

CASSIDY & ASSOCIATES CIS

Creating opportunities. Solving problems.

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ABOUT CASSIDY & ASSOCIATES CIS

With leading practitioners in all key disciplines, Cassidy & Associates CIS works independently or in partnership with our Washington DC office which is ranked as one of the top government relations firms in the US --or with our Brussels' office which has extraordinary reach across Western and Eastern Europe, to offer a comprehensive list of strategic and tactical services that clients may require in the government relations and public policy arena.

We are often engaged to either create opportunities or solve problems and guide our clients through the governmental process, working jointly with the Presidential Administration, the Prime Minister's Office, the various Ministries and Agencies, and relevant committees of the Russian Parliament to influence legislative and regulatory proceedings.

Also, through our parent company the Interpublic Group of Companies, (NYSE: IPG), one of the world's leading communications service companies with 43,000 people working worldwide in 130 countries, Cassidy & Associates CIS offers a comprehensive and, when appropriate, integrated range of communications services to national, multinational and global clients throughout the world.

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NEWS

- ▶ Cassidy & Associates CIS joined forces in September 2005 with the International Tax and Investment Center (ITIC) to provide complimentary tax and government relations services to foreign and Russian clients. ITIC serves as a clearinghouse for tax and investment policy information and as a training institute for key policy makers in the former Soviet Union and other transition economies.
- ▶ Cassidy & Associates CIS works in partnership with its Brussels' office to offer extraordinary reach across Western and Eastern Europe and a comprehensive list of strategic and tactical services that clients require in the government relations and public policy arena.
- ▶ Elizabeth Bayles has joined Cassidy & Associates CIS Advisory Board to provide strategic consulting services in the US. She has been working closely with foreign governments, including Russia (USSR) since 1989-- to attract investors to the region.
- ▶ James S. Friedlander has joined Cassidy & Associates CIS' Advisory Board to provide communications services with the Brussels office.
- ▶ Cassidy & Associates DC celebrated its 30th anniversary as a leading government relations firm in the US and its 2nd anniversary as principle lobbyists in Russia
- ▶ Viacheslav Tabachnikov, Cassidy & Associates CIS' Director spoke at the Moscow Time's 3rd Annual PR roundtable discussion: "PR-campaigns of the Year 2005" on September, 27, 2005.
- ▶ Peter Ordjhonikidze, Cassidy & Associates CIS' Managing Partner and expert on lobbying in Russia spoke on international lobbying practices at the Government Relations Committee meeting of the Russian Managers Association on February 11, 2005 and at the Strategic PR Forum on April 19, 2005

EVENTS

January, 2006 - "Basic Tendencies for Doing Business in Russia in 2006"
Association of European Businesses, Corporate Governance Working Group

POLICY

Putin Reshuffles Cabinet, Promotes Potential Successors

On November 14th, 2005, a surprise cabinet shake-up has fueled speculation that President Putin is seeking to increase his allies', Ivanov's and Medvedev's, visibility and test their performance ahead of the next presidential election.

In a rare government reshuffle, since May, 2004, when the current structure of state bodies was formed, President Vladimir Putin promoted Defense Minister Sergei Ivanov to Deputy Prime Minister. He also appointed his chief of staff, Dmitrii Medvedev, as First Deputy Prime Minister. The shake-up has fueled speculation that Putin is seeking to lift the profile of two of his trusted allies ahead of the 2008 presidential elections.

Both Ivanov and Medvedev are trusted allies of Putin and are seen as possible successors to Putin after he steps down in 2008 at the end of his second and last term. The Russian Constitution bars presidents from seeking three consecutive terms, although there has been speculation that it could be amended to allow Putin to remain president. Medvedev studied with Putin at St. Petersburg's law faculty and he is also the chairman of the Russian gas giant, Gazprom.

Putin announced the changes during a cabinet meeting, part of which was broadcast on Russian television. He said that Sergei Ivanov will retain his duties as Defense Minister and added that his appointment as Deputy Prime Minister is aimed at reforming Russia's armed forces. Ivanov's task will also be to coordinate the work of the agencies engaged in military policy: the Federal Industrial Agency, the Federal Service on Defense Order with the Defense Ministry as well as the Directorate of Weapons.

Although formally downgraded, Dimitri Medvedev has actually gained additional power. He has been assigned as the Deputy Head of the Presidential Council on the Implementation of National Projects, chaired personally by the President. The Council is in charge of working out and implementing strategies in four areas: health, education, residential housing and agriculture.

Currently, the new entity filled with ministers of the social block, some regional governors, and representatives of academic circles form a kind of parallel government without subordination to the Prime Minister. Even though formally placed under Prime Minister Mikhail Fradkov, Mr. Medvedev actually oversees the implementation of the top-priority national projects which will be allotted over 500 bln rubles in the next three years. At the new post in the government he will also apply his experience as the Chair of the Board of the state-controlled monopoly Gazprom and will supervise the energy sector.

Some political analysts do not exclude further changes in the cabinet, and there has been some speculation that Prime Minister Mikhail Fradkov, who is regarded by many as lacking charisma and political ideas, could soon be replaced. Medvedev is regarded as his potential successor.

However, Prime Minister Fradkov is reluctant to lose power. In his order on the distribution of duties among his deputies he significantly extended the scope of responsibilities of Mr. Naryshkin, the Chief of the Government Office (of minister rank). He will oversee the administrative reform and civil service, management of the federal property, policies in the spheres of industrial development, and innovations and international relations. More importantly he has been assigned to carry out interagency endorsements. In fact, Mr. Naryshkin, loyal to the Prime Minister, has become the fourth Deputy Prim-Minister. In such a way Mr. Fradkov tries to recover his own position after having two deputies appointed from outside.

Another maneuver was carried out by Prime Minister Fradkov when he kept his position on key governmental commissions. He headed a new Commission on the Development of the Energy Complex and a Commission on Military-Industrial Issues. This is the testament of his intention to continue overseeing the areas assigned to Mr. Medvedev and Mr. Ivanov correspondingly. The former will head the Commission on Intellectual Property and the latter – the Maritime Commission which are not of top priority.

Prime Minister Fradkov's attempts to retain actual control will hardly be successful. Most observers state that this is the beginning of the campaign which will promote Putin's heir. It means that with equal degree of probability it could be Medvedev or Ivanov depending on the trends in public perception. The former is a manager with liberal views but has not formally announced his intention of becoming a public politician. The latter is a representative of the "force wing" which adheres to a tough style of administration.

In the reshuffling, Medvedev will be replaced by Sergei Sobyenin, governor of oil-rich Tyumen Oblast, in Siberia. Putin said Sobyenin's appointment reflected Siberia's vital role in the Russian economy. Mr. Sobyenin proved himself as one of the most loyal governors when participating in the implementation of the municipal reform. He has good relationships in the oil sector through TNK-BP structures, currently engaged in a few projects in his region, and could be probably promoted by the lobbying canals of "the Alfa-Group". Though the new position is too demanding for his previous experience, the Presidential Administration will not lose its political currency due to the influential Deputy Heads, Mr. Sechin and Mr. Surkov who retained their posts.

A number of presidential envoys were also replaced as part of the reshuffle. Putin's envoys to the Volga and Far Eastern federal districts, Sergei Kirienko and Konstantin Pulikovskii, were dismissed from their posts. They were replaced respectively by Aleksandr Konovalov, a former prosecutor-general of Russia's Republic of Bashkortostan, and Kamil Iskhakov, a former mayor of the city of Kazan.

Later Mr. Kirienko was appointed as Head of the Russian Nuclear Agency. Perhaps, Mr. Kirienko, being an outsider, will manage to reform the nuclear complex, a task in which his predecessor, Mr. Rummyantsev, did not succeed. Curiously, Mr. Pulikovskii headed the Federal Service on Industrial, Environmental and Nuclear Control which oversees the Nuclear Agency. He stressed his plans to focus on the environment protection and restriction of penalties for the environmental offenses.

Interagency Conflict: Federal Fund of Federal Property & Federal Property Agency Suspend Privatization Process

The conflict between agencies engaged in privatization procedures in the first half of the year caused the suspension of privatization process and revealed a struggle for power inside the economic block of the government.

Earlier the Federal Property Agency, manager of state property, was to transfer the managerial powers to the Russian Fund of Federal Property after the enrolling of a certain asset in the privatization plan for the next year. However, at the end of 2004 the government deprived the Fund of the right to manage state property intended for privatization and limited its powers to arranging auctions and the selling of the state-owned assets. Unless there is change, the privatization process has ceased: the Fund refused to arrange auctions without having the blocks of shares from the Agency in accordance with the old statute. The Agency refused to transfer the shares to the Fund anticipating delays in the privatization procedures by the Fund which is interested in benefiting from the management of state assets.

Furthermore, the head of the Agency, Mr. Nazarov, supported by Mr. Gref, the Minister of Economic Development and Trade, offered to eliminate the monopoly right of the Fund to sell the federal property. His idea was to allow private companies to arrange tenders or to sell out the state shares on stock exchanges with the help of investment funds. In March, Prime Minister Fradkov refused this initiative, but three months later the Agency had some success. The Ministry of Economic Development and Trade introduced to the Government a number of amendments to the Fund's statute considerably reducing its powers. It will retain the responsibilities of ordering the appraisal of the asset, arranging a tender and transferring the shares to the winner. After 2007, the Fund will not have the right to set a commission fee (about 3% of the asset price) Therefore, it will lose its independent finance source and will be financed from the federal budget like all the other public agencies. Another privatization-related idea promoted by Mr. Gref is "stock shops" where an individual will be able to buy shares of state-owned enterprises. But this all shall be amended in the Privatization Law.

Nevertheless, the necessary changes to the statute of the Fund have not been adopted as of yet by the Prime Minister backing Mr. Petrov, the Fund's head. This situation allows Mr. Fradkov who constantly opposes Mr. Gref's initiatives, to execute control over privatization process formally overseen by the Minister. Hence, these revolutionary changes are not likely to occur in the near future. However some investment funds and banks have already expressed their interest in participating in privatization procedures as underwriters.

BUSINESS

Significant changes in Russia's Federal Bill "On Competition Protection" Prepared by the Antimonopoly Service

After his appointment in 2004 to head of the Federal Antimonopoly Service, Mr. Igor Artemev's political weight has considerably increased. Though after the administrative reform it lost status of ministry, it began to carry out more active policy than in previous years. There were several proceedings against companies with dominating market positions that were productive in 2005. The most well known were the Coca-Cola and Pepsi Cola cases, "Eurotsement" punishment for 1,9 bln rubles, and the FAS activity during the September gasoline price crisis when a number of oil producers were accused of a conspiracy to fix prices.

The powers of the Agency will increase after the adoption of the new Competition law. After long debates with business representatives, it passed the first reading in June. It contains a number of innovations which are critical to business. For example, the new law introduces the notion of a "dominating company" instead of a "monopoly". These will be three companies jointly controlling over 50% of the market or five companies controlling over 70%. They will be prohibited from imposing disadvantageous conditions on their partners, from deliberately raising prices and decreasing the supply of goods. The large oil corporations succeeded in lobbying for the specification of the "dominating position." According to the new version, this definition can be applied only to oligopoly markets where the choice of suppliers of goods and access on the market is limited.

Another innovation is the idea of establishing fines for violating antimonopoly regulations depending on annual turnover - about 0.5 – 4% of a company's revenue. The current fines do not exceed \$ 15 000, a troubling fact. Even the fact that the penalties would be set by the court and not by the regulators was not satisfactory.

The first reading was in June, and the date of the second hearing has not been determined...This bill affects many industries and interests. The Presidential Administration, lobbied by oil concerns and natural monopolies, sent two negative recalls for the bill; Mr. Putin stated the bill could not solve the problem of corruption.

By December the FAS drafted some amendments to the bill which make it more liberal. The company cannot be regarded as dominant if its market share is fewer than 10% (not 5% as in the original draft). The companies are also allowed to buy assets under \$ 5M without permission from the regulator. The agency will be empowered to prescribe the "behavioral conditions" for the merging companies. For example, the requirement will be to sell one of the assets or brands for permission to buy another one.

The Kremlin and the State Duma's Committee on Economic Policy are satisfied with the

amendments On the other hand, large enterprises expressed an extremely negative reaction on the bill. The further empowerment of the antimonopoly regulation comes into direct opposition with the general concentration tendencies in the majority of Russian industries. So the second reading promises to be filled with lobbying, debates and behind the scenes diplomacy in the Duma and Federation Council.

Controversial New Advertising Bill to Replace Outdated 1995 Law

The only bill in 2005 that can rival the Federal Budget Bill 2006 in the number of industries affected and lobbyists engaged is the Advertising Bill. It will replace the outdated law adopted in 1995. Among the authors of the bill, are the influential deputies Mr. Draganov, Head of the Committee on Economic Issues and Mr. Komissarov, Head of the Committee on Information Policy.

On the whole, the bill tightens control over advertising of socially harmful goods (tobacco, alcohol, dietary supplements, gambling games) but some norms are even more liberal than those in the 1995 law.

First, the bill prohibits the application of the “umbrella brands” under which goods prohibited for advertising are marketed. For instance, “Flagman” alcohol is posted as “Flagman” candies. Second, it bans e-mail spamming but does not contain any punishment for violators. Concurrently, the bill allows broadcasting of the same advertisement on TV/radio more than two times an hour but tightens requirements of advertising and prohibits TV/radio ads on days of mourning.

It also bans outdoor and transport advertising of alcoholic drinks and tobacco goods, but allows for it in printed mass-media except for the front and back covers. The industry lobbyists are buying store front advertising, but at present the Bill defines it as outdoor advertising. The marketing agencies predict the redirecting of advertising budgets to BTL-campaigns in points of sale. The advertising of pharmaceuticals, medical equipment and dietary supplements is also tightened up although industry lobbyists succeeded in removing the initial ban to employ the images of medical staff in advertisements of such goods, except of dietary supplements, from the bill.

Beer lobbyists can also celebrate a partial victory. The bill does not equate beer with alcoholic drinks as alcohol importers and manufacturers desired and contain fewer requirements in its advertising. In particular, it allows beer producers to sponsor national sport events, and advertise on public transport as well as outdoors. Though the bill passed the first reading in April, the second hearing was put off several times and will be held on December, 21. This is not surprising. At this stage all amendments from the interested parties are considered thus providing a wide field for lobbying. The market leaders agree with tightening up of norms and concealing their intentions to secure their leading market positions under social arguments. On the other hand, newcomers lobby for fewer controls over advertising. Since the cost of the issue is high, the bill is likely to be adopted in 2006.

New Public Procurement Law to Be Adopted

At the end of July President Putin signed a new bill on “Public Procurement” 94-FZ, which will come into force on January, 1, 2006. Public spending, which is mainly made through public procurement, is the largest field for lobbying activities. In 2005 this section totaled \$ 35 bln. The regulations were rather sophisticated and were to be found in many obsolete regulatory acts.

The new law makes the procedure of procurements more precise and is aimed, inter alia, at the liberalization of foreigners’ access to Russian public spending. According to the previous law foreign suppliers were allowed to the procurements only in case of absence of Russian equivalent of their production.

The new law, backed by the Ministry of Economic Development and Trade and by the Deputy Minister Mr. Sharonov, gives a foreign manufacturer the same rights as those of a national supplier’s in the event that Russian producers enjoy the same treatment in the countries of that foreigner’s origin.

The production of foreign origin mostly purchased by the Russian public sector is pharmaceuticals, medical, industrial and office equipment.

New Chief Appointed to the Bureau of the Russian Union of Industrialists and Entrepreneurs

The association representing large business in the dialogue with the government has a new Chair in favor of the Kremlin. In October, the Bureau of the Russian Union of Industrialists and Entrepreneurs elected Alexander Shokhin to replace the post of Arkadi Volski who was forced to resign. Mr.Volski comes from the “red directors”, the elite of the post-soviet industrial business, and was criticized for his inability to build working and flexible relations with authorities. Mr. Shokhin is a deputy to the State Duma and chair of the Advisory Board of the investment group “Renaissance Capital.” Earlier he held a Deputy Prime-Minister post.

Mr. Shokhin’s candidature suits the Presidential Administration well: he enters the pro-Kremlin “Unified Russia” faction in the State Duma and is known to be proficient in trade-offs. The members of the Union hope that the new Chair will manage to get the authority to listen to the needs of business. The association’s activity will probably become more loyal to the regime and will seem more like an institution of experts rather than a lobbying organization.

ECONOMY

Fitch, Moody and Standard & Poor's upgrade Russian Federation's long-term foreign and local currency ratings

This year all the three leading international rating agencies reflected positive trends in Russian economy by raising its long-term currency ratings by one grade.

In August 2005, Fitch Ratings, the international rating agency, upgraded the Russian Federation's long-term foreign and local currency ratings to BBB from BBB-.

The country ceiling was also upgraded to 'BBB' from 'BBB-' and ratings for the MinFin V and VIII bonds were upgraded two notches to 'BBB' from 'BB+'. The short-term foreign currency rating has been affirmed at 'F3'. The outlook on all long-term ratings is stable. "BBB" grade is the last but one on the Fitch's scale of the investment level. Two months later another international rating agency, Moody's, assigned Russia the analogous "Baa2" rating.

Standard & Poor's, the most conservative agency among the three, was the last to take a similar decision: on December, 15, it also raised its long-term foreign currency sovereign credit rating on The Russian Federation to 'BBB' from 'BBB-' and its long-term local currency sovereign credit rating to 'BBB+' from 'BBB'. S&P was also the last ratings agency, after Moody's and Fitch, to upgrade Russia's sovereign debt to investment grade in January, 2005.

The rating upgrade is a result of positive quantitative characteristics of Russian economy: steady increase in gold and currency reserves (over \$ 150 bln), a growing Stabilization fund (more than 1 trln rubles), where excessive money stock is being accumulated and early debt repayments are made to international institutions. Meanwhile, qualitative economic characteristics such as the corruption level, independence of the judicial system and competition levels leave much to be desired.

Though the rating upgrade is positive, real changes in the perception of Russia as an attractive place to invest will occur only when it is awarded A-grade. To meet the criteria for A-grade, a more aggressive promotion of positive trends in Russia's economy and improvements in the governmental policy are needed. Therefore, special attention to the political aspect of the issue is necessary.

Meanwhile, the Liberal Wing of the Government is troubled by the growth of The Russian Stabilization Fund, which amounted to RUR707.5bn (around USD25.26bn) on March 1, a source close to the Russian Finance Ministry told RBC. As of February 1, the Stabilization Fund rose to RUR647.2bn (around USD23.11bn) from RUR522.3bn (around USD18.65bn) as of January 1.

Russian Finance Minister, Alexey Kudrin, said that RUR74bn (around USD2.64bn) of the amount of Stabilization Fund's money exceeding the RUR500bn (around USD17.85bn) level will be allocated for financing the Pension Fund deficit under the Federal Budget law. Other funds are to be accumulated until they total RUR160bn (around USD5.71bn), and are to be spent on state debt settlement.

Kudrin also emphasized that the Stabilization Fund could be spent on increasing pensions in 2005. Extra budget revenue is first to be allocated for increasing pensions. The Stabilization Fund will be used for financing pensions only if extra budget revenue is needed for this purpose.

Currently there are discussions about the possibility of using the Stabilization Fund for paying compensations of lost budget revenue if VAT is cut. On January 1, the VAT rate was cut from 20 percent to 18 percent. Earlier the Finance Ministry announced its decision to lower the VAT rate to 16 percent starting January 1, 2006 with the possibility of canceling benefits on VAT. The issue is currently being debated...

Prime Minister Mikhail Fradkov insists on cutting VAT to 13 percent. The government office believes that the use of the Stabilization Fund for a purpose such as this could result in extra economic growth of 1.5-2 percentage points. The Finance Ministry and the Economic Development and Trade Ministry oppose this idea.

Finance Ministry experts point out that a higher pace of increase in the money supply could have a negative impact. If in 2005 RUR400 bln (around USD14.28 bln) are spent this way, it could result in additional growth in the money supply of 8 percent and in an annual increase of 36 percent instead of the earlier targeted 26-30 percent. This could spur the inflation rate by 1.5 percentage points in 2005. If the Stabilization Fund is allocated for debt servicing, the real effective ruble exchange rate might increase 1.5-2 percent in 2005. The Finance Ministry is afraid of forecasted decreases in oil prices which would cut oil exports revenue, which make up the Stabilization Fund.

The Stabilization Fund was formed on January 1, 2004. Extra federal budget revenue from high oil prices is transferred to the fund.

Moreover, the Minister of Economic Development and Trade has succeeded in promoting the idea of an Investment Fund which would finance infrastructural projects under public-private partnership. However, the Prime-Minister's Office and the Minister of Finance protested raising budget spending which could feed the inflation rate.

New Law on Special Economic Zones Welcomes Investors

The new Law on Special Economic Zones 116-FZ of July 22 2005 is one of the most significant acts prepared and promoted by the Ministry of Economic Development and Trade in 2005. It was proposed by President Putin in January 2005 and drafted in March 2005. The new law defines a special economic zone (SEZ) as a part of the Russian Federation where special favorable conditions for business apply. After the law took effect on August 27 2005, all special and free economic zones established prior to its enactment ceased to exist, except for two zones in Kaliningrad and Magadan.

Under the law, the Russian government can establish two types of SEZ for no more than 20 years. These are industrial production zones and technical innovation zones. The State will make an original investment in the infrastructure and determine the particular goals for these zones. Presidential decree 855 of July 22, 2005 states that the new Federal Agency for Management of Special Economic Zones will administer the SEZs. In the SEZ territories, foreign-manufactured goods will be subject to a free customs zone (which means they can be imported and used without payment of customs duties or VAT, and without economic restrictions applicable in the Russian Federation).

Russian-manufactured goods in the SEZ will be subject to the export laws, which involves paying excise tax but not export customs duties. There are additional benefits in the Tax Code, the Customs Code, the Land Code and other legislative acts.

Both residents and non-residents will be allowed to conduct business in these zones. But only the former will enjoy tax allowances. The goal is to encourage non-residents to register their legal entities under Russian law. The residents of industrial zones will pay 14% unified social tax (instead of 26%), and the residents of the technological zones will be allowed to write off R&D costs. The investors will also enjoy land and property tax remissions and will be allowed to import equipment and export their production free of duties and VAT.

The selection process is run by Mr. Gref's Ministry and the management of the zones will be assigned to the Federal Agency on Free Economic Zones, headed by Mr. Zhdanov, the former advisor to the Prime Minister.

In November the Ministry announced the list of the winners. There will be four technological areas tailored to develop projects in certain branches: in St.Petersburg (IT and analytical engineering), in Dubna of the Moscow region (nuclear-physical R&D), in Zelenograd of the Moscow region (microelectronics), in Tomsk of the Tomsk region (new materials development). There were nearly 30 bids for the industrial SEZ. The zones will be arranged in two regions: in Lipetsk region (manufacturing of household appliances and furniture) and in the Republic of Tatarstan (production of car components and petrochemical substances).

Besides the tax preferences, the SEZ will be given 16 bln rubles from the federal and regional budgets. The unsuccessful bidders will be welcomed again next year though Mr. Gref stated that

the priority will be given to the bids from the Far East and Eastern Siberia. The selection criteria which are rather vague include the region's experience in carrying out large investment projects and the submission of a comprehensive business plan. As the experience shows, there is a lack of qualified staff in regional administrations to carry out said work. Therefore, the demand for strategic consultancy in the regions is likely to grow.

In October, the Government considered the possibility of expanding the kinds of SEZ. Mr. Tkachiov, the governor of the Krasnodar Territory proposed the idea of establishing recreational areas to attract investments to the tourist industry. Unlike other SEZ, the recreational ones are proposed to spread over the boundaries of one region. Supported by the Minister of Regional Development, this initiative carried favor with the Prime Minister's Office.

The Governor of the Murmansk region where one of the largest Russian ports is situated is lobbying for another kind of SEZ. He lobbies to attract private investments for the modernization of port terminals by abolishing customs duties for the residents of this kind of SEZ. The Prime Minister has appointed the Ministry of Economic Development with the responsibility of drafting the relevant amendments to the law. However, they are unlikely to be adopted this year.

Attempts to increase the number of SEZ indicate that regional authorities, aware of their low prospects of attaining industrial and technological SEZ, still hope to gain budget finance. They do not want to be excluded from the budget flows made possible by vast monetary reserves, and they lobby the federal government by sticking to the fashionable concept of state-private partnership. In addition, having a SEZ on its territory enhances the region's image and serves a testament to the federal favor which means reduced political risks and cheaper loans from international institutions. For example, IFC has recently announced its plans to finance the infrastructural projects in the regions of Russia without requiring necessary guarantees from the federal government.

Still there is no consensus on the SEZ in the Russian government which reflects a split into "liberal" and "conservative" wings. While the "liberal" Mr. Gref treats them as a mechanism for attracting investments in R & D and industrial sectors, Mr. Fradkov is concerned that the zones will be turned into internal off-shores being used for tax evasion. The head of the Federal Agency on Free Economic Zones, Mr. Zhdanov, has worked under both Mr Gref and Mr.Fradkov. Time will tell whose side he is on and what the future of this initiative will be.

New Law on Concession Agreements to Boost Investment Activities

The new Law on Concession Agreements 115-FZ took effect on August 8, 2005. The goal of this landmark act is to boost investment activities, ensure effective use of state and municipally owned property, and enhance the quality of goods and services in Russia.

Under a concession agreement, a grantee (either a Russian or foreign legal entity, participants in a joint-venture agreement or an individual entrepreneur) shall, at its own expense, create or reconstruct the concession facility owned by a grantor and then operate it. Meanwhile the grantor (either the Russian Federation, a constituent of the Russian Federation or a municipal unit) gives the grantee the right to possess and use the facility.

The concession facilities may include the following types of immovable property: transport and municipal infrastructure, sea and river ports and vessels, airport infrastructure, pipelines and waterworks, public transport, and medical, recreational, sports or educational facilities. The list of immovable property subject to concession is exhaustive and does not include industrial objects such as mining facilities.

Concessions are widely recognized as one of the cornerstones of modern economic reform in Russia. Concessions are regarded as a form of public-private partnership intended for projects, which are not only investment-demanding, but also seek state support and resources. Concessions cover such spheres as road and railways construction, power plants and electric network development, construction and management of ports, hubs as well as housing and utilities infrastructure management.

The best prospect is predicted for transport and utilities projects, with these spheres being some of the most closed for entrance today. These issues are under regional and local authorities, and as such, the lobbying activities of investors are likely to shift from the federal level down, on the level of large regional centers.

The GR-efforts will be of even more importance because authorities will choose investors through tenders. There are no clear criteria for choice, and the result, to a certain extent, will depend on the ability to find a common language with the authorities.

Investment projects were planned to be financed from the special fund which needed to be established along with the Stabilization Fund, accumulating the super profits from oil export. Mr. Gref's idea of the investment fund faced criticism from the Minister of Finance who regarded these spending as a source of inflation. Prime Minister Fradkov and his Office also criticized the draft of the Fund's enactment arguing that it contradicts the Budget Code. Nonetheless, the promotion campaign arranged by Mr. Gref reached its goal: the issue of the investment fund and investment projects was widely aired in mass media and in public discussions.

At the end of November, the Enactment of the Investment Fund was signed by the Prime Minister even before the Budget Code was amended. The Fund will finance investment projects costing

above 5 bln rubles with the necessary share of private investments not less than 25%. The annual volume of the Fund is limited by 70 bln rubles. However, it can be increased in case many worthy projects are selected.

The selection process will be carried out by a commission headed by Mr. Gref, and his Ministry will conclude the contract in three months after the winner is determined.

Though there are several projects from different industries (aircraft production, aluminum plant construction, and development of “Moskva-City” complex) the first agreement will be concluded with the Administration of St.-Petersburg. The Fund will allot 17.9 bln rubles for the construction of a toll road in the city (“Western High-Speed Diameter”). A private investor has not yet been chosen and therefore, the tender will be held in the near future.

Nevertheless, the necessary amendments to the Budget Code, which are being drafted by the Ministry of Finance, are still to be passed. This means that some provisions or parameters of the Investment Fund may suffer corrections during the legislative procedures.

New Infrastructure Investment Fund in Russia: Investors Are Welcome

The investment fund, an instrument to help Russia create mechanisms for attracting private investment into economic development, will be built up over the next three years and will have funds of around 70 billion rubles to be spent on public-private partnership projects. Any economic agent, be it a federal region, municipality or simply a private company working in Russia, can initiate such projects that would be carried out with state assistance.

Funds will be allocated exclusively for infrastructure development projects. The Fund is prohibited from investing its money in commerce and business. Projects that will be considered will be only major national projects with a timeframe for implementation of not more than five years and with state participation of not less than 5 billion rubles.

The investment fund will select projects through a tender system. The first stage in the tender process to be overseen by the Economic Development and Trade Ministry and the selected projects will then need to be confirmed by a special tender commission headed by Mr. Gref and made up of representatives of the various ministries and agencies as well as economic experts. Their final conclusions will form the basis for the government’s decisions. Discussion of the projects will be as open as possible and the main selection criteria will be maximum effectiveness. The most important issue here is to ensure an open and effective selection process for the projects.

The investment fund should be an effective instrument that will enable us to effectively develop the economic sectors that the government considers most promising in this and perhaps even in the next century while continuing to hold to the fundamental principles that we have established for ourselves over the last few years.

No Consensus Has Been reached by Government to Restrict Access of Foreigners to Strategic Industries

In his Address to the Federal Assembly, President Putin demanded that restrictions on the access of foreigners to industries and deposits of strategic importance should be clearly stated. By the beginning of November the bill had had to be introduced in Duma, but the draft is still under consideration by the government. The problem is that there are several concepts supported by different agencies.

The Ministry of Industry and Energy run by Mr. Khristenko offers quite a long mechanism of endorsements. First, strategic industries should be listed in a presidential decree. In order to buy a controlling stake in an enterprise engaged in such an industry, there would be a requirement to pass the bid to an authorized Ministry (presumably, the Ministry of Economic Development or the Ministry of Industry and Energy). Then the bid should be considered by an interagency commission, examining the foreign economic activity of the enterprise, its referral to state secrets and other relevant aspects. The final decision would be made by the government which may overlook the recommendations of the commission. Later the Ministry may bring in some changes. This 3-step procedure was offered in reference to 40 kinds of activities (instead of industries as was originally planned) The Prime Minister will personally carry this out.

The Ministry of Economic Development has a more liberal view. He suggests prohibiting foreigners from participating in certain activities within the scope of strategically important industries. The access to other activities within these industries should be granted on the basis of distinct and clear criteria. Another, less corrupt way, is to list the strategically important enterprises prohibited for foreign investments.

The Presidential Administration has criticized both ideas; however, there is no consensus on the issue even in the Kremlin. The “force wing” represented by Mr. Shuvalov offers to set the limitations on the foreign shares in the industries of national importance with the undisclosed list of reasons for rejection. The Kremlin liberals such as Mr. Dvorkovich propose a soft approach: the decisions on the foreign access to industries and enterprises should be made individually: in some cases according to the list of industries, in others, according to the list of enterprises or deposits.

The representatives of the foreign companies support the idea of developing the list of criteria for strategically important industries and activities and they called for the individual approach of the government to foreigners' bids. In other industries all limitations should be lifted.

Obviously, foreign investors interested in branches such as IT, and/or aircraft and airlines industries do not agree with the minority shareholding proposed by Mr. Shuvalov. In addition, they are not satisfied with the long procedure according to Mr. Khristenko's idea. Mr. Gref's position meets with their approval. However, the government is unlikely to adopt it as is due to the obvious conflict between the Prime Minister and Mr. Gref. The former questioned the achievability of the goal of doubling the GDP by 2010 and criticized Fradkov's idea to reduce VAT from 18% to 13%. Perhaps, Mr. Gref will try to seek approval of the new First Deputy Prime-Minister, Mr. Medvedev, who is known as a liberal manager.

TRADE

Import Duties on 670 Items of Technological Equipment will be Abolished

Abolition of import duties for industrial equipment is the issue that the Russian government has been discussing for several years. But this year some definite steps have been taken and specific plans have been announced. Today there are about 1200 items of equipment subject to import duties. This year they were abolished for several car manufacturing facilities, textile and forest processing equipment.

In November, the Commission on Protective Measures in External Trade with the Ministry of Economic Development and Trade recommended that the Government abolish import duties for 670 items of technological equipment for 9 months. According to sources in several Ministries engaged in the process of reconciliation (the Ministry of Economic Development, the Ministry of Industry and Energy, the Ministry of Finance) the plans pertain to equipment not produced in Russia with duties fewer than 10%. The Governmental order will come into effect in February, 2006.

The focus is on what equipment will be listed. Lobbyists from different branches are each trying to convince the government of their need for modernization of facilities. At the same time national producers affected by such a measure will do their best to see that import duties for their production are retained.

Governmental Initiatives in the Forest Industry Aimed at Attracting Foreign Investments

Russia possesses 25% of the world forest resources. Due to outdated legislation, the timber industry is stagnating. Potential investors, primarily foreigners, are discouraged by high levels of corruption in the industry and unstable and out of date legislation. In April, a new version of the Forest Code passed the first reading, but a negative recall from the President and the Federation Council, as well as protests of ecological organizations put off the second reading until the fall session.

The new Code was drafted by Ministry of Economic Development and Trade although forest use falls under the domain of the Ministry of Natural Resources. This change resulted in numerous liberal innovations in the bill and prompted an outcry from environmentalists.

According to the bill, the forest plots can be owned by individuals and legal entities but there are no provisions for privatization. The forest plots will be leased through auctions for the term of 49

years, and the leaser will be obligated to bear forest protection and reproduction measures. This provision evokes ecologists' protests. They are frightened by too little control over forest cutting. The main forest regions of Russia have sent their negative recalls on the bill. They are concerned about an auction system that means that access to forests will depend only on the price paid for the license without any social and ecological responsibilities. On the other hand, foreign investors welcome this measure aimed at reducing the corruption that takes place under the current competitive system of license allotment.

Another problem the government tried to solve this year was the issue of timber export duties. The Ministry of Industry and Energy offered to replace export duties with export quotas sold through tenders to equal the amount of timber a purchaser is allowed to export. A similar quota system exists in the fish industry. This replacement will regulate the industry and provide closer control over timber exports. Prime Minister Fradkov saw an opportunity for conspiracy among the companies and a high probability of corruption. The Minister of Natural Resources then offered to reconsider the current classification of forest resources and to increase the category of forests allowed to be cut. He also insists on raising export duties for raw timber to encourage foreigners to build processing facilities in Russia, and he calls for the reduction of import duties for facilities and turn key pulp-paper plants. Earlier, in August, the duties for some kinds of timber processing equipment had been eliminated. Today there are 27 pulp and paper projects in Russia waiting for investments approximating \$ 1 bln each meaning that a potential investor could save \$ 150 mln after duties (15%) are abolished.

The reclassification of forests is obviously lobbied by foreigners who are interested in increasing raw timber exports and are afraid of a rise in export duties. The Prime Minister has criticized the whole concept presented by the Ministry and returned it to be reworked. Perhaps, these measures will be discussed during negotiations with Finland on WTO entrance and on the treaty on the mutual protection of investments thus giving Russia room to maneuver.

New Subsoil Law to be Delayed Until Spring

Russia's new subsoil law, a keenly awaited reform of rules for hydrocarbon producers and miners, may not be passed until spring next year at the earliest according to Sergei Mironov, speaker of the upper house, which also has to approve the law. The lower house had been scheduled to hold a first reading on Nov. 2, but it was postponed because of a lack of clarity on how to restrict foreign involvement in mineral resources that Russia considers strategic. The Ministry of Natural resources asked the Duma's Committee on Natural Resources to return the bill to be reworked.

The bill is supported by key ministries (of Industry and Energy, of Economic Development). Nonetheless, in terms of protectionist measures for national companies, it is considered to be insufficient by the Prime Minister as well as by the influential Presidential Advisor Mr. Shuvalov and Mr. Oganessian, the Head of the Federal Energy Agency. Mr. Fradkov stressed that the law should secure the state levers of regulation while Mr. Shuvalov and Mr. Oganessian questioned the need for a new law. They stand for the amendment of the existing one, 2395-I, adopted in 1992 with its new version 27-FZ passed in 1995.

The bill has been considered and discussed by all interested parties including deputies, businesses, governmental agencies and regional administrations during the year. The draft introduces elements of private law into regulation of the subsoil use. For example, the holder of a license will be allowed to sell or to pledge it. Another improvement aimed at protecting a hydrocarbon producer or miners' subsoil rights is a so called "through" license which automatically permits a user to exploit the field if it was discovered during exploration work. Under the current law, the explorer is not permitted to carry out extraction work on the discovered deposit - the production license must be obtained through a new tender.

To minimize the level of corruption and make the procedure of license issuance more transparent, the Ministry of Natural Resources offers to replace tenders by auctions with the only criterion being the price paid by the bidder. All regional administrations expressed a negative reaction to this provision because it deprives them of the power to set special requirements for the subsoil user as under the tender system. The users working on existing projects in the regions are against the auction system. They have established good relationships with regional administrations and do not want newcomers in their regions.

The main innovation of the bill is restriction on the access of foreign companies or Russian businesses controlled by foreigners to certain deposits of strategic importance. The criteria for the latter were announced by the Minister of Natural Resources in November. Such companies will not have access to deposits of uranium, diamonds, quartz and yttrium group of rare earths. The deposits with reserves over 150 mln t oil, 1 trln cubic meters gas, 10 000 t cuprum and 700 t gold will also be enlisted as strategic. These criteria are met by five deposits: oil fields named after Trebs and Titov, the gas deposit Chayandinskoe, the Udokan cuprum field and the gold deposit Sukhoi Log.

The State monopoly Gazprom is lobbying to amend the criteria for gas deposits. Its representative, Mr. Podyuk, proposed that deposits over 300 bln cubic meters should be considered as strategically important. Despite it being a monopoly, its global strategy is to further strengthen its position at home and abroad. As example, another Gazprom's initiative would be to allocate licenses through a two-phase process where a winner is chosen in a closed auction. Mr. Trutnev stressed that the restrictions will not pertain to deposits if they fall under the strategic criteria after supplementary explorations are carried out by a foreign developer. But later the Ministry decided to secure the state control over the strategic deposits in case they are discovered by a foreign company during exploration works. The foreign explorer will be obliged either to set up a joint venture with his share under 50 % or to withdraw from a contract and have his exploration costs reimbursed.

The off-shore deposits requiring far more investments will be considered separately. Their exploration will be regulated by a separate law. The Minister also proposed to reduce the subsoil tax depending on the degree of depletion of the deposit, complexity of its development and exploration maturity as well as on a user's investments in the exploration.

Currently, Minister Trutnev's position is rather weak, particularly since the Prime-Minister hinted that the oil and gas sector would be removed from the Ministry of Natural Resources under the Ministry of Industry and Energy. Despite the negative opinions by the Presidential Administration, the Prime-Minister and regions for the bill, Minister Trutnev insists it should be adopted in the first reading before the end 2005. However, it is unlikely to happen - the oil and gas lobby are doing their best to freeze the process.