

RUSSIA

TRADE SUMMARY

The U.S. goods trade deficit with Russia was \$17.4 billion in 2008, an increase of \$5.5 billion from \$11.9 billion in 2007. U.S. goods exports in 2008 were \$9.3 billion, up 26.8 percent from the previous year. Corresponding U.S. imports from Russia were \$26.8 billion, up 38.6 percent. Russia is currently the 28th largest export market for U.S. goods.

The stock of U.S. foreign direct investment (FDI) in Russia was \$13.0 billion in 2007 (latest data available), up from \$10.7 billion in 2006. 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 negotiation is with Georgia, but Russia may be approached by other WTO Members to engage in bilateral negotiations prior to completion of the process. Russia is now focused on multilateral negotiations regarding other terms for accession. Discussions continue on a number of issues including sanitary and phytosanitary measures, agriculture (including domestic support levels), intellectual property rights protection, import licensing of products with encryption technology, certain export duties, and the operation of state-owned enterprises on a commercial basis. In addition, Russia has much work to do to integrate WTO provisions into its domestic law and to comply with bilateral agreements already in force.

The global economic crisis and dramatic drop of commodity prices impacted the Russian economy severely in the last quarter of 2008. Although the government put anti-crisis measures in place beginning in mid-September to support the stock market, banking sector, and specific industries, fourth quarter economic output contracted sharply despite overall growth for the year as a whole. In November, the Prime Minister announced a package of 55 measures to stimulate internal demand, some which were being discussed prior to the crisis, and many of which, if implemented, could impact adversely U.S. trade. The measures range from the specific (reduce tariff-rate quotas (TRQs) on imports of poultry and pork in 2009) to the general (review import duties on a range of goods), and encompass a range of sectors, such as financial services, housing, agriculture, and manufacturing. The U.S. Government is monitoring these and other actions of the Russian government to shore up its economy.

IMPORT POLICIES

Russia continues to maintain a number of import restrictions; charges and fees that exceed the cost of the service; and licensing, registration, and certification regimes that are burdensome. Discussions continue on eliminating these and other measures or modifying them so that they are consistent with WTO requirements and internationally accepted practices.

In line with Russia's "Main Directions of Customs Policy for 2008-2010," approved in early 2007, the Russian government has been gradually reducing tariffs on a number of imports of capital equipment for which there is no analogous domestic production. The reduction, and even elimination in some cases, of tariffs on such products as offshore drilling rigs, equipment for nuclear reactors, sound and television recording equipment, medical and metalworking equipment, some spare parts for civilian aircraft, flight simulators for civil aviation, child safety seats, digital cameras, and rechargeable batteries for cell phones continued in 2008, albeit at a slower pace than in 2007. Overall, this effort has helped domestic industries modernize their technical equipment base. Most recently, however, in response to the global economic

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crisis, the Russian government announced increased tariffs on an array of goods, including automobiles, trucks, combine harvesters, soy meal, and selected dairy products, and has indicated that it will continue to review its tariff policy in light of overall economic conditions.

Tariff-Rate Quotas

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. Consistent with the 2005 United States-Russia Meat Agreement, the Russian Government established country-specific TRQ volumes (including for the United States) and reduced in-quota tariff rates for beef, pork, and poultry meat imports from 2006 to 2009. However, in October 2008, Russia proposed renegotiating the terms of access for poultry and pork for 2009. In December 2008, U.S. and Russian negotiators agreed to decrease the 2009 in-quota volume for U.S. poultry, increase the 2009 in-quota volume for pork, and increase the over-quota tariff rates for both poultry and pork. Because the 2005 Meat Agreement expires at the end of 2009, the United States expects to begin negotiations this year on these products.

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 technology, 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 unnecessary additional requirements for imported goods and to burden unfairly importation of these products.

For example, all importers of alcoholic products must have an activity license to produce or distribute and store such products, placing a burden on importers that should be applied only to distributors. Importers of vodka, tequila, grappa, and pure ethyl alcohol must also obtain an additional "white spirits" license, which can take up to two weeks to be issued. Imports of white spirits were disrupted for a two-month period from June to August 2008 because the Ministry of Economic Development (MED) suspended the issuance of new licenses while that ministry prepared to transfer this function to the Ministry of Industry and Trade (MIT). Application for the license requires submission of documents that can take an additional two months to obtain, in some cases 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 importation of goods containing encryption technology through the implementation of transparent, nondiscriminatory procedures. The Russian government agreed also to allow the importation of most commercially-traded goods containing encryption technology after a one-time notification, or in some cases, with no licensing or notification requirements at all. Although Russia agreed to implement the new regime by February 2007, the old regime remains in place. The United States continues to work actively with the Russian government on addressing its licensing barriers to trade in goods containing encryption technology and ensuring the full implementation of the terms of the bilateral agreement.

Customs Issues, Taxes, and Tariffs

In 2007, Russia's average "most favored nation" applied tariff rate was 11 percent. More specifically, U.S. agricultural exporters faced an average applied tariff of 14.6 percent, while industrial exports faced an average applied rate of 10.5 percent.

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 the Ministry of Economic Development and the Ministry of Finance.

Excise taxes apply to a number of luxury goods, such as liquor and cigarettes. Excise taxes on spirits of more than 9 percent ethyl alcohol are assessed at 191 rubles per liter of ethyl alcohol content, whereas spirits of 9 percent and less are assessed at 121 rubles per liter. Table wine is assessed at 2.6 rubles per liter, sparkling wines at 10.5 rubles per liter, and beer at 3 rubles per liter.

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. As a result of our bilateral agreement on leased aircraft, which entered into force on November 19, 2006, in January 2007, the Russian government 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 three years and would remain in force until January 1, 2011. However, the necessary decree implementing this tariff reduction has not yet been issued.

Instead, the Russian government eliminated the import tariff on small aircraft with up to 19 seats for a period of 9 months as of July 16, 2008. According to the Ministry of Transportation, the measure will be extended after nine months. In September 2008, the government announced that the import tariff for aircraft with up to 50 seats would be cancelled as of January 1, 2009, and that import tariffs for aircraft with 115-160 seating capacity, not more than 10 years old and imported into Russia prior to 2011 under leasing contracts for no longer than 5 years, would also be temporarily eliminated. Neither of the decrees finalizing these proposals has yet been issued.

The import tariff on foreign aircraft with over 300 seats was eliminated for a period of 9 months beginning in February 2008. In September 2008, the Russian government recommended permanent cancellation of import duties on aircraft seating more than 300 passengers, but no date has been set for this permanent tariff reduction measure to come into effect.

On January 11, 2009, the import duty on most new passenger vehicles was increased temporarily to 30 percent, from the previous rate of 25 percent, for a period of 9 months. When combined with the excise tax based on engine displacement and the VAT, the price after clearing customs of larger U.S. passenger cars and sport utility vehicles is increased by as much as 70 percent. Attempting to justify the duty increase, Russian government officials have cited the need to provide Russian-owned domestic manufacturers some protection from import competition in the wake of the global financial crisis. The increased duty, coupled with the strengthening trend in the dollar-to-ruble exchange rate, will likely have

a negative impact on U.S. automobile manufacturers' sales of imported vehicles in Russia. On the same day, the Russian government also made it more difficult to import used vehicles into Russia by imposing a prohibitive duty on cars older than five years (whereas the previous law imposed a prohibitive duty on cars older than seven years). 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. However, in February 2008, the Russian government announced a safeguards investigation in response to increased imports of agricultural combine harvesters. The Ministry of Industry and Trade concluded its safeguard investigation on February 15, 2009, finding that imports had caused serious injury to Russia's combine industry. Before that final determination was issued, however, the Interagency Commission on Safeguards and Customs Policy of the Russian Federation proposed an increase in duties for most types of grain harvesters. On January 14, 2009, following a visit by Prime Minister Putin to the largest Russian producer of combine harvesters, the Russian government published an increase in duties for combine harvesters (to 15 percent but no less than €120 per 1 kilowatt of engine capacity), to be in place for 9 months. At the same time, the government also announced a moratorium on further financing of foreign agricultural equipment. Because the tariff increase was already in place, the Ministry of Industry and Trade decided to impose no additional safeguard measures for the period of time the higher import duties are in place. The duty increase, combined with a moratorium on financing of purchases of all imported agricultural machinery, will reduce significantly U.S. and other foreign manufacturers' participation in the combine harvester market. Pursuant to the 1992 Bilateral Trade Agreement between the United States and Russia, the U.S. Government has entered into consultations with the Russian government concerning the safeguard investigation.

Customs authorities in Russia continue to assess duties on the royalty value of imported audiovisual materials, such as television master tapes and DVDs, *etc.*, rather than solely on the physical value of the carrier medium. U.S. industry has indicated that this practice represents a form of double taxation, since royalties are also subject to withholding, income, value added, and remittance taxes. U.S. consumer goods companies have also reported that Russian Customs are calculating customs duties based on a value that includes royalty payments made by the companies' Russian subsidiaries to their overseas parent companies for use of parent company-owned product trademarks. U.S. companies are disputing these assessments.

U.S. industry also complains of high tariffs on agricultural products such as fruit, processed food, sugar, and forest products. Once Russia is a WTO Member, it must bind its tariffs on all agricultural products, thereby providing more predictability in 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. The Customs Code 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 continues to issue 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

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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 fee structure. 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.

U.S. exporters have also reported to the U.S. Embassy that Russian customs officials often ask them to provide their Shippers Export Declaration (SED) to substantiate shipment values. The SED is a U.S. Census Bureau form that is intended to track exports for statistical purposes. The form explicitly states that it cannot be provided to any authorities outside the United States. As such, the SED is not one of the typical shipping documents, such as invoices, provided to customs officials. The Russian practice of asking for the form puts U.S. firms in a difficult and illegitimate position, and adds to the other costs and delays at the Russian border noted above.

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 and in bilateral United States–Russia discussions.

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 (based on value) in the Russian market. Market analysts have estimated that government purchases comprised about 26 percent of the entire pharmaceutical market in 2008. U.S. industry reports that imports, which are often safer and of a higher quality than locally produced pharmaceuticals, and are higher priced, are often absent from reimbursement lists and state purchases likely due to government concerns over price without regard to the quality and safety of the products. Senior Russian government officials have repeatedly stated that foreign producers' dominant share of the Russian pharmaceuticals market is a long-term national security risk. The government's long-term development plan through 2020 for the domestic pharmaceuticals industry calls for Russian drug manufacturers to capture at least 50 percent of total sales (based on value) by 2020.

Experts estimate that sales of counterfeit drugs in Russia total at least \$200 million per year, with the bulk of fake drugs being produced domestically, as well as in India and in China.

Alcohol

Alcohol trade in Russia is governed by a burdensome array of over 100 laws, decrees, and regulations. A partial list of Russian laws and regulations governing alcohol can be found in Russian at: <http://alcogol-info.ru/?page=normativ>. The regulation of alcohol has long been a politically sensitive issue in Russia. Senior government officials have suggested that the Russian government should reestablish a monopoly over the production of ethyl alcohol (such a monopoly existed during the Soviet era) and/or strictly regulate the minimum consumer price for vodka, in an effort to prevent the production and sale of moonshine and other forms of illegal alcohol, and to increase tax revenue from legal alcohol production and sales. Other recent proposals from senior government officials have included the creation of a new government body to consolidate alcohol regulation, the introduction of criminal penalties for the sale of alcohol products that are not legally tracked through a national automated control system, introduction of a uniform excise tax for alcoholic beverages, and the introduction of a new unified electronic database for

the reporting of retail alcohol sales. All of these proposals are currently the subject of policy-level interagency discussions within the Russian government, and none have advanced to the stage of draft legislation and submission to the State Duma of the Russian Federation ("Duma").

Importers of alcohol face a variety of discriminatory measures. Pursuant to the Russian Customs Code and Law on Production and Turnover of Alcohol, as amended in December 2008, all customs duties, excise taxes, and VAT on alcohol must be paid in advance using a bank guarantee and deposit. Because the actual amount of the duties and fees may not be known when the guarantees are procured, the Government of Russia has established fixed guarantee amounts, but these amounts often exceed the final actual amounts due, especially for lower value products. In addition, industry has reported that refunds of these guarantees are sometimes held up for as long as seven months. The advance payment requirement for duties and taxes, and the length of time the bank guarantee refund is held, may limit trade volumes due to the amount of money that must be tied up in guarantees. An earlier requirement for a "transit" guarantee has been eliminated, and Russian customs stopped collecting these additional funds in 2008. Furthermore, the customs registration fee, 7,000 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, which is to track alcohol from manufacture or import to the retail sales point. The deadline for the full implementation of UFAIS from production lines has been delayed several times since 2006, and the Russian government is expected to set the new deadline for no earlier than January 2010. While the federal authorities have not yet set an exact implementation date, the Moscow city government has already announced a new deadline of January 1, 2010 for implementation of UFAIS for products within its jurisdiction. Under the current UFAIS system, 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, importers of alcohol beverage products are required to report individual sequentially-numbered strip stamps while domestic producers may use and report stamps by batches of products. When the bottle enters the warehouse, 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 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 and distributors are required to report only to the Tax Authorities (and only by batches of products, not by individual sequentially-numbered strip stamp), importers must report their more detailed data also to Russian Customs, and in a different format, increasing the reporting cost as well as the possibility for error. The Russian government has stated that it will eliminate the discriminatory treatment of importers by applying the more burdensome bottle-by-bottle reporting requirements to domestic producers, but such action has not yet been taken.

Although the strip stamp system is currently operational, logistical challenges continue. Current problems with the UFAIS system include the difficulty in stamping miniature and food service-sized

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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.

Because of the numerous problems that have arisen in the implementation of the UFAIS system, the Russian government has attempted to ease some of the system's more burdensome requirements. Although production, distribution, and retail trade in alcoholic drinks were originally included in the UFAIS system, in November 2007 the UFAIS law was amended to exclude both wholesale and retail sales from the UFAIS tracking system. The production of ethyl alcohol and of alcoholic beverages is still covered by the UFAIS system.

Also in response to complaints about the UFAIS system, the Russian government is introducing new UFAIS software and hardware. Although the reporting requirements will be generally the same, the conversion is likely to disrupt business when the bottle enters the warehouse, in particular for importers. Of greatest concern is the incompatibility of the two software systems; that is, the new UFAIS software can not read the strip stamps created under the old UFAIS system. Because of the significant lag time between the bar-coding of the imports and their release onto the market, importers may be left with significant inventory that cannot be sold due to "invalid" stamps. By contrast, domestic producers bar-code their strip stamps only a few days before sale and hence will not face the same problem of unusable inventory.

Notwithstanding the initial and ongoing problems with the strip stamps, the Russian government has considered adding a second stamp across the top of the bottle to combat the problem of empty bottles being refilled and resold (a practice that raises both tax avoidance and health and safety concerns). However, the proposal is more than a year old and has yet to advance to a first reading in the Duma; in addition, one of the two Duma committees with responsibility for reviewing the bill issued a negative comment on the bill in February 2008.

The requirements on spirits alcohol, including 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 cosmetics, perfumes, and personal care products in packages of up to 500 ml. The Russian government may amend the law further to expand the list of exempt products. The United States is encouraging further amendment of the law to exempt all nonfood goods containing alcohol from the alcohol-related requirements above.

Development of Nuclear Power Generation

A number of factors impede the involvement of U.S. firms in the continued development and expansion of Russia's nuclear power industry, including inadequate nuclear liability protection for U.S. nuclear equipment suppliers in Russia, requirements for review of equity investments introduced by the Strategic Sectors Law, and laws establishing Rosatom as a State Corporation. An additional factor affecting the potential involvement of U.S. firms in Russia's nuclear industry is the absence of a ratified agreement between the United States and Russia on the peaceful uses of atomic energy (*i.e.*, a "123 Agreement" under the U.S. Atomic Energy Act).

EXPORT POLICIES

The price of natural gas for industrial consumers in Russia is held artificially low by price controls. Domestic gas consumers, both industrial and residential, pay a fraction of the export price that is charged

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to European consumers. Domestic prices range from approximately \$75/mcm (thousand cubic meters) to \$95/mcm, compared with European prices approaching \$500/mcm in late 2008. The Russian government is implementing a plan to raise domestic prices for industrial users to "market" levels by 2011, which should reduce distortions and provide incentives for greater gas production by oil companies and independent producers. However, it appears likely that the shift to market prices will be slower than originally envisioned, and the 2011 target is likely to slip. State-controlled firm Gazprom owns Russia's gas pipeline network and is by law Russia's monopoly natural gas exporter. No such restriction exists on oil exports, although Russia's oil pipeline system is owned by state-owned firm Transneft. Oil and gas export revenues are a significant driver of the Russian economy and the Russian government budget.

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 had 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; yet in July 2008, the Ministry of Industry and Trade proposed raising the specific component of export duty on ferrous steel scrap from €15 (\$18.90) per ton to €120-130 (\$151 to \$164) per ton while leaving the *ad valorem* rate of 15 percent unchanged. It is not yet clear if and when the proposed tariff increase will be approved and go into effect. Russia also currently maintains a 10 percent export duty on copper cathode, but 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. Export duties on crude oil, reaching 65 percent on the margin, are deliberately designed to redirect crude to domestic refineries. In late 2008, the government reduced, temporarily, some of the export tax burden on crude oil in an effort to blunt the effects of the global financial crisis on the Russian economy.

A variety of agricultural products are subject to export licensing and/or tariffs, such as certain fish products, oilseeds, fertilizers, and wood products. Russia has not been permitted to export sturgeon caviar since 2002, and there is currently no approved commercial export quota for any type of Russian caviar. However, the country is allowed a limited sturgeon catch quota under the Convention on the International Trade in Endangered Species for purposes of breeding and scientific research.

Over the last two years, the Russia government has been pursuing a policy of raising export tariffs on coniferous logs and round wood in order to stimulate the development of a domestic wood processing industry and to encourage the export of sawn lumber and value added wood products. The government has eliminated the export tax for processed wood products such as particle board, several types of cellulose from coniferous wood, certain types of paper, carton and cardboard, and railway and tramway sleepers. In May 2007, the government eliminated the import tariffs for equipment used to produce medium-density fiberboard, granulated and brick wood.

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 the "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.

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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 three months to 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 to 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 these 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 Duma approval, regulations can now be adopted by government decree without Duma approval. In 2008, for example, while four technical regulations were adopted by the Duma, one was adopted by government decree.

Sanitary and Phytosanitary Measures

Russia's application of its sanitary and phytosanitary (SPS) measures has had a major negative effect on U.S. trade. Russia often blocks the import of products deemed "sensitive," seemingly without a scientific basis for such action. In 2006, the Russian government issued resolutions directing that international standards, guidelines, and recommendations of the International Organization for Epizootics (OIE) and the International Plant Protection Convention be followed, although in practice they are not always followed. There is currently no corresponding government 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 the implementation of these bilateral agreements, U.S. exporters of poultry and pork continue to have shipments rejected at the points of entry because of the presence of trace amounts of food-borne pathogens and other violations of Russian sanitary requirements that do not appear to be based on science. Russia's SPS standards are extremely prescriptive with detailed requirements on facilities and how product is produced rather than focusing on the wholesomeness of the product. In some cases, Russia's minimum residue levels differ from international standards, but Russia has not provided risk assessments or a scientific basis for these differences.

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The Russian veterinary service (VPSS) recently questioned the reliability of the current certification system for U.S. poultry, pork, and beef imports. Under the terms of the November 2006 United States-Russia bilateral agreement on the inspection of U.S. meat and poultry facilities, the United States Department of Agriculture (USDA) Food Safety and Inspection Service (FSIS) has the right to inspect and certify that poultry, pork, and beef facilities meet the necessary sanitary requirements and thus are eligible to export products to Russia.

VPSS also considers that minor typographical errors on the export certificates that accompany agricultural imports constitute a violation of Russian law and regulations. VPSS has been rejecting U.S.-origin meat and poultry shipments that arrive at the border if the accompanying documentation contains minor typographical errors. USDA has emphasized that minor typographical errors on documents have nothing to do with the safety and quality of the product in question. USDA requested that VPSS accept "official correction letters" when minor typos caused by human error occur in an attempt to resolve this issue. To date, VPSS has refused this request. Since August 2008, Russia has sought to implement policies that seem to be aimed solely at reducing the volume of U.S. meat and poultry imports. As an example, following the 2008 joint audits of U.S. pork and poultry facilities, VPSS delisted facilities and refused to acknowledge FSIS's authority to inspect and relist plants that completed corrective actions, an authority granted under the 2006 plant inspection agreement.

VPSS has expanded its review of import procedures to those covering dairy products, feed (including pet food), and feed additives by requesting a list of facilities approved to export to Russia and seeking to audit these facilities to Russian standards. The immediate result has been a disruption in trade of feed and feed additives; dairy producers have also expressed concerns.

The United States continues to engage with Russia's government officials on these issues.

Pork

As part of the revised export certificate that was signed between VPSS and USDA in 2006, Russia agreed to accept freezing as appropriate mitigation for trichinae for U.S. pork imports intended for retail sale and for further processing. As a result, imports from certified plants are permitted when accompanied by the mutually agreed-upon export certificate. Unrelated to trichinae, VPSS has recently requested that the U.S. modify the existing export certificate to clarify that product meets Russian standards. The current certificate does not explicitly state that product must meet Russian standards.

Poultry

In June 2008, the Russian government issued a regulation that would have implemented a sanitary and phytosanitary norm ("SanPin") banning the importation and sale of chlorine-treated chicken as of January 1, 2009. This SanPin would have had a substantial negative impact on U.S. poultry imports to Russia, as the vast majority of U.S. poultry producers use chlorinated anti-microbial washes to kill foodborne pathogens during poultry processing. The same SanPin also places an upper limit on the amount of water content in chilled and frozen chicken. Some importers and distributors have had product removed from supermarket shelves or refused entry at the border because the water content level of frozen poultry exceeded the level permitted by this SanPin. The Russian government has also issued a resolution, scheduled to take effect January 1, 2010, requiring implementation of a SanPin banning the importation and sale of frozen poultry intended for further processing with respect to food intended for use in baby food and special diets; in 2011, the ban on further processing of frozen poultry will apply generally. Russia has not provided any scientific justification for these SanPins. U.S. trade and agricultural officials have discussed these issues extensively with their Russian counterparts, urging them not to implement

these SanPins and to adopt as soon as possible SPS measures that are consistent with international requirements such as those of the WTO SPS Agreement and the norms in the OIE and Codex Alimentarius. During United States-Russia consultations in November and December 2008, the Russian government agreed to delay the implementation of the SanPin on chlorine-treated poultry until January 1, 2010. Further discussions among technical experts will take place in 2009.

Inspection of Facilities Producing Pork and Poultry

Under the November 2006 United States-Russia bilateral agreement on the inspection of U.S. meat and poultry facilities, FSIS was granted the authority to certify new facilities and/or facilities that had remedied a deficiency based on agreed inspection criteria. In accordance with the agreement, the Russian government also agreed to specific time deadlines to respond to requests to list facilities that FSIS had inspected and determined to be in compliance with requirements to export to the Russian Federation. The Russian government also agreed to a new process for selecting facilities that would be subject to joint audit. As noted above, VPSS recently questioned the reliability of the current inspection and certification system for U.S. meat and poultry facilities that are eligible to export to Russia. The U.S. Government is continuing to discuss this issue with Russia's veterinary service.

Beef and Beef By-Products

The Russian market for U.S. beef was reopened following the negotiation of a bilateral agreement and a new export certificate in November 2006. Under the certificate, deboned beef, bone-in beef, and beef by-products from cattle under 30 months of age can be exported from plants that have been inspected and certified to export to the Russian Federation. As of October 2008, 75 U.S. beef processing and cold storage facilities are authorized 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 2008 OIE designation of the United States as a controlled-risk country. Negotiations on this new certificate are still ongoing. Under this new 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.

Seafood

VPSS also exercises control over fish and seafood entering Russia. They are insisting that these products be shipped to Russia only from facilities that meet Russian standards and that VPSS has approved for export. Discussions between VPSS and the Seafood Inspection Program of the National Oceanic and Atmospheric Administration on U.S. fish and seafood imports to Russia are under way. VPSS intended to cut off trade in fish and fishery products unless a date was proposed for an audit of the U.S. system. The audit has tentatively been agreed upon for early April 2009.

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. As a result of the bilateral agreement, in 2007 Russia restarted the approval of biotechnology varieties for animal feed use. However, Russia still does not have a system for approving biotechnology for cultivation. The Federal Service for the Protection of Consumer Rights and Human Well-Being registers biotechnology food products, while the Federal Service for Veterinary and Phytosanitary Surveillance registers biotechnology feed products. In either case, the registration process for biotechnology products takes about 12 months to complete and costs about \$150,000 to \$160,000. Russian law mandates that food products be labeled as containing genetically engineered

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organisms if the biotechnology components in the food product are equal to or greater than 0.9 percent of the product's weight (the same standard adopted by the EU). The United States continues to press the Russian government on significant concerns that U.S. food exporters have raised regarding Russia's food labeling policies.

Rice

In February 2008, Russia lifted a ban on imports of U.S. rice that was put in place after the September 2006 discovery of biotechnology rice seeds that were not approved for export to Russia. Currently, all shipments of U.S. rice to Russia must be accompanied by a phytosanitary certificate, a copy of a signed letter from the USDA Grain Inspection, Packers and Stockyards Administration, and a report from one of six approved U.S. laboratories indicating that the rice is free of LL Rice (a variety of long grain genetically modified rice), or indicating that the presence of LL Rice is below an agreed tolerance level.

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 phytosanitary permits for imports of U.S. corn samples for laboratory tests. Russia also requires phytosanitary certificates for shipments of processed products like soybean proteins, corn gluten and distiller's grain, which due to the nature of the processing process, do not present a pest risk and consequently do 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.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

Russia has made some progress in IPR protection and legislation, but concerns remain particularly with respect to Russia's implementation of the November 2006 Bilateral IPR Agreement between the United States and Russia. The IPR agreement 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. Russia has been slow to implement some of these commitments, such as the adoption of required IPR legislation. Moreover, while Russia has made some progress on enforcement, affected industries believe more work is needed. The U.S. and Russian governments have an ongoing dialogue to ensure the full implementation of this binding agreement.

In 2008, Russia's optical disc production capacity continued to be far in excess of domestic demand, raising concerns regarding optical disc piracy, including with respect to exports. U.S. copyright industries estimate that approximately 65 percent of sound recordings on the Russian market are pirated, which reportedly resulted in losses of nearly \$1.5 billion to the industry in 2007. 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

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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, distilled spirits, agricultural chemicals and biotechnology, and pharmaceuticals. Several U.S. firms have experienced problems with trademark "squatting", 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 the Russian Federal Service for Intellectual Property, Patents, and Trademarks (Rospatent).

In May 2008, the Business Software Alliance (BSA) reported in its fifth annual study of 108 countries that the estimated software piracy rate in Russia dropped the most of any country, declining from 80 percent in 2006 to 73 percent in 2007. The BSA attributed the decrease to software legalization programs, government engagement, user education and enforcement.

The United States is working to ensure that Russia takes appropriate actions to protect intellectual property rights and address piracy and counterfeiting. 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 2008 Special 301 Priority Watch List and was subject to an Out-Of-Cycle Review.

The most significant legislative development over the last two years was the 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., eliminating the reciprocity requirement for protection of geographical indications and instituting stronger rules on collecting societies), but still contains some provisions that raise concerns under the WTO and other international agreements. The Russian government pledged to ensure that Part IV and other IPR measures will be fully consistent with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement), and the United States continues to work with the Russian government toward this goal.

In October 2008, the Duma passed in the first reading amendments to the Russian Customs Code to provide customs officials with the *ex-officio* authority to seize suspected counterfeit goods and hold them for up to seven days to investigate their authenticity. In January 2009, the Duma passed the amendments to Part IV of the Civil Code to make Russian law consistent with the TRIPS Agreement. The second and third readings of the amendments to Customs Code, and the third and final reading of the amendments to Civil Code to Russian law have not yet been scheduled, but Russian trade officials have stated that those readings should occur early in 2009.

Under Article 39.3 of the TRIPS Agreement, Russia must, once it becomes a WTO Member, protect against disclosure and unfair commercial use of undisclosed test and other 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. In the November 2006 bilateral IPR agreement, Russia agreed to improve IPR enforcement and to enhance its supervision of

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both licensed and unlicensed optical disc factories, and the United States agreed to offer training programs for Russian customs and law enforcement officials. The U.S. Patent and Trademark Office has conducted training programs with the Russian Federal Customs Service to help Russian customs officials strengthen their enforcement efforts, and additional training programs are planned for 2009. In 2008, 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 in September 2008 that involved close cooperation between the St. Petersburg police, prosecutors, and rights holders. That raid resulted in the largest-ever Russian seizure of pirated discs from an optical disc warehouse and production facility. Rights holders report that the level of cooperation with police in optical disc raids is increasing, but that the quality of raids, and the level of police expertise, is uneven nationwide. Even when raids take place, they are often not successful in stopping optical disc piracy. A number of factors limit the effectiveness of raids, including the high monetary damages threshold required to establish criminal liability, and the general reluctance of prosecutors to initiate criminal cases in the field of IPR.

Judicial System

While the Russian government has intensified the investigation and criminal prosecution of IPR infringers, cases often fail at the prosecution stage and few convictions for IPR violations ever result in prison sentences. Seized production lines and equipment used for IPR infringing activities sometimes end up back in operation, allowing pirates to continue their illegal activities either in another location or under a different corporate entity.

In 2008, the Russian government closed down 101 illegal websites offering software, multimedia and audio/visual works for download. In 2007, the well-known Russian piracy website <http://www.allofmp3.com> was shut down, but the owners of the website, MediaServices, Inc., continue their operations under a different domain name (MP3Sparks.com). Both the U.S. Government and U.S. industry representatives have passed to the Russian government a list of alleged illegal piracy websites for further follow-up.

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. Nevertheless, statistics provided by the Ministry of Internal Affairs on criminal prosecutions under Article 146 show a decrease in prosecutions in 2008 compared to the equivalent period in 2007. Complete enforcement statistics for all of calendar year 2008 are not yet available, so it is not yet clear whether the full year numbers for 2008 will show an increase or decrease in the volume of prosecutions in 2008 compared to 2007. Likewise, some investigations under the new version of Article 146 may not have advanced yet to the prosecution stage, and therefore may not be reflected in statistics from the Ministry of Internal Affairs.

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 by removing a number of technical and legal barriers in both civil and criminal cases. It is not yet clear to what extent judges throughout the country have assimilated this guidance. Judicial education and training will be necessary in order to ensure that the benefits of the 2007 resolution are realized in the form of more effective protection of rights.

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 October 2008, U.S. companies were monitoring Russian proposals to develop new, draft legislation on retail trade which, if passed, could have potentially significant negative regulatory and legal implications for a wide range of retail trade and distribution activities.

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 Russia, U.S. firms will have improved access to services sectors including banking and securities, insurance, telecommunications, audiovisual 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. However, Russia does not allow foreign banks to establish branches in Russia.

The Russian government retains the prerogative to limit the foreign sourced element of charter capital in the banking sector to 50 percent of the sector's total charter capital, but it has never elected to activate this limitation.

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. Once Russia becomes a WTO Member and the United States grants permanent normal trade relations status, 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 maintains 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 ever 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, tightening regulation over non-incumbent telecommunications operators. Many in the industry have been disappointed that the amended federal law has not improved transparency in the licensing process, and

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have criticized the 5-10 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 of Communications and Mass Media 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 a foreign investment component.

The scarcity of civilian frequencies has led to fierce competition among Russian mobile operators and impeded the development of new wireless networks in Russia, such as 3G and WiMAX. (Only about 5 percent of Russia's communication frequencies are used for civilian purposes, while 95 percent are reserved for military use. In the European Union, the situation is reversed, with civilian use accounting for 95 percent of frequency resources.) Despite lobbying efforts from mobile operators, there is no indication that the Ministry of Communications and Mass Media will free up more frequencies for civilian use. Some senior Russian leaders, including President Medvedev, have supported the idea of requiring all users, including government entities, to pay fees for the use of a radio-frequency spectrum. In theory, this could force some government entities to give up their right to use certain frequencies and make more frequencies available for civilian use.

Certification of new products in the telecommunications industry still suffers from a lack of transparency, as does satellite regulation. The satellite industry reports that the certification process is overly burdensome and that 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.

INVESTMENT BARRIERS

Russia's foreign investment regulations and notification requirements can be confusing and contradictory, which has an adverse effect on foreign investment. In addition, U.S. investors and others cite corruption in commercial and bureaucratic transactions as a barrier to investment. In 2008, 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 requirements for all companies and banks to adhere to international accounting standards, and the failure of some companies to adopt and 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, and contribute to endemic corruption. Inadequate transparency in the implementation of customs, taxation, licensing, and other administrative regulations also discourages investment.

In 2008, the United States and Russia began exploratory discussions on the potential negotiation of a bilateral investment treaty.

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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 enacted the Strategic Sectors Law (SSL) in May 2008. The SSL introduces a list of 42 "strategic" sectors in which purchases of "controlling interests" by foreign investors must be pre-approved by the Russian government. The list of restricted sectors includes: 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; certain data-transmission (radio, television, telecommunications) infrastructure; production and distribution of encryption technologies and equipment; production and sales of goods and providing services under conditions of a "natural monopoly" (*e.g.*, activities such as operating certain gas networks); newspapers with a circulation of more than one million; and natural resource extraction. Many observers, while welcoming more clarity on the rules of the game, have criticized the SSL for being overly broad in the number of sectors it covers, and raised concerns that the approval process will prove to be non-transparent and burdensome.

The SSL approval process involves two steps. Initially, the foreign investment must be vetted by the Federal Anti-Monopoly Service (FAS). The FAS must determine whether the proposed investment is subject to the SSL and then recommend to the Government Commission on Control of Foreign Investment in the Russian Federation ("Commission") whether the investment should be approved. The head of the FAS is appointed by the Prime Minister. The Commission is headed by the Prime Minister and is comprised of Cabinet Ministers with jurisdiction over most of the restricted sectors, as well as the Director of the Federal Security Service.

To date, only two foreign companies have received approval under the SSL: DeBeers (diamond mining) and Alenia Aeronautica (development of Sukhoi Superjet 100). These approvals provide little guidance regarding implementation of the SSL. Both investments were pre-approved by Prime Minister Putin when he was still president, and no information about the process was publicized by government authorities. It is not clear how many projects, if any, have been denied approval under the Strategic Sectors Law's procedures.

Taxes

In response to investor concerns over the arbitrary and heavy-handed application of the tax code, the Russian government initiated a package of tax reforms in 2005 that was designed to limit aggressive tax collection practices while lowering the overall tax burden. The Duma continues to work on a series of measures that are expected to introduce tax benefits for the high technology sector, protect the rights of

investors with licenses to work in the energy sector, and raise the transparency of the tax audit process. The corporate profit tax was 24 percent from 2002 - 2008, 11 percentage points higher than Russia's flat 13 percent tax on personal income. However, in late 2008, as an economic stimulus measure, Russia cut the corporate profits tax rate from 24 down to 20 percent, effective January 1, 2009.

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.

Foreign companies have also raised concerns about the Russian tax authorities' scrutiny of payments that cross Russia's border but remain within the structure of the same legal entity. This tax issue has arisen chiefly in two contexts: (1) when a multinational company transfers an employee temporarily to the company's Russian office from another office outside Russia; and (2) in intra-company payments for the use of intellectual property. Under internationally accepted accounting standards, these normal business practices are handled as an intra-firm payment from one office to the other, or to the headquarters in the case of royalty payments. However, tax inspectors have often disputed such expenses as "economically unjustified" and, consequently, not permissible under the Russian Tax Code. While foreign firms with Russian operations have been careful to ensure that their accounting methods are consistent with the Russian Tax Code, several foreign firms have been subjected to audits and claims for back taxes in these situations.

Energy Sector

In conjunction with the SSL, amendments to the sub-soil legislation were also passed requiring governmental approval for foreign investment in excess of 10 percent in companies operating a "strategic" deposit, which includes major oil, gas, and other mineral deposits. Foreign oil and gas companies are concerned about the potential application of these provisions, including how and when the government may declare a given field strategic and what compensation a field licensee may be given under such declarations.

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. 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 Shell) agreed to reduce their stakes by selling a controlling share to Gazprom. The two remaining major PSAs are ExxonMobil-led Sakhalin I and Total-led Kharyaga, both of which have come under pressure from various state bodies.

In 2008, the Russian government finally approved expansion of the Caspian Pipeline Consortium (CPC) pipeline, operational as of 2001. The agreement on expansion was signed by all parties in December 2008. CPC expansion is critical for export of rapidly growing Central Asian oil production.

For the first time since 2000, oil production declined in Russia for the year. Production declined 0.9 percent in the first eight months of 2008 compared to the same period in 2007. Production stagnation and decline is widely blamed on an onerous tax burden that does not provide adequate incentives for investments in new fields. To boost oil production, the Russian government in 2008 approved certain tax breaks, to take effect in 2009, that are estimated to provide \$4 billion of relief to the sector. However, most analysts believe this limited tax relief, particularly when combined with lower oil prices and a difficult international investment climate, will not be enough to reverse declining production trends.

In July 2008, RAO UES, the electricity holding company that controlled all of Russia's power assets, with the exception of those connected to nuclear energy, completed its corporate reorganization and ceased to exist. It has been succeeded by 24 companies: 6 wholesale private generation companies (OGKs) and 14 "territorial" generation companies (TGKs); the hydroelectric giant RusHydro; a Federal Grid; and a number of distribution operators. Although the unbundling and privatization of RAO UES was initially hailed as a huge success, concerns are growing.

As a condition to the generating companies' spinoffs, investors in the OGKs and TGKs agreed to implement plans to modernize and expand their respective electricity infrastructure. These plans were premised on the assumptions of robust economic growth and demand and access to affordable credit. In light of slowing Russian economic growth and tight financial conditions due to the global financial crisis, these investment obligations have become very expensive. Consequently, a number of investors are backing out of acquisition deals or seeking to renegotiate the terms of their acquisitions with the Russian government. It seems unlikely that modernization and expansion of the sector's infrastructure – a major purpose of the reorganization – will occur in the near future. Because the restructuring was only completed in July 2008, it is still unclear to what degree the electricity generation market will ultimately be deregulated, and whether it will operate in a transparent and non-discriminatory manner.

Aviation

Russia's commercial passenger and cargo airlines have been working to modernize their aging fleets, in light of the operational inefficiencies of domestically produced aircraft. Russian aircraft are 10 percent to 40 percent less efficient than comparable Airbus and Boeing aircraft in terms of fuel efficiency, weight, level of after sale service, and noise reduction capacity. These problems with inefficiency have been further exacerbated by increases in the price of jet fuel in Russia over the past 12 months. With rising fuel costs, several leading Russian carriers have announced plans to withdraw all of their domestic aircraft from their fleets and to replace them with Western manufactured alternatives. Several Russian carriers have also recently experienced cash flow and other financial problems, because of rising fuel prices and a lack of available credit stemming from the global financial crisis. Some Russian airlines have agreed to merge into larger regional carriers to resolve their financial difficulties. In October 2008, Russian government officials announced a series of anti-crisis measures for Russian airlines, including granting the Ministry of Transportation the power to regulate the financial stability of airlines, up to 30 billion rubles financing for Russian airlines through the end of 2008, and a 6 month delay in the payment of customs duties on imported aircraft and components.

Russia's passenger aircraft manufacturers are not yet competitive with Western manufacturers due to insufficient production levels (Russia produced only 15 aircraft from January to October 2008) and the lack of competitive aircraft products, especially in the long-haul aircraft segment. In the medium and

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short-haul segments, Russia is planning to complete the certification process for the SuperJet-100 by the end of 2009 and begin offering it for sale to commercial air carriers. The SuperJet-100 is a family of regional aircraft developed by the Sukhoi Design Bureau in cooperation with major U.S. and European aviation corporations, including Boeing, Snecma, Thales, Messier Dowty, Liebherr Aerospace, and Honeywell.

While there has not been any new production of the Antonov-124 cargo aircraft since 1993, some observers believe there would be demand for this large cargo plane by global delivery and logistics companies. Russian cargo carrier Volga-Dnieper has stated it would be willing to order up to 40 Anotonov-124 planes over the next 10 years to 15 years, if the aircraft were produced again. However, Russian aircraft manufacturer UAK has stated it would like to have firm commitments from buyers for 50-60 planes over the next 10 years to 15 years in order to restart production. Further production of the plane may depend on a joint venture investment from a foreign aerospace company. If production of the Antonov 124 were restarted, the plane would compete with other large cargo aircraft produced by American and other manufacturers, such as the 747 Freighter.

As noted above under the section on Customs Issues, Taxes and Tariffs, Russia has recently lowered or eliminated the duties on many types of imported aircraft. In addition, 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, but developing, 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 Duma for several years. While closely following an International Chamber of Commerce model bill, the draft before the 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 tax and customs duty implications of electronic commerce in Russia are still unclear. Russian law states that the movement of goods over the "electronic border" is subject to customs regulation, and thus there is a possibility that the import of products electronically could be subject to import duties in Russia,

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which would be against the current international customs duty moratorium. However, it is unclear how Russian customs officials could exercise control over this method of importation.

Despite a general reluctance to use credit cards for online purchases because of the risk of fraud, the sales volume of Russian Internet stores doubled in 2007, and some experts predict that Internet sales in Russia will reach \$10.3 billion in 2008.

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 IPR 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 November 2008, the Russian Supreme Arbitration Court established an important precedent to settle Internet disputes under WIPO rules, which involved a domain name owned by a Japanese company.

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. The development of the Russian government's "E-Russia" program is also intended to stimulate the growth of electronic commerce throughout the country by using federal and local E-Government initiatives as a catalyst.

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 Russian Far East, due to its proximity to China, where many illegally harvested Russian logs are smuggled for further processing. 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. A government program approved in 2008 ("Forestry Development Plan 2020") outlines several ways to combat illegal logging, including: establishing better interagency cooperation, mandatory forestry certification, improving monitoring, and tightening enforcement for illegal logging.