestic policy, the Kremlin has strategically postponed the brunt of many politically sensitive reforms, including adjustment of energy tariffs and communal housing costs, as well as the further overhaul of the country's federal system, until after the electoral cycle. The President's approval ratings have thus far been immune to isolated instances of social unrest during initial implementation of these reforms.

Still, challenges could come on the foreign policy front. A potential US invasion of Iraq in winter 2003 could polarize the Russian elite, testing Putin's ability to assuage hardliners already smarting from earlier concessions on the ABM treaty and NATO expansion. Putin's ability to refocus attention to the war on terrorism will be important, and in this regard, relations with neighbouring Georgia will be a crucial, though unpredictable variable. The President has continued his course of integration with the West, and Russia's exclusion from the FATF blacklist represents the latest feather in his cap. At the same time, the momentum has slowed a bit since the May summit as Russia and the West move from the realm of political gestures and rhetoric to the nitty-gritty details. WTO negotiations, for example, have hit snags on various issues and accession now looks more likely in the 2005–2007 timeframe.

*Looking ahead: political engineering*

Empowered for the first time with a loyal parliament, the Kremlin, together with the pro-government 'United Russia' party, has launched a number of legislative initiatives aimed at reshaping Russia's formal institutional landscape. Many initiatives point to a further consolidation of political authority, such as raising electoral thresholds for parliament or attempts to wrench control over natural resource licensing and rents from regional administrations. While some proposals smack of political opportunism, such as the ban on holding referendums during election years (directed against the Communist party) and the see-sawing debate on gubernatorial term limits, others reflect the natural process of institutional tinkering as Russia's political and economic environment changes.

Some of the Kremlin's more outspoken critics have claimed that the endgame of the 'Putin project' is a de-facto authoritarian regime – or, in softer terms, a controlled democracy. While there's little doubt that the Kremlin intends to shift the formal institutional balance of power in its favour, it is also constrained by a number of factors. For example, President Putin, perhaps more than anyone else, realizes that the burdensome state administrative apparatus inherited from the Soviet era is not the best tool for implementing structural reform and mobilizing the nation's resources. Initiative at the local level will be paramount, and in a country as large as Russia only some degree of robust political competition and activation of civil society can counterbalance bureaucratic inertia.

In the year ahead, we will continue to keep an eye on the process of 'political engineering' in Russia. One aspect of institutional change that will have a profound impact on the country's overall financial health is fiscal federalism. The section below provides a brief update on the latest developments in this arena.

*Fiscal federalism: municipal government reform and beyond*

At the end of October 2002, President Putin and regional leaders assembled to hammer out draft legislation on reforming municipal government, the latest step in a wide-reaching overhaul of Russia's fiscal federal system. Putin stressed that the legislation intends to better match fiscal capabilities with social responsibilities, enabling both urban and rural localities to play a larger, and more autonomous, role in public service delivery. The Government plans to submit the final version to the Duma by the end of the year, with the legislation coming into effect in 2005.

The primary aim of the legislation, developed by a commission chaired by presidential adviser Dimitry Kozak, is to minimize the dependence of mayors and rural administrations on governors by assigning fixed sources of revenues to each level and instituting a unified, formula-based system for intergovernmental transfers. During the course of discussions, however, compromises have resulted in some degree of overlap in responsibilities between rural, municipal and regional administrations, which may lead to bureaucratic turf wars.

As well as being a step toward budgetary transparency and fiscal efficiency, this initiative is part of a wider project to curb the power of Russia's regional bosses and restore a greater measure of accountability – both to the Kremlin as well as the electorate – in regional governance. Uprooting, or at least 'declawing', entrenched regional interests is vital to the successful implementation of reforms that threaten to redistribute financial flows and challenge the monopolistic position of regional political and business groupings.

Putin has made it clear that he wishes to modernize the regional elite, making them more into efficient financial managers rather than national political players. To this end, stronger municipal government would act as a counterbalance to overbearing governors. Indeed, tensions between governors and mayors characterize the political landscape in many regions as the former manipulate budgetary flows to keep the latter under their political thumbs.

The Kremlin has also launched a number of other legislative initiatives to pursue its goal, including procedures to remove irresponsible governors who lead their jurisdictions into financial troubles, as well as strengthening the effectiveness of 'vertical' levers of accountability in the regions, such as national parties and presidential representatives. The possibility of reducing the number of regions (merging richer regions with their poorer neighbours) to a more 'manageable' number is also being considered. Currently the most heated debate revolves around control over the country's natural resources and recentralization of related rents. The Ministry of Natural Resources has forwarded a plan to the Cabinet that would greatly reduce the role of regional administrations in the formal process of granting and revoking licences.

As well as increasing state capacity to implement reforms, fiscal centralization and administrative reorganization would help to smooth over high levels of interregional socioeconomic asymmetry caused by natural resource windfalls, which is a constant source of political tension. However, the approaching electoral season has forced the Kremlin to proceed with caution in the face of resistance from outspoken regional heavyweights. No governor has been removed so far; instead many have received the green light to run for third and fourth terms. And federal legislation on regional elections has stalled. Likewise, recentralization of resource licensing is only at the conceptual stage; an earlier trial balloon to change the status quo by introducing a system of concessions was scrapped after it sparked a wave of protest from oil companies and governors.

Thus we can expect further developments on this front in 2004. A decisive victory in parliamentary and particularly presidential elections would provide a second wind for the sails of the Kremlin's centralization drive.

## *Economic overview: watch the finance!*

**On the market reform front, two major developments stand out**. First, a number of 'quick fix' reforms – those requiring moderate adjustments to existing legislation – have entered the implementation stage. These include reform of the tax system, deregulation (reducing the number of licensed activities and simplifying business registration procedures), loosening of currency controls (easing the export revenue sales requirement and allowing private individuals to hold deposits abroad). The jury is still out on the effectiveness of these measures: bureaucratic inertia in Russia's far-flung provinces has proven to be a formidable obstacle to smooth implementation.

Second, the Government launched a wide array of more comprehensive structural reforms aimed at addressing chronic distortions in Russia's political economy. These include reform of Russia's natural monopolies, including the electric utility and railway sectors, in addition to landmark legislation authorizing the sale of urban and agricultural land. Likewise, legislation paving the way for a transition from a 'pay-as-you-go' to a 'fully-funded' pension system, together with the creation of private investment funds, has mostly made its way through parliament. President Putin also recently signed new bankruptcy procedures into law that are designed to make the process more transparent and safeguard against its use as a convenient asset-stripping tool.

When these reforms will actually be implemented is another matter, however. Banking reform – which promises a state deposit guarantee system, transition to IAS and strengthening of banking supervision – still remains at the initial stage. Restructuring of the electrical power, rail (and especially gas) sectors is also unlikely to be completed in the short term. In addition to resistance from vested interests, election year concerns will hamper smooth and timely implementation, as politicians proceed cautiously to avoid the political consequences of unpopular tariff increases.

**On the macroeconomic side**, after a slowdown in the spring, growth in the real sector is taking off, inflation remains predictable, and external accounts – still the driving force on Russia's road to prosperity – are again at high levels, thanks to oil prices recovering to the vicinity of US$ 25 per barrel. Rising domestic income has finally triggered consumption and savings growth in the formal economy, which has generated an additional impulse for both the real economy and banking sector. Fortunately for Russia, imports are not growing at dangerous rates, suggesting that domestic producers are managing to remain competitive.

**At the micro-level**, falling profits in industry have resulted in a slowdown of fixed capital investment. The slump in profits stems from adjustment of wages and energy tariffs, as well as stiff competition with imports in value-added sectors. The impact of these factors is expected to increase in 2003, largely due to implementation of structural reforms.

Domestic investment activity has been somewhat sluggish. Growth in fixed investment slowed to 3 per cent in 2002 from 7 per

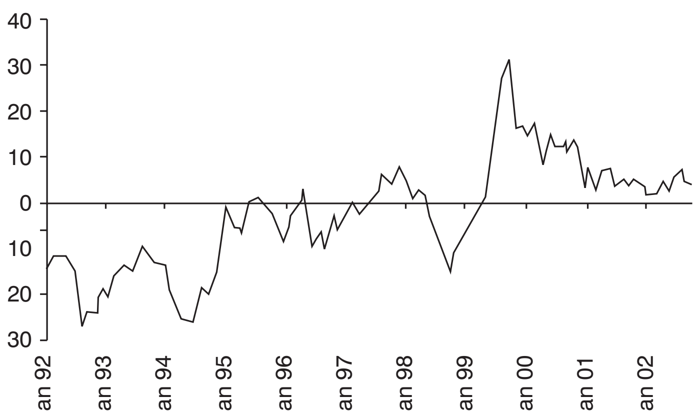


**Figure 1.1.1** Growth of industrial production (year-on-year, per cent)

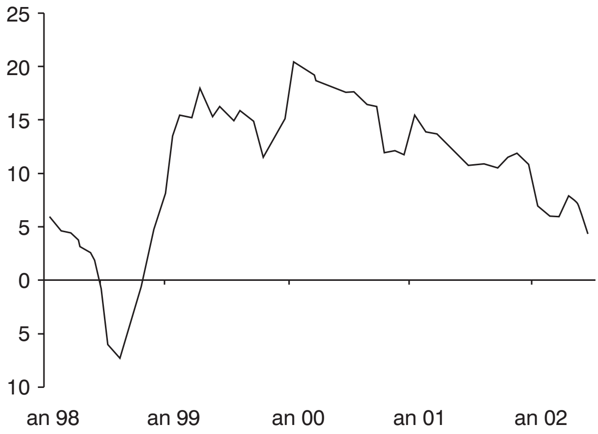


**Figure 1.1.2** Enterprise profits (per cent of GDP)

cent last year. However, this could partly reflect changes in reporting procedures linked with new profit tax legislation that abolished tax privileges related to investment activity. While investment from retained profit may be dwindling, expanding borrowing opportunities are helping to fill the gap. A new credit cycle is gaining momentum; Russian borrowers are increasingly attracting funds in a variety of ways from domestic and international markets. This has been facilitated by tangible improvements in Russia's international status. Support for Russia joining the WTO, recognition of Russia as a market economy, and the fact that the OECD's Financial Action Task Force on Money Laundering (FATF) dropped Russia from its blacklist of worst offenders – though all largely political gestures – have nevertheless been helpful in terms of giving the country a 'facelift' in terms of its image as a borrower.

Foreign direct investment remains at low levels, and again the US$ 3 billion mark is unlikely to be passed in 2002. Foreign investors, despite evidently remaining favourable toward Russia's financial assets, are still cautious about long-term commitments in the real economy.

*The major macroeconomic risks come from:*

- External factors: a deepening recession in global markets (primarily the United States and Western Europe) would negatively impact on Russia.

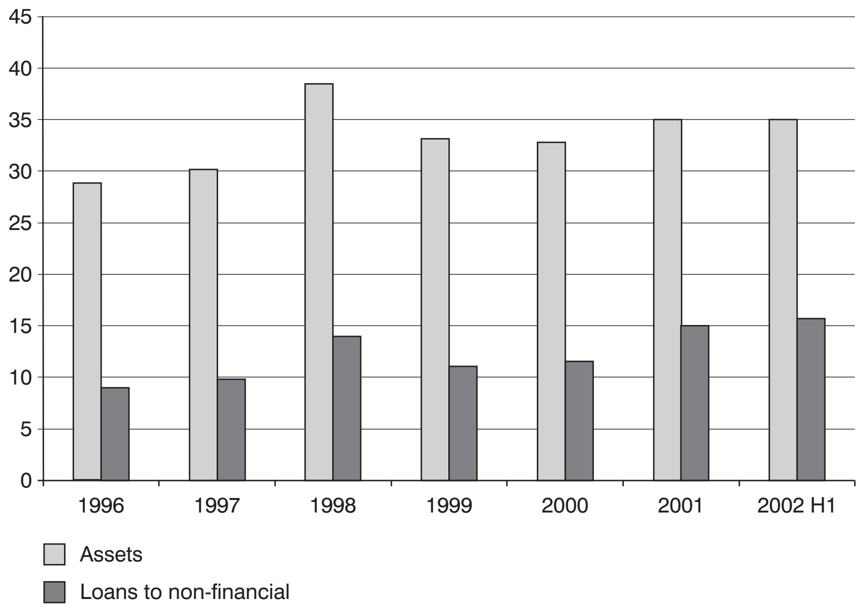


**Figure 1.1.3** Banking sector performance: loans vs assets (per cent of GDP)

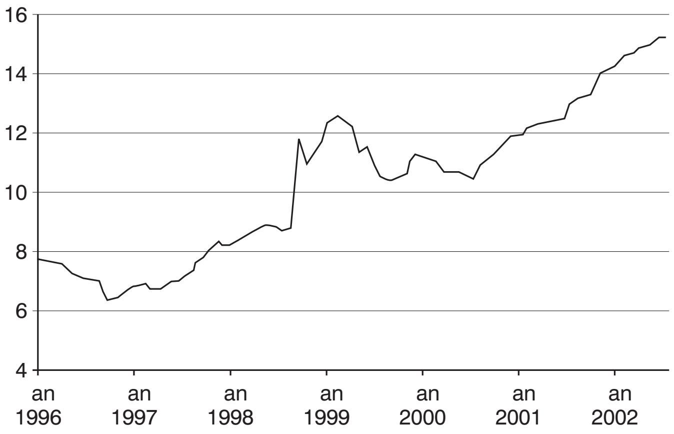


**Figure 1.1.4** Foreign loans to Russian banks and companies (US$ million)

- Internal factors: sustainability of domestic financial stability in both the public and corporate finance sectors is vital, and entails further strengthening of capital markets. On one hand, healthy finance is dependent upon commodity prices. On the other, the Government needs to use the appropriate combination of fiscal and monetary policies to regulate interest rates and build up trust in the rouble debt market and the banking sector.

Below we consider the prospects for the development of public finance, Russia's domestic capital market and banking sector, and their impact on the development of the economy.

*Public finance*

The Government's ambitious plans for fiscal performance in 2002, which envisaged an average oil price of US$ 23.5 per barrel and a general budget surplus of 1.6 per cent of GDP, came under fire when oil prices plunged in the first half and corporate profits deteriorated on the back of rouble appreciation and rising input costs. The impact on federal coffers became especially noticeable in the spring, when revenues fell below last year's level by 1 per cent of GDP on average. Even though budget balances vacillated from surplus to deficit, the Government managed to post a surplus for the first three quarters of the year.[1] To a large extent, the battle was won thanks to a surge in revenue over the summer (in July alone revenues skyrocketed to 19.5 per cent of GDP), as oil prices began to rebound and as economic growth picked up after a winter lull.

**Table 1.1.2** Main federal budget parameters (per cent of GDP)

| | *2002 plan* | *2003* | *2004* | *2005* |
|---|---|---|---|---|
| **Total revenues** | 19.6 | 18.5 | 18.3 | 18.1 |
| **Total spending** | 17.8 | 17.9 | 17.0 | 16.5 |
| Interest | 2.6 | 2.2 | 1.9 | 1.7 |
| Non-interest | 12.5 | 12.8 | 12.3 | 12.1 |
| *Pension transfers* | *2.6* | *2.7* | *2.8* | *2.7* |
| **Primary surplus** | 6.8 | 5.6 | 6.0 | 6 |
| **Balance** | 1.6 | 0.6 | 1.3 | 1.6 |
| **Financing** | –1.2 | | –1.04 | –1.91 |
| *External* | *–1.1* | | *–1.28* | *–2.1* |
| Internal | *–0.1* | | *0.24* | 0.2 |
| financial reserve (eop) | | | 0.59 | 0.2 |
| ***Memo items*** | | | | |
| GDP (roubles, billion) | 10,600 | 12,850 | 15,000 | 17,300 |
| Inflation* (per cent, per annum) | 11.0–13.0 | 10.0–12.0 | *8.0–10.0* | *6.0–8.0* |
| GDP growth (per cent) | 4.3 | | | |
| Rouble/US$, year average* | 31.5 | 34.0 | *35.7* | *37.5* |
| Oil price US$ per barrel | 23.5 | | | |

*Source:* Ministry of Finance, RBA

*for 2004–2005 – implied according to official statements

[1] Here and below all figures reflect our own estimations based on federal budget performance data released by the Ministry of Finance, excluding items related to social tax. Social tax accounting in the budget balance sheet remains confusing, since the proceeds enter in full into revenues and only partially into the expenditure side.

Budgetary targets for 2003 look quite reasonable, with revenues (excluding social tax) projected at approximately 16 per cent of GDP. In subsequent years federal revenues are forecast at lower levels, indicating either a fiscal loosening[2] (eg as of 2003 the road tax on 1 per cent of sales will be abolished), or redistribution of funds between federal and regional budgets in accordance with the upcoming reform of Russia's fiscal federal system. At the same time, non-interest expenditure targets for the next few years reveal the Government's intention to broadly maintain current spending levels with just a slight reduction. Maintenance of surpluses remains a priority, and budgetary figures will be a key indicator for the overall financial health of the economy in the years ahead. In this respect, debt management has become an important issue. In particular, the Government has given priority to:

- controlling external debt payments;
- building up the budget's financial reserve;
- replacing external with internal borrowing.

Table 1.1.3 summarizes figures for projected surpluses, estimations of debt payments, as well as potential sources of financing including the Financial Reserve (not taking into account the possibility of borrowing from the CBR, whose reserves are likely to approach US$ 50 billion in 2002). The 'financial gap' figure is simply the difference between projected surplus and scheduled principal payments for external debt. Even with conservative assumptions of surpluses under 1 per cent of GDP for 2003, the problem of large principal payments does not represent a threat to financial stability. First of all, the sizeable Financial Reserve Fund accumulated by the end of 2002 will help the Government to fill the gap.[3] Even if the Government does not refinance its external debt, the accumulated funds, with the help of increased borrowing from the domestic market and, perhaps, more large privatization auctions, will be sufficient to cover the scheduled payments. At the

[2] This would contradict recent statements by officials on the need to maintain the current tax burden.

[3] The Reserve Fund is expected to reach US$ 3.5–4.0 billion by the end of 2002. The Government's target for the end of the year is 178 billion roubles, or US$ 5.6 billion, which seems highly unrealistic given that within the first eight months, the fund fell from 89 billion roubles to approx. 75 billion roubles. A recovery in the second half of the year is expected based on improved fiscal performance, but the resulting figure is still expected to be much lower than the official target, within the range of 90–115 billion roubles, according to our estimates.

same time, we don't exclude the possibility of new Eurobond placements in 2003, when Russia is expected to receive another rating upgrade. As a percentage of GDP, both principal and interest payments will be gradually diminishing over the next year, and by 2004 they will comprise less than 3 per cent of GDP, compared to 4.7 per cent of GDP in 2001 and an estimated 4.1 per cent of GDP in 2003.

The Government's general strategy for 2003 and beyond is to increase the supply and terms of rouble bonds in order to meet the growing demand for long-term assets that accompanies pension reform. This includes establishing a set of interest rates that would serve as an additional tool for monetary regulation, alongside manipulation of the exchange rate and reserve levels. Increased borrowing on the domestic market will replace external borrowing (estimated values of net internal borrowing are shown in the Table 1.1.3). The benefits of this policy include promotion of rouble-denominated instruments and the concomitant reduction of the overall significance of exchange rate fluctuations. At the same time, this policy heightens the risk of the Government getting bogged down in an unmanageable volume of costly domestic debt. The State Pension Fund and (likely) Social Insurance Fund will remain the largest investors in governmental bonds, and the market's

**Table 1.1.3** Federal budget – is the financial gap really a threat?

| | *US$ billion* | | | | | *Per cent of GDP* | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *2001* | *2002* | *2003* | *2004* | *2005* | *2001* | *2002* | *2003* | *2004* | *2005* |
| **Federal budget surplus** | **9.2** | **4.6** | **2.9** | **5.6** | **7.2** | **3.0** | **1.3** | **0.8** | **1.3** | **1.5** |
| External debt principal payment | 8.1 | 5.6 | 10.5 | 6.5 | 7.8 | 2.6 | 1.6 | 2.7 | 1.5 | 1.7 |
| External debt interest payments | 6.5 | 5.7 | 5.5 | 5.04 | 4.7 | 2.1 | 1.6 | 1.4 | 1.2 | 1.0 |
| **Financial gap** | **1.1** | **–1.0** | **–7.6** | **–0.9** | **–0.6** | **0.4** | **–0.3** | **–2.0** | **–0.2** | **–0.1** |
| **Sources of financing** | | | | | | | | | | |
| 1. Borrowing from international market (eurobonds) | 0.0 | 0.0 | 0.7 | 0.0 | 1.0 | 0.0 | 0.0 | 0.2 | 0.0 | 0.2 |
| 2. Net borrowing from domestic market | -0.8 | 1.3 | 1.8 | 1.2 | 1.2 | -0.3 | 0.4 | 0.5 | 0.3 | 0.3 |
| 3. Privatization revenues | 0.3 | 0.9 | 1.6 | 1.0 | 1.0 | 0.1 | 0.3 | 0.4 | 0.2 | 0.2 |
| *Total for 1–3* | –0.5 | 2.3 | 4.0 | 2.2 | 3.2 | –0.2 | 0.6 | 1.1 | 0.5 | 0.7 |
| **Financial Reserve Fund, eop** | **3.0** | **3.7** | **1.1** | **3.1** | **4.9** | **1.0** | **1.0** | **0.3** | **0.7** | **1.0** |

*Sources:* Ministry of Finance, FITCH, RBA ability to absorb new issues is virtually guaranteed. If, however, the Government has to refinance in order to make redemptions, the threat of financial destabilization could become real.

Thus the chief potential danger for domestic asset prices from the public finance side would be excessive borrowing by the Government; one of the first alarm bells to sound would be a string of monthly deficits coupled with sizeable debt issues. However, given the vigilance that the Government has displayed regarding fiscal discipline, we assign a low likelihood to this scenario.

On the other hand, potential threats from the corporate finance side are more realistic than those from the public finance sphere. Companies are actively increasing their leverage, using whatever means are available, including borrowing on both domestic and international markets. While taking on debt is in itself a healthy sign on the micro level, avoiding a wave of large-scale corporate defaults means proper risk assessment by investors and lenders, as well as the availability of macro-level measures for stabilizing the market in case of a crisis. Both of these are still underdeveloped areas in Russia.

*Banking sector*

Though the banking sector still has a long way to go, there are clear signs of progress, including much strengthened balance sheets. Below we address the major trends and scenarios for the development of the sector as a whole.

Progress has been most visible in increasing levels of capitalization. The aggregate capital of the sector has grown to approx US$

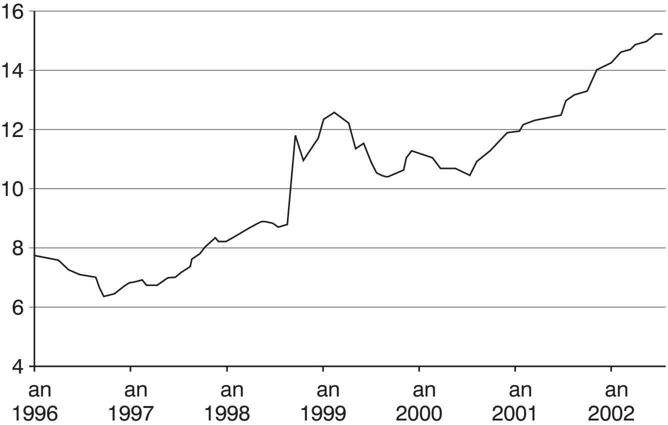


**Figure 1.1.4** Commercial banks' loans to private sector (per cent of GDP)

22.5 billion (6.7 per cent of GDP). Additionally, improvement on the liabilities side is reflected in the growth in volumes and terms of household deposits.

While total deposits are generally expanding in line with economic growth, household deposits are growing faster than corporate deposits. Over the last two years the share of household deposits increased from 41 per cent to 50 per cent of the total, and in terms of GDP they grew from 6 per cent at the beginning of 2000 to 8 per cent at the end of 2002. Remarkably, the share of deposits for one year or longer have increased from 4 per cent to 35 per cent of all household deposits over the same time period. However, consumers still prefer the greenback as a savings instrument: the share of dollar-denominated deposits constitutes 37 per cent of total household deposits, up 7 per cent for the last two and a half years. Thanks to the return of economic stability and fading memories of the 1998 banking crisis, the population has slowly started to trust commercial banks with some of its 'mattress money' (US$ 20–70 billion according to different estimations). However, currency risk still remains a major concern.

The major trend on the asset side is a noticeable shift toward lending to the corporate sector. The rising influx of household savings, coupled with quick growth in banking capitalization, has

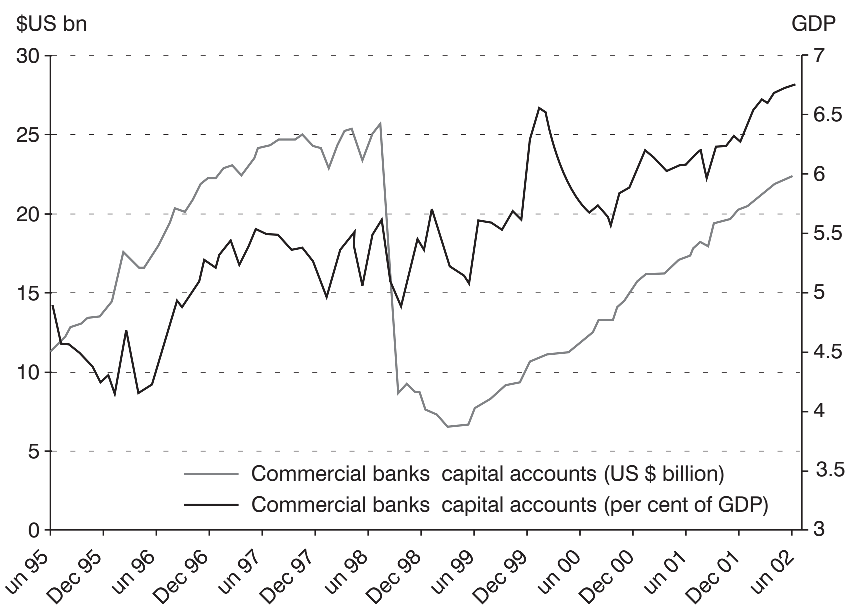


**Figure 1.1.5** Growth of banking capital

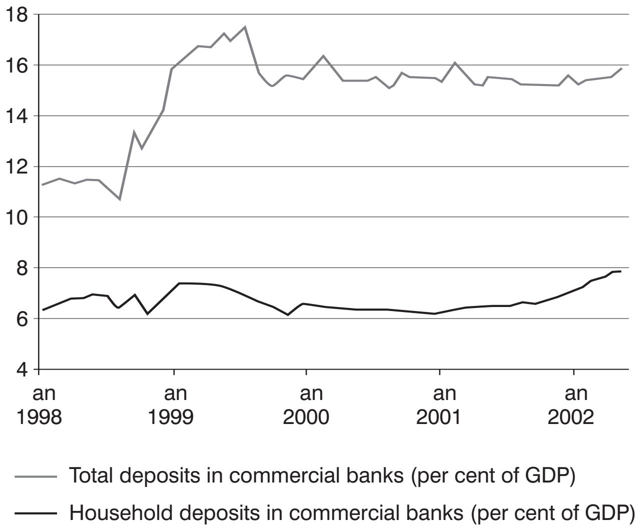


**Figure 1.1.6** Stock of private sector deposits in commercial banks

provided more financing for corporate lending. Since the end of 2000, loans to the private non-financial sector increased from 30 per cent to 45 per cent of banking assets, climbing from 11 per cent to 15 per cent of GDP. At the same time the share of bad loans remains within the range of 2–3 per cent according to official statistics. So the possibility of a new banking crisis that is gaining popularity in the media should be discounted at least for the next couple of years.[4] The credit cycle in Russia is still at an early stage and there is ample room for credit expansion before the system approaches the 'red line'.

The structure of the sector's loan portfolio, however, is still biased toward export-oriented industries, as demonstrated by the high number of loans, ranging from US$ 30 million to US$ 500 million, given to oil and metal heavyweights such as Lukoil, Norilsk Nickel, RusAl and Severstal. At the same time, the retail loan business is taking off rapidly, and over the next couple years we expect to see robust growth in consumer credit (auto loans, credit cards, mortgage loans, etc).

## *Sector composition and scenarios for development*

While state-owned banks and large private banks affiliated with industrial groups will continue to dominate the sector, two other

[4] A shake-up might occur if new bankruptcy legislation is implemented on a large scale, but these cases will concern mostly small banks and should not trigger a systemic crisis.

groups, foreign banks and medium-sized regional banks, are poised for expansion within the next couple of years. In particular, medium-sized regional banks may successfully compete with their larger rivals for market shares due to their superior flexibility and knowledge of local enterprises. Foreign banks have also carved out a niche on the Russian market, which is likely to expand in the near future due to the general economic upturn and further stabilization of the macro-political situation. While those banks willing to take higher risks in exchange for better returns have already settled in Russia, the time is coming for more risk-averse banks to enter. The most likely areas for cooperation with local Russian banks include lending (syndicated loans, mortgage loans, etc), trade finance and the pension and insurance business.

The sector's trajectory will depend on the dynamics of competition between these groups of banks, especially in the regional arena. The prospects for medium-sized and foreign banks to enlarge their market shares, as well as the pace of acquisitions of smaller banks by the dominant groups, both depend on the progress of major structural reforms, including:

- Banking reform, particularly the creation of a deposit guarantee system and tightened supervision of commercial banks. Should both enjoy substantial progress, solvent mid-sized banks will be the first to reap the benefits of improved trust in the banking system.
- Implementation of pension reform and liberalization of the insurance business. Both would create a favourable environment for foreign banks to enter Russia.
- The transition to IAS, planned for 2004, should substantially improve borrowers' transparency, allowing medium-sized banks to expand lending activity.

**Table 1.1.4** Banking sector breakdown (H1 2002)

| *Market shares (per cent of total)* | *Assets* | *Deposits* | *Loans* |
|---|---|---|---|
| Largest state-owned banks* | 35.5 | 47.7 | 39.4 |
| 10 largest Russian banks** | 27.0 | 25.6 | 21.3 |
| Foreign banks | 7.7 | 10.2 | 7.5 |
| Others | 29.8 | 16.5 | 31.8 |

Sources: CBR, Standard&Poor's, Interfax, RBA

*Sberbank, Vneshtorgbank

** by assets: Alfa Bank, Gazprombank, Bank of Moscow, IMB, Mezhprombank, MDM, Rosbank, Surgutneftegazbank, Trust and Investment Bank

The following scenarios could materialize over the next couple of years:

- **'Quick reform, more competition'** Under this scenario, foreign and medium-sized banks would considerably expand their activities and increasing competition would raise the quality of banking services. Together with the corresponding improvement of trust in the banking system, this would allow the sector to play a more traditional role as a catalyst of growth in the economy. Though the share of state banks would decrease, this group of banks, and larger banks associated with financial industrial groups that enjoy nationwide networks and export-oriented clients, would retain their dominant positions, albeit to a lesser degree. This scenario would be the most desirable in terms of efficiency, though it requires substantial liberalization of financial sector regulations and expedient implementation of the reform programme.
- **'Foot-dragging and limited liberalization'** Lacklustre implementation of reform, protectionism, and limited liberalization would only encourage further strengthening of the largest state and private banks, and the 'crowding out' of regional and foreign banks. This scenario would entail high risks and a fragile stability in the financial sphere, with many banks being exposed to a limited number of borrowers. Respectively, the risk of systemic crises would increase, especially in times of less favourable external economic conditions.

*Corporate bond market*

The rouble-denominated corporate bond market has burgeoned over the past year, both in terms of borrowing volumes and industry diversification. The average monthly placement volume doubled since the spring to 5–7 billion roubles (approx. US$ 100–200 million). Secondary market turnover is also climbing rapidly from month to month. In total, the value of marketable corporate and banking bonds more than doubled last year, surging to 55 billion roubles by October 2002 from 18 billion roubles as of September 2001.

At the same time issues have become both larger and 'longer', which has boosted liquidity on the secondary market. The average term between put options is being extended from three to six months, and more issues now include options after 12 months.

The composition of the market is evolving as well. Toward the end of last year, the market was primarily represented (apart from banks) by oil, metals, engineering, and telecoms. Since then, two dynamics are noticeable: incumbents have further expanded their presence, but rapid diversification has also been taking place, with debuts from food and chemical industries such as LMK and Nevinnomyssky Azot, as well as petrochemical producers like Nizhnekamskneftechm. Meanwhile, banks and telecoms have nearly doubled their share of the market over the last six to eight months.

The supply of corporate Eurobonds is also expected to grow in the year ahead. The general rise in popularity of Russian assets, improvements in borrowers' financial status and the need to finance investment projects have triggered a new wave of placements since autumn 2001.

The major corporate issuers include companies in the oil and gas sector, and the metals and telecommunications industries. The pioneers on the international bond market were giants of domestic industry such as Gazprom, Magnitogorsk Metal Works (MMK), Rosneft, Sibneft, Vimpelcom, MTS and Tyumen Oil Company (TNK). A new issue by Gazprom, as well as market debuts by Transneft and Diamonds Russia Sakha (ALROSa) are currently in the works. Additionally, the largest banks, such as MDM-Bank and Alfa-Bank, are entering the Eurobond market. Currently the stock of corporate Eurobonds amounts to US$ 2.8 billion, and it could easily climb to US$ 4.0–4.5 billion in the first half of 2003.

While corporate Eurobonds offer a higher rate of return than sovereign bonds, potential investors should assess the risk associated with individual issuers quite thoroughly, and bear in mind that so far the liquidity of these two categories of assets is generally much lower than that of sovereign Eurobonds.

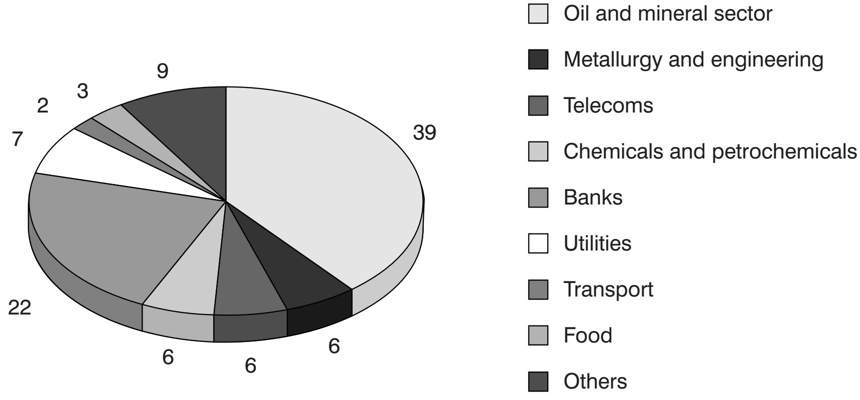


**Figure 1.1.7** Composition of the corporate bond market, per cent of total (October 2002)

1.2

# The Legal Regime and Regulatory Environment

*CMS Cameron McKenna*

Russia is in the midst of economic and legislative reforms. Since 1990 the Russian government has put into place the statutory framework to bring the country up to modern standards and harmonize legislation. Although Russia does not yet have a stable and established legislative system, this issue remains one of the key priorities of the Russian government.

The legal structure developed at a rapid pace during the 1990s with significant reforms being attempted in almost every sphere of law. The process of consolidating and rationalizing the legal framework of Russia's market economy remains ongoing with major changes anticipated in a number of key areas.

## *Constitutional structure*

*Constitution*

The Constitution of the Russian Federation was adopted by National Referendum on 12 December 1993. The Constitution defines the sovereign power of the Russian Federation and describes the federal structure of the Federation, the governing system of the Federation and the principal human rights enjoyed by citizens of the Federation. The Russian Federation is governed by a political system modelled after many in the West. The governing system is composed of three branches: the executive, the legislature and the judiciary.

*Federal structure: local and federal government*

The Russian Federation consists of 89 'subjects', including regions, ethnically based autonomous republics, territories and the federal cities of Moscow and St Petersburg. The Constitution granted these 'subjects' certain autonomy over internal economic and political affairs.

The Constitution sets out a general list of powers reserved by the federal authorities. Other powers are expressed as jointly exercised by the federal and local authorities. The regional authorities are then allocated all other powers not specifically reserved by the Federal Government or exercised jointly. These powers include the power to manage municipal property, establish regional budgets, collect regional taxes and maintain law and order. Bilateral power-sharing treaties between the central government and the subjects of the Russian Federation have become an important means of defining and clarifying the boundaries of their respective power and authority. The Constitution gives regional bodies the right authority to pass laws provided those laws do not contradict the Constitution and existing federal laws. Many subjects, however, have adopted their own constitutions, which in several cases allocate powers to the regional government that are inconsistent with the provisions of the Federal Constitution.

*Executive branch and its structure*

Under the Constitution, the executive branch is headed by the president, who is elected for a four-year term. The Constitution does not provide for a vice president. The president has the right to choose the prime minister, with the approval of the State Duma (the lower house of the Russian parliament). The president, upon the recommendation of the prime minister, appoints ministers, who are responsible for the introduction of primary and secondary legislation in their respective fields.

Russia's president determines the basic direction of Russia's domestic and foreign policy and represents the Russian State within the country and in foreign affairs. The president is commander-in-chief of the Russian armed forces; he approves defence doctrine, appoints and removes the commanders of the armed forces, and confers higher military ranks and awards.

The president has broad authority to issue decrees and directives that have the force of law, although the Constitution states that they must not contradict other federal laws or the Constitution. In certain circumstances, the president has the right to dissolve the Duma.

*Parliament and the basics of the legislative process*

The legislative branch of the Russian Federation is the Federal

Assembly (*federalnoye sobraniye*), which consists of the Federation Council (*sovet federatsii* – 178 seats, filled by the representatives of executive and legislative branches of power of each of the 89 federal administrative units) and the State Duma (*gosudarstvennaya duma* – 450 seats, half elected by proportional representation from party lists winning at least 5 per cent of the vote, and half from single-member constituencies; members are elected by direct popular vote to serve four-year terms). The principles of election to the State Duma may soon be changed because the president has submitted a new draft law on elections to the Duma for its consideration. The two chambers of the Federal Assembly possess different powers and responsibilities, although the State Duma is the most significant.

The Federal Assembly is a permanently functioning body, in that it is in continuous session except for a regular break between the spring and autumn sessions. Deputies of the State Duma work full-time on their legislative duties; they are not allowed to serve simultaneously in local government or to hold Federal Government positions.

Each legislative chamber elects a chairman who controls the procedure of the chamber. The chambers also form committees and commissions to deal with particular types of issue. The committees prepare and evaluate draft laws, report on draft laws to their chambers, conduct hearings and oversee implementation of the laws.

Draft laws may originate in either of the legislative chambers, or they may be submitted by the president, the government, local legislatures, the Supreme Court, the Constitutional Court, or the High Arbitration Court. Draft laws are first considered in the State Duma and must pass three readings before being passed to the Federation Council. After adoption by a majority of the State Duma members, a draft law is considered by the Federation Council. If a bill is rejected by the Federation Council, a Conciliation Commission may be established, comprising representatives of the Duma and Federation Council, to review and amend the draft before it is presented again to the Federation Council. Conciliation commissions are the prescribed procedure to work out differences in bills considered by both chambers.

When a draft law is adopted by the Federation Council, it must be signed into law by the president. The president has a veto, which, if exercised, can be overridden by a resolution passed by two-thirds of the members of the Duma and the Federation Council.

*Judicial system*

The judicial system in the Russian Federation is split into three branches: the courts of general jurisdiction with the Supreme Court at the top, the *arbitrazhniy* (commercial arbitration courts) with the High Arbitrazhniy Court as the supreme body, and the Constitutional Court. The judicial system is also divided into a federal system and a system of local courts belonging to the various subjects of the Russian Federation.

The Constitutional Court decides whether federal and local legislation and regulations comply with the Constitution. The Constitutional Court also resolves jurisdictional disputes between federal or local authorities and it may interpret and clarify the Constitution.

Criminal, civil and administrative cases involving individuals not engaged in business activity are dealt with by the courts of general jurisdiction. The initial stage in the system is the magistrate. Magistrates serve each city district and rural district. The whole system consists of the magistrates, district courts of general jurisdiction, Supreme Courts of the constituent subjects of the Russian Federation and the Supreme Court of the Russian Federation. Decisions of the lower courts of general jurisdiction can be appealed through intermediate district courts and the Supreme Courts of the subjects of the Russian Federation up to the Federal Supreme Court.

Economic disputes involving legal entities, individuals engaged in business activity and disputes between legal entities and their participants (shareholders) (this was established by the new draft of the Arbitration Procedure Code which was signed into law and came into force on 1 September 2002) are dealt with by the *arbitrazhniy* (commercial arbitration courts). These are sometimes referred to, rather misleadingly, as 'arbitration courts'. The arbitrazhniy court system consists of arbitrazhniy courts of the subjects of the Russian Federation, federal arbitrazhniy courts and the High Arbitrazhniy Court of the Russian Federation. The High Arbitrazhniy Court is the highest court for the resolution of economic disputes.

The Ministry of Justice administers Russia's judicial system. The Ministry's responsibilities include administering the court system, supervising court activity and organization, as well as performing a number of other supervising, administrative and systematic functions.

Law enforcement functions are performed by the Procurator General's Office (*procuratura*), which has local offices in cities and provinces, by the Ministry of Internal Affairs and by the Federal Security Service. The Procurator's office supervises the law enforcement agencies and investigates and prosecutes crimes. The Ministry of Internal Affairs controls all the various police agencies and supervises prisons and the fire service. The Federal Security Service (formerly the KGB) is responsible for counter-intelligence work and investigates organized crime and terrorism.

## *Basics of the civil law system*

*Legal system and legislative subordination*

The Constitutional Laws, Federal Laws and Laws of the Russian Federation form the foundation of the legal system. Presidential Decrees, Orders of the Government and decisions of various ministries support and describe the provisions of the primary laws and, as a matter of constitutional theory, should not contradict them.

The Russian legal system is a civil law system in the Continental European tradition. Various codes govern all major spheres of business activity. The principal codes are:

- Civil Code of the Russian Federation (*grazhdanskiy kodeks*);
- Tax Code of the Russian Federation (*nalogovyi kodeks*);
- Customs Code of the Russian Federation (*tamozhennyi kodeks*);
- Labour Code of the Russian Federation (*trudovoi kodeks*).

*Civil and corporate legislation*

Civil legislation of the Russian Federation is based on the Civil Code (Parts I, II and III – the fourth Part should be adopted soon) of the Russian Federation of 1994. Pending adoption of Part IV of the Civil Code, some parts of the Civil Code of the Russian Soviet Federal Republic of 1964 and of the Civil Code of the USSR of 1991 remain in force.

Within the past decade Russia has developed comprehensive corporate legislation covering all major issues of corporate activity. The general principles of corporate legislation are discussed in 4.1 'Business Structures in Russia'.

*Tax legislation*

Russia is currently in the midst of significant tax reform. In August 2000 Part II of the Tax Code was signed into law and it became effective in January 2001. Many tax regulations are in transition. The main taxes are:

- Profit tax: Profit tax is levied on the enterprise's gross profit. The general tax rate is 24 per cent of gross profit with some exceptions.
- Value added tax (VAT): VAT is calculated on the sales value of goods (services, works) at a general rate of 20 per cent with certain exceptions. Imported goods are also subject to VAT.
- Excise tax: Excise tax is levied on the sale or importation of certain goods (alcohol, tobacco, jewellery, cars, oil, gas and others). The tax rate varies for each product.
- Sales tax: Sales tax is levied by local authorities at a maximum rate of 5 per cent on the value of goods and services sold in wholesale and retail stores. Certain types of goods and services are tax-exempt.
- Land and property taxes: Land and property taxes are levied by the local authorities at a rate depending on the location of the property.
- Personal income tax: Personal income tax is calculated at a flat rate of 13 per cent.

*Property, currency, customs and international legislation*
The Constitution gives Russian citizens general rights to own, inherit, lease, mortgage and sell property; however, there are many gaps and ambiguities in the legislation that implements those rights. A new Land Code came into force on 29 October 2001 regulating the use and ownership of municipal and industrial land. Agricultural land is specifically excluded from the jurisdiction of the Land Code and is regulated by a separate federal law, which will come into force on 27 January 2003. The law on agricultural land provides that agricultural land cannot be owned by foreign legal entities or individuals or by Russian legal entities if more than 50% of their charter capital is owned by foreigners.

Russia has extensive and complex currency control legislation. The Russian currency, the rouble (RUR), is the only legal tender in Russia. There are two types of currency operation according to the Law of the Russian Federation on Currency Controls of 9 October 1992:

- Current operations: includes import/export contracts with deferral of payment for less than 90 days, loans not exceeding 180 days and some other transactions.
- Capital operations: includes direct and portfolio investments, import/export contracts with deferral of the payment for more than 90 days, loans exceeding 180 days and some other transactions.

Capital operations generally require a licence of the Central Bank of the Russian Federation (CBR). Non-residents of the Russian Federation may have both hard currency and rouble accounts to service their operations in Russia.

The main legislative act governing the customs legislation of the Russian Federation is the Customs Code of the Russian Federation of 18 June 1993. Russian import tariff rates vary from 0 per cent to 20 per cent, depending on the imported item. The tariff rate for cars is 25 per cent and the sugar and tobacco rates are 30 per cent. In addition to import tariffs, VAT and selective excise tax are also applied to imports. Import licences are also needed for certain types of goods (sugar, alcohol, etc).

The Constitution states that general principles of international law and international treaties are part of the legal system of the Russian Federation. If Russia is party to an international treaty that contains provisions contradictory to the provisions of the Russian legislation, the provisions of the international treaty prevail.

## *Foreign investment legislation*

While the encouragement of foreign investment is a stated Russian government priority, there have been difficulties in creating a stable, attractive investment climate. Foreign investors' concerns about the legal system, corruption and taxation are key factors affecting foreign investment, rather than any explicit express restrictions imposed by the government.

*Foreign investment law*

The main legislative act governing the sphere of foreign investments is the Law of the Russian Federation on Foreign Investment in the Russian Federation of 9 July 1999 (Foreign Investment Law). The Foreign Investment Law provides the statutory basis for the treatment of foreign investment. The Law states that foreign investors and investments shall be treated no less favourably than domestic investments, with some exceptions. Such exceptions may be introduced to protect the Russian constitutional system, the morality, health and rights of third persons, or in order to ensure state security and defence.

Russian legislation may also introduce special rights promoting foreign investments. The Law permits foreign investment in most sectors of the Russian economy and in all forms available in the Russian economy: portfolio of government securities, stocks and bonds, direct investment in new businesses, the acquisition of existing Russian-owned enterprises, and joint ventures, etc. Foreign investors are protected against nationalization or expropriation unless this is provided by federal law of the Russian Federation. In such cases, foreign investors are entitled to receive compensation for the investment and other losses.

*Restrictions on foreign investment*

Currently, there are relatively few explicit restrictions on foreign direct investment. Foreign ownership in the natural gas monopoly, Gazprom, is limited to 14 per cent. Legislation limits foreign investment in the electric power company, Unified Energy Systems (UES), to 25 per cent.

The Russian Law on Insurance of 27 November 1992 established a ceiling of 15 per cent on the total amount of foreign investment in the insurance industry of the Russian Federation as a percentage of the total insurance capital in Russia. Insurance companies in which foreigners own more than 49 per cent of the Charter Capital may not engage in certain types of insurance business, including life assurance.

The CBR has the right to use reciprocity as a criteria to specify the types of business that foreign banks may be licensed to conduct in Russia and is permitted to impose a ceiling on the total amount of foreign bank capital as a percentage of the total bank capital in Russia. At present, foreign banks' share of the total capital bank is well below the 12 per cent ceiling set by the CBR.

*International treaties*

Russia is party to a number of international treaties, which are aimed at the protection of foreign investments:

- Bilateral investment treaties: these treaties generally guarantee non-discriminatory treatment for foreign investments and investors in Russia, provide for compensation to be paid for expropriation or nationalization and allow disputes to be referred to international arbitration. Russia holds such agreements with the United Kingdom, Germany, Italy, Spain, the Netherlands, Finland, France, Switzerland and others. The treaty entered into with the United States has yet to be ratified.
- Treaties for the avoidance of double taxation: these treaties generally provide relief from double taxation, guarantee non-discriminatory tax treatment and provide for cooperation between the tax authorities of the respective signatory countries.

Russia has such agreements with Austria, the United Kingdom, Greece, Denmark, Ireland, Spain, Italy, Canada, Cyprus, the Netherlands, the United States, Germany, France, Switzerland and many other countries.

# 1.3

# The Political Environment

*William Flemming*

### *Introduction*

Governing the Russian Federation – a country which spans 11 time zones, with around 145 million inhabitants, and covering almost one-seventh of the world's land mass – presents a formidable task for any Russian president. This resource-rich country stretches from the Pacific Ocean to the Baltic Sea and from the Arctic Circle to the Black Sea and China. The Russian Federation emerged from the ruins of the Soviet Union in 1992 as the legal successor state to the Soviet Union, and since then has certainly not enjoyed the smoothest of transitions from a totalitarian political system and centrally planned economy to democracy and the free market.

Vladimir Putin was elected president of the Russian Federation in March 2000 (garnering a first-round majority of over 52 per cent), in what was feted as the first democratic transfer of power from one leader to another in Russia's 1,000-year history. Pre-term elections were triggered by the resignation of Boris Yeltsin – Russia's first president – who stepped down on New Year's Eve 1999, making Putin acting president until new elections could be held. Putin's overwhelming election victory completed a dizzying career ascent that took him from relative obscurity to prime minister, acting president, and then president of the Russian Federation in less than a year.

This chapter looks at the political landscape and the main political institutions in Russia, and then proceeds to a brief and preliminary assessment of the achievements of the Putin presidency to date.

## ***The president and presidential administration***

Russia's first post-Soviet constitution – adopted in 1993 – laid the foundation for what is sometimes referred to as a 'super-presidential' system, in which considerable formal powers are vested in the office of the president, in addition to which the president commands an equally impressive set of 'informal levers' for exerting influence over the body politic. According to the constitution, the president is elected for a term of four years and may sit for a maximum of two consecutive terms. The president plays a leading role in setting the domestic and foreign policy agenda, is Russia's top representative on the international stage, and is commander-in-chief of the Russian armed forces. He nominates the prime minister (as well as having extensive control over other government appointments), who must then be approved by the lower chamber of the Russian parliament (called the State Duma). He also has certain powers of decree and can veto legislation passed by the legislature, which then requires a two-thirds majority in both the lower and upper chambers in order to be overturned. Furthermore, the president has the power – indeed is obliged – to dissolve the Duma, if his nominee for prime minister is rejected three times in a row. And if the Duma passes two motions of no-confidence in the government within a period of three months, the president must either dismiss the prime minister and his government or dissolve the Duma.

To help him in fulfilling his constitutional duties, the president has a sizeable staff – the presidential administration – with a total of around 2,000 employees. Head of the presidential administration is Alexander Voloshin, who held the position in the final year of Boris Yeltsin's reign. Despite his identification with certain Yeltsin-era cronies who are now out of favour, Voloshin has not only managed to hold onto his position, but has also retained considerable influence under Putin. On the economic side of the administration, the key figures are the highly competent Anton Danilov-Danilyan, head of the economic department, and Andrei Illarionov, economic adviser to the president. Aside from advising the President, Illarionov periodically gets into very public spats with the Government over economic policy and with Unified Energy Systems CEO Anatoly Chubais (particularly vis-a-vis Chubais' plans for the restructuring of UES).

One of the key levers for exerting informal influence at the disposal of the president is the so-called 'household department' of the presidential administration (*upravlenie delami prezidenta*).

This department controls a not-so-small empire of hotels, dachas, apartments, chauffeur-driven cars, top-notch medical facilities, etc and is responsible for taking care of the needs of government officials, Duma deputies, officials in the General Prosecutor's Office, Supreme Court judges, etc. It provides the President with a rich source of patronage and largesse which can be (and has been) used extremely effectively for political ends. Numerous political disputes have been resolved by a liberal dose of the 'carrot and stick', with the Kremlin's household department dangling the carrot. Even the most ardent political opponents tend to be susceptible to the influence of material incentives offered by the Kremlin, and this is probably not surprising given that official salaries – even of top government officials, judges and MPs – are extremely meagre (somewhere between US$ 300 and US$ 800 per month).

## *Government*

Although the Russian constitution has a number of features in common with the French constitution of the Fifth Republic (both of which provide for a form of dual executive), the main difference – in practice at least – has been the preponderance of the president over the parliament in influencing cabinet formation in the Russian case. Throughout the post-Soviet period (with the possible exception of the short-lived cabinet of Yevgeny Primakov), the Government has depended on the president for support rather than resting independently on a parliamentary majority. As a result, the Government has always been the junior partner in the executive, possessing limited political weight and lacking a strong political base of its own. During the Yeltsin era, this was reinforced by the president's efforts to consolidate his own position within the executive by means of frequent prime ministerial sackings, cabinet reshuffles and playing cabinet members off against one another. Although Putin has so far eschewed his predecessor's penchant for frequent government shake-ups, the Government is nonetheless weak as it depends upon the president's support and the legitimacy that his popularity confers. Moreover, Putin's strong approval ratings and his support in the Duma mean that, at present, he would be unlikely to incur serious problems or damage to his political capital if he were to change the Government – although militating against such a scenario is the fact that political stability is one of Putin's main achievements to date, and one would presume, therefore, that he would be loath to undermine it unless he had very good reason to do so.

The key figures in the Government responsible for the economy are: Prime Minister, Mikhail Kasyanov; Deputy Prime Minister and Finance Minister, Alexei Kudrin; and Minister of Economic Development and Trade, German Gref. Although Kudrin and Gref are formally subordinate to Kasyanov, their real influence is considered to be on a par with the Prime Minister's due to their long-standing ties with Putin and their access to the President on a day-to-day basis (both worked with Putin in the St Petersburg city administration under Mayor Anatoly Sobchak).

The Government has its own apparatus (in the UK, the cabinet office would be the nearest equivalent), which is separate from, although its functions overlap with, the ministries and other agencies which comprise the government. The lack of a clear chain of executive command, in part caused by the duplication (and even triplication) of roles and responsibilities between the presidential administration, the apparatus of the government, and the ministries/agencies, has seriously impaired the effectiveness of the executive. Although this is partly the legacy of the Soviet Union and the tangle of institutions inherited, Yeltsin made precious little effort to dismantle these institutions and create a streamlined bureaucracy, probably because the institutional ambiguity only served to bolster his own position within the executive and strengthen his role as supreme arbiter of bureaucratic turf battles and clan conflicts.

## *Parliament – the State Duma and Federation Council*

Russia has a bi-cameral parliament, the lower chamber being called the State Duma and the upper chamber, the Federation Council. The Duma is made up of 450 deputies (MPs), half of whom are directly elected in first-past-the-post contests and half of whom are elected through party lists. Duma elections occur once every four years, providing the president does not dissolve the lower house pre-term (under one of the scenarios outlined above). From 1993 to the end of 1999, the Duma was dominated by the Communist Party and its satellites, while pro-governmental and pro-presidential forces were weak in number. As a result, the executive and legislative branches of government were frequently at loggerheads and relations, at best, were characterized by grudging cooperation. Yeltsin never gave the parliamentary opposition the opportunity to attempt to form a government, although he did from time to time appease the communists by removing ministers who the opposition considered particularly odious, replacing them with more acceptable figures, and sometimes even co-opting individual members of left-wing parties into government. The Government managed to push a certain amount of important legislation through the Duma, normally by a mixture of browbeating, cajoling and the 'carrot and stick' methods alluded to above – however, often the price was the watering down and emasculation of legislation, or its capture by powerful interest groups.

The parliamentary elections in December 1999 fundamentally altered the balance of forces within the Duma, with pro-Kremlin parties strengthening their position considerably and the left opposition losing its prior ascendancy over the legislative process. The shift is graphically illustrated by the strong majorities garnered for key government-backed bills: Part II of the Tax Code was passed with a more than two-thirds majority (362 votes); two pieces of controversial legislation strengthening central government control over the regions were passed by 363 and 308 votes respectively; and ratification of START II (288 votes in favour) provided an important symbolic victory, as left-wing opposition parties had repeatedly blocked ratification attempts under Yeltsin. Moreover, Mikhail Kasyanov, the president's nominee for prime minister sailed through his parliamentary confirmation in May 2000 receiving a more than two-thirds majority (325 votes). And more recently in September 2001, a government-backed Land Code was passed, despite bitter opposition from the Communists and their allies.

However, it is important to mention that the pro-Kremlin bloc in the parliament is not monolithic. In order to muster a simple majority in the Duma, an alliance of four or five parties is generally required, even under the favourable conditions that currently prevail. Some of these parties have multiple allegiances, and in particular many deputies are closely tied (and in some cases beholden) to the regional or business elite; as a result of which, protracted conflict between the Kremlin and the regional governors or big business could sorely test the loyalty of parts of the bloc.

The upper chamber or Federation Council, until Putin's accession to the presidency, was composed ex officio of the governors of each of Russia's 89 regions and the speakers of the regional legislatures, thus consisting of 178 members in total. This provided the regional elite with considerable political clout at the federal level, and also the ability to block federal legislation that did not serve their interests. The upper chamber has the power to veto legislation and send it back to the lower chamber, with a two-thirds majority then being required to override the veto, which, given the balance of forces under Yeltsin, was very difficult to achieve. One of the first major reforms undertaken by Putin following his inauguration as president was to weaken the governors' influence at the federal level by, inter alia, depriving them of their seats in the Federation Council (thus depriving them also of the constitutional guarantee of immunity from prosecution afforded to all members of the State Duma and Federation Council). This reform did not require amendment to the Constitution, as the Constitution itself is rather vague, stating only that: 'The Federation Council consists of two representatives from each of the regions of the Russian Federation; one each from the legislative and executive branches of government'. As a result, governors and heads of regional legislatures have been replaced by full-time delegates nominated by them (this process was completed at the beginning of 2002).

## *The Putin presidency*

More than two and a half years into the Putin presidency, Putin's approval ratings remain consistently high (over 80 per cent at the time of writing). However, his core 'political' projects and reforms can only be considered to have been partially successful; and a number of changes, trumpeted as a clean break with the corruption and muddle of the Yeltsin years, remain more cosmetic than real.

When he came to power, Putin's main proclaimed political objectives were: 1) the introduction of measures targeted at bringing Russia's powerful regional governors to heel and strengthening central government control over the regions; and 2) cutting certain 'oligarchs' down to size and reducing the political influence of the business elite. Another objective (less widely advertised) was the promotion of members of his team – many of whom had worked with Putin, either in the St Petersburg city administration or in the KGB – to key positions in the presidential administration, government, and major state-controlled companies (an ongoing process which started in earnest when Putin was made prime minister back in August 1999). Putin's agenda had two components: 1) to consolidate his position within the executive and, some would argue, to bring all competing centres of power under the administration's control, including the major mass media outlets; and 2) to strengthen the state and increase its capacity to implement policy.

*Strengthening 'the executive chain of command'?*

Under the banner of 'strengthening the executive chain of command', Putin started his assault on the regional elite immediately after his inauguration in May 2000. His approach was two-pronged. First, in order to beef up the Kremlin's presence in the regions, he issued a decree dividing the 89 regions of the Russian Federation into seven federal districts and appointed seven plenipotentiary presidential representatives to head up these districts. Second, he rammed a package of bills through the parliament, which deprived regional governors et al. of their seats in the Federation Council and made it possible for the president to: dismiss governors and disband regional legislatures if they adopt laws that contravene federal legislation; and suspend governors facing criminal charges, under certain circumstances.

However, to date Putin has proved reluctant to use his newly-acquired powers, preferring instead to cut backroom deals or rely on strong-arm tactics. For example, when the notorious former governor of Primorye, Yevgeny Nazdratenko, became too much of an embarrassment, Putin prised him out of his 'fiefdom' with the promise of a cushy job as head of the State Fisheries Committee and, presumably, the threat of problems if he did not comply. This did not set a particularly good precedent pour encourager les autres.

A number of other 'undesirable' governors have either been bullied and browbeaten into not running for re-election, or have been excluded from running on some technicality or other.

In the first half of 2002, the Kremlin showed signs of softening its line towards the regional elite. And in July 2002, the Constitutional Court – apparently with the president's blessing – ruled that many incumbent governors will be able to run for third and fourth consecutive gubernatorial terms, despite a law limiting them to two.

Following on from attempts to recentralize power, Putin is now trying to launch a major reform of the country's federal system. A commission was created in 2002, charged with drawing up proposals on the delineation of powers and responsibilities between the federal, regional and local levels of government – under the chairmanship of presidential aide Dmitry Kozak. In December 2002, the first packet of legislative amendments on the basis of the Kozak commission's recommendations are to be introduced into the Duma, although the reforms are not expected to be completed until 2005. The gist of the reform is simple enough: to clarify the functions of each level of government (there are a number of grey areas in the constitution) and provide adequate sources of finance for each level to carry out its functions. However, exactly how this is to be achieved is not entirely clear.

Moreover, the proposed reforms have already come up against opposition from various sections of the political elite and it remains uncertain how hard the Kremlin will be prepared to push, given that parliamentary and presidential elections are looming on the horizon.

In conclusion, although governors have lost a certain amount of clout at the federal level (and the Kremlin is trying to further reduce governors' influence by limiting their powers to recall delegates to the Federation Council), they still very much rule the roost on their home turf. The president's plenipotentiary representatives, with weak and poorly defined powers, have yet to become either a significant check on the regional elite or effective agents of the centre in ensuring that reforms are implemented on the ground. The Kremlin, presumably not desiring to rock the boat during the upcoming period of elections, will most likely pursue a fairly conciliatory line towards the regional elite at least until March 2004.

*Oligarchs at arm's length?*

Putin has largely failed to deliver on his promise as presidential candidate to 'eliminate the oligarchs as a class', although since he became president two prominent 'oligarchs' have had to leave the country. Putin's main achievement to date has been in more or less enforcing an agreement that the 'oligarchs' not publicly interfere in politics. However, in many respects the influence of big business remains undiminished; and probably the main difference vis-a-vis the Yeltsin years is that nowadays cosy relations between big business and the authorities are not flaunted quite so publicly.

A recent study shows that eight Russian business groups control the top 64 privatized enterprises in the country.[1] The authors of the study see this as a positive development, arguing that the private sector business elite, having consolidated control over their assets, have a direct interest in lobbying for stronger property rights, and policies that improve the investment climate and increase the value of their companies; their hand is seen behind the tax reform, land reform, Putin's pro-Western foreign policy, etc. However, by no means everyone is convinced of the benefits of such a concentration of wealth and property in the hands of a few magnates. Indeed, assuming that the conglomerates

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[1] See Peter Boone and Denis Rodionov, *Rent-seeking in Russia and the CIS*, unpublished mimeo; and *Reformed Rent-Seekers Promoting Reform?*, The Moscow Times, 23 August 2002.

are motivated by rational self-interest, it seems highly unlikely that they will be pushing for genuinely independent regulatory bodies or pro-competition policies; on the contrary, the chances are that they will do what they can to obstruct competition by maintaining close relations with the authorities, and making sure that administrative barriers to doing business are kept high, so that competition is limited.

*Petersburg personnel policy*
On the personnel front, Putin has continued to promote members of his team to key positions. In the past year, inter alii, former First Deputy Finance Minister Sergei Ignatyev (part of the first wave of St Petersburgers to join the Russian Government back in 1991–1992) was appointed to replace Viktor Gerashchenko as chairman of the Central Bank; and Sergei Mironov, an unknown from the St Petersburg city legislature, was made speaker of the Federation Council.

*What is to be done?*
Ultimately, the weakness of the state and the predatory activities of government agencies continue to be the main source of risk impinging on the business environment and blocking the creation of a nationwide 'level playing field' for business. This point is corroborated by a recent World Bank study to monitor the impact of federal deregulation measures intended to reduce the burden of red tape on small- and medium-sized enterprises. The survey of almost 2,000 enterprises in 20 regions shows that there has been little overall improvement and that, in some respects, administrative barriers have been getting worse.

Putin seems to be well aware of this problem, as he devoted considerable attention to it in his state of the nation address in April 2002:

*At the moment, the country's colossal potential is being blocked by a cumbersome, inflexible, and ineffective state apparatus. … I would like to note that the way the state apparatus is organized at present, unfortunately promotes corruption. … Any administrative measure can be surmounted by a bribe. The higher the barrier, the greater the bribe and the more highly placed the official taking it.*

Although the president seems to be committed to far-reaching administrative and civil service reform and has chastized

Kasyanov on more than one occasion for dragging his feet on this issue, there has been little action to date. Politically this is a very sensitive area and with the presidential election in March 2004 already looming, it is very unlikely that any major reforms will be undertaken before then. It remains to be seen what Putin will do once he is elected (as he almost certainly will be) to a second term.

## 1.4

# Russia's Foreign Trade

*Professor Valery A Oreshkin, Director, All-Russia Market Research Institute (VNIKI)*

During the period 1992–2002, amidst the backdrop of a severe decline in Russia's economic potential, the dependence of the country's economy on external markets has increased sharply. The GDP of the Russian Federation has contracted by 31 per cent during 1990–2001, industrial production volume has declined by 40 per cent, and agricultural output by 33 per cent. However, the general economic decline has had its sharpest impact on the investment sector, where gross fixed capital investment has fallen by almost 72 per cent during the 1990s. As a result of these developments, even despite the relatively favourable trends in Russia's economy emerging from the 1998 rouble devaluation, the country's macroeconomic indicators are still well behind those of the late 1980s. During the last 10 years, Russia's GDP share in the total world GDP fell to 2.2 per cent in 2001 (from 5.5 per cent in 1990), its share in world exports fell to 1.7 per cent (from 2.2 per cent), and imports fell to 0.8 per cent (from 2.3 per cent). One has to admit that Russia's participation in world exports and imports of services (0.7 per cent and 1.3 per cent respectively) and in globally accumulated foreign direct investments (Russia's share has averaged 0.3 per cent for 1992–2001) has been more of a symbolic nature than of anything significant.

In this context, it is worthwhile noting that Russia's export quota has jumped to 60 per cent in 2001 from 16.5 per cent in 1990 (although it never exceeded 15 per cent during the entire existence of the Soviet Union). As a result of these developments, foreign trade tax proceeds contributed only between one-third to one-half of the total state budget revenues during those years. This situation leaves the country exposed to an extremely dependent position with regard to fluctuations in the global commodities markets, suggesting that the nature of Russia's export/import pattern is in essence of a mono-cultural nature. International competitiveness ratings produced annually by the Institute for Management and Development (Switzerland, Lausanne) have commonly rated Russia in 40th position in comparative country studies. In terms of competitiveness, Russia ranks not only behind developed countries, but also behind many developing countries and even other former Soviet republics.

## *Exports*

Russia's export sector, the most successfully developing sector of the national economy, has expanded by more than 16 per cent during the period 1990–2001. The highest growth rates (around 15–20 per cent) in the export sector were experienced during the first half of the 1990s, and the previously recorded high volumes of 1990 (US$ 88.5 billion) were hence reached in 1996. However, export growth began to decline soon after, both in terms of annual growth rates and in absolute terms. Exports jumped rather sharply again in 2000 (by some 38.5 per cent), reaching US$ 106 billion that year. In 2001, however, exports dropped to US$ 103.0 billion. For the first nine months of 2002, Russia's exports amounted to US$ 75.4 billion, 0.2 per cent less than for same period of 2001. The positive developments on the export front during 2000–2001 were largely the result of an exceptionally favourable economic situation in the global primary products markets, specifically in the markets for energy related products.

Export growth during the last 10 years may be accounted for by the expansion of the physical volume of export trade. During 1991–2001 it rose by 62 per cent, while the average export price fell by 28 per cent. Although export prices for 1995 were up by 16 per cent, physical volume of the export sector rose by just 4 per cent. In 1996, the corresponding rise was 8.6 per cent for export prices and a minimal 0.1 per cent for export volume. In 2000, average export prices jumped by 28 per cent, while exports in physical terms rose by 10 per cent. In 2001, and January–September 2002, exports grew again in physical terms but were accompanied by falling export contract prices. Russia's export commodity structure is consistently dominated by fuel and other primary products – the share of crude petroleum, natural gas, metals, chemicals semi-products, timber and paper amounts to nearly 80 per cent of total exports. On the other hand, the share of machinery and equipment has dropped during this period, from 18 per cent to 10 per cent.

The export quota has been rising for Russia's main exportable products, and external markets absorb around 33 per cent to 80 per

**Table 1.4.1** Russia's export/production ratio for selected commodities (per cent)

| | *1992* | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* |
|---|---|---|---|---|---|---|---|---|---|---|
| Crude petroleum | 35.4 | 34.7 | 40.2 | 41.0 | 41.7 | 41.5 | 45.3 | 44.2 | 44.7 | 45.9 |
| Petroleum products | 14.8 | 30.3 | 25.4 | 26.1 | 32.4 | 34.0 | 32.8 | 30.2 | 36.0 | 39.8 |
| Natural gas | 30.2 | 27.6 | 30.4 | 32.3 | 33.0 | 36.9 | 35.6 | 34.6 | 34.9 | 32.8 |
| Mineral fertilizers | 69.3 | 72.0 | 70.4 | 74.0 | 75.0 | 72.0 | 72.8 | 82.2 | 82.9 | 81.8 |
| Round wood | 6.8 | 8.8 | 12.5 | 22.3 | 23.2 | 29.3 | 34.1 | 40.1 | 42.4 | 53.4 |
| Saw timber | 6.6 | 11.2 | 20.5 | 17.2 | 13.3 | 17.2 | 17.0 | 17.9 | 24.5 | … |
| Wood pulp | 40.8 | 66.4 | 79.1 | 74.8 | 85.7 | 82.8 | 77.6 | 79.1 | 82.4 | 83.7 |

*Source:* Russia: Foreign Economic Relations. Trends and prospects, m., VNIKI (1997), No4, 2000, No4, 2001, No3, 2001.

**Table 1.4.2** Commodity structure of Russia's exports (per cent)

| | *1990* | *1992* | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Exports, total* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* |
| Foodstuffs and agricultural primary products (except textile) | 2.1 | 3.9 | 4.0 | 4.2 | 3.3 | 2.0 | 1.9 | 2.1 | 1.3 | 1.6 | 1.8 |
| Mineral products | 45.4 | 47.1 | 46.7 | 45.1 | 42.0 | 48.1 | 48.4 | 42.8 | 44.9 | 53.8 | 54.1 |
| Chemical, rubber | 4.8 | 6.2 | 6.4 | 8.2 | 9.9 | 8.7 | 8.3 | 8.7 | 8.5 | 7.2 | 7.5 |
| Timber, pulp and paper products | 4.1 | 3.2 | 3.6 | 3.9 | 5.6 | 4.2 | 4.2 | 4.9 | 5.1 | 4.3 | 4.4 |
| Textiles and articles thereof, footwear | 1.1 | 1.0 | 0.7 | 2.0 | 1.5 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 0.8 |
| Precious metals and precious stones, articles thereof | 16.0 | 18.4 | 20.6 | 26.4 | 26.1 | 24.1 | 24.0 | 27.6 | 26.5 | 21.6 | 18.8 |
| Machinery and transport equipment | 18.1 | 10.8 | 8.1 | 8.3 | 9.9 | 10.0 | 10.7 | 14.4 | 10.9 | 8.9 | 10.5 |
| Other goods | 8.4 | 8.4 | 9.9 | 1.9 | 1.7 | 1.8 | 1.4 | 1.4 | 2.1 | 1.5 | 2.1 |

*Source:* Russian statistical annual, RF Goskomstat, 1995–2001, Russia in figures, RF Goskomstat, 2002

cent of national output of primary goods and semi-manufactured articles.

The main buyers of Russia's products are the EU countries. Their share of Russian exports has increased from 35.2 per cent in 1994 to 36.9 per cent in 2001. The share of Russia's exports of the APEC member states has fallen from 16.8 per cent to 14.8 per cent, whilst the share of the states of Central and Eastern Europe is up from 11.8 per cent to 16.6 per cent during the same period. Other CIS countries have been reducing their purchase of Russian exports, however, from 22.3 per cent in 1994 to 14.6 per cent in 2001.

## Imports

In contrast to the export sector, imports have not recovered back to the levels of the late 1980s after more than a decade of economic reforms. In 2001, imports stood at 56 per cent of the 1990 level. The highest import figures were attained in 1997, a total of US$ 74 billion worth of imported goods recorded as coming into the country. Following the rouble's sharp devaluation, imports began to tumble from US$ 60 billion in 1998 to US$ 39 billion in 1999. From 2000, imports once again started rising gradually – from US$ 45 billion in 2000 to US$ 54 billion in 2001. For the first nine months of 2002, total imports amounted to US$ 33.0 billion: 11 per cent more than in the similar period of the previous year. The bulk of goods coming into Russia are machinery and equipment (34 per cent), food and primary goods for food manufacture (18 per cent), and various chemicals (18 per cent).

The share of imports in the total consumption of available goods in the domestic market is, as before, rather significant, especially

**Table 1.4.3** Commodity structure of Russia's imports (per cent)

| | *1990* | *1992* | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Imports, total* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* |
| Foodstuffs and agricultural primary products (except textiles) | 22.7 | 28.1 | 26.8 | 27.7 | 28.2 | 25.0 | 25.1 | 24.8 | 26.1 | 21.88 | 22.0 |
| Mineral products | 3.0 | 2.8 | 4.1 | 6.5 | 6.4 | 6.7 | 5.8 | 5.4 | 4.0 | 6.3 | 2.5 |
| Chemical, rubber | 9.3 | 9.1 | 8.4 | 10.0 | 10.9 | 14.2 | 14.4 | 15.1 | 16.0 | 17.9 | 18.1 |
| Timber, pulp and paper products | 1.0 | 1.3 | 0.6 | 1.5 | 2.4 | 3.2 | 3.6 | 3.8 | 3.6 | 3.8 | 4.0 |
| Textiles and articles thereof, footwear | 9.1 | 12.6 | 13.2 | 7.9 | 5.5 | 5.0 | 4.5 | 4.1 | 5.2 | 6.3 | 5.4 |
| Precious metals and precious stones, articles thereof | 5.3 | 3.1 | 4.0 | 6.7 | 8.4 | 9.9 | 7.1 | 7.2 | 7.3 | 8.6 | 7.4 |
| Machinery and transport equipment | 44.5 | 38.2 | 34.0 | 35.2 | 33.7 | 32.1 | 35.3 | 35.6 | 33.3 | 31.4 | 34.1 |
| Other goods | 5.1 | 4.8 | 8.9 | 4.5 | 4.5 | 3.4 | 4.2 | 4.0 | 3.9 | 3.9 | 6.5 |

*Source*: Russian statistical annual. RF Goskomstat, 1995–2001, Russia in figures, RF Goskomstat, 2002 with respect to consumer products. In the mid-1990s this share exceeded 50 per cent, while after the 1998 default it contracted to 36 per cent, before rising to 40–41 per cent in 2000–2001. The phenomenon of the suitcase – or ‘shuttle’ – trade in the Russian consumer goods sector has become very characteristic of Russia at present and is essentially comprised of largely non-organized trade conducted by physical persons. The ‘shuttle’ trade accounts for around 20 per cent to 33 per cent of total imports.

The EU countries are the main suppliers of goods to the Russian market. Imports from the European Union amounted to 37 per cent of total imports in 2001. However, despite the fact that the European Union is the largest source of Russian imports, as of 1994 the EU share of Russian imports has been falling, from an initial high of 40 per cent recorded for that year. The share of the APEC states has risen from 15 per cent in 1994 to 18.5 per cent in 2002; while the share of Central and Eastern Europe decreased to 7.5 per cent from 10 per cent. CIS countries’ imports share remained unchanged during the period, recording 26 per cent of total imports in 1994 and 27 per cent in 2002.

In contrast to the export sector, import dynamics have demonstrated a clear-cut trend. Up to 1997, average import prices rose more rapidly than physical volume of imports, but as of 1997 the trend was reversed. As a result, both indices actually remained at the same level for the period of 1990–2001: the index of physical volume was 83 per cent and the index of average import prices was 55 per cent. The so-called index of ‘terms of trade’ from 1990–2001 increased by 33 per cent.

## *Foreign trade policy*

The formation of the foreign trade regulatory system in contemporary Russia was largely created during the Yeltsin presidency. However, the regulatory environment developed irrationally, resulting in the creation of a cumbersome, ineffective and over bureaucratized management apparatus for the regulation of external economic relations. A paradox arising out of the regulatory system’s creation, however, is that Russia’s foreign trade regime is excessively liberalized and market reforms have ‘shocked’ this sector more intensively than the domestic economy. The opening of the domestic market turned out to be a unilateral act and no reciprocity followed from the external counterparts. Liberalization of foreign trade ties did not take into account either the internal socio-economic realities of the time or the trends in the development of international trade.

The only significant reforms related to foreign trade regulations introduced since President Putin came to power have been the levying of new import duties – effective from 1 January 2001. The Government has also brought in cardinal, though on the whole unfounded and inefficient, alterations to the customs tariff, where 1) the number of effective duty rates were cut down, and 2) duty rates on homogeneous or close parameter goods have been unified. The change-over was carried out from the seven-level system of import duties (0, 5, 10, 15, 20, 25 and 30 per cent) effective in 2000 to the four-level system (5, 10, 15 and 20 per cent). Application of the other duty rates (0, 25 and 30 per cent) became possible only in exceptional cases.

Russia's ongoing process of joining the WTO has been at the centre of foreign trade policies during the last three years. Nearly 85 per cent of dutiable commodity positions have been agreed upon in the wake of bilateral negotiations between Russia and members of WTO. Still remaining on the agenda, however, are the questions of the so-called conditions of Russia's accession that relate to alterations of the effectual tax, investment and foreign trade legislation. Russia run into numerous requirements from WTO member countries during the negotiations, including: the problems of supporting agriculture production and exports; the need to sharply reduce tariffs on furniture and aviation equipment: and the stopping of state energy price regulation etc. So far, the balance of pluses and minuses of Russia's bid to enter the WTO has not been determined, and the very notion of Russian accession meets strong resistance from a number of economic lobbies and power centres in Russia's regions.

Active discussions are also under way in the corridors of power and in the business community with respect to the suggested liberalization of foreign exchange legislation. Proposed reforms in this area envisage cancellation of the mandatory sales of the part of exports foreign currency proceeds, prolonging the time limit for keeping currency proceeds abroad, simplification of procedures and lifting restrictions on transfer of capital abroad.

## 1.5

# Russia – a Market Economy

*Andrew B Somers, President, American Chamber of Commerce in Russia*

In June 2002, the Russian Federation formally acquired 'market economy' status under US trade law, with retroactive effect from 1 April 2002. The US Department of Commerce found that the Russian economy is substantially driven by market forces. The Department's ruling responded to a formal application by two Russian steel companies, with the support of the Russian Government, requesting a change in Russia's legal status from a 'non-market economy' to a 'market economy'. An extensive review process took place, including submission of briefs and testimony by interested parties at a public hearing in Washington. The inquiry centred on an analysis of the extent to which resources are allocated by the market or by the Government, taking into account the level of government involvement in currency and labour markets, pricing, and decisions on production and investment. The Department concluded that Russia has succeeded in transforming its old state command economy into an economy based on market principles, and is therefore entitled to be treated under US trade law as a country with a market economy.

The primary effect on Russia of market economy status is to simplify and make more favourable for Russia the processing of US antidumping actions brought by US producers against imports of Russian products. Such actions claim that Russian products are sold at unfairly low prices on the US market, and seek the imposition of antidumping duties on such imports. These duties, which are in addition to normal customs duties, are imposed in the amount by which the US sales price of the import is lower than what is considered a normal or fair value. This extra duty has the effect of increasing the price of the import on the US market.

Dumping claims may be lodged against importers from both market economies and non-market economies. Thus, Russia's new trade status does not shield Russian importers from allegations of unfair pricing. However, in cases where such claims are upheld, the amount of the dumping duties, known as the dumping margin, imposed on the Russian import, is likely to be substantially less than would be the case if Russia were still treated as a non-market economy. The resulting lower dumping margins should make Russian imports more price competitive on the US market.

The reason for likely lower dumping margin assessments lies in the differing methodologies used by the Commerce Department in calculating the dumping margin. The purpose of the calculation is to determine the so-called 'normal value' of the product. In the case of market economies, sales prices in the importer's home market are generally regarded as reliable indicators of 'normal value'. Not so with non-market economies, where the home market price is regarded as artificially low due to the lack of market-based pricing. In these situations, the Department of Commerce calculates normal value by 'constructing' a value. The constructed value is the result of a set of calculations that try to quantify, on a 'per unit' basis, the value of energy, labour, materials and other elements in the manufacturing process for a similar product in a 'surrogate' market economy at a comparable stage of development eg Brazil, to the non-market economy whose imports are being challenged. To the total value of the elements in the production process are added the values of administrative and sales expenses and profit, again relying on a surrogate market economy. The total constructed value is deemed the normal value for comparison with US prices. Because of the surrogate aspect of the valuation calculation, including the broad discretion permitted in choosing a surrogate market and selecting the available pricing data, an exaggerated and artificially high dumping margin is usually imposed on non-market economy imports.

As a market economy, Russia will generally benefit from the lower dumping margins assessed on its imports in antidumping cases. However, two words of caution should be heeded:

1. Given the significance of the energy sector in the production of metals, fertilizers and other products manufactured in both countries, and the relatively low domestic energy prices in Russia, US producers who bring future anti-dumping claims may well argue that 'normal value' should be established not by reference to the domestic Russian price of the energy input but by a constructed value based on world market prices. If this

argument is successful, Russia will face the same risk it endured previously as a non-market economy, namely the imposition of artificially high dumping margins, making its products prohibitively expensive in the US.

How real is the risk? Very real. The Department of Commerce memorandum of 6 June 2002, supporting market economy status for Russia, singles out Russian domestic energy prices as a notable exception to the Administration's conclusion that the Russian Government no longer controls prices. The memorandum emphasizes that local energy remains a significant distortion in the economy, slowing the adoption of efficient production methods. It should be noted, however, that Russia has recently begun the arduous process of restructuring its electric energy sector, as reflected in draft legislation which has passed the first of three required readings in the Duma, as of the December date of this chapter. Also domestic energy prices have been slowly rising in Russia during the latter part of 2002. If Russia continues on this course, it will insulate its exporters from the risk of having artificially high dumping margins imposed on Russian exporters in antidumping cases.

2. A second note of caution is that a country with market economy status becomes subject to US countervailing duty proceedings in addition to antidumping challenges. Under US countervailing duty law, extra duties above and beyond normal customs duties can be imposed against imports that benefit from foreign government subsidies. Non-market economies are not subject to such proceedings. In view of the Russian Government's prior involvement in many segments of the economy, US producers may not have great difficulty in demonstrating subsidization. Also, since Russia is not yet a member of the World Trade Organization (WTO), in order for US producers to prevail in these countervailing duty proceedings, they will not have to prove injury, as they would for imports from WTO members. In this important respect Russia's lack of WTO membership undermines its ability to take full advantage of its new legal status as a market economy. To counter this negative factor, the US and Russian governments are negotiating an agreement, pending Russia's WTO accession, that would afford Russia reasonable protection in such cases pending WTO accession by requiring the claimant to prove injury.

As a market economy, Russia will enjoy equality of treatment with developed economies in antidumping cases with the developed countries. As it is only six months since Russia received this designation, it is too early to quantify any immediate trade benefits for Russia arising out of market economy status. Total Russian exports to the US for the period January–July 2002, according to the Department of Commerce, were $3.5 billion, pointing to a full year estimated volume of $7 billion, an increase over the 2001 figure of $6.3 billion. This positive trend should continue as market economy status facilitates Russian access to the US market and underscores the significant successes of Russian reform. While not technically relevant to Russia's accession to the WTO, market economy status should have a positive psychological effect on WTO negotiators. Russia's prospects for entry have significantly improved during the past year of 2002, suggesting 2004 as the likely year for Russian accession to the WTO. In any event, market economy status is a leading indicator of Russia's substantial progress toward full integration into the global marketplace.

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# Part Two

# The Foreign Investment Climate and the Financial Sector

# 2.1

# The Foreign Investment Climate

*Kate Mallinson, Russia Analyst, Control Risks Group*

## *Introduction*

Times have changed since the aftermath of the 1998 devaluation in Russia, when one investor was widely quoted for saying that he would rather 'eat nuclear waste than invest in Russia'. Increasing political stability under President Vladimir Putin has substantially improved the investment climate in Russia and many investors are again looking at the Russian market, with its vast, well-educated labour force, its enormous potential reserves and large demand for consumer goods.

Putin has benefited from the election of a parliament that is far better disposed to the economic and institutional reforms favoured by the Government. The passage of laws has become a quicker process, their quality has improved and legal reforms should lead to a more predictable business environment. The Government has made efforts to reduce taxes, allow land sales, reduce red tape, modernize the labour code towards a more flexible market and move towards more workable production-sharing agreements (PSAs). In addition, Russia has witnessed a decline in capital flight and the return of formerly exported capital; key indicators of the improved domestic climate.

All these developments have led to an improvement in outsiders' perceptions of Russia and a revived interest from leading multinationals and companies throughout the world. Old problems – such as a lack of transparency, corruption, non-independent judiciaries and over-regulation or unclear regulation – still apply, but the overall development of the business environment is positive and with the right knowledge, Russia is a rewarding market in which to invest.

## *Economic background*

In comparison with former president Boris Yeltsin, Putin is a careful but systematic economic reformer. Since late 1999, Russia's macroeconomic performance has been impressive; the economy has grown on average between 4 per cent and 5 per cent annually. This has been aided by high international commodity prices and the advantage of the 1998 devaluation. The Central Bank's reserves are growing and inflation is down. Russia has recently been repaying its debts to the IMF ahead of schedule. However, a significant acceleration of growth over the medium term looks unlikely and the economy still remains vulnerable to a sudden decline in crude prices. Much depends on foreign investment, which must expand if the economy is to maintain strong growth rates. If investment growth only remains at 2.5 per cent, Russia will experience a consequent decline in economic growth over coming years.

Putin's vision to sign Russia up to the World Trade Organization (WTO) by 2003, which would help to encourage badly-needed foreign investment, is fading rapidly. Russia's entry to the WTO could be delayed until 2005 by the Government's failure to pass the laws necessary to bring its trade regime into compliance, its refusal to liberalize domestic energy prices, its insistence on high import tariffs for certain goods, and tough curbs on foreign involvement in its service sector.

## *Foreign direct investment*

Foreign direct investment (FDI) remains low; during the first half of 2002 it stood at US$ 1.9 billion, 25 per cent less than the same period for 2001. In comparison, China attracted nearly US$ 47 billion in FDI in 2001. Investment is the key to Russia's future; if the amount of investment in the Russian economy remains at today's level between 2003 and 2010, Russia will not be able to reach the forecasted growth rate of 5–6 per cent per year.

## *Energy*

A prime target for foreign investment is Russia's vast energy sector, where foreign involvement has so far been fairly scarce. High international oil prices, and greater transparency and improved management at some of Russia's oil majors, are attracting foreign capital to the vast opportunities in the energy sector. Political instability in the Middle East has also helped to reignite interest in Russia as an alternative supplier.

In 2002, Exxon Mobil pledged US$ 4 billion to begin developing oil fields off Russia's eastern coast while British Petroleum, despite previous unpleasant experiences, increased its stakes in a Russian oil company.

However, numerous obstacles to getting Russian oil to Western markets remain. In terms of oil exports, Russia ranks second after Saudi Arabia, but unlike Saudi Arabia it has minimal spare production capacity and its export infrastructure is already at full capacity. Another big deterrent for Western oil investors is the poor legal framework. The Government has been promising improvements to the law on PSAs for years, but it has yet to deliver. This has left dozens of foreign oil projects on hold as they seek PSAs. However, it is possible that the PSA law will be less and less important as Russia's general tax and legal environment improves.

### *Food and beverages*

Foreign companies are investing in industries that offer long-term prospects. More foreign companies are beginning to manufacture goods in Russia or to set up basic consumer industries such as food production. Household demand and investment – particularly in the food and machine-building sectors – and increased productivity have been replacing oil prices as the main driver of growth.

The beer industry in Russia has witnessed remarkable success in recent years, thanks to the improving quality and diversity of Russian brands. There is significant foreign investment in the sector and robust consumption growth, encouraged by recovering household incomes and changing tastes, which should lead to strong earnings.

### *Telecommunications and information technology*

Foreign investment in the telecommunications and IT industries remains low. The telecommunications sector is one of the leading areas of contention in Russia's negotiations with the WTO, because of the Government's wariness of opening it up to increased foreign competition. If a government plan to impose a 49 per cent limit on foreign stakes in Russian telecommunications companies is implemented, it could deter foreign investment, not only in the struggling fixed-line sector, but also in the flourishing mobile telephone industry, which has attracted significant sums from prominent global corporations such as Deutsche Telecom, Norway's Telenor, Sweden's Telia and Finland's Sonera.

Internet services are growing rapidly but the market remains fragmented and underdeveloped. Over the last five years the maximum audience (all those who accessed the Internet at least once) grew by 80–200 per cent annually. In comparison to declining Western markets, the Russian IT market is largely growing because of its relative self-sufficiency. Meanwhile, the mobile telephone industry is booming; Russia is in second place among the countries of Eastern Europe in terms of absolute numbers of subscribers, though the level of cellular communications penetration is extremely low. The majority of investment in the information technology sector is made in Moscow and St Petersburg, but the potential for investment in the regions remains vast. The main issues currently thwarting investment are constraints on competition, underdeveloped infrastructure, tariff imbalances, cronyism, and the lack of liquidity.

## *Retail*

The retail sector has grown by 50 per cent since the start of 1999 thanks to a sizeable amount of foreign investment, despite the retreat of many Western retailers after the 1998 devaluation. As retail space is in short supply, foreign companies are building their own shopping centres and department stores. Further to the recent liberalization of land ownership, the main problem that companies are facing is endemic bureaucracy.

One prominent success story is the Swedish furniture group IKEA, which opened its first shop in 2000 just outside Moscow city limits. IKEA expected to make about US$ 50 million in the first five years but sales amounted to US$ 130 million in the first year alone. The company has greatly expanded, adding a major shopping centre and its own furniture factory to its operations.

## *Obstacles to foreign business*

### *Local business elites*

Foreign companies often have tensions with local business elites who are fearful of foreign competition. This fear about foreign competition keeps Russian legislators from passing laws to support PSAs. Aggressive lobbying by business interests fearful of foreign competition has also weakened Russia's bid to join the WTO.

*Banking sector*

An effective banking sector is essential for attracting investment in Russia. Although reform is starting, there is a long way to go. The country's largest banks continue to be run by the Government or leading domestic companies, usually in the natural-resources sector. Only a few have begun to engage in market-driven deposit taking and corporate and consumer lending. Greater confidence in, and oversight of, Russian banks will stimulate more deposits by households and corporations, creating the means for investment in sectors of the economy other than natural resources. Opportunities for international banks to invest directly into the domestic banking sector should increase after reforms are implemented.

*Tax*

There have been substantial achievements in the sphere of tax legislation. Profit tax has been reduced to 24 per cent, personal income tax has been set at 13 per cent (lower than in Western Europe) and turnover-based taxes are to be abolished in 2003. However, further legislation is vitally needed. There are often unexpected changes in tax codes and regulatory policies, and the existing laws are often unclear leading to commercial risk, disputes with authorities and additional costs. Foreign businesses often complain that they are charged arbitrary fines by tax inspectors.

*Legal system*

Investment in Russia continues to be inhibited by the lack of a legal and commercial framework to make investments economically attractive. Russia's legal system is based on a Civil Code that was created in 1995. Regulatory environments are opaque and often arbitrary. Although some judicial reform measures have already been passed, the system remains inefficient and largely corrupt. There has been an increasing use of the arbitration courts to settle business disputes, indicating a gradual increase in trust in the legal system. However, even if a foreign company gets a decision in its favour, it frequently remains unimplemented.

Judges are poorly paid and thus susceptible to corruption, and can be influenced by local businesses. Regional courts often have close connections with the local authorities, and in general the legal system is not independent.

Companies cannot expect to receive fair treatment when in dispute with local interests, particularly if the local company is large and influential in the region. The Government has pledged a thorough overhaul of the legal and regulatory system, but real change will be slow because of entrenched corruption and links between legal bodies and local business and criminal groups. There have been a number of cases of Russian business partners failing to honour contracts with foreign investors.

Particular issues regarding legislation that deter foreign investors are:

- Many laws are poorly worded, leaving them open to contradictory interpretations.
- Judges, lawyers and other court officials are poorly trained and are often uncertain how to deal with complicated corporate law issues.
- There is unclear and conflicting legislation concerning foreign investment, which is often issued by presidential decree; secondary legislation clearing up contradictions is seldom adopted.
- There is a marked difference between the theory and the practice of law. Personal contacts and political clout are often worth more than legal documents, and court officials are often targets of bribery and coercion.

*Bureaucracy*

The huge bureaucracy, which runs through multiple tiers of Government and every sector of the economy, is inefficient and often corrupt. With some exceptions – the tax authorities, for example – state officials are poorly paid and could hardly survive without the occasional bribe. Because of contradictory legislation, a relatively minor official often makes the final decision on the legality of a venture and may ask for money to do so.

Small and medium-sized enterprises are often more vulnerable to licensing and bureaucracy than the larger companies, which have the resources and connections to get round the complications. Obtaining the necessary licences or the countless other documents that foreign companies need to survive in Russia can be a frustrating experience. It is best to employ local staff who understand how the system works and have their own contacts to ensure at least some efficiency. Severe reforms are needed to make the bureaucracy more flexible and efficient, but in many regions the State is the largest employer and much-needed cutbacks in staff would provoke social problems.

*Corruption*

Corruption is central to business life in Russia. Most foreign business people working in Russia will encounter it. The level of corruption varies from small fees requested to bypass low-level bureaucracy to fines imposed by traffic police for a trumped-up motoring offence to huge fees requested by government officials to approve large-scale business deals.

Corruption is a product of the old Soviet system, when rampant bureaucracy required 'lubrication' to make things work. The continued high level of bureaucratic control, the complexity of many laws (especially tax legislation) and low pay for state officials have made corruption an even greater problem in the post-Soviet period. Government campaigns against high-level corruption have had only limited success.

As long as much political decision-making goes on behind the scenes and without proper parliamentary or judicial scrutiny, there will be plenty of scope for such opaque deals, and foreign investors bidding for a tender will continue to find that their offer is not always accepted if they are in competition with a Russian company with powerful political patrons.

Foreign companies deal with the problem of corruption by aiming to establish personal relationships with a range of business and political figures early on in the deal-making process. Companies that are familiar with influential individuals on a personal level are less likely to encounter bribe demands.

*Corporate governance*

Russian companies are beginning to realize that in order to attract foreign investment, they have to improve their corporate governance. The number of corporate scandals has decreased and companies are taking a long-term view of business. In February 2002, the Government introduced a corporate governance code, encouraging firms to adopt international accounting standards and elect outside directors to their boards. The Federal Securities commission is also working on a corporate governance code. Stock markets have rewarded Russian firms such as Yukos, Sibneft and even Lukoil for making their accounts more transparent: Yukos's share price tripled in a year, while other firms have attracted a surge of interest on international securities markets.

However, the still unsettled ownership position of many companies and the susceptibility of many companies to political interference especially at the regional and local levels warrant caution. Real behavioural changes will take time and corporate governance is likely to remain a key challenge for several years.

# 2.2

# Corporate Governance Overview

*The International Finance Corporation (World Bank Group)*

### *Corporate governance in Russia, 1992–2002*

Corporate governance is seen by many as the keystone of economic reforms in Russia. President Putin underscored the importance of corporate governance when, in October 2001, he stated that:

*...Russia has a strategic goal – to become a country that makes competitive goods and renders competitive services. All our efforts are committed to this goal. We understand that we have to solve questions pertaining to the protection of owners' rights and the improvement of corporate governance and financial transparency in business in order to be integrated into World capital markets.*

Today, even with Russia's newfound economic and political stability, as well as improved legal and regulatory framework, investors continue to shy away from large-scale investments in Russian companies. The main reason cited by investors over and over again is poor corporate governance practices.

The International Finance Corporation (IFC) sees corporate governance as structures and processes for the direction and control of companies. Corporate governance, in essence, concerns the relationships among a company's management, board of directors, shareholders (both controlling and minority) and other stakeholders (for example creditors, employees and suppliers). Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside sources of capital. The OECD Principles of Corporate Governance[1] provide the framework for

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[1] The OECD Principles of Corporate Governance can be downloaded from the OECD Web site: www.oecd.org

the work of IFC in this area, identifying the key issues such as the rights and equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the responsibilities of the board of directors.

Corporate governance is a priority for IFC as it presents opportunities for IFC to manage risks *and* add value for clients. In addition to the benefits to individual client companies – better resource allocations and lower cost of capital – working to improve corporate governance contributes more broadly to IFC's mission to promote sustainable private sector investment in developing countries.

*The importance of corporate governance to Russian companies*

Is corporate governance important for Russian enterprises? And more importantly, are Russian companies prepared to implement good corporate governance practices as determined by the Federal Commission on the Securities Market's (FCSM) Corporate Code of Behaviour? The IFC Russia Corporate Governance Project (IFC RCGP) recently conducted a Corporate Governance Survey to answer these and other questions.[2] The survey's initial findings (the final results will be made available online at www.ifc. org/rcgp/ in early January 2003) can be summarized as follows:

- Fifty per cent of the companies surveyed find implementing good corporate governance practices unimportant. On the other hand, 56 per cent of those companies willing to implement corporate governance are prepared to pay for consulting services and 38.2 per cent to provide training for their board members.
- Only 46.9 per cent of the companies surveyed in the regions are aware of the FCSM's Code of Corporate Behaviour, the country's main corporate governance code, and 64.6 per cent of those companies that are aware of the Code have not yet introduced changes that are recommended by this document and have no plans to do so during next year.
- Of the companies surveyed, 63.4 per cent find that the main barriers for improving corporate governance is a lack of information on corporate governance and 49.8 per cent feel it is due to a lack of know-how or qualified specialists.

[2] The IFC Russia Corporate Governance Project surveyed 307 open joint stock companies with over 50 shareholders in four Russian regions (83 companies in St Petersburg, 104 companies in the Ekaterinburg and Sverdlovsk region, 64 companies in Rostov-on-Don, and 56 companies in Samara). Sixty per cent of the respondents were chief executive officers, their deputies or chairmen, with the remaining 40 per cent consisting of senior executives, legal counsels or chief financial officers.

- Only 3.7 per cent of the surveyed companies have standing committees and only 31.3 per cent have official systems of director remuneration.
- One-quarter of the companies have implemented a two-tiered board structure and the typical executive board consists of seven members and meets 20 times per year.
- The general meeting of shareholders is typically conducted without independent monitoring of the voting.

*Russia's main corporate governance transgressions*

The Russian market has had numerous high-profile shareholder rights violations that have played themselves out in the Russian and international press. The most severe seen over the years include, *inter alia*, share dilution (the issuance of new shares to dilute shareholder voting rights, often below the 25 per cent threshold); transfer pricing (the sale of products at fire-sale prices to affiliated or 'friendly' companies, who in turn resell these at market value); and asset stripping (the sale of assets below market value to affiliated or 'friendly' companies, which in turn resell these assets at market value). A myriad of violations still occur on a regular basis – both expressly and inadvertently. The most common include restricting access to, or outright manipulation of, the company shareholders' register, violation of shareholders' rights to participate in a general shareholders meeting or company reorganizations; violations of information disclosure rules, notably with respect to financial reporting; delayed or non-dividend payment; and fraudulent bankruptcies with the subsequent sell-off of assets to insiders at low prices (the new law on bankruptcy, only recently passed, should serve to address the main corporate governance violation in and around bankruptcy proceedings).

*Corporate governance concerns as a result of privatization*

Russia's mass privatization programme began in 1992–1993 and led to the creation of over 30,000 open joint stock companies in Russia. Two distinguishing features made their mark on this first privatization phase. Firstly, the privatization process, via vouchers distributed to each citizen, dispersed equity stakes of companies to the population at large and by July 1994 there were 40 million small shareholders in Russia. Secondly, company insiders, namely management, obtained large stakes in companies, effectively giving them control. In 2000, the Bureau of Economic Analysis estimated that insiders own approximately 62 per cent of privatized companies. Moreover, insider ownership is often made opaque through offshore vehicles and complex holding structures.

Starting in 1995, the well known 'loan for shares' scheme transferred ownership of many of Russia's most valuable enterprises to a new class of 'oligarchs'. Many members of this seemingly invincible economic elite went on to strengthen their position vis-à-vis minority shareholders through the above-mentioned violations of corporate governance. Thus, a pattern of ownership emerged, with majority stakes in the hands of the well connected, and minority stakes in the hands of vulnerable workers groups, a few intrepid outside investors and widely dispersed individual shareholders, setting the stage for widespread abuse of minority shareholders' rights during the late 1990s.

Russia's biggest shareholder, the State, continues to own stakes in many Russian companies including controlling stakes in most strategic enterprises and natural monopolies. The challenge of balancing the interests of various groups of stakeholders (large shareholders, minority shareholders, holders of preferred stock, insiders including company officers and managers, government agencies and workers' groups) will require the development of a common corporate governance culture in the Russian corporate sector.

*Other root causes*

Privatization is seen by many as the root cause behind poor corporate governance in Russia. There is, however, arguably, a series of other factors, too many to enumerate here, that serve as the basis for the many corporate governance violations witnessed in the last decade. Some of these root causes are:

- **Ineffective enforcement due to corruption in the courts and enforcement agencies.** In the absence of sound financial markets that exert pressure on companies, as well as deep labour markets guaranteeing management turnover, effective enforcement becomes paramount in effectively implementing good corporate governance. However, shareholders seeking legal redress are often frustrated by lengthy legal proceedings, poorly trained judges and corruption in parts of the judicial system. Moreover, the Federal Commission for Security Markets (FCSM) is under-funded and lacks specific authority to levy heavy fines against corporate wrongdoers (the current maximum is set at approximately US$ 5,000).
- **Collective action problem.** Russia continues to face a high concentration of ownership holdings by insiders in combination with weak outside owners that are unable to monitor company

management. Investment funds, ideal candidates to slip into the role of active outside investors and corporate governance champions, in addition to banks, are still unable or unwilling to take on this responsibility. In essence, there is a dearth of corporate governance champions with teeth as seen in OECD Member counties (for example institutional investors as CALPers or TIAA-CREF).

- **Lack of experienced company managers.** In industries outside power/energy and defence, management is considered by many to be the most powerful group among corporate owners. This holds particularly true for the Russian regions. Many managers are indeed firmly entrenched, with their large, insider shareholdings and little to no outside oversight. Acting as both owners and managers, self-interest transactions prevail and there is little or no incentive to change old business habits or adopt good corporate governance practices.
- **Old style mentality.** Under the Soviet planned economy, managers reported directly to government authorities and are thus unaccustomed to reporting to a go-between board of directors. Further, management typically places short-term personal gains over long-term strategic planning, which often involves difficult and resource-intensive restructuring. Finally, the tradition of strong and central leadership is still adhered to and followed.

*Improvement in the legal and regulatory framework*
The legal and regulatory framework for corporate governance has improved noticeably since the 1998 financial crisis. Applicable legislation includes civil and criminal codes, a securities law, a company law and a special law protecting shareholders' rights. These basic laws are relatively comprehensive and address the main corporate governance concerns, although inconsistencies and contradictions persist. Moreover, the new Russian Code of Corporate Conduct, which IFC helped shape, is quite detailed and lays out the basics of good corporate governance practice for Russian companies. However, the Code is not widely distributed (only 46.9 per cent of the companies surveyed in the regions are aware of the Code) and often poorly understood at the corporate level, especially in the Russian regions.

## *Corporate governance indicators*

IFC has developed a series of broad indicators to help determine whether a Russian company follows good corporate governance practices. These indicators are based on four principle paradigms, namely if:

1. THE COMPANY IS COMMITTED TO CORPORATE GOVERNANCE

There are three basic methods of determining whether a company is committed to corporate governance. The first is to analyse the company's charter and by-laws with a view towards how they address the main corporate governance issues. These documents are key to assessing the corporate governance risk of the company. For example, the charter will define the amount of authorized but un-issued equity shares, which is vital in determining whether future share issuances could dilute current shareholder interests. The charter is generally available to shareholders from the corporate secretary and can also be obtained from the office of the regional administration. The National Association of Broker-Dealers (NAUFOR) publishes a significant number of charters on its Web site (www.naufor.ru). The second is to determine whether the company has a corporate governance code. The importance of a company code on corporate governance is steadily, albeit slowly, gaining recognition among Russian executives. According to the above-mentioned survey conducted by the Russian Institute of Directors, some 20 per cent of Russian companies either have, or are in the process of approving, their own company code, 30 per cent have begun to draft codes, and over 35 per cent are considering introducing their own codes in the future. The third is whether the company has a designated officer responsible for periodic disclosure to shareholders and investors, and ensuring compliance with the best corporate governance practices and policies of the company on a full-time basis.

2. THE COMPANY IS TRANSPARENT AND DISCLOSES FINANCIAL, OWNERSHIP AND CONTROL STRUCTURES

Another key indicator is whether the company discloses information on all material matters in a timely and accurate manner, notably its ownership structures, financial and operating results, objectives, members of the board and their remuneration, material foreseeable risk factors, and governance structures.

Of fundamental concern to shareholders, potential investors, creditors, employees and other stakeholders is the ownership position of the company's majority shareholders, providing former parties with the necessary information to make informed investment decisions and understand management's motivation and intentions towards the company. A main determinant of good corporate governance is thus whether the company publicly discloses such information, for example on its Web site.

Does the company prepare, audit and disclose financial information in-line with international standards? It is well known that accounting, as the primary method of recording economic transactions, provides the financial information required for businesses to operate in a market environment. Audit serves to attest the reliability of a company's financial statement and plays an equally important role in market economies. Both lie at the heart of any investment or business decision and inappropriate accounting, auditing and financial disclosure practices add an element of risk, and subsequently affect the cost of operating and investing. Russian Accounting Standards remain tax driven and thus are largely inappropriate for financial reporting purposes. More often than not, they fail to show a true and fair view of the company's financial position and leave much room for manipulation, especially within large holdings. For example, Russian standards do not require companies to write-off bad debt, and assets are thus recorded at historical costs. Russian Auditing Standards on the other hand are seemingly identical with IFAC's International Standards on Auditing, having been translated into the Audit Law in 2001.

### 3. The company adheres to good board practices

Boards of directors are key corporate governance watchdogs, representing shareholder interests, serving as corporate stewards and holding management accountable. The first key indicator in determining the effectiveness of a company's board is whether the company has non-executive, independent directors.[3] The use of non-executive, and perhaps more importantly, independent directors is a key corporate governance issue in Russia, as the Law on Joint Stock Companies (LJSC) endows the board with broad powers. Further, independent board members are extremely useful

[3] The Law on Joint Stock Companies (LJSC) defines independent directors as individuals who are at the time of the approval of a transaction or during one year immediately preceding the approval of such a transaction not in any of the following positions: the general director, or a member of the management team or a member of the governing bodies of the management organization of the company; a person whose spouse, parents, children, brothers and sisters by both parents or by one parent only, hold a position in governing bodies of the company or its management organization, or are the company's manager; or a person whose adoptive parents or adopted children hold a position in governing bodies of the company or its management organization, or are the company's manager; or an affiliate of the company other than a member of the board of directors of the company.

in obtaining access to key information on the financial situation of the company. According to the FCSM's Code, 75 per cent of a company's board should consist of non-executive directors, which is generally the case in most Russian companies.[4]

Moreover, the concept of independent directors is slowly gaining a foothold in Russia and some companies now boast at least three independent directors. On the whole, however, Russian companies fail to comply with international best practice, which calls for a majority of board members to be independent. An average board in one of the four surveyed regions thus contains 6.8 directors, of which 1.3 are considered non-executive and 0.8 independent.

The second indicator is to determine if the company has established board committees, notably on strategic planning, auditing (composed of independent directors), human resources and remuneration, and corporate conflicts resolution, each of which is staffed with qualified individuals. Once again, current Russian practice paints a fairly conclusive picture, with a minority playing leadership roles – UES has, for example, created committees on human resources and remuneration, corporate governance and ethics, auditing, and strategic planning – and the large majority falling behind international best practice. The IFC RCGP survey finds that a mere 3.7 per cent of the surveyed companies have board committees, with the audit committee being the most popular (23 per cent). Moreover, the IFC's work in the regions finds that Russian boards of regional companies are often unstructured and lack clear division of responsibility among members. Most boards also fail to provide for appropriate risk management and internal controls systems.

Third and finally, does the board of directors meet regularly, deliberate independently of the executive management, keep minutes of each meeting and adopt a formal assessment procedure? The answer to this question will, in most cases, provide a clear-cut answer as to the board's effectiveness in representing the interest of shareholders.

#### 4. The company respects shareholder rights

Shareholder rights abuse still abounds in Russia and the general meeting of shareholders remains one of its premier playing grounds. Low quorum requirements – focusing on the percentage of those participating in the Annual General Meeting rather than the

[4] A recent survey conducted by the FCSM and Institute of the Securities Market and Management finds the ratio of executive to non-executive directors to be 3:7.

majority of shares – short notice periods, last minute changes to the agenda and/or venue are still prevalent. For example, the IFC RCGP survey found that over 30 per cent of the companies in the regions fail to distribute the results of the general meeting of shareholders to its shareholders. Also, companies rarely use independent and licensed shareholder registries. Compliance with approval procedures regarding major transactions also needs to be improved. And finally, companies need to better implement proxy voting procedures to increase shareholder participation in general shareholder meetings.

## Conclusion

Raising the corporate governance practices in Russian firms to OECD country standards will require a series of concerted actions by the FCSM, State Duma, the Russian Government, international organizations, and public- and private-sector organizations, as well as by market participants themselves. IFC has identified priority areas for reform in and around the private sector and has launched a corporate governance initiative to help implement good corporate governance practices in Russian companies.

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# 2.3

# The Banking System: an Overview

*Allen & Overy*

### *Regulatory system: the Central Bank*

The Russian banking system is headed by the Central Bank of Russia (the CBR) – the institution that prints money, maintains Russia's currency reserves, implements currency control legislation and licenses, regulates and supervises Russian banks and other credit organizations (eg those of clearing houses). It also owns the controlling interest in Sberbank, the national savings bank, and, until recently, Vneshtorgbank, the country's foreign trade bank (VTB) (together Russian's largest banks), keeps budgetary accounts and accounts of state agencies and authorities, runs the national settlement system and conducts banking transactions. All of this is done at the same time by the same entity.

These extensive powers have been, and still are, the subject of a lengthy and rigorous political struggle, which has resulted in the CBR gradually, over the course of the last few years, losing some of its powers and privileges. For example, since 1997 the CBR has been obliged to transfer 50 per cent of its profits to the federal budget (but still keeps the remaining 50 per cent) while previously it kept all its profits including the seniorage. Around 1996–1997 the CBR lost out to its long-standing rival – the Federal Securities Markets Commission (the 'FSMC') – and as a result the activities of Russian credit organizations in the securities markets (eg broker–dealer operations) are now licensed by the FSMC rather than by the CBR. In 2001 the CBR lost the fight to control money-laundering activities under the new anti-money-laundering law – these are now controlled by a separate, newly created agency, with the CBR playing a more limited role. However, the worst year in the CBR's history was the year 2002, when the new Law on the Central Bank of Russia, adopted at the initiative of the Russian

President, Mr. Putin, expanded the authority of the National Banking Council, the public body designed to supervise the CBR, and significantly increased the influence of the Government, the legislature and Russian regions, over CBR policy. In addition, in 2002 the Government has 'persuaded' the CBR to sell its shares in VTB at their nominal value and to receive in exchange rouble denominated bonds bearing just six percent interest and having a maturity of nine years.

Nevertheless, despite these developments, the CBR is still a powerful agency keeping tight day-to-day control over virtually every Russian credit organization. In order to carry out its functions the CBR employs roughly 81,000 people and maintains 78 local branches throughout Russia.

## *History*

The modern Russian banking system originally emerged through the introduction of the 1990 Law on Banks and Banking Activities. In just a few years more than 2,000 banks came onto the scene previously occupied only by the CBR, Sberbank, Vnesheconombank (VEB), Promstroybank and a few other ex-Soviet state banks. This high number of banks, however, neither represented the same quality nor corresponded to the level of economic development in Russia at that time. Most of the banks profited either by servicing accounts of state authorities (with the most lucrative ones being, perhaps, customs and tax authorities) or by trading on the speculative GKO (ie state short-term bonds) market.

## *August 1998 Crisis*

Not surprisingly, the collapse of the Russian GKO market during the so-called August 1998 Crisis (the 'Crisis') was a heavy blow to the fledgling Russian banking system. The results were shocking: many banks went bankrupt (with the most famous examples being SBS-AGRO, Rossiiskiy Credit and Inkombank) and hundreds of thousands of people lost their savings. The adoption of the Budgetary Code in 1998 and the subsequent transfer of most of the budgetary accounts to the Federal Treasury left many surviving banks without stable sources of income. According to the CBR, during the period from 1997 to the end of 2001 the number of operating banks dropped from 2,029 to 1,319. It is expected that this number will continue to reduce even further, though not at the same rate.

## *Current status of the Russian banking system*

Obviously, it is easier for the larger banks to survive. However, the level of merger and acquisition activity is rather low. Immediate post-Crisis restructuring activities were limited to asset stripping and changes of name as bank owners busied themselves hiding assets from their creditors. Many of the reported mergers represent intergroup restructuring (eg the merger of Alfa Bank with Alfa Capital, and the merger of Bank Austria with International Moscow Bank due to the merger of their parent companies/banks in Germany and Austria) rather than mergers in the true sense. While various acquisitions of small regional banks by their larger counterparts have been reported, the only prominent example of any real M&A activity one can recall is the acquisition by Nikoil of Avtobank.

The current league table of the largest Russian banks is headed by ex-Soviet giants such as Sberbank, VTB and VEB. However, the league includes new names as well, eg Alfa Bank, Gazprombank (controlled by the Russian gas monopoly Gazprom), Rosbank, Bank of Moscow, MDM, Nikoil (controlled by Lukoil, one of the largest Russian oil producers) and Sobinbank.

There is no prohibition against foreigners establishing Russian banks or buying shares/participation shares in existing Russian banks. However, the acquisition of more than 5 per cent of the shares/participation shares in a Russian bank needs to be declared and the acquisition of more than 20 per cent of the shares/participation shares requires preliminary consent from the CBR. The Government plans to change both of these figures to 10 per cent. Federal law can set the overall limit on foreign investment in the Russian banking system. So far, no such law has been adopted. As of the beginning of 2002 there were 126 banks with foreign capital, including 23 wholly foreign-owned and 12 banks with a majority foreign participation. The top 100 banks include several subsidiaries of foreign banks, eg ABN AMRO, Citibank, CSFB and ING.

Obviously, size alone does not necessarily correspond to the level of commercial activity/profitability. For example, the commercial activities of VEB are rather limited and it mainly performs the agency functions in relation to the Russian external debt.

The strongest Russian banks are typically members of the larger financial–industrial groups and often perform mostly treasury functions. The most probable explanation for this is that there are simply not enough trustworthy banks in the country to service the large Russian corporates and, as a result, they have had to establish/acquire their own banks. The Ministry of Anti-monopoly Policy has recently declared its plans to prohibit the shareholders/owners of banks from maintaining their own bank accounts in the banks they control as this reduces the competition because there are simply not enough valuable clients left in the banking services market for other banks. Not surprisingly, these plans have been widely criticized and it is unlikely that they will be implemented.

The main problem of the Russian banking system is, of course, its under-capitalization. As of 1 January 2002, Russian banks as a whole had only 453.9 billion roubles of their own capital (approximately US$ 14.4 billion at the exchange rate of 1 US$ to 31.5 roubles) and their total assets were approximately 3.2 trillion roubles (approximately US$ 101.6 billion at the exchange rate of US$ 1 to 31.5 roubles).

## National currency and currency control legislation

The Russian rouble, the national currency of the Russian Federation, is not freely convertible. Due to the unstable state of the Russian economy and high inflation levels, the rouble often loses out to the US$ and other hard currencies in terms of people's preference. Banks, corporates and individuals often prefer to keep their reserves and savings and to receive their income in US$ or other hard currencies, rather than in roubles. It is worth mentioning that even the Russian budget is prepared on the basis of the estimated rouble to US$ exchange rate. Capital flight is estimated to be in the region of US$ 20–40 billion per year.

In order to support the rouble, Russia maintains rigid currency control legislation. As a general rule, all settlements between Russian residents may be conducted only in roubles. Exporters must repatriate their hard currency proceeds back to Russia and convert 50 per cent of their export proceeds into roubles at the Russian currency market within seven days of receipt of the hard currency. At some stage after the Crisis, the portion of the export proceeds subject to mandatory conversion into roubles was further increased to 75 per cent; however, it was later reduced back to its initial level. The press has reported that the Government has submitted to the state Duma a new version of the law on currency regulation and control which envisages that the percentage of export proceeds subject to mandatory conversion will be reduced to 30 per cent and the mandatory conversion will be cancelled altogether by 1 January 2007. As a general rule, Russian exporters should receive export proceeds within 90 days after the export of goods or services. The acquisition of hard currency by Russian residents is strictly regulated by the CBR.

In order to operate in Russia (other than through a subsidiary), non-residents can only open certain types of rouble accounts, namely K (conversion), N (non-convertible) and F (for individuals) accounts. The regime of these accounts is restricted. The legislation lists the permitted credits and debits allowed in relation to each of these accounts, the result being that only funds received into K- or F-type accounts can be freely converted into hard currency and repatriated. Funds credited to N accounts are of limited convertibility, ie in order to be converted into hard currencies, they need to be effectively blocked for 365 days.

In addition, investors who acquired GKOs and OFZs (fixed-income state bonds) prior to the Crisis continue to have their securities (as well as new securities resulting from the post-Crisis restructuring of GKOs and OFZs) and their proceeds blocked in special S-type accounts until they are able to dispose of these securities and repatriate the proceeds.

Russian banks with a CBR licence permitting them to conduct operations in hard currencies, the so-called Russian Authorized Banks, act as 'agents of currency control', ie they control every single payment between residents and non-residents as well as all payments in hard currency.

## *Bank lending*

As described above, Russian currency control legislation creates various barriers against the use of hard currencies. Russian law, however, allows the parties to a contract to express monetary obligations in hard currency (or any other equivalent) so long as the obligation is actually performed in roubles. Not surprisingly, the bulk of bank loans in Russia are either made in hard currency or are linked to a particular hard currency, which results in borrowers bearing the risk of exchange rate fluctuations.

Due to high inflation rates (which are usually higher than those reported in official statistics), few banks offer long-term loans. Loan terms rarely exceed three years and interest rates are prohibitively high.

The Russian tax system is undergoing significant change and the situation is slowly improving. Nevertheless, the effective taxation level is unreasonably high when compared with that in the West. Russian accounting standards are designed mainly for taxation purposes rather than for the purposes of making investment decisions. They differ from international and US accounting standards and do not always reflect the true state of companies' financial affairs. As a result, 'creative tax planning and accounting' is widely used in Russia. Coupled with the fact that there are no credit reporting bureaux in Russia, this often leaves banks in a difficult position when considering granting a loan, as they have to assess credit risks on the basis of limited and often unreliable information. Therefore, banks generally grant loans only to their long-standing customers, though exceptions may be made for large companies with proven track records, especially in export-oriented industries.

Since foreign banks have access to international capital markets they are often able to offer lower interest rates and longer-term loans to Russian borrowers of an appropriate calibre than their Russian rivals can. As a result, foreign banks, together with their subsidiaries, occupy a significant share of the corporate lending market for large Russian borrowers (transactions are often, for various reasons, negotiated in Russia, but are documented as taking place abroad).

## *Investment banking*

The Russian securities market is at a fairly early stage in its development and is slowly recovering after the Crisis. Legally, Russian banks are not divided into investment banks and commercial banks. Generally, all major banks are big players in the Russian securities market, whether directly or through their investment companies. It is worth mentioning that while Russian banks occupy most of the positions in the relevant league tables, first place is often taken by CSFB.

## *Retail banking*

Russia does not have a system for guaranteeing private deposits. Because many people suffered and lost out during the Crisis, the level of trust enjoyed by Russian banks is generally pretty low. Russian law provides, however, that in the case of banks created by the State or where the State owns more than 50 per cent of the voting shares, the State guarantees the safety of private deposits. This rule puts banks with a majority state participation in a preferential position. However, it is yet to be seen how and whether this rule will work in practice.

The retail banking market is heavily dominated by Sberbank, which attracts most private deposits; its market share has increased since the Crisis and the collapse of its nearest competitors like SBS-AGRO and Inkombank. For example, in 2001 Sberbank attracted 82.5 per cent of all private rouble deposits and 51.3 per cent of all private hard currency deposits, had the largest credit portfolio and received the largest profits in the whole banking sector. Sberbank estimates that in 2002 it achieved an 86.6 per cent share of all private deposits and a 20 per cent share of all corporate deposits. This achievement reflects the high public confidence enjoyed by Sberbank, which enables it to pay quite a low interest rate on deposits.

After the Crisis, the CBR urged foreign banks to start retail operations. Some foreign banks have complied with the request and several of their subsidiaries (eg Raiffeisen Bank and International Moscow Bank) have achieved notable success in attracting the funds of high-income individuals. However, their operations are limited to just a few branches in Moscow and some other major Russian cities and cannot be compared with the tens of thousands of branches maintained by Sberbank. It is worth mentioning that foreign banks pay an even lower interest on deposits than Sberbank.

At the moment, foreign banks do not target low-income clients and structure their tariff policy accordingly. ABN AMRO and Citibank, for example, do not offer private banking for individuals unless they are employees of their corporate clients.

## *Mortgage financing*

Mortgage financing is at an early stage in its development. Interest rates start above 10 per cent per annum for hard currency or hard currency linked loans.

Apart from the problems described above in relation to banking transactions generally, there is one further obstacle to the development of mortgage financing. According to Russian law, in order to be valid, a real estate mortgage has to be notarized. The notary fee is set by law at the ridiculously high level of 1.5 per cent of the 'value of the contract', ie the mortgaged property. This requirement creates an unjustified expense for borrowers and seems unnecessary in view of the introduction in 1998 of state registration of rights to, and transactions in, real estate.

## *Plans for reform*

On 30 December 2001 the Government and the CBR released their joint Strategy for Development of the Banking Sector of the

Russian Federation (the 'Strategy'). The Strategy lists the plans for future reform of the banking system. Among rather general statements of the goals, the Strategy includes several specific steps worth mentioning:

- The Government will dispose of its minority interest (25 per cent or less) in all banks, will consider on a case-by-case basis whether it should dispose of its interest in other banks where its participation exceeds 25 per cent and will not create further new state banks.
- The commercial business of VEB will be transferred to VTB, with VEB continuing to perform agency functions in relation to Russia's foreign debt. It was reported in the press that the commercial business of VEB will be transferred not to VTB, but to another bank.
- The Government, jointly with the CBR, will tighten control over Sberbank; the CBR will continue to be the majority shareholder of Sberbank.
- All Russian entities (and not just banks) will switch to international accounting standards by 1 January 2004. It is highly unlikely that this will be implemented as intended.
- A system for guaranteeing private deposits will be created.
- Credit bureaux will be created.
- There will continue to be no legal restriction on banks combining investment with commercial business.
- There will be no limit on the overall foreign investment in the Russian banking system.
- The CBR will consider allowing foreign banks to operate in Russia through their branches.
- The CBR will dispose of its interest in 'Soviet Foreign Banks' (ie its foreign subsidiaries). The press has reported that this plan has encountered strong resistance from the regulatory authorities in the countries where these banks are located.

Experience shows that not all plans are implemented as intended. It remains to be seen whether this rule will apply to these as well. However, the steps already taken by the Russian President, the Government and the CBR send a clear message that they are eager to avoid old mistakes and to make things happen.

## 2.4

# A Seamless Web: Business, Politics and the Grey Economy

*Merchant International Group*

### *Introduction*

The grey economy has met with a mixed fate under President Vladimir Putin since 2000. The days of the violent robber barons, who stripped Russian industrial assets and sent the capital abroad in the early 1990s, have gone. Gone too are the powerful oligarchs such as Boris Berezovsky, who swallowed up huge swathes of the Russian economy and held political power rivalling the President's. These have given way to a new era, shaped by the determination of Mr Putin to implement what he has labelled a 'dictatorship of the law'. The actors on this stage are Russia's new oligarchs. They are gathering Russian industrial assets together, but this time pumping capital in instead of sucking it out.

In this new world, the overt violence of the grey economy in Russia has decreased, but graft and crime remain growth industries. These activities thrive in the gap between Mr Putin's 'paper' legal dictatorship, and the reality of a state apparatus without the capacity to act against them. The new oligarchs operate easily in this gap, and the President struggles to control them. Progress against the grey economy is heavily dependent on Mr Putin's person, and how well he plays a limited hand.

Russia has many of the trappings of an attractive investment target. It is the second largest oil producer in the world, and sits upon the largest proven global gas reserves. After years of erratic growth, rampant inflation and large-scale capital flight, the macroeconomic outlook has stabilized. Growth of around 4 per cent is predicted for 2002 and 2003, and inflation, though still in double digits, is under control. Russia's foreign debt is shrinking, aided by a solid current account surplus.

## *The new oligarchs: exploiting the weak State*

Much has been written about the rise of Russia's new oligarchs. Men such as Andrei Melnichenko, Vladimir Potanin and Oleg Deripaska have driven the consolidation of industrial assets in the past few years. Oil, metal and heavy engineering have already been carved up. Manufacturing, agriculture and financial services are likely to be next. This has helped to facilitate unprecedented levels of investments in badly neglected sectors. June 2001 saw the first net inflow of Russian capital in the country's post-Soviet history.

This reshaping of the legitimate economy has impacted directly on the grey economy beneath. The problem for Russia is that the rise of the oligarchs has depended more on Mr Putin's strengthening of the political centre, and the perception of stability this has created, than the effective implementation of legal and regulatory reforms.

The oligarchs have built their empires through the manipulation of a bloated and underpaid police, judiciary and civil service. Aluminium tycoon Oleg Deripaska for example 'acquired' a large pulp and paper mill in Koryazhma this year through a combination of paramilitary activity and blatant manipulation of local legal structures. While appearing cleaner and less violent than their predecessors in the early 1990s, the new oligarchs reinforce the bribery, corruption and criminality of Russian corporate culture just as surely as their predecessors.

Alongside this illegal manipulation of a weak State, traditional connections continue to exist between organized crime, business and the government, with sporadically violent results. The recent kidnap of senior Lukoil executive Sergei Kukura, along with the death of Vladimir Golovlyov in August 2002 and the surprise acquittal of Anatoly Bykov in June of the same year, shows that the old culture of banditry is still very much alive.

The rationale for all three incidents lies in the complex network of interests connecting Russian politics and business. Bykov, a heavyweight in both spheres, was found guilty in Moscow of conspiring to murder another businessman, then, to general astonishment, given a suspended sentence. Golovlyov, a dissident Duma deputy, looks to have been killed after threatening to reveal the involvement of high-ranking officials in a privatization scandal in Chelyabinsk in the early 1990s. Kukura's kidnap blurs the lines between business rivalry and organized crime. The Russian investment climate may be calmer than ever on the surface, but the culture of corruption continues to flourish.

This has not deterred investors. Mr Putin's achievements have created the impression of stability, and the US administration is determined to build up Russia as a stable alternative energy supply as relations with key Arab producers continue to decline. The result has been significant investment interest in the oil and gas sectors in particular.

Many projects are on the table. Plans announced in July to build up the Sakhalin oil field in the Far East alone will bring in US$ 13 billion in FDI in the next four years. Western oil majors are deepening their interests. In April 2002, British Petroleum (BP) boosted its block shareholding in mid-tier oil producer Sidanco to 25 per cent in a US$ 375 million deal. Distribution routes to the West are also being strengthened, through the construction of a pipeline to Primorsk on the Baltic Sea, and the possible construction of a deep-water port in Murmansk to facilitate direct exports on a greater scale.

## *Grey area dynamics: the illicit network*

It is vital that investors understand the potentially lethal grey area risks they face in the Russian market. The starting point in Russia is the State. Prosecutor Vladimir Ustinov estimates that corrupt acts on the part of state officials cost the Russian economy US$ 15 billion annually. Appearing on television in December 2001, Mr Putin himself publicly acknowledged the culture of racketeering and bribery that exists in the state sector.

The crux of the problem is an oversized, underpaid public sector, which sells its services to the highest bidder to supplement its meagre earnings. This is a deep-rooted cultural problem. Russia has no tradition of an impartial, regulatory state. Bribery and graft has propped up the State both during and after Communism. High domestic subsidies, particularly in the energy sector, meant that this state structure could hardly have survived otherwise.

Official corruption is mirrored by what Transparency International has labelled 'corporate corruption'. The abuse of power within firms, as well as between firms and the government, is endemic. The legacy of 'insider' privatization in the 1990s is a culture of opacity. Financial information is poor; outside shareholders have little control over management; and minority shareholders are frequently trampled upon.

This passive backdrop fuels more active grey area threats, namely counterfeiting, theft, drug running and arms smuggling. Russia is a rapidly growing market for counterfeit goods of almost every kind. An estimated four out of every five music CDs and computer programs sold in Russia are unlicensed. Illegal production facilities sometimes operate under the protection of state-owned enterprises and even on premises rented out by government departments.

Under US pressure, Mr Putin's government is beginning a concerted anti-counterfeiting drive. Headed by a prime ministerial task force, this effort includes the banning of unlicensed traders and the strengthening of police powers to act against the pirates. As Mr Putin strives for WTO membership, this is likely to produce some high-profile closures and arrests.

The underlying grey economy, though, is likely to emerge largely unscathed. Piracy in Russia is a socially accepted norm which will be difficult to erase as long as supply exists. Corporate investors lament the Russian consumer's insensitivity to the value of brands, which makes intellectual property protection very difficult. The issue is also economic. Russian consumers, happy to pay 15 roubles for a compact disc, will be extremely reluctant to begin paying 350 with no visible benefit.

## *The active threat: organized crime*

Counterfeiting is just one of the range of illicit activities conducted by Russia's organized criminals. There are three main types of group. The first are the traditional 'mafia' families, often dating back to before the fall of the Soviet Union. The second are 'national' or ethnically-based groups, that have come to prominence since 1991. The third are the 'governmental' groups, or criminal networks that have emerged from redundant areas of the Soviet security state.

The mafia clans have traditionally conducted protection rackets in both the overt and covert economy, often with the tacit acceptance of regional bureaucrats and law enforcement. Chechen and Georgian 'national' groups initially emerged as a form of contracted security against the mafia, and have evolved and now run their own protection rackets. 'Governmental' groups got into the act in the 1990s, using their resources and expertise to provide access and 'protection' for Western businesses eager to enter the Russian market.

Organized criminal groups exert influence over the legitimate Russian economy in several ways. The criminals themselves own or control large swathes of business activity, and have penetrated all major economic sectors. *Jane's Intelligence Review* estimates the

Tambov mafia clan alone controls over 100 major enterprises in St Petersburg, including those in the petrochemicals sector. The mob has also penetrated the growing financial sector by propping up ailing banks, through extortion and intimidation, and even open purchase. They use their position to launder illicit proceeds and obtain financial information about competitors. By 1998 organized criminals had penetrated more than 550 banks, according to government sources. Further income comes from controlling trade through the major Russian ports. Even 'independent' businesses partly rely on criminal groups for protection, debt collection, capital, information gathering and dispute settlement.

### *The international element: drugs, arms and people*

The Russian gangs of today are fewer, bigger and more cosmopolitan than those of a decade ago. Their reach extends through the Baltics and Eastern Europe, into Austria and Germany, and even as far as the United States, providing products, services and contacts for existing gangs.

The loosening of border controls, both within the former Soviet Union, and between it and the West, has greatly facilitated smuggling of various illicit substances into and out of Russia. The country has become well integrated into international drug-trafficking networks. The former Soviet Union has become a significant market and transit mechanism for heroin, opium and hashish from Afghanistan in particular. In most cases, these cargoes also pass through Russia. Some idea of the scale of the increase is provided by the quantities of drugs seized by Russian customs officials. According to a study by the UN Office for Drug Control and Crime Prevention, heroin seizures increased sevenfold between 1998 and 1999 alone.

At home, drug use has exploded. Though absolute levels of usage are still low (the Interior Ministry estimates around 2 per cent of the population, as opposed to more than 5 per cent in the United States), the increase has been more than fivefold since 1990. A decentralized, multi-level retail and wholesale network has grown up to service this vibrant market.

Organized criminals play a major role in drug-trafficking and wholesaling. However, despite government rhetoric, they generally do not control distribution and local retailing, as UN studies have shown. The key mechanism is a disparate network of drug dealers, operating in small groups, supplementing meagre wages in the open economy.

The key, once again, is the weakness of the State. Drug-trafficking and usage is fuelled by the susceptibility of Russian law enforcement mechanisms to bribery. In some urban areas, organized police extortion regimes have been reported. As long as public sector pay remains so low (police generally receive less than US$ 100 a month), this culture is likely to be sustained.

Arms and people have poured through the same porous borders as narcotics, and have often been handled by the same criminal gangs. Recent cases have included Russian groups operating people-trafficking operations as far away as Thailand. The groups often use legitimate front businesses such as marriage firms, tourist firms, and migration bureaux to move their victims in and out of Russia.

Most ominously, Russian criminals seem prepared to deal on a quid pro quo basis with a range of terrorist organizations. Some of the assistance provided by al Qaeda to Chechen radicals seems to have been spent buying weapons from Russian gangs. Such links are likely to deepen as international terrorism is driven further underground, and the terrorists turn to the underworld for arms, documentation, transportation and other services.

## *The State and Mr Putin*

As is so often the case in Russia, all roads in the grey economy lead back to the State. Mr Putin is no friend of the mob, and will not tolerate the dissipation of his political authority into the grey economy to the degree Boris Yeltsin did. Since his inauguration, Mr Putin has secured the passage of important tax reforms and a new business law code, and created a private land market for the first time since 1917. On the enforcement side, an organized crime crackdown, under Putin's ally Boris Gryzlov at the Interior Ministry, has been launched. Money-laundering legislation has been passed. New counterfeiting legislation will soon follow, under pressure from a new lobbying group of 24 major international and domestic consumer goods companies.

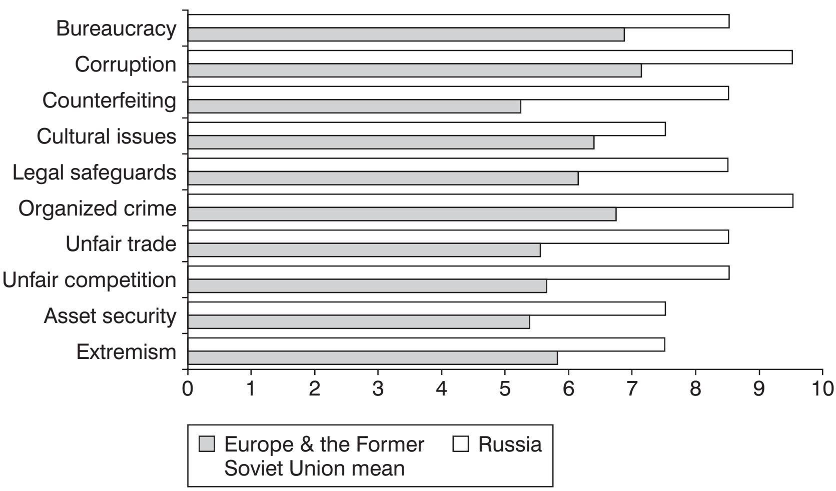
However, the nature of the Russian State dictates that close relationships will continue to exist between the State, the business class and the criminals. This network is part of a political culture that Mr Putin, who also has his favourites, cannot break, only chip away at. The Bykov, Golovlyov and Kukura cases clearly illustrate the persistence of this culture.

Furthermore, the much-mythologized Russian criminal gangs almost certainly earn most of their income from manipulating legitimate business activity, not through drug- and arms-smuggling. Manipulating a weak State and supplying cheap produce to the eager but cash-strapped Russian consumer seems far more lucrative than difficult and hazardous drug-dealing.

The new oligarchs may be cleaner and less politically powerful, but many still enjoy privileged access to the corridors of power in return for their good behaviour. Mr Putin regularly seeks out the tycoons for their input on economic policy. Some, like the 'aluminium king' Oleg Deripaska, are reinvented ex-Yeltsin cronies playing a similar game to the 1990s, albeit with more deference to the Centre.

It is this pervasive culture that has slowed effective reform of investment conditions, and blunted the crackdown on organized crime. Despite progress under Mr Putin, Russia remains a systemically corrupt commercial environment (rated 71st out of 102 by NGO Transparency International) with high and growing criminality. The Interior Ministry itself reports an increase in crimes connected to organized crime of 83 per cent over the year.

With Duma and Presidential elections looming and the global economic outlook uncertain, the mandate and momentum for reform is likely to erode. This will leave key issues such as banking and bureaucratic reform largely untouched. Without such reforms, which cut into the very nature of Russian political and commercial culture, the grey economy will continue to flourish in the gaps left by Mr Putin's weak but dictatorial State.




Note: Each grey area dynamic is scored from 0–10; the higher the rating the greater the risk to the investment. GADs are scored up to 100. GADs change in intensity relative to several issues, such as nationality, sector, etc.

**Figure 2.4.1** Russia: Grey area dynamics (GADs), fourth quarter 2002

# 2.5

# The Russian Leasing Industry – a Rapidly Developing Source of Investment Finance

*Greg Alton, Project Officer, The International Finance Corporation (World Bank Group)*

### *Introduction*

The Russian leasing industry has seen its operating environment develop rapidly from a low base due to recent improvements in the legal and regulatory base. It is increasingly fulfilling an important role in improving access to enterprise finance for all types of equipment. While difficulties remain, particularly for cross-border leasing arrangements, the broad freedom of contract and lack of barriers to entry for new entrants should allow for further rapid development and growth of lease financing in Russia. Lease finance is often more flexible, entrepreneurial and adaptable than other forms of finance, since ownership of the leased asset by the lessor allows for allocation of risk amongst the parties to a lease finance arrangement.

As the industry's access to capital improves and court practice and knowledge of leasing grows, access to lease finance should become even more straightforward. Considerable room for growth remains, since many industries and regions have few sizeable and actively operating leasing companies. The International Finance Corporation's (IFC) Leasing Development Group estimates the size of the Russian leasing market at US$ 2.3 billion in 2002 and that there are approximately 100 leasing companies working actively on the Russian market, although there are more than 500 companies participating in the market to varying degrees.

Foreign investment in the leasing sector is increasing, and the IFC has invested over US$ 19 million in four separate leasing companies. Domestic leasing companies, while often small and overly dependent on single sources of finance or small numbers of (often related) clientele, have shown considerable capacity to adapt to changing circumstances. Foreign companies often find that leasing companies provide the best source of finance for equipment acquisition, particularly for smaller companies that would otherwise have difficulty sourcing finance for capital investment. Foreign equipment suppliers have begun to establish captive leasing operations, but Russian equipment suppliers are behind foreign companies in this respect.

### *Legal and tax environment for lease finance*

Leasing is subject to relatively few regulations and has a relatively straightforward and appropriate legal and tax regime since the adoption of a series of amendments and new laws in 2001 and 2002. Broad freedom of contract is provided for, allowing for considerable flexibility in the finance and allocation of risk for leasing contracts. The tax regime provides an appropriate treatment for lease financing, and a market-based tax reduction to provide an incentive for investment in productive assets.

Leasing in Russia follows a form-over-substance approach common in Civil Code countries and differs substantially from the system generally used in countries with a Common Law legal tradition. 'Leasing' in Russia applies only to finance or capital leasing, while operational leasing does not exist as a legal concept and is considered rent. Some contracts that would be considered capital leases in other countries would not qualify under Russian law, and vice-versa.

Leasing is formally always a three-sided deal, where the lessor acquires equipment on behalf of the lessee from a supplier for subsequent leasing. Buy-back leasing is permitted, although not specifically defined, as there is no restriction upon the supplier and the lessee being the same party. Broad freedom of contract is ensured, and aside from the lease agreement itself, other agreements (and the lease agreement itself) may provide for almost any number of additional conditions, including eventual disposal (or purchase) of the leased asset, risk-sharing provisions, etc. Leases may be linked or indexed to a foreign currency, and indeed much of the leasing market in Russia is effectively written in US$ or euros, although the rouble portion of the market is growing more rapidly.

Tax treatment is relatively straightforward, although substantially different from that in many other countries. For the lessee, lease payments are fully deductible expenses, and hence, equipment acquired under leasing may be fully depreciated over the term of the lease, particularly since most leases provide for acquisition of the asset by the lessee at the end of the lease. VAT must be paid on each lease payment, but may be offset against VAT receipts; in effect, the lessee delays VAT payments somewhat but also pays VAT on the finance portion of the lease.

For the lessor, VAT payments on the acquisition of the leased asset are offset by VAT collected on lease payments, although timing may have a significant effect on the financial effect. Equipment leased out may, in most cases, be depreciated at an accelerated rate of three times the normal depreciation schedule; this is the main tax benefit accorded leasing under the Russian tax code. Since many types of equipment have a useful service life for tax purposes of 10 years, equipment is often leased under 40-month contracts (although the lease contract may differ from the amortization period). Leasing companies pay the same profit tax as other companies, and the only remaining turnover tax (the 1 per cent road tax) will be abolished as of January 2003.

The leased asset may be carried on the balance sheet of either the lessee or the lessor; while the accounting treatment differs, in most respects the tax treatment is the same. If property tax is applicable, the party on whose balance sheet the asset is carried pays.

Leasing companies are no longer subject to licensing. Some antimonopoly and anti-money-laundering regulations apply (as to other companies), but these requirements are no different than for most other companies.

Application of the legal, and particularly the tax, regime governing leasing can be uneven and unreliable, particularly in the regions. The situation is improving, however, and a considerable basis of court practice and standard treatment is developing across the country. Repossession, while still relatively rare, is no longer an almost unheard-of occurrence, and is expected to improve as general court reform progresses and experience with this relatively new instrument accrues.

### *Using leasing in Russia*

Leasing can be an appropriate tool for a variety of companies, although the approach to using leasing depends on the nature of the business. Equipment suppliers need to find appropriate leasing companies to finance their customers, foreign leasing companies must decide how they will approach providing lease financing on Russian territory, and all companies may consider using lease financing as another form of enterprise finance.

*Equipment suppliers*

The single most difficult aspect of using leasing to sell equipment in Russia is finding an appropriate leasing company. The leasing industry is still highly fragmented along several lines, particularly geographical presence, type of client, size of deal, and type of equipment. Many Russian banks have subsidiary leasing companies. Russian leasing companies are increasingly demanding of foreign equipment suppliers, and want to work with companies that show a strong commitment to the Russian market (preferably with a strong local support network), are willing to share some risk (in the form of either buy-back guarantees, financing, or remarketing arrangements), and with whom they can have repeat business. While leasing companies often finance one-off deals, the transaction costs of dealing with a new supplier are an issue and are less viable for smaller deals. Equipment that can be easily repossessed is, naturally, more easily leased.

*Foreign finance companies*

While entry into the leasing market by foreign finance companies is still relatively low, the entrants include some of the most active domestic players. A foreign finance company interested in providing leasing must decide whether to work using cross-border lease arrangements, which means high transaction costs and significant legislative and regulatory problems, including the practice of applying duty and VAT to the finance portion of cross-border leasing. Foreign financial institutions that wish to finance domestic leasing companies face relatively few barriers, although margins are obviously sacrificed to the domestic partner and the number of leasing companies with sufficient capital is still small.

As a result, in many cases the appropriate approach may be to establish a Russian-domiciled leasing company. Russian-domiciled companies operate in a clearer legislative environment with few or no restrictions on foreign participation, a still-underserved domestic market, and potentially high returns. Finding on-shore financing, however, can be difficult, particularly in roubles.

*Other companies*
Foreign-owned companies are among the most active users of lease finance in Russia because they understand the mechanism well, are often considered to be better credit risks, and often wish to source financing in the same market where project risk resides. Although the rates paid can often be higher than would be paid at the level of the corporate parent, domestic tax benefits may offset this penalty. Smaller or start-up foreign-owned companies may have few other sources of available capital, just as would be the case for Russian-owned companies. Finally, lease financing can be appropriate when amounts needed are small, such as for vehicle operation. Incidentally, we often find that foreign companies operating in Russia will counsel their Russian business partners and counterparties to use lease financing.

## Lease financing: obstacles to growth

While lease financing is growing rapidly, there are a number of barriers to further development. Some of these are specific to leasing companies, some to the leasing industry in general, and some are 'macro' issues related to the Russian economy in general.

*Leasing company issues*
Few Russian leasing companies are sufficiently well capitalized to easily source funds, and the relative opacity of their financial reports (very few companies have audited annual reports to international accounting standards) also increases risk. Since most companies are relatively new and small, they also lack experienced, qualified staff, and do not have the operational scale to allow for high-volume leasing operations. Many leasing companies also lack diversification on both the asset and/or the liability side of the balance sheet, and are effectively dependent on one company or a group of companies (often a related party).

*Leasing industry constraints*
While demand for lease financing is strong, the newness of leasing and the lack of knowledge of how to use leasing on the part of potential lessees greatly increases transaction costs and the availability of financing. The legal base – while greatly improved – has some remaining imperfections, and the volume of changes to the regulatory environment has also created some uncertainty.

*Macro constraints*
Most of the 'macro' issues are ones that either apply to the banking and financial sectors or the Russian economy in general. In particular, the lack of an effective banking sector caps financing, the lack of long roubles both caps growth and raises risks where there is a rouble/dollar mismatch, and the lack of effective financial intermediation raises the risk of liquidity or financing problems. After these issues, the problems facing the Russian economy in general also affect the leasing industry, but the longer-term nature of lease financing means that stability is all the more essential.

## *Types of equipment financed*

The types of equipment financed vary considerably, but IFC estimates indicate that roughly half of equipment leased is 'production equipment' of various kinds, roughly a quarter is vehicles (both passenger and freight), and the balance is made up of other types of equipment. The clear preference – as in the leasing industry worldwide – is for moveable equipment in discrete units that are liquid. Since secondary markets in Russia are still relatively underdeveloped, liquidity is often a problem and supplier risk-sharing can play a more important role than in other, more established markets.

Leaving vehicles aside, we have seen significant demand for equipment in fast-growing sectors of the economy, such as food production, printing, construction and woodworking. It is also worth noting that these are areas that are often dominated by newer, smaller companies that focus on niches that are and were underserved by the giant industrial behemoths, which often have rather monolithic production capabilities.

Certain types of specialized equipment, particularly aircraft, are commonly leased, but only by very specialized companies, usually with the participation of the manufacturer. Big-ticket items such as aircraft and ships are commonly leased using cross-border arrangements, primarily because the high transaction costs and legal fees may be offset by tax savings. Some types of equipment, such as railcars, that are commonly leased in other countries are subject to high demand but specialized leasing companies to provide this service are still uncommon.

For larger projects and immoveable equipment, there are two major factors to note. First, lease financing will often be considered as essentially project finance, and may be used as only part of a financing package in which banks or their leasing subsidiaries may participate. Second, leasing may be used to increase security by leasing an entire productive complex such as an entire factory complex where appropriate, often using a buy-back leasing structure; this is particularly true where land or real estate is an essential part of the collateral for the project.

## *IFC investments in the leasing sector*

The International Finance Corporation has been an active supporter, and has played a significant part in the development, of the Russian leasing industry, and currently has over US$ 19 million in exposure to four different leasing companies. IFC's strategy for working with the leasing sector is to expand the availability of alternative financial instruments (such as leasing), to support development and improvement of the legal and regulatory environment, and to invest (using debt, equity and other appropriate financial instruments) in the leasing sector in partnership with both foreign and domestic partners.

The IFC does not generally provide lease financing directly to end-users, but helps leasing companies to reach market niches where lease financing is appropriate, where it reaches new customers, and where it is profitable. IFC will also consider specialized leasing companies when appropriate. Investments to date have included founding a leasing company with an established foreign leasing company (Deutsche Leasing Vostok), providing financing to a small and medium-sized enterprise leasing company with foreign participation (Delta Leasing), providing financing to a Russian-owned regional leasing company (Baltisky Leasing in St. Petersburg), and founding a specialized agricultural leasing company (Agroindustrial Finance Corporation). The IFC continues to consider other potential leasing investments.

The IFC has also devoted considerable effort and resources to improving the institutional environment for leasing, and has had several technical assistance projects (funded by the Canadian, UK and Finnish governments). More information about these activities is available at www.ifc.org/russianleasing. The IFC's Russian Leasing Development Group has also recently published a more detailed annual survey of the Russian leasing market, which is available at www.ifc.org/russianleasing/eng/analit/leas2002.pdf.

## *Conclusion*

The Russian leasing industry is developing rapidly from a small base, and is increasingly a viable form of finance for many types of companies working in the Russian market. While problems remain and the industry is small and undercapitalized, the trends are positive and the dynamic development of this alternative financial instrument is particularly important for small and medium-sized enterprises and others in need of corporate finance.

## *Key statistics*

**Table 2.5.1** Age structure of production assets (machinery and equipment) in industry

| *Year* | *All equipment at the end of the year (%)* | *Age of equipment, years* | | | | | *Average age, years* |
|---|---|---|---|---|---|---|---|
| | | *Up to 5* | *6–10* | *11–15* | *16–20* | *Over 20* | |
| 1995 | 100.0 | 10.1% | 29.8% | 21.9% | 15.0% | 23.2% | 14.3 |
| 2000 | 100.0 | 4.7% | 10.6% | 25.5% | 21/0% | 38.2% | 18.7 |

*Source:* Investment market: Conditions in 2001/Investment in Russia

**Table 2.5.2** Development of small business in Russia and other countries

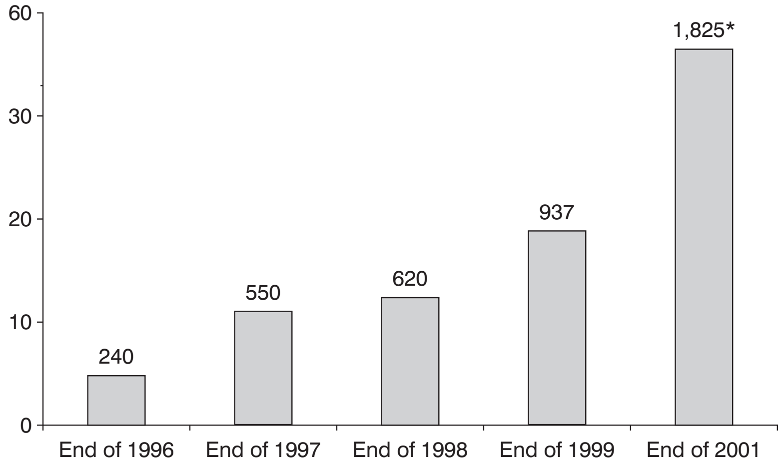
| Country | Number of small and mid-sized businesses (thousand) | Number of small and mid-sized businesses per thousand residents | Number employed in small and mid-sized businesses (million people) | Share of small and mid-sized businesses in overall employment (%) | Share of small and mid-sized businesses in GDP (%) |
|---|---|---|---|---|---|
| European Union | 15,770 | 45.0 | 68.0 | 72 | 63–67 |
| United States | 19,300 | 74.2 | 70.2 | 54 | 50–52 |
| Japan | 6,450 | 49.6 | 39.5 | 78 | 52–55 |
| Poland | 1,726 | 18.3 | 7.1 | 63 | 48.1 |
| Russia | 891 | 6.1 | 6.5 | 10 | 10.2 |

*Source:* Dresdner Kleinwort Wasserstein – Bloomberg Sachs Russia and CIS Conference, March 2002

**Table 2.5.3** Volume of Russian market for leasing services

| *Year* | *1998* | *1999* | *2000* | *2001* | *2002 (forecast)* | *2003 (forecast)* |
|---|---|---|---|---|---|---|
| US$ billion | 1.4 | 0.4 | 1.2 | 1.7 | 2.3 | 2.8 |
| Billion roubles | 14.4 | 10.6 | 35.2 | 49.7 | 72.45* | 95.2* |

Source: IFC Leasing Development Group




*Source:* Economic Development and Trade Ministry

* Licence issuance has been subject to periodic interruptions, but since the end of 2001 leasing is no longer subject to state licensing.

**Figure 2.5.1** Number of licensed leasing companies in Russia

**Table 2.5.4** Size of average leasing deals (US$ thousand) in Russia

| *Year* | *Average* | *Median* |
|---|---|---|
| 2000 | 238 | 53 |
| 2001 | 169 | 58 |

*Source:* IFC Leasing Development Group

*For more information, please contact IFC Moscow Office on +7 (095) 7558818*

## 2.6

# Ten Years of the Russian Insolvency Regime

*Eric Zuy, Allen & Overy*

### History

*Initial legislation*

Back in the old days of the Soviet Union, there was no insolvency legislation because almost everything was owned and controlled by the State. Later, when the market reforms got under way there arose the need for a mechanism to deal with the insolvency of market participants. The legal vacuum could not exist for too long and on 14 June 1992 the President issued Decree No. 623 on Measures for the Support and Rehabilitation of Insolvent State Enterprises (Debtors) and the Application to them of Special Procedures (the **'Decree')**.

The Decree was fundamentally flawed. Firstly, as follows from its title, it applied to state enterprises (which included enterprises in which the State had a shareholding of at least 50 per cent) only and did not apply to private companies or individuals. Critics of the Decree could not see much point in the State initiating special insolvency procedures in relation to wholly-owned state enterprises rather than simply liquidating them – a process which was already within the powers of the state in its capacity as owner of the enterprise.

Secondly, the Decree envisaged out-of-court insolvency proceedings to be administered by the relevant State Property Committee – in the case of wholly-owned state enterprises – or a commission of the owners of the enterprise – in the case of partially state-owned enterprises (both referred to further as the 'Owners'). Obviously, the Owners of insolvent enterprises did not prove to be the right people to protect the interests of the creditors of those enterprises.

Thirdly, the Decree envisaged that the Owners would review the insolvency petition and determine whether the debtor was insolvent by applying the so-called 'inability to repay/inadequate assets' insolvency test, (ie a debtor was deemed to be insolvent only if its total debts exceeded twice the value of its assets). In practice this was a difficult test to meet as most state enterprises had numerous non-productive, and often absolutely illiquid assets on their balance sheet.

Once a debtor was acknowledged to be insolvent, its Owners were to prepare a rehabilitation plan specifying the timeframe during which the insolvent enterprise was to be under the so-called independent management (6–18 months) of an independent manager (which could also be a foreign entity) selected at auction (and which had to have provided security in the amount of not less than 10 per cent of the balance sheet value of the debtor's assets). While the powers of the independent manager were quite wide, it could not make more than 30 per cent of the work force redundant, which often left little room for manoeuvre.

In light of the above, the Decree was never considered successful in achieving its ends.

*The first insolvency law*

On 19 November 1992 the legislature took the lead from the President and adopted the first Russian law on bankruptcy (the 'First Law'). The First Law was a step forward in comparison with the Decree.

Firstly, it applied to all commercial legal entities and entrepreneurs irrespective of their form of ownership. Secondly, the insolvency proceedings were to be administered by the Arbitration Court (ie the Russian state commercial court) rather than by the Owners.

The First Law reduced the insolvency threshold by half (ie the debtor was considered insolvent if its total debts were equal to or exceeded the value of its assets). An insolvency petition could be filed by a creditor only if the debtor failed to pay debts equal or exceeding 500 minimal monthly wages within three months of the same becoming due. In addition, the First Law required the creditor to send to the debtor a last-minute warning to the effect that the creditor would file an insolvency petition if the debtor failed to pay its debt within seven days of the date of the warning.

The major flaw of the First Law, from the perspective of the debtor, was that it did not relieve the debtor from interest, fines and penalties accruing during insolvency proceedings in relation to the breach of the debtor's obligations. Thus, while the moratorium imposed during insolvency proceedings would prevent the creditors from collecting their debts it would not stop the interest/penalties/fines from accruing. As a result, even where the debtors were able to qualify for external management or rehabilitation proceedings (and, thus, initially avoid liquidation), most of them still ended up in liquidation immediately after the termination of the initial proceedings since, once the moratorium ended, and debtors would find themselves unable to meet their liability for the interest, fines and penalties which had accrued during the insolvency proceedings.

With time it became apparent that the First Law did not serve its purpose of restructuring inefficient businesses as it did not give debtors sufficient opportunity to recover. The number of bankruptcy cases was relatively small (eg in 1993, the courts completed 74 cases and in 1994, 231 cases) and did not correspond to the level of non-payments/defaults in the economy.

The tough monetary policy of the Government and the Central Bank led to a lack of money in the economy; the so-called 'crisis of non-payments'. Cash settlements were rare and businesses preferred to settle debts among themselves and even with the State via barter, set-off, promissory notes and other arrangements not involving any money. These arrangements were often associated with creative tax planning. The President tried to remedy the situation and on 18 June 1996 adopted the famous Decree No. 1212, which prohibited, among other things, debtors with outstanding tax obligations from having more than one bank account. Many Russian businessmen, however, preferred not to use any bank accounts at all rather than see their money being interfered with by the tax authorities. It became apparent that where the State was not able to change a business's practices, it would need to create a mechanism to change the management and the ownership of the troubled entities by modernizing insolvency legislation.

*The second bankruptcy law*

On 8 January 1998, Federal Law No. 6-FZ 'the Law on Insolvency (Bankruptcy)' (the 'Second Law') was adopted. The Second Law was intended to make insolvency proceedings easily accessible to creditors in the hope that it would help to restructure troubled companies, to replace the old management with a more efficient one and would cope with the so-called 'crisis of non-payments'. The reality turned out to be very different.

The Second Law got rid of the 'inability to repay/inadequate assets' insolvency test for indebted legal entities, but left the test intact for debtors who were individual entrepreneurs. An insolvency petition could be filed by a creditor if the debtor failed to pay debts equal or exceeding 500 minimal monthly wages (which was approximately US$ 3,000 at the time) within three months of the same becoming due, irrespective of the cause of the non-payment. The Arbitration Court had to review the insolvency petition (basically, on formal grounds) within three days of its filing date. The insolvency proceedings were due to commence automatically following the acceptance of the insolvency petition by the Arbitration Court. The Second Law did not require the Arbitration Court to invite the debtor to the hearings. Later the Constitutional Court acknowledged such practice to be unconstitutional, but that was long after the initiation of the most famous insolvency proceedings – Imperial Bank and Inkombank.

Once the Arbitration Court accepted the insolvency petition, it was obliged to appoint a temporary manager who would identify the state of the debtor's financial affairs, take measures to preserve its assets, identify its creditors and convene the first creditors' meeting. The creditors' meeting would then decide whether to petition the court to liquidate the debtor (if the debtor was hopelessly in debt) or to put it into so-called external management (if the debtor had a chance of recovering). The creditors could also enter into an amicable settlement with the debtor.

The arbitration managers (temporary managers, external managers and liquidators) were meant to be independent licensed professionals who would protect the creditors and play a key role during insolvency proceedings. This was quite a challenging role for a newly created profession. The Second Law provided for a transitional period during which no licences were required and the functions of the arbitration managers could be performed by so-called 'anti-crisis managers'. In practice, this meant that virtually any man off the street could become an arbitration manager by completing a one-month course and passing a simple test. Clearly, this was not always enough to prepare a manager to cope with the insolvent entities, many of which were giant companies or some of the largest Russian banks, run by huge management teams.

The draftsmen of the Second Law did not take into account the possibility that arbitration managers and the Arbitration Court could be serving the interests of people other than the creditors. The Second Law created a solid basis for abuse: it lacked any system of checks and balances, it did not differentiate between independent creditors and affiliates of the debtor, it excluded the shareholders/participants of the debtor and its management from the insolvency proceedings, it limited the role of the creditors and created a fairly poor mechanism for supervising the activities of the arbitration managers. It was not surprising then that the Second Law became a popular mechanism for ruining and taking over the business of a competitor, cheating creditors and the State. The Second Law well deserved its reputation as the Russian Federation law that did more than any other to promote the development of corruption.

Following the adoption of the Second Law, the number of insolvency cases snowballed year by year. While initially one could argue that the increasing number of insolvency cases was due to the August 1998 financial crisis caused by the collapse of the Russian GKO market, later it turned out that the growth in the number of insolvencies continued for years after the crisis.

**Table 2.6.1** Insolvency statistics

| *Year* | *1992* | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* |
|---|---|---|---|---|---|---|---|---|---|---|
| Number of petitions filed | * | * | * | * | * | * | * | 19,041 | 47,762 | 55,934 |
| Number of cases completed | – | 74 | 231 | 716 | 1,226 | 2,269 | 2,628 | 5,959 | 10,485 | 18,993 |

*No data available

While the Second Law envisaged that it was the specific duty of the temporary manager to identify the debtor's creditors and while the creditors had the right to file their claims (eg if for some reason their claims were not properly identified by the temporary manager), the Second Law was interpreted and applied in such a way that creditors wishing to participate in insolvency proceedings and to be entitled to repayment, had to file their claims (together with the relevant supporting documents) with the debtor in order to 'establish' their claims, irrespective of whether the debtor and the temporary manager knew or should have known about the relevant creditor and the amount owed to it (except for claims confirmed by the court decision). The debtor had seven days to object to the claim. The failure to object meant that the claim was 'established' and should be included in the register of claims. In practice, temporary managers often raised objections or refused to enter the relevant claim in the register even where the debtor did not object to or even acknowledged the claim.

Cases of disputed claims had to be resolved by the Arbitration Court. The Second Law neither required the debtor to have sufficient grounds for objections, nor provided for any sanction for frivolous objections being made to creditors' claims either by the debtor or by the temporary manager. As a result, the courts were inundated with disputed claims. The hearings of such claims would typically take just a few minutes and, what was still more frustrating, the relevant court resolutions on the establishment or dismissal of the claims were not subject to appeal. One could only imagine a creditor's reaction and the impact this had on an investor's confidence where the validity of multimillion dollar claims depended on the outcome of a brief hearing which was often little more than a formality. Later, the Constitutional Court acknowledged such practice to be unconstitutional, but for many creditors/insolvency cases it was already too late.

*Insolvencies of credit organizations*

Dissatisfied that its role had been downgraded to the position of a mere creditor, the Central Bank lobbied for the adoption of Law No. 40-FZ 'The Law on the Insolvency (Bankruptcy) of Credit Organizations' of 25 February 1999 (the 'Banks Insolvency Law'), which put the Central Bank back in a position to control insolvency proceedings of banks and other credit organizations (eg the Central Bank became entitled to impose additional qualification requirements on arbitration managers of credit organizations and to issue special certificates to them).

In line with the First Law, the Banks Insolvency Law provides that insolvency proceedings could be initiated against the bank only after revocation of its banking licence by the Central Bank. Taking into account the fact that after revocation of the banking licence the former bank cannot conduct banking business and, thus, cannot recover, the Banks Insolvency Law provides that the system of external management does not apply to banks, ie if a bank becomes insolvent it should be liquidated. For some reason the Banks Insolvency Law also prohibited bankrupt banks from entering into amicable settlements with their creditors.

On 8 July 1999, Federal Law of Russia No. 144-FZ 'The Law on Restructuring of Credit Organizations' was adopted. This law envisages various insolvency prevention measures that can be taken in relation to the bank and also deals with the rehabilitation of the banks by the state Agency for Restructuring of Credit Organizations. The procedures envisaged by this law serve effectively the same purpose as external management and financial rehabilitation (see below) procedures serve in relation to corporate debtors. If none of these measures work, the Central Bank would revoke the debtor's banking licence and would effectively put it into liquidation in accordance with the procedure envisaged by the Banks Insolvency Law.

*Natural monopolies*
Astonished by the scale of criminal activities arising from the Second Law, the legislature rushed to protect Russian corporate monopolies and on 24 June 1999 adopted Law No. 122-FZ 'The Law on Specifics of the Insolvency (Bankruptcy) of the Subjects of Natural Monopolies in the Fuel and Energy Complex' (the 'Natural Monopolies Law') which increased the minimum level of indebtedness required in order to file an insolvency petition by a thousand times, reverted back to the 'inability to repay/inadequate assets' insolvency test and introduced special qualification requirements for arbitration managers. It is not surprising that this law has rarely, if ever, been tested in practice.

## Current status

On 26 October 2002, the President of the Russian Federation signed the new 'Law on Insolvency (Bankruptcy)' (the 'Insolvency Law'). The Insolvency Law came into force (with some exceptions) on 28 November 2002.

The Insolvency Law replaced the Second Law as well as the Natural Monopolies Law. However, it still envisages that the insolvency of banks will be subject to a separate legal regime. Thus, both the Banks Insolvency Law and the 'Law on Restructuring of Credit Organizations' continue to apply. The press has reported that the Banks Insolvency Law will be significantly amended soon, presumably in connection with the introduction of the system of insuring private deposits in banks.

The scope of the Insolvency Law has been extended. It now applies (with some exceptions) not only to commercial legal entities but to non-commercial legal entities as well (such as state corporations, public organizations, non-commercial partners, and autonomous non-commercial organizations and condominiums (partnerships of owners of apartments)). It also now applies to natural monopolies (including nuclear power stations, which were previously exempt from insolvency proceedings).

The Insolvency Law was drafted with the primary purpose of preventing the numerous abuses that occurred on the basis of the Second Law. To this end the Insolvency Law:

- makes it more difficult to initiate insolvency proceedings, ie an insolvency petition can be filed against a debtor only if its indebtedness is confirmed by a court judgement that has come into force (in case of civil law claims) or by a decision of the relevant tax or customs authority on the levy of enforcement over the debtor's assets (in case of tax claims); and such indebtedness is not satisfied within 30 days after the submission of the writ of execution to the bailiff (in the case of civil law claims) or after the relevant decision of the relevant tax or custom authority on the levy of enforcement over the debtor's assets (in case of tax claims);

- gives the debtor, its shareholders/participants/owners and the state authorities a greater say in insolvency proceedings, eg both the debtor and its shareholders/participants/owners can now officially participate (though with no voting rights) in insolvency proceedings, and the state authorities (eg tax/customs/municipalities) have equal status with other creditors and can vote at each creditors' meeting and not just at the first meeting, as was the case under the Second Law;
- increases state and public control over arbitration managers, eg the qualification requirements for arbitration managers have been tightened, the creditors can introduce certain further qualification requirements for the arbitration managers, and the procedure for the appointment of arbitration managers has been complicated and now resembles to a degree the jury selection process;
- introduces various measures to avoid abuse of process, eg all claims are established by the court only. The arbitration manager or the creditors can decide to transfer the function of keeping the register of creditors' claims to an independent registrar, and the arbitration manager no longer has the authority to manage the debtor during the supervision stage even where the head of the debtor's executive has been removed by the court – a tactic often used to gain complete control over the debtor in the past.
- Along with 'closing loopholes' in the Second Law, the Insolvency Law introduces various further changes with a view to improving the efficiency and outcome of insolvency proceedings. For example, the Insolvency Law:
- introduces (in addition to supervision, external management and liquidation) a new stage of insolvency proceedings, namely, financial rehabilitation, whereby the debtor's shareholders/participants/owners, state authorities or third parties guarantee and procure the performance of all the debtor's obligations in full;
- specifically authorizes the debtor to issue additional shares (by closed subscription) in order to repay its debts;

- has reduced the number of classes of ranked claims from 5 to 3. What is more important is that it has improved the position of secured creditors, ie claims secured by a mortgage/pledge are satisfied in priority to all other claims except for claims of first (claims for harm caused to health or life) and second (salaries, severance and copyright payments) priority arising prior to the creation of the pledge, in contrast to the position under the Second Law whereby the claims of secured creditors were satisfied after all claims of the first and second priority, irrespective of when they had arisen. In addition, the Insolvency Law clarified that claims of the secured creditors are satisfied in priority to unsecured claims out of the value realized from the sale of the pledged/mortgaged assets rather than from the pooled property of all secured creditors and potentially all property of the debtor.

On paper, the Insolvency Law constitutes a significant improvement in the Russian legal environment. There is no doubt that it will stop many of the abuses conducted on the basis of the Second Law. However, it remains to be seen whether it will be widely used in practice as a civilized way of dealing with insolvencies, or whether it will go the way of the Natural Monopolies Law, which was not used due to the complexity of initiating insolvency proceedings.

# 2.7

# Administrative Barriers to Investment in the Russian Federation

*Jacqueline Coolidge, Foreign Investment Advisory Service**

## *Overview of administrative barriers*

Over the past two to three years, there have been many legal reforms designed to improve the business environment in the Russian Federation. These have included a new Tax Code, a new Land Code, and new legislation in the areas of business registration, licensing, inspections, and certification. However, in spite of the legislative reforms on the books, there are many instances of a disconnection between theory and practice. There is too much uncertainty, as interpretation and enforcement of laws – from registering a new company, to acquiring land, to paying taxes – change rapidly and depend on which government official is doing the interpreting or enforcing. There is too much corruption; from high-level officials who demand 'partnership' in companies that look like they will be profitable ventures to the lowest level customs or expertise official. Russia suffers in comparison with most other emerging markets in these respects, even in comparison with other transition economies such as those in central Europe and the Baltic region. These conclusions apply to all private firms, whether their owners or managers are Russian or foreign.

A team from the Foreign Investment Advisory Service (FIAS) has analysed these problems – called administrative barriers – in a number of regions including St Petersburg City, and the oblasts of

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* The Foreign Investment Advisory Service is a joint facility of the International Finance Corporation and the World Bank. The views expressed in this chapter are entirely those of the author and do not necessarily represent the views of the World Bank Group.

Leningrad, Velikiy Novgord, Sverdlovsk and Tomsk (2000–2001), followed by assessments begun in Kaliningrad, Perm, Nizhny Novgorod, and Magadan (2002).

Figure 2.7.1 shows the major obstacles that were found, based on a detailed business survey covering Kaliningrad, Perm and Tomsk in 2002. At the top of the list for all firms are obstacles associated with access to real estate and construction permits, followed by taxes, corruption, and licensing. If firms who did not give definitive answers about particular problems are excluded, then construction permits and land are still at the top of the list, followed by corruption; but taxes and licences appear to be relatively less severe problems while customs and the judiciary appear as significant sources of complaint.

Large, former state-owned firms can usually manage these procedures because they have established relations with many of the relevant officials. Large foreign investors can hire lawyers, accountants, consultants, and agents to help them through the procedures. Smaller firms, both foreign and domestic, are more often deterred by the procedures because they lack either connections or the resources to pay for hired expertise to help them.

It should be noted that one of the major difficulties in investigating administrative barriers in a setting such as Russia is the significant difference between existing investors and 'potential' investors. Government officials at all levels in Russia want to see

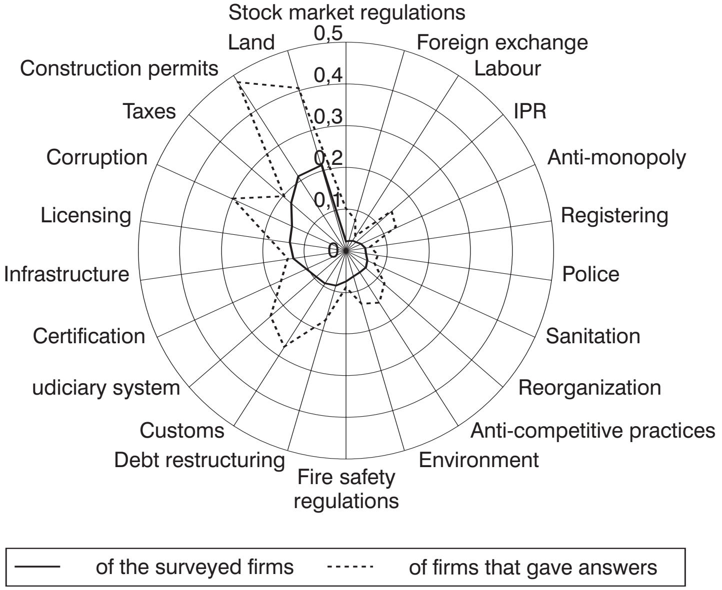


**Figure 2.7.1** Obstacles to investments

more investment. Some of this might plausibly come from existing businesses making new investments to expand or upgrade their facilities or to introduce new production lines or new services. However, much of the new investment will have to come, and should come, from new investors.

The problem is that existing investors, and their attitudes and perceptions, are not necessarily representative of potential investors. In this regard, for all the bitter complaints and harsh criticisms, the findings of the various case studies, interviews and surveys are probably biased in favour of the status quo, relative to the views of the potential investors that Russia wants to attract. It has therefore been necessary to filter and interpret the views of existing businesses to find clues about the needs of potential investors and to judge priorities for reform. In particular, the notorious 'unlevel playing field' in the Russian Federation must be viewed as a fundamental deterrent to new investment.

These findings are confirmed by many other sources. Another recent survey of administrative barriers, carried out on behalf of the Ministry of Economic Development and Trade, also found that tax problems ranked highest, along with 'purchase of premises' (that survey did not include any questions about construction permits) as specific areas of difficulty for firms.[1] Transparency International ranked Russia at 71 (alongside India and Tanzania, among others) out of 102 countries in their corruption perception index for 2002.[2]

## *Low investment levels as a result*

Russia as a whole has been clearly underperforming both in terms of gross domestic private investment and foreign direct investment. Gross domestic investment in the Russian Federation contracted severely from 1990 to 1998, and has only recently started expanding again. For the period 1992–2000, foreign direct investment constituted less than 2 per cent of Russia's GDP (and usually at or under 1 per cent), compared with 3–4 per cent or more of GDP in Poland and Romania, and much higher rates in other countries in Central and Eastern Europe. Figures 2.7.2 and 2.7.3 show how Russia compares with other large emerging market economies and other European transition economies, respectively.

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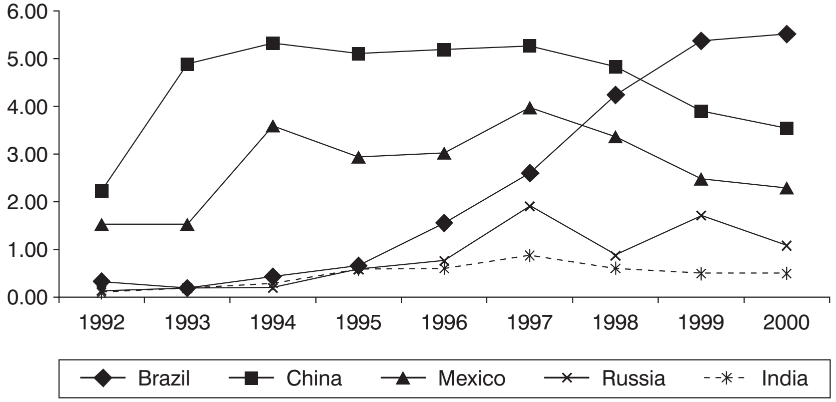
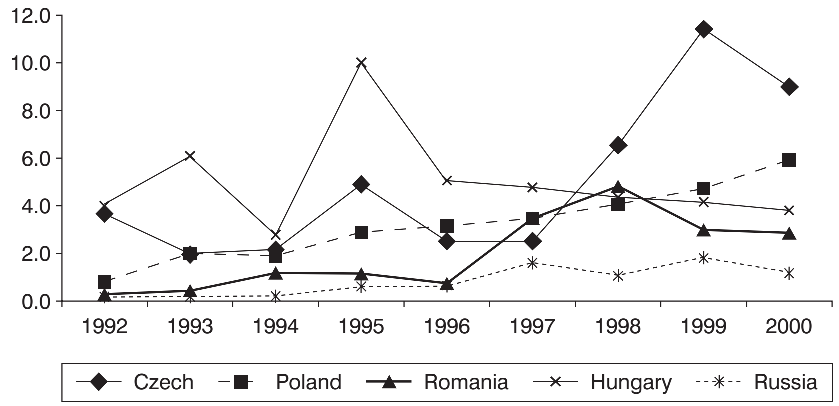
[1] Center for Economic and Financial Research and the World Bank, 'Monitoring of Administrative Barriers to SME Development in Russia, 2002

[2] Transparency International, http://www.transparency.org/




*Source:* IMF International Financial Statistics, and World Bank, World Development Report 2000

**Figure 2.7.2** Foreign direct investment in large emerging market economies




*Source:* IMF International Financial Statistics, and World Bank, World Development Report 2000

**Figure 2.7.3** Foreign direct investment in selected transition economies

Not only the amounts of investment, but also the activities in which it has been concentrated, are symptoms of festering problems. The 'missing investors' are readily identifiable. FIAS noted in its first report on Russia (1992) that the only foreign investors coming to Russia were those that *had to be there*. This has included mostly producers of brand-name consumer goods (especially in and near the large consumer markets of Moscow and St Petersburg) and some investors in the extractive sector (a significant proportion of the total within Russia but still much less than in other resource-rich countries). The pattern has not changed much since then. Notably sparse are the export-oriented manufacturers and others involved in the new 'globalized' production system, which are so prominent in other transition economies, including Central Europe, the Baltics, East Asia and Latin America.

For example, Russia should have a clear comparative advantage in the world economy in the production of research and development-intensive, high-technology goods and services, based on its highly educated workforce and a critical mass of world-class scientific talent in a diverse range of disciplines. However, Russian exports of new high-technology products have been meagre, and Russia's participation in and influence on global developments in this sector has been disappointingly limited. Although there are other problems hampering their activities (eg unclear intellectual property rights, lack of marketing expertise, lack of venture capital), it is worth considering whether the tangle of regulatory red tape has been a substantial hindrance to Russia's involvement in the most dynamic and lucrative sectors of the world economy, which require speedy responsiveness to the world market.

## *Key findings*

Administrative barriers are important components of the reason why private investment in Russia has been so low for the past 10 years. They are not the whole story; there are clearly other important problems facing investors, including weak financial markets and corporate governance. While the direction of Russian reforms is now clear, and the pace of reform has definitely accelerated, all the participants recognize that there is still a great deal of work ahead. In addition to the ongoing policy and legal reforms, which are well under way, there is a need to develop detailed regulations to accompany the new legislation, and beyond that, a need to ensure that new procedures are implemented efficiently, consistently, and fairly throughout the Russian Federation.

The findings should therefore be viewed in context: some of the findings are about relatively clear obstacles that need to be removed in order to improve investment levels; others are broader issues that will probably be harder to address, but also need to be improved in order to encourage higher investment.

The study of administrative barriers to investment uncovered at least three distinct problem areas that could be described as **choke points** for investment. These are: 1) access to real estate; 2) a burdensome tax regime; 3) onerous regulations on foreign economic activity.

1. ***The relative lack of a secondary (private) market for land*** forces the great majority of investors to deal with the State as landlord and makes it difficult to value real estate assets. This is how many regional and local governments control and/or intervene in the investment process, which probably deters many potential investors. Many regional governments clearly prefer to rent land rather than sell it, and go so far as to set rental rates that are much lower (in present value terms) than the sales price and often even lower than land taxes.

   The procedures for obtaining construction permits are extremely time-consuming, cumbersome, opaque, and prone to corruption. In practice, construction permit procedures have been tangled up with many of the procedures associated with transfer of real estate. However, while the lack of a secondary market in land is associated with bureaucratic interference in investment, it is probably the construction permit process that is most associated with delays and petty corruption. The findings of the first FIAS study appear not to have improved: many investments involving new construction or major renovation involve delays of 2–3 years. This is a significant factor deterring export-oriented investment, where the demands and time-pressures associated with the global production chain mean that delays of this length become 'deal killers'. Foreign investors, in particular, who have the choice of locating in other countries with faster and more certain procedures, can start production and sale with less waste of time and effort, and less tied-up capital.

2. ***The tax regime*** for business is improving, but still represents a formidable source of state control over private enterprise. In addition to the complaints about high tax rates and complex tax structures (many of which are being addressed in the development of the new Tax Code), most businesses are also burdened by procedural problems in tax administration.

   A couple of years ago, most interviewees (including investors, private accountants, and even tax inspectors) agreed that tax inspections were heavily influenced by 'revenue targets', which could (and usually did) include fines and penalties. Meanwhile, it appeared that some companies were not in the system at all, and others allegedly colluded with tax inspectors to evade taxes. Tax inspectors could assess penalties regarding infractions of rules that had nothing to do with tax and even against technical errors that had no effect on calculated tax payments. It was also widely agreed by tax inspectors and taxpayers alike that tax arrears (again, including penalties) could drive an otherwise healthy company into bankruptcy.

There are some signs that the new Tax Code is starting to improve the situation, but there is a great deal of distance to travel in terms of sound and consistent implementation, which in turn will require vigilant monitoring and enhanced accountability within the tax inspectorates.

3. ***Foreign exchange controls, customs procedures, and other controls on foreign economic activity*** were the source of many complaints, and are clearly a significant deterrent to export-oriented investment (particularly foreign direct investment, where investors can easily choose a different location).[3] The main complaints include the following:
   - The restricted list of transactions that are considered 'current', the practice of defining all other transactions as 'capital', and the fact that transactions are subject to heavy controls and severe penalties adds significantly to business risk and delays.
   - The requirement to change a major percentage of gross foreign exchange earnings within a few days of receipt adds significantly to costs.
   - Delays and corruption within the customs administration and monopolistic behaviour among customs brokers with close ties to the customs administration.
   - Regional-based 'registration' (in practice, licensing) of foreign economic activity is cumbersome, an unnecessary impediment to efficient business operations, and often discriminatory.
   - Controls on the trade of some goods (eg those requiring certification based on Russian product standards) leads to lengthy delays and uncertainty and adds to the costs and risks of foreign economic activities.

More generally, the study of administrative barriers to investment identified two broad themes covering a complex web of problems that appeared in many of the administrative procedures we examined. These include: 1) the problem of the lack of competition in the economy; 2) the related favouritism in implementation and interpretation of laws and regulations. These were especially problematic in gaining access to land, the construction permit process and

[3] These issues were also prominent in the 1999 report by the Expert Institute and Ernst and Young, 'The Investment Climate in Russia'.

customs, but also in tax, sector licensing, foreign exchange, immigration, and several other procedures.

1. ***Ultimately, there is a critical need for much stronger competition within the economy of the Russian Federation***. In the Western developed economies it is competition between firms that is the engine of growth. Most rapidly growing economies around the world and throughout history have been open to trade and investment (both internationally and inter-regionally) and thus subject to robust competition. This is true, for example, of both the South East Asian and Latin American countries that have grown the fastest over the past 20 years.

   Foreign direct investment is a particularly effective stimulant to growth, providing not only new sources of capital, but more importantly, new technology, and the most effective management and marketing methods. The very essence of economic development is the rapid and efficient transfer and adoption of 'best practice' across borders. Foreign direct investment is particularly well suited to effect this and translate it into broad-based growth, not least by upgrading human capital. There is also significant evidence that these benefits of foreign direct investment have substantial spillover benefits to the domestic economy.

   The famous McKinsey report of 1999, unsurprisingly, linked the lack of competitiveness in Russia to a lack of competition – not only internationally – but also within its own borders.[4] Further, the International Institute for Management Development, working for the World Economic Forum, ranked Russia last in terms of overall competitiveness in its list of 47 developed and emerging market economies in 2000 and 64th out of 80 countries in 2002.[5]
2. ***The problem of inconsistent implementation and interpretation of laws*** and regulations was a recurring theme. Businesses are nearly unanimous in stating that success in overcoming administrative barriers depended heavily on 'personal contacts'. Even a majority of officials admit that 'knowing a business' is an important influence on their decision-making process. This seems to be especially a problem in land

[4] McKinsey Global Institute, 1999, *Unlocking Economic Growth in Russia,* http://mgi.mckinsey.com/mgi/russian.asp

[5] International Institute for Management Development; http://www.imd.ch/wcy/ranking/ranking.cfm.

acquisition, the entire construction permit process, and customs, but also affects most investment procedures to some degree. Unfortunately, such inconsistency in treatment, in turn, can give rise both to cronyism and to corruption. Corruption was revealed to be among the top five barriers to investment in the FIAS survey.

Even where corruption is not an issue, and even if two differing interpretations are both 'reasonable', investors often cannot tolerate an outcome that treats competing companies differently. A firm that is treated more harshly by the tax authorities than another firm faces obstacles and costs that the other firm avoids. A firm whose imports are held up at the border is seriously disadvantaged relative to a rival whose imports clear customs expeditiously. A start-up enterprise whose construction permits are delayed may suffer if a competitor enjoys a head start. For this reason, inconsistency (especially within an administrative jurisdiction) cannot be dismissed as a 'minor' problem. The very existence of an unlevel playing field deters new investors, who know they are unlikely to earn a profit in competition with firms favoured by the authorities.

Foreign investors in particular expect a regulatory regime that operates like a 'vending machine' (in the words of Max Weber):[6] A businessman inserts a proper application and/or an official fee and the expected good, service, or permit is delivered. This is a fundamental premise of the rule of law in a market economy, but is seriously lacking throughout the Russian Federation.

Even relatively progressive, business-friendly jurisdictions in Russia fall into the trap of relying on 'individual assistance' to investors instead of simplifying procedures. As investment levels grow, as they should, such administrations will discover that it is impossible to provide individual assistance to all or even most investors. They usually end up helping only a favoured few, which exacerbates the problem of the unlevel playing field and deters many potential new investors.

## *Conclusions*

Under the administration of President Putin, the Russian Federation has now clearly embraced meaningful reforms to improve the investment climate. The Government has made good progress with

[6] Weber, Max, 1968 *Economy and Society.* Edited by Guenther Roth and Claus Wittich.

its legislative reform agenda, and has begun to turn its attention to the 'second tier' of regulatory reform (including new efforts to reform 'technical regulations', including standards). However, no one should underestimate the massive task of ensuring sound implementation of the reforms throughout the vast country.

No one should expect dramatic improvements in the investment climate 'on the ground' on the basis of legislative reforms alone. The legislative reforms need the reinforcement of civil service reform in order to improve transparency and accountability, and judicial reform as a critical recourse to failures within the civil service bureaucracies. Selective monitoring can help the Government identify the problem areas in implementation that need to be corrected over time. Regions with relatively sound reform programmes should, over time, begin to attract more investment than the laggards, which in turn will increase the pressure for reform and encourage it to spread more evenly across the country.

The economic potential of the Russian Federation is enormous. On the one hand, Russia faces a significant risk that the recent growth (attributable as much to high oil prices as to the recent reforms) will invite complacency. On the other hand, there is a new sense of optimism that the reform process in the Russian Federation has sufficient momentum that it will work through the various levels to meaningful implementation. This process might be slow, but the achievements over the past two to three years provide grounds for hope.

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# Part Three

# Market Potential

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# 3.1

# The Oil and Gas Industry

*Keith Byer, Deloitte & Touche*

In its annual international energy forecast, the US Energy Department predicted global oil demand would rise to 120 million bpd (barrels per day) in 2020 from its current level of about 77 million bpd. This view is not dissimilar to projections from the IEA, OPEC and others. Organizations representing oil importing nations as well as those dedicated to serve the interests of exporters agree that oil demand will continue to grow – albeit at a slower rate than that for the development of the world's economy as a whole.

The overall message is clear – oil remains a crucial factor in global economic development. Even through economic downturns, and during a decade in which sustainable development and energy efficiency have been constantly high on the agenda of the developed world, overall demand continues to grow – albeit at a slower rate than that for the development of the world's economy as whole. This is the market opportunity for Russia to address: and it is a bright prospect.

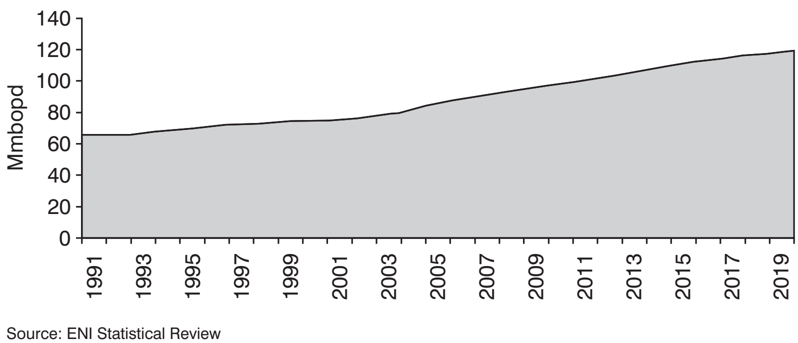
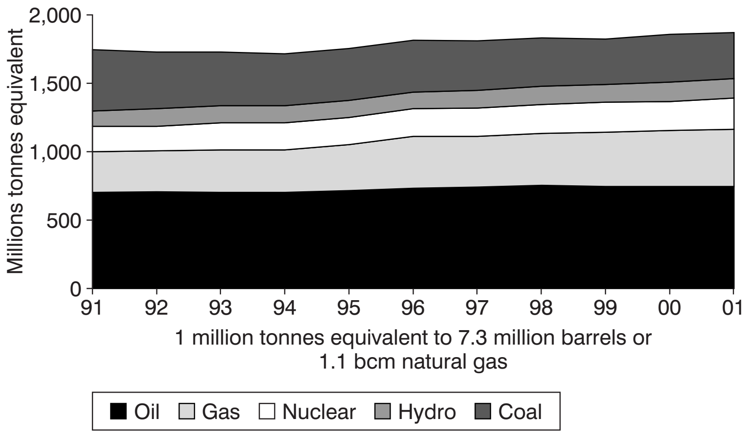



**Figure 3.1.1** Global oil demand growth




Source: BP Statistical Review

1 million tonnes equivalent to 7.3 million barrels or 1.1 bcm natural gas

**Figure 3.1.2** European energy consumption 1991–2001

Figure 3.1.2 offers a regional view of European demand growth for all primary energy sources over the last decade. Amongst the major consumption markets in the world, Europe is where Russia's role as a supplier has historically been the most significant, in oil and especially in gas. One can draw two conclusions from this information: Europe is a post-growth market for energy, but still accounts for 16 per cent of global energy demand; and gas is meeting an ever greater share of total demand, with a rising trend. Again, the message is clear, there is incredible opportunity for Russian energy companies.

## *The players*

While the Russian gas market is dominated by the natural monopolist Gazprom, Russia's oil industry has 10 key players. Within the top 10 there are different strata evidenced by the top four producers accounting for 67 per cent of July production of the group and the top two producing 42 per cent.

Exploitation of the opportunities will require large amounts of capital. While prices in recent years have generated significant operating cash flows, the majority of companies require access to the Western capital markets in order to fully develop. Each of these companies has taken slightly different roads in transparency and building reputations. There is an interesting contrast between the relative size according to production (as shown above) and their

**Table 3.1.1** Oil production from January–July 2002, thousands of tonnes

| *Company* | *Jul 2002* | *% increase year on year* | *Jan–Jul 2002* | *% increase year on year* |
|---|---|---|---|---|
| Lukoil | 6,324 | 119.0 | 43,739 | 119.2 |
| YUKOS | 5,951 | 118.5 | 38,390 | 117.2 |
| Surgutneftegaz | 4,200 | 112.3 | 27,495 | 110.1 |
| TNK | 3,196 | 112.6 | 20,821 | 111.1 |
| Tatneft | 2,101 | 101.5 | 14,215 | 99.4 |
| Sibneft | 2,260 | 126.6 | 13,996 | 124.3 |
| SIDANKO | 1,372 | 175.3 | 9,121 | 173.0 |
| Slavneft | 1,368 | 107.7 | 8,929 | 104.9 |
| Rosneft | 1,400 | 108.2 | 9,078 | 107.9 |
| Bashneft | 1,022 | 99.6 | 6,656 | 97.0 |

*Source:* State Statistics Committee

market capitalizations. The top 10 are not identical due to some entities being State owned or not publicly traded. AK&M Information Agency reported the following market capitalization as of 18 September 2002.

**Table 3.1.2** Market capitalization statistics

| | *Company* | *Capitalization, US$ million* |
|---|---|---|
| 1 | YUKOS | 19,421 |
| 2 | Lukoil – oil company | 13,104 |
| 3 | Surgutneftegaz | 12,695 |
| 4 | Sibneft | 8,710 |
| 5 | TNK | 4,550 |
| 6 | Tatneft | 1,584 |
| 7 | Eastern oil company | 603 |
| 8 | Orenburgneft | 574 |
| 9 | Slavneft-Megionneftegaz | 503 |
| 10 | Bashneft | 489 |

The strata of the players becomes even more pronounced when you evaluate based on market capitalization. The top four account for 87 per cent of the group's market capitalization (compared with 67 per cent of production) and the top two account for over half the group's market capitalization, accounting for 52 per cent of market capitalization (compared to 42 per cent of production). It is further interesting to note that as of 18 September 2002, YUKOS market capitalization exceeded that of Gazprom, the latter having a market capitalization of US$ 16.6 billion. When you compare YUKOS's 2002 first half-year revenues of US$ 13 billion, which is 4 per cent of Gazprom's revenues of US$ 297 billion, it becomes apparent that investors are ever more discerning.

### *The future – go west young man*

Historically Russia has served as *the* energy supplier to Europe. While YUKOS and TNK have both transported oil to the United States, the main market continues to be Europe. As Europe becomes more homogenized due to the formation of the European Union, there may be effects on Russian energy producers. In the European Union though, there is something of a conundrum and a policy ambivalence as a result. As an illustration, these two contradictory positions were articulated in different EU forums in the same month earlier this year. The European Union contended that a strategy based on long-term contracts appears to be an inefficient approach to ensuring security of supply; implying that market security is better served through multiple, shorter-term, competitive contracts. But conversely the European Union acknowledged the difficulty of financing the major development and infrastructure projects needed for additional supplies without the collateral afforded by long-term offtake deals. This debate continues and will not easily be resolved.

There is a strong consensus on the scale of the investments needed – some US$ 200 billion by 2020. Neither the producing companies nor their bankers are, as yet, willing to commit major capex whilst retaining both market and price risk. With the European Union seeking to set the negotiation framework for the European countries as a block, there are signs that some of the gas exporters might also be discussing how they might at least consult together in responding to commercial framework proposals made by the European Union. Commercially, it is apparent that buyers are looking to manage perceived risks through greater market liberalization and competition, whilst producers are keen to maintain the security of the traditional long-term agreement model.

In looking at increasing sales into the European gas markets, Russia needs to be particularly aware of several major trends shaping the European corporate landscape for energy companies. Following a series of national and EU regulatory moves, each EU country is advancing along a path of restructuring its energy sector:

- Ownership of transportation infrastructure is being split from responsibility for supply of gas.
- A number of formerly national energy suppliers are increasing their market share across Europe.
- Network owners are consolidating responsibility for similar assets across the gas and power sectors.
- Energy suppliers are offering ‘packaged’ contracts covering gas and power – supported by expanded energy trading activity.

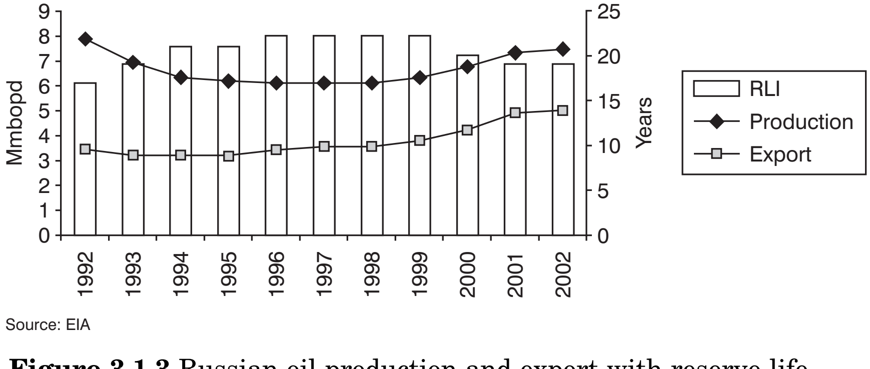
Recent corporate difficulties, especially amongst several major players in the US and UK energy trading markets, have however, at least temporarily, reduced liquidity and flexibility available to support the development of a more liberalized competitive gas market in Europe. Fundamentally this trend was driven by power sector restructuring – and just for the present at least – that EU initiative seems to have stalled.

## *Competing with OPEC: will Russia deliver?*

Having established that the global oil and European gas markets are growing and attractive to increased Russian exports, we will now ask the question: ‘What will it take to ensure that Russia can deliver?’

Figure 3.1.3 shows Russia’s overall oil production, the proportion exported and the reserves to production ratio over the last decade.

Recent trends in production and exports have been strongly upwards – but the remaining reserve is on the decline. To sustain the positive trends will require an acceleration in capex spending on exploration and new developments: the excellent progress made




Source: EIA

**Figure 3.1.3** Russian oil production and export with reserve life index 1992–2002 in recent years through improved recovery techniques applied largely to mature fields will not alone be sufficient.

Russia's oil industry has bounced back over the past few years, posting strong profits and healthy increases in production. Buoyed by relatively high world oil prices in 1999 and 2000, as well as a decline in production costs following the August 1998 devaluation of the rouble, Russian oil companies stepped up production, and by 2001 the country was pumping out an average of over 7 million barrels a day – a 20 per cent increase on the 1998 level. Russia is currently the world's second largest crude oil producer, behind only Saudi Arabia.

With continued high oil prices, Russian oil production increased in the first nine months of 2002, reaching 7.8 million barrels a day by September 2002, and Russian Energy Minister Igor Yusufov forecast that the country will produce an average of 7.6 million barrels a day for 2002 as a whole. The Russian government has set a target of reaching and maintaining 7.8 million barrels a day in the next few years. In order for Russia's oil producers to achieve this production level Yusofov estimates the country's oil industry will need US$ 1 billion in annual investments, but many analysts think the real demand for incremental capital will be much higher than that.

## *Attracting capital*

Whilst there is some foreign participation in the Russian oil sector, the overall concession map is dominated by increasingly large

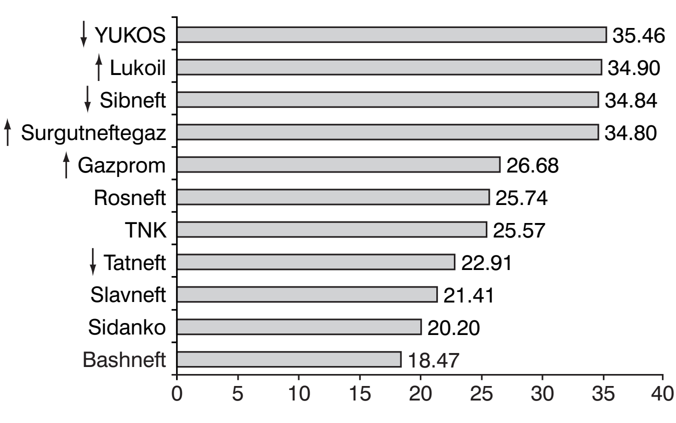



**Figure 3.1.4** Russian oil and gas companies are improving conduits for new investment capital

domestic companies. The fortunes and reputations of the Russian 'majors' have fluctuated over the last decade – but most have now established a clear profile with sophisticated investors in capital and debt markets.

The credibility and confidence index in Figure 3.1.4 is one way of seeking to measure and compare the absolute and relative standing of the Russian companies with regard to their ability to attract investment funding. Overall it is clear that many of the Russian companies are now in a position to tap international capital markets as well as domestic markets, to source additional investment funds.

As such, it is our expectation that they will be the primary players in the quest for increased production capacity to meet export demand. Exploration in the Russian sector of the Russian companies teaming with Western oil majors are under way in the Arctic region, in East Siberia, and on Sakhalin Island in Russia's Far East. Russia's future level of oil production will be defined by the ability of oil companies to develop these greenfield deposits, which will require a massive amount of infrastructure investment in order to deliver this oil to market.

## *Summary*

The world needs more oil and Russia is well positioned to seize the international market opportunity – as long as it maintains a fair and stable regulatory and fiscal regime to encourage and reward the risk capital required.

Europe will consume much more gas. Restructuring in both domestic and European markets will necessitate very careful management but is essential if the overall shift to gas is to be maximized whilst improving market efficiency, diversity and public perceptions of security of supply.

## 3.2

# The Regulatory Framework for the Oil and Gas Industry

*CMS Cameron McKenna*

### *Introduction*

Russia's extensive oil and gas reserves have attracted energy companies from all over the world. There are currently plans to invest tens of billions of dollars in various oil and gas production projects in Russia. However, because of the many legal and practical obstacles to investment in this sector, foreign companies have invested less than US$ 2 billion to date, the majority of it in fairly small joint ventures. This chapter describes the most important Russian oil and gas legislation and summarizes a number of its most important provisions.

Russia's oil and gas sector is overseen by the Ministry of Energy of the Russian Federation. Russia's oil sector is dominated by large joint-stock companies created by privatization. Russia initiated a two-step oil privatization process in 1993. The first phase, which involved organizing state-owned enterprises as joint-stock companies, ended in 1994 and resulted in the establishment of several vertically integrated oil companies. The second phase, which has been ongoing since 1995, involves the auctioning off of government shares in these companies.

### *Legislation*

Russian oil and gas legislation is based on the Constitution of the Russian Federation and the following three laws constitute the basic legal framework for oil and gas exploration and production:

- Law on Underground Resources of 21 February 1992 (Subsoil Law);

- Law on Production Sharing Agreements of 30 December 1995 (PSA Law);
- Law on Gas Supply in the Russian Federation of 31 March 1999.

Russian legislation provides two distinct regimes for oil and gas exploration and production. First, the Subsoil Law establishes a general licensing and administrative law regime under which federal and local authorities issue, amend and terminate rights granted by licence. Second, the PSA Law establishes a quasi-contractual regime for production sharing agreements (PSAs) between the investor and federal and local government.

## *The Subsoil Law*

The general principles of the oil and gas legislation are set out in the Subsoil Law, which establishes the administrative system for the exploration and production of mineral resources and defines the State as the owner of all mineral resources in the earth. The Subsoil Law also defines the scope of authority of the federal and local governments in the mineral resources sphere. Every 'subject' of the Russian Federation may adopt its own legislation on the use of natural resources within the scope of authority granted to it by the federal legislation and by any agreement defining the scope of authority that may have been entered into by the Federal Government and the government of the subject.

The Subsoil Law states as a general principle that a licence to use subsoil resources may be issued to Russian or foreign legal entities. A licence to produce oil will be issued in most cases only after a tender and on the basis of a joint decision of the federal and local authorities. The Russian Federation Committee on Underground Resources (Roskomnedra) is the federal licensing agency. The issuance of the licence may also be subject to approval by federal mining safety and environmental agencies.

A licence confirms the right of the licence-holder to use subsoil resources according to the terms and conditions defined in the licence. The terms and conditions stipulated in the licence remain in effect for the period stipulated or for the whole term of validity of the licence. The terms and conditions may be changed only with the consent of the licensee and the authorities that granted the licence, or in certain other cases defined by law.

The basic criteria applied by the relevant authorities when deciding a tender are: the scientific and technical level of the proposed programmes for geological study and use of subsoil; the extent of mineral extraction proposed; the contribution to the social and economic development of the territory; the effectiveness of the environmental protection measures proposed; and the national security interests of the Russian Federation. Usually however, the winner of an auction for a subsoil licence is determined on the basis of the total amount offered for the right to use that subsoil block.

All information on forthcoming tenders for subsoil user rights is published in the Russian national media and local media for the different subjects of the Russian Federation.

## *The PSA Law*

The PSA Law establishes a special regime for production sharing agreements. Russia has had a law on PSAs in place since 1996, but due to delays in adopting additional legislation, few projects have gone forward on production sharing terms. PSAs, according to Russian legislation, should be treated as civil law contracts subject to a special statutory regime and entered into between the Russian Federation and an investor or investors.

In general, a PSA is implemented as a result of an open tender conducted by the Russian Federation. The winner of the tender negotiates the terms and conditions of the PSA with the Federal Government and the relevant local government. The PSA defines the rights and obligations of the investor and the Russian Government – for example, the PSA will set out a formula for calculating how the winner of the tender and the Russian Government will share the hydrocarbons produced. Production is split into 'cost production' and 'profit production' (though such 'distribution' may be changed in accordance with a PSA). The 'cost production' belongs to the investor to pay off the costs of the project, while 'profit production' is divided between the investor and the Russian government when the costs of the project are paid out.

The PSA Law does not eliminate the requirement to obtain a licence for the use of mineral resources under the Subsoil Law, but the government is obliged to issue the licence within 30 days from the date the PSA is signed. The PSA law prohibits the government from revoking the licence once the PSA is concluded. For a field to be developed on a PSA basis, it must first be approved by a Federal Law, often referred to as a 'List Law'. Some smaller deposits are exempt from these requirements.

## *Tax*

The tax burden is one of the most significant issues for those oil and gas producers in Russia that operate under the Subsoil Law regime. Among the numerous taxes that producers are required to pay are excise tax, **tax on production of** mineral **resources**, property tax, road use tax **(this should be abolished as of 1 January 2003)**, **unified** social tax, profit tax and value added tax. As many of these taxes are calculated on gross revenues rather than profits, taxes exceed sales revenues for some producers. Projects developed on production sharing terms under the PSA Law pay profit tax, royalties and bonuses, and share 'profit production' with the government. The PSA Law also exempts PSA parties from the otherwise mandatory hard currency conversion requirements.

The PSA Law provides that parties to the PSA may elect international arbitration for dispute resolution. For the purposes of a PSA the Russian Federation may waive its sovereign immunity.

The PSA Law still contains some disincentives to foreign investment. Tenders to award PSAs require the participation of Russian companies in the PSA project in proportion defined jointly by the Russian Federal Government and the relevant local government for each particular PSA. It is required that at least 70 per cent of equipment, materials and technical assets used in the PSA project (measured by cost) are produced by Russian companies or by foreign companies conducting business and registered for tax in Russia. At least 80 per cent of employees must be Russian citizens with foreign employees restricted to the first stages of the project or when no appropriately qualified Russians are available.

The Sakhalin I and Sakhalin II projects, each being developed by consortia that include Western companies, currently operate under PSAs. Those PSAs, however, were signed in 1995 before the PSA Law came into effect. The Sakhalin II project produced its first oil in July 1999.

## *Gas*

Russia's gas sector is dominated by the joint-stock company Gazprom (RAO Gazprom), which is 38 per cent owned by the government of the Russian Federation. Gazprom was established by the government of the Russian Federation of 17 February 1993. It has a dominant position in the gas production and distribution market owning almost all gas production, transportation and distribution facilities on the territory of the Russian Federation.

## *Transport issues*

The company Transneft has a monopoly over crude oil transportation, while the company Transnefteprodukt transports petroleum products. Tariffs are generally established by the State. Oil companies and joint ventures are constrained in their ability to export crude oil by two factors:

- There is only limited capacity in Russia's oil pipeline system for transporting oil to points outside Russia.
- The Russian government limits exports to ensure domestic supplies.

For a variety of reasons, the price of crude oil is significantly lower in Russia than abroad, which makes it unprofitable to sell oil domestically.

**3.3**

# Metallurgy

*Leonid Vasiliev, Equity Analyst, Raiffeisen Bank*

The structure of the Russian steel industry was shaped during Soviet times, when steel consumption for military means comprised a significant portion of overall output. Steel production was considered of strategic importance, and it was the volume, not the efficiency, that was important. Consequently a large number of steel enterprises were built and are still scattered around the country. More than a decade has passed since the beginning of market reforms but the Russian steel industry still suffers from overcapacity and obsolete technologies.

Total steel production was 59 million tonnes in 2001, which is well below the 1990 level of 89.6 million tonnes, though fortunately, it is above Russia's nadir of 48.8 million tonnes in 1994. Following the collapse of the Soviet Union, domestic steel production plunged as a consequence of diminished military consumption and the general decline in economic activity. Fortunately for Russian steel enterprises, the world market softened the blow, absorbing a large portion of the 50–70 per cent of Russian steel that is not consumed domestically.

Prior to the financial crisis of 1998, even the leading steel plants were in a difficult financial situation. A strong rouble made steel production costly, and companies did not earn enough to invest into capacity upgrades, while cheap long-term borrowing was not available. As a result, the companies sold inexpensive, low-quality products that they were able to make.

The 1998 currency devaluation provided a strong impulse for domestic consumption of rolled products. Our estimates indicate that in 2000 and 2001 apparent domestic consumption grew 50 per cent and 9 per cent, respectively, in absolute terms and currently constitutes approximately 50 per cent of total rolled product output. Some categories of domestic rolled product consumption have risen even higher, ie flat product consumption grew 14 per cent in 2001 and currently comprises about 60 per cent of total flat product output. Higher flat product growth has been fuelled by demand from oil companies for pipes and growth in the machine building sector.

The upsurge in domestic consumption following the devaluation came just in time for the industry, allowing steel plants to augment output despite a decrease in exports due to trade restrictions. Together with strong prices on world markets in 2000, robust domestic markets also allowed major steel plants to considerably improve their financial health. As a result, steel majors have finally accumulated enough cash to invest in upgrades of production assets. An improved working capital structure and accumulated cash should allow steel plants to weather downturns on the global markets in the future.

Severstal serves as a good example. The company has significantly improved its financial and operating performance over the last five years. The company reached positive working capital in 1999, allowing it to accumulate a hefty sum of cash (US$ 309 million) in 2000 and slash its debt burden to a mere US$ 27 million. As a result, by 2000 Severstal achieved a healthy financial position. Margins have also evidenced positive dynamics – Severstal improved its operating margin from 8.2 per cent in 1997 to 20.6 per cent in 1999 and 33 per cent in 2000. EBITDA per tonne of output rose from US$ 46 in 1997 to US$ 98 in 2000.

The situation on export markets was less rosy. In 2000 and 2001, total Russian rolled product export decreased by 2.4 per cent and 4 per cent, respectively. Although the 2001 decline is linked to falling worldwide consumption, the drop in export volumes in 2000 can only be a consequence of restrictive measures against Russian steel producers, as global consumption surged by 7.2 per cent that year.

## *Current industry structure*

At the moment, the Russian steel industry consists of over 1,000 plants. Most of the enterprises are relatively small and inefficient. They still function only because local administrations provide tax deferrals and other hidden subsidies in order to maintain employment and avoid social unrest. A positive sign is that the majority of steel production is concentrated in a few large enterprises. The five largest Russian plants produce about three-quarters of total Russian steel product output.

MMK, Severstal and NLMK are usually considered to be the strongest of all the Russian steel plants (the 'Big Three'). Their

**Table 3.3.1** Finished rolled product output by leading Russian enterprises, 1,000 tonnes

| *Company* | *January–August 2002* | *2002/2001 growth, %* |
|---|---|---|
| MMK | 6,620 | 7.2 |
| Severstal | 5,587 | 3.4 |
| NLMK | 5,250 | 8.8 |
| Zapsib | 3,300 | 3.2 |
| NTMK | 3,077 | n/a |
| **Total Russia** | **32,200** | **2.7** |

*Source:* AK&M, Goskomstat, Companies

leading position is mostly due to the wise policies of management teams that reportedly own the enterprises. During recent years the companies have modernized their production capacity and accumulated some cash reserves. They all have significant experience in working on both domestic and export markets.

We estimate that Zapsib is in worse shape, mostly due to management inefficiency. The plant inherited relatively modern equipment from the Soviet era. Last year the company was in bankruptcy proceedings and currently a new group of shareholders (Evrazholding) who specialize in managing steel plants and ore extracting enterprises have taken control. It is likely that under the new management the company will find itself in better financial shape. Another negative factor that could have led to the company's plight is the fact that Zapsib products are mostly consumed by the Railway Ministry, which substantially slashed its spending during the last decade.

NTMK has less chances of catching up with the 'Big Three'. It is burdened with obsolete equipment; approximately half of the steel is produced via the polluting and inefficient open-hearth process. NTMK's location in the Urals, far from export markets, further reduces the enterprise's profitability. NTMK produces relatively low value added products, and the Railway Ministry is one of its main consumers. The company is also owned by Evrazholding group.

## *Resource base*

The main ingredients for steel production are iron ore and coking coal. Russia possesses sufficient amounts of both to supply steel plants far into the future. It is not surprising that most large steel plants prefer to have full control over deposits of these raw materials. In the past, possession of ore deposits had often been used to take control over plants. Ownership of iron ore and coal producing companies guarantees reasonable prices, stable supplies and low and predictable production costs.

As an example we could look at the strategy that Severstal followed in 1998–2001. The company made a number of strategic acquisitions, including controlling stakes in its key iron ore suppliers, Karelsky Okatysh and Olkon, which account for 96 per cent of pellets and 55 per cent of concentrate consumed by the plant. In October 2001, Severstal and MMK teamed up to acquire a controlling stake (about 51 per cent) in Kuzbassugol for approximately US$ 91 million. At present Severstal's dependence on Kuzbassugol coking coal is low as it mostly relies on Vorkutaugol coking coal. Still, the acquisition may be important to guarantee a stable coking coal supply should Vorkutaugol come into unfriendly hands during privatization.

## *International steel import tariffs*

Based upon the recommendation of the US International Trade Commission, at the beginning of 2002 President Bush introduced restrictive duties on steel imported from Russia, Japan, China, South Korea, Ukraine and other countries. Although the market economy status recently awarded to Russia softens the impact of antidumping procedures against Russian exports to the United States, the overall level of Russian exports is still constrained by the quota. South Korea and Brazil announced that they were also considering restrictions on steel imports in order to protect domestic producers. China, meanwhile, has undertaken an investigation into allegations of dumping of Russian steel exports, which could lead to import restrictions on cold- and hot-rolled steel supplies.

Although no significant actions have been undertaken so far, the problem may arise again in the future and the potential repercussions for the Russian steel industry may be serious. Major consumers of Russian steel in 2001 included China (5.2 million tonnes), Iran and Turkey (2.3 million tonnes each), the European Union (2.9 million tonnes) and the United States (1.8 million tonnes). These countries account for 56 per cent of Russian exports with the balance evenly distributed among other countries.

We estimate that under the worst-case scenario, if all the aforementioned countries decide to introduce restrictive measures, the

Russian steel industry may lose up to 28 per cent of its export volume. The threat of such action may well encourage companies to focus more on the domestic market. The main problems we envisage here are: 1) export earnings will not grow in line with the expected recovery in global demand; and 2) an increase in supply to the domestic market will create a glut, dragging down prices.

In our view, the closure of foreign markets is the most serious threat to Russian steel producers at the moment.

## *Industry developments*

The growth of Russian steel output is limited by the capacity of domestic and export markets. Russian steel consumption is likely to follow the GDP growth rate while the world steel market is likely to grow at an even lower rate. We do not expect any significant growth in Russian steel output in the future, especially given the widespread use of protective import restrictions by countries around the world.

In fact, Russian steel producers might find themselves squeezed between rising domestic costs due to real rouble appreciation, relatively stable prices on the saturated domestic market and volatile export prices. These circumstances would likely phase out small metallurgical enterprises in Russia, mainly because their cost of production is relatively higher than that of larger plants. Only those who manage to upgrade their equipment and find their own market niches would remain.

We do not expect large players to actively acquire smaller competitors, as the capacity of large companies is not fully utilized at the moment and will not be in the near future. Besides, as their capacity is usually more technologically advanced than that of smaller plants, large companies prefer to load their own capacity rather than invest in upgrades of the outdated capacity of smaller plants.

'Big Three' plants have been considering consolidation plans for the last 1–2 years to make their operations more efficient. At the moment MMK and NLMK are considering merging their operations (although almost a year ago NLMK wanted to combine with Evrazholding). We believe that apart from partly monopolizing the domestic market and streamlining product variety, the consolidation would hardly offer any major benefits.

## 3.4

# Investing in Russian Agriculture

*Dominique Le Doeuil, Head of Representation of the Cargill Group in Russia, a member firm of the American Chamber of Commerce in Russia*

The agricultural industry in Russia today is significantly underperforming. With its outdated equipment and inefficient farming methods, this is a sector that is clearly in need of investment. At the same time, it offers great opportunities and rewards for investors who are willing to take the risk. So, where do these opportunities lie?

To answer this question, we will first take a broad look at the key characteristics and issues affecting the state of Russian agriculture. Then, we will discuss the impact of recent trends in the industry on the country's economy. Finally, we will consider possible investment options.

### *Key factors that influence the competitive position of Russian agriculture*

*Geography and climate*

Although there is a considerable quantity of available land in Russia, most of the rich black soils are located in areas that suffer from regular droughts. The largest and most significant crop production region (Krasnodar and its immediate neighbourhood) has a statistical record showing that shortage of rain is likely to be a problem in two out of every seven years. With poorer climatic and soil conditions in many of the other regions located in the north and east of the country, Russia's agricultural output is likely to remain relatively volatile, being heavily dependent on the weather in the south-west.

*Infrastructure*
Except for instances where private interests have addressed specific situations, the majority of the infrastructure inherited from the former regime is inadequate.

The percentage of land benefiting from irrigation facilities in working conditions is extremely low, meaning that any climatic incident will have irreversible impact on the crop in any given year.

Most of the logistical infrastructure, silo facilities, railcars, port elevators, etc, are outdated, inadequate or insufficient, implying that optimal benefits cannot be derived from a good crop year.

A large majority of the animal production farms have outdated facilities and produce only a fraction of the meat and poultry volumes that were generated under the Soviet regime. Similarly, milk production has also collapsed and the current infrastructure does not allow the milk to be appropriately handled between the farms to the dairy producers.

*Finance*
The whole agricultural sector became cash starved in the 1990s and the situation culminated in late 1998, when farms were simply unable to meet their obligations to the State or to their creditors. The banking sector was equally bankrupt at that time and was not in a position to help.

Four years after the crisis, there is still no real government incentive to develop production. Some subsidized loans have been made available but their impact is very marginal and there is no real action aimed at improving the sector's infrastructure.

*Agricultural policy*
A clear vision for the future of Russian agriculture has not been articulated and communicated. Changes in agricultural policy mostly reflect the interests of private groups who have the ability to influence policy-making. The most influential of these tend to be former Soviet agricultural organizations, businesses led by well-connected agricultural entrepreneurs, or non-agricultural groups that consider agriculture as a good target sector to reinvest cash flows earned in other sectors.

Although it may contradict certain views, the lack of State funding and of a strong approach in policy setting, has resulted in Russia having one of the least subsidized agricultures in the word.

*Inputs*
Input quality is very poor. The insufficient use of quality seeds, herbicides and pesticides has resulted in very low efficiency. The

issue is compounded by the poor state of sowing and harvesting equipment that add to waste even when climatic conditions have otherwise created favourable conditions. Overall yields in crop are desperately low, averaging between 1 and 2 tonnes per hectare for most crops in a good year.

*Skill deficit*
Farm management and operators in general do not have the right skills to make and implement the decisions that are required to reverse the trend. Some modern farms have already converted to modern standards, acquiring and securing land, selecting good labour, obtaining loans to invest into new equipment and good quality inputs. However, these turnaround situations are the exception rather than the rule, and the efficiency of the vast majority of agricultural processes is still impaired by the inability to make and implement viable business decisions in what is no longer a planned and supported market economy.

## Bureaucracy, tax and legal framework

Russian agriculture suffers from the same problems that plague the Russian economy, such as the heavy bureaucracy at best or the corruption at worst, and the unclear legal and regulatory environment. In the absence of real drive and funding coming from the central Government, development can only come from private operators who need a clear framework to make valid investment decisions. The complexity of land ownership issues, difficulties associated with obtaining clean lease rights, excessive red tape and nonsensical regulations, are all deterrents to investors.

*Land reform*
The impact of the recent land reform on agricultural land usage is still unclear. For many years, the most active farmers and farming companies have been able to acquire significant quantities of land by collecting privatization vouchers that were allocated to former kolkhozes members. This land reform is only one of the many steps that are required to achieve an effective redistribution of agricultural land. Nevertheless, implementing the reform was very important from an image standpoint, and the publicity it generated has certainly accomplished much to improve Russia's image with the most advanced nations of the world.

It will take some time, however, before small farmers are freely able to buy and sell land or offer it as security for a loan. What is most likely to change is that large and well-connected companies will be able to buy large quantities of land and keep it out of the reach of ordinary farmers. Whether this results in a significant change in the quantity of land that is actually operated or attracts the funds that are required to improve production methods remains to be seen.

## *The impact of Russian agriculture on the country's economy*

From a historic perspective, Russia's production of grains and meat peaked during the 1980s, when the combination of Russia's and Ukraine's resources (along with a few other FSU countries) meant that the south west of the Soviet block (Russia and Ukraine) generated significant surpluses (of wheat and barley) that were able to balance out other chronic deficits (sugar).

*Meat production*
Decreasing quantities of meat production led to a severe drop in consumption, taking meat consumption in the mid-1990s to approximately half its level in the mid-1980s (70 kg per capita/per annum). Consumption is rising again; it reached 45 kg in 2001 and may exceed 50 kg in 2002. Of this number, approximately half of the poultry volume and approximately a quarter of the pork and beef volumes are imported, so dependence on imports is high.

*Grain production*
Grain production followed similar trends. It was well in excess of 100 million tonnes at the end of the 1980s and dropped to just over 60 tonnes in the late 1990s. Today, Russia's grain production is again on the rise with the 2001 and 2002 harvest generating in excess of 80 million tonnes, of which nearly 50 million tonnes relates to wheat only. Wheat surplus in Russia has generated a sharp drop in prices with feed wheat being negotiated at approximately US$ 35 per tonne, whilst milling wheat is priced at a little above US$ 50 per tonne. Poor market mechanics and logistical issues prevent large tonnages – of what is otherwise a reasonably good quality wheat – from being exported and reaching world prices. This means that a significant portion of the surplus weighs on domestic prices and destroys economics. The barley crop, mostly used in the feed chain, suffers from a similar situation.

Other production data indicates a heavy reliance on imports for sugar and soya products, whilst the corn and sunflower crop can swing from a small surplus to deficit, depending on the quality of the harvest. Rapeseed is rarely grown. Owing to the poor and volatile climatic conditions discussed above, the potential for Russia to ever generate a large surplus in sunflower and corn remains doubtful. The sunflower crop size is currently in the range of 3 to 4 million tonnes and is absorbed locally, mostly in the local oil industry. Corn production will reach 2 million tonnes in a good year with most of the production used for feed purposes, mostly by integrated farms and agro complexes. Of this, the quantity of corn reaching the open market is under 1 million tonnes.

*Sugar production*

Sugar consumption is currently in excess of 6 million tonnes, of which approximately 1.5 million tonnes is produced from local sugar beet. The balance is imported, predominantly from tropical countries producing sugar cane. In spite of recent efforts from the Government to promote higher local production, it is unlikely that the volume of sugar produced from local beet can meet even half of the total demand. The country is likely to remain predominantly an importer of sugar.

*Overall impact on the economy*

The overall picture of Russia as an agricultural producer is that it is a country that is significantly under-performing. Low yields and inefficient logistics have so far resulted in production levels that are insufficient to fulfil local requirements and in lost opportunities to earn export revenues. However, beyond the negative aspects of the under-performance, it would appear that an appropriate injection of resources (cash and management especially) could dramatically improve this situation and turn the industy around.

## *Investment opportunities in Russian agriculture*

*Farming*

If farming remains risky, mainly due to the climatic conditions in the southern grain belt, the fundamental economics of farming still look attractive. The soil is of very good quality, labour is cheap, and large areas are available for farming in conditions that can be extremely efficient (million of hectares of flat land cut into neat rectangles all over Russia). Many regions north and east of Krasnodar have a much lower statistical risk of drought while still providing good soil.

Pilot farms developed by crop science companies or Western farmers demonstrate that yields comparable to international benchmarks can be generated in many regions if proper farming methods are implemented. Investing in better sowing equipment and better seeds that can provide resistance against dry conditions – or shorter maturity for regions affected by heavy frost – and investing in fertilizers, pesticides, herbicides, combines and irrigation systems will dramatically affect returns and could take yield averages two or three times higher than what they are today.

It seems today that wheat-producing farms can generate positive cash flows, subject to yielding 3 to 4 tonnes per hectare, even with wheat prices at US$ 35 per tonne, suggesting that all-inclusive costs of production could be as low as US$ 100 per hectare. However, this reflects incomplete economics where land has been acquired for a nominal amount, combines have been inherited from former kolkhozes, inputs are minimum and basic seeds are used. In other words, this type of business is not viable in the long run as it does not invest in improving and renewing production capacity. It does provide the vast majority of today's crop, though.

Recent studies show that the 'real' cost of producing sunflower, barley, wheat or corn is in excess of US$ 250 per hectare, using advanced technology. At this level of cost, returns are better owing to higher – and more consistent – yields and much more efficient harvesting. Better combines will actually collect most of the crop as opposed to leaving up to 20 per cent waste in the field, as is the case with the machinery used in many of today's farms. At this level of cost, investing in crops that trade at world price level (ie not feed crops) close to the US$ 100 per tonne mark, such as corn, sunflower, malting barley and premium milling wheat, can look very attractive. Yields of 4–5 tonnes per hectare are realistic for wheat, barley and sunflower whilst corn can go even higher. The sugar economics, although different because of a different price structure, also show the same picture of possible high returns.

To conclude, farmers or farming companies that are ready to face up to the challenging environment in Russia and to deal with the bureaucracy with the right mix of patience and diligence, have real opportunities in this country.

*Providing inputs*

We have already discussed how the poor quality of inputs has contributed to the poor performance of Russian agriculture. There are obvious opportunities for providers of quality inputs, ranging from machinery and equipment companies to biotechnology companies selling seeds or crop enhancement products. However, the vicious circle currently affecting most farmers (I have no cash, so I cannot buy good inputs, so I cannot produce good crop, so I have no cash…) has to be broken. Providers must take and manage risks, develop partnerships with quality farmers (or crop off-takers), and provide technical assistance.

*Buyers of agricultural products*
A high profile food processing sector creates a positive environment for agriculture by increasing demand for locally made premium products. Increased investment in the local food sector will therefore have a direct impact on local agriculture by increasing demand volume and quality, and encouraging investment.

From the standpoint of the users, an efficient Russian agriculture can offer very interesting prospects to the food sector by improving the competitiveness of food businesses.

Most agro-food businesses based in Russia will see increasing the proportion of local supplies as a key business driver. Across the whole range of agricultural supplies however, many of the food companies still have to rely on a significant percentage of imported products for their local production. Investing in the supply chain by investing in, or developing links with local farmers (and breaking the vicious circle described above), can contribute significantly to their own results. These businesses have a vested interest in improving agriculture.

## *Conclusion*

In conclusion, Russian agriculture offers numerous opportunities to investors, whether they are interested in agricultural production, or in the upstream or downstream sectors. However, as always in Russia, good economics and opportunities on paper are only part of the story. Commitment, resilience and good risk management will be key to ensuring success.

# 3.5

# Russian Telecommunications: Primed for Growth, but Challenges Remain

*Standard & Poor's, RatingsDirect*

## *Introduction*

With moderate growth prospects, the Russian telecommunications sector is standing at a crossroads. If the combined effects of ongoing industry consolidation, regulatory reform, and internal restructuring of incumbent fixed-line operators (FLOs) are a success, the market will surge forward, with increasing competition between incumbent and alternative operators spawning the provision of high quality, mass-market services. For those regional companies that remain, however, credit quality will be sensitive to the challenges of business concentration and investments in the diversification of services over the medium term.

The creditworthiness of Russian FLOs has been improving gradually since the 1998 currency crisis in the Russian Federation (Russia; BB-/Stable/B), when a number of operators either failed to service their debt or rescheduled payments. Telecoms companies subsequently became more cautious about foreign-exchange risk, with the result that they can no longer afford to rapidly upgrade obsolete equipment in the local fixed-line networks.

The majority of operators are at present striving to change their debt structure in favour of rouble-denominated instruments and also to reduce their exposure to foreign currency debt. Nevertheless, in spite of good prospects for raising debt on the Russian capital markets, development of the fixed-line infrastructure will continue to be heavily dependent on the rouble exchange rate, because most telecoms equipment is purchased from foreign suppliers under vendor financing arrangements.

The credit ratings on Russian FLOs are supported by projected further economic growth in Russia and reforms designed to improve the regulatory environment and market institutions. As a result, the FLOs' future ratings are more likely to be affected by changes in the quality of their service and regulatory environment than by any improvement in Russia's sovereign ratings.

## *Continued market consolidation will boost issuance*

From the start of Russian corporate reform in early 1990s, it became clear that the Russian telecoms sector needed large operators to exploit the benefits of economies of scale. The very first privatization plan for Russian telecoms, which appeared in 1992, implied incorporation and partial privatization of the numerous fragmented fixed-line telecoms enterprises controlled by the Ministry of Communication, with follow-up consolidation that has yet to take place.

In 2001, the plan was resurrected by Svyazinvest, the government-owned holding company, to increase its capitalization – a necessary step for the company's disposal. At present, Svyazinvest's ownership is split 75 per cent, less one share, to the Federal Government and 25 per cent, plus one share, to Mustcom Ltd – a consortium of Russian and foreign investors that includes Onexim Bank, Quantum Fund (affiliated to Soros), Deutsche Morgan Grenfell, Morgan Stanley Asset Management, and Renaissance Capital. Under the planned consolidation, more than 70 existing subsidiaries currently majority-owned by Svyazinvest are being merged into seven large regional operators. Standard & Poor's rates five issuers taking part in this restructuring – JSC Central Telecommunications Co. (CCC/Stable/–), JSC Volga Telecom (B-/Stable/–), JSC North-West Telecom (CCC/Stable/–), JSC Southern Telecommunications Co. (CCC+/Stable/–), and JSC Uralsvyazinform (B-/Stable/–) – all of which are core companies in their respective regions (see Table 3.5.1). The largest existing regional FLO, JSC Moscow City Telephone Network 'MGTS' (CCC+/Stable/–), is not involved in this consolidation, however. This is because the controlling stake of MGTS is held by AFK Sistema, with Svyazinvest the second-largest shareholder, and the two parties could not reach a satisfactory agreement on control of the enlarged regional company.

Once the consolidation of Svyazinvest's subsidiaries is complete,

**Table 3.5.1** Rated Russian telecommunications companies

| *Issuer* | *Service region* | *Date of latest rating action* | *Corporate credit rating** | *Russia national scale rating* |
|---|---|---|---|---|
| JSC Central Telecommunications Co. | Moscow region | 14/12/01 | CCC/Stable/– | Not rated |
| JSC Moscow City Telephone Network | City of Moscow | 14/12/01 | Foreign currency: CCC+/Stable/– | RuBBB |
| JSC Volga Telecom | Nizhegorodskaya region | 12/03/02 | B-/Stable/– | Not rated |
| JSC North-West Telecom | City of St Petersburg | 11/12/01 | CCC/Stable/– | RuBB |
| JSC Southern Telecommunications Co. | Krasnodarskiy Kray | 27/12/01 | CCC+/Stable/– | Not rated |
| JSC Uralsvyazinform | Perm region | 17/12/01 | B-/Stable/– | Not rated |
| Rostelecom | Russia | 30/04/02 | B-/Stable/– | Not rated |

*At 29 July 2002

expected in late 2002 or early 2003, the Russian Government plans to further reduce its stake in the domestic telecoms sector, which could open up opportunities for the incumbent operators to raise equity capital and be less susceptible to political and social pressures. (MGTS and Rostelecom (the national long-distance carrier; B-/Stable/–) are not taking part in this restructuring, but their market positions are likely to be affected once the final structure is in place, which may put pressure on their ratings.)

Consolidation of Svyazinvest's subsidiaries will have a significant impact on the whole of the Russian telecoms sector, some effects of which are already apparent:

- Newly consolidated regional operators are expected to play a more serious role in the long-distance market. The management teams of these companies ambitiously claim they will roll out intra- and inter-regional connections that bypass Rostelecom.
- A number of small local alternative FLOs that previously benefited from affiliations with local regional operators can expect to see the negotiation of lucrative interconnection terms with the consolidated regional operators become more difficult. As a result, they are potential targets for a large alternative operator looking for regional expansion through acquisitions.

- In order to finance considerable capital expenditure requirements, the consolidated regional companies may spin off some of their smaller associate operators.

At the same time, large alternative FLOs and mobile operators from Moscow and St Petersburg will find it easier to enter regional markets because they can approach just seven incumbents for interconnection. In addition, the consolidated regional incumbents are unlikely to protect their service areas from competition as effectively as the local incumbents did previously, due to tighter control by the Ministry for Antimonopoly Policy (MAP). Moreover, the regulator would be in a better position to execute control over any abuse in monopoly power among the seven consolidated regional players and intervene if necessary. Under the old regime, local operators and other local companies collaborated with their area governments against competitors outside of their region. Furthermore, the CEOs of these companies were not so heavily controlled by Svyazinvest and had a free hand to determine their own strategy.

The consolidated group of Svyazinvest subsidiaries is expected to accelerate competition in the Russian telecoms market, bringing in stronger and larger players. At the same time, transaction costs for negotiating and arranging interconnection, as well as the incumbent FLOs' total costs of working with the regulator, will decline. These factors should force the development of the Russian telecoms market, improving customer choice and providing faster access to modern technology.

In terms of credit quality, the enlarged regional FLOs will benefit from economies of scale and stronger market positions. The downside, however, is that the existing core companies may suffer from both a deterioration in operating standards and the effects of higher leverage among the merging operators. This is mainly because the core companies represent the strongest subsidiaries of Svyazinvest. Additional pressure will result from higher capital expenditure requirements to reshape the topology of existing operators' networks, to merge billing systems and other business processes within the enlarged entities, and to exploit benefits from the mergers.

## *Credit quality driven by four fundamentals*

The factors influencing credit quality among Russian telecoms issuers cover market growth, the regulatory environment, competition, and operating standards.

*Market growth*

Pushed by rouble devaluation and high oil prices in 1999, the Russian economy has shown positive growth over the past three years. Although 2002 GDP growth is projected to be at a more moderate 3.5–4.2 per cent, compared with 5 per cent in 2001 and 9 per cent in 2000 (see Table 3.5.2), it is starting to reflect domestic demand and the growth of non-export industries.

Increased demand for telecoms services in Russia rests on these continuing positive trends and the expanding role of telecoms in the Russian economy. In 2001, the telecoms sector grew more than 40 per cent in nominal terms, reaching 186 billion roubles (US$ 6.4 billion) in size. The Russian telecoms market, even measured by purchasing power parity figures, which at least double this total, is still a relatively small market compared with Eastern and Western European telecoms markets (see Table 3.5.3).

**Table 3.5.2** Macroeconomic trends in the Russian economy 1999–2002

| | *2002 (estimate)* | *2001* | *2000* | *1999* |
|---|---|---|---|---|
| GDP growth (per cent) | 3.5–4.2 | 5.0 | 9.0 | 5.4 |
| GDP per capita (at market exchange rate, US$) | 2,290 | 2,140 | 1,700 | 1,264 |
| GDP per head* (US$) | 5,680 | 5,400 | 4,970 | 4,355 |
| Inflation (per cent) | 16.0 | 18.6 | 20.2 | 36.5 |
| Average exchange rate (rouble/US$) | 32.0 | 29.2 | 28.1 | 24.6 |

*Adjusted for purchasing power parity. Adjusted to consumer price index.
*Source:* Goskomstat, OECD, and the European University Institute

**Table 3.5.3** European telecommunications – market statistics 2001

| | *Telecommunications market value (US$ billion)* | *Telecommunications market value per head (US$)* | *Telecommunications market value per head* (US$)* | *Fixed-line penetration (per cent)* | *Mobile penetration (per cent)* |
|---|---|---|---|---|---|
| Germany | 41.9 | 511.0 | 592.0 | 65.0 | 78.0 |
| United Kingdom | 32.4 | 546.0 | 557.0 | 59.0 | 81.0 |
| France | 30.9 | 523.0 | 606.0 | 63.0 | 63.0 |
| Czech Republic | 2.3 | 218.0 | 520.0 | 39.0 | 61.0 |
| Hungary | 2.0 | 196.0 | 435.0 | 35.0 | 46.0 |
| Poland | 5.3 | 136.0 | 251.0 | 30.0 | 26.0 |
| Russia | 6.4 | 44.0 | 112.0 | 24.0 | 5.3 |

*Adjusted for purchasing power parity.
*Source:* Company data and Standard & Poor's

On the positive side, however, telecoms market growth exceeds that of the Russian economy, the telecoms market share of GDP having almost doubled in three years to 2 per cent in 2001. Much of the increased demand comes from the mobile segment, with fixed-line telecoms growing at a rate slightly higher than inflation.

Although penetration levels of both mobile and fixed-line telephony in Russia are low (see Table 3.5.3) and there is considerable unmet demand for new fixed-line phone installations, the growth of fixed-line subscribers is expected to remain moderate. In 2001, the number of fixed-line subscribers increased by 1.49 million, compared with 4.4 million new mobile subscribers. This pushed fixed-line and mobile teledensity to 24 per cent and 5.3 per cent of the population, respectively. At present, unmet demand for fixed-line phones is about 5.3 million installations.

As in Europe, the Russian fixed-line market is moving gradually from simple voice transmission toward services based on data transmission – a positive influence on creditworthiness as it will improve both diversification and margins. Consequently, the number of subscriber lines is becoming a less reliable indicator of an FLO's size.

High variances in personal income and an uneven spread of business activity create differences in the structure and volume of demand for telecoms services across the Russian regions. In geographical terms, the bulk of demand is generated in Moscow and St Petersburg, mainly because of the concentration of business and higher personal incomes (see Table 3.5.4). The remaining

**Table 3.5.4** Geographical distribution of Russian voice telephony traffic

| | | | *Voice traffic** | | |
|---|---|---|---|---|---|
| | *Income per capita, (roubles)* | *Share in total personal income (per cent)* | *Domestic long distance (DLD) (per cent)* | *International long distance (ILD) (per cent)* | *DLD and ILD traffic per capita (mins)* |
| Russia | 4,016 | 100.0 | 100.0 | 100.0 | 50.5 |
| City of Moscow | 16,666 | 24.7 | 19.0 | 36.0 | 181.1** |
| City of St Petersburg | 5,349 | 4.3 | N/A | N/A | N/A |

*Voice traffic carried by Rostelecom in 2001. At December 2001.

**As Rostelecom controls just 42 per cent of the international long-distance market in Moscow, but more than 90 per cent in other regions, Moscow provides an even larger share of total voice traffic than indicated.

Russian territories lag behind these regions, with less demand for new value-added services.

Traditional telephony services are expected to remain the major revenue driver for the remaining regional markets for a further five to seven years, until foreign and domestic direct investments accelerate economic activity. This creates a challenge for the FLOs: for many years, residential demand for fixed-line telecoms services has been the major focus of incumbent operators in Russia.

There was a strong belief that the incumbents existed to provide services to residential customers at acceptable prices, enabling alternative operators to cherry-pick business demand for a wide range of high-quality services. As the FLOs strive to upgrade their networks with digital equipment, however, this business model is no longer appropriate. In the longer term, residential customers are expected to become a marginal revenue stream for most FLOs, while wholesale and data transmission services generate the primary revenues.

*Regulatory environment*

Along with overall market reform in Russia, regulation of the fixed-line telecoms market shifts from a discretionary approach to one that is more rules-based, with a focus on the economic rationale of regulatory decisions. The main regulatory issues for fixed-line telecoms include tariff regulation, interconnection arrangements, antimonopoly regulation, licensing, and the role of the Federal Government as a major shareholder.

The existing regulatory model provides for the state regulation of local and domestic long-distance (DLD) tariffs of incumbent operators, which qualify as natural monopolies. Before 1998, regional governments regulated local tariffs, while the Ministry for Communications controlled DLD tariffs. Since then, after the authority for tariff regulation passed to the MAP, the regulatory process has been run on a more predictable and professional basis, with less political pressure. In particular, the MAP has gradually reduced the lag between tariffs and the actual costs of local telephony services to a minimum, although further significant progress is still needed.

Apart from the discretionary nature of the regulatory tariff model, serious concerns surround the disincentives to develop unregulated value-added services. For many years, regulatory decisions have been based on the gross revenue requirements of individual operators, which was considered reasonable up to the point that regulated services became almost the only revenue source for public operators. With the increased importance of value-added services, however, regulated incumbent operators have little incentive to develop, mainly because tariff revision is largely dependent on gross revenue generation. Until now, the FLOs have often transferred the most profitable unregulated businesses to subsidiaries in order to secure increases in regulated tariffs. That said, the FLOs have rarely received any significant benefits from the diverged businesses, while the total capital expenditure of the respective groups increased because subsidiaries were striving to build up independent overlay networks, rather than pursue a unified technical policy.

The absence of a clear plan and schedule for tariff revisions in the medium term also creates uncertainty in terms of the FLOs' future revenues. Under existing regulations, the FLOs initiate tariff revisions by applying to MAP with their rationale. Until recently, there were no strict rules, time frames, or criteria for the regulator to process these applications, with the result that the regulator had significant discretion. The process was improved in 2001 when the Russian Government issued a resolution requiring the MAP to introduce a short-term schedule for tariff rebalancing and to respond to operators' applications within 30 days. Implementation of this regulation remains a concern, however, largely because tariff rebalancing has never previously worked out as planned.

The current level of regulated tariffs is very controversial, due mainly to the absence of a true estimation of the economic cost of providing particular telecoms services. According to Svyazinvest, the average residential monthly subscription fee of incumbent operators is US$ 2.5–US$ 3.0, representing about 85–90 per cent of operating costs under Russian accounting standards, up from about 65 per cent in 2000.

In dollar terms, Russian fees lag far behind those of European operators. At the end of 2001, fees in Europe ranged from US$ 4.3 in the Czech Republic (Cesky Telecom a.s.; local currency: A/Negative/–, foreign currency: A-/Stable/–) to US$ 12.4 in the United Kingdom (British Telecommunications plc; A-/Negative/A-2). Adjusting these figures for purchasing power parity, however, gives a true residential subscription fee of more than US$ 7 – a level close to those of Eastern European countries (see Table 3.5.5).

Tariff structure remains the main credit risk for Russia's incumbent operators. Given the increasing competition in all telecoms market segments, such operators are disadvantaged by an unbalanced tariff structure, compared with unregulated operators. Cross

**Table 3.5.5** European fixed-line monthly tariffs in 2001

| | *Actual tariff (US$)* | *Adjusted tariff* (US$)* |
|---|---|---|
| Russia | 3.5 | 8.87 |
| Russia (average for Svyazinvest) | 2.8 | 7.2 |
| Czech Republic (Cesky Telecom a.s.) | 4.3 | 10.2 |
| Hungary (Magyar Tavkozlesi Rt.) | 7.7 | 17.1 |
| Poland (Telekomunikacja Polska S.A.) | 5.9 | 10.9 |
| Turkey (Turk Telekom) | 3.3 | 7.7 |
| United Kingdom (British Telecommunications plc) | 12.4 | 12.6 |
| Germany (Deutsche Telekom AG) | 10.0 | 11.6 |
| France (France Télécom) | 9.6 | 11.1 |

*Adjusted for purchasing power parity. Residential subscription fees.
*Source:* Svyazinvest, OECD, Tarifica, and The Economist

subsidies in Russian public fixed-line telecoms is rather complex and involves at least five subsidy streams, namely:

- long distance to local telephony;
- city to rural areas;
- business customers to residential customers;
- Moscow customers to customers in other regions;
- customers with low minutes of use (MOU) to those with high MOU.

For most regional FLOs, DLD telephone services constitute about 50 per cent of total revenues. This is mainly due to the level of international long distance (ILD) and DLD tariffs, which are relatively high by international standards. Revenues from local telephony contribute a further 30–35 per cent. On the costs side, local services make up more than one-half of the total, although exact calculations are not available. Local services for residential customers could still be profitable in the city areas with larger numbers of customers, however, especially in Moscow and St Petersburg where significant cost savings from economies of scale and high teledensity offset a relatively low tariff.

In contrast with other incumbent regional operators, MGTS is deprived of profitable long-distance revenues: in Moscow, Rostelecom owns long-distance switching capacity and directly bills subscribers, while MGTS' chances of procuring a licence for ILD and DLD services are negligible in the medium term. Furthermore, an unregulated interconnection arrangement between Rostelecom and MGTS is influenced by Svyazinvest, which is the controlling shareholder in Rostelecom and a minority shareholder in MGTS.

Under the terms of the existing interconnection arrangement, MGTS receives about 11 per cent of long-distance revenues collected by Rostelecom in Moscow. In other regions, DLD interconnections with Rostelecom are regulated by MAP through the integral settlement rate that limits Rostelecom's share of DLD revenues to 20 per cent. In addition, regional operators share outbound ILD revenues with Rostelecom on a 50:50 basis, with incoming ILD revenues being totally retained by Rostelecom.

Under existing interconnection arrangements, MGTS subscribers are indirectly subsidizing customers in other regions. MGTS obtains the bulk of its revenues from business customers, which pay higher subscription fees and per-minute charges. The company has lobbied the regulator to raise subscription fees for residential customers, as well as introducing a per-minute billing system. Unfortunately, residential per-minute billing has not been introduced because of political resistance from the Government of the City of Moscow (BB-/Stable/–). At the same time, MGTS has been losing business customers since the early 1990s to alternative operators, including some of its subsidiaries, although the company did manage to maintain its share of business subscribers at 11.8 per cent in financial 2001, contributing 58.2 per cent of total revenues.

Revenue streams from long-distance services and profitable city business customers also support telephony services in high-cost rural areas, where tariffs are almost as high as those in the cities. In spite of the universal service obligations, the FLOs are not making serious investments to meet existing demand in rural areas, preferring to focus their attentions on urban areas. Incumbent operators, however, are unable to avoid subsidizing the high maintenance costs of existing obsolete rural lines from their operations in urban areas.

Finally, many regional operators have not yet successfully introduced per-minute billing for all customers. Although existing legislation provides for the introduction of time-based billing, the concept continues to face strong resistance from local governments. Operators are also slow to install the equipment because of the significant capital expenditure involved in developing billing systems and the upgrade of analogue exchanges. Furthermore, time-based billing is unlikely to boost the regional operators' revenues: the regulator has declared that the price of local calls will be structured in such a way as to maintain the same level of revenues for the operators as previously. In the longer term, this should provide regional operators with an incentive to increase revenues by attracting more voice traffic.

*Competition*
Increased competition, with more market-oriented and flexible alternative operators, will have a negative impact on the business profiles of incumbent FLOs. Over the next 10 years, Russia is expected to see a further decline of incumbent FLOs' market share in terms of traffic. Competition is already intense in Moscow and St Petersburg, and although the incumbent operators continue to dominate the market by number of subscribers, they have already been overtaken by the alternative operators in terms of revenues. In 2001, for instance, Svyazinvest controlled 83 per cent of access lines, but only 38 per cent of revenues in the Russian telecoms market.

Competition arises mainly from alternative FLOs, mobile operators, and the industrial network operators established by Russia's Ministry of Railway Transport (MRT), OAO Gazprom (B+/Stable/–) and JSC Unified Energy Systems of Russia (UES). None of these operators have social obligations to fulfil, nor are their tariffs subject to regulation. Existing regulations require incumbent operators to provide non-discretionary connection to their networks, with interconnection fees determined on a cost basis. The challenge for incumbent operators, therefore, is to secure their market position as wholesale backbone service providers, utilizing economies of scale and the significant investments made in network infrastructure over the past few years.

A strong position in backbone transit services could improve the incumbent operators' revenue generation from unregulated services and gain benefits from the market expansion of alternative operators, which are more flexible and customer oriented. In Moscow and St Petersburg, incumbent operators have lost their dominance as backbone network service providers, controlling only the general access infrastructure and benefiting from revenues generated by the collocation of alternative operators' equipment. In St Petersburg, for example, JSC North-West Telecom placed a project for the development of a backbone network with one of its associated companies, Petersburg Transit Telecom, which is no longer under its full control. Elsewhere, MGTS is completing the construction of the backbone network in Moscow, although other alternative operators have already constructed their own overlay networks and so have little need for this MGTS backbone. Nevertheless, the company has the opportunity to develop its wholesale market position by offering cheaper services than other backbone service providers.

In other regions, public operators have much stronger positions in wholesale services, due to both the lower quality of the service area and the smaller size of the market. This makes it harder for alternative operators to reach break-even point and eventually become profitable. That said, industrial networks in regional markets carry a lot of business traffic that bypasses regional public operators. MRT, Gazprom, and UES business units use their own networks to carry internal local and DLD traffic. They are also progressively entering Russia's DLD and local market, at the same time facing up to licensing problems and meeting the significant capital expenditure requirements involved.

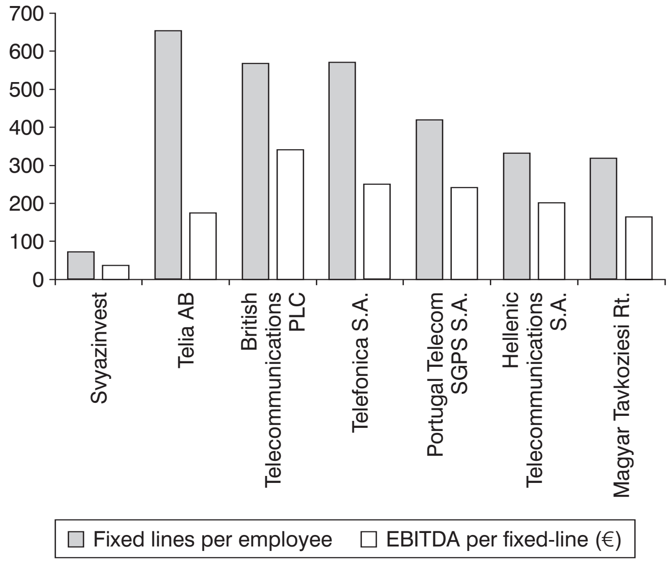
*Operating standards*

There is a significant gap in operating standards between the alternative and incumbent fixed-line operators. Incumbent operators continue to offer poor customer and telephony services, the bulk of their analogue equipment requiring replacement. These operators also face the challenge of reconfiguring the topology of their network and deploying multi-service digital networks that deliver voice telephony as one of many services provided via customer access lines.

Over the past five years, Svyazinvest has seen significant expansion in digital networks, to 34 per cent for local networks and more than 70 per cent for DLD channels from 19.3 per cent and 47.9 per cent, respectively, in 1997. Although the simple deployment of digital channels and digital switches can improve voice telephony service quality, it has little effect on the diversification or costs of services provided. That will require incumbent operators to introduce modern signalling systems and make other improvements.

To effectively compete with alternative operators for business customers, incumbent operators will need to restructure internally to increase operational efficiency. In this respect, Svyazinvest has already started to carry out corporate restructuring among its subsidiaries to improve budgeting, management accounting, marketing, technical policy, and human resources management. The most challenging task, however, is to cut the excessive number of employees and introduce competitive salary levels that will encourage professional staff to stay with the subsidiaries.

Although the operational efficiency of incumbent operators has been improving continuously, it remains relatively low compared with peers in Eastern and Western Europe, especially when judged by the number of access lines per employee – a principal indicator for Svyazinvest (see Figure 3.5.1).




*Source:* Company data and Standard & Poor's

**Figure 3.5.1** Operational efficiency of European telecommunications operators in 2001

## *Concerns raised over new regulatory initiatives*

Over the next few years, the Russian fixed-line telecoms market may also witness fundamental changes in the regulatory environment. The most significant include the introduction of the universal service fund (USF), which is a mechanism to compensate public operators' disadvantages arising from asymmetric social obligations, price cap regulation, and continuing tariff rebalancing.

The USF has already proved itself in a number of countries. Russia's concept of USF, established by the Ministry for Communications, is slightly different from global best practice, however, and may have a negative impact on the credit profile of incumbent FLOs. Financing of the fund is to be based on contributions from all telecoms operators. Although global practice links the size of a company's contribution to a USF expenditure programme with the volume of its revenues on a proportionate basis, the Russian model implies a fixed 3 per cent of sales from each operator. On the expenditure side, Russia's USF model does not assume compensation for losses incurred in providing services in high-cost areas and to privileged customers. Rather, it takes in financing for the development of rural networks, which only serves to increase the scale of loss-making activities for incumbent FLOs. At the same time, compensation for loss-making activities of the incumbent FLO would be allowed through the introduction of higher interconnection charges. Judged by global best practice, the latter mechanism lacks transparency and is inconsistent with liberalized and competitive telecoms markets worldwide. So although incumbent FLOs will be granted additional funds partly at the expense of alternative operators, they will ultimately prove to be less profitable and have a weaker competitive position if this version of the Russian USF model is implemented.

The Russian Government has also optimistically announced price-cap regulation for the telecoms sector. This is set to take effect in 2003, although it is likely to be delayed because the regulator will need time to develop the model. If properly implemented, price-cap regulation could improve tariff predictability and provide market incentives to regulated FLOs. There is concern, however, that the regulator will be unable to impose a price-cap formula and then follow it rigidly for at least three years to ensure that an individual operator retains any gains from greater efficiency in the medium term. There is also concern about the fairness of the initial tariffs and the productivity factor built into the price-cap formula. These factors will have a direct influence on the amount of operating cash flow generated by the FLOs.

Tariff baskets (that is, a combination of tariffs that is regulated as a whole) will be crucial in price-cap regulation deals. Given existing imbalances in the tariff structure, the tariff baskets and applied price-cap formula could either freeze existing imbalances for the medium term or improve the overall tariff structure. At present, however, it is not clear whether the regulator will combine similar regulated telecoms services into tariff baskets to give the regulated FLOs greater flexibility, or keep the regulation of each tariff separate.

To further progress toward tariff rebalancing and the introduction of the price cap, the regulator badly needs more segment information on FLOs' costs. In this respect, the Russian Government has adopted a resolution to introduce separate revenue and cost accounting of telecoms services for all operators in Russia, commencing in 2003. The methodology should be finalized and adopted this year. Unfortunately, tariff rebalancing is viewed mostly as an increase in residential subscription fees, and other cross-subsidy streams have received much less attention. Ultimately, the competitive position and incentives for the FLOs will be impaired until all cross-subsidies are eliminated or financed through the USF.

### *Revised business model needed to protect fixed-line future*

The FLOs will need to significantly improve their business model if they are to protect their market position in future. Poor quality telephony services for residential customers, which were regarded as a social mission of the natural monopolies in the telecoms sector, are no longer appropriate. Customer service that concentrates on the queue for phone installations rather than the struggle for customers is equally outmoded, not least because it is of little help in effectively selling new value-added services. In addition, most of the commercially viable projects to provide new services have until now been run via subsidiaries and joint ventures. This enabled profits to be moved away from the core company, while keeping costs concentrated at the company level.

On the other hand, incumbent FLOs have yet to organize themselves effectively to provide network services to other communication companies, network operators, and service providers in the same way as their Western European peers. Elsewhere in Europe, the wholesale services revenues of British Telecom, for example, are as high as those from its retail operations. As a result, alternative operators in Russia would rather roll out their own backbone and access networks than lease network capacity from the local incumbents. The downside of this strategy is that excessive backbone capacity may well appear at some point in the future.

## 3.6

# Telecommunications: the Regulatory Framework

*CMS Cameron McKenna*

### *Introduction*

Rapid developments in technology and the growth of the Internet are among the drivers of fundamental change in the structure of the old telecommunications, broadcasting and media industries across the world. Russia is no exception. The Internet, mobile telephony and digital broadcasting are likely to grow at exponential rates, although starting from a comparatively low base (eg penetration rates for mobile phones remain low at approximately 5.4 per cent of the population). Significant investment is still needed in the public service telephone network if penetration rates are to be lifted from the current national average level of 21 per cent to the target level of 60 per cent, which has been set by the Ministry of Communications and Information Science. The Ministry has calculated that some US$ 60 billion of investment in telecommunications will be required over the next 10 years to achieve this.

### *Privatization*

Until 1993 the Russian telecommunication network was fully controlled and owned by the state authorities of the Russian Federation. In 1992 the Russian government announced plans for privatizing the telecommunications sector and local network operators were privatized according to the following scheme: 51 per cent of common shares were kept by the State; 5 per cent were transferred to the companies' management; 10 per cent were transferred to the companies themselves; 25 per cent were transferred to the employees as preferred shares; and the remaining shares were sold by the local state property management funds to investors. Later the government formed a holding company, Svyazinvest, which owned all government shares in all regional telecommunications companies. Currently, each 'subject' of the Russian Federation has its own telecommunications company. These companies tend to suffer from regulated low tariffs but enjoy a monopoly position in their respective regional markets.

The government developed a two-stage scheme to privatize part of Svyazinvest. In July 1997, 25 per cent of the capital plus one share in Svyazinvest was sold for US$ 1.875 billion. The second stage of privatization (25 per cent minus two shares) was postponed owing to poor market conditions after the financial crisis in 1998.

The second stage should start in 2003 according to the Decision of the Russian Government of 20 August 2002. Under the current plan Svyazinvest will reorganize the structure of its subsidiaries and affiliates to create seven interregional telecom operators by the end of 2002 with Svyazinvest acting as holding company. An additional Decree is still to be issued clarifying the privatization terms.

Today the major shareholder of Svyazinvest is the Russian Federation, represented by the Ministry of Property Relations (50 per cent plus one share) and the Russian Federal Property Fund (25 per cent minus two shares). The remaining shares belong to the Cyprus consortium Mustcom Ltd which consists of Russian bank 'ONEKSIM Bank', investment company 'Renaissance Capital', investment bank 'Deutsche Morgan Grenfell', 'Morgan Stanley Asset Management' and the George Soros fund 'Quantum Fund'.

The Russian Government expects the proceeds from the second stage of privatization to exceed 34 billion roubles (approximately US$ 1 billion).

Rostelecom is Russia's main international and long-distance telecommunications carrier. Svyazinvest currently owns 51 per cent of Rostelecom. Other strong players in the Russian telecommunications market are the State-owned natural monopolies, such as the Ministry of Railway Transportation, Gazprom and RAO Unified Energy Systems, which use their infrastructure networks for telecommunications business.

The general principles of Russia's telecommunication legislation are set out in the Federal Law on Communications of 16 February 1995. The Law sets out the framework for licensing the telecommunications business and the basic certification requirements for telecommunication equipment. Telecommunication networks may be owned by both Russian and foreign legal entities and individuals.

## Governing agencies

The principal ministries and committees that have jurisdiction over telecoms operators and equipment suppliers are set out below.

The agency responsible for regulating the telecommunications market is the Ministry of Communications and Information Science of the Russian Federation, which in turn is responsible for a number of state committees that have delegated authority in relation to specific areas. The Ministry is responsible for state policy and state management of the communications industries, including postal and courier services. The Ministry also manages a number of state enterprises operating in the telecommunication sphere. The Ministry is responsible for certification of telecommunications equipment and the issuing of licences to telecoms operators. The Ministry supervises telecoms operators on a day-to-day basis and has the power to inspect equipment and generally monitor compliance with licence terms.

A number of other state agencies and institutions have authority over the telecommunications sector. The Federal Agency for Government Communication and Information certifies and licenses the use of encryption codes and equipment. Jointly with the Ministry of Anti-Monopoly Policy, the Ministry of Communications and Information Science develops and coordinates tariffs and tariff policy for the telecommunication services. The State Committee for Radio Frequencies assigns radio frequencies, monitors the use of frequencies, and defines technical standards in broadcasting. The State Commission on Electronic Communication coordinates the development and construction of telecommunications networks and systems and supervises their operations. The State Commission on Information Science is responsible for state policy in the sphere of information distribution and control, as well as for developing state standards for certification and licensing. The Ministry of Health Protection regulates certain issues regarding the location of the telecommunications equipment.

## Licensing

The Ministry issues licences to provide various telecommunication services. The scope of licensing covers almost every type of telecommunication activity. For instance, the Ministry issues licences to provide the following services:

- local telephone services;

- interregional and international telephone services;
- cellular communications;
- mobile radio communication services;
- TV broadcasting and radio broadcasting;
- cable television services, etc.

An enterprise may hold several different licences to provide one or more services. A licence is not required for:

- internal communication networks within the same enterprise;
- networks within a single building or several adjacent buildings, or installed in vehicles, aircraft or vessels;
- telecommunication services provided exclusively for the purposes of the State, including security, defence and protection of public order.

A licence for a telecommunication service may be issued for a term from three to ten years (and in some cases for longer). TV broadcasting and radio broadcasting licences are subject to a maximum term of five years. Licences are renewable. The licence contains a detailed description of the services to be provided, including the area of coverage and the number of lines and subscribers.

Fees are charged for the issuance of a licence. The rate depends on the type of the licence but the amounts set out in the regulatory acts of the Ministry are surprisingly very low – for example, the fee for issue of a licence to provide international and interregional telephone services is approximately US$ 270. In practice, however, much higher amounts are paid to obtain a licence through a tender procedure.

Licences are usually issued through a tender procedure, although this is not a mandatory requirement and licences have also been issued without a tender. The terms and conditions of a tender are established for each licence by the Ministry. There are specific regulations governing tenders to provide cellular services and some other telecommunication services. In general, a special commission is organized to run the tender by the Ministry of Communication. Members of the commission include representatives of various state authorities of the Russian Federation including representatives of the Ministry of Defence, Federal Security Service, Ministry of Anti-Monopoly Policy and other state authorities. The terms of the licence offered, the starting price, the commencement date, the date of submission for applications and the procedure to be followed are determined by the commission, and information about those terms should be published in the media. Applications must be submitted to the commission indicating the annual fee to be paid for the licence. The applicant offering the highest annual price for the licence should win the tender.

A licence may be suspended or revoked by the Ministry of Communication. The licence may be suspended for the following reasons:

- failure to comply with its terms and provisions;
- failure to provide services within three months after the start-of-service date;
- provision of inaccurate information about the communication services provided to the consumers;
- refusal to provide documents requested by the Ministry of Communication in order to evaluate the quality and scope of the services.

The licence may be revoked for the following reasons:

- failure to remedy the circumstances which resulted in a suspension of the licence;
- unfair competition of the licence holder in providing the services;
- other grounds set out in either Russian legislation or international treaties.

The Ministry's decision to suspend or revoke a licence may be contested in the appropriate court.

## *Telecommunication equipment*

Telecommunication equipment imported or produced on the territory of the Russian Federation is subject to certification requirements. Certification is provided by the certification institutions approved by the Ministry of Communications according to the rules and conditions established by the Ministry. Certification is conducted to ensure technical correspondence of the equipment to Russian state technical standards. The certification process is lengthy and expensive, involving several stages of testing and evaluation.

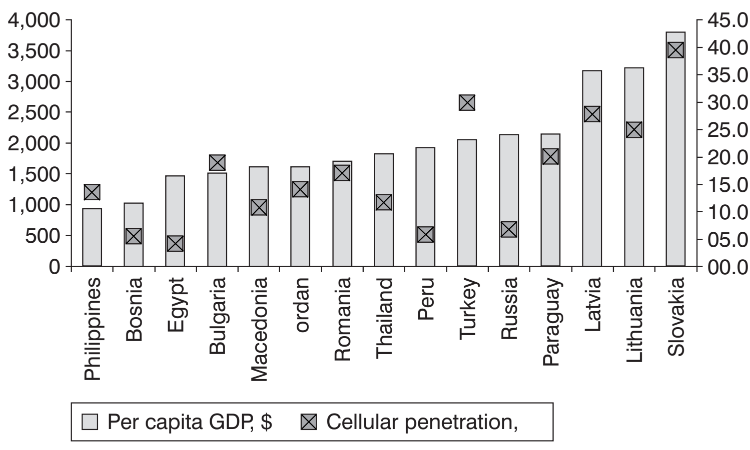
# 3.7

# Telecommmunications: the Mobile Sector

*Nadejda Golubeva, Aton Capital*

### *Overview*

Personal income growth on the back of economic recovery coupled with the rouble's real appreciation against the US dollar triggered explosive growth in the number of cellular subscribers in Russia. According to the Telecommunications Ministry data, in 2001 the overall number of cellular users in Russia increased by 130 per cent to 7.8 million. In the first four months of 2002, the army of mobile subscribers swelled by another 2.6 million, implying an average growth of 7 per cent per month. Mobile penetration in Russia, however, still amounts to just 5.3 per cent, which is very low by EMEA standards, even if adjusted for the GDP factor. Given the current favourable economic outlook and the rouble's real appreciation, there is no doubt that Russia remains on the threshold of a cellular boom.



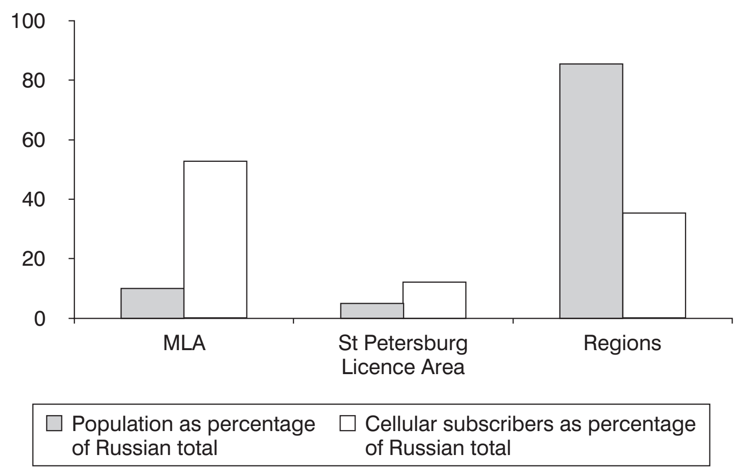

*Source:* World Bank, ITU, Aton

**Figure 3.7.1** Cellular penetration and GDP per capita

Until mid-2001, cellular market expansion had been primarily driven by the Moscow Licence Area (MLA), which is comprised of the City of Moscow and the Moscow region. This is hardly surprising, because based on official statistics, the area's per capita income is 2.5 times the Russian average. As of the end of 2001, MLA subscribers accounted for 53 per cent of all domestic mobile users. Russia's second-largest city, St Petersburg, had a 12 per cent share, while the remaining 35 per cent were spread rather unevenly across the rest of the country.

The subscriber base in the MLA more than doubled in 2001 to some 4.1 million, exceeding the most optimistic expectations. Cellular penetration here at the end of 2001 stood at 27 per cent (36 per cent in Moscow and 15 per cent outside the capital).
Although cellular penetration in the MLA is still far from market estimates of saturation level of 46–47 per cent, it can be expected that the rates of the MLA market growth in monetary terms will slow down in 2002, since further penetration into the low-end segment of the cellular market would result in an erosion of Average Revenue per User (ARPU).

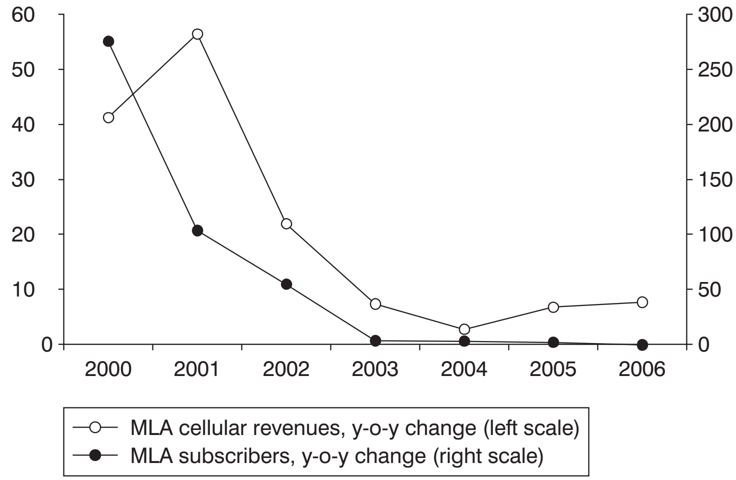
At the same time, cellular growth outside Moscow is rapidly gaining momentum. This is due both to steep declines in tariffs on the back of the Big Three's (MTS, Vimpelcom and Megafon) expansion into the regions and increased affordability of cellular services brought about by robust income growth. (In 2001 real income in




*Source:* Sotovik, State Statistics Committee, Aton

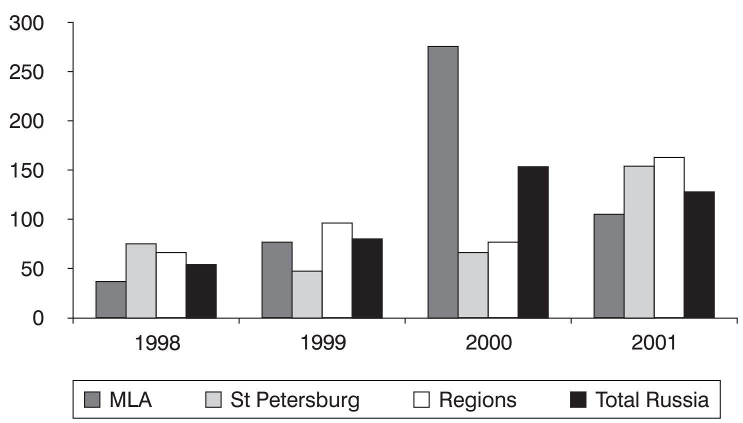
**Figure 3.7.2** Concentration of cellular subscribers in Russia (end-2001)

Russia rose by 6 per cent.) Last year, the regions outstripped Moscow in terms of subscriber growth and, given a favourable economic outlook, it can be expected that the regions will spearhead the Russian cellular market expansion going forward. Although large cities and industrially developed areas were the first to experience a spike in demand for cellular services, it is already evident that the less wealthy areas will join the race soon.




*Source:* Company data, Aton
*Estimated figures for 2002–2006

**Figure 3.7.3** Cellular revenue growth in MLA




*Source:* Sotovik, State Statistics Committee, Aton

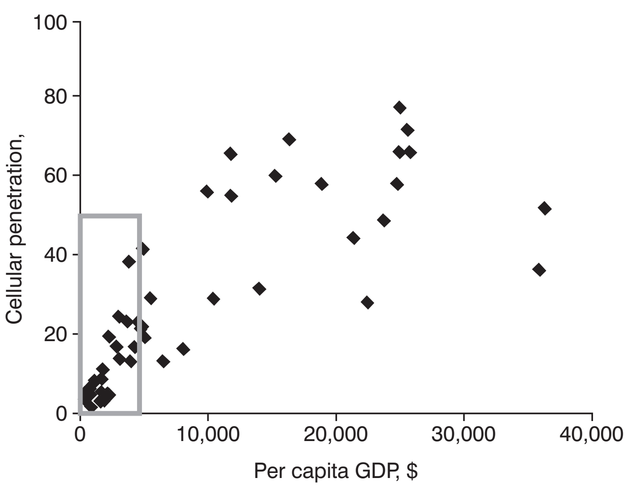
**Figure 3.7.4** Subscriber base growth (year-on-year)

## *Penetration model*

After studying international patterns of mobile penetration dynamics, we have come to the conclusion that affordability of cellular services remains a key factor in mobile market expansion only below a certain level of per capita GDP. As per capita GDP increases, the significance of affordability diminishes, while other factors, such as competition level, population density, demographics, cultural differences, etc, become more prominent. This finding is well supported by the per capita GDP/Cellular Penetration scatter plot (see Figures 3.7.5 and 3.7.6) based on a sample of 50 countries, which we have studied. The graph for the entire sample shows no meaningful correlation between the two variables. At GDP per capita below US$ 5,000, however, exponential approximation yields a reasonable fit of $R^2 = 0.7$.

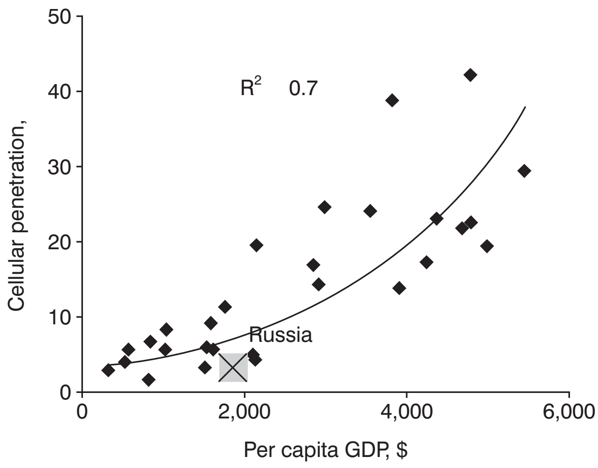
Since average per capita GDP in the Russian regions currently stands at about US$ 2,000 (adjusted for the shadow economy), cellular penetration outside the MLA can be modelled on the observed GDP/penetration relationship. While we recognize that this approach leaves significant room for error, it seems to be the most reasonable best effort based on quantitatively expressed international experience, and not just some intuitive 'feel' of where penetration should stand several years down the road.

We have modelled penetration in the regions based on the State Statistics Committee's numbers and our own macroeconomic




*Source:* WSJ, ITU, World Bank, Aton

**Figure 3.7.5** Cellular penetration vs. per capita GDP – worldwide




*Source:* WSJ, ITU, World Bank, Aton

**Figure 3.7.6** Cellular penetration vs. per capita GDP – for countries with per capita GDP below US$ 5,000

forecast for 2002–2006, using the Committee's estimate of the shadow economy (around 20 per cent of reported GDP) to adjust the statistical data. Since the Statistics Committee does not provide per capita GDP for the regions on a regular basis, we have used the regional differentiation in per capita incomes as a proxy for differentiation in per capita GDP.

Our model shows that cellular penetration in the regions is lagging far behind that justified by the GDP levels. We believe that the efficient development of the cellular market outside the MLA is inhibited by excessive market fragmentation and the lack of competition in the regions.

MTS, Vimpelcom and Telecominvest had focused their efforts until 2001 on Moscow and St Petersburg, as those cities offered the most handsome returns on investment due to higher per capita income and population density. Meanwhile, the small size of most regional operators did not allow them to raise adequate financing for their expansion plans. As a result, they failed to achieve economies of scale that are crucial to success in cellular business.

The combination of these two factors has stunted competition in the regions, keeping prices high enough to prevent cellular operators' entry into the mass market, which usually triggers explosive subscriber growth. Our model shows that the number of subscribers in the regions should be four times higher than the current level, based on the observed income level.

International experience has demonstrated that as the cellular market matures, the number of players is reduced to two or three large companies, while smaller operators are eliminated as they become uncompetitive. In our view, the entrance of big players into the Russian regions will initiate the consolidation process and let the 'genie of subscriber growth' out of the bottle.

According to our model, cellular penetration in the regions should reach 19 per cent by the end of 2006, and the number of regional subscribers should stand at 24.2 million. In absolute terms this translates into 21.5 million net adds in the Russian regions in 2001–2006, compared with 2.8 million in the MLA and 1.3 million in St Petersburg.

Albeit official statistics show that per capita income in the St Petersburg Licence Area (SPLA) is on par with the national average, cellular penetration in the city has already surpassed the level derived from our model. We are inclined to explain this phenomenon by the large share of the shadow economy here, bearing in mind that St Petersburg is Russia's second-largest city, and relatively close to the Finnish border. Therefore, we have modelled the SPLA penetration separately, arriving at a 42–44 per cent long-term target.

As far as Moscow is concerned, even its official per capita income exceeds that of many Eastern European countries. Indirect measures of the actual income level in Moscow (such as apartment prices, sales of cars, luxury clothes, etc.) indicate that per capita income in Moscow may be closing in on per capita income of some European countries, which would imply that a target cellular penetration of 60–70 per cent in Moscow is realistic. Assuming 30–35 per cent penetration in the rest of the Moscow region, we arrive at a target penetration of 46 per cent in the MLA.

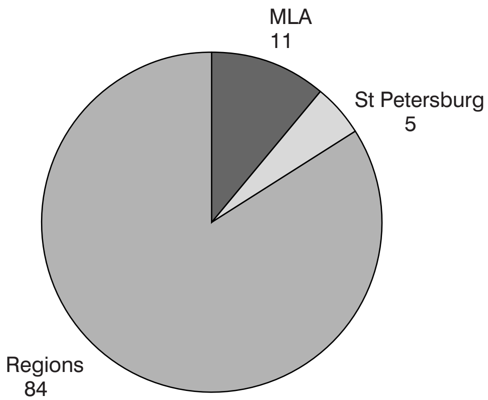
International experience shows that the cellular penetration curve sweeps steeply upward until the very point where it reaches the saturation level. For instance, last year Belgium and Greece added 19 percentage points to their already high cellular penetration level of 56 per cent as of the end of 2000. In 1Q02 alone, cellular penetration in the MLA grew from 27 per cent to 33 per cent, even though the first quarter is traditionally the weakest for cellular operators. Therefore, we expect mobile penetration in the MLA to reach 42 per cent by year-end.

In 1Q02, MTS and Vimpelcom derived some 30 per cent and 4 per cent respectively of their total revenues from their regional business. Based on our model, we expect the portion of regional revenues to grow to 46 per cent for Vimpelcom and 58 per cent for

**Table 3.7.1** Cellular penetration in Russia (end of period)

| | *1997* | *1998* | *1999* | *2000* | *2001* | *2002E* | *2003E* | *2004E* | *2005E* | *2006E* |
|---|---|---|---|---|---|---|---|---|---|---|
| **Moscow licence area** | | | | | | | | | | |
| Population (million) | 15.1 | 15.1 | 15.1 | 15.1 | 15.1 | 15.1 | 15.1 | 15.1 | 15.1 | 15.1 |
| Cellular penetration | 1% | 2% | 4% | 13% | 27% | 42% | 44% | 45% | 46% | 46% |
| GDP per capita*, US$ (current prices) | 8,750 | 5,571 | 3,902 | 5,294 | 6,319 | 7,239 | 8,180 | 8,916 | 9,630 | 10,400 |
| Cellular subscribers (million) | 0.22 | 0.3 | 0.53 | 2.0 | 4.01 | 6.34 | 6.64 | 6.80 | 6.95 | 6.95 |
| **St Petersburg licence area** | | | | | | | | | | |
| Population (million) | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 |
| Cellular penetration | 1% | 2% | 3% | 6% | 14% | 33% | 38% | 42% | 43% | 44% |
| GDP per capita*, $ (current prices) | 3,465 | 2,206 | 1,545 | 2,096 | 2,502 | 2,867 | 3,239 | 3,531 | 3,813 | 4,118 |
| Cellular subscribers (million) | 0.08 | 0.15 | 0.22 | 0.36 | 0.92 | 1.67 | 1.92 | 2.12 | 2.18 | 2.24 |
| **Regions (excluding MLA and St Petersburg city)** | | | | | | | | | | |
| Population (million) | 124.5 | 124.5 | 124.5 | 124.5 | 124.5 | 124.5 | 124.5 | 124.5 | 124.5 | 124.5 |
| Target cellular penetration | 13% | 8% | 6% | 7% | 9% | 10% | 14% | 15% | 16% | 19% |
| Actual cellular penetration | 0.1% | 0.2% | 0.5% | 0.8% | 2.2% | 5% | 8% | 12% | 16% | 19% |
| GDP per capita*, $ (current prices) | 2,870 | 1,827 | 1,280 | 1,736 | 2,073 | 2,374 | 2,683 | 2,925 | 3,159 | 3,411 |
| Cellular subscribers (million) | 0.18 | 0.3 | 0.59 | 1.04 | 2.72 | 6.61 | 10.35 | 15.38 | 20.53 | 24.27 |
| **Russia total** | | | | | | | | | | |
| Population (million) | 146 | 146 | 146 | 146 | 146 | 146 | 146 | 146 | 146 | 146 |
| Cellular penetration | 0.3% | 0.5% | 0.9% | 2.3% | 5.3% | 9.6% | 12.6% | 16.3% | 20.0% | 22.6% |
| GDP per capita*, $ (current prices) | 3,500 | 2,228 | 1,561 | 2,117 | 2,527 | 2,896 | 3,272 | 3,567 | 3,852 | 4,160 |
| Cellular subscribers (million) | 0.48 | 0.75 | 1.34 | 3.4 | 7.74 | 14.62 | 18.92 | 24.30 | 29.66 | 33.46 |

*Source:* State Statistics Committee, Aton estimates
*Adjusted for the shadow economy




*Source*: Aton estimates

**Figure 3.7.7** Total net adds breakdown (2001–2006)

MTS by 2006. Therefore, both companies' value heavily depends on their chances of winning the regional competition, and the regional battle represents the greatest challenge for them at the moment.

The situation in the MLA and St Petersburg, however, also must be watched carefully. These mature markets should help finance regional expansion, and hence the companies' business performance in these areas will be crucial to overall success.

In Table 3.7.1, we present detailed forecasts of the subscriber base and cellular revenue growth in the MLA, SPLA and the rest of Russia.

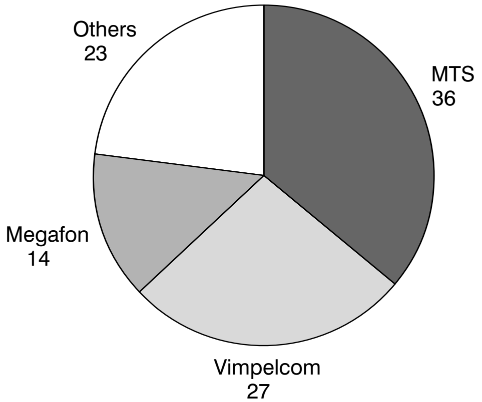
## *Market breakdown*

In mid-2002, MTS, Vimpelcom and Megafon serviced 78 per cent of all Russian cellular users, compared with 75 per cent at the start of the year. We expect this consolidation to continue, since the current three market leaders seem to be the only ones whose nationwide expansion plans are adequately backed by the combination of a broad licence portfolio, availability of funds, proven experience and political affiliations.

While some minor players have announced ambitious expansion plans, it will be very difficult for any of them to withstand competition from the Big Three, given the latter's three major advantages:

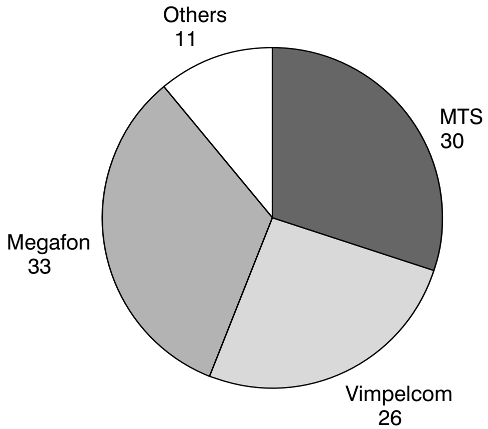
- intranet roaming;
- economies of scale;
- broad marketing experience.

We believe that the market share of minority players will gradually decline from 23 per cent at present to a maximum 10–15 per cent by 2006, and by then most of them will provide non-GSM services. As to the local GSM operators, we believe that the best strategy for them would be to sell out to whichever of the Big Three offers the best price.




*Source:* J'son&Partners

**Figure 3.7.8** Russian cellular market breakdown (end-April 2002)




*Source:* Aton estimates

**Figure 3.7.9** Russian cellular market breakdown (2006 forecast)

# 3.8

# E-commerce and the IT Sector

*Sergey Korol, Internet Securities, Inc., Emerging Markets Information System*

## *Overview*

The Russian information technology (IT) sector represents a growing and dynamic market that is especially attractive for the international market players in view of the slowdown in the global economy. Although still relatively small at about US$ 3 billion, the Russian IT market grew by 18–20 per cent in 2001. It is expected to reach US$ 4 billion in 2002 and add around 20 per cent more in the year 2003. Very loose dependence of the local market on the world economy, as well as growing local demand and project market segment extension, were the major factors that contributed to the Russian IT sector growth. Hardware, system integration and system security services were the champions in the race for the IT Russia Prize 2002.

Long gone are the times when Russia's IT market looked like that of America in Columbus' times. International and domestic companies have already stepped into the market quite aggressively with products and services that are available either directly or through representatives or through distributors. However, local demand is extremely price-sensitive. The average consumer generally prefers a low-cost computer to a globally recognized brand. Nonetheless, the Russian market remains one of the promising emerging markets.

There is growing demand for imported equipment in the corporate sector. A dramatic increase in electronic hardware and software procurements for state-funded federal and regional programmes has also contributed to the sector growth.

Continuing growth in the number and purchasing power of small and medium-sized private enterprises is driving demand for legally imported operating systems, software application packages and enterprise management software. Best immediate sales prospects also include peripherals, networking equipment and Internet technology.

## *Legal environment*

Laws and regulations for the IT sector were not a priority for the Russian authorities but during the last two years a number of important regulatory papers were developed. Some of them were adopted by the State Duma (Russia Parliament Lower House) and came into force. The real breakthrough was The Law on Electronic Digital Signatures that established a legal basis for the further development of e-commerce.

The Bill on E-commerce and the Bill on Electronic Document Flow, which are now under the State Duma's consideration, along with the already-passed Law on Electronic Digital Signatures, should improve the legal environment for Internet providers and boost the country's use of Internet technology. At the same time there are some problem areas in the legal environment in Russia's IT sector that are common for the whole international community. These are pirated software and 'grey' import issues.

Actual demand for IT products is difficult to determine due to the high level of pirated software products and grey imports (shipments through countries unauthorized by the original supplier), estimated by International Planning and Research corporation (IPR) to be as high as 89 per cent of the total market. In recent years, the Russian government has taken steps to improve enforcement against piracy, but pirated consumer software remains readily available in the street markets. Poor IPR enforcement is likely to severely limit the sales potential of legitimate software suppliers in Russia.

The IT Industry Association, founded in 2001, is perceived as an important step in the industry's development. Around 34 companies, both Russian and the local representatives of foreign companies, have become the founding members. The goals of the association are to represent the interests of the Russian IT industry domestically and internationally, to foster conditions for the future growth of the IT market and to protect corporate interests of IT companies. Among the association's members are IBM, Intel, Hewlett-Packard and Microsoft as well as the Russian companies IBS and Marvel.

The Russian State Customs Committee has introduced special customs declaration rules for electronics and home appliances. The Order #1132 allows 50 types of goods to be declared by the importer using a preliminary declaration form and with payment of customs fees before the goods are actually brought into the country. These goods include virtually the whole range of home electronics, photo equipment and timepieces, as well as computers and components for them.

The system was commissioned in February 2002 and has been installed at 22 customs points in various regions of Russia. About 20 major importers of electronics and home appliances were willing to use this new mechanism. All of them are members of the Russian Association of Electronics, Appliance and Computer Retailers and Producers. The Customs Committee claims a new procedure gives legal importers an additional competitive advantage over grey import smugglers.

## *Government sector*

The ambitious state programme named 'Electronic Russia' was launched in 2001 and was aggressively implemented to stress the IT sector's importance for the federal authorities. The estimated cost of the programme for the period 2001–2010 is about US$ 2.6 billion. The target is to achieve IT technology products export volume of US$ 1–2 billion a year; that is as much as 2 per cent of the Russian GDP.

Current Russian Government priorities for the sector are as follows:

- to make Internet access easy for private individuals and public sector organizations;
- to support IT investments, stressing support to domestic developers;
- to proceed with legislative and regulatory grounding of the IT sector.

State orders have become an important demand driver for IT products. Increased government spending on computers contributed to the growth of the sector, with more tenders held for government projects and budget-funded public schools in rural areas. In 2001, government and educational institutions accounted for 30–35 per cent of computer demand. Another factor that boosted PC sales turned out to be major IT investment projects in insurance, banking, financial services and manufacturing.

Several state-supported projects were implemented in 2001 including the Presidential programme 'Computerization of Rural Schools'. According to IDC, around 60,000 PCs were bought for this programme. The winners of the tender for this project included Croc, DellSystems, IVK and Kraftway.

The Russian Education Ministry plans to buy more than US$ 3 million worth of computer equipment for a programme called 'Federal Experimental Platforms for the Unified State Exam'. Centres to carry out state exams were built in five regions in 2001 and 12 more centres had to be built in 2002. Among the contractors for this project there are Dell Systems, which will deliver 109 personal computers for US$ 190,000, Moscow-based X-Ring supplier, IVK, and St Petersburg-based distributor, Lanck.

In 2001, tenders were held for the delivery of computer equipment and software for the CyberPocht@ project. CyberPocht@ was designed to set up public Internet access stations at post offices in remote regions of Russia. As of now, there are 40,000 post offices in Russia.

According to the Russian Communication Ministry officials, as of September 2002 there were 2,200 Internet access centres in Russian post offices operating within the CyberPocht@ project. The number of post offices offering Internet access services will increase to 15,000 by the end of 2003 if the proper financing is provided from the Federal budget. The cost of an Internet access centre is about US$ 1,500–1,700 on average and some of the post offices could provide Internet access only via satellite networks.

Under the scheme, 1,436 workstations with pre-installed Microsoft MS Office2000 were set up, including 500 in rural areas. Compaq was selected as a PC supplier, successfully outbidding domestic manufacturers, and Xerox Corporation supplied the printers. The bulk equipment was leased for a period of up to three years.

## *Internet*

The number of Internet users in Russia increased by almost 100 per cent in 2001 against 2000, exceeding 18 million people. The number of regular Internet users in Russia was estimated as 6.2 million at the end of 2001, an Internet penetration rate of just 4.3 per cent. The number of regular Internet users in Russia is estimated to reach 8–10 million by the end of 2002. According to IDC, revenues from Internet access services are expected to rise 10 per cent year on year to US$ 600 million.

Russia's well-educated population and the upward development of its economy presents a huge potential demand for Internet hardware and services. At the same time, this demand is significantly constrained by low disposable income. The outlook for economic growth is uneven across Russia's 89 regions. Moscow and St Petersburg, with their relatively strong economies and relatively high income levels, will remain the most attractive telecommunications and Internet markets. Other fast-growing markets include Krasnodar and Rostov in the South, and some cities of the Urals region. The Federal government is planning significant measures to improve Internet connectivity in the regions, as part of its Electronic Russia plan, but such plans are subject to fund availability.

In 2001, there were about 5 million PCs connected to the Internet, a number projected to grow to 7 million by the end of 2003.

The Internet Service Provider (ISP) market is very fragmented, with over 300 ISPs in Russia. Fifty ISPs provide Internet access services in Moscow alone. Representing one-sixth of Russian ISPs, they generate about 80 per cent of total revenue. However, consolidation of regional operators, and mergers and acquisitions are taking place. The largest ISPs are Sistema Telecom (US$ 42 million revenue), Golden Telecom (US$ 31 million) and Cityline (US$ 18 million), together controlling about 40 per cent of the Internet services market.

Average Internet usage in Russia is still behind that of the European Union and the United States, but it is increasing rapidly and is a good driver of the hardware sales. Over the last few years the country has seen a rapid growth of Internet service providers and users.

The number of corporate users has started to outnumber private ones. In 2000, 60 per cent of Internet users in Russia were corporate and 40 per cent were private, in 2001 63 per cent were corporate and 37 per cent private, and in 2002 the number of corporate users is projected at 65 per cent and private users at 35 per cent.

**Table 3.8.1** Estimates of Internet growth in Russia

| | *2000* | *2005 estimate* | *2010 estimate* |
|---|---|---|---|
| Number of phone lines (million) | 31.2 | 36.9 | 47.7 |
| Number of Internet users (million) | 2.5 | 6 | 26.1 |
| Internet penetration (%) | 1.7 | 4 | 17.9 |

*Source:* Ministry of Communications

Most of the Russian Internet users (64 per cent) are 16–34 years old and the majority are men (59 per cent). Territorially, Russian Internet users are mostly in Moscow and St Petersburg. They account for 66.3 per cent of the Internet users in Russia. Some increase of activity was registered during the last two years. The front-runners among Internet users in the regions are Yekaterinburg, Novosibirsk, Krasnodar, Vladivostok, Irkutsk, Nizhniy Novgorod and Samara. Optimistic estimates predict the total number of Internet users will reach 26 million by 2010.

There has been a drastic rise in the number of Internet transactions. In the first quarter of 2002, Internet transactions at the Stock Exchange section of Moscow Interbank Currency Exchange (MICEX) exceeded 70 per cent of the total number of transactions. But the share of the volume of Internet transactions was still under 50 per cent.

In contrast to the Moscow and St Petersburg mature markets, regional markets are just beginning to take shape. It is expected that there will be an active struggle for the regional users.

## *PC supply and production*

World PC supply has dropped by about 5.1 per cent in 2001 on a year-to-year basis. A slow and intermittent US recovery brings little optimism to the experts, who predict the same PC supply level for the year 2002. But this picture has nothing to do with the Russian market. In contrast to the negative rate of PC supply to the EMEA region countries (Eastern Europe, Middle East and Africa) the Russian market PC supply penetration rate in the third quarter of 2001 was 18 per cent on a year-to-year basis. The main beneficiary of these supplies was the educational sector due to the Federal Computerization Programme state budget allocations.

In 2001 the total number of computers in Russia exceeded 11 million, a penetration rate of 7.5 per cent. While this was a healthy increase over the 6.4 per cent rate of 2000 there is evidently significant potential for growth.

Imports account for 15 per cent of Russia's PC market, while low cost products assembled by Russian manufacturers from foreign components met most of the demand for PCs. PC assembly accounts for 76 per cent of hardware revenues, while peripherals, networking and larger system hardware are dominated by imports.

Based on first and second quarter 2002 results, IDC experts believe that PC market growth rate in Russia during the period 2002–2003 will slow down but the upward trend will continue.

Locally assembled PCs dominate the Russian market, and three dozen domestic computer companies are estimated to control half of the market. According to the International Data Corp., the fastest growing domestic PC producers in the year 2001 were Formoza, Aquarius, and R-Style. Among world-leading brands, Hewlett Packard, IBM and Compaq have enjoyed the largest growth. HP has become the top international vendor in the market, especially with a 150 per cent increase of notebook sales in Russia. Domestic company Aquarius boosted its turnover last year by 80 per cent to US$ 80.57 million. Another domestic company, Excimer-DM, reported 46 per cent annual growth and planned to assemble 120,000 computers in 2002; that may account for 5–6 per cent of the market. The company sells computers under the brands Intel and Excimer with VIA Technologies and Intel processors inside.

Demand in the Russian PC market is extremely price sensitive. Lower cost domestic producers compete successfully with foreign brands in the low end of the market, and have forced importers to lower their prices. Cost saving considerations have prompted some foreign equipment manufacturers to set up assembly operations in Russia; thus they are able to compete with domestic suppliers. HP is one step ahead of its international competitors; in 2001 it launched a domestic PC assembly line together with the Russian company Aquarius. The HP–Aquarius facility adopted Quality Production System Standards (ISO9001/ISO9002) and integrated with a HP facility in France. This domestic partnership opens for HP the door to one of the most solvent segments of the Russian markets – the state sector – because it is prohibited to Federal agencies to purchase an imported PC if there is an analogous domestic one.

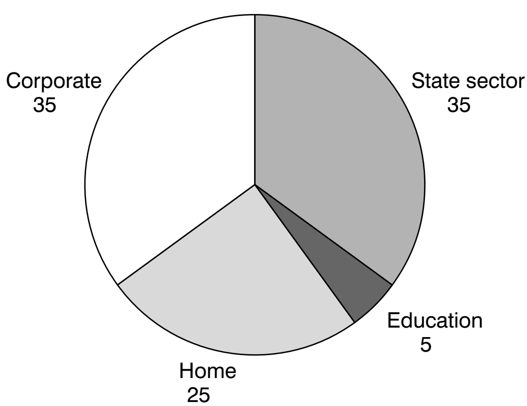



**Figure 3.8.1** Breakdown of PC demand in Russia, 2000

The volumes presented in Figure 3.8.1 are unlikely to change drastically during the year 2002, with corporate and state sector domination ahead of private and educational consumption.

### Demand for high performance equipment

As the Russian economy gains strength, an increasing number of up-to-date managed companies are looking for advanced IT systems. Rising need for Internet access, shared resources, networking and applications solutions has generated a substantial demand for computer systems and servers. For example, IBM and Sun Microsystems, sold in Russia as high-end computers, shipped US$ 7 million worth through Russian distributors, including Verysell.

### Software

Russia's rapidly expanding software market in 2001 was estimated at US$ 600–800 million, growing at an annual rate of 25 per cent. The best sales prospects are for the Enterprise Resource Planning (ERP) products, which currently account for 30 per cent of the software sector. There are no means for accurate evaluation of software demand due to the high level of pirated software, which, according to some industry estimates, is as high as 88 per cent.

The packaged software sector experienced a major boost during 2001, rising by 18–20 per cent to US$ 350 million. Growing demand has been reported for basic operating systems and integrated ERP and application tools for database development and management.

According to Brunswick Warburg, Russian enterprise solutions account for 55 per cent of the market, with Galaktika being a market leader. Since Russian software developers do not currently compete in the market for large ERP systems (23 per cent of the total software market), there is a demand for imported software in this segment and the mid-range segment.

**Table 3.8.2** Russian ERP-systems market size.

| *Year* | *1999* | *2000* | *2001 estimate* | *2002 estimate* |
|---|---|---|---|---|
| Market size, US$ million | 60–70 | 80–90 | 110–120 | 160–170 |

*Source:* PC Week, January 2002

## *IT services demand*

Russian companies spent around US$ 850 million on information technologies services in 2001 – 31 per cent more than in 2000. But their expenses for IT are tiny compared with Western companies. According to EDC, medium and large Russian enterprises spent US$ 288,200, on average, in 2001, and are forecasted to increase spending to US$ 432,300 by 2004.

The IDC study 'The IT Services Market in Russia 2001–2006' reports that more than 30 per cent of the total volume of services provided has been attributed to the system integration projects, including networking. Domestic system integration market volume in 2001 was at about US$ 300 million, in-box software and hardware costs excluded. Russian companies Croc, IBS and R-Style are mentioned as leading domestic players with 10 per cent of the market. But the maturity of this segment is still pending.

Information system development expenses made up around a quarter of the total money spent on IT services. The picture of this segment is still defined by large projects that were launched by banks or mining enterprises. The number of international companies present on the domestic IT services market is still scant. Most of them still focus on the development and technical support for the domestic partner's networks. The only exception is Hewlett Packard, rated among the top five suppliers of IT services to customers in Russia.

Enterprise management system services are among the most requested IT services in Russia. A steady rise in demand for these services is forecast for the next few years. The ERP/CRM segment has steady development in Russia due to the progress towards a clearer strategic IT vision on the part of the management of the domestic companies.

Frontstep Corporation reported increased demand for ERP, CRM and SCM systems that tripled the number of the deals concluded during the year 2001.

Consulting and outsourcing services was the most dynamically developing sector of the market during last two years and its volume is forecast to increase by 4.5 times by 2006.

The future for the Computer Aided Design (CAD) software segment is very promising in Russia, with annual volumes ranging from US$ 12 million to US$ 15 million. PLM Solutions, a division of EDS, provides a CAD solution to the Russian military aircraft developer OKB Sukhoi. PLM Solutions are also contracted by Komsomolsk-na-Amure Aviation Production Association to deliver

Unigraphics CAD software. The two Russian aircraft development and production facilities make use of more than 150 Unigraphics workstations.

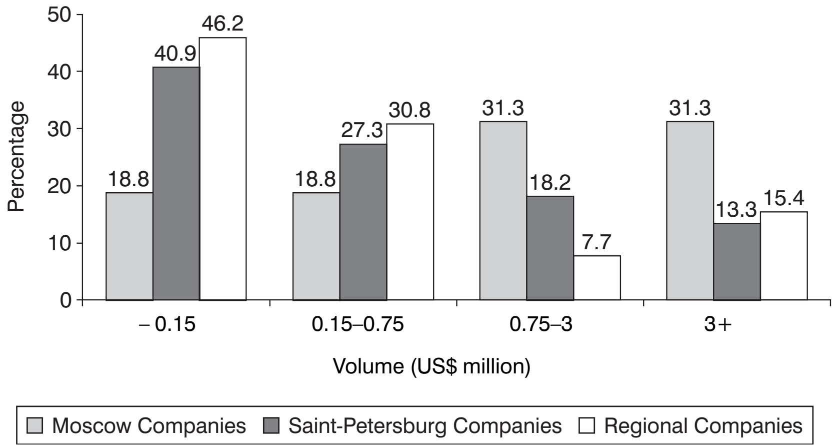
Import market trends in Russia are quite promising. The country is very receptive to foreign IT vendors. Globally recognized IT suppliers have gained market share by direct distribution or by establishing domestic subsidiaries. Microsoft, IBM, Hewlett Packard, Sun Microsystems, Novell and Oracle are all active in the Russian market, with the products available either directly or through representatives or distributors. The US companies are considered to be the leading suppliers of IT networking hardware to Russia and also major players in the market for software application solutions, system software and hardware supporting software. Most products legally imported into Russia come through official US representatives and distributors. Imports from other countries are also growing, although their current market share is small. US companies encounter increasing competition in the Russian market on the part of Asian computer manufacturers and European software vendors.

The IT security market almost doubled in 2001, reaching US$ 40 million. Internet security has become tremendously important worldwide and domestic leaders in this business use the circumstances to upgrade company competitiveness. The industry experts' view is that the domestic information security sector is very flexible to any demand increase.

Anti-virus protection software is among the most competitive of domestic products with progressive export capabilities. Kaspersky Lab, the company with the core product AntiViral Toolkit Pro (AVP), has entered the international market and has strong partnerships with Microsoft, Novell, Check Point Software and ISCA. The distribution network of Kaspersky Lab includes over 40 countries worldwide.

Software outsourcing represents a fast-growing sector, with Russia's significant cost advantage. There are many highly skillful software engineers and researchers with extensive experience in developing projects of premium complexity. According to Brunswick Warburg, the share of foreign orders varies from 20 per cent to 100 per cent of the total outsourcing revenues of the major domestic market players.

In 2001 the market for outsourcing software services was estimated at US$ 120–150 million with the growth rate of 20 per cent. Government and the software industry are cooperating to position Russia as a global leader in 'offshore' software development, with




*Source:* MarketVision

**Figure 3.8.2** Offshore programming volumes breakdown by company

an estimated growth rate of 50 per cent over the coming few years. Russian industry source estimates are that the eventual market for software developed in Russia could grow as high as US$ 20 billion–US$ 60 billion per year.

Moscow remains the centre of the offshore programming industry, followed by St Petersburg and Novosibirsk. The segment is relatively small by world standards but is well positioned for future expansion. Expected Russian offshore programming market growth is about US$ 350 million by the year 2003 (international vendors' development centres not included) with a penetration rate of up to 35 per cent of the total volume of software development.

More than one-third of Moscow-based companies have a US$ 3 million plus offshore programming component in their business but the same volumes of St Petersburg and regional companies do not exceed US$ 150,000. Among regional companies with the highest offshore volumes penetration are the companies from Novosibirsk.

The National Association of Software Developers, established in 2001, may also contribute to the promotion of Russia's image as an outsourced software development centre. The government is very supportive of the sector, striving to create encouraging conditions and to limit Russian software developers' outflow to other countries with better labour and life conditions.

## *End users*

The following are the major groups of IT end-users:

- multinationals;
- government agencies and institutions (especially participants of the Electronic Russia programme);
- Russian exporters of raw materials and commodities;
- Russian companies, with progressive management seeking to increase operational monitoring/control efficiency (telecom companies, freight and automotive industry, food processors);
- small and medium-sized Russian companies, which are growing in number and becoming an economic force in the country.

Moscow and St Petersburg have been the most important computer markets to date. However, there are heavily populated industry centres in Russia's vast regions that are starting to become of interest to IT products and services suppliers and distributors. The longer-term opportunities for expansion in the regions under the healthy economic conditions are more than promising.

## *Summary*

The main trends are as follows:

- Industrial growth has continued, spurred by IT spending by industrial enterprise.
- State-financed procurement has increased considerably.
- Organizational and financial support of the Electronic Russia programme has been given by the Russian Government.
- A decline in PC prices has resulted in a small market growth in US$ terms.
- Laptop and server markets have grown faster than the desktop market.
- Distributors are expanding from their traditional markets in Moscow and St Petersburg into Russia's regions.
- Demand for enterprise management software has increased, with domestic IT companies' expansion deeper into the sector providing enterprise solutions not only hardware delivery.
- Positioning of the Russian offshore programming sector as an export industry enjoys full government support.
- Internet (private and corporate) is booming.
- Drastic rise in the Internet transactions persists.

- The level of software piracy remains extremely high.
- High dynamics of the mergers-acquisitions-reorganization process inside the Russian business community prevents the domestic IT market from predictable and steady growth.

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# 3.9

# Shipping, Shipbuilding and Port Development: Opportunities for Western Businesses

*Trevor Barton, Clyde and Co*

## *Background*

Perestroika (restructuring), privatization and the 1998 financial crisis had a dramatic effect on the Russian shipping industry. Whole shipping companies have disappeared, and shipyards previously reliant on state orders have had to learn how to market themselves in the face of worldwide competition. Foreign investors suffered badly in the crisis precipitated by the 'crash' of August 1998, and adopted a more cautious approach thereafter. Matters have, however, improved somewhat in the last couple of years, both inside Russia and in the perception that businesspeople outside Russia have of the country.

At the time of writing (October 2002), it is clear that a measure of confidence in Russia has returned. Investment opportunities continue to increase as the economic and legal reforms introduced by Vladimir Putin's government are perceived to be working. Russia needs foreign investment and expertise to expand, modernize and 'green' its fleet, and to enable further development of Russian ports and maritime services to support international trade and the growing domestic market economy. Russia remains one of the world's leading maritime nations and there is limitless potential for investment and trade – if the terms are right and there are legal structures in place to reassure all parties. Russia's much publicized desire to join the WTO will, it is hoped, lead to further commitment to opening up the market.

## *The tide has turned: maritime law reform*

Prior to 1999 the shipping business in Russia was governed by Soviet legislation, which was based upon outdated concepts of ownership, corporate structure and liability. This was highly unsatisfactory in a nascent market economy. In 1999 Russia acceded to various treaties such as the 1952 Arrest Convention, the 1976 Convention on the Limitation of Liability (1996 Protocol) and the Hague Visby Rules, and in May 1999 the new Russian Merchant Shipping Code came into force.

These developments have brought Russian law more into line with international maritime law, in particular regarding the limitation of a carrier's liability for loss or damage to cargo and the general limitation on shipowners' liability for maritime claims. The new Code deals with bareboat charters, liability for oil pollution, liability for loss and damage arising from the carriage of dangerous cargoes, arrest of vessels, maritime lien and mortgage of vessels, including those under construction.

Other new legislation of a more general nature is also relevant. For example, the new Arbitration Procedure Code (September 2002), which deals with procedures at the Russian commercial courts, enables the courts to take measures previously impossible. Particularly relevant is that the courts may now grant security to a plaintiff before an actual Statement of Claim is filed. This is very significant in the context of the arrest of ships by owners or insurers of the cargo on board.

## *Shipping companies*

Under the Soviet system, Russian shipping companies were state-owned, centrally planned and run by the Soviet Ministry of Merchant Marine (Morflot). Today, much of Russia's shipping industry is privatized. (Figures vary, but apparently about 80 per cent of the Russian fleet is 'privately' owned.) However, the State retains a close interest in vessels operated by Russian shipping companies, and in some cases retains a significant shareholding in the companies themselves. This combination of state and private ownership and control is a source of some confusion and is one of the factors that has deterred foreign lenders and investors.

Government subsidies are no longer available to shipping companies other than to reduce operating losses for domestic passenger transportation, icebreaker services, and search-and-rescue. Forty-six per cent of merchant vessels are over 25 years old (the average age of the Russian fleet is 21 years) and over 70 per cent of the fishing fleet is operating beyond its planned life. There has been limited interest from Russian investors and banks in funding regeneration. Thus, Russian shipping companies have to find other sources of finance if they are to replace their vessels and survive. Joint ventures with foreign investors are one possibility, while another is to try to obtain finance from abroad, but many potential providers of such funds are concerned that, given present Russian law and legal procedures, they will not obtain effective security for their loans. The key legislation in this area is the Russian Civil Code; the rule is that provided a mortgage on a vessel is properly registered, it is enforceable. However, this area of law is still being developed; there are actual or potential contradictions with other laws, the interpretation and application by the Russian courts is still uncertain, and there are practical difficulties in enforcing pledges or mortgages against assets in Russia. Lenders and investors will need to consider how they may best protect themselves in advance from such problems.

As a result of these concerns, Western commercial banks have been extremely cautious about lending, especially since the events of 1998. To date, a substantial proportion of the finance made available for renewing the Russian fleet has been provided by the European Bank for Reconstruction and Development (EBRD).

One solution to the financing problem used by Russian shipping companies is to set up and register an offshore subsidiary company in a jurisdiction with a favourable tax regime. The subsidiary borrows money to finance the construction of a vessel, which is built and registered in a jurisdiction with a mortgage law and judicial system acceptable to the lender. The vessel is then bareboat chartered back to the Russian shipping company and manned by a Russian crew. Although there is evidence of a new trend for Russian shipping companies to have their vessels built by Russian yards, the necessity to raise money abroad often dictates the use of such alternative schemes.

Russian shipowners, like all shipowners, will be affected by new European regulations, which state that from 2003 all oil tankers navigating European waters must be double-hulled.

Presently, foreign flagships may not trade from one Russian port to another (so-called ‘cabotage’) or use the extensive internal waterway system.

## Developments in the far North

Partly driven by Russia's expansion into its Arctic oilfields, Putin's government plans to develop the Arctic Northern Sea Route (Yokohama–Arkhangelsk–Rotterdam), and the revitalization of the icebreaker and ice-capable fleet is under way. This might provide good but challenging opportunities for Western companies – further new vessels will be required, and port and maritime services must be developed. The Russian Transport Ministry maintains that by 2005 approximately 9 million tonnes of cargo will be transported via this route, necessitating infrastructure development at an estimated cost of US$ 1 billion. By 2015, according to the Ministry, cargo flows will be up to about 25–30 million tonnes of oil, and 15–20 million tonnes of gas, and that will require about 85 vessels operating on the Arctic route to regular schedules.

Independent observers, it has to be said, are somewhat sceptical – while acknowledging the saving in voyage time the route potentially offers, they point to the difficulties and unpredictability of navigating in ice, the predominantly old Russian icebreaker fleet, the potential threat of massive (and costly) environmental pollution due to accidents in dangerous waters, and the sheer amount of effort and investment that will be required to bring the present inadequate infrastructure for the provision of fuel, repairs, emergency and clean-up facilities, and cargo handling up to standard.

## Marine insurance

The Russian insurance industry is expanding rapidly and becoming more sophisticated, yet premium income remains low by Western standards. It is recognized, both inside and outside Russia, that many Russian insurance companies do not have the financial underpinning or reputation of Western insurers. The market should therefore be ripe for Western insurers and reinsurers.

Russian insurance law and the regulation of the insurance industry is, however, still being developed. The law is somewhat less comprehensive than in the West, regulatory aspects tend to be protectionist, and there are contradictions and conflicts with other laws. Marine insurance is specifically addressed in the new Merchant Shipping Code, and the Russian Tax Code makes special provision for insurance premiums being set off against the amount chargeable to tax for Russian shipping companies.

All insurance activities are subject to licensing (licences are issued by the Insurance Department of the Russian Ministry of Finance) and under present law all property risks must be insured with Russian insurance companies. While Western insurers can, like any foreign investor, set up subsidiary companies in Russia with 100 per cent foreign capital, there are restrictions on the services such companies can provide. In general terms, they may underwrite risks related to shipowners' liability (P&I insurance) but may not provide life insurance or property insurance. Western insurers must therefore presently look to other possible routes into the market, perhaps a joint venture with a Russian insurance company or by offering re-insurance.

## *Shipbuilding*

Although military vessels are still ordered, Russian shipyards can no longer rely on regular orders for merchant vessels as was the case during the Soviet command economy. They must now compete with other yards located all over the world. As previously mentioned, they are having some success in attracting orders from Russian shipping companies, but even Russian shipping companies now often look outside Russia to have their ships built in order to attract loan finance. Given the relative inexperience of Russian shipyards in marketing themselves, there are opportunities for Western companies to provide consultancy, technical assistance and training services.

In principle, Russian shipyards are well equipped to meet demands for large and complex orders. The workforce is highly skilled and can boast a long tradition in shipbuilding, dating back to the times of Peter the Great. They have access to cheap steel, advanced welding and casting technologies, competent design bureaux and vast production facilities. The practical problems they face, however, include raising finance to replace ageing equipment and overcoming an unfortunate, and not always justified, reputation for late deliveries.

If the Northern Sea Route goes ahead as intended, the demand for icebreakers and ice-class tankers will increase. Lukoil, Russia's largest oil producer, has already ordered 11 ice-class tankers, which are being built both in Western yards and at the Admiralty Shipyard in St Petersburg. The fourth in the series of five being built in Russia has recently been launched. The Russian Navy reportedly continues to test the viability of cargo-carrying nuclear submarines, which would operate under the ice to transport minerals and oil cargoes.

## Port development

On the dissolution of the Soviet Union, Russia lost control over many of its important ports, including Odessa on the Black Sea and the Baltic ports (Riga, Tallinn, etc), which were traditional gateways into Western Russia. A further problem is that the ports that were lost are now in direct competition with the remaining Russian ports and they have proved adept in attracting business away from the Russian ports, particularly in the Baltic. Russia recognizes that it must improve the services of its remaining ports, develop new facilities, rationalize customs regimes and raise investment into the road and rail infrastructure around the ports. The Russian government recently decided to prolong its Federal Programme on 'The Revival of the Russian Trading Fleet' for the period 2002–2010, and allocated 1 per cent of the Federal Budget to the financing of related projects (ie port development, reconstruction and modernization). With its enormous reserves of natural resources, these will be key factors in Russia's future position in the global economy. An added challenge is Russia's distinctly northern geography, which means that many ports are affected by ice in the winter and must be kept open by costly icebreaker services. Novorossiysk on the Black Sea, increasingly important as an oil port, is not affected. Murmansk on the Kola Peninsula, despite being the largest city in the world north of the Arctic Circle, benefits from the Gulf Stream and is ice-free all year round.

Russia has launched a number of ambitious port development projects. There are many opportunities for venture capitalists and foreign companies to invest, and for banks and financial institutions to provide finance. According to the Russian Transport Ministry, dry bulk cargo flows in Russian ports continued to increase in the period 2000–2002. The new Ust-Luga coal port near St Petersburg is fully operational now, and there are plans to complete a new oil port nearby in Primorsk by 2010 in order to provide a link with the Siberian oil fields. St Petersburg is currently also investing in new cruise ship facilities. In Novorossiysk a new container terminal project is being fronted by the Russian Ministries of Transport and Railways. Further plans exist to develop the ports of Taganrog, Sochi, Nakhodka and Vanino.

## Protecting the Russian environment

Although Russia has not yet ratified the 1991 Espoo Convention on Environmental Impact Assessment, the Russian Government has made it clear that it now has a greater commitment to protecting the environment. Russian environmental law provides that certain investment projects, including port development projects, must be assessed. During the preparatory stages, the project proposers must obtain an opinion and approval from a Russian environmental supervisory body such as Rosprirodkontrol, which, under the auspices of the Ministry of Natural Resources, is responsible for environmental safety. This provides numerous opportunities for foreign companies in the field of environmental consultancy and training, as well as the 'green' technology industry.

## *Bridging the finance gap*

For the promoters of Russian port developments, raising finance is no easier than for Russian shipping companies or shipyards. However, the success of large-scale infrastructure projects such as port development is perceived as vital by the international community and some funds have been made available through international finance/development institutions such as the World Bank, the EBRD and the International Finance Corporation (IFC), as well as by a number of commercial banks. Such financing depends on the presentation of comprehensive legal and financial analyses and well-structured business plans; this will open up opportunities for Western consultancy companies.

## *World Trade Organization membership: a vehicle for change?*

Further legal developments can be expected as Russia consolidates its efforts to gain entry into the World Trade Organization, which it hopes to achieve in the next few years. If it is to be successful, Russia must provide further evidence of effective legal and banking reform, in line with the 1994 GATT (General Agreement on Tariffs and Trade) and its Side-Agreements.

## *Conclusion*

Business in the 21st century has made it clear that investment in the Russian shipping and shipbuilding industries and the development of Russian ports remain key areas to enable Russia's successful integration into the global economy. The remarkable changes of the last 12 years, the relative economic stability achieved under Putin's government, Russia's maritime tradition and existing port infrastructure, combined with the promise of further economic and legal reform, provide a strong foundation and stimulus for Western companies to look towards Russia. However, Russia remains an economy in transition and the process of establishing a legal system that really encourages foreign investors is not yet complete. Russia continues to rationalize its tax system and a series of new laws are in place. Russia's own leaders recognize, however, that many areas, such as corporate governance, the granting and enforcing of realistic security for loans and the court system require further attention.

The possibilities for Western companies are enormous and wide-ranging, but any decision to venture into the Russian market should be taken with care and proper advice. Research and preparation, and that includes spending time getting to know potential Russian partners or counterparties (before you sign the deal), remain key.

# 3.10

# The Automotive Industry

*Alexander Bragin, Martin Harutunian and Natalia Abrosimova, Deloitte & Touche*

## *Introduction*

According to industry experts, the number of cars in Russia has increased by approximately 50 per cent over the last five years, reaching 20.1 million vehicles in 2001. This translates into car ownership of 141 vehicles per 1000 people, which is significantly lower than in emerging markets with comparable per capita GDP levels. In the period 1998–2001, car output grew in line with GDP, but sales rose much faster due to second-hand imports (31 per cent of car sales in 2001). Car prices in Russia are still relatively low, and most consumers are highly price sensitive.

Another special feature of the Russian automotive market is the significant proportion of obsolete vehicles. According to the GAI (Russian road police), 47 per cent of cars in Russia are 5–10 years old, and 21 per cent are older than 10 years. These figures suggest that a significant latent replacement demand exists, which is likely to materialize as disposable incomes grow. Industry analysts believe that the main beneficiaries of this trend will be domestic producers, as market research indicates that 78 per cent of consumers prefer, and can afford to buy, new or second-hand Russian cars. Analysts predict car ownership to continue rising at a rate of 4–5 per cent per annum until 2005, due to the growth of disposable incomes, increased availability of bank loan programmes and a government protectionist policy.

In July 2002, the Russian Government approved 'The Concept for Automotive Industry Development', an eight-year programme designed to upgrade the Russian car sector. The Government's objective is to encourage foreign car-makers to set up domestic production facilities during the transitional period, and give domestic producers time to focus on improving quality. Meanwhile, tariffs on new cars will go up and stay at an increased level for five years. Only in 2010 will tariffs come down again, in compliance with the requirements of the WTO.

While relatively slow in breaking from its central planned past, the vast majority (90 per cent by some estimates) of Russian automotive manufacturers have now been privatized. The private companies have begun to benefit from an expanding middle class and an improvement in management methods, objectives and protectionist policies. They are also becoming the main acquisition targets of FIGs (Financial Industrial Groups) and metals companies flush with cash from export sales. We see these trends continuing and accelerating as the Russian economy continues its expansion.

In theory, Soviet manufacturing had virtually 100 per cent vertical integration due to central planning, and the Russian automotive sector continues that trend. Major original equipment manufacturers (OEMs) often achieve over 80 per cent internal content, which is significantly higher than their Western European and North American counterparts. Prior to the financial crisis of 1998, several OEMs began importing 'high-tech' components such as drive trains. The economic hardships placed on Russian consumers made these imports cost prohibitive. Component manufacturers have recently begun to penetrate these companies again but this time with a Russian flavour and with Russian cost structures.

Internal content is not the only legacy from the Soviet period. Many manufacturers, both OEMs and component manufacturers, have been weaned off large military contracts due to the reduction in military spending. The internal and external secretiveness demanded of military contractors remains the norm even after the need has diminished or disappeared completely. Liquidity issues have forced the continuance of barter. By bartering finished vehicles, many of the OEMs have created confusion in their own back yard by making suppliers chase the same sales they wish to exploit themselves. The most daunting problem, however, may be the easiest to fix – the lack of financial transparency. This lack of transparency in the industry has made Western investors hesitant to place significant capital at risk and has made Russian investors demand high returns for their investment. In most cases, investments have been made for strategic reasons rather than based purely on financial returns.

The automotive sector is dominated by three large OEMs:

Volgski Automobile Plant (AvtoVAZ), Gorky Automobile Plant (GAZ) and Ural Automobile Plant (UAZ). KaMAZ dominates the heavy truck sector while Pavlov Autobus Plant (PAZ) is the leading manufacturer of buses. Recent production statistics reported by the State Statistics Committee show that in the most lucrative sector, personal automobiles, AvtoVAZ has begun to solidify its current market dominance. As Russia's largest car producer, it accounted for 75 per cent of domestic car output and 47 per cent of the Russian market in 2001, leaving its two main competitors, GAZ and UAZ, behind. Its new joint venture with General Motors, which started production of the Chevrolet-Niva in September 2002, will launch a new generation of Nivas that may very well provide its market dominance for the next generation, unless unforeseen creativity is exhibited by its competitors.

## *The Russian 'Big Three'*

*AvtoVAZ*

The personal car market is dominated by the Volgski Automobile Plant (AvtoVAZ) with its popular and virtually omnipresent Lada brand name. The history of AvtoVAZ dates back some 30 years to when it was developed with Fiat. The plant was built as a high volume manufacturer of passenger cars, and currently has an annual capacity of 750,000 units. The financial crisis of 1998 put used foreign cars 'out-of-reach' financially for most Russians who returned to the brand they knew and could afford. The challenge now facing AvtoVAZ is to maintain their market leadership position as the Russian economy rebounds on solid GDP growth and imports become economically viable for its core customer base. As discussed above, the new generation Lada (Chevrolet-Niva) may provide the success needed domestically and even provide export revenues due to its relative advantage in technology and cost. Because AvtoVAZ is also one of the few Russian OEMs with foreign production (FSU and Latin America), an export-ready product can be fully exploited.

*GAZ*

GAZ is Russia's second-largest automotive producer, producing large passenger cars, light and medium trucks, and minibuses. With a new management team and a new model, the Volga 3111, GAZ will prove a viable competitor in the personal car market. Volga joins Aeroflot and Borjomi in having the highest brand recognition in Russia; figuratively speaking the Coca Cola of the market.

To add to this strength, it dominates the light commercial vehicle (LCV) sector with the Gazelle, which has a load capacity of 1.5 metric tonnes. Lack of competition and low costs have made it a best seller with Russian enterprises and entrepreneurs.

*UAZ*

While UAZ is by far the smallest of the Big Three, its desire for modernization and Western cooperation may bode well for its future. However, its position in the market is relatively weak, as most of its products have not benefited from investments in design enhancements. Mainly a producer of LCVs and minivans, the 3160 and 3162 sport utility vehicles may provide the impetus it needs to become a stronger competitor. Severstal, a metallurgical behemoth, recently acquired a controlling stake in UAZ. New strategic investors, imported Swiss and German equipment, and a relatively good corporate structure make UAZ the company to watch.

## Recent trends

There are two significant trends currently affecting the auto manufacturing industry in Russia; the shift from 'screw-driver assembly' to full local production of joint ventures with foreign industry giants, and the increased attention these companies are receiving from domestic investors.

*Major FDI projects*

The most highly touted recent event to alter the status quo is General Motors' joint venture with AvtoVAZ. GM, AvtoVAZ and the European Bank of Reconstruction and Development signed a general agreement, setting up a joint venture in June 2001. Under the deal, AvtoVAZ provides the facilities, equipment and know-how while GM mainly contributes cash and some equipment. GM and AvtoVAZ each receive a 41.5 per cent stake worth US$ 99.1 million each, while EBRD owns the remaining 17 per cent of stock, worth US$ 40 million. The bank provides an additional US$ 90 million in loans. The joint venture started production of the Chevrolet-Niva in September 2002. The enterprise plans to produce 456 cars by the end of 2002 and increase its output to 35,000 cars next year. It is intended that 75,000 cars be produced by 2005. The joint venture will assemble components produced by AvtoVAZ and other local producers.

Ford Motor Company opened a US$ 150 million assembly plant in Vsevolozhsk near St Petersburg in July 2002 and started the production of Ford Focus cars. The company reduced the original price it charged in Russia for its European-produced Ford Focus by almost 21 per cent, creating a strong competitive advantage by offering its consumers an attractive price–quality combination.

According to the Business Communication Agency, Avtotor, a Russian company, which assembles BMW and Kia cars in the Kaliningrad region, plans to start assembling the Polish Autosan in October–November 2002. The Taganrog Automotive Plant (TagAz) assembles the Hyundai Accent and Citroën Berlingo under a licence agreement. Renault is expected to decide by the end of 2002 whether to go ahead with a US$ 246 million investment to build an assembly plant in Moscow. Renault previously assembled its Megane model locally through Avtoframos, a joint venture with the Moscow Government, but abandoned the project after the 1998 financial crisis.

*Consolidation*

Consolidation has begun in the industry driven by cash-rich investors, hungry to invest the profits from their primary businesses. Siberian Aluminum (SibAl) has been the most active, acquiring a controlling stake in PAZ and a blocking stake (over 25 per cent) in GAZ. It reportedly owns controlling stakes in Likinsky Autobus Plant (LiAZ) and several component suppliers to the industry, focusing mainly in high value components such as engines. Severstal, another metals giant, has acquired a controlling stake in UAZ. In almost all instances the new owners took immediate action to restructure the acquired companies by reducing debts, improving procurement and distribution, and eliminating barter schemes.

## *The future*

Perhaps the most significant effect on the auto manufacturing industry will come not from Russia directly, but from domestic laws in reaction to EU legislation. EU regulators recently passed legislation regarding what are commonly known as ‘end-of-life vehicles’. Under EU guidance, individual EU countries must pass legislation that will require auto manufacturers to accept ‘end-of-life vehicles’ from consumers and ensure that a minimum portion of the vehicle’s components are recycled. European manufacturers are only beginning to address the issues this creates, but there is much concern that Russia, along with other Eastern European countries, could become a dumping ground for high volumes of used cars. As the used car market has an effect on both the price and quantity of new car sales, low-cost imports of used cars would have a dramatic effect on Russia's domestic production. Several factions within the Government have begun to discuss raising import duties on older used cars to prevent this from occurring. Their decisions will be critical to the short-term health of the industry.

According to Brunswick UBS Warburg's analysis of consumer preferences, disposable income and the prices of Russian and imported cars, the Russian car market will probably be unable to support the large-scale production of Western passenger cars in the medium term, unless a significant portion of raw materials and components are sourced domestically. The ability of domestic component producers to satisfy this demand in terms of reliability, quality and safety standards remains in doubt. Moreover, Russia's vast territory, coupled with a lower income level in the regions, may impede the expansion of dealership networks and service centers by Western carmakers. The most viable strategy for Western producers willing to reduce the risks of independent entrance to the Russian market is to acquire large established automotive companies offering some competitive advantages such as better assets, efficient operations, a low cost base, a niche product and export potential. Industry analysts particularly favour the low-price light truck and bus sectors given their higher growth potential.

# 3.11

# Plastics Industry Equipment

*Marina Kamayeva, US Commercial Service, St Petersburg, Russia*

## *Introduction*

Russian production companies are in urgent need of re-equipping their facilities, and many of them have already begun to do so. The 1998 financial crisis resulted in a considerable increase in import prices and, at the same time, motivated domestic producers to expand their output and product ranges. Similarly, the main assets of the major plastics processing facilities have depreciated during the past decade: 65 per cent of equipment is obsolete and 60 per cent of current facilities have been in operation for more than 15 years.

Russia's plastics processing sector has been restructured over the past 4–5 years, and this process is continuing. As with many other domestic manufacturing sectors, large companies have been divided into smaller private entities that are now more specialized in their range of products. In 1990, there were about 1,000 large companies in the country involved in the production of plastic products. Now this number exceeds 1,000 in North West Russia alone and continues to grow.

Domestic machinery producers manufacture extruders for sheet production, polyethylene film production machines, machinery for small diameter pipe and hose production, polymer waste processing machines, and extrusion lines for various plastic products. Equipment that is currently 100 per cent imported includes: large machines for the production of round and flat films, pipes of large diameter and size, and thick sheets; large-sized moulding machines; equipment for the production of laminated combined materials; printing equipment; and various auxiliary equipment. On the whole, imports dominate Russia's market for plastics processing equipment and are led by Germany and Italy. Recently, machinery suppliers from China, Korea and other Asian countries have aggressively penetrated the market with their low-cost equipment. Due to the price factor, which is a very important competitive tool in the plastics sector, they are now strong competitors to US machinery suppliers, along with traditional exporters from Europe.

## *Market highlights*

In 1999, most Russian production industries, including the plastics industry, responded to the rouble devaluation. By July 2001, annual production growth rates in the chemical industry were 30 per cent higher than during the previous two years. After the 1998 recession, market demand for plastics processing equipment increased in 1999–2000. Fast development of the domestic food processing industry in Russia, which grew by 30–35 per cent in these two years, stimulated the packaging industry. That had a strong impact on the market for plastics processing equipment. Other industrial sectors, such as production of household products, furniture, electric devices and auto parts, also demonstrated a great demand for moulding machinery.

In 2001, production volumes continued to grow and, during the first six months of the year (compared with January–June of 2000), they increased by 8 per cent for polyethylenes, by 20 per cent for polypropylene, by 17 per cent for polystyrene and its co-polymers, by 5 per cent for PVC (polyvynilchloride), and by over 20 per cent for glass-fibre plastics. According to Kortes Information Analytical Centre (Moscow), this tendency will continue in the near future.

According to estimations published in the 'Plastic Materials' magazine, the Russian plastics industry currently produces 250,000–300,000 kinds of plastic goods, excluding pipes, sheets, and films. Production of such a large range of products, which is annually adjusted and innovated by 20–25 per cent, requires individual tooling and equipment with a wide range of sizes and technical specifications.

Production of plastics processing machinery in Russia has traditionally lagged behind other machine-building sectors, such as metalworking. The domestic production of tools and moulds is extremely obsolete. Consequently, manufactured equipment is not able to compete with advanced foreign technologies. Russian-made machinery is less reliable and productive, it does not provide a sufficient range of sizes and types of finished goods and it takes a very long time to develop a new model. Other problems cited include a lack of public-sector investment (indirect as well as direct), the fact that the domestic private sector is not investing in equipment production (preferring shorter-term investments), and the fact that unique machines producing a wide range of film and pipes require serious and time-consuming development. Domestic manufacturers of equipment for the plastics industry are not therefore able to meet the demands of the local plastics industry. Due to a lack of investment in currently operating facilities, two primary trends in the development in this equipment sector are obtaining licences for the production of new types of machinery and purchasing production factories on a turnkey basis abroad.

There are currently only about 10 companies in Russia making equipment for the production of polymers that manufacture a range of equipment according to up-to-date standards. However, in general, these facilities find it difficult to compete with Western manufacturers in terms of design and technology, range of products, and efficiency and productivity of the equipment they produce due to the low quality of steel and process controls that they employ. Neither are their terms of production and delivery typically acceptable. The chief competitive factor that the best domestic manufacturers of polymer machines enjoy is their low price.

Currently, the quality of the polymer machines that are installed and in operation at the plastics production facilities in Russia varies widely. Up to 60 per cent are obsolete models, with the operation period of time exceeding 10 years (30 per cent of these have never been under capital maintenance or modernized). Around 20–25 per cent are relatively modern models, with the operation period of time from 5 to 10 years (about 25 per cent of these were purchased second hand). Another 15–20 per cent are modern models of the last generation (imported). Consequently, the market development of end polymer products depends on replacing obsolete equipment with up-to-date efficient machinery and modernizing and developing the existing domestic machinery-building facilities. This situation results in the fact that the market is open for investments in machinery production and, at the same time, there already exists a strong competition among foreign suppliers of equipment seeking to fill in the urgent demand for modern machinery.

*Imports*

Currently, imports dominate the market for plastics processing equipment in Russia. In 1999, domestic manufacturers imported equipment worth US$ 156 million; in 2000 it was US$ 112 million.

The total dollar value of the imported equipment was somewhat reduced last year mainly because Asian suppliers offering less expensive equipment have recently become more active.

The most important niche in the market for plastics processing equipment is the subsector for injection moulders. Similar to the whole market for plastics processing equipment, imports dominate this subsector. Imports represent 90–95 per cent of all supplies of new injection machines. The major share of the second-hand injection moulding machines also belongs to imported products. In the 1980s, the former USSR's production companies installed more than 3,000 injection moulding machines annually. The largest suppliers of moulding equipment at that time were Ukraine, Yugoslavia ('Belmatic'), Germany ('KuAsy'), Italy ('BM Biraghi'), and India ('DGR Windsor'). However, later, in the 1990s, rapid development of extrusion and blow moulding technologies decreased the share of injection moulding equipment in the total production, and by the mid-1990s, the market for injection moulders had declined and did not exceed 300 machines per year. The projected market size for injection moulders for 2002–2003 is 600–700 units per year. According to the State Customs Committee of the Russian Federation, in 1999, the country imported 455 injection moulders (US$ 53 million worth), which was 34 per cent of the total imports of plastics processing equipment. In 2000, the total dollar value of imported injection machinery reduced to US$ 23 million, due to a greater demand for cheaper equipment. However, in terms of quantities, imports of injection moulders in 2000 increased by 9 per cent and was about 500 units.

Price will remain a decisive factor in the near future, especially for small and medium-sized companies, and will define, to a large extent, the market both for new and used equipment. In fact, used equipment does constitute an important characteristic of the Russian market for moulding equipment. According to various estimations, 60–70 per cent of the currently purchased equipment is second-hand.

Currently, leasing of moulders in Russia is not a very well-developed field. However, due to a lack of domestic companies' turnover capital, high bank credit rates and a high risk of direct investments, leasing may soon be an important instrument for the market of moulding machines and modernization of the domestic plastic manufacturers' assets.

*Best prospects*
The Russian polymer industry has an immediate demand for the following types of equipment:

- complete equipment lines for the production of plastic films (vacuum, laminated of 3, 7–9 layers, stretch, bi-axis oriented, and large-sized), sheets (up to 3,000 mm wide, laminated, made of foam thermoplastic materials, etc.), a wide range of pipes (gas, sewage, hot and cold water supply, medical pipes of small and super-small diameters), packing bags, profiles (including foam profiles, sidings, and sandwich-type and cell-type profiles);
- compression machines and granulation extruders for the production of painting super-concentrates, thermoplastic materials and their composites;
- extruders;
- blow moulders for the production of large-volume goods;
- injection moulders, including for the production of large-sized goods;
- hydraulic press machines;
- rotation moulding machines (for large-sized products such as containers, barrels, etc.);
- vacuum and pneumatic moulding machines;
- a wide range of auxiliary equipment (robots, hydrotooling, process controls, mixers, grinders, dryers, thermostats, etc.);
- blow moulders for the production of PET bottles, barrels, containers, etc;
- high-quality equipment for the production of small-sized packaging (cans, medical packaging, cosmetic packaging);
- thermo-vacuum moulding machines for the production of disposable kitchenware, and various packaging goods;
- equipment for the production of plastic bags (especially for sugar, cement, etc.);
- equipment for secondary processing of polymer products;
- equipment for flexographic printing.

The demand for these types of machinery is based on the growing requirements of the packaging industry and the polymer secondary processing industry.

## *End user analysis*

Russia's plastics processing sector has been restructured during the past 4–5 years, and this process continues. As in many other production sectors in Russia, large and very large companies have been divided into smaller private entities that are now more specialized in their range of products. In 1990, there were about 1,000 large companies in Russia involved in the manufacture of plastic products. By 1998, this number reached 2,000 and it continues to grow. In the St Petersburg and Leningrad region alone, there are now 500 such firms; and there are more than 1,000 companies in all of North West Russia. Each of these firms needs specific equipment to meet their requirements. Moreover, in 1995, 10 per cent of large chemical and oil companies produced up to 80 per cent of Russia's plastic product: their share has since been considerably reduced.

Currently, polyethylene manufacturers in Russia use 80 per cent of all the production capacities. Around 75 per cent of the production facilities for each product type of polypropylene and PCV (polychlorevynil) are now in operation. According to estimates by the Research Centre of Technical and Economic Research in Moscow, in 2000, Russia's production volume of synthetic rubbers and plastics was 2.5 million tonnes, 300,000 tonnes more than in 1999.

Of Russia's range of large-area plastics production, about 30 per cent is polyethylene, 8 per cent is polypropylene, over 16 per cent is polyvynilchloride, about 6 per cent is polystyrene, and the rest (about 40 per cent) is other large-area polymers. On the whole, in 2001, the Russian plastics processing industry produced about 250,000 tonnes of consumer goods made of plastics, over 50,000 tonnes of thermoplastic pipes and parts, 150,000 tonnes of films and 15,000 tonnes of sheets.

A relatively new sector is plastic packaging and pre-forms for the bottling of water, oils, juices and other liquids. Domestic production of polymer packaging is quickly developing. Before 1995, all flexible packaging materials, including polymer single-layer and laminated films, were imported into Russia. According to customs statistics, flexible materials represented 20 per cent of the total imports of packaging products in 1997. Starting in 1998, Russian plastics

**Table 3.11.1** Exports and imports of plastic materials in Russia, 2000

| *Products* | *Exports* | *Imports* |
|---|---|---|
| Plastics and synthetic rubbers | 700,000 tonnes (10% of the market) | 600,000 tonnes (12% of the market) |
| Goods made of plastics | 50,000 tonnes (2% of the market) | 500,000 tonnes (20% of the market) |

manufacturers started domestic production of flexible packaging materials and currently meet the market demand for these materials. The best-known domestic manufacturers of polymer films are LOMO-Plast (St Petersburg) and Slavich Ltd (Moscow).

Private firms starting new plastics processing facilities to produce packaging materials for the food processing industry normally equip their facilities with foreign-made machinery. For example, Plastic JSC and Uspensk Plastic Plant (Moscow region) use German technology to manufacture co-extrusion film for food and medical product packaging and Multiflex (Moscow) uses foreign-made equipment to produce a wide range of packaging polymer films.

Due to the after-crisis revival of the construction sector in Russia, a number of companies focus on the production of building materials and completing parts. Domestic manufacturers began production of plastic pipes for cold and hot water supply and plastic window and doorframes. All of the equipment is either imported from Germany, France and Austria, or is supplied by European companies as a part of their joint venture agreements with domestic manufacturers.

Due to the availability of funds in the Russian gas industry, a number of Gazprom's subsidiaries are creating new plastic production facilities. Gazprom purchases imported equipment to manufacture polymer products, for example: water supply pipes in Obninsk; plastic furniture, films, plastic bags and disposable cookware in the Kaluga region; pipes for gas distribution systems in Tyumen; and polymer insulation materials in Yekaterinburg, etc.

## Competitive analysis

*Domestic production*

Domestic production capability of moulding machines includes a dozen major plants. These companies have good production and research potential and are capable of manufacturing complicated machinery. However, mass production of moulding machines at these plants is currently not performed, and the range of equipment produced is very limited. These companies manufacture moulding machines by order only, and the cost of this production is relatively high. The list of Russia's major manufacturers of plastics processing equipment includes:

- Zlatoust Machinebuilding Plant (Zlatoust) manufactures production lines and units for the production of plastic film, 1,500 mm wide, of low-density polyethylene; laminated and super-thin films; polystyrene and polypropylene rolled materials; polystyrene sheets; extrusion heads; and tools.

- Kuzpolymermach (Kuznetsk, Penza region) manufactures production lines and machines for the production of polymer net, pipes of various diameters, heat supply pipes according to European standards, high-pressure hoses, stretch film 500–1,000 mm wide, extruders, rotary printing equipment, and drying and grinding machines.
- Arsenal Industrii (Moscow) produces extrusion lines for the production of plastic film 600–1,200 mm wide of low- and high-density polyethylene, polypropylene films, polystyrene sheets 0.02–0.7 mm wide, laminated profiles, and completing parts such as extrusion and calibrating heads, grinders, granulators, etc.
- Krasmachzavod (Krasnoyarsk) produces injection moulding machines.
- Salyut-S (Ulyanovsk) produces injection moulding machines (jointly with Merkum Company, Germany).
- Koshkin Design Bureau of Automatic Equipment (Klimovsk, Moscow region) produces automatic rotary conveyor lines for injection moulding of thermoplastic parts, and automatic and semi-automatic machinery for the production of polyethylene-reftolate products of 0.33–5 litres.
- BSV-PAK (St Petersburg) produces pneumatic moulding machines (completing parts are supplied by FESTO, Germany) for the production of various rolled film materials (polystyrene, polypropylene, and polychlorevynil).
- Prodvizhenie Group (Moscow) produces PET-bottle production equipment (productivity is 600 bottles per hour), and extrusion blow moulding machines for the production of polypropylene and polyethylene bottles and moulds.
- Taurakas-Fenix (St Petersburg) produces vacuum moulding machines for the production of disposable cookware.
- TSNILPolymerContainer (Orenburg) manufactures production equipment for polyethylene bags, and extrusion lines for the production of polyethylene parts.
- Savma (Kirmi, Tver region) produces injection moulders for single- or two-colour thermoplastic materials.
- Mayak-93 (Moscow) manufactures production lines for metal-polymer pipes, with external diameters from $^{12}/_{16}$ to $^{26}/_{32}$ mm.

*Foreign competitors*
Traditional European exporters of injection moulding machines to Russia are Germany, Italy and Austria. A considerable import market share also belongs to Canadian and US exporters of highly productive equipment. Recently, Asian suppliers from Taiwan, South Korea and China have begun to aggressively expand their presence in the Russian market for injection machines, and they may very soon become strong competitors to European suppliers. The main competitive factor of the injection machinery imported from Asia is its relatively low price. Germany leads the import market for blow moulding machines. For the period 1998–2000, the dollar value of the German exports was US$ 37 million, which is 42 per cent of total imports of moulding machines. In terms of quantity, Germany is also the leader of the import market and in 2000, 30 per cent of all moulding machines imported to Russia were German. Another large supplier of moulding machines is Italy, which has a 12 per cent import market share. Due to their aggressive marketing strategy, Korean manufacturers of moulders have considerably increased their presence in the Russian market for the past three years. While there were practically no supplies from Korea before 1997, the dollar value of imports from Korea reached US$ 1 million in 2000. The number of Korean-made moulders in 2000 exceeded the number of Italian-made machines. Chinese suppliers have also been very active recently and were the fourth in terms of the quantity of moulding machines supplied to the Russian market in 2000. The dollar value of imports from China is not large, due to the cheaper cost of Chinese equipment. Exporters from Taiwan recently demonstrated a lot of export activity in this sector too, and, according to market experts, the market share of Taiwan could reach 15–20 per cent in several years.

According to experts, about 50 Western manufacturers of moulding equipment are currently selling to the Russian market. Out of these, about 30 companies sell their equipment on a regular basis. However, only a few foreign manufacturers have a well-established distribution system and provide high levels of service and engineering maintenance.

The largest exporter of moulding machines to Russia from newly independent states is Ukraine. According to the State Customs Committee, Ukraine exported 126 machines, worth over US$ 1 million, in 2000. Ukraine's market share is 25 per cent in quantity and 5 per cent in dollar value. The Termoplastavtomat production company in Khmelnitsk, Ukraine, was the largest moulding equipment manufacturer in the Soviet Union and it still has well-established relations with the Russian plastics industry. Used injection moulders are supplied both from the domestic sources and from Germany, Poland, Ukraine and other countries.

## Market access

There are no insurmountable obstacles to entering the Russian market for plastics processing equipment. However, the competitive factor presents a substantial challenge to foreign companies wishing to establish themselves in Russia. Import duties on imported plastics processing equipment are currently 5 per cent of the total cost, including the contract price and transportation costs. The buyer also pays the customs fee equal to 0.15 per cent of the contract price and transportation costs. VAT is 20 per cent.

Moulding equipment needs to be certified by the Russian certification agencies. According to the list of products that require obligatory certification, moulding equipment is included in the category of casting and pressing equipment. The imported moulding equipment must meet the safety and conformity terms according to the Russian State Standards Committee, which correspond to ISO 9000, 14000, EN 45012–98, and other international regulations. Both an exporter and an importer, or a domestic distributor, may apply for domestic certification of new-to-market moulding equipment. Major certification centres in Russia that are accredited by Russia's State Standards Committee to certify plastics processing equipment include:

- Standartelectro-Certlit (Moscow) – certification of equipment (this agency has provided certificates of conformity for such companies as Demag Kunststofftechnik GmbH (Germany), Klockner Wilhelmsburger GmbH (Germany), Termoplastavtomat (Ukraine), and others);
- All-Russia Research Institute of the Russian Federation's State Standards Committee (Moscow) – certification of machinery;
- Test-St Petersburg, a testing and certification agency (St Petersburg) – certification of quality systems;
- Accept Bureau of International Certification (St Petersburg) – certification of quality management systems;
- Research Institute of Certification – certification of quality systems and industrial equipment.

There are no regulations regarding certification of tooling and moulds in Russia. To certify finished goods made of plastics and their parts, an applicant may contact a number of agencies, such as PolymerTrest (St Petersburg), The Testing Centre for Glass Plastics (Moscow), the Technologia Testing Centre (Obninsk), VNIIDrev Testing Centre (Kaluga), the department of medical appliances, VNIIMedtechnika (Moscow), and others.

*For more information please visit www.buyusa.gov/russia/en*

# 3.12

# Russian Healthcare – at a Crossroads

*Maria G Vlasova, Ph.D., Co-chair of the Healthcare Committee, American Chamber of Commerce in Russia*

## Introduction

Attempting to assess the potential of the Russian healthcare sector is not a trivial matter. There are compelling reasons both for and against entering the Russian market. This article reviews the attractiveness of the Russian healthcare sector, discusses the need for healthcare reform and key barriers to investment, and concludes with an outlook on, and recommendations for, improving the investment climate in the sector.

## Attractiveness of the Russian healthcare sector

In order to decide whether to get involved in the Russian healthcare market, one needs to answer two key questions. Firstly, what is the size of the market? (ie how many potential patients are there in this country?) The answer to this question gives an initial idea of the market's investment potential. Secondly, what is the level of healthcare spending? The answer to this second question would determine the feasibility of return on investment. The market could be large, but there could be no money to pay for medical needs. Let us look at these two questions with regard to Russian healthcare.

*Size of the market*

Perhaps the single most attractive feature of the Russian healthcare market is the enormous size of the consumer pool. Russia is the sixth largest country in the world in terms of population and as such is an attractive market.

Another positive characteristic is that the Russian healthcare sector has been relatively developed. It excels in a range of health infrastructure indicators. Russia has traditionally had a large number of trained physicians (4.1 per 1,000 people in 1990–1997), available hospital beds (11.7 per 1,000 people in 1990–1997) and registered high levels of both inpatient admissions (22 per cent of population in 1990–1997) and outpatient visits per capita (8 visits in 1990–1997) compared to both developing and developed countries (see Tables 3.12.1 and 3.12.2).

Finally, there is a high demand for healthcare services given the alarming state of Russia's demographics and its health situation. The Russian population is declining because of a very high mortality rate, which is 1.7 times higher than the birth rate. Since 1992, the number of deaths exceeded the number of births. The mortality rate has a growth tendency: 15.6 incidents per 1,000 people in 2001 compared to 15.4 incidents per 1,000 people in 2000. Russia shows a high mortality rate in children under five years old at 19.2 per 1,000 live births compared to 7.5 in high-income countries (while the situation in developing countries overall is much worse, with the mortality rate in the same group at 84.7).

The highest contributor to deaths in Russia is blood circulation diseases. In this category, ischemic heart disease (47 per cent) and

**Table 3.12.1** Comparative health infrastructure, Russia, 2001

| *Indicators (per 1,000 people)* | *Russia* | *Developing countries* | *High-income countries* |
|---|---|---|---|
| Physicians | 4.2 | 1.1 | 2.8 |
| Hospital beds | 12.7 | 7.4 | |

*Source:* World Bank, World Development Indicators, 2001

**Table 3.12.2** Comparative health indicators, Russia, 1990–1997

| *Country* | *Physicians (per 1000 people)* | *Outpatient visits (per capita)* | *Hospital beds (per 1000 people)* | *Inpatient admissions rate (per cent of population)* |
|---|---|---|---|---|
| Russia | 4.1 | 8 | 11.7 | 22 |
| China | 1.6 | _ | 2.4 | 4 |
| Mexico | 1.3 | 2 | 1.2 | 6 |
| Brazil | 1.4 | 2 | 3.0 | _ |
| Poland | 2.3 | 6 | 6.2 | 14 |
| Indonesia | 0.2 | _ | 0.7 | – |
| United States | 2.5 | 6 | 4.1 | 12 |

*Source:* World Bank, World Development Indicators, 1999 cardio-vascular disease (37.7 per cent) are the main two causes of death. Poisoning and accidents constitute the second main category of cause of death.

Life expectancy in Russia is very low and currently stands at 65 years, compared to 70 years in 1988. Life expectancy for men is just 58 years. These alarming statistics clearly indicate a demand for the provision of healthcare services. However, is this demand solvent?

*Level of spending*

For providers of healthcare services and manufacturers of medical devices, medical equipment and pharmaceuticals, the answer to the second question, on the level of healthcare spending, provides a more definitive basis for a decision about market entry and the size of investment. The level of healthcare expenditure is typically assessed in terms of percentage of GDP, as well as expenditure per capita. The current level of healthcare spending in Russia is very low. It has been kept at 4–4.6 per cent of GDP, based on government estimates, or about US$ 95–US$ 133 per capita in 2001. This is more than 20 times less than in developed countries and clearly insufficient to cover the actual cost of healthcare.

Even in purchasing power parity terms, the level of healthcare expenditure in Russia is two–three times lower than in Mexico, Brazil or Poland.

**Table 3.12.3** Comparative health spending indicators, 2001

| *Indicators (per 1,000 people)* | *Russia* | *Developing countries* | *High-income countries* |
|---|---|---|---|
| Health expenditure (per capita, US$) | 133.0 | 78.3 | 2,906.6 |
| Health expenditures total (per cent of GDP) | 4.6 | 5.6 | 10.9 |

*Source:* World Bank, World Development Indicators, 2001

**Table 3.12.4**. Comparative health spending, PPP, 1999

| *Country* | *Health expenditure (per capita, PPP US$)* |
|---|---|
| Russia | 262 |
| China | 90 |
| Mexico | 361 |
| Brazil | 382 |
| Poland | 297 |
| Indonesia | 54 |

*Source:* World Bank, World Development Indicators, 1999

Although these spending numbers are quite discouraging for anyone considering the Russian healthcare market, one has to consider that these figures reflect a decade of transition in Russia with two financial crises and a major dislocation in society. Given the current progress that Russia is making in normalizing government finances as well as overall stability, it is hard to envisage a scenario where these numbers will not grow.

However, the major stumbling block is the direction of healthcare spending. The little funds available for healthcare today are often wrongly spent, which poses a risk that new funds may be misspent as well unless systemic healthcare reform is implemented.

## *Need for healthcare reform*

Based on the current low levels of healthcare spending, in a static world, the Russian market would not be an attractive place to invest. The key question for investors is whether the healthcare sector will be reformed, and what those specific reforms will look like.

While the Russian president and the Russian Government have been successful in a number of reform areas, such as taxation and land reform, and have begun tackling pension reform and banking reform, the concept of healthcare reform has barely surfaced in government discussions. Yet it stands to be one of the most decisive areas for the future of this country.

Will there be healthcare reform? The answer to this question is yes. Although Russian healthcare is the most unreformed sector of the Russian economy, there are such grave consequences to doing nothing that the political establishment will be forced into action sooner or later. To assess the speed of the potential reforms, it is useful to understand the gravity of the problems. These fall into three key categories: population decline; the old healthcare financing model; a lack of effective diagnostics and treatments.

### *Population decline*

The first major consequence of this unreformed healthcare sector is that Russia today is facing what many view as a demographic catastrophe. The population has been steadily on the decline since the early 1990s and has been decreasing at an annual rate of 0.4 per cent. If the current trend persists, the Russian population will dwindle from the current 144 million to just 100 million based on a moderate forecast by the Russian State Statistics Committee. The committee's more radical forecast predicts an even steeper decline to some 80 million. Yet the demographic situation and an urgent need to address this problem seem to have been driven to the back of the political and economic agenda. Healthcare has to become a government priority in order to reverse this alarming trend.

*The old healthcare financing model*

The next major problem is an outdated model for financing healthcare costs, which means that investment in healthcare is minimal. Although there is an old Soviet healthcare model that guarantees free healthcare service, in reality that guarantee is on such a low level that it leaves most people without any kind of effective treatment.

In Russia, healthcare expenditures have been traditionally characterized by the predominance of public funding over private. Due to shortages and delays in budgetary funding, a number of social problems with public healthcare exist: Russians have to queue up for medical consultation, medical treatments and operations for a period of weeks or even months; high-efficacy drugs are not affordable; medical equipment is mostly dated; and payment of wages to public health professionals is small and sometimes delayed for several months.

The Soviet Constitution recognized the right of all citizens to healthcare and stipulated universal access to medical treatments. During the transition to a market economy, the right for free and equal access to healthcare has been preserved in the new Russian Constitution and a system of obligatory medical insurance has been implemented, but the lack of funds for healthcare is still a major problem. Recently, the Government has recognized that it cannot afford and does not in reality provide free healthcare services to all of the population, yet the creation of a new model for healthcare insurance is still in its infancy.

*A lack of effective diagnostics and treatments*

The third key problem is that healthcare in Russia is still heavily biased towards hospital care rather than prevention. The possibilities for diagnostics, both in terms of trained personnel and equipment, are scarce.

Healthcare awareness, while rising, is still low. The prescription and use of ineffective medicines, and application of outdated medical treatments are widespread. Consumers frequently choose no treatment until a disease becomes unbearable, or practise self-prescription of old and dated drugs, some of them with strong side effects. When people do ask for check-ups with a doctor, the disease has often become more acute and difficult to treat.

The supply of modern pharmaceuticals, medical devices and medical equipment is not commensurate with public needs. The recovering growth of the Russian pharmaceutical market has been tarnished this year by the introduction of a 10 per cent VAT on medicines which has effectively meant an increase of over 10 per cent in prices for the end user, the Government and the consumers. Importation of modern medical equipment and medical devices in a number of instances has been hindered by cumbersome customs clearance procedures and changing tax regimes.

Overall, it is quite apparent that the problems of the current healthcare system are so intimately intertwined with high mortality rates and low life expectancy that something will have to be done. The most important step in driving reform would be to implement a complete overhaul of existing healthcare regulations to reduce existing strong administrative barriers to trade and investment.

## *Barriers to trade and investment*

Non-transparent and inefficient regulations plague the Russian healthcare sector and serve as a barrier for market access and a deterrent to investment. Many vital regulatory norms are not harmonized with internationally recommended guidelines.

Substantial barriers that hinder the provision of modern medicines, medical devices and equipment in Russia have been highlighted in the '*Administrative and Regulatory Barriers in the Russian Healthcare*' report put together by the Healthcare Committee of the American Chamber of Commerce in Russia in April 2002. Highlights from this report have been presented to presidents Bush and Putin as part of the Russian–US Business Dialogue report during the Moscow summit in May 2002 and most recently were discussed in November 2002 by the first session of the Russian–US Interagency Cooperation Council on Reducing Technical Barriers in the Healthcare Sector.

These barriers can be largely grouped into three categories: a) registration, certification and licensing; b) intellectual property rights (IPR) enforcement; c) market access, including preferential treatment, customs controls, public governance and financing issues.

*a) Registration, certification and licensing*

An example from this area is the lack of recognition of the registration of pharmaceuticals and medical devices in the United States and European Union. There are outdated requirements by the Ministry of Health to perform local clinical trials in Russia to re-establish the efficacy and safety of pharmaceuticals and medical devices already approved by the FDA and the European Union. The United States–Russia Memorandum of Understanding on Pharmaceuticals has expired and the Ministry of Health declined to renew it on existing terms, requesting reciprocity that is not feasible or realistic in the short term.

Most recently, in April 2002, the Russian Government imposed a new administrative burden on legitimate producers of medicines, adding another obstacle to the import of pharmaceuticals. The Government enacted a new decree that will require mandatory conformity assessment for all medicines imported into or produced in Russia. Industry has been strongly opposed to the introduction of this new certification requirement and has been able to obtain a postponement of its introduction from 1 September 2002 to 1 December 2002. However, government officials have not yet taken a firm position on abolishing this new administrative barrier, suggesting it may help to protect Russian consumers against counterfeits. They disregard the fact that conformity certification of medicines: is not in line with the requirements of the Russian Law on Medicines; contradicts the overall policy of the Russian Government aimed at the significant reduction of obligatory certification requirements; runs contrary to international regulatory practices for medicines; and will lead to increased prices for medicines, thus placing this burden on Russian consumers and the budget. Moreover, rather than hampering counterfeiters, the new mandatory conformity certification system for medicines will create opportunities for more counterfeit medicines to be placed on the market while legal medicines will be hindered.

Another example can be drawn from the area of medical devices and equipment, where there is still no law today that can govern this sector. Instead, there are various ministerial regulations that often overlap and create double requirements in the area of registration and certification. The Ministry of Health makes a distinction between medical devices and medical equipment depending on the materials that make up a medical item. In practice, there are no clear criteria to determine whether the item belongs to the category of medical equipment or medical devices. However, depending on the assigned category, a different rate of VAT is applied and a different period of validity for the registration certificate is assigned (either 5 or 10 years).

*b) IPR enforcement*

In the area of IPR, insufficient protection of confidentiality for registration files handed over to the Ministry of Health and a lack of data exclusivity create a problem for registering innovative medicines in Russia. TRIPS Article 39.3 requires WTO members to protect against 'unfair commercial use' of undisclosed test data and other confidential protected data submitted to governments as a condition for obtaining marketing approval for pharmaceutical products utilizing new chemical entities. In most industrialized countries, a special legal regime ensures that no person may, without the permission of the person who generated and originally submitted costly and confidential data, rely on such undisclosed and proprietary test data in support of an application for product approval, not only while the originator's marketing application is pending before the regulatory authorities, but also for a specified period from the marketing approval date of the original product. Russian legislation does not provide for effective protection against unfair commercial use of confidential data submitted by pharmaceutical companies seeking marketing authorization.

Another concern is posed by the widespread counterfeiting of pharmaceuticals and the possibility of registering trademarks that abuse the rights of original trademark holders. There is still no legal basis and there are virtually no effective mechanisms or resources that would enable government agencies to find, withdraw and destroy counterfeit medicines. Cases that are being opened against companies suspected of selling counterfeits are often closed for lack of evidence.

*c) Market access*

In the area of market access, a frequent problem is that of the enforcement of procedures by the customs authorities, who apply them in an arbitrary manner often compromising the original goal of the procedure. As a result, customs officers who are not knowledgeable in the medical goods industry make their own judgments on the application of duties on medicines, medical equipment and medical devices, often questioning the medical purpose of these goods and ignoring accompanying documentation from the Ministry of Health.

Another problem is posed by discriminatory regulations. Federal and regional authorities often impose preferential treatment for the purchase of goods. Local manufacturers also continue to benefit from preferential treatment with regard to registration procedures and fees. The Ministry of Health requires international pharmaceutical companies that want to conduct multi-centre studies in Russia to insure patients only via Russian insurance companies, thus restricting their opportunity to work with those global insurance partners that are known to and approved by their corporate headquarters.

In this regulatory environment, the business choice to operate or not to operate in Russia is primarily dependent on an individual company's corporate decision and as such, in many instances, companies have remained undaunted by the 1998 financial crisis.

Some key success factors from the experience of international companies in Russia include: the recruitment and development of strong local staff; corporate support and commitment from the head office; reliable local partner relations; working relationships with local authorities, opinion leaders and experts; knowledge and use of local laws, formal and informal rules; and the flexibility and ability to anticipate and meet the changing needs of customers and consumers.

## *Outlook and recommendations*

There is an urgent need for the Russian Government to make healthcare a priority. The Russian Government should improve market access for healthcare providers and establish a transparent and efficient system of healthcare governance and financing based on proven international standards. More importantly, Russia has no choice. There is little hope to address the challenges posed by the gloomy demographic and healthcare trends Russia faces today without immediate action.

A concerted programme on reducing administrative barriers in the healthcare sector should be implemented to make Russia an attractive place for investment. Specifically:

- Russia has to harmonize its registration and certification regulations with international norms, and implement procedures to authorize competent authorities and foreign testing laboratories.
- In the area of IPR, Russia needs to ensure a consistent approach to IPR protection and undertake specific measures to enforce IPR and penalize counterfeiters.
- In the area of market access, Russia should lift restrictions on foreigners in the insurance sector, eliminate discriminatory or

non-objective criteria in decision-making, and launch a comprehensive reform of medical insurance.

These steps appear more likely today with Russia's firm intention to proceed with WTO accession. In doing so, Russia would facilitate international cooperation, particularly in the form of R&D, marketing and business know-how, and would open itself for additional investment to finance its significant healthcare needs.

# 3.13

# The Medical Equipment Market

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### *Introduction*

In the last three years, the Russian medical equipment and devices market has shown substantial and steady growth with annual rates exceeding 10 per cent. The total volume of the market is estimated at approximately US$1 billion. By comparison, the US medical equipment and supplies market in 2000 was 75 times larger and amounted to US$75 billion, of which US$10 billion was reinvested in R&D.

The 1998 economic crisis served as a spur for a number of Russian medical equipment and device manufacturers which, having taken advantage of the sharp rise in prices of imported medical equipment, managed to increase their share of the total market. However, in general, imported medical equipment and supplies still play a predominant role and currently account for 71 per cent of the total market. Despite the fact that the quality of some of the medical devices and supplies produced in Russia is highly improved, it does not, in many cases, match up to comparable foreign products. Foreign-made high-end medical equipment, sophisticated medical devices and many medical products and supplies, in the majority of cases, do not have Russian analogues. Leading suppliers of medical equipment to the Russian market are Germany, the United States, Japan, Italy and France.

Russia still does not have a developed legislative basis for the medical device and equipment market. The Law on Medical Equipment and Devices has been discussed in the Duma in recent years but has not yet been adopted. There are a number of regulatory documents, including orders and instructions issued by the Ministry of Health of the Russian Federation, regulating different aspects of the licensing, registration and certification processes. However, the state registration, licensing and certification processes need to be reformed to become less lengthy and expensive and more transparent.

## Market highlights and best prospects

*Market profile*

According to estimates from medical industry analysts, the total volume of the Russian medical equipment market in 2001 was about US$1 billion. The annual growth rates of the total market for the last three years have exceeded 10 per cent. Medical industry analysts predict steady growth of the market for the next five years.

In the last three years, due to a sharp increase in price for imported goods as a result of the 1998 economic crisis, domestic manufacturers were able to increase their share in a number of market segments, including electrocardiographs, patient monitors, X-ray devices, anaesthesia and pulmonary equipment, ultrasound scanners, and devices and instruments for endoscopy and laparoscopy, as well as electrosurgical instruments. Stronger positions were also achieved in home healthcare products, orthopaedic devices, ophthalmic products, test kits, polymeric and glass medical products, disposable syringes, and other disposables.

Generally, Russia has a strong manufacturing basis in the areas of traditional and mass medical equipment and devices, including such groups as traditional diagnostic X-ray equipment, MRI tomographs, anaesthesia and pulmonary equipment, electrocardiographs, blood pressure meters, eye pressure meters, endoscopes, electrosurgical and surgical instruments, artificial blood circulation devices, physiotherapy devices, altitude chambers, clinical laboratory instruments, and sterilizers. However, in medical equipment industry subsectors that have a large R&D component, and which use innovative, sophisticated technologies and automation, Russia is behind the majority of developed countries. Such industry subsectors include high-end ultrasound equipment, computer and X-ray tomographs, angiography systems, devices for array therapy, resuscitation equipment, functional diagnostic equipment, implants and prostheses, robotics clinical laboratory systems for express microanalysis, telemedicine complexes, hospital equipment and supplies, operating room equipment, many types of home healthcare equipment and supplies, infusion and transfusion sets, and IV solutions.

Domestic manufacturers supply only 29 per cent of the market while imports account for the remaining 71 per cent. In 2001, domestic production was growing slower (at 6.4 per cent) than imports (15 per cent).

Much of the medical equipment used in Russian hospitals and clinics is very old. Eighty per cent of the medical equipment is worn-out and has surpassed the established term of safe and efficient functioning and needs replacing. The major obstacle to renovation of the existing medical equipment is lack of financing on federal and regional levels. Servicing of medical equipment forms a significant market: the demand for quality maintenance and repair services is high. The main organization in the area of servicing medical equipment is the Russian Association of Enterprises Specializing in Sales and Repair of Medical Equipment (RAPMED).

Russian statistical and regulatory bodies use specific classifications of medical goods that are different from classifications adopted by Western countries. According to the Ministry of Industry, Science and Technology, from the point of view of production, all medical goods are divided into five major categories:

- medical apparatus (41 per cent of the total market);
- medical equipment (12 per cent);
- medical instruments (24 per cent);
- medical goods made of polymeric and glass materials (6 per cent);
- medical purpose supplies (19 per cent).

In fact, the first three categories basically include different medical equipment and devices while the last two cover medical supplies.

For registration purposes the Ministry of Health divides all medical goods into two major categories: ‘medical equipment’ and ‘medical items’, depending on the materials that make up the product. In fact, the medical equipment group unites all types of equipment, apparatus, instruments and devices while the medical items category includes basic supplies. In practice, there is no clear criterion to determine whether an item belongs to the medical equipment category or the medical items category. However, the assigned category is very important for suppliers and distributors of medical products as it affects the validity of the registration certificate. For the medical equipment category the validity is 10 years, while for supplies the registration certificate is only valid for five years. In addition, depending on the category, different VAT rates are applicable: for the majority of equipment there is no VAT at all, while for medical supplies it is 10 per cent.

The existing division of medical equipment into two groups causes much confusion at customs points. The customs authorities refer to the duration of the registration certificate issued by the Ministry of Health as a basis for determining the VAT rate. If the duration of the certificate is 10 years, the product is VAT-exempt, but if it is five years, then they impose a 10 per cent VAT rate. Because the distinction between medical equipment and supplies that the Ministry of Health uses when it registers the product is not clear-cut, some medical equipment items may be registered as supplies. However, the same products are considered medical equipment according to the General Classification Codes (OKP system), a classification system used by the Russian Government. They are also included in the list of vitally important medical equipment issued by the Russian Government and exempt from VAT. Despite these facts the customs authorities often question whether the medical product is subject to VAT exemption or not. The division of medical equipment into two categories used by the Ministry of Health results in misunderstanding, arbitrary decisions and delays at customs points. The State Customs Committee, instead of enforcing the Ministry of Health regulations, interprets the classification of devices in its own fashion without consulting the Ministry and, in many cases, to the detriment of the importer.

Classification systems used in Russia contribute to the fact that the whole regulatory system is less adapted to the general trend towards harmonization of global approaches to regulating the medical device industry and make it more difficult for the Russian medical equipment industry to be more involved in international trade.

*Best sales prospects*

Many types of medical equipment and devices are either not produced domestically or are inferior to Western analogues. The best sales prospects in the Russian medical equipment, devices and supplies market include:

- high-end ultrasound equipment;
- computer and X-ray homographs;
- angiography systems;
- devices for array therapy;
- resuscitation equipment;
- functional diagnostic equipment;
- implants and prostheses;
- robotics clinical laboratory systems for express microanalysis;

- telemedicine complexes;
- hospital equipment and supplies;
- operating room equipment;
- many types of home healthcare equipment and supplies;
- infusion and transfusion sets;
- IV solutions.

## *Competitive analysis*

*Domestic production*

In Russia, medical equipment and devices are manufactured by 1,275 enterprises, including 32 specialized medical device enterprises controlling 60 per cent of the total output, 300 defence plants, and 900 small and medium-sized enterprises with federal licences for the production of medical equipment and devices. A significant portion of high-tech medical equipment is still developed and produced at defence enterprises, which have traditionally had access to advanced technologies. According to medical industry expert estimates, domestic manufacturers supply only 29 per cent of the total medical equipment market.

Domestic production of medical equipment and supplies has been growing steadily in recent years. The most dynamic subsectors included devices for endoscopy and laparoscopy, electrosurgical instruments, polymeric and glass medical products, disposable syringes, and other disposable products.

In the last two to three years, because of the change in demand from imported to domestically produced medical devices and supplies, as well as some types of equipment, a significant number of Russian enterprises managed to strengthen their positions and increase their share in the market. Russia started to develop and launch into production new types of advanced medical equipment and instruments used in diagnostics and treatment of serious diseases. Such equipment and devices include:

- artificial kidney devices with non-kidney blood clean-up (Avangard Electromedical Plant, Sarov);
- medical monitors (Triton Elektronika Ltd, Yekaterinburg; NIOTK Scientific and Production Fund, Izhevsk; VNIIMP-VITA Closed Joint Stock Company, Moscow; Avangard Open Joint Stock Company, Saratov; Elips Open Joint Stock Company, Istra, Moscow region);
- electrocardiographs (Gelpik Open Joint Stock Company, Moscow);

- endoscopic and laparoscopic equipment (Efa Open Joint Stock Company; Optimed; Aksioma Open Joint Stock Company; Azimut Open Joint Stock Company; LOMO Open Joint Stock Company, St Petersburg; Endomedium Scientific and Production Fund; PPP Ltd, Kazan; Fotek Open Joint Stock Company, Yekaterinburg);
- MRI tomographs (AZ Scientific and Production Fund, Moscow);
- digital X-ray equipment for fluorographical tests and TB diagnostics (Spektr AP Ltd; Gelpik Ltd; Medical Radiology Scientific and Research Centre; Mosremtgen Open Joint Stock Company, Moscow);
- ultrasound medical scanners (Izomed Ltd);
- Microtron M-01 automated medical complex for array therapy (Scientific and Research Institute, named after Gerzen);
- cardiostimulators and cardioelectrodes (Elistim Cardio; VNIIMP-VITA Closed Joint Stock Company, Moscow);
- hearing aids (Audit-RR in Fryazino, Moscow region; Rythm Ltd in Moscow);
- haemoglobin meters for diabetes (Tekhnomedica, Moscow);
- sterilizers (TZMOI, Tyumen; Kasimovsky Priborny Zavod);
- operating room lights (Uralsky OMZ, Yekaterinburg; VNIIMP-VITA ZAO, Moscow);
- instruments for microsurgery and ophthalmology (GUP VNIPIMI and Kazansky MIZ, Kazan);
- hip implants (GUP VNIPIMI, Kazan).

These recently developed medical equipment and devices are successfully competing with their Western equivalents within the country due to high technical standards and relatively low prices. Generally only 25–30 per cent of medical equipment produced in Russia can compete internationally. Domestically made medical equipment and devices are from three to five times less expensive than similar Western equipment, although they are sometimes inferior in terms of design, efficiency and after-sales service.

*Imports*

Imported medical equipment and devices mostly come from Germany (46 per cent) and the United States (22 per cent), followed by Japan (9 per cent), Italy (5 per cent) and France (5 per cent). In general, imports dropped substantially after the 1998 economic crisis. In 2000, imports were US$ 470 million, while in 1998 they were US$ 952 million. The 2001 figure of US$ 750 million is still less than the level achieved before the crisis.

Inadequate protection of intellectual property rights (IPR) is a critical deterrent to foreign investment in Russia and has been a burning issue for foreign businesses operating in Russia in the last few years. On the highest level, Russia has signalled its commitment to protecting IPR. Russia is a signatory to several international agreements that require compliance to international standards of IPR law and enforcement. Russia has also made significant progress in introducing laws to ensure IPR compliance. However, IPR law enforcement is still rather poor. Especially low is the ability of Rospatent, the Russian Patent Office, to annul illegal registrations of trademarks and to implement court and Anti-Monopoly Ministry decisions.

Foreign trademark recognition and protection is an important issue. Trademark infringement and counterfeiting are everyday facts that remain a challenge to brand holders and trademark owners in Russia. Foreign companies are recommended to register their trademarks in Russia. Otherwise, in case of counterfeiting they are most likely to lose court cases because the Russian courts would be very protective of the trademarks registered in Russia, even though they may belong to foreign manufacturers and be registered illegally in the name of Russian agents or distributors.

## End-user analysis

The main end-users of medical equipment are clinics and hospitals. In the majority of cases they can only afford to buy supplies and small medical devices using their own finances. Purchases of expensive medical equipment are usually financed by federal and local health budgets. The role of the Federal Government in financing medical equipment purchases has diminished significantly while the role of local governments has increased. Local governments are attempting to modernize hospitals and clinics, located in their territories and subordinate to the local governments, by equipping those hospitals with modern equipment. Local healthcare authorities arrange a number of tenders to buy medical equipment and supplies for their territorial hospitals and clinics. The list of tenders is published on a regular basis in a special magazine called *Competitive Bids*. Foreign companies are allowed to take part only in some of the tenders either directly or through their local distributors. Funding of equipment and services in private clinics is self-financed.

## *Market access*

*Import climate*

Current Russian legislation is not a significant barrier to importers of medical equipment. Customs duties for the majority of these products are currently 5 per cent. Exceptions concern IV sets, and disposable syringes for which customs duties are 15 per cent. Jacuzzi baths and medical thermometers are subject to 10 per cent customs duty.

On 17 January 2002, as part of the newly pronounced Tax Code, the Russian Government issued a Resolution on the List of Approved Important and Vitally Essential Medical Equipment that is VAT-exempt while being sold in Russia. The list includes the following medical equipment, instruments and devices:

- mechanical instruments;
- piercing instruments;
- cutting instruments and beating instruments with sharp cutting edges;
- pressing back instruments;
- probing and bougieuraging instruments;
- medical kits;
- trauma instruments;
- functional diagnostics and measuring instruments;
- instruments and devices for diagnostics, except measuring ones;
- glasses;
- biological microscopes;
- medical radiology devices;
- devices and instruments for clinical laboratory research;
- devices and instruments for anaesthesia;
- devices for organ functions and systems replacement;
- platform medical scales;
- table medical scales
- sanitary and hygienic equipment;
- patient lifting and moving equipment;
- equipment for doctors' offices, wards, clinical laboratories and pharmacies.

The above list does not include syringes, sunglasses, optical glass frames and lenses, and protection masks and glasses.

### *Registration of medical equipment and devices*

According to Russian law, all medical equipment and supplies should be registered with the Russian Ministry of Health before being imported, sold and used in the territory of the Russian Federation. In June 2000, the Ministry of Health issued a new Instruction #237 on Registration Procedures for Foreign-Made Medical Equipment and Devices, which introduced several changes into the registration process. Under the new instruction, the registration procedure is governed and controlled by the Department of State Control over Quality, Efficiency, and Safety of Drugs and Medical Equipment of the Ministry of Health. The Department issues the registration certificate and enters the registered device or equipment with the State Registrar.

The registration procedure involves submission of the necessary documents and the conducting of tests on the actual equipment or device, including technical, toxicology, hygienic, clinical and other tests. The Department works with a number of expert commissions, which assist in deciding which tests should be assigned and where they should be conducted. These tests are performed by a number of expert institutes, laboratories and clinics. These organizations do not have clearly defined, standard operating procedures, which makes the process lengthy and biased. The fees for the trials are, in most of the cases, negotiated on a case by case basis. As for the duration of tests, they often last more than the three months set by Instruction #237. Under the new rules, the applicant must submit more documents, and the product should undergo more tests than before. Most of the documents should be translated into Russian, which leads to additional expenses for the manufacturer or its authorized Russian representative and a longer registration process.

The following are the documents necessary for registration of a medical device or equipment:

1. **A letter from the manufacturer (on a company letterhead) proving its intent to register a product/products.** The letter should be in the manufacturer's native language with a Russian translation.
2. **An application (on the applicant's letterhead) for registration (or re-registration) of a medical device/equipment.** The application should contain, if necessary, an exact and complete description of the product's components. The application letter should either be in Russian or followed by a Russian translation.

3. **A Power of Attorney to an authorized representative to conduct registration.** It should be given to a legal entity (addressed to the head of the company) and notarized in compliance with the current legislation. The Power of Attorney should be legalized in the country of the manufacturer's origin.
4. **Information on the medical device/equipment**. It should contain a brief description of its usage as well as information on when it was developed/launched into production and which world markets it is supplied to. The document should be prepared in Russian or have a Russian translation.
5. **A picture of the medical device/equipment (not smaller than 130 x 180 mm).** The picture should reflect the appearance of the device and its components.
6. **Illustrative advertising materials.** Can be provided in a foreign language.
7. **Documents on registration of a medical device/equipment in the country of origin.**
8. **Documents on the registration of a product in the country of origin as a measurement device.**
9. **National or international documents confirming the conformity of medical devices/equipment to the requirements of national and international normative documents and describing the manufacturing process.**
10. **Manufacturer's operational manual in Russian.**

Documents in for items 7, 8 and 9 should be originals or notarized copies with an Apostille.

The Ministry of Health identifies the testing centres that can perform technical and toxicology tests for a specific product. It works with approximately 30 such centres. The leading testing institution approved by the Ministry of Health to conduct technical tests is VNIIMP Scientific and Research Institute. Hygienic assessment is implemented by the Department of State Sanitary and Epidemiological Surveillance of the Ministry of Health, which, based on the results of the tests, issues conclusions on the hygiene of the equipment.

In order to undergo tests, a sample of the equipment or device must be imported into Russia. To be able to bring a piece of equipment or device into the country, the manufacturer or its authorized representative should apply to the Ministry of Health and get the appropriate permission to present at the customs point.

According to Instruction #237 the registration process should take not more than a week after the receipt of the results of all necessary tests. Registration is conducted at costs ranging from US$ 200 to US$ 1,000s. For some types of equipment, devices and supplies there is a fixed tariff while for others the tariff is calculated at a rate of 5 per cent of the cost. For expensive, complex equipment such as anaesthetic and respiratory devices, artificial blood circulation devices, accelerators, computer tomographs, laser equipment, dental complexes, laboratory analysers, hospital equipment, etc., registration fees might be considerable. For disposable systems and smaller devices like test kits, sutures, or surgical gloves, certification costs vary from US$ 200 to US$ 2,500. Registration certificates must be renewed every two years. The term for registration certificates for medical equipment, devices, instruments, plants and medical furniture is 10 years, while for medical supplies, including reagents and disposable items, it is five years. Re-registration is necessary in the following cases:

- expiry of the registration certificate;
- change of the manufacturer's name;
- change of the product name;
- change of the manufacturer of the registered product.

The Ministry of Health generally does not have a tradition of posting new official regulatory documents on its Web site in a timely manner. The new Web site of the Department of State Control over Quality, Efficiency, and Safety of Drugs and Medical Equipment has been developed to fill in this gap (www.regmed.ru).

## *Certification of medical equipment*

Imported medical equipment and devices should conform to Russian quality and safety standards, which are set by Gosstandart. Gosstandart ensures product conformity through a system of end product certifications. Gosstandart also maintains and updates annually lists of goods and services that are subject to obligatory certification and metrological control in Russia, and authorizes a number of national and international testing institutes to issue safety and quality certificates (GOST R certificates). Safety certificates requested by manufacturers of medical devices are usually issued for long terms – up to three years, while certificates sought by distributors or trading companies are usually issued for shorter terms – up to one year. The testing company will require that the distributor or trading firm submit their contract with the manufacturer. Certificates of conformity issued by Gosstandart can have a large coverage, including not only groups and shipments of similar products produced by one manufacturer in compliance with the same requirements, but also components and spare parts used for maintenance and repair. In such cases, one certificate is sufficient to have the right to sell both products and spare parts in Russia.

Medical equipment and devices are actually subject to mandatory double certification by the Ministry of Health and Gosstandart. In order to get the above certificates the company has to conduct product tests, which are practically identical, twice. There is no agreement between the Ministry of Health and Gosstandart on recognition by the Standards Committee of technical tests conducted by the Ministry of Health. The GOST R certification system exits separately from the Ministry of Health registration procedure. The two systems duplicate each other, thus creating additional costs. In addition, serial certification of medical equipment and devices involves the travel of Russian standards experts to foreign production sites, the cost of which is borne by the manufacturer.

The GOST R certificate and the registration certificate are the two major documents checked by the customs authorities when goods cross the country's borders. The customs points are still not equipped with the electronic version of the State Registrar of Medicines that they can refer to in conflict situations. Sometimes, the customs authorities question certificates issued by the Ministry of Health and Gosstandart which causes unnecessary costs and delays in customs clearance.

*For more information please visit www.buyusa.gov/russia/en*

# 3.14

# Gold Mining

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## *Introduction*

After almost a decade of depression, the gold mining industry in Russia has started to recover and develop. Two-thirds of Russian gold mining is located in Eastern Siberia and the Russian Far East (RFE). Recent statistics show a steady growth in gold production in the RFE. Considerable wear-and-tear of existing equipment and the necessity of introducing new technologies, combined with better access to financial resources provide improved business opportunities for international companies, particularly for exporters of mining machinery.

## *Industry overview*

*History in brief*

Gold mining has always been one of the traditional and leading sectors in the Russian Far East (RFE) economy. In Soviet times, the gold mining industry was a total government monopoly, although in the 1970s the first non-government enterprises (the so-called artels) started to appear. But the Government was still strictly regulating the extraction, production and sale of precious metals.

Before Russia started to go through reforms in the 1990s, the largest gold mining enterprise in the RFE was SeveroVostokZoloto, which covered Kolyma (Magadan), Chukotka and Kamchatka, and produced up to 50 tonnes annually. Yakutzoloto from Sakha (Yakutiya) manufactured up to 30 tonnes per year, Amurzoloto (Amur oblast) manufactured 10–12 tonnes and Primorzoloto (Primorskiy and Kahabrovskiy Krais, and Sakhalin) produced 8–10 tonnes.

Outdated labour-intensive technologies and equipment, low capital investments, turmoil in the Russian economy, and the drop in gold prices on the world market nearly resulted in the industry's collapse in the mid-1990s.

The reserves of gold in Western Russia are almost exhausted. But in Eastern Russia (Eastern Siberia and the RFE) there are at least five deposits with estimated reserves of over 300 tonnes, as well as a number of 100–300 tonne deposits.

During 1991–1997, after Russia began shifting to a market economy and the Government stopped supporting the gold mining industry, most of the companies were experiencing considerable financial constraints. In addition to this, the seasonal nature of gold production made it very challenging to find financial resources in advance to prepare for the mining season. Banks were very reluctant to provide loans and credit lines, and the interest rates were outrageous – 40–45 per cent in hard currency. The Government support through Komdragmet (The State Committee for Precious Stones) was more nominal than practical. Most of the gold miners found themselves in financial deadlock – they kept on borrowing money to pay back loans and interest.

*Current situation*

The situation in the industry improved in 1998. Like many other export-oriented industries, gold mining has benefited from Russia's August 1998 financial crisis. The rouble devaluation and resulting decreased production costs improved the development of the RFE's gold mining industry. Most of the loans taken by gold miners were in roubles, so with the rouble's collapse and with the world market prices starting to stabilize, the gold mining companies were able to pay them back very easily. As a result, the profitability of the gold mining industry and its attractiveness for the investors had grown significantly by the end of 1998.

Also, in March 1998, the Russian Government adopted a Federal Law on Precious Metals and Gemstones, and in December 1998 Decree #1419 was issued. These new regulations released the Government's strict control over the gold industry and gold exports. Commercial banks started to export Russian gold. For the first time in the history of modern Russia, its gold market became a part of the global market. Another positive factor was that gold prices on the world market started to stabilize and increase after a two-decade period of decreases (in 1998 the lowest price for 20 years was registered).

Extraction of placer gold (which is a seasonal process) always significantly prevailed over mining of ore gold. Over the last few years, however, the structure of the gold mining industry has been changing, and has started to shift from extraction of placer gold to lode gold mining. Lode gold mining is much more attractive to investors because it is not seasonal and is economically more effective.

Investors and banks started to finance gold mining projects and companies more extensively. Sberbank became an absolute leader in providing loans and credit lines to gold miners. Together with Vneshtorgbank, it accounts for almost 50 per cent of commercial loans given to the domestic gold miners. Among other banks, the most active were Moscow-based Alfa-Bank, MDM, Zenit, NOMOS-Bank and Menatep, as well as regional and local banks: Dalkombank, Regiobank, Neryungri Bank and Kolyma-Bank. In 2000 the average loan interest rate for gold miners ranged from 15–22 per cent in roubles, and 15–17 per cent in hard currency. Some banks even provided 3–5-year credit lines.

There are some negative factors impeding development of Russia's gold industry. The gold mining enterprises still lack sufficient capital to update equipment and technology as required. The introduction of a 5 per cent customs duty on gold exports in April 1999 disappointed Russian gold producers, as well as commercial banks involved in gold exports. To get around this tax, the Russian gold is now being exported via 'grey routes', ie through countries that are members of the customs union with Russia. The major route is through Belarus (according to the Russian State Customs Committee estimates, during 2001 the great majority of the total commercial banks' exports was made via this former Soviet Republic).

Although the current world trend in the gold mining industry is the merging of smaller gold manufacturers into larger corporations, the rate of small companies and artels in Russia is still very high – about 70 per cent (although they produce only 11 per cent of the total gold output). Such small entities fail to attract investments and are often unable to maintain financial sustainability. But there is already emerging an understanding in the industry of the necessity for amalgamation to better adapt to the existing situation. The latter requires decreasing production costs, introduction of new technologies, and attraction of domestic and foreign investments. Another reason for merging is the on-going shifting from the placer to lode gold production, which needs considerable initial capital investments.

*Recent gold production statistics*

In 2000, Russia produced 143 tonnes of gold, 13.2 per cent more than in 1999. In the first five months of 2001 (before the active season started) the growth was already 13.9 per cent more than in the same period of 2000. In the RFE, the most successful was Sakha Republic (Yakutiya), where gold production increased by 150 per cent. One of the reasons for such impressive growth was the 1-tonne 'golden loan' given to Aldanzoloto by Komdragmet of the Sakha Republic (Committee of Precious Metals, a state agency), and used for purchasing new equipment. Other leading enterprises in Sakha are Bamskaya, Drazhnik, Zolotinka, Zapadnaya, Nirungan, Ingali, Poisk, Zoloto Yinykchana and Zoloto Neryungri.

Annual gold production growth in Chukotka was over 1 tonne in 2000. Among the leaders are Ruda (35 per cent growth in ore gold mining), Chukotka (300 kg increase), Arctica, Polyarnaya, and Shakhtyor. Severniye Rudniye Tekhnologii produced 600 kg versus 80 kg during the previous year. According to the statistics of the Magadan Oblast Administration, the volume of gold produced in 2000 was 30 tonnes, which is 650 kg growth compared to 1999, and the highest results within the last seven years. There was a slight shrinkage in gold production in 2001.

Amur oblast also increased gold production, which reached 11.86 tonnes in 2000. The best results were achieved by Solovyovskiy Priisk (1.8 tonnes), Maya, Vostok-1, Zeya, Rassvet, Dalnyaya, Khergu and Petrovskoye. In the first seven months of 2001 the region produced 5.18 tonnes (1.29 tonnes of lode gold, and 3.89 tonnes of placer gold). This is 7.4 per cent more than in the same period of 2000. By the end of 2001 Amur region was mining about 13 tonnes.

The growth rate of the gold mining industry in Khabarovskiy Krai increased 10 times, and was 35 per cent, compared to 3.5 per cent in 1999. In 2000 Kahabrovskiy Krai was in 6th place among the leading gold mining regions of Russia, and produced 9.2 tonnes of gold. In 2001, growth was estimated at around 9 per cent, and the territory mined over 10 tonnes of gold. Such a dramatic increase was the result of the growth of ore gold mining, which now prevails over placer gold extraction. The largest deposits of ore gold are Monogovershinnoye (mined by the company with the same name, which produced 3 tonnes in 2000), and Ryabinovoye (mined by Amur, which is also one of the largest Russian platinum producers). Other companies with growing production are Vostok, Sever, Zarya, Pribrezhnaya and Ros-DV.

The results in Primorskiy Krai were much less impressive – 460 kg. This was mainly due to the fact that 2000 was the first year for several start-up companies. But in 2001 some growth was expected.

## *Major deposits, projects and key players*

The joint venture Omolonskaya Zolotorudnaya Kompaniya, the second largest gold mining company in Russia, mines the Kubaka lode in North East Magadan. Initially, the 50 per cent share belonged to the US company 'Cyprus Amax', and another 50 per cent was distributed between several local companies (Dukatskiy GOK, Magadanskaya Zolotoserebryannaya Kompaniya, Geometall, Elektrum, and the North-Evenk regional association of Evenk tribes). In 1996, Geometall and Elektrum merged into Geometall Plus, and their mutual share grew up to 28 per cent. Later Cyprus Amax sold its share in the joint venture to the Canadian 'Kinross Gold Co.', while 85.6 per cent of Geometall Plus was acquired by another Canadian firm 'Western Pinnacle'. Now it is a project with major Canadian participation. A total investment of US$ 250 million resulted in extraction of over 50 tonnes of gold since 1997. In 2000 the company mined 13 tonnes of gold.

The Kuranakh gold deposit (about 300 tonnes) in Yakutiya was expected to be mined by Kuranakh Gold Mining Company – a joint venture between the local Aldanzoloto, Sakhazoloto, and Canada's Echo Bay Mines. But now the US company 'Newmont Gold' is in the process of purchasing shares from Echo Bay Mines. The Kuranakh is included in the list of deposits that are to be mined under PSA, but the parties have not yet agreed about the terms and conditions. (Note: the PSA process can be very lengthy, and Echo Bay Mines has been involved in this process for several years.)

The Nezhdaninskoye lode was discovered in 1961 and is located 800 km to the east of Yakutsk (Sakha Republic/Yakutiya). Projected reserves are 95 million tonnes of ore (494 tonnes of gold with the content of 5.1 g per 1 tonne of ore). It is the second largest gold deposit in Russia. In 1996, the Irish Celtic Resources Holding plc together with the Russian companies 'Finansovo-Promyshlennaya Kompaniya' and 'Sakhazloto' formed the joint venture 'Yuzhno-Verkhoyanskaya Mining Company'. But the gold production can start only after the State Duma and the Government adopts the PSA on this deposit. Without a PSA specifying favourable terms for foreign investors, the low initial profitability and delayed returns on investments make this project unattractive.

The Pokrovskoye gold lode is one of the largest in the Amur oblast. It is mined by Pokrovskiy Rudnik company, which became famous throughout Russia for its unique experience of year-round production by the method of glomeroblastic leaching, and mined 1.5 tonnes in 2000. In 2001 the company started to build a new gold extraction plant with annual production capacity of 4 tonnes. The company produced 1.23 tonnes of gold in seven months during 2001. One of the largest deposits in the region 'Bamskoye' (over 150 tonnes of projected reserves) is being exploited by Apsakan company. In 1–2 year's time it plans to produce 2–3 tonnes annually.

The Mayskoye deposit in Chukotka (about 300 tonnes of gold in reserves) has already passed three readings, but was not signed by the President because, according to his advisers, it must go through additional editing to better meet the existing legal requirements. The licence belongs to the Fund of Chukotka's Development, Fund of the Development of the Chukotka's Economy, artel Chukotka, and Chaunskiy Mining-Geological Enterprise. If the PSA is adopted, several international investors are interested in participating in this project.

The Mnogovershinnoye lode is located in the north of Khabarovskiy Krai near the city of Nikolayevsk-on-Amur. Its reserves are 105 tonnes of gold with an average content of 9 g per tonne. Mnogovershinnoye is mined by the Mnogovershinnaya Company. It started development of the lode in 1999, and mined 3 tonnes of gold in 2000. The company was aiming to reach projected annual capacity of 5 tonnes in 2002.

## *Business opportunities*

Much of the local gold mining equipment is outdated, with a high wear-and-tear rate. There is substantial demand for a broad range of machinery for mining both placer and lode gold, as well as ore-dressing and engineering equipment. Owing to political, and then economic, reasons, equipment was rarely imported in the past. Both political and economic changes, as well as growing gold production in the RFE, present business opportunities for foreign exporters of mining equipment. Among the best sales prospects are:

- trucks;
- bulldozers;
- excavators;
- drilling machinery;
- ore-dressing equipment;
- ore-crushing/milling machinery;
- ore-recovering equipment.

*For more information please visit www.buyusa.gov/russia/en*

# 3.15

# The Brewing Industry in the Russian Federation

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## *Market potential*

With per capita beer consumption less than half that of Central Europe, the Russian Federation will remain attractive for investors over the next decade.[1] Demographic patterns show a clear shift from vodka and other spirits to beer among Russian consumers. Industry experts predict that this trend will continue in the near future. Over the past five years, the Russian beer industry has experienced a real boom. Since 1997, the beer market has had an annual growth rate of nearly 20 per cent. For the year ending 31 December 2001, production volumes grew to 62.7 million hectolitres – a 20.4 per cent per cent increase in comparison with the year 2000. However, industry experts expect the market growth to decline to 12–15 per cent in 2002. According to analysts' estimates, in the next five or six years the beer industry will cease to be the most dynamic sector of the food industry, and by 2007 the beer market's annual growth will decline to 5.7 per cent, production output will be approximately 86.6 million hectolitres, and the average Russian will drink 61 litres of beer a year.

## *Demographics and market characteristics*

Young Russian consumers aged 18–35 have shown a clear preference for beer over vodka and other spirits, and this preference continues to strengthen and gain momentum. Brand awareness, once considered as simply a capitalist manifestation and a scourge

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[1] According to industry experts, in 2001 per capita beer consumption in Russia was 42–44 litres, putting the country 30th in the world in terms of beer consumption.

to be avoided, is likely to take hold as these educated consumers become increasingly dependent on brands to ensure consistent and world-class quality. However, industry analysts have noticed that consumers are still eager to explore new brands, and in general brand loyalty is low.

The major market participants are investing heavily in advertising in the hope of developing the brand equity seen by their counterparts in established European, Asian and US markets. The competition is so high that advertising continues all the year round. According to Gallup Ad Fact, in 2001, brewers spent over US$ 400 million on advertising, which accounted almost for a quarter of the Russian advertising market. Advertising has centred on television, radio and, to a lesser extent, print media. A few beer festivals have also sprung up, mainly in the major cities. The St Petersburg and Moscow beer festivals now attract thousands of thirsty loyalists each year. Point-of-sale advertising has begun in bars and restaurants; however, kiosks, which still account for the majority of sales, present their own unique problems.

Geographical trends are also clear. Moscow and St Petersburg have a per capita consumption two times the average of other regions; however, less than one-tenth of the population lives in these two cities. Brewers must not only have a presence in Moscow and St Petersburg, but also coverage over vast regions of Siberia and the Urals to be considered an industry leader. Complicating the coverage issue, however, is the divergence in these two markets.

*The capital cities – Moscow and St Petersburg*

The Moscow and St Petersburg markets are dominated by consumers with higher disposable incomes, who are more concerned with quality and brand, although price still remains a factor. If the economy is able to maintain its healthy growth rate, industry leaders may be able to reap some rewards for the massive investments they have made. However, it is clear that within the capital cities price is less important among the young and affluent, but shows significantly increased sensitivity among the less well off and those consumers over 35. This differs dramatically with the regions. Price is the leading, and some would argue the only, factor in the regions.

*The regions*

For those unfamiliar with the Russian market, the difference between the capital cities and the regions can be mind-boggling to say the least. While nine out of ten Russians live outside the capital cities, wealth is almost inversely related. Most estimates place anywhere from 75 per cent to 90 per cent of the country's wealth in its two historical capitals. While Moscow and St Petersburg have large populations with disposable incomes, vast portions of the population in the regions have little, if any, disposable income. Disposable income tends to be more concentrated in the hands of a very few in the regions when compared to the capital cities.

These regional markets were traditionally served by low quality/low cost manufacturers, not only in the case of beer, but also in that of all consumer goods. Historically, only one brand (if 'beer' can be called a brand) was available. Manufacturing decisions were based entirely on cost reduction implications. Advertising in the regions is difficult due to the lower population density. In addition, brand awareness and loyalty can seem foolish to some people; in present times, beer consumption per capita does not exceed 20 litres in some regions.

The regions have proved to be one of the most difficult issues facing market leaders. While branding, advertising and quality control (areas in which international brewers excel) work in the capital cities, price, price and price are the three leading factors in the regions. Another issue is the sheer size of the regions. Operations in Vladivostok are geographically closer to the capitals of Canada, the United States, Japan and China, than they are to Moscow. Communications and travel logistics present another layer of difficulty when managing these remote regions.

Nevertheless, regional expansion is vital for those market players that wish to gain a leading position in the Russian beer market. Baltic Beverages Holding (BBH) has held its lead in the industry investment volume owing to investments of US$ 150 million to cut product costs and expand the distribution network, which at the end of 2001 included 20 sales divisions, and to build breweries in Khabarovsk and Samara. Moscow's Ochakovo Brewery, one of the leading producers of beer and other beverages in Russia, also increased production by expanding capacity and working in the regions. In November 2001, Ochakovo began producing beer in Krasnodar under a US$ 100 million project. In June 2001 it started building a new brewery in Penza that will cost approximately US$ 83 million, as well as a new US$ 40 million malt house in the Lipetsk region that will produce 100,000 tonnes of malt a year. Tatarstan's leading brewery, Krasny Vostok, a part of the Edelweiss Group, plans to invest US$ 124 million to build breweries in Novosibirsk and Kazan.

According to industry analysts, the Central region attracts the highest share of investments in the beer industry (28.5 per cent), followed by the North Western region (17.9 per cent), the Volga region (15.6 per cent), Siberia (7.2 per cent), the Southern region (6.8 per cent), the Urals (4.5 per cent) and the Far East (2 per cent).

*Competitive situation*

Although there are numerous small and medium-sized brewers, the market share is fairly consolidated. The top three producers, BBH, SUN Interbrew and Ochakovo, have a combined market share of approximately 57 per cent.

It is difficult to state the market share accurately, but reasonable projections are as follows:

**Table 3.15.1** Market share

| *Producer* | *Share (%)* |
|---|---|
| Baltic Beverages Holdings (BBH) | 36.3 |
| SUN Interbrew | 13.5 |
| Ochakovo | 6.8 |
| Edelweiss Group (Krasniy Vostok, Solodov) | 6.3 |
| South African Breweries Ltd (Zolotaya Bochka, Staropramen) | 2.9 |
| Detroit Brewing (PIT, Doctor Diesel) | 2.5 |
| Efes Beverages Group (Efes, Stary Melnik) | 2.0 |
| Others | 27.7 |
| Imports | <2.0 |

*Source:* WPS, The Russian Finance Report

Table 3.15.2 lists the annual production volume of the top three producers as of the end of 2001.

**Table 3.15.3** Annual beer production of the top three producers, 2001

| *Company* | *Production volume (million dal)* | *Year-on-year growth, %* |
|---|---|---|
| Baltic Beverages Holdings | 140 | 30% |
| SUN Interbrew | 129 | 29% |
| Ochakovo | 50 | 30% |

Three major trends that are expected to continue in the industry are further consolidations, mainly through foreign direct investment, struggling imports and regional expansion. Accounting for nearly 15 per cent of the market in 1996, the import segment was dramatically affected by the economic crisis of 1998 as consumers shifted their loyalties to locally produced brands. The economic crisis, coupled with improved branding and quality of local products, drove imports down to less than 2 per cent of the market in 2001. Many of the world's largest brewers have invested in the Russian market to capture market share not only with locally produced international brands, but also by investing in the creation of Russian brands. Other international brewers, without local operations, have licensed the local production of their international brands.

**Table 3.15.3** Brewers and their brands

| *International brewer* | *International and local brands* |
|---|---|
| Baltic Beverages Holdings | Baltica, Don, Yarpivo, Arsenalnoe, others |
| SUN Interbrew | Klinskoe, Stella Artois, Tolstyak, Sibirskaya Corona |
| South African Breweries Ltd. | Zolotaya Bochka, Staropramen, Holsten, Miller |
| Detroit Brewing | PIT, Doctor Diesel |
| Efes Beverages Group | Efes, Stary Melnik |

*Source:* Renaissance Capital, Business Communication Agency

BBH, Sun Interbrew, South African Breweries, Bravo, Carlsberg and Efes have all invested in the Russian market by buying Russian breweries. According to industry experts, by 2001, the Russian beer industry had received approximately US$ 1.5 billion of foreign investments, which accounted for 83 per cent of the total investment into this sector. Foreign capital dominance in the beer industry continues to grow, pushing out small domestic Russian brewers.

## *Branding – the national brand*

As with all consumer goods, branding, once irrelevant in the Russian market, has become critical. As stated above, the value of branding can differ between regions and between consumer groups. The race is on among the leading brewers to develop and promote a strong national brand and achieve national coverage.

Against the background of slowing beer market growth, competition for consumers is becoming fierce. Brewing companies are attempting to preserve their positions with the assistance of new brands, primarily in the premium segment. The number of new brands has grown noticeably: according to ACNielsen, before the beginning of the summer season of 2001, one point of sale had approximately 35 beer brands. By the end of the year it already had 48 brands.

BBH appears to be leading this effort, outspending its competitors in the promotion of its Baltica brand, and the new Medovoe and Party Mix brands. Others have followed suit. While some international brewers have introduced domestically produced international brands, others have sought to further increase the brand awareness of a number of their selected local brands. Sun Interbrew repositioned Sibirskaya Korona from the medium to the premium segment, and Klinskoe to the upper part of the medium segment. Ochakovo Brewery launched its new brand Stolichnoe for the premium segment.

According to ACNielsen, in 2001, the most successful debutants were Solodov (Krasny Vostok), Red Bull (Detroit Brewing Company, better known as PIT), Okhota (Bravo), Gonets (Wimm-Bill-Dann) and Party Mix (BBH). The successful introduction of new brands is partially explained by the fact that Russian consumers tend to be more loyal to new brands rather than to old brands which have been repositioned.

Overall, in the same year, mass-market brands were losing their positions, and premium brands were gaining them. The premium segment was growing rapidly, not only on account of the appearance of new brands, but also as a result of the repositioning of several old mass brands. Analysts predict that by the end of 2002, the share of premium beer will grow by 3 per cent at the expense of the mass and medium segments.

## *Distribution channels*

While traditional bars, pubs, restaurants and food outlets have their own slight deviations in the Russian market, no challenge is greater than that of the perennial Russian kiosk. The equivalent to Western convenience stores, these street corner stands sell the vast majority of the hectolitres consumed in the Russian Federation. Often stocked through middlemen, these independent outlets offer unique quality control issues to brewers intent on maintaining brand loyalty. While the brewing techniques are the primary focus for quality improvements, the brewers can lose all control at the point of sale. Most often, these sales are of the lower quality brands that are selling based on price; however, such issues create obstacles for premium brands to overcome.

## *Focus*

Acquiring local breweries, as opposed to greenfield projects, has driven growth among the largest market players. In most instances, the local authorities and the local management see these local entities as part of the beverage market rather than the beer market. Many local Russian beer companies also bottle local branded soft drinks, mineral water, juice or hard liquor. Maintaining focus can be an issue, as larger brewers must constantly fight to maintain their focus on beer. Some have maintained these side businesses; others have spun them off or have simply stopped producing. As with any acquisition in the Former Soviet Union (FSU), the 'other assets' accompanying the productive assets can present unique challenges to those who do not have a clear mission.

## *Conclusion*

As dynamic as it is lucrative, the Russian beer industry is an exciting market that has only recently been tapped and is still far from being fully exploited. The world's largest brewers are on the ground in Russia and are battling for the hearts of the consumers.

Unlike some other consumer goods industries, there will always be room for small niche players, but this space will continually decrease and the niche must be better defined than simply by geography.

With the challenges of branding, market segmentation and distribution high on CEOs' agendas, winners and losers will begin to emerge over the next three to five years. It is estimated that the top three companies will produce 65 per cent of beer sold by 2010. While local antimonopoly committees will continue to scrutinize each acquisition of local breweries, market forces will prove as efficient as ever and drive the largest forward and the rest out or into niche roles.

# 3.16

# The Russian Insurance Industry

*Ilan Rubin, UFG*

## *Overview*

In this chapter we take a close look at Russia's burgeoning insurance industry. Both the non-life and life sectors are poised for strong growth on the back of rising incomes. Support will come from legislative changes that reflect economic and social pressure from the population to turn rising incomes into organized savings, rather than pressure from the top to mould a civil society.

We expect non-life premiums to grow from what is probably around US$ 3.9 billion in 2001 to US$ 34.8 billion, which implies a CAGR of 14.49 per cent in 2002–2016. Moreover, we expect life premiums to grow from what was around US$ 48 million in 2001 to US$ 36.6 billion in 2016, implying a CAGR of 44.51 per cent in 2002–2016. We value the industry as a whole to be worth US$ 3.3 billion. Moreover, this valuation suggests that recent major acquisitions in the industry have been cheap. We value Troika's 49 per cent stake in Rosgosstrakh, purchased in 2001 for US$ 41 million, at US$ 83 million; and Allianz's 45 per cent stake in ROSNO, purchased in 2001 for US$ 30 million, at US$ 72 million.

We do not consider WTO entry in 2006–2007, which has been much talked about by both the industry and the Russian media in recent years, to be a major problem for insurance. Firstly, entry is not going to be a major threat to the existence of most insurance companies: by the time WTO entry actually happens, the vast majority of unviable companies will already have disappeared. Secondly, the appearance of foreign companies in the life sector will not threaten domestic companies as the life sector does not exist currently and will never be serviced by domestic companies anyway due to the unwillingness of the population to trust Russian private financial institutions with their long-term savings. The experience of Poland, the Czech Republic and Hungary backs up this view. In those countries, the dominant players in life are state and foreign companies, with domestic private companies occupying a very small market share. Thirdly, the appearance of foreign companies in the compulsory sector will not be a major threat to local companies owing to the fact that the leading local companies have already established sound reputations and brand names. Finally, in a rational world, demand for sound savings products would induce the authorities to open up the life sector to foreign suppliers quite apart from WTO entry. This is because rising incomes and the need to turn them into organized savings will create demand for products that only Western insurers will be trusted to provide.

We expect the forces of consolidation to be much in evidence over the next few years. So far, mergers and acquisitions have been few, with the number of companies actually increasing and now having reached around 1,400. However, most of these will prove unviable as competition heats up, with added pressure coming from technocratic changes that will increase capital requirements, force state sector insurance contracts to be awarded on a fair and open tender basis, and see the Government withdrawing from its ownership of insurance companies.

In the long run, we expect the top 20–30 companies to account for around 80 per cent of the market, following international experience. Companies that survive will be those that find Western capital to expand and Western expertise to develop better products and better ways to service their customers.

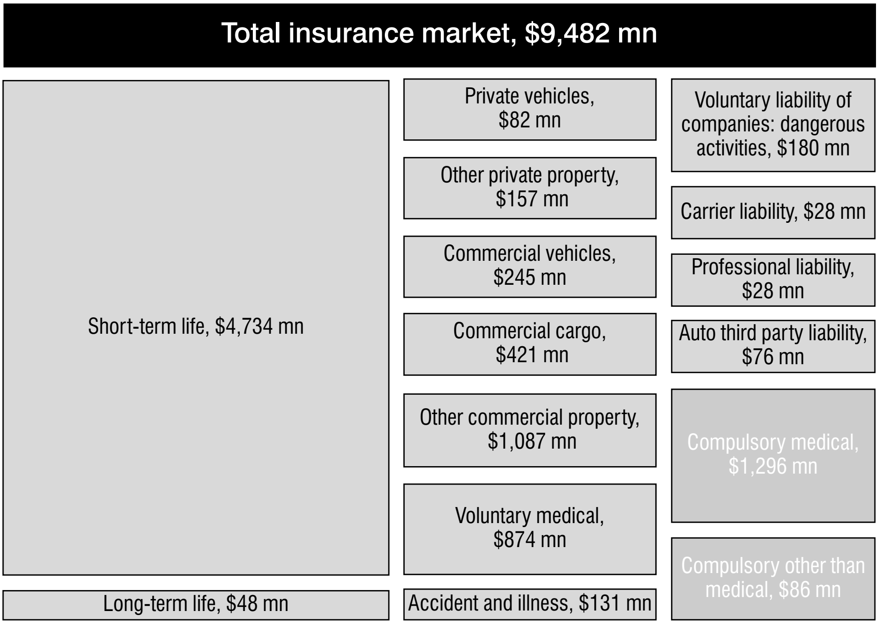
## *Market size and projections*

Russian insurance statistics are exceedingly poor and often misleading. The official returns of Russian insurance companies, as presented to the Insurance Inspectorate of the Ministry of Finance of the Russian Federation, are inflated by 'premiums' earned from three important sources. Firstly, around 99 per cent of 'life insurance' premiums do not represent any insurance at all: rather, they are a vehicle used by many Russian companies as a form of avoiding income taxes – one of the great banes of the Russian economy and society over the last 10 years. There are several variations on these 'grey schemes', but the thematic idea is that companies take out short-term (typically, one- to five-year) life insurance policies for their employees and then pay out tax-exempt annuities from this policy instead of a salary.[1] These schemes have been provided by most major insurance companies in Russia simply due to the demand for this service – it was not illegal as such – but the authorities are now clamping down on this. Particularly, under recent changes to the tax code, effective from 1 January 2003, tax annuities paid within five years of the policy being taken out are subject to income tax – and this is a major factor behind this pseudo insurance soon disappearing from the Russian fiscal and financial services landscape. Indeed, a number of major Russian insurance companies, including Ingosstrakh-Rossia and Alfa-Insurance, have already announced that they are no longer providing this service – clearly, the damage done to the reputation of the industry and specific companies has been one factor in persuading companies to move away from this form of insurance. For example, this 'grey scheme' practice was a major reason why Russian insurance companies were not allowed by Duma deputies to act as pension or fund management companies for the recently-introduced top-up part of the state pension.

Secondly, grey schemes of various sorts exist in the non-life sector as well. Insurance companies are able to offer, for example, property insurance so that these insurance payments are tax-exempt and then the money is repaid through insurance claims for losses that were never incurred – with the insurance companies getting their cut. Further, most of Russia's non-life insurance sector is made up of premiums paid to captives – the pocket insurance companies of major Russian corporates. Gazprom, Lukoil, Yukos, Surgutneftegaz, Interros and UES among others all have their own companies, which, with the exception of Yukos' company Progress Garant and Interros' Soglasie, have shown no signs of being interested in insuring anybody else.

Insuring property with oneself is not insurance – rather, it is a means of writing off expenses in order to avoid taxes on them. However, this practice, unlike the salary schemes, is likely to continue for some time: captive insurance companies exist in many parts of the world today. Moreover, the only pressures from the legislature to change this process have been in the realm of taxation rates – the corporate rate of income tax was reduced from 35 per cent to 24 per cent from 1 January 2002, while the personal income tax rate was reduced from 35 per cent to 13 per cent on 1 January 2001. Compliance is improving but the incentive to save via this insurance still exists.

[1] Rather than being 'life' insurance, this is often, in practice, 'death' insurance, in that, annuities are paid out if the insured person *does not* die. This illustrates the lack of maturity in the sector and its regulatory environment.




*Source:* All-Russian Insurance Union (ARIA), Interfax, Expert, Ministry of Finance, UFG Research
*Note:* in this and subsequent sections of this report, we have converted rouble sums for 2001 at an average exchange rate of Rb 29.17:US$ 1. Some of the sub-segments are estimates based on (incomplete) company statistics presented to ARIA, although we believe that these estimates of total premiums are accurate. The split between short- and long-term life insurance is an estimate based on discussions with insurance sector managers

**Figure 3.16.1** Misleading statistics: officially reported insurance premiums, 2001

There is no doubt that a significant proportion (although not really a quantifiable one) of premiums seen in the salary and captive schemes are no more than paper figures. These premiums are simply written but are not actually paid, in order to save companies the bother of moving cash sums around that they may not necessarily hold in liquid form. Finally, note that the sector is still fairly small in terms of capitalization – around 27 billion roubles (just under US$ 1 billion) at the end of 2001.

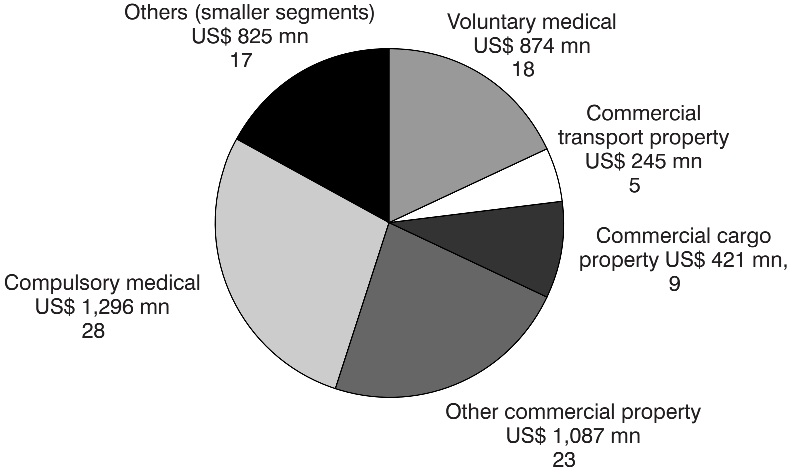
## *A kind of insurance*

Once we strip out short-term life insurance and just retain long-term life insurance, we then get a picture of premiums actually being earned by Russian insurance companies. It would be a mistake to dismiss the huge sums (approaching US$ 4 billion) being paid to captives. First, much of this money, in particular, voluntary medical insurance paid by the corporates on behalf of their employees to their own captives, is used to 'insure' employees to the extent that they do actually have private medical care. Secondly, such payments nevertheless represent a possible insurance market in the future – employees who enjoy the benefits of private health care (albeit primitive by Western standards, with typical membership of a clinic in Moscow costing in the region of just US$ 400 per year, this is far better than relying on state provision) will require this service in the future and, at some point, it may be profitable for Gazprom and the like to outsource this service, all the more so given current shareholder pressure at this and other major corporates for a return to core markets and spinning off of other activities. Indeed, such pressure could be exercised not just in order to encourage the companies to concentrate on core activities, but also to ensure that property, in particular, is genuinely insured. Hence, the figures of 'insured' property provide some hint of what the insurance market in Russia could develop into, from its own currently depressed levels.

Perhaps the biggest assumption that we make in our report is that long-term, ie 'genuine', life insurance makes up around 1 per cent of the current market. This figure is backed up by industry managers we have talked to – both those practising long-term and those practising short-term life insurance. It has frequently been reported in the press that the figure is between 7 per cent and 10 per cent, and these reports have tended to cite governmental sources, in particular, the Ministry of Finance's Insurance Inspectorate. However, our sources (which we consider more reliable) discount such figures; the main reason behind such assertions by the authorities probably lies in the desire to give the impression that they are having at least some success in enticing insurance companies to come out of the shadows, and that there is some substance to this potentially crucial leg of financial intermediation and savings of the population. Note that these governmental sources have not produced any documentary evidence to support their assertions – and no statistics comparing the difference in numbers or value between policies greater than five years and policies less than five years are published.

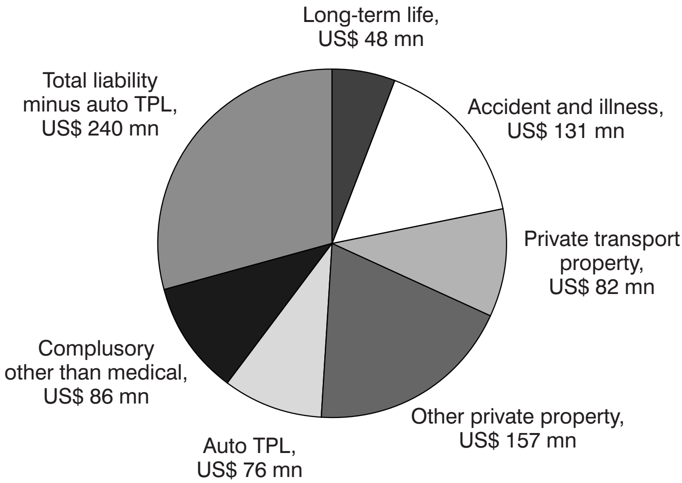
Once we strip out short-term life insurance, we find a 'kind of' insurance market that in 2001 looked like this (see overleaf):

However, not much of this market is currently accessible to the non-captives: around 90 per cent of all segments other than auto third-party liability, long-term life and the private property




*Source:* All-Russian Insurance Association (ARIA), Ministry of Finance, UFG Research

**Figure 3.16.2** Main Russian insurance segments ex-short-term life, 2001




*Source:* All-Russian Insurance Association (ARIA), Ministry of Finance, UFG Research

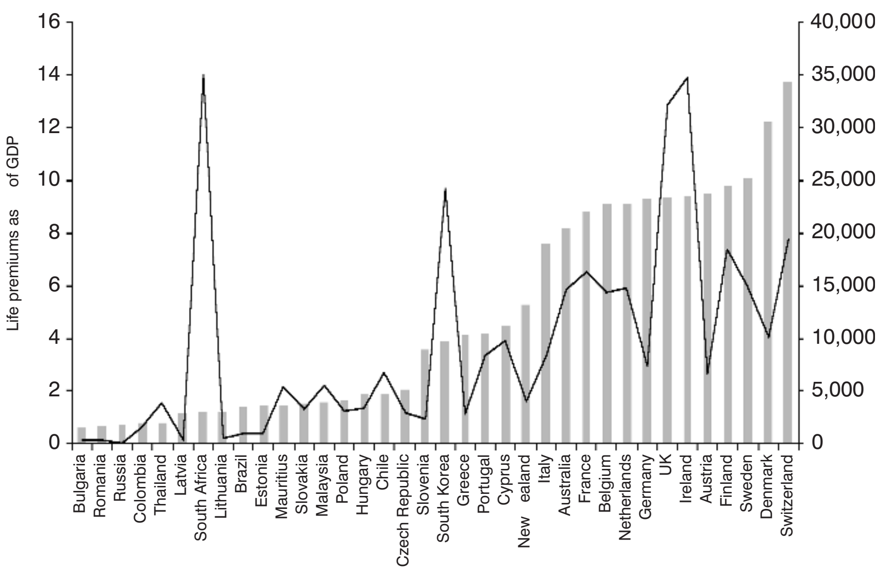
**Figure 3.16.3** Breakdown of smaller segments, 2001

segments, are purchased from captives by legal entities as a means of saving taxes (these three segments totalled around US$ 363 million in 2001). On the other hand, the adoption of a new law that makes automotive third party liability compulsory from July 2003 means that this market will expand tremendously in 2003. By combining expected auto TPL sales with the 'remainders' of the other segments and some less than perfect projections for them, we are able to sketch out a possible 'battle-ground' for the non-captives – ie the nearest thing Russia has to a genuine insurance market.

## *How big is a normal insurance market?*

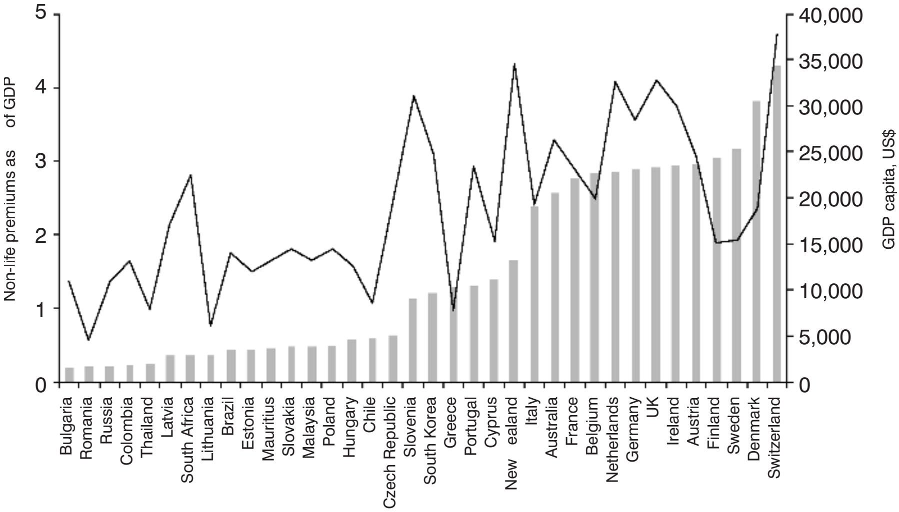
We have examined insurance premium statistics for 39 countries in 2000. These countries represent a wide range of developed and emerging markets, with GDP per capita ranging from US$ 1,500 (Bulgaria) to US$ 37,795 (Japan). While there are some variations that can be explained by a mixture of cultural and political differences between the countries, there is a clear link between per capita spending on both life and non-life insurance on the one hand and GDP per capita on the other – the higher GDP per capita, the higher the percentage of GDP that is spent on both forms of insurance.

Regression analysis provides a reasonable approximation of what we would expect from Russia. For the life segment, we selected for our calculations those countries from our universe of 39 states that had a GDP per capita of US$ 1,500 to US$ 11,250 in 2000 (we expect Russia to head towards the top of this range by 2016). However, we excluded those countries whose financial systems are fundamentally undeveloped or unstable as well as obvious outliers. At this



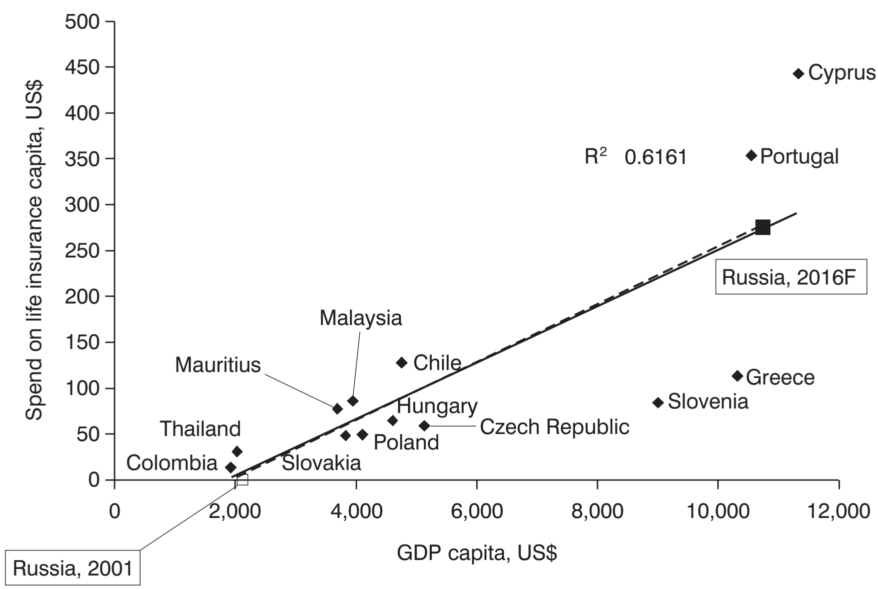

*Source:* Swiss Re, national insurance associations, World Bank, UFG Research

**Figure 3.16.4** Life premiums as a percentage of GDP vs GDP per capita, 2000



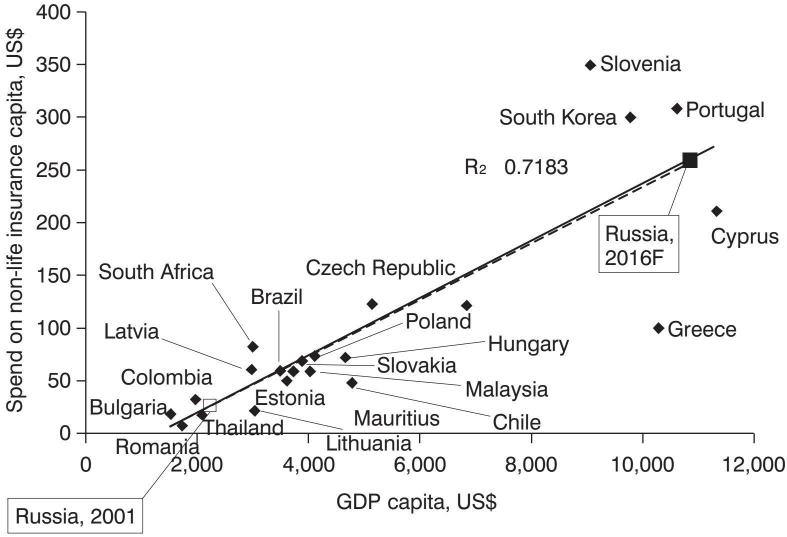

*Source:* Swiss Re, national insurance associations, World Bank, UFG Research

**Figure 3.16.5** Non-life premiums as percentage of GDP vs GDP per capita, 2000




*Source:* Swiss Re, national insurance associations, World Bank, UFG Research
Note: Cyprus and Slovenia seem to 'reverse' their positions – this implies that different methods for classifying life and non-life are used, but it does not call into question the overall picture

**Figure 3.16.6** Life regression, 2000, and Russia's trajectory




Note: Russia's points for 2001 are our estimates and do not reflect official statistics

**Figure 3.16.7** Non-life regression, 2000, and Russia's trajectory

income level, an increase in GDP per head of US$ 1 leads to an increase in spending on life insurance of 3.1 cents.

As for the non-life segments, we have no need to exclude such outliers or financially undeveloped countries, given that the risks involved in purchasing insurance here are much lower due to the short-term (mostly, one-year) nature of the payments. We do, however, exclude Russia, due to the grossly inflated figures resulting from payments to captives. At this income level, an increase in GDP per head of US$ 1 leads to an increase in spending on non-life insurance of 2.7 cents.

## *Who buys insurance in Russia?*

Segmentation in Russia's insurance sector is a surprisingly difficult task – again, due to the poor data available. Insurance companies themselves are able to suggest what sort of purchaser their products are aimed at, although there are no publicly available consumer 'models'. Nevertheless, we can with reasonable accuracy, assert the following:

- Voluntary medical insurance sold beyond the framework of the captives is sold overwhelmingly via corporate agreements. The typical consumers are companies looking to provide benefits to employees that they can write-off against tax.

- Long-term life insurance is also mostly sold via corporate agreements. In particular, foreign companies with international agreements with AIG (mostly American companies) and Allianz (mostly European countries) extend this cover for their employees to Russia. There is a totally insignificant market for individuals voluntarily purchasing life insurance. However, insurers believe that this market will take off, and that the 25–45 age group will be particularly interesting as that which has managed to accumulate significant savings under the mattress in Russian capitalism.
- Auto casco, fire and theft (ie fully comprehensive minus TPL) is not currently purchased as frequently as one might expect considering the growing and already high popularity of new and imported cars. The reason is probably the high price – fully comprehensive insurance (which is the form in which it has mostly been sold in the past, although whether this holds true in 2003 after the introduction of compulsory auto TPL remains to be seen) typically costs around 10–11 per cent of the car's current value per year. Once again, it looks like the 25–45 age group is the main purchaser for individuals, although good data is not available. A fall in tariffs is needed here to popularize this segment, although this could also lead to substantial losses among insurers.

## *Leading foreign insurance companies*

Of Russia's 1,350 insurance companies registered in 2001, 54 of them were recorded as containing some degree of foreign capital, although in most cases this capital did not belong to foreign insurance companies. Foreign insurance companies have not captured a large share of the Russian market. For example, Ost-West Allianz's premiums amounted to just US$ 16 million last year. The main reasons for this are: 1) the low purchasing power of the population, which means that it will not buy life insurance products, which is where the foreign companies would naturally have a competitive advantage due to the differing levels of trust enjoyed by foreign and local insurers; and 2) the lack of competitive advantage of foreign companies in non-life segments – the local companies have recognized brand names and are frequent advertisers and have been able to generate additional revenue from the grey schemes, in which the foreign companies are essentially unable to take part

**Table 3.16.1** Main holdings of foreign insurance companies, 2001

| *Company* | *Total premiums earned by local company, US$ million* |
|---|---|
| ROSNO (Allianz, 45% stake) | 572 |
| RESO (Coris, stake unknown) | 163 |
| AIG | n/a (US$ 20 mn in life insurance) |
| Rossia (AXA, 11% stake) | 19 |
| Allianz | 16 |
| Rus (Ergo, 99% stake) | 10 |
| Zurich-Rus | 9 |

*Source:* Interfax, Expert, UFG Research

owing to both the ban on foreign companies offering life (with the exceptions of AIG and Allianz) and these companies' own ethical standards and investment requirements.

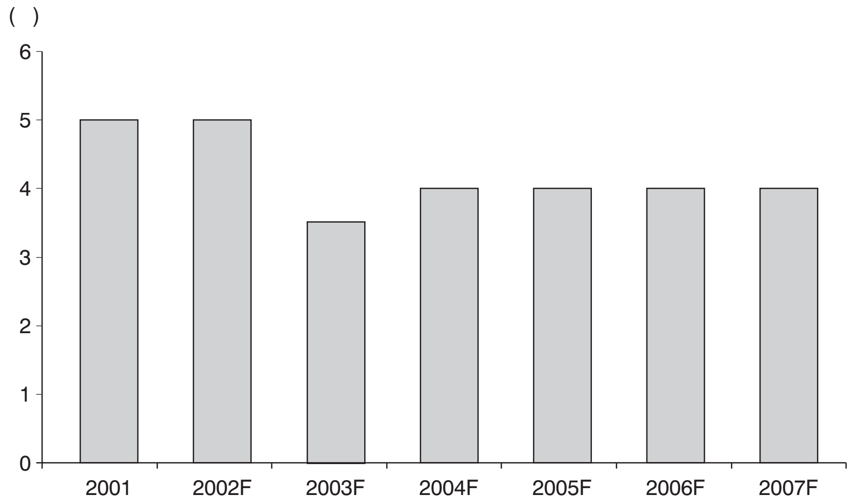
Both AIG and Allianz have recognized that the best way to tackle the non-life sector is actually through a local brand name, hence Allianz last year purchased a 45 per cent stake in ROSNO. Meanwhile, AIG is actively looking for a major local company to acquire, with the aforementioned Ingosstrakh as the prime target in press speculation (AIG has been linked with Ingosstrakh via reinsurance operations since 1968).

Other minor local players are AXA Colonia with 10.69 per cent ownership in Rossia (formerly, Ingosstrakh-Rossia), Zurich and Ergo (part of Alte Leipziger, in turn part of Munich Re), which has recently been attempting to purchase a stake in a major local company – with RESO-Guarantee reportedly a major target. Ergo owns a St Petersburg player, Rus, although Rus is a minor company (US$ 10 million in premiums written in 2001).

## *Main growth drivers*

*Economic drivers*

The single biggest driver will be the increase in incomes that will be accompanied by higher spend on non-essential goods, which together with the population's already high propensity to save will lead to an increasing need for organized savings. The nominal dollar increases in GDP forecasts for Russia and outlined in the previous section come from two factors: real GDP growth (see Figure 3.16.8) together with the real appreciation of the rouble. Russians save a lot of money, but most of it is kept tightly sewn into




*Source:* UFG Research

**Figure 3.16.8** Russian real GDP growth, 2001–2007F, UFG forecasts

mattresses at present – estimates of this volume are around US$ 40–50 billion. The reason for this is twofold: 1) a deep mistrust of banks and other financial institutions following the collapse of pyramid schemes and a number of banks in the second half of the 1990s that wiped out the savings of probably hundreds of thousands (and criminals posing as insurance companies have also been involved); and 2) the fact that a huge proportion of earnings are paid cash-in-hand and not declared to the State as a means of evading income and social taxes. People paid in this way are afraid to bank their earnings lest the tax authorities find out.

The advantages of life insurance as an alternative form of saving are that: 1) Russians can entrust their savings to institutions that are far less likely to collapse than local banks, given that two of the largest insurers in the world already offer this service (AIG and Allianz); and 2) the tax authorities do not currently show any interest in those people purchasing it. As for spending on non-life insurance, it is common sense – backed up by the country statistics we have examined – that spending on this increases as a proportion of income as incomes rise.

The skewed geographic nature of Russian wealth in favour of Moscow should act as a multiplier of the effect from rising national incomes. This removes the need in many cases for insurance companies to spend resources on operating outside of Moscow and a few other major cities. Moscow and the Moscow region have a population of 15 million with a population density of 130 per square kilometre. Average consumer spending in 2001 was US$ 4,000 – Russia's highest. For comparison, average spending in the Central super-region excluding Moscow and the Moscow region was only US$ 630 per head. Further, Moscow itself has around 2 million cars at present, which is one per five residents rather than one per 9.9 outside Moscow. Hence, the richest pickings for insurance companies are to be found in Moscow; at least in retail.

A third major economic driver is the expected expansion in Russia's currently very depressed mortgage market. The current Russian mortgage market is negligible. Once it takes off, it will see an expansion in life and buildings insurance as required by lenders. Efforts to develop this market are under way – at a presentation in Moscow in June 2002 to the American Chamber of Commerce in Russia, Alexander Semenyaka, General Director of the State Federal Mortgage Credit Agency, revealed that his agency plans to kick-start the mortgage market by issuing a 2 billion rouble (US$ 64 million) bond in the near future as the first stage in a process that should enable a mass market to develop through the mortgaging of properties with his agency followed by its issuing mortgage-backed securities in large numbers. At the time of writing, this plan looks likely to be followed through on time.

*Legislative and regulatory drivers*

The introduction of compulsory auto third-party liability in July 2003 will introduce most Russians to genuine insurance for the first time in their lives and will provide insurance companies with client lists and other valuable marketing data. The size of the auto TPL market will be a factor of the number of cars in circulation and the policy tariffs. We conservatively assume in our projections that premium payments on auto TPL will be US$ 600 million in 2003 and will then increase in proportion to the number of cars in circulation in Russia – as forecast by our automotive sector team.[2]

However, the effect of the appearance of this market may well be far greater than its size. First, most Russians simply do not know what insurance products are at present and what they are for. Hence, this market will help to introduce them to the concept of insurance products. Secondly, it is often suggested that automotive insurance is not a profitable activity in the West (and if the tariffs

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[2] Auto TPL of course applies to all vehicles, not just cars, but it is still a reasonable assumption to link the volume of auto TPL premiums to the number of cars in Russia.

are so low that the Russian market is worth just US$ 600 million in 2003 then the insurance companies are only expected to break even on this form of insurance anyway) and that the real advantage to insurers of selling automotive insurance is that it provides them with client lists and cross-selling opportunities. Some insurers we have been talking to believe this too and consider the introduction of compulsory auto TPL to be *the* leading driver behind the expected growth in the market for both non-life and life products. However, views on this are mixed, given that there is little proven correlation in the West between short-term auto sales and long-term life. Thirdly, the effect of the introduction of auto TPL will be the creation of networks (for it is a requirement under the new law that all companies offering auto TPL must offer it throughout the territory of the Russian Federation via local outlets, and companies are thus forming national alliances in order to meet this requirement as only very few of them have a presence in all localities). These networks, together with the prospect of fairly large amounts of cash coming in, are likely to make insurance companies more attractive propositions for Western investors that are able to bring their own insurance expertise in order to better explain to the population what insurance is for and why they should buy it.

Russia's expected entry into the WTO in 2006–2007, and the subsequent lifting of restrictions on foreign-owned companies offering compulsory and life insurance, will improve the quality of competition and the services offered. Russia currently restricts the activities of 'foreign' insurance companies. Companies that are more than 49 per cent-owned by foreign entities are not allowed to provide either life insurance (with the exception of AIG and Allianz, as they began offering life insurance before foreign companies were prevented from doing so by legislation in 1993) or compulsory forms of insurance. The latter market accounted for US$ 1,382 million in written premiums in 2001. Moreover, there is a 15 per cent limit to the total ownership of insurance companies in the Russian market, although last year this figure was just 4.1 per cent according to Interfax's 2001 insurance sector report. This number is sometimes argued about, but the highest figure we have seen quoted is just 7 per cent.

Such restrictions will eventually be lifted following Russia's WTO entry, although a grace period of a few years for both life and compulsory forms of insurance has been mentioned by the Government. We would like to believe that these restrictions will not actually survive for this long – rather, that economic forces could force the Government into actually liberalizing the life insurance market more quickly given that the increasing incomes and need for organized savings ought not to be ignored by the authorities for another five years. However, the Government's track record has tended to support producer rather than consumer interests, even if, as in this case, the producer interests are somewhat illusory.

The appearance of more Western companies offering better products will boost demand not only because the products are better, but also because insurance products will be better explained by better trained agents and better marketing. Actually, AIG has been criticized for offering a sub-optimal product, given that its policies are indexed in rouble and not dollar terms, while Allianz makes little effort to sell life insurance to individuals at present as it cannot find enough instruments in which to invest premiums earned that meet both Russian Government requirements and its own requirements.

Russia's 'great pension reform', which is turning Russians into savers whether they like it or not, will, in time, whet their appetite for organized forms of savings. The year 2002 saw the introduction of a major leg in Russia's pension reform – the 'funded' (or 'top-up') part of the state pension. Prior to this, the state pension was paid out of taxes, with no individually assigned and accrued contributions. Now, all Russians whose salaries are paid legally pay 2–4 per cent of their declared gross salary in top-up pension contributions labelled as their own. These funds are currently managed by the State Pension Fund, but Russians will have an option of moving them into private management from 2004 and they will be able to track the progress of these real savings. The total value of this fund could be around US$ 30–35 billion by 2012, when the first pension payments are made from them. It is this factor that has persuaded us to pinpoint 2013 as the year by which we expect the life insurance catch-up effect to complete its course. 2013 will be the first occasion in Russia when the population will see savings actually 'working' on a large scale and the fact that pensioners will see the payments sitting in their bank accounts will provide a welcome boost to the industry towards the middle of the next decade.

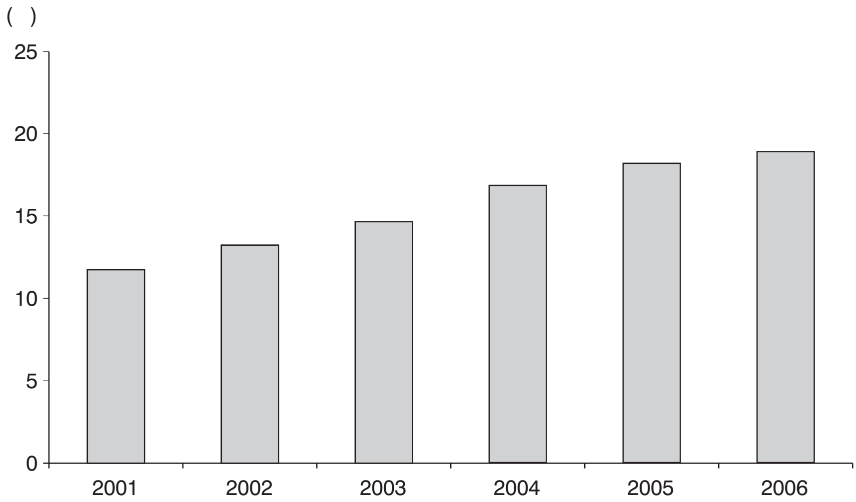
The current investment restrictions faced by insurance companies that actually force them to turn away clients at present will eventually be lifted and new investable assets will appear. The lack of investable assets has, from the point of view of insurance companies, been one of the biggest problems that they have faced in attempting to develop their business. On the one hand, some companies prefer to invest in only ultra-safe, AAA assets, which are not readily forthcoming in Russia, while the Insurance Inspectorate places heavy restrictions on the investment and reinsurance abroad of premiums collected by companies in Russia. On the other hand, the Insurance Inspectorate also has strict requirements on the variability of returns on investments by Russian insurance companies. In the absence of a large volume of stable, long-term, low risk assets, Russian companies find it hard to find investable assets meeting these requirements – the Russian stock market being too volatile to provide the main instruments for investment.

The Government is, however, slowly taking measures to address this problem. It has approved the issue of GSOs (long-term bonds aimed at institutional investors – specifically, insurance and pension funds) and the Ministry of Finance may hold the first auction in 2003. Likely volume this year is 10 billion roubles (US$ 320 million) in 10-year and 20-year instruments, to be sold next year (although there is no word as yet on volumes for next year). The danger for insurance companies is that the State Pension Fund will emerge as the buyer of the whole volume of this stock, but this remains to be seen and, in any case, the Government's attention to this problem means that it will be resolved sooner or later.

Further, another restriction that insurance companies face – which we also expected to be lifted in the face of lobbying efforts by local insurance companies – is in terms of reinsurance. Currently, only 60 per cent of premiums may be reinsured and only half of them (ie 30 per cent of the total) may be reinsured abroad. One more restriction is that no more than 15 per cent of the total volume may be reinsured with a single company – which is a major constraint on foreign companies given that they would naturally reinsure the risks abroad within their global organization.

*Social drivers*

The steadily increasing retail deposits to GDP ratio represents Russians' rising confidence in their financial institutions. Russia's retail deposits to GDP ratio, a measure of Russians' 'financial literacy', has increased from 8.8 per cent at the end of 1999 to 11.6 per cent as at end July 2002 – and our economy and strategy team estimates that this will reach 19.4 per cent in 2006. Hence, this indicates the increasing confidence of Russians in their financial institutions. Of course, in the long run, bank deposit and life insurance volumes move from being positively correlated to acting as substitute goods – as competing forms of savings – but Russia is far from this stage at present.




*Source:* UFG Research

**Figure 3.16.9** Retail deposits to GDP ratio, 2001–2006F, UFG forecasts

### *Relevance*

It should be clear from both the section 'Market size and projections' and the above discussion that the major growth driver behind the expected increase in the insurance market is the expansion in incomes of the Russian population. It is thus economic factors rather than technocratic factors that will play the key role. Entry to WTO is not, in fact, a major issue here. Although the industry and the media have raised much concern about the 'threat' of entry to local insurance companies, we do not expect the 'threatened' insurance companies to be around by the time of WTO entry anyway. One of the lessons of this report as a whole is that local companies able both to promote a strong brand name and to make use of Western expertise and investment are well positioned to compete with foreign companies in the non-life markets both before and after WTO entry. Further, arguments that WTO entry is a threat to the life insurance industry in Russia do not add up – this industry simply does not exist. It is, however, badly needed, both for the purposes of financial deepening and for the creation of a civil society. And it will be foreign companies who provide it, as can generally be concluded from the Eastern European experience.

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# 3.17

# The Aviation and Aerospace Industry

*Marina Vigdorchik, US Commercial Service, Moscow, Russia*

## *Introduction*

The Russian aviation industry has suffered a serious decline over the last decade. The majority of domestically-produced aircraft operated by Russian airlines do not meet international standards and need upgrading or replacement. However, domestic Russian manufacturers, with their current technical capabilities, are unable to meet the demand for such aircraft.

The Russian Government and industry planners are considering various strategies to support the domestic aerospace industry. These include restructuring the industry to improve operational efficiency and attract investment, and developing aircraft leasing schemes. They also seek broader cooperation with foreign firms in order to integrate Russian manufacturers into the global aviation industry. In the long run, the Russian market presents significant opportunities for US aerospace exports and investment. Several major US commercial aviation companies – such as Boeing, United Technologies, General Electric and Lockheed Martin – are engaged in joint production projects and component supply. While purchases by Russian airlines of Western-made aircraft are severely constrained by high import tariffs, Russian manufacturers are seeking partnerships and cooperative ventures with Western manufacturers.

## *Market trends and best prospects*

According to the Russian Aerospace Agency, the overall growth of the Russian aerospace industry in 2001 was estimated at around 5.3 per cent. However, production of civil aircraft remains at a very depressed level. In 2001, the State Civil Aviation Authority (GSGA) reported that Russian airlines procured only six new aircraft and one helicopter.

According to industry experts, Russian airlines own between three and four times the number of aircraft that they need to service their current routes. Russia's airports are littered with out-of-date aircraft inherited from Soviet times, when the domestic airline industry transported about 140 million passengers a year. During that period, airfares were priced at unrealistically low levels, set by the country's planning bureaucracy. Under the market conditions that have prevailed over the last decade, demand has dropped and most aircraft have become surplus to requirements. Many have been cannibalized for parts.

Most of the fleet currently operation is ageing, unreliable and inefficient. Around 95 per cent of existing aircraft were designed between 1960 and the early 1980s. Beginning in 1995, the Federal budget stopped providing financing for aircraft procurement, which made replacement of the currently operating aircraft almost impossible. However, over the next few years, Russia's airlines will reach a point where they will be unable to continue on surplus aircraft, and will be forced to replace their fleets. By the end of 1999, the average fleet age of most Russian aircraft was 12.1 years, with 75 per cent operating for more than 10 years. According to GSGA, the current Russian fleet includes 6,014 aircraft, only 46 of which are of foreign origin, and 27 new Russian types, (IL-96, Tu-204 and AN-38). Consequently, Russian airlines are scheduled to replace as much as one-third of their ageing fleet over the next five years. Many would strongly prefer to lease or buy Boeing or Airbus planes, but are prevented from doing so by the high import tariffs.

The majority of Russia's current aircraft fleet do not meet international standards and need upgrading or replacement. Starting from 1 April 2001, all aircraft flying in the air space of the European Civil Aviation Conference Member States (ECAC) are required to have anti-collision equipment (TCAS). Installation of TCAS costs approximately US$ 150,000 per aircraft. Another strict requirement on noise and emissions came into force after 1 April 2002. Only 4 per cent of the existing Russian aircraft fleet meet new international noise requirements and, according to GSGA, only 241 aircraft can be upgraded. Such aircraft as the IL-86 and IL-76 and Tu-134 can be upgraded only through installation of new engines, which industry experts consider economically inexpedient. Only a limited number of Russian aircraft, built after 1990, will be able to comply with European noise limits and be permitted to fly to Europe. These are the IL-96, Tu-214, Tu-204, and the newly developed Tu-334. Such aircraft as Tu-154M and IL-62 may be allowed to fly only after their modernization. Moreover, in 2006, when new European environmental requirements come into effect, Russian airlines flying internationally will face even more severe restrictions.

Forecasting the Russian aircraft market is extremely difficult. According to Russian Ministry of Transport estimates, Russian airlines may acquire 1,400 Russian aircraft and 1,150 Russian helicopters by 2015. However, industry experts consider that the acquisition of 117 aircraft and 96 helicopters annually by Russian airlines seems exaggerated since acquisitions of only six aircraft and one helicopter were reported by GSGA in 2001.

Another forecast of the Russian airliner market was made public by major Russian international carrier Aeroflot, which predicts that the market will be around 417 aircraft over 80 seats by 2015, including 53 long-range, 215 medium-range and 149 short-range aircraft. This forecast is based on the assumption that Russian economic growth will lead to 8 per cent annual growth in traffic. According to Aeroflot officials, the introduction of new, reliable and fuel-efficient aircraft combined with new air transport practices should reduce the existing fleet by 80 per cent by 2010.

The civil aerospace industry is unable to produce suitable replacement aircraft within a realistic time frame, leaving domestic operators with few options to meet demand for transportation needs. Airlines appear to have lost confidence in the capabilities of the domestic industry. In fact, there is no mass production of aircraft in Russia. Those few craft delivered to customers need significant technical maintenance. However, lack of spare parts prevents airlines from operating them efficiently. Though facing financial difficulties, the airline industry will be forced to procure foreign-made aircraft in order to be able to fly internationally.

## *Overview of the Russian aviation industry*

Russia's civil aviation industry is going through the most difficult period in its history. Originally established to supply the Soviet military, Russia's aerospace industry employed some 1.5 million people in 1990, accounting for more than 25 per cent of the world's civil and 40 per cent of the world's military production of aircraft. The civil aviation sector dropped dramatically in the 1990s, falling from production of 500 airplanes and 215 helicopters in 1990 to only 14 and 40 respectively in 1998. In 1999, Russia manufactured nine civilian and 21 military aircraft: production of civilian aircraft dropped to four in 2000.

The aircraft industry's results for 2000 show that gross output amounted to 73.8 billion roubles (US$ 2.7 billion), with a profit of 17.1 billion roubles (US$ 600 million). Output grew 41.4 per cent, with military aircraft and armaments accounting for 69.5 per cent of the industry's total output, civil aircraft for around 14 per cent, and consumer goods for 17 per cent. Exports of military aircraft reached US$ 1.33 billion with the share of civil aircraft amounting to 10.3 billion roubles (US$ 355 million).

The Russian aircraft industry is highly fragmented. It consists of around 300 design bureaux, plants and research facilities. This includes 10 major aircraft designers and over 20 major manufacturing facilities, which are involved in military and civil production. There is a rich heritage of design and construction of both commercial aviation and space products, and a continuing capability to produce a wide range of airplanes and rockets. At the same time, the industry is facing a crisis caused by the lack of clear policy in the field of domestic aviation development, a drastic decrease in defence orders and a decline in state funding. State funding of R&D and aircraft procurement is around 7.5 per cent of the level of Soviet times. At the same time, privatization within the industry hasn't produced the expected positive results.

The State no longer directly controls the industry, due to the sale of shares in the leading aircraft manufacturers that has taken place since 1992. Many aviation plants are struggling with a shortage of work, and declining state orders has meant that many are running at only 10–15 per cent of capacity. According to the Russian Aerospace Agency, only 14 of 300 Russian manufacturing research and design companies in the industry remain profitable and many are near collapse, due to reductions in state funding and significant decline of the domestic market.

## *Restructuring plans*

On 11 October 2001, the Russian Government approved the Federal Programme 'Reforming of the Russian Military Industrial Complex during 2002–2006'. The reorganization of Russia's aircraft industry is part of the country's defence industry restructuring plan, which is based on the principles of industry consolidation and establishment of holding companies. The goal is to reduce production costs and increase investment attractiveness (as well as to develop greater flexibility in the industry), in order to realize its potential.

A plan for consolidation of the aircraft industry, approved by the Russian Government, calls for the creation of five large integrated holding companies. Two of these will focus on developing civil and military aircraft, as well as their upgrade. One holding company will include ANTK Tupolev, RSK MiG, and Kamov (helicopter) and the other will be formed by consolidating AVPK Sukhoy, Aviation Complex Ilyushin and Mil MVZ ( helicopter) under one umbrella. Under the restructuring programme, an additional three holding companies will be created by consolidating firms specializing in aviation engines and parts, aviation armaments and avionics.

The means by which consolidation will take place remains unclear. The new entities are to be formed on the basis of state enterprises and joint stock companies. Currently, according to industry sources, the Russian aviation complex comprises 29 per cent of state-owned enterprises, 32 per cent of joint stock companies with blocks of shares owned by the federal government, 5 per cent of joint stock companies where the State exercises the special rights ('golden share'), and 34 per cent of joint stock companies free of government ownership. Industry professionals are rather sceptical about the Government's decisions on consolidation, because purely administrative measures are no longer effective without financial resources. One way for the Government to gain more control over the industry would be to become a major customer of aviation equipment. At the same time, while official administrative plans are met with much scepticism among industry specialists, consolidation of the industry is inevitable, and is mainly driven by economic forces; namely the industry's need to better utilize capacities in order to carry out and finance new projects.

## Core aircraft production groups

*Russian Aircraft Building Corporation (RSK MiG)*
RSK MiG (formerly MAPO) was created by the Presidential decree #92 in January 1996, and in 1999 was renamed RSK MiG. Currently it employs 15,000 people who design, produce parts for and assemble MiG fighters and Ka-helicopters. The company includes the Mikoyan design bureau, the Voronin Production Plant and Lukhovitsy Machine Building. It also includes component producer Krasny Oktyabr, Pribor, Aviatest and Perm Instruments, helicopter designer Kamov, and the Arsenyev helicopter production facility. Recently, RSK MiG announced plans to integrate the four companies currently involved in engine development and production – Klimov, Krasny Oktyabr, Moscow Chernyshov Machine-

Building Plant and Tushinsky Machine-Building Design Bureau Soyuz – into a the new structure. The company reported that by the end of 2001 the total amount of the contracts signed had reached US$ 1 billion. Demand for the company's main product, the MiG-29, is slowly recovering and the company centres its strategy on modernization of the aircraft. At the end of 2001, RSK MiG and ANTK Tupolev signed an agreement on investing in manufacturing and certification of a 100 seater Tu-334. Tu-334 programme is also supported by the Government, which considers it as a priority project. The Russian Aerospace Agency plans to invest around US$ 12.6 million in the programme. Voronin Production Plant reportedly started serial production of six aircraft for the Atlant-Soyuz the first of which will be delivered in 2004. According to RSK MiG, the aircraft will comply with ICAO Charter 4 in terms of noise and emissions.

*The Aviation Military Industrial Complex (Sukhoy)*
A 51 per cent state owned company, AVPK Sukhoi was created by a Presidential decree in August 1996. The main products of the Sukhoy group are the supersonic Sukhoy fighter jets and Beriev hydroplanes. AVPK Sukhoy is the major Russian exporter of military aircraft, enjoying a 14–15 per cent share of the world's military aircraft market. Sukhoy's exports account for 50 per cent of total Russian exports of military products, and its export potential between 2002 and 2005 is estimated at about US$ 17 billion. The major companies within the group include:

- Sukhoy Design Bureau;
- Beriev Design Bureau;
- KNAAPO, (Komsomolsk-na-Amure);
- IAPO (Irkutsk);
- NAPO (Novosibirsk);
- Taganrog Aviation Scientific and Technical Complex in the name of Beriyev.

In April 2002, the Russian Government announced that AVPK Sukhoy was the winner of a tender for the fifth generation fighter. By the end of 2002, Sukhoy must develop initial designs for the aircraft and prepare a programme for its development.

Sukhoy's daughter company Sukhoy Civil Aircraft is teaming up with Boeing and Ilyushin to announce plans to build a new civil regional jet. Tender on the development of the Russian Regional Jet Programme was announced on 9 July 2002 and will be completed by the end of November. Within this project Honeywell and Rockwell Collins were invited to participate in the tender for onboard equipment.

Aviation Complex, AK Ilyushin, was created in January 1997 to include all designers and producers of IL-family planes. At present the Ilyushin Complex includes:

- Ilyushin R&D bureau;
- VASO (Voronezh Aircraft Manufacturing Enterprise);
- TAPOiCh (Tashkent Chkalov Aircraft Manufacturing Enterprise).

The main challenge for the Ilyushin Complex was the project of production of IL-96M/T, powered with Pratt & Whitney engines and equipped with Rockwell Collins avionics. It was supposed to be the only world-standard Russian long-range aircraft. The project received partial financing from ExIm Bank, and Aeroflot placed an order for a number of aircraft. However, the project has been frozen due to a refusal by the Russian Ministry of Finance to provide sovereign guarantees to assure for ExIm Bank financing.

Opened joint stock company Tupolev was formed in 1999 and includes ANTK (aviation scientific and technical complex) Tupolev and Ulyanovsk aircraft manufacturer Aviastar, with 51 per cent of shares belonging to the State. The Tu-134 and Tu-154 are the workhorses of the Russian domestic airline industry, and together with the Tu-204 they account for 65 per cent of the Russian aircraft market. The company plans to introduce newly designed Tu-214s, Tu-324s and Tu-334s. In June 2002, the Egyptian finance company Sirocco announced plans to invest US$ 280 million in Ulyanovsk Aviastar, after which 25 per cent minus one share will belong to the Egyptian company.

## *Engines*

The aircraft engine industry has suffered significant difficulties, starting in 1990. Sales volume decreased to 16 per cent of its Soviet-era peak and the number of employees decreased by 60 per cent. About 85 per cent of engine enterprises were at the point of closure. Starting from 1999, the industry started to experience growth in production and sales volumes, increasing by 30–50 per cent annually. However, engine builders have been able to reach only 45 per cent of the production levels of the late 1980s. Though positive changes are seen in the development of engines for civil aircraft, such increases were mainly due to manufacturing of land-based turbines for the oil and gas industry. The Russian engine industry manufactures a broad range of engines for aircraft, which actually exceeds the demand, and at the same time aircraft producers are looking for Western engines because they are of better quality in terms of noise and emissions.

Salyut, one of the leading engine manufacturers, generated a turnover of US$ 220 million in 2001 with US$ 300 million expected in 2002. There are currently 12 types of engines under development, including engines for the Tu-334, An-70 and Yak-130 aircraft, as well as motors for missiles, hypersonic aircraft, and gas turbine-powered electricity generators. The company is reported to be conducting a large-scale renovation plan. It invested US$ 52 million in capital equipment in 2001, and plans to invest US$ 60–65 million in 2002.

Perm Motors joint stock company, manufacturer of the widely used PS-90A engine, reported 116 per cent production growth in 2001 with the revenues of around 3.5 billion roubles (US$ 115 million). PM announced its target revenue for the year 2003 at 6.2 billion roubles. PM's strategic partner, United Technology's Pratt & Whitney Division, plans to invest US$ 125 million with about half of this amount going towards a modernization of the PS-90A and PS-90A2 programmes, as well as investments in new technological processes at the Perm Motor Plant.

NPO 'Saturn', based in Rybinsk, manufactures military and civil aircraft engines as well as power sets for industrial applications. Its main products include engines for the Su-27, Su-30 and Su-35 fighters and engines for IL-76, IL-62M and Tu-154M airliners. The company has close business relations with the French firm Snecma. It opened two joint operations in conjunction with Snecma; Smartec, an engineering design office, and joint operation, SM146 Programme Office. These two projects confirm the Snecma Group's commitment to a long-term presence in Russia and are the signs that the Russian aerospace industry is slowly integrating into the global aviation industry. The SM146 Programme Office has been established to support the Russian Regional Jet Programme.

Sukhoy Civil Aircraft, created for the development and production of the Russian Regional Jet, has listed two engines for the project. These include the PW800 to be jointly produced by United Technologies' Pratt & Whitney Canada Corp. (P&WC), Aviadvigatel, MTU (Germany) and Fiat Avio (Italy), and the SM146, to be produced by NPO Saturn and Snecma. A decision will be made by the end of December 2002, with the two consortia required to submit detailed proposals by the end of October and evaluation being conducted in November. According to NPO Saturn, the cost of developing the engine and launching its production would be around US$ 600 million. It is reported that the winning engine project may expect government support of up to 10–15 per cent of its cost, which will be provided under a federal programme for the development of the civil aircraft industry through to 2015.

## *Materials industry*

The All Russian Institute of Aviation Materials (VIAM) was established in 1932 and is the major research centre for new materials in the aviation industry. Around 96 per cent of materials used in Russian aircraft industry were developed by VIAM specialists. Recently VIAM signed an agreement with Russian Aluminum, a major Russian metals producer, on cooperation in the development, manufacture and market promotion of aluminum alloys used in the aviation industry.

In the materials area, Verkhnayaya Salda Metallurgical Plant (VSMPO) must be mentioned as the major producer of titanium products for the aircraft industry. VSMPO exports 70 per cent of its production, 35 per cent of which sells directly to aircraft producers (including Boeing and Airbus), 25 per cent to aircraft engine manufacturers and 40 per cent to companies making alloys for the aerospace industry. The recently signed five-year agreement with Airbus, worth US$ 200–300 million, constitutes 50 per cent of Airbus's titanium consumption. Russian Aluminum is also reported to have been selected as a supplier of aluminum alloys to Airbus.

## *Federal Programme for the Development of the Russian Civil Aircraft Industry*

This programme is for 2002–2010 and further until 2015. The development of the domestic aircraft industry, in order to satisfy local demand and to export to external markets, is a top priority for the Russian Government. About 70 per cent of the existing fleet of aircraft is approaching retirement, while 30 per cent of the country's passenger transportation is carried by air.

The programme is to be realized in two stages. During the first stage (2002–2005), aircraft developed during 1992–2001 will be upgraded and modernized. The idea is to bring these aircraft in line with international noise, emissions, navigation and other requirements, which will allow them to be competitive in the foreign markets. The second stage (2006–2010 and further up to 2015) calls for the design of new types of competitive aircraft.

Currently, priority projects include four types of aircraft – the long-range IL-96, the middle-range Tu-204, and the short-range Tu-334 and regional Tu-324.The priority helicopter models are the heavy Mi-38 and Mi-382 with a 6-tonne load capacity. Mi-38 is being developed by Moscow's Mil helicopter plant and the Western investor Eurocopter. Certification of both helicopters is expected in 2005. Certification of the basic version of the Ka-62, with a load of 2 tonnes, is set for 2003.

The programme calls for the upgrade of existing aircraft and the development of new types of aircraft engines, avionics and navigation systems. Financing of the programme is estimated at around 158 billion roubles (about US$ 5 billion) including 35 billion roubles (US$ 1.1 billion) from the Federal budget and 122 billion roubles (US$ 3.9 billion) from other sources.

## *Leasing*

The Russian Government in cooperation with the aircraft and financial services industry are working to create an environment in which new leasing companies could provide financing for leases of Russian-made aircraft. Considering the financial state of Russian airlines and increases in fuel prices, aircraft leasing holds the best prospect for them to bring aircraft fleets up to date. The leasing of newly-built Russian aircraft has been discussed for several years, with one of the major issues being state support of leasing schemes. The first leasing projects are supposed to provide financing for 21–25 aircraft for Aeroflot, Transaero, Dalavia and Krasair. Two Russian leasing companies – Ilyushin Finance and FLC – won a government tender for leasing projects for the 10 IL-96–300 and 10 Tu-214 aircraft. These companies would be able to access state financing in return for the sale of a controlling interest to the Government. Major customers for these two leasing projects were supposed to be Aeroflot and Transaero.

## *Foreign investments*

Investments and cooperative projects with foreign companies could provide the capital needed to market newly-designed aircraft in domestic and international markets. However, a severe constraint on such projects is a 1998 law that restricts foreign ownership in Russian aerospace companies to 25 per cent. At the same time the

Russian Government and industry representatives are looking for broader cooperation with foreign firms in order to rescue the industry and integrate it into the global aviation industry.

In July 2002, EADS and the Russian Aerospace Agency signed an agreement on cooperation and investment in the Russian aerospace industry. The agreement calls for a broad range of cooperative projects in the military and civil aerospace areas, including Russian participation in the A-320, A-380 and other Airbus projects.

Recently, Kaskol Industrial Holdings, which controls a number of aerospace enterprises, signed an agreement with Airbus to establish an engineering centre. Kaskol Group controls the Nizhni Novgorod-based aircraft manufacturer Sokol (MiG fighters), Rosveretol, Gidromash (landing gear manufacturer), and the Volga-Dnepr (heavy cargo carrier). The Kaskol Group is considered a good partner for Western producers because of its exceptionally entrepreneurial, aggressive and politically well-connected management. The company has an unusually market-oriented and competitive approach, in striking contrast to many other Russian aircraft manufacturers. The creation of an engineering centre with Airbus follows an agreement between EADS and the Russian Aerospace Agency (RASA) to invest over US$ 2 billion in the Russian aerospace industry over 10 years. The engineering centre will employ 50 Russian engineers, who will be trained in Toulouse and Hamburg. The centre will manage contracts and coordinate future Russian involvement in the production of Airbus aircraft, including the A-380.

Egyptian company Sirocco International, Tupolev, Aviastar-SP and the Russian State Property Fund signed an agreement for a US$ 280 million investment by the Egyptian company in the Ulyanovsk aircraft producer Aviastar-SP. It will be used to develop the Tu-204–120 aircraft programme. This deal is the largest foreign investment in the Russian aerospace industry to date. In return, Sirocco will receive 25 per cent minus one share in OAO Tupolev, as well as 25 per cent minus one share in Aviastar-SP.

India and Russia have reached an agreement on future production of the Il-214 100. Having historically been a market and licensed producer of Russian aircraft, the Indian Government is very keen to develop its own aerospace industry. Ilyushin and Hal (Hindustan Aeronautics Ltd) have reached a principal agreement that covers the creation of a US$ 300 million joint venture aimed at producing the Il-214 for the Indian market, and also the development of a cargo version for the Indian Air Force. At the beginning of

2002, a number of protocols were signed by the Indian and Russian governments for cooperation in the aerospace industry. These include HAL's involvement in developing a fifth generation fighter.

The Russian Aerospace Agency and the Chinese State Committee on Defence Sciences, Technique and Industry signed an agreement in April 2002 for the development of a 'cooperative programme for design, production and supply of new aircraft equipment'.

## *End users: airlines*

Russia has a highly fragmented airline industry with about 267 airline companies operating in the sector. However, only four of them account for 50 per cent of all passenger transport operations in the country, and about 35 account for 90.8 per cent of such transport. Six companies handle 54 per cent of the country's air freight.

Russia's airlines suffered in the 1990s from falling traffic, poor management and a financial squeeze. However, the sector levelled out at the end of the decade due to a resurgence of real GDP growth in Russia, and new management teams that took over some airlines after the 1998 financial crisis. Clearly, the future for most of the smaller airlines is dim, and many will not survive. Many companies have as few as two aircraft, often in poor technical condition. According to Ministry of Transport's State Civil Aviation Authority (GSGA), the cause of many of the industry's problems lies in inexperienced managers who have taken control of small airlines and have in some cases compromised safety standards. In an effort to enforce greater safety standards on the airline industry, the Ministry of Transport introduced more stringent licensing requirements for airlines. It closed 36 airlines in 2001 and a further 27 in 2002 to date.

A major trend of the Russian air transport sector is consolidation. The number of carriers is being reduced through mergers or the creation of alliances. Two major Russian airlines – Aeroflot and Sibir – are taking the lead in consolidating the industry through acquisitions, although many regional carriers that were once part of Aeroflot and now owned by the regional governments strongly oppose their advances.

In 2001, Russian airlines continued to experience growth in passenger and cargo transportation with overall increases of 14.8 per cent and 12.1 per cent, respectively, in passenger and cargo traffic. Overall domestic traffic increased by 12 per cent. The State Civil Aviation Authority (GSGA) reported that Russian airlines carried about 25.07 million passengers in 2001. Cargo and mail traffic in 2001, on both international and domestic routes, grew by 12.1 per cent to about 0.613 million tonnes.

### First ten airline companies rated according to number of passengers carried in 2001:

1. Aeroflot-Russian airlines
2. Pulkovo
3. Sibir
4. Krasnoyarskiye airlines
5. Tyumenaviatrans
6. Domodedovo airlines
7. Uralskiye airlines
8. TULPAR
9. Vnukovo Airlines
10. Kvminvodyavia

*Source:* Air Transport Review Journal, GSGA

### Federal regulatory agencies

GSGA/the Ministry of Transport is the major regulating organization in the field of aviation affairs in Russia. It supervises compliance with federal and international regulations and requirements; is responsible for air-traffic control, airport issues, and air-traffic safety; issues licences for aviation and repair and maintenance activities; carries out registration of all operating aircraft; and supervises continued airworthiness of operating aircraft. Procurement of air traffic control equipment lies within GSGA's responsibility.

The Interstate Aviation Committee (MAK) was created in accordance with CIS interstate agreement on the use of airspace and its activity, and coordinates aviation activities of CIS countries. The Aviation register of the Interstate Aviation Committee carries out certification of civil aircraft and component manufacturers; issues type certificates for aircraft, engines and propellers; and issues initial airworthiness and export certificates.

Russian Aerospace Agency (Rosaviakosmos) develops and administers government policy in the aerospace industry. It is responsible for state orders for the development of aerospace equipment for civil applications. Rosaviakosmos has more than 200 enterprises within its structure. According to the Government Decree #346 of 27 May 2002, development, manufacture, testing and repair activities of aircraft equipment and parts is subject to licensing. The decree appoints Rosaviakosmos as the agency responsible for issuing licences for these activities, with the exception if repair activity is conducted by the organization within the supervision of the GSGA organizations.

## *Imports*

In the Russian classification, all flying aircraft and spacecraft, and their spare parts, are coded as a Group 88. The current tariff for all manufactured crafts is 20 per cent, irrespective of their general designation or size. The tariff for spares of all flying crafts listed under sections 8801–8802, including spares for civil aircraft and helicopters, is 5 per cent. All other items, including planes, helicopters, spacecraft of various specifications for both civilian and military applications, fall under a 20 per cent tariff.

Large purchases of imported commercial aircraft by Russian airlines are currently constrained by high tariff barriers and a lack of financing. A 20 per cent import tariff plus 20 per cent VAT makes importing aircraft prohibitive, increasing the price for the aircraft by 44 per cent. At the same time, while high tariff barriers prevent foreign aircraft coming into the market, Russian airlines need new equipment and domestic manufacturers currently do not have the capacity or the funding to respond to the demand.

*For more information please visit www.buyusa.gov/russia/en*

# 3.18

# Textile Machinery

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### *Introduction*

Like the Russian economy in general, the Russian textile industry experienced growth in 1999–2001. The large devaluation of the Russian rouble, which resulted from the economic crisis of 1998, has had the effect of making Russian-manufactured textiles machinery more competitive with foreign imports, particularly in the medium-quality market segment. In 2001, growth slowed down, and the current situation in the textiles industry in Russia is categorized by a number of analysts as a 'crisis'. There are several reasons for today's poor state of the industry. Before the collapse of the USSR in early 1990, up to 88 per cent of the demand for textile machinery was covered by domestic production. At present, most of the manufacturing equipment and machinery needs to be renovated or replaced.

Lack of investment in the textiles sector is the major reason for the industry's poor condition at present. During 1990–2001, the industry was, to a major degree, funded by state investments, about 10 million roubles a year (US$ 0.34 million). With the purchasing power of the population growing, the demand for textile and light industries production will also continue to grow. The purchasing power growth is set to increase in both fabric production and imports. In 2002, cotton fabric production grew by 7 per cent up to 2.77 billion square metres (as of September 2002). Imports of textiles and shoes increased by 60 per cent in January–July 2002, compared to the same period in 2001. These factors, together with the growing need for textile machinery renovation, will largely facilitate revitalization of national machine-building for the textiles sector. Money will be allocated for pieces of machinery and equipment necessary for domestic textile industry modernization. Imports of textile machinery and equipment is expected to grow in the coming years.

Germany, Italy, Switzerland, Czech Republic and Japan are the largest importers into the country. The United States is one of the top 12 importers of textile machinery and equipment to Russia. US textile machinery has a good reputation in Russia. The following categories of textile machinery and equipment are among the best prospects for sale in Russia: spinning machines; industrial sewing machinery, especially equipment for hot pressing (wet heat processing) and preparing for cutting equipment; finishing (trimming) machinery; and some others. Because of a lack of resources, used equipment has very good prospects in Russia.

## *Market highlights and best prospects*

Although reliable statistics for the textile machinery sector are somewhat scarce, it is still possible to ascertain some basic facts about the industry:

- Domestic production of both textile and light industry sector machinery was estimated at 67.9 billion roubles in 2001, which is 1.5 per cent of total industrial production in Russia.
- The textile machinery pool in Russia consists of approximately 200,000 weaving machines, and about 800,000 industrial sewing machines.
- Textile machine-building is well-developed in Central Russia, including Moscow, Ivanovo and Tula; and also in Cheboksary, Novosibirsk, Penza and several other major industrial centres in Russia.
- The market for sewing machinery is estimated at US$ 20 million.

While statistics for national production in 2001 are not available, production data for one of the largest textile machinery producers in Russia, Open JSC (Joint Stock Company) Textilmash, Cheboksary region, has recently been made public. In 2001, Textilmash produced 121 million roubles worth of machinery, equipment and components, including about 130 spinning looms. In January–June 2002, it produced 71.86 million roubles worth, including 87 looms, which was a 4.8 per cent increase over the same period in 2001 (*Textile Industry*, No.7, 2002).

According to official forecasts, average annual production growth in the years 2003–2005 will be about 6 per cent, and twice as much in the years 2006–2010. Exports of textiles machinery and equipment will also continue to grow (according to official statistics, exports grew from US$ 15.7 million in 1992 to US$ 36.5 million in 2000, mostly to the countries of the former USSR, and developing countries).

*Market trends and best prospects*

In March 2000, Acting President Putin participated in the textile and light enterprises meeting, which discussed major problems and ways to solve them, including the following: developing a programme of industry development, paying the state debt to the textile enterprises in full, allocating funds from the Federal budget for seasonal purchases of raw materials and equipment, lowering import tariffs on raw materials and equipment, streamlining customs clearance procedures, and others.

The Russian textiles manufacturers have expressed a general concern about the duties on imported machinery that is not otherwise produced in Russia, and demanded that the Government lift all import duties on it. Regional Governments are paying special attention to textile industry development, the textile industry being a key sector of their regional economy. This is true of Ivanovo, Vladimir, Tver, Saratov, Nizhny Novgorod, Perm, Novosibirsk and some other oblasts (regions).

The Ministry of Economic Development and Trade of the Russian Federation has recently reviewed the Programme of Economic and Social Development of Ivanovo Region for the years 2003–2007, jointly prepared by the Administration of the Ivanovo region and the International Centre for the Development of Regions. The Programme has been submitted for government review. The Ivanovo region administration hopes that the Programme will be included in the 2003 Federal budget, the draft of which was approved by the Russian Government on 15 August 2002, and was submitted to the State Duma for approval. The programme envisages a plan for technical renovation and restructuring of a number of Ivanovo region textile enterprises.

In 2001, Nizhny Novgorod Region Duma approved a new concept of textile industry development in the region. The programme is called 'Programme of the Textile and Light Industries Development in Nizhny Novgorod Region for the Years 2001–2005'. The main objective of the programme is to renovate industrial machinery of the region's enterprises and increase their turnover capital. If the programme is successfully implemented, by the year 2005, the volume of production in textile and light industries in the region should grow by 4 per cent. The programme envisaged allocating 85.05 million roubles (approximately US$ 2.7 million) from the regional budget and 72.5 million roubles (approximately US$ 2.3 million) – from the enterprises' budgets.

The following product categories are considered the best prospects:

- textile spinning machines;
- machines for reeling, unreeling, folding, cutting or pinking textile fabrics;
- machines for extruding, drawing or cutting man-made textile materials;
- textile printing machinery, other than ink-jet printing equipment;
- roving machines for cotton;
- circular weaving machines for cotton;
- single board (knitting) machines for cotton;
- industrial sewing machinery, especially equipment for hot pressing (wet heat processing);
- preparing for cutting equipment;
- finishing (trimming) machinery.

## *Competitive analysis*

*Domestic production*

After the disintegration of the USSR, 88 per cent of textile machinery-producing enterprises of the former USSR remained in the territory of Russia. They could produce almost every kind of machinery for cotton, flax and wool processing and preparing; weaving machines for cotton and wool; looms for producing all kinds of fabric; knitting machinery and hosiery production equipment; machinery for production of non-woven fabrics; and washing, bleaching and dyeing machines.

According to official statistics, 70–80 per cent of textile industry equipment needs to be renovated. Domestic production cannot satisfy the growing demand in textile equipment any more. No matter how hard domestic manufacturers try to rebuild the industry, certain types of machinery can only be imported and others need serious upgrading. By the year 2001, textile equipment that had been in use over 10 years constituted over 80 per cent of the market of textile machinery. Over 33 per cent of all machinery had been in operation over 20 years. According to expert estimates, about 90 per cent of hackling machinery is worn out and needs to be replaced immediately.

After the 1998 crisis, in 1999–2001, the industry started to show some growth. Domestically-produced machinery became more competitive. In 2001, equipment production exceeded 800 million roubles (about US$ 27.6 million), and the volume of produced machinery and equipment almost doubled compared to 1998. JSC Mostochmash, JSC Sibtekmash, JSC Oryoltekmash and JSC Vichugskiy Mashzavod (machine-building plant) were among the leading enterprises. Unfortunately, only a limited number of enterprises (such as JSC Kolomnatekmash, JSC Tsvet, Gribanovskiy Mashzavod, JSC Oryoltekmash, JSC Kostromatekstilmash and a few others) were able to continue producing high-technology equipment, the rest either had to reduce the production of high-technology equipment and start producing some other types of machinery, or limit their production to the production of parts. This way, enterprises were able to continue working. As a result, the number of items of textile machinery and equipment seriously decreased, and the structure of domestic production has changed in such a way as to push up spare parts production and minimize production of machinery.

According to a recent inventory, production assets in the textile and light industry sector included (approximately):

- 21,000 hackling and spreading machines;
- 34,000 spinning machines;
- 9,400 twiners;
- 200,000 looms;
- 27,000 circular knitting machines;
- 800,000 industrial sewing machines.

This is still one of the largest industrial assets in the world. According to the State Statistics Committee of the Russian Federation (Goskomstat), at present the value of the main production assets in the textile sector is estimated at 5 billion roubles (a little over US$ 172.4 million), including 2.1 billion roubles worth (over US$ 72.4 million) of machinery and equipment. According to Goskomstat estimates, textile machinery is worn out by 61 per cent.

Industrial sewing machinery production shrank from 72,700 items in 1990 to 3,800 in 1998. The volume of sewing machinery in Russia is estimated at 400,000 (before 1991 there were about 1 million industrial sewing machines in the USSR, half of them were in Russia). According to some estimates, 90 per cent of the sewing machinery is worn out and needs to be replaced or upgraded. Domestic industrial sewing machinery is primarily manufactured in Podolsk.

One of the most acute problems of the industry is the need for modernization. Russian industry experts believe that this task could be solved in the following two ways: through replacing old equipment with new, and by repairing and upgrading the old equipment. As estimated by experts, the first option is five–seven times more expensive than the second one. Because of a lack of funding, the majority of Russian enterprises choose the second scenario. While protectionist tendencies are very strong in Russia, it is recognized that both ways of modernizing textile equipment are not possible without importing equipment, parts and components.

Imported parts and components are also used by Russian textile machinery manufacturers for the production of new high-technology machinery. As an example, JSC Vulkan (based in St Petersburg), a knitting equipment manufacturer, widely uses imported parts and components for manufacturing machinery. Vulkan, one of the oldest Russian enterprises (since 1891) produces and upgrades textile machinery and equipment. The company produces custom-made knitting equipment, non-woven fabric production machinery and other types of equipment for the production of knitwear. According to Mr Barkov, Economics and Finance Director at Vulkan, 2–3 per cent of components for circular knitting machinery production may be imported. This 2–3 per cent may account for 50 per cent of the cost, said Mr Barkov in an interview with *LegProm-Business Newspaper*, No. 7, July 2002 (www.lpb.ru).

The following types of equipment were traditionally produced in Russia (and former USSR countries):

- machines for preparing textile fibres;
- hackling machines for preparing cotton fibres, and other machinery for the initial processing of cotton;
- weaving machinery for cotton and wool;
- loom equipment;
- hosiery knitting machines;
- flat knitting machines;
- circular knitting machines;
- bleaching and dyeing machines.

*Imports*

Germany, Italy, Japan and Czech Republic are playing a significant role in the Russian textile machinery sector. US textile machinery was well-known and had a very good reputation in the former USSR. After the disintegration of the USSR, however, the major distribution channels were disrupted, and US export sales went down. More dynamic European firms, which historically had closer ties with Russia, took over the textile machinery market. The following firms have been in the Russian market for a long time: Durkopp Adler AG, Pfaff Industrie Maschinen AG, Reiter, Wastema, Strobel, Veit, Groz-Beckert, Barmag Spinnzwirm GmbH, Karl Mayer, Fleissner GmbH, Oskar Fischer GmbH, Bullmer (Germany), Saurer-Alma GmbH (works from Germany and Czech Republic); Benninger AG, Santex AG, Cavitec AG (Switzerland); IS Printing Systems (Austria); Octir Industriale S.P.A., Texita Moscow, Cognetex S.P.A., Rimoldi, Arioli, Arratex S.R.L., Promatech S.P.A. (Italy).

Marden (Czech) is a major supplier of pneumatic looms, and components for Czech weaving and knitting machinery. The company operates through a representative office in Moscow, and its Russian representatives are Mirex (Moscow) and LegPromService (Ivanovo). Elitex (Czech) primarily imports printing machinery and stabilizers. Stork from the Netherlands is known for its printing machinery. Superfinish GFP has started a new finishing line in the Tver textile factory (TKK). Japan is another major supplier of textile machinery to the Russian market. JUKI, Brother and J.Et-Japan Eurotex Ltd are the largest Japanese firms operating successfully in Russia.

The largest suppliers of sewing machinery to Russia are Pfaff, Durkopp, JUKI and Brother. According to some estimates, Pfaff and JUKI each export approximately US$ 4 million worth of machinery annually. The four largest suppliers of imported sewing machinery account for approximately 70–80 per cent of sales (in cost value). Among other suppliers are: Mitsubishi Electric, Yamato (Japan), Hornung GmbH Indupress & Co. KG, Maier-Unitas GmbH (Germany) and others.

Moscow-based ‘Sewing Equipment Centre’ Company Ltd is an example of a successful sewing machinery distributor, set up with the participation of foreign capital. The company works closely with Yamato Sewing Machine Mfg. Co. Ltd and Mitsubishi Electric from Japan, and Hornung GmbH Indupress & Co. KG and Ferd. Schmetz GmbH from Germany. The company provides a wide range of services including machinery supply, installation, maintenance and servicing, and spare parts supply and information services on new sewing technology and equipment. The company is now working on establishing a network of dealers throughout Russia.

Companies that have never worked in Russia before have started to gradually offer their products in the Russian market, because they have witnessed a revitalization of the Russian economy and production growth. Among them is Shima Seiki, a Japanese manufacturer of flat knitting machinery with electronic control, the largest manufacturer of such machinery in the world (about 50 per cent of the world production of 4,000 machines annually). Russian JSC Roytex represents this in the Russian market and to win the customers' trust, the company opened a service centre in Moscow. Mostly private Russian companies and entrepreneurs invest money in such projects and buy this complicated computerized machinery for the production of knitwear. Unfortunately, the Russian Government is not financing such projects.

JSC Mirex is a Russian distributor for fabrics and textile machinery. They started in 1989 as a fabric exporter (now they export over 3.5 million metres annually, mostly to the East European countries), but it gradually moved to importing equipment, and is now involved in the renovation process for the textile industry. For several years, they have been importing equipment, machinery and parts for textile and light industry enterprises, as well as promoting into the Russian market textile machinery of the following firms from the Czech Republic: Elitex, Marden, AMF Reece (also referred to as a UK company, but originally a US firm), Trastfin, Investa International, and Singa. SinMos Ltd is one of the leading distributors of sewing machinery. The company's annual sales exceed US$ 5 million, including US$ 1.5–2 million in industrial sewing equipment.

## *End-user analysis*

Textile enterprises of Central Russia are the major end-users of textile machinery and equipment in Russia. JSC Concern Rostextile is the largest association of textile, apparel and light industry enterprises. Its shareholders are more than 400 Russian textile industry enterprises, situated in 62 of Russia's 89 regions. Rostextile's affiliates control 32 per cent of textile production in Russia, depending on the product. In some cases it controls 100 per cent of production.

The largest silk and woollen fabric producers are associate companies in Rostextile:

- Tchaikovsky Textile, Baltex and Orendurgsky Textile are the largest manufacturers of silk; they account for 51.5 per cent of all silk products.

- JSC Krosno, Kupavna Textile Firm, Tverskoy Textile Combinat, Rostokinskaya Factory, Pavlo-Posadsky Kamvolshik, Alexeyev Moscow Textile Factory, Nevskaya Manufactura, Ulan-Udenskaya Manufactura and some others (total 74 enterprises) produce 55 per cent of all woollen fabrics.
- 68 enterprises associated with Rostextile account for 60 per cent of flax production.
- 54 per cent of knitwear is produced by 25 manufacturers, including Trivel Factory, Cheboksarsky Trikotazh, Rus and some others.
- 57 per cent of all socks and stockings production is manufactured by 59 hosiery producers.

Partnerships and joint ventures with foreign capital production companies, such as Petromix, constitute an important part of the end-users of textile machinery. Petromix Ltd, based in St Petersburg, has been manufacturing and distributing fabrics in Russia for over 10 years. During the last five years, the company has been working closely with Italian woollen fabric producer, Rosati S.P.A.

Joint venture Vigopod is an example of the successful cooperation of Russian and several foreign companies. The joint venture was registered in 1992, and since that time has developed a dealer relationship with the following foreign companies: Pfaff GmbH (Germany), AMF Reece (UK), Protomet (Poland), Comel (Italy), Legmash (Ukraine); the company is a unique distributor in Russia for Siruba (Kaulin Mfg. Co., Taiwan) and Golden Wheel (Chee Siang Ind. Co., Taiwan). Vigopod is an authorized dealer for Russian manufacturer Zinger (Podolsk, Central Russia).

## Market access

*Import tariffs*

With the prospect of Russia joining the World Trade Organization, import regulations have been changed to lower tariffs. The Russian Government has recently halved customs tariffs on imports of textile machinery, equipment and components to 5 per cent. The customs tariff on industrial sewing machinery and knitting machines is 10 per cent. Nevertheless, total import charges can reach 33 per cent of the contract value.

*Certification of textile machinery*

The State Committee for Standards and Certification (Gosstandart) is the government agency overseeing standards and certification issues for textile machinery in Russia. Government regulations require that a Certificate of Conformity (and safety) is obtained for all imported textile machinery. Testing of equipment may also be required. The Certificate could be obtained from several agencies, including Federal State Institution, RosTest-Moscow.

The procedure for obtaining the Certificate varies depending on the size and timeframe of the contract. If textile equipment is imported into Russia as a one-time deal, testing will not be required, and the Certificate will be issued as a result of reviewing a set of documents. Such a Certificate will be valid for that particular transaction only and may cover two–three types of equipment. It will cost approximately US$ 400 to obtain it.

For a long-term business relationship, it is possible to obtain a three-year Certificate. In this case, textile machinery and equipment need to be tested at the production or the installation sites. Such Certificates are issued for a group of similar machinery. The cost of obtaining the three-year Certificate is US$ 1,000–1,200 (not including travel expenses for officials to the site for testing equipment).

Details on certification procedure and documents can be obtained from RosTest-Moscow, experts on textile machinery and equipment, at the following address:

Sergey Aleksandrovich Pas'ko, Chief Expert
RosTest-Moscow
31 Nakhimovsky Prospect
Moscow
Russia
Tel: +7 095 332 9819 (Russian only)
Fax: +7 095 124 9996 (please mark: For section 280)
Email: sergeyAP@rostest.ru

*For more information please visit www.buyusa.gov/russia/en*

# 3.19

# The Tourism Potential of the Russian Federation

*Helene Lloyd, Director, Tourism, Marketing and Intelligence (TMI)*

A fascinating and diverse country, Russia is a unique travel destination that cannot be easily substituted by another country. However, infrastructure problems (excluding Moscow and St Petersburg), the absence of a service culture for many years and the lack of a coherent marketing policy for promoting the country abroad are stunting the country's huge potential for inbound tourism. St Petersburg is one of the world's pearls in terms of its architecture and cultural life and is starting to attract substantial numbers of tourists during the summer months. Its potential as a cultural tourism destination is unquestionable; the city will try to increase its profile during 2003 with the 300th anniversary of St Petersburg celebrations. Moscow is well equipped to deal with business travellers and provides a gateway into the rest of this expansive country. Russia is a vast territory with variable and fascinating landscapes. The volcanic regions such as Kamchatka, and great areas of unspoilt territory in Eastern and Southern Siberia, where ancient cultures have been preserved, all have the potential to be developed for both cultural and adventure tourism, but will require substantial investment over a long period.

## *Recent infrastructure developments*

As the capital city, Moscow captures well over half of Russia's income and as a result, has seen substantial development of international hotels over the last 10 years, including a proliferation of 5* hotels including three Marriotts, a Kempinski, a Sheraton and, most recently, a Hyatt. Hilton and Rocco Forte intend to open hotels by 2004. However, these hotels cater for the business traveller or the top end of the leisure market and are out of the price range of the average tourist.

The introduction of fast rail links between Moscow and St Petersburg, as well as regular flights, makes travelling between Russia's two main cities relatively easy, although driving between the two cities is recommended to only the most enthusiastic.

Moscow, more than any other city, has successfully invested in the renovation of numerous monuments, churches, convents and other historical buildings to their former glory, making the city an attractive and colourful place to visit and unrecognizable to tourists who visited the city prior to 1995. Domodyedova Airport, one of Moscow's several domestic but privatized airports, has been renovated and now accommodates international airlines and has direct flights to London, Switzerland and Austria. The recently completed fast rail link from Paveletsky station into Domodyedova Airport, would seem to secure the airport's future development, as transportation by car in the city becomes almost impossible during peak hours.

On the other hand, Moscow's main international airport, Sheremyetevo II, has failed thus far to recreate itself. Grandiose projects to build a new terminal (Terminal III) and to put both international terminals (II and III) under the management of an international company have, as yet, failed to emerge due to political wrangling between government ministries, vested interests in the airport and constantly changing airport management. Substantial investment opportunities exist for foreign construction companies in both Moscow and other regional airports across Russia that would like to develop into transport hubs and aspire to being the connection point between Europe and Asia. St Petersburg international airport, Pulkovo, is under renovation in preparation for the city's celebratory year, 2003.

Although most of Russia's domestic airlines were scary enough to upset even the most seasoned traveller, there have been important developments by a number of the larger domestic airlines such as Siberia Airlines and Ural Airlines. Both have excellent levels of service including a first class service that could compete with international carriers. Eventually the larger carriers will put the smaller operators out of business and should raise the level of the internal flight services.

## *Tourism activities*

The are three principal kinds of tourism in Russia that can be considered to have potential for development: cultural, business and adventure.

*The potential for cultural tourism*

The capital of cultural tourism is, without a doubt, St Petersburg and a number of small historical towns in the north-west of Russia, such as Pskov and Novgorod. The second centre is the Golden Ring, a group of fascinating, ancient cities situated around Moscow, such as Suezdel, Vladimir and Yaroslav. All of these cities are crying out for more hotels, especially tourist class hotels. St Petersburg's intermediary solution to the accommodation problem has been led by private initiatives such as the 'Randhouse'. This is one of several privately-owned guest houses located in the city centre that has up to 10 rooms with en-suite facilities: prices range from US$ 60–US$ 80 per night, including breakfast. The main drawback of this ad hoc accommodation is that there is no quality control scheme or promotion of their services. Also, they are normally located in ordinary residential buildings which have very run down badly-lit entrances and small or non-existent lifts, and are therefore not suitable for older guests, the segment most likely to appreciate, and able to pay for, St Petersburg's cultural heritage.

Apart from the lack of appropriately priced accommodation for tourists, the Golden Ring cities, in particular, suffer from a lack of transport infrastructure; although a regular bus and a slow train connect these towns with Moscow, only the most ardent traveller would probably be able to find out the times and locations of this public transport. Patricharchy Dom Tours offers regular English-speaking guided tours to towns of interest in and around Moscow for day-trips or for a weekend, but for the independent traveller the only solution is for them to hire a car and try their luck with accommodation on arrival, which might not be very lucky during the popular summer months.

The election of Putin as president has assisted St Petersburg to regain some of its former glory. Important statesmen are invited to both capitals to meet with the President, increasing the awareness of the city. A huge restoration project of the main historical monuments of the city in preparation for 2003 has helped the city to look less run-down and more appealing to tourists. However, much of the renovations are cosmetic – a large percentage of the funds allocated for the renovations went missing and as a result, St Petersburg will not obtain as much as it could have out of this first attempt to promote the city to the world.

Moscow also has plenty to offer in terms of culture: the famous Pushkin and Tretyakovskaya galleries, filled with world-famous art collections; a unique collection of churches; the Bolshoi theatre, as well as numerous other theatres; and an extravagant nightlife scene. It is also home to the Russian Government 'the Kremlin'. Moscow has something for everyone, from numerous ancient monasteries to a vast variety of restaurants, bars, cafes and nightclubs equal to, and in many cases better than, other major European cities. Moscow's main limitation is its value for money. Prices are high, especially when you don't know your way around, as is the case for most tourists. There is little in the way of information in Latin letters, even in the centre.

#### The accommodation factor

Moscow is the fourth most expensive city in the world in terms of hotel prices. The shortage of tourist-class hotels may be accounted for by the higher risks involved, in turn owing to the slower returns on investment. This is made even less desirable by the city's policy of procuring a 51 per cent shareholding in all hotels built in the city. Holiday Inn has built a hotel on Moscow's outskirts and Novotel has recently completed a more centrally-located 3* hotel. A small number of private hotels, such as Ekaterina, Alrosa and Sretenka, are starting to emerge but they are not sufficient to accommodate tourism groups and do not always have contracts with tour operators.

The large Soviet dinosaurs, such as Hotel Moskva, Rossiya and Ukraine, which should be able to accommodate tourism groups, have still not been privatized and remain as a stark reminder of Soviet hospitality. The fact that these properties are being kept in limbo so long is preventing the development of tourism and their existence only serves to reinforce negative stereotypes of Russian service levels. The demolition of the Intourist and Minsk hotels are welcome decisions. For the sake of the city's skyline and its reputation for hospitality, they will be replaced by international hotels. The Ukraine Hotel has huge potential to be developed owing to its central position and its architectural heritage; it occupies one of the famous Severn sisters built to celebrate Moscow's 800th birthday. The Hotel Rossiya is Russia's largest hotel and is situated on the edge of Red Square. Although there are spectacular views from its windows, the building itself is a major eyesore, which spoils the embankment area and has tight, unfriendly security. The inside of the hotel is in a permanent state of semi-reconstruction, which tourists are expected to live with.

*The potential for business tourism*

If St Petersburg is the capital of culture, then Moscow is the king of business tourism. As has already been mentioned, Moscow has sufficient 4* and 5* hotels, and it also has an excellent variety of restaurants and other facilities for international business travellers. Moscow probably has great potential to be developed in terms of incentive travel and other aspects of corporate travel. St Petersburg has four international hotels with several others due to be completed in 2003, but probably too late to service the expected increased number of tourists. In terms of incentive travel, St Petersburg has the most to offer. Blessed with a number of breathtakingly beautiful royal palaces which make Buckingham Palace look like an ugly cousin, this has the potential to provide event organizers with highly original venues for top level receptions, which could bring the city some much-needed income.

Other cities that have one or more hotels of international standard are mainly located in pockets of prosperity. For example, in the Urals, both Ekaterinburg and Tyumen have excellent 5* hotels, whereas cities in the Far East, such as Vladivostock, have benefited from Korean investment in the hotel sector and have a better variety than in European Russia. Other business centres such as Perm, Samara, Novosibirsk and Irkutsk are still in desperate need of foreign investment to develop at least one business-class hotel.

*The potential for adventure tourism*

Adventure tourism has a huge potential in a country of this size where large areas remain unpopulated. Unfortunately, a massive amount of foreign investment will be needed, as well as a change in government policies, to develop areas such as Kamchatka (a unique, volcanic area in the Far East), Chukotka, (the extreme northern Far East) and the Altai (Western Siberia). One company, Paradise Travel, has cleverly combined adventure and cultural tourism in the area around Krasnoyarsk which includes tours to an unspoilt area with a fascinating mixture of different ethnic groups, eg Tuva, a far flung autonomous republic on the border with Mongolia, home of the famous throat singers.

The most obvious place to develop is Irkutsk, home of the world's largest freshwater lake, the Baikal. The neighbouring autonomous republic of Buryatia also has huge potential owing to its spectacular Asian steppes scenery but it is completely undeveloped in terms of infrastructure.

Finally one should not forget to mention the remarkable success rate of cruises in Russia, the main route running from Moscow and St Petersburg over six–seven days and including a two-day stay in both Moscow and St Petersburg. This has been successful because of the range and quality of some of the cruise boats. The Volga area and southern Russia have great potential for further development in terms of the introduction of more high-class cruise boats and add-on services.

## *Lies, damned lies and statistics*

Reliable tourism statistics are hard to find and those that do exist vary widely. According to the World Tourism Organization, which bases its statistics on those supplied by the Ministry for Economic Development, international tourism arrivals to Russia have reached 21.2 million. However, this number does not reflect the real number of tourists who visit Russia since a large proportion of this figure is accounted for by cross-border crossings. The real figure is estimated to be around the 2 million mark. As St Petersburg is the only city in Russia where over half the visitors come for tourism purposes, a more thorough observation of the city's statistics gives a more realistic picture. The average period of stay is short in both of the large cities; in Moscow it is 3.5 days and in St Petersburg it is 4.8 days. This is probably due to the popularity of cruises and the high cost of Western style accommodation.

It should be noted that the numbers from Finland and the Baltic States are partly due to their geographic proximity, and figures from the Baltic States may have been affected by the introduction

**Table 3.19.1** Top eight nationalities visiting St Petersburg

| | *Country* | *2000* | *2001* | *% to 2000* |
|---|---|---|---|---|
| 1 | Finland | 1,417.7 | 1,255 | –11.5 |
| 2 | Baltic States | 795.0 | 653.5 | –17.8 |
| 3 | Germany | 91.2 | 112.6 | +23.5 |
| 4 | United States | 78.0 | 72.3 | –7.4 |
| 5 | Great Britain | 56.8 | 69.9 | +22.9 |
| 6 | Italy | 45.9 | 51.0 | + 11.4 |
| 7 | France | 37.8 | 43.0 | +13.6 |
| 8 | Sweden | 28.5 | 23.5 | –17.5 |

Note: Figures in 1,000s

of visas for entering Russia. Nevertheless figures for the year 2001 look positive with all the nationalities except from Sweden and the United States showing an increase. The reduction in the number of Americans travelling to Russia reflects a worldwide tendency in Americans travelling outside of the country owing to the events of 11 September 2001 and the slow down in the economy.

## *Main factors preventing the development of tourism in Russia*

*Visas*

These are still complicated and bureaucratic and tend to put off tourists who can quickly find another destination without confirming a hotel booking. The inflexible and archaic visa policy is preventing the development of St Petersburg into a long weekend destination, which Prague, Budapest and Tallin (Estonia) have managed to achieve in a relatively short period. Despite recent attempts to introduce a three-day visa that could be collected at the airport, this has not yet materialized as a popular option owing to a lack of coordination with airlines (most international airlines refuse to let passengers on without a valid visa) and a lack of information outside Russia about the new visa. Unlike other CIS countries such as Azerbaijan, which efficiently sells you a visa at the airport in 10 minutes, or innovative countries like Armenia, which have made it possible to apply for a visa on the Internet, Russia is lagging behind its neighbours and missing the opportunity to attract more tourists.

*Facilities for independent travellers*

Although travel to the Former Soviet Union was acceptable, if only in groups, today, because of the lack of infrastructure for foreign tourists, the situation has changed little. There are no translations of street names into Latin script, except in the centre of St Petersburg. Maps of the metro are not readily available, although there are Latin transcripts of the stations inside the train. Nevertheless it is difficult to get around the city unless accompanied; this shows a lack of understanding of the needs of Russia's potential tourists since the main segment that is interested in cultural tourism in Europe prefer to travel as individuals.

*Double pricing system*

This is another hangover from Soviet times when foreigners were charged different rates to Russians. As a result, museums such as the Kremlin and Moscow's main art galleries charge substantially more to foreigners than to locals. The situation is more acute in St Petersburg, where the Hermitage charges foreigners up to 10 times more than locals, as does the Marinski Theatre, home of the Kirov Ballet. Double pricing does not only affect high culture, which does incur high production costs; it has turned into a free-for-all with even currency exchanges officially giving lower exchange rates to foreigners who are considered to be tourists. The canal boats charge double but fail to provide even a recorded commentary in any language other than Russian. The system of double pricing without providing the expected additional service leaves visitors feeling ripped off, which is unlikely to encourage repeat business.

*Services*

Although most of the top Moscow hotels have an enviably high service level, attained by employing highly educated young people who have been well trained, hotels of the price level affordable to the average tourist tend to be in the class of Soviet dinosaurs. Services include curt receptionists, inedible food and unsolicited telephone calls from ladies of the night. Although there are some Western 4* hotels that provide tourist rates during the summer months when business travel is low, none of this is a sound foundation for the development of tourism.

*Taxis*

Hotels of any kind in Moscow attract Almodova type taxis who try to impose a minimum charge of US$ 20 to go anywhere, even if it is only five minutes away. Frequently, the drivers speak no foreign language, have dirty or ageing cars and expect the passenger to assist in finding the way.

On a more fundamental level, there are a number of basic problems that are preventing the rapid development of tourism in Russia:

*A lack of tourism strategy*

Although, at the federal level, there *is* a strategy, it is not readily available. The Moscow Committee for Tourism is also unable to publicize its strategy and instead is principally occupied with building prestige white elephant projects reminiscent of the Soviet Five Plans. Potential tourists are still treated as lumps of steel whose numbers are to be increased to 5 million by the year 2010, and there is little idea, or interest to find out, who these potential tourists are and if their projects are profitable for such a market segment(s). Foreign investors are encouraged to fund tourism-related projects but little or no research has been done to assess their viability. A recent example of this is the huge amount of time and effort that Moscow City Government spent attracting the Formula 1 grand prix, only to find that they did not have sufficient interest from investors for this ambitious project.

*Weak PR management*

Although Russia has a motley assortment of national tourism office representations in key countries, they often receive little or no promotional budget. A professional PR company has never been commissioned to improve Russia's image abroad. There is very little positive PR about the great transformation of Moscow into a leading European capital city, and thus the image of Moscow in particular, and Russia in general, is stuck in a post Soviet time-warp of a gangster ridden, grey place that no longer reflects the realities of Moscow and St Petersburg, which are safe, cosmopolitan, lively cities.

## *Conclusion*

The tourism potential of Russia is truly colossal but owing to a lack of strategy and PR experience, and lack a of consistency on the side of the Government, the transformation of Russia into its true potential as a top world tourism destination may take somewhat longer than it should without the Government taking the tourism industry more seriously and creating a coherent strategy.

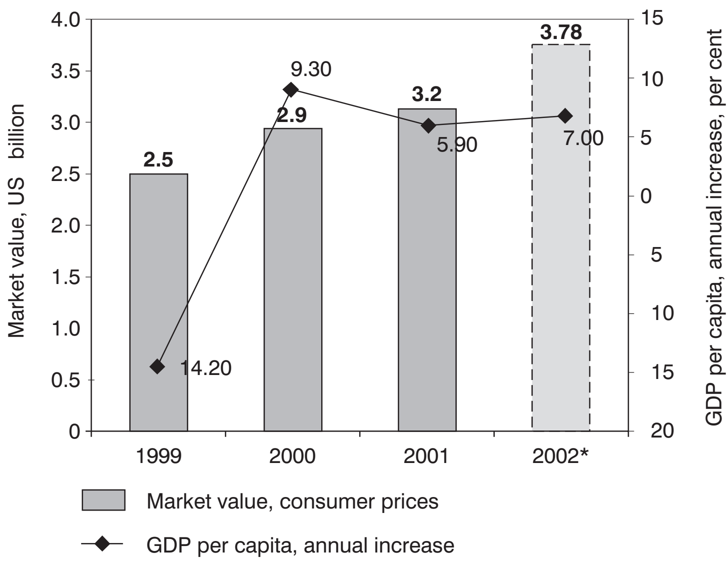
## 3.20

# The Pharmaceuticals Market

*RMBC*

### *Market size*

The Russian pharmaceutical market has now passed the serious breakdown period following the financial crisis of 1998 and, since 2000, has experienced steady growth. As the income of the population increases, this growth shows no signs of weakening (see Figure 3.20.1). In 2001, the annual market increase for the sector reached some 10 per cent, while in 2002 we expect that market growth will



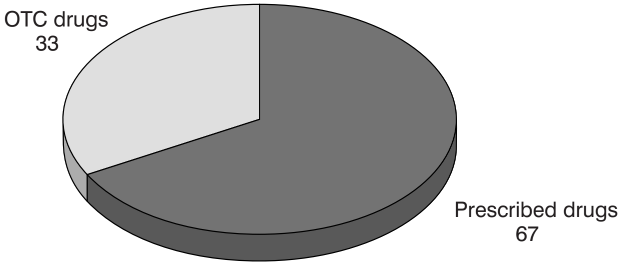

*Source:* Goskomstat, RMBC
*RMBC forecast

**Figure 3.20.1** The Russian pharmaceutical market value, US$ billion reach some 18 per cent in consumer prices. Such an intense increase is mainly due to the 10 per cent VAT imposed since January 2002, and we estimate the actual growth of the market in pre-VAT prices at about 8–9 per cent. The average annual consumption of drugs increased from US$ 17 per capita in 1999 to US$ 22 in 2001, and the 2002 expected level should be US$ 26. According to our forecasts, during the next three years the Russian pharmaceuticals market will be increasing at annual rate of 10 per cent, and in 2005 its value will total US$ 5.1 billion in final consumer prices. This estimate is based on the assumption that the Russian political system will remain stable and that no major changes take place in the Russian legislature.

## *Market structure*

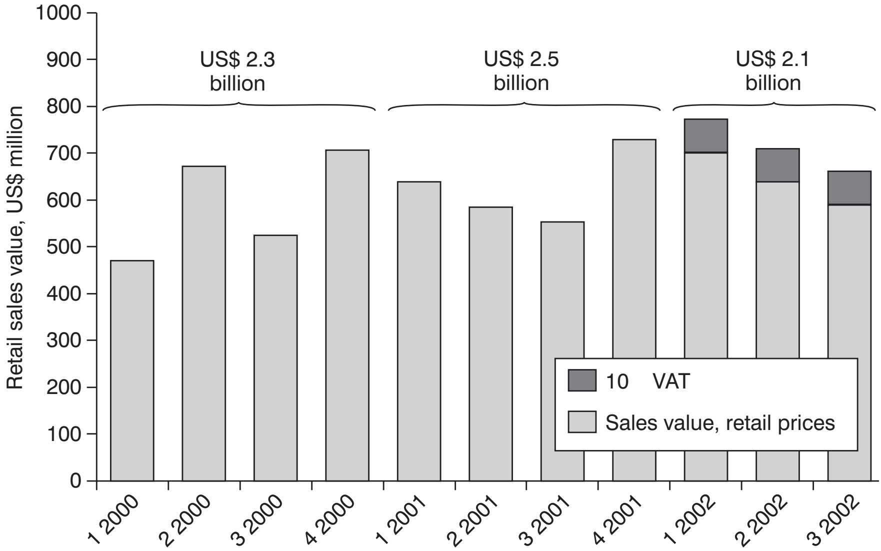
In 2001, sales of pharmaceuticals to pharmacies accounted for 80 per cent of the total sales in the market, 15 per cent were accounted for by hospital purchases, and federal state procurements accounted for 5 per cent. The retail sector is dominated by Rx drugs, which account for about 67 per cent of the retail sales (see Figure 3.20.2). Sales to pharmacies have a tendency to increase in the autumn–winter season, a cough and cold period, and have a stable minimum in the summer months (see Figure 3.20.3).

Sales in the Russian pharmaceutical market are concentrated in Russia's major economical and population regions. In the first nine months of 2002, the cumulative share of the top 10 regions by retail sales value accounted for about 40 per cent of the market, with about half of this figure being accounted for by Moscow and St Petersburg. The population of these two cities together accounts for about 10 per cent of the country's total pharmaceutical sales, while in the first nine months of 2002 the retail sales of drugs in Moscow



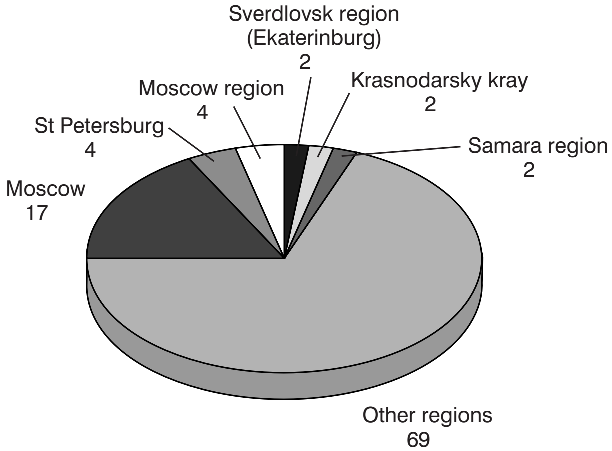

*Source:* RMBC

**Figure 3.20.2** Structure of the retail sector of the pharmaceutical market in January–September 2002, consumer prices




*Source:* RMBC

**Figure 3.20.3** Pharmacy sales of drugs, quarterly dynamics




*Source:* RMBC

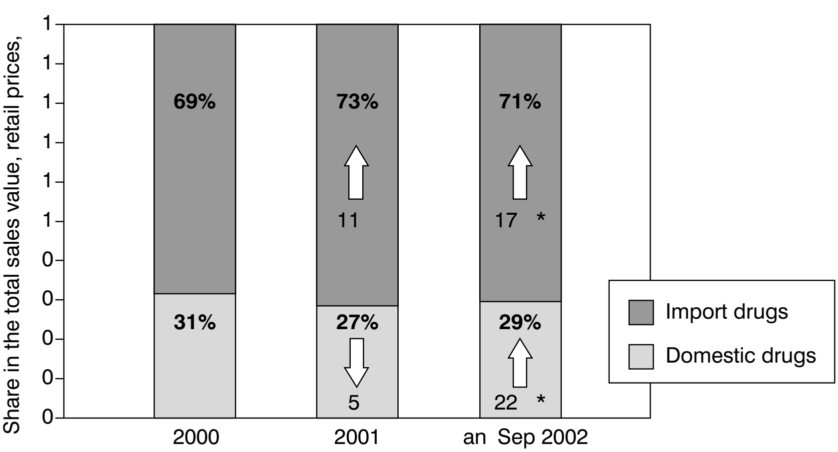
**Figure 3.20.4** Pharmacy sales of pharmaceuticals by regions in January–September 2002, retail prices

and St Petersburg accounted for 21.4 per cent of the total (see Figure 3.20.4). This cumulative share in 2000 accounted for 19.9 per cent of the retail sales, and has been slightly increasing since then at annual rate of 0.5 per cent points, which illustrates the trend of the population's income becoming centralized.

## *Pharmaceutical supply*

The pharmaceutical market in Russia is dominated by imports. In unit terms the cumulative share of the domestic manufactured drugs in both retail and hospital sectors accounted for about 75 per cent in the first nine months of 2002, but in money terms its value accounted only for about 30 per cent of the market. This means that the average per-package price for imported drugs is seven times higher then the average price for domestic drugs. Last year the cumulative share of the imported drugs in both retail sales and hospital purchases was almost the same in value terms and 5 per cent above the current share in unit terms. In the retail sector in the first nine months of 2002, the sales values of domestic manufactured drugs shows better dynamics compared to imported ones (see Figure 3.20.5).

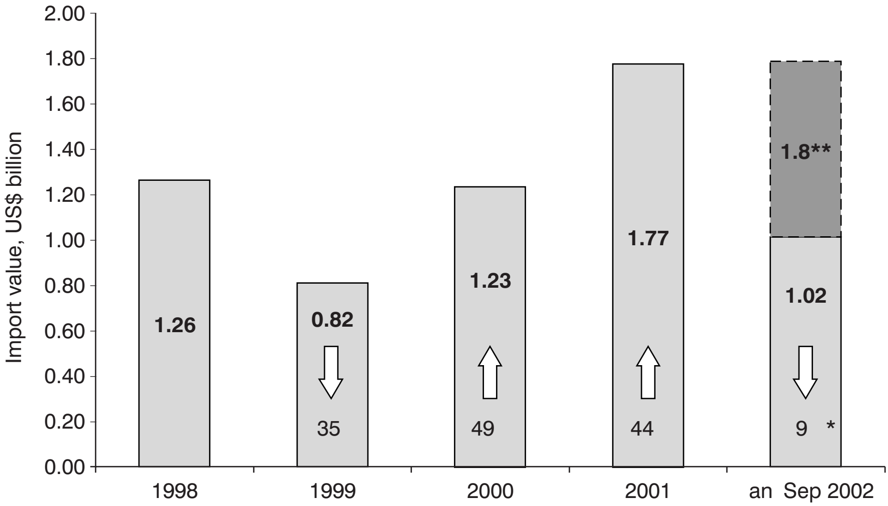
The annual imports of pharmaceuticals in Russia have been increasing rapidly since 2000 and totalled US$ 1.77 billion in 2001 (see Figure 3.20.6). The announcement of the VAT imposition strongly stimulated imports in the end of 2001, which led to an enormous increase of imports that year and a subsequent recession due to the over-stock effect. In the near future, the value of imports is expected to increase again owing to the introduction of the new custom certification rules. However, in reality it is unlikely that this increase would be bigger than that of last year and the value of imports is unlikely to exceed the 2001 level.




*Source:* RMBC

*Compared to the corresponding period in 2001

**Figure 3.20.5** Retail sales of foreign and domestic manufactured drugs, shares in the total retail sales and annual increase



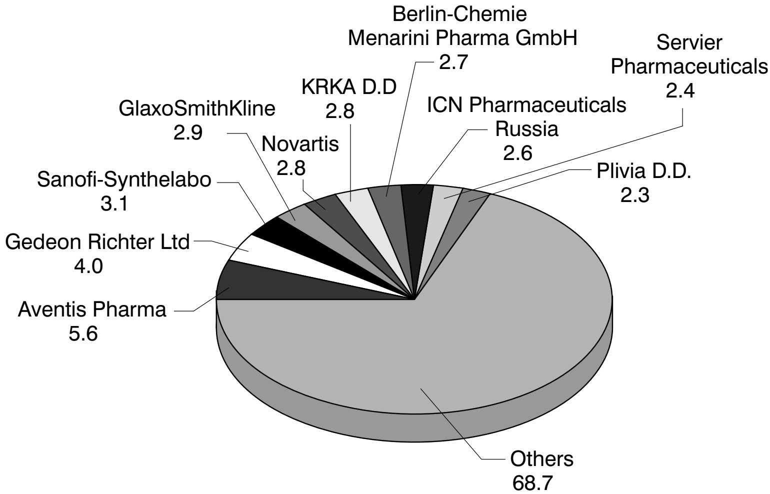

*Source:* State Customs Committee
*Compared to the corresponding period of 2001. **RMBC forecast

**Figure 3.20.6** Imports of pharmaceuticals in Russia

The main importers of drugs into Russia are European countries, and in 2001 Europe accounted for nine of the top ten importing countries by value. According to the State Customs Committee, the biggest importers were Germany (with 13.5 per cent share of total imports), France (10 per cent), Hungary (8.5 per cent) Austria (8.1 per cent) and India (7.3 per cent)

The only domestic manufacturer present in the top 10 manufacturers by retail sales and hospital purchases in the first nine months of 2002 is the Russian division of ICN Pharmaceuticals inc., which includes five previously state-owned pharmaceutical factories in Russia (see Figure 3.20.7). The list of the leading producers is relatively stable: since 2001, only one new manufacturer entered the top 10 – Pliva D.D. The same analysis of manufacturers by retail sales of drugs shows that in 2001 there was only one new manufacturer. Compared to the cumulative share of Glaxo Wellcome and SmithKline Beecham in 2000, the new GlaxoSmithKline managed to enter the top 10 manufacturers by retail sales in Russia in 2001.

Domestic manufacture of drugs in Russia has not as yet reached the pre-1998 crisis level. After a 38 per cent increase on 1999 production was recorded in 2000, growth has now almost stopped and in 2001, and most likely also in 2002, will not exceed 1 per cent




*Source:* RMBC

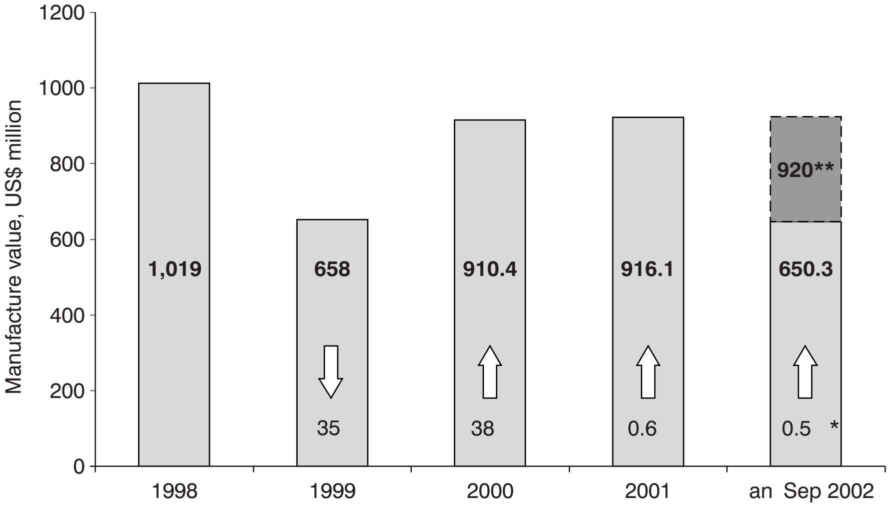
**Figure 3.20.7** Top 10 drug manufacturers by retail sales and hospital purchases value in January–September 2002, wholesale prices

(see Figure 3.20.8). Furthermore, in 2001, production values of most of the leading manufacturers decreased (compared to the 2000 level) by an average of 8 per cent (leading domestic manufacturers of drugs are given in Figure 3.20.9). This can be partly explained by the fact that, by 2005, all pharmaceutical manufacturers in Russia should pass certification under GMP international standard. Thus, today, most of the companies are forced to collect funds for re-equipment of manufacture and certification procedures, rather than invest in production expansion.

Most of Russia's current pharmaceuticals production facilities employ obsolete equipment and experts estimate that the cost of transition to the GMP standards for the entire Russian pharmaceuticals industry will need some US$ 2 billion worth of new investment. As a result, most of the drugs manufactured in Russia are of a quality suitable for domestic use only, or for exports to other post-Soviet republics and developing countries.

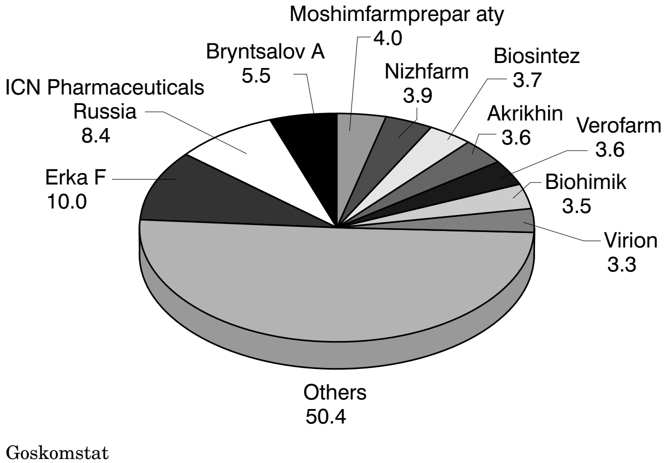
## *Wholesale distribution of pharmaceuticals*

Among the large variety of pharmaceutical distributors operating in Russia, many operate in their respective regions of the country. The largest national distributors are Protek Co., SIA International and




*Source:* State Customs Committee
*Compared to the corresponding period of 2001. **RMBC forecast

**Figure 3.20.8** Domestic production of pharmaceuticals in Russia




*Source:* Goskomstat

**Figure 3.20.9** Top 10 manufacturers of pharmaceuticals in Russia by production values in January–September 2002

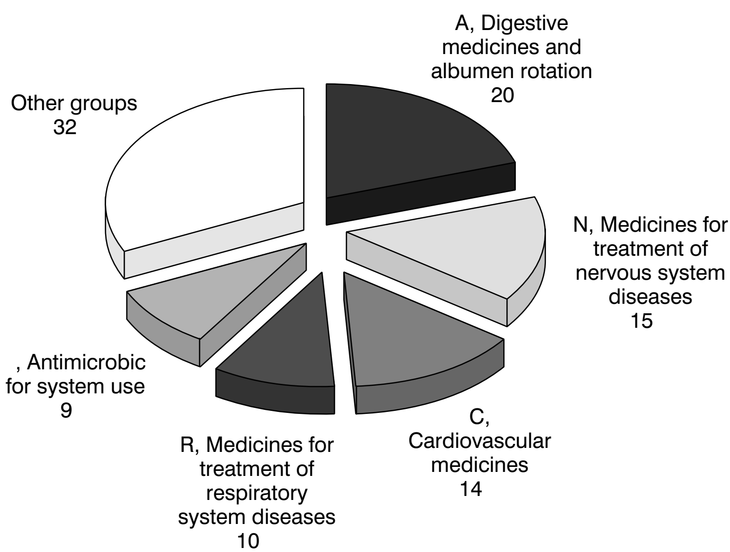
Shreya Corporation. Experts estimate that these three companies account for some 35 per cent of the total drugs distribution in Russia. Other large national distributors include Apteka Holding and Rossibfarmacia. In December 2002, Tamro, the Finnish wholesale group, announced the merger of its Russian subsidiary, the distribution company Farm Tamda 77, with Rossibfarmacia and Artromed, another local distributor. Thus, a new national player was founded which is expected to hold a 7 per cent market share.

## *Retail sector*

The pharmacy business in Russia includes over 66,000 retail outlets, among which are over 19,000 pharmacies, over 35,000 smaller drug outlets, and about 12,000 drug booths. About 65 per cent of the pharmacies and 62 per cent of the smaller outlets are state or municipal owned, with the share of the state- and municipal-owned booths accounting for about 50 per cent.

## *Sales structure*

The structure of the retail sales by therapeutic groups in the last two years was quite stable: in January–August of 2002, changes of shares of ATC groups by first level codes in retail sales did not exceed 0.6 per cent compared to 2001 figures (the top selling therapeutic groups are shown in Figure 3.20.10). A year later, the most significant changes in sales structure occurred in the digestive and antimicrobic medicine segments, with market share changing by around 1.5 per cent upwards and downwards respectively. The



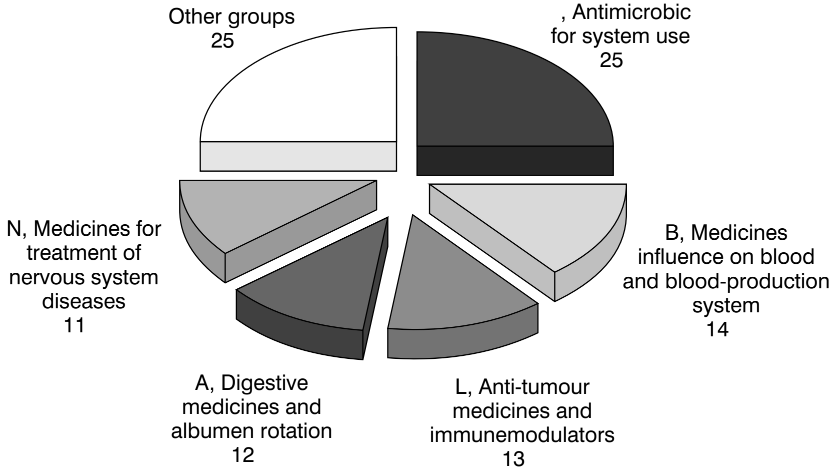

*Source:* RMBC

**Figure 3.20.10** Top five ATC groups by retail sales in January–September 2002, retail prices analysis of the retail sales by second level ATC codes groups shows that in the first nine months of 2002 there were no significant changes compared to the corresponding period of previous year (see Table 3.20.1).

The structure of hospital purchases (see Figure 3.20.11) by therapeutic groups in the first nine months of 2002 changed more

**Table 3.20.1** Top 10 therapeutical groups by retail sales in January–September 2002

| *Rank* | | | | *Share in the retail sales (per cent)* | |
|---|---|---|---|---|---|
| *I-IX 2002* | *I-IX 2001* | *ATC Code* | *Therapeutic group* | *I-IX 2002* | *I-IX 2001* |
| 1 | 1 | J01 | Antibacterials for systemic use | 7.4 | 7.9 |
| 2 | 2 | N02 | Analgesics | 6.1 | 5.3 |
| 3 | 3 | A11 | Vitamins | 4.7 | 5.1 |
| 4 | 4 | C09 | Agents acting on the Renin-Angiotensin System | 3.9 | 3.8 |
| 5 | 5 | N06 | Psychoanaleptics | 3.7 | 3.7 |
| 6 | 6 | C01 | Cardiac therapy | 2.8 | 3.0 |
| 7 | 8 | N05 | Psycholeptics | 2.6 | 2.6 |
| 8 | 9 | A02 | Antacids, drugs for treatment of pept. ulc. and flatul. | 2.5 | 2.5 |
| 9 | 7 | G03 | Sex hormones and modulators of the genital system | 2.5 | 2.7 |
| 10 | 10 | R05 | Cough and cold preparations | 2.5 | 2.3 |
| **Total top 10** | | | | 38.5 | 38.9 |




*Source:* RMBC

**Figure 3.20.11** Top five ATC groups by hospital purchase value in January–September 2002, wholesale prices significantly compared to the year 2001. The largest changes were a 2.9 per cent decrease in the antimicrobics share and 2.4 per cent increase in the immune modulators share.

# Part Four

# Getting Established: The Taxation and Legal Environment

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# 4.1

# Business Structures in Russia

*CMS Cameron McKenna*

## Introduction

In the last few years Russia has introduced extensive corporate legislation governing the creation, management and liquidation of a range of legal entities and other structures through which business may be conducted. These include public and private companies, branches and representative offices and limited and unlimited partnerships. A basic description of each of these forms is set out in the Civil Code of 1994 and in respect of some of the structures further, more detailed regulations are set out in laws governing particular types of structure, for example the Law on Joint Stock Companies of 1995 and the Law on Limited Liability Companies of 1998.

The structures most commonly used or encountered by foreign investors are the representative office, the limited liability company and the joint stock company (of which there are two forms – 'open' or public and 'closed' or private). This chapter will focus on these principal forms.

## Representative office

*Status*

A representative office with accredited status has been traditionally viewed as the simplest form of business presence that a foreign company could establish in Russia. In the USSR it was the only vehicle available to foreign companies and, although foreigners can now set up a wholly-owned subsidiary company and participate on an equal basis in the various forms of partnership prescribed under Russian law, a representative office remains an effective first entry vehicle either alone or in conjunction with a company of some form. Some of the reasons for this are explained below.

A representative office is not a separate legal entity but an office of the parent entity that is set up in Russia to represent the interests of that parent. Although a representative office may in practice conduct business in Russia and may be treated by the tax authorities as a separate profit centre from its parent company, the fact that as a matter of civil law a representative office does not have its own separate legal identity limits the types of business for which a representative office may be useful. For example, a representative office may not import goods for purposes other than its own needs, nor may it register title to immovable property in its own name. A representative office may also experience difficulties in obtaining licences and permits to conduct certain types of business.

A representative office may however carry out representative functions on behalf of its parent, including arranging marketing and advertising in Russia, negotiating the terms and conditions of agreements on behalf of the parent entity and facilitating the execution of those agreements by the parent company. It may also help in other commercial and legal transactions between the parent and Russian organizations, including the rental of property.

At one time an accredited representative office enjoyed a range of benefits that were not available to branches or companies. These benefits have been gradually withdrawn, for example, customs exemptions on equipment imported for the use of the representative office were withdrawn in February 1999. Foreign employees of a representative office may still obtain personal accreditation, which confers certain practical benefits such as the right to import and export personal effects free of customs duties and VAT and which assists with obtaining multi-entry visas. There has been considerable debate about whether accredited employees of a representative office require work permits but in practice having a work permit should avoid difficulties with Russian state and local migration authorities.

A significant advantage of a representative office is that it is not deemed to be resident for Russian currency purposes and, therefore, its foreign currency receipts are exempt from the mandatory requirement to convert those receipts into roubles. A representative office may have a number of different types of bank account: a foreign currency account; a rouble 'conversion' account (referred to as a type K account); and a rouble 'non-conversion' account (known as a type N account). These accounts enable the representative office to make payments in Russia to both residents and non-residents subject to certain currency control restrictions established by the Central Bank regulations and other applicable legislation.

Proceeds from business operations may be accumulated either on the type K account or on the type N account (depending on the type of proceeds) and, after conversion into foreign currency, may be transferred abroad.

*Liability*

Because a representative office is merely an extension of its parent, the parent remains responsible for the debts and liabilities of the representative office.

*Management*

A representative office is managed by the 'Head of the Representative Office', who is empowered to conduct the business of the office and so to represent the foreign parent company by way of a power of attorney. A representative office should also have a 'Chief Accountant'. There is no requirement for either the Head of the Representative Office or the Chief Accountant to be a Russian national although an accountant who understands the intricacies of Russian tax and accounting law is a practical necessity. Since the foreign parent company is fully liable for the debts and obligations of the representative office, some consideration should be given to the management of the office and any internal controls that may be appropriate to mitigate the exposure of the parent company.

Setting up a representative office is often the first step that foreign companies take when entering the Russian market and may be used for certain service industries on an on-going basis. For companies in many other business sectors, however, a representative office is not on its own sufficient, although it may form part of a larger structure including one or more companies or other entities.

## *Limited liability company ('obshestvo s ogranichennoi otvetstvennostyu')*

*Status*

A limited liability company is designated by the letters 'OOO' before or after its name. It is the simplest form of Russian company and for that reason is often used for wholly-owned subsidiary companies of foreign investors. It is similar in concept to a German GmbH or limited liability company.

The establishment of a limited liability company is governed by Part 1 of the Civil Code and by the Law on Limited Liability Companies of 8 February 1998. It is similar in many ways to another form of Russian company, the closed joint stock company, which is described below. The most significant difference between a limited liability company and a closed joint stock company is that a limited liability company does not issue shares. The charter capital is instead divided into 'participations' or 'interest' units ('doli'). Unlike shares issued by a joint stock company, these interest units are not considered to be securities and, therefore, they do not need to be registered with the Federal Commission on Securities, which goes some way to reducing the expenses of registration and also the level of bureaucracy to be dealt with by the company. Each holder of an interest unit is referred to as a 'participant'. The liability of participants in the company for the debts and obligations of the company is, as a general principle, limited to the amount of their respective contributions.

A limited liability company may be wholly owned by another business entity provided that entity is not itself a company wholly owned by a legal entity or individual. On the other hand if the number of participants in the company exceeds 50 then, unless the number of participants is reduced, the company is obliged to re-register as an open joint stock company within a year.

*Management*

The management structure of a limited liability company is relatively straightforward and may consist of a general director and the meeting of participants. A board of directors is not required but can be provided for by the terms of the charter.

Although a participant in a limited liability company is generally entitled, at the general meeting of participants, to the number of votes which represents the value of thier contribution to the company's capital. This principle can be changed in the company's charter either when establishing the company or by subsequent amendment to the charter which requires the approval of two-thirds of the company's participants.

*Transfer of interest units*

Interest units or participations in a limited liability company are freely transferable subject to a statutory right of pre-emption in favour of the other participants. This right cannot be excluded from a company's charter. Thus, a transfer to a third party can only take place once the other participants have had the opportunity to purchase the interest. The procedure for offering the interest units to the other participants and for determining the price at which the units are offered is usually set out in the company's charter.

The charter may prohibit the transfer of an interest to a third party in which case, if the other participants decline to purchase units offered to them, the company itself is obliged by law to purchase this interest. Payment may be in cash, or in kind with the agreement of the transferring participant. The participant has the right to receive payment for its interest within six months (unless a shorter period is provided for in the charter) after the end of the accounting year in which the participant offered its interest for sale.

*Right to withdraw*

Every participant of a limited liability company has a right to withdraw from the company at any time without the consent of any of the other participants or of the company. If a participant exercises this right the interest unit is transferred to the company with effect from the time the withdrawal notice is served on the company. The company is then obliged to pay the exiting participant the 'actual' value of his portion of the capital in cash. The 'actual value' of the interest unit of the participant is calculated as a proportion of the net value of the company's assets equal to the proportion of the company's participation interests that he or she holds. Payment, however, is only required to be made within six months after the end of the financial year in which the withdrawal notice was served. The company may pay the exiting participant its entitlement in kind provided the participant agrees to this.

This right to withdraw from a limited liability company cannot be excluded by the charter. Any provisions eliminating or limiting the right to withdraw are null and void. Although difficulties in valuing a participant's interest units and the procedure for repayment provides some practical disincentive to withdrawal, the existence of the right may undermine the usefulness of this type of corporate vehicle for anything other than a wholly-owned subsidiary.

## Open and closed joint stock companies

*Status*

The legislation governing a Russian joint stock company is to be found in the Civil Code and the Joint Stock Company Law of 26 December 1995. The latest Law on Amendments to the Joint Stock Company Law was published on 9 August 2001 (the 'Amendment Law'). Most of the amendments came into force on 1 January 2002, although one or two provisions were effective from the date the Law was officially published.

A joint stock company can either be ‘open’ or ‘closed’. An open joint stock company, (‘otkrytoye aktionernoye obshestvo’) is designated by the letters ‘OAO’ and a closed joint stock company (‘zakrytoye aktionernoye obshestvo’) is designated by the letters ‘ZAO’ which appear either before or after the company’s name. The distinction between the two corporate vehicles can be likened to that between a private company and a public company in jurisdictions such as England. The open joint stock company is the form used for public companies that can issue shares to the public and such shares are freely transferable without any pre-emption rights in favour of other shareholders or the company. A closed joint stock company, on the other hand, is designed for private or closely held companies and so, for example, cannot issue shares to the public.

Like a limited liability company, a joint stock company may not be wholly owned by another business entity that in turn is wholly owned by an individual or a single legal entity.

The maximum number of shareholders for a closed company is 50. If this number is exceeded the company is obliged to re-register as an open joint stock company. There is no limit to the number of shareholders in an open joint stock company.

*Management*

The management structure of a joint stock company consists of three bodies – the general meeting of shareholders, the board of directors, and the executive body, which can be either collective (eg a management board or board of directors), or a single individual (the general director).

The general meeting of the shareholders is the supreme corporate body of a joint stock company and is required to be held annually. Extraordinary meetings may be called by the board of directors on its own initiative or on the initiative of the auditing commission, the independent auditor or the holder(s) of more than 10 per cent of voting shares. The Law on Joint Stock Companies defines certain decisions which are within the exclusive authority of the general meeting of the shareholders and which may not be delegated to any other management body within the company.

The board of directors is responsible for general management of the company and has authority to decide on almost any issue except those within the exclusive competence of the general meeting of the shareholders. In a joint stock company with less than 50 shareholders, the functions of the board of directors may be performed by the general meeting of shareholders and authority to run the day-to-day business of the company delegated to the general director. Directors are elected by the general meeting of the shareholders for one year and may be re-elected any number of times.

The executive body of a joint stock company may consist of one person, the general director, or of a General Director and a group of persons acting as a collective executive body. The executive body is responsible for day-to-day management of the company. The executive body of the joint stock company is elected by the general meeting of the shareholders unless the charter of the company transfers this authority to the competence of the board of directors.

*Issue and transfer of shares*

An open joint stock company may make public offerings of its shares and those shares are freely tradable on the market. There are no pre-emption rights or restrictions on the transferability of shares in an open joint stock company though pre-emption rights exist for a closed joint stock company.

The shares of a joint stock company, whether closed or open, are treated as securities and, as such, are subject to the registration requirement of the Law on Securities Market of 22 April 1996. When issuing new shares, therefore, all joint stock companies must prepare and file with the Federal Securities Commission of the Russian Federation a copy of any decision to issue the shares, a report on the results of the share issue and, in certain cases, a prospectus for the share issue.

Title to shares in a joint stock company is determined by reference to the register of shareholders that all joint stock companies are required to maintain. Share transfers take effect on entry into the register and the shareholders entitled to participate in shareholders meetings are determined from that register. The register may be kept by the company itself or by an independent registry company duly licensed by the Federal Securities Commission. If the company has 500 shareholders or more then the register is required to be kept by an independent registrar.

Shares of a closed joint stock company may be distributed only to a limited group of persons. A closed joint stock company may not publicly offer its shares or otherwise offer them to an unlimited number of investors.

The transfer of shares in a closed joint stock company is subject to pre-emption rights in favour of other shareholders. The procedure and terms for the exercise of pre-emption rights should be specified in the company's charter subject to the overriding requirements of the Joint Stock Company Law, which provides that these rights must be exercised within not less than 30 and not more than 60 days from the time the shares are offered for sale and at a price offered to a third person.

Strengthening shareholders' rights is seen as a priority issue and there are a number of legislative and quasi-legislative initiatives under way to address the many concerns that investors have expressed about the corporate regulatory environment in Russia. The Amendment Law tidies up and clarifies the procedures for approving what are known as 'major transactions' and 'interested party' transactions, establishing more precise rules for conducting such transactions. Another major development in Russia has been the publication of a draft 'Code of Corporate Conduct' which the Federal Commission on the Securities Market (the 'Federal Commission') introduced this year.

The Code is based around the general principles set out in the OECD Principles of Corporate Governance and is presently recommended for use by large joint stock companies. Like Corporate Governance Codes in a number of other countries, the Russian Code will not be legally binding, though it is expected that major joint stock companies will incorporate most of the provisions of the Code into their internal documents.

Recently, the Russian Federal Commission for the Securities Market issued a number of documents governing particular issues of the conduct of general meetings and other issues relevant to corporate governance. By expanding in greater detail some of the basic rights that shareholders are entitled to, such regulations should play a significant role in strengthening the protection provided to minority shareholder interests.

### *Other entities*

The Civil Code provides for a range of other entities including branches and simple partnerships which are not legal entities, full and limited partnerships, and additional liability companies which are legal entities. There are also non-commercial organizations that may be used for charities, trade associations or other not-for-profit organizations.

# 4.2

# Establishing a Presence

*CMS Cameron McKenna*

## *Introduction*

Having decided the type of legal presence to establish in Russia, the next step is to register the presence with the relevant authorities. The registration procedure and the documents required for registration are very similar whether the entity to be registered is a representative office, a limited liability company or a joint stock company, whether open or closed. As shares in a joint stock company, both open and closed, are treated as securities, there are certain additional requirements to register the securities with the Federal Securities Commission (FSC).

Although it may be possible to purchase a company 'off the shelf', the registration requirements for transferring ownership of the shelf company, changing the charter so that it reflects the business to be carried on by the investor and changing the name is no less bureaucratic, burdensome and time consuming then setting up a new entity from scratch. In addition, it may even be necessary to obtain the prior consent of the Anti-Monopoly Ministry for the acquisition of a shelf company! This is the case if the aggregate worldwide assets of the founders (and related companies) is greater than US$ 320,000 (being 100,000 times the statutory minimum monthly wage, which in August 2002 was 100 roubles or US$ 3.2).

The registration procedure is timeconsuming and generally more expensive than establishing a company in most Western European jurisdictions, although, in December 2000, the Government announced a plan to streamline the laws for registering new companies by introducing a 'one-stop' registration process to reduce the time and cost it takes to establish a corporate vehicle.

## *Registration authorities*

*Representative offices*

The accreditation of a representative office involves obtaining a permit from one of several accreditation agencies. Foreign companies wishing to open a representative office in Russia usually choose between the Chamber of Commerce and Industry of the Russian Federation, the State Registration Chamber (SRC) of the Russian Federation, or the Ministry of Foreign Economic Affairs of the Russian Federation. Accreditation with any of these agencies enables a representative office to operate at federal level irrespective of where the representative office is physically located.

In addition to federal accreditation, a representative office must be registered at the local level. This requires registration with the local Registration Chamber (in major cities) or with the local administration (in smaller cities and regions of the Russian Federation). Certain legal requirements that apply to the registration of a company (see below), such as procuring a guarantee of a legal address and execution of a lease, also apply to a representative office and a branch.

If the federal accreditation was granted by an agency other than the SRC, the documents must also be filed with this agency, because the SRC maintains the register of all foreign companies accredited in the Russian Federation.

In addition, a representative office must register with its local tax inspectorate, the Russian Federation State Statistics Committee and four employment-related funds, which collect mandatory contributions from the payrolls of all entities operating in Russia. It should also open a bank account. For practical purposes, a representative office should also arrange to have a seal.

*Companies*

Pursuant to the Law on Registration of Legal Entities (the 'Law on Registration'), as of 1 July 2002, the State Tax Ministry of the Russian Federation is responsible for the registration of legal entities. The Law on Registration makes substantial changes to the procedure for the registration and re-registration of legal entities in that it transfers the function of registration to a single federal executive body – the State Tax Ministry.

The Law on Registration establishes a uniform procedure for the registration of legal entities regardless of their organizational and legal form and the kinds of economic activities pursued by them. Regional branches of the State Tax Ministry are required to carry out registration in accordance with centrally prescribed rules. In accordance with Article 1 of the Law on Registration, the registration process is governed by federal legislative acts. This provision is intended to restrict the legislative powers of the regions.

## *Registration procedure*

The Law on Registration provides for a 'one-stop' registration, avoiding the need for registration with or notification to numerous other authorities as was required previously.

State registration of legal entities should be made within five working days of the submission of the corresponding documents to the local branch of the Tax Ministry. A legal entity shall be deemed to be registered as soon as it is entered into the state register.

The application for registration and the requisite supporting documentation should be submitted to the local branch of the Tax Ministry in the administrative district identified in the entity's application as the seat of its permanent executive body. The Law on Registration provides that the relevant documents can be submitted personally by the applicant, by its authorized representative, or can be sent by post. The registration body is obliged to issue a receipt to the applicant. If the documents are sent by post, the registration body is required to send the receipt to the address of the applicant by registered letter not later than the next day after the receipt of the documents and to obtain a confirmation of delivery.

All other authorities will be informed of the registration of the legal entity by the registration body and not by the applicant. The Tax Ministry shall, within five working days of state registration, provide the registration data to various state bodies stipulated by the Government. The Tax Ministry shall be required to inform all other bodies and organizations not only of the fact of registration of the legal entity but also of all changes made to the data on such legal entity contained in the register.

## *Registration documents for representative offices*

The following is a list of basic documents for the accreditation of a representative office of a foreign company in Russia.

- Charter or Articles of Association of the parent company;
- Certificate of Incorporation or extract from the companies register for the parent company;
- reference letter from the parent company's bank;
- Power of Attorney for the head of the representative office;
- Power of Attorney to complete the accreditation and registration (Note: The above documents should be legalized or apostilled and a certified Russian translation of documents should be attached to them.);

- resolution of the parent company or founder to set up a representative office or establish a subsidiary;
- regulations of the representative office or Charter and Founding Agreement for a company.

Many of the documents required are straightforward, such as copies of incorporation certificates and copies of articles of association or charters. Reference letters are, however, required from third parties, including one from a bank in the home jurisdiction of the foreign company.

The registration authorities apply strict rules both as to the form and content of these documents and also as to the manner of their execution. Incorporation certificates and articles of association must be filed as notarized copies with an apostille affixed if originating from a country that is a member of the Hague Convention, or, if from any other country, the documents must be legalized. The procedure for obtaining an apostille varies from country to country and an investor should check with a locally qualified notary or the requisite government office to determine how and where to obtain an apostille.

Reference letters from the bank must also be notarized or have an apostille affixed, and thus it is necessary for an investor to liaise with the bank to ensure that the bank understands the procedure to be followed. If documents have not been submitted in the prescribed manner the registration authorities may reject them and require them to be re-submitted. Documents that are dated any more than six months prior to the date they are filed with the Registration Chamber will not be accepted.

All documents must be in Russian or have a certified translation into Russian attached to them before the documents are submitted to the registration authorities.

The exact procedure for registering representative offices and companies may vary slightly from region to region within the Russian Federation – for example, the Moscow Registration Chamber requires a copy of an executed lease for office premises before it will register a representative office or a company.

### *Registration documents for legal entities*

The Law reduces the number of documents for registration of a new company to just four (five for entities with foreign participation) and these are as follows (from 1 July 2002):

- an application;
- a resolution on the establishment of the legal entity;

- constitutional documents (charter and possibly also a foundation agreement);
- a document confirming the payment of the registration fee.

If one of the founders of the new company is a foreign legal entity, it will also be required to submit an extract from its trade register confirming its legal status. Other requirements with respect to the form of the documents to be submitted to the registration body are to be determined by the Government, although none has as yet been promulgated. Documents prepared in a foreign jurisdiction must be notarized and apostilled (or legalized, as applicable) and accompanied by a certified Russian translation.

The Law on Registration prohibits the registration authorities from requiring any other documents.

### *Contributions to capital*

The minimum share or charter capital of a Russian closed joint stock company or a limited liability company is 100 times the statutory minimum monthly wage. In August 2002 this was approximately US$ 3.20 and the minimum US dollar capital therefore was US$ 320.

Contributions to the charter capital of the Russian company may be made in cash or in kind. Contributions in kind may include securities, property, property rights or other tangible or intangible rights having monetary value. Certain rights that are granted exclusively to a shareholder or founder by Russian authorities – for example, licences – cannot be contributed to the company's capital if they are not fully transferable.

Exemptions from import duties and import VAT may be available for certain types of equipment that are contributed to the charter capital of a company by a foreign shareholder or participant. The equipment must be categorized as a fixed industrial asset and must not be subject to any Russian excise tax.

Any asset that is contributed to charter capital and to which is attributed a value of more than 200 times the statutory minimum monthly wage must be valued by an independent valuer.

### *Formation of charter capital*

No less than 50 per cent of the charter capital of a limited liability company or a joint-stock company must be contributed before the company is registered. The outstanding balance must be paid within one year from the date of the permanent registration certificate.

In order for a foreign investor to make cash contributions, an escrow account must be opened with a Russian bank in the name of the foreign investor.

### *Anti-Monopoly Ministry and Federal Securities Commission*

If the value of the assets contributed by the founders of a company is greater than US$ 320,000 (being 100,000 times the statutory monthly minimum wage of 100 roubles as of 1 August 2002), the Anti-Monopoly Ministry should be notified of the registration of the company within 15 days of the issue of the permanent registration certificate. The information to be supplied to the Anti-Monopoly Ministry is prescribed by statute and the Anti-Monopoly Ministry may cancel the registration if the establishment of an entity may lead to a restraint of competition in the market. If an investor has any concern that the Anti-Monopoly Ministry may challenge the registration, there is a pre-notification procedure that can be used.

Shares in any joint stock company, whether closed or open, are considered securities and must be registered with the local subdivision of the FSC before the registration of the company is completed.

# 4.3

# Business Taxation

*Deloitte & Touche*

### *Introduction*

With rising demand for consumer goods and an abundance of natural resources, Russia offers some of the best business opportunities in Europe. In the current environment of improving political and economic stability, it is widely expected that foreign investment will increase considerably in the next few years.

After the government debt crisis in August 1998 and the subsequent devaluation of the rouble, many Russian-based businesses benefited from a reduction in their costs and the economy as a whole saw a reduced reliance on imported goods. Furthermore, the country was blessed by an increase in the price of oil, and during 2000–2001 Russia enjoyed a period of significant economic growth. Many foreign investors, after having been badly burned once before, began to show renewed, albeit cautious interest.

In the past, one of the areas of greatest concern to foreign investors was an uncertain legal framework in which they could operate. Much work has been done in this area over the last 10 years, notably with the introduction of the Civil Code of 1994 and 1995 followed by comprehensive laws on joint stock companies, limited liability companies and bankruptcy. Further legislation is being enacted at a remarkable pace, with the introduction of the Land Code and the new Labour Code late last year.

Similarly, the tax system has undergone significant developments since 1991. It is now focused around the development of Russia's Tax Code. As components of the Tax Code are implemented, the problems of earlier years are being addressed and the system is becoming increasingly compatible with modern business. Part I of the Code, which sets out the administrative framework of the tax system, came into force on 1 January 1999. This was followed, in Part II, by a revamp of the laws on personal income tax, VAT, excise and social fund contributions; these came into force on 1 January 2001. Most recently, the laws on profits tax, sales tax and taxes on the extraction of minerals were also codified and came into force at the beginning of 2002. This work is expected to continue during 2003 venturing into additional areas including production-sharing agreements for the oil industry, tax on immovable property and others.

Russia is now able to claim one of the most generous tax regimes in the industrialized world, with a flat personal income tax rate for residents at 13 per cent and a combined total corporate profits tax burden at a maximum rate of 24 per cent.

There are, of course, a number of continuing problems. For example, frequent changes and lack of clarity of interpretations by the tax authorities, and certain grey areas in VAT and currency control continue to present significant challenges. However, we also see that in many areas of business taxation, the problems today are less often about the failure of the law to understand concepts, fairness or the substance of transactions, but are more often about the inappropriate application of the law and inconsistencies of treatment across the cities and regions of Russia.

The following overview of taxes and related legislation is based on the laws in effect as of 1 September 2002.

## Profits tax

As of 1 January 2002, a new chapter of the Tax Code, Chapter 25, introduced many substantial changes to Russia's previous profit tax regime. The main changes include:

- a reduction in the corporate profits tax rate to a maximum of 24 per cent;
- an 'open' list of deductible expenses where that which is not expressly listed as a non-deductible expense is therefore considered to be deductible;
- most tax concessions are abolished (although the loss carry-forward concession will still be applicable with the term extended for 10 years);
- taxpayers need to establish an accounting policy for tax purposes and also implement a system of tax accounting;
- the accrual basis of taxation for taxpayers whose average revenue was in excess of 1 million roubles per quarter for the previous four quarters. Those whose average revenue per quarter during the preceding four quarters was less than this amount, however, may choose between the accrual or the cash basis of taxation;

- dates of income/expense recognition are established for various types of income and expenses;
- the introduction of thin capitalization rules which affect the deductibility of interest expenses.

*Tax incentives*

Although the new Profit Tax Chapter abolishes all tax incentives, including the Capital Investment Concession, legislation was included which states that all privileges received by companies as part of their approved investment agreements with the regional authorities will continue for the full life of the original agreement. If the life of the investment agreement was not explicitly defined, the privileges will continue until the end of the term of recouping the investment project, but for no more than three years as from the moment of their granting.

*Tax rates and timing of payments*

Russia's standard corporate tax rate has been reduced to 24 per cent. Additionally, the regional governments have been given the authority to reduce their portion of the profits tax by up to 4 per cent. In other words, the overall profit tax rate may vary from 20 per cent to 24 per cent depending on the region in which the taxpayer is located.

Profits tax is subject to quarterly filing of returns and monthly advance payments.

*Russian source income for foreign companies*

Depending on the type of income, the following withholding tax rates apply:

- 10 per cent on income from international freight and the renting of property involved in international shipping;
- 15 per cent on dividends received by foreign companies from Russian legal entities, interest on state and municipal bonds;
- 20 per cent on royalties, interest (other than that received from state and municipal bonds), leasing activities (income is determined as the difference between the gross lease income less the cost of the asset);
- 20 per cent on all other income subject to withholding tax (with the exception of income received from the sale of shares in a Russian entity, which may be subject to withholding tax at the rate of 24 per cent as explained below).

The sale of shares in Russian entities is subject to withholding tax only if more than 50 per cent of the assets owned by the entity is comprised of immovable property. In this event, the shareholder may elect to be taxed either at the rate of 20 per cent on the gross sales price, or at the rate of 24 per cent on the difference between the sales price and original purchase price plus expenses related to the sale. The same rule applies to the income from sale of immovable property located in Russia.

*Transfer pricing*
In general, the tax authorities should accept the price of goods as stated by the parties to the transaction. However, Russia's Tax Code provides for four instances in which the tax authorities are entitled to verify the prices used:

1. if the agreement was concluded between related parties;
2. in the case of barter transactions;
3. in foreign trade transactions;
4. if the contract price varies by more than 20 per cent of the market price for identical (similar) merchandise within a short period of time.

In these instances, the Code empowers the authorities to apply the market price for tax purposes where the latter varies from the transaction price by more than 20 per cent.

## Value added tax

Value added tax (VAT) is charged on the majority of sales of goods and services 'realized' in Russia and on most imports into Russia. The tax is payable by all corporate businesses, including offices and branches of foreign companies and also individual entrepreneurs. However, companies and individual entrepreneurs can apply for VAT exemption should their taxable revenues (VAT and sales tax exclusive) for three consecutive months be below 1 million roubles.

*Tax rates*
The standard VAT rate is 20 per cent. A reduced rate of 10 per cent applies to certain foodstuffs and children's goods. A zero per cent rate applies to the export of goods and related shipping and forwarding services as well as passenger transportation when the destination is outside of Russia.

*Place of supply rules*

There are specific rules to determine the place of supply for cross-border works and services. For example, consulting, advertising, information processing, legal, accounting, engineering, educational, scientific research and development, and also services related to patents, licences and the like are subject to VAT if rendered to an entity with a place of activity in Russia. Payments to a non-registered foreign entity for such services are subject to withholding at source by a Russian payer.

*Exemptions*

Major VAT-exempt activities include the lease of office space and accommodation to accredited foreign representative offices and individuals; medical services and sales of medical equipment; banking and insurance services; operations with securities and derivative financial instruments; interest on loans; and gambling. The import of technological equipment and spare parts as a contribution to the charter capital is also exempt.

## Individual income tax

Personal income tax applies to tax residents on their worldwide income and to non-residents on their Russian source income. Russian source income includes any remuneration for duties performed in Russia, regardless of where or when it is paid. A tax resident is an individual who has spent not less than 183 days in Russia during a calendar year.

*Tax rates*

Income of residents is subject to a flat rate of 13 per cent except for specific types of income, which attract higher rates. Unless otherwise protected by a double tax treaty, non-residents are subject to a flat rate of 30 per cent.

Incomes subject to the higher rates include:

- dividends: 6 per cent;
- lotteries, gambling, etc: 35 per cent;
- interest on loans in excess of established norms: 35 per cent;
- insurance payments in excess of established limits: 35 per cent.

*Non-residents*

The tax rate of 30 per cent is applicable to non-residents irrespective of the nature of the income.

*Date of receipt*

Income is taxed when 'received' in cash, in kind or by way of 'material benefit'. Receipt includes power of disposition.

For salaries, the date of income receipt is the last day of the month for which the salary is accrued.

*Deductions*

In accordance with the current legislation, taxpayers may deduct 400 roubles from their monthly income if their accumulated annual income does not exceed 20,000 roubles. An additional deduction in the amount of 300 roubles can be taken for each dependant within the same limits.

Social deductions include:

- Charitable donations to Russian-financed entities are deductible within the limits of 25 per cent of the income.
- Payments for the education of taxpayers and their children (up to the age of 24) made by themselves are deductible up to a limit of 25,000 roubles per person per year.
- Payments for medical services made by the taxpayer for him/her and his/her family are deductible up to a limit of 25,000 roubles per year.

*Property deductions*

Proceeds from the sale of real estate owned for a period of at least five years should not be taxable. If the real estate is owned for less than five years, however, the taxpayer may elect to either pay tax on the difference between the sale price and 1 million roubles or pay tax on the difference between the sale price and the documented expenses.

Proceeds from the sale of other property owned for a period of at least three years should not be taxable. If the other property is owned for less than three years, however, the taxpayer may elect to either pay tax on the difference between the sale price and 125,000 roubles or pay tax on the difference between the sale price and the documented expenses.

The limit on the deduction of expenses on the purchase/construction of a house or apartment is 600,000 roubles, not taking into account the amounts used for interest payments on mortgages. If this deduction is not used in full during a particular tax period, its balance may be used in subsequent tax periods. (This deduction is not available in respect of property purchased from related parties.)

*Non-taxable income*
Non-taxable income includes:

- state pensions;
- most statutory allowances and redundancy payments;
- work injury compensation within certain limits;
- statutory insurance benefits and certain limited voluntary insurance benefits;
- interest on bank deposits within certain limits.

*Taxation of foreign nationals*
The only specific provision in the Tax Code relating to income of foreign nationals is concerned exclusively with staff of diplomatic or international bodies. In general, foreigners' taxation is governed by common procedures and depends on residency. Specific exemptions for certain benefits provided to foreign citizens (including residential accommodation and company cars) were abolished from 1 January 2001.

Foreigners may claim benefits under a double tax treaty only upon presentation of proof of treaty residence in the country with which Russia has concluded the relevant double tax treaty. Such proof must be presented by the end of the year following the year for which exemption is being claimed.

*Tax agent*
For purposes of withholding personal income tax, Russian organizations, entrepreneurs and accredited representative offices and branches of foreign companies are considered as tax agents and are required to calculate, withhold and remit income tax from payment to individuals. Those who have received income where tax was deducted at source and remitted to the budget do not need to file a Russian tax return within a given calendar year unless they wish to apply for social or property deductions.

## Unified social tax (UST)

Russian employers, including Russian representative offices or branches of foreign legal entities, are obliged to make UST payments for their Russian employees. Currently, salaries paid to expatriates are exempt from UST if there is a provision in the employment contract stating that they do not have the right to use Russian state pension, medical or social insurance. However, as of 1 January 2003, foreign citizens will be subject to making payments of UST without any exceptions under the same conditions as payments for Russian citizens.

*Taxable base*

The taxable base for UST is calculated for each employee individually, based on remuneration in cash or in kind. As employees are not payers of UST, it is payable only by the employer and calculated on a regressive basis ranging from 35.6 per cent on the first 100,000 roubles of salary to 2 per cent on salary payments in excess of 600,000 roubles.

*Exemptions*

Exemptions include most statutory allowances, healthcare services paid by the employer, obligatory insurance payments, voluntary insurance payments paid from net profit, etc.

There are certain exemptions for companies employing disabled staff.

## Excise tax

Excise tax is imposed on both the import and the manufacture of a list of goods, the primary categories of which are: alcohol, tobacco, oil, gas, petrol, jewellery and automobiles.

The payers of excise tax are Russian residing manufacturers and sellers (including those with foreign investments) of excisable goods, both companies and individual entrepreneurs, or importers of excisable goods.

*Exemptions*

Exports of excisable Russian goods outside the CIS countries are free from excise tax. To receive the exemption, however, a set of documents proving the export must be presented to the tax authorities.

## Property tax

Property tax is levied at a maximum rate of 2 per cent per annum on the property of commercial enterprises and organizations in Russia, including the property of foreign enterprises on Russian territory. Most non-profit organizations are exempt from property taxation.

*Taxable base*

The tax is levied on the property of enterprises and organizations. Exemption is available under a number of double tax treaties which provide that movable property should only be taxable in the country of residency of the owner of the property, provided the property is not connected with a Russian permanent establishment. Most non-profit organizations are exempt from property taxation.

Generally, the taxable base includes most fixed and intangible assets, inventory, stocks of goods, work-in-progress and unfinished construction. Land and certain non-productive property are specifically excluded.

In general, the taxable base is the average net book value (cost less depreciation) of the property of the enterprise.

*Exemptions*

Certain exemptions are available depending on the type of organization and the type of property concerned. In general, property tax exemption is granted to agricultural organizations (if at least 70 per cent of their sales relate to agricultural activities), state and municipal budget-financed institutions and organizations, scientific and research centres, companies employing disabled persons (not less than 50 per cent of the total average payroll), etc.

Several types of property are exempt from property tax, including land and property used in nature protection, agriculture, culture and education, and social and housing objects used by a company, etc.

## Road user's tax

Road user's tax is paid by entities, including foreign legal entities and also individual entrepreneurs. It is calculated by reference to gross revenues or, for trading companies, gross margin.

The tax rate is 1 per cent as of 1 January 2001. The government intends to abolish this tax in 2003.

## Vehicle owner's tax

This tax is paid by entities, including foreign legal entities, individual entrepreneurs and individuals who are owners of vehicles. The amount of tax depends on the type and power of the vehicle.

The tax on owners of motor vehicles is to be abolished as of 1 January 2003 when it will be replaced with the transport tax, which, although similar to the tax on owners of transport vehicles, expands the object of taxation to include other forms of transport such as aircraft and boats.

## Sales tax

Sales tax is paid by Russian and foreign legal entities and individual entrepreneurs. The sales tax is levied on the value of goods sold in retail or wholesale trade for cash. There is an exemption from the sales tax for: a number of basic food products; goods for children; medicines; cultural, educational, and housing services; and banking, insurance and financial services subject to licensing, etc. The rate of the tax is established by regional authorities and will not exceed 5 per cent.

## Customs duties

Import duties are levied according to the type of goods imported and their origin. Duties are normally expressed as a percentage of the value of the goods imported ('ad valorem' duties). However, they may also be expressed as a set amount of euros per unit or kilogram ('specified' duties) or as a combination (the greater of the two).

With effect from 1 January 2001, a new system of tariffs was introduced. Prior to 1 January 2001, there were seven ad valorem rates of duty ranging from zero per cent to 30 per cent. There are now five rates: 5 per cent, 10 per cent, 15 per cent, 20 per cent and 25 per cent. Certain goods may also continue to be imported duty free.

## Other taxes

Additional taxes, payments and fees may exist from region to region. Some of these include: the use of subsoil resources; the charge for the use of the words 'Russia' and 'Russian Federation' in the name of a legal entity; payments for generating pollution; various licence fees; water tax; timber duty; hard currency cash purchase tax; and the charge for street cleaning in populated areas.

4.4

# Auditing and Accounting

*Deloitte & Touche*

### *Current state of the auditing profession in Russia*

*History*

The auditing profession in the Russian Federation has a relatively short history. As with other professions that are part of an economic infrastructure in a market-oriented society, it simply did not exist as such before the start of the political and economic market reforms in the mid-1980s. In a state-planned and managed economy, where the owner of the resources and the user of the resources was the State itself, the only relatively similar profession that existed was that of the state controllers, who worked for various governmental ministries, as well as the higher level controllers working for the Ministry of Finance and specifically, in the area of foreign trade, the Ministry of Foreign Trade.

With the introduction of market reforms prior to the dissolution of the Soviet Union, for the first time the concept of auditing was introduced. This introduction followed the first Governmental Decrees of 1987 and 1988 on Joint Venture Activities in the USSR. The first audit firm ever to start working in the country was AO Inaudit – a state-owned and controlled company that was the sole empowered auditor working in this market.

The actual creation of the profession started later, during the late 80s–early 90s, when the largest international accounting and auditing firms (the Big Six) began entering the market, and the newly obtained economic freedom of entities created the need and demand for consulting and accounting services.

In the early 90s, the auditing profession was not governed by any specific legislation, although many attempts were made to create and introduce such legislation. Various professional unions and associations were created. First attempts were made to adopt auditing standards at least at firm or association levels. The first certification procedures were put in place by the most prominent professional associations and the local authorities. The process was chaotic until at last, in 1993, a Presidential Decree was issued enforcing 'The Temporary Regulations on Auditing Activities in the Russian Federation' (the Decree).

*Legislation*

The Decree attempted to fill in the legislative vacuum that existed and has served its purpose in putting together the various practices that existed, both international and domestic. It established the basic principles of independence and created a structure for the certification and licensing process. The basic feature of the Decree was that it empowered the Government to regulate the profession through its bodies (such as the Ministry of Finance). The regulation of bank audits was then under the separate responsibility of the Central Bank of the Russian Federation.

The 1993 Decree also established the Presidential Audit Commission (PAC). The PAC has so far set 34 Russian Standards of Audit (RSA).

In 1994, the Government issued Regulation #482, 'On the Approval of the Supervision of Auditing Activities', to initially form three audit industry licensing bodies, known as the Central Certification Licensing Auditing Commissions (Tsalak), covering general, banking and insurance, and budget funded and exchange organizations. In the summer of 1996, following a government reorganization, the two non-banking Tsalak bodies became a single Tsalak (MinFin Tsalak), which is comprised of 25 representatives, including representatives from the Ministry of Finance, the PAC, the Central Bank, and other governmental and professional bodies.

Tsalak within both the Ministry of Finance and the Central Bank had the responsibility for audit examinations, attestation and licensing issues. The PAC was responsible for professional standards in that it issued recommendations on exams and, more importantly, introduced auditing standards.

In May 1997, the PAC, the Ministry of Finance and the Financial Scientific Research Institute published a collection of 11 rules (standards) of auditing activity and a list of terms and definitions thereto. However, in the absence of an audit law, some auditing firms disputed the compulsory nature of these rules. Some clarification to the matter was provided by the Resolution of the Russian Government #472, dated 27 April 1999, 'On the Licensing of Some Types of Auditing Activity in the Russian Federation', which established that the quality of audits should correspond to the standards approved by the PAC. By the end of 2000, work on Russian auditing standards within the framework of the 'Action Programme for the Audit of Financial Statements of Economic Entities Using Internationally-Based Auditing Standards in the Period 1998 to 1999', adopted in accordance with Assignment of the Russian Government dated January 4 1998, was essentially complete.

In October 2000, with the participation of the ICAR, the 'Big Five' and several major Russian auditing firms, the official Russian translation of the International Auditing Standards and Ethics Code of IFAC was first published, and the second official edition of the Code, including some new documents, was published in August 2001. The two publications were of a reference nature that could be used in the process of developing new auditing standards.

Government Regulation #1355, dated 7 December 1994 (amended by Government Regulation #408, dated 15 April 1995), originally established the criteria for economic entities subject to compulsory annual audit as follows:

- open joint stock companies;
- banks and other credit organizations;
- insurance companies and mutual insurers;
- commodities and stock exchanges;
- investment institutions;
- extra-budgetary funds, which collect mandatory contributions;
- charity and (non-investment) funds that collect voluntary contributions;
- companies with foreign-owned capital;
- other economic entities if total annual revenues and assets exceed specified amounts.

The aforementioned decrees, pronouncements of the Central Bank, and the Presidential Commission have served as the legislative basis for the profession to date.

Provisions elaborating on the auditor's functions during the audit of some types of entities were included in the laws on joint stock companies and limited liability companies. The Federal Law 'On Joint Stock Companies', dated 26 December 1995, established that the auditor may have access to statutory documents of the joint stock company, assess property contributed in payment for shares and other securities, check correspondence of the company's net asset value to the size of its share capital, issue an opinion based on the results of the annual audit of the company and require that an extraordinary meeting of shareholders or board of directors be convened. Similar functions and authorities were granted to auditors by the Federal Law 'On Limited Liability Companies', dated 8 February 1998. An audit opinion confirming the financial statements of an entity subject to obligatory audit in accordance with the Federal Law 'On Accounting', dated 21 November 1996, became an integral part of the financial statements.

### *Current developments in the regulatory environment*

As time passed, business communities, as well as the auditing profession, realized that the existing legislative infrastructure was not sufficient to protect the public and the State's interests and to protect the auditing profession. A process has been under way to institute a comprehensive audit law. In the summer of 2001, following a long discussion with the participation of the Russian auditing community, the Federal Law 'On Auditing Activity' was finally adopted and took effect on 9 September of the same year.

The law provides that the following entities be subject to obligatory audit:

- open joint stock companies;
- credit institutions, insurance and mutual insurance companies, commodities and stock exchanges, investment funds, state extra-budgetary funds that collect mandatory contributions;
- entities or individual entrepreneurs whose annual revenue exceeds 500,000 times the minimum statutory monthly wage, or whose balance sheet assets at the end of the reporting year exceed 200,000 times the minimum statutory monthly wage;
- state unitary enterprises if their performance falls within the above limits.

Whereas before the adoption of the Law, audit certificates were issued for a limited period, now the qualification certificate is issued to auditors that successfully pass the qualification exam without time limitations. However, auditors are still obliged to pass professional training each calendar year.

The Law established that an authorized federal body will regulate auditing activity and the Russian Government assigned this function to the Department of Organization of Auditing Activity of the Ministry of Finance. To achieve a balance between the state regulation of auditing activity and the ability of the auditing community to influence the auditing market, an Auditing Activity Board under the above body was established. The Board, in addition to representatives of the federal executive bodies, other state authorities and the Bank of Russia, also includes representatives from seven professional auditing associations accredited with the Board including: the Institute of Professional Auditors of Russia (member of IFAC), the Russian Auditors Collegium, the National Federation of Consultants and Auditors, and the Auditing Chamber of Russia, etc.

In accordance with the Law, the Government must also develop and approve national auditing standards. With the participation of the above Board, the following federal auditing rules (standards) were developed and approved by Resolution #696, dated 23 September 2002.

*Rule #1*
Objective and Main Principles of an Audit of Financial Statements established, in particular, that the objective of an audit is to express an opinion on the financial statements of the audited entity and compliance of the accounting procedures with the legislation of the Russian Federation. The auditor should express an opinion on the reliability of the financial (accounting) statements in all material respects.

*Rule #2*
Audit Documentation maintains, in particular, that an auditing firm and an individual auditor should document all the information that is important in terms of providing evidence supporting the auditor's opinion, as well as evidence that the audit has been performed in accordance with the federal rules (standards) of auditing activities. Work documents can be in the form of data recorded on paper, film, in an electronic file, or in another format.

*Rule #3*
Audit Planning, based on International Auditing Standards, establishes unified requirements for planning an audit of the financial (accounting) statements and should be applied primarily to the audits of an audited entity other than the first year audit performed by the auditor. According to this rule, audit planning involves, in particular, the development of a high-level strategy and detailed approach to the expected nature, timing and scope of audit procedures.

*Rule #4*
Audit Materiality, also based on International Auditing Standards, establishes unified requirements in respect of the materiality concept and its connection to the audit risk. It requires the auditor to use professional judgment in determining materiality. In developing the audit plan, the auditor should set an acceptable materiality level such as to ensure detection of material misstatements (on quantitative grounds). However, account should be taken of both the value (quantity) and the nature (quality) of misstatements.

*Rule #5*
Audit Evidence establishes, in particular, that audit evidence is obtained through a set of tests of internal controls and substantive procedures. In certain situations, evidence can be obtained exclusively by performing substantive procedures. According to the Standard, audit evidence includes information received by the auditor during the audit and the results of their analysis of such information; and forms the basis of the auditor's opinion. Audit evidence includes, in particular, source documents and accounting records which underlie financial (accounting) statements, as well as written representations of the audited entity's authorized employees and information received from various sources (third parties).

*Rule #6*
Auditors' Report on Financial (Accounting) Statements According to this rule, an auditors' report is an official document intended for the users of the financial (accounting) statements of the audited entity, prepared in accordance with this rule and containing an opinion of the audit company or individual auditor. The report is to be expressed in a prescribed format and comments on the reliability of the financial (accounting) statements of the audited entity as well as the entity's compliance with the accounting laws of the Russian Federation. The reliability of the financial statements refers to the accuracy of the data in the financial (accounting) statements, which enables the users of the statements to make correct conclusions as to the performance, financial position and property status of the audited entities and make reasonable decisions based on such conclusions. In order to assess the degree of compliance of the financial (accounting) statements with the legislation of the Russian Federation, the auditor should establish the tolerable limits of deviations by determining the materiality of

accounting records and financial statements data for the purposes of the audit in accordance with federal Rule #4 'Audit Materiality'. At present, the Board continues to develop other rules (standards) of auditing activity, and professional auditing organizations have begun to develop rules to ensure the quality of audits performed by their members.

*Auditing in the Russian Federation – conclusion*
In conditions where most Russian auditors focus their attention on tax-related issues, one must also take steps to ensure audit quality, auditor independence and financial liability in cases of negligence, recklessness or fraud.
In the present Russian audit environment, an audit infrastructure is required to ensure a high quality statutory audit function, and the issuance of correct and credible financial statements by all that practise in the profession is in the process of active development. While some firms that practise in the profession do perform high quality audits, others do not. Such an infrastructure could broadly be classified in the following categories:

- control over the quality of audit services using the principles established by the respective International Auditing Standard;
- rules on audit firms and mutual recognition;
- uniting of currently disconnected professional auditing and accounting associations;
- completion of development of professional standards on auditing based on International Auditing Standards;
- ethical rules and independence based on IFAC's ethics code;
- disciplinary procedures and sanctions infrastructure;
- liability regime.

## Accounting standards in the Russian Federation

The Russian Federation's move to a market economy has also necessitated a change in the standards of accounting for the financial position and results of operations of Russian enterprises.

While the Russian Accounting Standards (RAS) have gone through reform over the years, major reform for such standards to be in full compliance with International Accounting Standards (IAS) has fallen short.

The Ministry of Finance of the Russian Federation has been given the responsibility to institute reform of the RAS. This holds true for all organizations, except those that are required to report to the Central Bank of the Russian Federation, which instead have their own rules for reporting.

Since 1998, the Ministry of Finance has increasingly instituted revisions in an effort to account for transactions under more internationally accepted methods. For example, accounting for revenue under the accrual method has been introduced and accruing expenses incurred but not paid is now required under certain situations. In particular, provisions on accounting (termed PBU) have been issued. These PBUs include the following topics:

- Organization's Accounting Policy;
- Material and Production Stocks Accounting;
- Fixed Assets Accounting;
- Organization's Income;
- Information on Affiliated Persons;
- Information on Segments;
- Non-material Assets Accounting.

Nevertheless, even with the issuance of these accounting policies, fundamental differences still remain. While the PBUs may be similar to IAS, they are not IAS, and therefore important differences remain.

Despite the intention declared by the Chairman of the Russian Government to transfer to IAS by 2004, there are still many differences between IAS and RAS. GAAP 2000 and 2001 surveys of National Accounting Rules in 53 countries showed the existence of multiple variances between national accounting rules and IAS in a number in European countries, including in more than 42 accounting areas in Russia.

Russian accounting may differ from IAS because of the absence of specific Russian rules on recognition and measurement. Some of the more significant areas include:

- the classification of business combinations between acquisition and uniting of interests;
- provision in the context of business combinations accounted for as acquisitions;
- consolidation of special purpose entities;
- the restatement of financial statements of a company reporting in the currency of a hyperinflationary economy in terms of the measuring unit currency at the sheet date;
- the translation of the financial statements of hyperinflationary subsidiaries;

- the treatment of accumulated deferred exchange differences on disposed by a foreign entity;
- impairment of assets;
- derecognition of financial assets;
- the recognition of operating lease incentives;
- accounting for deferred tax;
- accounting for an issuer's financial instruments.

It is unfortunate that RAS have not moved closer to IAS. As a result, many companies, especially those that are interested in obtaining Western investment, have the double burden of preparing their accounts under both methods, one to fulfil legal requirements and one to fulfil the interests of Western investors. Moreover, with the adoption of Chapter 25 of the new Tax Code, the Russian companies also need to keep tax accounts.

*Accounting in the Russian Federation – conclusion*

While many would believe that reform has already occurred, one only needs to compare a company's accounts prepared both under RAS and IAS to see that more reforms are needed. Many international organizations are anxious for these reforms to be carried out. At present, it is difficult to estimate when these reforms will take place. In the meantime, in order for an outside investor to be able to properly evaluate the financial position and results of operations of an enterprise, credible financial statements prepared under IAS (or another internationally accepted method, ie US GAAP) should be requested and obtained.

# 4.5

# Intellectual Property and E-commerce

*CMS Cameron McKenna*

## *Introduction*

The main types of intellectual property that are recognized and protected by Russian law include:

- trademarks;
- copyright (including computer programs) and neighbouring rights;
- patents.

## *Trademarks*

*Principal legislation: laws and normative acts*

Trademarks are subject to the following principal legal acts:

- The Civil Code;
- The Law on Trademarks;
- Regulations of the Patent Office.

*Concept of a trademark*
According to the Law on Trademarks, a trademark is a designation that distinguishes the goods and services of one economic entity from those of another. A trademark may take the form of a design, a symbol or a three-dimensional object, or a combination of these, and may be any colour or combination of colours.

The Law on Trademarks provides a list of designations that may not be registered as trademarks. These include state flags and emblems, the names of state and international organizations, official marks such as hallmarks or stamps of approval, generally used designations of particular kinds of goods, and generally accepted symbols and terms.

The owner of a trademark has an exclusive right to use and dispose of the trademark and to prohibit its use by others. Violation of the exclusive right of the trademark owner includes: any manufacture, use, import, offer for sale, sale, or the putting into commercial turnover or storage with a purpose to put into commercial turnover of a trademark or goods marked with the trademark – or a designation confusingly similar to the trademark – in respect of similar goods without the owner's consent.

*Trademark criteria*

To be registered as a trademark, a designation should not lead to confusion on the part of the public or be contrary to the public interest or principles of humanism or morality.

Designations that are identical to or confusingly similar to the following may not be registered as trademarks: registered trademarks; well-known trademarks; names of characters or quotations from literature, science or art; and names, pseudonyms or portraits of famous people.

*Protection of trademarks*

REGISTRATION OF TRADEMARKS

According to the Law on Trademarks, protection is granted on the basis of registration. A trademark may be registered only by a legal entity or an individual entrepreneur registered as such with the tax authorities.

Trademarks are registered with the Patent Office, which issues a trademark certificate. The legislation sets out the procedure, fees and requisite documents for registration. Applications must be submitted through trademark attorneys registered with the Patent Office.

Priority is given from the date an application for registration is made, or an earlier date if the application was first made under the Paris Convention in another member state or the goods were first exhibited in a member state. The priority date may also be established according to the date of international registration under an international treaty of the Russian Federation.

Registration is a time-consuming process, which may take from 18 to 24 months to complete. The Patent Office will make an entry in the State Register of Trademarks and issue a certificate of registration. Information concerning the trademark is also published in the official bulletin of the Patent Office.

TIME PERIOD AND CONDITIONS OF PROTECTION

A trademark certificate is valid for 10 years from the date of application. This term may be extended for another 10 years upon application by the trademark owner in the last year of the 10-year period. Extension is subject to a fee and is reflected in the State Register and the certificate.

The registered trademark must be used. The use of the trademark is its application on goods or packaging either by the owner or a licensee. Protection may be revoked if the trademark was registered in the name of a person who is not an individual entrepreneur or in breach of trademark criteria or was not used in the Russian Federation during the previous five years.

*Troubleshooting*

If the rights of a trademark owner are infringed, he may apply to the Supreme Patent Chamber of the Patent Office, to the courts, or to arbitration.

The registration of a trademark may be challenged by application to the Appeal Chamber of the Patent Office. If the trademark was registered, for example, in the name of an individual who is not an entrepreneur or the trademark is not used, the Appeal Chamber may consider the registration void. The decision of the Appeal Chamber may be appealed to the Supreme Patent Chamber and the decision of the latter is final.

Disputes regarding violation of rights of a trademark owner, or relating to licensing or assignment agreements, fall within the jurisdiction of state arbitrazhniy (commercial) courts.

Remedies available to the owner of a trademark include suing for damages and/or obtaining injunctions against the infringer requiring the infringer to delete the trademark from goods or to destroy a designation confusingly similar to the trademark.

The owner of the trademark may also apply to the Anti-Monopoly Ministry with a request to delete a particular designation that is so confusingly similar to a registered trademark that competition would be affected and consumers confused.

Trademark owners may also apply to the police with a request to open a criminal case against an infringer. According to the Criminal Code of the Russian Federation, an individual who intentionally, repeatedly and illegally uses a registered trademark may be fined between US$ 600 and US$ 1,200 or an amount equal to his income for a period of between two and four months, or be sentenced to up to two years of hard labour.

Foreign companies may also request that the customs authorities prevent the import of goods having a designation infringing the rights of a trademark owner.

*Assignment, licences and the need to register*
Trademarks may be assigned and the right to use the trademark may be licensed to a third party. Both an assignment agreement and a licence agreement must be made in writing and must be registered with the Patent Office. Failure to register renders these agreements void.

## *Copyright and neighbouring rights*

*Principal legislation: laws and normative acts*
The principal laws governing copyright and neighbouring rights are:

- the Civil Code;
- the Fundamentals of the Civil Legislation (Part IV of the Civil Code of the Russian Federation governing intellectual property rights is expected to be adopted this year, replacing the Fundamentals of the Civil Legislation);
- the Law on Copyright and Neighbouring Rights;
- the Law on the Legal Protection of Computer Programs and Databases.

*Concept of copyright*
Copyright protection is granted to a work which is the product of creative activity and which is expressed in any material form. Such works include: literary, dramatic, musical, choreographic and audio-visual works; sculptures; designs; photography; and computer programs. Copyright protection does not apply to ideas, methods, concepts, principles, discoveries, facts, official documents, state symbols and information on events.

*Rights of the author that may and may not be assigned*
The author is entitled to:

- be recognized as the author of the work;
- protect their name as the author;
- preserve the integrity of the work;
- publish and use the work;
- access the work.

These rights are not transferable and rest with the author even if other exclusive rights, such as, the right to reproduce, distribute, import, demonstrate, communicate, translate and redraft the work, are assigned to other people.

The author is entitled to receive remuneration from the use of his work by other people. There are very limited circumstances where the protected work may be used without permission of the copyright owner and without remuneration.

*Concept of neighbouring rights*
Neighbouring rights belong to performers. According to the Law on Copyright, a performer is an actor, singer, musician, dancer or other person who performs the work in any way including a director of a film and a conductor.

*No registration, by act of creation*
Copyright protection is granted by virtue of creation. No registration or other special procedure is required.

*Time period for protection*
As a general rule, copyright is valid during the lifetime of the author and for 50 years after his death. Some rights of the author, such as a right to be recognized as the author, are protected with no time limit.

*Troubleshooting*
According to reservations made by Russia on joining international conventions, protection under international treaties is granted for works first published after Russia joined those conventions.

With regard to copyright, the earliest date for granting protection is 27 May 1973, when the Universal Convention on Copyright became effective for the Soviet Union. Any work first published before this date in any other member state of the convention was not protected in the Soviet Union and is not protected in Russia. In addition, works first published later but in a country that is not a member of the Universal Convention are not protected either.

In order to protect their rights, copyright owners may apply to the courts, to arbitration and to the police. Remedies available to the owners include the recognition of their rights and compensation for damage. Counterfeit goods and equipment for the manufacture of counterfeit goods may be seized and destroyed in accordance with a court decision.

Upon filing an application to the court, copyright owners are also entitled to obtain an injunction to prevent counterfeiting activities of an infringer and to seize counterfeit goods and equipment for their manufacture.

An infringement of copyright also constitutes a criminal offence, which may be investigated by the police. Under the Russian Criminal Code (Criminal Code) an individual who intentionally infringes an author's intellectual property rights may be fined between US$ 600 and US$ 1,200 or an amount equal to his income for a period of two to four months, and be imprisoned for a period from six months to two years.

Repeated infringers or infringement by a group of people are punishable either with a fine of between US$ 1,200 and US$ 2,400 or equal to the amount of the infringer's income for a period of four to eight months, or imprisonment from six months to five years.

## Patents

*Principal legislation: laws and normative acts*
The principal laws regulating patents are:

- the Civil Code;
- the Patent Law;
- the Regulations of the Patent Office.

*Concept of a patent*
A patent may be granted for:

- an invention;
- a utility model;
- an industrial design.

A patent holder has exclusive rights to use an invention, utility model or industrial design, and to prohibit their use by others.

A patent holder may assign their rights by way of a licence agreement to third parties. Such licence agreements must be registered with the Patent Office and failure to register will render a licence agreement invalid.

*Patent criteria*
In order to qualify for protection by patent, an invention, utility model or industrial design must be new, have an element of invention and be capable of industrial application.

*Registration*
Patents must be registered with the Patent Office. The registration and issuing of patents involves application, expert examination and publication of information about the patent. The Patent Office sets out the rules for application.

The priority date is the date of application for registration or an earlier date if the application was first made under the Paris Convention.

*Time period of protection*
Protection is granted for a period of 20 years for an invention, five years for a utility model and 10 years for an industrial design. The protection period can be extended by the Patent Office upon application of a patent holder for up to three years for an utility model and for up to five years for an industrial design.

*Troubleshooting*
If the rights of the patent holder are infringed they may apply to the Supreme Patent Chamber of the Patent Office, to courts, or to arbitration.

The registration of a patent may be challenged by application to the Appeal Chamber of the Patent Office. The decision of the Appeal Chamber may be appealed to the Supreme Patent Chamber and the decision of the latter is final.

Disputes regarding violation of exclusive rights of the patent holder or relating to licensing agreements, as well as the illegal use of the patent, fall within the jurisdiction of courts of common jurisdiction if one of the parties is an individual, or the state arbitrazhniy courts if all parties are legal entities or individual entrepreneurs.

The patent holder is entitled to compensation for damages caused by illegal use of the patent. Infringement of a patent also constitutes a criminal offence within the jurisdiction of the police. Under the Russian Criminal Code, an individual who intentionally and illegally uses or discloses (prior to official publication) a patented invention, a utility model or an industrial design may either have to pay a fine of between US$ 600 and US$ 1,200 or an amount equal to his income for a period of two to four months, or be imprisoned for a period from six months to two years.

Repeated offences or infringement by a group of people are punishable either by a fine of between US$ 1,200 and US$ 2,400 or an amount equal to the infringer's income for a period of four to eight months, or with imprisonment for up to five years.

## *International treaties: Russia as legal successor to the Soviet Union*

Russia is a member of the World Organization of Intellectual Property. As legal successor to the Soviet Union, Russia is also party to a number of international treaties including the Paris Convention for the Protection of Intellectual Property (1883), the Madrid Agreement for the International Registration of Marks (1891), the Universal Copyright Convention (1952) and the Treaty on Patent Cooperation (1970). On 3 March 1995 Russia became a full member of the Berne Convention.

Russia is also party to a number of bilateral agreements on the protection of intellectual property, for example, with Austria, Bulgaria, Sweden and Slovakia. Bilateral agreements extend protection to works published both before and after the signature date. Finally, in 1993, Russia and other CIS countries signed the Agreement on Measures for Protection of Intellectual Property and the Agreement on Cooperation in the Sphere of Copyright Protection.

## *E-commerce*

*Lack of regulation*

The legal regulation and enforcement of the Internet in Russia is an area that is only now starting to be developed and thus court practice remains undeveloped and somewhat contradictory. For example, registration of domain names is not regulated by any legal act of government or parliament, nor has the legal status of domain names been clearly defined by the courts.

The registration of domain names is carried out by the Russian Institute for Public Networks, a non-commercial partnership established by the Ministry of Science, the Ministry of University Education and the Scientific Research Institute named after Academic Kurchatov. It is responsible for the development of the Russian zone on the Internet. This authority was delegated to the Russian Institute for Public Networks by the International Network Information Centre (InterNIC).

*Squatting, piracy, domain names and intellectual property rights*

Prior to 1 June 2000, the registration of domain names was a low cost procedure. Any person wanting to register a domain name simply applied to the Russian Institute for Public Networks and had to pay a registration fee within three months of registration.

Maintenance of the registration was also subject to a nominal annual fee. Failure to pay the fee did not prevent the person from applying for registration of the same domain name again. This led to a rush of cyber-squatting activity.

Of growing concern is the issue of copyright protection on the Internet. Russian law does not provide clear guidance as to what remedies may be available to a copyright owner when his rights are infringed by a site operator. The owner of the copyright might find limited comfort in the Copyright Law, which prohibits unauthorized communication of copyright-protected works by means of cable or wire transfer and other analogous means, or unauthorized distribution by means of copying and distribution of copies of the work by any means.

From 1 June 2000 a new Regulation on Registering Second Level Domain Names in Ru.Zone, adopted by the Russian Institute for Public Networks, came into force. To register a domain name an applicant must pay a registration fee of US$ 36 within one month. Failure to pay the registration fee or the annual maintenance fee of the same amount prevents the applicant from filing a new application until the fee is paid.

The new Regulation divides domain names into geographical and generic (for example, ac.ru, org.ru, net.ru), public (those that are not geographical or generic) and corporate (all other domain names).

The Rules for Resolving Disputes over Domain Names were developed on the basis of the Uniform Domain Name Dispute Resolution Policy recommended by WIPO and accepted by ICANN. The Rules provide protection for trademark owners against owners of domain names that infringe the intellectual property rights of trademark owners.

According to the Rules, the registration of a domain name should be cancelled if it is proved that the domain name is identical or confusingly similar to a trademark or was registered or used in bad faith.

A domain name is deemed to be registered or used in bad faith if it was registered or used:

- mainly with the purpose of a later assignment to the trademark owner for a remuneration considerably exceeding the cost of registration;
- to prevent the trademark owner from registering the domain name;
- to obstruct the activities of the trademark owner as a competitor of the domain name owner;

- in commercial interest and with an intention to attract third parties to the Internet resources of the domain name owner thus creating a possibility that the trademark will be considered by third parties as having a connection with the domain name holder.

Although the rules that apply to disputes considered by an arbitration forum at the Russian Institute for Public Networks do not provide for compensation for damages, they do leave open the possibility to apply to state courts for an award of damages.

*Contracts via the Internet: legislation on electronic signatures*

There is currently no law or regulation that deals with e-commerce. The regulatory framework for e-commerce is only now emerging in Russia. A number of drafts exist and some of them are presently at committee stage in the Russian parliament.

There are drafts of the Law on Electronic Commerce and the Law on Electronic Documents. There is even a proposed draft of a federal programme on e-commerce.

The first step in developing e-commerce was the adoption of the Law on Electronic Signatures, which came into force on 12 January 2002.

The Law on Electronic Signatures defines an electronic digital signature as a cryptographic symbol that depends on public key cryptography technology to decode it. If adopted in its present form, such a 'strict' definition would prevent usage of any other forms of technology for this purpose. Moreover, the cryptography is the exclusive public domain of the Federal Agency of Governmental Communication and Information (FAPSI), which allows additional state control over the electronic transactions.

At present, there is no sub-regulation applicable to electronic contracts that would recognize electronic transactions.

*Taxation of purchases made through the Internet*

Purchases of goods transferable through the Internet are not taxed because a means for tracking such purchases and assessing taxes does not presently exist. If goods are bought through the Internet and then delivered to the customer in a material form, they would be subject to all existing Russian taxes and customs duties.

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# Part Five

# Business Development: Operating an Enterprise

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5.1

# The Property Regime in Russia

*CMS Cameron McKenna*

## Introduction

The Russian Constitution of 1993 proclaims a right to hold land in private ownership. This is supported by the Civil Code of 1996, but Chapter 17 of the Civil Code, which was intended to establish a framework for transactions in land, was not brought into effect until 29 October 2001 when the new Land Code of the Russian Federation came into force. On 30 October 2001, almost 84 years to the day after the October Revolution of 1917, Russia passed a federal law overturning one of the remaining legacies of the USSR: state ownership of land. The new Land Code at long last permits private ownership of commercial land and, together with Chapter 17 of the Civil Code that has now come into effect, will govern transactions in land. In general, foreign individuals and companies will be allowed to buy and sell commercial land except in certain border and other designated areas. Agricultural land, however, has been excluded from the provisions of the Land Code and is to be dealt with in a law on agricultural land, which was adopted on 24 July 2002 but will come into force only on 27 January 2003. Perhaps the greatest practical significance of the Land Code is that it applies to the whole of the Russian Federation and the existing patchwork of regional land legislation is to be amended and brought into line with this federal law. This should remove the many discrepancies and inconsistencies that have appeared between regional and federal land law in the last few years as certain regions have forged ahead with their own land law reform programmes.

## Land

Article 9 of the Constitution provides that land and other natural resources may be held in private, state, municipal or certain other forms of ownership.

The Land Code divides land into several categories on the basis of a designated prescribed use. These are as follows:

- agricultural land;
- land for housing;
- commercial land for use by industrial enterprises, power companies, communications companies etc;
- land which is situated beneath an object which is itself specially protected (eg nature parks);
- forestry land;
- waterfront land;
- reserve land (land that is owned by the State, is not used for commercial purposes and that can be transferred to any of the other categories – in effect, a miscellaneous grouping).

It is important, therefore, to check the prescribed use of any land before buying it. The prescribed use should be stated in all title documents, any agreement for use of the land and all registration documents. Each category has different conditions for usage and the Land Code requires that each plot of land is used and exploited only in accordance with the category in which it is designated. So, for example, it will not be permissible to build a factory on agricultural land. It should be noted, however, that in this situation an application can be made to the relevant State authority to have the prescribed use of a particular plot of land changed.

Many of the 89 'subjects' of the Federation have their own local laws governing land and some of these (eg Samara) have permitted commercial land ownership for some time. The new Land Code requires all regional land legislation to be brought into line with the provisions of the Land Code itself.

As a general rule, the Land Code only applies to transactions occurring after its enactment. Pre-existing ownership rights, which are now inconsistent with the provisions of the Land Code, however, have to be re-registered. So, for example, a legal entity which has acquired a permanent right to use a plot of land is required to either re-register its rights as a lease or to purchase the right of ownership to this land prior to 1 January 2004. Similarly, where a building (or other item of immovable property such as a rig or a bridge) has been acquired, the land underneath that structure or land that is necessary for its use and that had previously been granted on the basis of a permanent right of use should be re-registered as a lease or the land acquired outright.

Unless and until land plots to which an earlier registered right of permanent use is attached are re-registered, further dealings with that land will not be permitted. In particular, note that it is no longer permissible for a permanent right to use land to be contributed to the charter capital of a company.

It is a general principle of the Land Code that foreign individuals and legal entities are to have the same rights to land as local residents. Despite this, there are certain restrictions applicable to foreigners. Thus, they may not own land located in border and other special territories. (A list of such land plots must be approved by the President of the Russian Federation.) The Land Code also provides that further restrictions may be imposed on foreigners leasing land but no additional restrictions have yet been enacted.

In some instances described in the Land Code and in the regional land legislation, residents may be entitled to receive land free from the State. Foreigners, on the other hand, may only acquire land for valuable consideration.

### *Lease of land*

There is no limit to the term of a lease of land plots. A lessee has a priority right to any subsequent lease of the same plot and, on the sale of the land, a priority right to purchase the same. Lease rights may themselves be sub-let, assigned, sold or contributed to the charter capital of another entity. Unless otherwise provided by the lease agreement, the aforementioned transactions can be entered into without the consent of (but after notification to) the lessor.

Land may be leased by companies and individuals whether Russian or foreign. In practice, leases are generally granted for a maximum term of 49 years and a lessee usually has a preferential right to renew the lease on expiry. The exact terms and conditions of a lease agreement will depend on negotiations between the lessor and lessee, but every lease should conform with the detailed requirements set out in the Civil Code and the Land Code.

Any change to the terms of the lease agreement requires the consent of both parties. Early termination by the lessor of a lease agreement with a term of five or more years will require a court order. An application for such an order can only be made where there has been a material breach of the terms of the lease agreement by the lessee.

### *Agricultural land*

Agricultural land was excluded from the provisions of the Land Code and a specific law on agricultural land was adopted on 24 July 2002.

The Law on Agricultural Land provides that foreign legal entities, foreign individuals and Russian legal entities in which foreigners control more than 50 per cent of the charter capital may not own agricultural land. They are instead only permitted to lease agricultural land and for up to a maximum period of 49 years.

### *Buildings*

One of the principles of the Land Code is to keep buildings and the land on which they are situated in the same ownership. The Land Code only allows buildings to be disposed of separately from the land on which they are situated where: (a) it is not possible to separate out the land (for example, a condominium); or (b) the sale and purchase of the land is restricted (army land, border areas, etc).

Where land is to be sold by a private entity, the owner of any building situated on that land will have a priority right to acquire the land. If the owner of the building chooses not to buy the land then the landowner can sell it to a third party. Where the land is to be sold by the State, however, the owner of any building on the land will have an exclusive right to purchase that land: if the building-owner chooses not to so purchase, the State cannot sell the land to anyone else. Thus buildings may be owned by individuals and companies including foreign investors, although the land beneath those structures may remain state (or private) property.

### *Mineral resources*

Ownership of a plot of land will not confer ownership rights on the resources situated beneath that land – those resources remain state property and may be exploited only in accordance with the provisions of the relevant subsoil legislation (see Chapter 3.14).

### *Building leases*

Buildings and parts of a building may also be leased. The terms and conditions of the lease agreement are regulated by the provisions of the Civil Code. These include, for example, a general duty imposed on the lessee to pay the rent agreed, to maintain the property in good repair, to pay compensation on termination for any improvements made, and a preferential right to renew the lease. Leases for more than one year must be in writing and must be registered with the relevant authority, which in Moscow is the Moscow City Committee for the State Registration of Real Property Rights and Real Property Transactions.

Rent payable on real estate leases is subject to VAT at a rate of 20 per cent. An exemption from VAT is provided on lease payments made by representative offices of companies incorporated in most Western European countries and the United States.

## *Mortgage*

There are no restrictions in the Land Code on the grant of security over land. Article 3 of the Land Code expressly states that this issue is to be regulated by the general civil legislation unless there are specific provisions to the contrary (thus, for example, a pledge cannot be taken over land which itself cannot be owned by foreigners). The Civil Code provides that a land plot can be mortgaged while Article 22 of the Land Code authorizes lease rights to be pledged.

Note that the Land Code does not prescribe any particular requirements as to the form or content of agreements for the mortgage of land, which are instead regulated by the Civil Code and the Law on Mortgages of 22 July 1998. Mortgages must be certified by a Russian notary and registered with the appropriate registration authority. Buildings and other real estate may be mortgaged but only together with whatever rights the building-owner has to the land beneath the building. Residential houses and apartments can also be subject to mortgage as can leasehold interests in real property.

In the event of default, a mortgagee may enforce his rights to possession of real estate only through court proceedings unless the parties agree otherwise. In either case, the property that is subject to the mortgage will be sold at a public auction organized either by the court or by specially registered auction companies.

## *Dispute resolution*

The Land Code stipulates that disputes involving land are to be settled in court proceedings although prior to such proceedings commencing, any dispute can be referred to arbitration.

In accordance with the Civil Procedure Code and the Arbitration Procedure Code, disputes concerning immovable property (including land) are within the exclusive competence of the courts of the Russian Federation. In this connection, Article 64 of the Land Code, which allows a dispute to be referred to arbitration, would appear to conflict with the legislation on jurisdiction. Pending an official explanation of this provision, we would recommend incorporating into contracts for transactions relating to immovable property a clause providing for the submission of disputes to the non-exclusive jurisdiction of a pre-determined arbitration body.

## *Registration*

All ownership rights in immovable property and any transaction involving property including leases for more than one year and the granting of servitudes and mortgages should be registered with the registration department set out by the local authorities under the supervision of the Ministry of Justice. Registration with the appropriate authority in accordance with the Law on State Registration of Ownership Rights to Immovable Property and Transactions Therewith is effective as confirmation of title. Rights that are created or transactions that are completed without registration (other than lease agreements for less than one year) are not valid unless and until they are properly registered. The appropriate authority in Moscow is the Moscow City Committee for the State Registration of Real Property Rights and Real Property Transactions. The information contained in the State Register is available for inspection against payment of a fee.

## *Payments for real estate*

Payments for real estate in Russia made to Russian individuals or Russian entities, whether lease payments or payments of purchase price, are subject to Russian currency control and should be made in roubles. Payments in foreign currency effected abroad may be possible where the lessor and lessee or buyer and seller are both foreign legal entities, although withholding taxes may be applied.

It is not uncommon for the price of many commodities, including land, to be quoted in a foreign currency, usually US dollars. Payment is then made in roubles by reference to the Central Bank rate of exchange applicable for the day of payment.

## *Use*

The specific use of land and buildings is usually defined by the State Register of Real Property Rights and Real Property Transactions. The most significant distinction is between residential and non-residential use.

## 5.2

# Land Relations in the Russian Federation

*Andrey Goltsblat, Managing Partner, Pepeliaev, Goltsblat & Partners*

The coming into force of the Land Code in 2002 and the adoption of the 'Law on Farm Land Turnover' caused an increased investor interest in land. The Land Code made more favourable the terms and conditions for the turnover of land plots and their acquisition, including through privatization.

Rights to land plots are primarily acquired in Russia through:

- a transaction with a land plot itself (purchase and sale, exchange, gift, contribution to authorized capital, etc);
- acquisition of ownership interests in land (interests in common ownership of farmland) with a possibility of subsequent land apportionment;
- acquisition of shares (ownership interests) in a legal entity owning a land plot;
- lease.

The types of objects of civil rights that are barred from circulation (objects withdrawn from circulation) should be expressly specified by law. For example: withdrawn from circulation are the lands of wildlife sanctuaries and national parks; lands under defence, security and atomic energy facilities; lands used for military and civil burials, etc. Restrictions have been imposed on the circulation of plots of forested land, farmland contaminated by hazardous waste and radioactive substances, other lands that have been subjected to degradation, etc.

Current Russian legislation sets forth the principle of plurality of ownership rights to land: the law treats as legally equal the right of land ownership of the Russian Federation (federal property), the constituent entities of the Russian Federation, municipalities, legal entities and individuals. All land owners enjoy equal protection. Unless otherwise provided by law, the right of ownership in a plot of land extends to the surface (soil) layer and closed reservoirs within the boundaries of this land plot and to the forest and plants which grow on it.

Owners of a land plot have the right to sell it, give it as a gift, erect buildings and structures thereon, pledge, lease out or otherwise dispose of it with regard to particularities, as set out in land laws.

Purchased, sold, leased out or otherwise disposed of can only be those land plots that are recorded in the State Land Cadaster and the rights to which are registered, as required by Russian laws. Marketable land plots are identified by means of cadaster registration – description and individualization of a land plot which result in assigning attributes to the land plot that unambiguously distinguish it from other real estate assets. The coming into force of the 'Law on Farm Land Turnover' on 28 January 2003 makes it possible to privatize farm land.

One of the specific features of the new Russian legislation is a special legal framework for land possession applicable to foreign individuals, foreign legal entities and stateless persons. For these categories of landholders certain restrictions have been imposed by the current laws:

- Their rights to land plots require payment in all cases and in no event may such rights be transferred gratuitously (unlike Russian condominiums and individuals who are allowed, in a number of specified cases, to acquire such rights gratuitously).
- Foreign legal entities, foreign individuals and stateless persons are not allowed to own land in frontier areas (the list of which should be set up by Presidential decree) and in other specially designated territories, as provided by federal law.

In addition, there are certain statutory restrictions in relation to the acquisition of title to plots of farmland:

- Foreign individuals, stateless persons and foreign legal entities may only possess and use plots of farm land based on a lease agreement.
- *Russian legal entities with more than a 50 per cent ownership interest held by foreign individuals, stateless persons and foreign legal entities may only hold plots of farm land on lease.*[1]

[1] This Law came into force on 28 January, 2003. Here and throughout the text the quoted provisions of this law appear in italics

- *The constituent entities of the Russian Federation should set the lower limits for plots of farm land and overall upper limits for farm lands which may be concurrently owned by an individual, his/her relatives and legal entities where this individual and his/her relatives have more than 50 per cent of the votes; such limit of the total area of farmland in the territory of one constituent entity of the Russian Federation may not be less than 10 per cent of the total area of farmland within the boundaries of one administrative and territorial unit.*

However, the vagueness and ambiguity of certain statutory provisions are raising apprehensions among investors conducting land transactions. The apprehensions are indeed well-grounded for there are no clearly identified market benchmarks and no objective methods to assess the market value of land. The land registration system is in its infancy stage and there has been no delimitation of state-owned lands. It is quite often that investors face difficulties in identifying the actual owner of a particular land plot or interests in land.

For instance, in the event of shared land ownership, if an investor (not one of the land co-owners but a third party) wishes to acquire a land plot which is in shared ownership, under the Civil Code the investor is required to obtain all co-owners' consent. This may prove difficult in reality, since more often than not the number of land owners runs into hundreds. We have developed and are successfully using our own methods to cope with potential difficulties.

Investors frequently have apprehensions related to the land plot forming procedure: it is difficult not only to find a suitable land plot but also to obtain this particular land plot for a project (be it construction of a plant, crop growing, etc).

Given that the Russian Constitution refers privatization laws and land legislation to the joint competence of the Russian Federation and its constituent entities, the specifics of legislation in each particular constituent entity of the Russian Federation need to be taken into account when conducting transactions. In addition, the regional and local authorities use different approaches to offering incentives for buying out or leasing land in their regions. When choosing a land plot it is important to take into consideration the specific features of regional legislation, which affect the terms on which the land plot may be granted, and deal with the local authorities individually.

The Russian land legislation distinguishes between seven basic land categories, depending on the intended use of land, including farmland, lands under settlements, industrial land, etc.

The lands referred to above are used only as intended. The legal framework for lands depends on the category they fall under and the permitted use in accordance with territorial zoning. Any type of permitted use is chosen by the land user independently and does not require any additional permits or approvals.

For objective reasons and for reasons of expediency, economic, social and the like, it is possible to convert land from one land use category to another. Such conversion requires that special rules and conditions be observed. The decision on land conversion falls within the competence of different authorities, depending on how the land plot is categorized and who its owner is.

The land legislation highlights as a priority the need to preserve especially valuable lands and lands of especially guarded territories. The law provides that withdrawal of valuable farmlands, forested lands, lands under first-class forests, lands occupied by especially guarded natural territories and facilities, lands occupied by cultural heritage assets, other especially valuable lands and lands of especially guarded territories for other purposes is limited or prohibited, as provided by Federal Law. For the construction of industrial facilities on farmland, and for other non-agricultural needs, lands are granted that are unfit for farming or farmlands of inferior quality in terms of cadastre value.

Withdrawal for non-agricultural purposes, including by means of a buy-out, of farm land with a cadastre value exceeding the average figure across the district is allowed as an exception, if required for the performance of the international obligations of the Russian Federation, for defence or security reasons, development of mineral deposits (except for common minerals), maintenance of cultural heritage assets of the Russian Federation, construction and maintenance of cultural, social and educational facilities, motorways, trunk pipelines, power supply lines, communication lines and other similar facilities.

Particularly valuable productive farmlands – including: farmlands of experimental production units of research institutions, and training and experimental units of higher educational establishments; and farmlands with a cadastre value exceeding the average figure for the district – may be included in the list of lands that are not allowed to be used for other purposes, as provided by the laws of the constituent entities of the Russian Federation.

The conversion of forested land to non-forested land for purposes other than forestry operation or forest use and (or) withdrawal of forested land in first-class forests fall within the competence of the Russian Government, while in second and third-class forests such conversion and (or) withdrawal are the responsibility of the authorities of a particular constituent entity of the Russian Federation.

In any event when construction or mining operations are performed damaging the soil layer, the fertile layer of soil is removed and used to improve low-productive lands. Provided the removed fertile layer of soil is put on low-productive or non-productive farm lands, the rate at which farm industry losses are required to be reimbursed may be halved.

To avoid unpleasant surprises in land transactions, attention should be paid to certain inconsistencies and discrepancies in regulatory acts:

- inconsistency between the provisions of civil laws and land laws in relation to the legal destiny of land plots and real estate assets located thereon, when the owner of the land and the assets alienates only the land or only an asset;
- discrepancy between the provisions of land legislation and privatization laws governing price calculations for land plots slated for privatization;
- discrepancy between the provisions of land legislation and privatization laws as to the gratuitous or not gratuitous basis of land privatization under certain circumstances;
- inherent inconsistencies in land laws in relation to the method of privatization of developed land plots;
- discrepancies between the provisions of land legislation and privatization laws, on the one hand, and the Russian Federation 'Law on Appraisal Activities', on the other hand, as to how the price of a land plot slated for privatization should be determined;
- insufficient legal regulation for situations where there is a combination of rights in personam and rights in rem in relation to one and the same land plot. What is meant is a fairly common situation where a party holding a land plot based on the right of perpetual (indefinite) use leases out this land plot with the owner's consent to a third party for real estate development.

When conducting transactions with land plots, in each particular case it is necessary to consider all surrounding circumstances and the specific features of the legal status of the objects of and parties to each single transaction.

*The lawyers of Pepeliaev, Goltsblat & Partners will be happy to provide assistance in regulating rights to land plots and other real* *estate assets and in solving other legal and tax problems. Our lawyers are ready to perform any of the following assignments:*

- *land and real estate due diligence, including examination of title documents for land and property;*
- *privatization of land and real estate;*
- *legal support for land and real estate transactions (purchase and sale, lease, mortgage etc.);*
- *drawing up contracts and negotiating contractual terms with counter agents;*
- *independent appraisal of land and real estate;*
- *acquisition of rights to land plots intended for commercial use;*
- *acquisition of rights to existing manufacturing facilities for setting up production;*
- *real estate mortgages as security for obligations under commercial contracts.*

# 5.3

# Arbitration and Dispute Resolution

*CMS Cameron McKenna*

## *The courts*

The financial crisis of 1998 led to a significant increase in the number and complexity of disputes being referred to the commercial courts in Russia, particularly the Moscow Arbitrazhniy (Commercial) Court. This was something of a baptism of fire for many of the judges who found themselves being asked to consider complex issues of fact and law, often under close scrutiny both from home and abroad. Although many Russian lawyers will claim that Russia is a civil law system and, therefore, individual court decisions do not create precedents that are binding on other judges and courts, in practice the significance of case law has increased greatly in the last few years. As in other civil law jurisdictions, Russian judges and lawyers are realizing the value of case reports that can give guidance on how previous cases were decided. A judge may not be required to follow precedents but he may be persuaded by them.

This chapter describes the court structure and the basic elements of litigation in Russia. Calls for the reform of the Russian legal system can often be heard but perhaps the most pressing need is to improve the quality and number of judges and the court facilities in which they are required to work. An average judge in the Moscow Arbitrazhniy Court is reportedly required to handle around 450 cases each year – an intolerable workload.

*Structure*

The jurisdiction of the Russian courts is principally divided between the courts of common jurisdiction and the state arbitrazhniy courts (see Figures 5.3.1 and 5.3.2), which between them deal with civil, criminal and commercial matters. There is also a separate constitutional court. It should be noted here that the arbitrazhniy courts are often referred to as arbitration courts. This can be confusing since the arbitrazhniy courts are state-run like their counterparts in the West. They should not be confused with commercial arbitration bodies that administer private arbitrations by agreement between the parties. These arbitration bodies operate independently from the State.

The Russian court system also includes federal military courts and so-called 'specialized' courts. In addition, a system of 'single judges' (mirovye sudyi) is being created to hear minor disputes that are currently referred to the first instance courts of common jurisdiction.

The structure, jurisdiction and procedure of the courts of common jurisdiction are set out in the Federal Law on the Court System of the Russian Federation and the Civil Procedure Code of 1964. The courts of common jurisdiction are organized on the basis of first instance district or municipal trial courts; second instance regional appellate courts with geographically discrete jurisdictions; and a single national Supreme Court (based in Moscow), which hears appeals from the regional appellate courts.

Under the Federal Law on Arbitrazhniy Courts in the Russian Federation a new arbitrazhniy court system was set up to deal with commercial disputes. These separate state arbitrazhniy courts have their own structure, jurisdiction and procedure as defined by the Arbitration Procedure Code.

There are three levels of state arbitrazhniy court. At the regional level, there are the Arbitrazhniy Courts of the Constituent Subjects of the Russian Federation. These are courts of both first instance and of appeals. Next there are the Federal District Arbitrazhniy

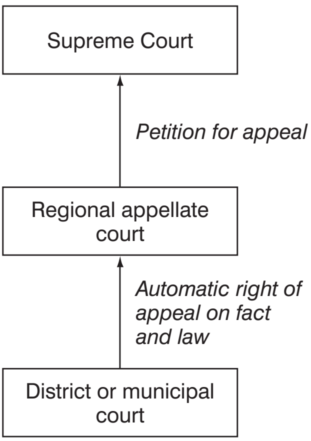


**Figure 5.3.1** Courts of common jurisdiction

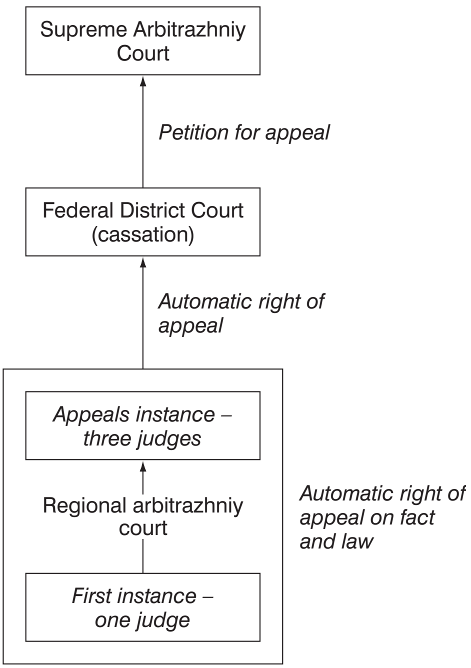


**Figure 5.3.2** Arbitrazhniy or commercial courts

Courts, of which there are roughly 10 throughout Russia. These district courts hear cassation applications, which are described below, from the regional courts. The Russian Supreme Arbitrazhniy Court occupies the highest level and exercises a supervisory role over the regional and district arbitrazhniy courts.

Although separate in terms of jurisdiction, the Supreme Court and the Supreme Arbitrazhniy Court occasionally publish joint resolutions, summarizing their practice in relation to particular issues and giving an authoritative interpretation of current law.

*Courts of common jurisdiction: first instance jurisdiction*

In effect, any matter not assigned to be dealt with elsewhere is dealt with by the courts of common jurisdiction.

Cases are normally commenced in the first instance district or municipal courts. In very limited circumstances – for example, in cases involving state secrets – a second instance regional appellate court may act as a tribunal of first instance. The Supreme Court acts as the first instance court for disputes arising in connection with the presidential and parliamentary elections and some other administrative matters.

Defendants should usually be sued in the first instance court for the area in which they reside, or, if the defendant is a firm, in the first instance court for the area in which it has its registered office. If the defendant's whereabouts are unknown or if the defendant is resident abroad, then the claimant may be able to issue proceedings in the court of the region in which the defendant's property is located.

The quorum of a first instance district or municipal court is usually one professional judge, but in some circumstances it is a judge and two lay citizen representatives.

*Courts of common jurisdiction: appellate jurisdiction*

The final judgement of a first instance court becomes enforceable after 10 days. During this period, each party has a right of appeal on fact and/or law to a regional appellate court. The appeal must be filed with the court whose judgement is being appealed.

No new evidence may be adduced on appeal unless it was not possible to present that evidence to the lower court. Respondents may reply to the points raised in the appeal by submitting a written response.

The quorum of an appellate court will usually be three professional judges.

Decisions taken by a regional appellate court can be further appealed to the supervisory appeal instance, the Presidium of the regional appellate courts, and then to the Supreme Court. The Supreme Court acts as the final court of appeal. It has the authority to reverse decisions of all first instance courts and rulings by appellate courts. Appellate proceedings before the supervisory appeal instances, including the Supreme Court, can only be brought by high-level judges and officials from the Prosecutor-General Office listed in Articles 320 and 321 of the Civil Procedure Code.

*State arbitrazhniy courts: first instance jurisdiction*

The jurisdiction of the state arbitrazhniy courts is confined to cases of a commercial or business nature. As of 1 September 2002 a new Arbitration Procedure Code came into force which replaced the old Arbitration Procedure Code of 1995. Any other type of dispute requiring a hearing in a public forum must be tried by the court of common jurisdiction.

As a general rule, an action should be started in the regional court for the area in which the defendant resides. If the defendant is a firm, then the action should be begun in the first instance court for the area in which it has its registered office. If the place of the registered office is not available, the claim should be filed with the arbitration court at the last known location of the defendant.

If there are two or more defendants and they are located in different constituent subject territories of the Russian Federation, the claimant can start the action in the relevant court for any of the relevant constituent subject territories.

If the defendant's whereabouts are unknown or if the defendant is resident abroad, then the claimant may be able to issue proceedings in the court for the region in which the defendant's property is located. In addition, if it is a contractual claim, legal action can be started in the first instance court for the region in which the agreement is meant to be performed. Whatever the location of the first instance court, it is sometimes possible to transfer a case to an alternative arbitrazhniy court of the same level of competence.

The quorum in a first instance state arbitrazhniy court is usually one professional judge.

The new Arbitration Procedure Code also permits legal entities to be represented in hearings by professional advocates (ie members of the advocates bureau) or its own employees – not a very significant change in itself, but this severely restricts the choice of those to appear in proceedings.

*State arbitrazhniy courts: appellate jurisdiction*

Decisions of first instance arbitrazhniy courts become enforceable after one month and during this time a party has the right of appeal on fact and/or law to the appeals instance of the regional court that first heard the case. The appellant cannot put forward new claims or adduce new evidence, unless it was not possible to present that new evidence at the first instance trial.

The appellant must serve a copy of the appeal documents filed with the court on all the other parties to the first instance trial. They then have a chance to enter a written response to the points raised in the appeal. The response must be filed with the appellate court before the date of the appeal hearing.

The Arbitration Procedure Code provides for a distinct appeal procedure called causation, under which a Federal District Arbitrazhniy Court has the power to cancel a decision or ruling of a regional arbitrazhniy court or against appeal rulings by such courts.

The final court of appeal is the Russian Supreme Arbitrazhniy Court, which has a supervisory appellate function empowering it to revise the decision of any state arbitrazhniy court that is illegal or lacking in legal substance. Appellate proceedings before the

Supreme Arbitrazhniy Court can only be brought by the chairman of the Supreme Arbitrazhniy Court or by the Prosecutor-General of the Russian Federation.

The quorum of an appellate state arbitrazhniy court is always an uneven number of judges. A minimum of three is required, irrespective of the level at which the appeal is heard.

*Procedure*

Generally speaking, the courts of common jurisdiction are open to all members of the public over the age of 16. In principle, state arbitrazhniy court proceedings are also open to the public. However, in practice, special permission must be obtained to gain access to any hearing. In addition, state arbitrazhniy courts will sit in closed hearing in order to protect industrial secrets or commercially sensitive information.

*Pleadings*

Actions are begun in the court of common jurisdiction when a claimant files a statement of claim with the appropriate first instance court. The statement of claim will contain a mixture of alleged fact and law, coupled with details of the evidence that the claimant proposes to adduce at trial. However, the claimant can modify or add to his claim at any stage up until the moment when the court retires to consider its verdict.

The service of the pleadings will be effected by the court.

Under state arbitrazhniy court procedure, the claimant files a written and signed statement of claim, just as he would do in a court of common jurisdiction case. While the defendant in a state arbitrazhniy court is expressly entitled to service a written defence as well as a counterclaim, the claimant in the court of common procedure has no such express right, although he will equally be permitted to serve a written reply.

*Evidence*

Under both the Civil Procedure Code of 1964 and the new Arbitration Procedure Code of 2002, the chairman of the court is responsible for preparing a case for trial. He will question the parties in an attempt to clarify the issues in dispute between them. The chairman may also instruct the parties to deliver further documentary or other evidence to the court and has the power to examine the parties' experts before commencement of the main hearing.

There is no equivalent of common law discovery and disclosure of documents and there is no mechanism for the pre-trial exchange of expert evidence. In state arbitrazhniy court cases such evidence will be in written form. In courts of common jurisdiction cases – where experts are usually court appointees in any event – expert evidence will be required in oral and written form.

*Judgements*

Usually judgement will be given orally and in writing immediately after the proceedings have ended. If the court has consisted of more than one judge, this will (if necessary) be a majority judgement. In a complex case before a state arbitrazhniy court, there may be a three-day delay before full judgement is given.

*Enforcement*

The enforcement of all court judgements and orders by both courts of common jurisdiction and state arbitrazhniy courts is dealt with by the enforcement officer attached to the court for the district in which the enforcement is to be executed. The enforcement officer is an employed court official often reported to be of variable quality and dedication. Should it prove necessary, the officer can be assisted in his duties by both the police and the militia.

*Litigation costs*

In the courts of common jurisdiction, the costs consist of the court fee plus the costs related to the trial of the case. In general, the claimant has to pay the necessary state court fee when starting an action, although there are certain exceptions.

The level of the state court fee will vary according to the value of the claim. It is calculated using the fixed table set out in the Law of the Russian Federation of the State Duty. Losing parties are usually ordered to pay the winner's costs. If a claim or a defence is only partially successful, then the cost award will reflect this.

Costs are dealt with in the same way in the state arbitrazhniy courts.

*Alternative dispute resolution mechanisms*

Under the Arbitration Procedure Code of 2002, the presiding judge has a duty at the pre-trial preparation to encourage the parties to settle their differences rather than engage in full-scale litigation. However, judges in the courts of common jurisdiction do not have a similar statutory duty and thus the public policy support for non-litigious civil dispute resolution remains patchy.

In addition to these limited alternatives to dispute resolution provided by the public court system, many arbitrarial bodies offer conciliation as well as arbitration services. However, formal alternative dispute resolution procedures are rarely used in Russia at the present time. Indeed, people are reluctant to use the new facility of private arbitration even for their domestic disputes.

*No concept of 'without prejudice' negotiations or settlement*

Neither the Civil Procedure Code of 1945 nor the Arbitration Procedure Code of 2002 restricts the ability of any party to plead in evidence any negotiations or offers made by any other party before or after proceedings are commenced. The practical effect of this is to severely hamper any opportunity for the parties to resolve and settle disputes without admitting liability. If an offer to settle is made then it may be introduced into court proceedings as evidence of admission of liability, and hence great care must be taken when dealing with customer complaints and disputes of any kind.

# 5.4

# Employment Law and Work Permits for Expatriates

*CMS Cameron McKenna*

### *Labour code*

As of 1 February 2002, a new Labour Code of the Russian Federation came into force. The new Labour Code replaced the previous Labour Code, which was adopted 30 years ago when the Soviet State was the only employer and concepts such as entrepreneurship and private property were largely unknown in Russia.

The new Labour Code deals with the following principal issues: the rights and obligations of employees and employers; trade unions and their regulation; the procedure for making, amending and terminating employment contracts; salary payments; the State as employer; and the procedure for dealing with employment disputes.

### *Employment contracts*

Russian law distinguishes between an employment contract that is subject to the Labour Code and a civil law contract between an organization and an individual for the provision of services. For the purposes of this chapter, we will be dealing with the former unless otherwise stated.

Employment agreements should be made in writing, although the Labour Code provides that an employee who starts working without a written agreement is nevertheless to be treated as an employee to whom all the provisions of the Labour Code will apply.

Employment agreements may be concluded for an indefinite period of time, or for a fixed period of time (but not exceeding five years).

The application of the fixed term contract is generally limited to work requiring fixed term employment (ie to replace a sick employee, for a fixed term projects, etc), but the new Labour Code specifically extended the possibility of fixed term employment contracts for directors and deputy directors of legal entities, chief accountants, retired persons and employees working outside of Russia.

A probation period of up to three months may be specified although this maximum limit can be extended to six months for certain executive staff including directors, managers and chief accountants. Three days prior to the expiration of the probation period both the employer and the employee have to notify each other in writing about termination of the contract. Moreover, the employer should indicate reasons for termination.

The new Labour Code provides a list of mandatory provisions that should be included into the Employment Agreement and sets out a list of documents that an employer may request from an employee at the time of hiring.

## *Working hours and holidays*

The statutory working week may not exceed 40 hours. Despite this, the Labour Code does envisage extra hours being worked and the procedure for this is strictly regulated. Thus, employees are required to agree in writing to work overtime and cannot work more than four extra hours on any two consecutive working days and the total number of hours overtime cannot exceed 120 hours per year. Overtime pay is set at time and a half for the first two hours and double time for each subsequent hour.

The minimum statutory paid holiday entitlement is 28 calendar days although longer periods are possible by agreement. Compensation for unused holidays will only apply to those holiday days in excess of 28. Finally, note that an employee is only entitled to holiday after serving a minimum of six months in the firm. Vacations may be divided into several periods though the shortest period may not be less than 14 days. The Code provides for mandatory extra vacations for employees working in certain industries and for those with no fixed working hours.

## *Minimum statutory wage and currency control issues*

The minimum salary must be no less than the minimum subsistence level established by the federal legislation (currently the minimum subsistence level is approximately US$ 80 per quarter, though legislation sets out a minimum salary level of US$ 15 per month). The Labour Code provides that salary must be paid at least twice a month although it does not specify whether these payments should be of equal amounts. Salaries should be paid in Russian roubles by bank transfer to the employee's account or in cash. Payment in foreign currency is not permitted, although salary levels may be fixed in foreign currency or by reference to a foreign currency amount. Some banks offer payment schemes that allow employees to convert rouble salary payments into dollar deposits or even, in the case of representative office employees, to receive dollar salary payments on employees' credit cards. Salaries may be a fixed amount per month or may be linked to performance. Any changes to salary should be notified to the employee at least two months in advance of the change coming into effect and the change should be agreed in writing. Employers who pay late may face fines on the due but unpaid amount for each day of delay in payment of wages. If wages are delayed for more than 15 days, employees may stop working until the wages are paid in full.

### *Termination of employment agreement*

An employment agreement may be terminated with the mutual consent of the employer and the employee, at the initiative of one or other party, or upon effluxion of time.

An employee may terminate his or her employment agreement, where the same was concluded for an indefinite period of time, by giving two weeks notice to the employer. Any longer period of notice required by the employer and specified in the agreement will not be capable of enforcement. Post-termination restrictive covenants are also largely unenforceable.

An employer's ability to terminate an employee's contract of employment is severely limited by the Labour Code. The grounds for termination include:

- liquidation of the employer;
- redundancy (for specific economic or technical reasons);
- lack of qualification (this does not extend to poor performance) or poor health of the employee;
- repeated and systematic breach of duty after disciplinary action has already been taken;
- absence from work for more than four hours without a valid reason;

- intoxication (alcohol or drug): this must be medically verified;
- committing theft at the work place (the theft must be confirmed by court or appropriate state authority);
- unauthorized disclosure of confidential information.

Employment contracts with members of the executive body of a legal entity may also be terminated in accordance with grounds provided in those contracts.

The change in ownership of a legal entity may not result in the termination of its employees' labour contracts, although the new owner may terminate the employment contracts of the head of the company, his deputies and the chief accountant within three months from the date of change of ownership.

In each case, care must be taken to comply with the strict procedural requirements of the Labour Code and due regard given to the priority rights granted to certain groups of employees. For example, the employment of pregnant women and women with young children may only be terminated if the employer is to be liquidated. Working students, war veterans and employees with more than two dependants have a priority right to remain employed in cases of redundancy. Decisions must be carefully documented and, in certain cases, an employee should be offered alternative employment within the organization. Compensation for dismissal will be payable in an amount equal to between two weeks and five months salary. Compensation for any unused holiday is also to be paid.

If the provisions of the Labour Code are not followed when dismissing an employee or employees then the employee may bring legal proceedings. Among the various rulings that the court can give is that of reinstatement, a ruling that is not uncommon.

## *Data protection*

An employer is obliged to protect personal data of the employee in the possession of the employer and may disclose such data to third persons only with a prior written consent of the employee. The employer must also develop internal procedures for safeguarding employee's personal data and notify each employee about such internal procedures.

## *Work permits for expatriates*

Russian companies that wish to employ foreign labour in Russia must apply for a general permit to do so. General permits are issued by regional divisions of the Ministry of Ethnic and Migration Policy and are issued for one year, which may be extended on request. For each individual foreign national, a Russian company requires a 'Confirmation' of the right to work, which is, in effect, a Personal Work Permit. Certain categories of employees are not covered by these requirements, including employees of foreign embassies, scientists and artists working in institutions established in accordance with international agreements, journalists accredited in Russia, ships crew and students on study internships.

Because work permits are not issued centrally by the Ministry of Ethnic and Migration Policy, the exact terms and conditions thereof tend to vary from region to region. In Moscow, for example, processing a work permit usually takes 3–4 weeks, whereas in the Far East, it can take considerably longer. The documents to be submitted with the work permit include:

- copies of passport and visa;
- results of HIV test;
- a copy of the employment agreement;
- a copy of the tax registration certificate of the employer;
- copies of the employer's statutory incorporation documents.

### *Personal accreditation of foreign employees of representative offices*

Individuals employed by representative offices of foreign companies may apply to the registration body where the representative office is accredited for their own personal accreditation. For example, the State Registration Chamber will accredit a representative office and usually will allow that representative office to accredit up to five individuals. On application this number may be increased.

Personal accreditation confirms the official status of a representative office's employee and gives that individual a right to work in Russia without needing a separate personal work permit from the Ministry of Ethnic and Migration Policy. Family members of employees may also be granted personal accreditation. The validity of personal accreditation is linked to the term of accreditation of the representative office, so personal accreditation may be extended only after accreditation of the representative office of a foreign company is extended.

### *Visas*

As well as a personal work permit or personal accreditation, a foreign employee may require a visa to enter, remain in and leave Russia.

### *Registrations with the Ministry of the Interior*

Foreign employees of Russian companies and representative offices in Russia must register with the Department for Visas and Registrations of the Ministry of the Interior ('UVIR'). Foreign nationals visiting Russia must register their passports and visas with the UVIR within three days of arriving in Russia. If you are staying at a hotel, the hotel will usually organize registration with UVIR. If you are not staying at a hotel, then registration with UVIR is still required. The UVIR places a stamp in the visa to confirm registration. Without this stamp foreigners may encounter difficulties with the militia and other authorities.

# 5.5

# The Security Industry and the Foreign Businessman

*Steve Lidstone, Control Risks Group, Moscow*

## *Introduction*

You may be forgiven for thinking that you face insurmountable peril when you make your fist trip to Russia. We have grown up in a period of antagonism and disinformation towards the East, which give us preconceptions of a dark place of mystery. The media does little to help, with dramatic stories of the short, turbulent years of Russia's new found existence: shootings on the streets, frequent bombings, kidnappings and beheadings. Do you really want to do business here?

The trip itself is not made easy with the visa process cutting some off at the first hurdle. On landing at Sheremetevo the tales of gloom and despair must start to ring true. The airport is dark, murky, forbidding. Glum, unsmiling faces peer at you from drab uniforms. The passport and visa queue can seem endless. The luggage often goes missing; there is confusion over what you really need to declare and how to do it; then the taxi driver gauntlet. Is this a real picture of life to come?

Of course there is no smoke without fire, but it is not the raging inferno you may think. Poor pay and lack of funding underpin the arrival scene. But if you arrived in Moscow through Domodedovo airport you would see a different picture. Recently renovated, the terminal is light and airy, as you would expect of a thriving metropolis. The true picture probably lies between the two venues. Yes, it can be gloomy, but it is getting better. The whole country, and Moscow in particular, is taking large strides forward. Some things have improved immeasurably over the last decade, but go cautiously, for the embers still glow and if you stoke too hard, it may flare in your face.

## *The security environment*

As in other areas, the security scene in Russia is evolving rapidly. Those elements that rapidly seized money and power at the collapse of the Soviet Union have either gone by the wayside or are now consolidating their positions. If you expected gunfire in the streets you would be disappointed. Moscow is not the wild frontier town it was reputed to be in the mid-90s. But as with any city of this size, there is a crime problem, some of it violent. It can be a rough and violent existence. Deaths are frequent – hypothermia can account for around 300 in the winter, drowning in the reservoirs about the same in the summer. More people fall to their deaths from Moscow's high rise apartment blocks throughout the year than servicemen die in the war in Chechnya.

The murder rate is high too. A cause for concern to foreign businessmen? It should not be. Eighty per cent of murders are domestic; the large majority of the rest are contract killings. These do not affect Westerners. It is extremely unlikely that a foreigner will get drawn into a business arrangement that could lead to his death. It has happened in the past, but the uproar may be such to preclude the risk, and most foreign businessmen conduct themselves in such a manner as to avoid these conflicts. There are deaths to Westerners, but they tend to be as a result of lifestyle rather than business and they are avoidable.

So what crime could affect the visitor and how serious is it? Next in the unpleasantness stakes is probably kidnapping. This is not a serious threat unless you are planning to work in or near Chechnya, where it is still viewed as a fundraising opportunity – and can be extremely unpleasant. Extortion, especially in conjunction with protection rackets, was a serious problem in the early to mid-90s. It is still a problem in the regions, but is less evident in Moscow, where it seems to have given way to a form of bureaucratic harassment.

Muggings exist, but are infrequent. There is, however, a growing move to racial violence by ultra-nationalists or young hooligans, often recognizable by their skinhead hairstyle. Such groups can cause sporadic and extremely unpleasant violence against foreigners and occasional groups of teenage 'rappers'. Particularly at risk are those of a non-European appearance, primarily those from Central Asia or the Caucasus republics, followed by Orientals and black-skinned people. Occasionally, groups cause problems in local markets or at football matches – the Japan vs Russia World Cup Match being a rare, but well feted example, where a rampage through the centre of Moscow caused a lot of damage and resulted in two deaths.

The terrorist threat should be mentioned, if briefly. It will be evident from the theatre hostage situation at Dubrovka in Moscow that the capital, like many major cities throughout the world, has its own terrorist problems. Generally these stem from the war with Chechnya, an independence struggle more than a rise in Islamic fundamentalism. Such action tends to be anti-Russian and not directed against foreigners, but if you are in the wrong place at the wrong time…

There is also the usual gamut of pickpockets, confidence tricksters, drugs in drinks and petty theft. All of it is pretty much avoidable if you take precautions.

## *Securing your investment*

If you decide to invest or do business in Russia, eyes will start to open and look at you with interest. The bigger your investment the more eyes there will be. Some will be keen to enter a symbiotic relationship with you, where you both make a bundle – no problem here, that is what you are both after. There is a possibly that a larger number that will view your activities with one-sided interest. In a land that has never known a system that is not corrupt, this requires a few more precautionary steps in the planning process to ensure your labours are not in vain.

Location is one of your first choices. Alongside your concerns of supply, logistics, infrastructure and labour force, spare a thought for who you will need to work with. If you are looking to the regions, can you deal with local officials at all levels? Do they have hidden agendas? Is your particular industry so riddled with crime in the area that it would be impossible to operate without some organized groups getting a foothold? You won't get the answers to these questions by skimming off the surface – you will need to make focused enquiries. If you are looking to the regions do not forget that you have fewer support systems than in the capital, possibly fewer people to turn to if things go awry. Do you have policies for dealing with crime, internal fraud and corruption or bureaucratic harassment? Don't be fooled – a one-off payment may soon be two.

Once you have decided on a location, do you then need a partner? Who can you work with to your mutual benefit? Could you trust your partner to allow him to have controlling interest? If not, could he wrest shares from you to take over the business? Does your potential partner have a track record of this? Speaking the language can go a long way to swaying a judge's decision if a case goes to court. So (I am told) can a few US dollars. If you do not take adequate precautions things could turn sour.

How do you go about selecting your workforce? You may want to use your own expatriates certainly in the initial stages. They understand the company philosophy and you may have known them for several years. But at some point you will need to take on local staff – an unknown quantity. Who do you trust in key positions? Who do you trust with your money, information and keys? Who do you trust with your security?

## *Choosing a security company*

It is a curious anomaly that when you have switched off the lights and gone home at the end of the day, you have probably left your business in the hands of your lowest paid workers. Your security may well now have free run of your buildings, stores and offices. Working independently or in conjunction with outside organizations they can strip your business clean or just turn a blind eye while someone else does it, for a consideration of course.

Security is one of the largest industries in Russia, employing over a million people. Security guards are everywhere – in offices, factories, watching you as you do your supermarket shopping. Yet it is also a relatively new industry. In the Soviet Union all was provided by the State, so there was no requirement for private security firms. It is still possible to get the militia to guard your property, even today. Is that a good idea? As everywhere, they are underpaid, overstaffed and underfunded. Hearts and souls are not usually in their work and financial remuneration may not be enough to keep them totally honest.

The strength of a security company usually comes from its management. In Russia this is drawn from three main spheres – ex-law enforcement (KGB/MVD), ex-military or sportsmen, (possibly ex-professional sportsmen who are unqualified to do anything else). There was also a criminal element, but this is gradually getting edged out. Because of the licensing requirements, companies tend not to work in all regions, although they will usually open an office if they have a contract.

Choosing a security company can be like choosing a business partner. Some things can be deduced from the way they conduct themselves: some things from reputation. If you skimp on the budget you may find that you are creating problems further down the line. They may have no experience working with foreign clients, they may be over-aggressive, the guards may get little pay and be looking to supplement it. If you are not sure, check it out.

## *To the future*

The rapid pace of recent change makes it almost impossible to predict just a few years down the line. It is certainly a country with problems, but it is addressing those. The heady days of the 90s are by and large a thing of the past. New strides to align Russia with the rest of the world are making new demands: demands of transparent business and an end to corruption. The country is rising to that call and gradually making the transition. It is too early to say whether the changes will be made fast enough or comprehensively enough, but it is moving in the right direction. With precautions it is already a great place to do business, but be prepared to plan and be prepared for a little frustration.

5.6

# The Russian Real Estate Sector: an Overview of the Market for Office Space and Retail Trading

*Jones Lang LaSalle*

## *Background*

Market liberalization and particularly privatization gave impetus to real estate market development in Russia. Moscow with it 8.4 million officially registered inhabitants living inside the city borders is the largest city in Europe in terms of population. Although Moscow's population constitutes only 6 per cent of the total for the Russian Federation, the city plays a very important role in country's economy, as almost 25 per cent of the national GDP is produced in the city.

Being the centre of economic life in Russia, Moscow attracts many businesses into the country. Ninety-nine per cent of international companies coming to Russia start their business from Moscow. These factors predetermined the leading positions of the Moscow real estate market. Nowadays the Moscow market is the most developed in the country. Although Russia's capital still lags behind other major European cities, it is growing very fast, and by learning from the experience of other countries, condenses several years' growth into one year.

## *Office market*

Moscow's office market, virtually non-existent until the late 1980s/early 1990s, was represented mainly by administrative buildings, seldom efficient and almost without any modern amenities (exclusive of air-forced ventilation units and toilets), which were built for and occupied mostly by state agencies and organizations. Until 1989 the Sovincentre Complex on Krasnopresnenskaya Naberezhnaya was the only fully serviced office centre in Moscow, with fully equipped offices, two hotels, a business centre, a congress centre, ample surface and underground parking, and shopping arcades and restaurants. Built for the 1980 Olympic Games with input from Armand Hammer of Occidental Petroleum, the complex created a secure environment for foreign athletes to live, work and shop without the need to leave the limits of the compound.

As the Russian economy began to open up to foreign investments and actual creation of joint ventures between Soviet (later Russian) enterprises and foreign companies started taking place in the late 1980s, the need for modern offices became more crucial. A surge in demand, coupled with only limited availability of stock, resulted in escalating rents in the early 1990s. At the market's peak in 1994–1995, base rents were as high as US$ 900 per square metre per annum.

Very little competition and strong demand for quality space gave those projects that were the first immediate success, leasing practically overnight to well-known international tenants.

In the early 1990s the demand for office space was outpacing supply. As a result, the best office buildings were pre-let six months before their completion. The rents were growing steadily, as tenants were willing to take more quality office space than existed on the market. By 1997, the demand was close to being satisfied, and the tenants became more demanding as to the quality of the space, the level of amenities, as well as to payment conditions.

Today, Moscow's total supply of all standards of office stock is estimated at 9–10 million square metres. Approximately 75 per cent of it consists of the so-called 'administrative space' housing Russian federal or domestic organizations, institutional premises, and renovated and unrenovated commercial space used by Russian enterprises. The high quality modern stock, which corresponds to the standard Western Class A and B space, constituted at the end of Q3 2002 only 2,400,000 square metres, where the true Class A segment only amounts to 470,000 square metres.

Significant changes have been taking place in the structure of demand. Prior to the 1998 crisis most Russian companies preferred to own office buildings. Hence, their share in the total take-up constituted no more than 20 per cent. Now they are more and more willing to lease office space, as this gives them more flexibility with quickly changing space requirements and allowing them to efficiently utilize available funds for business growth. Business service providers, manufacturers, mining and gas companies, and financial organizations were driving the office market accumulating more than 60 per cent of the total take-up.

The vacancy rate was close to zero through 1997, and some availability was due mainly to the inability of some inexperienced developers to market their buildings properly. At the beginning of 1998 the first signs of oversupply were evident. Vacancy rates began to rise from 7.5 per cent at the beginning of 1998 and peaked at 20 per cent in the first quarter of 1999. After that, it gradually decreased and by Q3 2002 it had stabilized at as low as 4 per cent.

We expect office vacancy rate to remain stable through to the end of 2003, as tight supply side is coupled with high demand. This inevitably will affect rental rates.

Rental rates for prime Western-standard offices peaked in 1994 at US$ 900–US$ 950 per square metre. This was achieved in about 12 large transactions involving less than 6,000 square metres in only two or three buildings, the most prominent of which was Japan House on Savvinskaya Naberezhnaya.

Since 1995, the rental level had gradually been decreasing up until August 1998, at which time the rents dropped by almost 40 per cent within six months.

Prime office rents for Class A space remained unchanged for over 12 months, from May 1999 to June 2000, demonstrating that the market had stabilized after the 1998 crisis. In July 2000, prime rents started increasing and currently the maximum rents vary from US$ 550–US$ 575 per square metre per year.

Standard lease terms are between one and three years for direct leases, sometimes reaching up to 10 years for large lettings, and between one and three years for subleased space.

Class A rents are quoted net of operating expenses and underground parking, which are in the range of US$ 70–US$ 100 per square metre per year and US$ 200–US$ 300 per space per month, respectively. Operating expenses are usually inclusive of management fees. Fit-out costs depend on the tenant's specific requirements, but usually they are estimated at US$ 300–US$ 500 per square metre.

Class B rents for new properties now range from US$ 450 to US$ 490 per square metre per year, including operating expenses.

On top of rental payments, operating expenses and parking charges, tenants pay 20 per cent VAT.

As a result of tightening supply, in 2001 the market returned to the pre-letting practice. Hence, almost 75 per cent of newly constructed Grade A space is now being leased before it is completed and ready for fit out works.

In real estate terms, Moscow is lying behind other markets in the Central and East European region, eg Poland or Prague, whereas we have identified that quality office stock per 1,000 inhabitants in Moscow is around 280 square metres, in comparison with 790 square metres in Warsaw and approximately 920 square metres in Prague. The difference in office space provision between Moscow and more advanced Western European cities is even more significant: it reaches 12,000 square metres in Brussels, 4,000 square metres in London and 3,700 square metres in Paris.

Moscow Central Business District (CBD) is defined as the territories inside or close to the Garden Ring – a busy thoroughfare encircling the city centre. Inside it there are three sub-markets, not only visibly different from each other, but also having different degrees of desirability as potential office locations for developers and tenants. The majority of the total high-quality office stock, and especially Class A buildings, is concentrated in the southern and north-western parts of the centre.

In the long term, Jones Lang LaSalle foresees the Moscow office market developing further outside the city centre. Fast developing transportation infrastructure and the construction of the Third Ring road should boost developments outside the city centre (52 per cent). The availability of land plots for the construction of the office buildings in the city centre is rather limited. Besides, not every tenant needs prime locations. For some companies, an office building on the main street outside the city centre would be more justifiable. The third factor affecting further development of the market outside the centre is expansion of the companies. If a firm opens a back office, it does not need a prime location.

Therefore, in the future, business park type developments will appear along the main city thoroughfares, outside the city centre.

## *Retail market*

The Russian retail market has undergone immense change since the early 1990s. In fact, the evolution of retail in Russia was rather remarkable. It only took a few years for the Russian consumer to get a feel of the 'capitalist' market mechanism – stores full of goods, a wide selection of products, intense competition among the market players to woo the customers, friendlier sales assistants who have finally learned to 'smile', and last but not least, the pleasure of realizing that in a market with a free interplay of the forces of demand and supply, the 'customer is king'.

Muscovites have always been the wealthiest people in the country. Their average per capita annual income reached the bottom line in 1992 and constituted just US$ 300 per annum at that time; next it started growing at a very fast pace and the highest achieved to date was in June 1998 at US$ 650 per month. As of December 2001 Muscovites' monthly income was US$ 554, four times higher than the average in Russia (US$ 133).

The Moscow retail market is currently experiencing a development boom, mainly due to rapidly growing personal incomes. Approximately 85 per cent of Muscovites' disposable income is spent on retail goods. A significant distinction of Muscovites is that they do not have to spend a portion of their income on housing, social insurance, education, etc, as most of them are still provided by the Government at almost no cost.

In Soviet times there were three major groups of stores in Moscow:

- state stores in the city centre (GUM, TsUM, Detsky Mir);
- large department stores (Krasnopresnensky, Danilovsky, Vesna, etc);
- other small stores.

Overall, those stores did not offer much in terms of variety of goods.

When the market-oriented reforms were introduced in Russia, the retail sector was the first to feel them. The market started developing in two directions – street retail, targeting the majority of people, and high fashion stores for the most affluent Russians.

A huge flow of goods was shipped to Russia by the shuttle traders, who were the predecessors of the wholesale retailers. Kiosks – small box-type shops of approximately one and a half metres in length, where goods are sold through a small window – were the first market-type 'stores'. By 1995 there were as many as 50,000 kiosks in Moscow.

Open markets represent the next generation of street retail. They are located on wasteland or areas which at that time could not be fully utilized. Open markets could occupy huge territories (on average between 10 and 40 hectares), the biggest being former VDNKh with 172 hectares. They specialize by product: food, clothing, footwear, construction materials, etc. Many people enjoy lower prices at the open markets in comparison with ordinary shops, and they continue to do their regular shopping there. At the end of 1998 there were 190 markets in Moscow and they occupied almost 1.5 million hectares.

Street retail captures as much as 44 per cent of total expenditures (Gfk, 2002), while modern retail (shopping centres, supermarkets) capture only 6 per cent. As street retail has improper janitorial conditions, it brings almost zero tax revenue, and as this style of trading creates a rather wild perception of the city, it is likely that this type of retailing will disappear. The Moscow City Government has already issued several orders that stipulate the gradual disappearance of kiosks and open markets. An estimated 1 million square metres of such retail is forecasted to be replaced with modern shopping centres in the next three to four years.

New shopping centres generally target upper-middle-class consumers and those who are financially well off. Petrovsky Passage and GUM were the pioneers in this segment. The first shopping centres in Moscow were of the gallery type. Their customers were mostly wealthy Russians, who represented only a small percentage of the total population.

The first 'true' shopping centre was the Turkish Ramstore, opened at the end of 1997. It has a hypermarket, shopping gallery and a food court, and the majority of its customers are middle-income Russians. The 1998 financial crisis postponed fast development of the retail sector, but in 2001 it became inevitable that Moscow will witness a real shopping centre boom, like the one which took place in Poland or in the Czech Republic in 1997–2001.

At the end of 2002 there were only some 30 existing shopping centres. The largest shopping centre in Central and Eastern Europe – IKEA MEGA – was opened at the end of 2002. IKEA MEGA clearly signals the size and potential of this market – this centre's gross area is approximately 200,000 square metres, there are over 220 shops, and it has 10,000 parking spaces.

In comparison with other European countries, Moscow has the lowest shopping centre stock per 1,000 inhabitants at only 42 square metres per 1,000 inhabitants, one-seventh of that of Prague or Budapest, one-tenth of that of Warsaw, and one-twentieth of that of Paris.

There are only 20 international retailers currently present in Moscow, most of whom prefer to work through franchising agreements. This situation will change significantly in the next two or three years. Many well-known major international retailers have already understood the potential of this market and are planning to open in Russia. Several hypermarket operators have announced their own ambitious plans for Moscow. French Auchan, which very successfully opened its first hypermarket in Russia in August 2002, proved to other retailers that the market potential is enormous.

Jones Lang LaSalle believes that the future of the Moscow retail market lies in the shopping centre segment. First, because with the growth in their income, people prefer to shop in more civilized places. Second, shopping centres have a competitive advantage over other retail patterns.

Retailers have realized that and they aspire to lease space in a shopping centre. The years 2000–2002 witnessed the unprecedented success of the shopping centre concept. Those projects that are under construction have been let several months before their completion dates. The most remarkable examples are Auchan, whose 65 stores in its retail gallery were leased out within six weeks, or IKEA MEGA, whose almost 90,000 square metres of retail space was pre-let well before its opening within less than one year.

Both local and international retailers are looking for large land plots for potential shopping centres. Since well-located large land sites are quite rare in Moscow, Moscow Region joined the race, and its Governor Ring project offers a sufficient number of land plots for potential shopping centres. The Moscow City Government also continues supporting retail market transformation into a more civilized one by adopting the measures aimed at further decreasing uncivilized retail, mainly open markets, and by issuing the City's programme aimed at creation of retail infrastructure.

Rental rates vary depending on the store type, location and physical condition. The highest prime retail rents achieved so far were registered in 1997–1998, when they were up to US$ 4,000 per square metre per annum.

Prime high street unit shops rents were growing very fast during 2000–2001 – by over 10 per cent per year. The highest rents are now achieved on Tverskaya and Novy Arbat streets and they range for a standard shop (100 square metres) from US$ 2,800 to 3,250 per square metres per annum. We expect further prime rental growth of 5 per cent in 2003.

In 2001 prime shopping centre rents also went up by 15 per cent reaching US$ 2,200–2,400 per square metre per annum. The highest rents are now registered in the Atrium shopping centre. In 2003 no further prime shopping centre rents increase is expected, as this segment is quite saturated and the majority of the developments will take place in the outskirts of the city.

In the outskirts the rents are averaging to US$ 1,400–1,500 per square metre per annum. It is highly plausible that the shopping centre rents in non-central locations will start to decrease in 2003 as competition strengthens in this segment.

## *Warehousing*

The Moscow warehousing market is still relatively immature. Prior to the 1990s there were almost no high quality warehousing facilities in Moscow and adjacent areas. One of the few examples was Olympic Warehouse in Pushkino, built in 1980. Most of the warehouses constructed before 1990 were multi-storey buildings, with built-in wall partitions, being very inefficient therefore.

The first speculative warehousing projects were implemented in 1994–1995, and since that time not that many warehousing facilities have been completed. With the total current stock of modern quality warehousing space being only 602,000 square metres (as of Q3 2002), there are quite a few warehousing projects that could come to the market in the future.

Out of that only 170,000 square metres could be considered to meet all western standards.

The Moscow warehousing market was developing very slowly in 1999–2001. Due to low demand and very few potential clients for quality space, developers were cautious to start new projects. In terms of quality warehousing stock provision, Moscow with its 73 square metres per 1,000 inhabitants has the lowest ratio among the leading markets in Central and Eastern Europe.

The demand for high quality modern warehousing stock comes mainly from international firms. Logistics companies have been very active in recent months. A growing economy, and, to a larger extent, fast rising retail expenditures are supporting the demand for quality warehousing space coming from both foreign and local retailers. A group that traditionally generates high demand for industrial facilities, manufacturers, are also active on the market, although not all of them need to have big warehousing facilities in Russia. On the other hand, those multinationals producing locally in Russia build their warehousing facilities near their plants, while the distribution is done through local companies.

Prime rents for warehouses increased by 10 per cent in 2001 to reach the level of US$ 120–140 per square metre per annum. This was a result of shortage of the quality product on the market.

The rents for lower quality warehouses are remaining in the range of US$ 70–90 per square metre per annum.

As with other commercial real estate properties, those rents do not include VAT.

## *Investment*

So far Moscow hasn't witnessed any true investment transactions per se. Foreign capital has not arrived in Moscow yet, although recently there was a significant increase of interest from several funds, developers and institutional investors.

Most of the transactions completed to date are purchases of office buildings or retail space for owner occupation. We do foresee a significant increase of volume of such transactions. In 2001 the volume of commercial property investment (value of all properties sold during the year) increased by more than 100 per cent in comparison with 2000 and exceeded US$ 500 million, all of these were for owner occupation. Approximately 60 per cent of the money invested in the Moscow commercial real estate market was Russian. European investors (19 per cent) are the next largest source of capital. Foreign companies are typically represented by international retailers, such as Benetton, Auchan, etc, or office space occupiers.

In the office segment two major Class A office building investment sales were concluded last year. Samsung Centre and Ducat Place II properties, fully let to prime tenants, were sold to some private investment groups. Achieved yields in those transactions are estimated at 16–18 per cent.

A number of Class B properties were purchased for owner occupation. Achieved yields in those transactions varied between 22 and 25 per cent.

In the retail segment in 2001 investment activity was boosting, compared to 2000 when there were almost no registered deals. In 2001, there were three major areas that attracted most of the investors' attention: (a) Purchases of land plots for future shopping centre development. Yields in this type of deal are estimated at 25–30 per cent. (b) Purchases of individual unit shops, primarily on prime streets but also on some busy routes outside the city centre, eg, acquisition of a shop. Yields in these deals could reach up to 30 per cent. (c) Purchases of old Soviet department stores for future renovation by international and local chains. Estimated yields are between 30 and 35 per cent.

Only one industrial property was sold during 2001. Estimated yield achieved in this deal is estimated at 18–22 per cent.

Stabilizing economy and improving legislation tax system in Russia should boost investment activity in real estate sector. Those factors should have a positive impact on financing available for real estate projects, as currently the supply remains rather limited. We expect prime yields for all types of real estate to harden in the next two to three years, 12–13 per cent yields should serve as a benchmark for the Russian real estate market. As a result, a potential investor might look for property value appreciation and capital gains.

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# Part Six

# An Introduction to Doing Business in Russia's Regions: focusing on the Urals and Western Siberia

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# 6.1.1

# The Urals Region

*The British Consulate General, Ekaterinburg*

### *The Urals: an overview*

The Urals region is one of the most significant in Russia. It is situated in Central Russia, on the border between Europe and Asia, along the slopes of the Ural Mountains. The area covered by the Consulate General is about 10 times the size of the United Kingdom, and is home to over 20 million people. There are four cities with population of more than 1 million people.

This is Russia's most resource-rich region, including minerals, fossil fuels and vast forests. The Urals region remains a major centre for oil and gas, heavy industry (metallurgy and machine building), as well as defence and aerospace plants. Other major industries are wood processing, food and packaging, and, increasingly, manufacture of consumer goods.

Almost all the large cities of this region were founded on the basis of industrial plants. The importance of this area was strengthened during World War II, when 1,300 industrial enterprises were moved to the Urals from the western part of the Soviet Union to escape the advancing German army. Following the war, the Soviet authorities continued to expand heavy industry. By the final years of Soviet regime, the Urals region accounted for around one-third of the country's steel production and a quarter of its cast iron production.

Much of the industry, however, is in need of an upgrade. The defence industry is facing problems of conversion to civilian production. Many companies are looking to re-equip their production facilities and are looking for international manufacturers of equipment.

The banking system in the Urals has recovered after the economic default in 1998. Some of the local banks enjoy credit lines with strong foreign financial institutions and state insurance organizations. However, they are not able to issue long-term credit lines and the companies seeking large investments have to rely on their own resources. Since 1999, some respectable Moscow banks (Alfa, Vneshtorgbank and MDM) have set up branches in the Urals; EBRD facilities are available for project-financing for large, small and medium-sized enterprises on case-by-case basis.

Its distance from Moscow, harsh climate (six months of winter with a minimum temperature of – 30°C), and the fact that most of the area was closed until 10 years ago, mean that the Urals region is still relatively unknown to the West. But, as the region reforms and continues to open up, that situation is changing.

## *Sverdlovsk oblast*

- **Population** 4.6 million
- **Area** 195,000 square kilometres
- **Capital** Ekaterinburg (population 1.3 million)

Sverdlovsk oblast and the city of Ekaterinburg consider themselves as the centre and capital of the Urals region. It is the largest of the oblasts in the Urals and has the largest GDP. And it is here that the Russian President's representative's office is situated.

The city of Ekaterinburg is situated on the River Iset, approximately 1,600 kilometres east of Moscow, in the eastern foothills of the Middle Urals. The 2,000 kilometre long Urals chain has come to represent the division between European Russia and Siberia and, by extension, between Europe and Asia.

The Russian engineer, Tatishchev, founded the city in the reign of Peter the Great and named it after Peter the Great's wife Ekaterina. During the 1720s, he developed the region's facilities for production and heavy industry, focusing on cannons and other military weapons. The city is probably most famous as the site where the last Tsar, Nicholas II, and his family were murdered by the Bolsheviks in 1918. During the Soviet period, the city was renamed Sverdlovsk after the local Bolshevik administrator Jacob Nikolaievich Sverdlov. After the fall of the Soviet Union, Sverdlovsk was given back its original name, Ekaterinburg. The region, however, keeps the name Sverdlovsk.

In Soviet times, Ekaterinburg was closed to foreigners. It became an 'open' city in December 1991. Since then, it has made moves to reform its economy and to open communication links to the outside world.

Ekaterinburg's geographic and strategic position, plentiful resources of minerals and raw materials, highly qualified personnel and a developed network of educational establishments are powerful factors boosting its development potential. Sverdlovsk has always been one of Russia's most prominent industrial centres and a powerful mechanical engineering complex. The region today produces a wide range of equipment for the metallurgical, chemical, oil and gas extraction and electrical engineering industries.

Sverdlovsk oblast has the largest GDP of any oblast in the Urals, producing 5 per cent of Russia's industrial output and ranking second only to Moscow oblast in that category. Heavy industry, ferrous metallurgy and machine building form a large chunk of Sverdlovsk's economy, much of it defence-related.

Ekaterinburg is one of central Russia's major road and rail transportation hubs, featuring air service to 10 foreign countries. Ekaterinburg has an international airport (Lufthansa have three flights a week to and from Frankfurt) with connections to other major cities in Russia. It also has the best infrastructure of all the Urals regions for attracting Western businessmen with the construction of two 4-star hotels. A number of Western-style restaurants, bars, and nightclubs have opened in recent years, giving the city more of a Western feel than other capitals in the region. But many parts are run-down with poor quality housing and utilities. Roads are in a state of disrepair, particularly outside Ekaterinburg.

In 1997, Sverdlovsk became the fourth oblast in Russia to receive an international credit rating. The oblast's top exports include steel, copper, chemicals, aluminium, titanium and radioisotopes. Non-ferrous metallurgy remains a growth sector, and the world's second-largest titanium producer (VSMPO) is located here. Growth has occurred in transport, telecommunications and food services. Another key growth sector is food production and processing, with firms seeking foreign equipment to upgrade production.

*Opportunities for international business*

There are good potential opportunities for trade and some potential investment projects in the region. Many formerly state-owned enterprises are now privatized and are desperately seeking foreign partners to help them develop. Local companies are taking advantage of European Union and other aid programmes to bring their business management techniques up to a recognized Western standard. A number have attained ISO 9000 status and have undergone management training, marketing and development programmes with Western organizations.

Traditionally the Urals developed as an industrial area. Most famous Russian enterprises are situated here. Uralmash, SUALholding, Urals Mining and Metallurgic company, VSMPO-AVISMA, Surgutneftegas, TNK are just a few examples of such companies. Most Ural companies are developing quickly. They are optimistic about the future and are looking for contacts with new potential partners from different countries. Economic stabilization and growth has enabled sustainable operation of local industry and has made companies capable of upgrading their production facilities. A number of enterprises have their own finance resources for purchasing new machinery; others are seeking for medium- to long-term project financing opportunities. Some enterprises have experienced difficulties since the economic crisis in 1998 but the indications are that economic activity is returning to pre-1998 levels. A stable exchange rate and oil price have helped kick-start the local economy again. About 41 per cent of investments in Sverdlovsk oblast were made in technical restructuring of industrial enterprises.

International companies have set up either joint ventures or invested heavily in the region. Coca-Cola – formerly Inchcape – has an investment of about US$ 40 million and Pepsi Cola have US$ 70 million in production facilities. Delcam, Rank Xerox, Caterpillar, AEG, Reuters and DHL are amongst others. In the last year EBRD made several investments in local enterprises: Concern 'Kalina' (a producer of cosmetics and perfumery) obtained US$ 9 million into their main capital and Verkh Isetsky Steel making plant received US$ 5 million investment for construction of new production facilities. Ninety-eight per cent shares in the 'Konfi' confectionery company belong to Baring Vostok Capital and Capital International; one of the largest Russian chromium compounds producers, Chrompic, sold the whole package of shares to the British-based company, Kermas Ltd, which invested US$ 12 million. There are other examples of foreign investment: ABB created a joint venture with Ural Electro Tyazhmash, a joint production of artificial lung ventilation units for infants was started in July 2001 at the Urals Optical-Mechanical Plant (UOMZ) with the British firm SLE Ltd (Special Laboratory Equipment Ltd), etc.

Construction has become one of the fastest-growing industries in the last two years, particularly in residential accommodation. There are also new Western-style shopping and business centres appearing almost every month. It has become profitable to invest in property as prices for real estate have increased dramatically during the last year. About 40 per cent of investments in Sverdlovsk oblast in 2001 were made in construction.

The rapid growth of industry in the last couple of years and increasing income of the local population has opened up good possibilities in the consumer market. The false impression is sometimes held that the Urals is an industrial region with low income and underdeveloped consumer markets. The purchasing ability of the population has clearly increased in the last few years and there is a demand for quality goods to replace cheap and poor quality imports from, for example, Turkey and China. The local administration is very keen to bring into the region strong European retail chains, which could meet this demand. A positive sign is that the new modern shopping centres are replacing older open markets developed at the beginning of the 1990s. During the last year five large shopping centres have been constructed and built up in Ekaterinburg alone, the largest of them being 54,000 square metres. Local companies working in the consumer market are seeking direct contacts with foreign suppliers.

There is scope for the import of good quality products. At present most distributors of consumer products are situated in Moscow but

**Table 6.1.1.1** Growth of international activity in Sverdlovsk region: 1998–2001

| | *Total foreign investments (US$, millions)* | *Leading investors in Sverdlovsk region* | *Total foreign imports (US$, millions)* | *Total exports from Sverdlovsk (US$, millions)* |
|---|---|---|---|---|
| 1998 | 119 | 1. USA<br>2. Gr. Britain<br>3. Germany<br>4. Netherlands<br>5. China | 1,567.4 | 2,527.5 |
| 1999 | 140 | 1. Germany<br>2. USA<br>3. Gr. Britain<br>4. Luxembourg<br>5. Cyprus | 864.1 | 2,567.9 |
| 2000 | 250 | 1. Holland<br>2. USA<br>3. Germany<br>4. Gr. Britain<br>5. Italy | 968.7 | 3,171.9 |
| 2001 | 746.9 | 1. USA<br>2. Gr.Britain<br>3. Virgin Islands<br>4. Cyprus<br>5. Panama | 966.2 | 2,645.3 |

*Source:* Sverdlovsk Regional Administration that is changing as more and more local companies working in the consumer market are looking for direct connections with suppliers from abroad.

The Federal Government through the administration of the President's Representative in the Urals Federal District is taking steps to overcome existing barriers to the foreign investment. Some of these steps are: to bring local legislation into line with federal laws and the Russian Sate Constitution; to reduce interference of the local authorities in business activity; to reduce complaints of corruption and bureaucracy; and to make the judiciary more independent. Since August 2001, a Consultative Council for foreign investors in the Urals Federal District has been set up to identify concerns of foreign companies represented in the region, to improve the business climate and to attract more companies to operate and invest in the Urals.

*Opening an office in Ekaterinburg*

(I) REGISTRATION OF AN ENTERPRISE WITH FOREIGN CAPITAL

A joint venture, a company completely owned by foreign investment or a representative office of foreign legal entity can register its presence officially through the Ekaterinburg City Administration.

If there is a Russian partner, they should provide certified copies of an agreement confirming both parties' interests in establishing a joint venture. Other documents that are required include:

- a stamped payment order confirming the payment of registration fee;
- an extract from the registration in the country of origin or equivalent proof of foreign legal status (must be presented with a Russian translation);
- a written application from both parties;
- a copy of confirmation of the foreign investor's bank status (must be accompanied by a Russian translation).

The registration period takes approximately 30 days to complete. All the documents submitted are returned to the applicant once registration is received.

(II) OFFICE SPACE

Good quality office space within Ekaterinburg city is often difficult to locate. However, the World Trade Centre (WTC), opened in September 1998, offers temporary and long-term offices. Outside the WTC, space is often available, but significant renovation may be required before use. The rental price for office space in the central districts of the city range from US$ 30–US$ 100 per square metre.

There are a number of property locators within the city. However, the foreign and economics department of the City Administration is efficient in locating space. They keep an updated list of premises and leasing agents available to foreign companies interested in setting up an office in the city.

#### (iii) Communications

Communications in Ekaterinburg have improved immensely over the past few years. Internet servers and international digital links are widely available. Internet cafes are available in hotels and throughout the city. Mobile telephones have become a common sight in the city and a GSM service was introduced in the autumn of 1997 to run alongside the older, popular analogue systems. Direct dial facilities to Europe are quite good. Inter-regional and local calls are, however, of poorer quality. Global-One, Lucent Technologies (formerly AT&T) and US West have operations in Ekaterinburg. The postal service, however, remains an unreliable one. It may take a long time for a package to arrive from abroad. For quick and safe delivery international courier services can be used (such as DHL). Communication by fax can also be a problem sometimes, because the majority of fax machines in Russia are manual, ie the same line is used for telephone and fax connections, so you have to ask the person at the opposite end to switch over to fax.

#### (iv) Currency and banking

All currency payments in Ekaterinburg, as throughout the Russian Federation, must be made in Russian roubles. Foreign currency can easily be changed at banks or hotels during working hours, but currently no bank is open in the evenings. However, there are a few exchange bureaux open later in the evening and two that are open 24 hours (Most Bank Exchange in the Atrium Palace Hotel and Oreolkombank in the Centralnaya Hotel).

A number of automatic cash machines have recently been installed in the city. Rouble withdrawals can be made using US, European or Russian debit cards. It is not recommended, however, to rely on this as one's only source of finance; the machines are temperamental and do not always accept 'foreign' cards.

Russia is a cash economy. One should expect primarily to pay all debts in Russian roubles.

A few restaurants and shops currently accept Visa and Mastercard as a form of payment. Credit cards are not widely accepted, however, and should not be considered a primary means of payment.

It is possible to obtain a cash advance from a Visa or Mastercard. Uralvneshtorgbank gives US$ advances on Visa (at a 2 per cent commission) and on Mastercard (at a 3 per cent commission). Their working hours are Monday–Friday 9–6 and Saturday 10–3. However, American Express is not likely to be accepted.

Money transfers are also now available through Uralvneshtorgbank, as they have recently signed an agreement with Western Union enabling their customers to make bank transfers worldwide.

Traveller's cheques are accepted by some banks. The commission charge is about 10 per cent but there is no guarantee that the cheques will be honoured. Visitors should therefore bring US dollars cash and a credit card.

*Doing business in Ekaterinburg*

(I) FREIGHT FORWARDING

There are a few major freight-forwarding companies serving Ekaterinburg from Western Europe. It is common for a company to ship their goods through Moscow. There are, however, other routes through St Petersburg or direct that can be used depending on the type of product to be imported. Big industrial equipment usually comes directly to Ekaterinburg. As for consumer goods, the situation varies. It is possible to ship any goods direct, but in many cases it may be inconvenient or too expensive. There is currently a cargo system connecting Ekaterinburg with those countries with which Ekaterinburg has the most consumer trade activity: Italy, Germany and Turkey.

(II) CUSTOMS AND IMPORT PROCEDURES

Import procedures and tariffs of the Urals region are based on the federal regulations of the Russian Federation. Ekaterinburg has its own customs and custom clearance is possible for goods coming directly from abroad. By the information obtained from Ekaterinburg customs authorities, depending on the product to be imported, requirements to customs procedures may vary. It is advised to check the requirements in each particular case. The following information is correct on the date of publication, but is subject to change.

***Documentation***

- **The Certificate of Conformity:** The GOST Certificate of Conformity is mandatory for the importation of many products into the Russian Federation. Even when it is not necessary for the product to be cleared at customs, it may be required at point of sale/use and should be available on demand by the authorities as evidence of certification.

The GOST Certificate of Conformity should be obtained from Gosstandart (State Committee for Standards and Certification) or an organization authorized by Gosstandard. This may be either Russian or foreign, appointed for the purpose of issuing Certificates. It is recommended that you should obtain the Certificate through one of these authorized authorities as the Gosstandart is often time consuming and requires more documentation to be submitted. Most of the Russian authorities are located in Moscow, but there are also two in Ekaterinburg which issue Certificates of Conformity.

- **A Decision on Classification:** This document confirms the category in which the imported goods fall. A decision on classification is issued by customs authorities and can be obtained by regional customs agencies (Sverdlovsk oblast in Ekaterinburg's case). A detailed description of the imported goods must be given in order to classify the imported goods. A decision of classification expires after one year and must then be resubmitted to customs.

***Import duties***

Goods imported into the Russian Federation are potentially subject to three types of taxation: import duty, excise duty and VAT. Excise and import duties are calculated on a percentage of the goods' customs value. VAT is calculated on a percentage of the total combined amount of import duty and customs value. The rates of import duty and VAT are set by Presidential decree and the State Committee on Revenue Services.

- **Import duty:** All individuals and enterprises are liable for import duty. Exemption is granted by the government on a federal level and can only become effective after confirmation has been received by the regional customs office.

  The categories of exempt goods are:
  – re-exported goods;
  – goods in transit;
  – goods for inbound warehouses;
  – goods sent to free economic zones;
  – charter capital;
  – goods sent for use in a representative office by an accredited organization.

- **VAT:** The standard rate of VAT is 20 per cent. Some products are 10 per cent. Calculation of VAT is determined according to a VAT classification, decided by customs. There is also a Sverdlovsk regional sales tax of 5 per cent, introduced in January 1999.
- **Excise:** Excise duty is applied only to some categories of goods. This is a small group of products sometimes called luxury (wine, automobiles, jewellery and some others). The exporter needs to check whether the product falls within this category.

(iii) Taxation and tax privileges

Bilateral double taxation avoidance (DTA) agreements, including one with the United Kingdom, allow tax breaks on moveable property, profits and similar budgetary elements. A federal letter of December 1997 states the documents needed to establish business anywhere in Russia. There are local tax breaks, making Ekaterinburg more attractive than some other parts of the country. The new Federal Tax Code, when adopted, will enshrine tax benefits for foreign investors.

The Ekaterinburg branch of the Federal Tax Authorities has weekly consultations (on Thursdays) with foreign companies on the latter's tax obligations. This covers DTA aspects. The Mayor and City Duma arrange individual local tax breaks by decree after approval by the Investment Committee. Additionally, there are two local companies that offer professional advice on the regional and city tax laws (The Centre of Economic Expertise and Nalogii Rosii). The Centre of Economic Expertise also offers commercial and financial legal advice. Contact details for these organizations are as follows:

**Centre of Economic Expertise 'Tax and Financial Law'**
Lenina 60a Room 505
Ekaterinburg 620062
Tel: +7 3432 657671
Fax: +7 3432 657349
Contact: Alexander Bruzgalin

**Nalogii Rosii**
Khimikov 3–300
Ekaterinburg 620014
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Fax: +7 3432 595804/595938
Contact: Dmitry Serikov

*Useful business related customs authorities contacts in Ekaterinburg*

**Department of Foreign Economic Relations, Ekaterinburg City Authority**
24 Lenina St
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Tel/Fax: +7 3432 717926/27
Contact: Mr Andrei Ivanovich Galchenkov (Head of Department)
Contact: Ms Svetlana Garipova (Chief Expert)

**Ministry for International and Foreign Economic Relations, Sverdlovsk Oblast**
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Ekaterinburg
Tel: +7 3432 771601
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www.midural.ru
Minister for FER: Mr Yuri Valeryevich Osintsev

**Urals Chamber of Commerce and Industry**
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Ekaterinburg
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Fax: +7 3432 555863/554458
Email: ucci@dialup.mplik.ru
www.ucci.ur.ru
Contact: Mr Dmitriy Tsion (Chief Expert of Vnesh Economic Service)

**Ekaterinburg Division of State Customs Committee of Russia (Rostek-Ural)**
50 Melnikova Street
Ekaterinburg
Tel: +7 3432 595102
Contact: Ms Regina Mamontova

**Ekaterinburg Customs Authorities**
50 Melnikova Street
Ekaterinburg
Tel: +7 3432 466422
Contact: Mr Aleksey Petrovich Tobolov

**Central Customs Authorities**
50 Malysheva St
Ekaterinburg
Tel: +7 3432 466751

**Airport Customs Authorities**
Koltsovo Airport
Ekaterinburg
Tel/Fax: +7 3432 266220
Tel: (Legal Department) +7 3432 268221
Tel: (Passenger Customs) +7 3432 268574
Tel: (Freight Customs) +7 3432 268854

## *Perm oblast*

- **Population** 3.1 million
- **Area** 160,000 square kilometres
- **Capital** Perm (population 1.2 million)

*Overview*

The city of Perm is situated on the western slopes of the Ural Mountains. It holds an advantageous position being the last large city in Russia before reaching the Asian border. Perm is a major river port, has two airports and is located on the Trans-Siberian railway. The city is located on the Kama River, the fourth-largest river in Europe and the main transport artery connecting the region to the Volga-Don River. The Kama serves as the primary connection to North West Russia and the Black Sea from Perm.

V N Tatishev, one of Peter the Great's closest associates, founded the city in 1723. Tatishev selected Perm to be the sight of the Egoshikhinsky Copper Factory. Although the factory was closed in 1788, it maintained the city's economy for years and is marked as the first establishment of Perm. In Soviet times, Perm was closed to foreigners but opened up in 1989. Since then, it has opened up links to the outside world, most notably twinning with Oxfordshire.

Perm region ranks ninth in terms of industrial output among Russia's regions. Heavy industry, primarily metallurgy and machine building, is still a large sector of Perm's economy. Much of the heavy industry is defence-related, and production of aircraft engines, Proton rockets and space control systems continues. Perm produces 30 per cent of Russia's paper and 98 per cent of its potassium-based fertilizers. The oblast is also a regional centre for electrical power generation. The main wealth of the Perm region is its natural resources. Most of the Perm region can be considered as oil-bearing. The region's top exports are refined oil and petrochemical products, fertilizers and metals. Perm has over 100 known deposits of oil and gas and two oil refineries. Annual extraction exceeds 9 million metric tonnes of oil and 500 million cubic metres of gas. Fifty per cent of Russia's magnesium, and most of its titanium ore come from Perm. Rare-earth metals, strontium, diamonds and gold are all extracted from within the region.

Since 1989, Perm has been actively seeking foreign investment. The region is slightly more progressive-minded than its neighbouring regions. After the crisis of August 1998 the Perm region has established a guarantee and risk insurance programme to protect foreign investments. The business climate is helped by the fact that, unusually, the city and oblast administrations work well together. The current Governor was previously Mayor. The Perm region is actively making improvements to their investment laws to make it more attractive to foreign investors.

There are many opportunities for trade and investment projects in the Perm region. Perm is one of the largest trading centres in the Greater Urals region of Russia. Defence conversion, mineral extraction, aviation and oil refining are the main industries of interest in the region. Indeed, Russia's largest oil company, Lukoil, is in the Perm region. A number of Western companies have set up either joint ventures or invested in the region. The British company, Sun Breweries, runs the Perm Brewery. The German company, Siemans and Klockner, and France's Alcatel also have a definite presence in the region.

*Useful contacts in Perm*

**Perm Oblast Administration**
International Relations Department
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Tel: +7 3422 587302 (Chief Expert: Ms Marina Milman)
Tel: +7 3422 587370 (Head of Department: Ms Lyudmila Kostareva)
Tel: +7 3422 587372 (Chief Expert: Mr Andrei Kurbatsky)
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Email: wes@permreg.ru

**Perm City Administration**
Foreign Economic and International Relations Committee
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Contact: Mr Viktor Anatolyevich Zamarayev, President

**The Urals Regional Business Support Agency (EU TACIS)**
Tel/Fax: +7 3422 901506
Svetlana Makovetskaya (local contact)
Email: sveta@smeda.perm.su
or
David Conway (Lancashire Enterprises)

**Perm City Customs**
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Perm
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Fax: +7 3422 451439

**Perm Oblast OVIR**
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Perm
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Fax: +7 3422 340558 / 341806

**Association of International Partnership 'Perm Region'**
Tel. +7 3422 982439
Email: aip.pr@permonline.ru
www.aippr.ru
Contact: Mr Andrey Kuchinky, Director

**Exhibition Centre 'Perm Fair' (Permskaya Yarmarka)**
65 Boulevard Gagarina
Perm 614077
Tel: +7 3422 481225/481559
Fax: +7 3422 481833/481559
Director: Mr Sergey A Klimov
Email: www.fair.perm.ru

**Non-commercial partnership of exporters 'Prikamye'**
14 Kuibysheva St
Perm 614006
Tel: +7 3422 905459/901736
Fax: +7 3422 905459/901736
Contact: Viktor G Kinev, Director

**Non-commercial partnership assisting industrial enterprises of Perm Region 'Sotrudnichestvo'**
28 Chernyshevskogo St
Perm 614007
Tel: +7 3422 160260
Fax: +7 3422 163999
Email: lider@permonline.ru
Contact: Grigory I Gordeyev, Director

### *Chelyabinsk oblast*

- **Population** 3.7 million
- **Area** 88,000 square kilometres
- **Capital** Chelyabinsk (population 1.1 million)

*Overview*
Chelyabinsk oblast ranks 12th in Russia in industrial output. Ferrous metallurgy and machine building play a key role in the region's economy; and metals account for 86 per cent of their exports and 43 per cent of total output. The region is rich in iron ore, copper, titanium, bauxite and gold. It is situated along the Trans-Siberian railway. Over 70 per cent of its exports of ferrous metals come from the giant Magnitogorsk Metallurgical Works.

The capital of the oblast is the city of Chelyabinsk, which is situated 1,500 kilometres from Moscow along the Ural River. The city was founded as a fortress in 1736 on the Ural River. In Soviet times, Chelyabinsk was closed to foreigners, but since 1991, it has made moves to open communication links to the outside world.

Historically, Chelyabinsk has been one of Russia's most agriculturally rich regions. The city was once among Russia's largest grain, tea and meat trading centres. However, today metals account for 40 per cent of the city's output. Chelyabinsk produces 35 per cent of Russia's ferrous alloys and a high percentage of large industrial steel pipes. The Chelyabinsk region abounds in diverse mineral resources. The city of Chelyabinsk possesses an almost inexhaustible reserve of facing and building stone such as limestone, marble and granite. It is also well known for its deposits of semi-precious stones such as jasper and malachite. During Soviet times, Chelyabinsk's huge iron ore deposits and coal resources made it one of the country's leading metallurgical centres. During World War II, it emerged as a key defence industry.

Unfortunately, Chelyabinsk's agriculture continues to decline and some parts of the region suffer from severe ecological degradation and radiation contamination as a result of industrial pollution and several nuclear accidents in the past.

On a more positive note, the Chelyabinsk region has attracted foreign investors, and a number of large joint ventures have taken place in the region. Foreign investment has been slow in making its way to the regions of Russia, and Chelyabinsk is no exception. The vast majority of foreign involvement in Chelyabinsk has been in the form of imported consumer goods and foodstuffs. In general, the first wave of foreign investment (1993) came in the form of joint ventures; now it is more common to see imported goods being distributed by local importers rather than joint projects.

More recently, relationships between large multi-nationals (German, British, Dutch and French) and local partners have been established. Leading the way is Pepsi International Bottlers. Pepsi has been producing in Chelyabinsk for almost eight years. Some other Western companies with significant investments in the region include Coca-Cola, Ford Motors, Caterpillar, Foster Wheeler and Kimberly Clark.

Foreign investments come from different sources. The biggest rouble investments in 2000 were made by: Great Britain (34.8 per cent), Gibraltar (34.1 per cent), and Ireland (26.4 per cent); and dollar investment by: Antilles islands (44.7 per cent) and Switzerland (46.8 per cent).

*Useful contacts in Chelyabinsk*

**Chelyabinsk Oblast Administration**
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**City Administration**
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**South-Urals Chamber of Commerce**
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Contact: Mr Fyodor Degtyaryov, President

**Hotel Victoria**
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Fax: +7 3512 989821
e-mail: vhotel@chel.surnet.ru
www.victoria.ru

## *Kurgan oblast*

- **Population** 1.1 million
- **Area** 71,500 square kilometres
- **Capital** Kurgan (population 400,000)

*Overview*

Kurgan was set up as an independent administrative unit in 1943. It is situated in the east of the Urals region and borders on Kazakhstan to the south. Sometimes it is called the gate to Siberia, as it is a significant transport junction with airport, railway and bus stations, linking Moscow to the Far East.

It is largely an agricultural area, the main treasure of the oblast being the rich arable lands that take up to 60 per cent of the whole territory (3.6 million hectares). This, and favourable climate conditions, account for the fact that Kurgan region is the largest agricultural producer of the Urals Federal District, supplying goods to the Urals industrial centres and federal food reserves. The proportion of agriculture in the regional gross product is 25 per cent. The region produces more than 1.6 million tonnes of grain, 420 thousand tonnes of potatoes, 129 thousand tonnes of vegetables, 100 thousand tonnes of meat, 500 thousand tonnes of milk, 100 million eggs, and 500 tonnes of wool. The amount of meat and milk produced places Kurgan in the five leading regions in the Russian Federation.

The region's economy depends mainly on machine building and metal processing, which account for up to 50 per cent in industrial volume production. Enterprises of this sector influence the regional economics greatly. Most of them were moved here during World War II; others were built after the war (for example the big Kurgan machine-building plant). As well as a range of light industry production, the enterprises of the region produce equipment for the oil and gas industries, chemical equipment, commodities for the motor industry, woodworking tools, buses, lorries, fire engines and fire-prevention equipment, bridges and bridge structures, and commodities for defence.

The region, however, lacks its own metallurgical base, natural resources, fuel and energy resources. But due to its convenient geographical situation, with the Trans-Siberian railway and major oil and gas pipelines, the region uses the resources of neighbouring regions: the Urals metals, Siberian oil and gas, Kazakh coal and other resources. Being largely an agricultural region, the Kurgan oblast does not have enough financial resources for development of social spheres: cultural, healthcare, educational, water supplies, transport and communication. Kurgan oblast is the only one in the Urals that depends heavily on outside donations.

Not unlike other regions in Russia the Kurgan oblast has problems in attracting foreign investment into the region. The situation became especially difficult after the crisis of 1998 when the amount of direct investments fell by more than 100 times (in 1998 foreign investments into the regional economy amounted to US$ 1 million, in 1999 it was less than US$ 10,000). But the economy is slowly recovering. The oblast actively cooperates with CIS countries and also with some European states.

*Useful contacts in Kurgan*

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Department of State Property and Industrial Policy
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## *Republic of Udmurtia*

- **Population** 1.6 million
- **Area** 42,000 square kilometres
- **Capital** Izhevsk (population 650,000)

*Overview*

The Udmurt Republic is a sovereign republic within the Russian Federation, established 1920. It is situated in the western part of the Middle Urals between the Kama and Vyatka rivers, which allows river shipment to the Volga River and to the sea. The distance between Izhevsk, the capital of the Udmurt Republic, and Moscow is 1,325 kilometres. Distances to other cities are St Petersburg – 1,904 kilometres and Ekaterinburg – 800 kilometres.

The main natural resources are timber and oil. As of 1 January 2000 98 oil fields have been discovered in the Republic. Forty-six per cent of the territory is covered with forests. There are reserves of peat, nitrogen and methane, and construction materials as well as mineral water and medical mud.

The economy of the Udmurt Republic is notable for the diversity of its industries. The oil extraction, machine building, metal-working and wood processing industries play the leading role. The republic also produces a wide range of weapons and special equipment.

Along with the military production, civilian products are manufactured, making Udmurtia one of the leading manufacturers in Russia for the following commodity goods: sporting and hunting guns (82 per cent of the Russian market), motorbikes (53 per cent), washing machines (5 per cent), medical equipment (8 per cent), and automobiles (3 per cent). The largest enterprises of the republic are concentrated in its capital, Izhevsk.

There are opportunities for trade and investment projects in the Republic of Udmurtia.

The main and traditional items exported from the Udmurt Republic are: oil (46 per cent of the export structure); timber; sporting and hunting guns; cars and motorbikes; rolled constructional, alloyed, stainless and other steels; microelectronics and communications equipment; different kinds of bearings; and casein. The main imports to the Republic are machines and equipment, medicines, medical equipment, consumer goods and food products.

In accordance with the programme of economic and social development of the Republic of Udmurtia priority directions were defined as food production, conversion from military to civilian production, usage of natural resources, fuel and power, housing, transport, communication and information. One of the priority goals is to increase oil production mainly by means of developing new oil fields and improving the operations of existing ones. To achieve this, the Republic of Udmurtia is counting on attracting foreign investors and partners for mutually beneficial cooperation. Within the period 1990–1999 the largest investors were Germany, the United States, the Czech Republic and Japan. Foreign companies invested mainly in machine building and metalworking, the foodstuffs industry and communications.

The largest companies with foreign investment are:

- Russian–German joint venture 'IZHTEL' (manufacturing and distribution of modern digital communication systems);
- Izhevsk Radio Plant (exporting products to Motorola);
- Russian–Czech Republic joint venture 'Ural Invest Oil Corporation' (UOIL) (workings of oilfields);
- Russian–Finnish joint venture 'Sarabella' (footwear manufacturing);
- British enterprise 'Furniture International' (furniture production);
- Russian–American joint venture 'IZHCOM' (developing of telecommunication systems);
- Russian–American joint venture 'UVIMEX' (jewellery production);
- Russian–American joint venture 'Sotovaya Svyaz Udmurtii' (providing cellular communication services);
- Russian–German joint venture 'Guentner Izh' (manufacturing heat-exchangers).

The government of the Udmurt Republic actively pursues the policy of stimulation of investments in the region and foreign economic cooperation of all types.

*Useful contacts in Udmurt Republic*

**City Administration of Izhevsk International Relations Department**
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Head: Mr Anatoliy Beltsev

**Government of the Udmurt Republic The Ministry of International Relations**
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Deputy Minister: Mr Ilfat R. Nurgaleyev
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**Republican Centre of Assistance for Foreign Economic Activity**
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**The Udmurt Republican Department of the State Registration Chamber at the Ministry of Economy of the Russian Federation**
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Contact: Mr Stanislav A Filimonov, Chief

**The Udmurt Customs**
24 Ukhtomskogo St
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Tel: +7 3412 367800 (reception)
Fax: +7 3412 367609
Deputy: Mr Aleksey R. Zhuikov
Tel: +7 3412 368118

**The Udmurt Chamber of Trade and Commerce**
251a Udmurtskaya St
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Contact: Mr Yevgeny Vylegzhanin, President
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Fax: +7 3412 431176

**Intour-prin** (transportation services, representative of Western transport firms)
Office 23
130 Krasnoarmeyskaya St
Izhevsk, Udmurt Republic
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### *Republic of Bashkortostan*

- **Population** 4 million
- **Area** 143,000 square kilometres
- **Capital** Ufa (population 1.1 million)

*Overview*

The Republic of Bashkortostan is a sovereign state under the jurisdiction of the Russian Federation. It is located in the Southern part of the Urals on the border of Europe and Asia. Its area is 143,600 square miles. Its capital is Ufa, 726 miles from Moscow.

The republic boasts over 70 kinds of mineral resources, including oil, gas, coal, copper, iron, and several precious metals. The main natural assets are oil and gas. Overall, approximately 250 oil and gas deposits have been explored in Bashkortostan.

Bashkortostan ranks sixth in Russia in terms of industrial output and second after Sverdlovsk oblast in the Urals economic area. It produces 2.6 per cent of Russian GDP. The major industry sectors are production and processing of oil and coal, the chemical/petrochemical sector, machine building/metalworking, and ferrous/non-ferrous metallurgy. Other industries encompass energy generation, the food sector, light industry, lumber/woodworking, the pharmaceutical sector, and building materials. The Republic's industry mainly specializes in the production of raw materials and semi-finished products for further processing in other Russian regions. Bashkortostan produces 100 per cent of the synthetic fat spirits produced in Russia, over 60 per cent of calcimined soda, 27 per cent of rubber, 24 per cent of caustic soda, 23 per cent of polyethylene, 24 per cent of light bulbs, 18 per cent of metal-cutting machine tools, and 20 per cent of automobile gasoline, diesel fuel, fuel oil, etc.

There are good opportunities for trade in Bashkortostan. The key exportable products are oil and oil products, petrochemicals, machine building products and non-ferrous metal products. Goods with the highest percentage of imports are machines/equipment/vehicles (45 per cent), chemicals, foods, and metals.

Bashkortostan was declared a sovereign republic in October 1990, and since then its government has been actively seeking foreign investment. The government has adopted a law on foreign investment activities and a series of investment regulations, and has established a guarantee fund. Many foreign companies have already begun operations in the republic, including the French firm 'Technip', the Italian firm 'Technimont' and the German firms 'Bosch' and 'Siemens'. Several German banks are assisting investment projects in the region as well. Several US firms have established operations here, including IBM, which is supplying medical equipment to Bashkir hospitals and clinics. Now joint venture partners represent 54 countries, including Germany, Turkey, Canada, Poland, and the United States. Joint ventures produce goods such as petrochemicals, construction materials, home appliances, floor coverings, fur clothing, knitwear, food, sport shoes and some others.

The Government actively seeks foreign investment and the Republic has received a credit rating (B-) from Standard & Poor's. Bashkreditbank has negotiated credit lines with a number of German banks. They are interested in discussing cover with ECGD. This has led to a higher level of foreign investment in Bashkortostan than in other regions of the Urals. EBRD has also invested in a number of local companies. The capital, Ufa, is a bustling city with signs of rapid economic development. There is more construction going on than in other regions of the Urals.

*Useful contacts in Bashkortostan*

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Deputy Prime Minister of Bashkortostan Republic: Mr Rafil Garifullin

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**Chamber of Trade and Industry**
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**Representation of the Ministry for Foreign Affairs of RF**
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Head of the representation: Mr Zinnur Shaikhullinovich Mardanov

**State Property Committee**
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Fax: +7 3472 526736
Chairman: Mr Zufar Nigamatovich Abdrakhimov

**Department of Ministry of Taxes and Collections of RF in Bashkortostan**
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Fax: +7 3472 283855
Head of the department: Mr Rashit Fanisovich Sattarov

EXHIBITION CENTRES

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**'Bashexpo' Centre**
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Tel: +7 3472 525385
Fax: +7 3472 525641
e-mail: bashexpo@ufanet.ru

### *Tyumen oblast*

- **Population** 3.2 million
- **Area** 1,435,200 square kilometres
- **Capital** Tyumen

*Overview*

Life in Tyumen is driven by its oil and gas, which are largely situated in the two northern autonomous okrugs of Yamal-Nenets and Khanty-Mansiisk. The okrugs were administratively subordinate to Tyumen in Soviet times, but with the adoption of the December 1993 Russian Constitution, were given nominally equal status as federal 'subjects' to the oblast itself. This has resulted in a protracted constitutional struggle between the oblast and the okrugs, the underlying issue of which is control of the region's raw materials and financial resources. The problem is not yet resolved.

Tyumen is situated in Western Siberia rather than the Urals region. It is Russia's third largest region (if you include the okrugs), reaching from Kazakhstan in the south to the Arctic in the north. The climate is continental, with long harsh winters (average January temperatures of –28°C) and short summers.

Tyumen's economy is based on huge oil and gas reserves. As a result, the managers of local oil companies and the gas giant Gazprom wield considerable economic and political power in the oblast. They have traditionally been far and away the largest contributors to the local budget, and have also run much of the social and transport infrastructure. However, as these now largely private companies are increasingly subject to tighter commercial pressures, they will become ever keener to shed non-essential activities, in particular looking to hive off welfare provision to the local and regional administrations.

In the period since the break up of the USSR, Tyumen has been cushioned by the wealth from its natural resources. However, the use of export earnings from oil and gas to subsidize inefficient parts of the local economy has been a mixed blessing: it has meant that these sectors remain under-developed. Apart from oil and gas, the region has machine building, metalworking, chemical industries and wood processing. Food processing and the fish industry are also being developed. The main industrial centres are Tyumen, Surgut, Nizhnevartovsk and Nadim. The Tyumen oblast is twinned with the Grampian region of Scotland.

KHANTY-MANSIISK AUTONOMOUS OKRUG

Khanty-Mansiisk contains over two-thirds of Russia's oilfields and has an important strategic role in the transportation of gas from the neighbouring Yamal-Nenets AO (see below). Oil reserves are estimated at 35 billion tonnes. It is the largest regional contributor to the federal budget revenue other than Moscow city (Moscow 27 per cent – Khanty Mansiisk 9 per cent). Nizhnevartovsk (population around 175,000) exists largely to support the immense Samotlor oilfield and the other small oilfields in the area. It has extensive port facilities on the Ob river, a rail link with Surgut and an airport (there are direct flights from Yekaterinburg to the capital town, Khanty Mansiisk, Surgut and Nizhnevartovsk).

**Regional Administration of Khanty Mansiisk**
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Nizhnevartovsk and Surgut are major focal points of the okrug's pipeline and primary oil processing facilities. The volume of oil extracted in the okrug is around 170 million tonnes a year, or 60 per cent of Russia's total volume of extracted oil. Oil and gas are being extracted by 23 joint stock companies and 8 joint ventures. The major operators are Russian oil companies but Western oil companies such as Shell and BP are interested in investing in the area. The total length of pipelines passing through Khanty-Mansiisk is over 9,000 km. Oil and gas pipelines run to east and west, carrying oil for example to the Republic of Bashkortostan and Perm for refining. Much of the gas is refined in Khanty-Mansiisk, which has eight refineries with a total capacity for processing of 16 billion cubic metres per annum.

YAMAL-NENETS AUTONOMOUS OKRUG

What Khanty-Mansiisk is to oil, Yamal-Nenets is to gas. It is a harsh environment in which to operate, with temperatures in the north (on the Arctic) rising to just 4°C in summer. Average winter temperatures between –22°C and –26°C. Yamal-Nenets produces over 90 per cent of Russia's gas and 12 per cent of its oil. As with other oil and gas areas, the large operating companies exercise considerable influence and power in the okrug. They not only provide most of the local budget revenue, but also control much of the social and transport infrastructure.

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Contact: Mr Vladimir Mikhailovich Kolunin (Head of Department)

## *Orenburg oblast*

- **Population** 2.2 million
- **Area** 125,000 square kilometres
- **Capital** Orenburg

*Overview*
Orenburg is a large region though sparsely populated compared with the likes of Sverdlovsk or Perm. It is the most remote area from the centre of the Urals and has a large defence industry. It was founded in 1735 and, according to press reports at the end of the 1990s, was the site of one of the strangest experiments of the Cold War. In 1954 the Red Army apparently exploded an atomic bomb near the city during military exercises. Subsequently local villagers suffered a 50 per cent increase in cancer and of the 44,000 soldiers who participated, only 1,000 still survive. Orenburg is home to the military aviation academy where Yury Gagarin studied. A jet that he used is located at the entrance to the academy.

The gas giant Gazprom wields considerable economic and political power in the region. Besides being the largest contributor to the local budget, the company also owns much of Orenburg's social and transport infrastructure.

## 6.1.2

# Regional Overview for the Novosibirsk Region, Western Siberia

*Azim Mamanov, BISNIS representative in Novosibirsk*

### *Overview*

Novosibirsk is Russia's fourth-largest city and represents one of the most important commercial centres outside of European Russia. It has one of the highest levels of agricultural production in Russia, and has a highly specialized machine building sector. Novosibirsk's Akademgorodok (academic city) is home to one of the world's highest concentrations of scientific institutes and scientists. Much of Novosibirsk's importance is due to the fact that it serves as the processing and handling centre for much of the resources from the surrounding regions. While Novosibirsk does not contain the vast natural resources of its neighbours, it serves as the processing and distribution centre for those goods. Novosibirsk region is known for its manufacturing, transport, and research and development capabilities.

Novosibirsk is home to the Siberian Branch of the Russian Academy of Sciences (SB RAS). Novosibirsk Science Centre, the largest in SB RAS, includes approximately half of the resources of the Siberian Branch. Novosibirsk Akademgorodok, situated 30 kilometres to the south of the city centre, was intended as the world's first comprehensive science centre. The scientific and technological achievements of the local research institutes are recognized worldwide. There are a number of inventions developed by the research institutes that were successfully implemented by well-known international companies such as Hewlett Packard, Dupont and Motorola. However, turning the developed inventions and technologies into commercial value, and adjusting to a market economy, remains a serious problem for the institute.

Regional statistics show that the local economy has been growing, mostly owing to the rouble devaluation during the financial crisis in 1998. Locally produced products became more competitive in the Russian market than imported goods, despite the traditionally poorer quality of Russian goods. In addition, tariffs for electricity remained at pre-crisis levels, ie lower than in the world market. This allowed the Russian producers to keep production costs to a minimum. However, as Russia has almost recovered from the crisis, and prices for locally made goods have been gradually going up, imported products gained market share in Russia, and in the Novosibirsk region particularly, almost to pre-crises levels.

Of particular interest to foreign companies are the food processing, mechanical engineering, software development and construction materials industries. Other industries, such as heavy machinery, ferrous and non-ferrous and tin production, can also be beneficial for foreign investors.

## *Geography and population*

The Novosibirsk region is located in Western Siberia, right in the middle between the Ob and Irtysh rivers, and occupies an area of 178,200 square kilometres. In the south, the Novosibirsk borders with the Altai region and Kazakhstan, in the west it borders with the Omsk region, in the north, with the Tomsk region, and in the east, with the Kemerovo region. The Novosibirsk region is situated in plain land; in the south the steppes prevail, whereas the north features enormous tracks of woodland with a great number of marshes. The climate is continental. Winter is long and cold (up to –50°C), and summer is short and hot (up to 40°C).

Economically and geographically, the Novosibirsk region is traditionally divided into four zones. The Suburban Zone consists of the Novosibirsk, Iskitim, Kochenyovo and Moshkovo districts, and has well-developed industry and agriculture. The Eastern Zone includes six districts with sufficiently developed industry and diversified agriculture: Bolotnoye, Maslyanino, Ordynskoye, Suzun, Toguchin and Cherepanovo. The Baraba Zone consists of 14 northern and north-west districts mostly covered with taiga and forest-steppe land: Barabinsk, Vengerovo, Dovolnoe, Zdvinsk, Kargat, Kolyvan, Kyshtovka, Kuibyshev, Severnoye, Tatarsk, Ubinsk, Ust-Tarka, Chany, and Chulym. Beef and dairy animal husbandry are primarily developed in this zone. The Kulunda Zone includes six steppe districts where grain production and sheep husbandry are mainly developed: Bagan, Karasuk, Kochki, Krasnozerskoye, Kupino, and Chistoozernoye.

Over 2.7 million people inhabit the region. The unemployment rate is estimated to be 15.6 per cent. Nominal per capita income has been rising from its late-1990s levels of around 1,280 roubles, although it is still lower than the national average. Over 1.5 million people live in the city of Novosibirsk. It is the largest city in Siberia, and has traditionally been considered as the 'capital' city of Western Siberia, encompassing the Tomsk, Kemerovo, and Altai regions, and the Altai Republic. Novosibirsk serves as a distribution hub for these regions. The other largest cities in the region are Berdsk, with a population of 79,000 people, Iskitim, with a population of 67,800 people, and Kuibyshev, with a population of 51,900 people.

## Natural resources

Unlike many other Siberian regions, Novosibirsk does not have significant mineral resources. However, deposits of oil and gas, coal and anthracite, gold and copper-nickel, peat and plant fertilizer, building materials (including marble) and mineral waters found in the region are, or potentially may become, of interest for both local and foreign companies.

*Oil and gas*

Six oilfields with extractable reserves of 31.7 million tonnes, and inferred reserves of 11.4 million tonnes are found in the region. Only two of them have been exploited at present: the Little Icha and East Tara fields. The most promising is the Upper Tara oilfield, located 340 kilometres from the city of Novosibirsk and 160 kilometres from a railway. Extractable reserves of the field are estimated at 24.5 million tonnes. Its proximity to the Trans-Siberian railway and an oil pipeline make the deposit even more attractive for potential investors. Considerable deposits of gas are explored in the Veselovskoye gas field, with reserves of 0.5 billion cubic metres of free gas, and 0.1 million tonnes of condensed gas.

*Gold and coal*

The largest deposits of gold in the region were explored in the Yegorievskoye field, and were estimated to be up to 17 tonnes. There are six other locations with a total amount of 3,045 kilograms of gold. Russia's only field of high-quality anthracite that can be used for industrial electrode production is located in the Novosibirsk Region. Presently, two of four coalfields, Gorlovka and Listvyansky, have been exploited. Coal is mined opencast. Prospected reserves of coal are 550 million tonnes, and forecasted to be 5.7 billion tonnes. The Novosibirsk Electrode Plant, the largest producer of industrial electrodes in Russia and the NIS countries, has been using the resources of the Listvyanski coalfield.

## *Transportation*

Lying on the banks of the Ob River and along the Trans-Siberian Railway, Novosibirsk acts as a transportation centre and distribution hub for the surrounding regions of Kemerovo, Altai, and Tomsk. Thus, the main railways from Kuzbass (one of the major coal mining locations in Russia), Central Asia, and the Trans-Siberian Railway meet in Novosibirsk. Airlines connecting the Russian Far East and Europe land in Novosibirsk. Highways from Omsk, Tomsk, Barnaul, Kemerovo and Novokuznetsk go through Novosibirsk, which is located on the ancient Moscow Highway. Finally, ships carrying cargo to the north by the Ob River go through Novosibirsk as well. The railway dominates the other means of transportation. Its operating length is 4,180.7 kilometres and it remains one of the important means of passenger transportation

The major local air carrier is the Sibir Airline Company, ranked in the top five largest airline companies in Russia. The company established air routes to almost all the major Russian cities, such as Moscow, St Petersburg, Vladivostok, Irkutsk, Samara, Nizhny Novgorod, etc. From the Tolmachevo International airport, flights to the NIS and other foreign countries, such as China, Germany, Thailand and Turkey, have been established. Foreigners coming to Novosibirsk usually take a direct four-hour flight from Moscow.

*Banking*

Unlike other regions in Siberia, the Novosibirsk region came out of the August 1998 financial crisis with minimal losses. Over 20 banks are currently operating in the region, half of which are local banks, and another half are affiliates of banks from Moscow and other Russian cities. In the pre-crisis period non-local banks were dominating, and the ratio was 40 per cent to 60 per cent, whereas the post-crisis ratio became 65 per cent to 35 per cent. Today, as Russia has recovered from the crisis, non-local banks dominate once again. The key role of Sberbank (the Saving Bank) in the banking system of Russia was revealed during the crisis. A large number of corporate clients and individuals with their savings in bankrupt banks switched to the Novosibirsk affiliate of Sberbank.

Many local banks specialize in different sectors of the local banking market. Bank Alemar provides services in the promissory notes market, NovosibirskVneshTorgBank and SibEcoBank deals in the hard currency market, and SibAcademBank provides services mainly to the West-Siberian Railway Company and the Siberian Branch of the Russian Academy of Science. Banks compete for large corporate clients engaged in trade, transportation, mining and other industries. A substantial capital turnover and demand for a wide range of banking services characterize that category of clients. Only large banks having sufficient financial resources and a wide range of high-quality services can satisfy this demand. Traditionally, Moscow banks occupied this niche. Local banks can compete with Moscow banks in a number of other segments of the market. For instance, NovosibirskVneshTorgBank is successful in the segment of trade finances and hard currency operations, SibEcoBank is successful in the sphere of information technologies, and Levoberezhny and Municipalny Banks in the segment of the government budget funds.

The other major category of clients is small and medium-sized companies. Before the crisis, all the banks would provide services in that category. Presently, small banks providing services at lower fees, such as Municipalny, Belon, Levoberezny and Accept, work with these types of companies. Non-local and larger stable local banks, such as NovosibirskVneshTorgBank, SibEcoBank and SibAcademBank, provide services at the highest fees, and thus are more focused on attracting large corporate clients. Among local banks, the most stable and reliable ones are SibAcademBank, NovosibirskVneshTorgBank, SibEcoBank and Accept Bank.

*Telecommunications*

The major provider of phone lines is the Novosibirsk State Telephone Station (NSTS) Company. The Novosibirsk Inter-city Telephone Station (NITS) Company is the main provider of inter-city and international phone lines. A number of local companies, such as Novocom and Global-One, provide high quality telecommunications services. Novocom is a Russian–US joint venture. Its founders are NSTS, Belcom (US), and the International Telecommunication Company. The companies have been able to do well in price competition in the long distance and international tariffs sector, generally under-pricing NITS in per-minute calls to Europe and North

America. In addition, the companies install Moscow phone numbers. Both local and foreign firms that have extensive business ties with Moscow companies find this extremely useful. In addition, Global One Company began to actively market its relatively new product in Russia: CONTACT-cards. Using the CONTACT-card, one can make inter-city or international phone calls at much cheaper rates. The cards can be used in all of the major cities of Russia, and are very helpful for those who need to make long-distance phone calls while traveling throughout Russia.

There are three major cellular phone providers in Novosibirsk: Sotovaya Kompania JSC, regional operator of BeeLine company, which operates in D-AMPS (800) standard; the Sibirskie Sotovye Sistemy company – GSM-900 standard; and the Novosibirskaya Sotovaya Svyaz company which works with SOTEL Federal network in NMT-450 standard. As a result of ongoing competition among these companies, prices for their services are constantly decreasing, whilst the quality is getting better.

Major Internet service providers in Novosibirsk are Rinet, NITS, Global-One and Cardinal. Another provider, Magistral Telecom JSC, owns fibre-optic and wireless networks and equipment. The company was founded by Andrew Corporation (US), Regional Association 'Siberian Accord', and a number of local companies. Clients of the Magistral Telecom are banks and large corporate clients, which appreciate high-speed Internet connection, reliability and high quality, despite the fact that the services provided by the company are much more expensive than those of regular providers.

## *Non-traditional sectors to watch*

### *Apparel and footwear market*

#### Market profile

The city of Novosibirsk, the largest commercial centre outside of European Russia, is an attractive market for foreign-made apparel, footwear and accessories, as well as for modern manufacturing equipment and technology. During 2000 and 2001, market turnover grew 10 per cent annually. Annual turnover in the apparel and footwear retail market in Novosibirsk is presently estimated to be up to US$ 300 million, which is 20 per cent of the city's overall retail market. Retail sales of ready-made garments make up 40 per cent of the market, sales of knitted garments up to 20 per cent, footwear up to 25 per cent, and fur coats up to 5 per cent.

Since August 1998, there has been a tremendous change in the purchasing power of the local population, and a significant decline in the market share of imports. However, for the past few years the share of imported products has increased. Another tendency noticed is that local stores are specializing in certain products, such as footwear, expensive branded clothing, fur coats, sportswear, jeans wear, etc.

Apparel and footwear sold in Novosibirsk can be placed in three categories: Western produced, locally produced, and third world produced goods. Each of these categories represents a different market segment for footwear and clothing in Novosibirsk. The share of locally made products (except for footwear) in the sales structure is up to 10 per cent, the share of those products made in Russia outside of the region, and NIS countries is up to 35 per cent, and the share of foreign-made products is up to 60 per cent. The sales structure for footwear is different: the share of locally made footwear (mostly manufactured by KORS, and the Westfalika factories) is 40 per cent, the share of footwear made in Russia outside of the region, and NIS countries is up to 35 per cent, and the share of foreign-made products is up to 35 per cent.

The share of contraband goods (mostly made in China, Turkey and South Korea) in the sales structure is significant, and estimated to be no less than 30 per cent. These products are usually imported by individuals directly from abroad, and sold at open-air markets. High-quality Western apparel and footwear is mostly brought from Moscow. Some of the elite and very expensive products are imported directly from European and other countries.

Most of the clothing and footwear (up to 60 per cent) is sold at markets, where the prices are usually lower. Sales at retail stores constitute about 40 per cent. However, this tendency is changing slightly, and the share of sales in retail stores has been increasing. In particular, more and more people prefer to purchase footwear in recently developed chains of retail footwear stores.

The leading retail outlets in the local market are CUS (Central Universal Store), and SUS (State Universal Store). According to the National Trade Association of Russia, the stores are ranked in the top 200 retail outlets of Russia. The CUS has 11,000 square metres of space for retail sales, and the SUS has 17,000 square metres of space. The annual trade turnover of each of these stores is estimated to be US$ 3–5 million, or 1.5 per cent of the market. The overall share of these two stores, including sales of other retailers renting spaces in these stores, is estimated to be up to 10 per cent.

The leading retailers of footwear are the retail store chains of the KORS (six stores), Rossita (two stores), and Westfalika (six stores) companies. The share of each of these companies in the footwear market is up to 5 per cent. One of the most popular brands among the higher income population is Ecco (Denmark). There are several stores specializing in Ecco products.

There are various ways to distribute clothing and footwear. Most of the branded products available in Novosibirsk come from the Moscow partners of a foreign producer, such as the MEXX company in the Netherlands. Elite and very expensive clothing is brought directly from abroad. Some companies, such as Milavitsa in Belorussia, bring products to Novosibirsk, and work with retail stores directly.

High-end products available in Novosibirsk are mostly made in Europe (Italy, Germany, Denmark, etc). A number of multi-brand (Maxima, Shi & He, etc), as well one-brand boutiques (Hugo Boss, MaxMara, Marina Rinaldi, Gerry Weber, Escada, Steilmann) are operating in Novosibirsk. The boutiques are mostly located downtown, on Vokzalnaya Magistral, Krasny Prospect, Lenin Street and Sovetskaya Street. The products available in the boutiques are mostly brought from the Moscow partners of the producers. A recently opened Timberland boutique is among just a few US brands found in Novosibirsk.

Western brands of sportswear (Nike, Reebok, Adidas, etc) are widely found in Novosibirsk. The annual turnover in the market segment is estimated to be no less than US$ 2 million. The products are manufactured in and/or imported from third world countries such as China, United Arab Emirates, South Korea and Indonesia.

#### Regional production

Over 10 enterprises specializing in clothing, fabrics, and footwear production operate in the region. Within the first four months of 2002, these enterprises produced products worth US$ 10 million. The largest enterprises are Sinar, KORS, Severyanka, and Westfalika. The share of Sinar in coat and suit production in Russia is up to 3.5 per cent. The production volume of footwear by the KORS company is estimated to be 37,600 pairs, and by Westfalika up to 15,000 pairs per month.

#### Advertising and marketing

Local companies use various forms of advertising and marketing, aimed to increase their market share, and promote products in surrounding regions. A number of local producers (Westfalika, KORS and Sinar) are actively developing their own chains of stores. Companies selling expensive products mostly use outdoor and TV and radio advertising. There are a number of locally produced TV shows devoted to fashion. Wholesalers usually advertise in weekly business magazines, such as 'Kommercheskie Predlozhenia' (Commercial Offers), 'Reklama', etc. A number of companies and stores (mostly footwear stores and stores specializing in branded clothing, such as Westfalika, Ecco, Sinar, and stores selling high-end products) actively use discount cards. Some producers, such as the Westfalika Company, provide franchising to local entrepreneurs opening retail footwear stores.

#### Business opportunities

Even though prices for foreign products are not very competitive in the regional market, there still are good opportunities for international companies selling high quality clothing and footwear. An excellent example is the Diva lingerie shop, which sells goods from the US chain Victoria's Secret. The shop was established by Eric Shogren, an American entrepreneur, who 'has built up a multimillion-dollar empire in Novosibirsk that includes a chain of pizza restaurants, a bakery, a furniture workshop and the only Russian outlet of top US lingerie chain Victoria's Secret' according to the Moscow Times (themoscowtimes.com/stories/2002/07/26/002.html). US companies have more chances to succeed in selling sports footwear and clothing of well-known brands that are not well represented in Novosibirsk, such as New Balance, Converse, No Fear, Esprit and Arrow. US firms can explore various ways to enter the market, such as finding an exclusive distributor in Moscow to be responsible for expanding in other regions, working directly with a local partner, and establishing a branded chain of stores.

#### Industry contacts

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**KORS JSC (footwear producer)**
35 Sukharnaya St
Novosibirsk
Tel: +7 3832 285 091
Fax: +7 3832 253 861
www.nsk.su/kors

**Severyanka JSC (clothing producer)**
113 Kirov St
Novosibirsk
Tel: +7 3832 667 198
Fax: +7 3832 662 882
e-mail:
severyanka@online.nsk.su

**Westfalika JSC (footwear producer)**
87 Dzerzhinsky Prospect
Novosibirsk
Tel/fax: +7 3832 119 441
www.westfalika.ru/english/eng_main.php

**CUS (Central Universal Store) JSC**
5 Dimitrov St
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Tel: +7 3832 221 083
Fax: +7 3832 222 088

**SUS (State Universal Store) JSC**
1 Marx Prospect
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*The advertising market*

MARKET PROFILE

The advertising market is rapidly developing in Novosibirsk. Although the advertising market in Novosibirsk was severely hit by the financial crisis in 1998, for the past two years, the market has been growing by 40–50 per cent annually, and has almost reached its 1997 level. Currently, the overall monthly turnover of the market is up to US$ 2 million. Over 300 advertising agencies are operating in Novosibirsk. The advertising industry in Novosibirsk currently consists of the following specific industry subsectors: print media/advertising, outdoor advertising, and radio and television. In 1996–1997, local agencies founded a union of advertising agencies for Novosibirsk, known as GORN (Gorodskoe Ob'edinenie Reklamistov Novosibirska), aimed at facilitating the further development of the market in an organized way. The union combines a number of leading agencies, including AtrBusinessLine, ImageMedia, Melekhov & Filyurin, Petra, RIM and Europa Plus.

PRINT MEDIA

The overall turnover in print media in Novosibirsk is estimated to be up to US$ 600,000 per month. The main tendencies in the market are: an ongoing increase in the annual turnover (by 40 per cent); a development of magazines specializing in specific industries (for instance, the 'Stroika' newspaper is devoted to construction materials) and newspapers/periodicals distributed solely in specific districts of the city; enlargement of major 'players' of the market; and printing of a number of colour magazines and further development of this segment (there were no colour magazines issued regularly in the 1990s in Novosibirsk).

The major types of periodicals printed in Novosibirsk are weekly newspapers distributed free of charge ('Va-Bank' and 'Megapolis'), commercial weekly periodicals ('Kommerchaskie Predlozhenia' and 'Reklamny Most'), specific industry/sector-oriented newspapers and magazines, and non-commercial newspapers.

Producers of local periodicals, newspapers and magazines include: Afina Pallada (produces 'Va-Bank' periodical and 'Telesem' TV-guide); Russky Kharakter ('Metro' periodical and 'Kontinent-Sibir' newspaper); Sibirskaya Pressa ('Vse Dlya Ofisa', 'Vse Dlya Doma', 'Torgovaya Gazeta' and 'Snabzhenie I Sbyt'); Doska Ob'yavleny ('Novosibirskie Novosti', 'Doska Ob'yavleny' and 'Ot & Do'); and AlfaMedia ('Epigraph', 'Megapolis' and 'Computerra-Novosibirsk').

Over 100 advertising agencies are involved in print advertising. The share of advertising agencies in the total turnover of print advertising is 40–50 per cent, or up to US$ 300,000 per month. The leading agency is Afina Pallada (it's an exclusive agency for the Afina Pallada trust), and its share is approximately US$ 100,000 per month. Other well-known agencies are Melekhov & Filyurin (www.m-f.ru), and Petra (www.petra.siberia.net). The shares of each of these two agencies is estimated to be 2–3 per cent of the market segment.

**Table 6.1.2.1** Monthly circulation and average prices for advertising services of the leading local periodicals

| *Periodical* | *Circulation* | *Price, US$ per sq.cm.* |
|---|---|---|
| Ot & Do | 230,000 | 1.23 |
| TeleSem | over 200,000 | 2.24 |
| Va-Bank | 222,000 | 1.76 |
| MegaPolis | 210,000 | 1.15 |
| TV-week | over 130,000 | 1.92 |
| Kommercheskie Predlozhenia | 40,000 | 1.05 |
| Sibirsky Ezhened. Reklama | 40,000 | 0.90 |

Foreign companies distributing their products in Russia may consider putting advertisements in wholesaler-oriented magazines, such as 'Kommercheskie Predlozhenia', 'Sibirsky Ezhenedelnik Reklama', 'Reklamnye Predlozhenia' and 'Reklamny Most'. One of the best newspapers to put in advertisements on job opportunities is 'Continent-Sibir' (http://com.sibpress.ru). Many readers of the newspaper are business-oriented people (top-managers, entrepreneurs, etc).

### Television

Television commercial/advertisement turnover in Novosibirsk is estimated to be approximately US$ 600,000 per month. This segment of the advertisement market has continued to increase by 50 per cent annually since 2000. There are over 12 TV channels in Novosibirsk, including ORT, RTR, TSM (retranslating NTV), NTN-4 (retranslating REN-TV), NTN-12, GTRK-Novosibirsk, and NTSC (retranslating NTSC). Moscow broadcasters provide the local TV companies with airtime to insert advertising clips and programmes produced locally. The local TV advertising agencies offer the following services: commercial billboards, ad lines, advertising clips and commercial TV programmes.

Leading local TV channels in terms of revenues from commercials are TSM (30 per cent of the market), NTN-4 (up to 20 per cent), and GTRK-Novosibirsk (up to 20 per cent). Video International's (VI'S, www.vis.siberia.net), founded by the Trend advertising agency (included in Moscow-based Video International group of companies), runs advertising clips on a number of TV channels, including ORT, TSM, NTSC, and Region TV. The share of the company in this segment is estimated to be over 75 per cent. TV advertising is priced at US$ 8–22 per second, depending on channel, day and time. Foreign companies are advertised on the national TV channels, rather than on local channels in each region, thus covering all of Russia.

### Radio

The monthly turnover on radio broadcasting channels in Novosibirsk is estimated to be up to US$ 200,000. Over a dozen local radio stations are operating in Novosibirsk. The majority of them are in the FM band. The leading radio stations in Novosibirsk are Yuniton (with up to 40 per cent of the market), and Europa Plus (up to 30 per cent). Other popular stations are Russian Radio, Melody, Shanson, Avtoradio, and Radio-7. The leading advertising agency in radio broadcasting is Aliance Media, holding 50–60 per cent of the market. The agency runs advertising clips on Europa Plus and Melody channels. One second of broadcasting of an advertisement varies from US$ 0.25 at night to US$ 1.3 at prime time.

### Outdoor advertising

Outdoor advertising in Novosibirsk is one of the most developed in Russia, after Moscow and St Petersburg. The total area of outdoor advertising shields is estimated to be 30,000 square metres. Over 10 agencies are operating in this segment of the market. The monthly turnover in outdoor advertising is estimated to be US$ 400,000. Leading advertising agencies are Design-Master, RIM and ArtBusinessLine. The first two companies are ranked in the top 20 Russian agencies. Design-Master holds up to 50 per cent of the market, RIM holds up to 30 per cent, and ArtBusinessLine holds up to 10 per cent. The average price for outdoor advertising on a 3 x 6 metre billboard is US$ 200–400 per month depending on the location of the billboard.

### Other forms of advertising

Other forms of advertising are printed advertisements and souvenirs, direct mail and advertising on the Internet. The monthly turnover of all these forms of advertising is approximately US$ 200,000. The leading producer of print advertising is the Harmens printing house, with up to 40 per cent in the market segment. The leading direct mail service agency is Marathon, and the leading company in advertising on the Internet is the Novosibirsky Gorodskoy Sait (www.ngs.ru). The Sparks agency provides advertising services in the Novosibirsk Subway, consisting of 11 stations. Monthly turnover in this type of advertising is up to US$ 100,000.

### Trade shows and exhibitions

The Siberian Fair company (www.sibfair.ru) conducts 'SibPrint.– The Books of Siberia – SibAdvertising' trade show in Novosibirsk in April annually. This trade show is a great opportunity for international companies, specialzing in advertising technologies, printing equipment and materials, to learn more about the market, and promote their services and products in the region.

### Commercial opportunities

Foreign made products, including film and paper masking, application tapes, and banners by American Biltrite Inc. and 3M films are highly praised by advertising agencies. The following materials and equipment have good potential for the local advertising market:

- film, paper, adhesives, plastics, banners, etc;
- full colour prints;

- digital printing equipment;
- silk-screen decoration print, etc.

INDUSTRY CONTACTS

**MediaSOFT (market research company)**
5 Frunze St, Office 530
Novosibirsk 630099
Tel: +7 3832 210 265
Fax: +7 3832 216 558
www.mediasoft.ruў

**DirectMEDIA (marketing company)**
59 Krasny Prospect, Office 118
Novosibirsk
Tel/fax: +7 3832 216 990

**Afina Pallada (advertising agency specializing in print media)**
49a Sovetskaya St
Novosibirsk
Tel: +7 3832 223 674
Fax: +7 3832 221 364

**Kommercheskie Predlozhenia (commercial magazine designed for wholesalers)**
137/1 Nemirovicha-Danchenko St, Office 511
Novosibirsk
Tel/fax: +7 3832 541 728
http://satren.nsk.su

**Sibirsky Ezhenedelnik Reklama (commercial magazine designed for wholesalers)**
104 Nemirovicha-Danchenko St, Office 104
Novosibirsk
Tel/fax: +7 3832 543 823
www.reklama.pressa.biz

**Siberian Press ('Sibirskaya Pressa' – publishing house)**
15 Vokzalnaya Magistral, Office 710
Novosibirsk 630099
Tel: +7 3832 224 002
Fax: +7 3832 295 879
http://sibpressa.ru

**TCM (TV station)**
16 Gorskaya St
Novosibirsk 630032
Tel/fax: +7 3832 462 510
www.tcm10.ru

**Video International's (advertising agency)**
48 Kommunisticheskaya St
Novosibirsk 630007
Tel: +7 3832 182 535
Fax: +7 3832 183018
http://www.vis.siberia.net

**ArtBusinessLine (outdoor advertising agency)**
1 Krasny Prospect, Office 314
Novosibirsk 630007
Tel/fax: +7 3832 235 808
www.abl.sib.ru

**Petra (advertising agency)**
99 Krasny Prospect
Novosibirsk 630099
Tel: +7 3832 494 188
Fax: +7 3832 119 348
www.petra.siberia.net

*Other industries*

MECHANICAL ENGINEERING

Mechanical engineering and metal processing remains a leading industry in the region. The most significant subsectors in that particular industry are railway machinery, agricultural machinery and instrument making. Major local enterprises involved in the industry are Elsib (one of the leading producers of various types of generators in Russia and NIS); the Novosibirsk Tool-Making Plant, StonkoSib (producers of various type of instruments, tools and machinery); SibSelMash and SibTextilMash (producers of agricultural and light industry machinery). The main products of the machine building industry are mobile electric power stations, generators for turbines, heavy electric machines, looms, sewing machines, chemical equipment and equipment for light industry.

METALLURGICAL INDUSTRY

Major enterprises involved in the industry are the Novosibirsk Tin Works, a major Russian supplier of superior quality tin in the world market; the Novosibirsk Electrode Plant, one of the largest Russian exporters of high quality graphitized and carbon electrodes; and the Novosibirsk Metallurgical Plant producing steel, rolled stock and pipes. The main products of the non-ferrous sector are electrodes, tin, steel and gold.

FOOD INDUSTRY

The largest enterprises are the Meat Processing Plant, VINAP (alcohol and soft drinks producer), the Novosibirsk ZhirKombinat (producer of margarine, mayonnaise and related products), and the Siberian Milk Plant.

CHEMICAL INDUSTRIES AND BUILDING MATERIALS

The main products produced in the chemical industry are: plastic materials and moulded items, produced by KhimPlast and Plastic Making Plant; paints and varnish, produced by KhimProduct; and household chemicals, produced by the Household Chemicals Plant. In the forestry and woodworking industry the largest companies are the Bolshevik Factory and the Sibir Wood-Working Company.

AGRICULTURE

The agricultural land in the Novosibirsk region covers 7.15 million hectares. Nearly 580 companies have been operating in the agricultural sphere of the region's economy. Plant cultivation dominates agricultural production. Producers of agricultural products in the region can be divided into three categories: agricultural enterprises, farmers and local population. The local population dominates agricultural production. The population produces over 65 per cent of agricultural products, while the share of farms is insignificant, and amounts to 1.7 per cent. Agricultural enterprises are the main producers of grain (93 per cent), sunflower (98 per cent), and flax (99 per cent). The main producer of potatoes (98 per cent) and vegetables (92 per cent) is the local population.

Local farms and agricultural enterprises are still experiencing serious problems, such as lack of financing and support of the local government, and lack of modern equipment and agricultural machinery. These problems hinder further development of agriculture in the region, and lead to bankruptcy of farms. The main agricultural products produced in the region are grain, potatoes, vegetables, meat, milk and eggs. In a survey conducted by the regional Statistics Committee among agricultural enterprises, locally produced products are getting more competitive compared to imported products. Consumers believe that locally produced food and agricultural products are fresher, contain less preservatives, and are cheaper.

*Foreign companies in Novosibirsk*

Compared to other Siberian regions, Novosibirsk dominates in terms of the presence of Western firms, such as Arthur Andersen, Coca-Cola, Pepsi, Kodak, Philip Morris, Sea-Land, Procter & Gamble, Tractor Barlows, Honeywell, Daewoo Electronics and Mars. Mars company has been building a plant for pet food production, and Coca-Cola company has been running its soft drinks plant for a number of years in Novosibirsk.

The main products imported into Novosibirsk are machinery and equipment, petrochemical products and consumer goods. The major exporters are the Novosibirsk Chemical Concentrates Plant, VINAP and Elsib. The most active foreign trade partners of the region among non-NIS countries are Germany, China, Japan and South Korea.

*Useful contacts in Novosibirsk*

TRADE

**Mr Viktor Tolokonsky,**
**Governor of the**
**Novosibirsk Region**
18 Krasny Prospect
Novosibirsk 630099
Tel: +7 3832 238 724
Fax: +7 3832 236 972

**Mr Nikolai Titenko,**
**Chairman of Department of**
**Foreign Economic and**
**Inter-Regional Relations**
18 Krasny Prospect
Novosibirsk 630099
Tel: +7 3832 235 245
Fax: +7 3832 236 972

**Mr Vladimir Gorodetsky, Mayor of the city of Novosibirsk**
34 Krasny Prospect
Novosibirsk 630099
Tel: +7 3832 224 932
Fax: +7 3832 180 114

**Novosibirsk Chamber of Commerce and Industry**
Mr Boris Brusilovsky, President
1 Marx St
Novosibirsk 630064
Tel: +7 3832 464 150
Fax: +7 3832 464 150

**Siberian Accord**
Mr Sergei Tikhomirov, Deputy General Director
1 Krasny Prospect
Novosibirsk 630007
Tel/fax: +7 3832 232 711
e-mail: root@sibsogl.nsk.su

**World Trade Center – Novosibirsk**
Mr Dmitry Yevsikov, Director
220/10 Krasny Prospect
Novosibirsk
Tel: +7 3832 259 845
Fax: +7 3832 269 802

BANKS

**NovosibirskVneshTorgBank**
44 Kirov St
Novosibirsk 630102
Tel: +7 3832 102 089
Fax: +7 3832 103 024
e-mail: nvtb@nvtb.nsk.ru
www.nvtb.ru

**SibEcoBank**
8a Vokzalnaya Magistral
Novosibirsk
Tel: +7 3832 181 508
Fax: +7 3832 181 548

**Alfa Bank – Novosibirsk**
1 Dimitrov Prospect
Novosibirsk
Tel: +7 3832 235 566
Fax: +7 3832 239 739

TELECOMMUNICATIONS COMPANIES

**Novocom**
Mr George S Piskunov, General Director
12 Lenin St, Office 1101
Novosibirsk
Tel: +7 3832 119 701
Fax: +7 3832 119 704
e-mail: sales@novocom.nsk.su
www.novocom.nsk.su

**Global One**
Ms Natalia A Guskova, Account Manager
42 Oktyabrskaya St, Floor 4
Novosibirsk
Tel: +7 3832 106 002
Fax: +7 3832 106 067

**Rinet**
86a Kirov St, Office 304
Novosibirsk
Tel: +7 3832 229 097
Fax: +7 3832 229 491
www.nsk.ru

**Magistral Telecom**
12 Lenin St, Office 901
Novosibirsk
Tel: +7 3832 225 678
Fax: +7 3832 180 442
e-mail: sales@siberia.net
http://magistral.siberia.net

*For more information, please visit www.bisnis.doc.gov*

## 6.1.3

# The Wood Processing Industry in Siberia

*Azim Mamanov, BISNIS representative in Novosibirsk, and Sergey A Dyachkov, independent consultant*

### *Forest resources*

This chapter provides a brief overview of the forestry and wood-processing industries in Siberia, including the Tyumen, Omsk, Novosibirsk, Kemerovo, Tomsk, Irkutsk, Chita, Altai, Krasnoyarsk, and Irkutsk regions, and the Buryatia and Tyva republics. Over 10 per cent of the forest area and wood resources of the world are concentrated in Siberia. Regions with significant forest areas are Krasnoyarsk (1,112 square kilometres), Irkutsk (593 square kilomteres.), Tyumen (417 square kilometres), and Chita (236 square kilometres). Overall, forested area in Siberia totals 2,911 square kilometres. About 30 per cent of forest resources are concentrated in Krasnoyarsk, and over 20 per cent are in the Irkutsk region. These two regions are the main producers of timber products (up to 60 per cent of the products are produced in these regions), and determine most of the wood-processing industry conditions and market features in Siberia.

### *Structure of forest resources*

Over 10 per cent of the forest area and wood resources of the world are concentrated in Siberia, whereas the share of coniferous timber resources of Siberia is up to 30 per cent. The most valuable species in Siberia is the 'Angarskaya' pine tree growing in the basins of the Angara and Yenisey Rivers in the Krasnoyarsk region. Mature forests of commercial value constitute about 30 per cent of all forests in Siberia. Reserves of timber increase by 300–400 million cubic metres annually.

Forest structures in the Krasnoyarsk and Irkutsk regions, which are major producers and exporters of round timber, mainly consist of coniferous and deciduous groups of species. Thus, the share of forests in the Krasnoyarsk region consist of coniferous (share of coniferous is 81 per cent, or about 900,000 square kilometres) and deciduous (19 per cent, or 210,000 square kilometres) groups of species. The main species are fir (share of fir trees is 28 per cent, or 3.5 billion cubic metres), pine (20 per cent, or 2.6 billion cubic metres), larch (15 per cent, or 2 billion cubic metres), cedar (up to 15 per cent. or 2 billion cubic metres), and birch (up to 15 per cent, or 2 billion cubic metres). Mature forests constitute 10–15 per cent, and over-mature are more than 50 per cent.

Forests in the Irkutsk region consist mainly of coniferous species (the share of coniferous is 82 per cent or up to 110,000 square kilometres). The main species are larch (30 per cent, or 180,000 square kilometres, or 3 billion cubic metres), pine (15 per cent, or 1.5 billion cubic metres), and birch (up to 15 per cent, or 90,000 square kilometres, or 1.5 billion cubic metres). Mature forests constitute 30 per cent, and over-mature are about 20 per cent.

Unfortunately, neither the Federal nor regional governments (except those of the Irkutsk and, partially, Krasnoyarsk regions) pay adequate attention to issues related to preservation and reproduction of forests. Thus, forests in Siberia periodically suffer from fires. Up to 200 million cubic metres of forests can be wasted by fire annually.

## *Roundwood lumber and saw materials production*

Roundwood lumber production volume in Siberia totals approximately 25 million cubic metres annually. The share of the Irkutsk region is up to 40 per cent (9.4 million cubic metres in 2001), and the Krasnoyarsk region has up to 20 per cent (about 4 million cubic metres in 2001).

Only about 12 per cent of allowable commercial forest is harvested in Siberia. Annual roundwood lumber production has declined by 3–4 times over the past 10–15 years, mostly due to a lack of state support of the industry. Nevertheless, 5 per cent production growth was recorded in 1999–2000. However, in 2001 production declined by 5 per cent. For some of the Siberian regions, production volumes declined over 10 per cent compared to the production volumes in 2000. Thus, production in the Krasnoyarsk region declined by 19.3 per cent, in the Tomsk region by 22.3 per cent, and in the Kemerovo region by 28.3 per cent. Increases of

**Table 6.1.3.1** Production volume of saw materials in Siberian regions in 1990–2000 (million cubic metres)

| *Region* | *1990* | *1995* | *1998* | *1999* | *2000* |
|---|---|---|---|---|---|
| Krasnoyarsk | 6.69 | 2.60 | 1.74 | 1.72 | 1.70 |
| Irkutsk | 7.91 | 2.37 | 1.93 | 1.63 | 1.46 |
| Tyumen | 2.69 | 0.87 | 0.57 | 0.60 | 0.60 |
| Tomsk | 1.63 | 0.53 | 0.28 | 0.28 | 0.35 |
| Chita | 1.07 | 0.25 | 0.11 | 0.09 | 0.11 |
| Omsk | 0.96 | 0.30 | 0.13 | 0.11 | 0.11 |
| Buryatia Republic | 1.19 | 0.21 | 0.14 | 0.15 | 0.16 |
| Kemerovo | 1.47 | 0.39 | 0.16 | 0.16 | 0.18/0.12 |
| Altai | 0.94 | 0.31 | 0.33 | 0.41 | 0.45 |
| Tyva | 0.16 | 0.02 | 0.01 | 0.01 | 0.01 |
| Novosibirsk | 0.72 | 0.21 | 0.17 | 0.19 | 0.20 |
| **Siberia total** | **25.43** | **8.06** | **5.57** | **5.35** | **5.33** |
| **Russia total** | **75.0** | **26.5** | **18.6** | **19.1** | **19.8** |

*data for 2000 are rough estimates

electric energy and transportation tariffs, and price decline in the world market were among the main reasons for this production decline in 2001.

At the same time, the production of roundwood lumber in the Irkutsk region, strongly supported by the local administration, increased by 5.5 per cent in 2001. The overall production of roundwood lumber in Siberia can be roughly estimated to be US$ 1 billion annually.

Saw materials production in Siberia has declined by 13 per cent. Some experts expect that production of the materials, as well of roundwood lumber, will increase in the near future, mostly due to a growing demand for the products in the Russian and regional markets. Overall annual production of saw materials in Siberia is estimated to be up to US$ 500 million. One of the major problems of regional enterprises is obsolescence of industrial equipment. According to the Russian President's representative in the Siberian Federal County, Mr Leonid Drachevsky, the physical depreciation of industrial equipment is over 70 per cent. The equipment is 25 years old on average. The annual equipment renewal in Siberia is up to 5–10 per cent.

This is true for the wood processing industry in particular. According to Mr Drachevsky, Russian exports of timber endorse further development of the wood processing industry of countries that import Russian wood. Mr Drachevsky stated that a government programme for support and development of the forestry and wood processing industry in the Siberian Federal County needs to be developed. This programme should stipulate equipment renewal and modernization of woodworking enterprises, stimulating the establishment of financial and industrial groups and the development of small- and medium-sized enterprises, which, as well as large enterprises, will provide jobs to people living in taiga areas.

Up to 65 per cent of roundwood lumber harvested in Siberia is processed within the Siberian Federal County. Up to 5 per cent of the lumber is exported to other Russian regions, and up to 35 per cent is exported outside of Russia. Losses of lumber during harvesting total 5 per cent. About 60 per cent of the lumber harvested in Siberia is processed for the production of saw materials, and 40 per cent of the lumber undergoes deeper wood processing.

Consumers of saw materials are: construction enterprises located in Siberia (30–35 per cent); industrial enterprises, including wood processing companies (10–15 per cent); private companies and individuals (10–15 per cent); other Russian regions (5–10 per cent); and foreign countries (30–35 per cent).

The Irkutsk and Krasnoyarsk regions are two of the major producers of lumber and saw materials in Russia. Wood processing enterprises located in other Siberian regions that are not rich with forestry resources (such as the Novosibirsk region) and established during Soviet times have to develop deeper wood processing.

One of the leading producers of lumber in Siberia is the Ust-Ilimsky LPK wood processing enterprise (Ust-Ilimsk, in the Irkutsk region). The enterprise produces 2.5 million cubic metres of timber annually (which constitutes about 10 per cent of all the timber produced in Siberia), and sells about 1 million cubic metres of roundwood lumber per year.

The largest producers of saw materials in Siberia are Novo-Yeniseysky LXK (Lesosibirsk, Krasnoyarsk region), and Ust-Ilimsky LDZ (Ust-Ilimsk, in the Irkutsk region). Each of these enterprises produces up to 6 per cent of all saw materials produced in Siberia. Annual export volumes of wood and wood products from Siberia are roughly estimated to be US$ 1 billion, which constitutes about 30 per cent of the product export volume for Russia.

The structure of wood product exports from Siberia is similar to that of Russia in general. Roundwood lumber exports constitute 30–35 per cent (or up to US$ 350 million) of the total export volume, saw materials 15–20 per cent (US$ 150 million), cellulose and paper 40–45 per cent (US$ 450 million) and other types of wood products 5–10 per cent (US$ 50 million). Major regions and exporters are Irkutsk (roundwood lumber, cellulose, cardboard), and Krasnoyarsk (saw materials). Export volume of lumber from the Irkutsk region in 2001 totalled 4.3 million cubic metres, as opposed to 3.9 million cubic metres in 2001.

## *Business opportunities*

Despite the great demand for wood processing, pulp and paper equipment, domestic production is well below capacity and usually of poor quality due to outdated equipment and technology. The region offers great opportunities for the sale of machinery and equipment related to timber, wood processing, and pulp and paper production. Types of equipment in demand in Siberia include:

- portable band sawmills;
- drying cameras;
- cutting instruments for wood;
- moisture measuring systems.

Financing of equipment purchases is the most sensitive issue, and foreign companies should be flexible regarding payment terms for the equipment. Koetter Dry Kiln Inc., a US manufacturer of wood drying kilns, is a good example of a foreign company working in the Siberian market. The company has a representative office established in the city of Novosibirsk, and successfully markets its products throughout Siberia. Some Western manufacturers of equipment, such as Michael Weining AG and Felder-Group, have distributors in Siberia.

Siberian wood is a highly competitive product in the world market. Export prices for the Siberian roundwood lumber are up to US$ 55 per cubic metre, whereas the prices in the world market are at least US$ 80. Foreign companies, investing in lumber and saw materials production with the purpose of exporting them to European, Asian and other countries, benefit highly. Igirma-Tairiku, a Russian–Japanese joint venture is one such enterprise. It is one of the largest enterprises in the Irkutsk region specializing in wood processing and exports of saw materials to Japan. The enterprise processes 600,000 cubic metres of wood annually.

The exported wood is mostly transported by sea through ports in St Petersburg (exports to European countries) and Vladivostok (exports to Asian counties). From Siberia to these ports, the wood is transported by rail. Wood exported from the Krasnoyarsk region is transported from the Igarka and Dudinka ports by the North Ice Ocean.

## *Production of plywood and other products*

Total production of glued plywood in Siberia is estimated to be up to 150,000 cubic metres (production of the plywood in Russia in 1999 totalled 1.32 million cubic metres, in 2000 1.48 million cubic metres, and in 2001 1.59 million cubic metres), or the equivalent of US$ 45 million per year. Production of plywood is mostly concentrated in the Irkutsk region. In 2001, 127,000 cubic metres of plywood were produced in the region. Production of door and window blocks in Siberia totals up to US$ 75 million per year (or 150,000 windows and 200,000 doors), or up to 750,000 square metres of the product (annual production of the blocks in Russia totals 7.2 million square metres).

Up to 80 per cent of door and window blocks produced by wood processing enterprises in Siberia are being installed in newly built buildings, and the products market, as well as saw materials production, is heavily dependent on the construction market. Up to 70 per cent of plywood produced in Siberia is exported. Major buyers are construction and related enterprises (they purchase 10–15 per cent of the products), furniture manufacturers (10–15 per cent), and industrial enterprises (5 per cent).

The largest producer of plywood in Siberia is the Bratsky LPK enterprise (Bratsk, Irkutsk region). The enterprise produces over 5 per cent of the products manufactured in Russia, and up to 80 per cent of those manufactured in Siberia. Producers of window and door blocks market their products mostly within the region in which they are located. A leading producer in the Novosibirsk region is the Bolshevik enterprise, which manufactures 25–30,000 square metres of windows, and 30–35,000 square metres of doors (up to 8 per cent of total production in Siberia) annually. The Sibirksy Les enterprise (in Biysk, Altai region) is the leading producer in the Altai region, manufacturing up to 15,000 square metres of windows and 25,000 square metres of doors annually. The Narodny Dom enterprise (Tyumen) is the leading producer in the Tyumen region, manufacturing up to 15,000 square metres of windows and 25,000 square metres of doors annually.

Production of particle board in Siberia totals 250,000 cubic metres annually (production of the board in Russia totalled 1.99 million cubic metres in 1999, 2.32 million in 2000, and 2.48 million in 2001). Production of fibreboard in Siberia totals about 80 million square metres annually (production in Russia totalled 242.7 million square metres in 1999, 277.7 million in 2000, and 277 million in 2001). Major producers of fibreboard in Siberia are in the Krasnoyarsk (about 45 million square metres of fibreboard produced in 2001), and Irkutsk (25 million square metres in 2001) regions. A main tendency in the glued plywood, fibreboard and particle board markets of Siberia is a continuously growing demand for these products, and consequently, production growth by 5–10 per cent annually. Up to 70 per cent of the products are exported.

## Cellulose paper and cardboard production

Production volume in the pulp and paper industry in Siberia in 2001 was estimated to be US$ 600 million. A major producer is the Irkutsk region, where production volume was US$ 425 million in 2001. Equipment used in the industry was mostly installed in the 1970s and is in need of replacement. The enterprises are mostly oriented toward the production of cellulose and cardboard. Only the Krasnoyarsky CBK enterprise produces paper. Annual paper production totals up to 40,000 tonnes (production in Russia is estimated to be 3.5 million tonnes).

There are five cellulose producers in Siberia. Three are located in the Irkutsk region (Ust-Ilimsky LPK, Bratsky LPK and Baikalsky CBK), one is in Buryatia (Selenginsky CKK), and one is in Krasnoyarsk (Krasnoyarsky CBK). These enterprises produce 30 per cent of all cellulose in Russia (see Table 6.1.3.2)

The largest producers of cardboard are Bratsky LPK (produced approximately 170,000 tonnes in 2001), Selenginsky CKK (75,000 tonnes), and Krasnoyarsky CBK (35,000 tonnes). The total produc-

**Table 6.1.3.2** Production of cellulose by Siberian enterprises

| *Producer* | *2001, thousand tonnes* | *Compared to 2000, per cent* |
|---|---|---|
| Ust-Ilimsky LPK | 560 | 111 |
| Bratsky LPK | 650 | 113 |
| Baikalsky CBK | 185 | 97 |
| Selenginsky CKK | 85 | 106 |
| Krasnoyarsky CBK | 55 | 65 |
| Siberia total | 1535 | 107 |
| Russia total | 5300 | 107 |

tion volume in 2001 in Siberia was estimated to be 325,000 tonnes, and for Russia 1.9 million tonnes.

## *Trade promotion opportunities*

Trade shows devoted to forestry products and technologies conducted in Siberia, present a special opportunity to tap into Siberia's growing forestry and woodworking market. These events provide a unique opportunity to foreign companies to become acquainted with the market or gain a stronger foothold in it. Below is a list of exhibitors, including addresses of their Web sites, where one can find information about forestry, woodworking and related industries shows.

**Siberian Fair company**
220/10 Krasny Prospect
Novosibirsk 630049
Tel: +7 3832 106 290
Fax: +7 3832 259 845
www.sibfair.ru/en/index.php

**SibExpoCenter company**
253-A Zabaikalskaya Street
Irkutsk 664050
Tel: +7 3952 352 239
Fax: +7 3952 352 900
www.sibexpo.ru/index.jsp

**Krasnoyarsk Fair company**
Krasnoyarsk 660049
Tel: +7 3912 362 450/363 287
Fax: +7 3912 363 329/362 425
www.krasfair.ktk.ru/fairE/indexE.htm

**Kuzbass Fair company**
18 Orjonikidze Street
City of Novokuznetsk
Kemerovo Region 654005
Tel: +7 3843 452 886/464 958
Fax: +7 3843 453 679
www.kzfair.infus.ru/

# 6.2

# Russian Reforms Prompt Improved Regional Government Creditworthiness

*Elena Okorotchenko and Felix Ejgel, Standard & Poor's (RatingsDirect)*

## *Introduction*

Russia is undergoing a series of reforms that are influencing its local and regional governments (LRGs). Almost all aspects of an LRG's life are affected: tax revenues, debt, equalization mechanisms, responsibilities, and accounting and reporting. In the long term, these reforms are expected to lead to a stronger, more stable, and more creditworthy intergovernmental system. This article focuses on the effects of these reforms on Russian regions' general creditworthiness. It also looks closely at the widely discussed redistribution of revenues between various levels of government and their effects on stronger Russian regions.

## *Rated LRGs are representative of the strongest regions in Russia*

Standard & Poor's rates 11 LRGs in Russia. It has been more than five years since Standard & Poor's assigned its first public finance rating in Russia to the City of Moscow. Since then, Russian regions have undergone cycles of foreign interest, mostly correlated to national, economic, financial, and political crises. Russian LRG ratings plummeted to 'CCC-' in the midst of the 1998 Russian crisis but have gradually recovered since 1999. Although the ratings on Russia are the same as in 1997, much has changed. The same is true of the rated cities and regions. Long-awaited tax, financial,

**Table 6.2.1** Russian ratings

| | *Local currency / National scale* | *Foreign currency* |
|---|---|---|
| **Bashkortostan** (Republic) | B/Positive/– | B/Positive/– |
| **Cherepovets** (City) | ruBB/–/– | –/–/– |
| **Irkutsk Oblast** | –/–/– | B-/Positive/– |
| **Khanty-Mansiysk** (Autonomous Okrug) | ruAA/–/– | B+/Stable/– |
| **Moscow** (City) | –/–/– | BB-/Stable/– |
| **Moscow** (Oblast) | ruA/–/– | B-/Positive/– |
| **Samara Oblast** | –/–/– | B/Positive/– |
| **St. Petersburg** (City) | BB-/Stable/– | BB-/Stable/– |
| **Tatarstan** (Republic) | –/–/– | CCC+/Positive/– |
| **Yamal-Nenets** (Autonomous Okrug) | –/–/– | CCC+/Positive/– |

*At 4 October 2002

structural and legal reforms are reshaping the LRGs' operational environment, and influencing their financial profile and creditworthiness.

Consolidated revenues of the rated 10 regions (at 621 billion Russian roubles or US$ 21.4 billion) represented 48 per cent of total consolidated revenues in Russia's 89 regions in 2001. These regions are among the fiscally strongest in Russia, with the majority of Russia's revenues collected on their territories (56 per cent of tax revenues in 2001). These regions also hold most Russian LRG debt (71 per cent of total foreign-currency debt and 56 per cent of total interest payments in 2001) and finance the majority of capital investments (68 per cent of total capital expenditures in 2001). Therefore, the rated group of regions is by no means representative of all Russian LRGs, but comprises the strongest regions in Russia.

## *Tax, equalization, and intergovernmental reforms are on the rise*

The Russian intergovernmental system continues to evolve with reforms affecting all major areas of an LRG's day-to-day operations and strategic planning. The evolution creates uncertainty in the LRGs' operating environment and makes planning and budgeting difficult. It has also resulted in uneven revenue growth at various government levels. On the other hand, the reforms show positive trends in equalization, transparency, budgetary discipline and stabilization of the legal environment.

Since 1999, the Federal Government has introduced new regulations and laws that affect areas such as taxes, intergovernmental relationships, accounting and budgeting, debt, equalization mechanisms, regions' legal environments, and cash management.

Firstly, the Budget Code, approved in 1998, came into force in 2000. It has codified rules in budgeting and execution of federal, regional and local budgets and has imposed restrictions on borrowing.

Secondly, the first part of the Tax Code has replaced numerous federal laws and statements. The second part of this Code, containing articles on individual taxes, has been undergoing a chapter-by-chapter approval process for the past two years. The tax reform pursues at least three main targets: abolition of turnover taxes (such as maintenance tax and road tax, which restrain economic development), improving tax management efficiency (by reallocating taxes according to the ability of various government levels to influence them), and reducing the number of taxes with the same base. These reforms will create a more stable and transparent tax environment, thereby helping to improve Russia's investment climate and leading to higher revenues at all government levels.

Thirdly, the equalization mechanism, redistributing revenues between the regions, has been made more transparent and reflects more accurately the regions' tax potential (which is currently measured by GDP). More money has started to flow into equalization funds to gradually smooth out major inequalities in wealth among Russian regions.

The Federal Government is striving to resolve the issue with so-called 'underfunded federal mandates', when the federal legislation imposes spending on LRGs without sufficient compensation. In 2001, the share of unconditional equalization payments reduced to 41 per cent from 72 per cent in 1999, while remaining inter-budgetary transfers represented earmarked financing of federal mandates or block conditional grants. The positive trend toward a full inventory and compensation of imposed spending offers hope that the issue of mismatched revenues and expenditures at the regional level, which was a key negative rating factor in the past, will become less acute in the near future.

On the other hand, the future of Russian municipalities (the true 'local government' in Russia) is still unclear as there is strong debate in the Russian Government with regard to the taxing powers, equalization mechanisms and responsibilities that should be handed over to them.

Fourthly, the Government has put a lot of effort into eliminating discrepancies in federal and regional laws. By the end of 2001, almost all regions had harmonized their legislation with the requirements of the federal authorities. In addition, tax shares of all regions have been equalized. Although several internal offshore zones with tax privileges still exist, the scale of the problem has reduced significantly. In addition, seven federal districts, headed by representatives of the Russian president, have been established to tighten control over local federal authority branches such as defence, the police and the prosecution office.

An additional boost to transparency and liquidity has resulted from the elimination of non-cash payments at all levels of the inter-budgetary system. Since the introduction of obligatory cash payment of taxes to all levels of government in 2000, most regions have received their revenues in cash. In 1999, when cash payments were obligatory only to the federal budget, 35 per cent of all taxes were paid to regions in non-monetary form. In 2001, the Federal Government approved the development of fiscal federalism in Russia until 2005, which followed the reform of 1999–2001 in most areas. The federal policy on reforming intergovernmental relations has been fairly stable for the past four years and will continue for the foreseeable future, offering greater visibility.

Reforms in tax and revenue redistribution have had, arguably, the most noticeable financial effect on Russian regions. In 1999–2001, more than 50 per cent of regional and local taxes were affected with the introduction of the Tax Code, which eliminated some taxes and changed others. The Federal Government continued to redistribute tax shares between various levels of government. The biggest changes for regions have resulted from the redistribution of VAT receipts, income tax receipts, and natural resources extraction tax, changes in income and corporate tax rates, the abolition of road tax and housing tax, and the temporary introduction of sales tax.

The structure of LRGs' revenues and expenditures will have altered dramatically by 2004 compared with 1998, when the reform started.

The above changes have led to a widely debated revenue redistribution at various government levels. The general belief is that the recent intergovernmental reforms have led to a significantly higher share of revenues to the federal budget, thereby affecting the

**Table 6.2.2** Structure of consolidated regional tax revenues and earmarked budgetary funds

| *Taxes* | *Proposed changes in 2003–2004* | *Half year ended June 2002* | *2001* | *1999* |
|---|---|---|---|---|
| VAT | 0 | 0 | 0 | 10.4 |
| Maintenance tax (housing tax) | 0 | 0 | 0 | 7.8 |
| Earmarked budgetary funds | Main source: road tax will be replaced by other sources, including land tax, transport tax, and fuel excises (from 1 Jan 2003); (see natural resources extraction tax for info) | 15.5 | 19.6 | 17.4 |
| Road funds | | 12.0 | 12.8 | 9.9 |
| Natural resources regeneration funds | | 0 | 1.1 | 7.1 |
| Other | | 3.5 | 5.7 | 0.3 |
| Sales tax | Tax rate may be reduced or abolished (from 1 Jan 2004) | 4.0 | 4.2 | 3.4 |
| Profit tax | Tax base reduced, share allocated to LRGs' budget changed (1 Jan 2003); regions' share will increase by 1.5% | 24.8 | 28.0 | 22.3 |
| Personal income tax | | 25.6 | 23.5 | 16.7 |
| Property tax | Will be replaced by real estate tax | 9.4 | 8.2 | 9.0 |
| Excises | The rate of petrol excises will be changed, other excises, for instance, on tobacco, may be redistributed | 3.8 | 3.7 | 4.2 |
| Natural resources extraction tax | Natural resources extraction tax has replaced regular payments on exploitation, payments on reproduction of natural deposits, and excises on oil (from 1 Jan 2002); further redistribution of shares is expected | 7.8 | 7.5 | 5.9* |
| Other taxes | | 9.6 | 5.3 | 2.9 |

*Excluding natural resources regeneration fund

regions' financial health. It is also believed that the fiscally strongest regions have been most negatively affected by the changes, which has led to considerable loss of income.

Data shows, however, that redistribution has primarily affected the local government level. The share of consolidated revenues of all Russian regions (including central government transfers) decreased to 43 per cent in 2001 from 50 per cent in 1999. The share of regions' non-consolidated revenues, however, has remained nearly the same. In other words, municipalities have absorbed the

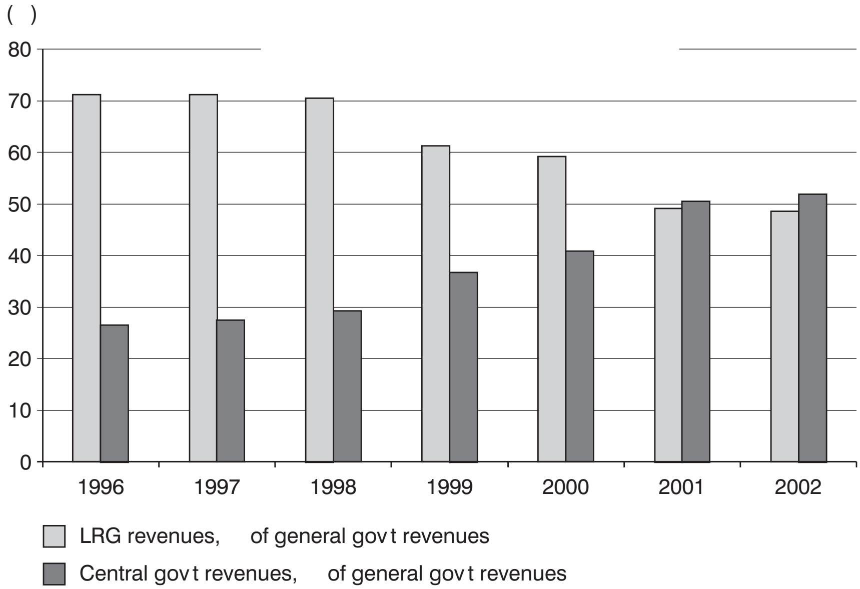



**Figure 6.2.1** Total revenue distribution between federal and regional consolidated budgets*

loss in relative income as regions have continued to redistribute consolidated revenues toward regional budgets.

In 1999–2001, federal revenues grew much faster than consolidated regional revenues, while federal expenditures showed somewhat slower growth. Therefore, the federal budget showed a large surplus in 2001 (primarily for debt repayment), while consolidated regional budgets showed only a small surplus. Furthermore, federal governments and regions saw their revenues increase significantly at constant 1998 prices, while Russian municipalities only managed to maintain the same revenue levels as in 1998 before interbudgetary transfers. The municipalities' share in consolidated public sector revenues decreased dramatically in 1999–2001, while regions lost only 0.5 per cent of revenues after interbudgetary transfers.

It is difficult to ascertain why the regions decided to redistribute revenues within consolidated regional budgets, but this was probably due to one, or a combination, of the following reasons: to replace lost revenues due to changes at the federal level, to increase control over consolidated revenues, to improve equalization, and to facilitate the financing of important expenditures following their consolidation in the regional budget.

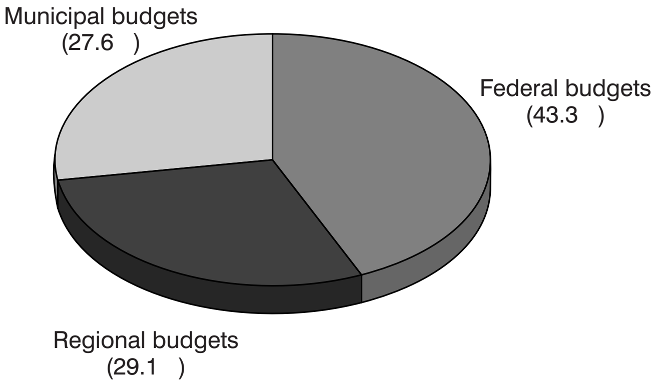



**Figure 6.2.2** Total revenue distribution between federal, regional and municipal budgets in 1999*

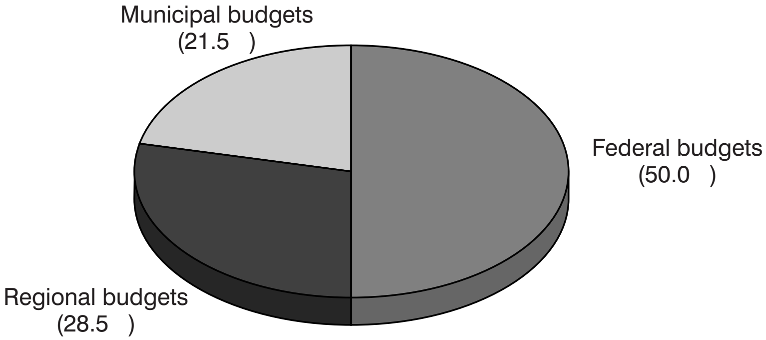



**Figure 6.2.3** Total revenue distribution between federal, regional and municipal budgets in 2001*

Equalization is increasing, with the share of federal interbudgetary transfers reaching 8.4 per cent in 2001 from just 5.4 per cent in 1998–1999. Interbudgetary transfers increased by 2.6 times at constant prices in 1999–2001 while those from regions to municipalities have also grown. This reflects the increased compensation for the execution of federal mandates, which partly eases the problem of shrinking LRG budgets.

As far as fiscally strong regions are concerned, their revenues continued to increase in real terms helped by growing economies and despite budget redistribution. Although their revenues might have been affected by greater equalization among Russian regions, their stronger economies appear to have compensated for the reduction in the relative share of income.

The cities of Moscow and St Petersburg and the Moscow oblast benefit from the ongoing reforms more than other rated regions. The land reform is expected to have a great impact on these LRGs from 2003 as the real-estate market is well developed in all three, and prices will continue to rise following high demand for new office spaces and plots for commercial activity and housing. The reform will create huge potential for additional capital income for these LRGs, as they will be able to sell and continue to rent out valuable land or properties.

The Federal Government plans to remove the remaining part of the natural resource extraction tax from the regions (currently 20 per cent goes to the regions and 80 per cent to the Federal Budget). This could affect oil- and gas-dependent regions, such as the autonomous okrugs of Yamal-Nenets and Khanty-Mansiysk. Both okrugs, however, still have a large safety margin, as their per capita budget revenues are significantly higher than the Russian average, even adjusted for harsh climate and living conditions.

Revenues of the Republics of Bashkortostan and Tatarstan will gradually decrease. Both republics currently receive large additional Federal Government transfers to compensate for tax share redistribution, which will gradually cease. The current agreement, however, will be valid until 2006, giving the Republics enough time to adjust to the changes.

Overall, rated Russian regions have coped well with the fast pace of intergovernmental reforms, often better than their weaker peers, despite the negative effects of increased equalization.

### *Growing economies also support higher revenues for Russian LRGs*

High economic growth in industrially developed Russian regions and the service-oriented largest cities leads to increasing revenues. However, growth is difficult to sustain due to underinvestment.

Nearly all rated regions have shown economic growth since 1999 due to the effects of the rouble devaluation (import substitution and reinvestment), positive trends in oil prices, and general stabilization of the country's economic policy. This has had a positive

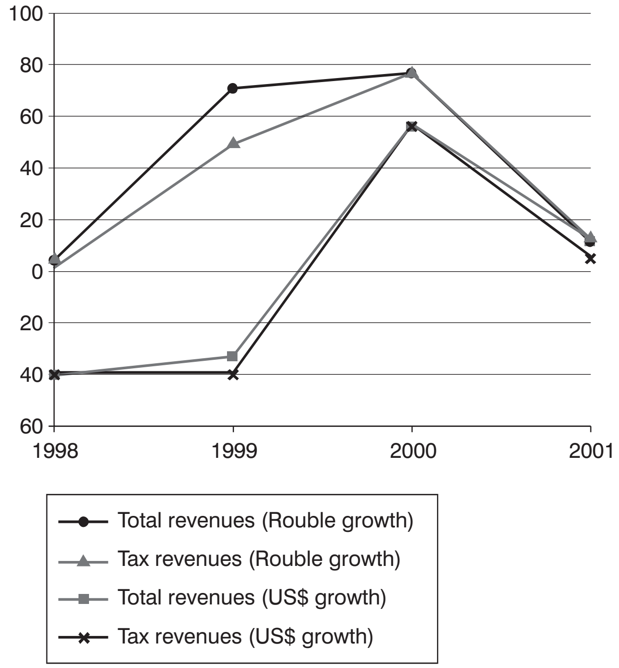



**Figure 6.2.4** Average total and tax revenue growth for the 10 rated Russian regions

effect on the regions' revenues as has the improved tax environment on Russian enterprises.

With very few exceptions, investment levels, especially in FDI, are still fairly low. This means that when existing industrial capacity is fully utilized, there will be no impetus for further economic growth. Realizing this, and as they do not have enough funds to invest, many Russian regions have started to open up to investments, including FDI. One good example is Bashkortostan. Prior to the latest wave of reforms that reduced the Republic's revenues significantly, Bashkortostan controlled, sustained and subsidized most large local enterprises. The administration has now declared its willingness to start a gradual privatization programme to attract long overdue investments in buildings and equipment.

The service sector is largely underdeveloped and also needs significant investments. The only exceptions are the cities of Moscow and St. Petersburg.

Another worrying characteristic of many large Russian LRGs is low diversification of the economy and taxpayers. Many regions' revenues depend on one or two large taxpayers and/or industries. This leads to significant budgetary volatility and vulnerability to small changes in the business or financial position of a few large enterprises.

Therefore, large LRGs need to continue to diversify their economies, attract investment, and develop the service sector, while the economy is growing.

### *Overall effect on LRG creditworthiness is positive, but there is a long way to go*

All in all, the creditworthiness of Russia's strongest regions continues to improve. The system is increasingly transparent and equalization mechanisms are clearer. There is a better match between federal mandates and revenues. Debt and budgetary policies are tightening while regional laws are being harmonized with the federal legislation. Previously substantial and opaque off-budget funds are being gradually eliminated or included in the budget.

The general strengths and weaknesses of rated Russian LRGs are summarized below:

*Strengths:*

- significant natural and labour resources;
- investment and economic growth potential;
- possibility to considerably increase revenues by improving tax collection, increasing efficiency of fund flows and reducing tax privileges;
- relatively low tax burden;
- low debt burden and relatively high debt capacity.

*Weaknesses:*

- still weak and constantly changing legal environment;
- continued redistribution of responsibilities and revenues, as well as intergovernmental and tax reforms, adding to planning and forecasting uncertainty;
- still low transparency, underdeveloped control and management systems, hidden (not properly documented) debts, and various issuing departments;
- uncertainty due to potential extreme changes after elections;
- no independent audit (or only very rare examples) of budgets and balance sheets;

- significant infrastructure upgrading needs massive financing;
- still significant past due indebtedness to utilities and on social benefits;
- high potential off-balance-sheet liabilities, owing to significant regional participation in local economies, financial sector and/or loss-making budgetary enterprises;
- risky debt structure: short-term bank loans, bullet maturity;
- lack of economic diversification, underdeveloped service sector, and large infrastructure financing needs;
- lack of proper debt culture and continued debt disputes with the Ministry of Finance.

Although financial management, transparency, and governance have improved significantly, Russian LRGs still have a long way to go. Off-budget funds, which were previously opaque and quite substantial, are gradually being incorporated into the budget, making finances more transparent. Some regions, however, still have significant funds outside the budget (such as Khanty-Mansiysk's Road Fund and Sverdlovsk's capital expenditure funds).

Treasury systems of budget execution are being implemented in many regions and are already effective in regions like Irkutsk and cities like St Petersburg, increasing fund flow efficiency and economizing budget funds by as much as 30–40 per cent. Some regions are still only considering the introduction of treasury systems however.

Information transparency has improved significantly since 1997–1998. Almost all large regions have Web sites now, where they publish regional laws, as well as economic, financial and debt information. Many sites contain regional news, discussions on major political issues, and feedback. St Petersburg, Irkutsk oblast, and the City of Moscow, for example, have established exemplary Web sites, which publish up-to-date information for investors and the general population. On the other hand, there is almost no auditing of financial reports or financial consulting.

Debt culture and monitoring are also improving as regions continue to unearth and properly document their existing commercial and bank debts and guarantees. The process is driven by the Federal Government through, among other things, the introduction of debt books and an inventory of Ministry of Finance debts to the LRGs.

This leads not only to improved transparency of operations, intergovernmental flows, and finances, but to better budgetary discipline, higher budget funds flow efficiency, and improved creditworthiness.

**Table 6.2.3** Comparative economic, financial and debt data of rated Russian LRGs

| *Entities* | *Bashkortostan (republic)* | *Irkutsk (oblast)* | *Khanty-Mansiysk (autonomous okrug)* | *Moscow (city)* | *Moscow (oblast)* |
|---|---|---|---|---|---|
| Rating (fc ICR) | B/Positive/–, | B-/Positive/– | B+/Stable/– | BB-/Stable/– | B-/Positive/- |
| Population (million) | 4.1 | 2.6 | 1.4 | 8.5 | 6.5 |
| Local GDP (billion roubles) | 164.5 (2000) | 134.2 (2001) | 429.9 (2000) | 677.4 (1999) | 193.6 (2000) |
| GDP real growth (2000) | 3.9 | 2.8 | 4 | | 6.7 |
| GDP real growth (2001) | 3.3e | 4.1 | 6.1e | | 6.0e |
| Economic concentration | some in oil and oil products | some in aluminum and energy | oil | none | some concentration in machinery and engineering |
| Total revenues in 2001 (million roubles) | 24,999 | 9,582 | 41,776 | 232,714 | 27,326 |
| Capex, per cent of total expenditures (2001) | 27.2 | 10.8 | 24.3 | 26.3 | 9.3 |
| Average operating balance, 1998–2001 | 26.6 | 16.5 | 20.3 | 17.9 | 6.5 |
| Average after capex balance, 1998–2001 | (1.8) | 2.4 | 3.3 | 7.7 | 0.3 |
| Average after debt repayment balance, 1998–2001 | (3.1) | (11.3) | 0.3 | 7.3 | (7.0) |
| Cash, per cent of operating expenditure | 4.3 (2001) | 2.1 (2001) | 9.7 (2001) | 0.7 (2000) | 1.9 (2001) |
| Direct debt, per cent of operating revenues (2001) | 4.4 | 17.0 | 0.9 | 16.8 | 5.6 |
| Total tax supported debt, per cent of total revenues, 2001 | 8.8 | 23.3 | 2. | 17.9 | 5.9 |
| Debt service, per cent of total revenues (2001) | 1.2 | 7.1 | 0.1b | 1.5 | 9.1 |

| *Entities* | *Samara (oblast)* | *St Petersburg (city)* | *Sverdlovsk (oblast)* | *Yamal-Nenets (autonomous okrug)* |
|---|---|---|---|---|
| Rating (fc ICR) | B/Positive/– | BB-/Stable/– | CCC+/Positive/– | CCC+/Positive/– |
| Population (million) | | 4.6 | 4.6 | 0.5 |
| Local GDP (billion roubles) | | 232.8 [2000] | 213.4 [2001] | |
| GDP real growth (2000) | | 10 | 0.1 | |
| GDP real growth (2001) | | 4e | 0.1 | |
| Economic concentration | car manufacturing | some in ship building and heavy machinery | some in steel | gas |
| Total revenues in 2001 (million roubles) | | 50,054 | 15,784 | 21,842 |
| Capex, per cent of total expenditures (2001) | | 24.5 | 25.4 | 17.2 |
| Average operating balance, 1998–2001 | 13.5 | 20.8 | 23.5 | 8.6 |
| Average after capex balance, 1998–2001 | 13.7 | 0.3 | 2.5 | (11.7) |
| Average after debt repayment balance, 1998–2001 | 13.3 | (27.7) | (12.8) | (29.7) |
| Cash, per cent of operating expenditure | 6.2 (2000) | 6.6 (2001) | 3.2 (2001) | 3.0 (2000) |
| Direct debt, per cent of operating revenues (2001) | | 20.8 | 3.0 | 10.8 |
| Total tax supported debt, per cent of total revenues, 2001 | | 23.8 | 11.4 | 10.9 |
| Debt service, per cent of total revenues (2001) | | 29.8 | 6.7 | 11.2 |

e = Estimate

During 1998–2001, all rated Russian regions showed relatively high operating surpluses of 10–25 per cent of operating revenues, and surpluses or only moderate deficits after capital expenditures. The direct debt burden declined considerably during this period to less than 20 per cent of operating revenues for all rated regions. This is partly explained by the inclusion of off-budget funds into budget revenues, general revenue growth in line with growing economies, and continued negative net borrowing (see Table 6.2.3).

The creditworthiness of rated Russian regions has improved over the past few years in line with that of the Russian Federation; evident by increased credit ratings (to 'BB-' for Moscow and St Petersburg in 2002 from 'CCC-' in 1998). The improvement has not, however, been the same for all regions. Although some regions managed to achieve pre-crisis rating levels of 'BB-', others remained in the 'CCC' category due to unresolved debt and guarantee situations.

As Russia continues to improve its legal, economic, and financial environment, and to harmonize interbudgetary relationships, Standard & Poor's expects that the creditworthiness of Russian regions will improve. The gap between fiscally stronger and weaker regions may continue to widen, however, offering a greater differentiation between creditworthiness and ratings.

# 6.3

# The Creditworthiness of Russia's Oil and Gas Regions

*Boris Kopeykin and Carol Sirov, Standard & Poor's (RatingsDirect)*

## *Introduction*

Standard & Poor's rates four Russian regions where industry is concentrated in oil and gas extraction, and which account for the most important oil and gas extraction fields in the country. These regions are the Republics of Bashkortostan (B/Positive/–) and Tatarstan (CCC+/Positive/–), and the autonomous okrugs (districts) of Khanty-Mansiysk (KMAO; B+/Stable/–) and Yamal-Nenets (YNAO; CCC+/Positive/–). Dependence on oil and gas extraction is one of the main factors determining the credit profile of these regions. Compared with their Russian peers, they are distinguished by their higher revenues and volatility of those revenues. Dependence on the extraction of hydrocarbon resources is more important for the two autonomous okrugs, where two-thirds of oil and 90 per cent of gas in the Russian Federation (BB-/Stable/B) are extracted. Their revenues mainly come from oil and gas companies' taxes. Dependence on gas extraction is very similar to dependence on oil, because export prices are usually linked to crude oil prices, albeit with several months' lag. The republics of Tatarstan and Bashkortostan also depend on the oil industry because 30–40 per cent of their budget revenue consists of payments from the oil extraction and oil-refining industries.

## *High revenues*

All four regions have a developed industrial base and high industrial production levels. Consequently, they enjoy relatively high

**Table 6.3.1** Per capita consolidated budget revenues of the oil and gas regions compared with the average for other Russian regions*

| *Russian average = 1* | *2001* | *2000* | *1999* | *1998* |
|---|---|---|---|---|
| Bashkortostan | 1.1 | 1.8 | 1.6 | 1.3 |
| Tatarstan | 1.9 | 2.6 | 1.9 | 1.7 |
| Khanty-Mansiysk | 7.9 | 11.6 | 8.7 | 6.8 |
| Yamal-Nenetz | 9.1 | 10.0 | 9.3 | 10.9 |

*Based on Federal Ministry of Finance and States Statistics Committee data. The real ratio should be even higher, because KMAO did not consolidate its road fund in the budget, although many other regions did.

budget revenues. KMAO and YNAO, however, have relatively high public service provision costs because of their remoteness and severe climate. According to the Federal Ministry of Finance, the cost of public services provision in KMAO and YNAO is 1.9 times (x) and 2.6 x higher than Russia's average respectively. Tatarstan and Bashkortostan, which, comparatively, are favourably located, benefit from lower-than-average public services costs. The level of per capita revenues, however, even when adjusted to the relatively high cost of public service provision in the okrugs, is nevertheless several times higher than the Russian average. Table 6.3.1 illustrates the nominal per capita budget revenues of the four regions compared with the average in other Russian regions. Consolidated budgets, ie combined regional and municipal budgets, were chosen for comparison because in Russia the distribution of taxes between regions and municipalities is mainly carried out at regional level.

## The consequences of dependence

The short-term effect of dependence on oil and gas is higher revenues, but long-term risks remain for the oil- and gas-dependent regions:

- volatility owing to low diversification and high dependence on oil prices;
- higher risk of revenue redistribution in favour of the Federal Budget compared with other territories;
- low level of diversification, which is unlikely to increase significantly, especially in the remote autonomous okrugs.

*Dependence on industry is only partly mitigated by expenditure flexibility*

The main negative effect of low diversification and dependence on oil and gas extraction is revenue volatility. The existing economic structure results in a comparatively high share of unpredictable

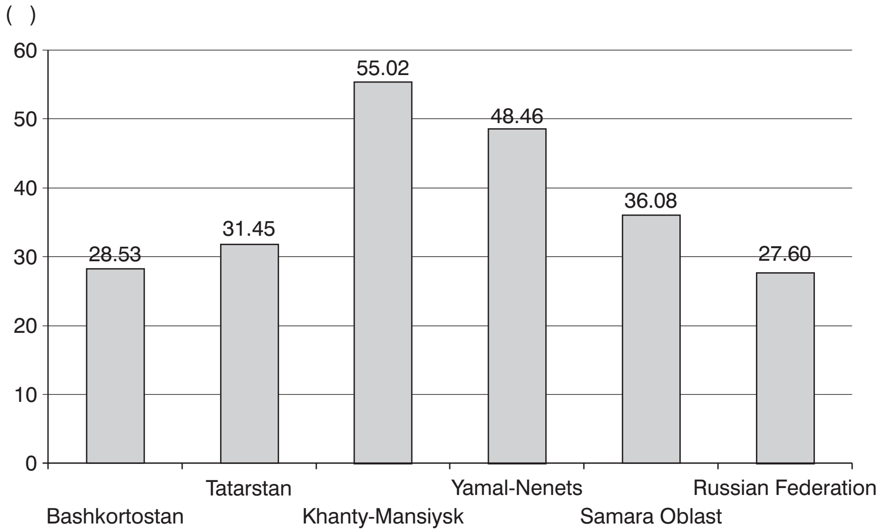



**Figure 6.3.1** Share of volatile taxes in 2001 revenues for the Russian Federation and selected regions

revenues in budget revenues. This unpredictable share comes from enterprise profit tax and extraction tax. They make up to 30 per cent of revenues in Tatarstan and Bashkortostan and about 50 per cent in KMAO and YNAO. The share of extraction tax in the KMAO and YNAO budgets continued to grow in 2002, increasing further their exposure to volatile oil markets. Volatility was previously mitigated by the existence of several different extraction taxes not directly linked to the market price. The introduction of a single extraction tax in 2002 directly exposed these regions to the oil export price.

A low level of diversification constrains creditworthiness irrespective of the dominant industry of a region. Compared with the Samara oblast (B/Positive/–), which is highly dependent on the large auto manufacturer Avtovaz, Tatarstan and Bashkortostan have a lower share of profit and extraction taxes in their budget revenues. The difference between Samara and those regions lies, however, in the fact that oil prices are more volatile and less predictable than those of automobiles. The variation of Samara revenues in US dollars was less than 1.6 x during 1997–2000, ie before, during, and immediately after the financial and economical crisis of 1998. Revenues in Bashkortostan varied more than 2 x during the same period as the decline in oil prices further contributed to the crisis. KMAO and YNAO revenues are even less

**Table 6.3.2** Comparison of regional budget expenditures in 2001

| *(per cent of total expenditure)* | *Salaries and benefits* | *Capital expenditure* | *Financial aid to local budgets* |
|---|---|---|---|
| Bashkortostan | 4.6 | 30.3 | 29.7 |
| Tatarstan | 4.1 | 29.3 | 17.7 |
| Khanty-Mansiysk AO | 4.5 | 20.6 | 38.5 |
| Yamal-Nenets AO | 3.6 | 21.6 | 23.9 |
| Samara oblast | 9.8 | 11.8 | 10.5 |
| Moscow oblast | 11.1 | 8.7 | 25.5 |

diversified and are consequently more dependent on volatile revenue sources. Their revenues denominated in hard currency varied 2.5 x–3 x during the same period.

Revenue volatility is only partly mitigated by the regions' existing expenditure flexibility. Excess revenues do, however, provide some room to maneuver. All four regions have a high capital expenditure and low personnel expenditure share in their budgets, compared with other rated Russian regions such as Samara or the Moscow oblast (B-/Positive/–). They should be able to absorb severe revenue drops more easily because they have more flexible expenditures. In addition, some of the oil and gas regions already enjoy, in comparison with the Russian average, more developed infrastructure and can cut their capital expenditures more easily.

The existing system of revenue distribution between regions and municipalities also implicitly provides financial flexibility to the regions. The regions set distribution rates for the main taxes they share with municipalities. Federal legislation only sets average minimums for these rates for the whole region at very low levels. A few regions, including the four regions concerned, implement comparatively more generous policies towards municipalities. In 2001, municipal budgets in the four regions grew faster than the regional ones. In Moscow oblast and Samara the situation was reversed, because of tougher policies implemented by the regional authorities. Some revenues are passed on to municipalities via tax-sharing mechanisms, while the remainder is distributed through transfers. The level of such transfers was higher than the Russian average in all the oil and gas regions except Tatarstan. In Tatarstan, however, per capita municipal budget revenues were 1.5 x higher than the national average, and slightly higher than, for example, in Moscow oblast. The comparative wealth of the municipalities supports regional expenditure flexibility: the more wealthy a municipality is, the easier it is for the region to cut transfers or keep a larger share of taxes.

Even in these regions, however, in cases of real financial distress, the decision to cut transfers or keep a larger share of taxes is politically painful. In addition, the regions' ability to cut their own expenditures is limited by their growing desire to implement capital projects. In this situation, the level of management sophistication becomes very important. If the administration is able to build reserves during more successful years, as it did in KMAO in 2000, and is able to cut expenditures, revenue volatility becomes less of a risk.

*Federal distribution risks*

One of the greatest risks is that of tax payment redistribution, because the Russian Federation controls tax rates and shares. It is a risk for all Russian regions, but it is higher for the four oil and gas territories because of the larger share of extraction tax in their revenues. The Russian Federation is likely to consider natural resources payments as the common property of the country as a whole. All the four regions, which are highly dependent on such taxes, may suffer severely from extraction tax redistribution, which is now widely discussed at federal level. There was an attempt to redistribute all these proceeds in favour of the Federal Budget in 2001, when the new extraction tax was discussed, but the regions managed to keep a 20 per cent share.

*Poor prospect for diversification*

All four regions realize the long-term problems of low diversification, and have attempted to promote the development of other industries. The ability of other industries, services or hi-tech sectors to compensate for such high dependence is limited, however, especially in KMAO and YNAO, which are remote and have severe climates. This is a very serious long-term constraint on the future prospects of these regions. The potential for their ratings to be raised largely depends on their ability to raise the level of diversification in their economies.

Such a high dependence on oil resources is relatively specific to some Russian regions, but Standard & Poor's rates other local governments throughout the world that are either dependent on one industry, such as the tourist Balearic Islands in Spain, or one taxpayer, such as the city of Boulogne-Billancourt in France, which depends on the automobile group Renault for about 18 per cent of its revenues.

*Dependence on a few large taxpayers*

Other risks that arise from low diversification include a dependence on a few important taxpayers. In Tatarstan and Bashkortostan only Tatneft OAO (B-/Stable/–) and Bashneft, respectively, are significant. In addition, they extract comparatively lower-quality oil. In KMAO and YNAO, the level of industry diversification is higher: almost all of the large Russian oil companies are present in KMAO and several operate in YNAO. The diversification of the economy is lower, however, and the dependence of KMAO on Surgutneftegaz, which provides about one-third of all tax payments, is very high. Natural gas extraction in YNAO is almost monopolized, and OAO Gazprom (B+/Stable/–) provides more than 40 per cent of tax payments to the regional budget. All the risks attributable to big oil and gas corporations in the Russian environment are therefore automatically transferred to the regional budgets.

## Conclusion

The high level of industrial base development in Tatarstan, Bashkortostan, KMAO, and YNAO results in additional revenues, and in the short-term supports the level of creditworthiness. The volatile nature of budget revenues, however, constrains the four regions' credit ratings. Although the short-term position depends on the state of the world crude oil market, the future also largely depends on federal policies on natural resources extraction taxation, which are expected to be unfavourable, and their ability to increase diversification in their economies, which is limited. These risks are factored into the ratings. Management sophistication, financial and debt policies implemented, and many other issues are very important for assessing the overall credit quality of these regional governments. This may result in diverging ratings across the four regions or changing rating trends.

## 6.4.1

# Case study 1: Breaking into Russia's Food Processing Market

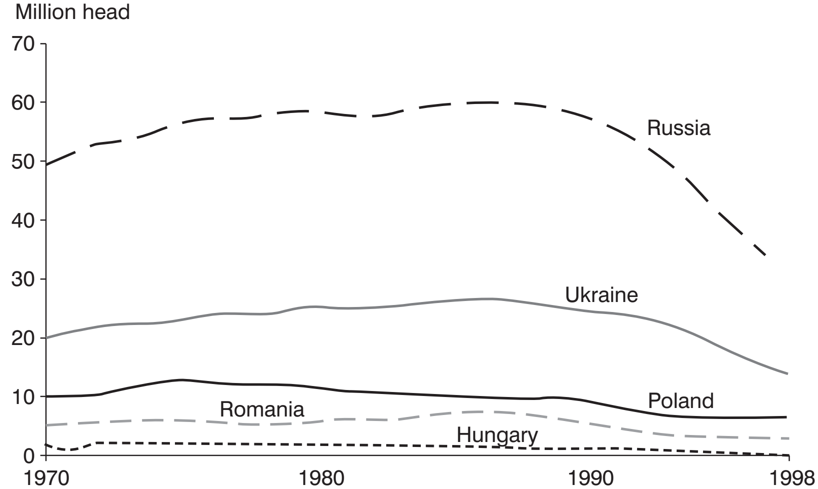
*The International Finance Corporation (World Bank Group)*

### *Food processing market overview*

In the mid-1990s, the sales of food imported into Russia were skyrocketing. Russia quickly became one of the fastest-growing markets in the world. However, the Russian financial crisis of 1998 and the fourfold devaluation of the Russian rouble made foreign goods too expensive for the majority of consumers. Exporters of products to Russia lost their markets overnight, while local producers received a golden opportunity to expand sales and fill the vacuum left by the foreign companies.

Under the circumstances, in order for foreign food producers to compete in the Russian market, they had to begin producing locally. However, a lack of quality and stable supply of raw ma-terials to support local production was a major obstacle. Russian primary agriculture was at the verge of collapse. In 1998, only 12 per cent of farms operated profitably. The cattle herd size dropped by 30 per cent from 1990 to 1998. Due to an equal drop in yields per cow, milk production was nearly halved during the same period. Russian banks withdrew completely from the sector, as centralized government subsidies ceased to exist. A common phrase used to describe the agricultural sector in Russia, was an *economic black hole.*

The following case study examines how a Dutch dairy company, Campina Melkunie B.V., overcame these difficulties with assistance from the International Finance Corporation (IFC) and established its production in Russia. The second part of the chapter presents IFC's new project – Agro-industrial Finance Company – that is designed to stimulate the growth of Russian suppliers of raw materials through providing them with access to financing.




*Source*: USDA 1998

**Figure 6.4.1.1** Cattle herd size 1970–1998

## *Campina case study: Capturing the second-largest share in Russia's yogurt market*

Before 1998, a Dutch dairy company, Campina, held a leading position in the Russian yogurt market. The 1998 financial crisis jeopardized Campina's position. In order to solidify its position in the Russian market, Campina clearly understood that local production was the key prerequisite of success.

However, when Campina began to consider local production in Russia, it faced a major obstacle – inadequate quality, insufficient quantity, and instability of raw milk supply. Resolving this issue was crucial to Campina's commitment to invest in a new yogurt production plant just outside Moscow. The Russian agricultural sector had virtually collapsed after the introduction of market reform in the early 1990s. The dairy sector was no exception. Milk production levels dropped to the levels of the 1960s. The quality of locally produced milk was unacceptable with a bacteria count 10–100 times above European standards. Local milk processing plants could not pay for the milk supplied to them, and the farms were losing money on every litre of milk they produced.

Campina's plans for local production presented struggling Russian dairy farms with a great opportunity, but only if they could overcome the old-style production methods and dramatically improve the quality of the milk they produced. To help Russian farms capitalize on this opportunity, IFC began working with 11 farms to introduce modern technical and management know-how to boost the quality and quantity of their milk to meet European standards. This technical assistance programme was funded by the Netherlands (Senter) and Campina itself.

The first step of IFC's technical assistance programme involved assisting with negotiating long-term supply contracts between Campina and the farms. This process was not as simple at it might appear. In the Soviet period, the farms had never negotiated contracts on their own. This was always done by central authorities alone. In the post-Soviet period, they had never had any real choice in negotiating with dairy processors. In addition, many local dairies paid low prices for milk, paid little attention to quality, and often were either late in paying or did not pay at all. In short, the farms had no trust in working with dairy processors. Campina on the other hand wanted a long-term (5–10 year) relationship with the farms. Many farms were concerned that a long-term contract would lock them into a relationship that would cheat them as they had been cheated previously. The IFC team acted as an honest broker between Campina and the farms, helping to form a mutually beneficial relationship.

IFC's initial analysis of the farms' milk production process revealed that in order to boost the production and quality levels improvements needed to be made in two areas. First, IFC, with the assistance of Dutch agricultural specialists, trained the farmers in better production and sanitary practices. This assistance ranged from training the farms in such simple things as properly cleaning the milking equipment to more efficient ways of producing better quality and larger quantity of feed. This assistance allowed the farms to make much more efficient use of the resources they already had.

Second, farms needed to upgrade their outdated equipment if they were to make dramatic improvements in quality and production levels. The priority investment areas were in the farms' milking and cooling equipment. The old refrigeration equipment took too long to cool the milk, which led to increased bacteria content. And the old milking equipment was inefficient, limited the volume of production, and damaged both the milk and the dairy cows. IFC worked with the farm managers to develop an investment programme to begin investments in the farms. The programme included financial analysis of the farms, determining priority needs for investment, and training in financial management to help the farms make informed investment decisions. Consultants hired by IFC and Campina also helped select suitable equipment suppliers.

Given the almost complete absence of agricultural finance in Russia, IFC, together with Campina, developed an innovative financing model. According to this model Campina purchased the new milking and cooling equipment from Swedish, Dutch and Italian manufacturers and leased it to the farms. Since the farms had little dispensable capital to pay for equipment in cash, the price of equipment and lease payments were calculated in milk. The farms made their lease payments using the milk they were already supplying to Campina. They had from three months to four years to pay Campina back after which ownership of the equipment was turned to them.

In just two years, the results were impressive. This financing model worked well – none of the farms have had any problems with their payments. Thanks to the new equipment and new production practices, the average milk yield per cow has increased by 30–40 per cent. Not only are the farms producing more milk, but also because of the higher quality, they are getting a better price for the milk. The improved quality of the milk has dramatically increased profits by approximately 20 per cent. Thanks to the farms' overall growth, the farmers' work conditions have improved with their rouble salaries having more than doubled.

Now that Campina could count on a stable supply of quality raw milk, it went ahead with its plans and built a US$ 50 million greenfield dairy processing plant south of Moscow. IFC provided a

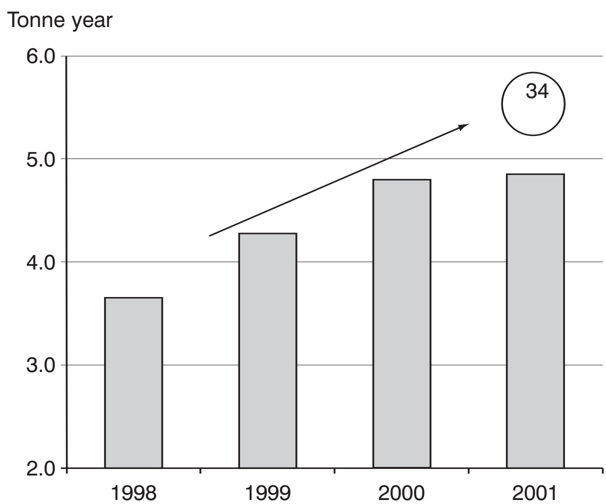



**Figure 6.4.1.2** Increase in yield per cow as a result of IFC's technical assistance programme to 11 Russian farms

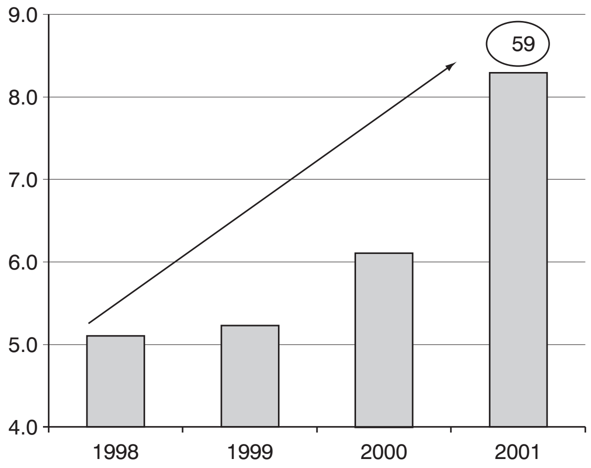



**Figure 6.4.1.3** Increase in sales of milk (US$ million) by the 11 Russian farms, receipt of IFC's technical assistance programme

9.3 million euro loan. Today, Campina's plant operates its two production lines at full capacity and the company has begun a new investment project, substantially increasing the production and storage capacity of the plant. Currently, Campina holds the second-largest share of the Russian yogurt market.

## *The Agro-industrial Finance Company – the first private company to finance Russian agriculture*

The success of the IFC–Campina technical assistance project and the successful application of the investment model to re-equip Campina's supplier farms paved the way for the launch of the first leasing company devoted to the primary agricultural sector in Russia. The Agro-industrial Finance Company (AFC) was established jointly by the Rabobank Group, the International Finance Corporation (IFC) and the Netherlands Development Finance Corporation (FMO). The three founders of AFC provide equity and medium-term loans, amounting to US$ 16 million in total. AFC is the first private financial intermediary to address the problem of almost complete absence of medium-term capital available to the agricultural sector due to its high perceived investment risk.

At the farm (primary production) level, as well as at the level of the processing companies, companies like Campina wish to invest in better equipment to secure higher output and quality, but often are unable to access medium-term finance to do so. To date, the funding through commercial banks or leasing companies for these farms and processing companies has not been readily available: this has resulted in less investments in this increasingly promising sector.

The main concept behind the company is that it intends to finance Russian agriculture only in close cooperation and through risk-sharing mechanisms with food and agribusiness companies – the same companies whose main problem in Russia is the inadequate supply of agricultural raw materials. This risk sharing significantly reduces the risks of financing Russian farms and is the main reason private financial institutions have shown interest in the model.

The AFC is designed to finance the purchase of modern agricultural equipment by farms that have long-term, reliable supply contracts with major food and agribusiness companies. The AFC will also provide technical assistance to farms, in order to ensure proper use of the new equipment, and improve farm management practices. The company is planning to work with numerous processors in the following key sectors: dairy, oil seeds, grains, potatoes, and meat and poultry. The company has already received statements of interest from a number of large foreign processing companies.

The AFC would lease equipment (one to three year term) to supplier-farms with already existing supply contracts with selected processors. The AFC would then receive as payment raw materials based on an agreed schedule. The value of these raw materials will be approximately 5–15 per cent of the total value of raw materials supplied to the processor. This limit is set in order to avoid too high lease payments and resulting deterioration of cash flow for the farms. The AFC would then sell the raw materials received, to the processor, using the same conditions and prices as those agreed between the farm and the processor. Of course, the physical transfer of goods remains unaffected; it is directly between the farm and processor.

The above model is used to ensure payment by the farms. By requiring raw materials instead of cash as payment, the AFC can be reasonably certain that as long as the farms continue to supply the selected processor, the risk of non-payment is quite low. This model also assists processors by giving farms more incentive to become reliable, long-term suppliers.

The AFC's core business is leasing of new equipment, by providing contract lengths of between 12 and 36 months, which represents longer-term finance than is typically available in the local market. To facilitate these arrangements the AFC will focus on establishing sustainable credit relations both with farms and processing companies, on the basis of long-term supply contracts from farms to processors for their produce. Examples of the equipment that is expected to be leased by the AFC include: tanks for cooling milk, feed installations, tractors and agricultural equipment.

The AFC will begin work with Campina farms but quickly expand to other processors, working also with their supplier farms. Dairy and meats are the priority sectors, but others, such as vegetables and grains, will also be considered.

*For more information, please contact IFC Moscow office on +7 (095) 755 8818*

6.4.2

# Case study 2: A Profile of Russian Mobile Phone Companies

*Nadejda Golubeva, Aton Capital*

### *Key players*

*MTS – strong, but not invincible*

MTS (Mobile TeleSystems) is Russia's largest cellular operator, with a total of 4.08 million subscribers as of the end of May 2002, including some 1.86 million in the regions.[1] The company's licence portfolio covers 64 per cent of the country's population.

MTS was founded in October 1993 by the Moscow city fixed-line operator MGTS and several other domestic shareholders, on the one side, and Deutsche Telecom's subsidiary DeTeMobil and Siemens, on the other side, as a closed joint stock company. Russian and German shareholders owned 53 per cent and 47 per cent in the company, respectively. In early 1995, AFK Sistema, a Moscow-based financial group rumoured to have close relations with the

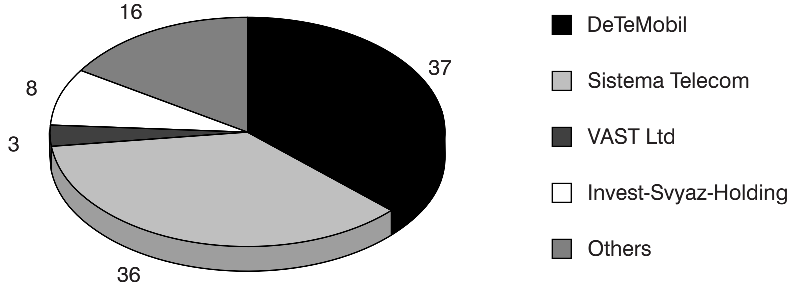



**Figure 6.4.2.1** MTS ownership structure

[1] J'son&Partners

Moscow government, consolidated the stakes of Russian shareholders; at the same time, DeTeMobil purchased the Siemens stake. Sistema's telecommunications arm, Sistema Telecom, boasts dominance in the Moscow telecoms market, including control over MGTS and the city's biggest CLECs.

MTS's parent companies laid a solid foundation for the company's future success by securing very comfortable conditions for its daughter. Back in 1993, MTS obtained an exclusive licence for the most promising GSM900 standard for a period of 10 years or until the company's subscriber base reached 90,000. This gave MTS a head start on competition in terms of both timing and standard quality. In 1996, when MTS faced the need to build a large capacity network, the company easily obtained a GSM1800 extension to its Moscow Licence Area (MLA) licence. MTS was also able to obtain direct Moscow telephone numbers at a much cheaper rate than Vimpelcom, which later followed in its footsteps.

It would be a mistake, however, to think that MTS's success was exclusively due to the preferential conditions the company enjoyed in Moscow. MTS managers have proved highly professional in their business. For instance, after the 1998 crisis quick changes to the company's tariff and marketing policy allowed MTS to minimize the outflow of subscribers and retain many clients, especially in the corporate segment, who became active users again once their financial position improved.

The history of MTS as a public company began in 2000, when it triumphantly accessed the US market with an IPO, netting US$ 350 million from the placement of about 17 per cent of its shares. Since then, the company's total market capitalization has increased by some 50 per cent to US$ 2.928 billion.

Strong business positions in Moscow may help MTS develop its business in St Petersburg, because AFK Sistema should be able to bargain for better conditions for MTS in the northern capital in exchange for certain concessions to Sonic Duo in Moscow. In the remaining regions, however, MTS is unlikely to enjoy the preferences it has grown used to (except for those given by its 'first entrant' status).

*Vimpelcom – Cinderella goes to the ball*

Vimpelcom is Russia's number two cellular operator boasting a 52 per cent market share in the MLA. As of the end of May 2002, Vimpelcom had 3.09 million subscribers,[2] including about 400,000

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[2] J'son&Partners

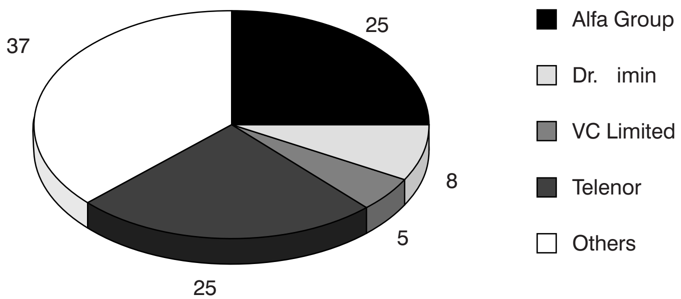


**Figure 6.4.2.2** Vimpelcom ownership structure

in the regions. The company's GSM licence portfolio covers a territory accounting for 70 per cent of the country's population.

Vimpelcom is an example of a successful venture project. The history of Vimpelcom (Beeline trade mark) is not typical because the company was established not by a businessman, but by deputy chief designer of the country's anti-ballistic radar system and director of a specialist research centre, Dmitri Zimin. His meeting in 1991 with a US cellular equipment manufacturer Augie Fabela, who joined what he perceived was a promising project, resulted in a unique combination of Russian technical and US marketing expertise.

The personality of the founder and his initial non-affiliation with political circles determined Vimpelcom's strengths and weaknesses in the development process. High disclosure standards, clean sources of starting capital and the ability to speak with Western investors figuratively and literally in their mother tongue helped the company build an image of one of the most civilized players in Russia. Vimpelcom became the first Russian company to be quoted on the NYSE by issuing Level III ADRs. The IPO brought Vimpelcom US$ 110.7 million as the share price soared by 48 per cent in one day. Portfolio investors willingly paid a good premium for excellent corporate governance. Vimpelcom was also among the trailblazers to debt finance in the West.

On the other hand, lack of political support, which often becomes a major hurdle for businesses in Russia, has hindered the company throughout its history. At the very start, Vimpelcom failed to obtain a licence for the GSM900 standard. In the early 1990s, the Telecommunications Ministry decided to issue one licence per region per standard. Although the decision was justified by the shortage of frequencies, the criteria for allocating bandwidth to specific companies were very vague, to say the least. When cellular licences were first issued in 1993, MTS received a GSM900/1800 licence, Moscow

Cellular (MCC) obtained NMT, and Vimpelcom ended up with AMPS.

Failing to get hold of a GSM900 licence, in 1995 Vimpelcom obtained a licence for GSM1800, which was just being tested worldwide, plus an impressive 20MHz bandwidth. The biggest disadvantage of GSM1800 was that it required significantly more base stations to cover the same territory than GSM900. Because of this, Vimpelcom decided to build a GSM1800 network in Moscow alone.

Another factor that depressed the value of the GSM1800 licence was that GSM1800 networks were very undeveloped worldwide. At that time, there were only two GSM1800 operators in the United Kingdom and one was beginning the rollout in Germany. Not surprisingly, restricted roaming capacity and the dearth of dual-band handsets made Vimpelcom's GSM1800 network in Moscow unpopular.

However, building the GSM1800 network was the only way for Vimpelcom to tap the GSM potential at the time, and the company continued to invest in the rollout of the network that was not delivering immediate returns. At the same time, Vimpelcom had to commit large sums toward the expansion of its dead-end AMPS/DAMPS network, which experienced high subscriber growth rates at the time.

By the time Vimpelcom obtained the GSM900 licence for the MLA in August 1998, its main competitor MTS had already built a vast two-band GSM900/1800 network in the Moscow Region (MTS obtained a GSM1800 extension to its licence in 1996) and had fully capitalized on being the only GSM operator in the MLA. Despite obtaining a dual-band licence, Vimpelcom was still at a disadvantage vis-à-vis MTS, because it had less capacity in the 900MHz bandwidth.

After the financial crisis in August 1998, from which Vimpelcom sustained heavy losses, Dr Zimin decided to attract a strategic partner. In December 1998, Norway's Telenor paid US$ 162 million for 25 per cent of Vimpelcom voting stock. Realizing that inferior coverage compared with that of MTS made the company uncompetitive in the high-end segment, Vimpelcom decided to capture the mass market. The company began to offer pre-paid services and sharply increased its advertising budget.

Although the gap between Vimpelcom and MTS in terms of subscriber base began to narrow, investments in the advertising campaign did not pay off due to the low loyalty of pre-paid customers. In 1999, Vimpelcom's EBITDA margin stood at just 11 per cent, and intensive handset subsidies made the company's Q4

1999 EBITDA-negative. Vimpelcom came to be perceived as a second-rate operator.

Vimpelcom's plight prompted Telenor to take active steps. In August 1999 Dr Zimin stepped down in favour of Telenor representative Jo Lunder. Lunder proclaimed the return to profitability as his primary task. The company stopped subsidizing handsets, negotiated lower interconnect costs and reviewed its marketing policy. The funds received from Telenor enabled Vimpelcom to speed up the construction of the dual-band network, and by the end of 2000 the company managed to reach parity with MTS in terms of coverage in the Moscow Region. However, the most difficult task was to reassure subscribers that Vimpelcom was also competitive in terms of service quality. Only one-third of all new subscribers chose Vimpelcom, while two-thirds preferred MTS.

The turnaround in customers' attitudes toward Vimpelcom took place in summer 2001. One of the most efficient marketing moves by Vimpelcom was to have cars travel in the Moscow Region and offer free phone calls to people on the street in order to demonstrate that the connection was good. Fortunately for Vimpelcom, this coincided with the peak of accusations against MTS concerning its non-transparent billing practices.

The first results became visible in Q3 2001, when Vimpelcom managed to reach parity with MTS in terms of new additions. In the following two quarters Vimpelcom amazed the market by adding 6.7 times more subscribers than MTS and taking the lead in the Moscow market in terms of subscriber base.

Although Vimpelcom achieved a breakthrough in Moscow, the company still lacked funds for regional expansion. In May 2001, Vimpelcom struck a strategic deal with Alfa Eco, a branch of Alfa Group, selling to it a blocking stake both in Vimpelcom and Vimpelcom's 100 per cent owned regional vehicle, Vimpelcom-R. Alfa Eco acquired both the newly issued shares and some of the shares controlled by Dr Zimin. Telenor also purchased additional shares to retain its 25 per cent stake in Vimpelcom. Alfa and Telenor have four representatives each on the nine-member Board. Alfa brings with it a vast banking network and connections. At the same time, it lacks telecoms experience and may potentially conflict with the other strategic investor, Telenor.

As a result of the deal, Vimpelcom is expected to obtain US$ 220 million from Alfa until the end of 2003 to finance its regional expansion. Alfa has already paid the first US$ 103 million in exchange for the blocking stake in Vimpelcom. The subsequent US$ 117 million should be paid in two equal portions in the first and

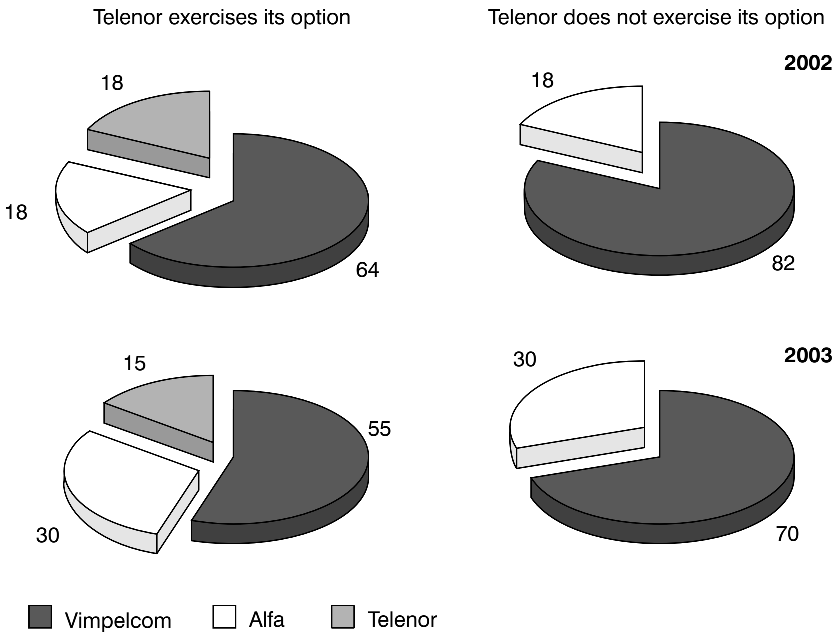


**Figure 6.4.2.3** Vimpelcom-R ownership structure

second year after the initial payment. Under the initial arrangement, Vimpelcom and Telenor had options to invest simultaneously with Alfa. Should both of them exercise their options, Alfa's stake in Vimpelcom-R would stand at 30 per cent. If they don't, Alfa's share would increase to 42 per cent.

In May 2002, Vimpelcom's AGM approved the conversion of the company's options to invest in Vimpelcom-R into obligations, accelerating the investment date to November 2002 (ie Vimpelcom will invest a total of US$ 58.5 million in November 2002 instead of putting up two portions of US$ 29.5 million in November 2002 and 2003, as originally planned). Telenor was also given an option to accelerate its investment to November 2002. Assuming that Alfa does not accelerate its investment, Vimpelcom's ownership in Vimpelcom-R after all investments are made in 2002 and 2003 will stand at 55 per cent if Telenor exercises its option, and 70 per cent if it doesn't (see Figure 6.4.2.3).

*Megafon – Trojan horse from St Petersburg*

Megafon, the nationwide cellular project launched by the St Petersburg-based holding Telecominvest in August 2001, is the youngest among the Big Three. Nevertheless, it is the only one whose GSM licences cover the entire country. Megafon was created on the basis

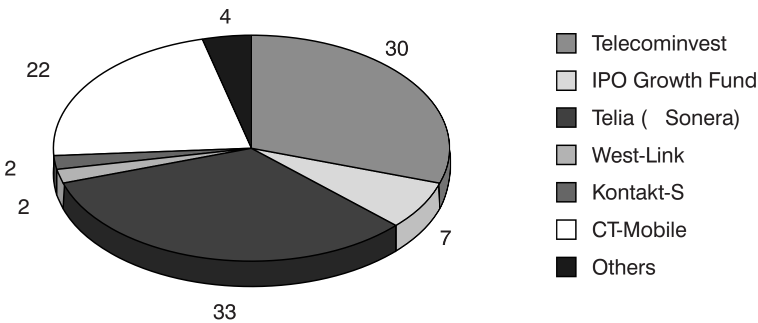


**Figure 6.4.2.4** Megafon ownership structure

of Russia's third-largest cellular operator 'North-West GSM', and its formation as a legal entity was completed on 29 May 2002. As of the end of May 2002, Megafon's total subscriber base stood at 1.54 million.

The secret of Megafon's success in building the best licence portfolio within the shortest period of time can easily be explained by the efforts of its powerful parent, Telecominvest, which controls about 90 per cent of the telecom market in the North West region. Most top positions in Russian telecommunication bodies are occupied by natives of St Petersburg, whose career at one time or another had to do with one of Telecominvest's subsidiaries. Many of those officials are rumoured to own interests in Telecominvest's regional cellular subsidiaries. In addition, they enjoy close proximity to the 'powers that be' represented by the so-called 'St Petersburg team' brought to Moscow by President Putin.

Although Telecominvest wants to do Megafon's IPO in the future, Megafon is not yet a public company, and there is little information available on its financial performance. We note that Megafon has little experience of acting in a highly competitive environment, because until the end of 2001 North-West GSM remained the only St Petersburg GSM operator. At the same time, Megafon's strategy for entering the Moscow market through its local operator Sonic Duo, as well as the company's preparations for MTS's entry into St Petersburg last year, show that Megafon management may well rise to the challenge.

## *Smaller players*

*MCT Corp.*

At the beginning of this year, the US-based holding company MCT Corp. had equity stakes in 24 regional GSM, AMPS and NMT operators, whose total licence area covered 50 per cent of Russia's territory. The company's presence in Russia was built through the purchase from Golden Telecom of 100 per cent of the Vostok Mobile holding company, which owned stakes in 14 regional AMPS/D-AMPS operators (in exchange, 24 per cent of MCT went to Golden Telecom), as well as through the acquisition from AT&T of 95 per cent of the RTDC Corporation, which has large stakes in eight cellular operators. In the spring of 2001, MCT introduced a single brand ('Indigo') for all of its Russian operators, apart from MCC and St Petersburg-based Delta Telecom. The company announced ambitious plans to do an IPO at the end of this year and gain a 20 per cent share of Russia's cellular market by 2005.

MCT's future prospects, however, have been cast into doubt after it lost the 95 per cent stake in RTDC, having missed a deadline for payment to AT&T. The stake was promptly snatched up by RTK-Leasing, a former leasing arm of Rostelecom affiliated with Gamma Group, which in turn has signalled its intention to sell some of RTDC's cellular interests to Svyazinvest. As a result of RTDC's loss, the total subscriber base of MCT's operators in Russia has fallen to around 100,000, below our estimates, from about 450,000 previously. We believe that in this situation MCT will likely give up its ambitious plans and sell its remaining cellular assets to the competition.

*Svyazinvest*

Svyazinvest, the holding company with majority stakes in 74 regional fixed-line operators, owns interests in about 40 regional GSM operators and in dozens of NMT and AMPS/D-AMPS companies through its daughter companies. Svyazinvest's intention to purchase some cellular assets from RTDC was a real surprise to the market. Until recently, one could barely conceive of Svyazinvest as a player in the domestic cellular market. Regional companies have had a record of disposing of their cellular assets, often at below-market prices, drawing criticism from minority shareholders.

The most prominent case was the sale by Southern Telecom (then Kubanelectrosvyaz) of 27 per cent of its 51 per cent stake in Russia's fourth-largest mobile operator, Kuban GSM, to its daughter company, reportedly controlled by the Kubanelectrosvyaz General Director. The remaining 24 per cent stake in Kuban GSM was sold to MTS for US$ 34 million.

Soon after the purchase of RTDC by RTK-Leasing, Svyazinvest stated it was developing a strategy for its cellular holdings. The purchase of cellular assets from RTK-Leasing is bound to strengthen Svyazinvest operators' positions in the Siberia, Volga and Southern mega-regions. It is difficult to say, however, whether Svyazinvest's efforts in the field of cellular communications will bear fruit in the longer term, given fierce competition from the Big Three. We believe that Svyazinvest's strategy might consist of grooming its cellular operators for sale to one of the Big Three after a couple of years.

*FORA Communications (Tele2)*

Sweden's Tele2 controls 12 Russian AMPS/D-AMPS operators (stakes vary from 55–95 per cent) that it purchased last year from Millicom International Cellular (MIC). MIC brought these assets under the single roof of the FORA Telecom holding**.** The biggest among them are St Petersburg Telecom, Personal Communication Systems in Nizhny Novgorod, Rostov Cellular Communications in Rostov-on-Don, Siberia Cellular Communications in Omsk, and Smolensk Cellular Communications. All of them have received GSM1800 licences in exchange for endorsing the closure of their AMPS/D-AMPS networks by 2010, but none of the operators has started to build networks yet. We estimate that FORA had about 175,000 subscribers at the start of 2002.

*Accord-Tel*

Accord-Tel, owned by St Petersburg companies with links to the Telecommunications Ministry and Svyazinvest management, has stakes in 39 NMT operators, which, when combined, account for 51.5 per cent of all NMT operators' revenues in Russia. The company is betting on the transition from the old analogue NMT-450 standard to IMT-MC-450, based on the CDMA technology, which can be used for building 3G networks.

Until recently, CDMA was officially (and arbitrarily) banned from use in mobile communications in Russia. Nevertheless, Moscow's MCC and St Petersburg's Delta in December 2001 received permits to build IMT-MC-450 test networks. Accord-Tel is reportedly planning to buy MCC and, in our view, it is well positioned to become Russia's largest NMT operator.

## 6.4.3

# Case study 3: Young American Brings Pizza and Lingerie to Siberia

*Victoria Lavrentieva, Moscow Times*

When Eric Shogren was working hard to get a small business off the ground in Minneapolis in 1992, he could hardly have imagined that a decade later he would have made it big in Siberia.

But a chance introduction to a Russian businessman and a talent for business ideas changed all that. At 36 years of age, Shogren has built up a multimillion-dollar empire in Novosibirsk that includes a chain of seven New York Pizza restaurants, two cosy restaurants (Klassika and Delicatessen), NY Times bar and grill, three coffee houses, a bakery, a furniture workshop and the only Russian outlet of top US lingerie chain Victoria's Secret.

Although Shogren has some Russian blood in him – his relatives on his mother's side emigrated from Russia at the beginning of the 20th century – he had little idea early on of how big an influence the country would have on his life.

After finishing secondary school, Shogren decided to set up a business in his hometown, Minneapolis. Like many other young Americans he was involved in a small video-production business and was selling sports art.

But in 1992, Shogren's brother, Brad – then studying Russian at Novosibirsk University – introduced him to a Siberian businessman during a visit to Minnesota on a cultural exchange. The man said he was looking to do some business in the United States. He told Eric that whatever he could buy in the United States, he could sell in Novosibirsk.

Like many modern Russian oligarchs, Shogren started his career in Russia 10 years ago with 'buy-and-sell' business.

After some thought the pair decided to ship American cars to Novosibirsk. His partner would send Shogren cash in dollars, and all Shogren had to do was arrange for the cars to be shipped as far as St Petersburg and then driven to Novosibirsk.

The business was very successful, but Shogren soon became bored of exporting cars and decided he wanted to sink his teeth into a new project. In 1993, he approached his partner with the idea of opening a supermarket in Novosibirsk. Although it seemed unrealistic at first, the idea was well timed because it was very difficult to buy foreign goods in Russia.

But the supermarket fell apart a year later because of Novosibirsk's remote location and problems with delivering goods, which lost quality during their transportation on the Trans-Siberian Railway.

At about the same time, Shogren's partner decided to emigrate to the United States and Eric had to move to Novosibirsk, which he was already fond of, to oversee the business.

After Shogren moved to Russia full-time, he not only married a Russian girl but also expanded his business in many directions. One of his first ventures was a chain of pizza restaurants called New York Pizza, which he founded in 1996. His first New York Pizza restaurant cost about US$ 100,000 and now the seven-strong chain makes several million dollars a year.

After the 1998 financial crisis, Shogren decided he needed to diversify, and so later that year he set up his furniture business. One of his buyers is a British company and he is exporting wood to Europe through the United Kingdom. The furniture is now made by European manufacturers, but in the long term he wants to move production to Siberia.

Also after the crisis, he bought into the Bavarsky Khleb bakery. The bakery now produces and bakes a tonne of dough a day, and Shogren has plans to increase production to 10 tonnes a day.

In the beginning of 2002, Shogren made himself popular with the women of Novosibirsk by opening the Diva lingerie shop, which sells goods from US chain Victoria's Secret. Shogren says he runs the store as much for pleasure as business because he just wants to make lingerie more accessible to Russian women. His store is much less expensive than the local Dikaya Orkhideya (Wild Orchid) chain.

But the Siberian market is not the limit for this American businessman. He is already thinking about expanding to other regions, including the most attractive and enormous market – Moscow. This time Shogren wants to compete with McDonald's in bringing to Moscow his own fast food chain – NY Pizza.

Another business idea of Shogren's is to help a local Siberian software company to bring in foreign clients interested in offshore programming. He thinks he can be helpful to the company in building strategic relationships and acting as their marketing and business agent abroad.

Unlike many modern-day Russian businessmen, Shogren says he does not think only of money when he embarks on a new venture. He agrees that he has made a fortune in Siberia and has a very successful business. But another important part of his job is that he tries to make the place better.

'People here should have equal opportunities with those who live across the ocean,' he says.

One of the ways in which Shogren has tried to fulfil this philosophy has been by supporting Novosibirsk University. He not only sits on the Board of the University and helps it with financing but also recruits young talent to manage his projects. The operations manager of his Klassika restaurant is a 21-year-old, and suppliers are dealt with by an 18-year-old; both are among the brightest students in the University.

For Shogren, who himself never had a chance to continue his education, Russia was the best school and the best teacher.

There is a good saying in Russian, which gives an idea of business practices in the country: 'A car makes the road.' In many cases there is no road, so you need to start riding first and then figure out how to get to the desired destination. For Shogren, Russia was a place with many opportunities and a lot to learn along the way.

To be successful in the country, he said, you not only need to have adventurism and the business feeling in your blood, but more importantly, you need to believe in what you are doing. In this case, Russia will at least give you a chance to start, and it won't take you five years to see if you are successful or not.

For Shogren, an important part of his success is to have a clear vision of what exactly he wants to do. Another thing that helps him to be successful is flexibility to the approach of doing business and readiness to listen and respect other people. He is ready to roll up his sleeves and work instead of telling people that he knows something better.

Shogren cannot explain why more foreign investors have not come to the region in the 10 years since he started working here, although he suggests that many have been discouraged by the unwholesome image of Russian business abroad.

He agrees that there were a lot of things that he was worried about when he first came to Russia, but now he finds them reasonable.

More than that, Shogren has even found some aspects of working in Russia preferable to the United States. In America, they say how much you make is less important than how much you keep. In Russia, it is different: here how much you make is less important than how much you share, he said.

During 10 years of doing business in Russia, Shogren has learned that in order to be successful in the long run it is important to play by local rules, to listen to other people and not to take money behind someone's back.

But even after so many years in Russia, language and communication still present the biggest challenge to him. 'The combination of language and culture creates situations where people sometimes have misunderstandings with each other over things they should not disagree about,' he says.

Shogren says he does not want to be a foreigner who comes and tells Russians how bad they are and how impossible it is to do business here. He just starts doing it, and then it becomes possible.

# Part Seven

# Appendices

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## Appendix 1

# Useful Business-Related Websites for Russia

*www.gksoft.com/govt/en/ru.html*
A directory of all of the federal government institutions of the Russian Federation including a list of all ministries

*www.embassyworld.com/embassy/russia1.htm*
A directory of all of the Russian embassies and consulates around the world

*www.embassiesabroad.com/embassy.cfm?embassy=home&fkcountry=75*
A directory of foreign embassies and their Web sites in Russia

*www.users.globalnet.co.uk/ chegeo/ or www.russiaexport.net*
Interesting English language site providing information about Russia's foreign trade since 1994, detailing different products imported and exported to and from the Russian Federation, main trading partners, and companies involved in foreign trade with Russia, etc

*www.rmg.ru*
English language site containing information about breaking news from the Russian financial markets, including market analysis, daily quotes and indices, corporate finance, etc

*www.roscredit.msk.su/*
KB 'Rossiyskiy Credit' was the first bank in Russia to have its own home page on the Internet. This Web site gives information about the bank and the banking system in Russia

*www.fipc.ru/fipc*
The Web site of the Russian Government's foreign investment promotion centre under the Ministry of Economy

*www.mid.ru*
The Russian Ministry of Foreign Affairs' English language site providing current political information and various documents

*www.rbcc.com/*
Russo-British Chamber of Commerce in the United Kingdom

*www.amcham.ru/*
American Chamber of Commerce in Russia (Moscow based)

*www.russianbusinesssite.com*
The Web site of the Russian government entity set up to promote the development of small to medium-sized business sector in Russia

*www.britemb.msk.ru*
Web site of the British Embassy in Moscow, listing the services the embassy provides for British companies

*www.tradepartners.gov.uk*
Advice and information from the UK government network that helps UK companies trade internationally, including basic information about Russia's business environment and economy

*www.tradeuk.com*
Trade partners UK's Internet service for international buyers and UK exporters

*www.russianembassy.org*
The Web site of the Russian embassy in Washington, DC – a useful resource providing excellent information on contemporary society as well as recent and ancient history plus links to news sources, etc

*www.bisnis.doc.gov/bisnis/country/rusfed.cfm*
US Department of Commerce site, established to provide Business Information Service for the Newly Independent States (BISNIS) – a massive web-based resource pertaining to all aspects of business in Russia. This includes a commercial overview of Russia, comprising an economic profile, a foreign trade profile, a foreign investment summary (giving information on intellectual rights and existing US-Russia bilateral agreements), a banking and finance summary, a section on practical information for travellers and a section on useful contacts/addresses

*www.eia.doe.gov/emeu/cabs/russia.html*
US-DOE Energy Information Administration: Country Analysis Brief on Russia – a description of Russia's energy economy, including oil, natural gas and electricity. Elsewhere on this site are: a somewhat dated (1999), but still useful, Country Energy Balance for Russia (www.eia.doe.gov/emeu/world/country/cntry_RS.html) with information on oil, coal, natural gas and electricity; a Russian Oil and Gas Exports Fact Sheet (www.eia.doe.gov/emeu/cabs/russexp.html); and an Environmental Issues Briefing (www.eia.doe.gov/emeu/cabs/ russenv.html) with information on air pollution, energy

intensities, carbon emissions, renewable energy, and an outlook for the 21st century

*www.odci.gov/cia/publications/factbook/geos/rs.html* CIA World Factbook 2002 – A very useful information summary about Russia, including sections on geography, people, government, economy, communications, transportation, military forces and transnational issues

*www.russialink.org.uk/embassy*
Online Russian international visa service. This is a non-government site affiliated to the Russian Embassy in London, offering a full range of visa support services for visitors to Russia (including arranging invitations for business and tourist visas)

*www.visatorussia.com/*
Russian visa support services available online

*www.russiangateway.co.uk*
Another of the, now numerous, Internet-based visa and travel support service agencies serving the Russian Federation, providing information on visas, tours and hotels from the UK's leading Russia experts

*www.russia-travel.com*
Official Web site of the Russian national tourist office

*www.city.ru*
Russian cities on the web – a complete Internet-based guide to numerous large (as well as not so large) Russian cities

# Appendix 2

# Russian Banking Sector Ratings Raised Amid Improved Economic Climate

*Standard & Poor's, RatingsDirect*

In September 2002, Standard & Poor's Ratings Services, prompted by improvements in Russia's economic climate, revised its outlook to positive from stable on six Russian banks: International Industrial Bank, Ural-Siberian Bank, Impex Bank, Menatep St Petersburg, Surgutneftegazbank, and TransCreditBank. All ratings on these banks were affirmed. At the same time, Standard & Poor's has raised its long-term counterparty credit ratings on four other Russian banks, as follows:

- **International Moscow Bank**: raised to single-'B' from single-'B'-minus;
- **Alfa Bank** and **OJSC Commercial Bank Petrocommerce**: raised to single-'B'-minus from triple-'C'-plus;
- **MDM Bank**: raised to triple-'C'-plus from triple-'C'.

The outlook on Alfa Bank and MDM Bank were revised to stable from positive; all four banks now have stable outlooks. All short-term ratings were affirmed. A complete list of rating actions is displayed in Table A2.1.

The rating actions reflect the improvement in the Russian economic environment during the past three years, which has increased business opportunities for Russian banks and reduced the extremely high credit risk linked to clients in the public and private sector. The actions also reflect the banking sector's progress in rebuilding after the massive defaults that followed the August 1998 financial crisis. The three years of development and expansion that started in the second half of 1999 have brought the sector to a stage where a glimmer of real banks can be seen.

Many private sector banks now generate a material volume of business outside their financial industrial groups (FIGs), and top-tier Russian banks can now offer clients a broader range of products instead of just cash management services. Moreover, new capital is moving into the sector, and several banks are emerging as profitable. Foreign banks are showing increased interest in the sector, and the retail banking market is growing.

While this progress is laudable, the sector nevertheless remains underdeveloped and Russian banks still rank among the riskiest in the world. Moreover, the leading private-sector banks are greater credit risks than the large rated Russian industrial companies. FIGs continue to dominate the Russian economy, and FIG banks remain captive to the funding needs and revenue flows of the FIGs to which they belong. Private-sector banks in Russia remain small in terms of capital and economic power, and consequently have very high single-party risk concentrations with their much larger Russian industrial clients.

The dominance of the giant state-owned savings bank, Sberbank (not rated), distorts pricing on both sides of the balance sheet. General credit culture is underdeveloped in Russia, and the legal system is unpredictable in relation to enforcement of claims. Lastly, banking supervision and regulation has been ineffectual to date, although this could change with the recent appointment of a new Central Bank head. The potential for Russian banks to raise their creditworthiness to a level close to, or as strong as, that of the highest-rated Russian entities (currently double-‘B’-minus) will be limited, unless the Russian banking sector addresses many of these weaknesses.

The four banks that received upgrades have all improved their commercial position during the past three years. International Moscow Bank does not face the risk factors associated with FIG membership, as it is owned by a consortium of foreign banks, led by Bayersiche Hypo-und Vereinsbank. Its independent status and foreign-bank supervision attracts top-grade clients. Both Alfa Bank and MDM Bank have successfully expanded their networks and extended their franchises, and have built capital through retained earnings. Recent bank acquisitions by MDM have brought many new customers to the MDM banking group, but these may prove difficult to integrate. OJSC Commercial Bank Petrocommerce’s strategic role within Lukoil OAO, Russia’s largest oil company, was reinforced by the latter’s US$ 115 million capital increase in the bank in late 2001, and the bank continues to expand its business outside of the Lukoil group.

The positive outlooks on the other six banks mentioned primarily reflect the potential that Russia's improving economy will provide uplift to the credit ratings of many Russian banks in the future – if the banks can meet the challenge. International Industrial Bank's capital strength and useful political connections help it gain corporate banking business. Ural-Siberian Bank's good business franchise and improved financial profile make it well positioned to achieve its expansion plans. For both, successful management of credit risk and further diversification of business lines will be key to the future ratings. Menatep St Petersburg faces a similar challenge, with the additional need to raise capital to support the expansion of risk assets.

Surgutneftegazbank and TransCreditBank are somewhat smaller players closely linked to their respective owners – Surgutneftegaz and the Russian railways, respectively. The future role of these two banks within their respective groups will be the primary element that drives their ratings. The future rating of Impex Bank will depend on the bank's ability to truly rebuild its franchise and financial performance while shaking off the negative legacy of its past link to the failed Rossiyskiy Kredit Bank.

## *Ratings list*

**Table A2.1** Counterparty credit ratings

| | *To* | *From* |
|---|---|---|
| International Industrial Bank | CCC+/Positive/C | CCC+/Stable/C |
| Ural-Siberian Bank OJSC | CCC+/Positive/C | CCC+/Stable/C |
| Impex Bank | CCC-/Positive/C | CCC-/Stable/C |
| Menatep St Petersburg | CCC/Positive/C | CCC/Stable/C |
| Surgutneftegazbank | CCC/Positive/C | CCC/Stable/C |
| TransCreditBank | CCC/Positive/C | CCC/Stable/C |
| International Moscow Bank | B/Stable/C | B-/Stable/C |
| Alfa Bank | B-/Stable/C | CCC+/Positive/C |
| OJSC Commercial Bank Petrocommerce | B-/Stable/C | CCC+/Stable/C |
| MDM Bank | CCC+/Stable/C | CCC/Positive/C |

A complete list of rating actions is available to subscribers of RatingsDirect, Standard & Poor's web-based credit analysis system, at www.ratingsdirect.com. The list is also available on Standard & Poor's public Web site at www.standardandpoors.com; under

Ratings Actions, select Newly Released Ratings Listings. The release is also available on Standard & Poor's Russian-language Web site at www.standardandpoors.ru. Alternatively, call the Standard & Poor's Ratings Desk in Paris on +33 (1) 4420 6705.

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# Appendix 3

# Will New Tariff Regulation Improve Russian Utility Credit Standing?

*Standard & Poor's, RatingsDirect*

Owing to its approval of a new tariff regulation mechanism for utilities in April 2002, the Russian Government has taken another step toward building a new institutional framework in the nation's electricity sector. (For a detailed description of the Russian electricity sector restructuring plan, see the article entitled: 'Is the Russian Electricity Sector Running Out of Power?' published on RatingsDirect on 9 October 2001.)

The previous tariff setting system was highly politicized, and, therefore, tariffs tended to reflect the social priorities of regional administrations rather than utility costs. The question now is whether the new system will enable the avoidance of these drawbacks.

Standard & Poor's considers that the new system is essential to the development of a more transparent and logical regulatory framework, which is a key credit factor. The sector will only benefit if the new regulatory system is properly implemented while political and social resistance remains and other parts of the reform package are likely to be difficult to pass. The reform itself represents a major change in industry structure, which is also a significant risk.

Standard & Poor's will closely monitor sector developments, particularly enforcement. Rating actions will reflect the implementation track record, as well as general reform progress and risks arising in the process.

## *New regulatory system*

Compared with the previous tariff regulation system, which came into effect in February 1997, the new system incorporates improvements that should enhance transparency and facilitate sector reform by providing efficient regulation. The main differences to the new regulatory system are:

- Explicit separation of electricity generation, transmission and distribution tariffs. There was only one electricity tariff under the old tariff regulation system.
- Extension of the regulatory powers of the Federal Energy Commission (FEC) at the expense of the regulatory powers of the Regional Energy Commissions (RECs). The FEC will now be responsible not only for regulating the wholesale market, but for setting transmission and distribution tariffs. The RECs will regulate electricity tariffs for end users. The latter should be determined as a sum of the average price of the electricity produced, the total transmission, distribution, and supply costs, and a balancing fee. This will narrow the RECs' ability to make biased and subjective decisions.
- The key tariff regulation principle will now be 'compensation of economically reasonable costs plus return on capital'. Weighted average cost of capital (WACC) is the basis for determining the required return on capital. Until a methodology for calculating WACC and asset valuation is developed and approved, either the Central Bank of Russia discount rate or the LIBOR rate can be used to determine the required regulatory return on new investments. The criteria for investment project evaluation and approval are still to be finalized.
- In addition to the 'cost plus' method, the system introduces some simpler methods of regulation, including inflation-linked indexation and adjusting for changes in key pass-through costs, which is new for Russia.
- Electricity tariffs should exclude all costs related to non-core activities. At present, almost all utilities have substantial social assets that have not yet been transferred to the municipalities (such as hospitals, recreation areas and kindergartens). In addition, the utilities have developed various non-core activities, the costs of which are often included in the overall tariff calculation when submitting proposals to regulatory bodies.
- 'Economically reasonable' costs incurred in the period and not included in the tariff must be included in the tariff for the next

period. From January 2001, it has been possible to include customer receivables in the tariff, thereby allowing utilities to solve the problem of collection, which has been one of the key weaknesses in the sector.

- RECs are supposed to set various consumer tariffs, so that users can select either simple, time zone or voltage tariffs.
- In order to avoid regulatory cross-subsidization, such as when tariffs for industrial consumers are higher than those for households, regulators must follow a number of requirements. According to the new document, regulators cannot set privileged tariffs for certain groups without clearly defining the funding source of those privileges. To set privileged tariffs the regulator should obtain the approval of the federal Anti-Monopoly Ministry; or set lower tariffs for certain consumer groups at the expense of other consumer groups (differentiation is only possible if it is based on technical factors, like sales volume, demand pattern, or service reliability).
- Finally, the new system is intended to make the whole tariff-setting procedure more transparent. The FEC and RECs will now have to explain their decisions through a detailed breakdown of tariff components, such as what fuel prices were used, and which investments were included. At present, they just publish the final result. In addition, there are time limits for the new regulatory procedure.

## Will the system work?

The new regulatory system is unquestionably a step toward more transparent and efficient utility tariff regulation. The major achievement of the new regulatory framework is the reduction of REC powers and the formalization of their activity. However, there are a number of factors that make it difficult to establish a fair cost-based tariff regulation in the short term.

First, there is no track record of implementation. It is unclear what will happen if the resolution is not followed, and how disputes would legally be settled. Generally, poor enforcement, rather than the lack of a solid legal base, is the key problem in Russia. This is the primary concern.

Second, regulatory independence can be brought into question. Strong political resistance remains over the introduction of economically reasonable pricing, and this could force regulatory bodies to break the law. Although the Federal Government formally supports the reform, it is fighting to keep inflation at 10–12 per cent per year. For many years, the Government has used utility price regulation as one of the most important tools for mastering inflation and boosting economic growth.

Third, the customers' ability to pay is not addressed in the new regulatory system. The utility will not benefit from price increases if it is unable to collect cash from customers, and huge receivables from budgetary organizations are still a problem for the sector. From the social and political prospective, the elimination of cross-subsidization (lower tariffs for residential customers balanced by higher bills to industrial customers) is a challenging task and it will not be possible to stop this widespread practice overnight.

Fourth, there remains speculation about 'economically reasonable' utility costs. Unfortunately, few companies accurately conduct separate revenue and cost accounting on individual business activities. Therefore, unless accounting practices improve, these 'economically reasonable' costs will still be subject to negotiation and speculation by both regulators and utilities. Another particularly non-transparent area is earnings calculation asset valuation, and the regulatory criteria for investment project evaluation.

Ultimately, the government resolution is just a part, albeit an important one, of the general sector reform package. A key part of regulatory activity – municipal heating tariffs – remains outside the scope of the new regulatory requirements. This could be a very important risk if tariff moves are not well balanced. Other key reform documents will require the approval of the Federal Government and also the State Duma, which could be more difficult to obtain.

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## Appendix 4

# IFC's Corporate Governance Initiatives in Russia

*The International Finance Corporation (World Bank Group)*

### ***IFC's comparative advantage in corporate governance***

*IFC and corporate governance in emerging markets*
The task of reforming the legal and regulatory corporate governance framework in Russia is an essential, albeit a difficult and lengthy, process, which requires a broad constituency. On the other hand, improving corporate governance practices at the company level, as currently implement by IFC, is feasible in the short to medium term.

IFC is able to add value to clients in the area of corporate governance because of the expertise it has developed in this area since 1956, structuring client companies, appraising investment opportunities and nominating board members across a wide range of markets and industries. This practical experience allows IFC to tailor global principles to the realities of the private sector in developing countries. Development banks and other investors working in emerging markets often look to IFC for leadership on corporate governance issues in emerging markets.

In addition to working directly with client companies, IFC plays a leading role in the global policy dialogue on corporate governance through the Global Corporate Governance Forum[1] and provides technical assistance to regulators, stock markets and other financial market participants. The IFC staff organizes corporate governance events and carries out advisory work across the world.

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[1] More information on the Global Corporate Governance Forum can be found under www.gcgf.org.

Finally, corporate governance is one of the pillars of IFC's focus on sustainability.[2] Better corporate governance that improves access to capital and enhances performance will help ensure the long-term, sustainable growth of client companies. As with other elements of sustainability, corporate governance should not be seen as another hurdle to potential investment, but rather as an opportunity to add value to the client and increase the developmental impact of IFC's investment. A company that is well governed is one that is accountable and transparent to its shareholders and other stakeholders (such as employees, creditors, customers and the wider society).

*IFC and corporate governance reform in Russia*

More specific to Russia, IFC recently launched the Russia Corporate Governance Project.[3] Operating in Moscow, Rostov-on-Don, St Petersburg, Samara and Ekaterinburg, the project follows four objectives that are structured around four key stakeholders:

1. to improve the corporate governance practices of, and access to capital for, Russian open joint stock companies (OJSCs);
2. to increase the training capacity of Russian educational institutions;
3. to improve the legislative framework regulating corporate governance issues, in cooperation with relevant public sector institutions;
4. to increase public awareness of corporate governance issues and implement sustainable reforms by supporting the leading corporate governance institutions.

The main thrust of the IFC's project activities are the seminars, consultations and pilot programme it conducts for Russian OJSCs in the above-mentioned regions. This work can be broken down into three phases. The first consists of public seminars and roundtables, and it serves to educate company executives and directors on good corporate governance practices. The second consist of consultations and workshops, and targets OJSCs interested in improving their corporate governance practices. This phase is probably the most important and is expected to produce the biggest sustainable impact. The third phase consists of a comprehensive pilot programme, including corporate governance assessments, or due

[2] See IFC Annual Report (www.ifc.org/)

[3] Sponsored by the Swiss State Secretariat for Economic Affairs (seco) and the Dutch Ministry of Economic Affairs (MEA)

diligences, of selected enterprises. This concluding phase will help these enterprises prepare for potential investments and will be conducted on a demand-driven basis for potential investors. In support of these activities, the IFC's Russia Corporate Governance Project is developing a Corporate Governance Manual in cooperation with the US Department of Commerce. The purpose of the manual is to help companies implement good corporate governance practices. In addition, the project is conducting a Corporate Governance Survey to gauge the current state of corporate governance practices in Russia today.

To date, the project has provided some 200 consultations on various corporate governance issues that have served to make a real, if initial, impact on the corporate governance practices of many companies. Moreover, the project has conducted over 25 training events for some 250 organizations and helped shape the Federal Commission on the Securities Market's Code on Corporate Behaviour. More information on how to cooperate or work with the IFC's Russia Corporate Governance Project can be found under www.ifc.org/rcgp/.

Other planned IFC corporate governance activities in Russia include the Banking Sector Corporate Governance Project, the purpose of which is to help banks with their internal corporate governance issues on the one hand, and, on the other, to develop a due diligence tool to assess the corporate governance practices of client companies seeking corporate financial services. Another related activity currently being launched is IFC's Alternative Dispute Resolution Project, which aims to strengthen and deepen the culture and practice of alternative dispute resolution as a method of resolving business disputes in Russia.

## *Other corporate governance initiatives and institutions*

There are numerous initiatives and institutions that promote improved corporate governance practices in Russian companies and, more importantly, can be of assistance when doing business in Russia. Public sector institutions include:

- the Federal Commission on the Securities Market (see also www.fedcom.ru);
- the Ministry of Economic Affairs and Trade (see also www.economy.gov.ru);
- the State Duma's Task Force on Corporate Governance (see also www.duma.gov.ru).

The main international organizations include:

- the European Bank for Reconstruction and Development (www.ebrd.com);
- the Organisation for Economic Cooperation and Development (www.oecd.org);
- the World Bank Group's International Bank for Reconstruction and Development ( www.worldbank.org).

On the private sector side, the main corporate governance champions include:

- Standard & Poor's (see also www.standardandpoors.ru);
- Troika Dialog (see also www.troika.ru).

Finally, there are numerous non-governmental initiatives that aim to promote corporate governance, namely:

- the Institute of Corporate Law and Governance (see also www.iclg.ru);
- the Russian Institute of Directors (see also www.rid.ru);
- NAUFOR (see also www.naufor.ru);
- the Investor Protection Association (see also www.corp-gov.ru);
- the Independent Directors Association (see also www.naid.ru);
- the Russian Institute of Market Participants and Management (see also www.ismm.ru).

More detailed information on corporate governance in Russia can be found on IFC's Russia Corporate Governance Project Web site under www.ifc.org/rcgp/.

## Appendix 5

# Standard & Poor's Issues Russian Transparency and Disclosure Survey

*Standard & Poor's RatingsDirect*

In September 2002, Standard & Poor's Ratings Services published its transparency and disclosure study on 42 Russian companies, including the 18 companies in the S&P/IFCG Index and 24 of the largest companies in Russia. Although the 42 companies represent about 98 per cent of Russia's total market capitalization, only the shares of the 10 largest can be considered liquid.

Most companies in this index have very concentrated ownership structures – more than 50 per cent are controlled by one or more connected shareholders. This is a result of the process by which these companies were privatized in the 1990s. This type of ownership structure appears to influence the level of transparency of Russian companies. The survey is a research project by Standard & Poor's. It is based on public information alone, and should not be compared with Standard & Poor's Corporate Governance Scores, which measure the corporate governance standards of companies via an interactive analytical process using both public and non-public information.

The survey primarily analyses disclosure from an international investor's perspective and measures the inclusion of 98 items relating to:

- ownership structure and investor relations;
- financial and operational information;
- board and management structure and processes.

This is the fourth phase of Standard & Poor's transparency and disclosure study. Previous phases of the study include companies in the following Standard & Poor's indices:

- S&P/IFC Emerging Asia;
- S&P/IFC Latin America;
- S&P Asia-Pacific 100;
- S&P/TOPIX 150 (Japan).

The studies are based on an analysis of the documents that are most commonly available to investors (typically English and local language annual reports). In certain cases, including that of Russia, regulatory filings have been used where these are the primary public reference document. The fourth phase used data for Russian companies until 13 August 2002.

The survey highlights the differences in Russian companies' disclosure levels. The top two companies in the study, JSC Mobile Telesystems (MTS; B+/Stable/–) and Wimm-Bill-Dann, reported more than 70 per cent of the items analysed, which is comparable with disclosure levels in many Western European companies. YUKOS, Vimpelcom B.V., Golden Telecom, and Rostelecom (B-/Stable/–) reported on about 50 per cent of disclosure items. The remaining 36 companies have significantly lower levels of disclosure, with the bottom three disclosing just over 10 per cent of items. This demonstrates the Russian approach to transparency, which can be partly attributed to ownership structures, but also to legal, cultural, and educational differences.

In comparison, companies in the Japanese study had average disclosure levels of between 50 per cent and 75 per cent; 80 per cent of companies in the S&P Asia-Pacific 100 disclosed 40–85 per cent of analysed items. At 34 per cent, the average disclosure level for Russian companies falls short of the leaders in the Asia-Pacific and emerging Asia regions, and is comparable only with disclosure levels in Latin America, the region with the lowest scores to date.

The key findings of the fourth phase include:

- The weakest aspect of disclosure is executive remuneration, at an average of 11 per cent. Only two companies, Golden Telecom and MTS, scored more than 50 per cent in this area.
- Of the largest 42 companies, 26 produce financial reports in accordance with internationally recognized standards, and as of 14 August 2002, 18 of these companies had published financial reports for 2001, not all of which were accompanied by substantial comments.
- Twenty-four of the companies scored 50 per cent or more in operations.

- With average disclosure levels of 59 per cent, telecommunications is the most transparent Russian industry.

A further study of Russian companies' market valuations showed a positive correlation between the level of transparency and the valuation coefficients. Although transparency is obviously not the only

**Table A5.1** Results of Russian Transparency and Disclosure Survey

| | | *Total* | *Block 1* | *Block 2* | *Block 3* |
|---|---|---|---|---|---|
| 1 | MTS | **77%** | 77% | 79% | 75% |
| 2 | Wimm-Bill-Dann | **73%** | 83% | 80% | 56% |
| 3 | YUKOS | **52%** | 40% | 67% | 45% |
| 4 | Vimpelcom | **49%** | 33% | 77% | 26% |
| 5 | Golden Telecom | **49%** | 18% | 73% | 48% |
| 6 | Rostelecom | **48%** | 52% | 56% | 35% |
| 7 | Sibirtelecom | **45%** | 46% | 50% | 38% |
| 8 | MGTS | **45%** | 41% | 55% | 35% |
| 9 | Lukoil | **44%** | 42% | 57% | 30% |
| 10 | RAO UES | **43%** | 41% | 52% | 33% |
| 11 | North-West Telecom | **42%** | 49% | 39% | 39% |
| 12 | Norilsk Nickel | **42%** | 35% | 47% | 40% |
| 13 | Sibneft | **43%** | 29% | 56% | 39% |
| 14 | Lenenergo | **39%** | 44% | 36% | 37% |
| 15 | Mosenergo | **39%** | 32% | 52% | 28% |
| 16 | Bashkirenergo | **38%** | 40% | 39% | 36% |
| 17 | Center Telecom | **38%** | 41% | 35% | 39% |
| 18 | Samaraenergo | **38%** | 32% | 41% | 39% |
| 19 | Aeroflot | **36%** | 27% | 49% | 27% |
| 20 | MMK | **36%** | 40% | 37% | 30% |
| 21 | Surgutneftegaz | **34%** | 23% | 47% | 26% |
| 22 | Tatneft | **33%** | 21% | 53% | 17% |
| 23 | Volga Telecom | **30%** | 32% | 34% | 23% |
| 24 | Irkutskenergo | **30%** | 21% | 41% | 23% |
| 25 | Uralsviazinform | **29%** | 30% | 27% | 31% |
| 26 | South Telecom | **29%** | 27% | 35% | 24% |
| 26 | Sberbank | **28%** | 19% | 39% | 20% |
| 28 | Baltika | **27%** | 22% | 41% | 12% |
| 29 | Gazprom | **26%** | 30% | 23% | 27% |
| 30 | UHM | **26%** | 20% | 35% | 20% |
| 31 | TNK | **26%** | 25% | 32% | 18% |
| 32 | Krasnoyarskenergo | **25%** | 25% | 25% | 26% |
| 33 | Severstal | **25%** | 23% | 26% | 26% |
| 34 | Permenergo | **23%** | 28% | 20% | 22% |
| 35 | Sverdlovenergo | **31%** | 38% | 27% | 28% |
| 36 | Bashinformsvyaz | **21%** | 19% | 22% | 23% |
| 37 | GUM | **19%** | 17% | 20% | 19% |
| 38 | Rostovenergo | **17%** | 15% | 17% | 18% |
| 39 | Red October | **15%** | 12% | 17% | 13% |
| 40 | Kuzbassenergo | **14%** | 10% | 17% | 15% |
| 41 | AvtoVAZ | **14%** | 11% | 18% | 13% |
| 42 | GAZ | **10%** | 9% | 9% | 12% |

**Table A5.2** Standard & Poor's Company Transparency and Disclosure Survey, 2002

| *Overall decile ranking* | *Company Name (in alphabetical order within decile)* | *Country* | *Industry (Based on GICS*)* | *Sub-categories decile ranking: Sub-category I** Ownership Structure and Investor Relations (total 28 attributes)* | *Sub-category II** Financial Transparency and Information Disclosure (total 35 attributes)* | *Sub-category III** Board and Management Structure and Processes (total 35 attributes)* |
|---|---|---|---|---|---|---|
| 10 | – | – | – | – | – | – |
| 9 | – | – | – | – | – | – |
| 8 | MTS | Russia | Telecommunication services | 8 | 8 | 8 |
| **8** | Wimm-Bill-Dann | Russia | Consumer staples | 9 | 9 | 6 |
| **6** | Yukos | Russia | Energy | 5 | 7 | 5 |
| **5** | Vimpelcom | Russia | Telecommunication services | 4 | 8 | 3 |
| **5** | Golden Telecom | Russia | Telecommunication services | 2 | 8 | 5 |
| **5** | Rostelecom | Russia | Telecommunication services | 6 | 6 | 4 |
| **5** | Sibirtelecom | Russia | Telecommunication services | 5 | 6 | 4 |
| **5** | Lukoil | Russia | Energy | 5 | 6 | 4 |
| **5** | Moscow City Telephone | Russia | Telecommunication services | 5 | 6 | 4 |
| **5** | Sibneft | Russia | Energy | 5 | 6 | 4 |
| **5** | UES | Russia | Utilities | 5 | 4 | 4 |
| **5** | North-West Telecom | Russia | Telecommunication services | 4 | 5 | 5 |
| **5** | MMC Norilsk Nickel | Russia | Materials | 3 | 6 | 4 |
| **4** | Lenenergo | Russia | Utilities | 5 | 4 | 4 |
| **4** | Mosenergo | Russia | Utilities | 4 | 6 | 3 |
| **4** | Samaraenergo | Russia | Utilities | 4 | 4 | 4 |
| **4** | Bashkirenergo | Russia | Utilities | 5 | 4 | 4 |
| **4** | Centre Telecom | Russia | Telecommunication services | 4 | 5 | 4 |
| **4** | Aeroflot | Russia | Consumer discretionary | 3 | 5 | 3 |
| **4** | MMK | Russia | Materials | 5 | 4 | 3 |
| **4** | Surgutneftegas | Russia | Energy | 3 | 5 | 3 |

**Table A5.2** Standard & Poor's Company Transparency and Disclosure Survey, 2002 (continued)

| *Overall decile ranking* | *Company Name (in alphabetical order within decile)* | *Country* | *Industry (Based on GICS*)* | *Sub-categories decile ranking: Sub-category I** Ownership Structure and Investor Relations (total 28 attributes)* | *Sub-category II** Financial Transparency and Information Disclosure (total 35 attributes)* | *Sub-category III** Board and Management Structure and Processes (total 35 attributes)* |
|---|---|---|---|---|---|---|
| **4** | Tatneft | Russia | Energy | 3 | 6 | 2 |
| **4** | Sverdlovenergo | Russia | Utilities | 4 | 4 | 3 |
| **4** | Irkutskenergo | Russia | Utilities | 3 | 5 | 3 |
| **3** | Volga-Telecom | Russia | Telecommunication services | 4 | 3 | 4 |
| **3** | Southerntelecom | Russia | Telecommunication services | 3 | 4 | 3 |
| **3** | Uralsviyazinform | Russia | Telecommunication services | 2 | 4 | 3 |
| **3** | Sberbank | Russia | Financial | 3 | 5 | 2 |
| **3** | Gazprom | Russia | Energy | 3 | 3 | 3 |
| **3** | Baltika | Russia | Consumer staples | 2 | 4 | 2 |
| **3** | *UHM* | Russia | Industrials | 3 | 4 | 2 |
| **3** | TNK | Russia | Energy | 3 | 3 | 3 |
| **3** | *Krasnoyarskenergo* | Russia | Utilities | 3 | 3 | 3 |
| **3** | Severstal | Russia | Materials | 3 | 3 | 3 |
| **3** | *Permenergo* | Russia | Utilities | 4 | 3 | 3 |
| **3** | *Bashinformsvyaz* | Russia | Telecommunication services | 2 | 3 | 3 |
| **2** | GUM | Russia | Consumer discretionary | 2 | 3 | 2 |
| **2** | Rostovenergo | Russia | Utilities | 2 | 2 | 2 |
| **2** | *Kuzbassenergo* | Russia | Utilities | 2 | 2 | 2 |
| **2** | *Avtovaz* | Russia | Industrials | 2 | 2 | 2 |
| **2** | Red October | Russia | Consumer staples | 2 | 2 | 2 |
| **2** | *GAZ* | Russia | Industrials | 1 | 1 | 2 |

Survey cut off date: 13 August 2002. *Global Industry Classification standard. **As percentage of total sub-category. Note: Companies in *italics* were assessed on the basis of native language annual reports only.

factor that adds value, it is an important one, since, by improving transparency, companies can increase added value.
Standard & Poor's Transparency and Disclosure Survey is available on Standard & Poor's Web-based credit analysis system at www.ratingsdirect.com. It is also available on Standard & Poor's Web site at www.standardandpoors.com. Under Forum, click on Ratings Analysis, then Corporate Governance, and then on Index.

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# Appendix 6

# Accounting Changes Should Improve Russian Reporting

*Standard & Poor's, RatingsDirect*

In a move that should improve transparency in financial reporting and provide management with better information, the Russian Government will make International Accounting Standards (IAS) mandatory for all banks and corporations by the beginning of 2004. Better transparency for Russian and international investors will improve access to financial markets. By implementing the same standards that will be used in the European Union, Russian banks and corporations should boost their image in Western financial markets. The international standards are also more appropriate for effective management. Information about internal cash flows and profitability, rather than just the tax-reporting data generated by the current Russian accounting requirements, should enable firms to better manage their businesses.

Prime Minister Mikhail Kasyanov has ordered the Ministry of Finance to develop instructions for the new accounting requirements by January 2003, which would give businesses a year to make the necessary adjustments before the standards come into effect. A January 2004 implementation date in Russia would put it ahead of the European Union, which will make the IAS mandatory in 2005, with extensions likely until 2007 for companies with secondary listings on stock exchanges beyond the European Union.

The Russian schedule is quite ambitious and there is some scepticism about how achievable the dates are. But even if it slips some, the main goal is to get companies moving toward an accounting system that has some real utility for managers, as well as providing a new level of transparency. Although there has been some movement toward international standards over the last several years, evidenced by the adoption of a number of new regulations that are closer to IAS than to the old Soviet-style tax accounting, much remains to be done. Banks and companies will have to completely change the way their accounting departments work. This is a huge task and a dramatic change for Russia's corporate and bank sector, since only a small portion now have IAS or GAAP accounts.

Regulatory changes will require amending existing laws that govern accounting or legislating new ones. Establishing the legal foundation for an effective financial reporting framework will take some time. Currently most companies use Russian accounting standards, which are legally required for tax and reporting purposes. The Russian regulations differ significantly from either IAS or US GAAP: in their focus on taxes; their treatment of critical areas such as asset valuation, consolidation, revenue recognition, and disclosure; and their emphasis on legal form rather than the economic substance of transactions. Banks and corporations doing business in Western markets (or hoping to) prepare a second set of financial statements using either IAS or US GAAP. The switch will benefit these companies by reducing their overhead and allowing for earlier disclosure, since they will no longer need to spend time and money restating Russian financial reports to comply with Western accounting standards.

The major Russian banks, numbering about 30, are already using IAS, and most of the Russian corporations rated by Standard & Poor's have prepared statements using either IAS or US GAAP. The major downside to IAS is that there is not a huge cadre of Russian accountants who understand it. And bank systems are not geared to producing this kind of information. It's going to take years of training to get up to speed on IAS accounting in Russia.

The Russian decision to go with IAS over US GAAP will buoy critics of the US standards. They contend that the principles-based IAS would have uncovered the accounting issues now plaguing some major US companies more quickly than the rules-based US GAAP did.

There are problems with both approaches, however. The IAS guidelines could be misinterpreted, or interpreted in a manner that appears most favourable to the reporting entity. Sometimes it's good to have rules. Underscoring that IAS should *not* be viewed as infallible, Standard & Poor's Managing Director, Barbara Ridpath, instead highlighted 'the virtues of international comparability and improved transparency as the key benefits of the switch to IAS in Russia.'

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# Appendix 7

# Russia's Rouble Bond Market Cries Out for a Stronger Credit Culture

*Standard & Poors*

Although the rouble bond market has added a new dimension to Russia's capital markets – it still displays the characteristics of an underdeveloped market. Specifically, credit risk is not well differentiated on the basis of good fundamental analysis and refinancing risk is high due to the very short maturity characteristics of debt issues. Therefore, until risk is better understood and managed by investors, the smooth functioning of the market will remain particularly vulnerable to unexpected defaults and other events that shake market confidence.

With the underdeveloped Russian banking system only able to provide limited alternative funding in the event of a liquidity shortage in the bond market, it is crucial for Russia's economy that the rouble bond market develops a strong credit culture at the earliest opportunity. This will enable investors to be more fairly compensated for risk and allow the market to cope with issuer defaults.

To date, there have not been any defaults on publicly placed rouble bonds due to Russia's currently favourable macroeconomic situation, the market's small number of issuers, and its short history. Even the petrochemical holding company Sibirsko-Uralskaya Neftegasokhimicheskaya Kompania (Sibur), which was on the brink of default in December 2001, paid its bonds in full and on time after a cash infusion by its parent, OAO Gazprom (B+/Stable/–), just before the due date. The rouble bond market's lack of defaults does not mean that the risks are low, however. Rather, it reflects that credit quality has yet to be tested.

## Short-Dated Market Increases Risk

Bond pricing largely reflects the market's familiarity with issuers' names or brands. Comfort is derived from the short duration and perceived liquidity of issues rather than a comprehensive analysis of issuer credit quality. In reality, the short maturity profile of the market and frequent put options on bonds make the rouble bond market more vulnerable to refinancing risk in the event of surprise defaults or other shocks. Although investors perceive that put options every six or 12 months – a common feature of rouble bonds – will mitigate risk, such options increase the risk of a liquidity crisis for individual issuers, often at the time when they would most benefit from stable funding. These options also increase the likelihood of contagion that leads to a loss of confidence by rouble bondholders and the subsequent contraction in funding that affects all issuers after an unsettling market event.

## Oversimplified Investment Criteria Leave Bondholders Exposed

Rouble bond investors, encouraged by good payment records over the three years that Russia's capital markets have been functioning, largely make their investment decisions using dangerously oversimplified criteria. These include:

- issuer name: typically, investors will consider a potential issuer that is well-known and perceive that as everybody knows its name or brand, it should always pay in full and on time;
- size: generally, investors will believe that a big issuer will always find some money to repay its debt;
- sector: typically, investors will look at currently profitable sectors such as oil and gas or metals and mining and believe that all companies in these sectors will be capable of providing a good return;
- underwriter names: if major investment banks are assisting the issuer in a bond placement, investors believe that there should be no problem with debt repayment;
- credit history: typically, investors will infer that if an entity has previously paid on its bonds, it will continue to pay on future issues.

Although such information might prove useful and is easy to obtain, it is insufficient for comprehensive credit risk analysis or a firm basis for investment and pricing decisions. As recent experience in the international telecommunications, media, and technology sectors demonstrates, large well-known borrowers and fashionable industry sectors can run into problems. Similarly, the use of major underwriters may help assure a good level of disclosure and due diligence, but they offer no guarantee of the issuer's principal and interest. Equally, although an issuer's credit history can be material, good credit analysis includes many other factors that accentuate and mitigate risk in order to develop a forward-looking assessment of the issuer's credit quality. This is particularly true in an economy as dynamic as that of Russia.

## Credit Ratings and Greater Transparency Are Key to Better Bond Pricing

Emerging markets such as Russia that have seen rapidly changing conditions and development can accelerate the creation of a credit culture by utilizing credit ratings and research based on transparent criteria and methodology that are validated by broad, long-term statistical studies.

Credit ratings reflect the level of credit risk – that is, the probability of issuer default – and Standard & Poor's empirical data on global default statistics stretches back 20 years. Ratings performance is tracked in groupings called static pools, which are formed on the first day of each calendar year (see table A7.1). These pools, which comprise issuers, not issues, compare members' ratings on the first and last days of each calendar year. Intermediate rating actions are ignored and companies that default, or whose ratings are withdrawn, are excluded from subsequent pools.

**Table A7.1** Static Pools Cumulative Average Annual Default Rates (%)*

| | *Year 1* | *Year 2* | *Year 3* | *Year 4* | *Year 5* |
|---|---|---|---|---|---|
| AAA | 0.00 | 0.00 | 0.03 | 0.07 | 0.10 |
| AA | 0.01 | 0.03 | 0.08 | 0.16 | 0.26 |
| A | 0.05 | 0.14 | 0.24 | 0.40 | 0.57 |
| BBB | 0.26 | 0.61 | 0.98 | 1.56 | 2.15 |
| BB | 1.20 | 3.43 | 6.06 | 8.40 | 10.46 |
| B | 5.93 | 12.63 | 18.17 | 22.18 | 24.95 |
| CCC | 24.64 | 33.06 | 38.37 | 42.55 | 46.80 |

*Data represent annual default rates between January 1 to December 31 and do not include year-to-date defaults.

*Source: Standard & Poor's Risk Solutions CreditPro® 6.0.*

There are no short cuts in terms of the disclosure, research, and analytical effort required to make good credit decisions. Applying globally proven criteria and methodology to analyze credit risk in Russia, however, facilitates the accelerated development of a healthy credit culture. And although credit risk is not the only factor affecting the pricing of bonds, developed fixed-income markets do show a strong correlation between pricing and risk, witness the average spreads of rated bonds in the European market (see table A7.2).

**Table A7.2** European Bond Spreads in 2002

| *Issuer credit rating* | *Bond spread* (basis points)* |
|---|---|
| AA | 30–50 |
| A | 55–90 |
| BBB | 150–220 |
| BB | 400–700 |

*Data cover period between March and August 2002.
*Over LIBOR swaps.
*Source: Bloomberg Generic Pricing.*

Future default rates for the small sample of issuers in Russia are likely to deviate from the European and global averages because of the relationship between the national economy and major industry sectors. Specifically, large segments of the economy are likely to prosper or decline in tandem. This, coupled with the dynamic nature of Russia's economy, is likely to prompt periodic reassessments and adjustments to issuer ratings. Nevertheless, although objective assessments of credit quality will change over time based on new information, such assessments provide a better basis for investment decisions than the familiarity of a name or other proxies for in-depth analysis.

There is no clear correlation between yield and credit risk in the Russian rouble bond market at present, mainly because of widespread name-based lending, the limited market size (less than $3 billion), and the liquidity of the secondary market. Anecdotal evidence shows that little correlation exists between market access or yield and objective credit risk proxies such as the credit rating level or the lack of a credit risk proxy (unrated issuers, for example). At present, favorable market sentiment enables most issuers to refinance issues that mature or are 'put' back to them. Over the longer term, issuers should not count on this environment being sustained. A stronger credit culture would help deepen and broaden the market by attracting more sophisticated investors looking for a fair trade-off between risk and reward. This would benefit both issuers and investors alike.

## Defaults May Speed Path to a Stronger Credit Regime

The short-dated nature of Russia's rouble bond market – compared with the long-term, capital-intensive assets financed by issuers – in combination with inadequate risk assessment, has the potential to turn a future economic downturn, or market shock such as an unexpected default, into a general liquidity crunch. Ideally, a rational credit culture will develop quickly and Russia's capital markets will learn to better recognize and price for the risk of default before the event occurs. The 1998 crisis triggered by the sovereign default on The Russian Federation (BB-/Stable/B), and similar experiences in other emerging markets, however, run counter to this maxim. Markets usually need to experience defaults before they learn to anticipate them. Paradoxically, in the current environment where sentiment remains generally positive and the economy continues to grow, a default on a rouble bond – which is a strong possibility, given the number of speculative-grade and unrated issuers in the market – could be healthy in the longer term if it accelerates the development of a stronger credit culture in Russia.

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## Appendix 8

# Supporting British Companies in Russia: Trade Partners UK

*Russia Unit, Trade Partners UK*

British Trade International was established in 1999 as the British Government's trade and investment organization. It operates through two arms, Trade Partners UK, which assists UK companies selling in overseas markets, and InvestUK, which helps foreign companies locate in the United Kingdom. Trade Partners UK's services are focused on helping small and medium-sized British companies with day-to-day practical help and assistance to ensure that business is well placed to respond to market movements and developments in order to meet the challenges of an increasingly competitive global marketplace.

The British Government is firmly committed to encouraging UK companies to investigate the Russian market, which represents a vast potential market for UK goods and services. Particular sectors where Russian needs are matched by UK expertise are: food and drink, IT and telecoms, processing and packaging machinery, furniture and furnishings, clothing and fashion, construction, oil and gas, security services, education, textiles, and metals and mining equipment.

The Russian Government has made an admirable effort to stabilize the economy and to put in place a more sound legal base since the 1998 economic crisis, and market conditions have improved markedly over the last couple of years. Companies from all over the world are now discovering the potential of Russia and it is important that the United Kingdom is not left behind.

There is a dedicated team at Trade Partners UK's Russia Unit (Tel: +44 (20) 7215 8445, e-mail: exportinfo.russia@tradepartners.gov.uk). We work closely with Trade Partners UK colleagues at the British Embassy in Moscow and the British Consulates General in

St Petersburg and Ekaterinburg. We respond to enquiries from a wide range of companies seeking anything from basic information about Russia to detailed market analyses; we address seminars at trade associations, talk to chambers of commerce, and give briefings to members of trade missions bound for Russia. We are also in regular contact with the international trade teams based at the Business Links around the United Kingdom.

The Trade Partners UK teams in Moscow, St Petersburg and Ekaterinburg comprise approximately 15 people in total, a mixture of UK and local staff. All the local staff speak excellent English. As well as having good general knowledge of the local rules, regulations and practices affecting exporters to Russia, they have each developed particular expertise in various sectors and useful contacts in local businesses. This can be of immense value to UK companies intending to get involved in the market. The teams can give general advice, assist with arranging visit programmes and facilities for meetings, and provide specific advice on particular business opportunities.

A large amount of useful information about business conditions in Russia, opportunities, ways of approaching the market, customs rules, establishing a presence, whom to contact, etc is available from the Trade Partners UK Web site – certainly a useful starting point for any research. Visit www.tradepartners.gov.uk/russia. The site incorporates an events database and links to other useful Web sites.

### *Some free or cost-effective schemes that TPUK runs*

The Sales Lead Service provides access to potential opportunities identified by our teams in Russia and other sources. Information is tailored to the requirements of individual firm and is delivered using the Internet/e-mail. The UK Suppliers Database is used by international buyers looking to source products and services from the United Kingdom. For further information and to register visit www.tradepartners.gov.uk.

Two of the best ways to explore the Russian market are to visit as part of a Trade Partners UK supported trade mission, or to participate in a supported trade fair or exhibition. Trade fairs and exhibitions have always played an important part in the Russian business calendar (Russian businesspeople favour face-to-face meetings) and a wide range take place every year. For further information on supported events visit our Web site at www.tradepartners.gov.uk/russia/events.

Trade Partners UK's Russia Unit in London publishes a quarterly e-bulletin highlighting recent developments, trade statistics and forthcoming events, including seminars in the United Kingdom on Russian business. It is e-mailed to British companies free of charge. To subscribe, e-mail your company details and areas of interest to exportinfo.russia@tradepartners.gov.uk.

A UK company may (through its local Business Link) decide to commission a Tailored Market Information Report (TMIR) from one of Trade Partners UK's commercial teams in the Embassy or Consulates in Russia. A TMIR, as its title implies, is a focused document produced after research by the commercial team into the likely level of interest in Russia in the product or service the UK company is proposing to offer and into likely customers. The commercial team makes initial contact with possible customers and reports on those contacts – that, it is hoped, will lead to fruitful meetings or further contact. A charge is made to the UK company for a TMIR.

Other useful Web sites are the British Embassy in Moscow at www.britemb.msk.ru (included on this is access to the monthly economic report on Russia produced by the Embassy), and the British Consulates General in St Petersburg at www.britain.spb.ru and in Ekaterinburg at www.britain.sky.ru.

In summary, Trade Partners UK has a considerable fund of knowledge and expertise regarding the Russian market, and is ideally placed to keep abreast of the latest political, economic and commercial developments. Russia is perceived as a market offering great potential for the future, and it is hoped that companies, chambers of commerce and trade associations will take advantage of the assistance that Trade Partners UK actively offers.

## Appendix 9

# Extra Information for Chapter 3.16 The Insurance Industry

**Table A9.1** Major insurance companies, non-life segments, 2001

| *Company* | *Premiums, US$ mn* | *Payments, US$ mn* | *Sales margin, US$ mn* | *Sales margin, %* | *Segments in which co. is a top 10 player** | | | | | | | | | *Major owners* | *Prospects* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Compulsory | Legal-entity property | Liability | Voluntary medical | Cargo | Legal entity transport property | Private property | Accident and illness | Private transport property | | |
| **National Insurance Group** (16 branches, 122 agents) | 68 | 1 | 66 | 98 | | ✓ | | | | | | | | Organica Feinchemie GmbH (German chemical company), Russian state and private insurance and other companies | Uncertain: no Western expertise, investment situation unclear, although clearly very profitable at present, a major grey scheme player. Profitability indicator seems suspicious |
| **Lukoil Insurance** (5 branches, 10 agents) | 199 | 9 | 190 | 95 | | ✓ | | | ✓ | ✓ | | | | Lukoil | N/A: a captive with no real market orientation or inclination. Profitability indicator probably due to moving of money within the Lukoil structure |
| **Soglasie (ex-Interros Soglasie)** (34 branches, 133 agents) | 145 | 9 | 135 | 94 | ✓ | ✓ | ✓ | | ✓ | ✓ | ✓ | | ✓ | Interros (ex-captive) | Reasonable: solid investment backing from Interros group, brand name, but no Western expertise. Profitability indicator probably due to moving of money within the Interros structure |

| *Company* | *Premiums, US$ mn* | *Payments, US$ mn* | *Sales margin, US$ mn* | *Sales margin, %* | *Segments in which co. is a top 10 player** | | | | | | | | | *Major owners* | *Prospects* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Compulsory | Legal-entity property | Liability | Voluntary medical | Cargo | Legal entity transport property | Private property | Accident and illness | Private transport property | | |
| **Priroda** (2 branches, 0 agents) | 53 | 4 | 49 | 93 | | | ✓ | | | | | | | Dolgosrochni Investitsy Holding | Poor: niche player, but no Western expertise. Profitability indicator seems suspicious |
| **Progress Garant** (21 branches, 150 agents) | 78 | 11 | 66 | 85 | | | | ✓ | ✓ | | | | ✓ | Yukos (ex-captive) | Reasonable: investment forthcoming and market outlook, although no Western expertise, major grey scheme player. Profitability indicator probably due to moving of money within the Yukos structure |
| **Sibir** (5 branches, 78 agents) | 52 | 9 | 43 | 82 | | | | ✓ | ✓ | | | | | Slavneft (captive) | N/A: a captive with no real market orientation or inclination. Profitability indicator probably due to moving of money within the Slavneft structure |
| **Industrial Insurance Company (PSK)** (56 branches, 996 agents) | 63 | 12 | 52 | 81 | | | | | ✓ | ✓ | | ✓ | | NIKoil | Reasonable: potential to enjoy investment from new owners, NIKoil/Lukoil, but no Western expertise and ex-grey scheme player; is beginning bancassurance venture with Avtobank (also belonging to NIKoil), but currently at a very |

| *Company* | *Premiums, US$ mn* | *Payments, US$ mn* | *Sales margin, US$ mn* | *Sales margin, %* | *Segments in which co. is a top 10 player** | | | | | | | | | *Major owners* | *Prospects* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Compulsory | Legal-entity property | Liability | Voluntary medical | Cargo | Legal entity transport property | Private property | Accident and illness | Private transport property | | |
| | | | | | | | | | | | | | | | early stage of development; overall number one premium collector last year if salary grey schemes are taken into account. Profitability indicator seems suspicious – is probably linked to non-life insurance grey schemes |
| **Alfa Insurance** (48 branches, 795 agents) | 74 | 14 | 60 | 81 | | ✓ | ✓ | | | ✓ | | | ✓ | Alfa Group | Reasonable: potential to enjoy investment from Alfa Group, potential for bancassurance and national distribution, brand name, but no Western expertise and ex-grey scheme player |
| **RESO-Guarantee** (101 branches, 2,299 agents) | 102 | 28 | 75 | 73 | | ✓ | ✓ | | | ✓ | | ✓ | ✓ | Coris (French insurance broker and international assistance company) Chupa Chups (Spanish confectionery producer), Ingosstrakh, Sberbank and many others | Good: market orientation with foreign investment, some Western expertise, major grey scheme player |
| **MAKS** (11 branches, 627 agents) | 54 | 16 | 38 | 70 | | | | ✓ | | | ✓ | ✓ | | Over 100 different companies, including atomic industry, banks, metallurgy | Reasonable: well known in medical sphere, building up retail business, but no investment prospects or Western expertise |

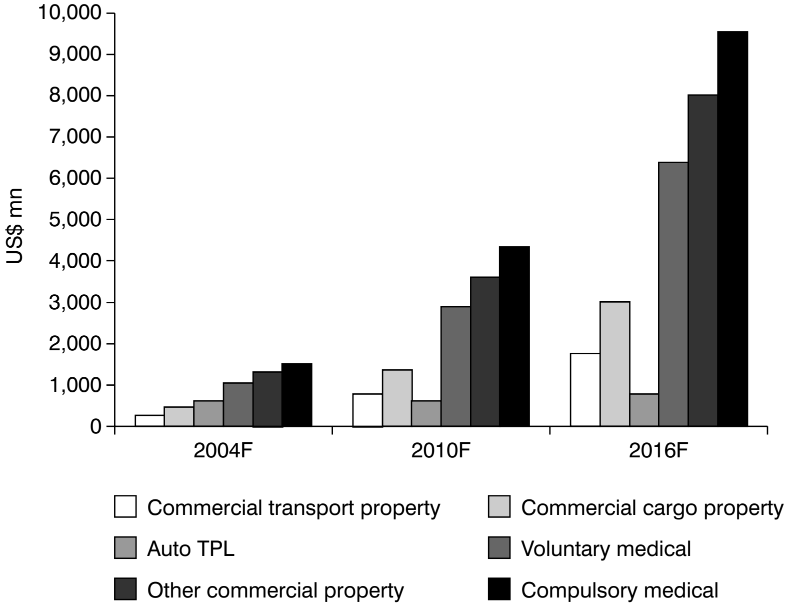
| Company | Premiums, US$ mn | Payments, US$ mn | Sales margin, US$ mn | Sales margin, % | Segments in which co. is a top 10 player* | | | | | | | | | Major owners | Prospects |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Compulsory | Legal-entity property | Liability | Voluntary medical | Cargo | Legal entity transport property | Private property | Accident and illness | Private transport property | | |
| **Rosgosstrakh** (155 branches, 36,736 agents) | 161 | 49 | 112 | 70 | | | ✓ | | | ✓ | ✓ | | ✓ | State, consortium fronted by Troika Dialog | Uncertain: investment forthcoming and market outlook, brand name, largest regional network in Russia, although no Western expertise; tension between 49 per cent consortium and 51 per cent state shareholders |
| **ROSNO** (77 branches, 2,691 agents) | 152 | 46 | 106 | 70 | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | Allianz, Sistema | Good: mixture of Western investment and potentially strong investment backing from both Allianz and Sistema, brand name, experience in long-term life. Has won accolade of 'most financially open insurance company' for three years in a row from the Financial Press Club of Russia, ex-grey scheme player |
| **Ingosstrakh** (41 branches, 1,431 agents) | 159 | 61 | 98 | 62 | | | ✓ | | ✓ | ✓ | | ✓ | ✓ | Consortium of SibAl, Millhouse Capital (ie Sibneft) and Nafta-Moskva | Good: potentially strong investment backing from both Sibal and Sibneft, strong brand name, but no Western expertise |

| *Company* | *Premiums, US$ mn* | *Payments, US$ mn* | *Sales margin, US$ mn* | *Sales margin, %* | *Segments in which co. is a top 10 player** | | | | | | | | | *Major owners* | *Prospects* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Compulsory | Legal-entity property | Liability | Voluntary medical | Cargo | Legal entity transport property | Private property | Accident and illness | Private transport property | | |
| **Sheksna** (1 branch, 23 agents) | 52 | 20 | 32 | 61 | ✓ | ✓ | | | | | | | | Severstal, Cheperovetskii Steel | Reasonable: good investment potential plus alliance with Vneshtorgbank |
| **Sogaz** (25 branches, 144 agents) | 96 | 41 | 55 | 57 | | ✓ | ✓ | ✓ | ✓ | | | ✓ | | Gazprom (captive) | N/A: a captive with no market orientation or inclination |
| **Military Insurance Company (VSK)** (90 branches 3,591 agents) | 83 | 36 | 47 | 56 | ✓ | | | | | ✓ | ✓ | ✓ | ✓ | Management | Reasonable: strong military-based niche, branching out, but no investment potential or Western expertise |
| **Surgutneftegaz Insurance Co.** (5 branches, 79 agents) | 49 | 22 | 26 | 54 | | | | ✓ | | | | | | Surgutneftegaz | N/A: a captive with no real market orientation or inclination |
| **SKPO** (51 branches, 911 agents) | 41 | 33 | 8 | 20 | ✓ | | | | | | | | | PSK (majority), state | Unclear: PSK may help, low profitability |
| **Gazprommedstrakh** (25 branches, 16 agents) | 81 | 70 | 11 | 14 | | | | ✓ | | | | | | Gazprom (captive) | N/A: a captive with no real market orientation or inclination, low profitability probably linked to internal Gazprom transactions |

| *Company* | *Premiums, US$ mn* | *Payments, US$ mn* | *Sales margin, US$ mn* | *Sales margin, %* | *Segments in which co. is a top 10 player** Compulsory | Legal-entity property | Liability | Voluntary medical | Cargo | Legal entity transport property | Private property | Accident and illness | Private transport property | *Major owners* | *Prospects* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **ROSNO-MS** (54 branches, 75 agents) | 88 | 83 | 5 | 5 | ✓ | | | | | | | | | ROSNO (Allianz, Sistema) | Reasonable: mixture of Western investment and potentially strong investment backing from both Allianz and Sistema, brand name, low profitability perhaps to do with high profitability of ROSNO itself |

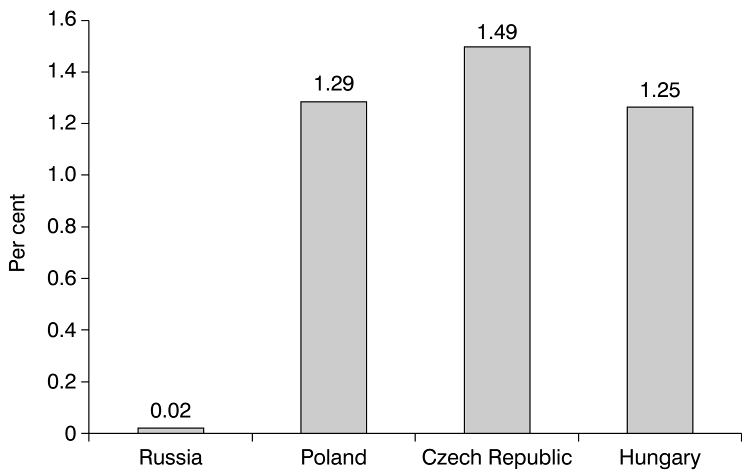
*Source:* Interfax, ARIA, UFG Research

*Legal-entity property excludes vehicles and cargo; liability refers to all forms of liability; compulsory refers to all forms of compulsory; private property excludes vehicles



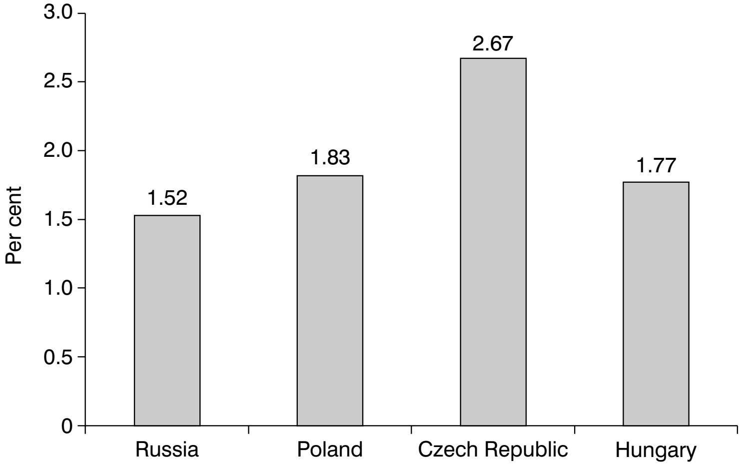

*Source:* UFG Research
*Note:* this includes 'captive' figures

**Figure A9.1** Main non-life segments, 2004–2016F




*Source:* national associations, UFG Research
*Note:* for Russia this includes only long-term life insurance

**Figure A9.2** Life insurance spend as a percentage of GDP, 2001




*Note:* for Russia this includes 'captive' figures

**Figure A9.3** Non-life insurance spend as percentage of GDP, 2001

**Table A9.1** Valuations of major Russian insurance companies (in US$ million)

| | *Premiums, 2008F* | *Sales margin, 2008F* | *Value* |
|---|---|---|---|
| PSK | 203 | 165 | 78 |
| Alfa Insurance | 237 | 192 | 90 |
| RESO-Guarantee | 329 | 240 | 112 |
| MAKS | 173 | 122 | 57 |
| Rosgosstrakh | 517 | 361 | 169 |
| ROSNO | 487 | 339 | 159 |
| Ingosstrakh | 510 | 314 | 147 |
| Sheksna | 168 | 103 | 48 |
| VSK | 268 | 151 | 71 |
| SKPO | 131 | 26 | 12 |
| **Total market value** | **12,565** | **7,036** | **3,299** |

*Source:* UFG Research

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