

# RUSSIA

## TRADE SUMMARY

The U.S. goods trade deficit with Russia was \$11.3 billion in 2005, an increase of \$2.4 billion from \$8.9 billion in 2004. U.S. goods exports in 2005 were \$3.9 billion, up 33.1 percent from the previous year. Corresponding U.S. imports from Russia were \$15.3 billion, up 28.5 percent. Russia is currently the 33<sup>rd</sup> largest export market for U.S. goods.

The stock of U.S. foreign direct investment (FDI) in Russia in 2004 was \$2.2 billion, up from \$1.8 billion in 2003. U.S. FDI in Russia is concentrated largely in the mining sector.

Russia is in the process of negotiating terms of accession to the World Trade Organization (WTO). By the end of 2005, the Government of Russia had met over 30 times with WTO members in formal and informal Working Party meetings. Russia tabled its initial goods and services market access offers in February 1998 and October 1999, respectively. Russia has subsequently revised these offers and continues negotiations with Working Party members. As of the end of 2005, Russia reported concluding bilateral market access and services negotiations with most WTO members.

The United States and Russia signed a Bilateral Investment Treaty (BIT) in 1992. Though ratified by the U.S. Senate that same year, it was never ratified by the Russian State Duma.

## IMPORT POLICIES AND PRACTICES

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

### Quotas

In January 2003, the Russian government announced the imposition of a quota for poultry and tariff-rate quotas for pork and beef. Quotas became effective in April and May 2003, respectively. The United States reached an agreement in principle with the Russian government in September 2003 for market access parameters on poultry, pork, and beef. After much delay by the Russian side, the agreement was signed in Washington, D.C. on June 15, 2005. There have been a number of persistent concerns about how the agreement has been implemented, namely, the potential for the quota to be used by other countries. Discussions between the two sides on current and future quota allocation procedures continue in the WTO accession context. Russia announces quota allocation based on historical export levels as provided for in the agreement.

## FOREIGN TRADE BARRIERS

## **Import Licenses**

During 2005, the Russian government eliminated and streamlined many existing import license requirements. Import licenses are now required for explosive substances, drugs, nuclear substances, medicines, white spirits, hazardous wastes, some food products, and products containing encryption technology. Additionally, licenses to import many of these products, including alcoholic beverages, pharmaceuticals, and products containing encryption technology, are limited to companies that have been granted Activity Licenses to produce or distribute in Russia.

Russia has proposed a new regulatory regime that would formalize previously informal controls on imports and exports of products containing encryption or ciphering technology. As proposed, the Federal Security Service (FSB) and the Ministry of Economic Development and Trade (MEDT) would apply a multi-stage inspection and permit process consisting of an experts' evaluation, authorization by the FSB, and import and activity licensing by MEDT. The draft regulation raises strong concerns about the transparency of its implementation. The scope of its coverage appears to be unnecessarily broad and the time required for obtaining all of the relevant evaluations, approvals, and licenses is estimated to be more than 80 days if the product is covered by the broad list. There is the potential for the experts' evaluation process to be expensive and arbitrary.

In September 2005, to protect its domestic fish resources, Russia announced new licensing requirements for fish and roe. Russia is a large importer of roe, including from the United States. Most import licenses are issued by MEDT or its regional branches and are enforced by the Federal Customs Service.

## **Customs**

A new Customs Code, intended to bring Russia's customs regime into compliance with WTO requirements, came into force on January 1, 2004. It simplified the customs process and established specific procedures for the application and payment of tariffs, but several problems still remain. Russia continues to assess the value for compact discs (CDs) and digital video discs (DVDs) on the royalty value of imported audiovisual materials - such as TV master tapes and DVD masters - rather than basing these duties on the physical value of the medium on which the content is recorded. This artificially increases the effective tariffs imposed on imported U.S. products. Amendments to the Customs Tariff Law that address customs valuation are being reviewed within the Duma.

The weighted average applied import tariff for Russia is 10.4 percent for industrial goods and 21 percent for agricultural goods. Earlier reforms in 2001 consolidated Russian tariffs into basic categories and lowered some tariff rates, but many tariffs still are accompanied by alternative minimum specific tariff rates (these are not included in the averages) and higher tariffs remain on some used goods. Tariff consolidation helped to combat customs fraud and improve collections, yet, the overall weakness of the Russian customs administration still leads to many abuses. Producers of the following goods, among others, have complained about excessively high tariffs: automobiles, aircraft and aircraft parts, motorcycles, sugar, distilled spirits, wine, fruit, processed food and forest products.

## **FOREIGN TRADE BARRIERS**

A value-added tax (VAT) is applied to virtually all imports, and excise taxes are applied to a small selection of goods. As of January 1, 2004, the VAT, which is applied to the price of the imported good plus its tariff, was reduced to 18 percent. In the case of automobiles, combined tariffs, VAT and engine displacement-weighted excise duties can increase import prices by 70 percent for larger U.S.-made passenger cars and sport utility vehicles. When the import tariff is added to the VAT and other customs handling fees, the amount of total taxes paid on the importation of foreign aircraft exceeded 40 percent in 2005. Pharmaceutical importers have complained that new pharmaceuticals imported solely for clinical trials (prior to registration) nevertheless had the VAT assessed because the importers could not produce a certificate of registration, which is impossible for them to obtain as registration is only granted to drugs that have completed clinical trials. These issues are key subjects under discussion in Russia's WTO accession negotiations.

### **Non-Tariff Barriers**

Non-tariff barriers are frequently used to restrict foreign access to the market and are also a significant topic of discussion in Russia's WTO negotiations. While phytosanitary certificates are customarily required for agricultural goods, Russia's Federal Service for Veterinary and Phytosanitary Surveillance (VPSS) has recently begun to require such certificates for products such as styrofoam cups, furniture, and various processed agricultural products.

For the importation of pharmaceutical products, Russia requires product registration, an "experts' analysis," product certification, and an import and activity license. In the context of its WTO negotiations, Russia is working to eliminate discriminatory fees for experts' analysis and product registration and is moving towards manufacturers' self-certification for Good Manufacturing Practices on pharmaceuticals. Russian government decisions regarding which 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 excluded from reimbursement lists and state purchases because the government focuses more on price concerns than on the quality and safety of the products.

The Russian government has retained tight controls on the production, importation, and distribution of alcoholic products, including wine. Current requirements include the need for importers to obtain an import and activity license and to pay high excise taxes to obtain excise stamps. On January 1, 2005, the excise tax for distilled spirits with an alcohol content greater than 25 percent was increased to 146 rubles per liter of pure alcohol. Spirits containing between 9 percent and 25 percent are assessed an excise tax of 108 rubles per liter of pure alcohol. The rate for spirits below nine percent alcohol is 76 rubles per liter of pure alcohol. The vast majority of U.S. spirits are subject to the highest excise tax rate. In 2005, Russia eliminated import quotas and minimum import prices for imports of alcoholic products and eliminated the need for an import license for non-white spirits. A July 2005 law effective January 1, 2006, requires that excise stamps only be affixed to imported goods once they are in the territory of the Russian Federation. This requirement was eliminated through amendments in late 2005. There continue to be concerns, however, about the timely availability of excise stamps for use during 2006.

## **FOREIGN TRADE BARRIERS**

Manufacturers of telecommunications equipment, construction materials and equipment, and oil and gas equipment have reported serious difficulties in obtaining product approvals. A new Law on Telecommunications, however, overrode an amendment to the Federal Law on Communications that had encouraged government agencies to purchase Russian-produced equipment.

Although Russia is expected to represent a significant market for new nuclear plants, instrumentation, and nuclear fuel over the next decade, U.S. companies are largely excluded from the market. One significant obstacle is Russia's lack of a nuclear liability regime providing adequate protection for U.S. firms that creates a prohibitive risk to business operations. Because few private companies will operate without such liability protections, Russian state-owned nuclear suppliers largely control the domestic market. Although Russia did ratify the Vienna Convention on nuclear liability in 2005, that convention remains incompatible with domestic U.S. legislation, and therefore offers no additional protection to U.S. firms.

## **EXPORT POLICIES AND PRACTICES**

The Russian government's industrial policy guidelines emphasize export promotion, but this process is still in its infancy and there has been limited budgetary funding for such initiatives. The subsidy-like effect (for Russian industrial consumers of natural gas) 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. There is uncertainty as to whether prices in Russia's domestic market are below the full cost of production. Russia has indicated that it is currently considering numerous reform plans for the sector, and has been gradually increasing domestic prices (prices rose 23 percent in January 2005 and are expected to rise a further 10 percent to 15 percent in 2006). However, the gas sector and Gazprom, Russia's monopoly distributor, play a significant role in Russia's economy and foreign relations. The Russian government is proceeding slowly and cautiously with any changes in the sector, even ones that bring prices up to cover full production cost, including recovery. Russia has no direct export subsidies on agricultural products, although it has asserted in WTO accession talks that it would like to reserve the option to use agricultural export subsidies in the future.

Russia maintains export taxes on a large but slowly decreasing variety of products. Russia currently imposes a 15 percent export tariff on ferrous steel scrap (amounting to not less than 15 euros per metric ton). This policy further restricts world supplies of steel scrap and artificially ensures that Russian steel producers have access to scrap. Russia also currently maintains a 10 percent export tariff on copper cathode and no export duty on copper wire rod, allowing Russian copper wire rod producers to have access to copper cathode at favorable prices for the production of the value-added copper wire rod, which then can be exported from Russia duty free.

## **STANDARDS, TESTING, LABELING AND CERTIFICATION**

Russia continues to work to bring its technical regulations, including those related to product and food safety, into conformity with international standards. Companies continue to report frequently shifting requirements and inconsistent enforcement. In November 2004, the Russian Federation published a list of 74 laws and regulations that will be amended within the next two years according to the Law on Technical Regulation.

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This effort is designed to bring Russian legislation into compliance with WTO norms. Targets for reform include many statutes and regulations relating to agriculture, including food safety, biotechnology, and agricultural production. Drafts of these measures are in the process of being submitted or have been submitted to the Duma for approval.

On June 1, 2005, Russia unified the administration of its certification and standards setting agricultural agencies under its Federal Service for Veterinary and Phytosanitary Surveillance (VPSS), eliminating the Russian State Plant Quarantine Service (SPQS). Many certifying responsibilities of State Sanitary and Epidemiological Health Service were also moved to the VPSS. Sanitary and phytosanitary restrictions have had a major negative affect on U.S. trade, with products deemed as “sensitive” by Russia being blocked, seemingly without a scientific basis.

The ban on U.S. beef and liver for Bovine Spongiform Encephalopathy (BSE) is approaching its third year. There also are continuing concerns about Russian poultry plant inspections, restrictions on U.S. pork exports due to trichinae issues, regulations related to biotechnology, and reporting requirements for avian influenza. U.S. horses, genetics, dairy, eggs, and other products remain affected by a lack of agreed certification between the United States and Russia. In addition to these specific issues, in the context of Russia’s WTO accession, the two sides are discussing Russia’s adoption of international standards, guidelines and recommendations set by internationally recognized bodies such as Codex Alimentarius, Office of International Epizootics (OIE), and International Plant Protection Convention (IPPC).

## **GOVERNMENT PROCUREMENT**

The Russian government spends more than a third of its budget on procurement - \$30 billion in 2005. A new law on government procurement went into effect in July 2005, which provides for auctions on all government purchases over \$8,000 (except for those made in commodity exchanges). To improve transparency in the procurement process, auctions will have to be advertised on agency websites as well as on a consolidated government procurement website. The new law eliminates restrictions on the participation of foreign suppliers, though it permits exceptions for reasons of national security or defense. A special enforcement agency will oversee implementation of the new regulations.

## **INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION**

While Russia has made advances in its efforts to improve its IPR protection regime, many challenges remain, particularly in the area of copyright piracy. 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, and will be subject to a review in early 2006. IPR is a key issue of discussion in Russia’s WTO accession negotiations.

## **FOREIGN TRADE BARRIERS**

## **Copyright**

U.S. industry is increasingly concerned about the deteriorating IPR situation in Russia. U.S. copyright industries estimate they lose in excess of \$1.7 billion annually due to copyright piracy (films, videos, sound recordings, books and computer software). The U.S. film industry estimates that over 80 percent of all DVDs on the Russian market are pirated. Piracy of music is estimated at approximately 66 percent of sales. The business and entertainment software industries, however, report declining levels of piracy.

2005 saw a continued increase of optical disc production capacity far in excess of domestic demand, with pirated products apparently intended not only for domestic consumption, but also for export. U.S. industry reports that unauthorized domestic production of optical media has increased in Russia. There are approximately 46 known optical disc plants now in operation, an estimated 30 of which are believed to be engaged at least part-time in the illegal production of pirated goods. Between 12 and 16 of these plants are operating on government-controlled military-industrial sites. Further, Russia's large, porous border contributes to the worldwide spread of pirated materials produced in Russia.

The Russian government's Licensing Law, adopted in August 2001, included licensing requirements for optical media producers. While several licenses were suspended in 2005 as a result of pirate activity, only a court can revoke a license. Rosokrankultura, the responsible agency, successfully went to court to revoke two licenses for illegal operation in 2005, and has delayed approval of some applications where it was not able to determine that the operators would only be engaged in legitimate production. The Russian government has so far been unable to strengthen the licensing regime to revoke licenses of pirate operators and to deny new licenses to applicants known to have been engaged in piracy. U.S. copyright industries have pressed the Russian government to adopt a comprehensive regulatory framework dealing with the production and distribution of optical media.

Internet piracy has become a growing concern with the growth of internet access. Russia is home to some of the world's most used Internet-based pay download services for pirated music, such as allofmp3.com, which offers global distribution from its well-protected location inside Russia.

## **Enforcement**

Russian law enforcement has begun to take a more aggressive approach toward pirate optical disc producers. In late 2005, Russian authorities conducted a series of raids on production facilities and launched criminal proceedings against allofmp3.com. It remains to be seen whether these efforts will result in sustained reduction of piracy rates, the seizure of equipment and materials used to create pirated optical media, and prison sentences for violators. Even where Russian law provides for serious penalties such as the destruction of counterfeit or pirated goods, machinery seized during enforcement actions are rarely destroyed, and consequently, may return to the stream of commerce even if they are found to be illegal. In the vast majority of cases, alleged infringers receive miniscule fines or suspended prison sentences.

Administrative and judicial review bodies are also beginning to become active in protecting IPR in Russia, 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 piracy. U.S. investors also consider the Russian court system ill-prepared to handle sophisticated patent cases. On the other hand, a specialized higher patent chamber has been established at Rospatent, which has brought greater expertise and efficiency to resolution of patent and trademark disputes.

### **Legislative Framework**

In 2004, Russia passed amendments to the Law on Copyright and Related Rights to provide protection for pre-existing copyrighted works and sound recordings. These amendments included provisions for giving rights holders control over Internet distribution of their work. However, entry into force will not occur until September 2006. In 2002 and 2003, Russia enacted amendments to laws on trademark and appellations of origin, patents, protection of layout designs for integrated circuits, plant varieties, and protection of computer software and databases. Strengthened criminal penalties for IPR infringement went into effect on January 1, 1997, and even stronger penalties were adopted in Article 146 of the Criminal Code in 2003.

Despite concerted efforts to put into place a strong legislative framework for intellectual property rights protection, several deficiencies remain in Russia's legal regime. Russia continues not to provide national treatment for the protection of geographical indications. Upon completion of its WTO accession, Russia would be required by Article 39.3 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) to 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. The United States is working with the Russian government in the WTO accession negotiations to amend its Law on Medicines so that Russia complies with the TRIPS Agreement. In late 2005, the Russian government proposed legislative changes to address these concerns; these changes, however, have not yet been considered by the Duma.

### **Patents and Trademarks**

U.S. and multinational companies continue to report counterfeiting of patented and trademarked goods as a serious problem, especially for consumer goods, wine, distilled spirits, pharmaceuticals and other products. Several U.S. firms have also experienced problems with trademark counterfeiting, with Russian enterprises attempting to use well-known foreign trademarks not currently active in Russia. Rights holders have been moderately successful in countering these schemes through the Russian court system or with Rospatent. U.S. firms need to take steps to protect their intellectual property, including registering their trademarks with Rospatent.

## **SERVICES BARRIERS**

Discrimination against foreign providers of non-financial services is, in most cases, not the result of federal law, but can stem from abuse of power, sub-national regulations and practices that may violate Russian law. For example, a few foreign providers of services have sometimes noted discrimination in obtaining licenses from local authorities. Foreign providers are forced to pay a range of fees that domestic companies allegedly avoid through bribery.

Central Bank regulation 721-U previously required that purchases of foreign currency of greater than \$10,000 for a limited number of imported services, mainly in the hospitality and tourism sector (e.g. Russians seeking to buy foreign currency to pay foreign suppliers), receive advance permission from the Ministry of Finance. While intended to combat capital flight, this measure had the potential to delay financial transactions and impede the participation of foreign firms in this sector. The Law on Currency Monitoring and Regulation, signed by President Putin on December 10, 2003, eliminates the need for advance permission, but requires Central Bank notification in most circumstances unless specifically noted in the law. Under the new law, all currency controls are to be lifted by 2007.

### **Financial Services and Insurance**

The federal law on "Banks and Banking Activity of 1996" permits foreign banks to establish subsidiaries in Russia. However, the law also allows the Central Bank to impose a ceiling on the total amount of foreign bank capital calculated as a percentage of the total bank capital in Russia. To date, the Central Bank has never invoked this authority. Since 1997, the Central Bank has required new foreign bank subsidiaries to have a minimum of Euro 10 million in capital (the same requirement is applied to domestic banks). There is a further requirement that at least 75 percent of the bank's employees and 50 percent of the bank's management board are of Russian nationality. Heads of foreign banks' Russian offices are required to be proficient in the Russian language. In WTO accession talks, the United States has urged the Russian side to liberalize completely by allowing bank branches, as well as subsidiaries. To date, Russian officials remain unreceptive.

Since 1999, foreign majority-owned insurance companies have been subject to a 49 percent equity restriction in the life-insurance, compulsory and statutory insurance sectors. (Foreign majority-owned firms that were actively selling these products in Russia when this requirement came into effect were grandfathered). In addition, total foreign capital in the Russian insurance sector is limited to 25 percent. In January 2004, however, a law came into force (based on a 1994 Russia-EU treaty) that exempts EU-based insurance companies from the 49 percent cap on these sub-sectors. This exemption also applies to EU subsidiaries of non-EU foreign insurance companies. The Russian government has stated that these preferences given to EU-based insurance companies will be eliminated upon Russia's accession to the WTO. Until then, however, EU firms will enjoy an advantage over their counterparts from the United States and elsewhere, since they can offer life and mandatory forms of insurance in Russia directly, without the requirement to work through a majority Russian-owned partner. The new law retains the requirement that chief executives and chief accountants of foreign insurers operating in Russia be Russian citizens.

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## **Telecommunications**

A new Law on Communications went into effect on January 1, 2004. Final implementing regulations, however, have still not been released. The Law's impact on the business of competitive alternative telecommunications operators (many of which enjoy large foreign investment), could be substantial because these companies will now be subject to tighter government regulation. In particular, new regulations on interconnection -- the process by which alternative operators connect their networks to the Russian public switched telephone network -- place interconnection contracts and fees under the tight regulatory authority of the Ministry of Communications. Alternative operators fear that interconnection fees will be raised to subsidize network upgrades of government-owned and ministry-controlled local and long distance operators.

Many in the telecommunications industry were disappointed that the new law did not improve transparency in the licensing process and have criticized the five-year to ten-year limit on licenses, which they argue do not allow them sufficient time to recoup their investment. Russian policy in the telecommunications sector is a subject of discussion in negotiations on Russia's WTO accession, and WTO members have expressed concern that the new Law on Communications may restrict access to a now relatively open market, particularly through the adoption of new rules and regulations as set forth under the new Law.

In 2005, no progress was made in clarifying the legal situation in the telecommunications sector. As noted above, the Law on Communications is a framework law that depends on implementing regulations in order to function properly. Very few of these regulations have been completed, leading to much legal confusion in the sector over such important issues as licensing requirements and procedures, equipment certification, and the nature of the Law's universal services provision. Regulators are also attempting to deal with such social issues as the control of spam, access of minors, and pornography. The regulations are not expected to be completed until sometime in 2006 at the earliest.

On January 8, 2006 the Prime Minister signed a resolution approving the rules for auctions or tenders for licenses to provide communication services for territories with a limited number of frequency resources. In addition, the Minister for Information Technologies and Communications has said that the government will begin in 2006 to offer licenses for third generation (3G) mobile telephones which will provide music, TV, video and internet access. At that time, the largest mobile phone operators will seek tenders for this technology, and U.S. companies will be seeking a substantial share of the new business. 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 lacks transparency.

Significant barriers have been identified in the provision of satellite telecommunications services in Russia. In particular, satellite regulation is not transparent, and the legal requirements and administrative responsibilities associated with the provision of these services appear to be discriminatory. The Russian Federation maintains a preference for the use of Russian satellite communications systems.

Russian entities with more than 50 percent foreign ownership are prohibited from sponsoring television or 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 a law regulating foreign investment being in effect since June 1999, Russian foreign investment regulations and notification requirements can be confusing and contradictory. The law on foreign investment provides that a single agency, which still has not been designated, will register foreign investments and that all branches of foreign firms must be registered.

Corruption in commercial and bureaucratic transactions and problems with the implementation of customs regulations inhibit investment. Trade and investment would benefit, for example, from improved dispute resolution mechanisms, the systematic protection of minority stockholders rights, the adoption of international accounting standards and adherence by companies to codes of conduct related to ethics and good governance. 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. Accession and implementation of the OECD Bribery Convention would help provide more discipline in addressing bribery of foreign public officials and is a requirement for OECD membership. More transparent implementation of customs, taxation, licensing and other administrative regulations is necessary.

### **National Treatment**

The 1999 Investment Law codifies the principles of national treatment for foreign investors, including the right to purchase securities, transfer property rights, protect rights in Russian courts, repatriate funds abroad after payment of duties and taxes, and receive compensation for nationalizations or illegal acts by Russian government bodies. The law, however, 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." The potentially large number of exceptions thus gives considerable discretion to the Russian government. The law also provides a "grandfather clause" which 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 over \$4.1 million and with a total investment of over \$41 million. The lack of corresponding tax and customs regulations, however, means that any protection afforded investors by this clause remains theoretical.

The Land Code that was passed in 2001 provides for equal treatment of domestic and foreign entities to buy most land and buildings, although purchase of agricultural land by foreigners is still prohibited. Discussion on specific land policy continues, including legislation on transfer of use, but a conclusion has not yet been reached. Foreign entities are restricted from buying land close to federal borders and in areas that the President determines are critical to national security.

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Current Russian legislation restricts foreign investment in the aerospace industry to less than 25 percent of an enterprise. Foreign investment in the state-owned natural gas company, Gazprom, is formally limited to 20 percent. Foreign investment in the electrical power giant, Unified Energy Systems, is limited to 25 percent.

Foreign investment in the Russian spirits industry is limited to 49 percent. In addition, a new draft Law on Natural Resources or Subsoil Law (see Energy section below) regulating the licensing and oversight of natural resource assets is currently being debated within the Russian government. It is possible that the government will include language in the draft that would restrict foreign company participation to minority stakes in certain “strategic” fields. A draft law on investment in strategic sectors is also being discussed within the government, which could involve reviews of proposed inward investment for national security reasons.

In addition to a burdensome certification process, the satellite industry reports that a local presence requirement and discriminatory treatment create barriers to doing business in Russia. Telecommunications companies also report investment restrictions.

## **Taxes**

In response to investor concerns over the arbitrary application of the tax code by the tax administration in the case of the Russian oil company Yukos, the Russian government developed a package of tax reforms in 2005 that is designed to limit aggressive tax collection practices while lowering the overall tax burden. The series of laws and amendments to the tax regime to be ratified by the Duma would: (1) introduce transparency measures to the auditing process; (2) simplify the procedure for refunding VAT on exports (see below); (3) introduce tax benefits for the high-technology sector through changes to the profit tax structure; and (4) protect the rights of investors who possess licenses to work in the energy sector. In 2005, the Duma also lowered the statute of limitations on all transactions, including privatization deals, from ten years to three years, signaling that the privatization deals of the 1990s are unlikely to be reexamined. Effective January 1, 2005, the Unified Social Tax, which is paid by employers and covers pensions, healthcare, and social security, dropped from an effective rate of about 30 percent to a top rate of 26 percent on salaries up to 280,000 rubles (about \$10,000) a year. The Russian flat income tax rate of 13 percent for residents and 30 percent for non-residents in 2001 and corporate profit tax of 24 percent, established in 2001 and 2002, respectively, remain in effect. The U.S. securities industry also complains about the low threshold for triggering criminal investigations of underpayment of tax (currently about \$50,000) and the need for a motives test to distinguish between criminal intent and honest mistakes.

Regions and municipalities have the authority to grant exemptions to the regional portion of profits taxes, with some regions granted specific regional exemptions. Legislation related to Kaliningrad is under consideration in the Duma. Regions are not able to grant individual tax exemptions.

Duties on the production and export of oil, which are generally quite high, have been adjusted several times over the past several 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 sectors and towards the

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energy sector. Given the slowdown in oil production growth, the Russian government is considering ways to stimulate output, including implementing a differentiated tax regime on oil production.

## **Energy Sector**

A new Law on Natural Resources (also called the Subsoil Law) that would regulate the licensing and oversight of natural resource assets is currently being debated within the Russian government. The most recent version of the draft law represents a modest improvement over the current law (as amended). In the current draft, the government has included several of the key provisions that industry had been seeking, including a guarantee that licenses will carry over from the exploration to the development stage, a provision that licenses will be based on civil rather than administrative law, and a limitation on the number of reasons for license revocation. It is possible, however, that the government will include language in the draft that would restrict foreign company participation to minority stakes in certain “strategic” fields. It is also unclear whether the new Subsoil Law will be used to exclude foreign energy service suppliers from offering their services on the gas or oil production site.

In 2005, the energy sector continued to undergo significant reorganization with the government assuming a larger role. First, the state-owned oil firm Rosneft took over the largest production subsidiary of the embattled oil company Yukos. More recently, Gazprom purchased the private Russian oil company Sibneft for \$13.1 billion in the largest-ever merger in Russian corporate history. The “ring-fence” -- the cap on foreign share ownership in Gazprom -- was eliminated. Removal of the “ring fence” would clearly be a boon for investors (increased ability to trade in Gazprom shares) and Gazprom (improved access to capital), but the long-term significance is that it is the first step in reforming Gazprom. It is unclear, however, whether the government has the political will to follow through with reform of the company. In addition, Gazprom has been acquiring other assets in related industries (electrical generation and oil) in what appears to be an effort to create a national champion in the energy sector. Several major oil companies are working out the terms for joint exploration and development of large gas fields under Gazprom’s control.

In 2003, President Putin signed legislation implementing legal amendments restricting Russia’s use of production-sharing agreements (PSAs). PSAs are designed for energy projects that require high capital expenditure and a long period before profits or significant tax revenues are generated. These amendments severely limit the number of energy deposits eligible for PSA status and favor companies that bid to develop energy deposits on a non-PSA basis. The PSA amendments include local content requirements or targets for the use of locally produced equipment and local labor. Another provision in the existing PSA regime limits the total amount of foreign investment to 30 percent of Russia’s “strategic” oil reserves. The precise meaning and significance of this restriction remain unclear.

More than \$5 billion has been invested to date in the Sakhalin II consortium, and in September 2005 ExxonMobil celebrated the first production of oil at its \$12 billion Sakhalin I venture. The \$2.6 billion Caspian Pipeline Consortium (CPC) project, inaugurated in 2001, continues to work with the Russian government to come up with an agreement that will allow the intended expansion of the pipeline's capacity.

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Pipeline expansion requires unanimous approval from the 11 shareholders in the consortium. The producing companies have acquiesced to almost all of the Russian government's demands and have now taken a unified stance and presented the GOR with a final proposal for expansion.

Central Bank restrictions on medium-term loans (more than 180 days) of hard currency for the purchase of imported inputs have also presented an obstacle to foreign investment projects in Russia's energy sector. In addition, non-transparent regulations concerning environmental permits and pipeline access remain of concern to potential U.S. investors.

## **Aviation**

Many of the Russian-flagged carriers have aging fleets and use outmoded avionics and engines, and several are seriously considering significant purchases or leases of foreign aircraft in an attempt to be more competitive with Western airlines. The domestic civil aviation industry cannot keep up with the airlines' demand for modern, relatively fuel efficient aircraft, so Russian airlines are looking to foreign manufacturers despite a 20 percent import tariff plus VAT imposed by the GOR. Current Russian law stipulates preferential treatment (tax holidays and guarantees on investment) for Russian and foreign investors in aviation-related research and manufacturing ventures. The law, however, 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 facilitate further investment. Some observers, however, doubt that recent proposals to raise the limit to 49 percent would be sufficient to attract capital from abroad for Russia's aircraft industry from abroad.

In 1996, the United States and Russia concluded a Joint Memorandum of Understanding (MOU) reflecting U.S. concerns about barriers to the Russian civil aircraft market and the application of international trade rules to the Russian aircraft sector. The MOU states that U.S. aircraft manufacturers will be able to participate in the Russian market and share in its growth. The MOU also makes clear that the Russian aircraft industry will become fully integrated into the international economy over time. Russia pledged to eventually undertake the same international trade principles in the aircraft sector as the United States and many others have done, as embodied in the Agreement on Trade in Civil Aircraft.

The Russian 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. Specifically, large-scale consolidation of the aircraft industry took place with the government creation of the Unified Aircraft Corporation. Government officials have suggested using proceeds from Russia's Stabilization Fund to support this new corporation. The GOR expects it to fulfill no less than twenty contracts in the next year for helicopters, sports planes, and engines (worth approximately \$380 million). Several Russian airlines operate Western aircraft, however, despite the import tariff plus VAT. Two airlines, Aeroflot and Transaero, previously received tariff-waivers and discounts for these planes, but have exhausted their tariff discount and are now purchasing aircraft at full tariff rates, just as other airlines have always had to do. Russian airlines and foreign governments have been vocal about seeking further tariff waivers. For the first time in 2005, Russian Ministers have suggested that the Russian domestic aircraft industry is not capable of producing the number of high-quality passenger jets Russian airlines want in a timely fashion. Discussions within the Russian government on possible tariff reductions continue.

## **FOREIGN TRADE BARRIERS**

Despite previous bilateral assurances that the Russian government would join the Agreement on Trade in Civil Aircraft, Russia has expressed an unwillingness to join the Agreement in the context of WTO accession.

### **Capital Flows**

Russia has assumed obligations under Article VIII of the IMF Articles of Agreement to permit free payment of current transactions, but the Central Bank continues to maintain controls on capital flows. A new law on currency controls took effect in 2004, which reduces the maximum amount to which Russia's surrender requirement for export earnings may be set to 30 percent, and will completely abolish the requirement by 2007. In November 2004, this surrender requirement was reduced to 10 percent of export earnings, well under the 30 percent limitation imposed on the Central Bank. Investors may repatriate coupon payments on government and corporate bonds and invest in other bonds. Licenses are not required for most transactions transferring money into or out of Russia, but proper notification is required. Russia also maintains an advance import prepayment requirement that serves as a trade barrier.

### **ELECTRONIC COMMERCE**

E-commerce in Russia was expected to increase from \$660 million in 2004 to \$1 billion in 2005, but the Russian market is still embryonic. Despite this growth, there are only about 700 electronic stores on the Russian Internet. The draft Law on Electronic Trade has been stalled in the Duma for several years, but it was under consideration again in late 2005 by the Duma's Committee for Information Policy. Although Internet access in Russia is steadily growing, penetration is only around 15 percent to 20 percent of the population, with roughly half of these users located in the Moscow and St. Petersburg regions. Relatively low usage, combined with a low number of credit card users and onerous tax laws, means that e-commerce will grow slowly in the near future. 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 electronic trade legislation, while closely following the International Chamber of Commerce model bill, has significant problems, such as limiting on 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. Settlement issues need to be considered in conjunction with applicable currency control provisions. The tax effect of electronic commerce is virtually unexplored, and this area of the law is still developing.

In Russia, registered trademarks are not recognized as entailing rights to the equivalent domain names. Further, the property rights that trademarks secure for their registered owners are currently not protected for the purposes of Internet advertising and commerce through web sites. This has led to cases of cyber-squatting where domain names have been established in conflict with trademark names. The courts have taken divergent approaches to litigation arising from such disputes.

## **FOREIGN TRADE BARRIERS**

A law on electronic digital signatures came into effect in 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, and thus gives the government access to the source code.

### **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.