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ANALYSIS OF RUSSIA'S NEW FOREIGN INVESTMENT LAW

by David M. Wack

On July 9, 1999, President Yeltsin signed into law the new Russian Foreign Investment Law (FIL). The new FIL replaces the previous FIL, which had been in effect since 1991. In general, the new FIL offers many of the same protections provided by the previous law, with a few notable additions, including a new tax stabilization clause and greater detail on the use of branch offices in Russia. Although the new FIL offers protection to all forms of foreign investment, a number of its provisions are expressly designed to promote "direct" foreign investment, which is defined as (1) the acquisition of a more than 10 percent stake in a Russian commercial entity, (2) investment in a branch of a Russian legal entity, or (3) leasing of certain electric and transportation equipment (including aircraft). In response to the financial crisis of August 1998, Russia is encouraging such forms of direct investment as preferable to portfolio investment.

Tax Stabilization Protection

The tax stabilization protection of the new FIL is its principal innovation. Although the protection is fairly strong, its efficacy is still somewhat uncertain, particularly in the absence of implementing regulations and the presence of ambiguities in the law. Under the new FIL, the enactment of any new laws or regulations that change the amount of certain federal taxes, customs, and other mandatory payments, or amendments to existing laws and regulations that increase the total tax burden on or otherwise limit foreign direct investment, is not applicable until recovery of investment (as determined by implementing regulations to be enacted by the Russian Government). Protection under this clause appears to be available only to Russian commercial entities engaged in "priority investment projects," which are defined as projects in which total foreign investment is at least $40 million, or foreign equity investment is at least $4 million, in industry sectors specified by the Russian Government. However, the language of other provisions in the new FIL suggests that tax stabilization is intended to apply to all direct foreign investment projects in which foreign investors hold a 25 percent equity stake, regardless of size or industry. This ambiguity will need to be addressed in implementing regulations or through amendments to the new FIL.

Although the stabilization protection covers the majority of applicable federal taxes, a few significant taxes are not covered, including excise taxes and value-added

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OPPORTUNITIES IN THE RUSSIAN PACKAGING SECTOR

by Sergey Minko

Russia's packaging industry, which imports some $2 billion worth of foreign packaging materials and equipment annually, increasingly needs modern packaging materials and machinery to improve the look and quality of packaging and make domestic products more competitive with imported packaged goods. Currently, only a few U.S. companies participate in this market.

Current Russian customs duties favor the importation of finished packaging materials, rather than stimulate domestic production from imported or domestic raw materials. Nonetheless, many Russian companies are looking for ways to develop and improve local production of finished packaging materials. Demand for both packaging materials and machinery provides U.S. companies with trade and investment opportunities.

Update on the Packaging Materials Sector

Although Russia possesses the raw materials re-

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LETTER FROM THE U.S. OMBUDSMAN

The Russian economy has begun to stabilize, following the economic crisis of August 1998, but there is still a considerable amount of work to be done before foreign—and Russian—investors' confidence in Russia begins to return. We need to keep in mind that the transformation of Russian society is a very complicated task that will likely take a generation to complete. There have been, however, positive developments in the U.S.-Russian relationship, and you, the business community, are a large part of this picture. In June, I cochaired the fourth annual meeting of the U.S. West Coast-Russian Far East Ad Hoc Working Group (AHWG) in Vladivostok, in which over 200 Russians and Americans participated. A key result of this meeting was an expansion of the CLEAR-PAC project, which streamlines customs procedures in the Russian Far East. Representing Vice President Gore, I was present at the July 30 celebration of the first oil output from the Sakhalin II project—the first oil to come from a production-sharing agreement (PSA) to develop deposits offshore Sakhalin Island. Even in the midst of economic difficulties, clear progress is being made.

Rule of Law

We have now completed a draft *Handbook on the Russian Commercial Arbitration System*. We have also drafted the *Basic Guidelines for Codes of Business Conduct*, designed to promote good business practices and ethical behavior in commercial relations between private firms, as well as with government authorities. Both of these works in progress have been presented at international roundtables and conferences and have received strong support from Russian and Western businesspeople and government officials. This fall, building on this success, we initiated a project on the *Handbook on Corporate Governance and Shareholder Rights*, and are encouraged by the broad, positive response to this idea. These concrete steps are aimed at developing a functioning rule of law and court system that will provide greater protection for business and assist in the fight against corruption.

Regional Cooperation

As many of you are well aware, some of the Russian regional governments have proved more successful than Moscow in establishing a market economy and providing a business climate that encourages foreign investment. During the past year, I have visited many regional capital cities—Novgorod, Irkutsk, Yuzhno-Sakhalinsk, Yekaterinburg, and Perm—and have noted regional officials offering tax and other incentives to attract investors, Russian and foreign alike, to their cities. Other regional governments are working hard to have projects approved as PSAs by the federal government.

Commercial Energy

As evidenced by Sakhalin II's first oil, the PSA framework is beginning to produce tangible results, and the Russian Government is currently working on the normative acts needed to support this framework. The Duma is moving toward authorizing more projects to move forward under a PSA by adding those projects to the "Law on Lists." There is still much to be done, such as revising the tax code to fit the PSA structure and reducing tariffs, and the U.S. Government remains committed to working with you to meet these challenges.

We are encouraging the Russians to work with us, as well as with other Western countries, on projects that could significantly benefit the regions. Moreover, we continue to pursue private-public sector partnerships that will prove beneficial to both U.S. companies and Russia.

The task ahead—to transform Russia into a growing free-market democracy—is enormous. There have been successes, but still far too few. Nonetheless, the best way to pursue this transformation remains the same—and centers on the private sector. The U.S. Government will continue to be actively engaged in pursuing the reforms Russia needs to move forward—and to support your efforts as you continue to play such a critical role in the process.

Jan H. Kalicki
Counselor to the Department of Commerce and
U.S. Ombudsman for Energy and Commercial
Cooperation with the New Independent States

(***RUSSIAN FIL**, continued from p. 1*)

tax (VAT) on domestically produced goods and Pension Fund contributions. In addition, it should be noted that the stabilization protection does not apply to regional or local taxes. However, regional and local governments have considerable authority to grant tax incentives for these taxes.

The new FIL calls for the Russian Government to enact a series of regulations implementing the tax stabilization protections, including regulations governing the procedures for: determining whether a change in law has an adverse or limiting impact; registering priority investment projects; and oversight of foreign investors' compliance with investment commitments.

Other Relevant Provisions of the New FIL

1. *Application and Definitions.* The definition of foreign investor in the new FIL includes legal entities, noncorporate entities, and individuals, as well as international organizations acting under international agreements and foreign governments. Investment is defined broadly to include cash, securities, property, property rights, intellectual property, services, and information. Specifically excluded from the definition are investments in banks and other credit organizations, insurance companies, and nonprofit organizations for the purpose of socially desirable objectives, which are to be governed by separate laws. The protections of the new FIL also apply to branches of foreign investors and commercial entities in which foreign investors participate, but not to subsidiaries or affiliated companies of the latter.

2. *National Treatment.* Under the new FIL, foreign investors are guaranteed the same legal rights and privileges available to Russian residents, subject to limitations or benefits that may be established by Russian law.

3. *Expropriation and Compensation of Losses.* Like the previous law, the new FIL protects foreign investors against expropriation and nationalization of their property. However, unlike the previous law, it does not enshrine the principle of "prompt, adequate and effective compensation," which is widely regarded as the international standard; rather it merely requires that the investor be compensated for the value of its property without indicating the timing, method of determining value, or currency of compensation.

4. *Repatriation of Profits.* Under the new FIL, a foreign investor is guaranteed unrestricted use of its after-tax income, both within Russia and abroad.

5. *Preferential Treatment.* Except for tax stabilization protection, the new FIL does not grant any tax or customs concessions to foreign investors. Priority investment projects are eligible to receive tax and customs benefits in accordance with Russian tax and customs law. Currently, however, Russian tax and customs laws do not contemplate any special tax concessions for large-scale investments. The new FIL underscores the ability of regional and local governments to offer tax and other incentives to foreign investors.

6. *Foreign Personnel.* Unlike the 1991 law, the new FIL does not explicitly address the issue of employment of foreign personnel, but implies that such employment is permitted by stating in the preamble that one of its purposes is attracting foreign managerial experience. Moreover, unlike the previous law, the new FIL does not guarantee import customs duties exemptions for personal effects of expatriate employees.

7. *Dispute Resolution*. The new FIL provides that a foreign investor is guaranteed the right to settle disputes arising out of its investment or business activities in Russian courts or through arbitration in Russia or abroad. Unlike the previous law, the new FIL does not differentiate between disputes with private entities and the Russian Government.

8. *Registration and Accreditation*. The new FIL removes the separate national registration requirement of the previous law for Russian companies with foreign investment. It now appears that such companies are to be registered with the local registration bodies in the same manner as purely Russian companies. In addition, the new FIL spells out in greater detail the procedures for accreditation, operation, and liquidation of branch offices of foreign companies, an area that previously lacked any meaningful legal guidance.

On the whole, the new FIL reiterates in a more succinct fashion many of the protections that have been available to foreign investors in Russia for over 8 years and eliminates a number of provisions of the previous law that became inconsistent with subsequent Russian laws. The new FIL's principal innovation—the tax stabilization provision, although not without its flaws, is a positive step toward mitigating one of the greatest uncertainties related to investment in Russia.

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*For a lengthier analysis of the new Russian FIL, visit **BISNIS Online** at www.bisnis.doc.gov/bisnis/isa/isa.htm#Kisa.*

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(**PACKAGING**, continued from p. 1)

quired for domestic production of various packaging materials, current government tax and import duty policies hinder development of local production of packaging materials. The customs duty for imported finished packaging materials is set at 5-10 percent, while the customs duty for supplies to be used in creating the packaging is 15 percent.

Russia imports almost all types of packaging materials. Although Russian producers meet as much as two-thirds of demand in the overall packaging materials market, over a billion dollars worth is imported. Companies that sell printed materials and packaging films are most successful in this market, selling $290 million worth to Russia in 1997. Foreign suppliers provide 25 percent of the corrugated market ($75 million annually), 40 percent of cardboard boxes ($82 million annually), 65 percent of cardboard, 45-55 percent of labels, and 70 percent of label paper.

According to Yury Alpeev, marketing director of packaging materials company **Gotek**, before the August 1998 financial crisis, Russian companies imported foreign packaging machinery and packaging materials worth $1.8-2.3 billion annually. Half of this amount was packaging ($0.9-1.2 billion a year) and half was packaging materials ($0.8-1.04 billion annually). In 1998, imports of wrapping films, PET bottles, stickers, and metal cans increased about 30 percent over 1997, but have declined 40 percent since the crisis.

Among the major exporters to Russia in this sector are Italy (30 percent of total packaging materials), Germany (17 percent), and Finland (11 percent). Imports of U.S. packaging materials accounted for only 4 percent. One of the major U.S. export products to Russia is Scotch™-type packaging tape, accounting for $15.7 million.

Packaging Industry Situation by Market Sector

The demand for packaging varies greatly by sector. Nearly all sectors need upgraded products and equipment, but only a few sectors are experiencing vigorous demand at this time.

Confectionery—Confectionery packaging is one of the most developed segments of the industry. Although some leading confectioneries use modern packaging technologies and pack their products very attractively, most confectioners lack modern packaging technologies to extend product shelf life.

Bakery—The majority of Moscow's bakeries supply retail outlets with products packed in plastic bags or wrapped in plastic film, but little bread is distributed under sealed and branded product lines. Many regions are following Moscow's example by requiring bakery products to be wrapped for sale, thus creating the need for new packaging materials and equipment.

Dairy—Russian dairies rely heavily on modern packaging. Moscow is the leader in introducing dairy packaging technologies, while the bulk of dairy products produced in the regions is still packed in plastic bags and glass bottles. Therefore, most domestically produced dairy products are uncompetitive in the market. Milk processing plants could significantly improve production by purchasing Pure Pak or Tetra Pak-type milk processing and packaging lines.

Household chemicals and paints—Enterprises in this sector usually use simple plastic and glass containers for household chemicals and metal cans for paints. To be more competitive with imported products, Russian producers must significantly improve quality and add convenience features such as handles, measuring scoops, and printed instructions.

Prospects for U.S. Companies

The overall improvement of the Russian economy will provide U.S. packaging equipment companies and packaging producers with enormous opportunities to increase exports to Russia through direct sales, leasing, and investments. Many Russian companies welcome foreign investment, and some foreign companies have already invested in packaging raw material companies. For example, in 1998, **International Paper** (Purchase, NY) acquired 80 percent of the Svetogorsk Pulp and Paper Mill, which reportedly produces 293,000 tons of paper and cardboard annually.

Another sign of the favorable investment potential of Russian companies is the success of the Russian company Gotek (one of the leaders in producing corrugated cardboard). Gotek uses modern equipment to provide packaging materials for major U.S. companies operating in Russia, including **Procter & Gamble**, **Mars**, **McDonald's**, and **Coca-Cola**, and for several large Russian companies. Other Russian companies such as **Poligrafooformlenie**, **MKPG**, **Polipak**, and **Dozakl** have attracted investments to renew their production facilities. Overall, Russian industry experts believe that Russian packaging companies have the potential to attract up to $8 billion in foreign investment.

Those U.S. packaging equipment and materials companies that want to expand their business in Russia or enter the Russian market should be more aggressive. Strategies that have proved successful include participating in local trade shows, establishing representative offices or representation by Russian dealers and distributors, and marketing products more widely and persistently.

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TRICKS OF THE TRADE

Need to Russify Your Brand?

by Shane Farrell

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For foreign businesses introducing products to the Russian market, how best to "Russify" their brand is a common, yet critical dilemma. Qualitative research conducted by F-Squared Market Research + Consulting for a leading ad agency in Moscow set out to answer this question. Researchers wanted to understand whether imported brands need to be Russified and the best ways to achieve this goal. Other objectives were to discover what constitutes a brand for Russian consumers as well as the perceived differences between Russian versus imported brands.

Last October, F-Squared researchers organized 12 focus groups made up of male and female participants of various ages, looking at brands across numerous categories. They conducted focus groups in Moscow, Yekaterinburg, and Nizhny Novgorod.

Highlights

- The Russian consumer does not really understand what constitutes a brand.
- Quality is the key differentiator between Russian and western brands (western brands are seen as having superior quality). Brand recognition is secondary.
- The appeal of Russian brands depends on the category. For example, food and skin care are two categories where Russian brands are considered strong. Conversely, coffee and perfumes are deemed domains for western brands.
- Associations with Russian brands are linked with products exclusively from Russia and Russian heritage. When asked to name Russian consumer brands, respondents often mention Rossiya, Krasny Octyabr, Kristall, Rot Front, VAZ, GAZ, Yava, and Svoboda.
- As trusted quality is the main branding issue for Russians, the strongest potential is seen for those Russian brands with quality traditions.
- The majority of participants welcome the development of Russian consumer industries, and expect Russian brands to become stronger and more competitive in the future.
- Respondents associate western brands with western heritage, names, culture, and lifestyle.
- Russification of brands is not always necessary; each case should be considered individually.
- Advertising is considered one of the main means to generate empathy with a western brand. In this sense, the Russian way can be understood simply as "culturally relevant" and "nationally correct." Western ads are appreciated by the Russian audience, if they do not totally contrast with national values and morals.

Dual Brands

As well as Russian versus western brands, the researchers looked at dual brands, or brands that combine western and Russian elements such as:

- Russian brands with western image (Wimm-Bill-Dan/J-7);
- Western brands with Russian image (Vodka Rasputin);
- Joint brands: western brands produced in Russia/CIS or by cooperating with local brands (Tetra Pak plus local milk and juices);
- Russian brands produced by western companies or with their participation (Peter I, Sh.O.K).

Again, Russian consumers could not clearly identify certain brands as either western or Russian.

Wholesome Values

In terms of brand attributes, participants were asked to describe a Russian brand, a western brand, a dual brand, and themselves along a number of attributes.

Researchers found that the Russian consumer is more likely to identify with western brands when it comes to attributes such as dynamic, solid, and unique. Wholesomeness is the attribute associated with Russian brands. Thus, "Russification" advertising would probably work best if focused on wholesomeness, a quality identified by most respondents. The most effective approach may be to adapt a brand within Russian culture without changing its identity. This can be facilitated by promotion and advertising, but the major factor is recognition by Russian consumers and wide usage in a Russian way.

To make a successful Russian ad for a western brand, it is not enough to duplicate a western advertising idea within the Russian context—ads should show real Russian people instead of westernized Russians.

However, participants indicated they like to see original western ads along with Russian ads for international brands.

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*For more information on the **American Chamber of Commerce in Russia**, telephone +7 (095) 961-2141, email amcham@amcham.ru, or visit www.amcham.ru.*

REGIONAL CORNER: Saratov Oblast, Russia

by Alexander Gordienko

The Saratov oblast is located in the Russia's Lower Volga Valley, about 450 miles southeast of Moscow. The region has a population of 2.7 million, while its capital city, also called Saratov, has approximately 900,000 residents. In the Soviet era, Saratov was closed to foreigners because many enterprises of the military-industrial complex were located in the region. It was opened in 1993. Other large cities in the region include Balakovo (207,000 inhabitants) and Engels (185,000 inhabitants).

The Saratov oblast is crossed by the Volga river. Saratov is one of the largest river ports on the Volga. Waterways provide access from Saratov to Moscow, the western Urals, the Black Sea, the Baltic Coast, and the White Sea.

The oblast also features abundant energy resources. The Balakovo Nuclear Power Plant and Saratov Hydroelectric Plant alone produce one-quarter of the power in the Volga Valley and 3 percent of energy in Russia. Oil and gas are the most significant natural assets of the region. Average oil output is 1 million MT annually, the bulk of which is processed in Saratov. The oil/gas and energy generation sectors account for 37.3 percent of regional industrial output.

Major Companies of Saratov

The **Saratov Aircraft Plant** manufactures various modifications of YAK-42 aircraft for commercial and training purposes. The **Saratov Trolleybus Plant** is a major supplier of trolleybuses in Russia. It also exports them to Europe, Asia, and Latin America. The **Saratov Bearing Plant** specializes in producing a broad line of roller bearings. **Litiy-Element** is the only Russian supplier of lithium batteries. Rubber products made by **Balakovorezinotekhnika** are widely used by such Russian automakers as VAZ and KAMAZ. The region is also the largest Russian producer of chemical filaments and fibers, and local companies produce acrylic acid, methyl acrylate, phenol, sulphuric acid, and fertilizers.

Foreign Trade and Investment

Saratov oblast's principal foreign trade partners are the United States, Great Britain, Italy, Holland, Turkey, and Germany. The region's main exports consist of electronic devices, electrical equipment, vehicles, crude oil and oil products, mineral fertilizers, and chemicals/petrochemicals. Imports include machinery, medical equipment, nonorganic chemicals, metals, plastic wares, paper, and food.

During the past three years, the Saratov oblast Duma, in conjunction with the Regional Government, adopted a number of laws to stimulate and guarantee private investments in the Saratov region. Under these laws, investors are entitled to exemptions from local taxes on profits, property, and vehicles for 3 years. Furthermore, they allow land for investment projects to be leased (for up to 49 years) or purchased by individuals or commercial entities (including foreign ones).

In 1998, over 80 companies with foreign capital were operating in the Saratov oblast. The majority of them have German partners, including a joint venture with **Bosch** that manufactures automotive spark plugs and a joint venture with **Henkel** that produces detergents. Large-scale investment projects currently under way include the modernization of the oil-processing company **Kreking**, involving U.S. and Spanish companies; a joint venture between the U.S. **Grace** corporation and the **Kalininsk Rubber Products Plant**, and the construction of a furniture factory in Balakovo with the French company **Seribo**. In addition, the **Saratov Aircraft Plant** is negotiating with U.S. company **Case** regarding the possibility of assembling harvesters in its facility.

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*For more information on the Volga region, visit **BISNIS Online** at www.bisnis.doc.gov/bisnis/country/regions.html#VolgaUrals.*

AGENCY SPOTLIGHT

U.S. Department of State, Bureau of Educational and Cultural Affairs—The bureau (formerly part of the U.S. Information Agency) has announced an open competition (RFP E/PN-00-09) for assistance awards for exchanges and training programs for the Newly Independent States of Russia, Belarus, Moldova, Ukraine, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, and Uzbekistan. The bureau seeks exchange programs that address the following themes: Women's Leadership Programs (all countries), Women's Political Leadership Programs (Russia, Moldova, Ukraine, Kazakhstan), Professional and Business Associations Programs (Russia, Moldova, Ukraine, Armenia, Azerbaijan, Georgia), Content-Based Internet Training (West NIS, Caucasus), Distance Learning in the Field of Business Management (Ukraine), Public Library Reform (Ukraine), Caucasus Regional Cooperation, and more. The bureau is interested in proposals whose designs take into account the need for ongoing sharing of information and training.

The deadline for submission of proposals is 5:00 pm, December 22, 1999. For further information, visit http://e.usia.gov/education/rfps/. To request an application package, contact Thomas Driscoll, program coordinator, tel: (202) 260-6230 or email: tdriscol@usia.gov.

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