**DOCUMENT OF THE EUROPEAN BANK**
**FOR RECONSTRUCTION AND DEVELOPMENT**

# STRATEGY FOR

# THE RUSSIAN FEDERATION

# 2009-2012

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## LIST OF ABBREVIATIONS

| | |
|---|---|
| BAS | Business Advisory Services |
| BAT | Best Available Techniques |
| BEEPS | Business Environment and Enterprise Performance Survey |
| BIS | Bank for International Settlements |
| BSIF | Black Sea Investment Facility |
| CARDS | Community Assistance for Reconstruction, Development and Stabilisation |
| CCGT | Combined Cycle Gas Turbine Plant |
| CEC | Central Election Commission |
| CIS | Commonwealth of Independent States |
| CP | Commercial Paper |
| CPS | Country Partnership Strategy |
| DSM | Demand-Side Management |
| GEF | Global Environment Facility |
| GHG | Green House Gas |
| EE | Energy Efficiency |
| EEAP | Energy Efficiency Action Plans |
| EIA | Energy Information Administration |
| EIB | European Investment Bank |
| EITI | Extractive Industry Transparency Initiative |
| ENA FLEG | Europe and North Asia Forest Law Enforcement and Governance |
| ENPI | European Neighbourhood and Partnership Instrument |
| E&S | Environmental and Social |
| ESCO | Energy Service Company |
| ETCs | Early Transition Countries |
| EU | European Union |
| EUR | Euro |
| FATF | Financial Action Task Force |
| FCSM | Federal Commission for the Securities Market |
| FDI | Foreign Direct Investment |
| FSAP | Financial Sector Assessment Programme |
| FSFM | Federal Service on Financial Markets |
| GDP | Gross domestic product |
| GEF | Global Environment Facility |
| GIS | Green Investment Scheme |
| HELCOM | Helsinki Commission, or Baltic Marine Environment Protection Commission |
| IAS | International Accounting Standards |
| IBRD | World Bank |
| ICMM | International Council for Mining and Metals |
| IFC | International Finance Corporation |
| IFIs | International Financial Institutions |
| IFRS | International Financial Reporting Standards |
| ILO | International Labour Organisation |
| IMF | International Monetary Fund |
| IMO | United Nations International Maritime Organization |
| IOSCO | International Organisation of Securities Commissions |
| IPOs | Initial Public Offerings |
| IPP | Independent Power Producer |
| IRS | Interest Rate Swaps |
| JEP | Joint Environmental Programme |

| | |
|---|---|
| JI | Joint Implementation |
| LIS | Legal Indicator Survey |
| MARPOL | International Convention for the Prevention of Pollution from Ships |
| MCCF | Multilateral Carbon Credit Fund |
| MICEX | Moscow Interbank Currency Exchange |
| MEDT | Ministry of Economic Development and Trade |
| MEI | Municipal and Environmental Infrastructure |
| MISP | Municipal Infrastructure Support Programme |
| MoU | Memorandum of Understanding |
| MSME | Medium, Small and Micro Enterprises |
| NBFI | Non bank financial institutions |
| NCBV | Net cumulative business volume |
| NDEP | Northern Dimension Environmental Partnership |
| NEFCO | Nordic Environmental Finance Corporation |
| NGN | New-Generation Networks |
| NGO | Non-Governmental Organisation |
| NIB | Nordic Investment Bank |
| OCE | Office of the Chief Economist (EBRD) |
| ODA | Official Development Assistance |
| ODIHR | Office of Democratic and Human Rights |
| OSCE | Organisation for Security and Co-operation in Europe |
| OTC | Over-the-Counter |
| PACE | Council of Europe's Parliamentary Assembly |
| PCA | Partnership and Co-operation Agreement |
| PRs | Performance Requirements |
| PSP | Private Sector Participation |
| RAB | Regulatory Asset Base |
| RFID | Radio Frequency Identification |
| RFQ | Request for Quote |
| RNOA | Republic of North Ossetia-Alania |
| ROSC | Review of Standards and Codes |
| RSBF | Russia Small Business Fund |
| RSECF | Russian Sustainable Energy and Carbon Finance Facility |
| RSPP | Russian Union of Industrials and Entrepreneurs |
| RUB | Rouble |
| RUI | Russian Urban Institute |
| RZD | Russian Railways |
| SAC | Supreme Arbitrazh Court |
| SECO | Swiss State Secretariat for Economic Affairs |
| SEFF | Sustainable Energy Financing Facility |
| SEI | Sustainable Energy Initiatives |
| SME | Small and Medium Enterprises |
| SMP | Strategic Master Plan |
| SOLAS | International Convention for the Safety of Life at Sea |
| SSF | Shareholder Special Fund |
| TACIS | Technical Assistance for CIS |
| TAM | Turn-Around Management |
| TC | Technical Co-operation |
| TEN | Trans-European Network |
| TIMS | Transition Impact Monitoring System |
| TIRs | Transition Impact Retrospective Reports |

| | |
|---|---|
| UNEP | United Nations Environmental Programme |
| UNICTRAL | United Nations Commission on International Trade Law |
| USD | US Dollar |
| WB | World Bank |
| WTO | World Trade Organisation |

# EXECUTIVE SUMMARY

The Russian Federation is committed to the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank. While there has been a welcome reaffirmation of the importance of these principles by the current administration, a more consistent application of them would facilitate attainment of the country's medium-term development goals. In particular, policy innovations to address Russia's key transition challenges are most likely to emerge from a free flow of ideas and information, open engagement with civil society and enhanced political competition. Recent efforts to increase transparency, step up judicial reform and the rule of law and combat corruption are particularly encouraging, but implementation will be the key.

Over the last decade and during much of the previous Strategy period, Russia enjoyed high rates of economic growth. Gross domestic product increased by 82 per cent between 1999 and 2008 in real terms, helped by a steady increase in oil price from the low of USD 9 per barrel of Urals brand in early 1999 to the peak of USD 138 per barrel in August 2008. Economic growth resulted in rapidly rising income levels, a reduction in poverty and expansion of the nascent middle class and continued integration into the world economy. The medium-term fiscal framework provided for accumulation of oil revenue stabilization funds that have helped to absorb the effects of the global financial crisis.

However, progress in structural and institutional reforms during this period has been uneven and during the past year the economic landscape has changed dramatically. The Russian economy has been severely affected by the global financial crisis through a steep reduction in commodity prices (terms of trade shock), capital flow reversal and credit crunch, and lower global demand for Russian manufacturing exports. While adjustment to the new external environment will be facilitated by the prudent fiscal management and monetary and public debt policies of recent years, it will likely be associated with structural shifts, as the economic crisis may give rise to banking sector and corporate bailouts involving nationalisations, economic stimulus packages may increase trade barriers, lower demand may translate into weaker competition as firms go out of business, and a sharp fall in foreign direct investment inflows may slow down transfer of technologies and skills and postpone essential investment into modernising and developing new capital-intensive infrastructures, notably in the area of energy. The economic crisis has led to the adoption of a number of restrictive trade measures. WTO accession should remain a priority for Russia. In view of its intention to join the WTO together with Belarus and Kazakhstan, with which it is forming a customs union, it will be important to keep the accession process on track.

### Challenges

On its modernisation and transition path Russia faces a number of fundamental challenges cutting across sectors:

- The economic downturn and a fall in global commodity prices emphasized the importance of **diversification of output and exports** for sustainable long-term economic development. Diversification will in turn rely on both innovation and further integration into the world economy, as well as addressing the infrastructure bottlenecks.

- Lower global demand also highlighted the **need to bolster competitiveness** of the Russian industry through market-based restructuring and improved production efficiency, in particular energy efficiency where there remain large gains to be made, and has emphasised the importance of developing the MSME business sector.

- Deepening Russia's **integration into the global economy** and advancing its membership in the World Trade Organisation is an important anchor to promote competitiveness of domestic industry and services. WTO membership would also lessen trade frictions by providing a rules-based framework and dispute settlement mechanism for measures such as the recently introduced trade restrictions.

- The sharp economic slowdown also highlighted the importance of strengthening the financial sector and **capital markets development**, and exposed the current fragility of the rouble markets, as the de-dollarization trend of previous years went into reversal.

- Remaining weaknesses in the institutional and regulatory framework and in corporate governance practices need to be addressed to **improve the investment climate** and revive foreign direct investment.

**Strategic directions**

In the face of the economic crisis and the identified transition challenges, the core objective of all the Bank's activities in Russia will be to assist to Russia's efforts to modernise and diversify its economy to reduce the current concentration on extraction and processing of natural resources and move towards a greater share of value-added manufacturing. The Bank will focus on the need to confront and mitigate the effects of the crisis in the short term and to support the post crisis recovery in the medium term, making the best of its local presence in all regions of Russia

In parallel with the thematic and sectoral priorities outlined in this document, the systematic implementation of the Bank's mandate – private sector focus, transition impact, additionality, sound banking, environment – and a continued focus on integrity will drive a strong sense of priority, selectivity and quality in all Bank's operations.

- In the context of the second phase of the Sustainable Energy Initiative, **energy efficiency** will become an integral part of the business of each sector of Bank activity in Russia. The Bank will address with increased determination the **demand side of energy** use by reducing waste of energy and greenhouse emissions in all sectors, which will be important to support corporate competitiveness and combat climate change. An Energy Efficiency Action Plan is being negotiated with the Russian authorities.

- **Modernisation, competitiveness and diversification of the real economy will be the overarching priority of the next strategic period**, in order to address the immediate financing needs and keep trade flowing in response to the crisis, and promote economic development, competition, productivity and energy efficiency in the medium term.

    - In its operations the Bank will focus on facilitating continued trade flows through its Trade Facilitation Programme; ensuring adequate access to working capital as well as refinancing and restructuring support to existing and new clients and supporting resumption of foreign direct investment.

    - Beyond the crisis response measures the Bank will focus its direct support to the corporate sector on diversification and enhancing value added manufacturing, focusing on sectors where most impact could be made by the Bank, including a more comprehensive development of the food chain (with a focus on agri-processing and logistics), high tech industries, local forestry companies, automotive suppliers and industrial equipment, without excluding projects with high transition impact in other sub-sectors when appropriate.

- Technical assistance will be provided to identify regional companies and assist them, when needed, to restructure and reach financial, legal, management and corporate standards that would enable them to work with the Bank.

- Financing the Mittelstand and micro, small and medium enterprises (MSMEs), as key sources of competition, productivity, diversification and jobs, through direct investments or framework lending schemes with financial intermediaries and through private equity funds, will be a key priority to address the needs of the real economy. A specific effort will be made to open new channels to reach MSMEs, including working together with the authorities to design innovative support and financing schemes.

- This overarching priority of modernisation, competitiveness and diversification of the real economy will be supported by active infrastructure development and efficient financing mechanisms.

  - **Infrastructure Development**: Recovery and diversification of the economy will not be possible without the necessary infrastructure that would ensure physical flow of goods, access to utility services and supply of energy to industry. The immediate challenge is to ensure availability of public and IFI financial support for critical infrastructure projects, and to support viable private companies and municipalities in the sector. To assist Russia in meeting its medium term transition and development goals, the Bank will continue to provide investment in the transport and municipal infrastructure sectors using concession mechanisms and public private partnership structures, as well as working with private companies, with an increased effort in the rail sector. The Bank will finance investments in generation and transmission capacity, to support the momentum of liberalisation and renew ageing and inefficient power infrastructure, using where appropriate an integrated approach, with an increased focus on energy efficiency, so as to meet the needs of the industrial sector. The Bank will work with private sector companies, and, selectively, with well managed market oriented state owned entities promoting reform, restructuring or commercialisation of their activities in those sectors, to address key infrastructure bottlenecks, while supporting competition, transparency and good corporate governance practices. Lastly, the Bank will have a focussed activity in the oil and gas sectors, in projects that promote energy efficiency, good governance and best environmental practices.

  - **Efficient Financing Mechanisms**: Another key priority is to stabilize the financial sector to enable it to resume its crucial role of an intermediary for financing of the real economy. To address this, the Bank will focus in its current operations on existing clients' balance sheet strengthening as well as on support to consolidating initiatives. The Bank will continue in the medium term to seek new partners especially in the regions, probing new relationships by trade facilitation and MSME lines. The Bank will give a new prominence to domestic capital market development and local currency funding to help address the excessive reliance of the Russian economy on external sources of funding. Systematic efforts will be undertaken to deepen capital markets through the support of insurance companies and development of on-shore savings and investment vehicles, including equity funds, leasing, and pension and life insurance.

Through continued policy dialogue and in co-ordination with other IFIs the Bank will contribute to developing a robust capital market infrastructure. The financial crisis has made equity funding even more necessary and even more difficult to attract. The Bank will therefore actively seek **equity investment opportunities in companies and banks**, all the more that the use of the equity instrument enables the Bank, through its proactive investor role, including on investee company boards, to influence positively corporate governance standards.

- Four important considerations will be present in the operations of the Bank:

  - The Bank will aim to assist Russia in transforming its advantages, including a well-educated population, into successful knowledge based industries and innovations across all sectors of the economy. The Bank will encourage the use of best available technologies and practices.

  - The Bank will direct its investments into sectors where there is clear and sustained political will and momentum for market friendly reforms. It will reinforce policy dialogue efforts in these sectors to promote transition, with a focus on addressing legal and regulatory issues that arise from specific project experience. Areas of special attention will be the development of the institutional and regulatory framework for promoting energy efficiency, encouraging competition, ensuring equal access to infrastructure, tariff reform, improving the framework for private sector participation in provision of transport and utilities services, banking sector and capital markets regulation. The Bank will promote, when appropriate, systematic approaches combining policy dialogue and financing mechanisms, in order to achieve greater impact.

  - In all its activities the Bank will promote competition, integrity, transparency and higher standards of corporate governance and business conduct, as well as good environmental practices.

  - For activities with state-owned companies, the Bank's involvement will focus on such enterprises that operate competitively and are moving to participation in the market-oriented economy, and on enterprises in transition to private ownership and control. The Bank will actively support the efforts of the Russian Government to accelerate privatisation of stakes in state-owned companies, and to bring back into private ownership companies and banks in which the economic crisis has forced the state to increase its involvement. The Bank will consider pre-privatisation investments in state companies that the government is committed to privatise, to support corporate governance improvements and restructuring to increase attractiveness of such companies for the private sector. The Bank will also consider investing along-side strategic investors in state companies at the time of privatisation or taking a minority equity stake during IPOs.

In working to achieve the above, the Bank will continue to closely co-ordinate with other IFIs in its policy dialogue efforts, in activities in the context of the Northern Dimension initiative, and in mobilising co-financing for priority investment programmes, in particular with the European Investment Bank, which is considering increasing its operational scope and budget in Russia and will remain a key partner for EBRD, as well as the Russian Bank for Development (Vnesheconombank).

Implementation of the priorities underlined above will require strong and sustained technical cooperation support, particularly in energy efficiency, infrastructure and municipal sectors but also in the financial sector and the corporate sector to assist companies to implement international accounting and corporate standards in order to access financing. The Bank will seek technical support for the development and implementations of its projects from existing and new donors, including the Russian Federation.

The Bank will continue to ensure that all EBRD operations in Russia meet sound banking principles, have transition impact, are additional and are subject to the Bank's Concession Policy and Environmental and Social Policy and incorporate, where appropriate, Environmental and Social Action Plans, which will contribute to a high selectivity and quality of projects financed by the Bank. The Bank will continue to channel the major part of its investments to the regions of Russia to support regional development and growth.

# 1. THE BANK'S OPERATIONS TO DATE AND CURRENT PORTFOLIO

## 1.1 Overview of Activities to Date

Over the last 3 years the Bank has signed close to 270 projects in Russia bringing the total number of projects signed in Russia to 583. At the end of September 2009, Russian projects accounted for a net cumulative business volume of EUR 12.1 billion and a total project value of approximately EUR 38.1 billion. The table below provides a breakdown of the Bank's net cumulative business volume to date in Russia, which shows a balanced picture of involvement across sectors.

**Table 1. Russia: Overview of the Bank's Activities to Date (30 September 2009)**

| EUR million | No. of Projects* | Total Project Value | EBRD Finance | Debt | Equity | Per cent of Cumulative Commitments |
|---|---|---|---|---|---|---|
| Private | 535 | 32,466 | 10,055 | 7,574 | 2,482 | 83 |
| State | 48 | 5,639 | 2,023 | 1,890 | 133 | 17 |
| | | | | | | |
| POWER &ENERGY UTILITIES | 15 | 4,651 | 973 | 633 | 340 | 8 |
| | | | | | | |
| NATURAL RESOURCES | 36 | 3,696 | 1,022 | 900 | 122 | 8 |
| | | | | | | |
| MEI | 35 | 3,519 | 804 | 743 | 61 | 7 |
| Transport | 29 | 4,115 | 1,494 | 1,206 | 288 | 12 |
| INFRASTRUCTURE | 64 | 7,634 | 2,298 | 1,949 | 349 | 19 |
| | | | | | | |
| Agribusiness | 55 | 3,962 | 1,296 | 1,122 | 174 | 11 |
| Property & Tourism | 16 | 1,026 | 282 | 198 | 84 | 2 |
| Telecoms, Informatics & Media | 22 | 1,928 | 454 | 368 | 86 | 4 |
| General Industries | 106 | 7,570 | 2,148 | 1,906 | 242 | 18 |
| CORPORATE SECTOR | 199 | 14,485 | 4,179 | 3,593 | 586 | 35 |
| | | | | | | |
| Equity Funds | 42 | 2,032 | 706 | 0 | 706 | 6 |
| MSME Debt Finance | 88 | 731 | 526 | 520 | 6 | 4 |
| MSME SUPPORT | 130 | 2,762 | 1,232 | 520 | 712 | 10 |
| | | | | | | |
| Bank Equity | 24 | 474 | 338 | 1 | 338 | 3 |
| Bank Lending (incl. TFP) | 75 | 2,337 | 1,339 | 1,339 | 0 | 11 |
| Non-bank Financial Institutions | 40 | 2,066 | 697 | 529 | 169 | 6 |
| FINANCIAL SECTOR | 139 | 4,877 | 2,375 | 1,868 | 506 | 20 |
| | | | | | | |
| TOTAL | 583 | 38,105 | 12,078 | 9,464 | 2,615 | 100 |

*Number of projects excludes TFP operations

Annual business volume more than doubled between 2005 and 2007 from EUR 1.1 billion to a peak of EUR 2.3 billion. As most of the Bank's operations in Russia are in US dollars, a more relevant measure is annual business volume in dollar terms which has trebled from USD 1.2 billion to USD 3.6 billion during this period. Annual business volume receded slightly to EUR 1.8 billion in 2008 as the crisis hit the economy in the fourth quarter of the year, leading to the interruption of a number of ongoing project negotiations with financial intermediaries. In line with the strategic priorities identified in the past strategy, special focus has been made on increasing the share of infrastructure investment, which has grown from 2 per cent of the annual business volume in 2005 to over 23 per cent in 2008. The Infrastructure and Energy sectors together accounted for 42 per cent of 2008 business volume.

Annual business volume in the corporate sector increased strongly in 2006 and 2007 reaching EUR 753 million, more than double the 2005 level of EUR 334 million, with the share of the corporate sector during the period at broadly one-third of annual business volume (30-33 per cent per annum). Corporate sector business volume has been driven mainly by growing activity in the agribusiness and general industry sectors. Business volume in the agribusiness sector increased more than four-fold from EUR 50 million in 2005 to EUR 225 million in 2008. General industry annual business volume peaked in 2007 at EUR 527 million, averaging EUR 300 million per annum for the period 2005 to 2008.

As at the end of 2008, Russia remained the largest single country exposure for EBRD, accounting for 30.9 per cent of the total portfolio and 33.7 per cent of operating assets. By the end of September 2009 the Russia portfolio had grown to EUR 7.0 billion, including regional projects amounting to EUR 0.6 billion, with operating assets of EUR 5.6 billion. This portfolio is well distributed across all sectors, with the corporate sector accounting for 32 per cent, Infrastructure and Energy 40 per cent and Financial Institutions for 28 per cent. Operating assets more than doubled between the end of 2005 and the end of the third quarter of 2009, while the portfolio growth in the same period was 63 per cent. This strong growth in the level of operating assets is the result of a high level of disbursements, especially in 2008 (EUR 1.8 billion).

**Table 2. Russia: Sector Distribution of Annual Business and Portfolio**

| Sectors | 2006 | Per cent share | 2007 | Per cent share | 2008 | Per cent share | Q3 2009 Portfolio | Per cent share |
|---|---|---|---|---|---|---|---|---|
| **Corporate** | 621 | 33.3 | 753 | 32.8 | 543 | 29.9 | 2,219 | 31.7 |
| **Financial Institutions** | 937 | 50.3 | 893 | 38.9 | 515 | 28.4 | 1,943 | 27.8 |
| **Infrastructure** | 214 | 11.5 | 405 | 17.6 | 426 | 23.4 | 1,731 | 24.8 |
| **Energy, incl.** | 92 | 5.0 | 246 | 10.7 | 332 | 18.3 | 1,098 | 15.7 |
| Power | 92 | 5.0 | 139 | 6.1 | 175 | 9.6 | 702.6 | 10.1 |
| Natural Resources | 0 | 0 | 107 | 4.7 | 157 | 8.6 | 395.7 | 5.7 |
| **Total** | 1,864 | 100.0 | 2,297 | 100.0 | 1816 | 100.0 | 6,990 | 100.0 |

Over the last three years, the share of equity operations in Russia has increased significantly, reaching 29 per cent of the annual volume in 2008, as the previous Russia Strategy made equity investments one of the strategic priorities. Thus, the share of equity in the Russian portfolio increased from 13 per cent in 2005 to 25 per cent at the end of the third quarter of 2009. The share of private sector portfolio increased from 73 per cent as at the end of 2005 to 80 per cent at the end of the third quarter of 2009. Sovereign deals accounted for 5 per cent of the portfolio at the end of the third quarter of 2009, and non-sovereign public sector projects accounted for 15 per cent.

The quality of the loan portfolio had been improving significantly until mid 2008 and to date has not been notably affected by the crisis, with only EUR 122 million (2.9 per cent) of loan impairment. However, the equity portfolio has suffered a significant fall in value with close to 50 per cent of equity operating assets classified as impaired at the end of September 2009, and the value of the portfolio 16 per cent below historical cost. This reflects the loss in the fair value of the Bank's equity portfolio in Russia with some large investments listed on the Russian Stock Exchange Index RTS which dropped 74 per cent during 2008.

Up to the end of the third quarter of 2009, the total project value of EBRD operations in Russia reached EUR 38.1 billion. In addition to the EUR 12.1 billion financed directly by the Bank, the cumulative amount of co-financing mobilised by the EBRD in Russia reached approximately EUR 8.5 billion. This is the largest volume among the Bank's countries of operation. During 2007 alone, the amount of co-financing was a record EUR 1.8 billion. The Bank continues to act as a catalyst to encourage the involvement of commercial banks as well as other sources of co-financing in Russia notwithstanding limited commercial resources availability during the crisis.

The Bank has made special efforts to direct its resources to the regions of Russia, where it has been most additional. Thus, the annual investments outside of Moscow and St Petersburg have grown from 68 per cent in 2005 to 94 per cent in 2008.

**Table 3. Annual Business Volume in Russian Regions (EUR million)**

| Regions | 2005 | Per cent | 2006 | Per cent | 2007 | Per cent | 2008 | Per cent |
|---|---|---|---|---|---|---|---|---|
| Russian Regions and Multi-Regional | 760 | 68.2 | 1,459 | 78.3 | 2,133 | 92.9 | 1,702 | 93.7 |
| Moscow City and Moscow Oblast | 229 | 20.5 | 363 | 19.5 | 150 | 6.5 | 96 | 5.3 |
| St. Petersburg City | 126 | 11.3 | 41 | 2.2 | 14 | 0.6 | 18 | 1.0 |
| Total | 1,115 | 100.0 | 1,864 | 100.0 | 2,297 | 100.0 | 1,816 | 100.0 |

Projects in the regions of Russia account for 87 per cent of the Bank's portfolio as at end September 2009 up from 71 per cent in 2005.

**Table 4. Cumulative Commitments and Portfolio in Russian Regions (EUR million)**

| Regions | Number of projects | NCBV | NCBV (Debt) | NCBV (Equity) | Portfolio | Portfolio per cent |
|---|---|---|---|---|---|---|
| Russian Regions and Multi-Regional | 445 | 9,767 | 7,532 | 2,236 | 6,078 | 86.9 |
| Moscow City and Moscow Oblast | 96 | 1,611 | 1,301 | 310 | 635 | 9.1 |
| St. Petersburg City | 42 | 700 | 631 | 70 | 277 | 4.0 |
| Total | 583 | 12,078 | 9,464 | 2,615 | 6,990 | 100.0 |

The current pipeline of passed concept review transactions consists of EUR 5.3 billion (for details please see Annex 5).

## 1.2 Implementation of the previous Country Strategy

The previous country strategy, approved in 2006, outlined a number of priorities which have been the focus of the Bank's activities during the strategic period, as described below:

- ***A strong emphasis on infrastructure (transport, power utilities and municipal);***

Over the previous Strategy period the Bank expected to see core infrastructure sectors-transport and municipal rising together to about 20-25 per cent of annual commitments. In 2008 infrastructure accounted for 23.4 per cent of annual business volume and the share of infrastructure in the portfolio as at end March 2009 was just above 20 per cent.

In the transport sector the Bank has supported the implementation of large scale railway reform with investments both in the newly created commercial subsidiaries of the Russian Railways company (Transcontainer, Freight One) as well as private rail operators (Globaltrans, Inpromleasing), complemented by active support for the first intermodal operator on the Russian market (FESCO). The ongoing cooperation with the federal port landlord, Rosmorport, have resulted in transition impact gains in terms of corporate governance and operational transparency, while policy dialogue with the authorities, together with EIB and other IFIs, has been material in bringing the first set of road PPP projects to the market for tendering. The Bank has been playing a leading role among the IFI group on preparation of the Pulkovo Airport Project and Moscow- St Petersburg motorway which are expected to be the first concessions to proceed in Russia.

The Bank has stepped up its financing of municipal infrastructure, signing 16 transactions during the strategic period in water, wastewater, heating services, and a first loan in the housing sector in Surgut. The Bank now is engaged with municipal enterprises in 14 regions, including 4 projects in KHMAO (and 3 more under preparation). During this period the Bank has undertaken its first projects with key private operators Rosvodokanal, Novogor and RKS, which are collectively present in 14 regions, with the aim of financing priority investment programmes while bringing the contractual relations of private operators with municipalities closer to best international practice. Active policy dialogue has been pursued to promote competitive selection of private operators, improvement of the concession framework and tariff reform. A key element of the Bank's contribution has been the preparation with sector experts of the Russian Urban Institute (RUI) of a set of key principles for the establishment of well-balanced long-term contractual relations in the municipal sector (www.ebrd.com/country/sector/muninfra/ppp/index.htm).

In the power utilities sector the Bank supported international and domestic strategic investors who participated in the privatisation of generating companies, thereby facilitating the most significant element of the power sector restructuring plan. The Bank's funds were used to finance the construction of safer and more efficient new power plants and modernise existing facilities. The Bank continued to engage in extensive policy dialogue as a member of the Strategy and Restructuring Committee of RAO UES thereby ensuring the Bank's participation in strategic decision-making that determined the pace of privatisation and restructuring of the power sector.

- ***Broader presence in the Russian corporate sector and with strategic investors from all countries in order to foster competitiveness and industrial diversification of the***

***economy as well as to promote transition and market developments in Russia's regions;***

The Bank's financing of the Russian corporate sector has expanded with about one hundred new projects during the previous Strategy period, which represents more than Euro 2.3 billion in Bank's own commitments. The projects delivered are almost exclusively in the Russian regions outside the two federal cities. About half of the projects have been with local sponsors and two thirds of the projects in general industry with a significant impact on enterprise reform and modernisation of production facilities. The Bank has facilitated substantial FDIs in the Russian corporate sector with transfers of know-how and technology into key economic sectors such as automotive, machine building, forestry, agribusiness, construction materials, consumer goods, pharma, logistics and telecom. The Bank has partnered with key strategic investors from a wide range of countries such as the US (Alcoa, Guardian), Japan (Toyota, Komatsu), Korea (LG Electronics, Korean Telecom), Germany (Volkswagen, Globus), France (Lafarge), Belgium (Solvay), Finland (Stora Enso).

- ***Support to smaller companies, which contribute greatly to economic diversification and employment, will be given as high a priority as larger companies;***

About forty per cent of projects in the Russian corporate sector during the strategic period involved medium sized sponsors. Moreover, the Bank's work with larger sponsors and larger projects continues to have a strong positive impact on the business opportunities and trade funding for SMEs in their roles as suppliers and distributors.

The Bank continued to mobilise significant volumes of equity financing for SME through its investment in private equity funds, where during the period of 2006-2008 the equity funds supported by the Bank provided over USD 800 million in equity financing for SMEs. The Bank's own investment was leveraged by the participation of other investors in proportion of almost 8:1. The outstanding portfolio of loans to micro and small enterprises under the Russia Small Business Fund ("RSBF") increased between 2005 and 2008 from USD 530 million in 63,000 loans to USD 2,140 million in more than 106,000 loans (with EBRD funding of around USD 200 million, with the balance being financed from the partner banks' own resources). Whereas at the end of 2005 the RSBF worked through 8 partner banks, this number had increased by the end of 2008 to 18 partner banks.

- ***A selective intervention in the banking and non banking sectors, with a parallel strive to develop capital markets transactions;***

Special emphasis was made during the strategic period to support Russian regional banks. Thus, 15 banks out of the 36 EBRD banking relationships in Russia, are purely regional banks. Up until the financial crisis hit the Russian financial sector in September 2008, the Bank intensively supported development of assets securitisation in Russia by taking higher risk components, enabling and stimulating participation of foreign private financiers. Five securitisation transactions have been completed for Russian issuers. The Bank was active in syndications, bringing mid-sized private Russian banks to international capital markets and attracting foreign capital into the Russian banking sector. Ten syndicated loans have been organised by EBRD in the Strategy period, in most cases improving the terms of borrowing by attracting a wider number of participants and stretching tenors.

During the last three years, other important market segments such as mortgage and consumer financing were developed with the EBRD being in the forefront in providing term financing for the best operators and promoting best practices in the market.

The Bank has also expanded its activities in the non-bank financial institutions sector mainly focusing on leasing, insurance and private equity funds sectors. Several projects have been completed with the key market operators in this respect, leading to seven leasing and four insurance relationships in the portfolio, as well as growing the portfolio of equity funds in Russia to 14. To facilitate development of capital markets infrastructure, the Bank selectively engaged with the main investment banks and brokerage companies, however these activities have been significantly disrupted by the September 2008 financial crisis.

The Bank has significantly increased its financing of projects in roubles, especially in the financial institutions, municipal infrastructure and power sectors. This has contributed to the de-dollarization of the Russian economy and assisted clients generating only rouble revenues to minimize foreign currency exchange risks. Lending in roubles has accounted on average for over 20 per cent of annual business volume in 2006-2008. However, recent volatility and high level of Mosprime have caused temporary problems for borrowers, which could be mitigated in future by strengthening and deepening of the Mosprime index.

- ***Approach to energy efficiency and reducing GHG emissions across all sectors.***

Russia is the most significant country both in terms of energy use as well as energy efficiency potential among the EBRD countries of operations. Consequently, Russia has been the largest single recipient of EBRD sustainable energy investment during Phase I of the Bank's Sustainable Energy Initiative, representing 28.3 per cent of the total cumulative SEI investments across all countries of operations. The Bank has invested EUR 755 million[1] in sustainable energy projects in Russia for a total project size of over EUR 3.7 billion over the period of 2006-2008 (For a more detailed review, see Annex 6).

Transactions included a landmark EUR 600 million loan to the leading Russian steelmaker Severstal to finance the company's strategic energy efficiency programme; a pilot credit to the Russian Centre-Invest bank to promote energy efficiency lending in southern Russia; a 14 year loan to HydroOGK to rehabilitate outdated hydro power stations on the Volga and Kama rivers. These project activities were driven or supported by the Bank's energy audit program and related technical assistance to help identify, structure, and incorporate sustainable energy investments.

- ***Across sectors, equity and equity-type financial products, associated to real improvements in clients' corporate governance, will be at the forefront of the Bank's offer of services in Russia.***

The previous Strategy targeted increasing the share of equity in the annual business volume to 20 per cent. The share of equity in the Bank's operations has strongly increased over the past three years with equities accounting for 29 per cent of the 2008 annual business and now representing about 27 per cent of the Bank's portfolio in Russia. On average every third project in the corporate sector during this period was a minority equity or quasi-equity investment, for example in Petrovax, Toyota, Sinara Transport Machines. The Bank made its first equity investments in the municipal sector (Taganrog Teploenergo) and in the power sector (TGK-9 and OGK-5). The Bank's equity investment in support of Enel in the privatisation of OGK-5

[1] EBRD share of financing, excluding syndication with commercial banks and own funds from a project sponsor.

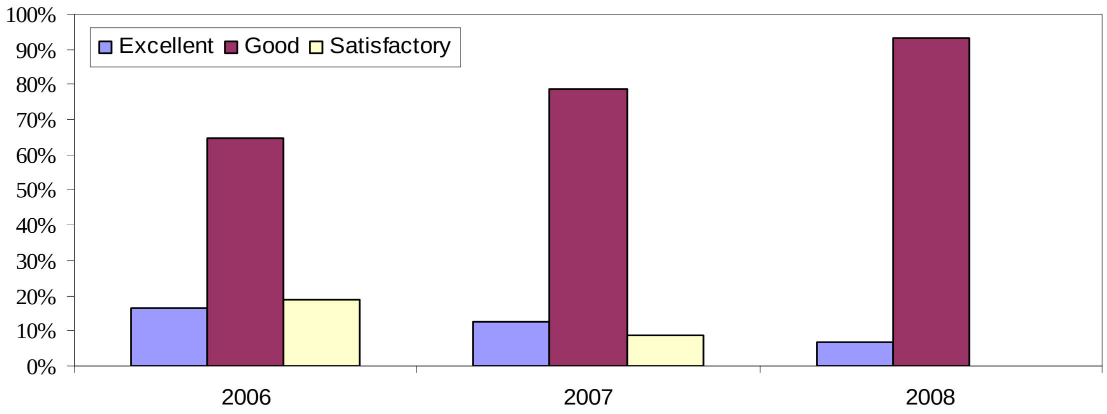
promoted foreign direct investment in the Russian power sector. Investments in Transcontainer, Globaltrans and FESCO support continued reform and competition in the rail sector. The equity investment in Irkustk Oil Company strengthened the Company's balance sheet and facilitated funding for its gas flaring reduction program. The Bank's equity transactions are frequently associated with the right to appoint independent directors to the board of companies, which further strengthens the corporate governance of investee companies.

A special emphasis in implementation of the previous Strategy was made on the provision of equity and quasi-equity instruments in the financial sector. The Bank completed a number of such transactions supporting capitalisation and critical mass growth of both locally-owned entities and banks with foreign strategic investors, bringing the number of investee banks to 12 out of a total of 36 banking relationships in Russia. As a rule, equity investments in locally-owned banks have been accompanied by comprehensive institutional building programmes to strengthen banks' internal systems, risk management and improve corporate governance, which have supported the banks' ability to cope with the stresses raised by the crisis.

### 1.3 Transition Impact of the Bank's Portfolio and Lessons Learned

The Bank's operations have consistently been focused on achieving significant transition impact, with over 86 per cent of the projects monitored through the TIMS having Good or Excellent transition impact potential rating at approval stage, with all projects signed in 2008 rated Good or Excellent (Figure 1). In the course of transition impact monitoring 27 per cent of all projects have been upgraded while 6 per cent have been downgraded as of end-2008. Most downgrades (in terms of higher risks to transition or lower expected potential) occurred in the corporate sector, reflecting business environment that remains difficult and the recent economic downturn. Projects with Excellent transition impact have been broadly distributed across sectors and recently included an independent gas producer (Irkutsk Oil Company), a nationwide supermarket chain (Monetka), a car manufacturer (Volkswagen), an insurer (ING Life) and a food processing plant in Siberia (Kuzbass Pishecombinat), among others.

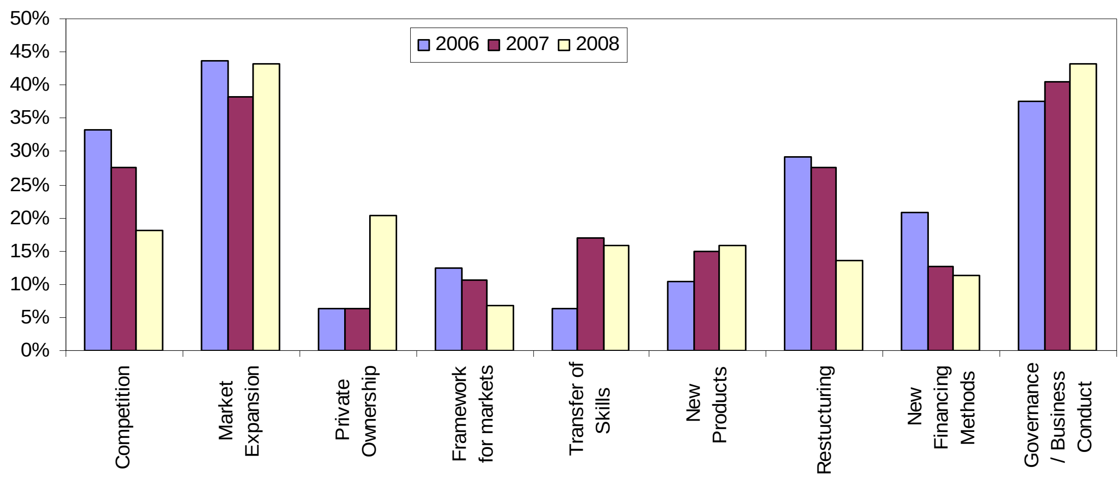
**Figure 1. Russia: Transition Impact Potential Ratings of Projects at Signing**




In terms of transition impact objectives, there has been a steady increase in the number of projects targeting improvements in corporate governance and standards of business conduct, while the proportions of projects targeting competition and new financing methods have been declining as transition advanced (Figure 2). Market expansion remains the most commonly pursued objective, with especially large contribution from agribusiness projects. These projects promoted competitive behaviour through improvements in clients' interactions with suppliers (backward/upstream linkages) and customers (forward/downstream linkages) and contributed to regional expansion of products, services, and markets.

The share of projects aiming at supporting successful restructuring of operations is expected to rise with the onset of the financial crisis.

**Figure 2: Russia: Share of Operations Pursuing Certain Transition Objectives**




The following analysis of the impact of the Bank's portfolio and lessons learnt relies upon previous findings found in the Transition Impact Retrospective Reports (TIRs), OCE updates on remaining challenges, TIMS reports, and the evaluation undertaken by the Bank's Evaluation Department of 45 Russian projects and TCs implemented during the history of the Bank.

## Corporate Sector

***Agribusiness* –** The successful project with the local brewery Baltika Transition was a good example of turn-around management and improvement of corporate governance. In the operation with Narzan, a leading Russian mineral water producer, the Bank facilitated the introduction of IFRS compliant accounting and integrated MIS systems. The contentious issue of installing an independent board director however, prevented the project from fully achieving its objectives. State influence in the sector is still present and at times even stronger, as in the case of the establishment in 2008 of a state-grain trading company. A ***lesson learned*** is that a clear investment strategy including a contingent plan is essential to help the Bank in pursuing its original endeavour when adverse circumstances are encountered.

***Industrial sector* –** While still supporting foreign strategic investor activities, joint ventures, and greenfield projects, the Bank has increasingly targeted its operations towards Russian standalone companies. The 2001 loan to Togliatti Azot, contributed to introduce IAS accounting, MIS and foster discipline in reporting to the Bank. The Arcelor-Severstal JV project did not fully achieve its objectives, and its transition impact was rather limited. A ***lesson learned*** by the Bank is to carefully assess the strategic motivations of each party when dealing with joint ventures.

***Natural Resources Sector –*** In the Russian hydrocarbon and mining sector, the Bank has targeted corporate governance improvements with varied success. ***A lesson learned*** is that the Bank should encourage its clients to implement core principles of international industry best practices from the Extractive Industry Transparency Initiative (EITI) and the International Council for Mining and Metals (ICMM).

***Property and Tourism –*** EBRD provided a loan to the Russian subsidiary of IKEA for constructing a shopping centre in South-West Moscow. The project performance was excellent and introduced a new format of shopping and entertainment centres acting as a benchmark of quality and success. The 2006 approved loan to the Saratov Shopping Centre aims to replicate this, albeit with a high risk. A ***lesson learned*** is that the Bank should demonstrate its efficiency and good will to the client by aligning whenever possible its monitoring procedures with the client's internal process.

***Telecommunications, informatics and media –*** Since 2003, the Bank supported the leading advertising operator, News Outdoor with very good success. Nowadays the client operates in more than 90 Russian cities and has brought transfer of know how and advertising skills to the regions. EBRD has also extended a loan to Rising Star Media, a start up private company in the cinema exhibition market and thus, contributed to increased competition. ***A lesson learned*** here is that the advertising and media sector lends itself to regional expansion and integration when the efforts are driven by a strong and experienced sponsor.

***Energy Efficiency (EE) –*** Until recently, the Bank’s involvement in this segment was limited to energy efficiency components in its industrial projects and a number of TC advisory projects. In 2007, the Bank extended a EUR 600 million loan (with the A portion of EUR 150 million) to Severstal to refurbish the construction site Cherepovets in line with EE requirements. A key challenge has been to encourage energy savings in an environment of artificially low energy prices. A ***lesson learned*** from the Severstal project is that the Bank technical cooperation (TC) must focus on project identification to support Energy Management Systems (EEMSs) and power cogeneration through the use of the latest technologies. Besides providing energy audits, the assistance should help develop analyses of investment profitability, even under unfavourable energy price conditions. In addition, the Bank must keep promoting transparent and fully monitorable approaches to energy savings (including carbon trading).

***Private Equity Funds*** – The Bank has been supporting several of the stronger managers of its early Regional Venture Fund programme in follow-on activities e.g. Norum, Russian Partners, Quadriga and others. Being supported by substantial TC, these funds have well demonstrated the feasibility of private equity investment in Russia with the Baring Vostok Fund showing outstanding results. A ***lesson learned*** here is that successful fund managers in challenging transition environments need a balanced mix of financial engineering, industrial and commercial management skills.

***SMEs –*** The Bank provided credit lines to a number of local financial institutions, such as Spurt Bank, SovcomBank, Bank Kazansky, Impex and others. The co-operation with Yugbank indicated that a private bank on the regional level can compete successfully in its market niche, in spite of suffering from implementation problems. Projects signed with Absolutbank and Impex in 2004 offered to regional SME clients longer tenor funding and trade finance products. A ***lesson learned*** is that financing should be tailored with adequate support in institutional building, in particular setting requirements in corporate governance in order to bring the bank in compliance with the best international practices.

**Infrastructure**

***Power and Energy Utilities -*** The Bank has extensively supported the restructuring process of RAO UES, both at parent group level and at the level of Mosenergo and Lenenergo by using investments, Technical cooperation and policy dialogue. July 2008 marked a major step in unbundling the sector when RAO UES ceased to exist and separate generation and distribution companies were spun off and sold to various investors. The sector reform, however, is yet to be completed with fully competing and effectively regulated companies in the generation, transmission and distribution subsectors. ***A lesson learned*** is that the Bank should set in the context of its projects a clear and realistic time line for successive reforms in the sector to allow vigilant monitoring and extra time for setbacks and delays.

***MEI –*** Several EBRD loans supported the development of municipal services in St. Petersburg and saw replication in other regions and 'secondary' municipalities. In Siberia, the Bank implemented a string of water, district heating, and housing projects, successfully introducing service agreements between municipality and utilities and raising tariffs towards cost recovery level. The 2004 urban transport operation in Togliatti, however, suffered from a local governance crisis. ***A lesson learned*** is that the Bank needs to undertake a thorough and broad-based institutional analysis, identifying main constituent parties and their implementation capacity in order to maximise transition impact in MEI projects.

***Transport –***The Bank expected – amongst others through its Russia Road Sector Reform projects - to improve road sector finance, promote restructuring of road maintenance companies and to contribute to the development of a PPP strategy. So far the results are mixed in this area. In the railway sector, EBRD has to some extent facilitated the reorganisation of key institutions and supported operational improvements. ***A lesson learned*** in infrastructure projects is that where practical, a holistic approach needs to be considered by the Bank during project preparation with particular focus on project interfaces.

**Financial Sector**

***Banking*** – Through equity and debt financing supported by extensive institutional building plans, EBRD essentially supported the growth of the local regional banks and their expansion within the respective regions and country-wide, and facilitated development and introduction to international capital markets of larger Russian banks as well as assisted the early entrances of foreign banks into the market. The project with the private Sibacadembank demonstrated high standards of corporate governance and business conduct throughout the sector. The framework facility provided to Rosbank increased the geographical diversification of its operations. A syndicated loan was provided to CIB for helping to promote best mortgage lending standards. Overall, EBRD was able to play an important role in the consolidation of the financial sector with timely interventions. However, regarding a key aspect of transition impact, frameworks for markets, the regulation of banking activities and bank supervision in Russia have remained relatively weak in spite of the Government initiatives taken after the

1998 crisis. These fragilities could undermine the benefits of Bank investment operations, especially if determined policy dialogue and co-ordination with other IFIs are not pursued.

***NBFI -*** The Bank successfully targeted the consumer finance and leasing segments, benefiting from a gradual improvement of the regulatory environment. In 2004, EBRD took an equity stake in the greenfield life insurance company Renaissance Life. The Bank also acquired an equity stake in a leading Russian insurance company RESO Garantia, which later partnered with French AXA , further enhancing know-how transfer and competition in the sector. The Bank's penetration of the leasing market, however, has been limited so far.

# 2. OPERATIONAL ENVIRONMENT

## 2.1 The General Reform Environment

### *2.1.1 Political Environment*

The political situation remains stable and support for both the President and Prime Minister is strong. At the end of then-President Vladimir Putin's second term in early 2008, Russia had an orderly, if largely predictable, election in which power was transferred in accordance with the procedure in the Constitution to President Dmitry Medvedev. He secured 71 per cent of the vote, while his nearest rival, the Communist candidate Gennady Zyuganov, won 18 per cent. As he had promised during his campaign, President Medvedev appointed his predecessor as Prime Minister. Although the Russian Constitution grants more executive authority to the President than the Prime Minister, there is some uncertainty about which of the two executives has real decision-making authority which complicates the political framework for reform.

There is an agreed-upon strategic framework for development, laid out in the Russia 2020 programme, and there are no significant signs of tension between the President and Prime Minister (who are long-time political allies); however, misalignment within the Cabinet and between the Cabinet and the Presidential administration over some key policy issues – such as the role of the state in the economy – occasionally arise. While this is normal in a functioning democracy, in Russia's partially consolidated democratic system divisions over policy are less likely to get worked out through a transparent process of interest intermediation involving voters and civil society and can instead contribute to policy stalemate. Economic and political reform ideas have surfaced but have not coalesced into a concrete agenda with a clear driver.

President Medvedev campaigned for office on themes of political pluralism, open society, the rule of law and good governance, which was welcomed by the international community and domestic civil society groups alike. Since his inauguration in May 2008 there have been some signs of tangible progress in this direction while many initiatives have been delayed. The re-formation of the Presidential Council for Promotion of Civil Society Institutions and Human Rights in February 2009, and appointments of well-regarded independent rights campaigners to the Council, was a positive step towards strengthening ties with civil society organisations. Subsequent changes to the law on NGOs went in the right direction toward creating a more permissive environment for civil society. However, these were still only tentative steps and power continues to be highly centralised and concentrated with few binding checks on executive power by the parliament, the judiciary or the society. The results of local elections in October 2009 further concentrated power at the regional level in the hands of the United

Russia party. In his first state of the nation address, President Medvedev introduced a major political reform that will extend the Presidential term of office from four to six years and the term of the Duma to four to five years. This move may weaken political accountability.

The financial crisis, which hit Russia with full force in autumn 2008, may have affected the timetable for introducing many of the President's policy priorities. One exception is in the area of anti-corruption legislation (see section 2.1.2 below). Otherwise, the attention of the Government has been understandably focused on short-term policy measures to cushion the impact of the crisis on business, the financial sector and households. The sharp increase in unemployment and decline in living standards, reversing two of the key achievements of the previous administration, has produced a shift in sentiment – fewer people believe the country is on the right track and there have been a number of public demonstrations against deteriorating economic conditions.

In the North Caucasus the impact of the crisis on employment and general economic conditions together with pre-existing underlying sources of tension has produced greater levels of political volatility. Human rights conditions in the North Caucasus continue to raise concerns while investigations into high-profile cases of murders and attacks against civic activists and journalists in the past year remain unresolved and have drawn attention from the international community. Difficulties in the operating climate for NGOs is a concern raised by domestic and international organisations alike.

### *2.1.2 Governance and Integrity Issues*

The issues of modernisation of the state, streamlining of bureaucracy and fighting corruption featured prominently during the 2008 presidential election campaign and in President Medvedev's post-election speeches. The problems stem largely from a steady growth in the size of the bureaucracy, perceived deficiencies in the professionalism and integrity of its staff its interaction with private businesses and households and the lack of consistent political will to tackle the problems at the root.

In April 2009, the State Statistics Committee published data showing that the state bureaucracy doubled in size from 1998 to 2008 – large increases were recorded in the number of people employed by the federal power structures, the regional governments and municipal authorities. Corruption in the bureaucracy, which is difficult to measure precisely, appears to have increased over the past few years, according to surveys by Transparency International, the EBRD and World Bank, and by independent organisations in Russia. For example, Russia's score on the Transparency International Corruption Perceptions Index decreased from 2.4 in 2005 to 2.1 in 2008 (out of a possible 10), placing Russia 147th in the overall country ranking and seventh from the bottom among transition countries.

There have been a number of positive changes introduced by the previous and the new administration designed to combat corruption, including continued efforts to strengthen the rule of law and effectiveness of the judiciary, to simplify licensing, the inspections regime, registration and taxation, in particular for small businesses, and to strengthen competition legislation and its implementation. In September 2008 the President approved a new National Anti-Corruption Plan and since then several new initiatives have been produced (see Annex 1). However, on balance, the enforcement of contract and property rights has been uneven and steps to rationalise the state bureaucracy and advance administrative reforms have been halting. The authorities have repeatedly acknowledged these problems, making the rule of law, elimination of "legal nihilism" and the fight against corruption the cornerstone of

President Medvedev's reform agenda. In addition to administrative and legal reforms, institutional reforms strengthening democratic mechanisms of accountability, including civil society organisations and independent media, could also contribute to reducing incidence of corruption and building a strong well regulated and transparent public sector.

Despite some notable improvements in recent years and a number of initial public offerings (IPOs) on international stock exchanges by large Russian corporates, overall there remains a substantial scope for further improvements in the areas of corporate governance, transparency and standards of business conduct.

### *2.1.3 Social Conditions*

Russian population continued declining at an annualized average rate of around 0.4 per cent a year, which has remained broadly constant since the mid-1990s. The negative differential between the birth rate and the mortality rate (which reached 7 per cent in the early 2000s but has since moderated to 3–4 per cent) has been partly offset by net immigration, predominantly from the CIS countries.

The decline in life expectancy has been arrested and reversed, with male life expectancy surpassing the retirement age of 60 in 2006 for the first time since the early 1990s. Overall life expectancy at birth is currently approaching 68 years. This welcome development reflects improving standards of living and health care, more comprehensive social safety nets, and scaled up federal support to more economically depressed regions. At the same time, ageing population will result in additional burden on the pension system. The average monthly pension of RUB 4550 (USD 135) in the first quarter of 2009 was barely above the official poverty line (RUB 3660 for pensioners, based on the third quarter of 2008 data).

The poverty rate has fallen dramatically over the last decade, from almost 30 per cent to 13 per cent in 2007, with substantial progress achieved in both urban and rural areas. Nonetheless, in relative terms the urban-rural divide has been growing, as witnessed by the increasing share of poverty accounted for by the rural population. Gini coefficient, a common measure of income inequality, also increased from 0.41 in 2004 to 0.42 in 2007.

The population is well educated, with levels of adult literacy at 99 per cent, gross secondary enrolment rate at 84 per cent and gross tertiary enrolment rate at 72 per cent. Over 25 per cent of employed people have a higher education degree.

The rate of unemployment has been declining steadily from 13 per cent a decade ago to 5.4 per cent by mid-2008. However, unemployment started rising sharply with the onset of the financial crisis in the last quarter of 2008, reaching 9.5 per cent according to the February 2009 survey, and 12 per cent in the South of Russia, where relatively high rates of unemployment persisted throughout recent years, especially in the North Caucasus. In some regions unemployment rates top 20 per cent. In addition, the crises led to an increase in wage arrears and part-time employment and increased instances of infringements of rights of migrant workers. Employment rates for women and men are similar, with women accounting for 49.6 per cent of total employment in the economy. Whilst the literacy rates for females is almost equal to that of males, Russia's UN Human Development Index score for gender-related development has slipped slightly from being 58th in 2005 to being ranked at 67 in 2008.

Poverty may also be on the rise as real incomes are hit, but the adverse impact of the economic crisis will be partly mitigated by the fiscal stimulus. The revised 2009 budget clearly prioritises social spending providing additional funds for pensions, unemployment benefits, retraining programmes, housing benefits, and federal transfers to sub-national governments responsible for primary and secondary education, housing, and health care.

Russia is home to some 46 indigenous minorities. As many of them live in the Artic North, their livelihoods may be particularly drastically affected by the climate change. The federal framework policy for sustainable development of indigenous minorities adopted in 2009 seeks to preserve the indigenous habitat and traditional way of life of indigenous minorities of the North and recognizes their right to receive priority access to historical natural resources. Climate change and environmental damage issues are included in the Natural Security Strategy 2020, although the process of approval of Kyoto Joint Implementation projects has been slow.

### *2.1.4 Legal Environment*

Steady progress of the Russian legislative reforms continued in the last three years following the date of approval of the previous Russia Strategy (see Annex 2 for a detailed assessment).

The Russian Joint Stock Company Law was amended at the end of 2006 to incorporate new mandatory tender offer rules and new squeeze-out rules to reflect the balance between the interests of minority shareholders and the interests of development of companies in general. The new version of the anti-monopoly law came into effect at the end of October 2006 and was further substantially amended to extend the scope of this law application and the powers of the Federal Anti-Monopoly Service with effect from the end of August 2009. Various restrictions on hard currency and rouble transactions between residents and non-residents of the Russian Federation were lifted from 1 January 2007.

Significant clarifications and amendments were made in 2008 to the Law "On Concession Agreements" in an effort to encourage the development of concession projects and improve the institutional framework for concessions in Russia. However, despite such legislative improvements concession laws still contain number of areas that cause serious concerns on the part of foreign investors.

Despite a number of legal uncertainties and shortcomings that continue to prevail, the position of secured creditors in Russia can be expected to improve as the result of various legislative developments that took place in 2008. The rules on foreclosure on collateral have been substantially changed and respective amendments were made to various laws including the Civil Code, the Law on Pledges, the Law on Mortgages, the Law on Enforcement Procedures and the Law on Insolvency (Bankruptcy). A non-judicial foreclosure procedure has been introduced which appears to simplify and expedite the procedure for enforcement by the creditors of their rights over the collateral. The practical implications of such new provisions remain to be tested. In addition, changes were made to the Law on Enforcement Procedures improving the secured lender's position in enforcing payment obligations of borrower's in non-bankruptcy situation by allowing such claims to be satisfied before claims of first and second ranking creditors. At the end of April 2009 further changes were made to the Law on Insolvency (Bankruptcy) introducing, inter alia, amendments to the rules on challenging debtor's transactions and a new regime for mandatory filing of a debtor's insolvency declaration.

Perhaps the most significant recent development in the area of corporate law is the reform of legislation on limited liability companies. This reform is effective from 1 July 2009. The reform provides flexibility in the way the participants can regulate their relationship within limited liability companies, introduces new rules on transfers of interests and withdrawal rights and addresses various corporate governance issues. In addition, the system of registration of pledged participatory interest is introduced.

Although a significant number of new laws were aimed at improving the perception of investors of the Russian investment environment, the Federal Law No. 57-FZ on Procedure for Foreign Investment in Businesses of Strategic Significance for National Defence and State Security and the corresponding amendments to the Law on Foreign Investment were a cause of concern for international investors. The Law 57-FZ introduced the requirement of a prior approval of the Russian authorities in case of an acquisition of control over a strategically important enterprise by foreign investors. The criteria for "control" and transaction affected by Law No. 57-FZ were specified. The corresponding amendments to the Law on Foreign Investment resulted in an extension of such prior approval requirement to an acquisition of blocking rights or 25 per cent of voting rights or voting shares/interests in any Russian company in case of such acquisition being made by foreign states, international organisations or organisations under their control. The impact of this law has been felt particularly in the energy sector, critical both to Russia's economy and for foreign investors.

While substantial legislative reforms are taking place in Russia, their implementation is still affected by the inconsistent application of the laws by the federal, regional and municipal authorities and by the judiciary. Further improvement of implementation and enforcement of the legislation shall remain a priority for Russia. For investors, enhancing the current regulatory system notably with regard to investment protection remains an essential element to improve the overall investment climate.

### *2.1.5 Physical Environment*

Environmental challenges in Russia remain significant and present one of the most critical and complex areas in achieving environmentally sustainable economic growth. The state of environmental affairs in Russia has been influenced most recently by the wide-ranging impact of the global economic crisis. On the one hand, as government and businesses seek to cut costs, it is becoming more and more difficult to make caring for the environment a top consideration. The shortage of funds, however, forces the government to revisit its current strategy on environment and energy issues, and to explore opportunities for encouraging the development of renewable energy, energy efficiency and resource efficiency measures.

Despite the progress of the past years in implementing environmental protection programs and adopting new regulations, the environmental situation in Russia remains serious. The official report of the Ministry of Natural Resources of Russia issued at the end of 2008 provides a detailed summary of the country's environmental situation and unresolved problems. The current environmental challenges of Russia include air pollution from heavy industry, emissions of coal-fired power plants, and transportation in major cities; industrial, municipal, and agricultural pollution of water bodies and coastal areas; greenhouse gas (GHG) emissions from associated gas flaring; deforestation; soil erosion; soil contamination by agricultural chemicals; scattered areas of radioactive contamination from nuclear waste and facilities; problems with industrial and solid waste storage and disposal; ground water contamination from hazardous waste; and considerable biodiversity loss with continued degradation of habitats among other problems. In addition, a potentially high risk of industrial emergencies and accidents exists in some areas due to the outdated and dilapidated infrastructure and assets that jeopardise occupational health and safety and which may seriously harm the environment.

There exists a legislative and institutional base for the environmental regulation and control of businesses and state activities. The foundations of Russian environmental policy are laid in its Constitution, Federal laws, Ecological Doctrine and the National program for socio-economic development of Russia. The state system of environmental protection is of central importance but unfortunately it is operating under a significant shortage of funding and other necessary resources for effective environmental control. Lack of transparency of the current Russian legislation, characterised by frequent changes, inconsistencies and lack of clarity in some areas are some of the major challenges for businesses operating in Russia.

Russia's state governance of environmental and social issues and institutional organization has undergone several changes in recent years and may represent important implications for the implementation of projects. Thus, legislative framework amendments include adoption of a new Land Code, Water Code, Forestry Code, changes in the process of the State Ecological Expertise, new practices in the area of environmental emissions norms and limits allocation, and introduction of emissions declaration instead of limits for SMEs. A proposed development which offers further progress is the introduction of a Best Available Techniques (BAT) approach and the development of Russian technical requirements and standards in accordance with the BAT by 2012.

Substantial changes occurred at an institutional level for the re-distribution of responsibilities between different authorities and between federal and regional bodies responsible for environmental control. From June 2008 the overall structure of the state governance on environmental protection changed. The Ministry of Natural Resources of the Russian Federation, as part of its legislative and regulatory functions, was assigned the additional role of coordinating four major environmental oversights and monitoring agencies: Rosprirodnadzor, Rosvodresursy, Rostechnadzor, Roshydromet. However, the focus of controlling bodies differs from sector to sector with an emphasis on solid waste and waste water regulation and monitoring, with lack of enforcement and oversight remaining a cause for concern in areas like forestry. The above mentioned legislative and structural changes of Russian environmental governance have serious implications for the general investment process and present challenges for businesses and investors. For example, as a result of the changes in the State Ecological Expertise procedures, the majority of infrastructure and construction projects will not require to undertake public consultations on the EIA. In addition, negative conclusion of the ecological expertise on a project will not necessarily lead to the rejection of a permit issue.

In spite of the Russian state initiatives and program for addressing environmental challenges, the existing ecological problems remain exacerbated by low levels of domestic and foreign investments, underperformance of the existing national environmental management framework, lack of preventive measures and excessive use of natural resources. It is necessary to further strengthen the legal and regulatory framework for the environment, make the regulatory setting clearer and less complex, foster intergovernmental cooperation, build effective compliance and enforcement programmes, encourage meaningful public participation, and in particular participation of indigenous peoples. It is crucial to invest in environmental management, incorporate technology-based standards for pollution control, strengthen monitoring systems and adopt better environmental indicators.

The challenges and opportunities in the environmental domain of Russia will continue to be appraised and addressed by the Bank through its due diligence, monitoring and sustainability initiatives. Further information on EBRD's approach and priorities, Bank's environmental and social focus in different sectors, and Russia's climate change agenda is provided in the Annex 4.

## 2.2 Macroeconomic Conditions relevant for Bank Operations

Over the last decade Russia enjoyed high rates of economic growth. Gross domestic product increased by 82 per cent between 1999 and 2008 in real terms and 8 times in nominal US dollar terms, helped by a steady increase in oil price from the low of USD 9 per barrel of Urals brand in early 1999 to the peak of USD 138 per barrel in August 2008, and the corresponding increases in prices of other commodities.

Prudent management of the resource boom helped Russia to accumulate substantial fiscal and foreign currency reserves. The Oil Stabilisation Fund was set up in 2004 and was later subdivided into the Reserve Fund and National Wealth Fund. By early 2009 the Fund accumulated USD 225 billion (around 17 per cent of GDP), and external public debt has been largely repaid. International reserves peaked at USD 598 billion (41 per cent of GDP) in August 2008. At the same time, constrained by insufficiently developed local capital markets, corporates and banks have been actively borrowing abroad, and accumulated almost USD 500 billion of external debt by end-September 2008, of which commercial banks accounted for around USD 200 billion. Furthermore, the dependence of the economy on hydrocarbons revenues has increased: oil and gas accounted for 69 per cent of total export receipts in 2008 compared with 62 per cent in 2005, and around 60 per cent of manufacturing output was concentrated in sectors closely related to natural resources, such as oil refining, fertilizers and metals.

Starting from September 2008 the Russian economy has been adversely affected by the global crisis through a number of channels. Firstly, the economy has been exposed to a sharp terms of trade shock as the price of Urals brand oil plummeted from the peak of USD 138 per barrel in July 2008 to an average of around USD 44 in the first four months of 2009 before recovering to USD 65-70 by June 2009, and prices of ore, metals and steel also fell steeply. Secondly, in August 2008 Russia experienced an outflow of capital on a large scale and withdrawal of deposits from the banking system, in particular from medium-sized and regional banks prompting the Central Bank to inject liquidity on a large scale through uncollateralised loans to the banks and to permit gradual rouble depreciation. The rouble has appreciated somewhat in recent months but remained about 18 per cent below the July 2008 peak against the dollar-euro basket. The stock market has lost around three quarters of its capitalisation before bouncing back strongly. A few sizable banks on the brink of failure were swiftly nationalised through takeovers by state-owned entities. Availability of trade finance and MSME credit has been sharply reduced, and syndications markets have been shut for all but a few top borrowers.

Thirdly, weaker domestic and external demand and tight liquidity in the banking sector hit the real sector hard. In the first half of 2009 output declined by 10.4 per cent year-on-year, with the steepest declines in the automotive and construction-related sectors. Large corporates have been forced to scale down, postpone or cancel large modernisation projects, including those with important energy efficiency components.

The government adopted a comprehensive fiscal stimulus package, backed up by fiscal reserves. The package centres on social transfers (unemployment benefits, retraining programmes, pensions, transfers to subnational governments primarily responsible for education, health, and housing), as well as support for selected industries and companies in one-employer towns. The budget deficit is expected to be kept under 9 per cent of GDP in 2009, declining to 7 per cent in 2010. In order to establish a market benchmark in case the downturn proves to be long-lived and external financing is needed further down the road, a Eurobond issue is being seriously considered and a road show is planned for late 2009 or 2010.

The fiscal stimulus package, liquidity injections into the banking system, and higher commodity prices are expected to arrest a sharp fall in output observed in the first half of 2009, with the economy returning to growth in late 2009 or 2010.

### 2.3 Progress in Reforms and Key Remaining Challenges

Progress in structural and institutional reforms has been modest during the past Strategy period, as favourable external conditions and robust growth throughout most of the period acted as a break on reform momentum and the political succession occupied the attention of decision-makers for much of 2007. Still, as measured by the Bank's annual transition indicators there was further progress on financial sector reforms (both banking and non-bank financial institutions) and in several areas of infrastructure during the past three years, which have addressed some of Russia's remaining second and third-phase transition challenges.

A broad-based acceleration of reforms promised by the former government and the current one has not materialised. Most importantly, the reform of state institutions remains largely incomplete. The government has remained divided over a number of major issues including the degree of state involvement in the economy. The state has maintained or enhanced its control in a number of key sectors considered to be of strategic importance, with the intention of building national champions that can compete for market share internationally. Consistent and even-handed protection of property rights remains an issue, with several high profile cases of abuse of shareholder rights garnering international attention and affecting investor sentiment. Russia's transition challenges remain much as they were during the previous Strategy period, and have been further accentuated by the impact of the current crisis on the financial sector and the real economy, which highlighted very limited progress in terms of economic diversification to date as well as insufficient level of capital market development. The overarching challenges are:

- The economic downturn and a fall in global commodity prices emphasized the importance of **diversification** of output and exports for sustainable long-term economic development. Diversification will in turn rely on both innovation and further integration into the world economy, as well as addressing the infrastructure bottlenecks.

- Lower global demand also highlighted the need to bolster **competitiveness** of the Russian industry through market-based restructuring and improved production efficiency, in particular energy efficiency where there remain large gains to be made, and has emphasised the importance of developing the MSME business sector.

- Deepening Russia's **integration into the global economy** and advancing its membership in the World Trade Organisation is an important anchor to promote competitiveness of domestic industry and services. WTO membership would also lessen trade frictions by providing a rules-based framework and dispute settlement mechanism for measures such as the recently introduced trade restrictions.

- The sharp economic slowdown also highlighted the importance of strengthening the **financial sector and capital markets development**, and exposed the current fragility of the rouble markets, as the de-dollarization trend of previous years went into reversal.

- Remaining weaknesses in the institutional and regulatory framework and in corporate governance practices need to be addressed to improve the **investment climate** and revive foreign direct investment.

These can be advanced by addressing key transition challenges in specific sectors and areas, which can be summarized as follows:

**Energy efficiency and curbing energy demand** is one of the key transition challenges in Russia cutting across all sectors. Artificially low domestic prices of gas and other energy inputs that large enterprises have been enjoying so far resulted in insufficient attention to energy management issues. Despite recent improvements, industrial production remains highly energy intensive, and sustained competitiveness of many sectors crucially depends on reductions in energy consumption. The convergence of domestic and international energy prices remains firmly on the agenda, although full implementation may now be postponed beyond 2011 in the light of the current economic crisis. At the same time, facing much tighter liquidity constraints, many large corporates have recently curtailed or postponed large modernisation projects with important energy efficiency components.

Broader economic benefits of improvements in energy efficiency include lower domestic demand for natural resources and thus longer reserve life helping to secure additional export capability, especially in natural gas. Furthermore, greenhouse emission reductions could be monetised providing additional source of financing for industry modernisation initiatives.

Natural resources and related sectors account for a major part of the total value added in the economy and make an even greater contribution to exports, highlighting the importance of addressing the key transition challenges to ensure sustainable and efficient **energy supply**:

- Effective technology and know-how skills transfer, especially in the upstream sector in connection with development of new fields and in mining, as well as adoption of higher environmental and health and safety standards that would help to increase energy efficiency, reduce gas flaring and remedy past environmental liabilities continue to be key challenges.

- The energy security agenda has brought to the forefront the need for diversification of energy supply and resolving transportation bottlenecks and transit issues, including pursuing regulatory reform to ensure third party access to the oil and gas transportation and trade networks and reform tariffs.

- Transparent revenue flows between companies and the state and greater transparency and accountability in the licensing process would promote further investment in the sector.

Given that large state companies in infrastructure, power and natural resources sectors have been the key players in the local market in terms of visibility and capitalisation and are likely to remain so, improvements in governance of state entities and their restructuring and commercialisation remain a priority and an important challenge.

The need to advance the emergence of a modern, **diversified, competitive and knowledge based real economy** is the overarching challenge faced by Russia.

- In the **industrial sector**, competition in the Russian markets is hindered by substantial strategic uncertainty, a high degree of industry concentration, substantial barriers to entry and insufficient controls over possible non-competitive behaviour by important players. Achieving improvements in these areas through further market-based restructuring in individual sectors presents a substantial challenge.

- The financial crisis resulted in partial scaling back of trade finance available to companies and a surge in protectionist inclinations among the policy makers around the world, including Russia, putting the advancement of free trade at risk. Thus **trade facilitation** through provision of trade finance once again became one of the key immediate challenges.

- The **MSME sector** holds substantial potential for development, currently accounting for only around 5 per cent of total investment, 12 per cent of total value added, and 18 per cent of total employment, according to official estimates. Access to finance remains one of the key constraints, and MSME lending has been disproportionately hit by the financial crisis.

- The **agribusiness sector** faces similar challenges. In addition, while in recent years the modern retail format has firmly established itself in large cities and advanced into a number of regions, many agribusiness sub-sectors remain fragmented with poor quality of products, inadequate hygienic controls and low production efficiency. There remains a substantial scope for restructuring and efficiency gains in farming, which could be achieved either directly or through competitive pressures and restructuring along the agribusiness value chain.

  The economic crisis has led Russia to adopt a number of trade restrictions including hikes in import tariffs in order to protect domestic industries. Most measures have been introduced on a temporary basis with an explicit expiry date, however some have been extended and Russia has recently stated that some of the restrictions may be consolidated under the Common External Tariff of the Russia-Belarus-Kazakhstan customs union. It should be noted that Russia has at the same time also introduced certain trade liberalisation measures. Liberalisation and lowering of import protection would facilitate Russia's integration in the global economy and support its efforts to raise the competitiveness of its industry.

  In this context WTO accession remains an important step for Russia to create a more stable and predictable trade and investment environment and would serve also as grounds for the further modernisation of Russia's economy. Russia recently announced that it may seek WTO accession together with Kazakhstan and Belarus, with which it is forming a customs union, although retaining the option of individual accession if this proves faster. The precise modalities of this approach remain to be clarified, and it would be important to ensure that it does not cause delays to Russia's accession. The Customs Union should be used as a tool to promote trade both in the region and with the rest of the world. This would require determined action to achieve an open common trade regime, including reversing restrictions introduced in response to the crisis

Further upgrading of **infrastructure** is key to facilitating the development of the real sector, given Russia's immense infrastructure needs.

- In recent years the private sector has been playing an increasing role in **transport services** accounting for a major part of port terminal expansion and rail fleet renewal. This trend should continue given the vast scale of investment needs in the road and other transport sectors, and a number of specific challenges remain to be addressed:

- A level playing field in transport service provision would require a stronger regulatory framework, with cost-based non-discriminatory tariffs for track, traction, and airport use and transparent and even access to monopoly assets and services.

- Improvements in governance of state entities and their restructuring and commercialisation remain a key challenge. The implementation of the reform agenda in the railway sector should be continued, and the corporatisation and restructuring model of the Russian Railways can be deployed in other sectors.

- One of the key reforms of the last decade in Russia was the **power sector** restructuring involving vertical unbundling, privatisation, and establishment of markets for power. The major transition challenges have to do with the development of remaining market elements and the implementation of effective government regulation and self-regulation, most importantly: (1) the introduction of the long-term capacity markets without which the viability of new investments can not be ensured; (2) the liberalisation of retail electricity and capacity markets, and (3) the adoption of RAB tariff system in transmission, distribution and possibly heat generation. Clear regulation of renewable energy has yet to be developed.

- Regulatory improvements in the **municipal utilities** sector need to be pursued further to support long-term financial sustainability of the local infrastructure. While important progress has been made over the past years, including introduction of competitive tendering requirement for concession and following recent legislation passed in June 2008 for lease awards, the necessary tariff adjustments have not been implemented across the entire country. Therefore it is important to adopt and apply tariff methodologies that ensure full cost recovery for utility services (inclusive of capital costs), with adequate support provided to poor households, and to switch to incentive-based tariff setting mechanism (e.g. RAB methodology).

  Restructuring of municipal utilities would help to reduce costs, facilitate implementation of essential asset renewal programmes, and make the relations between the utilities and municipalities more transparent and clear.

  Modernisation of the municipal utility sector calls for stronger private sector participation. Building on recent improvements in the legal environment, PPP practices need to be adjusted to ensure adequate tendering procedures and fair and balanced contractual terms. The financing of PPPs for municipal services presents a major challenge in the crisis environment, with innovative financing solutions required to channel know-how and finance to the sector.

Swift recovery and sustainable development of the real sector relies on the existence of a developed **financial sector** and **domestic capital markets** capable of efficiently intermediating and allocating capital.

- One of the key challenges will be to facilitate restructuring in the **banking sector**, in particular in medium-sized and regional banks. While in recent years the banking sector has become more resilient, more competitive, and better supervised, and major banks have made significant progress in corporate governance, management practices, and accounting standards, risk management and liquidity management have not been developed adequately during the years of rapid loan book expansion in the run-up to the financial crisis. The immediate challenge is to facilitate deleveraging of banks in an orderly manner, coupled with improvements in risk management and liquidity management practices.

- **Capital market development** remains one of the key challenges in the financial sector, requiring improvements in the legal and technical infrastructure, in particular with respect to financial derivatives and hybrid financial instruments, such as convertible debt. In addition, it is important to support growth of institutional investors that will become core players in the market (including pension funds, insurance companies, and asset managers).

- A particular challenge is to promote the use of rouble instruments as benchmarks, building the term funding capabilities that could adequately address the country's vast investment needs. Gradual de-dollarization of the Russian economy can be viewed as one of the key achievements of recent years, with more than three quarters of domestic corporate credit and almost 90 per cent of consumer credit denominated in local currency at end 2007. The reversal of this trend with the onset of the financial crisis highlights the need to actively support **rouble lending and rouble financial instruments**. (See Annex 7 for further details on Capital Markets Development)

## 2.4 Access to Capital

Since the last strategy in 2006 Russia first saw a sharp increase in all components of capital flows, before witnessing an equally sharp reversal from August 2008. Central bank data underline this important change in Russia's access to international capital, and the corresponding volatility imposed on Russian banks and enterprises: following the first miniscule net capital inflow in post-Soviet history in 2005, 2006 saw a substantial inflow, which was again doubled in 2007. The capital outflow in 2008 (on the order of about 8 per cent of Russian GDP in the fourth quarter of that year alone) then more than reversed the inflow of the previous two years. Over the same period Russian banks and enterprises have increased their gross foreign liabilities by over USD 276 billion, though this debt was primarily of short maturities, and denominated in US dollar, against which the rouble rapidly appreciated over that period.

In July 2006 the Russian authorities fully liberalised capital account transactions through the abolition of the remaining unremunerated reserve requirements on bond purchases by non-residents, thereby establishing capital account convertibility. Following this step, the further reduction in the risk aversion of international investors towards emerging markets, coupled with Russia's improving sovereign credit risk, contributed to a sharp increase in capital inflows into the domestic bond markets. The increase in foreign holding of Russian bonds was estimated by the IMF at about USD 38 billion over the two years 2006 and 07. From the second half of 2008 Russia saw substantial capital outflows, with the liquidation of foreign bond holdings and the exercise of widespread put options in the domestic bond market leading to acute market illiquidity and re-financing problems among Russian enterprises. Flows of debt and equity portfolio investment are typically highly volatile, and recovered again in mid-2009. Over the medium term, these flows are likely to recover more rapidly than bank flows though the global de-leveraging process is likely to constrain new exposures to Russia.

Over the period since mid-2006 Russian banks and enterprises similarly widened their access to international bank credit. Exposures of international banks reporting to the BIS nearly doubled from USD 110 billion at the end of 2006 to USD 211 billion in September 2008. 2007 alone showed a doubling in international syndications concluded to over USD 73 billion. Bank lending came to an abrupt halt in late 2008, and in the first quarter of 2009 only two syndications were concluded with Russian entities. Market participants signalled that over the medium term loan restructurings and refinancing of key client relationships will dominate the loan market, as maturities and margins of lending had substantially deteriorated. This situation is likely to persist while international banks repair their balance sheets, in particular through reducing exposures to emerging markets which require relatively high capital charges.

Unlike many other transition countries, the stock of foreign direct investment within Russia remains relatively small, and strong inflows have been a relatively recent phenomenon. Gross inflows increased from USD 28 billion in 2006 to USD 73 billion in 2008. Rosstat data indicate that nearly half of these flows came from countries where Russian companies run off-shore financing institutions, underlining the important role of the return of flight capital. Nevertheless, the greater role of multinational companies within Russia is clearly evident in a range of sectors, importantly those catering to the hitherto rapidly growing Russian consumption, such as food processing and consumer durables. For this reason the high regional concentration of FDI inflows around Moscow, and a few resource rich regions has somewhat declined. The stable share of earnings reinvested by established foreign direct investors, and forward looking surveys of investment intentions underline the greater stability of FDI flows, even though FDI flows to Russia will suffer from weak prospects for corporate investment throughout the industrialized countries.

## 3. STRATEGIC ORIENTATIONS

In the face of the economic crisis and the identified transition challenges, and taking into account the priorities identified by the Russian Government in “The Concept for Long Term Social and Economic Development of the Russian Federation up to year 2020”, the core objective of all the Bank’s activities in Russia will be to contribute to and make a difference in Russia’s efforts to diversify its economy to reduce the current concentration on extraction and processing of natural resources and move towards a greater share of value-added manufacturing. The Bank will focus on the need to confront and mitigate the effects of the crisis in the short term and to support the post crisis recovery in the medium term, selecting projects in accordance with the additionality, transition impact and sound banking principles, with a strong emphasis on integrity in all Bank’s operations. In all its projects and policy dialogue the Bank will promote competition, transparency and higher standards of corporate governance and business conduct, as well as good environmental practice. In meeting these challenges, the Bank will seek to leverage its transactions and associated policy dialogue and technical cooperation projects to achieve sustainable improvements in the quality of market-supporting institutions alongside the Russian authorities and other stakeholders. The Bank will aim to assist Russia in transforming its advantages, including a well-educated population, into successful knowledge based industries and innovations across all sectors of the economy.

- **Energy efficiency will be a cross-cutting objective** of the Bank efforts, in the context of the second phase of the Sustainable Energy Initiative, so as to become an integral part of the business of each sector of Bank activity. This focus on reducing waste of energy and greenhouse emissions will be important not only to ensure corporate competitiveness, but to improve overall energy security and combat climate change.

- **Support to the real economy will be the overarching priority** of the next strategic period, in order to address the immediate financing needs and keep trade flowing in response to the crisis, and support competition and economic diversification, stimulating innovation and increasing productivity in the medium term.

- Recovery, modernisation and diversification of the economy are dependent on active **infrastructure development** and **efficient financing mechanisms:**

  - Recovery and diversification of the economy will not be possible without the necessary infrastructure that would ensure physical flow of goods, utility services and supply of energy to industry. The Bank will engage with both private and state companies to address the key infrastructure bottlenecks. Improvement in the regulatory framework to enable infrastructure investment would continue to be a key objective of the Bank's policy dialogue efforts.

  - A key priority is to stabilise the financial sector and ensure that the Bank's clients are adequately capitalized to resume financing of the real economy. In the medium term the excessive reliance on external sources of finance must be addressed and a domestic capital market developed to enable mobilization of local savings and expansion of rouble funding.

- The Bank, in line with the strategic priorities identified above, will seek for projects in the real sector in support of economic diversification (including direct loans and equity investments, as well as MSME lending and trade facilitation through financial intermediaries, and private equity funds) to account for 40-50 per cent of its annual business, with an emphasis on direct investments. Infrastructure, including municipal services and transport, would account for 20-30 per cent of the Bank's annual activities. Investments in the power sector would account for 10-15 per cent, whilst investments in natural resources would account for up to 10 per cent. Support for capital markets and the banking sector *stricto sensu* (i.e. excluding support to the real economy through financial intermediaries) would account for 5-15 per cent. The table below summarises these indicative targets:

**Indicative Structure of annual business volume**

| | Strategy Indicators 2009-2012 (per cent) |
|---|---|
| Modernization and Diversification of the Corporate Sector | 40-50 |
| ➢ *direct loans and equity investments* | *25-30* |
| ➢ *financing the real economy through banks (MSME finance, TFP) and private equity funds* | *15-20* |
| Infrastructure | 20-30 |
| Power Sector | 10-15 |
| Natural Resources | up to 10 |
| Capital Markets and Banking Sector *stricto sensu* | 5-15 |

- The financial crisis has made equity funding even more necessary and even more difficult to attract. The Bank will therefore actively seek **equity investment opportunities in companies and banks**, all the more that the use of the equity instrument enables the Bank - through its proactive investor role, including on investee company boards - to influence positively corporate governance standards. The Bank will aim to invest 25-35 per cent of annual business volume in equity instruments.

- The Bank will actively support the efforts of the Russian Government to accelerate privatisation of stakes in state-owned companies, and to bring back into private ownership companies and banks in which the economic crisis has forced the state to increase its involvement. The Bank will consider pre-privatisation investments in state companies that the government is committed to privatise, to support corporate governance improvements and restructuring to increase attractiveness of such companies for the private sector. The Bank will also consider investing along-side strategic investors in state companies at the time of privatisation or taking a minority equity stake during IPOs.

- The Bank will continue to focus on investing in Russian regions outside of Moscow and St Petersburg, continuing to work with the more progressive regions to re-enforce the demonstration effect of reform policies and governance as conducive to increased investments, as well as encouraging the less advanced regions to embark on reforms in order to attract financing. The Bank has now completed its network of regional offices, with a presence in each federal district – St Petersburg (North West), Ekaterinburg (Urals), Vladivostok (Far East), Rostov-on-Don (South), Krasnoyarsk (Siberia), Samara (Volga) and in the Central Federal District. This network will enable the Bank to reach out over time to a higher number of regional mid-sized companies. The Bank will seek projects in agribusiness, general industry, forestry, mining, telecommunications, hotel business and other sectors that promote regional development.

### 3.1 Curbing Energy Demand: Energy Efficiency and Sustainable Energy

The EBRD’s strategy for Russia will apply the whole range of instruments available to the Bank under its Sustainable Energy Initiative (described in more detail in Annex 6) to support its activities in Russia, with the aim to enable Russia to transition towards a low-carbon growth strategy consistent with market principles.

The proposed focus on energy efficiency and sustainable energy is in line with evolving priorities in Russia. The challenge and importance of enhancing energy efficiency as well as the potential benefits thereof have been acknowledged widely by Russian political and economic actors. There has been a fundamental positive shift in the attitude towards energy efficiency on the level of policy makers, as well as concrete steps being taken to address the challenge. This is reflected, for instance, in the decree by President Medvedev issued in 2008 on measures to promote energy efficiency in Russia; the introduction of targets for energy efficiency and renewable energy in the Russian Energy Strategy up to 2020; ongoing work on the development and adoption of a new energy efficiency law; progress with the adoption of the procedures for Joint Implementation projects under Kyoto protocol; the announcement of plans to establish a dedicated energy efficiency agency; the power sector reform which is now largely completed, as well as the ongoing liberalisation of domestic energy prices which will continue to serve as a key driver for energy efficiency in Russia. The recently created Commission for Modernisation and Technological Development of Russia's Economy chaired by President Medvedev identified energy efficiency as one of its priorities.

The significant ramp-up of sustainable energy investments under the SEI Phase II strategy will be achieved through further mobilisation of resources for existing SEI activities (e.g. by channelling more investments through the local private and state banking sector), deepening of sector coverage (e.g. by targeting new energy intensive sectors for dedicated energy efficiency loans or exploring sustainable energy components within less energy-intensive industries), as well as development and roll-out of new financing instruments addressing and supporting new SEI themes and sectors (such as energy efficiency in buildings or renewable energy). In order to maximise its effort and impact, the Bank will work with private and public sector clients to introduce improvements in energy management practices (e.g., encouraging the introduction of automation and control techniques across energy systems) and pursue horizontal technologies consistent with best international practice which can be replicated across different sectors. The Bank will also utilise energy benchmarking tools to ensure consistency of objectives and applications across companies within the same sector.

The above strategy will be transformed into an SEI action plan to be agreed with the Russian authorities by the end of 2009.

Sectoral activities and focus are foreseen as follows:

- **Sustainable Energy Financing Facilities -** the Bank will seek to enhance and broaden current activities into, for example, renewable energy projects, and will launch dedicated energy efficiency financing facilities with a number of financial intermediaries in order to be able to effectively reach SMEs, residential clients, as well as a wider regional cluster of industrial energy efficiency projects. 2009 will see the roll-out of a large financing facility with the initial focus on industrial energy efficiency.

- **Industry** – the Bank will enhance ordinary lending operations with energy-efficiency lending to promote systemic change in the area of sustainable energy and to ensure the future competitiveness of clients. Through the instruments available (e.g., energy audits and energy benchmarking analysis), the Bank will promote dissemination of best available techniques and amplify its demonstration effects by building critical mass.

- **Clean Power Production** –the Bank will increase the drive for high-efficiency rehabilitation and new construction of power generation assets, to ensure that the future growth in electricity demand can be met by lower carbon generation technologies.

- **Buildings –** the Bank, while utilising donor funds to trial innovative financing of public and residential building rehabilitation, will pursue policy dialogue with the Russian government and municipalities to facilitate commercially based solutions, like Energy Service Companies (ESCOs), and enable lending for the municipal and private residential sector.

- **Municipal Infrastructure** – the Bank will put a strong focus on the renewal of district heating and the refurbishment of public buildings, to reduce energy consumption and increase comfort of users, while engaging in policy dialogue to support broad introduction of metering and meter based billing and tariff reform.

- **Renewables –** the Bank will pursue policy dialogue to support the development of detailed renewable energy legislation and seek to support specific windfarm and other renewable energy projects; it will also continue to invest in the modernisation of existing renewable energy facilities, e.g. in refurbishing hydro stations.

- **Transport –** the Bank will focus on energy efficiency investments in railway infrastructure linked to the development of a Sustainable Energy Strategy by Russian Railways (RZD) with the aim of improving efficiency across all operations, including non-transport related, e.g. optimisation of space heating in service buildings. It will also seek to support where appropriate piloting Strategic Energy Management Action Plans. It will pursue energy efficiency opportunities in other transport infrastructure projects, such as upgrading of airport terminals.

- **Natural Resources –** the Bank will in particular pursue reduction of gas flaring, but also extend knowledge transfer and lending to oil and gas producers to reduce the environmental impact of their operations while increasing their efficiency.

- **Carbon Finance –** the Bank will focus on supporting Russia in developing the frameworks to make successful access to carbon finance a reality for companies and municipalities.

The Bank will use targeted policy dialogue to strengthen the framework for sustainable energy in Russia, for example by supporting the carbon emission reductions trading market or by facilitating regulatory changes removing barriers and enabling new financing instruments to be made available such as in the public and residential buildings sectors.

### 3.2 Building a Competitive Diversified Real Economy: the Overarching Strategic Priority

The sharp drop in commodity prices at the end of 2008 once again highlighted the importance of economic diversification to achieve broad-based sustainable long-term growth. Economic diversification and competitiveness of the Russian economy will rely on modernisation of various industries, on support for innovation and a knowledge-based economy and on development of small and medium-sized businesses. With this objective, the Bank through its projects will address directly the financing needs of the larger enterprises, facilitate FDI, and expand support to the MSME sector through intermediary banks and equity funds.

#### *3.2.1 Partnering with the Mittelstand and Larger Enterprises*

In view of the crisis, the Bank will make an extra effort in the near term to serve companies' short-term needs for reliable working capital (through the Corporate Support Facility) and trade financing to rebuild trade linkages and maintain a functioning industry supply chain, while supporting operational restructuring, efforts to refocus on core assets and mergers and acquisitions.

At the same time the Bank's strategic focus over the recovery period will be to promote economic diversification and play its catalyst role in mobilising finance to the corporate sector to support companies' technological modernisation, resource efficiency and productivity improvements. The Bank, targeting three populations of companies – independent Russian regional companies, industrial financial groups, foreign investors – particularly but not exclusively in agribusiness (with a focus on agri-processing and logistics), high tech industries, pharmaceuticals, bio technology, forestry, automotive suppliers, and industrial equipment, will:

- Promote regional growth by working with **independent Russian regional companies, likely to form the basis of a future Russian Mittelstand -** with near term prospective sales of more than EUR 100 million. The Bank will seek to assist their development with prudently staged investment plans correlated with the recovery from the current crisis, and help strengthen their capital bases and long term funding through equity and debt facilities (e.g. using the Medium Sized Equity and Mezzanine Facility). The Bank will work with RSPP (main employers' association) to identify promising regional companies and will provide technical assistance to such companies to enable them to reach sufficient corporate, management, legal and financial reporting standards to start working with EBRD. However cooperation from the Russian authorities is required to mitigate the impact of the amendments to the Law on Foreign Investment referred to in section 2.1.4, which may significantly hinder the Bank's capacity to process equity investments.

- Continue to engage with **financial industrial groups** that are already Bank clients and have shown consistent commitment to high standards where further engagement would have important transition benefits. The Bank will explore selective engagement with other such groups provided they are drivers of diversification and modernisation of the economy, and prepared to adopt high standards of corporate governance and transparency, environmental and energy efficiency practices, and introduce best available technologies. Financing of such groups will have an additional effect of reaching out to the regions of Russia, boosting innovation and diversification, and providing improved trade and finance terms to their smaller suppliers and distributors. More collaboration between these groups and foreign firms will be sought.

- Remain a reliable partner for **foreign investors –** in particular Mittelstand companies - at a time of increased uncertainties, by taking higher risk and providing comfort to investors through proactive support to ensure access to utilities and to resolve administrative and regulatory matters, at regional level and sometimes at national level. The Bank will thereby contribute to building and strengthening confidence among the different market participants as well as between businesses and the state.

Across all sectors the Bank will seek to promote the application of the best available industry technology, business processes and innovative products to **support the development of a knowledge-based economy**. It will support enhancement of information communication technologies, introduction of modern database management systems and shared networks, construction of data centres, technoparks, international standard warehousing and logistics management; radio frequency identification (RFID) technology in agribusiness and retail, inventory control systems in manufacturing. The Bank will work with the Russian Corporation for Nanotechnologies (Rusnano) to identify high tech innovative projects that could be considered for financing.

As an example of focus, the Bank will pay special attention to the **agribusiness sector** and the comprehensive development of the food chain. The Bank will target large foreign or local companies that are leaders in their relevant markets to assist with debt restructuring and balance sheet strengthening combined with operational restructuring as well as industry consolidation via acquisition or greenfield development. The Bank will support specific sub-sectors with strong backward and forward linkages as well as sound growth prospects. The Bank will explore the possibility to develop credit facilities in support of farm entities.

In its operations the Bank will:

- Concentrate on production efficiency and costs optimization of food processing including diary, confectionary and beverages sectors.

- Focus on financing industries with linkages in the food chain including logistics, packaging, storage and distribution.

- Provide crisis response measures including refinancing packages, provision of working capital, debt and equity instruments and de-leveraging of companies.

- Support the introduction and development of strong local brands and consistent product quality; finance improvement of quality standards of local inputs including traceability and higher hygienic standards

- Finance projects that introduce new processes and higher energy efficiency standards in food production/processing; promote carbon trading transactions.

- Support primary agriculture on a very **selective** basis as part of integrated agro-holdings, for instance high quality seed production;

- Continue policy dialogue under institutional frameworks or joint projects especially with the Russian Ministry of Agriculture and the Russian Grain Union and bring together the public and private sector to resolve bottlenecks (such as at the World Grain Forum in St Petersburg in June 2009). Promote adoption of uniform and internationally accepted standards and discourage discrimination based on ungrounded requirements that may be used as trade barriers.

### *3.2.2 Building Vibrant Medium, Small and Micro Enterprises*

The current crisis has most affected MSME companies and individual entrepreneurs at a time when micro and small companies could be playing an important role in mitigating unemployment resulting from layoffs by the larger enterprises. The immense needs of micro, small and medium-sized enterprises will be addressed through a renewed emphasis on trade finance, private equity development and MSME programmes through financial intermediaries and equity funds. The Bank will also seek new approaches to reach the SME sector, including by providing investment and restructuring support to large enterprises to encourage them to create new niches for SMES through outsourcing of services and building supply chains. While the Bank will prioritise and strive to work as much as possible with private sector intermediaries, it may also collaborate with select state owned banks, taking care not to crowd out private sector banks, in order to broaden its outreach and address MSMEs needs in the most effective way, including with specialised energy efficiency facilities. The Bank will work to develop a dedicated MSME facility with the Russian Government and a programme supported by the Russian Bank for Development (Vnesheconombank) for financing MSMEs through EBRD partner banks.

The scale back of **trade finance** available to companies puts at risk, together with the surge of protectionist inclinations among policy makers around the world, the advancement of free trade, which is an important driver for diversification of production and exports. Therefore, EBRD traditional trade finance guarantees and pre-export and post-import cash advances to local banks have become more important than ever before. The objective will be to increase the number of participating banks in the EBRD Trade Facilitation Programme, including private, foreign-owned subsidiaries and selected state-owned banks, which are actively involved in supporting international trade and can be used as efficient channels for such funding to the real economy.

With the onset of the financial crisis, MSMEs access to debt finance, which was already insufficient to meet the demand, was curtailed further, particularly in the regions, as banks struggled with the outflow of deposits and suspension of wholesale borrowing. At the same time these companies require additional equity injections to strengthen their capital base.

In response to this situation, to address the needs in debt financing, the Bank is seeking to increase funding, in particular in RUB, to the strongest **bank intermediaries**, and in particular to those with strong regional networks, using both state and private banks, in order to help them maintain lending activity to MSME clients in the difficult market environment and at a time when many financiers are dramatically reducing their funding to MSMEs. Moreover, EBRD financing to local banks is aimed at strengthening market confidence, allowing banks to maintain and later grow their MSME portfolios through well developed branch networks, thereby safeguarding lending capacity that was built up with previous EBRD projects. Credit lines will be used to promote energy efficiency through provision of much needed financing for small and medium scale commercial energy savings projects, and building institutional capacity in the banking sector to assess, finance and monitor such projects.

The Bank will address the equity needs of medium and small companies through **private equity funds**. The portfolio dynamics of the equity funds supported by the EBRD have been adversely affected by the lack of bank financing for portfolio companies, the reduced valuations and by the absence of proceeds from exits. Fundraising for new funds has also become extremely challenging and in many cases impossible even for experienced management teams. In the short term the Bank will focus on selectively supporting existing fund managers, e.g. in situations where other fund investors are unable to honour their financial obligations due to the impact of the financial crisis on other parts of their portfolios and are looking for an exit. The Bank will also continue to provide direct support to portfolio companies via the Co-investment Framework Facility when considered appropriate. The Bank will review new fund projects during this period, focussing especially on the ability of the management teams to propose a coherent investment strategy and to attract institutional investors. The Bank may also selectively review fund projects focussing on addressing the consequences of the financial crisis, such as debt/mezzanine funds, restructuring funds, sector specific funds, etc.

In the medium term the Bank will continue with its traditional focus on identifying and helping to bring to the market promising new fund management teams with attractive strategies. The Bank will also selectively support new funds to be raised by established fund managers with a strong track record and proven hands-on approach. These efforts should result in establishing private equity as a recognised asset class, bringing additional foreign investment into the Russian economy and ultimately in developing a local institutional investor base. In terms of sector priorities, the Bank will pay particular attention to the new fund managers operating in the technology / venture capital segment, in line with the objective of developing a knowledge economy.

## 3.3 Closing the Infrastructure Gap

The Bank will continue its strategic focus on addressing key infrastructure bottlenecks to facilitate physical flow of goods, necessary utility services and supply of energy to industry, as well as stimulate demand, thereby softening the impact of the crisis and supporting the recovery and diversification of the economy. Priority will be given to creating an effective legal and regulatory framework for sustainable development and implementation of PPP projects. The Bank will continue its close co-operation with EIB and with the Russian Bank for Development (Vnesheconombank) in the sector.

### *3.3.1 Transport: Ensuring Flow of Goods*

The main objective in the near term would be to support operators and infrastructure providers affected by market contraction and limited access to funding, by assisting with financial restructuring and mobilising financing of key investments to sustain and improve the efficiency of existing transport infrastructure and operations while safeguarding or promoting transition. Support to such operators may involve balance sheet restructuring to assist the key industry players with liquidity problems arising from the banking crisis.

Once the economic situation improves, the Bank will concentrate on selecting priority development investments, involving new construction and network expansion aimed at increasing the capacity of the various transport networks and preventing bottlenecks as demand for transport services increases.

In the **private sector**, in support of greater involvement of private companies in the provision of transport services, the Bank's efforts will be directed towards financing the needs of private rail operators in rolling stock and/or leasing, and encouraging private railway infrastructure development and upgrading (e.g. short freight lines, with industrial clients). The Bank will also consider supporting renewal of shipping fleets, allowing smaller shipping companies in particular to benefit from lower new building costs in an effort to enhance business prospects and realise significant environmental and safety improvements.

In air transport, the Bank will work with private investors to provide financing for airport terminal upgrades and landside developments as well as support, through asset backed financing and pre-delivery payments, private airlines efforts to upgrade fleets, improve operating efficiency and enhance environmental and safety impacts. With port infrastructure remaining a key bottleneck, the Bank will consider, with the private port operators, viable new port investments, as well as terminal expansion and modernisation. The Bank will finance selected privately-run multimodal logistic centres facilitating the containerisation of freight and the transit between road, rail, sea and inland waterways.

The Bank's activities with regard to the Government's **PPP programme** are envisaged to continue, together with EIB and other IFIs, on the dual level of providing financing to the private partners and active policy dialogue to assist in creating an effective legal and regulatory framework for sustainable development and implementation of PPP projects. This would be complemented by a technical co-operation programme to support the preparation of future PPP projects in accordance with best international practice.

The Bank will also continue to support financially **viable state-owned entities** committed to restructuring and commercialisation of their activities. The Bank will consider providing sovereign-backed financing for necessary restructuring and priority federal infrastructure projects and will also continue to seek viable solutions for utilising forms of local government support for investments in regional infrastructure. In supporting development of regional road infrastructure, the Bank will seek to promote road safety.

The Bank will enhance its support for the on-going final stage of reform of the rail sector through investments in railway infrastructure; it will also consider financing passenger rolling stock as well as high-speed rail operations and regional railway services. In light of the current crisis and its impact on the newly restructured railway sector, the Bank will consider providing balance sheet restructuring and/or pre-privatisation financing for the new companies within the Russian Railway (RZD) Group that were established as a result of the ongoing unbundling of the state rail monopoly. There have been steps towards tariff harmonisation between domestic and international freight trade since 2001, though this process has stopped since early 2009 and risks being partially reversed. The Bank will continue working, together with RZD, towards harmonisation of tariffs by the regulator to ensure a level playing field for all market participants and improve the Bank's ability to operate in this sector.

The Bank will continue its successful work with Rosmorport, the unified ports authority, supporting its infrastructure upgrading and greater commercialisation of its activities. The Bank would consider financing priority investments in the inland waterways sector, subject to progress in reforms. The Bank will explore co-financing with the state of investment in airside infrastructure and navigation facilities and remains willing to work with the Government to support the modernisation of the Russian air traffic management sector. An outstanding issue which may make this more difficult is the lack of progress on the implementation of the agreement between the EU and Russia on Siberian overflight fees. The Russian Government has approved this agreement, but has linked its actual implementation to the conclusion of the WTO accession negotiations, and due to the delay with this accession, the problem remains.

In support of the Russian government efforts to restructure the aeronautics industry, the Bank will continue to support Russian made aircraft, provided projects are in accordance with the international and European standards for aviation and aeronautics and are sustainable and viable on international markets.

The collaboration and **policy dialogue** in supporting the on-going rail sector reform and developing and financing a sustainable PPP programme will continue to dominate the Bank's effort at the policy and regulatory level. This will be complemented by cooperation in the airport and inland waterway sectors to assess the possibility of identifying funding mechanisms which would allow the Bank to support urgently needed investment in regional airport infrastructure and the network of inland waterways. The Bank will continue actively supporting ratification by the Russian Federation of the Cape Town convention and its related protocol.

### *3.3.2 Accessible Municipal Services*

The rehabilitation of dilapidated infrastructure has been the key priority of the last strategy period. Underinvestment remains pregnant in certain sectors or regions (e.g. district heating and urban transport in most cities, water supply in smaller cities) and therefore further effort to rehabilitate existing infrastructure is needed. The Bank will continue to roll-out decentralised financing solutions on the basis of commercialised utilities and with the backing of reform-oriented public authorities, with increased efforts to reach the smaller municipalities through consolidation of projects at the level of regional multi-utility companies.

However new operational priorities shall include i) the development of new infrastructure ii) further development of the PPP market and iii) support to emergence of local corporate specialists in municipal services, while encouraging entry of strategic investors.

Support for development of **new infrastructure**, linked to further restructuring of commercially oriented utilities, will aim to:

- upgrade facilities to recent, more energy efficient or environmentally friendly technology or processes (e.g. in heating, urban transport, solid waste disposal, public buildings, housing);

- expand existing infrastructure to cover new areas within or around medium and large municipalities (e.g. expansion of water supply and sewerage networks to suburban areas or new housing or industrial developments, development of urban/regional transport infrastructure); and

- create facilities where they are lacking (e.g. water and wastewater treatment plants, heat generating/co-generation facilities, or solid waste processing).

The above priority will require substantial **technical cooperation support** mobilised from international donors as well as the structuring of larger loan facilities due to the size of such investment programmes (vs. the traditional EUR 10 million equivalent size of priority investment programmes financed in the previous strategy period). The Bank will seek to co-operate, through co-financing and risk-sharing arrangements, with Sberbank, the Russian Development Bank and other local financial institutions to support such projects. The financial sustainability of such larger loan facilities will need to be supported by Bank efforts to progress two key factors: (i) regulatory improvements to establish objective and incentive-based tariff methodologies based on full cost recovery (including capital costs) such as the regulatory asset base (RAB) methodology, with adequate support for poor households; and (ii) the further development of an efficient and liquid rouble market so as to ensure that larger debt volumes can be funded with reasonable certainty as to the long term stability and predictability of interest rates.

The second operational priority for the Bank will be to contribute to the development of the nascent **PPP market** by supporting both granting authorities, lacking technical experience and resources, (notably through technical cooperation assistance to organise an open, fair, transparent and efficient tendering process on the basis of a balanced concession contract) and private parties (by offering debt and/or equity financing to the winning bidder assuming the Bank can satisfy itself that the process followed good practice and the winning bidder has relevant qualifications). This operational priority will be underpinned by recent legislation passed in June 2008 imposing a competitive selection process as standard for private sector operators to lease public assets to participate in public services and thereby enabling the Bank to support those operators who entered into the market as a result of proper competitive tendering. The Bank endeavors to contribute to the success of these efforts through policy dialogue at two levels, central on the one hand (e.g. at ministerial working group level) and local on the other hand (e.g. by raising municipalities' awareness to good practice and desirable outcomes).

A third operational priority will be to facilitate the emergence of reliable corporate specialists of municipal infrastructure with the know-how and financial ability to deliver broad-based investment programmes and service levels of international standard. This complex undertaking will include several components including: (i) enhancing transparency and corporate governance; (ii) consolidating existing private operators into well structured, technically competent and financially able organisations; (iii) introducing international know-how through partnerships with world class operators (not only in terms of technology, operation and maintenance but also in terms of customer service); (iv) making funding available to such operators both at the equity level (through joint ventures, strategic partnerships, or financial investment by specialised private equity funds or the Bank itself) and the debt level (through long term corporate facilities or project finance facilities extended by the Bank and commercial banks where available). For the Bank, this will involve significant intermediation efforts (to familiarise investors with the Russian market and facilitate contacts), risk taking (to offer early 'seed' equity as well as strategic equity to back consolidation efforts) and innovation (to develop new market instruments such as infrastructure funds).

The Bank will continue to expand beyond the water, wastewater, heating sectors and urban transport sectors and will target energy efficiency improvements in public buildings and housing stock by financing municipal or private companies implementing energy efficiency investments in public buildings and residential housing stock under energy performance contracts, where repayment of investments is supported by future energy savings. The Bank will get involved in the development of projects in solid waste sectors providing financing to municipal/regional and private waste management operators.

### *3.3.3 Efficient Electricity Supply*

Russian power sector reform achieved many of its original objectives – the vertically integrated electricity sector has been successfully restructured, market mechanisms and infrastructure created and operational, most thermal generating companies have been sold to strategic investors and the electricity and capacity market liberalisation is on track. A key next step, together with the development of the remaining market elements and implementation of effective government regulation and self-regulation, is to implement the new investment commitments by the private generating companies and to address transmissions and distribution bottlenecks.

As electricity demand has dropped as a result of the crisis and availability of external financing for investment projects is very low, many generators seek government support for renegotiation of the timing and amount of investment commitments, while pushing for completion of reforms that would ensure the return of investments. State support is selectively offered to state controlled companies. As part of its crisis response actions, the Bank will provide effective, non-distortionary support to help both private and state owned power companies face the challenges of the financial crisis, including urgent balance sheet restructuring, refinancing, liquidity support or financing of investment shortfall for priority projects with high energy efficiency parameters. Such financing would be linked to reform efforts including implementation of incentive based RAB methodology in distribution and transmission, significant improvements in reliability, energy and environmental management and governance.

To step up activities in the sector during the current strategic period, the Bank will seek to

- Provide debt financing to privatised generating companies and their majority shareholders for the financing of priority investment projects, including the projects committed to at the time of privatisation; ensure that new generation units meet the best international environmental and efficiency standards, including carbon emission intensity.

- Support removal of transmission bottlenecks by providing debt financing to transmission and distribution companies to finance the implementation of their investment programs, targeting primarily projects with high transition impact and energy efficiency benefits and development of vital infrastructure.

- Support renewable energy projects by offering equity and long-term debt financing for commercially viable renewable energy projects, particularly undertaken by private companies.

- Promote further competition and new entries into power generation by engaging in the development of commercially viable independent power producer (IPP); support market driven mergers and acquisitions.

- Continue to support foreign direct investments in the Russian power sector, specifically through support of foreign private investors in power generation; international IPP developers, including industrial sponsors (inside-the-fence IPPs) in new IPP projects in Russia; reputable international sponsors participating in energy efficiency projects, including energy service companies (ESCOs) and in renewable energy projects.

The Bank will continue its policy dialogue with the relevant market regulators primarily through technical cooperation assistance on the implementation of the remaining aspects of the power sector reform, including completion of the electricity market liberalization (translation of wholesale prices into retail markets), practical application of the RAB tariff methodology in distribution and transmission, as well as introduction of the methodology for heat business. It will support the development of specific legislation in the field of renewable energy and of market based energy efficiency enabling frameworks, and will engage in policy dialogue to promote high environmental and technical standards and post-Kyoto carbon framework.

### *3.3.4 Promoting Energy Efficiency and Environmental Standards in Energy Supply and Transport*

While the sharp drop in commodity prices at the end of 2008 once again highlighted the importance of economic diversification to achieve a broad-based sustainable long-term growth, it is important to promote diversification not only out of the natural resource related sectors, but also within the natural resource segment, better exploiting linkages along the value chain and ensuring sustainability of resource revenues as a source of financing diversification programmes. Contraction of private sector financing has enhanced the need for the Bank's financing in the oil and gas sector, where the Bank will focus on issues of energy security, energy efficiency and diversification of energy sources.

As part of the Bank's short term crisis response, it will consider supporting companies with fundamentally stable business which may need access to capital to deal with short term liquidity constraints and enhance/maintain their focus on corporate governance, environmental aspects and transparency.

The Bank medium term strategic focus will be on supporting with great selectivity private sector participation and competition and foreign direct investment against the past trend of increased state participation in the sector, where it is possible to encourage adoption of higher environmental and H&S standards and practices through projects. The Bank will promote with government agencies, select state enterprises that are implementing reforms, restructuring or commercialisation of their activities, and private companies projects focused on energy efficiency and reduction of CO2 emissions.

## 3.4 Efficient Capital Markets and Financial Intermediaries

### *3.4.1 Strengthening the Banking Sector*

In the short-term, in response to the financial crisis in Russia, EBRD's focus in the **banking sector** will be mainly on existing bank clients' balance sheet strengthening, equity and quasi equity financing. In the environment of market uncertainty, growing non performing loans and continuing pressure on banks' capitalisation, EBRD financing for strengthening banks' balance sheets and capital base will be an important contribution to faster stabilisation of the banking sector and re-gaining of investors' confidence.

In the medium term, the Bank will resume the expansion of its client base, probing new relationships by trade facilitation and MSME lines and developing deeper co-operation, . In particular, EBRD will identify the banks, which are systemically important country-wide or in their respective regions, have robust business models, and have successfully withstood the liquidity squeeze and which will form the core of the future banking system.

Through its investments in the capital (tier 1 and tier 2) of banks that have the potential for organic growth through regional expansion, or are willing to pursue mergers with other banks and/or bringing strategic partners, the Bank will continue to actively promote higher standards of corporate governance and business practices. The Bank will support mergers and acquisitions of existing clients as well as identify new investment opportunities with the aim to facilitate consolidating initiatives. The Bank will support acquisition of troubled banks by larger market players, including with the help of state agencies – with the objective to facilitate smooth and professional merger and integration process as well as building better institutions by increasing their critical mass and realising synergies.

The Bank will provide lending resources to partner banks to stimulate introduction of new products (energy efficiency, mortgages, etc). In parallel, the Bank will work at re-introducing international syndications, risk-sharing and assets-backed financing. Development of rouble syndications will be a priority on this front.

The Bank will use its expertise and credibility to engage in more broadly based **policy dialogue**, in particular on the regulatory aspects of bank consolidation and restructuring and with regard to aligning financing and restructuring efforts with various state agencies. In the crisis environment cooperation with other IFIs becomes yet more important, when together with various state agencies, IFIs are one of the few remaining sources of liquidity for Russian banks. Therefore coordination of efforts and priorities as well as co-financing complementing each other in larger and more complicated transactions will be crucial for achieving greater efficiency and impact on the market.

EBRD will continue being one of the main sources of **technical assistance** and knowledge transfer to Russian banks. In particular the focus will be on a number of initiatives such as (a) dictated by the crisis, provision of technical assistance related to loans quality improvement and enhancing of collection efficiency; (b) professional support to banks' integration in the selected merger and acquisition cases and restructuring troubled banks; and (c) more traditional institutional strengthening for new relationships.

### *3.4.2 Deepening Domestic Capital Markets*

The financial crisis has underscored the need and importance of a deep and developed **domestic capital market**.

Whilst there currently exists limited demand for personal pensions, retail asset management, personal and life insurance products, efforts will be undertaken to further stimulate the development of a domestic institutional investor base. As part of these efforts, it is imperative to encourage improvements to financial product, debt and equity security clearing and settlement/payment systems. Local exchanges can lever off recent and current developments in western exchanges and clearance/settlement systems.

The Bank will be looking at expanding the range of financial instruments available in Russia by working with **non-bank financial institutions** in the areas of leasing and insurance. Fostering business diversification, growth of the critical mass and capitalisation increasing risk taking capacity as well as stimulating and assisting in sectors' consolidation will be the priorities in working with non-bank financial institutions.

Growth in the capital markets will be greatly assisted through the development of a non-callable, long term fixed interest rate bond market. The first stage of this has been achieved through the creation of the MosPrime index, which is also needed in order for the RUB interest rate derivative market to operate. An active and liquid derivative market is needed for both issuers and investors in long term RUB fixed rate bonds to manage their interest rate risks. The Bank will continue to utilise and promote MosPrime which needs to be more widely used in the marketplace.

To support the development of local capital market infrastructure and collective investments instruments, the Bank will support distinct market leaders, which create local securities market and provide assets management solutions. Through continued policy dialogue, the Bank will contribute to developing a robust capital market infrastructure including a comprehensive legal and regulatory framework.

## 4. CO-OPERATION WITH THE EUROPEAN UNION

EU-Russia relations are based on the Partnership and Cooperation Agreement (PCA) which came into force in December 1997. It establishes the institutional framework for bilateral relations, sets the common objectives and calls for activities and dialogue in a number of policy areas. The PCA was enhanced by agreement to work together on four "common spaces": the Common Economic Space; the Common Space for Freedom, Security and Justice; Common Space on External Security; and the Common Space on Research, Education and Culture. At the EU-Russia summit in May 2005, Road Maps for the implementation of the Common Spaces were agreed. They currently determine the agenda for cooperation between the EU and Russia. The Common Economic Space, which is the most relevant for the Bank, seeks to strengthen cooperation in the field of economic and trade relations, trade facilitation and customs, infrastructure development, as well as energy and the environment.

The June 2008 Summit launched the negotiations on a new EU-Russia agreement to update and replace the PCA. The objective is to have a New Agreement which provides a durable and comprehensive framework for EU-Russia relations. Negotiations are ongoing.

The renewal of Northern Dimension (ND) policy, initially elaborated in 1999 with the participation of Norway, Iceland, EU Member States and the Russian Federation and focusing on co-operation in northwest Russia, Kaliningrad, the Baltic, Barents seas and Arctic areas, was launched at the Helsinki Summit in November 2006. As a result, the cooperation among the actors in the region was intensified substantially. The two main characteristics of the renewed policy are: 1) the co-ownership of EU, Iceland, Norway and Russia and 2) the strong link between the ND policy and the four EU/Russia Common Spaces, and specified in Road Maps. In order to facilitate the project implementation within the framework of the ND policy, the following partnerships were created: the Northern Dimension Environmental Partnership (NDEP) and the Northern Dimension Partnership in Public Health and Social Wellbeing (NDPHS). In October 2008 the decision to establish the ND Partnership on Transport and Logistics was taken.

The EU has been a key provider of technical assistance to Russia with the TACIS programme having provided more than EUR 2.7 billion since 1991. The EU European Neighbourhood and Partnership Instrument (ENPI) includes a national allocation for Russia of EUR 30 m per annum over the period 2007-2010, as well as regional and cross-border components (Cross Border Co-operation Programme). Financial co-operation is focused on selected support intended to entrench the Common Spaces and a certain proportion is allocated to Kaliningrad. The major cooperation areas between the EU and the EBRD have been the environment with special regard to the Northern Dimension initiative, development of the European transport infrastructure, strengthening financial institutions and supporting development of municipal infrastructure.

The European Commission is the largest contributor to the NDEP Support Fund with EUR 70 million to date. Out of this amount, EUR 40 million is earmarked for nuclear clean up projects in the north-west Russia and EUR 30 million are for environmental projects in the Northern Dimension Area. The European Commission chairs the NDEP Assembly of Contributors and is an active member of the NDEP Steering Group. (For further details regarding NDEP, please see Annex 5)

In the *financial sector*, the European Union (EU) and the Bank have established and are working on a number of technical co-operation programmes, aiming at:

- improvements in efficiency, effectiveness and transparency in the sector, resulting in the provision of better access to financing for enterprises, particularly MSMEs;
- maintenance or creation of successful and healthy financial institutions that finance the real economy, operate on market principles and follow sound business practices and
- provision of assistance to banks which have been particularly affected by the global financial crisis and in which EBRD has invested as part of a crisis response package.
- addressing local development and reduction of regional disparities as well as assisting sustainable socio-economic growth.

Examples of the cooperation include:

- A financial and institutional strengthening programme (EUR 6.5 million) for the period 2004 – 2009 for regional banks and banks with sizeable operations outside of Moscow, whilst pursuing the objective of providing on-lending funds and ultimately making a significant equity investment in some of the banks.

- A programme for the period 2009 – 2011 for the Northern Caucasus ( EUR 5 million) to help the region in revitalizing its economic and social infrastructure. The EU-funded technical cooperation programme administered by the EBRD focuses on the Republic of North Ossetia-Alania (RNOA) and aims to implement a MSME Credit Advisory Programme and a TurnAround Management Programme (TAM) for selected partner banks and enterprises in RNOA under this Initiative. This is part of an EU assistance package of EUR 20 million for the North Caucasus, which includes also education and health.

- A programme (EUR 2 million) for the period 2009 – 2011 agreed to provide funding to be used for tailored support to banks in the area of active loan portfolio management including loan workout and corporate recovery procedures. The programme will help strengthen and develop commercial banks across Russia to ensure that they continue to act effectively as intermediaries which can deliver appropriate and timely finance to the private business sector.

EU's and EBRD's active partnership in Russia will continue to significantly contribute to the enhancement of the financial sector and will be particularly important in coming years of crisis and post crisis environment.

In the *municipal infrastructure sector* co-operation has focused on co-financing and technical assistance for transactions particularly in the municipal and environmental sector. Technical co-operation funding provided by the EU as official co-financing has been utilised by the Bank in the preparation and implementation of projects with a particular focus on institutional capacity building. The Bank has also been able to utilise bilateral pools of TC funding established by the EU for project development. TC funding has been established in support of Russian projects under the Municipal Infrastructure Support Programmes (MISP) I and II. MISP I (covering 2005) and MISP II (covering 2007) had a significant leverage impact on the outcome of funding brought to each project. For MISP I EUR 1.5 million in EU TC funding supported EUR 157.8 million in EBRD finance – a ratio of EUR 1:105 - and total project financing of EUR 248.1 million – a ratio of EUR 1:165. For MISP II, EUR 0.6 million in TC funding supported an EBRD investment programme of EUR 254.8 million - a ratio of EUR 1:436.

In 2008, to facilitate *transport* between the European Union and the Russian Federation, the European Commission has allocated a EUR 3 million to support the development of the Pan European transportation corridor 2 (Berlin-Minsk-Moscow-Nizhniy Novgorod) and 9 (Helsinki-St Petersburg-Moscow). The Bank has elaborated with Roads of Russia (the public entity in charge of the federal motorway PPP program) a technical assistance program in support of development of the above road projects based on the PPP model.

The Bank has also been participating in the Working Groups under the EU-Russia Energy Dialogue to share its experience, notably in energy efficiency, and infrastructure projects.

# 5. CO-OPERATION WITH IFIS

The Bank works in close co-operation with other IFIs active in the Russian Federation. Its current partners in Russia include EIB, the World Bank, IFC and the Nordic Investment Bank and the Bank is developing deeper relations with the Black Sea Trade and Development Bank and the Eurasian Development Bank.

## 5.1 European Investment Bank

### *5.1.1 Background*

The EBRD cooperation with the European Investment Bank (EIB) was formalised in a tripartite Memorandum of Understanding (MoU) between the Bank, the European Commission and the European Investment Bank on 15 December 2006 in order to organise cooperation in Russia, Moldova, Ukraine, Belarus[2], Armenia, Azerbaijan and Georgia, as well as Central Asia[3].

The EIB loans in the area are governed by a mandate decided in 2006 by the EU Council for the period 2007-2013. This mandate includes an amount of EUR 3.7 billion for Russia, Moldova, Ukraine, Belarus, Armenia, Azerbaijan and Georgia (within this amount of EUR 3.7 billion, the relevant Council Decision does not prescribe a particular allocation per country). Central Asia is included in the regional sub-ceiling for Asia.

Under the 2006 mandate, the EIB finances “projects of significant interest to the EU in transport, energy, telecommunications and environmental infrastructure. Priority should be given to projects on extended major Trans-European Network axes, projects with cross-border implications for one or more Member States and major projects favouring regional integration through increased connectivity. In the environmental sector, the EIB should in Russia give particular priority to projects within the framework of the Northern Dimension Environmental Partnership. In the energy sector, strategic energy supply and energy transport projects are of particular importance.” This mandate allows the countries in question to benefit from the EIB expertise in financing public and private sector investments in the four permitted sectors.

### *5.1.2 Cooperation Achievements*

The cooperation between EBRD and EIB has successively developed since the EIB started activities in Russia a few years ago (first mandate expired in 2005). Both institutions have different – although complementary – mandates in Russia and have focussed on their comparative advantages in working together. Some challenges in practical project cooperation remain such as somewhat different priorities due to the different but complementary mandates and some differences in rules. One of the challenges remaining is the alignment of the EBRD's transition and private sector development mandate with the EIB's mandate to support EU policy.

Specific joint activities of EBRD and EIB in Russia to date have included:

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[2] eligible for EIB financing upon the receipt of political go-ahead;

[3] for Central Asia this go-ahead was received in November 200

- 4 projects in St Petersburg under the NDEP, with the total amount of lending from EBRD comes to EUR 343 million, EUR 153 million from NIB, EUR 102.5 million from EIB and EUR 7 million from NEFCO. These projects include the:

  St Petersburg Southwest Wastewater Treatment Plant (signed 2003)

  St Petersburg Northern Sludge Incinerator plant in (signed 2005)

  Petersburg Flood Protection Barrier (signed 2005); and the

  St Petersburg Neva Closure of Direct Discharges, or "the St Petersburg Neva Program" (signed 2009)

- Loan to OGK-5 (EBRD signed, EIB signature pending) for the upgrade of the Nevinnomyssk GRES power plant in Southern Russia;

- Financing for MTS, Russian telecommunications company (EBRD and EIB signed 2009). This important pathfinder project forms the basis of EBRD and EIB cooperation in the telecoms sector;

- EBRD / EIB Joint PPP activity as follows*:*

  - Evaluating as potential co-financiers the Russian Federal Motorway Projects (eg M10 Moscow St Petersburg transaction);

  - Participation in a trilateral working group with VEB (Vnesheconombank). EBRD and EIB supporting VEB's efforts to support regional promoters on PPP project development. EBRD and EIB PPP experts work with VEB to educate local promoters and ensure a higher standard of project preparation than would otherwise be achieved. It is hoped in the longer term that this will also generate enhanced lending opportunities.

  - Participation in VEB led working group to explore mechanisms of FX mitigation within the PPP projects in order to enable projects to be funded in the financial crisis.

- An EIB Representative based in EBRD's Moscow Office; whilst currently awaiting agreement of its Country Host Agreement, EIB has identified an expert in project financing including PPP financing and currently this expert works in the EBRD Moscow office whenever needed.

- Preparation of joint financing for Moscow district heating;

### *5.1.3 Future Perspectives*

For the coming years, the cooperation between the EBRD and the EIB is going to continue to benefit from the EIB's technical, financial and project financing expertise for infrastructure projects. Given that EIB is one of the largest infrastructure and PPP investors in the world (with a PPP portfolio of over EUR 20 billion), and that the EBRD has in depth local knowledge and presence, both banks can contribute to sustainable financing of infrastructure investments necessary for improving potential growth in Russia.

In addition, and following on from the template established by EBRD and EIB to jointly lend to MTS, EIB would expect to leverage its extensive private sector financing experience and contribute its expertise to further fund the telecom sector.

An increased focus shall be placed on energy and energy efficiency projects in order to achieve better environmental standards. EBRD and EIB are currently reviewing a number of early phase projects (refurbishment of power plants, flared gas reduction and district heating projects) which are expected to contribute to this goal.

Finally, the current financial crisis has inevitably led to a shortage of liquidity in the financial markets as a whole and more specifically a significant reduction in the availability of rouble funding, an escalation of the pricing of rouble interest rates and an increase in rouble interest rate volatility. In order to address these issues, EBRD and EIB Treasury teams are:

- exploring mechanisms by which the organisations can cooperate to most efficiently access capital and local currency in order to deliver the best possible value for clients and stakeholders.

- exploring with key Russian partners (eg VEB) innovative mechanisms by which the IFIs may be able to access long tenor, fixed rate, affordable roubles for high priority projects.

### 5.2 Nordic Investment Bank

Nordic Investment Bank activities in Russia are concentrated in North West Russia on i) environmental projects; ii) energy, energy efficiency and renewable energy; and iii) infrastructure. NIB is promoting projects related to emissions reductions to water or air, waste water treatment, solid waste management, cleaner production, and is focusing on the HELCOM Baltic Sea Action Plan. In infrastructure, it is involved in the Northern Dimension Transport and Logistical Partnership.

The main focus of NIB's co-operation with the EBRD has been the Northern Dimension Environmental Partnership. At the end of 2009 the NDEP Assembly of Contributors approved in total 16 environmental projects put forward by the Steering Group. The EBRD is the lead financial institution for 8 of these projects (total value of EUR 2.3 billion[4]) while the NIB is the lead institution for 5 projects (total project value of EUR 603 million[5]). In addition, NEFCO (Nordic Environment Finance Corporation) is the lead implementing agency for 3 projects with total project volume of EUR 38.8 million. Within the NDEP portfolio of projects, the total loan amount of EUR 343 million comes from EBRD, EUR 153 million from NIB, EUR 102.5 million from EIB and EUR 10.3 million from NEFCO. The upgrade of the St. Petersburg's Northern Wastewater Treatment Plant and pumping stations for the main underground sewage collector is the most recent joint transaction signed in 2009.

Going forward, close collaboration between the Bank and the NIB within the NDEP will continue, and this collaboration is beginning to expand to transport infrastructure projects. Teams from both institutions have co-operated on the preparation of the Pulkovo airport project. The two institutions are also working on the MTS transactions and will be looking at

[4] Total cost of St Petersburg Flood Protection Barrier alone is €2billion. The remaining 7 projects total €300 million

[5] The cost of NIB led Neva project calculated as €340 million and included in the total figure

opportunities to co-finance energy efficiency or renewable energy projects in North West of Russia.

## 5.3 World Bank and International Finance Corporation

### *World Bank (IBRD)*

World Bank activities in Russia are currently guided by the three-year Country Partnership Strategy (FY07–09), which met its primary objective of delivering a new form of cooperation based on non-traditional approaches. In keeping with the Government's strong financial position, the IBRD portfolio wound down from 22 to 16 projects for total commitments of USD 1.57 billion, primarily aimed at public administration reforms (60 percent by volume) and social and communal services (20 percent). New federal borrowing was limited to important institutional operations for judicial reform and state statistics.

In contrast, demand grew rapidly for Bank-IFC sub-national lending, without a sovereign guarantee, and fee-based services that provide knowledge transfer on regional development in key areas of the joint strategy. Strategic priorities include macroeconomic stability, the investment climate, economic diversification, public sector management, regional development, public-private partnerships for infrastructure finance, and social and communal services. In addition, the Russian Federation sought World Bank cooperation to develop an Official Development Assistance system based on multilateral principles. Substantial progress was achieved in raising Russia's capacity as donor through joint initiatives to address the global food price crisis, educational quality, financial literacy, and more recently, the global financial crisis.

The current CPS period expires in June 2009 and will be extended from FY10-12. In the context of the ongoing financial crisis, the Government has reconsidered its borrowing strategy. There is scope for World Bank financing, particularly guarantees, to attract long-term capital for vital infrastructure investments. Other operations could support anti-crisis measures and policies to improve the efficiency of public and social expenditures, particularly to protect the most vulnerable, and to diversify and modernize the economy. In addition, the government has expressed interest in signing the "Housing and Communal Services" loan already approved by the Board. The regional focus will remain, including economic analysis (growth and business environment diagnostics), regional development strategies, and more effective use of social expenditures. Sub-national borrowing and new fee-for-service arrangements for investment and policy advice will continue but at a level consistent with fiscal and liquidity constraints in the regions.

### *IFC*

By 1 June 2009, the IFC had invested USD 4.5 billion of its own funds and syndicated over USD 1 billion in more than 180 projects in Russia. IFC's committed portfolio in Russia as of 30 April 2009 was USD 2.2 billion, which made Russia the second largest country exposure, representing about 7.5 percent of IFC's global portfolio. IFC has committed between USD 500 and USD 750 million in Russia each year since 2005. Approximately half of the portfolio is in the financial sector.

The rest of IFC's portfolio consists of investments in a wide range of sectors, including transport and logistics infrastructure, manufacturing, oil, gas, mining and chemicals, agribusiness, telecommunication and IT, private health care, sub-national finance, and retail trade. Advisory services programs have focused on different aspects of the financial sector (corporate governance in banks, legal advice on securities regulation, leasing development, primary mortgage market development), supply chain management in agribusiness and forestry, as well as environment and energy efficiency. Advisory services focused on crisis response address demand from banking sector clients for assistance with portfolio management and special loan servicing and from real sector clients for assistance with crisis response and risk management.

There have been numerous transactions jointly financed by the IFC and the EBRD. Co-operation in the current environment is focused on operations in the financial sector and in infrastructure, including through participation in jointly financed facilities.

### 5.4 Relations with the IMF

Following a series of financial programmes with the IMF in the 1990s, the Russian authorities retired all outstanding obligations to that organisation (USD 3.6 billion) in March 2005. IMF engagement with the Russian Federation is therefore limited to the annual Article IV consultations, and one or two additional visits for informal discussions in the middle of this annual cycle. The last Article IV consultation was concluded in September 2008, and the staff discussions on the 2009 Article IV consultations were held in late May 2009, with the IMF Executive Board discussion to follow.

As part of its surveillance work, the Fund conducted a Financial Sector Assessment Programme (FSAP) (jointly with the World Bank), and a number of modules of ROSC (Review of Standards and Codes), most recently on FATF recommendations on anti-money laundering and combating the financing of terrorism. The Fund continues to provide technical assistance, including in the area of economic statistics, and maintains a Resident Representative's office in Moscow.

## ANNEX 1: POLITICAL ASSESSMENT

### Compliance with Article 1

The Russian Federation is committed to principles of multi-party democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank. While there has been a welcome reaffirmation of the importance of these principles by the current administration, a more consistent application of them would facilitate attainment of the country's medium-term development goals. In particular, policy innovations to address Russia's key transition challenges are most likely to emerge from a free flow of ideas and information, open engagement with civil society and enhanced political competition. Recent efforts to increase transparency, step up judicial reform and the rule of law and combat corruption are particularly encouraging, but implementation will be the key.

### Political Accountability

According to the 1993 Constitution, Russia's political authorities are held accountable through several measures: competitive periodic elections, a separation of powers among the executive, legislative and judicial branches of government, and the freedom of its citizens to participate in independent associations. However, for the past several years each of these mechanisms for ensuring accountability and checks and balances in the political system has been weakened while concentration of power in the hands of the executive has been strengthened.

National elections held in December 2007 (parliament) and March 2008 (president) were conducted in an orderly fashion, but many aspects of the process were questioned by the international community and by independent media and opposition groups. The December Duma elections were the first national elections held since the introduction of electoral reforms in 2005 which changed the voting system to one of full proportional representation (PR) in place of the mixed PR and single-mandate voting system. The reforms also raised the threshold needed by a single party to enter the Duma from 5 to 7 per cent of the popular vote and prohibited the post-election formation of coalitions amongst parties that did not meet the higher threshold. In the end, four parties exceeded the threshold, with one – the pro-presidential United Russia – establishing clear dominance with a total of 315 out of 450 total seats, enough to form a super or Constitutional majority.

The conduct of the Duma election could not be monitored by an international election observation team from the OSCE Office of Democratic Institutions and Human Rights (ODIHR) due to a disagreement over the terms of the mission. Delays in receiving an invitation and restrictive conditions imposed by the Russian Central Election Commission (CEC) made it impossible for ODIHR conduct a mission within its mandate. However, a group of 70 parliamentary observers from 28 countries deployed by the Council of Europe's Parliamentary Assembly (PACE) concluded that the 2 December 2007 State Duma elections "were not fair and failed to meet many OSCE and Council of Europe commitments and standards for democratic elections." The main observations made by PACE were the excessive use of administrative resources by the United Russia party (which had then-President Putin atop its party list giving them the imprimatur of the state), media bias in favour of United Russia and widespread reports of harassment of opposition parties. A monitoring mission from the CIS found no significant problems with the conduct of the election.

The Presidential election in March 2008 was contested by four main candidates. However, the endorsement by the popular incumbent president Putin of then-First Deputy Prime Minister Dmitry Medvedev, and a commitment by Medvedev to appoint Putin as Prime Minister should he win the election, made the outcome a forgone conclusion. Further, opposition candidates faced significant obstacles in registering and/or running an effective campaign. In the event, Medvedev secured 70 per cent of the vote and his nearest challenger received 18 per cent. As in the case of the Duma election, ODIHR was unable to send observers for the Presidential election due to an inability to resolve their outstanding differences with the CEC over the terms (size and duration) of the mission. The PACE sent a small delegation of 22 members, and reported afterwards that the will of the people may have been served in the election but Russia's "democratic potential was, unfortunately, not tapped". The main concerns raised by the PACE and by domestic observers were over cumbersome registration procedures, media bias, the use of administrative resources to increase voter turnout and allegations of ballot box stuffing.

Three encouraging features of the election deserve mention: first, the country experienced a peaceful transfer of power through a normal, albeit flawed, Constitutional procedure. Speculation that the Constitution would be altered to allow President Putin to serve a third term turned out to be unfounded. Second, the election results reflected the will of the people. Notwithstanding a biased broadcast media, it is not contested that President Putin and the man he endorsed as his successor were highly popular leaders whom the population voted for willingly. Third, President Medvedev campaigned for office on themes of political pluralism, open society, the rule of law and good governance, which was welcomed by the international community and domestic civil society groups alike. He affirmed his commitment to strengthen the political party system and move to a form of democracy "without adjectives" (such as "managed" or "sovereign"). However, since Medvedev's inauguration in May 2008 there have been few signs of tangible progress in this direction. The results of local elections in October 2009 further concentrated power at the regional level in the hands of the United Russia party. In his first state of the nation address, President Medvedev introduced a major political reform that will extend the Presidential term of office from four to six years and the term of the Duma to four to five years. This move may weaken political accountability.

Political accountability in a democratic state requires adequate legal protection for individuals and organisations who seek to gather and disseminate information on the conduct of public agencies. NGOs in Russia have raised serious concerns regarding limitations on the rights of civic groups to participate in the vital function of monitoring elections and holding the government accountable. A law on NGOs signed by President Putin in January 2006 required Russia's 240,000 NGOs to re-register with a regulatory agency overseeing their activities. In accordance with the new law, NGOs must report on sources of funding and how such funds are being spent. The law prohibits the use of foreign funds for "political activity". The oversight agency – the Federal Registration Service – is authorised to initiate legal proceedings to close down foreign NGOs that "threaten the sovereignty, political independence, territorial integrity, national unity and self-identification, cultural heritage and national interests of the Russian Federation".

The law in practice has not resulted in a reduction in the number of registered NGOs, according to international human rights monitors such as Human Rights Watch, but it has made it more costly to establish and run an NGO due to the bureaucratic hurdles created under the new law. Moreover, a number of registered NGOs have complained of arbitrary application of the law and harassment by inspectors, which the new law facilitates through its vague provisions on such things as "compatibility with the security of the state", the need to prepare documents “in an appropriate manner” and the wide discretion it allows inspectors investigating administrative violations. The re-formation of the Presidential Council for Promotion of Civil Society Institutions and Human Rights in February 2009, and appointments of well-regarded independent rights campaigners to the Council, was a positive step towards strengthening ties with civil society organisation. In a meeting in April 2009 with civil society representatives, President Medvedev acknowledged these flaws in the design and application of the NGO law and he referred openly to the difficulties faced by NGOs when restrictions are placed on their activities “without sufficient justification”. The President admitted that civil servants sometimes see NGOs as enemies of the state, a view he described as “dangerous”. A working group formed to review and recommend modifications to the NGO law following the April 2009 meeting has proposed two main changes: to ease the registration process and to simplify accounting requirements. This fell short of the proposals put forward by NGOs prior to the working group meeting, but was viewed as a reasonable compromise and step in the right direction toward creating a more permissive environment for civil society.

**Rule of Law**

The current administration has made the rule of law, elimination of what the President refers to as “legal nihilism” and the fight against corruption the cornerstone of his agenda. Since coming into office in May 2008, the President’s administration has launched a steady stream of new legislation and initiatives that underline the political will behind this effort.

Russia’s judiciary and courts system have been overhauled since the transition began, but the work is unfinished. The independence, professionalism and effectiveness of the judiciary in upholding the rule of law is still questioned, and trust in courts is low. Amongst the most notable achievements in judicial reform in recent years is the strengthening of the Supreme Arbitrazh Court (SAC), where the Court chairman has introduced income disclosure requirements for judges, greater transparency in recording meetings with government officials and publication of judicial decisions on the internet, and fought to uphold property rights and reduce the incidence of corporate “raidering”.

The administration has sought to build on the successful experience at the SAC by calling publicly for an end to “telephone justice” (the practice of deciding cases politically rather than on the basis of law) and a campaign to modernise the courts, increase transparency, upgrade the professionalism and competence of judges and enhance oversight and quality control. This is an ambitious agenda which will take time to implement. Another major challenge is enforcement of judicial rulings: although judges may be better qualified to reach just decisions rooted in the law, enforcement is widely perceived to be poor. The authorities have referred to data showing that roughly half of all judicial rulings are not enforced.

The current administration’s programme to combat corruption includes continued efforts to simplify licensing, the inspections regime, registration and taxation, in particular for small businesses, and to strengthen competition legislation and its implementation. In September 2008 the President approved a new National Anti-Corruption Plan and since then several new initiatives have been produced. In December 2008, parliament passed a new law on combating corruption and a law protecting companies and entrepreneurs from predation by regulators and supervisory agencies, and in March 2009 a five-year programme of state service reforms was announced that will address incentives for performance of public servants. In April 2009 the Prosecutor General’s Office created a new unit with offices in all Russian regions to tighten enforcement of the law on protection of the rights of entrepreneurs whose businesses are subject to inspection by state agencies. The law and new functions with the PGO were created in response to President Medvedev's injunction to state officials not to intentionally harass entrepreneurs. April 2009 saw the implementation of a new law on public disclosure of assets held by government officials and their families which constitutes a step towards greater transparency and higher ethical standards in government.

These are welcome and necessary steps to deal with a problem that is a significant impediment to business and to good governance. However, the legacy of the recent past, in which agents of the state sent contradictory signals on their intentions and capacity to improve governance standards cannot be overcome easily. Corruption in the bureaucracy, which is difficult to measure precisely, appears to have increased over the past few years, according to surveys by Transparency International, the EBRD and World Bank, and by independent organisations in Russia. For example, Russia's score on the Transparency International Corruption Perceptions Index decreased from 2.4 in 2005 to 2.1 in 2008 (out of a possible 10), placing Russia 147$^{th}$ in the overall country ranking and seventh from the bottom among transition countries. There are concerns now amongst corruption watchdog organisations that the money trail from the Government's anti-crisis fiscal stimulus plan is not adequately monitored and could, without proper oversight, contribute further to the problem of corruption.

The 2008 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) revealed that about 10 per cent of businesses see corruption as the most significant obstacle to doing business amongst a list of 15 obstacles in the business environment. Since the BEEPS was last conducted in 2005, a larger percentage of firms in Russia list corruption as a minor, moderate, major or very severe obstacle to their business. Recent high frequency surveys by the Russian association for small businesses, Opora, also detected a rise in problems related to administrative pressure on businesses (both the number of checks and the amount of associated unofficial payments). The Opora surveys reveal a significant percentage of respondents – around 12 per cent – complaining of illegal actions by law enforcement and tax officials and a similar percentage complaining of the worsening problem of illegal corporate "raidering", wherein a company's assets are seized by a private entity using a cooperative agent of the state or local courts.

**Civil and Human Rights**

The protection of civil and human rights is a core responsibility of a democratic polity, and the Russian Constitution provides for the necessary guarantees. With a few notable exceptions, these guarantees are upheld in practice. As in the past, the main concerns voiced by the international community and rights groups apply to media freedom and human rights conditions in the North Caucasus. In addition, there are growing concerns regarding the rise in expressions of racism and intolerance toward minorities.

While independent print and internet-based media continue to thrive in Russia, the state has maintained its control over the national broadcast media and has increased its stakes in regional media outlets. The state – either directly or through state-owned entities such as Gazprom – has controlling interests in all 6 national television stations and all 3 national radio broadcasters. Nearly two-thirds of the country's other 2,500 television stations are wholly or partly owned by the federal or local governments. This has affected editorial freedom at the news outlets where most Russians get their news and information, and has imposed constraints on reporting on sensitive topics such as the impact of the financial crisis, turbulence in the North Caucasus and the conflict in August 2008 with Georgia over the breakaway territories of South Ossetia and Abkhazia. Only one of the three radio broadcasters, Ekho Moskvy, provides independent coverage of controversial news stories.

In 2007, the authorities placed limitations on the ability of international news media to broadcast across the country. Radio Free Europe/Radio Liberty and Voice of America continue to broadcast freely in Moscow and St. Petersburg, but a number of state-controlled outlets in the regions have discontinued their programmes. In the same year, the Russian partner of the BBC World Service, Bolshoye Radio, was pressured to drop BBC programmes or lose its licence. BBC no longer broadcasts in Russia on the FM band, and is confined to medium and shortwave broadcasts.

The human rights conditions in the North Caucasus continue to raise concerns. The situation in Dagestan and Ingushetia has deteriorated markedly in recent years, with a rise in insurgency attacks on public officials, law enforcement agencies and civilians. The conflict has sparked large-scale public demonstrations in the region. Human rights abuses continue in Chechnya, though with far less frequency than in the past. Investigations into past alleged abuses, many brought before the European Court of Human Rights (ECHR) are ongoing but without resolution. The Russian authorities have not fully implemented judgements by the ECHR on cases related to abuse in Chechnya, in particular through its failure to ensure effective investigations and hold perpetrators accountable. This contributes to a climate of impunity. Moreover, a number of unresolved killings and violent attacks against journalists and civic activists has raised questions by human rights organisations regarding the efforts taken to investigate and prosecute these cases.

Concerns about the rise in incidents of extremism and violence against minorities, including alleged abuse and exploitation of migrant construction workers, have been voiced by local and international NGOs. Many of these abuses are at the hands of private actors, but rights monitors maintain that the Government has not done enough to prevent or prosecute criminal acts, which are rising partly in response to the impact of the financial crisis.

# ANNEX 2: LEGAL TRANSITION

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Russia, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

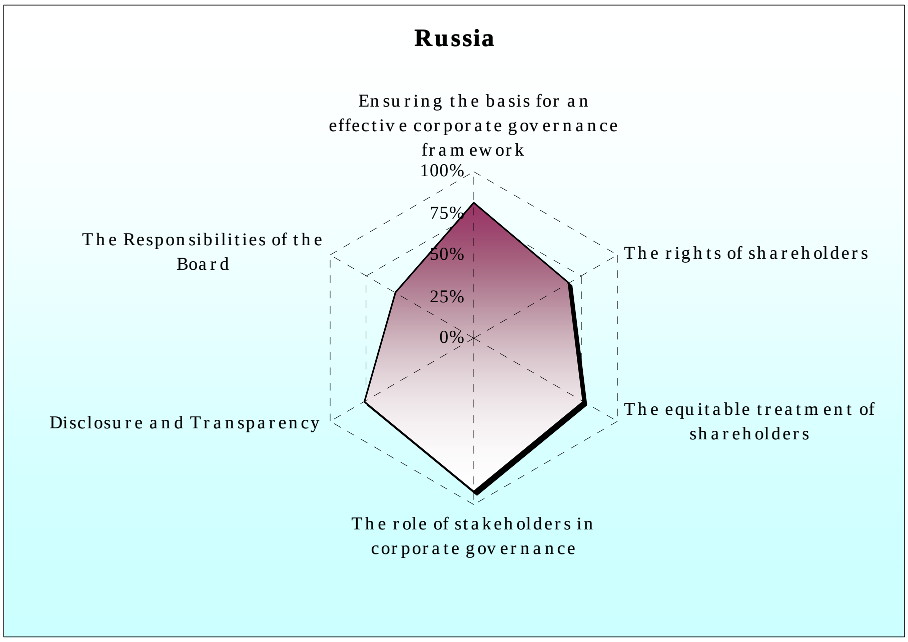
## Company Law and Corporate Governance

The main corporate governance legislation in Russia is contained in the Civil Code issued on 1 January 1995 and in the Law on Joint Stock Companies (the "JSC Law"), dated 26 December 1995. Both laws have been amended several times since their enactment.

In 2002 the Federal Commission for the Securities Market ("FCSM"), Russia's former securities market regulator, issued a Corporate Governance Code developed with the technical assistance of the EBRD. The Code is voluntary and listed companies are only required to report compliance with the Code's principle, according to the "comply or explain" mechanism.[6]

In Russia, joint stock companies with 50 or more shareholders must be organised under a two-tier system, where the general shareholders meeting appoints both the supervisory board and the management board, unless otherwise provided by the company's by-laws.

**Quality of corporate governance legislation – Russia (2007)**




*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the 'web', the more closely the corporate governance laws of the country approximates these principles

*Source:* EBRD Corporate Governance Sector Assessment, 2007

[6] See a collection of corporate governance codes in the EBRD region, including the Russian one, at: http://www.ebrd.com/country/sector/law/corpgov/codes/index.htm

According to the results of the 2007 EBRD Corporate Governance Sector Assessment, under which corporate governance related "laws on the books" were assessed, the Russian Federation was rated as having achieved "high compliance", when compared to the OECD Principles of Corporate Governance.

A general reform priority for Russia is to improve effective implementation and enforcement of its existing legislation. The effectiveness (how the law works in practice) of corporate governance legislation was assessed by the EBRD in 2005, examining a case study dealing with related-party transactions. The case study investigated both the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction had been entered into by the company, and how to obtain compensation in case where damage was suffered. Effectiveness of legislation was then measured according to four principal variables: complexity, speed, enforceability and institutional environment. The survey revealed a variety of actions available to minority shareholders to obtain disclosure and redress but procedures were seen as complex. When considering enforceability, the procedure can be difficult and time-consuming. Finally, when examining the institutional environment, the survey identified difficulties in finding reliable corporate information and independent statutory auditors. Otherwise, courts and the market regulator are deemed generally competent and experienced in corporate law cases, but courts can be biased - especially in favour of powerful defendants - while the regulator's position was deemed unpredictable.

**Concessions and PPPs**

The 2005 Russian Law on Concession Agreements, as amended, (the "Concession Law") is a relatively comprehensive document, largely regarded as having no fundamental deficiencies. When enacted, it provided a fair basis for the development of private sector participation in infrastructure. However, the Concession Law can not be seen as being designed for forms of PPP other than concessions. Specifically, it is restrictive regarding the assignability of a concession, the creation of security during the construction phase and the use of international arbitration. It is also too detailed and over prescriptive, imposing a number of restrictions that could make the implementation of projects difficult. It should be noted that currently there is an initiative to develop a general PPP law at the federal level.

Since 2005 both the Russian federal and regional authorities have been working on improvements to the Concession Law and PPP regime. EBRD has been engaged in ongoing dialogue both directly with the federal authorities in an effort to address deficiencies, and through various conferences and forums.

The 2008 amendments to the Concession Law introduced a number of improvements, including: some flexibility vis-à-vis sub-lease of concession assets (but not the assignment of rights during the construction phase); a softening of the binding nature of template agreements; the introduction of some flexibility into timeline regulations lifting restrictions (e.g. originally 90 days deadline for signing the Concession Agreement and reaching financial close which was unrealistic); a reiteration and expansion of quality criteria for tenders; and, an allowance for independent experts to be used by the evaluation commission. However, the amendments clarified the venues of choice for dispute resolution as being within Russia, thus excluding any international arbitration.

In addition, 2008 amendments to the Competition Law include the requirement for holding a tender/auction in order to transfer public assets into private use and/or possession. Thereby, the loophole that allowed municipalities and municipal companies to award leases to private operators in the heating, water and wastewater sectors directly, without any competitive process, has now been closed which should, in the longer term, encourage the development of concessions in the municipal utilities sector.

Another positive development in the recent years has been in the areas of PPP policy formulation and the institutional framework. It is noteworthy that the 2020 development programme provides explicit support to PPPs. At least two agencies, the Roads of Russia and the PPP Unit of Vnesheconombank have started actively working on PPP transport and municipal project development respectively.

In addition to federal legislative initiatives, in order to increase efficiency and bankability in implementing private sector participation schemes, some regional authorities have introduced good-quality regional PPP laws, e.g. the 2006 St Petersburg Law on the Participation of St Petersburg in public-private partnerships, as well as regional PPP institutions.

**Insolvency**

The Law on Insolvency (Bankruptcy) (the "Insolvency Law"), which governs bankruptcy and insolvency in Russia, came into force in 2002 and has been amended on a number of occasions, most recently and extensively in December 2008 and then in April 2009. This law, as amended, represents a significant improvement over the previous regime. In a 2006 Update to EBRD Insolvency Law Sector Assessment, the law achieved a score of "medium compliance" when benchmarked against international standards. This determination, however, did not take into account the most recent 2007, 2008 and 2009 amendments to the law.

The Insolvency Law is notable for its treatment of the qualification, appointment and removal of insolvency administrators. The framework for insolvency administrators was further improved by the December 2008 amendments, which empowered the profession to adopt national professional standards and a code of ethics for insolvency administrators. The Insolvency Law rates relatively high in terms of its treatment of creditors, the commencement of proceedings and the liquidation process. The December 2008 amendments provided for detailed procedures for evaluation of assets, assets sale procedures and financial analysis. Improvement can also be noted in the treatment of secured creditors.

The Insolvency Law has a number of weaknesses, however. Specifically, it does not provide a balance sheet test for insolvency, nor does it provide sufficient safeguards with respect to reorganisations including a failure to prohibit critical suppliers from threatening to cut off supply unless past debts are paid in full. The cross-border insolvency provisions are insufficient, relying on international treaties and reciprocity rather than the UNCITRAL Model Law or similar EU regulations.

The 2006 EBRD Assessment noted that the power of insolvency administrators to review pre-bankruptcy transactions was weak and ineffective, preventing insolvency administrators from maximising the estate value and preventing improper behaviour by debtors. However the most recent Amendment Law to the Insolvency Law (April, 2009) introduces detailed and improved rules on avoidance of transactions, setting criteria for preferential, undervalue and damaging to creditors transactions that may be avoided, provides for the secondary liability of responsible persons (e.g. managers, majority shareholders, etc.), and sets the rules for the recovery of assets. The Amendment Law is a big step, in particular, as a preventive measure and should help the process of recovery of debtor's assets. The investigatory powers of the insolvency administrators to uncover such transactions and gather sufficient information to challenge them remain weak though, which undermines the value of the amendments.

While, when implemented, these recent amendments should help to make the system more effective, administrative improvement is still required. Insolvency administrators are at the heart of any insolvency system; without improvements to their training, licensing, regulation and professional conduct, only minimal improvements to the system will be achieved. To this end, the EBRD and the Russian Ministry of Economic Development and Trade (MEDT), with funding from the Swiss State Secretariat for Economic Affairs (SECO), are undertaking a project designed to build the capacity of insolvency regulators in Russia. Additionally, under the auspices of the same technical cooperation project EBRD is assisting MEDT to shape the Insolvency Law in other critical areas: investigatory powers of insolvency administrators and further improvement of the regime for concealment of assets and transactions avoidance, handling of assetless and "phoenix" companies, and insolvency taxation.

**Secured Transactions**

Russian corporate and financial sectors have become more and more sophisticated. However, the legal system has not followed pace and in many respects is slowing down financial market development or burdening it with unacceptable risks at all levels of the economy.

A well known deficiency comes from the law underpinning security rights over movable property (otherwise known as pledge law), by which movable property of all types serves as collateral to secure claims. The EBRD has for a number of years called for reform of this important area of the law. The Law on Pledge was adopted in 1992 when the market economy was in its infancy and the relatively modern features that this law provided have quickly been outpaced by the sophistication that the market required. More importantly, the 1995 Civil Code's chapter on pledge established a narrow approach to the subject, which has severely limited for parties the ability to structure transactions in a way that fits their needs. Examples of issues EBRD routinely experiences in its activities are as follows. These issues could only be resolved by a comprehensive reform of the Pledge Law:

- Difficulty of taking security over a wide range of assets, including equipment, stock in trade, raw materials, especially when fluctuating in nature, value or location.

- Uncertainty as to validity and enforceability of security over bank accounts.

- Limitations as to security over future account receivables.

- No system of registration of pledges, which makes it impossible for the lender/creditor to verify independently whether there are any pre-existing security rights granted to other persons on the property.

- Uncertainty regarding pledges and mortgages in syndicated financing

The legal regime for mortgages**,** primarily governed by the 1998 Federal Law on Mortgage, is also in many respects deficient. Examples of problematic areas include the registration procedure, the definition of the secured debt, and priority ranking.

On 30 December 2008, an Amendment Law was signed which introduces important changes to the enforcement of pledges and mortgages. As per the Amendment Law, parties can now contractually agree that the security right could be enforced out of court. Should the debtor refuse to cooperate upon default, the secured creditor could nevertheless proceed by seeking a notary's executory endorsement, on the basis of which court bailiffs would seize the collateral and transfer it to the secured creditor for realisation by public auction or direct sale. The creditor could also choose to have the assets sold by court bailiffs if so preferred. The Amendment Law has also significantly restricted the legal grounds which the debtor could evoke to resist enforcement, the lack of which had led in the past to quasi systematic debtor's obstruction.

It is too early to assess the robustness and efficiency of these new provisions but they represent a real breakthrough, proving that Russian law can take significant departure from entrenched legal approaches.

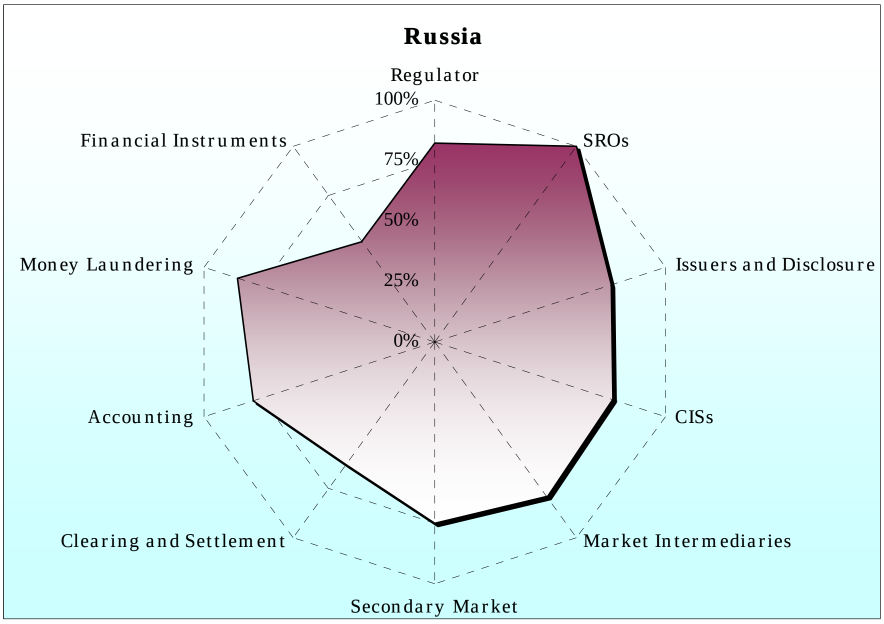
The Russian government is currently considering acceding the 2001 Cape Town Convention on International Interests in Mobile Equipment and the Aircraft Protocol. Such accession would greatly enhance the current legal framework, thereby significantly reducing the risk in aircraft financing centred on creditor's (be it a lender or lessor) reasonable reliance, in the case of a default by or insolvency of a debtor, on the value of aircraft security and its ability, if necessary, to be efficiently redeployed, regardless of the place where the aircraft is located or the nationality of the parties.

**Securities Markets**

In the Russian Federation the basic legislation on the securities market is mainly contained in the Federal Law No. 39-FZ "On the Securities Market", dated 22 April 1996, as amended (the "Securities Law"); the Federal Law No. 46-FZ "On Protection of Rights and Legitimate Interests of Investors on the Security Market", dated 5 March 1999, as amended (the "Investors Protection Law"); the Federal Law No. 208-FZ "On Joint Stock Companies", dated 26 December 1995, as amended (the "JSC Law"); and the Regulations on the Federal Service on Financial Markets (the "Regulations on the FSFM") approved by Decree of the RF Government No. 317, dated 30 June 2004.

The securities market is regulated by the Federal Service on Financial Markets (the "FSFM"), which controls professional market makers and securities' issuers and enacts standards for securities issue. Other government bodies that influence the Russian securities market are the Central Bank, the banking regulator; the Federal Service for Insurance Supervision, responsible for insurance activity and the Russian Federation Pension Fund, responsible for pension insurance (the Fund is under the supervision of the Ministry of Health and Social Development).

**Quality of securities market legislation – Russia (2007)**




*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

*Source*: EBRD Securities Market Legislation Assessment 2007

The 2007 EBRD Securities Markets Legislation Assessment (see chart above), found Russia in "medium compliance" with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO), and close to high compliance. The major shortcomings were found in the regulation of derivatives.

In order to understand how securities markets legislation works in practice, in 2007 a survey (the Legal Indicator Survey ("LIS")) was conducted asking practitioners in the region to comment on a hypothetical case study, advising an investor who lost his savings after buying shares in a national company's Initial Public Offering (IPO), misled by erroneous information in the prospectus. In particular, the LIS concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The LIS revealed that disclosure practices in Russia are generally sound, but some weaknesses exist. In particular, the prospectus does not always disclose the full ownership structure or indicate who the beneficial owner is. Further, financial reports might suffer lack of substance. Other shortcomings include the fact that the regulator is not fully independent from the political power and is often unable to investigative complex international cases. Courts can also be biased, especially in favour of powerful defendants. Courts and prosecutors are progressively developing their expertise in investigating securities cases, but this effort needs to continue and be tackled as a priority.

**Telecommunications**

*Institutional framework:* The Ministry of Telecommunications and Media Communications (the "Ministry") consists of three agencies; the Federal Agency for Post and Communications; the Federal Agency of Information Technologies; and, the Agency of Press and Mass Communications, as well as the Federal Supervisory Service on Telecommunications and Mass Communications. The Ministry carries out coordination and control of activities of these three agencies/services and other organisations accountable to the Ministry within the sector. In cases where the law has established tariffs on certain communications services, these tariffs are regulated by the Federal Tariff Service. The concept of regulatory independence, as envisaged in international best practice, does not exist in Russia and central government control of the sector remains.

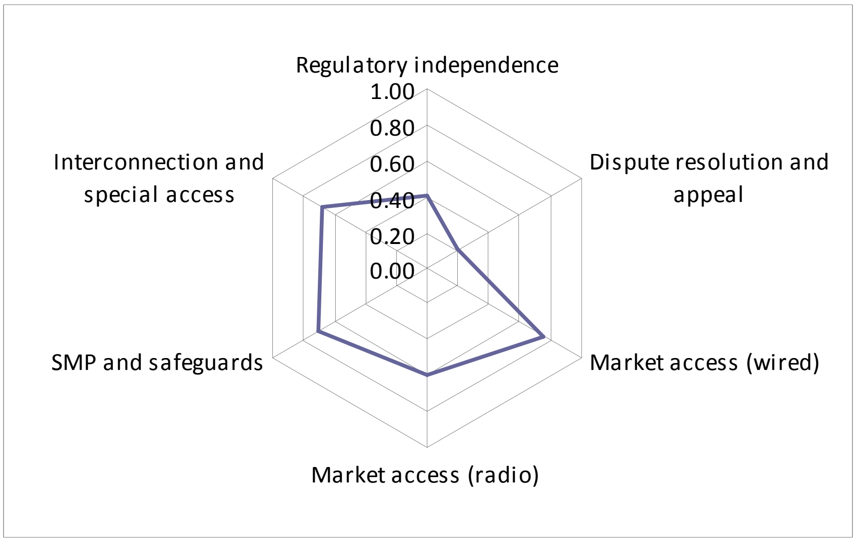
*Market access and authorisations:* Licensing of communications services is carried out in accordance with the Federal Communications Law, 2003, as well as the decision of the government *"On the list of communications services, included in licences, and list of licence conditions"* of 18th February 2005. Although most types of services are open to competition, there is still only limited competition in the carriage of international voice services. The licences that are granted are typically specific in terms of which activities may be carried out and an operator may need several licences in order to provide a given basket of services. Decision-making on radio spectrum allocations and radio frequencies is established the by state Commission of radio frequencies. Information on the allocation of radio frequencies is published on the Ministry's website. WiFi frequencies and digital TV frequencies were allocated in 2006. Three 3G licences were awarded in April 2007, with all three licensees yet to fully launch services.

*Market development*: The fixed market was effectively liberalised in 2006, when the long-distance market was finally opened. There has been active investment in network infrastructure, and mobile phone penetration has risen dramatically in recent years, and now stands at over 120 per cent. Fixed network investment includes fibre, New-Generation

Networks (NGN) and fixed wireless, now with a rapid take up of broadband services, which are already used by around 19 per cent of businesses and 3 per cent of residential customers.

*Assessment:* In a 2008 assessment of the communications sector of EBRD Countries of Operation the sector regulatory regime in the Russian Federation was deemed to have "Medium Compliance" when measured against international best practice.

**Quality of telecommunications regulatory frameworks – Russia (2008)**




*Note: The diagram shows the combined quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. The extremity of each axis represents an ideal score of 100 per cent, that is, full compliance with international standards. The fuller the "web", the closer the overall telecommunications regulatory framework of the country approximates these standards.*

*Source: EBRD Telecommunications Regulatory Assessment, 2008*

# ANNEX 3: SELECTED ECONOMIC INDICATORS

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|
| | | | | | | *Estimate* | *Projection* |
| Output and expenditure | | | *(Percentage change in real terms)* | | | | |
| GDP | 7.4 | 7.1 | 6.4 | 7.4 | 8.1 | 5.6 | -8.5 |
| Private consumption | 7.5 | 12.1 | 11.8 | 11.4 | 13.7 | 11.3 | na |
| Public consumption | 2.2 | 2.1 | 1.3 | 2.4 | 3.4 | 2.5 | na |
| Gross fixed capital formation | 12.8 | 12.6 | 10.6 | 18.0 | 21.1 | 10.0 | na |
| Exports of goods and services | 12.5 | 11.8 | 6.5 | 7.3 | 6.3 | 0.5 | na |
| Imports of goods and services | 17.7 | 23.3 | 16.6 | 21.3 | 26.5 | 15.0 | na |
| Industrial gross output | 8.9 | 8.0 | 5.1 | 6.3 | 6.3 | 2.1 | na |
| Agricultural gross output | 1.3 | 3.0 | 2.3 | 3.6 | 3.3 | 10.8 | na |
| Employment | | | *(Percentage change)* | | | | |
| Labour force (end-year) | 0.6 | 0.1 | 1.2 | 0.5 | 1.2 | 0.6 | na |
| Employment (end-year) | 1.3 | 0.0 | 2.2 | 0.8 | 2.4 | -1.7 | na |
| | | | *(In per cent of labour force)* | | | | |
| Unemployment (end-year) | 7.8 | 7.9 | 7.1 | 6.7 | 5.7 | 7.8 | na |
| Prices and wages | | | *(Percentage change)* | | | | |
| Consumer prices (annual average) | 13.6 | 11.0 | 12.5 | 9.8 | 9.1 | 14.1 | 12.3 |
| Consumer prices (end-year) | 12.0 | 11.7 | 10.9 | 9.1 | 11.9 | 13.3 | 11.9 |
| Producer prices (annual average) | 16.4 | 23.4 | 20.6 | 12.4 | 14.1 | 21.4 | na |
| Producer prices (end-year) | 12.5 | 28.8 | 13.4 | 10.4 | 25.1 | -7.0 | na |
| Gross average monthly earnings in economy (annual average) | 26.1 | 22.6 | 26.9 | 24.3 | 27.8 | 26.7 | na |
| Government sector[1] | | | *(In per cent of GDP)* | | | | |
| General government balance | 1.3 | 4.5 | 8.1 | 8.4 | 6.0 | 4.8 | -8.8 |
| General government expenditure | 29.9 | 27.4 | 31.5 | 31.1 | 34.4 | 33.6 | na |
| General government debt | 27.0 | 20.4 | 13.5 | 9.0 | 7.3 | 6.5 | na |
| Monetary sector | | | *(Percentage change)* | | | | |
| Broad money (M2, end-year) | 50.5 | 35.8 | 38.6 | 48.8 | 47.5 | 1.7 | na |
| Domestic credit (end-year) | 30.6 | 20.9 | 5.0 | 30.0 | 43.6 | 29.6 | na |
| | | | *(In per cent of GDP)* | | | | |
| Broad money (M2, end-year) | 24.3 | 25.6 | 28.0 | 33.4 | 40.1 | 32.4 | na |
| Interest and exchange rates | | | *(In per cent per annum, end-year)* | | | | |
| Central Bank refinance rate (uncompounded) | 16.0 | 13.0 | 12.0 | 11.0 | 10.0 | 13.0 | na |
| Treasury bill rate (all maturities) | 5.4 | 4.5 | 3.9 | na | na | na | na |
| Deposit rate | 4.4 | 3.8 | 3.6 | 4.0 | 5.2 | 7.0 | na |
| Lending rate | 12.4 | 10.0 | 11.1 | 10.5 | 10.8 | 15.5 | na |
| | | | *(Roubles per US dollar)* | | | | |
| Exchange rate (end-year) | 29.5 | 27.7 | 28.8 | 26.3 | 24.5 | 29.4 | na |
| Exchange rate (annual average) | 30.7 | 28.8 | 28.3 | 27.2 | 25.6 | 24.9 | na |
| External sector | | | | | | | |
| | | | *(In millions of US dollars)* | | | | |
| Current account | 35,410.0 | 59,511.7 | 84,602.2 | 94,686.4 | 77,011.8 | 102,399.3 | 39,021.9 |
| Trade balance | 59,859.3 | 85,824.9 | 118,364.0 | 139,269.0 | 130,915.0 | 179,742.0 | 112,414.8 |
| Merchandise exports | 135,929.0 | 183,207.0 | 243,798.0 | 303,550.0 | 354,401.0 | 471,603.0 | 282,961.8 |
| Merchandise imports | 76,069.7 | 97,382.1 | 125,434.0 | 164,281.0 | 223,486.0 | 291,861.0 | 170,547.0 |
| Foreign direct investment, net | -1,769.0 | 1,662.4 | 118.3 | 6,550.4 | 9,157.6 | 20,424.5 | 707.8 |
| International reserves, excluding gold (end-year) | 73,172.1 | 120,805.0 | 175,690.0 | 295,277.0 | 466,376.0 | 411,494.0 | na |
| External debt stock | 186,000.0 | 213,500.0 | 257,200.0 | 313,200.0 | 471,000.0 | 483,500.0 | na |
| | | | *(In months of imports of goods and services)* | | | | |
| International reserves, excluding gold (end-year) | 8.5 | 11.1 | 12.8 | 17.0 | 19.8 | 13.4 | na |
| | | | *(In per cent of exports of goods and services)* | | | | |
| Debt service | 26.0 | 24.1 | 26.3 | 28.0 | 28.3 | 29.5 | na |
| Memorandum items | | | *(Denominations as indicated)* | | | | |
| Population (end-year, million) | 145.0 | 144.2 | 143.5 | 142.8 | 142.2 | 142.0 | na |
| GDP (in billions of roubles) | 13,243.2 | 17,048.1 | 21,625.4 | 26,903.5 | 33,111.4 | 41,668.0 | 40,795.1 |
| GDP per capita (in US dollars) | 2,975.8 | 4,103.1 | 5,328.0 | 6,928.8 | 9,102.6 | 11,806.9 | na |
| Share of industry in GDP (in per cent) | 27.4 | 31.5 | 33.7 | 32.9 | 31.8 | 30.6 | na |
| Share of agriculture in GDP (in per cent) | 6.3 | 5.7 | 5.2 | 4.8 | 4.7 | 4.8 | na |
| Current account/GDP (in per cent) | 8.2 | 10.1 | 11.1 | 9.6 | 5.9 | 6.1 | 3.1 |
| External debt - reserves (in US$ million) | 112,827.9 | 92,695.0 | 81,510.0 | 17,923.0 | 4,624.0 | 72,006.0 | na |
| External debt/GDP (in per cent) | 43.1 | 36.1 | 33.6 | 31.7 | 36.4 | 28.8 | na |
| External debt/exports of goods and services (in per cent) | 122.2 | 104.8 | 95.7 | 93.6 | 119.6 | 92.5 | na |

[1] General consolidated government includes the federal, regional and local budgets and extra-budgetary funds, and excludes transfers.

## ANNEX 4: ENVIRONMENTAL AND SOCIAL DEVELOPMENTS

EBRD's new Environmental and Social Policy entered into force on 12 November 2008. Together with the Public Information Policy and revised Project Complaint Mechanism, the new Environmental and Social Policy establishes a set of 10 Performance Requirements (PRs) for the Bank and its clients so as to integrate environmental and social considerations in business operations. These requirements help EBRD's clients to introduce best practice for the management of environmental, occupational health and safety, labour and other social issues, with a special attention brought to gender through out the Policy.

In particular, the Bank adopts a rigorous approach to labour and working conditions issues which are one of the areas of concern in Russia. The application of a specific Performance requirement (PR2) covers assessment of such areas as labour conditions, fair wages, non-discrimination, gender equality, retrenchment policies, trade unions and collective bargaining practices. Stakeholder engagement is now a requirement for all projects and is expected to be carried out in a meaningful manner proportionate to the risks and issues involved.

For the Bank's Projects in Russia the issue of Indigenous Peoples is also of high relevance, in addition to the previous requirements of avoidance of adverse impacts on traditional lands and activities. When Indigenous Peoples have to be relocated from their traditional lands, or where there are impacts on traditional and customary land use and/or where there is to be use of cultural resources, the Bank will require that the Sponsor enter into good faith negotiation with the affected people and obtain their free, prior and informed consent before initiating project activity.

With relation to Gender, and going beyond the scope of the environmental and social appraisal that is required in accordance with the Environment and Social Policy, the EBRD has adopted a Gender Action Plan to mainstream gender throughout its investment and technical cooperation projects. A Senior Gender Adviser is responsible for implementing this plan in coordination - locally - with a gender focal point to be named in the Moscow office. The main objective of this endeavour is for the Bank to contribute to creating equal opportunities for women as well as their empowerment.

All EBRD operations in Russia are subject to the Bank's environmental and social appraisal and incorporate, where appropriate, Environmental and Social Action Plans into the legal documentation. Issues raised during due diligence, are thus able to be addressed, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investments. All these measures are intended to help guide companies' operations in Russia towards better performance standards in line with the Russian and EU environmental standards, ILO core labour conventions and other international best practice.

The Bank is facing many environmental and social challenges within the framework of its diverse activities in Russia and addresses those accordingly, making sure that appropriate safeguards are being built into every project to minimise any negative environmental and social impacts and to maximise potential benefits.

The Bank is committed through its projects to help Russia to abate air, soil and water pollution, to implement energy efficiency measures, to manage its natural resources in a sustainable way and to be in compliance with international environmental standards and best practices. In addition to that, significant environmental implications and opportunities are introduced in many other EBRD's initiatives and activities, including technical cooperation funds and training. The Northern Dimension Environmental Partnership (NDEP) will continue to play an active role in addressing most urgent environmental concerns in the North-West of Russia.

EBRD will also continue to finance sustainability initiatives in different sectors of the Russian economy. In accordance with the forthcoming legal changes and direction of Russian state environmental policy there are potential opportunities for projects in the area of solid waste and waste water utilisation and disposal, municipal environmental (waste water) infrastructure, sustainable forestry and agriculture, public transport, property & tourism, and construction. The environmental issues made their way as well to the top of the Sochi 2014 Olympic Games' agenda in Russia with potential for sustainability opportunities.

The Bank has pursued a number of Technical Cooperation initiatives to support practical identification of the best environmental solutions and capture environmental opportunities within its projects. It has also supported institutional capacity building and fostered the development of economically viable and environmentally sustainable business opportunities. Most recent examples include identification of financial structures and instruments to promote biodiversity in the steppe ecosystems of the Eurasia region, identification of opportunities for carbon finance projects in forest-related sectors, and supporting improved environmental management in maritime transport through a comprehensive training programme.

With support from the Global Environment Facility (GEF) the Bank is pursuing grant funding for a market transformation programme on energy efficiency in GHG-intensive industries in the Russian Federation; improving energy efficiency in public sector buildings; and improving urban housing efficiency through support to the government to develop mechanisms for financing renovation of residential apartment buildings.

The Bank is involved in numerous natural resource projects in Russia, mainly consisting of projects in oil and gas and precious metals mining. Each of these projects presents its own unique challenges; however, EBRD takes a consistent approach in applying its Environmental and Social Policy. The Bank encourages each of its clients to follow international best practice, such as the Extractive Industries Transparency Initiative and minimisation of gas flaring. In the oil and gas sectors, the Bank encourages gas utilisation and discourages routine flaring. At a minimum, all Bank-financed projects will need to comply with the time lines set forth in upcoming legislation regarding gas utilisation; however, the Bank will encourage all sponsors to achieve compliance ahead of the regulatory driven time frame. While the main focus on these projects is on impact reduction and minimisation, the Bank also helps to identify environmental offsets, local capacity building opportunities and opportunities for environmental and social investments. With respect to projects involving the mining of precious metals the Bank's focus is on minimising the land take or footprint, sound practices for the use, handling and storage of hazardous materials, safe storage of tailings, no adverse impacts to water resources and the early development and funding for reclamation of the sites. Whenever cyanide is used on these projects, the EBRD encourages clients to operate in accordance with the International Cyanide Management Code for the gold mining industry.

In the power and energy sector, the Bank is continuing to focus on improving the efficiency of power generation. This is mainly achieved through replacing old inefficient units with state-of-the-art and high efficiency generating technologies that meet EU environmental standards. The direct and indirect replacement of old units has significant environmental benefits, as the new generating assets have a much lower carbon footprint. Most recent examples include the OGK-5 project with the refurbishment financing and development of renewable energy sources (hydro power). A major focus of the Bank's activities is the identification of energy efficiency opportunities as part of the Bank's due diligence process. This can have significant environmental opportunities alongside with the financial benefits (e.g. carbon credits). These efforts are also supported by the ongoing Sustainable Energy Initiatives (SEI) I & II that is the EBRD's specific contribution to address the climate change challenges, with a particular focus on energy efficiency and renewable energy. SEI Phase 2 (2009-11) will be focussed on climate change mitigation and adaptation issues.

In the forest products industry sector the Bank is supporting forest industry investments that promote transition from primary forestry and export of round logs and primitive timber products towards high value added processes and products based on legal and sustainable forest resource use. The Bank acknowledges that illegal logging persists as a problem in Russia and that it is a critical issue affecting the perceived investment climate for forest industry investments. The Bank strives to ensure that the wood used for its projects is of legal and sustainable origin by requiring its clients to adopt and implement sustainable wood procurement procedures that are in line with internationally recognised sustainable forest management standards as well as to give preference to certified wood, where available on competitive terms. The Bank welcomes the Russian Government's ongoing commitment to enhance its forest law, enforcement and governance to address illegal logging and associated forest crimes under the Europe and North Asia Forest Law Enforcement and Governance (ENA FLEG) process. The Bank also acknowledges Russia's new Forest Code and the associated by-laws, and notes this as a step forward in further developing relevant legal framework in the country. However, concerns exist about the lack of resources devoted to oversight and inspection.

In the financial sector, the Bank continues to provide environmental and social (E&S) risk management training and guidance for its new and existing financial clients in the implementation of the EBRD's environmental and social requirements. An e-manual has been developed to assist Fis with EBRD's environmental and social risk management procedures. This will ensure that the Bank's financial intermediaries are capable of adopting more stringent environmental and social due diligence procedures and continue to report to the Bank on a regular basis. Recent participants of environmental and social risk management training for Russian Fis included Forus Bank, NBD Bank, RosEvroBank, SovcomBank, and TransCapitalBank. The EBRD coordinates its efforts with other IFIs, UNEP FI and other initiatives to promote sustainable and responsible financing in the country, and recently has supported WWF's conference on promoting sustainable finance mechanisms in Russian financial sector. The EBRD will continue to support Russian Fis by providing further capacity building on E&S issues.

In the transport sector, the Bank has supported initiatives to upgrade existing infrastructure and to introduce new technology to improve safety and environmental performance of operations. In the aviation sector, such initiatives have involved introduction of new aircraft that comply with international environmental, health and safety standards. In the rail transportation sector the projects have involved modernisation of the rolling stock, which improves efficiency as well as the environmental, health and safety standards of transportation. The Bank has increasingly formed long-term partnerships with Russian rail cargo operators through equity investments and other corporate finance instruments, guiding them to improved environmental, health, safety, human resource and contractor management practices. The Bank has financed maritime navigation safety improvements in the Baltic Sea, the Gulf of Finland, the Barents Sea and the Azov/Black Sea. These will help mitigate the risks arising from shipping accidents involving hazardous chemicals and particularly oil products in areas with considerable and growing maritime traffic and accident records above international norm. The Bank's finance to port infrastructure and shipping companies is helping in implementation of IMO (United Nations International Maritime Organization) environmental and safety standards such as the MARPOL and SOLAS Conventions on pollution prevention and worker health and safety.

In the agribusiness sector the key focus was on food processing, storage facilities, glass containers/bottles production and facilitating trade in a range of commodities. Within the food processing sector the Bank is involved, for example, in brewing, meat processing, mineral water, and confectionary. Although the Bank rarely engages in the direct financing of primary agriculture, Bank-financed food processing projects have a positive upstream effect as the processors are in need of quality inputs to ensure the quality of their products. Many of the processors operate assistance programmes to help farmers improve the way in which they farm and to improve the quality of produce. With regard to grain trading the Bank is providing financing to assist both primary producers and grain traders through the provision of working capital facilities. This is of particular importance to farmers as it gives them the access to capital required to improve their production techniques and efficiency. There is also a great potential here for sustainability initiatives related to supply chain.

In the property development sector, retail centre, warehouse, hotel and housing development has been pursued in which planning permits, traffic impacts, public consultation, resettlement and economic displacement, grievance mechanism and construction worker issues have been addressed through the environmental and social due diligence process. Legal protection of immigrant workers and health and safety of construction workers, in general, are specific issues of the property sector in Russia, and the relevant action points are included in the action plans for each property project to meet the Bank's requirements in a reasonable time frame.

As a matter of priority, the Bank has continued to support improvement of municipal environmental services through a number of projects involving rehabilitation of water, wastewater and/or waste management facilities, as well as district heating. Along with the actual infrastructure improvements, the Bank is supporting institutional strengthening and improvements in management of the utility companies to further improve their operational sustainability. In the new projects involving concessions and acquisitions of water and wastewater companies, the Bank requires the use of specific Environmental Guidelines, mirroring its own due diligence procedures. Several projects in this sector are supporting the objectives of the Northern Dimension initiative and have received funding from the NDEP. For example, the financing structure of the St Petersburg Neva Closure of Direct Discharges ("the Neva Program") includes EBRD loan and NDEP grant components which, when completed, will help the city to achieve compliance with HELCOM commitments and deliver significant environmental benefits for the Gulf of Finland and the Baltic Sea region as a whole.

The NDEP provides a unique way of combining donor funding with the expertise of the international financial institutions responsible for project implementation to deliver vital environmental benefits. NDEP has been recognised and replicated as a good model for other partnerships based on international cooperation, and at present the NDEP Fund is set to run till the end of 2017.

The EBRD has played a key role in establishing the Northern Dimension Environmental Partnership (NDEP), which offers an innovative approach to solving some of the most pressing environmental problems in the Northern Dimension Area, north-west Russia in particular. Within the NDEP framework, the Bank has been cooperating with other International Financial Institutions such as the Nordic Investment Bank (NIB), the European Investment Bank (EIB), Nordic Environmental Finance Corporation (NEFCO) and the World Bank (WB), with the donor community and the Russian government in order to mobilise financial resources to address longstanding environmental problems in areas such as wastewater treatment, municipal and agricultural solid waste management, district heating and handling of the nuclear waste.

The NDEP Support Fund is managed by the EBRD under the supervision of the Assembly of Contributors. At the end of 2009, contributions to the Fund reached EUR 277 million with funding pledged (in volume order) from: the European Community, Russia, France, Canada, Germany, Sweden, Finland, UK, Denmark, Norway, Netherlands, Belarus and Belgium. Roughly half of the funds have been assigned for nuclear safety activities, while the remaining EUR 127.4 million are for environmental infrastructure investments.

By the end of 2009 the Assembly of Contributors allocated EUR 88 million in grant funding for 16 environmental projects in the north west of Russia. This has helped to leverage over EUR 3.2 billion in investment capital including EUR 604 million in IFI lending. The NDEP grants are intended to complement the IFI loan funding and to leverage local financing. In this way the grants provide an incentive for environmental projects that may not be otherwise financially viable.

Two out of the 16 projects have now been completed, the St Petersburg Southwest Wastewater Treatment Plant in 2005 and the St Petersburg Northern Sludge Incinerator plant in 2008. Other NDEP projects under implementation in Russia include:[7] St Petersburg Flood Protection Barrier (EBRD), Municipal Environmental Investment Programme in Leningrad Oblast (NIB), Komi Syktyvkar Municipal Services (EBRD), Kaliningrad District Heating (EBRD), Archangelsk Municipal Water Services (EBRD), Kaliningrad Water and Environmental Services (EBRD), Kaliningrad PIU (EBRD), Murmansk District Heating (NIB), Novgorod Water and Wastewater Rehabilitation (NIB), Vologda Municipal Water Services (EBRD), St Petersburg Neva Closure of Direct Discharges, or “the St Petersburg Neva Program” (NIB), Sosnovyi Bor Municipal Water and Wastewater Rehabilitation (NEFCO), Petrozavodsk Water and Wastewater Services (NEFCO) and PIU for Poultry Farms in Leningrad Oblast (NEFCO). In 2008 the EBRD decided to support NDEP environmental projects through its Shareholder Special Fund (SSF). The first allocation of EUR 6 million from the EBRD SSF was made in parallel support for the St Petersburg Neva Program.

Regarding the joint EBRD-NDEP strategy for the environmental infrastructure projects in the northern Dimension Area, it is worth pointing out that large municipal investment programmes, especially in wastewater sector, have by and large been completed. To deliver further environmental improvements in the region with cross border effects, the focus needs to remain on a cumulative impact of smaller scale investments. In addition, as a result of NDEP’s close cooperation with HELCOM and the EU initiatives for the Baltic Sea, new area of environmental concern has been identified, i.e. agricultural waste mainly from poultry and other intensive animal farming in the region. NEFCO as one of the NDEP implementing agencies is preparing a project in this sector in Leningrad Oblast to be partly financed by an NDEP grant.

[7] The NDEP lead IFI for each project is shown here in brackets.

The NDEP nuclear window deals with the legacy of the spent nuclear fuel and radioactive waste generated by the Soviet Northern Fleet. For nuclear safety projects, the NDEP grants are designed to fully cover the investment costs. The first task of the nuclear window was to prepare a Strategic Master Plan (SMP) as a comprehensive decommissioning programme delivering a concrete project pipeline. It was concluded in 2007 and supported by an extensive Strategic Environment Assessment commissioned by the EBRD and the first to be conduced in Russia. By the end of 2009, eight grants totalling EUR 95 million have been allocated to various nuclear safety projects in the north-west of Russia, including decommissioning of the Floating Maintenance Base “Lepse”, decommissioning of Building no 5 in Andreeva Bay, construction of transportation system and buffer storage of spent nuclear fuel in Andreeva Bay, unloading of spent nuclear fuel from Papa-class nuclear submarine, creation of safe storage conditions for spent nuclear fuel in Gremikha, enhancement of the radiation monitoring and emergency response systems in Murmansk and Archangelsk regions.

Due to the fact that the municipal infrastructure projects require long time for preparation and implementation, and Kaliningrad projects have been experiencing certain difficulties and delays, it is unlikely that the current projects, such as St Petersburg Neva Program or Kaliningrad Wastewater Treatment Plant, will be completed within the present mandate of NDEP which expires at the end of 2012. Also, the nuclear safety projects face the same situation due to their complex nature and lengthy preparation and implementation schedule. Therefore, the NDEP Assembly of Contributors agreed to extend the NDEP Support Fund by 5 years till 2017.

## ANNEX 5: PIPELINE

| EUR million (as of 30 September 2009) | Cumulative Business Volume | Portfolio | Undrawn Commitments | Operating Assets | Pipeline Stock[1] | Expected Crisis Response in 2009[2] |
|---|---|---|---|---|---|---|
| TOTAL | 12,111.9 | 7,023.6 | 1,432.1 | 5,591.5 | 5,268.9 | 1,750.0 |
| | | | | | | |
| DIRECT | 11,233.8 | 6,442.3 | 1,083.4 | 5,358.9 | 4,732.5 | - |
| REGIONAL | 878.2 | 581.3 | 348.7 | 232.6 | 536.1 | - |
| | | | | | | |
| DEBT | 9,008.0 | 5,130.7 | 953.8 | 4,176.9 | 4,365.8 | 1,530.0 |
| EQUITY | 2,631.4 | 1,767.3 | 352.6 | 1,414.6 | 833.0 | 220.0 |
| GUARANTEE | 472.5 | 125.7 | 125.7 | 0.0 | 69.7 | - |
| | | | | | | |
| PRIVATE | 10,101.2 | 5,621.4 | 1,171.0 | 4,450.3 | 4552.2 | 1,370.0 |
| STATE | 2,010.7 | 1,402.3 | 261.1 | 1,141.2 | 716.4 | 380.0 |
| | | | | | | |
| NON-SOVEREIGN | 11,292.0 | 6,643.6 | 1,411.8 | 5,231.8 | 5268.9 | 1,750.0 |
| SOVEREIGN | 820.0 | 380.1 | 20.3 | 359.8 | 0.0 | - |
| | | | | | | |
| CORPORATE | 4,244.5 | 2,291.2 | 534.0 | 1,757.1 | 2,128.0 | 470.0 |
| ENERGY | 1,984.0 | 1,096.2 | 138.2 | 958.0 | 808.9 | 210.0 |
| FINANCIAL INSTITUTIONS | 3,601.5 | 1,918.2 | 418.5 | 1,499.7 | 1,321.8 | 610.0 |
| INFRASTRUCTURE | 2,282.0 | 1,718.0 | 341.3 | 1,376.7 | 1,009.9 | 460.0 |
| | | | | | | |

[1] As at end October 2009
[2] Excludes TFP activity

## Pipeline stock volume by Industry in Russia as at end October 2009

| EUR million | | Concept Reviewed | Passed Structure Review | Passed Final Review | Board Approved | Total Pipeline |
|---|---|---|---|---|---|---|
| POWER &ENERGY | Power and Energy | 530 | | | 136 | 666 |
| NATURAL RESOURCES | Natural Resources | 95 | 37 | | 11 | 143 |
| | Municipal & Env Inf | 325 | | | 34 | 359 |
| | Transport | 569 | 41 | 41 | | 650 |
| INFRASTRUCTURE | TOTAL | 894 | 41 | 41 | 34 | 1,010 |
| | Agribusiness | 182 | 20 | 27 | 44 | 274 |
| | Property and Tourism | 233 | | | 39 | 272 |
| | Telecoms Informatics & Media | 67 | | | 9 | 76 |
| | General Industry | 955 | 8 | | 544 | 1,506 |
| CORPORATE | TOTAL | 1,437 | 28 | 27 | 636 | 2,128 |
| | Bank Equity | 25 | | 25 | 216 | 266 |
| | Bank Lending | 180 | | | 443 | 623 |
| | Non Bank Financial Institutions | 196 | | | 38 | 234 |
| FINANCIAL INSTITUTIONS | TOTAL | 400 | | 25 | 697 | 1,122 |
| | Equity Funds | 24 | | | 25 | 49 |
| | MSME debt finance | | | 6 | 145 | 151 |
| MSME FINANCING | TOTAL | 24 | | 6 | 170 | 200 |
| TOTAL PIPELINE | | 3,380 | 106 | 99 | 1,683 | 5,269 |

## ANNEX 6: SUSTAINABLE ENERGY AND ENERGY EFFICIENCY AS KEY TO ECONOMIC GROWTH AND TRANSITION

Energy efficiency is among the most acute issues facing the European Union, Russia and many EBRD countries of operations and has important linkages to energy security and climate change mitigation. This annex provides a detailed overview of energy efficiency activities in Russia during the course of the strategy, and outlines how these will be increasingly integrated with banking operations. The annex also outlines how the expertise of the Bank gained in energy efficiency operations and renewable energy during Phase 1 of the Sustainable Energy Initiative may be applied in Russia to overcome the existing barriers to the implementation of energy efficiency projects and renewable energy.

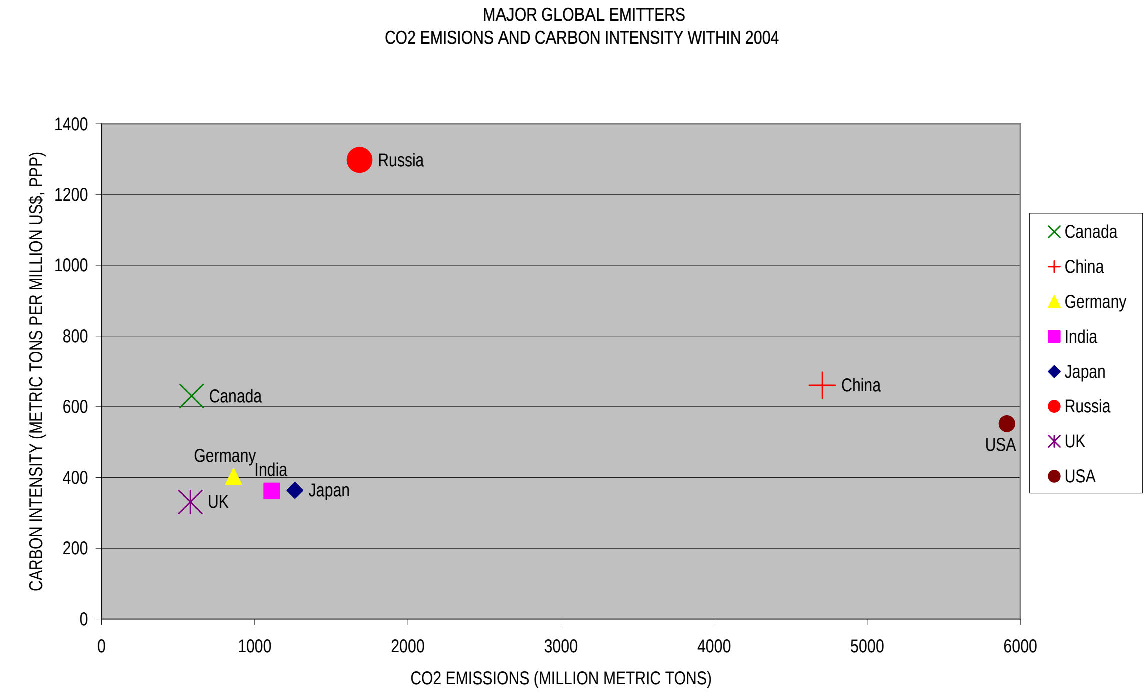
Russia is an important country in global energy terms. It possesses vast energy resources and is the third largest energy producer in the world, the largest energy exporter, and the third largest energy consumer. Russia also plays an important role in the negotiations for the successor to the Kyoto Protocol. Russia's GHG emissions were 2.1 billion tCO2e in 2004, and it ranked as third emitter in the world after the US and China, accounting for 4.3 per cent of global emissions.

**Context and opportunities**

Energy intensity in Russia is very high by international standards, and despite improvements in recent years remains the highest in the G8 economies. Recent studies estimated Russia could save 35-40 per cent of its current annual energy consumption through improved efficiency.[8] The following chart provides the total emissions and energy intensity, measured by carbon emissions per unit of GDP of Russia and other major global emitters. This chart shows that Russia is among the eight major global emitters but has the highest energy intensity; something that offers a serious opportunity for improvement.[9]

[8] World Bank Group report "Energy Efficiency in Russia: Untapped Reserves," 2008

[9] IEA, 2006




The benefits of increasing energy efficiency in Russia can be summed up as follows:

- Timely investments into energy efficiency will soften the adverse impact of future energy tariff increases and will help **sustain the competitiveness** of Russian industry. According to the Russian Energy Strategy, domestic gas and electricity prices are to become liberalised by 2011, and higher prices will erode the competitiveness of the Russian industry.

- Rapid economic growth observed in Russia before 2008 (when growth dynamics became affected by the global financial crisis) has led to the growth in energy demand outstripping supply, which may constrain future **economic growth**.

- Energy efficiency enhances **energy security** by supporting the ability to meet export obligations while satisfying rising domestic demand for energy. Domestically and abroad, gas demand is growing and Russia risks facing a supply/demand shortfall in the future. Saving natural gas domestically will also allow Russia to increase **revenues from exports**. A recent IFC/World Bank report estimated that **Russia could earn an additional USD 84 - 112 billion in export revenues** every year by reaching its technical energy efficiency potential.

- Similarly, Russia is under pressure to **invest heavily in new power generation** capacity (and modernisation of existing assets) and the development of **new gas deposits** to meet the growing domestic and foreign demand for energy. Energy efficiency can offset a significant part of the need for costly new infrastructure.

- Energy efficiency **improves welfare** by lowering energy expenses of municipalities and energy bills of households, and by creating more comfortable living conditions.

- Addressing energy efficiency could result in **additional revenue** from the sale of associated GHG reductions under the Kyoto protocol, e.g. by gas flaring reduction.

Whilst Russia may be concerned about emission caps limiting its growth post 2012, moving more broadly towards a low-carbon growth model would mitigate this risk and enable its industry to compete with foreign companies working to higher standards for emissions and energy efficiency.

- As a major global energy producer and consumer, Russia can significantly contribute to **climate change mitigation**.

This overview establishes the context for the EBRD's future operations, whereby sustainable energy becomes a key priority building on the set of competencies established by the Bank to support Russia in its drive to address the challenge of supporting transition by enhancing and promoting energy efficiency. The Bank's expertise and track record in the area of sustainable energy investments in Russia to date, as well as the plans for scaling-up activities in this priority area in the next strategy period are outlined below.

**Russia SEI Phase 1 Track Record and Results**

Considering the size, importance and potential contribution of Russia in terms of addressing the challenges of energy efficiency, energy security and climate change in the EBRD region, particular attention and support has already been provided to Russia during Phase 1 of the SEI. The Bank intends to extend this support through Phase 22 of the SEI covering the period 2009-11.

During SEI Phase 1, the EBRD has been successful in mainstreaming sustainable energy investments in Russia across SEI areas and banking operations, as described below:

| | No. of operations | Signed SEI, EBRD (EUR M)[10] | Signed SEI as % of total | Total Project Value (EUR M) |
|---|---|---|---|---|
| SEI 1 – Industrial Energy Efficiency | 15 | 284 | 38 | 2,277 |
| SEI 2 – SEFFs[11] | 1 | 3.5 | 0.5 | 28 |
| SEI 3 – Power and Natural Resources Sectors | 5 | 227 | 30 | 465 |
| SEI 4 – Renewable energy | 1 | 66 | 9 | 588 |
| SEI 5 – Municipal Infrastructure Energy Efficiency | 15 | 175 | 23 | 352 |
| **Total** | **37** | **755** | **100** | **3,710** |

More specifically, the Bank has been active in promoting and scaling up sustainable energy investments in key sectors forming the backbone of the Russian economy:

| Sector | No. of operations | Signed SEI, EBRD (EUR M) | Signed SEI as % of total | Total Project Value (EUR M) | Type of projects financed |
|---|---|---|---|---|---|
| Agribusiness | 3 | 5.6 | 0.7 | 360.1 | Food processing; beverage bottle manufacturing |
| Bank Lending | 1 | 3.5 | 0.5 | 27.8 | Energy efficiency credit lines for Small and Medium Enterprises |

[10] EBRD share of financing, excluding syndication with commercial banks and own funds from a project sponsor.
[11] Sustainable Energy Financing Facilities: dedicated credit lines through the local banking sector

| | | | | | |
|---|---|---|---|---|---|
| General Industry | 6 | 196.5 | 26.0 | 1091.2 | Cement, wood and paper products; primary steel production; steel products; transport machine building |
| Municipal Infrastructure | 15 | 174.5 | 23.1 | 351.8 | Municipal services; urban transport; solid waste; water and sewage; urban housing; district heating |
| Natural Resources | 3 | 62.3 | 8.3 | 299.9 | Oil and gas extraction; support activities for oil & gas operations |
| Power and Energy | 2 | 165.0 | 21.8 | 165.5 | Power generation |
| Renewable energy | 1 | 66.3 | 8.8 | 587.9 | Large-scale hydro power |
| Property and Tourism | 1 | 0.6 | 0.1 | 54.5 | Commercial real estate |
| Transport | 5 | 80.9 | 10.7 | 771.3 | Rail transportation |
| TOTAL | 37 | 755.2 | 100 | 3,710 | |

Over the SEI Phase 1 period the Bank has been successful in developing reference projects in each of the above sectors, such as the landmark €600 million loan to the leading Russian steelmaker Severstal in 2007/2008 to finance the company's €700 million strategic energy efficiency programme; the USD 85 million equity stake in Irkutsk Oil in 2008, supporting projects to reduce associated gas flaring through re-injection and downstream processing; a pilot USD 10 million credit to the Russian Centre-Invest bank in 2007 to promote energy efficiency lending in southern Russia; as well as a number of power sector and municipal infrastructure energy efficiency projects. These project development activities were driven or supported by the Bank's energy audit program and related technical assistance to identify, structure, and incorporate sustainable energy investments. This support was critical to the development of new SEI themes and initiatives, such as the pilot project on public building energy efficiency projects under development in one of the Russian regions.

The above results and track record provide for a solid foundation on which to build the Bank's operations in Russia in the next medium-term strategy period. Energy efficiency will continue to be among the key transition challenges and priorities for the Russian Federation going forward.

**Barriers.** The ability of the Bank to put sustainable energy finance on the agenda in Russia will be influenced by the economic crisis and, as with other activities, will depend on the availability of sufficient donor-funds, and overcoming specific barriers. The issues outlined below represent existing barriers to the improvement of energy efficiency in Russia in the short term, and will have to be addressed by a mix of policy reforms, including the introduction of innovative finance mechanisms, public awareness campaigns and tariff adjustments.

**Tariff policy.** Domestic energy tariffs still do not reflect the costs of energy production, and are based on significant cross-subsidies from energy exports. For example, domestic gas prices in Russia were only around 15-20 per cent of the rate at which Russia's gas was sold to Germany in 2006; consequently not creating adequate financial incentives for resource efficiency in energy usage. On the energy demand side, low energy tariffs stand in the way of rational energy use at company and household level, as well as profitable investments into energy efficiency. On the energy supply side, low tariffs, and the caps imposed on tariff increases, do not allow for an adequate return on investments into energy efficiency and restricts cash-flow for investments. Low prices have impacted the energy industry's ability to finance capital spending and have hurt incentives to increase efficiency. Raising domestic gas prices towards parity with rates in Europe is now a major component of Russia's energy strategy and will play a significant role in avoiding supply shortfalls in the future. Planned increases in gas and electricity prices are listed in the table below.

| **Domestic Natural Gas and Electricity Price Increases (2008 - 2011)** | | | | | |
|---|---|---|---|---|---|
| | Annual Percentage Change | | | | |
| Year | 2008 | 2009 | 2010 | 2011 | Total |
| **Natural Gas** | Actual | Planned | | | |
| Wholesale Market | 28.6 | 19.9 | 28 | 40 | 176% |
| Regulated Prices | 25 | 20.3 | 28 | | 92% |
| For Households | 25 | 25 | 30 | 40 | 184% |
| For all others | 25 | 19.6 | 27.7 | | 91% |
| **Electricity** | | | | | |
| For Households | 14 | 25 | 25 | 25 | 123% |
| For all others | 16.7 | 26 | 22 | 18 | 112% |

Source: IEA

The prevailing **policy and regulatory framework** does not align incentives or create opportunities to improve efficiency across all sectors and stakeholders. There is a need for a coherent policy and institutional framework to promote and support energy efficiency in Russia. On the supply side, tariffs of utility and power generation companies are set on a short-term "cost plus" basis and may be reduced if the cost base is improved, not allowing energy efficiency investments to be recovered. Existing regulations on heat supply do not incorporate energy efficiency benchmarks and requirements to be met by the municipal and privately operating heat suppliers. On the demand side, residents pay utility bills according to norms as opposed to metered consumption and therefore have no incentive to improve efficiency. Existing technical standards are missing items such as comprehensive energy efficiency requirements and benchmarks which could allow to check projects submitted under permit procedures. Regulation regarding energy performance assessment of buildings, energy certification and inspection of building services is missing. Housing codes do not specify responsibility for the operation and maintenance of buildings and in common areas of multi-apartment blocks. There are also no streamlined procedures for the establishment, registration and decision making of associations of apartment owners. Legal empowerment of these associations is weak. Additionally, budget holders in the public sector are not able to retain budgetary funds saved through the implementation of energy efficiency measures. The liberalisation of energy tariffs alone is unlikely to be sufficient to stimulate energy efficiency without these issues being addressed.

**Carbon finance.** Russia has put into place a regulatory framework for Joint-Implementation (JI). The operational processes and realisation of additional revenues are stalling as no JI projects have been approved by the Government to date. In addition Russia has no regulatory framework in place which could enable it to engage in the emerging market for Green Investment Schemes (GIS). As a consequence, Russia may forego an estimated €1 to 2 billion in JI-related revenues. Furthermore, diminishing market confidence may hamper Russia's ability to begin engaging in GIS, as purchasers do not see a disciplined greening route that ensures the environmental integrity of their actions in meeting Kyoto compliance targets.

**Information and awareness.** The lack of metering at both the supply and demand side does not allow for proper assessment of the patterns of energy use, as well as recognition of the potential for profitable energy saving measures. The long history of cheap energy prices results in wasteful energy utilisation practices and low awareness and appreciation of energy efficiency issues at both private individual and company level. Poor energy management cultures at the company level (as reflected in the lack of prioritisation of energy saving measures, or the lack of departments and programs focused on energy saving) leads to profitable energy saving measures and investments being overlooked or not implemented. There is also little appreciation and utilisation of best practices and best-available energy efficient equipment and technologies by end-users, as well as at the level of primary engineering and design of industrial plants, residential and public buildings, etc.

**Financing.** Russian companies (especially in the SME sector) lack access to long-term funding to match the paybacks of energy efficiency projects (which, even at current tariff levels, can be as short as 1 year but can also reach 5 years and beyond). The current financial crisis exacerbates credit constraints for SMEs and extends the difficulties in access to finance to larger companies as well. More importantly, some actors such as municipally-owned entities (schools, kindergartens) do not have access to private financing and require dedicated financing and implementation mechanisms to be developed.

**State ownership and competition.** Low levels of private sector involvement and competition prevailing in the infrastructure and utility sectors result in decreased operational and energy efficiency. Increasing competition and private sector participation would support energy efficiency in these sectors, which form the backbone of the economy and have a major impact on the country's energy balance.

**Environmental and climate change agenda.** On both the citizen and corporate level there is poor awareness of the issues of climate change and environmental footprints, which commonly serve as major drivers for enhanced energy efficiency. There is no formal system in place to price the negative footprint of energy use (e.g. a system of direct carbon taxation) or to reward reducing usage (e.g. through the system of carbon trading schemes). At the same time, the share of economic actors who voluntarily rationalise energy consumption in order to reduce their environmental footprint is still low in Russia.

**Availability of donor funds.** In order to overcome these obstacles, there is a need to create an enabling and motivating environment for sustainable energy investments. This requires targeted grant funding for technical assistance and possibly incentives. In 2008, the share of donor-fund commitments supporting sustainable energy work in Russia, out of total donor funds supporting Bank SEI activities, was 14 per cent. This is equal to the share of the early transition countries (ETCs). However, Russia accounts for 49 per cent of $CO_2$ emissions in the Bank's region, compared to 7 per cent for the ETCs. The ability to conduct targeted work to overcome barriers and assist in unlocking this emission reduction potential is linked to mobilising funding so that the Bank can follow up on many of the opportunities in Russia. In order to be able to make energy efficiency a central element of the Bank's strategy in Russia, additional donor funds will be required, and this need would be increased significantly with the opening of new business areas which, in the short-term, may require grant elements to realise their potential; (this may be the case even in the long-term for tackling sustainable energy investments in residential buildings).

**Proposed EBRD activities**

The Bank will combine its experience from SEI Phase 1, sectoral expertise and client relationship management activities to influence to the fullest extent possible the linking of EBRD financing in Russia to energy efficiency, while scaling up the development of dedicated support mechanisms for sustainable energy investments in the country to address the barriers for sustainable energy investments described above. This will be done by applying the Bank's experience in this sector, leveraged with contracted technical resources to: (i) support clients in being fully informed when making investment decisions; and (ii) define and create an enabling environment for investments to flourish. These interventions will take place across all sectors of the Russian economy as outlined below.

**Industrial and Corporate Sector Energy Efficiency**

For the period of the strategy the Bank will expand the provision of energy efficiency support to its corporate sector clients, and make this support an integral part of its corporate sector lending operations and client relationships. Energy intensive companies meeting normal credit criteria will continue to be targeted for potential EBRD support and the energy audit and energy management training programme will continue to be made available to Bank clients as broadly as possible to capitalise on and replicate the past successful track record in developing reference projects in energy intensive industries, such as the €600 million EBRD loan to Russian steelmaker Severstal.

As part of its lending to the corporate sector, EBRD already works with Russian industrial energy users (in steel, chemicals, agribusiness and other sectors) to promote best practice and encourage companies to implement energy efficiency projects. This is done by screening all existing and potential projects to identify opportunities for energy savings and providing energy audits through TC assignments and energy management training to unlock savings potential. The aim of such assistance is to identify opportunities for energy saving, prioritise and select the most profitable projects and incorporate those in whatever financing EBRD is considering for the client. Within this approach, even smaller projects can be efficiently incorporated into a larger investment programme. Where feasible the Bank also supports sustainable energy transactions by carbon finance mechanisms.

Dedicated marketing efforts to identify sectors and regions where energy efficiency can be a value driver in defining the use of EBRD funding will be conducted. EBRD will also increasingly target less energy intensive sectors, including focused project development activity in specialised industries (such as Agribusiness, Property, Telecom). Origination of such transactions will be supported with the energy audit facility, which has proved its effectiveness in helping to identify and incorporate SEI components across a range of projects financed by the Bank.

Existing client relationships will be targeted to identify ways in which they can improve their resource efficiency. The SEI investment experience will be part of the marketing pitch to present the Bank's track record in this regard and the underlying results achieved. Additionally, energy efficiency investments will be prioritised in the context of recapitalisation projects, by incorporating energy efficiency components, and by promoting the implementation of energy management systems to help clients measure and control their energy costs for planning and future operations.

The EBRD will deepen the scope of its intervention and underlying support to promote sustainable energy investments in the Russian industry as well as in the corporate sector in general. Going beyond energy audits, the Bank would also seek to assess and promote the implementation of Best Available Techniques (BAT) – equipment, engineering and operational management practices – leading to a more optimal energy utilisation in the corporate sector (including within greenfield projects). The Bank will increasingly utilise Energy Efficiency Action Plans (EEAP)[12] as a means to influence or develop a systematic and long-term approach to sustainable energy and carbon footprinting on a corporate level, especially within diversified holdings (whereby a sponsor may commit to implement EEAPs at its subsidiaries). Energy management training and energy management systems implementation support will be provided to support this. The Bank will also look for new financing and implementation vehicles for energy efficiency such as through third-party energy outsourcing and energy service companies, especially when engaging companies with state ownership.

During the period of the strategy, the Bank will further deepen the reach of the successful SEFF model in the industrial sector, and begin to implement a new, technology-driven approach to industrial energy efficiency with a view to increasing market penetration of materials and equipment with appropriate energy performance characteristics, which will also meet the particular need of SMEs in financing their energy efficiency investments.

**Clean Energy Production**

According to a recent World Bank Group report[13], Russia will have to invest USD 106 billion to improve the efficiency of fossil-fuel thermal power plants. Most of the potential can be captured by upgrading the current gas-fired condensing power plants and combined heat and power plants with the introduction of modern CCGT units, while the introduction of new units of super-critical steam parameters and the rehabilitation of selected coal fired plants also offers considerable opportunities.

Through its clean energy technical assistance programme the Bank will provide generating companies with support to assess and analyse the full range of technology options and highlight the benefits of advanced technologies with greater efficiency and a lower carbon footprint. A particular focus will be on the generating companies where EBRD holds an ownership stake, with the intent to make these companies market-leaders in terms of efficiency and competitiveness. Energy audits and technical assistance will continue to be key tools in addressing this sector, and carbon finance is expected to become available to further increase support over the course of this strategy. The Bank will also work with power companies on the introduction of EEAPs (with an emphasis on carbon footprint mitigation) at the corporate level and to promote Demand-Side Management (DSM) and least-cost planning programmes to utilise end-use energy efficiency to tackle capacity shortages and ensure cost-effective investment. Beyond this, the Bank will put increased emphasis on distributed generation, to ensure that the growing demand for electricity in Russia is met in the most efficient manner possible. This will be reinforced by close co-operation of power sector operations with municipal and industrial projects.

12 An EEAP can include specific investments to reduce energy intensity as well as a definition of energy efficiency policies and guidelines and / or a list of actions focused at improvement of energy management practices (e.g. setting up of organisational units dealing with energy efficiency, introduction of energy management system, benchmarking and targeting tools, etc).

13 World Bank Group report "Energy Efficiency in Russia: Untapped Reserves," 2008

**Sustainable Energy Financing Facilities (SEFF)**

Development of dedicated financing and implementation vehicles is critical to the promotion of energy efficiency in Russia. Through its Sustainable Energy Financing Facilities (SEFFs) the Bank aims to extend its support for improving energy efficiency to smaller companies or for smaller projects which can not be directly financed by the Bank. This is achieved through wholesale credit facilities with participating commercial banks for on-lending to their clients for energy efficiency projects. SEFFs are supported by a technical assistance programme to raise awareness about energy efficiency matters, assist clients to identify and assess potential projects through audits, and to assist participating banks in marketing the facility, as well as appraising and financing energy efficiency projects.

In Russia the Bank aims to launch a new USD 300 million framework of Russian Sustainable Energy and Carbon Finance Facility (RSECF) in 2009 with initial financing of USD 130 million through two banks targeted at larger industrial companies. The objective of developing sustainable energy investments in businesses and using financial intermediation as a route to market for such investments is novel for Russia. Whilst the SEFF model is successful in other countries, it will be important in Russia to show results with these first transactions to enable the expansion of the facility to other Participating Banks. The replication of the SEFF model on a wide scale by other commercial and possibly state-owned banks will further contribute to the promotion of energy efficiency lending and investments in Russia.

Subsequently, the intent over the course of this strategy is to broaden the model by targeting residential consumers, a wider range of industrial clients (including SME's) and trialling new approaches, such as technology-driven lending to increase the uptake of targeted equipment. For example, as regulations and incentive systems become further developed in Russia, the scope of SEFF can be broadened to support other sectors and priority areas, for instance, by launching vendor finance schemes supporting the uptake of industrial equipment meeting high standards of efficiency (based on efficiency standards which are yet to be developed in Russia), by supporting individual consumers purchasing high efficiency consumer appliances (with high efficiency labels), or by supporting households or housing associations undertaking energy efficiency retrofits in individual apartments or common areas in multi-apartment buildings (once relevant regulations for housing associations become effective). Residential energy efficiency programs are already being successfully deployed by the Bank in other countries of operations.

These facilities could also become an effective mechanism for channelling grant resources (potentially including Russian federal grants) to support the development of energy efficiency projects by providing additional funding for technical assistance or incentives schemes provided to sub-borrowers under the framework (including possibly through state-owned banks which could participate in the EBRD framework). For example, in order to overcome affordability constraints, in particular in the residential sector, performance-based incentives to end-borrowers are likely to be required to ensure uptake and intermediary interest. The length for which these incentives are required will depend on the sub-sector, with the residential sector likely to require such support for the long term, while other sectors, such as renewables, maybe able to operate without incentives beyond technical assistance after a relatively short start-up period. The residential sector is highly fragmented and non-homogeneous from institutional and social point of view. This in addition to lack of proper regulatory makes access to financing difficult for the sector. Market imperfections in terms of low penetration rates of high performance technology, low capacity of local design and engineering services, market immaturity, show the necessity for intensive technical assistance and high rates of incentives. A common practice of developed economies is to provide intensive incentives for residential energy efficiency, taking into account the barriers to investment such as myopic payback horizons, lack of information, inability to access the full benefits of the investment, and also the immense environmental and social benefits from these long life investments. Conditions in Russia with a number of serious additional barriers increase the need for both end-borrower incentives and technical assistance. Where incentives are required, these will be linked to performance, and the Bank will utilise policy-dialogue to, over time, remove or at least lower the barriers that necessitate the incentives.

**Renewables**

EBRD will continue to seek economically viable renewable energy projects such as the refurbishment of older hydro power stations, and support these with financing and technical assistance. Furthermore, through the course of the strategy the Bank will work to facilitate the establishment of a regulatory framework that will enable the development of a market for new renewable energy, such as wind, in Russia. Renewable energy opportunities will also be considered in other areas, such as waste management, water treatment, and municipal heating.

**Buildings**

Despite the large proportion of Russia's energy balance accounted for by buildings, and the substantial potential for improving efficiency, very little private sector finance has been utilised to improve energy efficiency in buildings, while public financing for this purposes is limited. Although the structural issues limiting progress on energy efficiency in the buildings are complex and will take time to resolve, the Bank is focusing on the development of financing mechanisms which can be applied now.

Over the course of this strategy, additional finance vehicles will be explored, which could include financing to private third-party companies implementing energy efficiency projects in public buildings under energy performance contracts. Similar dedicated mechanisms can be effectively deployed in the residential and municipal sector, as well as when engaging with state-owned entities, subject to sufficient budget funding being available for payments under energy performance contracts. During the course of this strategy, the Bank will first pilot, and then attempt to roll out such an approach in Russia, supported with policy dialogue and technical assistance, and funded by the Global Environment Facility (GEF).

Practical implementation of energy efficiency measures in buildings would be strengthened by developing an appropriate regulatory framework enabling energy performance contracting. This would include performance-based energy efficiency standards for buildings, technical rules, ordinances and directives from relevant authorities (such as Ministries, Regional Governments, State Agencies on Construction) as well as primary legislative acts issued by Federal Government and Regional Governments.

**Public Buildings**

In public buildings, where access to funding by municipalities is very limited, the Bank is supporting the development of commercial structures that will enable private service companies to finance energy efficiency improvements where re-payment is supported with future energy savings. Traditional financing approaches are not always adequate in this complex area, while the development of new commercial structures will require existing budget practices to be modified in order to incentivise energy savings by ensuring that municipal budgets are not cut in reflection of lower energy expenditure; bearing in mind that the primary source of repayment will always be the underlying municipal budget.

While the involvement of private service companies may be difficult in the absence of an enabling regulatory framework for energy performance contracting, an intermediary step may be required whereby the Bank will work through corporate municipal service companies. This will allow testing the approach and developing model contractual structures, and will enable private sector involvement in the future once the model is proven effective. The Bank has important experience in these sectors and is exploring ways to provide financing for public buildings, for example through ESCOs or a combination of direct municipal lending and technical assistance.

In the first instance, an energy service contract is being piloted by the EBRD in one of the Russian regions. Such an approach can potentially offer municipalities the possibility to substantially accelerate their investment programmes for improvements in public buildings without creating additional burdens on public sector budgets. Against the background of continued increases in energy prices this will have substantial fiscal benefits as well as the possibility to improve conditions in essential public service buildings such as schools, hospitals and kindergartens. The Bank’s activity in public building energy efficiency is supported by a technical assistance project launched in 2008 with a €7 million grant funding from the GEF to analyse the existing regulations and develop appropriate contracting structure for the ESCO model in Russia. This will support the replication of the concept in Russian regions and scale up of the Bank’s operations in public buildings energy efficiency during the strategy period.

**Residential Housing**

In the residential sector, in the short term, the application of the SEFF model based on a simplified eligible list of material and equipments for demand side energy efficiency by individual households will be pursued with marketing of such approach to commence during the period of this strategy.  In parallel, and for the longer term, models for working with collectives or managing agents (including housing management companies) to enable lending for communal projects to improve energy efficiency in apartment buildings will be pursued. This will depend on legislation being passed which would enable the creation of legally registered associations of apartment owners, with sufficient reinforcement of their legal liability and full responsibility over all building properties including the land and common areas. This model works well in markets where there is a legislative framework for collectives to function, make investment decisions and fund reserves for maintenance and investment. The Bank will, over the course of this strategy, support the development of housing codes which cover this area, transferring the positive experience from other eastern European countries like Slovakia, Poland, Estonia where commercial financing is effectively combined with state support apartment building refurbishment. Until these reforms take place, the Bank will attempt to introduce intermediate finance facilities to enable refurbishment of apartment-specific items, such as windows.

An important element of developing demand side efficiency in buildings will be to engage with municipalities and district heating companies to organise metering and billing arrangements for heat consumption.

**Municipal Infrastructure**

The Bank has developed a strong track record and pipeline of lending operations in Russia focused on the refurbishment of municipal infrastructure, which by their very nature, are investments that improve efficiency and lead to substantial energy savings. Over the course of the strategy, the Bank will continue to prioritise and support energy efficiency projects in district heating, water and heat supply, waste treatment, urban transport and other areas. The scaling-up of operations will be subject to some of the existing constraints being alleviated, such as the high cost of local currency financing in the current economic environment coupled with the inability of municipalities to borrow in hard currency which comes at more affordable rates. However, the Bank will seek to capitalise on the emergence of private utility companies which do not face the above constraints.

Municipal sector operations will be enhanced with technical assistance to assess additional sustainable energy interventions and integrate supply and demand planning where feasible. This may be pursued by leveraging municipal relationships and providing technical assistance to help municipalities and private operators in the municipal sector consider all options for financing of projects, including the Bank energy audit facility for power generation to optimise supply arrangements including CHP, biomass and other renewables potential, as well as waste-to-energy opportunities. The Bank would also seek to influence the development of a systematic approach towards energy efficiency on the municipal level including through working with regional authorities on the assessment of hot-spots for enhanced energy efficiency and development of regional energy efficiency programs.

**Transport**

In the urban transport sector the Bank will continue focusing on modernisation and expansion of transport infrastructure together with traffic management and integrated transport solutions. However, the Bank’s increased involvement in this sector will be subject to the progress with the development of supportive regulatory policy in the urban transport sector in Russia (e.g. ensuring the ability for urban transport companies to secure long-term contracts for servicing transport routes).

The key opportunity for investment during the course of this strategy outside urban transport is for reducing energy demand in railway transportation, which is a significant share of total demand in the Russian transport sector. The Bank will promote projects aiming to reduce the use of diesel through increased electrification of the network, thereby reducing emissions of all kinds and improving local air quality. It will furthermore aim to reduce the specific use of electricity which will have positive effects throughout the energy supply chain by supporting e.g. rolling-stock renewal, or the refurbishment of railway power supply systems. The Bank will also engage closely with the railway operators to introduce best practice in terms of energy management, and to target horizontal energy efficiency opportunities such as those associated with optimisation of space heating solutions for stations and service buildings which represent a significant share of final energy use in the industry. The piloting of Strategic Energy Management Action Plans will be pursued in order to introduce such practices.

The Bank will also seek to apply the recently developed methodology to assess the impact of the Bank’s investment activities in the Transport sector on energy use and related GHG emissions. Opportunities for SEI components within transport infrastructure projects, such as airports, ports, or warehouses, will also be explored, including through the use of energy audits and other technical assistance.

**Natural Resources**

The Bank will prioritise projects that reduce the environmental impact of oil and gas exploration and production by increasing efficiency and improving management practice; transport, by reducing methane venting; and processing by improving energy efficiency in refining operations. Dedicated marketing and support for the utilisation of associated gas to promote gas flaring reduction projects will be among the key priorities in the oil and gas sector. Companies servicing the oil and gas sector will also be covered under the above activities, building on the Bank's successful project with the Integra oil service group in Russia, whereby the EBRD energy audit allowed to identify profitable energy saving investments at the company's manufacturing facilities producing oil service equipment.

The Bank will explore sustainable energy opportunities in the mining sector by leveraging TC-funded energy audits, feasibility studies and equipment Life Cycle Assessment tools to identify and review opportunities for improved efficiency and reduced energy use along the supply chain (e.g. by replacing conveyor equipment or assessing opportunities for on-site heat and power generation through the utilisation of coal-bed methane or renewable energy sources in the coal mining sector). The introduction of best-practice techniques will also be promoted, such as the use of advanced coal treatment technologies to produce "clean" coal for power generation. Energy audits and technical assistance will continue to be key tools in addressing sustainable energy in the natural resources sector, while carbon finance is expected to play a significant role over the course of the strategy.

There is a vast potential for enhanced energy efficiency at the level of state-owned energy sector majors which form the backbone of the Russian economy and which themselves are major energy users. The Bank will seek to engage with these companies directly or through intermediaries (such as energy service or leasing companies). The Bank will also seek to build a dialogue with natural resources majors around the implementation of EEAPs at corporate level or development of DSM programs at the end-user level. This activity will contribute to the establishment of "energy efficiency champions" in Russia, which can have significant demonstration impact on the private sector.

**Carbon Finance**

Russia's commitment to and participation in carbon finance schemes under the Kyoto Protocol is crucial considering the country's scale and importance in terms of energy production and consumption and therefore its contribution to the global efforts to address the challenges of climate change, energy efficiency and energy security. Carbon finance can also serve as an effective mechanism to stimulate investments into energy efficiency: Russian companies have a vast potential for improving energy efficiency and monetising the associated carbon emission reductions through the Kyoto mechanism. However the awareness of Kyoto mechanisms to potentially generate additional cash streams and improve profitability of energy efficiency projects is low, and so far no JI projects have been approved in Russia.

During the strategy period the Bank will continue to support the development of carbon finance as a means to enhance the profitability of sustainable energy projects, as well as raise the awareness of economic actors about the carbon footprint of their operations. Through the Multilateral Carbon Credit Fund (MCCF) jointly managed by the EBRD and the EIB, the Bank will work with its clients across various sectors to assess the scope of carbon emission reductions resulting from the implementation of sustainable energy investments, as well as provide necessary support in the monetisation of carbon emission reduction units through a carbon transaction where feasible. The RSECF launched in 2009 has a technical assistance component to assist the participating banks and sub-borrowers in capacity building for carbon financing.

According to UNEP, 99 Russian JI projects are currently in the pipeline, expected to generate 200 Mton of carbon credits up to and including 2012. The MCCF currently has an advanced pipeline of 5 potential JI projects in Russia that could generate up to €40 million in revenues for project sponsors from selling carbon credits. In addition, a further 10 projects are being considered by the MCCF that could increase the revenues by a further €80 million. These projects are in industrial energy efficiency, gas flaring reduction and municipal services. The Bank, through the MCCF, will continue to actively promote these projects to become eligible for Russian JI. The JI projects being developed by the Bank are early movers, and many other potential project sponsors are awaiting strong political signals to confirm that JI is a real option, such as the issuance of Letters of Approval by the government.

**Policy Dialogue**

Establishing effective policy, regulations, as well as incentive and support frameworks is key to alleviating the prevailing barriers and promoting energy efficiency in Russia. This will require a coordinated effort on behalf of the Russian Government in terms of developing and adopting effective regulations across a broad range of areas and sectors, and on the part of other actors such as municipalities or regions to establish long-term approaches to sustainable energy use in their jurisdiction.

During the course of SEI Phase 1 the Bank has developed knowledge and expertise which it intends to transfer to Russia as part of its transition mandate to support this process. Policy dialogue during the period covered by this strategy is expected to be targeted directly in support of EBRD activities, and focus on removing particular barriers and supporting sectoral reforms, to enable EBRD financing and technical assistance mechanisms to become available in additional sectors of the Russian economy. This work will be harmonised effectively with the technical assistance and support mechanisms provided through the Bank’s projects and facilities in Russia.

To achieve and support this, EBRD will leverage donor funds to provide technical assistance, capacity and institution building support, or conduct studies in priority areas and sectors. EBRD will seek to harmonise its activities with the budget funds being made available by the Russian Government to support energy saving initiatives, with the aim to leverage those funds with EBRD finance and other sources such as the other IFIs, the European Commission, the Global Environment Facility (GEF).

Particular areas that may benefit from this dialogue are the development of legislation such as for feed-in tariffs to support renewable energy generation; energy efficiency indicators, standards and labels for equipment and buildings; setting targets for improved efficiency in utility companies; introducing systems to measure and assess performance including through metering; developing incentives for energy efficiency including through carbon finance and emissions pricing; developing awareness campaigns and technical assistance; or setting up dedicated support programs and mechanisms.

On the Federal level, EBRD will continue discussions with the relevant government stakeholders to support the adoption and implementation of new energy efficiency legislation in Russia. This could be done in terms of supporting the responsible parties such as relevant ministries or a dedicated energy efficiency agency that can be established as a central vehicle for co-ordinated actions in the development and implementation of concrete regulations and programs to promote sustainable energy. Further support could be made available for work on tariff reform in the power and heat sectors.

On the municipal/regional level, the Bank will engage with authorities to identify local/regional sustainable energy plans, and to co-operate by supporting the development of least-cost supply strategies, and introducing demand-side management practices into the standard supply/demand analysis frameworks of Russian private and municipal energy supply companies.

In the industrial sector, the Bank will support the downstream implementation of the regulatory framework by deploying dedicated financing and technical assistance instruments such as dedicated energy efficiency credit lines for industrial energy efficiency projects. The EBRD has also developed a project proposal and received a concept approval for a USD 16 million grant from the Global Environment Facility (GEF) to support the program for industrial energy efficiency in Russia, including support with the development of energy efficiency standards and labels, energy management certification, incentive systems, training and information campaigns, and possible support for the establishment of a dedicated energy efficiency agency in Russia to coordinate this and other programs.

The Bank will work with the Russian Federation on the development or enhancement of regulatory frameworks enabling the deployment of dedicated financing instruments for energy efficiency in the residential and public buildings sectors. This work will be focused around the implementation of the GEF-funded technical assistance projects described in the respective operational sections, followed by the development of pilot projects to develop public buildings ESCOs or relevant financing structures in the residential sector.

To promote renewable energy use in Russia, the Bank will explore the role that could be played in facilitating the establishment of the necessary regulatory framework for the development of renewable energy market in Russia, which will be a precondition for scaling up the much needed investment in this priority area. It will also consider engaging with regions and cities to encourage the utilisation of biomass resources for heat production, as part of district heating refurbishment projects.

To enable the use of carbon finance, and to support the recent adoption of Kyoto protocol Joint Implementation (JI) procedures by the Ministry of Economic Development of the RF, the Bank will raise awareness of its mainstream investment clients and provide support on the development of Joint Implementation projects and monetisation of associated emission reductions under Kyoto procedures. To enable Russia to benefit from and/or comply with a successor agreement to the Kyoto Protocol, the Bank is willing to enter into a dialogue with Russia on its climate policy for post-2012 and the design of implementing measures, whereby it would share its opinions and expertise, particularly with a view to increase investments in low carbon projects.

EBRD may also support the establishment of a Green Investment Scheme (GIS), which can serve as yet another mechanism to catalyse investment into energy efficiency in Russia. Under GIS, the Bank’s Multilateral Carbon Credits Fund may facilitate the sale of carbon credits between Russia (as a sovereign seller of carbon credits) and sovereign fund participants (EU countries), as well as channel the proceeds from carbon credit sales to support financing mechanisms promoting energy efficiency (e.g. to fund technical assistance as part of the Bank’s energy efficiency credit lines). The Bank is already structuring such a GIS scheme in Poland and will explore the potential for this scheme to be replicated in Russia.

# ANNEX 7: CAPITAL MARKETS' DEVELOPMENT

## EBRD's Funding Experience:

EBRD has issued Rouble bonds in the domestic and international markets. The former have exclusively been floating rate notes linked to MosPrime, whereas the latter have been fixed rate. The difference between the coupon structures for these bonds is a reflection of the protracted issuance process and bureaucratic procedures beleaguering the domestic market, as well as the lack of a satisfactory onshore derivatives' infrastructure. Typically, the maturity for floating rate issuance has been longer than that obtainable either for fixed rate domestic issuance, or for offshore issuance. The limited tenors available in the domestic market denote the lack of a long-term domestic institutional investor base including pension funds, insurance and asset management, with investor demand concentrated on the banking sector. This has added to the vulnerability of the bond market during the current financial turmoil. In the international market, investor focus in shorter maturities signifies the preponderance of demand from those taking a view on the prospective strength of the Rouble, and is therefore inconstant.

The Bank's Rouble issuance is accepted by the Central Bank of Russia for repo transactions, adding to the perceived liquidity of these instruments, and thereby their attractiveness as an asset class for banks. The recent change in the law that has made the Bank's Rouble issuance eligible for purchase by the State Pension Fund, is of mutual benefit, as there is a shortage of eligible assets of good credit quality for the State Pension Fund to invest in, whereas EBRD seeks to broaden the investor base for its Rouble bonds to those seeking longer duration.

A simplified process for issuance in the domestic market, which limits the obstacles to successful fixed rate financing through the domestic bond market, governs the Commercial Paper (CP) market (also known as Stock-Exchange Bonds,) for issuance up to three years. In recent legislative amendments to the Securities Market Law, which governs this market, a revision to allow International Financing Institutions ("IFI") to issue domestic CP was introduced, which conditional on an IFI is having outstanding bonds listed on Moscow Interbank Currency Exchange (MICEX). Implementing regulatory provisions to the Issuance Standards, Listing Rules and Disclosure Regulations need to be introduced before the Bank can issue such CP, and EBRD is seeking to ensure that the special regime which governs its domestic bond issuance, including all relevant exemptions, will be extended to IFI's CP issuance.

## Reforms for Russian Capital Markets' Development:

Well-functioning markets in derivatives are vital to the lengthening of contract maturities in loan, bond and hedging instruments and in establishing a reliable term structure of interest rates. Availability of longer maturities and the presence of a reliable rouble yield curve will enable financial institutions to improve management of their interest rate and exchange rate exposures, a particularly important task in the prevailing volatile interest rate environment. Better management of individual interest rate exposures will in turn reduce liquidity risk and the overall vulnerabilities in the financial system. Financial institutions will be better able to implement appropriate internal fund transfer-pricing mechanisms, which will enhance the efficiency of their loan operations. Transparent internal transfer pricing mechanisms are important to correctly identify and distinguish liquidity from credit risk.

Establishing a risk-free interest rate, a key benchmark for the financial markets, is another major challenge in an environment where federal government borrowing is sporadic. In this respect, sufficiently broad and deep markets for rouble interest rate swaps (IRS) will be instrumental in establishing an alternative risk-free benchmark to supplement that of the federal government. Similarly, in the Eurozone, the euro IRS acts as a deep and liquid alternative to the respective government bond markets.

Deeper markets in futures and derivatives can build on the existing open architecture of the MICEX, better exploiting its existing infrastructure and potential. Due care needs to be taken in the use of the exchange traded model for the development of over-the-counter (OTC) derivatives with respect to pre- or post-trade reporting. Price formation in single homogeneous instruments (e.g. 3-month MosPrime) can be done on exchange but IRS price formation is done through more anonymous OTC channels such as brokers or “request for quote” (RFQ) trading systems. This market segment will make an important contribution to the development of the rouble as an actively traded international reserve currency and enable the Russian financial market to develop to its full potential.

Overcoming the remaining obstacles to swift development of markets in futures and derivatives is a clear priority. Active participation of both domestic and international banks will be essential as they will from the outset be the core providers of market liquidity in both exchange traded futures and OTC derivatives. To facilitate the broader use of the derivative markets as risk management and trading instruments, obstacles to effective netting and collateralisation need to be removed, thereby enabling counterparties to minimise and mitigate the counterparty credit exposures inherent in the derivative markets. Netting of all transactions under a single master agreement to one net exposure reduces counterparty risk and, in the case of bankruptcy, netting at market value eliminates the risk of a liquidator arbitrarily “cherry-picking” individual contracts to be enforced. To this end the bankruptcy code for credit institutions, the corporate bankruptcy code, and other relevant legislation require urgent modifications to enable the broader adaptation of these instruments by both financial institutions and corporations in Russia. Effective collateralisation is essential for reducing counterparty risks, in particular in the markets in futures and derivatives. The accounting and tax treatment for derivative hedges must also be addressed. To enable the rouble financial markets to form part of the international capital markets, the respective legislation and regulation ought to be consistent with international standards to enable the effective use of rouble instruments alongside those in other international currencies.

The recent carve-out for derivatives from gambling laws needs to be extended both in terms of permissible counterparties (to include major corporations and foreign-owned financial institutions), and permissible derivative instruments. Neither of these should be defined in primary legislation, which should provide only a loose definition of derivative instruments and specify the appropriate regulator who will define permissible counterparties and derivatives at a sub-regulatory level. This will allow these categories to be updated by the regulator in-line with market innovations and policy priorities (i.e. emissions trading).

The rouble payment system needs to facilitate the processing of all payment instructions within the same day through a continuous settlement system, and the granting of intraday credit limits. The current system of multiple discontinuous payment sessions in which only funds received in the first few sessions are usable for same-day payments combined with limited or no intraday credit availability restricts volumes and drives up the costs of executing onshore transactions by creating a requirement to pre-fund.

An important priority is the development of a long-term institutional investor base including pension funds, insurance and asset management. A positive step is the broadening of the investment criteria of the state pension fund to include non-government/municipal issuance of satisfactory credit quality. Government owned funds enjoying a combination of large endowments and long investment horizons could play an important role by attracting international asset managers to accelerate the creation of a high quality private sector asset management industry in the Russian market.

While a case could be made for focusing efforts on unification of stock exchanges, establishment of one central depository ought to be a higher priority at the current stage. The central depository standardises, centralises, automates and streamlines settling processes that are critical to the smooth and safe functioning of the capital markets, including those for over-the-counter derivatives. As is common in the world financial markets, a single depository could provide services to security issues traded at various exchanges, linking the National Depository to the international central securities depositories (such as DTCC, Euroclear and Clearstream).

Additionally, the bond issuance process should be simplified to allow long-term issuance by large, rated, frequent issuers (including foreigner issuers) targeted to both domestic and international institutional investors as well as private placements to be executed without registration or similar requirements.

**Conclusion**

The challenges of further developing the rouble financial market to allow Russia to fully utilise its potential are significant, but so are the opportunities and ultimate benefits. Bypassing the lengthy legislative process by creating enclaves subject to special regulation and supervision may seem appealing. However, international experience suggests that sustainable long-term development of financial and capital markets requires strong commitment to improving the legal and technical infrastructure for all resident and non-resident market participants who are attracted to this market.

## ANNEX 8: TECHNICAL COOPERATION

Technical cooperation commitments have evolved around EUR 11 million per year over the last years, with significant fluctuations in the recent past. The financial sector (including "group for small business") has been the most TC intensive sector, closely followed by the MEI sector.

**Technical cooperation commitments in Russia per year and sector (EUR million)**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 (to November) |
|---|---|---|---|---|---|---|
| Energy efficiency and climate change | 0.2 | - | - | 0.2 | 0.8 | 1.2 |
| Financial Institutions | 0.7 | 3.7 | 1.5 | 4.1 | 0.5 | 4.3 |
| Group for small business | 4.2 | 3.2 | 3.2 | 0.03 | 2.2 | (merged with Financial Institutions) |
| MEI * | 2.1 | 2.7 | 1.8 | 10.6 | 2.4 | 1.6 |
| Power & energy | 0.2 | - | 0.03 | 0.2 | 0.1 | - |
| TAM/BAS ** | 2.4 | 0.5 | 1.2 | 1.8 | 1.0 | 1.6 |
| Transport | 0.4 | - | - | 0.1 | 0.03 | 0.5 |
| Others | 0.7 | 0.8 | 0.4 | 0.6 | 0.7 | 1.1 |
| **TOTAL** | **10.8** | **10.9** | **8.2** | **18.0** | **7.7** | **10.3** |

* Municipal & Environmental Infrastructure

** Turn-Around Management & Business Advisory Services

Looking forward, the needs anticipated for 2010 amount to roughly EUR 12 million approximately, including EUR 3 million for energy efficiency & climate change, EUR 2 million for the financial sector, EUR 4 million in infrastructure/transport/power and EUR 1 million for TAM/BAS.

In the medium term, whilst it is difficult to establish any quantifiable link between projected the business volume and technical cooperation needs, priority sectors as set out in that strategy call for sustained technical cooperation activities. That is obviously the case of the municipal and more broadly the infrastructure sector which remain high on the Bank's agenda in Russia.

That is also the case in the field of energy efficiency where the Bank has ambitious targets as Russia remains a country with a vast potential for energy intensity reduction. As described in the context of the second phase proposal of the Bank's "Sustainable Energy Initiative", despite the support received thus far (including a dedicated facility for the support of energy efficiency in buildings provided by Austria) the volume of TC available for sustainable energy operations in Russia lags behind that in other countries, both in proportion to lending and in proportion to opportunities for carbon emissions abatement. This means that the Bank is less able to engage in high-impact operations that build capacity and overcome systemic bottlenecks to sustainable energy financing, for example in the challenging areas of municipal and buildings energy efficiency. In order to meet the business objectives of SEI2, significant additional TC resources will be required for Russia.

Needs for technical cooperation related to the Bank's operations in the financial sector will remain significant as well as the financial institutions have been severely fragilized thanks to the crisis and often require technical assistance in addition to loan or equity support. The corporate sector will require TC resources to assist companies to implement international accounting and corporate standards in order to access financing, including from EBRD. Finally, the priority given to agribusiness should be highlighted: That sector has not been a significant user of technical cooperation so far but this may change with notably the focus put on policy dialogue and the improvement of the business environment.

In terms of funding, the EU has been over the past the dominant source, followed by the funds provided by Japan and funds from the NDEP and the "Russian Small Business Fund". More recently, the EBRD Shareholder Special Fund has also been a significant source of funds. However, one cannot ignore the reality of declining and/or more volatile contributions as donors tend to focus their actions on ODA ("Official Development Assistance") countries, especially at a time when they face financial constraints themselves. Therefore, the strategy of the Bank in the field of technical cooperation will be to look at avenues to secure predictable sources of funding, including from the Russian Federation, so as to be able to respond to the sustained TC needs highlighted above.

**Technical cooperation commitments in Russia per year and funding source (EUR million)**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| EU | 4.1 | 3.8 | 0.6 | 4.3 | 1.6 | 1.5 |
| RSBF * | 1.2 | 3.0 | 3.1 | 0.3 | 0.1 | 3.0 |
| Japan | 1.9 | 0.02 | 0.8 | 6.0 | 0.8 | 1.1 |
| NDEP ** | 1.6 | 0.8 | - | 3.8 | 0.2 | 0.2 |
| Finland | 0.5 | 0.6 | 0.9 | 1.3 | 0.5 | 0.6 |
| US | 0.3 | 0.9 | 0.4 | - | - | - |
| Germany | - | 0.1 | - | 0.1 | 0.6 | 0.3 |
| SSF *** | - | - | - | - | 1.7 | 3.1 |
| Others | 1.0 | 1.5 | 2.4 | 2.2 | 2.2 | 0.5 |
| **TOTAL** | **10.8** | **10.9** | **8.2** | **18.0** | **7.7** | **10.3** |

* Russia Small Business Fund

** Northern Dimension Environmental Partnership

*** EBRD Shareholder Special Fund

## ANNEX: 9 RUSSIA– TAM/BAS BRIEF

| | |
|---|---|
| **Previous TAM/BAS experience in Russia** | The TAM/BAS Programme supports economic transition by achieving enterprise change in potentially viable micro, small and medium enterprises (MSMEs) in the EBRD countries of operation. |
| **TAM** | TAM supports the introduction of international best practice in small and medium-sized enterprises with the potential of becoming future leaders in their market through the introduction of international advisors from developed countries with 15 to 20 years of professional experience in the specific business sector. TAM projects typically last around 18 months. The Programme also carries out seminar and training activities promoting international best practices by disseminating successful case-studies to entrepreneurs.<br><br>TAM has carried out 210 projects throughout Russia since inception in 1998, 18 of which are still in progress. These projects have been widely distributed throughout all Federal Districts. Currently, projects are being carried out in Far East Russia, the Urals, the Southern (North Caucasus) and the North Western Federal Districts. The largest donors of TAM projects have been Japan, the EU (under TACIS), the Russian Privatisation Centre, the UK, the Nordic Council of Ministers, Finland, the US and Sweden. Other important donors include the Denmark, Italy, Taiwan, Switzerland and Ireland. |
| **BAS** | BAS acts as a facilitator for the use of local, private-sector consultants by MSMEs to obtain a diverse array of services. BAS works on both the demand and the supply side. By assisting individual enterprises to engage with local consultants on narrowly-based, specific projects with a rapid payback, it stimulates demand and the understanding of the potential benefits of using external consultants. It also directly increases the supply and quality of local advisory services, through targeted market development activities. BAS supported projects typically last around four months.<br><br>The BAS Programme in Russia was first established in Northwest Russia, with the BAS office being located in St Petersburg in 2000 with funding from Finland and Germany. Further funding was then provided by Denmark, Luxembourg, Norway, Sweden, Switzerland, the United Kingdom and the EBRD. In July 2003, another office was established in Kaliningrad with funding provided from Finland, Luxembourg, Sweden and later on by the EBRD. Finally, the BAS office in Far East Russia was established in 2004, with funding from Japan. The Kaliningrad and St. Petersburg offices have been now closed in October 2009.<br><br>As of June 2009, BAS Russia has undertaken a total of 825 projects with MSMEs, engaging 232 local consultants. These projects have been widely distributed throughout the three main regions where BAS operates In addition to standard BAS projects, the Programme has also carried out market development activities by way of trainings for local consultants. Examples of these include a training programme for SME Support Centers' staff in Small Business Counseling carried out by the BAS Kaliningrad, and a Seminar on "Energy Efficiency and Energy Saving for Industrial SMEs: Innovative Technical, Organizational, and Financial Solutions" carried out by BAS in North West Russia. |
| **Linkages with banking** | To date, two TAM/BAS assisted companies in Russia have attracted two investments from the EBRD or EBRD related financial intermediaries, mobilising a total project value of over € 7.8 million. For MSMEs, the EBRD offers The Facility for Medium Sized Projects which includes mid-cap equity and unsecured debt for Russian SMEs. There is also the Mid-size Corporate Support Facility, providing loans for existing EBRD clients. Other sources of financing are available via local banks. |

| | |
|---|---|
| **A small and decreasing number of entrepreneurs despite a positive perception of entrepreneurship** | The MSMEs market in Russia is relatively small due to a heritage of industrial cooperatives which have been organized as whole entities. Slowly, these enterprises are being organized to compete in a free market. According to the Global Entrepreneurship Monitor (not-for-profit academic research consortium producing international research, including surveys of businesses) just over 1% of the population are owners of nascent and new businesses respectively, and less than 2% operate established businesses. The perception of entrepreneurship is positive: the majority of respondents consider that those successful in starting a business have a high level of status and respect in society. Less than 30% of respondents, however, consider starting a business a good career choice for themselves. The same number mentions the fear of failure as a main reason preventing them from starting a business. This may be linked to the fact that around 10% do not feel they have the necessary skills, knowledge and experience to start a business and/or do not see good start-up opportunities where they live. Persons aged 25 to 34 are the most active in setting up new businesses (46% of total entrepreneurs) closely followed by the group aged 18 to 24 (30% of total entrepreneurs). Established businesses are managed by entrepreneurs aged 35 to 44 (42%) and 45 to 54 (31%), with those aged 25 to 34 already accounting for 15% of business owners of established enterprises. |
| **Difficult business environment** | Russian businesses, including Russian MSMEs, face an array of obstacles in their operations. Taxes and lack of access to finance are perceived as the main obstacles by enterprises interviewed for the Business Environment and Enterprise Performance Survey (BEEPS), while Doing Business identifies legislation in the field of construction permits as the most significant problem. Further obstacles identified by the BEEPS include practices of the informal sector and political instability. Another obstacle identified by the BEEPS is the high corruption: 17% of MSMEs reported having had to make informal payments to obtain compulsory certificates and 10% reported that a gift or informal payment was requested during some tax regulation inspection. This suggests that a better application of the rule of law would create a more viable and stable business environment for MSMEs. |
| **Access to finance is a major constraint with a poor regulatory and legal environment** | Russia has a range of banks and other institutions offering MSME finance, though the demand is still far from being met. Few banks in Russia are organizationally geared towards MSME lending, reflecting the perceived high cost of setting up the infrastructure needed to reach the clients and a view that lending to this economic segment is a high risk and potentially expensive activity. Few MSMEs have bank accounts and significant cash payments contribute to lenders' perception of high risk, resulting in a continuing lack of access to financing. While many banks reported positive changes in their approach to MSME financing (such as simplified requirements for MSME borrowers, more flexible attitude towards collateral requirements, faster disbursements), this work has to be continued together with an increased focus on lifting the other constraints to MSME development. In terms of regulatory and legal matters, both credit registry and private credit information bureaus are in the early stages of development. Collateral and bankruptcy legislation are a further hindrance to MSME lending. The cost of registering collateral is more than twice the OECD countries' average. |
| **Skilled engineers and technical specialists are particularly difficult to afford** | According to a survey led by the Global Entrepreneurship Monitor, entrepreneurs with a technical or university qualification tend to be more successful in establishing viable enterprises. MSMEs find it difficult to afford qualified and trained personnel. According to a survey led by OPORA (Association of SME, Survey 2007-2008,), hiring skilled engineers and technical specialists as well as qualified workers is a serious problem for 43% of enterprises. |

**Women entrepreneurs are mostly active in large cities**

Women entrepreneurs are well represented in established businesses. The highest level of female entrepreneurial activity is among women who plan to set up a business. Women entrepreneurs operate most frequently in the cities of Moscow and Saint Petersburg as well as in other large cities in the regions.

**Business support services are affordable and of good quality, however in need of additional development**

According to the OPORA, enterprises find it relatively easy to train their employees in business skills related to business plans, quality management, marketing and strategic development, export, finance, production processes, and development of new products. 58% of enterprises think that on-the-job professional training is affordable and of good quality. However, 17% underline the lack of organization and technical programmes targeted at their specific needs. Given the current low level of national and international competitiveness of MSMEs, the survey expects demand for high-quality business advisory services and targeted enterprise training to rise considerably. This will play a crucial role in helping MSMEs increase competitiveness and introduce upgrades in technology.

**Consultancy market in Russia not providing certain services : entrepreneur skills or highly technical skills**

The Russian consultancy market was initially funded by international donors; by 1995, international companies as well as Russian consulting firms had entered the market. The current consultancy market in Russia provides basic consultancy services: mainly covering Marketing, Public Relations, and more recently Human Resources which are mainly accessible in the main cities. The local consulting market is often characterized by auditing, information services, or software companies that are offering consulting services on the side and not as a primary business. Consultancy services offered are mostly basic and standardized and they are targeted at the companies which are in growth stage. They are not adapted to respond to the needs and demands of companies neither at an introductory stage (entrepreneurs) nor at the maturity stage (technical and high skilled services).

**Government support**

In the past five years, the government has increased its support of MSMEs. SME policy became more prominent with the introduction in July, 2007 of an SME strategy: ‘Developing Small and Medium Scale Entrepreneurship in the Russia Federation’, allowing for better SME regulations and providing support to the growing number of MSMEs. The government is committed to raising the share of GDP generated by the sector. Various government programmes focus on the SME sector, ranging from facilitating administrative procedures to providing funds to alleviate financial constraints of the crisis on SMEs. Several associations and business organizations provide SME support at regional and local level. One example is OPORA, the Association of Small Business Organisations, which represents over 50 non governmental business associations. OPORA provides legal organization to entrepreneurs and aims at fostering dialogue between entrepreneurs and the state.

Recently the government has identified a gap in support for entrepreneurs and start ups and launched a couple of initiatives, such as the Innovation and Entrepreneurship website which is targeted at informing entrepreneurs in the field of innovative business, as well as the Russian partnership in a Gate to Russian Business Innovation Networks (Gate2RuBIN) project, that is aimed at creating opportunities for establishing partnerships between European and Russian companies and research organizations. However these efforts are not accessible to most entrepreneurs and there is a lack of funding available to promote new SMEs and encourage young people to stay, invest and do business in Russia.

**Number of international donor programmes significantly reduced**

With Russia having grown into a middle income country and emerging as a donor itself, the attitude of international donors towards Russia has changed. The number of programmes and the extent of assistance have been significantly reduced. The UK Department for International Development (DFID) for example has ceased aid to Russia in March 2007 and the EU funded TACIS programme came to an end in late 2006. International donors now concentrate mostly on programmes targeting underdeveloped regions and/or sectors and topics (such as economic development of the Northern Caucasian Republics (EU), support of the mining industry and craft businesses in the Magadan Region (IFC), innovation in the high-tech industry). Also, support from the EU continues on a national level through the European Enterprise Network Russia, which aims to provide Russian MSMEs with information on EU regulations and market requirements but also makes business data available to MSMEs.

The largest donors of TAM projects have been Japan, the EU (under TACIS), the Russian Privatisation Centre, the UK, the Nordic Council of Ministers, Finland, the US and Sweden. Other important donors from the past include the Denmark, Italy Taiwan, Switzerland and Ireland followed by the EBRD Special Shareholders' Fund. TAM is anticipating funding for six to seven energy efficiency projects in several parts of the country, and other funding has been forthcoming from Finland for the Northwest. Going forward, it is anticipated that bilateral donors will form the core part of the funding for TAM. By far the main donor for the BAS Programme in Russia has been Japan, followed by the EBRD Special Shareholders' Fund, Sweden and Finland.

**Continuation of TAM**

This Brief finds strong support among interviewed stakeholders for TAM to continue operating in the Russian Federation in 2009-2011. The main impediments faced by Russian MSMEs, which can be addressed through TAM assistance are lack of knowledge of: effective organizational and management structures, efficiency in production processes, business planning, marketing techniques and lack of exposure to international best practices.

TAM plans to target enterprises needing assistance to improve energy efficiency and those located in rural areas. Geographically, TAM will particularly target the Northwest, Far East and Southern Federal Districts. Key industry areas of focus will be machinery, electrical goods and chemicals manufacturing, renewable energy, wood processing, and shipbuilding and repairs in coastal areas. TAM projects with enterprises in these industry areas will provide important platforms for visibility and dissemination of knowledge throughout Russia to improve energy efficiency and encourage safer environmental practices. Further areas for TAM intervention include food production and retail. These will be a particular focus in growing rural areas including new mining districts where new development is most needed. Companies wishing to continue to receive TAM assistance after the conclusion of a TAM project should pay for services.

**and BAS**

Stakeholders in the enterprise sector unanimously believe that Russian entrepreneurs could benefit strongly from the help of business advisory services. The main advantage of BAS is that it contributes to the creation of a viable infrastructure of business support by operating on both the demand and the supply side of the market. Evidence shows that the local advisory market is not yet well developed hence, while the BAS grant should remain the key component of BAS assistance, targeted market development activities should play a significant role in BAS assistance to Russia.

A Grant Guideline Matrix is proposed in Far East Russia in order to prioritize intervention, avoid duplication of efforts from international donors and focus on the areas where Russian businesses have needs and no access to such services. Higher grants should be given to: i.smaller enterprises; ii.enterprises outside the main cities of Vladivostok and Khabarovsk; iii.projects involving technical and highly skilled types of advisory services aimed at improving market performance, environmental management, as well as quality management systems and environmental and energy efficiency.

**in addition to targeted market development activities**

It is recommended to complement TAM/BAS assistance at the enterprise level with the following market development activities in order to maximise the Programme's transition impact in Russia.

*Visibility and dissemination:* The BAS Programme should take steps to promote the use of business advisory services by MSME and should organise seminars and trainings related to international best practices in application of consultancy services and what benefits it brings.

*MSME and consultancy training:* The BAS Programme should continue to address the existing gaps in the supply of advisory services by providing more trainings and seminars covering quality management systems, international solutions to energy efficiency and sound environmental management.

*Support to and development of existing relevant local institutions:* The BAS Programme should continue to support the consolidation of the Russian consultancy industry, specifically by assisting existing associations of consultants to grow further. A considerable number of business associations operate in the different regions across Russia, but often do not offer a wide range of services to their members. BAS should continue to support these associations through MDAs, facilitating the promotion of business advisory services to MSMEs.

Moreover, the Programme should also assist local institutions with the objective to support the Russian MSME sector especially facilitating services targeted to young entrepreneurs and rural businesses.

**with a strengthened focus on addressing cross cutting issues**

In order to address cross-cutting issues that are pertinent to Russia's MSME development, the TAM/BAS Programme should promote measures to increase energy efficiency in production and reduce environmental pollution. TAM will seek projects with manufacturers for heavy industry, in areas such as chemical, metal, machinery and energy production, water sewage and water supply companies. As the attainment of environmental standards enhances (or is often essential) the ability of businesses to market in the EU, TAM will work with enterprises to ensure their manufacturing processes meet EU standards.

BAS should focus on the projects requiring high level technical advisory services to provide energy efficiency advice and help address environmental regulations in response to the lack in technical and skilled advisory services in the private sector.

BAS should furthermore focus specifically on offering services at the introductory level: targeted towards young entrepreneurs, including Market Development Activities such as mentoring, funding application, business planning.

However, such measures will only be successful if entrepreneurs start understanding the potential future payback for their enterprise which is not a priority for the smallest enterprises. TAM/BAS should also devote efforts to supporting rural areas as those areas outside the main cities face a lack of exposure to free market practices. Entrepreneurship should be encouraged through programmes for young entrepreneurs where young managers of enterprises work closely with a BAS consultant or TAM advisor.

**TAM/BAS would seek private funding specifically towards developing community and corporate social responsibility projects alongside EBRD investments in natural resources projects**

TAM/BAS is seeking other sources of funding for its activities in Russia since the number of donors in the country has been decreasing significantly over the years. The Programme should seek private sector funding specifically to address cross-cutting issues and for community corporate social responsibility projects which are in line with the current developments in Russia. TAM/BAS community projects could be developed alongside EBRD investments in large natural resources project given the high number of these sites in industries such as extraction and forestry.

By seeking private sector funding, TAM/BAS would expand its sources, and be able to help local communities while at the same time valuing corporate social responsibility. Most companies see corporate social responsibility programs as a way to fulfill the contract between business and society. But many companies are also creating real value through their environmental, social, and governance activities—through increased sales, decreased costs, or reduced risks—and some have developed hard data to measure even the long-term and indirect value of such programmes.

**This Brief as contribution to EBRD's policy dialogue**

By thoroughly analyzing the business environment and clearly identifying the challenges faced by the MSME sector, this brief further strengthens the EBRD's policy dialogue toolkit. Future challenges for the government (among others) are identified as improving law enforcement, reducing inequality of treatment and administrative corruption, improving tax administration and improving the educational system.

**An input for enhancing linkages with banking**

In line with TAM/BAS Strategic Plan 2008-2010, TAM/BAS should continue to assist the Bank to meet its objective of generating a commercially viable project pipeline for direct investments by the Bank that will be transitional in three ways:

i) identifying potential pipeline (pre-investment); ii) providing "consulting and business" *services* for the preparation and support of Bank private enterprise financing projects and for the enterprises themselves; iii) providing candidates for non-executive board member positions.

In addition, the Programme should link MSMEs in need of finance with the EBRD's Facility for Medium Sized Projects (for new clients of the bank) and the Mid-size Corporate Support Facility (for existing EBRD clients). TAM/BAS should also encourage enterprises to consider other sources of EBRD financing available via local banks. This will strengthen the Bank's impact in the enterprise sector and in the financial sector, as outlined in the EBRD Country Strategy for the Russian Federation.

## ANNEX 10: ASSESSMENT OF TRANSITION CHALLENGES

The table below provides an overall Assessment of Transition Challenges rating for 2009. Scores range from negligible, small, medium and large. "Negligible" means that the remaining challenges are minor and that the sector is well advanced in moving towards a well-functioning market economy. "Large" means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform. The overall rating in 2009 is based on individual ratings for market structure and market-supporting institutions and policies (also shown below).

| **Russia** | **Market structure** | **Market-supporting institutions and policies** | **Overall** |
|---|---|---|---|
| | | | |
| **Corporate** | | | |
| Agribusiness | Medium | Medium | Medium |
| General Industry | Medium | Medium | Medium |
| Property and Tourism | Medium | Large | Medium |
| Telecom | Medium | Medium | Medium |
| | | | |
| **Infrastructure** | | | |
| MEI | Medium | Medium | Medium |
| Natural Resources | Large | Large | |
| Power | Medium | Medium | Medium |
| Sustainable Energy | Large | Medium | |
| Transport | Medium | Medium | Medium |
| | | | |
| **Financial Institutions** | | | |
| Banking | Large | Medium | Medium |
| Insurance and financial services | Medium | Medium | Medium |
| MSMEs | Large | Large | |
| Private equity and capital markets | Small | Medium | Medium |

### Assessment of Transition Challenges by Sector

### Corporate

### Agribusiness

*Market structure: Medium*
*Institutions/policies: Medium*

Russia maintains high border protection for key agricultural imports and budgetary support to agriculture while currently comparatively modest is increasing. The government does use specific input subsidies, including interest rate subsidies as support measures to the agri-food sector. As a reaction to soaring food prices in 2008 the government additionally used ad hoc measures to control food prices such as agreements with retailers on price limits of essential food items. Some of the support measures lack coherence and further distort prices and linkages along the value-chain. Other problematic regulatory issues include import control measures such as tariffs, sanitary barriers, and the like. The land code recognizes private ownership, but the share system privatisation led to fragmented land-ownership which increases transaction costs, hampers consolidation and FDI. Agro-processors are largely privatized and foreign entry and restructuring has increased competitiveness in the sector in general. While the cereal market is comparatively well developed, cereal processors suffer from a lack of modernization of their assets and a key constraint remains insufficient specialised infrastructure (including specialized rail wagons, quality certified silos). In particular the meat and dairy sector do not comply with international standards, including traceability of produce, hygiene and quality standards. Private lending to the agribusiness sector remains limited and poses a significant constraint for efficiency and competitiveness improvements along the whole value-chain and particularly in rural areas. The law on warehouse receipt is not yet approved and future markets and forward contracts are at a nascent stage.

**General Industry**

*Market structure: Medium*
*Institutions/policies: Medium*

Russia received an overall upgrade in its rating, due both to improvements to competition and market-supporting institutions since the last assessment was made. Enterprise restructuring has advanced with many enterprises modernising their facilities, and some sectors have been consolidated through active mergers and acquisitions supported by the abundance of liquidity that was available until very recently. The state has increased its involvement in the sector with the launch of various schemes and initiatives through public private partnerships. The government has also actively instituted policies that protect certain domestic industries from competing imports and foreign direct investments, and competitive pressures, as measured by company mark-ups, have decreased in recent years. Therefore, there has been very limited impact on the overall efficiency and productivity improvements and increased competitiveness. Business standards remain far below the advanced countries in the CEB. Nonetheless, expenditures on R&D are relatively high. The concerted efforts to improve the corporate governance code and practices over the years have had a positive impact with many large enterprises aspiring to adhere to the code. On the other hand, institutional mechanisms to facilitate new entry and exit remain insufficient. There is also increased state interference in activities of large businesses and involvement of state regulatory and enforcement agencies in business disputes between private owners. There are signs that following recent financial difficulties faced by a number of Russian companies, the government is ready to adopt more protective measures and support ailing enterprises, especially where a large number of jobs may be at stake. This poses a major challenge for the overall competitiveness of the general industry sector in the medium to long-term.

**Property and Tourism**

*Market structure: Medium*
*Institutions/policies: Large*

The real estate sector continued to develop rapidly since 2005, but due to the global financial crisis many developers have put their current projects in the construction stage on hold. Both private developers and institutional investors have begun to operate in the country although focusing on the capital and a few other major cities. New instruments such as real estate funds and other investment vehicles targeting both domestic and international investors have started to emerge since 2005, but are still relatively scarce and need to be further promoted, especially outside Moscow and St. Petersburg. Regional development is lagging behind with a shortage of quality assets in all sub-segments – though retail is most advanced, its development is still far behind Central European comparables. Tourism assets are still below international standards, especially in regional Russia, but a positive impact is expected from the Olympic Games 2014 in Sochi. Despite the current adverse market conditions, the potential for growth of the property and tourism sector is strong, in line with increased demand from regional and international companies for institutional quality commercial space. Russia still falls short of providing investors and business players a legal framework with the necessary certainty and predictability. Mortgage lending is in its initial stages, and taking security over property remains highly challenging and complex. Tradability of land is limited de facto.

**Telecommunication**

*Market structure: Medium*
*Institutions/policies: Medium*

Russia's long-distance market was fully liberalised in January 2006, and significant alterations were made to the structure of local fixed-line billing in February 2007. However, the regulator - the Ministry of Communications – is not independent. Rostelecom and Svyazinvest control the majority of long-distance/international and local calls. Effective competition in the local fixed-line market has been hampered by the lack of an effective network access regulatory regime, with alternative operators consequently deploying alternative access network infrastructure. There was some rebalancing of the tariffs. The mobile market is characterised by a number of regional/local mobile operators, a number of which are vying to become the fourth largest player. There is no mobile number portability. The Russian broadband Internet market is well developed in Moscow and St. Petersburg, but not in the rural areas. There is no single dominant operator, but instead a number of smaller players employing a variety of technologies.

**Energy and Infrastructure**

**Municipal and Environmental Infrastructure**

*Market structure: Medium*
*Institutions/policies: Medium*

Significant progress has been achieved in the past few years that deserved an overall upgrade in the rating, due both to improvements to competition and market-supporting institutions. Russian municipal utility services are decentralised both in terms of ownership and decisions making. While a few utilities are fully corporatised (joint stock companies), most utilities are organised as municipal enterprises (semi-corporatised) with *de jure* management independence, but *de facto* heavily dependence on the local administration, especially in smaller cities. Smaller municipally-owned utilities often continue to be loss making. Utility systems remain supply driven (metering and meter-based billing remain uncommon) and cost inefficiencies (excessive employment, large network losses, high energy costs) continue to exist. Private operations are common in urban transport (mini buses and some large bus operators in bigger cities). There is significant private sector participation in the district heating sector, while in the water sector it is limited to a few large national operators. Private sector participation has not always been structured in line with best practice (e.g. no focus on service delivery, ineffective allocation of risks and returns). Although the legal framework for private sector participation has been improved (e.g. requiring competitive procedures for selection), the institutional capacity of the municipalities for managing contractual relations with the private sector is yet to be fully developed.

While the federal legal framework allows for cost reflective tariffs, including investment surcharges and connection fees for financing of investment programs, caps on tariff increases, the absence of independent tariff assessors for defining costs and affordability concerns often hamper tariff setting at adequate levels in most municipalities. Tariffs are already set at or very close to full cost recovery levels in several municipal utilities, but the variation in terms of levels remains very high (e.g. by a factor of 13 in the water sector). Cross-subsidies, while generally reduced compared to earlier years or even eliminated in certain utilities (e.g. Surgut, Yaroslavl), remain pervasive, particularly in remote areas. The governance of municipality-utility relationships needs to be improved further (e.g. service contracts are not yet common). Water and urban transport tariffs are set by municipalities and remain under strong political and administrative influence, but district heating tariff setting rests with the Regional Energy Commissions.

**Natural Resources**

*Market structure: Large*
*Institutions/policies: Large*

The oil and gas sector generated 64 per cent of Russia's export revenues in 2007, and accounts for 30 per cent of all foreign direct investment in the country. There are 42 oil refineries in Russia, many of which are incapable of meeting modern fuel standards. Russia also holds the world's second largest recoverable coal reserves.

The key market challenge in Russia is to reduce the dominance of the state-owned companies in the oil and gas sector. Over the past five years, the state has further consolidated its control of significant oil and gas reserves through state-owned companies Gazprom and Rosneft. Gazprom accounts for some 90 per cent of Russia's gas production and holds 70 per cent of the nation's gas reserves. Having acquired further assets from now-bankrupt Yukos, Rosneft has become the leading Russian oil producer, overtaking Lukoil. As a result, the share of independent oil&gas producers and mining companies in total production has decreased over time and supporting their future expansion remains a challenge. While the oil industry is relatively more competitive and transparent (following an IPO in July 2006, approximately 17 per cent of Rosneft have been floated), the liberalisation of the gas market is hampered by Gazprom's de facto monopoly in the downstream sector, depressed domestic tariffs and constrained third party access to the gas infrastructure network. A plan has been approved to gradually liberalise domestic gas paid by industrial users but household tariffs will remain subsidised until at least 2015.

Concerns over the security of licensing and the even-handed enforcement of legislation remain and have been corroborated by Gazprom's forceful acquisition of a controlling stake in the Sakhalin-II project from Shell and on-going negotiations with the TNK-BP JV over the Kovytka gas field development, following investigations over alleged breach of environmental and contractual obligations. According to the Strategic industries act, only Russian domiciled companies, majority owned by Russian interests are allowed to access a number of "strategic" assets, including oil and gas fields. More recently, Russia's state market regulator, the Federal Financial Markets Service (FFMS), published new rules limiting the sale of shares in strategic and mineral resources companies on foreign stock exchanges. The new regulations, which took effect in July 2008, will have the greatest impact on foreign investment in the geological and mineral exploration sector, where a 5 per cent cap has been imposed on companies' share sales abroad.

## Power

*Market structure: Medium*
*Institutions/policies: Medium*

Significant progress has been made in reforming the Russian power sector since the last assessment was made. The former state-owned, vertically integrated utility company, RAO UES, was unbundled and ceased operations in mid-2008. Separate generation and distribution companies were spun off from RAO and sold to various strategic investors, including foreign companies such as Enel, Fortum and E.ON. Full unbundling is therefore in place and progress in underway towards introducing a RAB-based tariff methodology for network monopolies. While the divestment of generation assets has been largely completed, further privatisation of generation companies and commercialisation and partial privatisation of distribution companies need to move forward.

Key market enabling institutions have been created as part of the sector reform. The temporary rules governing the new capacity market, to stimulate investment in new power generating capacity, were approved in 2008, but implementation is hampered by political intervention and uncertainty about the long term approach. A bilateral power market is operating and gradual liberalisation of the wholesale and retail markets (i.e. the transition to full competition) has started with 50 per cent market opening expected by July 2009, up to 100 per cent by 2011. Low energy efficiency in power generation and network losses in transmission and distribution remain significant challenges. There is very limited penetration of renewable energy although a regulatory framework is under development. Remaining challenges include to: improve transitional capacity market rules and establish a long-term capacity market; clarify and strengthen the functioning of the various energy sector regulators; improve the functioning of the mechanisms for network access for generators and consumers; invest in new transmission and distribution infrastructure; ensure effective anti-monopoly regulation in isolated systems and non-market areas; support the development of renewable energy projects and develop regulations for the retail market.

## Sustainable Energy

*Market structure/outcomes: Large*
*Institutions/policies: Medium*

Russia shows an increasing commitment to promoting energy efficiency and putting in place a supporting institutional framework. The basic primary legal and institutional setup for energy efficiency is already in place (including targets for energy savings), but the absence of secondary legislation and inexistent or weak related institutions hinder the effective operation of the institutional support for sustainable energy. Energy tariffs are below the cost of provision and do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently and to invest in RES projects. Furthermore, a large proportion of residential and many non-residential energy users continue to pay utility bills according to norms as opposed to metered consumption, budget entities are not allowed to retain budgetary funds saved through energy efficiency and the institutional framework in the housing sector does not provide sufficient guidance on energy related rights and responsibilities, all of which provide little economic incentive for energy savings. Thus many private sector solutions to reduce energy use, such as ESCO companies, are not available in the current context. The lack of adequate price signals, weak institutional capacity and the legacy of inefficient heavy industries translate into very high energy and carbon intensity. The

RE sector is at an early stage of development and adequate institutional and regulatory mechanisms (e.g. secondary legislation to complement the RE related) are yet to be implemented. Russia ratified the Kyoto protocol in 2004 and is Annex 1 party. There has been only limited progress in implementing Kyoto-based JI projects and there has been limited interest in AAU trading.

The key challenges include the full development of the legal and institutional capacity for EE project deployment, including the creation of adequate standards and incentives for energy savings, continuation of the ongoing reform of energy tariffs to provide incentives for a more efficient use of energy and RES project development; development of secondary legislation and institutional support for RES development; in the area of climate change the adoption and strengthening of international and/or national commitments to reduce emissions is key for the post-Kyoto period, which needs to be complemented with further institutional and regulatory capacity development to support decentralised market based emissions reductions undertakings.

**Transport**

*Market structure: Medium*
*Institutions/policies: Medium*

While overall the railway sector reform has been successful to date, there have been some delays in the implementation of the most difficult phase (i.e. phase III), which remains a key challenge. Operating and policy setting functions have been separated and some of the core businesses have been partially divested. In the past few years, private sector participation has significantly increased particularly in the provision of freight services, wagon leasing and other rail-related activities (e.g. maintenance and container businesses). A tariff regulator was established, but sector regulation continues to rest with several state institutions with overlapping responsibilities. Competition in service provision has increased substantially in the past few years, but the Russian Railways continue to enjoy a dominant position.

In roads, Rosavtodor remains responsible for developing and managing the federal road networks, while the responsibility for regional road networks was transferred to regions and municipalities. A new concession law was approved in 2005 (then amended in 2008) which enables the preparation and implementation of PPP projects in the infrastructure sector. The authorities made significant efforts to develop large-scale PPP projects, but so far there have been no closures. Road user charges have increased moderately but are insufficient to cover operational costs. The successful completion of recently initiated PPP projects to is a key challenge ahead.

The management of most port infrastructure remains under the state owned enterprise "Rosmorport", the centralised maritime port administration. The landlord model was adopted and the majority of port terminal operations are carried out by private port terminal companies.

The institutional framework of the airports sector follows the model of the maritime sector, which is not a common feature outside of Russia. The airport infrastructure/airside (i.e. runways and taxiways) remains state owned and is administered by the Federal Airport Enterprise. The majority of the airport/landside terminal companies are owned by local or municipal authorities together with private investors. The ownership split between the airside and landside combined with the lack of a clear legal framework governing the relationship between the two have been the most significant obstacles in attracting external investment in the airport sector. The provision of auxiliary services (e.g. aviation fuel) remains insufficiently competitive.

## Financial Institutions

### Banking

*Market structure: Large*
*Institutions/policies: Medium*

Russia's banking system grew rapidly over recent years, in particular in the consumer credit segment. The ratio of private sector credit-to-GDP increased from 22 per cent at end-2004 to 43 per cent in early 2009, with consumer credit growing from 3.6 to 10 per cent of GDP over the same period. Regulation and supervision have been strengthened, the deposit insurance scheme has been expanded, and standards of disclosure of interest rates to retail borrowers have improved. Minimum capital requirements will be raised from 2010, and bank mergers will be facilitated. At the same time, state-owned banks continue playing the leading role (as of end-2008 6 out of the top 7 banks were state-controlled), while at the other end of the spectrum around 150 banks (out of total of over 1,000) have capital below EUR 2 million. The pace of consolidation remains slow. Mortgage lending has been growing but still accounts for only around 2 per cent of GDP. Access to financial services is highly uneven across Russia's regions, with southern regions and Siberia particularly under-banked. In response to the onset of the financial crisis in the fourth quarter of 2008, the authorities deployed a number of timely measures, including extension of deposit insurance coverage, provision of ample liquidity support through collateralized and uncollateralized lending by the central bank and placement of treasury deposits with selected banks, additional funds for recapitalization of state-owned banks, and programmes of Tier II capital support through the state development bank (VEB).

### Insurance and financial services

*Market structure: Medium*
*Institutions/policies: Medium*

Insurance legislation and regulation have been historically weak, and tax optimisation schemes involving both life and non-life insurance products used to be fairly common. In recent years regulation and supervision have improved, and the "true" insurance market has been growing, helped by the entry of a number of international companies, even though the overall premia-to-GDP ratio declined by around one percentage point reflecting phasing out of the tax optimisation schemes. At the same time, the size of the market (2–2.5 per cent of GDP) remains modest. The legal environment for leasing has improved and the sector has been growing gradually, albeit from a very low base. Privately managed pension funds operate both mandatory and voluntary schemes, however, the mandatory schemes market segment remains dominated by the State Development Bank, and investment guidelines need to be fine-tuned and expanded.

### Micro, Small and Medium-sized enterprises

*Market structure: Large*
*Institutions/policies: Large*

Russia features a range of banks and other institutions offering MSME finance, though the demand is still far from being met. Few banks in Russia are organisationally geared towards MSME lending, reflecting the cost of setting up the infrastructure needed to reach the clients and the perception of lending to this economic segment as a high risk and high cost activity. Few MSMEs have bank accounts. Significant cash payments contribute to generating a perception of high risk, resulting in a continuing lack of access to financing on reasonable terms. While many banks reported positive changes in their approach to MSME financing (such as simplified requirements for MSME borrowers, more flexible attitude towards collateral requirements, faster disbursements), this work has to be continued together with an increased focus on lifting the other constraints to MSME development. In terms of regulatory and legal matters, both credit registry and private credit information bureaus are in the early stages of development. Collateral and bankruptcy legislation is not very supportive of MSME lending. The cost of registering collateral is more than twice the OECD countries average, which represents a considerable impediment for lending to MSME segment. The government is committed to raising the share of GDP generated by the sector, which is currently low at an estimated 12 per cent.

**Private equity and capital markets**

*Market structure: Small*
*Institutions/policies: Medium*

Russia is close to high compliance with the IOSCO principles of securities legislation, though effectiveness of enforcement is poor, and some areas – notably derivatives or the regulation of investment advisers – remain to be resolved. Failure to disclose indirect ownership in public offerings is a major shortcoming. The regulator seems to be effective, though its authority and independence remain in doubt. Russia has among the most developed private equity markets, owing partly to a relatively large market, which offers a good variety of investment targets and partly to active equity markets which offer good exit opportunities; significant potential nevertheless remains in Russia’s regions. The financial crisis has raised some fundraising difficulties, in particular for venture capital funds focussing on high risk start ups and technology intensive companies. Local institutional investment in private equity funds has yet to materialise. The domestic equity market is reasonably well capitalised and liquid to provide a viable funding source in conducive market conditions. The domestic corporate bond market is still underdeveloped at about 4 per cent of GDP capitalisation, and suffers from an inadequate domestic investor base, and problems in registration of issues and in settlement procedures in the secondary market.