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

STRATEGY FOR

THE RUSSIAN FEDERATION

**As approved by the Board of Directors at its meeting on
25 July 2006**

TABLE OF CONTENTS

LIST OF ABBREVIATIONS

ADR	American Depository Receipt
BBL	Barrels
BPD	Barrels per Day
CAS	Country Assistance Strategy
CBR	Central Bank of Russia
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
CRR3	The EBRD's 3rd Capital Resources Review
EIB	European Investment Bank
EU	European Union
EUR	Euro
FCSM	Federal Commission for the Securities Market
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIG	Financial Industrial Group
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GRP	Gross Regional Product
IBRD	World Bank
ICAO	International Civil Aviation Organisation
IFC	International Finance Corporation
IFIs	International Financial Institutions
ILO	International Labour Organisation
IMF	International Monetary Fund
IMO	United Nations International Maritime Organisation
IOSCO	International Organisation of Securities Commissions
IPOs	Initial Public Offerings
JSC Law	Law on Joint Stock Companies
JV	Joint Venture
LNG	Liquid Natural Gas
LPR	Law on the Protection of Rights and Lawful Interests of Investors on the Securities Market
MARPOL	International Convention for the Prevention of Pollution from Ships
MCI	Ministry of Communications and Informatisation
MEI	Municipal and Environmental Infrastructure
MSE	Micro and Small Enterprises
NATO	North Atlantic Treaty Organisation
NDEP	Northern Dimension Environmental Partnership
NGOs	Non-governmental Organisations
NIB	Nordic Investment Bank
OCE	Office of the Chief Economist (EBRD)
ODIHR	Office of Democratic and Human Rights
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Co-operation in Europe
PACE	Parliamentary Assembly of the Council of Europe
PCA	Partnership and Co-operation Agreement
PPPs	Public Private Partnerships

PSP	Private Sector Participation
RSBF	Russia Small Business Fund
RUR	Rouble
RVF	Regional Venture Fund
S&P	Standard and Poor’s
SDR	Special Drawing Rights
SME	Small and Medium Enterprises
SML	Law on the Securities Market
SOLAS	International Convention for the Safety of Life at Sea
TC	Technical Co-operation
TFP	Trade Facilitation Programme
TNP	Transnefteprodukt
UES	United Energy Systems
UNDP	United Nations Development Programme
UNESCO	United Nations Educational Scientific and Cultural Organisation
UNICTRAL	United Nations Commission on International Trade Law
USD	US Dollar
VTB	Vneshtorgbank
WTO	World Trade Organisation
YOY	Year on Year

EXECUTIVE SUMMARY

The Russian Federation is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank. However, a more consistent application of these principles would facilitate Russia's global integration and its ability to absorb future shocks.

Russia's evolution from its Soviet past and from the chaotic early days of democracy has been swift. Judged against the standards of the Soviet Union, Russia today stands as a strikingly different country where basic political, civic and economic freedoms are both guaranteed by the Constitution and, on balance, enjoyed in practice by its citizens. Judged against the standards of the 1990s, when the country went through a series of political and economic crises and the state at times appeared on the verge of collapse, Russia today has achieved a noteworthy level of political and economic stability that has reassured markets and the public alike. These are welcome developments. However, judged against the standards of a developed market-oriented democracy, Russia today would benefit from further strengthening of democratic and market-supporting institutions, enhancing accountability, more even-handed application of the rule of law and firmer protections of human and civic rights. Moreover, developments over the past two years have seen the continuation of a trend in which the implementation of these basic elements of a democratic polity has wavered, raising concern in the international community. Further progress in the area of democratic governance would help to unlock Russia's obvious economic potential.

A. From an economic perspective, despite recent slow reforms and a trend of economic recentralisation, there are many positive elements in today's Russia:

- The stability of the country;
- The robustness of economic growth in the last eight years;
- The high level of the gold and foreign currency reserves and the accumulation of the windfall tax revenues from oil and gas into a stabilization fund;
- The sound management of foreign debt.
- The recent further liberalisation of capital account transactions;
- The reduction of the number of people living under the official poverty line;
- The expansion of a nascent middle class that fuels domestic consumption and retail industry development;
- The rising level of foreign investment, undeterred so far by assertive moves to return certain strategic assets to state control beyond the oil and gas sector;

B. There remain however fundamental challenges in Russia's modernisation and transition process, including:

- The demographic crisis which hangs over the future of Russia, in particular the depopulation of Siberia and the Far East, and the brain drain that affects certain sectors of the economy;
- The further integration of Russia in the world economy;
- The improvement of the business climate;

- The low level of investment compared with the huge investment needs to upgrade infrastructure and strengthen the competitiveness of the corporate sector;
- The need to diversify further the economy away from oil and gas;
- The reform of the state (administration, judiciary, law enforcement agencies);
- The underdevelopment of micro, small and medium sized businesses;
- The need to make local companies more transparent and to improve their business and governance standards with a view to improving their access to finance and capital markets;
- The lack of progress in the improvement of security of property rights;
- The fight against corruption.
- The widespread waste of energy in most sectors of the economy.

C. In the face of these challenges, **the Bank's strategic directions** need to reflect the Russian Government's priorities and the Bank's own analysis of transition challenges, as well as the evolving needs for the Bank's support and finance in accordance with the additionality, transition impact and sound banking principles, with a strong emphasis on integrity in all Bank's operations:

- Economic diversification, competitiveness, entrepreneurship, environment, energy efficiency, stronger regional presence and policy dialogue at federal, regional and local level will be central to the strategy;
- The Bank is intent on increasing its annual business volume after a period of relative stability. Russia's share of the Bank's annual business volume is under the CRR3 projected to rise to EUR 1.6 billion in 2010, i.e. 41% of the Bank's annual commitments;
- The sector allocation of the annual business volume is intended to shift towards transport, municipalities, power utilities, and the corporate sector, with an energy efficiency focus cutting across all sectors;
- The Bank will aim at increasing indicatively the share of equity in the annual business volume in Russia to 20% from the current 12%; and
- There will be an increased effort to develop larger direct projects with strong demonstration effects, in particular equity transactions, whilst MSME support will remain a strong priority addressed on a wholesale basis and on a framework basis.

D. As per these strategic directions, **the Bank's operational priorities** will be:

- Infrastructure investment in the transport, municipal/environmental sectors using concession mechanisms and public private partnership structures, as well as attracting government and sub-sovereign co-financing and private sector finance in order to construct or rehabilitate airports, ports, roads, bridges, multi-modal logistic centres; improve rail infrastructure and rolling stock; and develop waste processing, district heating, public transport, water treatment and housing.
- With the beginning of the third stage of power sector reforms, a range of equity and debt investment opportunities will be actively pursued in the power sector targeting significant improvement in power generation capacity, as well as infrastructure modernization and energy efficiency. Further liberalization of the energy market and diversification of shareholder ownership of power companies through capital

increases will be key. It is expected that the Bank's portfolio of commitments to the power sector will reach between EUR 1.5 and 2 billion by the end of 2008.

- The corporate sector is projected to be of growing importance - with emphasis to be placed on expanding equity investments in local manufacturing companies needing to increase their capital base in order to develop a modernisation and expansion plan aimed at fostering competitiveness (and improve their environmental and energy efficiency as part of this plan). The Bank will be available to support market-based restructuring of industrial companies associated with demonstrable improvements in corporate governance. Other priority areas include investments to lift constraints on the development of oil and gas production and transport as well as continued risk sharing with foreign strategic investors. Smaller companies, which contribute greatly to promote economic diversification, will be given an equal priority as larger companies and will be addressed through private equity funds, framework lending schemes and MSME programmes with financial intermediaries with a regional network, including both finance and appropriate technical assistance. The MSME sector will be further strengthened through the Turnaround Management (TAM) and Business Advisory (BAS) programmes. The Bank will be pursuing actively the development of its activities in the regions of Russia and, in accordance with the high priority expressed by the Russian authorities, will examine opportunities to develop financing to high technology companies.
- There is still a range of opportunities open to the Bank for supporting the development of the financial sector and financial intermediation in Russia. There is also a need for consolidation of the banking sector which the Bank will address by supporting mergers and acquisitions. The Bank's partners will include strong regional banks and large banks with a national presence or those banks looking to build a national presence through acquisitions. The EBRD will also be looking at expanding the range of financial instruments available in Russia by assisting banks and non-bank financial institutions in the areas of leasing, insurance and mortgage lending.
- The Bank will seek to improve energy efficiency wherever possible through its projects and policy dialogue. The power sector, industries whether large or small and medium-sized and district heating will be the main focus. It will also seek to promote emission trading as a way of enhancing the viability and returns of emission reduction projects.
- Across all sectors, the Bank will pursue actively project origination in the regions of Russia, including through the planned opening of two resident offices in the Volga Federal District and in the Southern Federal District and the possible future opening of another resident office in Western Siberia, the locations of which will be based on a business case. The Bank will be open, accessible and flexible to support investment opportunities in all regions of Russia, including in the Moscow region, in the Central Federal district, and in the St Petersburg region given their economic importance. In accordance with the priorities expressed by the Russian authorities, the Bank is prepared to make an increased effort to cluster projects across various sectors in the Kazan, Krasnodar, Krasnoyarsk and Perm regions, in the Far East Federal District and in any other region where transition can be furthered. The Bank will further analyse the investment climate in the regions of Russia.

E. The Bank will use **a wider range of instruments** to achieve its objectives, such as:

- Increased utilisation of the equity instrument in all sectors, in particular in the power sector, the industrial sector and the banking sector, including selective Bank's participation in Initial Public Offerings;
- Design and financing of Public Private Partnerships in conjunction with government and sub-sovereign entities, supported by an expansion of the Bank's rouble funding in the Russian bond market;
- Increased project co-financing with Russian banks, in particular in the area of rouble-denominated loans.

Over the strategy period, the expected **indicative** business breakdown of the Bank's activities would see core infrastructure sectors - transport, municipal - rising together to about 20-25 per cent of annual commitments. The power sector share is expected to account for another 15-20 per cent of annual commitments. The share of natural resources projects (oil, gas, mining) is expected to be 5-10 per cent. Direct business with the corporate sector (general and specialised industries) is expected to account for 30-35 per cent whilst MSME support (private equity, working capital and medium term finance to MSMEs) is expected to account for another 10 to 15 per cent of commitments. The proportion of projects in the banking and non-banking sectors (including trade facilitation) is expected to be within a 10 to 15 percent range.

In order to implement this strategy, management of the Russian operations has been strengthened with the appointment of a Business Group Director for Russia based both in Moscow and in London and exercising direct leadership within the Bank's matrix structure upon three Directors based in Moscow, covering between them the whole array of the Bank's activities: infrastructure/energy, corporate and financial. Moreover, the number of professional staff will be doubled over the next 12 months from the current 40 to about 80, consistent with the annual budget approved by the Board of Directors, whilst staff expertise will be strengthened.

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

1.1 Overview of Activities to Date

Since 1991 the Bank has signed 253 projects in Russia accounting for a net cumulative business volume of €7.2 billion and a total project value of about €19.8 billion.

The table below shows a breakdown of the Bank's cumulative business volume to date in Russia which shows a balanced picture of the Bank's involvement across sectors.

Table1. Russia: Overview of the Bank's Activities to Date (February 2006)

EUR million	No. of Projects (weighted)	Total Project Value	EBRD Finance	Debt	Equity	Per % of Cumulative Commitments
Private	226.9	16,658	5,721	4,687	1,034	80
State	26.0	3,165	1,475	1,475	0	20
POWER &ENERGY UTILITIES	8.0	956	542	542	0	8
NATURAL RESOURCES	23.0	3,637	735	704	31	10
MEI	14.0	1,702	490	490	0	7
Transport	15.5	1,754	772	762	10	11
INFRASTRUCTURE	29.5	3,456	1,262	1,252	10	18
Agribusiness	26.1	2,091	570	453	118	8
Property & Tourism	7.2	473	171	161	11	2
Telecoms, Informatics & Media	14.7	1,186	386	320	67	5
General Industries	56.3	4,150	1,322	1,243	79	18
CORPORATE SECTOR	104.3	7,900	2,449	2,177	275	33
Equity Funds	20.7	1,077	532	1	531	7
MSME Debt Finance	2.3	359	242	237	5	3
MSME SUPPORT	23.0	1,436	774	238	536	10
Bank Equity	12.8	274	183	12	171	3
Bank Lending (incl. TFP)	31.6	1,452	1,005	1,005	0	14
Non-bank Financial Institutions	20.3	709	245	232	13	3
FINANCIAL SECTOR	64.7	2,435	1,433	1,249	184	20
TOTAL	252.9	19,822	7,196	6,162	1,034	100

Annual business volume has remained stable since 2002 at €1.1 to 1.2 billion with a peak at €1.4 billion in 2004. Over the last two years the share of infrastructure in the annual business volume has remained marginal at 3-4%, whilst the share of power and energy increased from 5 to 21% and the share of the corporate sector decreased from 55 to 37%. Direct operations in the banking sector increased from 35 to 41% of annual commitments. The current pipeline of transactions is above €4 billion.

Over the last two years, the share of equity in the Russian portfolio declined from 14.2 percent in 2004 to 12.3 percent in 2005, for three reasons: (a) an insufficient focus on equity in Russia; (b) the growing availability of medium-term debt finance for larger enterprises; and (c) the need for improvements in transparency in local enterprises. Debt represented 83.5 percent of the portfolio stock at the end of 2005. The share of private sector projects since the start of the previous Strategy period fell marginally, from 75.5 percent in 2004 to 73.3 percent in 2005. Sovereign deals accounted for 19 percent of the portfolio at the end of 2005.

Operating assets stand at EUR 2.7 billion, representing 65 percent of the portfolio. Operating assets grew faster at 45 percent against a 25 percent growth in the portfolio over the last two years. This increased growth is the result of a high level of disbursements, especially in 2004 (EUR 853 million). The overall quality of the portfolio has considerably improved and the stock of impaired assets has decreased by over 74 percent since December 2003, down to EUR 31 million, due to a number of successful restructurings.

Up to now, the Bank has mobilised EUR 19.7 billion for projects in Russia. In addition to the EUR 7.2 billion financed directly by the Bank, the cumulative amount of co-financing in Russia reached approximately EUR 4.8 billion. This is the largest volume among the Bank's countries of operation. During 2004 alone, the amount of co-financing was a record EUR 669 million, followed by EUR 503 million in 2005. The key sectors attracting commercial co-financing to date have been Financial Institutions, Natural Resources, Agribusiness and General Industries. The Bank continues to demonstrate its commitment to finance a wide industrial base and expects to go on playing a significant role as a catalyst to encourage the involvement of commercial banks as well as other sources of co-financing in Russia. In 2006, the Bank broke new ground when it closed the first long term rouble syndication and six banks bought into its 7.2 billion rouble loan to Moscow's power utility, Mosenergo.

1.2 Implementation of the previous Country Strategy

The previous country strategy, approved in November 2004, outlined a number of priorities, the achievement of which is described below:

Promote upgrading and reform of Russia's infrastructure: The Bank has worked with the Russian Government in a number of sectors to identify sovereign operations involving major sector reform elements and environmental improvements. The Bank participated in key major projects (Federal Grid Company, System Operator SCADA and Mosenergo) to help the modernisation of the Russian power sector reform process. The Bank's membership in the restructuring committee of RAO UES and the involvement in this sector's restructuring at the regional level contributed to the achievements of the power sector reforms. In other infrastructure sectors, the Bank has selected projects where the promotion of private sector involvement, environmental improvement, energy saving investments, as well as the priorities of the Russian Government, such as the development of key transport arteries, are most prominent. Very little has been achieved in district heating as the main obstacles to energy efficiency investments remained. The only district heating project signed was with the city of Ufa in early 2006. The Bank's launch of long-term RUR-denominated loans in the Russian municipal infrastructure market has been important for this sector as the Russian Budget Code does not allow municipalities and regions to raise additional borrowing in foreign currency.

Assisting the modernisation and restructuring process of key Russian industries and large enterprises: To support the restructuring and modernisation of large companies and industrial sub-sectors the Bank has provided financing for quality Russian companies (for example Ufa Glass Packaging, Belaya Kalitva Metal and others) that have demonstrated commitment to good business practices. Special emphasis has been given to projects that diversify the economy away from the oil and gas extraction and improve energy efficiency. In this respect the Bank has developed visible projects with these companies that can compete in international markets and can promote Russia as an investment destination. The Bank has also provided financing to support the export of Russian high technology by providing finance for the export to China of the Tupolev 204 aircraft (Sirocco project).

Broadening the Bank's activities and promoting entrepreneurship including through more active use of equity instruments: There have been few new direct equity projects in the corporate sector, with the exception of the ground-breaking Toyota transaction. This has coincided with an increased appetite for Russian listed stocks by international institutional investors. The predominant sectors have been equity funds, both private and donor-supported. In addition, there has been a significant element of co-investments with major sponsors and specific, but typically smaller investments, in the TIM sector. While the level of operating assets has remained broadly stable at circa EUR 270 million, there have been significant realisations from the Regional Venture Fund portfolio: at the end of 2004, 59 investments have been fully or partly exited out of a total of 97, with an IRR of 11%. Equally there have been significant new commitments made to the established private equity fund managers and support given to the first commercial fund-raising efforts by previously donor-supported fund managers (e.g. Quadriga, Norum and Berkeley Capital Partners). Throughout the period, there has been a steady stream of new commitments to smaller well managed regional funds. The Bank's twenty-three equity funds, including RVFs and two regional funds which invest mostly in Russia, have supported so far about 200 companies and entrepreneurs with equity.

A key Bank instrument for the promotion of grass-roots entrepreneurship is the Russian Small Business Fund, which works through commercial banks to encourage them to lend to micro and small enterprises. While RSBF has made considerable achievements during the last Strategy period, the demand for MSE finance is still far from being met. RSBF has now disbursed over 200,000 loans in 128 cities in all time zones of the Russian Federation. A particular focus going forward will be to orient the financing towards lending to enterprises outside Moscow. In addition, the Bank strengthens the private sector development of SMEs through the Turnaround Management (TAM) and Business Advisory Services (BAS) Programmes, which provide enterprises with advisory services in areas such as management skills, market positioning, information systems, and environmental issues. TAM/BAS assist companies to be more competitive on domestic and international markets and in particular cases help them access financing. This grassroots initiative provides positive results.

Assistance in the consolidation and reform process of the financial sector and support for the development of the capital markets: The process of consolidation in the banking sector is still in its initial phase and there have been few opportunities to date to participate in bank mergers and acquisitions, but the EBRD is, by significantly expanding its relationship with Russian banks, building up the critical mass needed to add value to that process, which is expected to gather momentum over the new strategy period and will be a focus of the Bank's activity. An early example is the Bank's support for the merger under way between Sibacadembank and Uralvneshtorgbank, which will create a powerful regional player in the Siberian and Urals regions. The EBRD has sought to assist in the reform process largely through its broad lending and investment operations, recognising that one of the main objectives of the government's banking sector strategy is to increase the level of financial intermediation so that banking assets account for 56-60 percent of GDP by 2009.

One of the key areas of reform supported by the Bank has been the transformation of some banks into universal banks with improved transparency and governance. Linking its financial support with concrete benchmarks for addressing issues of corporate governance and business conduct, the Bank has established a relationship with Rosbank (Interros Group). The Bank has also supported competition by working with foreign investors in both debt and equity projects. Equity investment in banks is at the core of the Bank's activity in the financial sector and the portfolio now includes eight such investments. The range of instruments employed by the Bank in the Russian financial sector has increased, with preference shares and rouble-denominated subordinated debt complementing extensive credit lines to support SMEs, as well as mortgage and consumer lending. Regional banks have continued to be significant recipients of the Bank's funding - with a network of 10 banks in the regions established to date.

Support of the development of capital markets has centred on the establishment of the MosPrime index as a reliable benchmark for rouble borrowing. This has in turn allowed the EBRD's rouble funding programme to be expanded through the issue of the Bank's own bonds. The EBRD is also supporting the emergence of new capital markets instruments, in particular securitisation, by using its willingness and ability to take risk to facilitate the structuring of this new asset class to attract investor demand.

Implementation of a Regional Approach: The Bank had recognised the importance of building a balanced regional investment portfolio already prior to the previous Strategy period. A series of federal reforms, clarifications in the area of fiscal federalism, and rule-of-law reforms delivered major improvements and greater predictability in relations between the Federal centre and the regions. These changes have made it possible to develop business opportunities in a wider cross-section of regions, rather than focusing on priority regions selected on the basis of *a priori* criteria. While it is impossible for the Bank to maintain a meaningful presence in all of Russia's regions, the creation of a common economic and legal space has enabled the Bank to look at the investment potential of regions across the entire Federation. The EBRD's portfolio now comprises 253 projects and sub-projects in 47 regions. More than 65 percent of the Bank's projects are in the regions. The Bank's operations are supported by the planned expansion of its network of resident offices to the Volga Federal District, the Southern Federal District and Siberia. The BAS office in St Petersburg has been focussing on operations in regions of the North West of Russia. To date thirty eight BAS projects have been undertaken in those regions. The Vladivostok office is working in the regions of Khabarovsk and Sakhalin.

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

Over the years the Bank has built up a substantial portfolio in all key sectors of the Russian economy and has had - through its investments, policy dialogue and mobilisation of other investors – a tangible impact on several dimensions of Russia's transition process. The transition benefits generated by the Bank's operations and policy dialogue have been positively influenced by Russia's strong post-crisis recovery and the adoption and implementation of the Government's comprehensive modernisation and reform agenda in 2000.

A major source of the Bank's transition impact has been its contribution to the ongoing institution-building process in a wide range of sectors and reform areas. The Bank has provided assistance for developing the legal framework: among others, for secured transactions, joint stock companies, bankruptcy proceedings and concessions. The Bank has been involved through several transactions in sector reform programmes such as power sector restructuring, road sector financing and the railway sector. New areas of active policy dialogue include the tariff system for different types of renewable energy, implementation of PPPs in specific sectors, as well as securities market regulations.

Institution-building at the level of individual economic entities have been a standard feature of the Bank's municipal infrastructure and environment operations. Creditworthiness enhancement and institution-strengthening programmes with a number of Russian municipalities and utilities across many regions of Russia have been or are being implemented in a number of cities like St Petersburg, Perm, Yaroslav, Archangelsk, Syktyvkar and the Republic of Komi, Kaliningrad, Togliatti, Krasnodar and Surgut.

Setting a high standard of transparency and corporate governance has traditionally been among the main transition objectives for the Bank's operations in the corporate sector. The Bank's operations with Severstal, Togliattiazot and Lukoil, among others, were early examples of this followed by more recent transactions such as Kalina, Chelyabinsk Tube, Sual and Rusal. Most of these transactions also involved important enterprise restructuring components. The projects involving reputable foreign strategic investors have substantially contributed to the modernisation and restructuring process in a number of industrial sectors including the automotive, glass, aluminium, white-goods production, forestry and agribusiness. The associated positive demonstration effects were particularly strong in those areas where the strategic investor took over and restructured Russian businesses. Stinol, Bor Glass, Belaya Kalitva or Baltika are good examples of such cases. Operations involving strategic investors also developed strong market-oriented linkages with suppliers, especially in agribusiness, forestry and retail projects.

For promoting private entrepreneurship the Bank's RSBF programme and the private equity funds have been key vehicles. The Bank is also committed to advancing entrepreneurship through participation in privatisations and promoting private sector involvement in infrastructure, although progress in these areas has been slower. The Bank has also assisted in promoting entrepreneurship through its technical assistance operations including business advisory services, TAM programmes or support for Foreign Investment Advisory Service (FIAS) studies and TAM/BAS programmes. TAM has carried out 182 projects in the country so far. The BAS programme has undertaken a total of 321 projects through 4 local offices in the Far East (Vladivostok), Kaliningrad, St Petersburg and Samara.

In the financial sector, one of the Bank's strongest contributions to the transition process has been its support for Russia's regional banks, including through equity participation in an increasing range of them. Providing successful examples of the transformation of previous pocket banks into transparent universal financial institutions has been another transition objective followed in several operations. The Bank has also played a path-breaking role in assisting in the introduction of new financial instruments such as leasing, consumer finance, warehouse receipts, mortgages or participating in initial securitisation transactions. Following the issuance of a pioneering RUR 5 billion bond in May 2005, a larger share of Bank transactions was financed in local currency, thereby mitigating currency mismatches in un-hedged borrowers and stimulating the development of domestic capital markets.

Over 80 per cent of the projects monitored through the TIMS had good or excellent rating at approval stage. The expected transition impact (i.e. the proportion rated 1-4) stood at around 45% end 2005, reflecting both substantial risks to transition impact and occasional adverse developments in individual transactions. By the end of March 2006, there have been 22 transition rating upgrades and 10 downgrades in the monitored portfolio. A large part of the downgrades, including that of GM-Avtovaz and Power Machines, happened over the last two years, indicating a continued difficult business environment.

One of the key lessons the Bank has learned (and relearned) from its own activities is that despite major progress in stabilisation, economic performance and reforms, the Russian private sector suffers from structural and institutional weaknesses, state intervention and continued major distortions in the incentive structure of many economic agents. This in turn reduces the degree of predictability of individual investments. Hence special attention should be paid to understanding the specific conditions of the Bank's transactions, as well as the motivations and the credibility of the commitments of our clients. Creating and maintaining strong leverage over the Bank's clients also remains an important consideration.

In addition, the Bank has learned that it must increase significantly its project origination, preparation and legal structuring capacity in Russia, strengthen its presence in the regions, and work more closely with the Russian authorities, in particular the Russia Investment Fund, in the context of major infrastructure projects.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Political Environment

Russia has maintained political and social stability over the past Strategy period, thanks in part to its good economic performance and rising living standards. However, at the same time the centralisation of political power and control – over the regions, over society, over the polity and in the economy – has increased over the past several years. The state has gained control over nearly all national broadcast media. A new law on state regulation of NGOs has been criticised by rights groups for its expansion of discretionary authority to state agencies and the imposition of stricter guidelines for foreign-funded NGOs. The dominance of the United Russia party in national, regional and municipal politics has narrowed the space for rival political parties. The Council of Europe has expressed concerns about human rights violations in Chechnya, while Russia does not share that opinion.

Despite these developments, a dynamic private sector and the middle class continue to grow and a sizeable majority of eligible voters support the basic concepts of democratic governance, even while they question the democratic experiments of the 1990s. According to most public opinion polls, Russian citizens believe that the country needs a viable political opposition. They believe in fundamental freedoms of expression, association, worship and travel. Over time, Russia's middle class – its entrepreneurs, professionals, homeowners and educated workers – could form the political interest group that demands reinforcement of market-supporting institutions such as the rule of law, protection of property rights, a stable regulatory regime and more accountable decision makers. For that process to succeed, however, it will be important to ensure access to the means of collective action – most importantly, an independent media and an engaged civil society.

Partnership with western countries in fighting global terrorism, preventing the proliferation of weapons of mass destruction, securing energy and reducing carbon emissions continues. However, recent disputes with Russia's neighbours over gas prices have affected the country's image as a reliable energy supplier, and concerns have been raised by Russia's G-8 partners over perceived lack of progress in democratic institution-building.

The European Community is currently working with Russia to develop a new Partnership and Cooperation Agreement for post 2007 which provides a durable and comprehensive framework for EU-Russia relations.

2.1.2 Governance and Integrity Issues

The Russian president has expressed repeatedly the need to increase the efficiency of the state and its provision of services to businesses and individuals. Since coming to power in 2000, he has called for a streamlining of bureaucracy and government deregulation. There have been some positive changes, especially on deregulation and reduction of administrative barriers to business (licensing, registration, inspections, land use, taxation) and in some of the institutions enforcing corporate governance laws and regulations. However, steps to rationalise the state bureaucracy and advance administrative reforms have on balance been halting and ineffective and the enforcement of contract and property rights has been uneven.

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 deteriorated from 2.8 in 2004 (out of a possible 10) to 2.4 in 2005, placing it seventh from the bottom among transition countries. Similarly, the EBRD-World Bank Business Environment and Enterprise Performance Survey, conducted in 2005, showed that more businesses in Russia see corruption as a significant problem than was the case in 2002. Bribe payments to public officials during this period went up by approximately 50 percent, although they represented a smaller share of annual sales in Russia's growing economy.

The authorities have recognised this problem, though not enough has been done to combat it. For example, in his 2005 state of the nation address President Putin complained that the "bureaucracy remains a closed and sometimes simply arrogant caste which sees state service as a kind of business". The president accused "unscrupulous bureaucrats" of using the state to "achieve their own selfish ends" and he returned to this subject again in his 2006 state of the nation address. Beyond the reforms that have already been tried, institutional reforms that would strengthen democratic mechanisms of accountability – such as independent civil society organisations and a free media – have been associated with lower levels of corruption.

2.1.3 Social Conditions

Russia is undergoing a demographic crisis associated with the steady decline in its population. Since the break-up of the Soviet Union in 1991, Russia has lost some 4 million people, with the population contracting by an annual average of 0.5 percent over the first half of this decade. This decline would have been even more pronounced had it not been for considerable net immigration. According to a recent World Bank study, at current rates the country's population could further decline by over 30 percent by 2050. Life expectancy, especially among men, has sharply decreased and remains at a very low level standing at 58.9 years at end-2004 though there are recent signs that the decline has bottomed out. Despite the previous fall in life expectancy, the population is ageing, putting the pension system under strain. The average monthly pension in 2005 was RUR 2395 (US$ 85). The pay-as-you-go system will be unable to cope with the ageing population while the reform of the pension system is at its early stage.

However, recent developments on the standard of living front are encouraging. Real wages and incomes grew by an annual around 10 percent over the recent years. The share of population living below poverty line fell sharply from around 30 percent at the beginning of the decade to 15.8 percent in 2005. Unemployment also shrunk from 9.0

percent in 2001 to 7.6 percent in 2005. Moreover, the four National priority projects in health, education, housing and agriculture launched in September 2005 are directly targeting some of the so far neglected aspects of the standard of living of the population. The high priority attached to these projects promises a gradual improvement and new policy initiatives in these areas over the time horizon of the new strategy.

2.1.4 Legal Environment

Steady progress of the Russian legislative reforms continued in 2005. The State Duma approved a number of laws that are likely to contribute to the improvement of the investment climate in Russia.

One of the most important Federal Laws adopted in 2005 was the Law "On Concession Agreements". This Law creates a legal framework which enables private participation in the provision of public services and creates a viable model of public-private partnership in Russia. Consistent approach in applying the new Law by the Federal, regional and municipal authorities, as well as by the courts is necessary to ensure that it is successfully implemented.

The Federal Law "On Special Economic Zones," which took effect on 25 August 2005, is designed to stimulate investment in Russia – it provides for a special regime (including tax and custom duties exemptions) for entrepreneurial activities carried out in such special economic zones.

Perhaps the most significant development in the area of corporate law took place on 27 December 2005, when the State Duma adopted the Law "On Amendments to the Federal law 'On Joint Stock Companies'", which amendment will enter into force on 1 July 2006. This amendment significantly modifies the requirements which apply to those shareholders who hold more than 30% of the shares of an open joint stock company. It introduces mandatory and discretionary buy-out rules, and appoints the Federal Service for the Securities Market as the authority responsible for implementation of these new requirements.

A new Federal law dated 3 January 2006 helped removing various discrepancies between the Civil Code, the Federal Law "On Insolvency (bankruptcy)" and the Federal Law "On insolvency (bankruptcy) of the credit organizations". This law addressed, in particular, the order of priority of the creditors' claims in cases of bankruptcies of legal entities and credit institutions.

Judicial reforms continued to be among the top priorities of the current administration and there have been significant positive steps to increase judicial independence (including increases of salaries of judges).

Successful implementation of the legal reforms has been affected by the inconsistent application of the laws by the Federal, regional and municipal authorities and by the judiciary. Further efforts are needed in this area to achieve a change in the on-going negative public perception regarding the stability of the business climate in Russia.

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. In spite of achieving some progress in addressing the environmental legacy from the past, Russia's environment still remains in a state of emergency. Key issues of concern include pollution of water bodies, deterioration of fresh water resources and water quality; air pollution as a result of industrial emissions, energy generation and transport; increase in waste generation, including hazardous and radioactive waste; soil contamination, continuation of land degradation and decertification resulting in reduced productivity of farmlands and grasslands, and degradation of flora and fauna. Industrial pollution becomes more pervasive and more costly to control, especially for small- and medium-sized enterprises. At the same time, increasing pollution from transport, solid waste and municipal wastewaters due to accelerating development of housing and municipal services sector and deterioration of utility infrastructure are creating an increasing pressure on living conditions and threatening the health of the urban population. Russia's contribution to regional and global environmental problems such as acid depositions and greenhouse gas (GHG) emissions is of increasing concern.

Critical issues and challenges related to the existing environmental management framework in Russia remain to be related to the deteriorating data on environmental quality, insufficient institutional capacity, some uncertainty in the division of responsibilities between regional and federal government and allocation of financial resources, as well as big differences in regional performance. A wide-ranging public sector reform in the country is ongoing, aiming to streamline decision-making, make better use of public resources, and eradicate conflicts of interest between the government's regulatory functions and administration of its assets. 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.

Russia has an enormous environmental investment potential, and further improvements in the environmental regulatory framework could help to foster further domestic and international assistance. An environmental chapter was included in the EU-Russia Common Economic Space road map adopted in May 2005, setting priorities for the agenda for EU-Russia co-operation during the coming years. The launch of a wider dialogue between EU and Russia on environment is expected at a Permanent Partnership Council meeting with Russia in October 2006.

The decision by Russia to ratify the Kyoto Protocol in 2004 was an important step forward and has been followed by close cooperation between the EU and IFIs with the Russian authorities on implementation of Kyoto agreements. This provides Russia with the means to monetise the environmental benefits of reducing GHGs and energy waste.

The EBRD has played a key role in the establishment of the Northern Dimension Environmental Partnership (NDEP), which offers an innovative approach to solving some of the most pressing environmental problems in north-west Russia with profound cross-border effects. Within the framework of the NDEP, the Bank has been co-operating with other international financial institutions such as the Nordic Investment Bank (NIB), the European Investment Bank (EIB) and the World Bank (WB), with the donor community and the Russian government in order to mobilise financial resources for tackling longstanding environmental problems in areas such as water supply, wastewater treatment, solid waste management, district heating and nuclear waste.

The NDEP Support Fund is managed by the EBRD under the supervision of the Assembly of Contributors. As at the end of April 2006, contributions to the Fund amounted to €226 million and the funding was pledged from the European Community, Denmark, Finland, Norway, Russia, Sweden, France, United Kingdom, the Netherlands, Germany, Canada and Belgium. Two thirds of this amount, €150 million, has been earmarked for nuclear safety activities. The remaining €76 million for environmental investments has helped to leverage over €1.5 billion in investment capital from IFIs. The Assembly of Contributors has approved NDEP co-financing of almost €57 million for ten environmental projects. These are such projects as the St. Petersburg Southwest Wastewater Treatment Plant, the St. Petersburg Flood Protection Barrier (which requires increased focus on implementation), the St. Petersburg Northern Wastewater Treatment Plant Incinerator, the Neva Discharge project, a Municipal Environment Investment Programme in the Leningrad Oblast (Phase 1), the Komi Municipal Services Improvement project, the Kaliningrad District Heating Renovation and Reform, the Archangelsk Municipal Water Services project, the Murmansk District Heating project, the Kaliningrad Water and Environmental Services, and the Kaliningrad Project Implementation Unit. The first NDEP project, the Southwest Wastewater Treatment plant has been in full operation since September 2005 and has enabled the city of St Petersburg to treat 85% of its wastewater.

The NDEP Nuclear Window addresses the legacy of the nuclear-powered ships and submarines of the Soviet Northern Fleet in Russia, and has been operational since 2003. Its first task was to obtain a comprehensive view, which was achieved through Phase 1 of the Strategic Master Plan - completed in October 2004 - and complemented with a Strategic Environment Assessment in 2005 allowing for extensive public consultations. As of July 2005, grant support totalling €19.1 million has been allocated to urgent projects, as identified in the Strategic Master Plan. These include Phase 2 of the Strategic Master Plan, aimed at the development of an overall decommissioning programme, the installation of a radiation monitoring and emergency response system in the Murmansk region and the creation of safe storage of spent nuclear fuel in Gremikha Bay. NDEP Donors approved in principle in June 2005 two new projects, consisting of the decommissioning of major hazardous nuclear objects, the “Lepse” service ship and building No 5 in Andreeva Bay, currently estimated to cost €60 million.

The Bank's environmental approach to Russia continues to reflect and address its environmental challenges and opportunities through the Bank's project portfolio. Further information is provided in Annex 5.

2.2 Macroeconomic Conditions relevant for Bank Operations

Russia continues to register strong growth rates, though shifts in the composition of growth underline the structural problems that need to be addressed. Real GDP growth in

2005 slowed to 6.4 percent, slightly below the levels registered in 2003 and 2004, in part due to a very notable decline in growth rates of the manufacturing sector and in mineral extraction. Investment continued to recover but remain low by the standards of similar emerging markets, and is highly concentrated in a few sectors. Lifting the relatively low rate of investment remains the central long term challenge for the Russian economy. Household consumption remains the most dynamic component of aggregate demand, and is supported by the expansion of private incomes and credit to the private sector.

Growth rates have to some extent been supported by an unusually favourable external economic environment. Russia's export prices increased by over 30 percent in 2005, helping to raise the current account to about 12 percent of GDP. This also contributed to another record level of official foreign reserves (US$ 182 billion) by the end of the year. Despite lingering political uncertainties, gross foreign direct investment inflows to the non-financial sector reached a record US$ 16.7 billion in 2005. Private external transactions also recorded a first net inflow in the year, and financing conditions (in terms of yield spreads and maturities offered) improved further. These trends in the capital account underline the greater investor confidence in the economy, as it is reflected in the investment grade rating that is awarded to Russia by all three rating agencies.

The authorities have so far managed the oil windfall prudently, although the rules that govern the fiscal oil windfall remain in flux. The consolidated government budget registered an overall surplus of 7.4 percent in 2005, reflecting higher revenues from the natural resources sector, although the structural balance (assuming constant oil prices) deteriorated somewhat. The Oil Stabilisation Fund (OSF) that was set up in 2004 and accumulates part of fiscal revenues from the oil industry reached USD 55 billion at the end of February 2006, equivalent to about 7 percent of GDP. This fund not only saves a large part of the oil windfall for future generations (and retired USD 20 billion in debt owed to the IMF and the Paris Club in 2005), but plays an important role in insulating the economy from price pressures. The fund is held in an account with the central bank, and hence does not translate into increases in domestic liquidity as other increases in foreign reserves do. Even though several proposals for spending the oil windfall have been discussed, the authorities have maintained discipline in the rules governing the fund, and are considering a number of options for a more long term and diversified investment allocation. Preserving the sterilisation function of the fund will be crucial for containing inflation.

In the face of rapid monetary expansion, the financial sector will need to play a key role in absorbing and allocating the liquidity inflows of the coming years. The monetary authorities continue to target stability relative to a basket of the Euro and dollar. Substantial current account surpluses – and recently surpluses in private capital account transactions – hence translate into reserve accumulation and, given the very limited sterilisation options on the illiquid domestic capital markets, into an expansion of broad money (last year at a rate of 37 percent). Consequently, inflationary pressures persisted in 2005, CPI inflation was at 10.9 percent at the end of the year. This is the lowest in seven years, but above the authorities' earlier target. A number of administrative measures (including on regulating increases in administered prices in public utilities) have been ineffective in containing such pressures. Reductions in the income velocity of broad money – basically through a stronger growth in bank deposits – have played an important role in containing price pressures.

Growth in 2006 is likely to be at a level close to that in 2005, at about 6.5 per cent. Short term risks to the liquidity of the fiscal, corporate and banking system are limited. Given the current reform scenario most observers predict a moderation in growth over the medium term, though the outlook for growth will hinge on whether the private investment rate can be raised to an extent that addresses the increasingly apparent capacity constraints and regional and sectoral imbalances. The key risks to price stability are further fiscal loosening and the failure to adapt exchange rate policy to inflation objectives.

2.3 Progress in Reforms and Key Remaining Challenges

In the context of the ongoing trend of increasing globalisation Russia's integration into the world economy and its institutional structures acquires added importance and urgency. Addressing many international economic, financial, environmental, infrastructure, energy supply and other issues needs Russia's active co-operation. The G8 framework is one of the major fora for that, as well as various specialised initiatives such as the EU/Russia Energy Dialogue or the US/Russia Energy Dialogue. The integration and co-operation processes with other key global and European institutions, however, need fresh momentum. The recent ratification of the Kyoto protocol is an important step in this process. Russia is the only large economy remaining outside the WTO framework though major progress has recently been made in the accession negotiations. Integration between the European Union (EU) and Russia also needs further deepening. WTO membership as well as closer ties with the EU could serve in many respects as an important external anchor for Russia's domestic reforms and improvements of the investment climate. Greater opening up of the Russian economy to the outside world would strengthen both the competitive pressures and the transfer of resources and skills to the modernisation and efficiency enhancement process. Integration into the world economy and its institutions would provide benchmarks also for the regional integration process among the CIS countries.

In contrast to the country's solid macroeconomic performance, progress in structural and institutional reforms has remained modest although fiscal reforms and financial sector reforms can boast of important achievements such as the establishment and successful operation of the stabilisation fund, the recent transition to a three-year fiscal planning framework or the creation of a deposit insurance scheme in the banking sector. There have also been advances in important dimensions of the social, administrative, power, telecommunications and railway sector reforms. There have been positive developments in the legal and regulatory framework as well.

Nevertheless, the planned broad-based acceleration of reforms by the new government has not materialised. Most importantly, the reform process of the public institutions has proved to be a more complex task than originally assumed. The Government itself has been divided over a number of major issues including the degree of state interference in the economy. The state reasserted control over a number of large companies considered to be of strategic importance. No progress in the improvement of protection of property rights was made. Concentration of ownership in state hands in the oil and gas sector in the wake of the dismantling of Yukos may prove to have an adverse impact on efficiency and productivity growth in the sector in the medium term, although international investors' interest in the recent IPO of Rosneft does not seem to confirm that sentiment.

However, modernisation, restructuring and reforms at the microeconomic level have been progressing strongly, underpinned by the liquidity throughout the economy, combined with the spontaneous market forces unleashed by the previous reforms. Financial market developments and fast growth in the retail and telecommunications sectors are the key illustrations of this transformation. The widening presence of the private sector in municipal infrastructure and the housing sector, or the rapid expansion of businesses into Russia's regions, are also good examples. The liberalisation of the SME sector also continues, although less consistently than originally intended. The liberalisation and market development process has received new incentives and scope also from the recent initiatives involving different schemes and mechanisms of public private partnerships (PPPs).

Looking ahead, the current combination of strong state presence in areas considered to be strategic and liberalisation tendencies in the rest of the economy is expected to remain a fundamental feature of the Russian economy. The operational and reform environment is likely to remain complex with major uncertainties involved, given that the state is assuming a much stronger role in the economy while the public institutions, both at federal and local levels, are at the early stages of their own reform process. The prospects of continued high oil prices, while encouraging in many respects, reduce the sense of urgency of reforms. The approaching elections add an extra layer of uncertainties. Liberal reforms tend to have limited support from the public.

Nonetheless, at the sectoral and microeconomic levels there will be a wide range of opportunities to advance Russia's transition process. In this context, the main transition challenges which the Bank can help address are:

- Promote modernisation and restructuring of Russia's infrastructure with special regard to facilitating private sector participation and engaging in path-breaking public private partnership transactions;
- Support reforms of the power utilities sector in their third crucial phase;
- Broad-based support of the ongoing enterprise restructuring and technological upgrading process, increase the transparency, the capital base and the financing options of the corporate sector in order to help diversify the economy and secure a long term competitiveness of Russian enterprises including in the regions, and both for larger enterprises and MSMEs;
- Identify specific obstacles to financing small enterprises to unblock the current bottlenecks to financing small enterprises in the regions;
- Continue to improve the financing of the economy through promoting innovative ways of financing, facilitating restructuring of the banking sector and the development of capital markets as an alternative source of funds.
- Promote energy efficiency across all sectors.

These challenges are discussed below.

Upgrading and developing the municipal infrastructure and transport remains among Russia's most complex, long-term and resource-intensive challenges. Modernisation and development of the transport infrastructure is also is a key precondition for the country's deeper international and inter-regional integration. Accordingly, infrastructure investment is a top priority for the country and for the Bank.

The creation of Russia's Investment Fund opens important opportunities for the Bank to work with the government on co-financing key infrastructure projects, primarily those which are structured as Private-Public Partnerships. The Bank's ability to generate and structure projects and to make rouble loans will be crucial to its ability to finance infrastructure projects in Russia. The Bank has acquired some expertise of PPPs in Central Europe which it needs to develop further.

Despite recent reforms, many municipal utilities are still in need of tariff reform and commercialisation. The regulatory framework does not provide appropriate incentives for efficiency. Some private sector participation has occurred in district heating, water services, and public transport (mostly minibus services). A few municipalities have commercialised their services and are able to borrow without a sovereign guarantee in order to finance infrastructure investment. Corporate governance needs to be improved.

In the transport sector, reform has been achieved at different speeds in the different sub-sectors. At the forefront are certain privatised shipping companies, which are capable of competing in world markets and the rail sector, which has undertaken substantial reform, driven by the demands of the internal market. However, in the road sector, the reform process is slow. Road user charges are insufficient to cover costs and private sector participation is limited. In other transport sectors, such as the airports sector the nature of ongoing restructuring and reform is still under debate. Cooperation could be significantly strengthened following a solution to the issue of Siberian overflights. As a consequence, the transition challenges for the Bank in the sector are diverse and include:

- fostering the restructuring and corporatisation of state entities, such as Rosmorport, with a view to putting their operations on a commercial footing and clarifying their relationship with the state, to enable them to enter into normal commercial relations and to put in place an efficient and logical corporate and management structure;

- continuing to assist in the development of concessions and PPPs and their preparation, tendering and administration to internationally acceptable standards;

- bringing acceptable standards of corporate governance to companies to be privatised, by providing pre-privatisation support and where appropriate taking an equity stake and a position on the Board of Directors; and

- demonstrating the benefits of good corporate governance and transparent financial reporting by supporting those transport related companies which have implemented sound corporate structures and policies.

A major process of restructuring is currently underway in the Russian power sector. During the first stage, independent, wholly-owned subsidiaries for its transmission assets and the system operating/dispatching services have been created. A market operator (the Administrator of the Trade System) has been also established to administer free trading of power, which is currently limited to 15 percent of total electricity produced but anticipated to increase to almost 50% by 2007 and fully liberalised by 2009. Unbundling of the vertically integrated regional utilities into generation, transmission, distribution and supply companies is almost complete at both the federal and regional levels. The next, and most crucial stage of the reform process is aimed at: increasing the private ownership of the competitive parts of the new structure: generation and supply; improving regulation of the monopoly activities such as system and grid operation; phasing out of RAO UES's role with distribution of its ownership in various subsidiaries to its own shareholders: and attracting massive investment into the sector which is vital to ensure reliability and stability of efficient supply to meet the growing demands of the economy.

The natural resources sector represents a significant part of the GDP and even larger portion of export revenues. The main challenges in the sector include:

- security of supply and increase energy fuel mix in the region and its further integration in the world economy;
- corporate governance and transparency standards and restructuring of the state-owned companies;
- policy dialogue on transparent revenue management, accountability of licensing agreements and revenue flows between corporations and the state;
- regulatory reforms, including accounting separation of upstream from mid-stream and downstream activities, competitive and transparent allocation of licenses, and development of crude quality accounting;
- development of internal gas market and independent gas producers;
- technology and know-how transfer; and
- improved environmental, social, health and safety standards and enhanced economic and social benefits.

Transition challenges in the Russian industrial sector remain large. Recent progress in deregulation, administrative reform, tax reform, and corporate governance improvements in a number of large enterprises were affected by uncertainties regarding property rights and overall rules for the private sector, especially large businesses. An overarching objective of the Bank's work in this sector will be to enhance corporate governance by promoting transparency, strengthening competition and encouraging good business conduct and compliance with higher business standards. Larger enterprises and medium-sized companies call for a different approach by the Bank. A particular focus will be energy efficiency, which is an essential condition for many industries to be competitive on a global basis. An important and growing focus is expected to be market-based industrial restructuring, for instance in the automotive sector which is characterised by an openness to foreign investment and a dire need to modernise in parallel some elements of the national industry.

The high energy intensity of the Russian economy presents significant challenges but also a great many opportunities to improve competitiveness of industry and the efficiency of public services on a sustainable basis. Russian energy consumers have been able to enjoy artificially low energy prices for many years, and as a consequence little attention has been paid to demand side energy management. However as energy prices are now increasing the need to improve efficiency – and the benefits from doing so– are becoming apparent in key sectors such as industry, power, oil & gas, district heating and transport. Broader economic benefits will also be realised through reduced demand on natural resources – extending reserve life and helping to secure additional export capability.

In the agribusiness sector, significant state support and intervention are still present at national or regional level, in particular in grain, meat and sugar markets. Farming sector is not yet fully privatised and still needs to be restructured. Most of the agribusiness enterprises have been privatised and the sector overall has shown robust growth over the past few years with emerging leading local enterprises and selected international investors. Russia has also developed into a major producer and exporter of agricultural commodities. However, most agribusiness subsectors are still fragmented with poor quality of products, hygienic controls and inefficient production, packaging and distribution process. Counterfeiting also represents a serious limitation to quality improvement. As in the corporate sector, local enterprises still need to improve transparency and corporate governance.

Unlike markets in Central and Eastern Europe, the Russian post-1998 private equity landscape has been characterized by the presence of Russian financial and industrial groups or cash rich businesses trying to invest their surplus profits outside of their core industries. Russia is marked by high level of domestic liquidity that is generated by such groups, with a very limited presence of private equity fund managers operating to international standards. Although the latter have been able to tap international institutional investors for funding, a number of private equity or private-equity like funds operating in Russia are on an extremely limited scale and the amount of quality risk capital available to entrepreneurs in Russia remains at a very low level compared to the size of the Russian economy (private equity investments as a percentage of GDP was 0.006% in 2004). While Russia is enjoying the status of an emerging market giant along with India, China and Brazil, the capital flow to private equity from institutional investors remains highly volatile and cyclical. In addition, a lack of corporate management skills, ownership disputes and regulatory uncertainties hamper the wider development of private equity in the country. This requires that the Bank be a consistent investor in private equity funds managed by qualified managers throughout the economic cycles and ensure that it plays the role of an active investor.

The challenges in the MSME sector continue to be large. While there are an estimated 6 million MSMEs in Russia (though fewer than 1 million operate as legal entities), their macroeconomic and social contribution is well below the levels achieved in some other transition economies. Key constraints include pervasive administrative obstacles, limited niches of expansion, lack of transparency of ownership, and significant cash payments which contribute to generating a perception of high risk, resulting in a continued lack of access to financing on reasonable terms. 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. EBRD continues to play a leading role in financing MSMEs through the RSBF program with credit lines through local banks and a dedicated microfinance bank are actively lending to MSMEs. While many banks, including the RSBF partner 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 outlined above. In terms of regulatory and legal matters, both credit registry and private credit information bureaus are in 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.

Supporting consolidation, competition and innovation remains the key priority for the Bank's operations in the <u>financial sector</u>. A special challenge is the fragmentation and low capitalisation of the banking sector, the continued strong positions by state-owned entities and the limited transparency of many banks' ownership structures and operations. Credit to the private sector remains relatively low when compared to other emerging markets at similar levels of income, at about 28 per cent percent of GDP. Nevertheless, the financial system is rapidly deepening, with domestic credit to the household and corporate sectors growing at 90 percent and 31 percent respectively in 2005. The very rapid expansion of retail finance has made relatively new products, such as mortgages and consumer finance, increasingly available throughout Russia's regions. Maturities extended slightly (37 percent of rouble loans to the corporate sector are at maturities of one year or longer). The availability of credit varies greatly between regions, and large parts of the Russian corporate sector remain constrained for credit. Following this sustained period of high loan growth, the capital adequacy ratios of most Russian banks have fallen. According to CBR data, the regulatory capital ratio by Russian accounting standards decreased from 19% at end-2003 to 16% by end 2005 and some banks are approaching the regulatory minimum of 10%.

Transition challenges are medium in the <u>non-banking sector</u>. Securities markets legislation and regulation almost meet IOSCO standards, but much progress still needs to be made in market supervision and prudential requirements for exchanges and intermediaries. Insurance legislation and regulation are weak and the sector is characterised by life and non-life insurance schemes designed for tax optimisation. The "true" insurance market is small.

Cutting across sectors, <u>energy efficiency</u> is a key transition challenge of Russia. Of all the countries of operations of the Bank, Russia presents by far the largest potential for energy savings and greenhouse gas emission reductions due to its size and the inordinately high amount of energy it uses to produce its GDP. This "energy intensity" is 3.2 times higher than the EU-25 average when adjusted for Purchasing Power Parity. It puts Russian enterprises at a tremendous disadvantage in the competitive global economy. By improving energy efficiency Russia could export more oil and (chiefly) gas to its foreign consumers. Russia could also significantly reduce greenhouse gas emissions and monetise the resulting carbon credits, thereby attracting additional resources for its development and modernisation.

2.4 Access to Capital

Over the strategy period, Russia may continue to benefit from ample liquidity in external and domestic credit. Current monetary policy targets exchange rate stability, and given projected substantial inflows in the current and capital accounts, this policy will translate into the accumulation of international reserves and a further rapid expansion of domestic money supply. This policy will continue to depress money market interest rates, which are negative in real terms, and provide incentives for credit expansion. The authorities have designed a number of administrative and regulatory measures to deal with inflation, which remains stubbornly ahead of central bank targets, though the exchange rate policy is unlikely to become more flexible until an inflation targeting regime will be implemented in about two to three years.

It is important to emphasise that domestic securities markets have become an important alternative source of funding for large enterprises. In the equity market, valuation and trading volume have increased sharply over the course of 2005, and the sharp correction in valuations in May and June 2006 was in line with trends in emerging equity markets, sparked by a broader risk aversion of portfolio investors. A number of large enterprises envisage initial public offerings on the primary market in 2006, and the correction in equity markets will delay some of these issues. The volume of outstanding corporate rouble bonds has more than doubled in the year to February 2006. Total liquidity is set to expand further as the federal government's debt management strategy seeks to substitute domestic for external debt, and large enterprises increasingly meet their funding needs in the domestic bond market. As in the corporate credit market, maturities remain limited, with 71 percent of bonds issued at original maturities of less than one year.

In July 2006 the Russian authorities further liberalised capital account transactions through the abolition of the remaining unremunerated reserve requirements on bond purchases by non-residents, and the legalisation of rouble denominated accounts held by Russians abroad, and by non-residents within Russia (capital account convertibility). These measures are likely to result in greater private capital flows to Russia, in particular to the government bond market. Use of rouble accounts abroad may also result in greater foreign direct investment by Russian entities, in particular in the financial sector. Over the medium term the liberalisation is likely to imply greater volatility in private capital flows, and, correspondingly, in asset prices and funding costs for Russian entities. Financial openness implies greater opportunities for diversification, but equally a greater exposure to often volatile foreign investor sentiment. Ultimately, the combination of an open capital account, coupled with the dual objectives of controlling inflation and targeting exchange rate stability is likely to prove unsustainable. The central bank's stated objective of setting explicit inflation targets while allowing greater exchange rate flexibility is therefore appropriate. Capital account openness also underlines the need for further trade liberalisation to ensure efficient allocation of additional capital inflows, as well as for a further strengthening of the banking system that will intermediate these flows.

Russia's access to external debt was supported by highly favourable conditions in international capital markets, as reflected in the further compression of emerging market yield spreads up to May 2006. However, the improvement in financing terms is in large part due to strengthened macroeconomic fundamentals, as is evident in the investment grade rating that is now awarded to the sovereign by all three major credit rating agencies. A widening group of corporates has accessed the syndicated loan market. However, of all syndicated lending to Russian borrowers in 2005, 58% was to the oil and gas sector, and 20% was to the financial institutions sector, demonstrating how little of the industrial sector benefits from the liquidity flowing into Russia. In 2005, gross external debt increased by about USD 18 billion in the banking sector, and by USD 50 billion in the corporate sector (thereby more than off-setting the reduction in official debt). The current tightening in global liquidity conditions is likely to impede capital market access for smaller or riskier borrowers.

Foreign direct investment (i.e. flows of debt and equity between affiliated enterprises) has also revived. An estimated total gross inflow of about USD 16.7 billion in 2005 still leaves Russia well behind its peers in the transition region, once FDI flows are related to GDP. Nevertheless, FDI is now flowing to a much wider set of regions and sectors, importantly including financial services.

3. STRATEGIC ORIENTATIONS

In line with the Government's medium term strategic priority to strengthen competitiveness, and in accordance with the transition challenges in Russia, the Bank will focus on the following priorities:

- a strong emphasis on infrastructure (municipal and transport), power utilities, and energy efficiency;
- a 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;
- support to smaller companies, which contribute greatly to economic diversification and employment, will be given as high a priority as larger companies;
- a selective intervention in the banking and non banking sectors, with a parallel strive to develop capital markets transactions;
- An emphasis on energy efficiency and reducing GHG emissions across all sectors.

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.

3.1 Infrastructure

Two key elements will determine the expansion of the Bank's support to infrastructure projects.

The first element will be the implementation of the tripartite Memorandum of Understanding between the EBRD, the EIB and the European Commission to co-finance Trans-European networks in transport, energy, telecommunications and environmental infrastructure. In the environmental sector, cooperation between EBRD and EIB will give particular priority to projects within the framework of the Northern Dimension Environmental Partnership. The priorities for extension of the major trans-European networks to the neighbouring countries outlined in the report from the High Level Group chaired by Loyola de Palacio will be a useful guide for action.

The second element will be to develop a practical cooperation on concrete projects with the Russian Investment Fund, which will be able to intervene as a guarantor, an equity investor or a debt co-financier on selected infrastructure projects.

The Bank's plans for the municipal and transport sectors are described below. Investments in these activities hold significant potential for energy efficiency and the reduction of greenhouse gas emissions.

It is expected that infrastructure will account indicatively for about 20-25% of the annual business volume over the strategy period, a strong increase from the 3% achieved in 2005. Such an increase will require full support from the Russian authorities to organise a fruitful cooperation with the Investment Fund.

3.1.1 Municipal and Environmental Infrastructure

The main objective will be to significantly scale up municipal operations in order to achieve increased transition impact. The Bank will develop relevant mechanisms to do so. More specifically, the Bank will be pursuing the following avenues:

- a Memorandum of Understanding has been entered into with Rosstroy, the State Agency for municipal investment, in order, in some cases, to match EBRD loans and federal grants. A tentative and flexible list of 18 cities has been selected to implement this cooperation;
- The emergence of private Russian companies dedicated to infrastructure investment and operations, and growing foreign investor interest in this area, provides an opportunity for the Bank to support public private partnerships (PPPs) in municipal infrastructure in partnership with operators, as in the case of Omsk together with the Eurasian Water Partnership and in Perm together with Novogor, but also with other emerging private operators;
- The Bank will explore the possibility to design regional frameworks for on-lending to municipalities.

The Bank will continue to offer decentralised financing solutions such as local government loans or loans to local public companies with local government guarantees in order to assist reform-minded local administrations with the establishment of a successful borrowing track record and turning their utilities into viable commercial entities. The Bank will push for the introduction of cost recovery and "user pays" concepts within the limits of affordability constraints while continuing to promote transparency in the sphere of transfers and payments. It will support the institutional strengthening and financial and operational sustainability (corporatisation) of utility companies, as well as creditworthiness of local authorities including through the mobilisation of donor-funded technical co-operation assistance.

The Bank will promote the development of transparent competitive selection procedures and ensure that existing PPP contracts it supports are bankable and reflect adequately the sharing of risk and responsibility between the public and private sectors. Private operators and financiers are likely to be keen to participate if they see a clear commitment of the Russian authorities to support projects of a reasonable size.

Regarding the different sub-sectors of municipal infrastructure, the Bank will focus on enhancing the portfolio with waste processing, district heating (which holds great potential for improved energy efficiency) and urban transport operations, while continuing to respond actively to opportunities in the provision of water and waste water treatment. Developments will be largely driven by demand and the degree to which potential client municipalities are open to reform, as well as by progress in the underlying fundamentals, of which tariff reform is the most important. In addition, the Bank will engage in the housing sector with transactions to support municipalities in the rehabilitation of energy inefficient and dilapidated housing stock whilst improving regulatory oversight. Transactions will be designed to ensure a greater participation of the private sector in both operation and maintenance as well as increased private ownership of flats.

Subject to approval by the Bank's Board of Directors, the Bank will consider supporting municipal investments in Sakha Yakutia (district heating), Vologda (water treatment), Krasnoyarsk (all sectors), Surgut (housing), Khanti Mansi (all sectors), Cherepovets (district heating), Perm (water treatment), and Kazan (water treatment). The Bank is also implementing a specific Action Plan for Kaliningrad which includes environmental improvements (waste water treatment plant, heating rehabilitation).

3.1.2 Transport Infrastructure

The quality of the transport network and associated services in Russia is one of the main determinants of the Country's economic prosperity and is key to maintaining the integrity of the Russian domestic market. Given the scale and scope of the sector, the Bank will pursue a flexible approach to the financing of each transport mode to take account of the diverse needs of its clients and in line with the priorities identified by the High Level Group on the extension of the major trans-European transport axes to the neighbouring countries. Particular attention will be given to investments enhancing transport security (maritime, aviation, land and urban transport, supply chain security).

The transport sector remains largely state-owned. In light of the current Russian government policy not to provide sovereign guarantees for infrastructure development, the strategic direction and priorities of the Bank in the transport sector represent a combination of non-sovereign projects with state-owned corporate entities benefiting from identifiable and regular revenue streams; non-sovereign projects with support from local authorities or development initiatives such as the Russian Investment Fund; PPP solutions where such structuring is appropriate and purely private projects.

The Bank is keen to draw on its experience of financing infrastructure projects on a PPP basis in other countries of operation and collaborate with the Russian Federation and Russian and international banks in developing and financing a PPP programme for upgrading infrastructure. The Bank will also encourage and be supportive of the establishment of a dedicated PPP Unit at the appropriate government level, which will allow the centralising of expertise, the preservation of institutional experience and a consistent approach to the markets.

While the investment needs of the sector are considerable, the operational environment for the Bank is challenging in view of the limited operational and credit history of many of its potential major clients, significant integrity issues and the dominance of the Federal regulatory agencies in the sector, which to a large extent determine the investment climate and opportunities in the transport sector. Nonetheless, the Bank will continue to pursue opportunities in the areas outlined below.

- ***Road and Bridges:*** Emphasis will therefore be put on encouraging greater private sector participation. In particular, the Bank will continue its policy dialogue with the Government on the new Concession Law which represents an important step forward in terms of the introduction of Public-Private Partnerships (PPPs) in infrastructure. Without prejudice to the normal assessment of the business case and subject to approval by the Bank's Board of Directors, the Bank intends to consider participation in the financing of the high profile road concessions (PPPs) which are currently under preparation and could materialise in the short-medium term, such as the Western High Speed Diameter in St Petersburg and the Moscow-St Petersburg motorway. Similarly, the Bank intends to consider supporting the design and construction of toll bridges in Perm and Krasnoyarsk.

- ***Railway Sector***: The Bank will seek to support continued reform of the sector and to develop investment opportunities in the areas of: railway infrastructure development and upgrading with both RZD/infrastructure and the private sector (e.g. short freight lines, with industrial clients); rolling stock investment and/or leasing, such as freight wagons and traction with private sector operators and passenger rolling stock for long-distance passenger operations with both RZD/Passenger and private passenger operators; high-speed rail operations (both infrastructure and rolling stock) and regional railway services subject to their development in the medium term. The Bank will also consider providing pre-privatisation financing for the newly established subsidiaries of RZD.

- ***Air transport infrastructure and safety:*** There is a need for an extensive airport runway and land navigation rehabilitation programme, especially at regional airports. These projects could be financed on a non-sovereign basis provided take-off and landing charges and, where available, other revenue sources are in place and can be used for repayment purposes. Government support or co-financing of this state-owned infrastructure may be required. Simultaneously, the Bank is ready to work with private investors to provide financing for airport terminal upgrades and landside developments. The Bank is willing to work with the Government to identify and prepare an investment programme to support the modernisation of the Russian ATM sector and to allow the implementation of priority air navigation following an agreement between the EU and Russia on Siberian overflights. The Bank is also keen draw on its experience of financing airport development on a PPP basis, which may be applied in Russia, and to co-operate with the Government and private sector operators to develop regional airport projects such as Perm, Krasnoyarsk and Sochi.

- ***Aviation and Aeronautics:*** Asset backed financing will be an appropriate tool to support fleet replacement. The Bank will support aircraft financing with registration on shore (such as the Vim airlines project), thus promoting Russia as a recognised country for aircraft finance. Legal transition will play an important role, as the Cape

Town Convention is now effective and the Bank is ready to support Russia's ratification of the convention to support access to long term finance and leasing for airlines in Russia. In support of the Russian government efforts to restructure the aeronautics industry, the Bank will continue to support Russian made aircraft which are able to compete in the market place such as the Tu 204-120 which is exported to China (Sirocco project) and the **Russian Regional Jet** by providing finance or supporting the provision of finance for the purchaser or by taking the performance risk of the manufacturer, provided such projects are in accordance with the international and European standards for aviation and aeronautics.

- ***Shipping and Inland Waterways****:* The Bank will consider further transactions in the shipping sector which promote transition or which demonstrate one of the tangible benefits of commercialisation, thereby providing encouragement for other entities to follow suit. The need for fleet renewal should present the Bank with further opportunities to finance new buildings, such as deep sea tankers; general cargo vessels (including containers); and offshore supply ships for developments in Russian waters and the Caspian. However, the lack of transparency, weak adherence to good business practice and poor corporate governance remain the principle obstacles and challenges to both long term debt finance and direct equity investments from international sponsors, which are considered low compared to other sectors. Russian Inland Waterways have the potential to capture a significant share of bulk cargo transportation, with corresponding environmental benefits. However, the sector requires extensive renewal and rehabilitation of its canal network, navigation and safety system and hydrological installations. The Bank will continue its efforts to structure potential non-sovereign investment in this sub-sector by looking at opportunities in key regions in cooperation with dedicated development initiatives (e.g. Russian Investment Fund).

- ***Ports:*** The Bank has been influential in the restructuring of the State's role in the port sector through the establishment of Rosmorport as a unified ports authority. There is further work to be done in the corporatisation of Rosmorport and further defining its relationship with the state; the Bank will provide finance to this end. In addition the Bank will support the transformation of ports to the landlord port model where this has not already taken place and the activities of the private sector at such landlord ports. Where identifiable revenue streams arising from port dues or other sources are available, then lending to ports without a state guarantee of repayment may be undertaken, in particular for enhancements to safety and security and for the finance of navigation aids. In addition, there is further demand for new Russian ports to meet demand arising from the growth of the Russian economy and its increasing engagement in international trade. The promotion of sea transport will reduce the stresses on the rail and road networks, accordingly helping to mitigate the environmental impact of the increased trade flows. The Bank will support well-structured private investment in the sector.

- ***Multimodal:*** The Bank will also consider the financing of selected privately-run multimodal logistic centres facilitating the containerisation of freight and the transit between road, rail, sea and inland waterways.

3.2 Power and Energy Utilities

The reform of the Russian power sector is about to enter its third and crucial stage, during which the State will gradually exit from the competitive generation sector. The Bank will therefore need to step up its investments, in particular through equity, in the newly emerging generating companies to enable them to fund urgently-needed capacity upgrades and expansion and increase the share of the private sector in their ownership. The recently approved Mechanism for Investment Guarantee will allow the System Operator to guarantee payments for high priority new capacities to be tendered competitively. This scheme, which will facilitate new private entry into the independent power market in Russia, will also require the Bank's support either through the provision of performance guarantees or financing for these new entities. The Bank will continue to finance the modernization and refurbishment of the power sector infrastructure, including the grid network as this remains a critical factor in the development of a competitive and efficient power sector in Russia. Particular attention will be given to investments enhancing the safety and security of critical infrastructure.

The Bank will therefore pursue actively the following activities:

- Continued policy dialogue with the Regulator on tariff issues through TCs;
- Equity investments in newly created OGKs and TGKs as part of privatization tenders and the Mechanism of Investment Guarantees;
- Heat production;
- Increased focus on renewables – hydro refurbishment, completion of large hydros, development of alternative sources of energy (tidal and wind); regulatory framework for renewables;
- Following Kyoto ratification by Russia, energy efficient/emission reduction investments in Combined Heat and Power plants, including projects using associated gas.

Subject to approval by the Bank's Board of Directors, the Bank is considering supporting with a rouble-denominated loan the refurbishment of the Volga-Kama 10,000 MW hydro cascade, a critical element of the security and reliability of the Russian electric system, as it provides 90% of the country's regulating reserves.

In accordance with the priority expressed by the Russian Government through the recent announcement of a US$ 1.3 billion support from the Investment Fund, and subject to approval by the Bank's Board of Directors, the Bank would explore supporting the BEMO project, whose sponsors, Hydro OGK (subsidiary of RAO UES) and Rusal, are developing the 3,000 MW Boguchanskaya Hydro Power Plant and a new aluminium smelter in the Krasnoyarsk Lower Angara region. As far as heat production is concerned, the TEPLO 13 project in Krasnoyarsk, indicated by the Russian authorities as a priority investment, will be explored as well.

The power sector is expected to account indicatively for about 15-20% of the annual business volume over the strategy period.

Russian nuclear power is a major source of electricity generation in the country. The Bank is ready to consider projects that would improve the safety of existing nuclear generation facilities.

3.3 Sustainable Energy and Energy Efficiency

As mentioned above, in the field of renewable energy, the Bank will increase its efforts to promote these energy sources in Russia, both through its own investments and with the support of TC funding for the development of the sector's nascent regulatory and legal framework. The immediate focus will be on hydro and wind power.

On the energy efficiency front, the Bank will seek to expand its reach in the industrial sphere through more systematic targeting of large energy users, in particular through the use of TC-funded energy audits. It will also develop energy efficiency credit lines, targeting industrial SMEs and the residential sector. The Bank will support municipal projects with significant energy efficiency benefits in particular the refurbishment of district heating systems. Moreover, the Bank is ready to assist clients in monetising, through the sale of carbon credits, the emission reductions arising from Bank-funded projects. Russia will be the key focus of the recently announced Sustainable Energy Initiative. TAM/BAS can also contribute to the Sustainable Energy Initiative by supporting and promoting an energy efficiency approach in the MSME sector.

The Bank is working on the design and financing of a large energy efficiency programme with an important Russian company in the metals sector.

3.4 Natural Resources

The Russian oil and gas sector is faced with multiple challenges that raise development risks. These are: technical risks, transportation issues, (bottlenecks and state of repair of the pipeline network); financial needs (tens of billions required to maintain production while developing new export routes), marketing outlets (need for creditworthy buyers able to commit on a long term basis). Given how serious these challenges are, Russia and its natural monopolies (Gazprom and Transneft) cannot avoid to engage in a wide-ranging cooperation with neighbouring countries (transit or destination countries) and with private investors, including foreign companies, to be able to bring together all required elements enabling developments. This cooperation will not be successful if sector reform issues are not addressed, notably regulation and third party access.

The Bank will pay particular attention to additionality in financing oil and gas ventures given the increasing access of this sector to international and local financing sources.

Where it is additional, the Bank will maintain its involvement in financing the production, transportation, distribution, servicing and processing of oil and gas. The Bank will also use policy dialogue to encourage increased opening-up and de-regulation and the need for the establishment of a clear, predictable and fair legal framework for energy trade and investment in and with Russia. The Bank's involvement will include a focus on the development of the energy markets and financing:

- infrastructure type projects, like pipelines serving both the domestic and export markets, along with gasification projects of various regions. The Bank continues to follow various potential infrastructure projects in different regions of Russia, including the Far East;
- projects addressing gas flaring;
- projects and companies contributing to the environmental improvements of past practices and/or enhances future practices. The Bank is discussing the possibility of a long term loan to a Russian major oil company, the proceeds of which would be used for important rehabilitation and remediation uses exclusively; and
- downstream projects in petrochemicals.

Supporting operations involving major technology and know-how transfer and providing political comfort for investors will also remain important strategic orientations. The Bank is currently structuring with a Western sponsor a financing which would bring important new technology and know-how to the Russian oil sector regarding remediation work in arctic conditions.

The Bank will also consider involvement in mining, ore and metal processing, and coal projects.

Consistent with the Bank's recently approved Energy Operations Policy, the Bank will encourage endorsement by the Russian authorities of the EITI (Extractive Industries Transparency Initiative) basic principles, namely that all revenue flows from oil, gas companies to the government be disclosed to the public and reconciled by an independent third party. The EITI initiative received support from the G-8 at the Gleneagles Summit. This support was reaffirmed by the G-8 at the recent St Petersburg Summit under the action plan on energy security and under the action plan on fighting high level corruption.

Investments in the natural resources sector are expected to account indicatively for about 5-10% of the annual business volume over the strategy period.

3.5 Corporate Sector

The objectives and methods of the Bank to address **the needs of the larger Russian and foreign enterprises** will be to:

- The Bank will target companies in the regions with sales of more than EUR 100 million (indicative threshold) and will strive to develop with them a modernization plan to foster competitiveness and energy efficiency, and to structure an appropriate combination of equity and debt financing, correlated with a corporate governance improvement plan;
- On the basis of the above modernisation programmes, participate selectively participation in IPOs and in financing operations conducted in connection with mergers and acquisitions;
- Assist foreign investors by sharing equity risk with them and making commitments to help with administrative and regulatory matters (such as with Toyota's planned St. Petersburg plant).

The Bank will further promote greater diversification of the Russian economy in the regions by supporting Russian and foreign industrial companies in key sectors such as agribusiness, telecommunications, automotive, paper and forestry, chemicals, cement, building materials, ferrous metals and non-ferrous metals, as well as engineering. As the economy diversifies, it is expected that the predominance of oil and gas will lessen.

In the <u>agribusiness sector</u>, the Bank will target large foreign or local corporates; among market leaders in their relevant markets, with specific emphasis on (i) technology and efficiency improvements; (ii) corporate governance improvements; (iii) debt restructuring and balance sheet strengthening; (iv) industry consolidation via acquisition or greenfield development; and (v) regional development. The Bank will focus on specific sub-sectors with strong backward and forward linkages as well as strong growth prospects such as food retail, edible oil, dairy, confectionary, packaging and distribution. For example, the Bank has just approved a loan to finance the modernisation of an important local edible oil producer in the south of Russia. Like in other sectors, energy efficiencies and equity upsides will be sought, when possible.

In the <u>telecommunications, informatics and media sector</u> the Bank will support projects promoting development of internet and data communications and other IT projects, including roll-out of broadband networks, software development and support of techno-parks. It will also continue promoting the international and regional expansion of local telecommunications companies. The Bank will continue supporting development and restructuring of the Russian media sector and will participate in debt and equity financing of various subscription-based and advertising-driven media businesses. The Bank will also extend financing for content development and its distribution infrastructure including cable TV networks, IPTV, cinemas and film studios. The Bank will further explore financing for the development of satellite communications, navigation systems and support modernization of the postal services and the development of digital broadcasting.

In <u>property and tourism</u> the Bank will promote new instruments such as real estate funds and other investment vehicles targeting both domestic and international investors. In order to stimulate economic development and foreign investment in Russia’s regions, the Bank will support projects in regional centres with growth potential and give selective backing to projects with strong sponsors in areas that have the potential to develop into major tourist and sporting attractions, such as Sochi in the south of the country. The Bank will also pursue opportunities to meet the growing demand for international standard warehousing and logistics management. The Bank will foster the liquidity of the real estate secondary markets by participating in dedicated property funds sponsored by local and international fund managers. The Bank will strive to finance residential developments for the middle and lower middle class.

In various industries, the Bank’s project selection will be adapted to the circumstances:

- In the <u>heavy machinery and engineering sectors</u>, the Bank will co-operate with companies which are in the process of upgrading their technology, efficiency and business and governance standards. A few projects under discussions with the Bank have emerged with local companies engaged in industry consolidation and modernisation in the markets for agricultural, construction, mining and road machines. The Bank is expanding its leasing business with foreign investors producing heavy machines for use in mainly the construction, mining and agriculture markets, including through frameworks where risk is shared between lessees and co-financiers, such as the multi-vendor leasing framework recently approved by the Board of Directors.

- In the automotive sector, the Bank is in discussion with several foreign investors (automotive manufacturers and equipment suppliers) who are planning greenfield or brownfield expansion in Russia with the support of the Russian authorities. In addition, the Bank is prepared to engage in market-based restructuring and modernisation of local manufacturers of vehicles and components which are willing to improve corporate governance and transparency standards. Given its ongoing involvement in the sector, the Bank is uniquely positioned to promote policy dialogue with the Russian authorities.
- In the ferrous metals and non-ferrous metals sectors, the Bank is in discussion with a variety of existing Russian sponsors on expansion projects including a strong environmental and energy efficiency component which will release export potential and enhance corporate development. Particular attention will be given to the behaviour of these companies on export markets.
- In the chemicals sector, the Bank will focus on the development of investment in petrochemicals, fertilizers and polymers for export and domestic consumption, and in import substitution in domestic demand for specialised chemicals, whilst seeking improvements in energy efficiency and environmental performance. For example, the Bank will explore environmental improvements in a chemical plant in Perm.
- In the cement and building materials sector, the Bank will both support local and international operators in a rapidly changing and consolidating market.
- In the forest products sector, several foreign and local investments are under development in anticipation of an improved operating environment once a new forest code becomes effective. Until such time, the Bank expects mainly a few projects with those existing sponsors who are able to adhere to key principles of sustainable forest management, and ensure environmentally sound and sustainable wood supply and focus on value added production. This area will continue to be an important element of the Bank's policy dialogue with the Russian authorities.

In accordance with the priority expressed by the Russian authorities, the Bank will make an increased effort to support high technology companies which make the best use of Russia's intellectual capital. The Board of Directors will consider shortly an equity investment in one of these companies.

The corporate sector is expected to account indicatively for about 30-35% of the annual business volume over the strategy period. It is an essential vehicle of the diversification of the Russian economy.

3.6 MSME Support

The needs of micro, small and medium-sized enterprises will be addressed through a renewed emphasis on private equity development and MSME programmes.

The Bank will build up its capacity for co-investments alongside equity funds in Russia and seek new relationships with credible emerging managers, possibly targeting innovative technology-intensive sectors, benefiting from the achievements of Russian research and development. It will investigate the feasibility of attracting a wider range of institutional investors to Russian private equity.

As part of its lending to Russian banks, the Bank will provide dedicated credit lines to finance, in particular, micro enterprises and SMEs with an emphasis on increasing regional penetration, and where possible energy efficiency. The objective is to support banks which are equipped to reach such borrowers by virtue of their branch network, knowledge of local borrowers and strategic orientation on developing these business segments. These banks may include state-owned banks with a wide regional network and committed to improving their technology, management systems and internal processes, provided that transition impact can be demonstrated. The Bank will provide medium to long-term funding to enable its bank borrowers to extend the maturities of loans on offer to SMEs, which still typically lack access to funding for investment projects with longer payback periods. Since the robustness of procedures and the efficiency of the lending process are key elements of building sustainable operations in SME finance, technical assistance will continue to be selectively employed to assist banks in strengthening their lending infrastructure and in particular to modernise their technology. The Bank will build on the experience acquired and the lessons learned through the implementation of the SME Finance Facility in Central and South East Europe, in particular that technical assistance is necessary and useful to kick start SME lending activities but should be temporary and conditional on the achievement of measurable results in order to ensure sustainability.

Supporting MSMEs through financial intermediaries may not be sufficient. MSMEs need not only medium term finance, but also working capital, in particular in labour intensive industries. The Bank will therefore innovate by setting up framework schemes to provide working capital to reach small and medium sized companies in certain dynamic sectors, such as:

- private sector providers of public services (utilities);
- private sector construction companies;
- companies outsourced by larger clients of the Bank; and
- suppliers of larger companies financed by the Bank.

In addition, the Bank will strengthen the private sector development of SMEs through the Turnaround Management (TAM) and Business Advisory Services (BAS) Programmes, which provide enterprises with advisory services in areas such as management skills, market positioning, information systems, environmental issues. TAM/BAS assist companies to be more competitive on domestic and international markets and in particular cases help them access financing.

The Bank will also develop its capacity to work with non-bank institutions such as credit cooperatives to increase the flow of financing to this dynamic sector and to expand the provision of advisory services to small enterprises through its TAM/BAS programme.

It is worth noting that the Bank’s specific Action Plan for Kaliningrad aims inter alia at supporting MSMEs.

MSME support is expected to account indicatively for about 10-15% of annual business volume over the strategy period.

3.7 Capital Markets Development and Financial Sector

The Bank will support the development of asset securitisation in Russia by using its own risk taking capacity. The Bank will also mobilise external sources of Tier 2 capital for mid-sized banks by sponsoring and taking mezzanine risk in structures designed to give access to capital markets. The Bank may choose to utilise capital market products (as mentioned above or via credit derivatives) to transfer parts of its own Russian credit portfolio risk to the capital markets in order to more effectively manage its own risk and to give investors access to a wider selection of assets that may not be readily accessible.

The Bank will seek to expand its funding in local markets by broadening the investor base for triple-A rouble denominated credits, which will be assisted by the planned opening of the EBRD's rouble bonds for investment by the State Pension Fund. The Bank will also work with Russian banks on rouble loan syndications. Further, it will work with the Federal Service for Financial Markets to develop the legal infrastructure for capital market transactions; and with the Central Bank of Russia to develop the supporting technical infrastructure.

In the banking sector**, the provision of equity will play an increasingly important role** in supporting capitalisation and institution-building needs. The Bank will focus on equity participations in Russian-owned entities as well as foreign strategic banks, supported where necessary with technical assistance in support of institution-building plans to strengthen banks and improve the quality of management. It will consider taking minority equity stakes at the pre-IPO or IPO stage. It will also support the growing capitalisation needs of banks by providing Tier 2 capital to underpin balance sheet growth, with the ultimate objective to mobilise capital markets for such instruments. The Bank will assist in the privatisation process of state and regional government-owned banks and support the process of consolidation by promoting, providing funding for, or participating in mergers and acquisitions.

With regard to non-bank financial institutions, the Bank will support the rapidly-growing **leasing sector** by taking debt and equity exposure to financially robust leasing companies. It will support the development of consumer finance, leasing and mortgage operators with both debt and equity, and also through capital markets products, as outlined below. The Bank will also participate in the next critical phase of development of the insurance sector by making equity investments in existing insurance companies, supporting new entrants and by making acquisition finance available to strong counterparts, amongst other things, to support consolidation of the sector. In addition, the Bank will support the establishment of registrars and, selectively, the development of brokerage houses.

The banking and non-banking sectors are expected to account indicatively for about 10-15% of the annual business volume over the strategy period.

More generally, the Bank will support the development of the local securities market and will consider participating in IPOs, in particular domestic floats. It will also seek to facilitate public listings which enhance transparency, corporate governance and lead to a broader share ownership structure in line with international best practices.

4. CO-OPERATION WITH THE EUROPEAN COMMUNITY

EU-Russia relations are based on the Partnership and Cooperation Agreement (PCA) which came into force in December 1997 for an initial period of ten years. It establishes the institutional framework for bilateral relations, sets the principal common objectives, and calls for activities and dialogue in a number of policy areas. A protocol to the PCA was signed by the EU and Russia on 27 April 2004 to extend the agreement to the 10 new Member States as of 1 May. The EU is currently working with Russia to develop a new agreement for post 2007. The aim is to have a new agreement which provides a durable and comprehensive framework for EU-Russia relations and a basis for moving the relationship forward in the coming years.

At the St. Petersburg Summit in May 2003, the EU and Russia agreed to reinforce their co-operation by creating in the long term four 'common spaces' (Economic Space; Freedom, Security and Justice; External Security; Research, Education and Culture) in the framework of the Partnership and Cooperation Agreement. The common economic space will seek to strengthen cooperation in the field of economic and trade relations, trade facilitation and customs, infrastructure development (telecommunications, transport), as well as energy and the environment. At the Moscow Summit in May 2005 a single package of Road Maps were adopted to act as the short and medium-term instruments for the implementation for the creation of the four Common Spaces. They determine the agenda for co-operation between the EU and Russia for the medium-term.

The EU is a key provider of technical assistance to Russia through the TACIS programme: more than EUR 2.6 billion has been allocated to Russia since 1991. The major cooperation areas between the EU and the EBRD include the environment with special regard to the Northern Dimension initiative, development of the European transport infrastructure, projects derived from the EU-Russia Energy dialogue, specific action plan for Kaliningrad, and cross-border and regional integration issues.

The EC is the single most important donor to the EBRD managed Support Fund of the Northern Dimension Environmental Partnership. In 2005 the EC made additional contributions of 10 M€ to the non-nuclear window (environment projects) and 20 M€ to the nuclear window.

The Bank has been invited to join the Working Groups under the EU-Russia Energy Dialogue to share its experience, notably in Energy Efficiency, and Infrastructure projects. The Bank is already active in the Energy area, approving in 2004 an EC TC project for an Energy Audit and Energy Management Training Programme (0.5 M€).

The Bank has also been receiving technical cooperation funds out of the EC horizontal Investment Preparation Facility (EU IPF 2001, 2002, 2003) although this Facility will come to an end in the coming months as part of the de-concentration process of EC funds in Russia.

In addition, over the past two years, the Bank has received project-specific support for Small Business Credit Bank Branch Expansion and the EBRD-EC Municipal Investment Support Programme. The Bank has also recently signed a contribution agreement for the EC-EBRD Russian Regional Bank Institution Building Programme.

In response to requests from the Moscow EC Delegation, the Bank is in discussion regarding micro-finance in Northern Caucasus.

Based on the National Indicative Programme over the years 2007-11 there is potential for further cooperation in the following areas:

- Environment
- Energy and energy efficiency
- Transport
- Trade facilitation
- Investment Climate related issues.
- Municipal infrastructure through the NDEP and in Kaliningrad

As for future cooperation, the European Commission has made it clear that it will welcome this, but is concerned to see that any financial support it provides to the EBRD or other IFIs is aimed at the achievement of the objectives of the Common Spaces.

5. CO-OPERATION WITH IFIS

5.1 European Investment Bank (EIB)

A Memorandum of Understanding (MoU) has been recently agreed and initialled between the Bank and the European Commission in liaison with the European Investment Bank in order to organise cooperation in Russia, Eastern Europe and the Southern Caucasus (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine) as well as Central Asia in the context of the policy objectives of the European Union (including the European Neighborhood Policy, the EU-Russia Strategic Partnership and the EU's Central Asia Policy), the EIB's present and future external lending mandates in support of these policies, and the Bank's transition and private sector mandate.

The MoU builds on the successful modus cooperandi already defined in the framework of the Northern Dimension Environmental Partnership (NDEP) as well as the existing close cooperation between EBRD and EIB in the western Balkans.

EIB's first mandate for activities in Russia was granted in the form of a special lending action under the Northern Dimension for EUR 100 million for selected environmental projects on the Baltic Sea rim of Russia and expired in May 2005. EIB signed three operations under this mandate for a total of EUR 85 million, all of which were co-financed by EBRD and NIB, and received support from the NDEP.

EIB's second mandate (which expires in July 2007) is for EUR 500 million for Russia as well as Ukraine, Moldova and Belarus for projects in environment, transport, telecommunications and energy infrastructure on priority Trans-European Network

(TEN) axes having cross-border implications for a Member State. This mandate requires cooperation/co-financing with EBRD. EBRD and EIB have worked closely together (a first important co-financing, with EBRD and EIB aiming at lending EUR 200 million each, is being finalised for Ukraine's MO6 motorway).

A new mandate is currently in preparation. The amount of that mandate is expected to be €5 billion for the 2007-2013 period (7 years) and will be decided upon in November 2006 by the European Council.

The scope of the EIB's mandate is expected to include "projects of significant interest to the EU in transport, energy, telecommunications and environmental infrastructure. Priority will be given to projects on priority 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, priority will be given 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." It is understood between the European Commission, the EIB and EBRD, and supported by the EBRD's Board of Directors, that the mandate would not cover projects in the industrial sector, municipal projects of only local impact or global lending to the banking sector.

In the frame of this mandate, the main elements of the MoU are as follows:

- Both EIB and EBRD will ensure that their funding is additional to private sector financing, and will mobilise it whenever possible;
- Co-financing between the Bank and EIB will be the general rule, and EBRD and EIB agree to establish a preferred mutual partnership by offering each other a right of first refusal to co-finance projects in areas and sectors covered by the Council's decision on EIB's external lending mandate. Any possible exceptions to this rule must first be addressed by the Steering Committee foreseen under the MoU;
- EIB's and EBRD's target shares in their combined financing of a project will be set in the light of the scope and scale of the EIB's mandate and of the EBRD's medium-term scenario. By default, these target shares will be 50% each. Variations will be agreed on a case-by-case basis and, if necessary, reviewed by the Steering Committee. In any event, without exception, EIB will comply with its own rule of lending maximum 50% of project costs;
- The Bank and EIB will submit to clients agreed joint proposals respecting each institution's standards and respective mandates, in particular in the areas of transition impact, additionality, sound banking, integrity, transparency, corporate governance, accounting standards, environment and procurement;
- The Bank will normally be responsible for leading project preparation (i.e. origination and execution), and for coordinating project appraisal and negotiation in close cooperation with EIB;
- To avoid duplication of efforts, EIB intends to use the Commission's and EBRD's information and analysis for its own decisions. In that event, a fair remuneration by EIB of EBRD's due diligence costs will be agreed upon;
- The European Commission is expected to make appropriate technical cooperation resources available to help implement the MoU; the EBRD will normally be the recipient of these funds;

- A Steering Committee, composed of representatives of the Commission, the EBRD and the EIB will meet on a regular basis at senior management level to review progress, address together any issues arising in the implementation of the MoU and consult each other on major policy issues;
- By agreement between EBRD and EIB, the co-financing arrangements will start being implemented for the remaining part of the period of the EIB's current external mandate in the countries covered by such mandate.

5.2 Nordic Investment Bank

In the last few years the Bank's co-operation with the Nordic Investment Bank has focused on the Northern Dimension Environmental Partnership. There are 16 environmental projects in the NDEP pipeline approved so far by the NDEP's Steering Group. The Bank is the lead institution for 9 of these projects (total value of €1.3 billion) whilst the NIB is the lead institution for 7 projects (total project value of €1.1 billion). To date the Bank and the NIB have co-financed a total loan amount of €409 million (of which €285 million for the account of EBRD and €124 million for the account of the NIB).

Going forward, co-operation between the Bank and the NIB is expected to be mainly NDEP related. The current pipeline for NDEP in Russia, including Kaliningrad, is close to Euro 1.1 billion.

5.3 World Bank and International Finance Corporation

World Bank (IBRD)

The World Bank's financial commitments to Russia were USD 13.8 billion as of March 2006 for 65 adjustment loans and investment projects, 42 of which have been implemented. Since 1999 the Russian federal government stopped borrowing from the World Bank for adjustment programmes. There are currently 20 investment projects and one regional-level adjustment operation (Tatarstan) under implementation with total commitments amounting to USD 1.9 billion. A new Country Partnership Strategy (CPS) for 2006-2009 identifies priority areas in macroeconomic stability, the investment climate, diversification, public sector management, regional development, social services, and the new roles of Russia in the G-8 and global community.

The most recent investment operations are the Hydrometerological System Modernization Project, the Cadastre Development Project, the Registration Project, the Health Reform Implementation Project, the Tuberculosis and AIDS Control Project, the Customs Development Project, the St Petersburg Economic Development Project and the e-Learning Support Project. New lending is constrained by the limited availability of sovereign guarantees. New project initiatives potentially eligible for sovereign support should target and maximise knowledge transfer in three broad areas: (i) public infrastructure projects of national importance, (ii) institutional strengthening of public administration and (iii) social infrastructure.

The key focus of the World Bank's current activities in Russia, however, lies with a wide-ranging advisory work on important reforms deriving from the strategic priorities of the CAS including civil service and judicial reforms, banking sector restructuring and a series of reform areas associated with regional development and reform issues such as intergovernmental finances reform, housing and communal services reform and strategies to reduce poverty and regional disparity.

IFC

By 1 March 2006, the IFC had invested USD 2.5 billion of its own funds and syndicated over USD 245 million in more than 120 projects in Russia. IFC's committed portfolio in Russia stood on 1 March 2006 at USD 1.8 billion, which made Russia the single largest country exposure representing about 7.4 percent of IFC's global portfolio. IFC doubled its commitment to Russia in 2005 by investing USD 832 million compared to USD 486 million in 2004. About USD 800 million of new commitments are expected for 2006. The sector composition of the portfolio is dominated by the financial sector with more than half of transactions in the banking and non-bank financial institutions sector. The remainder of the IFC's operations are spread across a wide range of sectors including industry, natural resources, telecommunication, utilities, transportation and retail trade. Technical assistance operations have been focusing on different aspects of the financial sector (corporate governance in banks, legal advice on securities regulation, leasing development), information and communication technologies, as well as environment and energy efficiency. There have been numerous transactions jointly financed by the IFC and the EBRD. Co-operation remains focused on operations in the financial sector with special attention to strengthening regional banks and introducing new financial instruments. Co-operation is further expected in infrastructure markets, namely in transport, where IFC is increasing efforts to develop significant additional business.

5.3 Relations with the IMF

Following a series of financial programmes with the IMF 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 additional visit for informal discussions in the middle of this annual cycle. The last Art. IV consultation was concluded in August 2005, and the next consultation is scheduled for consideration of the IMF Executive Board in October of 2006.[1] As part of this surveillance work, the Fund conducted a Financial Sector Assessment Programme (FSAP) in 2003, for which an update is planned for the fall of 2006. There is an ongoing programme of technical assistance activities, including on statistical standards, and the Fund also provides a resident advisor on banking supervision issues.

[1] The staff report is available at http://imf.org/external/pubs/ft/scr/2005/cr05377.pdf

ANNEX 1: POLITICAL ASSESSMENT

Compliance with Article 1

The Russian Federation is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank. However, a more consistent application of these principles would facilitate Russia's global integration and its ability to absorb future shocks.

Political Accountability and the Rule of Law

Russia's political authorities are held accountable through several measures articulated in the 1993 Constitution: 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. Because of the public's robust support for the president, the absence of strong institutions of political accountability have not resulted in serious social tension. However, weak political institutions over time undermine the legitimacy of government and make it difficult to create social trust. Moreover, this could hinder the state's effectiveness – i.e. in its fight against corruption, in its capacity to develop policy solutions to complex transition challenges and in its ability to attract foreign direct investment.

The increasing dominance of the United Russia party and its close ties to the Presidential administration has narrowed the space for alternative political views to be represented in the legislature at the federal and regional levels. With the return to the system of appointed regional governors and mayors in 2005, more and more regional and municipal-level governments are headed by United Russia representatives. Both the lower and upper houses of parliament are controlled by United Russia, which in turn closely coordinates its positions with the Kremlin.

In 2005, the President signed a new law that reformed the electoral system in a way that may further benefit United Russia. Under the new system, Russia's lower house – the Duma – will be elected entirely by proportional representation (PR) voting, in place of the mixed PR and single-mandate voting system it had previously. To enter the Duma, a party must receive at least 7 per cent of the popular vote, and parties will be unable to form electoral blocs.

These changes, along with several others that were adopted in 2004, have the potential to accelerate the development of a modern political party system. However, in the short term, they also may reduce the number of independent opposition deputies in the Duma who currently are elected in single-mandate races and could swell the ranks of the United Russia party as deputies previously elected in district races rush to join the party that will most likely allow them to keep their seats and their privileges. The incentive is there for disparate opposition groups – in particular the liberal parties which failed to get past the 5 per cent threshold in the 2003 Duma election – to join forces and create a single party before the 2007 election; however, personality differences continue to impede their unification efforts.

The new electoral law also stipulates that only political parties contesting the election will have the right to register election observers; independent observers – for example from NGOs – will not be able to monitor the polls. This places an unnecessary limitation on the rights of civic groups to participate in the vital function of monitoring elections and holding governments accountable. Other measures introduced in the past year also worry international human rights groups that track the development of civil society and the treatment of NGOs, particularly those engaged in political activity. A new law on NGOs signed by the president in January 2006 requires Russia's 450,000 civic organisations to re-register with a regulatory agency overseeing their activities. NGOs will have to report on sources of funding and how such funds are being spent. The law prohibits the use of foreign funds for "political activity". The 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". In his 2004 state of the nation address, President Putin commented that many organisations active in Russia exist mainly to "receive funds from influential foreign and domestic foundations, for others the aim is to serve dubious groups and commercial interests". This was viewed as a signal that NGOs would come under increasing pressure and that the new legislation would be used selectively by state agents seeking to silence dissent or muffle criticism for political purposes. Human Rights Watch, a US-based NGO, published a report in November 2005 documenting a number of cases of harassment of Russian NGOs and threats against human rights activists over the past two years.

The protection of individual and group rights from arbitrary arrest and prosecution is guaranteed under the law, and there has been encouraging progress in legal and judicial reforms that underpin this. In particular, legal reforms call for the strengthening of the judiciary in relation to the Prosecutor General's office by requiring a judge's approval for issuing arrest warrants, searches and seizures, and detentions. Also, judges salaries have been increased, which may address the problem of corruption in the judiciary. At the same time, judicial independence is still a subject of concern among domestic and international rights groups which have noted the continued involvement of the executive branch and the security services in politically sensitive cases. The Prosecutor General's office still enjoys wide latitude as both the state's representative in court cases and the public's advocate in cases of alleged abuses by the state. In its 2005 report on Russia's fulfilment of its obligations and commitments, the Council of Europe described this as "incompatible with the principle of the rule of law".

The President has voiced his strong support for the development of democracy and civil society in almost all his major public addresses. In his 2005 state of the nation speech, he said Russia "must become a free society of free people" if it is to solve its most pressing national problems. In that speech he also underlined Russia's European history and its commitment to European values. However, to date, the international community has noted that far from matching its words with concrete deeds, the Russian authorities have continued a pattern of weakening the checks on executive power that are the hallmark of a mature democratic society. Increasingly, the disagreement appears less about the pace of implementation of principles of freedom and democracy, and more about the authorities' sincerity in striving toward them.

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 Chechnya. In addition, there are growing concerns regarding the rise in expressions of racism and intolerance toward minorities.

While independent print and internet-based media continues to thrive in Russia, the state has achieved near total dominance of the national broadcast media and has increased its stakes in regional media outlets. Through its control of companies such as Gazprom and Eurofinance Bank, which in turn own large stakes in several media concerns, the state is able to exercise indirect influence over the content and tone of news reporting even among the private media outlets. Gazprom, which already owns one of the country's three major broadcast networks, purchased a controlling stake in one of the largest print dailies, *Izvestiya*, in 2005 and is considering adding the popular tabloid *Komsomolskaya Pravda* to its media holdings. *Izvestiya* was sold shortly after it came under pressure from the government for its critical reporting of the response to the Beslan attack. The state can also apply indirect pressure on the media by initiating legal proceedings against reporters giving unfavourable coverage of government policy or particular officials. Libel and defamation cases have in the past resulted in very large awards, which local news organisations can ill afford.

Partly due to these developments, many observers have noted an increase in self-censorship by reporters and editors who do not wish to attract unwanted attention from state authorities. Sensitive issues, such as the conflict in Chechnya, corruption and failures in government policy, are avoided by most private media companies. The state-owned media – which includes all three national TV networks, two-thirds of the country's 2,500 regional TV stations and the two largest radio stations – receives "guidelines" from the Presidential Administration on which items to report and in what manner.

Several Russian and international NGOs, as well as the OSCE and the Council of Europe, have noted the difficult environment for news organisations trying to report from or about the conflict-ridden areas of the North Caucasus. Both foreign and domestic broadcasters have faced restrictions on their access to the region, and those who are admitted report frequent harassment from local authorities,

The unrest in Chechnya and surrounding regions continues, and numerous cases of human rights abuses against civilians – including many ethnic Russians - caught up in the conflict have been documented by advocacy groups. A report in December 2005 by the Parliamentary Assembly of the Council of Europe (PACE) found that human rights violations occur "on a massive scale in a climate of impunity in the Chechen Republic and, in some cases, neighbouring regions". The report refers to numerous and well-documented allegations of forced disappearances, murder and torture. At the same time, a major source of human rights abuse – in the infamous “zachistki” or mopping-up operations – have declined over the past year. Also, the authorities have opened several criminal cases against alleged offenders; however, these cases have not been pursued aggressively by the General Prosecutors office. Several programmes to improve the economic and social conditions in Chechnya are being implemented, which the authorities believe could reduce the sources of tension in the region.

Chechen citizens, as well as numerous other ethnic minorities, have also encountered more frequent racially motivated attacks outside their region. According to a May 2006 report from the European Commission against Racism and Intolerance (ECRI), a body created by the Council of Europe, Chechens living outside the Chechen Republic are routinely subject to arbitrary search and seizure and official discrimination. Chechens and Caucasians feel themselves to be constantly under suspicion by the police and private citizens alike. Other groups, such as Africans, Roma, Jews and Meshketian Turks in Krasnodar, have been the victims of a rise in racial violence and racist inflammatory discourse. The ECRI report noted that there has been progress in adopting the requisite criminal law provisions aimed at combating racism, but that these are not adequately implemented.

Finally, trafficking in persons remains a concern, although the government has been firm in its commitment to combat the problem and prosecutions have increased over the past two years. According to the 2006 report on trafficking in persons issued by the US State Department, “Russia is a source, transit and destination country for men, women and children trafficked for various purposes. It remains a significant source of women trafficked to over 50 countries for commercial sexual exploitation”. The report concludes that the Government of Russia “does not fully comply with the minimum standards for the elimination of trafficking however it is making significant efforts to do so”.

ANNEX 2: LEGAL TRANSITION

ASSESSMENT OF THE RUSSIAN FEDERATION'S COMMERCIAL LAWS

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 the Russian Federation, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Capital Markets

The principal legislation governing the Russian securities market includes the Civil Code - enacted in December 1994 and amended in 2003; the Law on the Securities Market ("SML") – enacted in April 1996 and amended several times, most recently in March 2005; and the Law on the Protection of Rights and Lawful Interests of Investors on the Securities Market ("LPR") - enacted in March 1999 and lastly amended in December 2004.

By decree effective 12 March 2004, President Putin abolished the Federal Commission for the Securities Market ("FCSM"), and transferred its control and surveillance powers to the Federal Service for Financial Markets ("FSFM"), operating directly under the jurisdiction of the federal government. The FSFM is the federal executive body that controls and supervises activity in the financial markets, including the activity of exchanges, and issues the relevant regulations. It also regulates the investments of pension funds.

The Moscow Interbank Currency Exchange (MICEX) is the largest financial exchange operating in the Russian Federation. Trading in non-government securities was launched in March 1997. Later that year, following the example of the MICEX, regional currency and stock exchanges in Samara, Rostov-on-the-Don, St. Petersburg, Nizhniy Novgorod and Yekaterinburg also launched trading in bonds and stocks. The financial crisis of 1998 had a disastrous effect on the Russian stock market and the MICEX Summary Stock Index (the MICEX SSI) dropped to its historically lowest level of 20.92 units. Since then the market has continued to grow, and at the end of 2004, the MICEX Index[2] reached 552.22 points with 413 securities of 267 issuers traded in the MICEX.

According to the findings of the EBRD's Securities Market Legislation Assessment in 2004, the Russian Federation is a country whose existing securities market legislation

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[2] On 28 November 2002, the name "The MICEX Summary Stock Index" was changed for "The MICEX Index". The MICEX Index is an effective capitalization-weighted index of the market of most liquid stocks of Russian issuers admitted to circulation on the MICEX.

(i.e. "law on the books", not how the relevant legislation is being implemented) when assessed against relevant international standards was rated among "medium compliance" countries.

The Assessment showed room for improvement in market supervision, clearance and settlement and prudential requirements for exchanges and intermediaries. For example, the regulator should be subject to a code of conduct and its activities made more publicly accessible, it should have investigatory and rule-making powers and should cooperate with regulators from other jurisdictions. In other areas, Russia needs to implement listing particular requirements, further minority shareholder protection and impose real time trade confirmations and delivery versus payment clearance systems, as well as to centralise the securities depository system. There currently are no "know-your-customer" rules and no regulatory powers to impose margin calls, reduce exposures to large share positions, or otherwise empower a market authority to take action against systemic risks.

The assessment was updated in 2005 and the results confirmed the medium compliance rating. The little change that there has been in the legislation mostly relates to the licensing of Market Intermediaries where the powers - including sanctioning - of the FSFM have been strengthened.

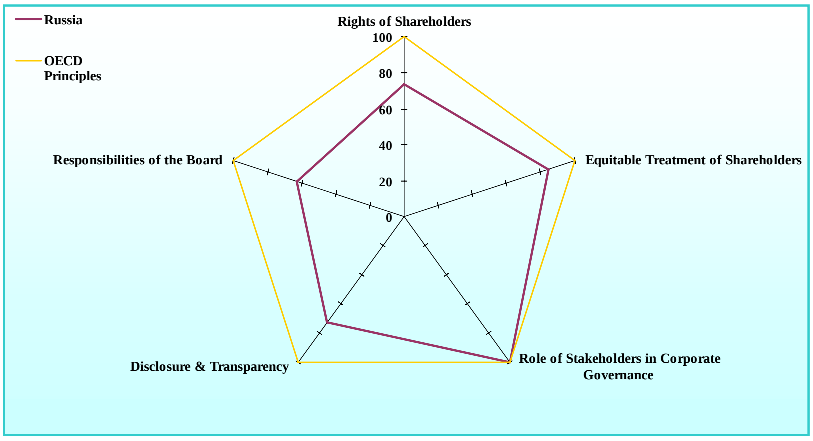
Corporate Governance

The main legislation concerning corporate governance in Russia is the Law on Joint Stock Companies (the "JSC Law"), which came into force in January 1996 with amendments in subsequent years, the most recent being in February 2006. The latest amendment, due to enter into force on 1 July 2006, will substantially change the requirements for the acquisition of major shareholdings in open joint stock companies. In summary, each acquisition of more than 30, 50 or 75 % of the voting shares in an open joint stock company will trigger an obligation to launch a public offer to buy the remaining shares. The same amendment introduces minority shareholders squeeze out provisions, according to which a dominant shareholder holding more than 95 % of an open joint stock company's voting shares as a result of a public offer can force the minority shareholders to sell their shares.

In 2002 the FCSM, Russia's former securities market regulator, issued a Corporate Governance Code, developed with the technical assistance of the EBRD and the financial support of the government of Japan. The Code, although being voluntary by nature, provides important guidelines on board composition (for example, there should be at least three independent directors and the audit committee should be composed of such directors) and transparency. The Code is voluntary and JSCs are only required to report compliance with the Code's principles and explain deviations from these principles. In December 2004 a new regulation issued by the FSFM made some of the principles included in the Code enforceable starting from 1 July 2005 – then extended until 1 January 2006 - with respect to those companies that have listed equity and/or debt. In addition, the regulation introduced a requirement to publish audited IFRS or US GAAP annual.

According to the 2004 results of the EBRD's 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. Some minor shortcomings were noted in the "Responsibilities of the board" section, where under the law, the responsibilities of the board do not include functions such as reviewing key executive and board remuneration, ensuring a formal and transparent nomination process for board members, ensuring the integrity of the corporation's accounting and financial reporting systems and overseeing the process of disclosure and communications.

Quality of corporate governance legislation – Russian Federation (2004)



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 approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2004 assessment

A general reform priority for Russia is to improve effective implementation and enforcement of existing legislation. The effectiveness (how the law works in practice) of corporate governance legislation was assessed by the EBRD in 2005. A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company and on how it was possible to obtain compensation in case 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 are generally considered quite complex while it is reported to be easy for the defendant to further delay the proceedings. When considering enforceability, because of deficiencies in the Russian court system, such as case overload and the scarcity of judges, the procedure to enforce actions can be difficult and take more than several months.

Finally, when considering the institutional environment, the survey evidenced the difficulty to find reliable corporate information and independent statutory auditors. 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 market regulator's position was deemed unpredictable.

Concessions/PPP

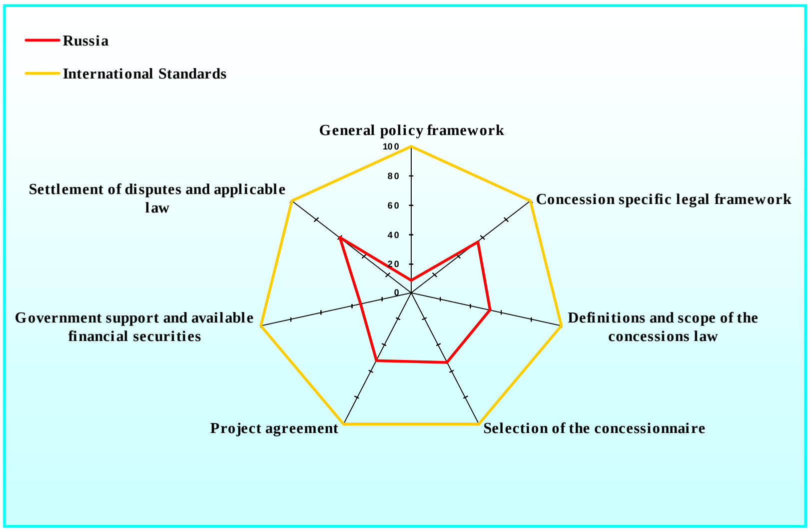
The new Law on Concession Agreements (the “Concession Law”) was enacted in August 2005. The Concession Law is relatively detailed and covers all the most important areas including definitions and its scope of application, identifying sectors subject to concessions, entities involved in the concession granting process, selection procedure and dispute resolution, concession agreements as well as certain aspects of financial security and government support issues. Thus, the Concession Law seems to contain no fundamental omissions.

However, the Concession Law appears too detailed and over prescriptive on a number of issues which can make the implementation of concession projects difficult, if not impossible in practice. In particular, the Concession Law is very restrictive regarding the creation of security instruments and assignment of concession rights, too prescriptive regarding concessionaire's obligations and selection procedure. Furthermore, it contains a number of ambiguous rules, the application of which can create a certain degree of insecurity in practice, e.g. it lacks a clear reference to international arbitration.

Among other critical issues affecting private sector participation that still remain unresolved are the lack of flexibility in the new regime (notably the limited negotiable terms) and a degree of uncertainty regarding property rights (e.g. restrictions to ownership over concession objects).

On the positive side, the Concession Law provides for detailed rules and greater stability in concession arrangements and offers mechanisms for concession application. It is well drafted and constitutes a solid basis for the development of PPPs in the country. It is very recent however, so its implementation is still to be verified in practice.

Quality of concession legislation –Russian Federation (2005)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the ‘web’, the more closely concessions laws of the country approximate these standards.

Source:*EBRD Concessions Sector Assessment 2005*

As revealed by the EBRD 2004-2005 Assessment of Concession Laws (see the graph above), one of the most significant obstacles to wide application of PPPs remains the lack of a clear national policy.

Overall, since the enactment of the Concession Law, the idea of using concession-type schemes for financing transport infrastructure projects has been widely discussed and promoted by the government, with the first PPP related projects using public monetary means from the Investment Fund to be announced in June 2006. The application of the law in the municipal utility sector is somewhat less certain and many advisors still seem inclined to apply general contract law schemes. It remains to be seen how the Concession Law will work once tested in practice.

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. As noted in the previous country strategy for the Russian Federation dated 18 November 2004, this represented a significant improvement over the previous regime. In the 2003 EBRD Insolvency Law Sector Assessment, the law achieved a score of medium compliance when benchmarked against international standards

According to the Assessment, the Insolvency Law was notable for its treatment of the qualification, appointment and removal of insolvency administrators and its allowance for priority reorganisation financing. It rated relatively high in terms of the treatment of creditors, the commencement of proceedings and the liquidation process. It had a significant number of weaknesses, however. The Insolvency Law did not provide a balance sheet test for insolvency, nor did it provide sufficient safeguards in respect of 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 were insufficient, relying on international treaties and reciprocity rather than the UNCITRAL Model Law or similar EU regulations. 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. Most critical, however, the system was slow, inefficient and presented significant barriers to creditor participation.

Recent amendments include the enactment of stiff new penalties. Top managers who disclose a firm’s insolvency after it is too late face severe fines; deliberate bankruptcies can result in prison terms of up to 6 years; and opposition to arbitrary managers, withholding or falsifying information can result in prison terms of up to 3 years.

These recent amendments should help to make the system more effective, but to make the system significantly more effective, administrative improvement is required. Insolvency administrators are at the heart of any insolvency system; without improvements in their training, licensing and regulation, only minimal improvements to the system will be achieved. Moreover, the insolvency system would benefit from a dedicated judiciary that has proper training and experience in the conduct of insolvency files. To this end, the EBRD and the Russian Ministry of Economy and Trade, with funding from the Swiss State Secretariat for Economic Affairs (SECO), are set to undertake a project designed to build the capacity of insolvency regulators in Russia. It is expected that this project will help with the development of a more effective insolvency system in Russia.

Secured Transactions

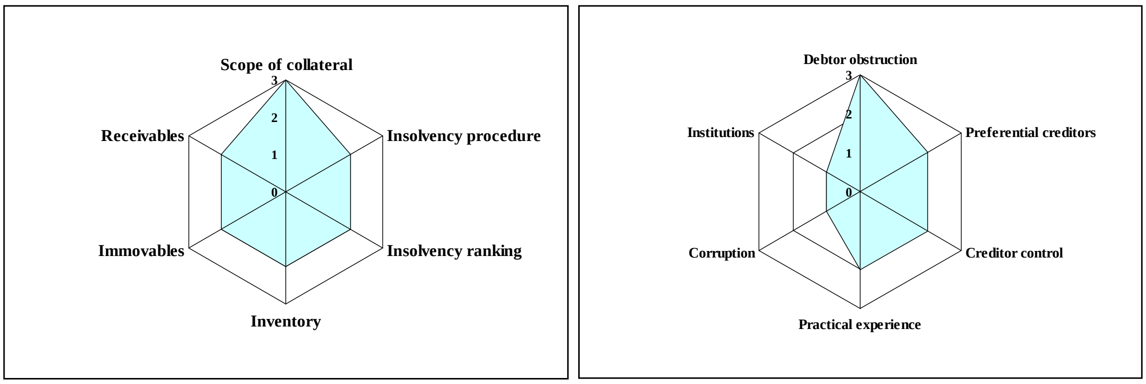
Taking security over property in the Russian Federation remains highly challenging and complex. The main provisions can be found at Articles 334 - 358 of the Civil Code, in the Federal Law on Pledge of 29 May 1992, as well as in the Law on Mortgage of 22 July 1998. Despite the recent reform substantially reducing notarial fees applicable to mortgages, Russia still falls short of providing investors and business players in the legal framework with the necessary certainty and predictability in many respects.

The main areas for concern are the following:

- the taking of security over intangible property, such as account receivables or bank accounts, which remains untested: despite efforts by the Bank and others, no appropriate legal provisions have been adopted. The Bank's projects routinely include this type of security with the understanding that it may not be enforceable;
- the taking of security over generally described and fluctuating pools of assets, which is too restricted to be used in transactions;
- the priority ranking that creditors enjoy, since there is not centralised place where security rights would be recorded for all interested to see: as recently as 2004-05, the World Bank sponsored a project whose objective was to review the possibility of creating a centralised, notice-filing system. However it is unsure whether the project led to specific reform measures being adopted;
- Enforcement of the security and foreclosure, which is a long and uncertain process. This holds true whether a mortgage or a pledge is to be enforced.

Obstacles to charge enforcement process – Russian Federation (2003)

Scope **Process**



Note: The fuller the web, the more serious the problems are in each of the respective categories. "Process" factors measure the impact that specific obstacles would have on the enforcement proceedings. "Scope" factors give an indication of how effective enforcement would be when conducted on various types of collateral and in the case of debtor insolvency.

Source: EBRD Legal Indicator Survey 2003

Despite a constant dialogue with the Russian authorities and repeated offers of technical assistance, the EBRD has not found political will or commitment to undertake the necessary reforms, not even with respect to a reform of more limited scope, such as the taking of security over aircrafts.

Given the increasing sophistication of the deals taking place in Russia (recent securitisation of consumer loans being just one example), it is regrettable that the legal framework, instead of supporting these deals, is in fact a hurdle to their implementation.

Telecommunications

The telecoms sector in the Russian Federation is currently regulated by the Ministry of Communications and Informatization (the 'MCI') and its Federal Communications Agency unit, and largely governed by the Federal Communications Law, 2003 (the '2003 Law'). The MCI was created in 2000 to administer government responsibilities within the sector. In addition to sector specific regulatory oversight, certain elements of the sector, such as local tariff setting are also subject to regulation by the Federal Anti-Monopoly Service and local administrations. Prior to 2003, laws governing the sector were somewhat confused and seen as outdated, failing to cover many important recent developments in the sector. However, the legislative base of the sector resulting has been clarified by 2003 Law, which took effect in January 2004.

The Russian Telecom Sector is currently undergoing significant change with the key drivers of this change being liberalisation and privatisation. The liberalisation agenda is being partly driven by Russia's desire to accede to the World Trade Organization (expected in 2006/7) and a framework to support this liberalisation is currently being implemented by the Ministry, based upon the 2003 Law. That Law provides for the implementation of a number of modern legal and regulatory standards for the sector.

Most elements of the Russian market have been liberalised for a number of years and, after some delay, full formal liberalisation came into effect at the beginning of 2006 with the lifting of the monopoly of long distance fixed-line state controlled incumbent Rostelecom. While Rostelecom still dominates its market, vigorous competition is expected from new competitors. Local fixed-line operations are dominated by the regional subsidiaries of Svyazinvest, the state controlled local incumbent. While the fixed penetration level for the entire country is below 30%, there are major disparities in coverage between urban and rural areas. The mobile sector has recorded healthy growth in most of the recent years, with three leading operators competing: MTS, VimpelCom and MegaFon. The official mobile penetration rate is quoted as being in excess of 80%, though the actual figure for live and continually active subscribers is likely to be somewhat lower.

While the reforms of the telecom sector the Russian authorities are undertaking are significant and notable, implementation of the practical machinery that underpins these reforms (e.g. secondary legislation, regulatory mechanisms and institutional reform) has been painfully slow, with many of the enabling secondary legislation and mechanisms only now being (or yet to be) put in place. Critical enabling reforms such as rebalanced tariffs, a functioning non-discriminatory interconnection framework and transparent licensing procedures have yet to be fully implemented. In addition to the slow pace of reform implementation, failure to harmonise the current sector institutional structure with international best practice continues to impact negatively on investor perception and therewith sector development. Most notable in this respect is the failure of the authorities to provide for a meaningful independent regulatory authority for the sector to implement policy and law and facilitate competition. Similarly, the Ministry's current role as policymaker, regulator and holder of state telecom assets is a notable deficiency. Such an institution is the cornerstone of a modern, vibrant and competitive telecom sector and essential if the government's liberalisation measures and forthcoming privatisation initiatives are to succeed.

Going forward, in order to maximise the benefits to consumers, investors and the economy as a whole which flow from a properly functioning competitive telecoms market, the authorities should ensure:

- the immediate separation of policymaking, regulation and operation (service/network provision) functions currently undertaken by the authorities;
- the immediate establishment of a fully independent regulatory authority, with all powers and resources necessary to implement, administer and enforce sector policy and the regulatory framework envisaged in the 2003 Law;
- the full and immediate implementation of all necessary second legislation arising from the 2003 Law; and
- an immediate start to a review of sector legislation to ensure it is both fully harmonised with international best practice and that it appropriately reflects market developments since the previous legislative base was developed.

ANNEX 3: MACROECONOMIC CONDITIONS

Trends in Output

Russia is experiencing a transition from growth that has been primarily led by the external sector to growth that increasingly depends on domestic sources of demand. Growth rates remain strong, and the 6.4 per cent registered in 2005 is only slightly below the levels in the previous two years. Shifts in the composition of growth underline the structural problems that need to be addressed. Sectors that have traditionally been the mainstay of growth, such as mineral extraction and manufacturing, have decelerated markedly, in the case of natural resources to only 1.7 per cent growth last year (see table). By contrast, a number of service sectors have accelerated, and construction has remained relatively buoyant.

Table 1: Russian Growth by Sector of Origin, 2003 - 2005

	2003	2004	2005
GDP	7.3	7.2	6.4
Agriculture, hunting, forestry	5.5	3	1.1
Extraction of mineral resources	10.8	7.9	1.7
Manufacturing	9.5	7.8	4.4
Electricity, gas, water production and distribution	1.6	2.1	1
Construction	13	10.2	9.7
Retail and wholesale trade, repair and maintenance of vehicles, white goods and personal effects	13.2	9.8	12.4
Transport and communication	7.2	10.5	6.2
Finance	9.6	4.5	6.4
Immovable property operations, leasing and services provision	3	4.5	9

Source: Rosstat, as reproduced by World Bank (2006).

Analysis by the World Bank suggests that the slowdown in individual manufacturing sub-sectors can be associated with rising competitive pressures following the real exchange rate appreciation (8.7 per cent last year against a basket of other currencies).[3] Even though investment has recovered as the uncertainty surrounding the Yukos re-nationalisation dissipated, the share of investment in total GDP at about 18 per cent remains very low by the standards of other emerging markets. In consequence, capacity constraints have become increasingly apparent in a number of sectors, most notably resources extraction and transportation. Lifting the relatively low rate of investment remains the central long term challenge for the Russian economy.

[3] World Bank: Russian Economic Report, April 2006.

Table 2: Russian Growth by Sources of Demand, 2003 – 2005

	2003	2004	2005
Total consumption	6.2	8.9	8.6
Private consumption	7.5	11.6	11.1
Public consumption	2.2	2.1	1.8
Gross domestic investment	13.2	11.6	11.4
Gross fixed capital formation	12.8	11.3	10.5
Inventories	16.7	13.7	18.1
Net Exports of goods and services	3.0	-10.3	-15.0
Exports of goods and services	12.5	11.9	5.6
Imports of goods and services	17.7	22.5	16.2

Source: Rosstat.

A notable feature of recent growth has been the buoyant growth in household consumption. This has been fuelled by rapid gains in public and private sector incomes, and through the rapid growth in private sector credit. Given the rapidly widening coverage of the financial services industry of retail products and Russia's regions, this trend is likely to continue.

Balance of Payments

Growth has been supported by an unusually favourable external economic environment. Russia's export prices increased by over 30 per cent in 2005, helping to raise the current account to about 12 per cent of GDP. Strong prices, and the resulting growth in the merchandise trade surplus have persisted in the first quarter of 2006, when prices charged on energy deliveries to other CIS countries were also raised above previously charged levels. A moderation in the trade surplus is, however, imminent, as the growth in export volumes is slowing further, and import demand will continue to pick up on the back of rising consumer demand. These trends also contributed to another record level of official foreign reserves (US$ 182 billion) by the end of the year, though there is now also a positive balance in private transactions in the capital account.

Despite lingering political uncertainties, gross foreign direct investment inflows to the non-financial sector reached a record US$ 14.6 billion in 2005 equivalent to about 1.9 per cent of GDP, and just over 10 per cent of gross fixed capital formation, both ratios being somewhat below those in other transition countries (gross inflows were reduced due to a substantial reduction in FDI liabilities in the fourth quarter). The considerable outward investment by Russian corporates reduced the overall FDI balance to only about USD 1.4 billion, and underlines the ample cash balances within the top tier Russian corporates, and their growing regional influence. FDI flows to Russia now go to a much wider set of regions and sectors, importantly those catering to domestic demand such as financial services.[4]

[4] These figures are based on CBR statistics, which are derived from bank transactions

Russia's access to external debt was supported by highly favourable conditions in international capital markets, as reflected in the further compression of emerging market yield spreads. However, the improvement in financing terms is in good measure due to strengthened macroeconomic fundamentals, as is evident in the investment grade rating that is now awarded to the sovereign by all three major credit rating agencies. A continuously widening group of corporates and banks has also accessed the syndicated loan market. In 2005, gross external debt increased by about USD 18 billion in the banking sector, and by USD 50 billion in the corporate sector. This more than off-set the reduction in official debt following the USD 26 billion prepayments to Paris Club in the third quarter of 2005, and to the IMF (USD 3.6 billion) in the first quarter of that year. In-mid May Russia continued discussions with the Paris Club of creditor nations on the early retirement of the entire stock of outstanding liabilities, about USD 22 billion. This would likely require paying a premium over the face value of this debt, and underline the continued strengthening of Russia's external financial position, though a further upgrading of sovereign risk ratings is unlikely.

The abolition of the remaining capital account controls is now planned for July 2006, six months earlier than mandated by law. This would essentially abolish reserve requirements which are substantial for the investment in government securities. Investors are also likely to perceive a lower administrative burden on investing in Russian securities, and the liberalisation is likely to attract higher inflows, in particular to the sovereign debt market. It is unlikely that this measure by itself will aggravate Russia's balance of payments surplus, and the associated expansion in domestic money supply, given the ongoing operations of the stabilisation fund, sterilisation efforts of the central bank, and efforts to further retire external debt. Yet, the abolition of controls on inflows and outflows is likely to increase volatility in the domestic bond markets. Following the rapid yield compression, bond market valuations render the market liable to a correction and a reversal in sentiment, for instance in response to an oil price shock or abruptly tightening global liquidity conditions.

Fiscal Policy

To date the authorities have managed the oil windfall prudently. The consolidated government registered an overall surplus of 7.4 per cent in 2005, reflecting higher revenues from the natural resources sector. The budget for 2006 foresees a more moderate surplus at about 3.2 per cent of GDP, though this is in large part due to a relatively conservative oil price assumption at USD 40 per barrel. Budget targets are likely to be outperformed by a substantial margin, as was already the case in the first quarter. The federal budget nevertheless shows a continued deterioration in the structural fiscal balance (under the assumption of constant oil prices), following increases in current expenditures, and granting of further tax incentives. The benchmark oil price beyond which export duties and royalties are channelled to the Oil Stabilisation Fund (OSF) has also been raised from USD 20 to 27 per barrel.[5] On the current oil price scenario, the budget will continue to produce ample surpluses, though its cyclicality and sensitivity to the oil price has increased.

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[5] A part of this increase was to finance an investment fund, which is currently capitalised with about USD 2 billion.

The OSF was set up in 2003 and has accumulated about half of the windfall from high oil prices (it is financed out of the royalties and export taxes on the oil industry). The fund reached USD 61 billion at the end of April 2006, equivalent to over 7 per cent of GDP. This fund not only saves a large part of the oil windfall for future generations (and retired USD 20 billion in debt owed to the IMF and the Paris Club in 2005), but plays an important role in insulating the economy from price pressures. It is held in an account with the central bank, and hence does not translate into increases in domestic liquidity as other increases in foreign reserves do. In May 2006 the Russian government adopted a more active management of the stabilisation fund that will now be invested in highly rated sovereign bonds denominated in US Dollar, Pound Sterling, and the Euro. This will safeguard the fund's role as a savings and stabilisation instrument, and proposals for its use in domestic social expenditures have been contained. Russia's fiscal policies build on reforms over recent years that have made the budget process more transparent, and more responsive to medium term macroeconomic projections. The federal budget plan for the period 2006 – 2008 envisages a fairly conservative oil price base line, and an expenditure ratio that will stay roughly unchanged as a share of GDP. The accumulation in the OSF is to reach RUB 3.7 billion by 2008, from RUB 1.6 trillion currently, though resource revenues are likely to outperform, and preserving the stabilisation function of the OSF will be crucial for containing inflation. In this context the government also adopted a fairly conservative debt management strategy that aims at further repayment of external debt, in particular to the Paris Club, and a growing issuance of debt on the domestic debt market, the share of which in total government debt is to grow to about 57 per cent by 2009.

Monetary and Exchange Rate Policy

The monetary authorities continue to target exchange rate stability relative to a basket of the Euro and Dollar. Substantial current account surpluses – and recently surpluses in private capital account transactions – hence translate into reserve accumulation and, given the very limited sterilisation options on the illiquid domestic capital markets, into an expansion of broad money (last year at a rate of 37 per cent). The central bank allowed a Rouble appreciation in February and March against the targeted basket (and the currency has since strengthened in line with the Dollar's further decline). Yet, this seems to have been only a temporary pause in foreign currency purchases. Monetary tightening through increases in policy interest rates, and further open market operations have had limited effect. Consequently, inflationary pressures persisted in 2005, CPI inflation was at 10.9 per cent at the end of the year. This is the lowest in seven years, but above the authorities' earlier target. Since then latest figures show a further fall in inflation to 9.9 per cent, relative to a year earlier in April. A number of administrative measures (including on regulating increases in administered prices in public utilities) have been ineffective in containing inflationary pressures. However, the reduction in the income velocity of broad money has played an important role in containing price pressures. This basically reflects the stronger growth in Rouble bank deposits, also relative to foreign currency denominated deposits, and with it the growing confidence of the public in the currency and the banking system. As yet, real interest rates remain negative, skewing incentives for borrowers. In the face of rapid monetary expansion, the financial sector will need to play a key role in absorbing and allocating this liquidity in the coming years.

ANNEX 4: SELECTED ECONOMIC INDICATORS

Russian Federation

	2000	2001	2002	2003	2004	2005 *Estimate*	2006 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	10.0	5.1	4.7	7.3	7.1	6.4	6.5
Private consumption	7.3	10.1	8.5	7.5	11.6	11.1	na
Public consumption	1.9	-0.8	2.6	2.2	2.1	1.8	na
Gross fixed capital formation	21.5	10.3	2.8	12.8	11.3	10.5	na
Exports of goods and services	9.4	4.2	10.3	12.5	11.9	5.6	na
Imports of goods and services	31.5	18.7	14.6	17.7	22.5	16.2	na
Industrial gross output	11.9	4.9	3.7	7.0	7.3	4.2	na
Agricultural gross output	7.7	7.5	1.5	1.5	2.9	na	na
Employment			*(Percentage change)*				
Labour force (end-year)	0.4	-1.9	1.1	0.8	1.5	na	na
Employment (end-year)	3.2	-0.3	2.3	0.2	2.0	na	na
			(In per cent of labour force)				
Unemployment (end-year)	10.2	8.7	8.8	8.6	8.5	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	20.8	21.6	15.7	13.7	11.0	11.3	9.0
Consumer prices (end-year)	20.1	18.6	15.0	12.0	11.7	10.9	8.0
Producer prices (annual average)	46.6	19.2	14.0	15.6	24.0	21.9	na
Producer prices (end-year)	31.6	10.7	17.1	13.1	28.8	15.0	na
Gross average monthly earnings in economy (annual average)	42.5	45.7	34.5	24.8	24.0	20.9	na
Government sector[1]			*(In per cent of GDP)*				
General government balance	3.2	2.7	0.6	1.1	5.0	7.5	5.0
General government expenditure	33.7	34.6	37.1	35.7	33.6	36.0	na
General government debt	62.5	48.2	41.4	32.4	25.9	17.1	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	62.4	40.9	32.4	50.5	35.8	38.6	na
Domestic credit (end-year)	12.1	27.0	26.5	26.5	18.7	20.0	na
			(In per cent of GDP)				
Broad money (M2, end-year)	15.7	18.0	19.7	24.3	26.0	27.9	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Central Bank refinance rate (uncompounded)	25.0	25.0	21.0	16.0	13.0	12.8	na
Treasury bill rate (all maturities)	18.2	14.7	15.0	4.5	4.5	3.9	na
Deposit rate	4.2	5.2	4.3	4.4	3.8	4.0	na
Lending rate	18.2	16.5	15.0	12.4	10.0	10.7	na
			(Roubles per US dollar)				
Exchange rate (end-year)	28.2	30.1	31.8	29.5	27.9	28.8	na
Exchange rate (annual average)	28.1	29.2	31.3	30.7	28.8	28.3	na
External sector			*(In millions of US dollars)*				
Current account	46,839	33,934	29,116	35,845	58,592	84,249	95,611
Trade balance	60,171	48,120	46,335	60,493	85,825	118,266	134,753
Merchandise exports	105,033	101,884	107,301	135,929	183,207	243,569	280,104
Merchandise imports	44,862	53,764	60,966	75,436	97,382	125,303	145,351
Foreign direct investment, net	-463	216	-72	-1,769	1,662	1,473	2,500
International reserves, excluding gold (end-year)	24,264	32,542	44,054	73,175	120,809	182,200	na
External debt stock	160,027	151,122	152,101	185,869	214,500	258,500	na
			(In months of imports of goods and services)				
International reserves, excluding gold (end-year)	4.8	5.3	6.3	8.6	11.1	13.3	na
			(In per cent of exports of goods and services)				
Public debt service due[2]	10.3	15.2	11.7	12.6	9.2	13.0	na
Public debt service paid	10.3	15.2	11.7	12.6	9.2	13.0	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	145.2	144.4	145.2	144.9	144.9	144.1	na
GDP (in billions of roubles)	7,306	8,944	10,818	13,201	16,779	21,665	25,842
GDP per capita (in US dollar)	1,789	2,123	2,377	2,968	4,019	5,312	na
Share of industry in GDP (in per cent)	38.6	36.5	34.8	34.9	36.0	na	na
Share of agriculture in GDP (in per cent)	6.4	6.8	5.7	5.4	5.0	na	na
Current account/GDP (in per cent)	18.0	11.1	8.4	8.3	10.1	11.0	10.5
External debt - reserves (in US$ million)	135,763	118,580	108,047	112,694	93,691	76,300	na
External debt/GDP (in per cent)	61.6	49.3	44.1	43.2	36.8	33.8	na
External debt/exports of goods and services (in per cent)	139.6	133.4	125.8	122.3	105.4	96.4	na

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

[2] Data for 1999 show debt service due. Debt service paid was 14.2 per cent.

ANNEX 5: ENVIRONMENT

All EBRD operations in Russia undergo the Bank’s environmental appraisal and are structured to meet Russian and EU environmental standards and/or international good (industry) practice, in accordance with the Bank's 2003 Environmental Policy and Procedures. It is important to note that the close attention is to be paid not only to traditional environmental issues but also to the social elements, including worker protection issues (occupational health and safety, harmful child labour, forced labour and unlawful discrimination) and community issues (cultural property, involuntary resettlement, and impacts on indigenous peoples), as defined in the EBRD’s 2003 Environmental Policy. In the implementation of all projects financed by the EBRD, close attention is given to the effective implementation by sponsors of all national laws, as well as compliance with the ILO’s Core Labour Standards and the respective IFC community-related safeguards. Where appropriate, Environmental Action Plans are incorporated into the legal documentation in order to address issues raised during due diligence, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects.

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 has pursued a number of TC initiatives to support practical identification of the best environmental solutions and capture environmental opportunities within its projects, as well as supported institutional capacity building in, for example, waste management or oil spills response planning in line with applicable international standards.

The Bank is involved on numerous natural resource projects in Russia, mainly consisting of oil and gas projects and precious metals mining. Each of these projects present their own unique challenges; however, EBRD takes a consistent approach in applying its Environmental Policy. The Bank encourages each of the clients to “publish what you pay” in accordance with the Extractives Industry Transparency Initiative. In the oil and gas sectors, the Bank encourages gas utilization and discourages routine flaring. While the main focus is on impact reduction and minimization, the Bank also helps to identify environmental offsets, local capacity building opportunities and opportunities for environmental and social investments. On the precious metals mining projects 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 sector, increased focus on renewable sources of energy, e.g. refurbishment or new hydro power installations and potential development of alternative sources of energy such as tidal and wind are being pursued. Identification of energy efficiency opportunities is part of the Bank’s due diligence process and has a potential to bring significant environmental opportunities alongside with the financial benefits (e.g. carbon credits). This has been demonstrated by a number of industrial rehabilitation and modernisation projects, such as, for example, Togliatti Azot – rehabilitation of the plant for ammonia-based products, or Samara Metallurgical Plant – modernisation and efficiency improvement of the aluminium rolling mill. Where feasible, the Bank will seek to include energy efficiency and environmental improvement components into investment programmes.

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 for ensuring 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 and to give preference to certified wood, where available on competitive terms. The Bank welcomes the Russian Government's commitment to enhance its forest law enforcement and governance to take action 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 Forestry Code as an opportunity to create an enabling environment for predictable, just, equitable and sustainable forest management practices, which would enhance the long-term competitiveness of forest industry.

In the financial sector, the Bank continues to provide environmental and social risk management training and guidance for its new and existing financial clients in the implementation of the EBRD’s Environmental Procedures. Recent participants of this initiative included Rosbank, Vneshtorgbank, OrgresBank, TransCapitalBank, Locko Bank, Probusinessbank, Credit Bank of Moscow, Spurt Bank, Sibacadembank, Absolut Bank, ImpexBank, Probsvyazbank and Quadriga Capital. 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. In close cooperation with UNEP FI, the Bank has also conducted training on sustainability, addressing environmental and social risks and opportunities for Russian financial institutions.

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 environmental, health and safety conditions of the transportation. Initiatives to improve maritime navigation safety have been introduced in the areas of the Baltic Sea, the Gulf of Finland, the Barents Sea and the Azov/Black Sea. These will help to 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. As demonstrated within EBRD’s projects, Russian ports and shipping companies have developed in-house capacity for enforcement of IMO (United Nations

International Maritime Organization) regulations, MARPOL and SOLAS (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 has not engaged in the direct financing of primary agriculture, these food processing projects do 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.

In the property sector, retail and real estate development has been pursued in which planning permits, traffic impacts and public consultation issues have been addressed through the due diligence process. Anticipating further development in the retail sector, the integration of urban planning, traffic impact and fire safety issues into project designs, as well as of meaningful public consultation, will be increasingly important for the sector's operation in Russia.

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. Many of the projects in this sector are supporting the objectives of the Northern Dimension initiative and have received funding from the Northern Dimension Environmental Partnership (NDEP). For example, the completion of St Petersburg Southwest Wastewater Treatment Plant (SWTP) has resulted in significant environmental benefits and reduction of effluent load to the Bay of Neva, expanding into the Finnish Gulf and the Baltic Sea.

The Northern Dimension Environmental Partnership, which has environmental cooperation in North West Russia at its core, has been mentioned as a good model for future partnerships, with international financial institutions playing a crucial role in this area. The concept of the Northern Dimension is expected to be reshaped by the end of 2006 in order to better fit into the new operational environment.

The Bank alongside other international organisations and financial institutions will continue to assist Russia in addressing key environmental issues by encouraging international good practices through the Bank's environmental due diligence process and by engaging in a dialogue with relevant Russian authorities.

ANNEX 6: TECHNICAL COOPERATION

EBRD Donor Funds in Russia

Summary

Russia is the largest single country recipient of donor support accounting for over one quarter of commitments. Historically the EU is by far the largest donor followed by the G7 plus Switzerland (for the RSBF), the US and Japan. The focus of donor funding to date has been on support to micro finance, SMEs and infrastructure.

EU assistance under the Investment Preparation Facility has come to an end and future efforts will focus on funding from the EU Moscow delegation with much smaller amounts. Many other donors are prioritising funds to poorer (ODA eligible) countries and are phasing down their programmes in Russia. With the exception of Japan in the Asian part of Russia, the Northern Dimension Environmental Programme in North West Russia in which Denmark, Norway, Sweden and Finland make important contributions, , and a few other smaller bilateral donors, those donors that are staying engaged tend to pursue business opportunities through TC funding.

TC needs in Russia will be dominated by the MEI team in the regions in the medium term yet donor funding in this sector is far from secure.

Historical

TC Commitments 1991-2005 by Donor

Donor	Commitments (€)
European Commission	82,313,225
RSBF	77,696,760
USA	23,939,347
Regional Venture Fund for North West Russia*	20,658,672
Japan	13,805,622
UK	8,850,149
Netherlands	8,602,129
Italy	7,232,715
Finland	4,013,391
Canada	3,304,138
Sweden	3,302,245
NDEP	2,494,650
Norway	2,449,692
France	2,389,971
Germany	1,298,585
Taipei	1,265,098
Denmark	1,197,457
Switzerland	819,655
Luxembourg	714,660
Russia	305,561

Donor	Commitments (€)
Austria	251,680
Ireland	186,892
Belgium	180,685
GEF	172,073
Korea	108,914
Iceland	103,302
New Zealand	97,035
Greece	70,280
Total	**267,824,582**

*donors are Finland, Norway and Sweden

TC Commitments 1991-2005 by Team

Team	€committed	Percentage
Financial Institutions	105,145,856	39%
Group for Small Business	48,249,242	18%
Early Stage Equity	46,238,427	17%
TAM/BAS Programme	12,276,113	5%
Municipal & Environmental Infrastructure	11,842,461	4%
Russia HQ	8,478,110	3%
Transport	7,981,953	3%
Power and Energy	7,417,413	3%
Legal Transition	1,379,347	1%
Energy Efficiency	1,698,376	1%
Natural Resources	2,504,564	1%
Agribusiness	2,373,354	1%
Telecommunications, Informatics and Media	1,825,652	1%
Other	10,413,715	4%

2005 Commitments

- Almost half of the investments signed by the EBRD in Russia in 2005 had received donor assistance. These investments, worth €470 million, provided finance and advice to smaller businesses, improved banking services and transparency and upgraded municipal infrastructure;
- EBRD activities outside of Russia's major cities grew significantly in 2005. Donor commitments in these areas rose in parallel, reaching €14.3 million, up from €12.6 million in 2004. Only 5 per cent of technical cooperation (TC) assignments were in Moscow and St Petersburg;
- Forty-four new TC assignments were undertaken in 2005, supporting a variety of projects dominated by financial institutions, small business support, and MEI. These ranged from support for local banks lending to small and medium-sized businesses to working with municipalities to enhance their creditworthiness;
- The European Community was the largest donor in Russia in 2005, through funding assignments in microfinance, financial institutions and municipal infrastructure. The United States provided over €1 million to the Lower Volga Regional Venture Fund. Finland committed just under €1 million for water and district heating projects and the Business Advisory Services Programme in north-west Russia and Kaliningrad. Japan

provided €1.8 million for a municipal investment in the Far East. The Northern Dimension Environmental Partnership committed €1.2 million to prepare environmental projects in St Petersburg and Archangelsk.

TC Funding in 2006

TC Commitments in Russia to date in 2006 are at €3.7m and are expected to reach €8-10m towards year end. This is lower than levels reached in previous years.

Donor	Commitments (€)
EC	830,000
Regional Venture Fund for North West Russia*	705,550
Norway	450,000
Finland	447,174
Switzerland	379,423
Luxembourg	299,000
Japan	239,960
USA	215,585
UK	76,375
Sweden	25,406
Denmark	15,841
Total	**3,684,314**

* donors are Finland, Norway and Sweden

Projected TC Needs 2006/7 in Russia

The latest pipeline of TC needs over the period 2006/7 prepared by banking teams was circulated to donors in May 2006. The Russia TC Pipeline is as follows:

Team	**TC Projections**
MEI	17,620,000
GSB	1,500,000
TAM/BAS Programme	1,276,000
Financial Institutions	1,050,000
Legal Transition	600,000
Energy Efficiency	250,000
Power & Energy Utilities	50,000
Environment	32,000
Total	22,378,000

The needs of municipal sector projects dominate the Russia TC pipeline, with lower needs identified for other activities.

Current donor priorities

- EU: the Investment Preparation Facility is coming to an end. The Bank is working closely with the EU Moscow delegation on future funding but the volumes are expected to be small. NDEP funding, including for nuclear safety, will continue to come from Brussels;
- Japan: regions east of the Urals are a priority. Focus is on non-sovereign projects.
- Northern Dimension Environmental Programme: the environmental window will be an important source of TC and grant investment co-financing for projects in North West Russia and Kaliningrad. This is dependent on replenishments expected late 2006, early 2007;
- Bilateral funds from Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Sweden, Spain and Taipei China are open to proposals for funding assignments in Russia;
- Canada is currently in discussions with the EBRD to establish a new trust fund which would focus on environment, municipal and environmental infrastructure, and private sector development and would likely include Russia as one of the countries of focus;
- US funds may be forthcoming depending on the priorities set by the USAID mission in Moscow.

Overview of donor fund availability (trends)

- The European Commission is likely to cease to be the dominant donor in Russia from 2007.
- Many donors are winding down or closing their programmes in Russia. This decision is often stimulated by the reclassification of Russia by OECD DAC as a middle income country.
- Several donors have indicated that they do not wish to support sovereign projects in Russia.
- Significant gaps remain in donor funding for larger assignments (e.g. for MEI and micro-finance) and to support the Sustainable Energy Initiative.
- North West Russia will continue to be a priority in the context of the Northern Dimension Environmental Initiative, and the Russian Far East for Japan. There is some bilateral donor interest in other regions. Donor funding for projects in and around Moscow and St Petersburg is unlikely.