

RUSSIA

TRADE SUMMARY

The U.S. goods trade deficit with Russia was \$15.1 billion in 2006, an increase of \$3.7 billion from \$11.3 billion in 2005. U.S. goods exports in 2006 were \$4.7 billion, up 19.1 percent from the previous year. Corresponding U.S. imports from Russia were \$19.8 billion, up 29.3 percent. Russia is currently the 33rd largest export market for U.S. goods.

The stock of U.S. foreign direct investment (FDI) in Russia in 2005 was \$5.5 billion (latest data available), up from \$3.8 billion in 2004. This number does not yet reflect substantial U.S. investments in Russia during 2006 in the energy, automotive, food-processing, consumer goods, information technology and banking sectors.

Russia is in the process of negotiating terms of accession to the World Trade Organization (WTO). On November 19, 2006, the United States and the Russian government signed a WTO bilateral market access agreement. The terms of that agreement are on USTR's website at [:http://www.ustr.gov/World_Regions/Europe_Middle_East/Russia_the_NIS/Section_Index.html](http://www.ustr.gov/World_Regions/Europe_Middle_East/Russia_the_NIS/Section_Index.html). The Russian government has completed its bilateral market access negotiations with most other interested WTO Members, and is now focused on multilateral negotiations regarding its terms for accession, as well as completing its implementation of WTO provisions, from the rules agreements covering areas such as non-tariff barriers and intellectual property rights to ensuring that state-owned and state-trading enterprises operate solely on commercial terms when they are engaged in commercial activity. To enter the WTO, the Russian government must also complete negotiations with WTO Members on the levels of funding for certain programs supporting its agriculture sector.

IMPORT POLICIES

Russia continues to maintain a number of barriers with respect to imports, including tariffs and tariff-rate quotas, charges and fees, and licensing, registration and certification regimes. Discussions continue within the context of Russia's WTO accession to eliminate these measures or modify them so that they are consistent with internationally accepted practices.

Quotas

In January 2003, the Russian government announced the imposition of a quota for poultry and tariff-rate quotas (TRQs) for pork and beef. These quotas became effective in April 2003 and May 2003, respectively. A United States – Russia Bilateral Meat Agreement (Meat Agreement) was signed in June 2005, establishing TRQs for beef, poultry, and pork, and a 15 percent tariff for U.S. high quality beef. It also calls for bilateral negotiations in 2009 to determine whether the TRQs will remain or whether Russia will provide tariff-only treatment for these products. Quota allocations under the Meat Agreement are based on historical export levels. The United States was actively engaged with the Russian government throughout 2006 to ensure that U.S. producers of poultry, pork, and beef continued to have access to the Russian market and that Russia implemented its obligations under the Meat Agreement. The WTO bilateral market access agreement with the United States sets out a framework, including the time schedule, for WTO negotiations on how such goods will be treated post-2009.

FOREIGN TRADE BARRIERS

Import and Activity Licenses

Import licenses and activity licenses required for wholesale and manufacturing activities are necessary to import products such as alcoholic beverages, pharmaceuticals, products containing encryption technology, explosive substances, drugs, nuclear substances, hazardous wastes, and some food products.

The 2005 Law on Spirits eliminated some licensing requirements and discriminatory fees applied to imported spirits, but it established the requirement that importers must register with the Ministry of Economic Development and Trade (MEDT) and obtain a general activity license from the Federal Tax Service, Ministry of Finance. The fee for obtaining the wholesale license, which is valid for five years and is subject to annual inspections, is approximately \$9,500.

As part of the bilateral WTO market access agreement with the United States, the Russian government agreed to set up a streamlined system for the import of goods containing encryption technology with transparent, nondiscriminatory and WTO-consistent procedures. The Russian government also agreed to allow the importation of most commercially-traded information technology and telecommunications goods after a one-time notification, or in some cases, with no licensing or evaluation requirements at all. The U.S. Government will continue to work on addressing the licensing barriers to trade in goods containing encryption technology and other products subject to licensing requirements. The system will operate on an interim basis in 2007.

Customs Issues, Taxes and Tariffs

In addition to tariffs, there are two types of charges applied to imports: the Value Added Tax (VAT) and selective excise taxes. The universal VAT rate was reduced from 20 percent to 18 percent in 2004, with the exception of foodstuffs, pharmaceuticals and medical supplies, for which the VAT is 10 percent. Some medical equipment is totally exempted from the VAT. Pharmaceutical importers have complained that new pharmaceuticals imported in the clinical trial stage (prior to registration) were improperly assessed the VAT because they could not produce a certificate of registration. There are ongoing discussions within the Russian government to lower the VAT further to 15 percent or 16 percent. However, no such proposals were included in the 2007 government budget law passed by Russia's parliament, the Duma.

The excise tax applies to a number of luxury goods, such as alcohol and cigarettes. Excise taxes for wine and spirits are 19.5 rubles per liter of ethyl alcohol and up to 108 rubles per liter for some wines. U.S. companies have faced significant obstacles trying to comply with the requirement to affix an excise stamp on bottles of spirits for which the excise tax has been paid (see Non-Tariff Barriers section). Excise taxes on other goods can total as much as 570 percent *ad valorem*.

U.S. industries complain of high tariffs on agricultural products such as sugar, distilled spirits, wine, fruit, processed food and forest products. As part of its WTO accession, Russia has agreed to bind its tariffs on all agricultural products, thereby providing more predictability on its tariff rates when Russia joins the WTO.

Russian import tariffs on automobiles, aircraft, and aircraft parts have presented particular obstacles to U.S. exports to Russia. The effect of the tariff, VAT and customs handling fees on aircraft was equivalent to a tax of 40 percent, making it virtually impossible for Russian airlines to afford to purchase foreign planes. The bilateral WTO market access agreement with the United States on tariffs and the bilateral agreement on leased aircraft will yield significant market access opportunities. When Russia

FOREIGN TRADE BARRIERS

joins the WTO, tariffs on aircraft will be substantially reduced. Tariffs on civil aircraft parts, including engines, will be reduced to an average of 5 percent. An agreement on leased aircraft, which entered into force on November 19, 2006, will immediately reduce tariffs on narrow body leased aircraft.

The current import duty on new passenger vehicles is 25 percent, to which an excise tax based on engine displacement and a VAT tax are added. The combination of these charges can increase import prices by 70 percent for larger U.S. passenger cars and sport utility vehicles. For motorcycles, Russia imposes a 20 percent special duty on large motorcycles, plus an additional 18 percent VAT, significantly increasing prices on imported large motorcycles.

In October 2006, Russia extended for 10 months an increase in the import duties to 15 percent on combine harvesters and threshers. Under the bilateral market access agreement on Russia's accession to the WTO, Russia agreed to rescind this increase by no later than July 2007, after which time duties will remain at 5 percent and will be bound upon accession.

As part of the bilateral market access agreement, tariffs on other key U.S. industrial exports will be cut substantially as well. Once Russia joins the WTO and the U.S. Congress grants Permanent Normal Trade Relations (PNTR) status to Russia, Russian tariffs on industrial products will be bound at an average of 8 percent, a reduction of approximately 36 percent from the rates applied in 2000.

A new Customs Code, intended to bring Russia's customs regime into compliance with WTO requirements, came into force in 2004. It simplified customs processes and established specific procedures for the application and payment of tariffs. Russia also amended its Customs Tariff Law to update its Customs Valuation practices in line with WTO provisions. However, significant problems remain. The Russian government issues unpublished recommendations on import valuations to customs posts to help to combat undervaluation of imports by importers. However, these recommendations can also be applied as reference prices for customs valuation or substituted for the invoice value of the imports, making the practice WTO inconsistent. Russia also has not fully implemented the WTO Customs Valuation Agreement in its laws, and must issue additional regulations to complete the process prior to its WTO accession. In addition, Russia's current customs clearance fees are not compatible with WTO obligations and will have to be revised. In terms of systemic concerns, U.S. exporters to Russia report that customs enforcement varies by region and port of entry and that frequent changes in regulations are unpredictable, adding to costs and delays at the border. Russia does not provide for the right to appeal customs decisions without penalty to a judicial authority, and, as in the case of the valuation recommendations, does not publish all laws, regulations, judicial decisions, and administrative rulings of general application to customs matters. The United States is working with Russia to make substantial improvements on these customs issues in the multilateral WTO Working Party process as part of its accession to the WTO.

Non-Tariff Barriers

U.S. companies continue to face a number of non-tariff trade barriers when exporting to Russia. Non-tariff barriers are a topic of detailed discussions in Russia's WTO negotiations.

Pharmaceuticals

Decisions by the Russian government regarding which pharmaceutical products to place on reimbursement lists for state-provided healthcare are having an adverse impact on U.S. exports to Russia. U.S. industry reports that higher-priced imports, which are often safer and of a higher quality than locally-

produced pharmaceuticals, are often absent from reimbursement lists and state purchases because the government focuses more on price concerns than on the quality and safety of the products.

Alcohol

As part of Law FZ 171, the “Law on Production and Turnover of Alcohol,” which went into force in April 2006, all customs duties, excise taxes and the VAT on alcohol now must be paid in advance of application for customs stamps, using a bank guarantee and deposit. The new regulatory regime relies on an information management system (UFAIS) for importers to print Universal Product Code (UPC) data on a stamp. This system, comprising both hardware and software, is expensive to purchase, difficult to use and has failed thus far to fulfill its purpose to track alcohol from manufacture or import to the retail sales point. There is no way to stamp miniature, food service-sized bottles (the stamps are too big). Businesses have experienced difficulties in re-stamping product imported prior to the new law’s introduction, and software glitches have caused importers’ data to be corrupted, costing them time and money.

The logistical and administrative problems above created a situation in 2006 where companies that wanted to comply with the Law’s stamping requirement could not comply. For much of 2006, the new stamps were not available and then the stamping machinery did not work. As a result a large volume of spirits was not re-stamped in time and had to be removed from retail shelves and relocated in warehouses in July 2006. Many bottles of spirits remain in wholesale warehouses because the appropriate legal provisions have not been established for wholesalers to apply for and obtain stamps. Approximately \$60 million in U.S.-origin products for which the excise taxes and associated fees have already been paid remain in warehouses. Meanwhile, wholesalers are not legally allowed to apply the stamps on behalf of importers. Although in early 2007 the Russian government extended further the deadline for the bottles to remain in wholesale without facing confiscation or destruction, the underlying problems have not been addressed. The United States and other foreign governments are pressing the Russian government bilaterally and in the WTO multilateral process to find a long-term solution to these problems on an urgent basis.

The new requirements on spirits alcohol – information reporting requirements, usage of the UFAIS system, payment of the excise tax, application of the excise stamp, and import and licensing requirements – are also imposed on products such as perfumes, cosmetics, household cleaners and solvents containing more than 1.5 percent alcohol. The implementation of these rules in April 2006 severely disrupted trade. Such goods were eventually given a temporary extension from the application of the UFAIS reporting requirement, a significant burden for the small retailers of such goods, until December 31, 2006. At the end of 2006, the Duma amended the law to extend this temporary exemption until July 2007. In addition, it permanently exempted products in aerosol cans from the alcohol-related requirements. The United States is encouraging further amendment of the law to permanently exempt all non-food goods containing alcohol from the alcohol-related requirements above.

Development of Nuclear Power Generation

In October 2006, Prime Minister Fradkov signed a decree officially approving the Federal Targeted Program (FTP) on "Development of Russian nuclear power and industry complex for years 2007-2010 and further until 2015." The major goal is to accelerate the development of Russia's nuclear power industry. In accordance with the program, the total capacity of Russia's nuclear power plants (NPP) should reach more than 33 gigawatts (GW) by 2015. If FTP is successfully completed, Russia will have commissioned 10 new power units with a total capacity over 11 GW, and 10 additional power units will be in various phases of construction. The export arm of Russia’s nuclear power sector, Atomstroyexport,

FOREIGN TRADE BARRIERS

is a significant competitor to U.S. companies. Furthermore, Russia's lack of a nuclear liability law to provide adequate legal protection for U.S. firms creates a prohibitive risk to U.S. suppliers of equipment, fuel and nuclear energy services to Russia.

EXPORT POLICIES

The subsidy-like effect of Russia's current domestic gas pricing policy is a key issue due to the potentially adverse impact this policy may have on certain U.S. industries. The price of gas for Russian industrial consumers is artificially low and, according to numerous reports, prices are well below the full cost of production. The downstream effects of this pricing policy are significant, because gas sells on Russia's domestic market for approximately \$40-\$45/tcm, while estimates of cost-recovery levels are at roughly \$35-\$40/tcm, with gas exported to Europe fluctuating between \$230 and \$350/tcm over the past year. The Russian government recently approved a plan to increase domestic prices to European levels by 2011. Over time, this should provide an incentive for producers to adopt more efficient production practices and greater energy efficiency. The gas sector and Gazprom, Russia's near-monopoly supplier, play a significant role in Russia's economy. The Russian government is proceeding slowly and cautiously with reform of the sector.

Russia maintains export duties on approximately 460 types of products. The Russian government intends to gradually eliminate such duties, except for products deemed as strategic, such as hydrocarbons and scrap metals, although it introduced such duties on lumber in early 2007. In May 1999, Russia imposed a 15 percent export duty on ferrous steel scrap, which remained in effect in 2006. These export duties create distortions in ferrous scrap trade, an important input to steel. However, Russia has agreed to reduce this duty rate to one-third of current levels within five years of acceding to the WTO. Russia also currently maintains a 10 percent export duty on copper cathode while no export duty is charged on copper wire rod. These two export duties together have created a market distortion, which is promoting vertical integration within the Russian copper industry: Russian copper wire rod producers can obtain favorable prices on copper cathode inputs, since Russian cathode producers cannot export their product for its fair market value. As a result, it is advantageous to export the higher value-added product (copper wire rod). As part of the bilateral WTO market access agreement, however, Russia has agreed to eliminate its export duty on copper cathode within four years of its accession to the WTO.

A variety of agricultural products are subject to export licensing and/or tariffs, such as some fish products, cereals, oilseeds and wood products. Russia was not permitted to export beluga caviar in 2006, but a limited quota was approved under the Convention on the International Trade in Endangered Species (CITES) for 2007. No export quota was approved for certain other types of Russia caviar.

STANDARDS, TESTING, LABELING AND CERTIFICATION

U.S. companies cite technical regulations and related product testing and certification requirements as major obstacles to U.S. exports of industrial goods to Russia. Russian authorities require product testing and certification as a key element of the product approval process. Opportunities for testing and certification performed by competent bodies outside Russia to be recognized by Russian authorities for purposes of demonstrating compliance to their regulations are limited, and some view procedures associated with Russia's approach to "supplier's declaration of conformity" as unnecessarily burdensome. Manufacturers of telecommunications equipment, oil and gas equipment, and construction materials and equipment, in particular, have reported serious difficulties in obtaining product approvals within Russia. The current classification and approval system for food supplement and dietetic products is costly and lengthy. Food and dietetic products that are legally sold in the United States and the European Union are subject to an expensive and lengthy certification process in Russia that takes between three and five

FOREIGN TRADE BARRIERS

months. Products are also subject to redundant technical reviews conducted by both the Nutrition Institute and Ministry of Health, which take between six and twelve months.

The United States continues to work with the Russian government to bring its product regulations and certification requirements into conformity with international standards and practices. The Russian government is attempting to put in place the necessary legal and administrative framework to establish transparent procedures for developing and applying standards, technical regulations, and conformity assessment procedures to accomplish this goal. The December 2002 “Law on Technical Regulation” provides a framework for the development of specific requirements for industrial goods, as well as sanitary and phytosanitary requirements for agricultural commodities, processed foods, and plants. In early 2007, the Duma began the process of amending this key framework law. It remains unclear what the final changes will be and how those changes will affect: 1) the scope of coverage of the law; 2) the legal procedures that will be used to develop technical regulations within Russia; and 3) how stakeholders will be able to participate in the development of technical regulations in Russia.

In 2006, the Russian government took a decision on fees for the certification of products and services and issued a decree on the list of the goods as subject to mandatory certifications. It also continued implementing a program to develop or amend some 84 technical regulations that began in 2004. While drafts of some technical regulations have made their way to the Duma for approval, many remain to be completed and approved.

The Russian government has required imported pharmaceutical products to complete a complex certification process, but has said that it would move to a system of self-certification for pharmaceutical products. At the end of 2006, the first details about this contemplated new approach became available. On December 20, 2006, a lengthy list was published of documents and their related approvals and measures that are needed for registration of pharmaceuticals. While industry and the U.S. Government are still analyzing the impact of the new requirements, they do not appear to be an improvement over the existing practice, and do not appear to constitute a true self-certification process.

Sanitary and phytosanitary (SPS) restrictions have had a major negative effect on U.S. trade, with products deemed as “sensitive” by Russia being blocked, seemingly without a scientific basis. In early 2006, in the context of U.S. bilateral negotiations on Russia’s accession to the WTO, the Russian government issued a decree allowing the adoption of international standards, guidelines and recommendations, such as those set by internationally recognized bodies such as Codex Alimentarius and the Office of International Epizootics (OIE). These international standards, guidelines, and recommendations formed the basis for addressing specific SPS issues. At the same time that the United States and Russia concluded the bilateral WTO market access agreement, Russia and the United States signed bilateral agreements to address SPS issues related to: trade in frozen pork; the certification of pork and poultry facilities for exporting products to Russia; trade in beef and beef by-products; and trade in products of modern biotechnology. The details of these agreements are set out below.

Pork

Historically, Russia has only accepted freezing as mitigation for trichinae for U.S. frozen pork destined for further processing. Costly testing for trichinae was required for all U.S. pork imported for retail sale. Russia has now agreed to accept freezing as mitigation for trichinae for U.S. pork for retail sale as well as for further processing. As a result, imports from certified plants are now permitted when accompanied by the export certificate that was agreed between Russia’s veterinary service and the U.S. Department of Agriculture’s Food Safety and Inspection Services (FSIS). These commitments went into effect on November 19, 2006.

FOREIGN TRADE BARRIERS

Inspection of Facilities Producing Pork and Poultry

Previously, Russian and U.S. officials jointly inspected all pork or poultry facilities that wanted to export product to Russia. This onerous process delayed exports from new plants or plants needing to remedy a deficiency found during the joint audit until a joint inspection occurred. U.S. exporters also noted concerns about the time it took Russian officials to provide formal approval for facilities after the inspection and to provide an updated list of approved facilities to its customs officials so trade could begin. The WTO bilateral market access agreement authorizes FSIS to certify new facilities and/or facilities needing to remedy a deficiency found in the annual joint audit by Russian and FSIS officials. The Russian government also agreed to specific time frames to respond to requests to list the facilities approved by FSIS and to a new process for annual joint audits.

Export of Beef and Beef By-Products

U.S. exports of beef and beef by-products to Russia have been restricted since a case of bovine spongiform encephalopathy (BSE) was discovered in the United States in 2003. Russia immediately banned all imports of beef and beef by-products from the United States, thereby closing the largest U.S. export market for frozen livers. Pursuant to the terms of the WTO bilateral market access agreement, the Russian government will immediately open its market to de-boned beef, bone-in beef and beef by-products from cattle under 30 months of age. Once the OIE takes a decision on the U.S. risk status with regard to BSE, the Russian government will permit U.S. exports based on that risk status. This decision would open Russia's market to U.S. beef of all ages (excluding specified risk materials that the OIE requires to be removed).

Products of Modern Biotechnology

U.S. suppliers of products of modern biotechnology have faced an unpredictable regulatory environment in Russia. For example, Russian officials halted product registrations and approvals in the area of feeds in 2004, initiated legislative reforms and began work on the development of a new permanent regulatory system for all products of modern biotechnology. In accordance with the WTO bilateral market access agreement with the United States, Russia will maintain an interim approval and registration system for products of modern biotechnology that is science-based, transparent, predictable, and consistent with the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (WTO SPS Agreement). In addition, Russia will establish a permanent biosafety regulatory system for products of modern biotechnology that is science-based, transparent, predictable, and consistent with the WTO SPS Agreement. The United States will have an opportunity to comment on the interim and permanent approval and registration systems for these products, and Russian officials will take U.S. comments into account. Although Russia agreed to register products covered by all pending applications that have received a favorable science-based risk assessment by November 15, 2006, the U.S. Government is continuing to follow-up on the registration process to ensure that all pending applications are addressed. Russia and the United States agreed to hold annual consultations on the status of applications for re-registration of products whose registrations have expired during the year and to establish an ongoing bilateral consultative mechanism to discuss issues of regulatory development in the area of agricultural biotechnology. The United States also continues to work with the Russian government on the significant reservations that U.S. industry has expressed regarding Russia's food labeling policy, including the substance of draft legislation on that subject.

In addition to these specific issues, exporters of agricultural goods face systemic concerns related to the certification of agricultural products. Russian authorities require phytosanitary and/or veterinary

FOREIGN TRADE BARRIERS

certificates for nearly all agricultural and processed food products. Russian authorities require that producers seek certificates from their domestic regulatory authorities for some products for which Russia has not provided scientific evidence of an alleged risk. For example, Russia requires certificates for roasted coffee, which due to the nature of the processing process, does not present a pest risk (and therefore, the United States does not issue a phytosanitary certification for roasted coffee). Russian authorities also require a sanitary-epidemiological certificate or certificate of state registration for the importation of non-food items such as styrofoam cups and furniture.

Also related to biotechnology, a ban by Russia on all U.S. rice imports was imposed in late September 2006, citing the discovery of genetically modified rice seeds in shipments of U.S. long grain rice. This calls into question whether Russia observed WTO requirements as the ban was imposed without prior notice or sufficient justification. Furthermore, the ban was imposed on both biotechnology and conventional varieties of rice. In December 2006, Russia also imposed a ban on all origins of rice noting a variety of sanitary and phytosanitary concerns. Since the bans were imposed, the United States has been working both bilaterally and multilaterally to resolve this issue.

GOVERNMENT PROCUREMENT

The Russian government spends over a third of its budget on procurement; it spent more than \$30 billion in 2005 on government procurement (2006 figures are not yet available). A new law on government procurement, (federal law “On Placement of Orders for Delivery of Goods, Performances of Works and Provision of Services for State and Municipal Needs”) entered into force on January 1, 2006. It regulates tenders on all government purchases over \$8,000 (except for those made in commodity exchanges). To improve transparency in the procurement process, tenders must be advertised on agency websites as well as on a consolidated government procurement website. The new law eliminates some restrictions on the participation of foreign suppliers, although it permits exceptions for reasons of national security or defense.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

U.S. industry continues to be concerned about the IPR situation in Russia. U.S. copyright industries estimate they lost in excess of \$1.9 billion in 2005 due to copyright piracy in Russia (business software - \$894 million; records and music - \$475 million; motion pictures - \$266 million; entertainment software - \$224 million; and books - \$42 million).

In 2006, Russia’s optical disc production capacity continued to be far in excess of domestic demand, with pirated products apparently intended not only for domestic consumption, but also for export. The U.S. film industry estimates that more than 80 percent of all DVDs and approximately 66 percent of music CDs on the Russian market are pirated. However, legitimate DVD sales are on the rise, in part due to increased law enforcement action against pirates and a growing preference by the middle class for high quality products. Internet piracy continued to be a serious concern. Criminal investigations are ongoing against operators of the Russia-based download website www.allofmp3.com, which offers global distribution of pirated music and is the most notorious of several problem websites operating within Russia.

U.S. and multinational companies continue to report patent infringement and counterfeiting of trademarked goods as a problem, especially for consumer goods, wine, distilled spirits and pharmaceuticals. Several U.S. firms have experienced problems with trademark counterfeiting, with Russian enterprises attempting to appropriate well-known foreign trademarks not currently active in

FOREIGN TRADE BARRIERS

Russia, although rights holders have been moderately successful in countering these schemes through the Russian court system or with the Russian Federal Service for Intellectual Property, Patents and Trademarks (Rospatent). U.S. firms should proactively take steps to protect their intellectual property in Russia, including registering their trademarks with Rospatent.

The United States is working to ensure that Russia takes appropriate actions to protect intellectual property rights. On November 19, 2006, as part of the WTO bilateral agreement, the U.S. Government and the Russian government concluded an agreement that sets out a blueprint for actions that Russia will take to address piracy and counterfeiting and improve protection and enforcement of intellectual property rights, both stated priorities of the Russian government. As part of the agreement, the Russian government has committed to fight optical disc and Internet piracy, protect pharmaceutical test data, deter piracy and counterfeiting through criminal penalties, strengthen border enforcement, and bring Russian laws into compliance with WTO and international IPR norms. This binding agreement is an integral part of the bilateral WTO market access agreement between the United States and Russia, and Russia's implementation of the commitments on IPR will be essential to completing the final multilateral negotiations on the overall accession package. In addition, the United States is reviewing Russia's status as a beneficiary country under the U.S. Generalized System of Preferences (GSP) Program. Russia has also been on the Special 301 Priority Watch List since 1997.

The most significant legislative development in 2006 was the Duma's consideration and adoption of Part IV of the Civil Code, which will replace most of Russia's IPR legislation with a single code. The Code and implementing regulations to be developed over the next year will go into effect on January 1, 2008. While Russian government ministries and the Duma took steps to address some concerns of certain rights holders and the U.S. Government regarding the new legislation, Part IV still contains provisions that raise concerns regarding consistency with WTO and other international agreements. The Russian government has pledged to ensure that Part IV and other IPR measures will be fully consistent with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) upon Russia's accession to the WTO.

In September 2006, amendments to the Law on Copyright and Related Rights came into effect, providing rights holders control over Internet distribution of their work.

Russia continues to deny national treatment for protection of geographical indications. As well, under Article 39.3 of the TRIPS Agreement, Russia must protect against unfair commercial use of undisclosed data submitted to government authorities to obtain marketing approval of pharmaceutical and agricultural chemical products. Russia currently does not provide such protection for pharmaceutical products. In late 2005, the Russian government proposed legislative changes to address these concerns. Unfortunately, these changes were not considered by the Duma in 2006. Russia committed in the November 2006 bilateral WTO agreement with the United States to work with the Duma to enact legislation to implement Article 39.3 of TRIPS by June 1, 2007.

Enforcement

Poor enforcement of IPR is a pervasive problem. The prosecution and adjudication of intellectual property cases remains sporadic and inadequate; there is a lack of transparency and a failure to impose deterrent penalties. Russia's customs administration also needs to significantly strengthen its enforcement efforts. Russian authorities initiated some enforcement actions in 2006, including raids on some optical disc production facilities and investigation of Internet sites. The November 2006 bilateral WTO agreement with the United States calls for specific actions to improve IPR enforcement.

Statistics provided by the Russian government indicate that Russian law enforcement has started to take action against pirate optical disk producers in the last few years. According to the Ministry of Internal Affairs and Rosokhrankultura, the agency responsible for implementing Russia's 2001 Licensing Law for optical media producers, raids during the first nine months of 2006 resulted in seven license suspensions and eight criminal prosecutions of plant operators. The Russian government committed in the November 2006 bilateral WTO agreement with the United States to strengthen the licensing regime for optical media plants. Necessary changes include denying new licenses to applicants known to have been engaged in piracy.

In the area of copyright infringement, 2,924 criminal cases were initiated in 2005. In 2006, 6,432 cases were initiated as of November 1. Russian authorities reported that 1,615 individuals were convicted of copyright offenses in the first nine months of 2006, as compared to 1,450 in the entire year of 2005. In trademark protection, whereas 545 criminal cases were initiated in 2005, over 500 were initiated in the first half of 2006. In 2005, 78 people were convicted of trademark offenses. In the first half of 2006, 95 were convicted. Finally, with regard to Internet piracy, Russian authorities claim to have initiated criminal cases against eight Internet sites distributing illegal software or counterfeit audiovisual products. Investigation and prosecution of the operators of the pirate website www.allofmp3.com are also ongoing, although progress is slow and their prospects are uncertain. Meanwhile, the site continues to operate.

Judicial System

While the Russian government has intensified the investigation and criminal prosecution of intellectual property rights infringers, cases often fail at the prosecution stage and few convictions for IPR violations ever result in prison sentences. Even where Russian law provides for serious penalties such as the destruction of counterfeit or pirated goods, products seized during enforcement actions often are not destroyed and consequently may return to the stream of commerce even if they are found to be illegal. In addition, production lines and equipment used for IP infringing activities are rarely seized, allowing pirates to continue their illegal activities either elsewhere or under a different corporate entity. In the vast majority of cases, alleged infringers receive small fines or suspended prison sentences. As part of the November 2006 bilateral WTO agreement with the United States, the Russian government made a commitment to take criminal actions against commercial scale piracy, with the objective of permanently closing down the production of optical media containing pirated and counterfeit material. It has also undertaken commitments to enact legislative amendments to provide broader authority to order the seizure and destruction of machinery and materials used in the production of infringing goods, and to make other improvements to the IPR legislative framework.

Russian administrative and judicial review bodies are beginning to become active in protecting IPR, and the number of police and judges with relevant expertise, though still small, is expanding. At the prosecutorial and judicial levels, many officials still do not consider IPR infringement a serious offense when compared to other crimes, although an increasing number of prosecutors are willing to file cases related to copyright infringements. On June 19, 2006, the Russian Supreme Court Plenum adopted a

long-awaited resolution issuing guidelines on the application of civil IPR legislation on copyright and neighboring rights. In the November 2006 agreement, the Russian government agreed to propose to Russia's Supreme Court that it clarify practices relating to the imposition of penalties for IPR crimes, including imposition of penalties that take into account the high degree of public harm from IPR infringement and the objective of preventing future crimes.

U.S. investors generally consider the Russian court system ill-prepared to handle sophisticated patent cases. However, a specialized higher patent chamber has been established at Rospatent, which has brought greater expertise and efficiency to the adjudication of patent and trademark disputes.

SERVICES BARRIERS

Reforms in Russia's economy during the last decade allowed new service sectors to emerge and contributed to the further development of existing sectors. Services providers often operated without sufficient regulatory and institutional framework, yet, in recent years, Russia's legislation and regulations have begun to catch up with the market. Russia's services market is relatively open to U.S. service suppliers in areas such as professional services and distribution, but specific problems remain in particular areas. The ability to provide services to public utilities and certain energy-related services (see section on energy), remains limited. The process for an individual or a company to obtain a license to provide a service remains difficult.

As part of the bilateral WTO market access agreement with the United States, Russia has committed to liberalization in a broad range of service sectors. Once Russia is a WTO Member and has Permanent Normal Trade Relations status, U.S. firms will have further improved access to service sectors including banking and securities, insurance, telecommunications, audio-visual services, distribution, express delivery, energy services, environmental services and professional services.

Financial Services and Insurance

The 1996 federal law "On Banks and Banking Activity" permits foreign banks to establish subsidiaries in Russia. As part of its bilateral WTO accession agreement with the United States, Russia has agreed to allow 100 percent foreign ownership in the banking sector. It has also agreed to allow the cross-border supply of services, such as financial leasing, financial information and data processing, credit cards and other types of payments, and advisory services. Starting in January 1, 2008, foreign-invested companies will be allowed to provide asset management services to investors. With respect to permitting banks to establish branches in Russia from abroad, the Russian government has indicated it will return to consideration of this issue upon joining the OECD or in the next multilateral round of WTO negotiations, whichever comes first.

While foreign-source banking capital in Russia now accounts for between 12 percent to 15 percent of aggregate banking capital, the Russian government retains the prerogative to limit the foreign-sourced element of charter capital to 50 percent of the total charter capital. Calculation of the foreign-sourced element of the cap, however, is subject to several exclusions. If the ratio of foreign-sourced to total charter capital ever exceeds the 50 percent cap, Russia's regulators have the discretion to take only those actions specified in Russia's WTO commitments.

In the insurance sector, foreign insurance companies have been allowed to operate in Russia since 1999, but are subject to a 49 percent equity restriction. Foreign firms that were active in Russia when this requirement came into effect, however, were grandfathered and are not subject to the foreign equity limit. In January 2004, a law came into effect that, based on a 1994 Russia-EU treaty, effectively exempts EU-

FOREIGN TRADE BARRIERS

based insurance companies from the 49 percent foreign equity limitation. This exemption also applies to insurance companies based in the EU that have since been purchased by non-EU foreign companies. The 2004 law retains the requirement that chief executives and chief accountants of foreign insurers operating in Russia be Russian citizens.

Total foreign capital in the Russian insurance sector is currently limited to 25 percent. The Russian government has agreed to a significant level of market access and national treatment for foreign insurance companies upon its accession to the WTO. As part of its bilateral WTO market access agreement with the United States, Russia will allow foreign insurance companies to operate through subsidiaries, including 100 percent foreign-owned non-life insurance companies, upon its accession to the WTO. The government of Russia has also agreed to allow insurance branching from abroad at the end of a nine-year transition period. As in the banking sector, Russia will maintain the discretion to limit foreign-sourced charter capital in the insurance sector. Exclusions from the ratio and limits on actions that Russia's regulators can take also apply to the insurance sector.

Telecommunications

In the telecommunications sector, the 2004 Law on Communications was amended in July 2006 by the law "On Information, Information Technologies and Information Protection." The 2006 law's impact on competitive alternative (non-incumbent) telecommunications operators, many of which enjoy large foreign investment, has been substantial, since these companies now fall under tight government regulation. In particular, regulations on interconnection – the process by which alternative operators connect their networks to the Russian public telephone network – place interconnection contracts and fees under the regulatory authority of the Ministry for Information Technologies and Communications. Alternative operators fear that these fees will be raised to subsidize network upgrades of government-owned and ministry-controlled local and long distance operators.

Many in the telecommunications industry have been disappointed that the new law has not improved transparency in the licensing process, and have criticized the five- to ten-year license validity, which they argue do not allow them sufficient time to recoup their investment. The Federal Anti-Monopoly Service has challenged in court the manner in which the Ministry for Information Technologies and Communications issues licenses to Russian mobile phone operators. As a result, the Ministry has been ordered to issue licenses on a non-discriminatory basis for all operators, which may benefit companies with foreign investment.

The Federal Anti-Monopoly Service, in September 2006, also cited the three largest mobile phone operating companies as charging discriminatory rates to other operators. Two of the three companies subsequently revised their rate schedules, but the third, allegedly linked to the Ministry for Information Technologies and Communications, has resisted.

The State Radio Frequency Commission (under the Ministry for Information Technologies and Communications) intends to allocate radio frequencies in the 1935-1980 MHz, 2010-2025 MHz and 2125-2170 MHz bands for the development of mobile IMT-2000/UMTS standard networks in Russia. As of January 16, 2007, Russia's Federal Communications Agency (Rossvyaz) began accepting bids through February 26, 2007 for three 3G licenses, on frequencies formerly reserved for military or government use but now being opened for commercial use. The license fees have been set at 2.64 million rubles (roughly US\$100,000), but criteria for the winning bidder(s) will include significant investment in network infrastructure development under certain deadlines and successful bidders will be required to begin offering commercial 3G services within two years of gaining their licenses. Potential opportunities for

U.S. companies will most likely be as subcontract suppliers to the successful bidders. In 2006, the Federal Agency for Networks started granting WiMAX licenses in the 2.5-2.7 GHz range.

Certification of new products in the telecommunications industry takes an average of two months, down from four months a few years ago, but the process still suffers from a lack of transparency.

There are significant barriers in the provision of satellite telecommunications services in Russia. In particular, satellite regulation is not transparent. The legal requirements and administrative responsibilities associated with the provision of these services appear to be discriminatory, with the Russian government demonstrating a preference for Russian satellite communications systems, which puts competing satellite systems at a disadvantage.

The satellite industry reports that there is a burdensome certification process in place, and a local presence requirement further creates barriers to doing business in Russia. Telecommunications and media services companies also report investment restrictions. Russian entities with more than 50 percent foreign ownership are prohibited from sponsoring television and video programs or from establishing television organizations capable of being received in more than 50 percent of Russia's territory or by more than 50 percent of the population.

INVESTMENT BARRIERS

Despite the passage of a law regulating foreign investment in June 1999, Russian foreign investment regulations and notification requirements can be confusing and contradictory. Corruption in commercial and bureaucratic transactions and problems with the implementation of customs regulations also inhibit investment. U.S. trade and investment in Russia would benefit from improved dispute resolution mechanisms, better protection of minority stockholder rights, the adoption of international accounting standards, and the adherence by companies to business codes of conduct. Initiatives to address these shortcomings, either through regulation, administrative reform, or government-sponsored voluntary codes of conduct, have made little headway in countering endemic corruption. More transparent implementation of customs, taxation, licensing and other administrative regulations is necessary.

National Treatment

The 1999 Investment Law codifies principles of national treatment for foreign investors, including the right to purchase securities, transfer property rights, pursue rights in Russian courts, repatriate funds abroad after payment of duties and taxes, and receive compensation for nationalizations or illegal acts of Russian government bodies. However, the law goes on to state that federal law may provide for a number of exceptions, including, where necessary, for “the protection of the constitution, public morals and health, and the rights and lawful interest of other persons and the defense of the state.” Thus, a large number of broadly-defined exceptions give the Russian government considerable discretion in prohibiting or inhibiting foreign investment. The law provides a “grandfather clause” that stipulates that existing ‘priority’ foreign investment projects with foreign participation of over 25 percent be protected from unforeseeable changes in the tax regime or new limitations on foreign investment. The law defines “priority” projects as those with a foreign charter capital of more than \$4.1 million and with a total investment of more than \$41 million. However, the lack of corresponding tax and customs regulations means that any protection afforded investors by this clause is only theoretical.

Foreign investment in businesses engaged in production and distribution of distilled spirits is limited to 49 percent. Foreign investment in the electrical power giant, Unified Energy Systems (UES), is limited to 25 percent. In practice, these limits have been exceeded, and there is discussion of whether to eliminate or

FOREIGN TRADE BARRIERS

raise the limits. The sale of UES subsidiaries began with the first Wholesale Generating Company selling 14.4 percent of its shares in November 2006. UES officials say that foreign companies are welcome to participate in the tenders as more power generation assets are put on the market in 2007.

Drafts of a new Law on Strategic Sectors have shown that foreign investment in the following sectors may be subject to prohibition and/or more burdensome approval requirements: enterprises in the nuclear industry or involved in handling radioactive materials; enterprises involved in work on infectious diseases; arms, munitions and military equipment production, maintenance or repair; the aviation and space industries; data-transmission infrastructure; production and distribution of encryption technologies and equipment; and production and sales of goods and providing services under conditions of a "natural monopoly" (e.g., activities such as operating certain gas networks); among others sectors. This draft law may be submitted to the Duma in 2007.

Taxes

In response to investor concerns over the arbitrary and heavy-handed application of the tax code, the Russian government initiated a package of tax reforms in 2005 that was designed to limit aggressive tax collection practices while lowering the overall tax burden. The Duma continues to work on a series of measures that are expected to introduce tax benefits for the high technology sector, protect the rights of investors with licenses to work in the energy sector, and raise the transparency of the tax audit process. The corporate profit tax has been 24 percent since 2002.

Regions and municipalities have the authority to grant exemptions to the regional portion of profits taxes. Regions are not able to grant individual tax exemptions.

Companies report that VAT refunds to a Russia-based exporter, which should be provided within three months after a claim is submitted, often do not occur on time, with customs and tax authorities applying a number of burdensome additional requirements. In addition, input VAT is often not refunded for a number of reasons, forcing exporters to seek court enforcement. VAT refunds on exports are also the source of significant fraud, making it that much more difficult for legitimate exporters to obtain refunds. Legislation to simplify VAT reimbursements took effect on January 1, 2007. Under the new law, VAT refund processing time is expected to fall from three months to two weeks. In addition, during the course of their audits, Federal Tax Service officials will have the authority to confiscate improperly disbursed VAT refunds, with penalties.

Duties on the production and export of oil, which are generally quite high, have been adjusted several times over the past few years. In 2003, new legislation restored full discretion to the Russian government in establishing export duties on refined petroleum products. Changes in the tax code in 2004 shifted the burden away from manufacturing and services and towards the energy sector. In 2006, the Russian government passed legislation that will put into place a differentiated tax regime on oil production for certain regions to help address the recent trend of slowing growth in oil production.

Energy Sector

In 2006, the Russian government decided to initiate amendments to the current Law on Subsoil Use rather than pursue the entirely new law it had been working on for several years. In these amendments, the Russian government may include language that would restrict foreign company participation to minority stakes in certain "strategic" fields, including the activity of natural resource extraction. The proposed amendments indicate that foreigners can only participate as a minority in a strategic field development.

The Russian government recently opened up its two key energy firms – Gazprom and Rosneft – to wider participation by non-state investors. In December 2005, the government eliminated the Gazprom “ring-fence” – the cap on foreign share ownership in the company. Gazprom has been acquiring other assets in related industries (electrical generation and oil) and has teamed up with Russia's largest coal producer in what appears to be an effort to create a national champion in the energy sector. In addition, several major oil companies are working out the terms for joint exploration and development of large gas fields under Gazprom's control. In July 2006, the Russian government held an initial public offering on the London Exchange for the oil company, Rosneft.

The Russian government will not enter into any further Production Sharing Agreements (PSAs - designed for energy projects that require high capital expenditure and a long period before profits or significant tax revenues are generated). Prior to 2003, three PSA regimes were in place: the Sakhalin I and II consortia, and Kharyaga. This year, the operator of Sakhalin II, Sakhalin Energy, has been subject to criticism by the government for alleged environmental violations that occurred during pipeline construction. The members of the Sakhalin Energy consortium (led by Royal Dutch Shell) entered into discussions with the Russian government which resulted in the consortium agreeing to reduce its stake and giving Gazprom a controlling share.

In addition, the Caspian Pipeline Consortium (CPC) project, operational as of 2001, continues to seek authorization from the Russian government to allow expansion of the pipeline's capacity. (Pipeline expansion requires unanimous approval from the 11 shareholders in the consortium.) Final agreement could come in 2007.

Aviation

Many of the Russian-flagged carriers have aging fleets and use outmoded avionics and engines, but several are seriously considering significant purchases or wet-leases of foreign aircraft in an attempt to be more competitive with Western airlines. Russia's aircraft manufacturers only produce ten planes per year on average and therefore cannot keep up with Russian airlines' projected demand for 1500 additional planes in the next twenty years.

Current Russian law stipulates preferential treatment (tax holidays, guarantees on investment, etc.) for Russian and foreign investors in aviation-related research and manufacturing ventures. However, it limits the share of foreign capital in aviation enterprises to less than 25 percent and requires that board members and senior management staff be Russian citizens. There is speculation that the 25 percent limit could be raised or eliminated to make way for further investment.

The government is also looking to reorganize and revitalize Russia's aircraft industry in the context of a larger restructuring plan for Russia's defense industry. Civil aviation and the aircraft manufacturing industry are under considerable Russian government scrutiny following three major airplane crashes in 2006. Large-scale consolidation of the aircraft industry took place with the government creation of the Unified Aircraft Corporation (UAC). The Russian government expects the UAC to fulfill no fewer than twenty contracts in the next year for helicopters, sports planes and engines (worth approximately \$380 million). The UAC is already negotiating with European Aeronautic Defence and Space Company (EADS) for long term design contract work and a possible joint-venture on the next generation of Airbus jets, and in 2006, the Russian government acquired 5 percent of EADS.

Capital Flows

On July 1, 2006, Russia began allowing the free flow of capital into and out of its financial system. The Central Bank no longer maintains either minimum-time requirements on capital flows or mandatory reserve requirements on the movement of capital.

ELECTRONIC COMMERCE

Electronic commerce exceeded forecasted growth in 2006, increasing from approximately \$1 billion in 2005 to over \$1.2 billion in the first six months of 2006. The volume is growing at a brisk pace and is expected to continue, though in comparison to many other countries, electronic commerce remains an embryonic market in Russia. The number of stores on the Russian Internet is estimated at only 2,000 to 4,000, and many do not accept on-line payments, merely using their websites for cash on delivery requests. Although Internet access in Russia is growing steadily, penetration is less than 20 percent of the population, with over 30 percent of these users located in the Moscow and St. Petersburg regions.

On January 1, 2005, the “Law on the Protection of Consumer Rights” took effect, which allows consumers a seven-day period to return goods purchased online. The “Law on Personal Data” came into effect in July 2006, and provides for the protection of consumer information. A draft law on electronic trade has been stalled in the Duma for several years. While closely following an International Chamber of Commerce model bill, it has significant problems, including the fact that it limits electronic transactions to the sale and purchase of moveable goods, services agreements, and shipments.

Russian law does not currently provide identical legislative protection for both electronic and paper documents. Because of this discrepancy, electronic settlement of outstanding charges is problematic, and currency control provisions may apply when paying in a currency other than rubles. The tax effect of electronic commerce is virtually unexplored, and this area of the law is still developing.

Registered trademarks are not recognized in Russia as entailing rights to the equivalent domain names. This has led to cases of cyber-squatting where intellectual property rights infringers register domain names that are identical or similar to established trademarks in hopes of illicit financial gain. The courts have taken divergent approaches to litigation arising from such disputes. The new Part IV of the Civil Code, which will replace the existing Russian intellectual property rights laws after January 1, 2008, contains provisions that address this issue, although it is difficult to tell at this juncture whether it may indeed correct the problem.

A law on electronic digital signatures went into effect on January 14, 2002. This law does not follow the Model Law on Electronic Signatures of the U.N. Commission on International Trade Law, but rather defines electronic signatures strictly, making public-key technology the sole acceptable digital signature technology. It also requires that hardware and software used in digital signature authentication programs be certified in Russia. This gives the Russian government the right to insist on the decompilation of electronic signature programs. These requirements, in addition to the aforementioned licensing requirements related to goods with encryption technology, present serious obstacles to trade in goods that Russia requires for further development of electronic commerce.

OTHER BARRIERS

The U.S. logging industry reports that illegal logging accounts for as much as 20 percent to 30 percent of Russia’s timber harvest. Illegal wood supplies have begun to appear in China, hurting U.S. exports to that market. Illegal logging continues to increase, particularly in the Far East due to its proximity to China.

FOREIGN TRADE BARRIERS

According to World Wildlife Fund data, the share of unregistered wood to total volume of timber consumption is 53 percent in Chita region, 34 percent in Primorskiy kray, 33 percent in Khabarovsk kray, 17 percent in Vologda region, and 10 percent in Krasnoyarsk kray.