

RUSSIA

TRADE SUMMARY

The U.S. goods trade deficit with Russia was \$12.0 billion in 2007, a decrease of \$3.1 billion from \$15.1 billion in 2006. U.S. goods exports in 2007 were \$7.4 billion, up 56.7 percent from the previous year. Corresponding U.S. imports from Russia were \$19.4 billion, down 2.4 percent. Russia is currently the 30th largest export market for U.S. goods.

The stock of U.S. foreign direct investment (FDI) in Russia was \$10.1 billion in 2006 (latest data available), up from \$8.6 billion in 2005. U.S. FDI in Russia is concentrated largely in the mining sector.

Russia's efforts to negotiate the terms for its accession to the World Trade Organization (WTO), begun in 1993, are well-advanced. Russia has completed its bilateral market access negotiations with most interested WTO Members, including the United States. Currently, the only outstanding bilateral negotiations are with Georgia, Saudi Arabia, and the United Arab Emirates. Russia is now focused on multilateral negotiations regarding other terms for accession. Discussions are ongoing on a number of issues including sanitary/phytosanitary measures, agriculture (including domestic support levels), intellectual property rights protection, and the operation of state-owned and state trading enterprises on a commercial basis. Russia also must enact the legislation to implement its commitments.

IMPORT POLICIES

Russia continues to maintain a number of restrictions with respect to imports, charges and fees that exceed the cost of the service, and licensing, registration and certification regimes that are burdensome. Discussions continue on eliminating other border measures or modifying them so that they are consistent with WTO requirements and internationally-accepted practices. Russia also maintains tariff-rate quotas (TRQs) on exports of interest to the United States.

Tariff-Rate Quotas

Consistent with the United States-Russia Meat Agreement, in December 2005 the Russian government established country specific tariff-rate quota volumes (including for the United States) and reduced tariff rates for beef, pork, and poultry meat imports from 2006 to 2009. Later, in June 2007, under its "Government Program for Agriculture and Market Regulation 2008-2012", the government announced that after 2009, country allocations would be abolished and out-of-quota tariff rates raised. Russia has committed that its agricultural policies will be consistent with its bilateral and multilateral commitments, including the United States-Russia WTO Bilateral Market Access Agreement that includes a framework and a time schedule for negotiating how these meat products will be treated after 2009.

Import and Activity Licenses

Import licenses and activity licenses for wholesaling and manufacturing activities are necessary to import a number of products, including alcoholic beverages, pharmaceuticals, products with encryption capability, explosive substances, narcotics, nuclear substances, hazardous wastes, and some food products (e.g., unprocessed products of animal origin). While some of these requirements address legitimate health and safety concerns, others appear to be an unnecessary additional requirement for imported goods and to burden unfairly importation of these products.

For example, all importers of alcoholic products must have a license to produce or distribute and store such products, placing a burden on importers that should be applied only to distributors. Importers of vodka and tequila must also obtain a “white spirits” license, which can take up to two months for the Ministry of Economic Development and Trade (MEDT) to issue. Application for the license requires submission of documents that can take an additional two months to obtain, some of them from Russian government offices. This costly and time-consuming endeavor is not required of domestic distributors and specifically targets vodka imports. (Additional burdens imposed on importers of alcohol-containing products are described below in the section on Nontariff Barriers.)

In a November 2006 bilateral agreement with the United States, the Russian government agreed to set up a streamlined system for the import of goods containing encryption capability with transparent, nondiscriminatory 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 notification requirements at all. The United States continues to work actively with the Russian government on addressing its licensing barriers to trade in goods containing encryption capability and ensuring the full implementation of the terms of our bilateral agreement.

Customs Issues, Taxes, and Tariffs

In addition to tariffs, there are two types of taxes applied to goods at the time of importation: the Value Added Tax (VAT) and selective excise taxes, both of which are also applied to similar domestic goods. 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. The U.S. government has raised this issue with MEDT and the Ministry of Finance.

Excise taxes apply to a number of luxury goods, such as liquor and cigarettes. Wine of 15 percent alcohol or less is assessed at 2.20 rubles per liter, whereas wines exceeding 15 percent alcohol are presumed to be fortified and are assessed at 112 rubles per liter of ethyl alcohol content. Because some California wines exceed 15 percent alcohol without fortification, U.S. industry contends that this differential tax rate constitutes a discriminatory tax against U.S. wine. Excise taxes on other goods can total as much as 570 percent *ad valorem*.

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 40 percent tax, making it virtually impossible for Russian airlines to afford to purchase foreign planes. When Russia joins the WTO, tariffs on aircraft and aircraft parts will be substantially reduced. Tariffs on civil aircraft parts, including engines, will be reduced to an average of 5 percent. In particular, the bilateral agreement on leased aircraft, which entered into force on November 19, 2006, obligated the Russian government to reduce immediately tariffs on narrow body leased aircraft. As a result, in January 2007, the Russian Interdepartmental Commission for Protective Measures in Foreign Trade and Customs Policy approved the decision to cut import duties on foreign leased aircraft from 20 percent to 8 percent for aircraft with 50 seats and fewer and from 20 percent to 10 percent for aircraft between 115 seats and 160 seats. The measure would apply to planes leased for no more than 3 years and would remain in force until January 1, 2011. However, the necessary decree implementing this tariff reduction has not yet been signed.

The current import duty on new passenger vehicles is 25 percent, which, when combined with the excise tax based on engine displacement and the VAT, increases the price of larger U.S. passenger cars and sport utility vehicles by 70 percent. Similarly, for motorcycles, Russia imposes a 20 percent special duty on

large motorcycles, plus an additional 18 percent VAT, increasing prices significantly on imported large motorcycles.

In a bilateral agreement signed in November 2006, Russia committed to revert to and maintain the previously applied 5 percent duties on imports of combine harvesters and threshers and to bind the rates upon accession to the WTO. In February 2008, MEDT announced a safeguards investigation in response to increased imports of agricultural combine harvesters. As of March 2008, it is not clear whether or not this investigation will lead to additional import barriers for these products.

Customs authorities in Russia continue to assess duties on the royalty value of imported audiovisual materials, such as television master tapes, DVDs, *etc.*, rather than solely on the physical value of the carrier medium. Industry has indicated that this practice is contrary to international and European legal standards, and that it represents a form of double taxation, since royalties are also subject to withholding, income, value added, and remittance taxes.

U.S. industries also complain of high tariffs on agricultural products such as sugar, fruit, processed food, and forest products. Once Russia is a WTO Member, it must bind its tariffs on all agricultural products, thereby providing more predictability on its tariff rates.

A new Customs Code, intended to bring Russia's customs regime into compliance with WTO requirements, has been in force since 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 to implement provisions of the WTO. However, significant problems remain. Reportedly, the Russian government issues unpublished recommendations on import valuations to customs posts to help combat undervaluation of imports. However, these recommendations can also be applied as reference prices for customs valuation or substituted for the invoice value of the imports. U.S. industry also reports that Russia does not publish all regulations, judicial decisions, and administrative rulings of general application to customs matters. In addition, U.S. exporters 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 recognizes that it will need to revise elements of its customs fees. In addition, the United States is working with Russia in the multilateral WTO Working Party process to make substantial improvements on these customs issues and ensure full implementation of the WTO Customs Valuation Agreement into Russia's laws.

Nontariff Barriers

U.S. companies continue to face a number of nontariff trade barriers when exporting to Russia. Nontariff barriers are a topic of detailed discussions in Russia's WTO accession negotiations.

Pharmaceuticals

Russia's pharmaceutical market has seen some of the fastest growth in the world over the last three years. Foreign firms account for 75 percent to 80 percent of total sales in the Russian market. Despite the impressive growth prospects in almost all segments of the market, the government's drugs benefit program for social welfare beneficiaries has slowed imports in 2007. The program, known as the Additional Drug Supply or "DLO" was plagued by deficit spending and distribution problems in late 2006 and early 2007. The DLO market share represented 10 percent of the entire pharmaceutical market in 2007 and is forecast to account for 20 percent of the market in 2008. 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.

Experts estimate that sales of counterfeit drugs in Russia are at least \$200 million to \$300 million per year, with some 70 percent of the fake drugs being produced domestically.

Alcohol

Alcohol trade in Russia is governed by a burdensome array of no fewer than 105 laws, decrees, and regulations. The complete list can be found in Russian at: <http://alcohol-info.ru/?page=normativ>.

Importers of alcohol face a variety of discriminatory measures. As part of the Law on Production and Turnover of Alcohol, as amended in April 2006, all customs duties, excise taxes and VAT on alcohol must be paid in advance using a bank guarantee and deposit. These funds must be deposited twice, once for import and once for transit (the second “transit” guarantee has purportedly been eliminated, but Russian customs has, for procedural reasons, ignored its revocation). The advance payment requirement for duties and taxes has the effect of limiting trade volumes due to the amount of money that must be tied up in guarantees. The deposit requirement also discriminates against imports because the bank guarantee required of domestic producers is equal to only the excise taxes. Furthermore, the customs registration fee, 7000 rubles, exceeds user fee levels for such services in other countries

Importers face additional burdensome and discriminatory procedures under the current regulatory regime. The United Federal Automated Information System (UFAIS) requires importers and domestic manufacturers to print Universal Product Code (UPC) data on a small paper excise stamp attached to each bottle. 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. The importer is responsible for marking the imported alcohol products with excise stamps before the products enter the Russian Federation. To do this, the importer must provide for registration of the imported alcohol product in the UFAIS system, as well as print data about the alcohol product on the excise stamps, procure such stamps, and attach them to the consumer packaging. The importer bears responsibility for the authenticity of the data as well as for the correctness of their placement on the excise stamps.

Not only is the process burdensome and expensive, but as implemented, it discriminates against imported spirits. Most notably, imported beverage alcohol products are required to use and report sequentially numbered strip stamps while domestically produced products may use and report stamps by batches of products. Importers are required to record by hand the strip stamp sequential number of each bottle, in blue ink, in a special notebook, every page of which has been hand stamped by tax authorities, when the bottle enters the warehouse. When bottles leave the warehouse, the strip stamp sequential number must again be recorded by hand, in blue ink, in the book. Moreover, importers must report the strip stamp sequential numbers contained on every packaging size (from the bottle to the case, pallet, batch, consignment, *etc.*). Finally, whereas domestic manufacturers/distributors are required to report only to the Tax Authorities (and only by batches of products, not individual strip stamp sequential number), importers must also report their more detailed data to Russian Customs, and in a different format, increasing the reporting cost as well as the possibility for error.

Since the UFAIS system was first introduced, numerous problems have arisen in its implementation. For much of 2006, the new stamps were not available and then the stamping machinery did not work. Wholesalers were not legally allowed to apply the stamps on behalf of importers. It was not until March 9, 2007, that the Russian government passed the necessary amendment that allowed bottles to receive new excise tax stamps in wholesalers’ warehouses with a March 30, 2007, deadline to re-stamp the bottles. Although the backlog of U.S.-origin products has been re-stamped and released from warehouses, logistical challenges continue. Problems include the difficulty in stamping miniature, food service-sized

bottles; the frailty of the stamps which tear easily; the discriminatory reporting requirements imposed on importers; and software glitches causing importers' data to be corrupted, costing time and money.

Notwithstanding the initial and ongoing problems with the strip stamps, the Russian government is considering adding a second stamp across the top of the bottle to combat empty bottles being refilled and sold, raising tax avoidance and health issues. The U.S. Government has discouraged such a step, noting the chaos in the market caused with the introduction of the original stamp, and the failure of the stamp to meet the intended goals.

The 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 – were also imposed on products such as perfumes, cosmetics, household cleaners, and solvents containing more than 1.5 percent alcohol, severely disrupting trade. In 2007, the Russian government amended the Law on Production and Turnover of Alcohol to exempt permanently cosmetics, perfumes, and personal care products in packages of up to 500 ml. The United States is encouraging further amendment of the law to exempt permanently all nonfood goods containing alcohol from the alcohol related requirements above.

Development of Nuclear Power Generation

Russia continues to pursue the expansion of its nuclear power generation capabilities and will commission a total of 9.8 GW of additional reactor capacity by 2015. In November 2007, the State Duma passed legislation approving the creation of Rosatom Corporation, a 100 percent government-owned corporation, to replace the existing Federal Atomic Energy Agency. Nearly all of the country's civilian nuclear industry assets (mining, enrichment, fuel production, equipment manufacturing, and nuclear power plant construction and operation) are being transferred to the Rosatom Corporation. The concept is that such a corporation will be better positioned to implement the ambitious domestic nuclear power expansion program and be more competitive on the world market. This new entity will report directly to the President of the Russian Federation, will be funded by the state budget, and will retain all profits from its activities.

Russia has also increased its efforts to reach supply agreements with other uranium supplying countries, such as Australia, which could allow Russia to utilize fully its uranium enrichment capacity and become the world's leading exporter of reactor fuel and other enriched uranium products. The export arm of Russia's nuclear power sector, Atomstroyexport, is a significant competitor to U.S. companies. Russia's lack of a nuclear liability law to provide adequate legal protection for U.S. firms creates a high risk to U.S. suppliers of equipment, fuel, and nuclear energy services to Russia and has impeded their entry into Russia's market.

Other

In October 2007, Deputies in the State Duma's Economic Policy Committee introduced a draft law that envisioned creation, as an anti-counterfeiting measure, of a complicated product tracking system, similar to the controversial UFAIS system now used for alcohol-containing products. Under the draft bill, a similar system would be applied to a broad range of traded goods including: audio and visual works, sound recordings, and computer software and databases on any media; pharmaceuticals; biologically active supplements; cosmetics and perfumery products (originally excluded from the reporting requirements); building materials; cars, aircraft, railway carriages, and spare parts thereof; and explosives. This draft bill was not brought up for a first reading in the State Duma during 2007, but U.S. industry and the U.S. government continue to monitor this issue.

EXPORT POLICIES

The price of gas for Russian industrial consumers is held artificially low by law. The downstream effects of this pricing policy are significant, because gas sells on Russia's domestic market for approximately \$75/tcm to \$95/tcm, with gas exported to Europe fluctuating between \$230/tcm and \$350/tcm over the past year (estimates of cost-recovery levels are at roughly \$35/tcm to \$40/tcm). The Russian government recently approved a plan that proposes increases in domestic prices to European levels by 2011. If implemented, over time higher domestic prices should provide incentives for both gas producers (greater investment and reallocation of resources) and consumers (greater energy conservation). The gas sector and Gazprom, Russia's near-monopoly supplier, play a significant role in Russia's economy and the Russian government is proceeding slowly and cautiously with reform of the sector.

Although Russia has eliminated export duties on a few products, it maintains export duties on nearly 450 types of products for both revenue and policy purposes. Russia has indicated that it intends to eliminate gradually most of these duties, except for products deemed as strategic, such as hydrocarbons and scrap metals. For example, Russia has agreed to reduce its 15 percent duty on ferrous steel scrap to one-third of current levels within 5 years after it becomes a WTO Member. Russia also currently maintains a 10 percent export duty on copper cathode while no export duty is charged on copper wire rod. As part of the bilateral WTO market access agreement, Russia has agreed to eliminate its export duty on copper cathode within four years after it becomes a WTO Member.

A variety of agricultural products are subject to export licensing and/or tariffs, such as certain fish products, grains, 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 other types of Russian caviar.

In November 2007, a prohibitive export tariff of 30 percent *ad valorem* was imposed on barley exports and 10 percent *ad valorem* on wheat exports. This policy is intended to insulate Russia's internal grain market from rising world grain prices, as the government of Russia seeks to constrain domestic inflation.

The Russia government is also pursuing a policy of raising export tariffs on round wood in order to encourage domestic processing and export of sawn lumber and finished goods. In 2007, the government increased the export tariff on coniferous logs to 20 percent, but not less than 10 euros for one cubic meter. On April 1, 2008, the tariff will increase to 25 percent, but not less than 15 euros per cubic meter, and as of January 1, 2009, up to 80 percent, but not less than 50 euros per cubic meter.

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 and agricultural 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 that are recognized by Russian authorities are limited, and some view the 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 sold legally in the United States and the European Union are subject to an expensive and lengthy certification process in Russia that takes between three months and five months. Products are also subject to redundant technical reviews conducted by both the Nutrition Institute and the Ministry of Health, which take between 6 months and 12 months.

In an attempt to move to a system of self-certification of pharmaceutical products, the Russian government has, since January 1, 2007, required imported pharmaceutical products to be accompanied by a complex declaration of conformity rather than a certification. Under the applicable regulations, the declaration of conformity has to be prepared by a Russian legal entity, acting on the basis of an agreement with the foreign manufacturer. The Russian legal entity has to obtain a license for the manufacture of medicines, register in its own name all of the medicines supplied, and obtain the right to use the intellectual property (patents and trademarks) with respect to the medicines that it will be releasing onto the Russian market. In addition, the system discriminates against importers by requiring them to provide a Declaration of Conformity for each batch of medicines, while Russian manufacturers are permitted to provide a declaration for a full series. Industry has alleged that the new requirements are not an improvement over the previous complicated certification practice and have increased costs. The Russian government has argued that the new regulations are a useful anti-counterfeiting measure.

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. The Law was amended in May 2007, resulting in the expansion of the methods by which technical regulations can be adopted. In addition to the current legal process requiring State Duma approval, regulations can now be adopted by government decree without State Duma approval.

Russian sanitary and phytosanitary (SPS) measures have had a major negative effect on U.S. trade. Russia often blocks the import of products deemed “sensitive,” seemingly without a scientific basis for the measure. In 2007, the Russian government issued resolutions directing that international standards, guidelines, and recommendations of the World Organization for Animal Health (OIE) and the International Plant Protection Convention (IPPC) be followed. There is, however, currently no corresponding resolution that states Russia will follow Codex Alimentarius recommendations and guidelines. In November 2006, the United States and Russia signed bilateral agreements to address SPS issues related to the 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. Notwithstanding progress on implementation of these bilateral agreements, U.S. exporters of poultry and pork continue to have product rejected at the border for the presence of salmonella and other requirements that lack scientific justification. We are continuing our engagement with Russia’s officials on these issues.

Pork

Historically, Russia had accepted only 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 now accepts 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 permitted when accompanied by the export certificate that was agreed upon between Russia’s veterinary service and the U.S. Department of Agriculture’s Food Safety and Inspection Services (FSIS).

Inspection of Facilities Producing Pork and Poultry

Previously, Russian and U.S. officials jointly audited all pork or poultry facilities that wanted to export products to Russia. This process delayed exports from new plants or plants needing to remedy a deficiency found during a previous joint audit. U.S. exporters also noted concerns about the time it took Russian officials to provide formal approval for facilities after an audit and to provide an updated list of approved facilities to its customs officials so trade could begin. The U.S. Food Safety and Inspection Service (FSIS) is now authorized to certify new facilities and/or facilities needing to remedy a deficiency based on agreed inspection criteria. The Russian government also agreed to specific time frames to respond to requests to list facilities FSIS has inspected and determined to be in compliance with requirements to export to the Russian Federation, and to a new process for selecting plants for a joint audit. During the first joint inspection under the new agreement, Russian inspectors at times continued to inspect based on unapproved standards (standards not agreed to by both sides and contained in the Act of Inspection). The U.S. Government has been addressing this issue directly with Russia's veterinary service. Plants have been certified for export based on an FSIS inspection.

Beef and Beef By-Products

The Russian market for U.S. beef was reopened following the negotiation of a bilateral agreement and a new veterinary health certificate in November 2006. Under the certificate, de-boned beef, bone-in beef, and beef by-products from cattle over 30 months of age can be exported from plants that have been inspected and certified to export to the Russian Federation. In October 2007, as a result of a U.S.-Russian joint audit, 18 U.S. beef processing and cold storage facilities were approved to export to Russia. The November 2006 bilateral agreement calls for negotiation of a new export certificate for beef and beef by-products to reflect the May 2006 OIE designation of the United States as a controlled-risk country. Negotiations on this new certificate are ongoing. Under this certificate, export of beef and beef by-products from cattle of all ages (excluding specified risk materials that the OIE requires to be removed) would be permitted.

Products of Modern Biotechnology

In accordance with a bilateral agreement between the United States and Russia signed in November 2006, Russia will establish a permanent biosafety regulatory system for products of modern biotechnology consistent with the WTO SPS Agreement. Until a permanent system is in place, 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 SPS Agreement. The United States is continuing to follow-up on the registration process for biotechnology products to ensure that all pending applications are indeed addressed. Russia and the United States agreed to consult annually 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 press 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.

Rice

In September 2006, Russia imposed a ban on imports of all U.S. rice, citing the discovery of genetically modified rice seeds not approved for import in shipments of U.S. long-grain rice. The ban was imposed without prior notice or sufficient justification. In December 2006, Russia also imposed a *de facto* ban on all rice from all origins, 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.

Systemic Issues

In addition to these specific issues, exporters of agricultural goods to Russia face systemic issues related to the certification of agricultural products. Russian authorities require phytosanitary and/or sanitary (veterinary) certificates for nearly all agricultural and processed food products. Producers are required to seek certificates from their domestic regulatory authorities for certain products for which Russia has not provided scientific evidence of an alleged risk. For example, Russia requires certificates for bulk shipments of roasted coffee, which due to the nature of the processing process, does not present a pest risk and consequently does not receive a phytosanitary certification from the U.S. Government. Russian authorities also require a sanitary-epidemiological certificate or certificate of state registration for the importation of nonfood items such as styrofoam cups, bulk shipments of cardboard boxes, and furniture. The Russian government issued revised regulations in February 2008 to bring its SPS regime into conformity with WTO requirements.

GOVERNMENT PROCUREMENT

The Russian government spends over a third of its budget on procurement. The 2005 Law On Placement of Orders for Delivery of Goods, Performances of Works and Provision of Services for State and Municipal Needs, which regulates tenders on all government purchases over \$8,000 (except for those made in commodity exchanges) was amended in 2007. The amendments, in force as of October 1, 2007, improve the law to make the process of procurement more transparent.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

U.S. industries continue to be concerned about the IPR situation in Russia. The copyright industry, in particular, continues to have serious concerns about the high level of piracy in Russia, which reportedly resulted in losses of nearly \$1.5 billion to the industry in 2007. Reported levels of piracy of works, *e.g.*, motion pictures, records, musical compositions, business and entertainment software, and books, range from a low of about 50 percent to a high of 83 percent.

In 2007, 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. copyright industries estimate that approximately 65 percent of sound recordings, 70 percent of business software, and 89 percent of information software 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 continues to be a serious concern. Criminal investigations are ongoing against operators of some of the notorious Russia-based websites. Western and Russian recording companies have initiated, and won, several civil suits against Internet pirates, although damages resulting from these victories have been minimal by U.S. standards. Overall, gaps remain in Russian law and enforcement efforts for adequately addressing Internet piracy.

U.S. and multinational companies continue to report counterfeiting of trademarked goods as a problem, especially for consumer goods, wine, distilled spirits, agricultural chemicals and biotechnology, and pharmaceuticals. Several U.S. firms have experienced problems with trademark "squatting" or counterfeiting, with Russian enterprises attempting to appropriate well-known foreign trademarks not currently registered or active in Russia. However, 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).

The United States is working to ensure that Russia takes appropriate actions to protect intellectual property rights. The November 2006 bilateral IPR agreement between the United States and Russia includes an agreement that sets forth actions that Russia will take to improve protection and enforcement of intellectual property rights. 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 other international IPR norms. The U.S. and Russian governments have an ongoing dialogue to ensure the full implementation of this binding agreement. 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 was also on the 2007 Special 301 Priority Watch List and is subject to an out-of-cycle review.

The most significant legislative development over the last 2 years was the State Duma's consideration and adoption of Part IV of the Civil Code, which replaced most of Russia's civil IPR legislation with a single code as of January 1, 2008. Part IV improves some aspects of IPR protection, *e.g.*, elimination of the reciprocity requirement for protection of geographical indications and stronger rules on collecting societies, but still contains some 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 TRIPS Agreement, and the United States continues to work with the Russian government toward this goal.

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. Legislative changes to address these concerns are being considered by the Russian government.

Enforcement

Poor enforcement of IPR in the Russian Federation has been a pervasive problem. The November 2006 bilateral IPR agreement committed Russia to improve IPR enforcement, and the United States to intensify training programs for customs and law enforcement officials. In 2007, the U.S. Patent and Trademark Office completed three training programs with Russian Federal Customs to help Russian customs officials strengthen their enforcement efforts. In 2007, Russian law enforcement agencies carried out raids on optical disc production facilities suspected of engaging in pirate activities, including a major raid in St. Petersburg that involved increased cooperation between the St. Petersburg and Moscow police forces. However, U.S. industry reports that some raided plants have been allowed to resume operation and that inspections of licensed facilities have been infrequent. The November 2006 agreement committed Russia to enhance its supervision of both licensed and unlicensed optical disc factories.

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. Production lines and equipment used for IPR infringing activities are often put back into operation and not destroyed, 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 IPR agreement with the United States, the Russian government committed 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. The Russian government has also agreed to work with the State Duma to enact legislative amendments to make other improvements to the IPR legislative framework.

Russia took some action against Internet piracy websites in 2007, reportedly closing 242 websites in the past year. Also in 2007, investigation and prosecution of the operators of the pirate website <http://www.allofmp3.com> continued. Denis Kvasov, the former director of Media Services, the parent company that operates the website, was tried and acquitted in a district court in Moscow, due to a finding of insufficient evidence of his personal involvement in the operation of the site. The verdict was upheld on appeal. Law enforcement officials stated that they are continuing to investigate others associated with the site, which has been shut down by court order pending the result of ongoing prosecution of others involved with the site. Other similar sites remain operational.

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

During 2007, amendments to the Criminal Code strengthening penalties for IPR violations took effect. Specifically, Article 146, which criminalizes copyright infringement, was shifted from the category of “crimes of medium seriousness” (which carry a penalty of 2 years to 5 years incarceration) to the category of “serious crimes” that would carry a penalty of 6 years to 10 years incarceration. The shift also allows the use of additional investigative tools in the investigation of IPR crimes. Russian law enforcement officials assert that these changes made it easier to investigate and prosecute IPR offenses and are beginning to have some deterrent effect.

Russian administrative and judicial review bodies are beginning to become active in protecting IPR, and the number of judges with relevant expertise, though still small, is expanding. In April 2007, the Supreme Court issued a resolution providing the appropriate needed guidance to lower courts on imposition of penalties for IPR infringements and other IPR issues. Among other things, the resolution clarifies the rules on the calculation of damages and the burden of proving ownership and infringement. Rights holders and law enforcement officials report that this resolution has also facilitated IPR enforcement.

SERVICES BARRIERS

Russia’s services market is relatively open to U.S. services suppliers, including in areas such as financial, education, legal services, and distribution, although specific problems remain in particular areas. The ability to provide services to public utilities and certain energy-related services (see discussion on energy in the section on Investment Barriers) remains limited. The process for an individual or a company to obtain a license to provide a service remains difficult and limitations on the form of commercial establishment affect some sectors. As of December 2007, U.S. companies were monitoring Russian proposals to develop new, draft legislation on retail trade which, if passed, could have potentially significant regulatory and legal implications for a wide range of retail trade and distribution activity.

As part of the bilateral WTO market access agreement with the United States, Russia has accepted commitments across a broad range of services sectors. Once Russia is a WTO Member and the United States grants permanent normal trade relations status to goods from Russia, U.S. firms will have improved access to services 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. Once Russia is a WTO Member and the United States grants permanent normal trade relations status to goods from Russia, U.S. firms will be allowed to operate through subsidiaries, including 100 percent foreign-owned subsidiaries, and offer all types of noninsurance financial services and to supply, cross-border, many financial services, such as financial leasing, financial information and data processing, credit cards and other types of payments, and advisory services. However, Russia has not committed to allow foreign banks to establish branches in Russia.

In addition, the Russian government will retain the prerogative to limit the foreign sourced element of charter capital in the banking sector to 50 percent of the total charter capital. Nonetheless, if the ratio of foreign sourced to total charter capital in the banking sector 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 firms 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. U.S. insurance companies will be allowed to operate through subsidiaries, including 100 percent foreign-owned non-life insurance companies, and will be able to open direct branches at the end of a 9 year transition period. However, as in the banking sector, Russia will maintain the discretion to limit foreign sourced charter capital in the insurance sector and if the ratio of foreign sourced to total charter capital in the insurance sector exceeds the 50 percent cap, Russia’s regulators will have the discretion to take certain actions specified in Russia’s WTO commitments.

Telecommunications

Amendments to the 2003 Federal Law on Communications entered into force on January 1, 2007. The law’s impact on competitive alternative (nonincumbent) telecommunications operators, many of which involve large amounts of foreign investment, has been substantial since these companies are now 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.

Many in the telecommunications industry have been disappointed that the amended federal law has not improved transparency in the licensing process, and have criticized the 5 year to 10 year license validity period, which they argue does 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 nondiscriminatory basis for all operators, which may benefit companies with foreign investment.

On April 20, 2007, the Ministry of Information Technologies and Communications awarded the eagerly-anticipated licenses for third generation (3G) mobile services. Losers in the 3G license competition asked that a fourth 3G license be awarded to a regional alliance of mobile operators using the networks of companies that obtain the licenses. The license fees have been set at 2.64 million rubles (roughly \$100,000), but criteria for the winning bidder(s) include requirements for significant investment in network infrastructure development under specific deadlines. In addition, successful bidders are required to begin offering commercial 3G services within 2 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. However, a major hurdle to WiMAX services countrywide is the lack of available frequencies. In mid-December 2007, Comstar announced plans to cooperate with Intel in developing the first WiMAX network in Russia, starting in the Moscow region with subsequent expansion to other areas. This development would capitalize on the spread of personal computers and the estimated 23 percent rise in Internet users in Russia over the September 2006 to September 2007 period, the fastest pace in Europe.

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.

Certification of new products in the telecommunications industry takes an average of 2 months, down from 4 months a few years ago, but the process still suffers from a lack of transparency. The satellite industry, in particular, reports that there is a burdensome certification process in place and a local presence requirement further creates barriers to doing business in Russia.

INVESTMENT BARRIERS

Russia's foreign investment regulations and notification requirements can be confusing and contradictory, which has an adverse effect on foreign investment. According to an industry report issued in March 2007, Russian companies raise up to one-fifth less money than foreign counterparts as international equity markets perceive Russia's legal regime as offering little protection for investors. Only 52 percent of Russian companies considering an initial public offering abroad have independent directors, a condition considered essential for an international listing. Independent foreign nationals make up only 3 percent of board seats at Russian companies currently planning to list.

U.S. investors and others cite corruption in commercial and bureaucratic transactions as another barrier to investment. In 2007, reports by the World Bank, Transparency International, the Foreign Investment Advisory Council, Russia's Higher School of Economics, and Columbia University found that corruption had worsened and had become a greater concern for Russia's businessmen. Reasons cited for these trends were slowing reforms and government complacency fostered by oil revenues.

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.

Further obstacles to increased U.S. investment in Russia include inadequate dispute resolution mechanisms, weak protection of minority stockholder rights, the absence of international accounting standards, and the failure of companies to adhere 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. Inadequate transparency in the implementation of customs, taxation, licensing, and other administrative regulations also discourages investment.

The United States and Russia have just begun to engage in exploratory bilateral investment treaty discussions.

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, “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 includes a “grandfather clause” that stipulates that existing (as of 1999) “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.

The government submitted the draft Law on Strategic Sectors to the State Duma in September 2007, where it has languished since then as different ministries have raised objections to the current draft. The draft law introduces a list of 39 “strategic” sectors in which foreign investment will be restricted, including: 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 other sectors. The State Duma committee chair overseeing the draft law expects passage of the law to be delayed until at least April 2008.

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 State 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, 11 percentage points higher than Russia’s flat 13 percent tax on personal income.

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, leasing companies find that input VAT is often not refunded at all, for a number of reasons. In some cases, local tax inspectorates have initiated audits and attempted to seize bank accounts of the leasing companies, thus forcing exporters to seek very expensive and time consuming court enforcement. VAT refunds on exports are also the source of significant fraud, making it even 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 was expected to fall from three months to two weeks, but anecdotal reports from Russian and U.S. companies indicate that the new law has not helped reduce refund processing time, and that in many cases, companies have to resort to court action to receive their VAT reimbursements. In addition, during the course of their audits, Federal Tax Service officials now have the authority to confiscate improperly disbursed VAT refunds, with penalties.

Energy Sector

In 2007, the Russian government decided to amend the current Law on Subsoil Use rather than include “strategic” sub-soil fields in the proposed Strategic Sectors Law it has 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 participate only in a minority position in strategic field development.

The Russian government continues its policy of not entering into any further Production Sharing Agreements (PSAs - designed for energy projects that require high capital expenditures 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. In 2006, the operator of Sakhalin II, Sakhalin Energy, was criticized by the government for alleged environmental violations that occurred during pipeline construction and came under pressure from the government for cost over-runs. In the wake of this pressure, members of the Sakhalin Energy consortium (led by Royal Dutch Shell) agreed to reduce their stakes by selling Gazprom a controlling share.

In addition, the Caspian Pipeline Consortium (CPC) pipeline, operational as of 2001, continues to seek authorization from the Russian government to allow expansion of the pipeline’s capacity. CPC stockholders, however, do not appear to support expansion. An agreement was reached in September 2007 to lower the interest rate on CPC’s debt and to raise transportation tariffs, with a 1 year timeline for agreement on expansion.

Aviation

Many of the Russian-flagged carriers continue to operate aging fleets with outmoded avionics and engines, but several are undertaking significant purchases or “wet-leases” (covering the aircraft, complete crew, maintenance, and insurance) of foreign aircraft in an attempt to be more competitive with Western airlines. Despite continuing high import duties, several Russian airlines purchased new and used Western aircraft in the last year and this trend promises to continue over the next few years. Russia’s aircraft manufacturers only produce 10 planes per year on average and therefore cannot keep up with Russian airlines’ projected demand for 1500 additional planes in the next 20 years. The Russian government has backed Sukhoi’s Superjet project in an effort to revive Russia’s civil aviation manufacturing industry.

Current Russian law provides 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, although even then foreign firms will not be allowed to acquire more than 49 percent of any Russian aviation-related enterprise. 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.

ELECTRONIC COMMERCE

Electronic commerce remains an embryonic market in Russia. Russia’s law does not currently provide identical legal status to 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 aspects of electronic commerce are virtually unexplored, and this

area of the law is still developing. A draft law on electronic trade has been stalled in the State Duma for several years. While closely following an International Chamber of Commerce model bill, the draft before the State Duma has significant problems, including limiting electronic transactions to the sale and purchase of moveable goods, services agreements, and shipments.

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 narrowly, 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 requirement gives the Russian government the right to insist on the decompilation of electronic signature programs. These requirements, in addition to the licensing requirements related to goods with encryption technology, present serious obstacles to trade in goods that Russia requires for further development of electronic commerce.

The relationship between trademarks and domain names is addressed in Part IV of the Civil Code which went into effect on January 1, 2008. Trademark owners have experienced 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.

In 2007, the Russian Government announced plans to adopt an electronic government policy, which could potentially streamline paper-intensive processes involving the government, such as tenders, licenses, and permits, but the plan will not take effect until 2010.

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; this percentage continues to increase, particularly in the Far East, due to its proximity to China. Supplies of illegally harvested timber in China's market adversely affect U.S. exports to that market. The Russian government is taking steps to combat illegal logging, having adopted a National Plan initiative in 2006 with the objective of reducing timber poaching by 20 percent to 30 percent. However, poor socio-economic conditions in remote forest areas, lack of transparent regulations, and weak law enforcement make effective control difficult.