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 18 December 2012

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The Russian Federation is committed to the principles of multiparty democracy, pluralism and market economics in accordance with Article 1 of the Agreement establishing the Bank, although progress in the application of these principles during the previous Strategy period has been uneven.

One of the key features of the Russian political landscape is the rise and political awakening of the middle class, particularly in major cities like Moscow and St. Petersburg. At the end of 2011 the new generation of Russia's urban middle class for the first time began to position itself as a more determined political force, asserting its rights to have a greater say over the future development of the country. The authorities have shown the capacity to respond to these bottom-up pressures with a willingness to advance certain democratic reforms and open dialogue but also with potentially more repressive measures such as laws that threaten to limit the freedom of assembly and association and curtail internet freedom. As the middle class is likely to only grow in size and influence, it will be important to harness its productive potential through policies of political inclusion and openness.

The Russian economy rebounded well after it had been severely hit by the global financial crisis in 2008-9, which had caused GDP to drop by nearly 8 per cent in 2009, the deepest recession among G20 countries. The impact of that crisis occurred mainly through a sharp drop in the oil price, which in turn led to a drop in export and fiscal revenues, large capital outflows, liquidity shortages and a gradual depreciation of the rouble by more than 30 per cent against the dollar-euro basket between November 2008 and February 2009. Owing to a strong anti-crisis response and a rebound in the oil price, the economy recovered quickly and grew by 4.3 per cent in both 2010 and 2011, which helped asset quality and employment to recover as well. However, net capital outflows continued and amounted to around US$ 80 billion in 2011 and US$57 billion during the first 3 quarters of 2012, reflecting continued economic and election-related political uncertainty, combined with the shift to a more flexible exchange rate regime, which has discouraged "one-way bets" on the rouble.

The growth momentum started decelerating towards the end of 2011 and GDP growth is now expected to slow to 3.2 per cent in 2012, mostly reflecting the eurozone debt crisis and the global economic slowdown. Inflation declined to a record low (in Russia's modern history) of 3.6 per cent year-on-year in April-May 2012 but has picked up to around 6.5 per cent since then, in part due to rising global food prices. Falling export demand, rising inflation and weaker investor and consumer confidence have led to slower investment and consumption growth. Moreover, agricultural output has been negatively affected by a weak harvest owing to unfavourable weather conditions.

Russia's outlook for growth remains highly dependent on commodity prices, particularly for oil and gas. Other vulnerabilities stem from significant private external debt of around US$ 500 billion, or over 25 per cent of GDP, of which banks account for approximately one third, and the high sensitivity of the fiscal balance to the oil price. The transition to inflation targeting and a free floating rouble, which has

already started and is to be completed by 2015, should help to improve the economy's resilience to shocks, and thereby investor confidence.

The Government has recognised the need to reduce the economy's excess dependence on natural resources through diversifying and modernising the economy, but progress with structural reforms has been slow. The state continues to play a dominant role in a number of sectors of the economy, sometimes crowding out the private sector, while corruption, a problem well-known to many countries across this region, remains persistent and puts a drag on sustainable growth and investment. Measures have been taken during the previous Strategy period to increase transparency, step up judicial reform, reinforce the rule of law and combat corruption. These measures are encouraging, but implementation is lagging behind and corruption in public administration, state-controlled companies, law enforcement entities and the judiciary remains a widespread concern.

Despite almost two decades of market reforms, Russia's labour productivity remains one of the lowest amongst industrialised nations, while the energy intensity of the Russian economy is estimated to be about 2.5 times higher than the world average. The main reform achievement in recent years was Russia's accession to the World Trade Organisation in August 2012, which has the potential to raise productivity through increased foreign investment and stronger import competition, and in turn will put more pressure on domestic firms to become more productive and efficient. However, this can only materialise if WTO membership is accompanied by necessary structural reforms and improvements in the business climate. For Russia to reap the long term benefits of WTO membership it will be necessary to respect and fully implement the commitments it has undertaken upon its WTO accession. A number of countries have expressed concerns regarding Russia's compliance with WTO rules and commitments. From within, Russia's growing and politically active middle class has come to expect continued growth, opportunity, fairness and higher living standards, including in Russia's less developed regions. The Russian Government, which has once again announced its strong vocal support for reforms, will need to find a way to meet these expectations.

The EBRD has been a strong and longstanding partner for Russia, its largest country of operations. In the next three-year Strategy period, this relationship will continue to flourish as the Bank endeavours to assist the Russian authorities achieve their important reform objectives during turbulent times and to sustain its high level of engagement. While the previous country strategy for 2009-11 focused in part on supporting the country's short-term crisis response, this new country strategy for 2013-15 will refocus the Bank's activities on addressing the longer-term core challenges of the Russian economy, which include (1) diversification, (2) modernisation and innovation; (3) private sector development; and (4) regional development.

Throughout its operations in a wide range of economic sectors the Bank will therefore pursue the following cross-cutting strategic priorities:

- **Diversifying the economy**: The Bank will support diversification by prioritising investments in private enterprises and private financial institutions that support non-resource sector growth. The Bank will also use policy dialogue and TC to support improvements in the business environment that are crucial for successful diversification.

- **Investing in and setting standards for modernisation and innovation:** The Bank will support enterprises that innovate, introduce modern new technologies, or upgrade to international standards, particularly with regard to corporate governance, transparency, energy efficiency, inclusion and gender issues. The Bank will seek to increase its partnerships with international and domestic technology players, technology parks, credible and competent equity fund managers and venture capital funds. The Bank will also consider projects to modernise the transport, power and municipal and environmental infrastructure sectors. Improving energy efficiency will be a key aspect of modernisation across various sectors of the economy.

- **Supporting privatisation and private sector development:** The Bank will support private sector development directly through its projects with private enterprises and banks, through dedicated MSME credit lines and equity funds, and potentially through (pre-)privatisation activities, provided they are transparent and increase competition. The Bank's core objective will be to increase the role of the private sector through strengthening existing private operators; increasing the MSME share in the economy; pursuing transparent and competitive majority privatisation strategies for state owned companies; conducting policy dialogue on privatisation; and promoting PPPs as a tool to attract more private sector investment into state-dominated sectors. Development and deepening of domestic capital markets will also be a priority to meet the private sector's growing financing needs.

- **Increasing economic opportunities in Russian regions:** Russia is a federal state divided into 83 regions that vary widely in terms of per capita income, unemployment and investment. To support regional development, the Bank will prioritise projects and reforms that promote transition in regions that are less advanced than Moscow and St. Petersburg and that are committed to improving the investment climate. With the support of technical assistance funds to be provided by the Russian government, the Bank will seek to develop commercially viable solutions in underserved regions where it has been difficult to identify bankable projects, combined with policy dialogue with regional authorities on improving their business environment. The Bank will pay particular attention to projects that increase economic opportunities for the emerging middle class in the regions through increasing access of regional SMEs to finance, supporting urban renewal, and improving the quality of jobs and services.

In all these areas, the Bank's activities in Russia will be aligned with the overarching priorities of the Government to diversify the economy, to make Russian companies more productive and competitive – especially SMEs – and to improve the quality and reliability of public services. Equity investment can be a particularly potent way to promote transition at the corporate level, bearing in mind risk-return factors and market conditions. To complement its investments, the Bank will use policy dialogue and technical cooperation, supported in part by the Russian Technical Co-operation Fund to be set up by the Russian Government, to support all priorities, with a special focus on strengthening governance, improving the investment climate, and sustainable energy. The Bank will strengthen its catalytic role through international syndications, co-financing and risk sharing with other financial institutions to enhance the impact of its operations in such a large country as Russia.

1. THE BANK'S PORTFOLIO

1.1 Overview over Bank activities to date

As at end-June 2012 the Bank has signed a total of 726 projects with cumulative investment value of Euro 22.3 billion since initiating its operations in the Russian Federation in 1991. The total value of these projects was Euro 65 billion, including over Euro 5 bln in syndicated financing. 35 per cent of the Bank's cumulative investments were made into the corporate sector, 36 per cent into the financial institutions sector, 18 per cent into the infrastructure sector and 11 per cent into power and natural resources. 198 projects representing 19 per cent of the Bank's cumulative business volume were equity investments. Reflecting the Bank's strategic focus on the development of the private sector, the private sector share in the Russia portfolio was at 83 per cent.

The Bank's portfolio in Russia as at end-June 2012 consisted of 338 standalone operations totalling Euro 10.3 billion and operating assets stood at Euro 7.9 billion. The portfolio is well diversified across sectors and the sector breakdown is consistent with the Bank's overall portfolio, however with a smaller share of sovereign and state-owned companies at 16 per cent compared to 26 per cent for the Bank as a whole and a higher exposure to equity at 33 per cent of the operating assets compared to 26 per cent for the Bank. The Russian Federation continues to be the largest country of the Bank's operations accounting for 32 per cent of the Bank's 2011 annual business volume and for 31 per cent of the Bank's operating assets and 28 per cent of the Bank's portfolio as at end-June 2012.

Table 1: Portfolio Development in Russia as of 30 June 2012

SECTOR	**NET CUMULATIVE BUSINESS VOLUME**				**CURRENT PORTFOLIO STOCK**				
Amount in EUR million	Number of projects	EBRD signed	Total Project Cost	*EBRD % of Total*	Number of projects	Portfolio	*% of Portfolio*	Operating Assets	*% of Operating Assets*
Energy	**58**	**2,653**	**10,268**	**26%**	**19**	**1,273**	**12%**	**1,079**	**14%**
Natural Resources	39	1,236	4,741	26%	9	395	4%	395	5%
Power and Energy	19	1,417	5,526	26%	10	878	8%	684	9%
Financial Institutions	**270**	**8,086**	**11,657**	**69%**	**104**	**2,712**	**27%**	**2,502**	**31%**
Bank Equity	31	647	802	81%	18	499	5%	499	6%
Bank Lending	89	5,370	6,874	78%	40	1,235	12%	1,052	13%
Small Business	97	705	986	72%	22	186	2%	181	2%
Insurance, Fin Services	53	1,364	2,994	46%	24	792	8%	771	10%
ICA	**314**	**7,854**	**27,363**	**29%**	**158**	**4,056**	**39%**	**3,034**	**39%**
Agribusiness	71	1,998	6,483	31%	35	1,075	10%	795	10%
Equity Funds	48	860	2,304	37%	27	414	4%	206	3%
Manufacturing & Services	140	3,819	14,019	27%	63	1,961	19%	1,631	21%
Property & Tourism	25	540	1,702	32%	20	407	4%	238	3%
Information & Communication Technologies	30	636	2,853	22%	13	199	2%	164	2%
Infrastructure	**84**	**3,748**	**15,384**	**24%**	**57**	**2,208**	**22%**	**1,242**	**16%**
MEI	41	1,077	4,318	25%	34	659	6%	320	4%
Transport	43	2,671	11,065	24%	23	1,549	15%	922	12%
TOTAL	**726**	**22,342**	**64,671**	**35%**	**338**	**10,250**	**100%**	**7,858**	**100%**

Over the previous strategy period, starting from 2010 through the end June 2012, the Bank signed 169 projects achieving annual business volume of Euro 2.3 billion in 2010 with 63 projects, Euro 2.9 billion in 2011 with 74 projects and Euro 1.3 billion with 32 projects in the first half of 2012.

Table 2: Portfolio Development in Russia, 2009-1H2012

Amount in EUR million	2009	2010	2011	30-Jun-12	Development over the previous strategy period (2010-1H2012)
Net Cumulative Business Volume	12,934	17,680	20,581	22,342	+9,430
Current Portfolio Stock	7,495	8,279	9,453	10,250	+2,777
Number of Portfolio Operations	305	310	331	338	+33
Operating Assets	5,857	6,457	7,327	7,859	+1,996
% Undrawn	22%	20%	21%	22%	
Annual Business Volume	2,366	2,309	2,928	1,347	6,584
Number of Operations	56	63	74	32	169
Gross Disbursements	1,829	1,636	1,907	1,012	4,558
Annual Cancellations	361	207	303	9	519
Active Pipeline Stock **(from CR to BA stage)**	4,643	3,762	5,097	4,116	
Private Sector Share (% Portfolio)	81%	85%	84%	83%	
Non Sovereign (% Portfolio)	95%	96%	97%	97%	

1.2 Implementation of the previous country strategy

The previous Strategy for Russia was approved by the Board in December 2009. The Strategy was formulated during the global financial crisis and at a time when the Russian economy was in a deep recession caused in part by a substantial fall in prices for its main export commodities. The 2009 contraction of global credit markets greatly reduced the ability of Russian banks and companies to access the market for refinancing of their large external borrowings.

Within this environment, the previous Strategy included crisis response measures and highlighted the following strategic priorities during 2010-2012:

- Support for modernisation, competitiveness and diversification of the real economy by addressing immediate financing needs and keeping trade flowing in a challenging economic environment, as well as promoting competition and economic diversification, stimulating innovation and increasing productivity in the medium term.
- Energy efficiency as a cross-cutting objective with a focus on reducing waste of energy and greenhouse emissions not only to ensure corporate competitiveness, but to improve overall energy security and combat climate change.
- Support to both private and state companies to address key infrastructure bottlenecks including through improvement in the regulatory framework to enable infrastructure investment.
- Support to the financial sector to strengthen current and new partner banks and enable them to provide financing for the real economy.
- Support for domestic capital market development to enable mobilisation of local savings and expansion of rouble funding.
- A focus on investing in Russian regions outside of Moscow and St Petersburg, continuing to work with the more progressive regions to re-enforce the positive

demonstration effect to encourage the less advanced regions to embark on reforms in order to attract financing.

The implementation of the above strategic priorities is summarised below.

Support for modernisation, competitiveness and diversification

Over the previous strategy period the overwhelming majority of the Bank's projects were in the non-resource sector (the Bank was highly selective and signed only 6 Natural Resources projects out of total 169 projects totalling Euro 89 mln or 1.4 per cent of the cumulative business volume over the previous Strategy period). The Bank's projects in the non-oil and gas sector – in automotive, forestry, agribusiness and knowledge-intensive industries – have contributed to the diversification objective of the Russian government and made an impact on modernising and improving the competitiveness of the economy. However, this remains a major challenge for the Russian authorities in the coming period, as oil and gas still accounts for nearly 70 per cent of total merchandise exports and around one half of government budget revenues.

In the **a*utomotive*** sector, the Bank played a key role in supporting the transformation of an outdated, inefficient, state-controlled sector to a modern, competitive marketplace where vehicles locally produced by foreign-owned companies now take the largest share of the Russian annual automotive demand estimated at 2.6 million cars or Euro 50 billion per year. During the previous strategy period the Bank has supported the sector through such projects as Kamaz equity, PCMA Rus financing for the construction of a new car plant, as well as focusing on supporting localisation of auto components productions by financing Takata, Andolin, to achieve transfer of know-how and skills dissemination.

In the ***forestry*** sector, the Bank supported several investments in wood processing and investments fostering the improvement of forestry operations associated with the modernisation of a large pulp and paper mill and encouraging more sustainable and efficient forestry activities in leased forest areas. Projects included the financing to Kronospan Russia to launch the first Oriented Strand Board (OSB) plant in Russia thus expanding the market and introducing a new product, and support of Mondi Syktyvkar that contributed to more sustainable and efficient forestry activities in the company's leased forest areas. With Russia accounting for a quarter of the world's forest resources and only 3.5 per cent of the market in the forest products, it is expected that the Bank's projects will eventually contribute to narrowing this substantial gap. The Bank also commissioned a study to analyse obstacles for development of the forestry sector in order to revive investments in the sector and promote sustainable development and competitiveness.

In the ***pharmaceutical*** sector, the Bank played a hands-on role in supporting the significant growth of Petrovax from a small pharmaceutical company to the second largest producer of anti-flu vaccines in Russia with some 12 million doses of modern anti-flu vaccines sold annually and used to vaccinate around 8 per cent of the population of Russia, thus supporting the wider commercialisation of local R&D.

In support of ***the knowledge economy***, building on its previous experience in mobile communications, the Bank supported other technologies such as WiMAX and regional development of Tele 2, the fourth largest GSM operator. The Bank also focused on projects promoting innovations such as KupiVIP (on-line shopping), IBS (systems integration) and Prognoz (software and data management solutions). Financing of the Technopolis Technical Park contributed to the growth of ICT companies in St Petersburg. However the overall impact of the Bank's operations on the growth of the Russian knowledge economy has been constrained both by a number of supply related factors (weak business environment, shortage of human capital, legal and regulatory barriers related to intellectual property rights protection, red tape, underdeveloped linkages between academia and business, and the lack of available financing for new ventures) as well as limited demand for innovations in Russia and the early "venture" stage of most projects which makes them un-bankable.

The Bank made an impact in developing high standard ***food processing***, wider use of modern agricultural equipment and the expansion of modern, high quality food retailing. The Bank worked with companies in support of development of modern distribution and logistics as well as supporting primary agriculture projects. Examples include projects with companies like Olam and Yug Rusi that will strengthen backward linkages with suppliers in farming and dairy operations. Policy dialogue in the agricultural sector has focused on instituting best practices among rural farmers in the South of Russia and fostering an international coordinated dialogue on food prices and security, as well as promoting the introduction of warehouse receipts to encourage financing of the sector.

In the ***petrochemical*** sector the Bank provided debt and equity financing for the RusVinyl project that was the largest JV investment outside of the oil sector since Soviet times. The JV between Russian Sibur and Belgium SolVin will make the country self-sufficient in production of PVC and introduce the best available production technology to avoid the use of the highly-polluting mercury. The project will improve energy efficiency of unit production by around 25 per cent and utilize 500K tones of associated petroleum gas per year from the Russian oilfields that would otherwise have been flared. The RusVinyl project financing received two highly prestigious "deal of the year" awards from the Project Finance and Project Finance International publications.

Energy efficiency to ensure competitiveness, overall energy security and combat climate change

In keeping with its Sustainable Energy Initiative and its growing capacity to build energy efficiency and energy savings elements into its investment projects, the Bank has sought to deliver high energy efficiency transition impact throughout the economy. Impact was achieved in energy-intensive sectors in industry, power, and municipal environmental infrastructure, while the Bank has also demonstrated the viability and importance of realising efficiency gains in less energy intensive sectors such as agribusiness, telecommunications and property.

While the Bank over the previous Strategy period provided a record level of financing for Sustainable Energy in absolute terms (Euro 1.1 billion), the share of energy efficiency financing in the Bank's business was about 15 per cent in Russia, lower than the 20-25 per cent share achieved in other countries of operations. SEI components have been mainstreamed as part of the Bank's projects in the corporate sector; however, the development of dedicated ***industrial*** energy efficiency transactions has been limited to several flagship projects (e.g. a dedicated energy efficiency financing of NLMK, co-financing with Rusnano of a JV between Nippon Sheet Glass and its local partner, STiS to construct a new facility to produce energy efficient glass deploying the most advanced coating technology, thus supporting expansion of the market for the energy efficient construction materials).

In the industrial sector the Bank also supported its clients through the industrial energy efficiency programme providing energy audits and related technical support designed to transfer best practice technologies and skills. Over the previous strategy period, the Bank conducted 30 energy audits, feasibility studies, energy management trainings and other support activities in order to address capacity and skill gaps of its client companies. This also helped the Bank to generate 13 new projects.

In 2011 the Bank launched a new Global Environment Facility (GEF)-funded programme aiming to help industry clients improve overall management of energy systems and production processes, implement innovative and best practice solutions for systems optimisation and process integration as well as implement modern fully integrated ISO-based energy management systems.

The Bank introduced energy efficiency components into ***transport sector*** operations – which have important long-term carbon impact and sustainability implications – covering railway fleet and infrastructure operators, ports and airport infrastructure and shipping companies.

While private sector bankable opportunities related to energy efficiency in the public and residential sectors have yet to materialise, to unlock the energy efficiency potential in the ***residential sector*** the Bank partnered with the IFC in initiating and implementing a comprehensive programme of TC support to the government to improve the regulatory framework and building standards for residential buildings and to introduce financing instruments able to provide the necessary capital for modernisation. In ***public buildings*** the Bank has been promoting the use of energy performance contracting to allow public clients to engage private sector ESCOs in order to finance and implement capital repairs which can be repaid from a share of the future energy savings. The EBRD's support made available under the GEF-funded programme contributed to putting in place the basic primary and secondary legislation governing energy performance contracting.

In the ***financial sector*** the Bank launched a USD 300 mln Russian Sustainable Energy Financing Facility (RuSEFF), channelling technical support and dedicated loans for the implementation of small-scale energy efficiency projects to industrial companies and SMEs via 4 participating banks. Beyond its impact at the enterprise level, RuSEFF builds the capacity of local financial institutions to market and finance these projects. However, EE lending via financial intermediaries was lower than expected due to lower demand for the product and limited capacity of banks, which resulted in adjustments to the programme.

Sustainable energy projects were prioritised with the Bank's ***natural resources sector*** clients, such as flagship gas flaring reduction projects with Monolit and Irkutsk Oil Company. These gas flaring projects have now also been approved by the Russian Federation as Joint-Implementation carbon projects under the Kyoto Protocol with a volume of 1.4 mt CO2 reduction to be generated over the life of the projects. Both projects were awarded 2012 Excellence in Flaring Reduction Award by the Global Gas Flaring Reduction (GGFR) partnership, a World Bank-led initiative.

EBRD has undertaken a large number of district heating refurbishment and other ***municipal infrastructure*** upgrade projects with private and municipal operators with the aim to reduce energy losses and CO2 emissions from the country's outdated infrastructure. Where possible, an integrated approach to energy efficiency has been pursued, whereby supply-side energy planning and modernisation has been enhanced to include considerations for demand-side energy efficiency at the level of residential and public buildings, for example as part of a loan to a municipal district heating company in the Far Eastern Republic of Sakha, Yakutiya. The project focuses on investments into the modernisation and upgrade of the district heating facilities in the northern settlements to improve the overall quality of heating services, reduce fuel consumption and heat and water losses and lower air emissions.

As part of its Sustainable Energy Action Plan signed in 2009 with the Russian Federation, EBRD engaged in active policy dialogue providing regulatory support to respective Ministries and stakeholders, as well as channelling its policy recommendations through FIAC's Working Group on energy efficiency, the Working Group on EE under the PPP Expert Council of the State Duma's Economic Policy Committee, and the Duma Committee for Housing and Public Utilities.

Addressing infrastructure bottlenecks

To promote private sector delivery of ***municipal infrastructure services***, in addition to 7 projects with municipal companies, the Bank financed 2 private sector transactions in the MEI sector, including a second loan provided to a private water operator Rosvodokanal. In addition to modernising municipal infrastructure and improving operational performance, these projects will address the lack of skills at the municipal and utility levels and introduce best financial practices and discipline through cost recovery at the level of operational companies and budgetary sustainability at the level of municipal or regional administrations.

The Bank actively engaged with authorities on the introduction of regulated asset base (RAB) tariffs in the municipal sector. A new federal law was approved in 2010 allowing in principle district heating companies to switch from the "cost-plus" to RAB methodology. However, as a practical matter, the new legislation requires further clarity and precision on tariff setting at the regional level, hence the Bank continues practical discussions with regional authorities on a project by project basis.

During the previous strategy period, major progress was made with railway sector reform, to which EBRD contributed. In particular, freight operations were restructured into two main subsidiaries and a specialist freight company; private sector participation increased significantly; cargo tariffs for private entities (including RZD subsidiaries) were deregulated; and competition in service provision increased substantially. The Bank contributed to these reforms through supporting private rail operators and wagon lessors, which helped to increase private sector participation and competition. In addition, the Bank contributed to improvements in corporate governance, which helped to prepare the specialised freight company, Transcontainer, for an IPO that was successfully closed in 2010 and the general freight subsidiary, First Cargo, for a majority trade sale in 2011. The Bank also engaged in policy dialogue with the Government, in connection with its Integrated Approach, to encourage further advancements in the reform programme for the railway sector.

In the ***aviation*** sector the Bank, together with partner IFIs and Vnesheconombank, pioneered the use of PPPs in the Pulkovo Airport PPP in St Petersburg in 2010. The Bank engaged in policy dialogue with the City in the initial stages of the Project's conception and then worked with the private sector to close the transaction in difficult market conditions and limited commercial bank appetite for project finance deals in Russia at the time. The Project to reconstruct Pulkovo Airport was named the European Airport Deal of the Year 2010 by Project Finance magazine, the Transport Deal of the Year by the Infrastructure Journal and received four other prestigious international awards.

The Western High Speed Diameter (WHSD) was the first ***road*** PPP the Bank financed in Russia, thus ensuring environmental standards of the project. As the sole international debt provider alongside local banks the Bank also provided significant input into developing a bankable project structure.

The Bank also engaged in extensive policy dialogue to support the development of the legal and regulatory framework for PPPs in Russia. The Bank engaged with the Duma, the Ministry for Economic Development, and other government bodies to promote amendments to improve the Law on Concession Agreements. The Bank co-operated with the Public-Private Partnership Development Centre and the VEB PPP centre on promoting the PPP concept in regions.

The Bank has also supported a range of investments in the ***maritime*** sector to improve public infrastructure including the financing of an environmental programme linked to institutional reform of Rosmorport, a state enterprise charged with management of the state port property and providing safety navigation services at all Russia's sea ports. The Bank has also encouraged private sector development and innovation by participating in an IPO by a major port operator Globalports and providing funds to develop port in infrastructure in the Russian Far East to remove capacity bottlenecks. In addition, the Bank has financed renewal of shipping fleets to replace old ships with modern, energy efficient vessels operating in the regional short sea shipping and deep sea dry bulk cargo markets, thereby supporting Russian exports and demonstrating best practice in terms of energy efficiency management.

In the ***intermodal*** sector the Bank has played a key role in supporting the development of innovative transport solutions and provision of integrated transport services by the private sector. In addition to its financing of FESCO, the Bank has also supported Globaltrans to expand its ports, shipping and rail activities.

Overall, several factors impeded deeper engagement in the transport sector. These included the slower roll out of PPPs, lower private investor appetite and liquidity in the local banking market, and difficulty in obtaining a commitment from some state-owned companies to apply EBRD public procurement procedures.

In the ***power*** sector the Bank focused on financing investments in generation and transmission capacity to support modernisation of the ageing and inefficient power infrastructure and promotion of energy efficiency under the Integrated Approach to thermal generation in the Russian power sector. The Bank supported energy efficiency investments in electricity networks of the Federal Grid Company and modernisation of RusHydro existing stations. However, the Bank’s strategy of providing financing to privatised generation companies and promoting new entrants including Independent Power Producers, was not fully realised due to delays with developing a long-term capacity market and large role of the state in the sector. While the Bank actively financed projects in the transmission sector, projects in electricity distribution did not materialise, in part due to inconsistent implementation of the incentive-based RAB tariff methodology. Vast renewable energy potential remained unrealised due to the lack of supporting legislation, and the Bank engaged with policy makers on developing the required supporting regulatory framework.

The Bank undertook policy studies for the Electricity Market Council and Ministry of Energy to recommend tariff methodologies supporting power generation from renewable sources (RES). The Bank has also supported the development of the investors’ marginal CO2 abatement cost curves for Russia to simulate the impact of economic, energy and environmental policies on investment incentives and expected emission trajectories.

Strengthening partner banks to provide financing for the real economy

The crisis of 2008 negatively affected financial markets and market participants. Over the previous strategy period the Bank’s key objective in the financial sector was to further strengthen private banks through capital increases and expansion of their product lines to enable them to efficiently finance the real economy and successfully compete with the state banking sector. Bank consolidation has been limited due to several factors, including the owners’ ability to survive without M&A, the lack of knowledge and technical capacity to properly integrate banks, and problems with corporate governance in the sector. Therefore, the Bank’s has not been active in facilitating consolidation.

In 2010-2012, the Bank developed and deepened several important relationships, and completed a number of projects aimed at ***financing regional MSMEs*** and ***energy efficiency*** projects. The Bank reached out to MSMEs through dedicated loans to financial intermediaries including under the ***Russia Small Business Fund*** (RSBF). In the beginning of 2012 RSBF’s loan portfolio to micro and small enterprises increased to USD 1.4 billion in more than 90,000 loans. This included Bank funding of around USD 154 million, with the balance being financed from the partner banks’ own resources, resulting in the leveraging of commercial funds by EBRD funds of 9 to 1. The average loan size remained at USD 15,700 clearly demonstrating the RSBF's capability to reach out to micro borrowers.

Another route to reach out to SMEs has been through ***equity funds***. The Bank has not only created institutional capacity across a number of Russian regions through its involvement in funds but directly and indirectly participated in more than 300 investments in typically smaller private businesses across a wide range of industry sectors. Over the previous strategy period the Bank supported 6 equity funds acting as anchor investor and focusing on generalist funds and lately on supporting specialist fund managers in niche sectors such as high technology, infrastructure and mezzanine financing. The Bank has also initiated support to local ***leasing companies***, the new channel of long-term capital expenditures financing, which is often more easily accessed by the SME businesses.

The Bank contributed during the previous strategy period to the development of ***a sustainable infrastructure of MSME support*** and local business advisory services through its two complementary instruments, the Enterprise Growth Programme (EGP) and Business Advisory Services (BAS) in North Caucasus and the Far East.

Developing domestic capital markets

The financial crises of 2008 has further underscored the need and importance of a deep and developed domestic capital market. Over the previous strategy period the Bank prioritised projects targeted at ***capital market development and market infrastructure***. The most significant project in this area was the Bank's equity investment in the MICEX stock exchange. EBRD participation in MICEX supported a number of corporate governance improvement measures, diversification of the shareholding structure and Board composition ahead of a planned IPO in 2013. The Bank also undertook its first time investment in a start-up private pension fund that offers pension plans to the wider public.

Over the previous strategy period the Bank has also expanded its focus to the ***insurance*** sub-sector. The Bank has made several equity investments supporting different life and non-life business models of the most transparent Russian insurance companies, such as RESO Garantia and Renaissance Life, as well as start-ups with foreign investments, such as Intouch.

The Bank took part in the Expert Council of the National Currency Association in promoting the development of the RUB money market and contributed to the work of Moscow as an International Financial Centre (MIFC) taskforce. Through its active participation in the FIAC working group on Financial Institutions and Capital Markets the Bank contributed to reform of the pledge legislation, development of payment systems, supervision and efficiency in the banking sector and insurance sector reform.

Investing outside of Moscow and St Petersburg

During the previous strategy period, the Bank completed the set-up of its network of 7 regional offices in Russia and has made strong efforts to invest outside Moscow and St Petersburg. During the previous strategy period about half of the Bank's business volume was achieved in the regions of Russia outside of the two federal cities. Another 30 per cent of the Bank's business volume was generated with companies that were present across different regions, while Moscow and St. Petersburg accounted for only 18 per cent of the Bank's business volume.

Expanding support for medium sized regional Russian companies and moving to less developed regions proved to be difficult because of the lack of credible sponsors and the weak business environment in many Russian regions. Developing projects with regional medium sized companies also proved a challenge due to the insufficient levels of transparency and to higher business risks.

During the last few years, the Bank has been able to identify and finance few ***regional champions***, such as Katren, a pharmaceutical distributor based in Novosibirsk with a retail pharmacy chain in Russia and other CIS countries, or Hlebprom, a confectionary producer in Chelyabinsk. Regional outreach was enhanced through investment in multiregional companies such as Lenta, a retail network headquartered in St Petersburg, which is increasing regional coverage and fostering local reliable quality suppliers (mainly SME's in the food sector), and improving its distribution chain and logistics through development of regional hubs.

With 13 projects signed in the ***real estate*** sector the Bank focused on increasing supply of modern office and retail infrastructure (such as the Saratov and Aura Shopping Centre projects) in the regions. The Bank addressed growing demand for regional logistics facilities that are crucial for the development of modern and efficient distribution networks for industries, wholesalers and retailers.

Municipal and environmental infrastructure projects are a key conduit to transform regional cities and a platform for dialogue with municipal and regional authorities on sector reform and broader investment climate issues. The model of engaging directly with municipal companies has also allowed the Bank to achieve significant regional coverage, strong environmental benefits, efficient implementation, and skills transfer. The Bank currently works in 28 municipalities all over the country from Kaliningrad on the Baltic Sea to the Far-Eastern Republic of Sakha (Yakutia). It was estimated that the EBRD projects benefit 22.5 million people or 16 per cent of the Russian population. Over the previous strategy period the Bank signed 9 MEI transactions.

The Bank has been applying the financial incentives offered by the Northern Dimension Environmental Partnership (NDEP) to improve the viability of MEI projects in the north west of Russia. NDEP is a multi-donor fund managed by the Bank that offers grants to leverage IFI loans and funds from the Russian municipal and federal budgets. NDEP have pooled donor contributions of close to Euro 338 mln from the European Union and 11 donor governments. Today Russia is the largest donor to NDEP environmental programmes. In 2011 the Russian government raised its contribution from Euro 40 mln to Euro 60 mln with a special focus on financing additional projects for energy efficiency. Over the previous strategy period the Bank provided Euro 54 mln of loan financing that was tied-in with Euro 40 mln of NDEP investment grants for four projects in St Petersburg, Pskov, Vologda and Kaliningrad. Three more projects in Murmansk, Novgorod and Lomonosov have been approved for grant funding by NDEP at Euro 10 mln to support EBRD loans of Euro 33 mln.

At the same time, the Bank faced new hurdles in its regional development, as a consequence of both economic constraints related to tighter public budgets and slower utility tariff growth and reluctance of smaller municipal counterparts, in light of increasing access to state bank funding, to adhere to high EBRD standards.

The Bank has engaged in ***policy dialogue*** with many regional governments on investment climate issues, for example, by participating in the Expert Group of the Ministry of Regional Development and in the FIAC working group for the Far East. The Bank implemented a TC funded project to develop a legal framework for the PPP projects in infrastructure in the Perm region. The Bank has also been invited to participate as an expert in a number of regional development councils and more recently in the federal Expert Council "Investment and Modernisation of Regions".

The Bank undertook together with the World Bank, the Ministry of Economic Development, the New Economic School and Vneshekonombank a Business Environment and Enterprise Performance Survey in 37 regions. The results will be used as an important tool to guide policy dialogue and support improvements in the investment climate in the regions.

1.3 Transition impact of the Bank's portfolio

During the previous strategy period, the Bank signed 114 transition-rated operations in Russia.[1] These new signings were largely concentrated in the financial and corporate sectors. The share of each sector in the total number of new projects during the period equalled around 40 per cent. The Bank rated 96 per cent of these new operations (110) as having "Good" or "Excellent" transition impact potential, which is well above the 80 per cent institution-wide target.

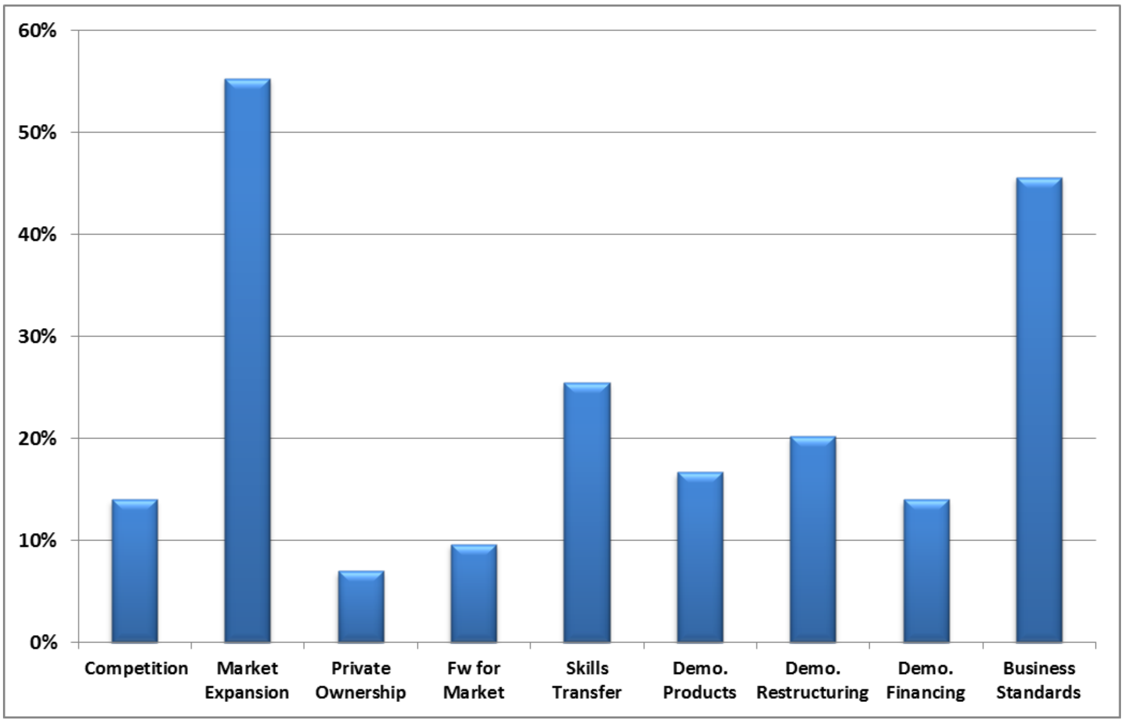
Out of the 12 projects assessed with an "Excellent" transition potential, seven were in the corporate sector, three in the financial sector, one in transport, and one in natural resources. The excellent-rated corporate sector projects had various transition objectives including (1) introducing technological products or processes that were new to the Russian economy; (2) facilitating policy dialogue, e.g., on the new energy efficiency law; and (3) offering new competitive products in underserved regions. The three excellent-rated financial sector projects were all expected to have a strong demonstration effect in terms of commercial financing for energy efficiency, in particular the potential to use credit markets to finance efficiency improvements. The excellent-rated transport project supported the first competitively and transparently procured airport concession in Russia, while the operation in natural resources supported private sector participation in the downstream oil and gas processing market.

Only four operations (or about 4 per cent of the total) across different sectors were assessed as having a "Satisfactory" transition impact potential. The transition impact potential of two of them, in the packaging materials and water transportation sub-sectors, was limited by the already highly competitive nature of the respective markets and the likely modest impact of these operations. Another project, a syndicated loan to a Russian commercial bank, had only modest transition potential due the very limited use of proceeds in segments where transition gaps in Russia are relatively large (e.g., SMEs). Finally, the EBRD's participation in the rouble-denominated bonds placement for the Bank's existing client was expected to have only a limited demonstration effect on the financial market and a small impact on rehabilitation investments in the country.

[1] In addition to these 114 operations, 20 additional operations were not individually rated by the OCE; these were either rated and monitored on a facility level only, or were approved "off line" by Credit.

The transition objectives of projects signed during the strategy period reflected the sectoral distribution of the Bank's activities in Russia, which was mostly demand-driven, as well as the existing transition gaps in the country and the main challenges brought about by the financial crisis. The most important transition objectives across projects during this period were improving standards for corporate governance and business conduct, as well as supporting market expansion, including through an increase in lending by financial institutions that were significantly affected by the crisis. Around half of all new signings in Russia during the period from December 2009 to end-June 2012 addressed at least one of these transition objectives. One fifth of all new projects in Russia targeted positive demonstration effects related to successful restructuring, mostly through realisation of operations in the corporate and infrastructure sectors (Figure 1).

Figure 1. Targeted transition objectives in Russia (share of projects), Dec 2009- 1H 2012



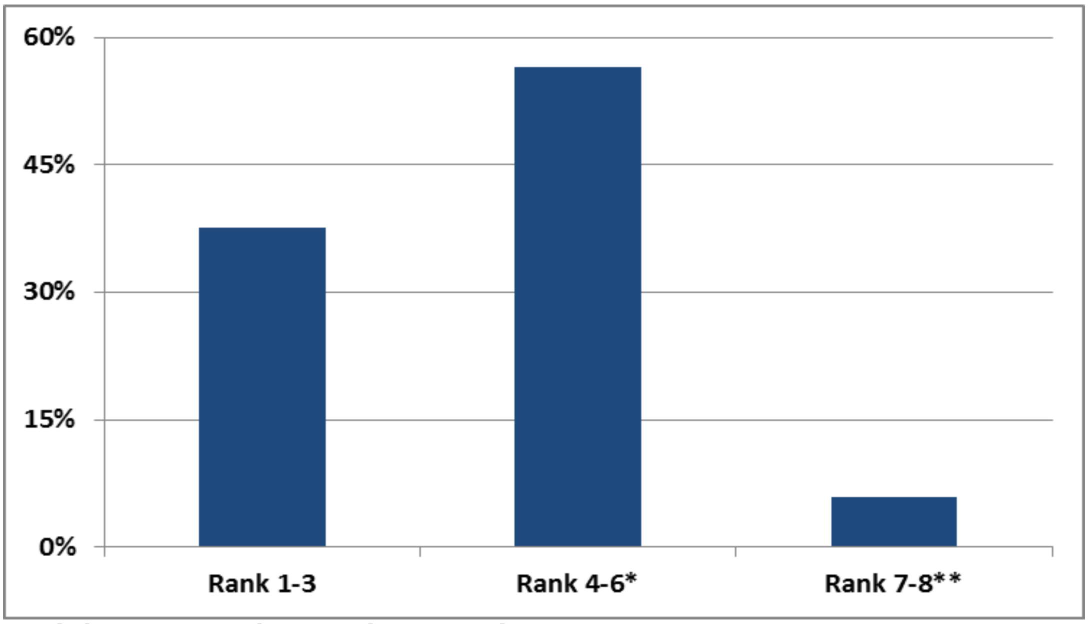
The projects in the Banks's Russia portfolio are performing relatively well from a transition perspective. At end-June 2012, there were 218 operations in the country's active TIMS portfolio,[2] out of which 82 operations, or about one third, have mostly achieved their desired transition potential (i.e. have a rank in the range from 1 to 3).[3] More than half of all monitored operations (125) are currently ranked from 4 to 6, which indicates that they are generally on the way to achieving their expected transition objectives. Thus far, 11 operations, representing six per cent of the Russia

[2] This includes all active operations more than 6 months since signing that were monitored at least one for their transition impact.

[3] The rank is a combination of the relevant rating for transition impact potential and risks to transition impact. The expected transition impact of operations is usually monitored once a year, mostly based on self-evaluation, and is ranked numerically from 1 to 8, with 1 to 3 indicating the mostly realised impact, 3 to 6 indicating that an operation is generally on track to achieve transition objectives, and 7 to 8 indicating minimum transition impact or excessive risk.

portfolio, have failed to achieve their envisaged transition impact. This includes four operations in the financial sector that were severely affected by the financial crisis. The failure of two projects in the corporate sector to achieve the envisaged market expansion activities appears to have also largely been associated with the difficult market conditions following the crisis. Finally, the transition impact potential of five infrastructure projects was significantly downgraded due to failed attempts to introduce tariffs above cost recovery levels or shortcomings in engaging private sector participation. Nevertheless, the country's overall portfolio performance from a transition perspective can be defined as good, with the vast majority of projects on track to achieving expected transition objectives. The average rank of Russia's active portfolio stood at 3.98, slightly better than that of all Bank's operations (4.08) and better than the Bank's institutional target (4.35).

Figure 2. The rank distribution of the Russia's active TIMS portfolio, as at end-June 2012



*Excluding projects with Marginal TI potential
** Plus Marginal-rated operations

2. OPERATIONAL ENVIRONMENT

2.1 Political Context

National elections held in late 2011 and 2012 raised concerns regarding the campaign environment and conduct of the elections. At the same time, the results of the elections have created some momentum for reforms, which could materialise in the coming Strategy period. Russia's new government stepped up its commitment to improving the investment climate while the country has a more pluralistic Duma and returned to the direct election of regional governors (after eight years of de facto presidential appointments). However, the political environment is also characterised by recent significant civic action by Russia's growing middle class and diverse opposition, which has been met on occasion with a harsh response by the authorities targeting opposition activists and foreign funded NGOs. The leadership continues to enjoy broad, albeit weakened, public support which it has sought to bolster through populist measures. These have put pressure on the budget and may not be economically sustainable. Moreover, the government is considering unpopular pension reforms and other measures that could have a negative social impact and stoke the mood of public protest.

Russia entered a new political cycle following the December 2011 parliamentary elections and March 2012 Presidential elections. In the first elections, the ruling United Russia party lost its constitutional majority and now holds 238 seats in the 450 seat lower house of the Russian parliament (the State Duma). Three other parties cleared the 7 per cent electoral threshold to enter the State Duma.

In the March 2012 Presidential elections Vladimir Putin, who served two terms as Russian President from 2000 to2008 and then as Prime Minister from 2008 to2012, won in the first round with over 63 per cent of the votes. Following a reform adopted in December 2008, President Putin will serve a six-year term until 2018 and can be re-elected for a second six-year term.

Both parliamentary and presidential elections were observed by international and domestic observers. The Organisation for Security and Cooperation in Europe (OSCE) final report on the conduct of the elections praised the Russian authorities for efficient administrative preparation of elections for nearly 110 million voters residing in a territory comprising nine time zones. At the same time, observers noted that parliamentary elections “were marked by a convergence of the state and the governing party, limited political competition and a lack of fairness”. Concerning the presidential elections, OSCE noted that “although all candidates were able to campaign unhindered, conditions were clearly skewed in favour of one of the contestants, the then-Prime Minister, Vladimir Putin, who was given a clear advantage over his competitors in terms of media presence and State resources were mobilised in support of him, in particular at the regional level”.

In both elections international observers remarked that genuine competition and voters’ choice were limited by overly restrictive candidate/party registration requirements. OSCE also noted a general lack of confidence in the independence of election officials at all levels, mostly due to their perceived affiliation with local administration and the governing party. Some observers documented multiple violations during voting and counting procedures in the parliamentary elections. Widespread criticism of the conduct of the election, including large-scale demonstrations, led the Central Election Commission to address concerns regarding transparency of voting and counting during the presidential election by placing web cameras in almost all polling stations across the country and equipping approximately 30 per cent of polling stations with transparent ballot boxes. All international observers noted the increased awareness and involvement of Russian citizens in the electoral process.

In April 2012 then-President Dmitry Medvedev signed into law amendments reconstituting direct elections of the heads of Russia’s 83 federal entities, including Moscow and St. Petersburg. The first five elections are took place in October 2012. All five regional elections were characterised by competition among representatives of several political parties. With a low turnout, candidates from the ruling United

Russia party won each of the five elections by a significant margin. Many non-parliamentary opposition candidates could not take part in the elections after failing to secure the necessary endorsement from between 5 and 10 per cent of local legislatures in at least three-fourths of municipalities of the respective region. However, several opposition candidates have won mayoral elections and formed significant factions in several regional legislatures. The new system has the potential to increase accountability at the regional level, but could also complicate decision-making and create tensions between authorities at different levels of government.

Following his inauguration, President Putin proposed his predecessor Dmitry Medvedev to the post of the Prime Minister. A new government was appointed on 20 May 2012. The new government has pledged to implement the economic modernisation agenda articulated by the Prime Minister. Measures have been taken recently to increase transparency, step up judicial reform, reinforce the rule of law and combat corruption. These plans are encouraging, but implementation is lagging behind and corruption in public administration, state-controlled companies, law enforcement entities and the judiciary remains a widespread concern.

One of the key features of the Russian political landscape is the rise and political awakening of the middle class, particularly in major cities like Moscow and St. Petersburg. At the end of 2011 the new generation of Russia's urban middle class for the first time began to position itself as a more determined political force, asserting its rights to have a greater say over the future development of the country. Over 100,000 people took part in the wave of public protests in Moscow, St. Petersburg and other cities across Russia, in response to alleged violations in the December parliamentary elections. The protests were further fuelled by grievances regarding widespread corruption, the poor quality of public services, weaknesses in the application of the rule of law and environmental concerns. The authorities have taken some positive steps to address some of these concerns, but also adopted tough new restrictive measures such as laws on NGOs 'performing the functions of foreign agents' and amendments to laws on rallies and manifestations, on defamation and on treason that threaten to place new limitations on the freedom of assembly and association.. As the middle class is likely to only grow in size and influence, it will be important to harness their productive potential through policies of political inclusion and openness.

See Annex 1 for a more detailed political assessment.

2.2 Macroeconomic context

The Russian economy rebounded well after it had been severely hit by the global financial crisis in 2008-9, which caused GDP to drop by nearly 8 per cent in 2009, the deepest recession among G20 countries. The impact of the crisis occurred mainly through a sharp drop in the oil price, which in turn led to a drop in export and fiscal revenues, large capital outflows, liquidity shortages and a gradual depreciation of the rouble by about 30 per cent against the dollar-euro basket.

Owing to a combination of fiscal and monetary stimulus and a rebound in the oil price, the economy recovered quickly and grew by 4.3 per cent in both 2010 and 2011, which helped asset quality and employment recover as well. However, net capital outflows continued and amounted to around US$ 80 billion in 2011 and

US$ 57 billion in the first nine months of 2012, reflecting continued economic and political uncertainty during an election year, combined with the shift to a more flexible exchange rate regime, which discouraged "one-way bets" on the rouble.

The economy started slowing again towards the end of 2011 and GDP growth is now expected to slow to 3.2 per cent in 2012, reflecting the eurozone crisis and the global economic slowdown. Falling export demand and weaker investor confidence have already led to slower manufacturing and investment growth, while higher inflation and lower consumer confidence have caused consumption growth to begin to slow down as well in the second half of 2012, reflected in lower growth of retail sales and construction output. Agricultural output has also been negatively affected by a weak harvest owing to unfavourable weather conditions.

Net capital outflows continued and amounted to US$57 billion in the first nine month 2012, most of which occurred during the first quarter, prior to the presidential elections. The official unemployment rate has thus far continued falling and declined to the pre-crisis level of around 5.5 per cent by mid-2012, although the level is likely underestimated and hides sharp differences between Russian regions.

The Central Bank of Russia (CBR) has started to put more emphasis on price stability as a priority and has already significantly increased exchange rate flexibility. In part as a result, but also helped by falling international commodity prices, inflation declined to a record low (in Russia's modern history) of 3.6 per cent year-on-year in May 2012, from 8.4 per cent in 2011. However, inflation has picked up since then to 6.5 per cent in November, due to higher food prices and regulated tariff increases and is expected to reach 6.8 by the end of the year – well above the 5-6 per cent inflation target. The CBR aims to keep its end-year inflation target at 5-6 per cent for 2013, reducing it to 4-5 per cent for 2014-5. It plans to complete the transition to inflation targeting and a free floating rouble by 2015, which should help to improve the economy's resilience to shocks, and thereby investor confidence.

Given its high natural resource dependence, the Russian economy is subject to the risk of "Dutch Disease" and its outlook for growth remains highly dependent on commodity prices, particularly oil and gas. The symptoms of Dutch Disease include an appreciating real exchange rate that in turn gives rise to permanently slower manufacturing growth relative to services sector growth ("de-industrialisation").[4] Other vulnerabilities stem from significant private external debt of around US$ 500 billion, or over 25 per cent of GDP, of which banks account for approximately one third, and the high sensitivity of the fiscal balance to the oil price. General government gross debt remains low at around 9 per cent of GDP in 2011, but the non-oil deficit now exceeds 10 per cent and the budget-balancing oil price has increased to around US$ 118 per barrel. A sustained drop in the oil price would threaten fiscal sustainability and could lead to additional capital outflows, further pressure on the rouble and a credit freeze.

In late June, the government approved the use of an additional RUB 200 billion from the Reserve Fund for real and financial sector support in case global market

[4] Nienke Oomes and Katerina Kalcheva (2007), "Diagnosing Dutch Disease: Does Russia Have the Symptoms?", IMF Working Paper No. 07/102 (Washington: International Monetary Fund). Available via the internet: http://www.imf.org/external/pubs/cat/longres.aspx?sk=20650.0

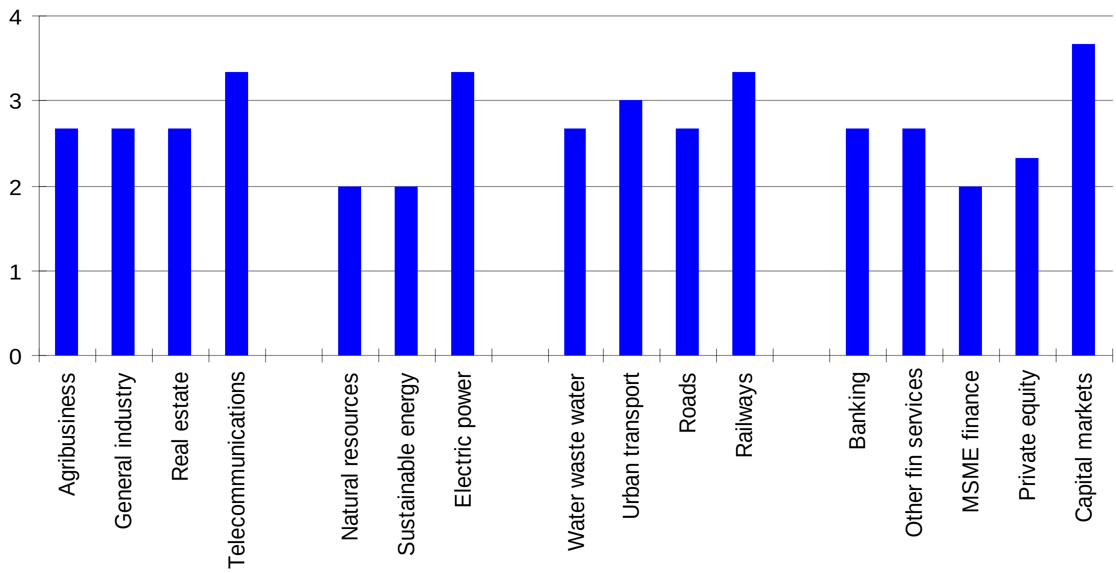
conditions deteriorate further. However, fiscal space is more limited now than during the 2008-9 crisis, when similar anti-crisis measures amounted to RUB 1.2 trillion. To improve fiscal sustainability, the Duma adopted in 2012 a more counter-cyclical fiscal rule, according to which future budgets will be based on the long-term average oil price rather than on the expected oil price during the budget year. However, the new fiscal rule will only be gradually phased in (by gradually increasing the number of years over which the average crude oil price is calculated from 5 years in 2013 to 10 years in 2018) and is less strict than the one in place before the global slump of 2008-09. Nevertheless, the adopted medium-term budget framework aims to reduce spending growth and targets a balanced budget by 2015.

See Annex 8 for a table with Selected Economic Indicators.

2.3 Structural reform context

Transition challenges in Russia remain significant across most sectors, with larger gaps in individual sectors, including MSME finance, natural resources and sustainable energy (see Figure 1).

Figure 1: Russia's Transition Scores, by Sector, 2011



Sources: EBRD Transition Report 2011.

In recent years Russia has made progress with regional integration, which has the potential to further leverage the country's competitive advantages, support innovation and serve as an anchor for improving economic institutions. After 18 years of negotiations, Russia officially became a member of the World Trade Organisation in August 2012, which will oblige the country to cut import tariffs from an average 9.5 per cent to 6 per cent by 2015, giving firms time to invest in improving their competitiveness. The Russian authorities have reiterated their commitment to subsequently join the OECD. At the same time, Russia has made further steps towards economic integration with its neighbours, which can be consistent with WTO membership provided Russia complies with its WTO membership commitments. A number of Russia's trading partners, including the European Union, have expressed concerns regarding its compliance with WTO rules and commitments.

On 1 December 2012 Russia assumed the presidency of the G20 for the first time. The key themes will be on measures to stimulate economic growth and create jobs. The largest national business organisations from the G20 countries have also launched the B20 Coalition. The EBRD is ready to assist the Russian authorities on implementing their G20 agenda in areas where it has demonstrated expertise and market knowledge.

Following the formation of a Customs Union with Kazakhstan and Belarus in 2009 and the adoption of a common external tariff structure and a common customs code in 2010, customs checks were removed from internal borders by July 2011. The next stage of the project was launched on 1 January 2012 with the formation of a Common Economic Area of the Eurasian Economic Community, which involves the strengthening of supranational institutions. The Eurasian Economic Commission is expected to gradually take over some of the competencies of the national authorities, including import tariff setting (already delegated to its predecessor, the customs union commission), technical regulations and competition policy. The ultimate objective is to achieve free movement of goods, capital and people.

Early evidence[5] suggests that the adoption of a common tariff structure within the Customs Union seems to have had small but positive trade creating effects for Russia, where tariff reductions outweighed tariff increases, while for Belarus and Kazakhstan the changes in tariffs appear to have led to a reduction in imports from a number of trading partners outside the union. To sustain the momentum of trade creation, it will be crucial to further lower non-tariff barriers to trade and improve market access for firms across the common economic space, including in services sectors. Further regional economic integration can provide the necessary institutional framework for coordinating such improvements.

Progress with privatisation has been slow. In 2010 the authorities announced a privatisation programme for 2011-15. As it currently stands, the programme foresees sales or initial public offerings of shares in state-controlled companies in various sectors including transport, power generation, pipelines, banking and insurance. Mostly these are minority stakes, although selected majority privatisations are also being considered. In 2010 a minority stake in VTB, the second largest bank, was sold via a public offering, and in October 2011 Russian Railways sold a 75 per cent minus two shares stake in Freight One, a rail freight operator, at an auction for over US$ 4 billion. In September 2012, further minority stakes in United Grain Company and Sberbank were successfully sold, and another railway freight operator, SGTrans, is about to be sold in full. Other sales anticipated in the near future include minority stakes in Novorossiysk Commercial Seaport and Sovkomflot, a maritime company specialising in oil and gas shipping. At the same time, the state continues to play a large, and growing, role in many sectors of the economy, including the energy and the financial sectors.

To promote innovation and modernisation of the economy the government set up a direct investment fund. The fund, which is anchored by the Russian government's

[5] "Regional Trade Integration and the Eurasian Economic Union", Chapter 4 in: *EBRD Transition Report 2012: Integration Across Borders*, November 2012.

contribution of around US$ 2.2 billion (potentially rising to US$ 10 billion), is expected to leverage private co-investment in individual projects from foreign strategic and institutional investors. Rusnano, previously a state corporation with a mandate to support development of nanotechnology and other high-tech sectors, has been transformed into a joint stock company. In addition, Skolkovo is expected to become a major centre for innovation. In May 2010 the immigration law was amended to facilitate the employment of highly skilled international experts both inside and outside special economic zones.

The energy efficiency law adopted in December 2009 regulates various aspects of energy efficiency in the industry, government and residential construction, including energy efficiency requirements and certification for new buildings. The law on heating, which was adopted in July 2010, further clarified tariff-setting principles for district heating, responsibilities for network planning and metering and sanctions for non-payment.

For a more detailed assessment of remaining transition challenges see Annex 2.

2.4 Business environment

Investors continue to be attracted to Russia due to its large internal market, natural resource endowments and growing middle class. At the same time, business environment and corruption perception surveys suggest that investors remain concerned about substantial administrative barriers to doing business, excessive red tape, and pervasive corruption.

According to the 2008-09 round of the Business Environment and Enterprise Performance Survey (BEEPS), as well as preliminary evidence from the 2011 round of the BEEPS, the main obstacles to doing business in the country relate to corruption and the lack of access to skilled workers, land, and electricity. Preliminary results based on the latest version of this survey (BEEPS V) that was conducted in 37 Russian regions during 2011-12 suggest that the top 3 reported constraints to doing business are now corruption and the lack of access to finance and skilled staff, although there is substantial regional variation in the severity of these constraints.

Russia's ranking in the World Bank's "Doing Business" index remains low, but improved from 120th place in 2012 (out of 183 countries) to 112th place in 2013 (out of 185 countries). The upgrade was driven by a significant improvement in Russia's score on "paying taxes", from 105 in 2012 to 64 in 2013.[6] While Russia scored relatively well in contract enforcement (11th place), registering property (46th) and resolving insolvency (53rd), the country continued to score particularly poorly on access to electricity (184th, second to last), and dealing with construction permits (178th). In the regional version of this survey, which covered 30 Russian cities, Moscow was ranked Russia's worst city for doing business, again because of the high costs associated with obtaining construction permits and connecting to the electricity grid. In the latest Transparency International's Corruption Perceptions Index, Russia's

[6] According to the Doing Business 2013 report, Russia eased the administrative burden of taxes for firms by simplifying compliance procedures for value added tax and promoting the use of tax accounting software and electronic services. Part of the improvement (11 out of 41 points) was due to data corrections and changes in the ranking methodology for paying taxes, based on which Russia's score in this area would have been 94th in 2012.

score remained in the bottom quartile (133rd out of 176 countries), confirming that corruption is still perceived to be a serious problem in Russia.

The authorities are increasingly concerned with the country's low business environment and corruption perception ratings and are making efforts to improve them. For example, President Putin has ordered the government to prepare a 100-step plan to lift Russia's position in the Doing Business index from 120 to 50 by 2015 and 20 by 2018. These measures will be developed in part by the Agency for Strategic Initiatives (ASI), which was created in 2011 to improve the investment climate and the dialogue between business and government. In December 2011, the ASI launched 22 projects to improve the investment climate. Thus far, ASI has prepared four "roadmaps" consisting of specific proposals to simplify construction permit procedures; improve access to energy infrastructure; supporting exporters; and streamline customs regulations. The authorities have also taken steps to improve anti-corruption legislation, including through investigating potential conflict of interest cases involving public sector employees, improving training of officials responsible for fighting corruption, and enhancing the role of civil society in providing public oversight. However, the effective implementation of these measures is likely to pose a major challenge.

Despite some improvements in the competition authority's capacity, and selected improvements in certain sectors, Russia's overall ranking in terms of competition has deteriorated and remains low compared to other countries. Based on the Global Competitiveness Index of the World Economic Forum, Russia continues to score poorly (124^{th} out of 144 surveyed countries, where 1 is the best) in both (a) "intensity of local competition" and (b) "effectiveness of anti-monopoly policies". It performs moderately better in terms of (c) "extent of market dominance" (107th) but for all three indicators, Russia consistently ranks well below the other BRICS countries.

2.5 Social context

The rapid rise in incomes that Russians enjoyed throughout the 2000s came to an abrupt halt with the crisis of 2008-09, and income growth has been much lower since. Nonetheless, the level of poverty (defined as the proportion of people with an income below the minimum consumption basket) has continued to fall, from 13.3 per cent in 2007 to 12.6 per cent in 2010 (approximately 18 million people), partly reflecting significant increases in pensions. Poverty rates remain substantially higher in the rural areas although the growth of the urban-rural divide has been arrested in recent years.

Official measures of inequality have remained broadly constant over this period, with a Gini coefficient of around 42 per cent. The second round of the EBRD-World Bank Life in Transition Survey (LiTS II), conducted in 2010, confirmed that a large proportion of ordinary individuals were negatively affected by the crisis of 2008-09 (59 per cent of survey respondents). Around one third of households had to cut back on spending on basic necessities in response to the crisis. Overall life satisfaction according to the LiTS survey (the share of people who agree or strongly agree that they are satisfied with their lives) is around the average for EBRD countries of operations (43 per cent). Spending on education and health care is seen as two top priorities for government spending.

Substantial income differences persist across Russian regions. GDP per capita in Russia as a whole is over $10,000, which is a level comparable to countries in Central Europe and Baltics. However, gross regional product (GRP) per capita in the richest regions was on average 60 times higher than in the poorest regions with GRP per capita reaching $120,000 in Nenets Autonomous District (a very sparsely populated region with large gas reserves) to less than $2,000 in Ingushetia and Chechnya. Moscow and St Petersburg account for 10 per cent of the Russian population but produce nearly 30 per cent of Russia's GDP.

Unemployment has declined since the 2008-9 crisis according to official figures and varies widely across regions. During the crisis, the official recorded unemployment rate increased but remained below 10 per cent, in part because it often took the form of reduced working hours, lower pay, or occasionally wage arrears. By mid-2012 the official unemployment rate had declined to its pre-crisis level of 5.5 per cent. Among Russia's regions, the lowest unemployment rates in April-June 2012 were posted for Moscow (0.8 per cent) and St. Petersburg (1.1 per cent), while the highest figures were posted for the Republic of Ingushetia (48 per cent) and the Chechen Republic (35 per cent).

In terms of education, all Russian regions continue to enjoy high literacy rates but there are significant differences in enrolment. The literacy rate remains very high at 99.4 per cent in Russia overall, while all regions have literacy rates of over 98 per cent except for Ingushetia (96.2), Chechnya (96) and Mordovia (97.9). The highest enrolment rates for persons between 7 and 24 years old were observed in Moscow and St Petersburg, while 62 regions had lower enrolment rates than the Russian average. The lowest enrolment rates were observed in the North Caucuses (Chechnya and Ingushetia) Chukotka Autonomous District, Leningrad region and Moscow region – but many students living in the latter two regions are likely enrolled in St Petersburg or Moscow.

Russia is facing major demographic challenges, as life expectancy is expected to increase while fertility rates remain low.[7] Average life expectancy in Russia remains very low, at around 60 years for men, but is projected to rise by at least 4 years by 2050. At the same time, fertility rates remain below the natural replacement rate. While the number of children per woman is expected to increase from the current level of around 1.4 to nearly 1.8 by 2050, it remains well below the natural replacement rate of 2.1. As a result, the old-age dependency ratio (the ratio of those aged 65 or older to the working age population) is projected to nearly double from around 18 per cent to 36 per cent between 2010 and 2050.

2.6 Legal context

Russia has implemented or initiated a number of legislative reforms during the last strategy period. The most significant initiative is the current reform of the entire Civil Code, which contains rules governing all business entities and commercial arrangements covering virtually all areas of life.

[7] See IMF Working Paper WP/12/201, "Reforming the Public Pension System in the Russian Federation", by Frank Eich, Charleen Gust, and Mauricio Soto, August 2012.

The Concession law has been improved, creating more flexibility for concessionaires, financiers and the authorities. At the same time, a significant number of subjects of the Russian Federation have enacted their own PPP law, and a federal PPP law is currently being discussed. All these developments have facilitated the emergence of PPP projects in St Petersburg, Perm, Nizhny Novgorod and Ekaterinburg, but sustained reform efforts will be needed to further strengthen private sector participation in infrastructure development. Further amendments are needed to the Concession Law and various other Russian laws (including budgetary code, tax law etc.) to create a comprehensive and effective legal regime for concessions in Russia and make concession projects in Russia more attractive to private investors. Similarly, the public procurement legislation, which is roughly on par with other countries in the region but displays a number of shortcomings in terms of efficiency instruments and remedy procedures, is being overhauled to align it with the 2011 UNICTRAL Model Law on Public Procurement. It is expected that this reform will be completed by the end of 2012.

In the financial law sector, the Russian authorities have acknowledged the current challenges prevailing in the country's legislation. To continue to play a leading role in the CIS region and to further its aspirations to transform Moscow into an international financial centre, it will be necessary to modernise a number of laws. This applies in particular to pledge laws and insolvency laws, as well as the corporate governance code enacted by the Federal Commission on Securities Markets (now the Federal Financial Markets Service) ten years ago. A number of legislative reforms are in the making, sometimes championed by different government entities at the same time. This inevitably raises issues of coordination and can make reform processes unduly complex.

When compared to other CIS countries, court decisions in commercial matters appear to be of relatively good quality and commercial courts demonstrate a certain degree of sophistication. Implementation of judgements remains, however, a critical issue, as highlighted by decisions of the European Court of Human Rights stating that non-implementation of judgements in specific cases amounted to a breach of the right to a fair trial. In addition, a perception of low integrity continues to affect public confidence in the judiciary.

New legislation on energy efficiency was adopted in 2009, including the mandatory use of metering in commercial and industrial buildings which has been put into effect since January 2011. In early 2012, the Ministry of Energy circulated a 'Complex of Measures' to stimulate the use of renewable energy sources. Overall, a greater government resolve and focus on these questions will be needed in order to reach meaningful improvements.

Through its Legal Transition Programme, the EBRD is involved in a number of the above reform efforts, in particular in the pledge law and concession law sectors. It will continue to cooperate with the Russian authorities on legal and institutional reforms during the new strategy period.

See Annex 4 for a more detailed assessment of the legal environment.

2.7 Energy efficiency and climate change context

Energy efficiency is among the key transition challenges facing Russia. The energy intensity of Russian GDP has improved in recent years but, even allowing for Russia’s industrial structure and harsh climate, the country consumes on average 2 to 3 times more energy to produce a unit of GDP as compared to western peers.

Russia is the world’s 4th largest CO2 emitter. The country has vast opportunities for improving energy efficiency and reducing carbon intensity across all sectors and along the entire chain of energy use: from energy generation, to distribution, and final consumption.

According to the EBRD annual assessment of transition challenges the transition gaps in sustainable energy are high for both market structure and for market institutions. According to the EBRD Index of Sustainable Energy, while Russia Index scores have improved since 2008, they are still low compared to Western European peers.

Since the previous strategy period, energy efficiency has climbed to the top of the Russian political agenda as reflected in the rapidly developing sustainable energy policy framework. Central to this is the President’s target to reduce the energy intensity of the Russian economy by 40 per cent by 2020, as well as an objective to achieve the share of electricity production from renewable energy sources at 4.5 per cent of the total electricity generation by 2020. A new Federal Law on Energy Efficiency as well as a State Target Programme on Energy Efficiency (2010) has been adopted in order to facilitate the achievement of governmental objectives. A Russian Energy Agency (REA) was established in 2009 under the auspices of the Ministry of Energy and tasked with the implementation of the state strategy on energy efficiency and renewable energy.

Climate change adaptation

Due to Russia's vast size, and its wide range of climatic zones, habitats and land use types, the projected impacts of climate change on the country and its economy are highly heterogeneous. In northern regions, increases in mean temperatures may result in some new opportunities, such as increased agricultural potential, more favourable working conditions and improved sea access along the Arctic coastline due to receding sea ice. However, northern regions may also experience new risks such as permafrost melting, with serious implications for infrastructure and industry, and a rise in the sea level along the long northern coastline. Southern regions are projected to experience higher summer temperatures and greater water stress, which may create risks for agriculture, including in Russia's most fertile 'black earth' regions, as well as an increase in the frequency of extreme heat events and droughts, such as those of 2010.

Specific sectors that are vulnerable to these impacts, which may need to be considered in the Bank’s investment operations through climate change resilience and adaptation measures, include the following:

- Infrastructure and industrial activities (including oil & gas exploration) in northern permafrost zones;

- Coastal infrastructure including ports and shipping activities;
- Agriculture and related industries such as agribusiness, especially in southern regions where future increases in heat and water stress are projected;
- Water infrastructure and water-intensive sectors/industries, especially in southern regions where future increases in water stress are possible;
- Forestry and the processing of forest products, which are vulnerable to extreme heat events and forest fires.

3. STRATEGIC ORIENTATIONS

3.1 Transition challenges

The Russian economy has recovered from the deep recession of 2009 but the economic outlook remains highly vulnerable to commodity price shocks. While the previous country strategy for 2009-11 focused in part on supporting the country's short-term crisis response, this new country strategy for 2013-15 will refocus the Bank's activities on addressing the longer-term core challenges of the Russian economy, which include (1) diversifying the economy to reduce its excessive dependence on natural resources; (2) modernising the economy to boost productivity, foster innovation and increase energy efficiency; (3) increasing the role of the private sector to promote competition, SME growth and the quality of jobs and services; and (4) developing Russia's underdeveloped regions.

- **Diversifying the economy:** The Russian economy is highly dependent on its natural resource base. Partly due to price increases, oil and gas now account for nearly 70 per cent of total merchandise exports and around one half of government revenues. The lack of diversification has made the economy and public finances highly vulnerable to commodity price shocks and has caused significant volatility. Diversification will help to reduce macroeconomic volatility, facilitate further development of market institutions, and result in increased productivity in the non-resource sectors of the economy. Further diversification would also support employment objectives, given the low intensity of job creation commonly associated with highly capital intensive resource sectors.
- **Accelerating modernisation and innovation:** Despite almost two decades of market reforms, Russia's labour productivity − a key indicator of overall economic efficiency − remains one of the lowest amongst industrialised nations, while the energy intensity of the Russian economy is estimated to be about 2.5 times higher than the world average. Speeding up Russia's transition to a modern market economy requires further progress with raising productivity and competitiveness, fostering innovation and reducing energy intensity through adopting modern technologies and standards, including in corporate governance, transparency, and energy efficiency.
- **Growing the private sector:** The state continues to play a large role in the Russian economy, particularly in natural resources, infrastructure, power and the financial sector. Private sector development, SME growth and competition are hampered by persistent weaknesses in the entrepreneurial culture and the business environment. Difficulties in the business environment can help explain why, unlike other leading emerging market economies, Russia has a very small SME

sector and has failed to sustain large inflows of much needed private foreign direct investment.

- **Developing Russia's regions:** Russia is a federal state divided into 83 regions that vary widely in terms of per capita income, unemployment and investment. As of 2010, gross regional product per capita in a median region such as Yaroslavl Region, Kaluga Region or Novosibirsk region was only one quarter of that in Moscow. Income per head in a poorer region such as Ivanovo is only around one eighth of that in Moscow. Unemployment remains particularly high in a number of regions, including in the South of Russia and in Siberia, and the spatial structure of production and employment has not changed much since the dissolution of the Soviet Union in 1991. Moscow, Moscow Oblast and St Petersburg account for around 30 per cent of Russia's GDP. Regional surveys reveal significant differences in perceptions of the business environment across regions, as reported by the firms operating there.

3.2 Bank's priorities for the strategy period

The Russian economy has recovered from the deep recession of 2009 but the economic outlook remains highly vulnerable to commodity price shocks. While the previous country strategy for 2010-12 focussed on short-term crisis response needs, the current strategy will refocus the Bank's activities on addressing the longer-term core challenges of the Russian economy.

The overarching strategic directions of the Bank for the next strategy period correspond to the assessment of the key transition challenges and are fully in line with the Government's reform intentions. The strategic priorities for the Bank will be:

- **Diversifying the economy**: The Bank will support diversification by prioritising investments in private enterprises and private financial institutions that support non-resource sector growth. The Bank will also use policy dialogue and TC to support improvements in the business environment that are crucial for successful diversification.
- **Investing in and setting standards for modernisation and innovation:** The Bank will support enterprises that innovate, introduce modern new technologies, or upgrade to international standards, particularly with regard to corporate governance, transparency, inclusion and gender issues. The Bank will seek to increase its partnerships with international and domestic technology players, technology parks, credible and competent equity fund managers and venture capital funds. The Bank will also consider projects to modernise the transport, power and municipal and environmental infrastructure sectors. Improving energy efficiency will be a key aspect of modernisation across various sectors of the economy.
- **Support privatisation and private sector development:** The Bank will support private sector development directly through its projects with private enterprises and banks, through dedicated MSME credit lines and equity funds, and potentially through (pre-)privatisation activities, provided they are transparent and increase competition. The Bank's core objective will be to increase the role of the private sector through strengthening existing private operators; increasing the share of the MSME sector in the economy, pursuing transparent and competitive majority privatisation strategies for state owned companies; conducting policy dialogue on

privatisation; and promoting PPPs as a tool to attract more private sector investment into state-dominated sectors. Development and deepening of domestic capital markets will also be a priority to meet the private sector's growing financing needs.

- **Increasing economic opportunities in Russian regions:** To support regional development, the Bank will prioritise projects and reforms that promote transition in regions that are less advanced than Moscow and St. Petersburg and that are committed to improving the investment climate. With the support of technical assistance funds to be provided by the Russian government, the Bank will seek to develop commercially viable solutions in underserved regions where it has been difficult to identify bankable projects, combined with policy dialogue with regional authorities on improving their business environment. The Bank will pay particular attention to projects that increase economic opportunities for the emerging middle class in the regions through increasing access of regional SMEs to finance, supporting urban renewal, and improving the quality of jobs and services.

In all these areas, the Bank's activities in Russia will be aligned with the overarching priorities of the Government to diversify the economy, to make Russian companies more productive and competitive – especially SMEs – and to improve the quality and reliability of public services. Equity investment can be a particularly potent way to promote transition at the corporate level, bearing in mind risk-return factors and market conditions.

To complement its investments, the Bank will use policy dialogue and technical cooperation to support all priorities, with a special focus on strengthening governance, improving the investment climate, developing renewable energy solutions and promoting energy efficiency across economic sectors. While focusing on private sector development, involvement with state companies on a selective basis will anchor the Bank's policy dialogue on sector reform, privatisation and modernisation. The Bank will also aim to strengthen its catalytic role through international syndications, co-financing risk sharing and other forms of cooperation with Russian and international financial institutions and development agencies so as to enhance the impact of its operations in such a large country as Russia. Finally, the Bank will continue to support select cross-border investments by Russian companies that enhance trade and economic integration.

Delivery of the Bank's strategic objectives in Russia will depend crucially on further progress in market reform, strengthening the role of the private sector in the economy, improving the business and investment climate, combatting corruption, and efforts to deepen Russia's integration into the global economy, taking into account international trade commitments.

3.3 Sectoral Challenges and Bank Operational Response

3.3.1 Diversification

Challenges

- Improving the investment climate is the main tool to attract domestic and foreign investment into the non-resource economy, especially at the regional level. Despite some recent improvements, Russia continues to score poorly in business environment rankings, particularly on corruption and on access to finance, skills, and electricity. These factors, together with deficiencies in the regulatory and legal framework, deter investment and limit new entry and exit of firms.
- The lack of competition in many sectors continues to be a main constraint to developing the non-resource economy. Russia's competition rankings remain low compared to OECD and other BRICS countries, and the intensity of competition has decreased as market dominance increased during the past few years. This may be due, in part, to the pronounced role of the state and policies that protect certain domestic industries from competing imports and foreign direct investment, e.g. through subsidised non-tariff barriers. WTO accession, if accompanied by the necessary structural reforms, will provide renewed incentives to increase competitiveness and raise productivity and efficiency through the attraction of FDI, new technologies and better use of ICT.
- The banking sector needs strengthening to improve access to finance and better intermediate natural resource revenues to the non-resource economy. A large number of banks remain poorly capitalised and are unable to respond to the non-resource sector demand for credit.
- Key bottlenecks remain in the agribusiness value chain, including inadequate logistic infrastructure and insufficient compliance with hygiene and quality standards. Farming standards need to be improved to enhance productivity and appropriate legislation is needed to develop financing mechanisms that use "soft commodities" as collateral.
- Further steps are needed to develop the private equity industry with quality institutional fund managers.

Bank's operational response

The core objective of the Bank's operational activities will be to support, both directly and through financial intermediaries, domestic and foreign investors, with special emphasis on assisting MSMEs in less advanced regions, which invest in manufacturing, agribusiness and other non-resource sectors in order to decrease the country's dependence on oil and gas.

- Focus on private sector investments in the non-resource sector that increase competition, develop "value added" manufacturing and services and support suppliers seeking to meet international standards.
- Support agribusiness development and improve regional food security by developing more projects that improve energy efficiency, develop modern related infrastructure and set higher standards in the food supply chain under the "Integrated Approach to Reform the Physical and Financial Infrastructure of the Grain Value Chain".

- Use existing and new partner banks and private equity funds to support MSMEs, particularly in the regions. Continuing with its catalytic role for the private equity industry the Bank will support both generalist funds and sector-focused funds whose strategies are complementary to the Bank's direct activities in these sectors (e.g. agribusiness, clean tech, innovative technologies, etc.).

Policy Dialogue and TC

- Continue efforts to assist the government in improving Russia's business climate and removing investment barriers through its direct dialogue with government bodies, active participation in the FIAC working groups, various expert groups and investment promotion bodies both at federal and regional levels. The weak investment climate remains a key reason for relatively low FDI and domestic investment in most of the non-resource sectors.
- Build on the Russian Forestry Policy Dialogue Initiative to promote an action plan to enable substantial foreign and domestic investments to develop forest resources in order to unlock the significant potential of this underdeveloped sector create appropriate incentives for private sector investment.
- Promote regulatory and legislative changes to improve farmers' risk management and access to financing through the warehouse receipt and crop receipt programmes under the Private Sector Food Security Initiative.
- To support the increase of the share of MSME's in the economy, seek ways to improve the framework for MSME development including by continuing its efforts on pledge law reform that would enable the expansion of MSMEs lending.

3.3.2 Modernisation, innovation and sustainable energy

Challenges

- Improving standards of business conduct, corporate governance and transparency remains a major challenge across all sectors. Although Russian standards in these areas are being improved, their implementation generally remains far below standards in more advanced countries and the new EU member states. Russian businesses also need stronger incentives to move their registration on-shore. In extractive industries, it is particularly important to further improve public disclosure, in line with international standards, of resource-related payments made to the authorities at all levels.
- Ensuring equal opportunities for women and other potentially disadvantaged groups of society is another important element of modernisation, as Russian still ranks below European transition economies in terms of the implementation of labour policies on equal pay and non-discrimination
- To support innovation and the establishment of competitive high-technology sectors, reform efforts need to be stepped up to effectively address fundamental obstacles to innovation, including financing gaps at the earliest stage of the innovation cycle which are best addressed through the development of a private venture fund industry. While the government has created a number of state

development institutions to support innovation,[8] it should play a supportive rather than directive role, including by providing appropriate, market driven incentives and intellectual property rights protection.[9]

- To increase incentives for modernising and upgrading public utilities, the priority in the Municipal and Environmental Infrastructure (MEI) sector is to improve regulation, reform tariff setting and increase commercialisation of utility service provision. To modernise urban transport, it is necessary to further strengthen the regulatory framework, including through competitive route tendering, facilitating improvements in the procurement of urban transport services through introduction of service-oriented and cost-efficient service contracts.
- Key steps to modernise the power sector include developing the long-term capacity market, incorporating market-based systems, and fine-tuning existing regulations.
- The energy intensity of the Russian economy is estimated to be about 2.5 times higher than the world average. Despite recent significant increases, domestic energy prices (particularly for households) still do not fully account for all costs and environmental externalities. To further improve incentives for sustainable energy use and investments, the key challenges are phasing out subsidies for natural gas, moving further towards cost reflective tariffs, improving demand-side management (including through more widespread metering and switching to consumption-based billing), and developing carbon markets with binding emission reduction targets.
- The institutional framework for sustainable energy should be strengthened through adoption of secondary legislation that improves and stabilises the investment framework for renewable energy, in particular by independent power producers, and energy efficiency. Most of the elements of the energy efficiency law still require implementation, the main priority being the development of mechanisms facilitating private sector participation.
- The level of penetration of best available energy efficient technologies and energy management practices remains low in Russia, while the general awareness of best-practice solutions and implementation capacity of all economic actors remains limited.

Bank's operational response

The Bank will support enterprises that introduce modern new technologies, or upgrade to international standards in such areas as corporate governance, environment, safety, transfer of new technologies and skills, sustainable energy, social inclusion and gender related issues. The Bank will also consider projects that modernise the transport, power and municipal and environmental infrastructure sectors in conjunction with improvements in tariff methodology and other sector reforms. The Bank will prioritise projects that encourage innovation, as well as projects that support the country's transition to a sustainable and low-carbon growth

[8] These institutions include the Russian Venture Company (established in 2006), the state corporation Rusnano (established in 2007 and further incorporated in 2011), the Skolkovo Innovation Centre (2010) and the Russian Direct Investment Fund (2011).

[9] This argument is further elaborated in Chapter 6 of the recently published EBRD report *Diversifying Russia. Harnessing regional diversity* (2012). Available at: http://www.ebrd.com/pages/research/publications/special/diversifying-russia.shtml

path, in accordance with the Phase 3 of the Bank's Sustainable Energy Initiative (SEI).

- Finance projects that support modernisation or innovations, R&D and the development of technologically advanced industries, and have an impact on improving business standards, corporate governance, transfer of new technologies and skills, and promote women's economic empowerment and inclusive labour practices.
- The Bank will deepen support for innovation through partnerships with international and domestic technology players (i.e., Rusnano), technology parks, capable and competent equity fund managers and venture capital funds in order to support the growth of firms offering innovative products and services to domestic and international markets.
- Finance private sector led projects that modernise transport and municipal infrastructure, promote sustainable energy upgrades and improve management of municipal facilities. The Bank will consider engagement with municipal or state owned companies when private solutions are not feasible (i.e. in the case of natural monopolies), provided that the project is adequately structured to ensure additionality and commercial implementation and involves significant sector reform. The Bank will also explore commercially viable approaches and investment opportunities related to municipal waste utilisation and recycling. This should contribute to addressing the infrastructure bottlenecks that remain an important obstacle for investment and growth of the real economy.
- Support investments in new and rehabilitated thermal capacity, promoting penetration of the best available power generation techniques. The Bank will continue to seek viable renewable energy investment opportunities and engage in upgrading power transmission, while seeking ways to support modernisation and development of regional power distribution companies including improvements in metering systems that provide for bi-directional communication and active consumer participation in the retail energy market. Such efforts to support the modernisation of the power sector will be a priority as connection to power supply is a critical bottleneck for economic development, with Russia in last place among 183 countries according to the World Bank Doing Business Survey.
- Consider, on a selective basis, projects in the natural resources extraction and processing sectors with significant transition impact potential and with private companies that have a strong commitment to high standards of corporate governance and transparency. The Bank will prioritise projects in this area with a strong SEI component including reduction in gas flaring and increase in gas utilisation and projects that have strong regional impact.
- Scale-up dedicated EE lending for the development and application of best-available energy efficiency technologies and energy management systems and practices of private companies operating in the energy intensive industries, including through broadening the scope of the Russia Sustainable Energy Financing Facility (RuSEFF) and expanding it to new partner banks, as well as mainstream sustainable energy in the less energy intensive sectors and the built environment. Support production of energy efficient equipment and construction materials.
- Develop commercial mechanisms for financing energy performance contracts to enable efficiency improvements in public buildings and off-balance sheet

financing of industrial sustainable energy projects with private sector involvement.

Policy Dialogue and TC

- As part of its policy dialogue on improving the overall business climate, the Bank will continue its efforts to improve corporate governance and transparency standards in Russia, including by assisting the regulator with improving the Russian Corporate Governance Code.
- Step up efforts, in coordination with IFC Renewable Energy Programme, to promote an enabling regulatory framework for renewable energy investments in order to unlock the potential of this sector to substantially reduce Russia's carbon footprint.
- With the support of GEF funded programs, in partnership with IFC, the Bank will continue dialogue under the Sustainable Energy Action Plan aimed at establishing an effective regulatory framework for energy performance contracting in the public sector and introducing commercial approaches to financing collective capital repairs of residential buildings as significant reduction of energy consumption can be achieved in these sectors with private investment if an enabling regulatory framework is put in place.
- The Bank will continue to work with the authorities on establishing a domestic carbon market and will provide TC for preparing sustainable energy projects as carbon emission reduction projects under Joint-Implementation (JI) on a selective basis. It will also procure carbon credits from JI projects through the EBRD - EIB Multilateral Carbon Credit Fund.
- In the power sector the Bank will continue to work with the regulator, including through technical cooperation, so as to improve the regulatory environment, deepen sector reform and address outstanding tariff issues, with an emphasis on implementing the RAB methodology, in order to encourage much needed private sector investment to modernise the sector.
- The Bank will continue its engagement with the Federal and regional tariff services to achieve improvements in tariff regulation in the municipal utilities sector without which private investment in upgrading municipal services will remain limited. The Bank will support the government's efforts to improve waste management regulation and recycling (in collaboration with IFC and the Association of European Business) in order to reduce negative environmental impact and promote sustainable energy.

3.3.3 Private sector development

Challenges

- Despite progress in transition towards a well-functioning market economy, the state continues to play a large role in many sectors of the Russian economy, both through state ownership and formal and informal state interference with business processes. This has hindered private sector development and competition.
- The banking sector remains highly concentrated and dominated by the state, with the largest state-owned bank, Sberbank, accounting for nearly 50 per cent of retail deposits, while 6 out of the top 7 banks are state-controlled and account for almost 60 per cent of total assets. To increase competition, it is crucial to increase the

share of the private sector through strengthening private banks (including through capitalisation and encouraging consolidation of small private banks) and pursuing privatisation strategies for state-owned banks.

- Further development of the private sector requires improving access non-banking financial services, including life and non-life insurance and re-insurance.
- Further development of local capital markets requires improvements in the regulatory framework, upgrades of physical capital market infrastructure, strengthening of local operators and increased participation of local institutional investors, including pension funds, in capital and private equity markets.
- The role of the private sector in the transport sector (rail, road, airport and port infrastructure) should be increased through strengthening existing private operators and increasing further private sector participation, including through PPPs or joint ventures; and where possible through privatisation of state-owned companies and their subsidiaries (e.g., the remaining state-owned rail freight company Freight Two). There is also a general need to increase competition in the transport sector through sector liberalisation, and reducing the remaining price subsidies and removing distortions in tariff setting.
- Increasing private sector participation in the energy sector remains a challenge. Competition should be increased through further commercialisation and privatisation of state-owned companies and expansion of independent private operators. In natural resources, this requires ensuring transparent access to mineral resources licenses allocation, further liberalising the gas market, and addressing constraints on accessing the infrastructure network by third parties.
- In the natural resource sector, the share of small and medium regional independent oil and gas producers and mining companies should be increased, particularly through ensuring transparent access to mineral resources licenses allocation.

Bank's operational response

The Bank will prioritise projects that increase the role of private sector in all sectors of the economy. The Bank will finance private companies and banks, encourage privatisation, and support the development of capital markets to improve private companies access to funding.

- Support and encourage privatisation of the state-owned companies and banks, including through pre-privatisation support, provided that there is a credible commitment to sector reform, major systemic improvement at the company level (in such areas as energy efficiency, corporate governance, operational efficiency, commercialisation and transparency), and a credible time bound transition process to majority private ownership and control.
- Facilitate expansion of the PPP market by developing and financing new PPPs in infrastructure and management of social infrastructure facilities as private sector investment, technologies, know-how and management skills would result in higher quality of services.
- Encourage competition, consolidation and private sector participation in the banking sector through providing equity investments, subordinated loans and other loan facilities to transparent, creditworthy, well-governed and well-managed private sector banks that are committed to financing the real sector thus strengthening the private banking sector and enhancing its ability to compete with state banks.

- Promote further development of the Russian capital market by supporting key private players, capital market infrastructure and new products and through bond issuance activities.
- Develop the private non-banking financial sector through promoting leasing and mortgage financing, strengthening and consolidating the insurance sector, developing the private pension sector, and re-introducing risk sharing and asset-backed financing mechanisms.

Policy Dialogue and TC

- The Bank will engage in policy dialogue with the authorities on how to further reduce the role of the state in the Russian economy, and further privatise state-owned companies and banks.
- The Bank will continue its engagement, including through the use of TC, with the government on further developing and improving the PPP framework and work proactively with selected regional governments on the development of regional PPP legislation in order to create an enabling legal environment for increasing private sector investment in infrastructure.
- The Bank will continue policy dialogue with key players such as RZD, the Ministry of Transport and the Ministry for Economic Development on further railway sector reform that would expand scope for private sector solutions.
- The Bank will engage with federal, regional and local governments to create acceptable templates for tenders, legal agreements and structuring energy performance contracts that would enable efficient mobilisation of private sector expertise and finance for public infrastructure.
- The Bank will continue to support its private partner banks by providing TC assistance to enhance the banks' underwriting and risk management standards.
- The Bank will continue policy dialogue in support of transforming Moscow into an International Financial Centre (MIFC) by promoting legislative changes and measures to improve the efficiency of market infrastructure with the overarching objective of enhancing the ability of the private companies to raise financing in the local capital markets, which should encourage Russian companies to register and conduct their fundraising on-shore.

3.3.4 Regional development

Challenges

- Russia's 83 regions continue to be characterised by vast differences in levels of development in terms of progress with transition-related structural reform and other factors affecting the general businesses environment and economic opportunities in regions, including the availability of jobs, education and training, ICT and public infrastructure, and corporate standards and practices.
- Access to finance remains a key obstacle in many Russian regions, for example, in the Far East and Siberia. Banking and non-banking financial services need to be improved in regions that are underserved relative to Moscow and St. Petersburg; including through term lending to MSMEs, retail borrowers, leasing and mortgage products, and improving underwriting and risk management practices in medium-sized regional banks.

- Other key obstacles to doing business in most regions, particularly for MSMEs, are corruption (often induced by administrative barriers) and lack of access to high skilled labour particularly managerial skills.
- One of the main reasons for the vast income differences between regions is that interregional labour mobility is low, exaggerating the shortage of skilled human resources in certain regions.
- A number of regions continue to have limited access to infrastructure and low quality of municipal services, which constrains investment.
- In the less developed remote and frontier regions that are rich in mineral resources, stimulating regional development could require the complex development of these resource sectors and related transport infrastructure, even if this is not in line with the diversification objective.
- In the power sector, there is a need to improve the regulatory environment so as to speed up tariff reform in the remaining isolated non-pricing zones (primarily the Far East of Russia).

Bank's operational response

Given the size of the country and the diversity among the regions of Russia, the Bank will continue to prioritise projects and reforms that promote transition in regions that are less advanced than Moscow and St. Petersburg and that are committed to improving their investment climate. With the support of technical assistance funds to be provided by the Russian government, the Bank will seek to develop commercially viable solutions in underserved regions where it has been difficult to identify bankable projects, combined with policy dialogue with regional authorities on improving their regions' business environment. Projects that support MSME development, upgrade/create high quality jobs in the regions, increase interregional mobility of the population and support urban renewal, which all contribute to the growth of the middle class in the regions, will be prioritised.

- In the corporate sector promote regional development by lending to or capitalising enterprises in order to assist in their restructuring, modernisation and inclusive growth.
- Support MSMEs in underserved regions through dedicated credit lines to EBRD partner banks, Russia Small Business Fund (RSBF), equity funds with regional focus, and direct engagement by the Bank combining investment with comprehensive efforts under EGP/BAS in the Far East, Siberia, Urals and the Southern Federal District with technical assistance support from the Russian government.
- Consider in the property sector addressing the lack of high quality and affordable office, retail, hotel, warehouse space and industrial and logistics parks in the regions. A few selected private residential developments at affordable prices could be considered to increase labour mobility between regions and set examples of environmentally and energy sustainable housing or earthquake resistant designs.
- Encourage and support consolidation at the regional level of municipal service companies that operate in smaller municipalities, given that often services in such municipalities are not commercially viable on a standalone basis.
- Seek opportunities to enhance interregional mobility through private projects and PPPs to develop regional airports and roads.

Policy dialogue and TC

- The Bank will seek, in coordination with other IFIs, to improve the business environment and regulatory framework through active policy dialogue with regional authorities, namely to address investment barriers, promote regional development and decentralisation and to create favourable conditions for the creation and further support of MSMEs.
- The Bank will complete the extended Business Environment and Enterprise Performance Survey (BEEPS) for the regions of Russia, disseminate the results to the government and engage in structured dialogue with regional authorities to address issues that were identified by the survey in order to encourage investment in the regions.
- The Bank will launch with the Russian government a TC programme to contribute to the development of a viable and conducive environment for MSMEs in underserved regions, with the aim of strengthening their performance and sophistication in areas such as management skills, marketing of products, compliance with international standards as well as human resources and environmental management. The TC will be supplemented by Small Business Support activities (EGP/BAS) and Bank financing where appropriate.
- In the power sector, the Bank will support the reform of the remaining isolated non pricing zones (primarily the Far East of Russia) to improve access to high quality electricity and heating services for local businesses.

3.4 Environmental and Social Implications of Bank Proposed Activities

The Bank will work with clients to assess the project's environmental and social (E&S) risks and opportunities, including stronger focus during the due diligence and monitoring phase on climate change resilience and adaptation and gender considerations, as well as GHG emission assessments for carbon intensive sectors. Additionally, large greenfield projects or high risk operations, that are eligible under Appendix 1: Category A projects of EBRD's Environmental and Social Policy (ESP), will require international ESIA and respective engagement of the affected public and other stakeholders. Corrective E&S Action Plans will continue to be prepared for projects, as appropriate, to address key risks and mitigation measures. For high risk sector projects, an extensive monitoring plan will normally be agreed as part of the project commitments in the legal documentation with the Bank.

New projects are subject to due diligence under the 2008 ESP. For direct investments, these require projects to be structured to meet EU and national environmental requirements. The commitment to EU requirements can sometimes be challenging, in particular, for projects in the municipal infrastructure, transport and power sectors, where technical capacity of the client may be limited or project parameters developed several years ago. In the event that projects cannot be structured to meet EU environmental requirements, this will be made clear in the Bank's information for the Board of Directors, with appropriate justification for any derogation, and in the public Project Summary Document. Also, where appropriate, EBRD will work with its clients so that any complementary action to projects that do not meet environmental criteria will bring them towards fully meeting EU standards in the future.

Depending on production capacities and sectors, the clients from different industries are benchmarked against Best Available Techniques (BAT) reference standards under EU Integrated Pollution Prevention and Control Directive. BAT documents in specific sectors indicate air, waste and waste water emission levels, their abatement measures, and resources consumption. Also best international practice will apply in relevant industrial sectors. Pharmaceuticals manufacturing and distribution will be required to implement Good Manufacturing Practices (GMP). Wood-processing companies will be encouraged to adopt sustainable wood procurement procedures as well as to give preference to certified wood (FSC or PEFC). In agribusiness projects, clients are required to apply best practices in food hygiene, safety of products and increasing potential for supply chain sustainability. In projects involving construction and property development such issues as planning permits, traffic impacts, public consultation, resettlement and economic displacement, grievance mechanism and construction worker issues will be addressed through the environmental and social due diligence process.

EBRD's involvement in municipal environmental infrastructure investments will continue to promote quality and efficiency, including energy efficiency, of essential municipal services, improved health of the population and reduction of pollution of groundwater and open watercourses, as well as improving resilience of the infrastructure to climate change and introducing gender balanced approaches. For new projects involving concessions and acquisitions of water and wastewater companies, the Bank requires the use of specific Environmental and Social Guidelines. The Bank will also continue working with NDEP to support critical investments in the Northern Dimension area.

In the energy and energy efficiency area, rehabilitation of old power generation facilities and development of new capacities in conventional and renewable power supply will be accompanied by introduction of best international practices for environmental performance, including replacement of old inefficient units with state-of-the-art and high efficiency generating technologies. With respect to natural resources projects the Bank will continue to focus on minimising footprint, sound practices for hazardous materials use, handling and storage, including tailings, water resources efficiency and early development for reclamation of the sites. Additionally, the Bank encourages each of its clients to follow international best practice, such as minimisation of gas flaring and increased utilisation in oil and gas projects.

In the financial sector, the Bank will continue to provide environmental and social risk management training, guidance and capacity building for its new and existing financial clients in the implementation of the EBRD's environmental and social requirements. Financial intermediaries in Russia receive training from the Bank's FI consultants to support developing their environmental and social policies and procedures and action plans to enable them to implement the EBRD's requirements for FIs.

Gender

In line with the Bank's Gender Action Plan, the Bank will work with its clients in a number of sectors and areas. In the infrastructure, energy and energy efficiency sphere, clients will be encouraged to promote equal opportunities in the work place and provided with support where necessary. The Bank will work with one of the largest providers of energy in Russia to support the company with over 6,000 employees promote equal opportunities in the work place, which will provide a demonstration effect in the sector. In line with the Bank's new MEI Policy, the Bank will seek to identify projects that are amenable to be designed and implemented so as to ensure that services are responsive to the needs of both men and women. In line with the Transport Strategy, the Bank will also seek where possible to promote gender equality through the projects it supports. The Bank will be working with its clients in the financial institutions sector to identify ways to support women entrepreneurs in terms of facilitating their access to finance and supporting their business activities.

See Annex 9 for an assessment of gender equality.

4. ACCESS TO CAPITAL: PRIVATE AND PUBLIC SOURCES OF FINANCE

4.1 Access to capital

Before the 2008-09 crisis, the Russian financial system had been growing very rapidly and Russian corporates and banks had increasingly tapped international capital markets. However, the pace of financial sector growth has slowed considerably in recent years. Private sector external debt has been broadly constant since mid-2008 hovering around the US$ 500 billion mark (28 per cent of GDP), with banks accounting for around one third of this amount and large corporates for two thirds. Several Russian companies, for example Yandex, an internet search engine, successfully completed initial public offerings (IPOs) in international and domestic markets.

The banking system consists of over 1,000 banks (almost 900 of them insured by the Deposit Insurance Agency). There has been some consolidation in the banking system in the aftermath of the 2008-09 crisis and in response to raised minimum bank capital requirements (in absolute terms) but overall it has been limited to date. At the same time, the top six banks, all of them state-owned, have increased their market share and now account for well over half of total banking assets.

Credit growth resumed towards the end of 2010 and accelerated to around 30 per cent by end-2011. The ratio of private sector domestic credit to GDP reached around 45 per cent. Consumer credit totals around 11 per cent of GDP, and the mortgages segment remains relatively less developed, accounting for around 3 per cent of GDP.

Substantial interregional differences in terms of levels of financial development persist, with credit-to-output ratios in many regions in Siberia and in the South of Russia falling well below 20 per cent. Micro, small and medium-sized enterprises (MSMEs) remain relatively disadvantaged in terms of access to credit. According to the 2009 round of the Business Environment and Enterprise Performance Survey (BEEPS 2009), around 35 per cent of MSMEs perceive access to finance as a major or very severe obstacle to operations of the firm.

Russia has a large number of private credit information reporting systems (bureaus) operating. A centralised database maintained by the Central Bank helps potential lenders to establish which of the many credit bureaus may have information on a particular borrower. The legal framework is generally adequate, and a number of laws, including the pledge law and the bankruptcy law, are currently being revised.

Russia's long-term foreign-currency sovereign rating has been unchanged over recent years (BBB by Standard & Poor's; BBB by Fitch and Baa1 by Moody's). As the budget balancing price of oil has increased significantly following the crisis, rating agencies emphasise that, in the absence of further fiscal consolidation, the ratings will be particularly sensitive to the oil price outlook.

The financial crisis has underscored the need to deepen and further develop domestic capital markets. The Bank will continue its support of the government's initiative to establish Moscow as an International Financial Centre and welcomes the progress already achieved by the various project groups. Keeping pace with regulatory and infrastructure developments in international markets is essential if the Russian financial market is to become a viable part of the global market and Moscow is to be considered a truly international financial centre.

Progress on the development of market infrastructure has been achieved most notably the MICEX-RTS merger, as well as the reform of the central securities depository in which international central securities depositories (such as Euroclear and Clearstream) can open accounts. The two main stock exchanges, MICEX and RTS, have now completed their merger and are expected to launch an IPO in March 2013. Capitalisation of the Russian stock market was around US$ 900 billion in the first half of 2012 (or about 50 per cent of GDP). The market is reasonably liquid, with a turnover-to-capitalisation ratio of around 65 per cent. While capitalisation is relatively high, it is accounted for by a modest number of companies (around 330), and around 60 per cent of market capitalisation is accounted for by state-controlled companies.

There have been reforms and evident growth of the private pension sector over the last few years. Despite this, take-up of personal pensions, retail asset management, and personal and life insurance products remains low. Initiatives can be undertaken to further stimulate the development of a domestic institutional investor base. As part of these efforts, it is imperative to encourage further improvements to the market infrastructure as well as the range of financial products and hedging instruments.

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

See Annex 3 for a more detailed review of the development of Russian capital markets.

4.2 MDB finance and collaboration with other IFIs and multilateral donors

The EBRD cooperates closely with the World Bank and the International Monetary Fund (IMF). The Bank also partners with other International Financial Institutions (IFIs) active in the Russian Federation.

The World Bank Group

The World Bank Group is now working under its 2012-2016 Country Partnership Strategy (CPS), which was adopted in December 2012. The CPS is based on three strategic and one cross-cutting theme: (i) *increase growth and diversification* through better management of public finances, improved investment climate and innovation, stronger financial sector, better infrastructure, and more effective protection of the environment, (ii) *expand human potential* by strengthening skills and social services through improvements in education, health, and social protection, (iii) *deepen Russia's global and regional role* related to its aspirations as a donor and the provision of global public goods and, as a cross-cutting theme (iv) *improve governance and transparency* through more accountability and better service standards in public administration, procurement and management.

International Bank for Reconstruction and Development (IBRD)
The new CPS for Russia endorses the envelope of US$5 billion over the five years period. Traditional investment loans are still used by Russia, however, the number of investment lending operations had decreased, and currently the IBRD portfolio includes 9 projects for a total amount of USD 756 million. Contrary to the decrease in the number of lending operations, the analytical and advisory activities (AAA) remain an important part of the IBRD's engagement in Russia.

International Finance Corporation (IFC)
As of 30 June 2012, the IFC has invested USD 6.6 billion in over 275 projects in Russia. IFC's portfolio in Russia as of 30 June 2012 was USD 2.3 billion, which made Russia the fourth largest country of operations representing about 5.4 per cent of IFC's global portfolio. IFC has committed an average of USD 780 million annually in Russia for its own account over the past five years. Approximately half of the IFC's portfolio is in the financial sector.

There have been numerous transactions jointly financed by the IFC and the EBRD. The two institutions share common focus areas, including SME finance, infrastructure, sub-national development, and energy efficiency. Co-operation in the current environment is focused on operations in the financial sector and in infrastructure, including through participation in jointly financed facilities and co-ordinating policy dialogue efforts especially on energy efficiency and renewables.

The European Investment Bank

The EBRD cooperates with the EIB on the basis of a tripartite Memorandum of Understanding between the Bank, the European Commission and the European Investment Bank. The EIB loans in the area outside the EU are governed by a mandate of the EU Council with the following sector objectives i) local private sector development, in particular support to SMEs; ii) development of social and economic infrastructure (including transport, energy, environmental infrastructure and information and communication technology); and iii) climate change mitigation and adaptation.

EBRD and the EIB Cooperation Achievements
The cooperation between EBRD and EIB has successively developed since 2001. Both institutions have different – although complementary – mandates in Russia and have focussed on their comparative advantages in working together. Co-financing activities in Russia to date have included seven operations: 4 projects in St Petersburg under the NDEP, a project with OGK-5 for the upgrade of the Nevinnomyssk GRES power plant in Southern Russia; financing for MTS, Russian Telecommunications Company; and for Mondi for the expansion and modernisation of Mondi’s integrated pulp and paper mill in Syktyvkar.

Future Perspectives of the EBRD and EIB Cooperation
The EIB operational focus in Russia will be on the priority areas defined under the EU-Russia P4M: energy security, sustainability, research and innovation and technologies. Given that EIB is one of the largest infrastructure and PPP investors in the world, with strong technical, financial and project financing expertise in infrastructure, and that the EBRD has an in-depth local knowledge and presence and strong experience in the Russian infrastructure sector, both banks can contribute to sustainable financing of infrastructure investments necessary for improving potential growth in Russia.

An increased focus will be placed on energy and energy efficiency projects in order to achieve better environmental standards. The EBRD and EIB are currently reviewing a number of early phase projects (in power generation and transmission) which are expected to contribute to this goal. In addition, and capitalising on previous co-financings in the private sector, the EBRD and the EIB expect to expand financing to support other priority sectors, in particular the industrial and the telecom sectors.

Reflecting the EBRD and EIB mandates, an area of particular interest for cooperation between the two institutions is the support of investment projects carried out in the context of FDI from the EU into Russia. Finally, the current financial crisis has inevitably led to a shortage of liquidity in the financial markets as a whole and more specifically a significant reduction in the availability of rouble funding, an escalation of the pricing of rouble interest rates and an increase in rouble interest rate volatility. In order to address these issues, the EBRD and EIB Treasury teams have agreed to cooperate with regard to rouble funding in order to ensure the delivery of the best possible value for clients and stakeholders.

The International Monetary Fund

The Russian Federation retired all of its outstanding obligations to the IMF in 2005. Since then the country’s engagement with the organisation has been limited to the annual Article IV consultation, additional visits for informal discussions and technical assistance. The last Article IV consultation was concluded by the IMF Executive Board at the end of July 2012 and the report was published on the IMF website. The Fund continues to provide technical assistance, including in the area of economic statistics and maintains a Resident Representative office in Moscow. As part of its surveillance work, the Fund conducted a financial stability assessment under the Financial Sector Assessment Programme in 2011, and a number of additional assessments, most recently on observance of IOSCO (the International Organization of Securities Commissions) objectives and principles of securities regulation.

The Nordic Investment Bank

The Nordic Investment Bank (NIB) is financing projects in North West Russia in such areas as i) environment; ii) energy, energy efficiency and renewable energy; and iii) infrastructure. NIB is promoting projects related to emissions reductions, water or air, waste water treatment, solid waste management, cleaner production, and is focusing on the HELCOM Baltic Sea Action Plan. In infrastructure, it is involved in the Northern Dimension Transport and Logistical Partnership. Projects with a substantial involvement of NIB member states companies are also of great interest to NIB.

The main focus of co-operation with the EBRD has been the Northern Dimension Environmental Partnership where NIB acted as the lead bank in 6 projects in Saint Petersburg, Leningrad, Kaliningrad, Novgorod and Karelia regions. While continuing financing of mainly waste water treatment and district heating projects within the NDEP Programme the partners are currently expanding the facility to cover other energy efficiency projects. The Bank and NIB have been active in developing the dialogue and cooperation with the Federal Grid Company and a joint MoU has been signed in 2011 with the purpose to identify potential projects for co-financing by the two institutions. Pulkovo airport as the first PPP transaction in St. Petersburg with the Bank and NIB involvement is successfully on-going. Close collaboration between the Bank and NIB and co-financing of projects within the NDEP Program, energy and energy efficiency and infrastructure will continue.

Regional development banks

The EBRD has cooperated with a number of regional development banks such as Eurasian Development Bank (EDB) and the Black Sea Trade and Development Bank (BSTDB). EDB is an international financial organisation established in 2006 to promote the economic growth and economic integration of its 6 member-states of Russia, Kazakhstan, Belarus, Armenia, Tajikistan and Kyrgyzstan. The EBRD has co-financed infrastructure projects with EDB in Russia such as Pulkovo airport, WHSD and the Macquarie Renaissance Infrastructure Fund, and will continue to seek new opportunities for co-operation.

BSTDB is an international financial institution established by Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Turkey, and Ukraine. In 2011 BSTDB granted its Observer status to the EBRD. BSTDB co-operates with the Bank in the corporate and financial institutions sector and has also participated in the Pulkovo airport modernisation.

The EBRD has also cooperated with the Russian development bank Vnesheconombank on co-financing infrastructure projects such as Pulkovo airport, WHSD and the Macquarie Renaissance Infrastructure Fund. Vnesheconombank has also supported the Bank-sponsored Business Environment and Enterprise Performance Survey in the Russian regions. EBRD will aim to seek further select opportunities for co-operation with Vnesheconombank Group in support of the Bank’s strategic priorities in Russia.

4.3 Cooperation with the European Union

EU-Russia relations are based on the Partnership and Cooperation Agreement (PCA) of 1997. It establishes the institutional framework for bilateral relations and calls for activities and dialogue in a number of policy areas such as four "common spaces" - the Common Economic Space, the Common Space for Freedom, Security and Justice, Common Space on External Security and the Common Space on Research, Education and Culture. The Common Economic Space, which is the most relevant for the EBRD, seeks to strengthen cooperation in the field of economic and trade relations, trade facilitation and customs, infrastructure development, as well as energy and the environment. Furthermore, the EU and Russia have been negotiating a New Agreement with a view to further enhance bilateral relations including in the area of trade and investments.

The European Union is a key partner for the EBRD in Russia and the Bank will continue to work closely with the European Commission in the environment and nuclear safety areas under the Northern Dimension Environmental Programme (NDEP).

In the *municipal infrastructure* sector co-operation has focused on co-financing and technical assistance for transactions particularly in the municipal and environmental sector. Thus Euro 1.5 million in EU TC funding supported Euro 157.8 million in EBRD finance – a ratio of Euro 1:105.

In 2008, to facilitate *transport* links between the EU and Russia, the European Commission has allocated a Euro 3 million to support the development of the Pan European transportation corridor 2 (Berlin-Minsk-Moscow-Nizhniy Novgorod) and 9 (Helsinki-St Petersburg-Moscow). The Bank has made efforts to implement this EC supported technical cooperation program with the state company “Russian highways” for road PPP projects within the Pan European transportation corridors, focusing on the development of the company’s environmental and social processes and procedures, but implementation has been hindered by legal constraints.

In the *financial sector*, the EU and the Bank have worked on a number of technical co-operation programmes, aiming at improving the efficiency, effectiveness and transparency of the banking sector and providing assistance to banks which were adversely affected by the global financial crisis and in which EBRD has invested as part of a crisis response package. Examples of the cooperation include:

- The EU-funded technical cooperation programme for 2009-2011 for the Northern Caucasus (Euro 5 million) administered by the EBRD to implement a MSME Credit Advisory Programme and a Turn Around Management Programme for selected partner banks and enterprises in Republic of North Ossetia-Alania under this initiative.
- Programme (Euro 2 million) for the period 2009-2011 to provide funding for tailored support to banks in the area of active loan portfolio management

including loan workout and recovery procedures to strengthen and develop commercial banks across Russia.

In addition, in 2010 the EU and Russia agreed on a Partnership for Modernisation (P4M). In support of the P4M the Bank will seek bankable projects together with the EIB and the Russian Vnesheconombank (VEB) as per the MoU signed between EBRD and VEB in 2011.

ANNEX 1 – POLITICAL ASSESSMENT

The Russian Federation is committed to the principles of multiparty democracy, pluralism and market economics in accordance with Article 1 of the Agreement establishing the Bank, although progress in the application of these principles during the previous strategy period has been uneven. While the Government has taken steps to amend the law on political parties and the electoral law and re-introduced direct elections of governors, OSCE and Council of Europe observers noted a lack of genuine competition and fairness in the conduct of recent parliamentary and presidential elections, and questions persist regarding the even-handed application of the rule of law.

Representative and Accountable Government

Free, fair and competitive elections

The Constitution provides citizens the right to change their government through periodic elections based on universal suffrage. The most recent electoral cycle included parliamentary elections in December 2011 and presidential elections in March 2012. Both were pluralistic and multiple candidates representing different political parties participated in both elections. The parliamentary elections were contested by seven political parties, while five candidates stood in the presidential elections, four of whom were nominated by political parties represented in the Parliament and one independent candidate.

Both parliamentary and presidential elections were observed by international and domestic observers. The Organisation for Security and Cooperation in Europe (OSCE) final report on the conduct of the elections commended the Russian authorities for efficient administrative preparation of elections for nearly 110 million voters residing in a territory comprising nine time zones. At the same time, observers noted that parliamentary elections "were marked by a convergence of the state and the governing party, limited political competition and a lack of fairness" and that genuine competition and voters' choice were limited by overly restrictive candidate registration requirements. OSCE also noted a general lack of confidence in the independence of election officials at all levels, mostly due to their perceived affiliation with local administration and the governing party. Some domestic observers documented multiple violations during voting and counting procedures in the parliamentary elections.

Following criticism of the conduct of the parliamentary elections, the authorities took a number of steps to increase transparency of voting and counting during the presidential election. They placed web cameras in almost all polling stations across the country and equipped approximately 30 per cent of polling stations with transparent ballot boxes. As a result, fewer concerns were raised about violations during the presidential elections. However, OSCE noted that "although all candidates were able to campaign unhindered, conditions were clearly skewed in favour of one of the contestants, the then-Prime Minister, Vladimir Putin, who was given a clear advantage over his competitors in terms of media presence and State resources were mobilised in support of him, in particular at the regional level".

In both elections international observers noted the increased awareness and involvement of Russian citizens in the electoral process. A record number of domestic observers were mobilised and trained by political parties and NGOs. The election process and results were actively discussed on the internet, as well as in print and broadcast media. According to the Central Electoral Commission, over 300,000 domestic observers participated in the October 2012 regional elections, which included gubernatorial, regional legislative, mayoral and municipal elections in 77 regions of the Russian Federation. The authorities introduced restrictions on the use of photo and video filming by the observers inside polling stations, as reported by the Association of Russian Non-Profit NGOs "In Defence of Voter's Rights "Golos", while web-cameras that had been installed were not operating in many polling stations.

Representative government that is accountable to the legislature and electorate

The Russian Federation has a Presidential system of government in which Parliament's power and capacity to hold the executive branch to account is provided for according to the Constitution but limited in practice. The President is the Head of State who is elected by direct popular vote for a six year term. According to the Russian Constitution the President is formally not part of the executive branch of government. De facto, however, the President plays the most powerful executive role in the country. The President appoints the Prime Minister, after his candidacy is endorsed by the Parliament, and appoints, upon recommendation of the Prime Minister, the federal government.

The Federal Assembly (legislative branch) of the Russian Federation consists of two chambers. The lower chamber – the State Duma – is elected on the basis of a proportional system and the upper chamber – the Federation Council – includes 2 representatives from each of 83 regions of the Russian Federation (one is elected by a regional legislature and one appointed by the regional governor. The ruling United Russia party currently holds the majority of seats in the State Duma, although it lost its Constitutional majority in the December 2011 elections. The State Duma holds government to account through (1) approval of the Prime-Minister; (2) approval of the state budget and subsequent monitoring of its execution by the Government; and (3) the power to vote "no confidence" in the Government.

In December 2008 President Medvedev signed amendments to the Constitution aimed explicitly at strengthening Parliament's oversight of the executive. Since 2009 the Government is now required to present annual reports to the State Duma on its performance, and on any specific issues identified by members of the Parliament. Deputies also routinely call individual Ministers for questioning on various aspects of Government policies and by sending parliamentary inquiries (*zaprosy*) to different government officials and agencies. However, the recent resolution of the Parliamentary Assembly of the Council of Europe (PACE) notes that "the reforms aimed at increasing parliamentary control over the executive and enhancing party pluralism have had little impact and have not contributed in any significant way to the improvement of the democratic process".

The Federation Council also has Constitutional powers to hold the executive to account. It approves the impeachment of the President (which is initiated by the State Duma in connection with a verdict by the Supreme Court); approves the declaration of the state of emergency by the President; approves the appointment of judges to the Constitutional Court, the Supreme Court and Higher Arbitration Court; appoints the head of the Audit Chamber which conducts regular oversight over public spending by the Government; and it confirms the appointment of ambassadors and ratifies international treaties signed by the Government.

Excessive/over-centralisation of Russia's political decision-making and fiscal federal system was identified by President Medvedev at his speech at St Petersburg Economic Forum in 2011 as one of the main obstacles to effective governance and economic development. In April 2012 the Duma approved a law reintroducing the direct elections of governors in Russia's 83 regions, including the cities of Moscow and St. Petersburg. In June 2012 President Putin submitted to the Parliament a draft law making the election of the upper chamber – the Federation Council – more transparent and integrated with the election of regional governors. Finally, the direct elections of mayors were reinstated, which were abolished in some cities. The new procedures for direct elections of governors, while enhancing accountability of regional officials, could complicate chances for independent candidates and opposition parties to run in regional elections. The new law requires that any candidate collects endorsement from between 5 and 10 per cent of local legislatures in at least three-fourths of regional municipalities. Independent candidates would also need to collect signatures from between 0.5 and 2 per cent of the local voters to appear on the ballot. In October 2012 the first five direct gubernatorial elections were held across Russia, involving candidates from several political parties. With turnout below 50 per cent of registered voters in four out of five regions, candidates from the ruling United Russia party won by a significant margin of votes in each of the polls. Several non-parliamentary opposition candidates were not able to participate in the elections due to demanding registration requirements. However, several opposition candidates won mayoral elections and formed significant factions in some regional legislatures.

After years of deliberations, Russia's Law on "Providing Access to Information on the Activities of State Bodies and Bodies of Local Self-Government" was passed by the State Duma in January 2009 and came into force on January 1, 2010. The law guarantees the right of Russian citizens to request and receive information, outlines a procedure for such requests, and determines government responsibility for providing such information. Passage of the law was facilitated by a public campaign by several Russian NGOs.

Effective power to govern of elected officials

In formal political decision-making, elected representatives in Russia, particularly its President, have the effective power to govern. The power of non-state actors over elected officials, such as business lobbies or the military, is lower than in other countries at a similar level of democratic development.

Freedom to form political parties and existence of significant opposition

Russia has a multi-party political system; however, in an environment of a strong executive branch and relatively weak parliaments at both the federal and regional levels, political parties remain underdeveloped and enjoy limited trust amongst the Russian public. For much of the past decade, Russian legislation regulating the activities of political parties has introduced more limitations. As a result, the number of political parties declined dramatically. In 2003 44 political parties were competing in parliamentary elections, reduced to 37 in 2006 and to 15 in 2007. In March 2012, the Venice Commission of the Council of Europe issued an assessment of the Russian Law on Political Parties which concluded that the law "establishes important obstacles to the very existence of political parties" and that it is "not in line with European standards".

In April 2012 the President Medvedev signed into law changes to Russian political parties' legislation. The amendments to the law "On Political Parties" simplifies the registration of political parties. According to the new law only 500 signatures are required to register a political party (down from 40,000) and the requirement to maintain a minimum level of party representation at its regional branches has been abolished. In the first six months after the amendments came into force over 25 new parties were registered. Some opposition parties that have previously denied registration were able to register alongside smaller populist and nationalist parties. Meanwhile, the law retained strict reporting requirements on party activities and finances and the ban on electoral blocs. Other important electoral reforms which were commended in the PACE resolution included reduction of the electoral threshold for political parties from 7 to 5 per cent starting from the 2016 elections and reduction in a number of signatures required for a presidential candidate from 2 million to 100,000.

The opposition is represented in Parliament mainly by the Communist Party and the "Just Russia" Party. Both parties often vote against draft laws initiated by the ruling United Russia party. Russia also has a diverse mix of political movements that have traditionally relied more on street protests and internet advocacy to express their dissenting political views. Some of these groups have been registered as political parties in 2012 under the new rules and could take part in the forthcoming regional and national elections.

Civil Society, Media and Participation

Scale and independence of civil society

Russian civil society has grown alongside the growth of urban middle class and the spread of information technology, including social networking sites, which opened new opportunities for civic participation bypassing traditional channels such as political parties.

According to the expert report prepared under the "Strategy 2020" project initiated by the Russian Government, civil society in Russia has been expanding rapidly. Today two thirds of Russians declare that they participate in various voluntary activities, over half have made charitable donations and over one third took part in events organised by local activists to address problems in their communities. At the same time, formal institutions of the third sector – non-commercial organisations (NCOs) – has potential for further development. Less than 3 per cent of Russians declare their participation in NCOs as volunteers and less than 2 per cent declare that their charitable activity was mediated by NCOs. Trust in NCOs remains low and state support for the development of the third sector is lacking. The main source of funding for socially orientated NCOs in 2010 was charitable donations and only 5 per cent of funding came from state funds. In August 2011 the Government initiated a programme aimed at dramatically increasing state support for socially orientated NCOs. In 2011 over 880 million roubles were allocated in the federal budget to support socially oriented NCOs and in 2012 the funding increased to 1bn roubles.

There are over 200,000 NCOs registered with the Russian Ministry of Justice. However, according to the Strategy 2020 report only 38 per cent of registered NCOs and civil society organisations operate in practice. According to research commissioned by the Russian Ministry of Regional Development, the share of NCOs in the Russia economy is still 7 times lower than in developed countries and in 2010 NCO incomes accounted for less than 1 per cent of GDP and this sector generated 0.9 per cent of overall employment in the country.

Independent pluralistic media that operates without censorship

The Russian Constitution guarantees freedom of expression, however a large share of press and media are under direct or indirect influence of the state. The government owns two of the 14 national newspapers, while more than 60 per cent of Russia's 45,000 registered local newspapers and periodicals are owned directly by the government or by state-owned (or state-controlled) companies. Approximately 66 per cent of 2,500 television stations, including six national channels, are completely or partially owned by the federal or local authorities. State controlled media occasionally broadcasts programmes that are critical of government policies and allows participation of opposition representatives. The recent mass public rallies in Moscow and other cities have been extensively covered by the state-controlled media. However cases of censorship or self-censorship, particularly in the national media, have been reported. Critical journalists and media are in some cases subjected to fines or investigations by the tax administration. OSCE observers noted press freedom abuses during the December 2011 parliamentary elections including harassment of media outlets, lack of equal access to information and arbitrary application of rules.

There have been cases where the "Law on Combating Extremist Activity" was used by the authorities to restrict regional newspapers. In August 2011 the entire print run of a regional newspaper in Kaliningrad was confiscated by the Regional Center for Combating Extremism on the grounds that an open letter to President Medvedev with allegations of corruption among regional officials contained extremist content. In July 2012 the defamation articles of the Criminal Code, abolished in 2011, were reinstated by the Duma and signed by President Putin. The new law carries up to 5 years imprisonment and up to 500,000 rouble fine for defamation. The law was criticised by the OSCE Special Representative on the Freedom of the Media. Russian journalists perceive the new law as an attempt to restrain freedom of speech and to discourage criticism of the authorities, including on corruption allegations.

While the state controls the national broadcast media, critical views about the authorities and investigative reporting are more prevalent in the print media (especially papers with small geographically restricted circulation), a few radio stations, and the Internet. The Internet has been an important source of diverse information and has been be relatively free from state interference. By March 2011 the total number of broadband subscribers in Russia reached 16.5 million with penetration almost 30 per cent. There were a reported 62 million Internet users in Russia in 2011, representing 45 per cent of the population. In 2012 new concerns about Internet freedom emerged. Several well-known websites and blogs reporting on alleged electoral abuses were brought down by cyber-attacks, both before and immediately after the parliamentary elections in December 2011. In July 2012 the Duma passed a controversial bill allowing the government to block blacklisted websites. Supporters of the bill say the proposed change to the country's information legislation is only intended to target child pornography and similarly questionable sites. Opponents warn that it could be used to shut down sites critical of the government.

Multiple channels of civic and political participation

The re-introduction of direct elections of regional governors and mayors is being complemented by plans for engaging Russian citizens more directly in the policy-making process. Prime Minister Medvedev continues to promote the 'Open Government' initiative overseen by the newly established special Minister for Open Government. The initiative provides an opportunity for Russian citizens and NGOs to contribute their ideas towards the National Action Plan for enhancing the transparency of government. According to the Constitution, an initiative with support of 2 million Russian citizens can be put to a referendum. Moreover, during his election campaign President Putin proposed, as a purported instrument of direct democracy, to make it compulsory for the Duma to consider draft laws that are endorsed by over 100,000 internet signatures from Russian citizens. The Russian Constitution grants the right to initiate laws only to the President, members of Parliament, the Government and the regional legislatures. In the absence of a federal law regulating citizens' legislative initiative, 24 regions included this practice in its legislation.

In 2004 the Public Chamber of the Russian Federation was created to increase public input into political decision-making. The first 42 members of the Public Chamber were appointed by the President, they in turn elect a further 42 members from federal non-governmental organisations, and finally these 82 members elect 42 members from regional non-governmental organisations. In addition Public Chambers and their equivalents now exist in 67 out of 83 regions as well as four Public Councils at the level of Federal Districts. There are 48 Public Councils in most Federal Ministries, Agencies and Services which comprise representatives of various NGOs, business, academic and cultural entities.

Mass protests in the streets of Moscow, St. Petersburg and other towns across Russia following the December 2011 parliamentary elections have demonstrated that Russian civil society is evolving into a more potent political force. The protests reflected the growing civic engagement by individuals, interest groups and local communities around issues such as corruption, household welfare, police abuses and protection of the environment. However, opposition NGOs continue to face limitations on their activities, including harassment of activists and attempts to limit funding for opposition NGOs, including from foreign donors.

Rule of Law and Access to Justice

Separation of powers and effective checks and balances

The Russian Constitution and laws provide for the separation of powers between the executive and the legislative branches of government and the judiciary, however in practice the system of checks and balances has been weak. Upon recommendation from qualification commissions, the President appoints justices at various levels, with the exception of justices of the Constitutional Court, the Supreme Court and the Higher Arbitration Court who are appointed by the Federation Council upon the President's recommendation. The court system is divided into Courts of general jurisdiction, Constitutional courts and Arbitration Courts. The Constitutional Court has the power to review laws, Presidential decrees, decisions of the Government and laws adopted by the subjects of the Russian Federation to determine their compliance with the provisions of the Constitution. The Constitutional Court has the power to reverse laws and administrative decisions. The majority of cases considered by the Constitutional Court since 1995 and in the recent years have been in response to requests made by citizens of the Russian Federation and public organisations.

Supremacy of the law

Article 1 of the Russian Constitution proclaims Russia as a democratic law-bound state which observes the principle of supremacy of the law. Politicians and officials are subject to the law of the Russian Federation as other citizens. Article 4 of the Russian Constitution states that the Constitution and federal laws shall have supremacy on the entire territory of the Russian Federation. While there has been significant progress over the past decade in streamlining and overcoming contradictions between federal and regional laws, the practical application of the rule of law continues to vary across different parts of the country. The UN High Commissioner for Human Rights has noted in a report that concern regarding "respect for the rule of law has been particularly acute in relation to the North Caucasus". In 2011 in the Republic of Dagestan a special legal regime to combat terrorism was introduced in accordance with the federal law on the fight against terrorism 34 times, thus temporarily suspending certain constitutional rights and guarantees of the Russian citizens residing in the region. In Kabardino-Balkaria a similar regime was in place for over 6 months. In 2010 the permanent regime of counter terrorist operations was lifted in Chechnya.

Government and citizens equally subject to the law

The Russian Constitution stipulates that all citizens are equal before the law; however, the judicial system does not universally observe the right to fair trial. The situation has been improving with regard to arbitration courts where court decisions are generally considered fair. However, this is not always true with court cases against state agencies and politically charged cases. The PACE resolution noted some progress on judicial reforms including the establishment of the Investigative

Committee and its separation from the Prosecutor's Office, the adoption of the Compensation Act, penitentiary reform and a considerable decrease in the number of detainees in pre-trial detention. However, the European Parliament expressed concerns over "judicial cases where politically constructed reasons are being used to eliminate political competition and threaten civil society".

President Putin called corruption the biggest threat to Russia's development and recognised that it covers all spheres of public life, including public servants, judges, law enforcement officials and employees in state-controlled companies. President Medvedev introduced a number of measures to fight corruption among officials when he was in office, including laying the legal foundation for Russia's anti-corruption policies. In 2009 he introduced requirements for government officials and members of their families to declare their income and assets, which have been published for the first time in 2010. In 2011 new amendments to the Penal and Administrative codes were adopted substantially increasing fines and prison sentences for offering and receiving bribes. The maximum penalties for receiving a bribe were raised to 15 years in prison and the maximum fine was raised to 100 times the amount of the bribe. It is now a crime to be an intermediary in an act of bribery and there is corporate liability for bribery.

The new legislation on direct election of governors allows the President to dismiss an elected governor if he or she is found to have engaged in corruption or has a conflict of interest as defined by Russia's new anti-corruption law. In 2008 a detailed national plan on the fight against corruption was adopted followed by anti-corruption plans for each of the subjects of the Russian Federation. In 2012 the new national plan for fighting corruption was adopted which provides for investigation of potential conflict of interest cases involving public sector employees and those appointed by the President or the Prime Minister and includes measures for enhancing training of officials responsible for fighting corruption. The plan also proposes to enhance the role of civil society in providing public oversight.

In 2012 President Medvedev acknowledged that the anti-corruption measures he put in place have so far produced few tangible results, as official corruption remains rampant particularly in education, law-enforcement and the judiciary. While Russia has slightly improved its position on the Transparency International Corruption Perceptions Index in 2011, it remains at 143rd place out of 182 countries. According to Russia's Prosecutor General the number of prosecutions of corruption related cases decreased markedly in 2011 (from 12,317 in 2010 to 921 cases in 2011), which he attributed to shortcomings in the investigations by law-enforcement agencies that underwent significant reorganisation in 2011.

Independence of the judiciary

The Constitution guarantees the independence of the judiciary, however significant challenges remain in the establishment of an independent judicial branch with strong de facto status and powers. From the first day of his inauguration in 2008, President Medvedev identified as a priority measures which could "strengthen respect for the law and help overcome legal nihilism". However, during his four years in office only limited progress was made.

The International Commission of Jurists, which consists of 60 jurists from around the world and is affiliated with United Nations Economic and Social Council (ECOSOC), UNESCO and the Council of Europe, produced a detailed report on the state of the Russian judiciary in 2010. The report concludes that the "poor state of judicial independence in Russia is clearly facilitated by a legislative and administrative framework that fails to protect judges from undue influence by state or private interests". Speaking at the Conference on development of the judicial system in 2008 President Medvedev noted that judges face "pressure and influence", that "administrative leverage" is applied, and that "bribery is often used". A report issued in May 2012 by the EU-Russia Center noted that judges routinely received telephone calls from superiors instructing them how to rule in specific cases. In the first nine months of 2011, 77 judges voluntarily resigned in Moscow, the highest rate in over a decade. Among reasons for resignations judges cited pressure from court hierarchy and from state agencies.

According to the ICJ report, the internal selection and appointment of judges lacks transparency, strict criteria and rules for selection and accountability which inevitably leads to abuses. Court presidents enjoy overly broad powers including a decisive role in promotion of judges, disciplinary proceedings and material benefits. Sometimes material benefits are used to try to achieve the loyalty of certain judges or courts in general. The process of allocation of cases by court presidents has been called into question by the ICJ report because cases are often assigned to certain judges to achieve a needed result or reassigned when judges do not agree to rule in a way required from a judge. In June 2010 a new law came into force requiring all courts to publish their verdicts and supporting material on the Internet. However, this increased level of transparency has not so far been accompanied by an effective oversight mechanism under which violations are properly investigated and redressed.

Civil and Political Rights

Freedom of speech, information, conscience, movement, association and assembly

The Russian Constitution guarantees fundamental civil rights and freedoms including the freedom of expression, freedom of conscience, freedom of association and assembly and freedom of movement. Russia has an independent Commissioner for Human Rights (Ombudsman), who is nominated by the President, the Council of Federation or the members of the State Duma, and elected by the State Duma for a five-year term. Russia has ratified the European Convention on Human Rights, the Universal declaration of Human Rights and the International Covenant on Civil and Political Rights. However, in practice these freedoms have not been consistently applied in accordance with international standards and with Russia's own laws and Constitution. Russia currently has a large number of cases pending before the European Court of Human Rights.

The newly elected State Duma adopted a number of laws that the European Parliament, OSCE and Council of Europe have warned could impose limitations on the freedom of expression, freedom of association and freedom of assembly, which raised concerns within Russian civil society and the international community. In relation to the **freedom of association**, a new law on non-commercial organisations (NCOs) was adopted by the Duma and signed into law by President Putin in July

2012. According to the new legislation, all NCOs wishing to engage in ‘political activities’ will have to register as organisations ‘performing the functions of foreign agents’ before receiving foreign funding. The law also contains harsh penalties in case an NCO fails to comply with the new requirements including 6 months suspension of its activity fines for up to 300,000 roubles, and up to 2 years of imprisonment. A statement by the UN Special Rapporteur warned that the law could have “vast negative consequences for civil society in Russia.” A number of prominent Russian NCOs announced their intentions to boycott the law, while others like the Moscow Helsinki Group began fundraising within Russia, appealing to Russian citizens for donations.

In relation to **freedom of assembly**, the Duma adopted and President Putin signed into law amendments to the law on rallies and manifestations and to the Administrative Code that increase the maximum penalty for individuals from 1000 roubles to 300,000 roubles and for legal entities to a maximum of 1 million roubles in the event a rally exceeds the number of registered participants or if a rally deviates from an agreed route. The Presidential Council on Development of Civil Society and Human Rights urged the President not to sign these amendments claiming that they contradict the Constitution’s guarantee of the fundamental right of peaceful assembly.

In relation to **freedom of information**, the Duma adopted the Act on ‘protection of children from information detrimental to their health and development’, introducing a Register of Prohibited Websites. Websites as well as IP addresses included in the Register will be automatically blocked. The Act applies to all the users of the Internet without the right to appeal against the decision to include the website in the Registry. According to rights proponents, the Act has not undergone a proper judicial review before being adopted. This was followed by amendments to the legislation on treason, which attaches criminal liability not only to the disclosure of state secrets, but also any assistance to a foreign state, international or foreign organisation if their activity is directed against Russia’s security. Several opposition MPs and the Presidential Council on civil society development and human rights expressed concerns that this law could be used to silence opposition and civil society activists, including those who conduct international advocacy on human rights issues.

Political inclusiveness

Russia has a generally positive approach to assuring political rights of ethnic minorities across the country. The Constitution and laws allow each federal entity to define languages used by people residing on its territory as state languages. In different national republics of the Russian Federation, indigenous nationalities are well represented in different political bodies, including regional legislatures and executive branches.

A report issued in July 2012 by the Advisory Committee of the Framework Convention for the Protection of National Minorities of the Council of Europe states that “steps have been taken to prosecute offences committed by far-right groups and various campaigns against racism and for increased respect for cultural diversity have been launched at federal and regional level”. However, the number of racially-motivated crimes, targeting in particular persons originating from the Caucasus, Central Asia, as well as the Roma, remains alarming. According to the abovementioned report and research conducted by the Minority Rights Group International (an international NGO affiliated with ECOSOC), some minority groups continue to face widespread discrimination in areas such as access to employment and housing. Such discrimination exists in different parts of the Russian Federation not only in regard to ethnic minorities but also ethnic Russians, in regions where they constitute a minority. People originating from the Caucasus and Central Asia, as well as the Roma, experience selective and disproportionately frequent identity checks by the police and are vulnerable to police corruption and other abuse, including the disproportionate use of force. Human rights organisations documented a range of abuses of migrant workers by Russian companies, including those engaged in large scale infrastructure projects.

The Russian Constitution and its laws confer equal political and civil rights for all citizens of the Russian Federation regardless of gender. During Soviet times women were well represented within political institutions, in many cases on the basis of quotas. In the post-Soviet period quotas have been abolished and women's representation in national and regional legislatures and in the government has declined. There are 59 women in the 450-member State Duma and nine women in the 166-member Federation Council, including Chairwoman Valentina Matvienko. There are 3 female ministers. Two of the 83 regional leaders are women. Three of the 19 judges currently on the Constitutional Court are women and there are five female judges out of 14 in the Presidium of the High Arbitration Court. Rights monitors have raised concerns regarding the treatment of women in the Chechen Republic, including the rise in the number of honour killings which often remain unpunished.

A PACE resolution stated that "continuing attacks on the rights of lesbian, gay, bisexual and transgender persons remain a serious concern". Nine Russian regions adopted laws banning homosexual propaganda among minors, and human rights organisations have expressed concerns that the application of such laws could lead to discrimination on the basis of sexual orientation and gender identity.

Freedom from harassment, intimidation and torture

Russia has ratified the Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment. However, allegations of torture and other ill-treatment by police remain widespread and successful prosecution of perpetrators are rare. The denial of adequate medical care in custody was widely reported, including in the high profile case of lawyer Sergei Magnitsky who died in custody in 2009. In March 2012, Sergei Nazarov died after being tortured in a police station in Kazan, the capital city of the Republic of Tatarstan. The case sparked public protests. Suspects in the Kazan case are currently facing trial. The European Court for Human Rights has delivered 16 verdicts in total finding Russia's law enforcement authorities' failure to abide by their obligations to conduct an effective investigation into reported torture committed by police.

In March 2011 President Medvedev initiated a comprehensive reform of Russia's law enforcement system which obliges all policemen to pass an evaluation review, following which the number of policeman was reduced by over 20 per cent by the end of 2012. The Internet helps to enhance accountability of the police by making allegations of misconduct public. In 2012 the new Russian Minister of Interior formed a special expert group to facilitate continuation of law enforcement reforms, which includes prominent human rights activists, lawyers and members of parliament.

The UN High Commissioner for Human Rights noted that “the lack of accountability and respect for the rule of law has been particularly acute in the North Caucasus. Despite some visible progress and stabilisation, there are continued reports of arbitrary detentions, extrajudicial executions and enforced disappearances, and this situation is almost certainly acting as an impediment to true and lasting peace and stability”. Russian human rights organisations regularly report cases of torture in state prisons in the Northern Caucasus. Over 500 cases concerning human rights violations in Chechnya have been admitted by the European Court for Human Rights, of which over 200 verdicts were already delivered. While Russian authorities generally paid the compensation and legal fees awarded by the ECHR in a timely manner, it failed to meaningfully implement the core of these judgements and to hold perpetrators accountable. Statistics on non-execution of judgements and decisions of the ECHR by the Russian Federation are included in the annual report by the Committee of Ministers of the Council of Europe, which was adopted on December 10, 2012.

The PACE resolution on the honouring of obligations and commitment by the Russian Federation, adopted in October 2012 expressed concerns over harassment of Russian human rights defenders, investigative journalists and political activists in Russia. Recent mass public rallies, which took place on the eve of Parliamentary and Presidential elections in Russia, have proceeded without interference from the police. One exception was the May 6 rally, where conflict erupted between protesters and the police and several arrests were made.

ANNEX 2 – ASSESSMENT OF TRANSITION CHALLENGES

Sectors	Market structure	Market-supporting institutions
Corporate sectors		
Agribusiness	Medium	Medium
Manufacturing and Services	Medium	Medium
Real estate	Medium	Medium
Private equity	Medium	Medium
Telecommunications	Medium	Medium
Energy		
Natural resources	Large	Large
Sustainable energy	Large	Medium
Power	Medium	Medium
Infrastructure		
Water and wastewater	Medium	Medium
Urban transport	Small	Medium
Roads	Medium	Medium
Railways	Small	Small
Financial institutions		
Banking	Medium	Medium
Insurance and financial services	Medium	Medium
MSME	Large	Large
Capital markets	Small	Medium

1. Industry, Commerce and Agribusiness

Agribusiness
Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) improving access to finance to primary agriculture, including through adopting the legal framework for effective, market-based financing tools such as warehouse and crop receipts; (ii) reviewing the state-support mechanism in the sector and embracing less market distorting measures; and (iii) accelerating overall infrastructure reforms to reduce transaction costs for agribusinesses.

The agribusiness sector is characterised by poor logistics infrastructure, high state protection and subsidisation and low efficiency and competitiveness. Russia maintains high border protection for key agricultural imports and budgetary support to agriculture compared to other countries in the region. This distorts prices and linkages along the value-chain. Other problematic regulatory issues have included import control measures such as sanitary barriers. The land code recognises private ownership, but the privatisation process led to fragmented land-ownership which has increased transaction costs, and hampers consolidation and FDI. Agro-processors are largely privatised and foreign entry and restructuring has increased competitiveness. Although retail is well developed in Moscow and St. Petersburg, there is a significant lack of modern food retail formats in the rest of Russia, especially the Far East. The sector generally suffers from poor logistic infrastructure, including the lack of distribution centers and on time delivery systems, hampering the quality of the end-products. Newly drafted legislation on warehouse receipts, once approved and implemented (with the assistance of the EBRD), should promote access to post-harvest financing, while a crop receipts system could alleviate lack of finance at the pre-harvest stage. Future markets and forward contracts are at a nascent stage. Russia's WTO accession in August 2012 will, over time, have important implications for Russia's agribusiness sector through increased competition from imports and through more liberalisation.

Manufacturing and Services
Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) increasing productivity and efficiency to meet the challenge of increased competitive pressures following WTO accession; (ii) attracting strategic investors in future privatisation by ensuring privatisations are open, transparent and competitive; and (iii) addressing the increasing shortage of skilled labour.

Enterprise restructuring and modernisation have advanced and some sectors have been consolidated through active mergers and acquisitions. State protectionism has increased while competitive pressures, as measured by company mark-ups, have decreased in recent years. However, this is likely to change following WTO accession in August 2012 and the scheduled reduction of tariffs across tradable goods. Competition policy has been strengthened since the establishment of the Federal Antimonopoly Service (FAS) in 2004. The FAS actively examines pre-merger notifications and has offices in each region of Russia that are reasonably independent. The competition law was strengthened further in 2011, but institutional mechanisms to facilitate new entry and exit remain insufficient.

Real estate
Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) increasing transparency and predictability of the institutional environment; (ii) streamlining the bureaucracy related to real estate, such as shortening the time required to obtain a construction permit; (ii) modernising construction techniques and technologies, including energy efficiency and sustainability; and (iii) increasing supply of modern commercial property outside major cities.

The real estate sector has significantly developed over the past decade but regional development and regulation are lagging behind. Both private developers and institutional investors have begun to operate in the country, focusing mainly on the capital and a few other major cities. New instruments such as real estate funds and other investment vehicles targeting both domestic and international investors have started to emerge, but are still relatively scarce, especially outside Moscow and St. Petersburg. Real estate development in the regions is lagging behind with a shortage of quality assets in all sub-segments. Taking security over property remains challenging and complex. The property-related bureaucracy remains an issue (e.g. according to the 2012 World Bank Doing Business it takes over 420 days to obtain a construction permit). The new energy efficiency law includes a focus on the building sector, but public awareness of the sustainability of real estate (energy efficiency, impact on environment) remains low.

Private equity
Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) broadening companies' access to PE and VC financing in particularly underserved regions of Russia; (ii) facilitating the launch of first-generation PE and VC funds; (iii) helping to mobilise investments of local institutions to the PE asset class; and (iv) finding new innovative ways to attract institutional quality international LPs and Sponsors to the country.

Russia has among the most developed private equity markets in the region. The development of the market has been fostered by such factors as a relatively large pool of potential targets, which offers a good variety of investment targets, and relatively active local public equity markets, which offer comparatively good exit opportunities (although local public equity markets are dominated by natural resource based companies). There are a little less than 30 country dedicated fund managers; while around another 15 regional fund managers have been identified for which Russia is included in their portfolio scope. Local institutional and private investor participation in private equity funds remains limited. Conformity with OECD Principles of Corporate Governance is relatively high.

Telecommunication
Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) privatising the fixed line incumbent Rostelecom; (ii) increasing competition in the fixed line segment; (iii) further developing the telecommunications infrastructure (broadband internet in the regions); (iv) ensuring the independence of the telecommunication regulator; and (v) further developing the regulatory framework (e.g. implementing and enforcing competitive safeguards).

The telecommunications sector has been liberalised to some extent but competition in the fixed line market remains limited and regulation needs to be improved further. The sector is regulated by the Ministry of Communications which is not independent. Although Russia's long-distance market was fully liberalised in January 2006, the regulatory framework is not yet in line with best practices (e.g. implementing competitive safeguards such as number portability or local loop unbundling). Within four years of its WTO accession in August 2012, Russia will need to eliminate the current restrictions on foreign investment in telecommunications and to implement the WTO's Basic Telecommunications Agreement. The process of rolling out the next generation mobile network (LTE / 4G) has recently raised significant concerns about the transparency of the regulatory process in the country. In the fixed line segment, the dominant incumbent Rostelecom still controls the majority of long-distance/international and local calls. Partial privatisation of Rostelecom was postponed until 2013, with the government preserving a majority stake. The Russian broadband internet market is well developed in Moscow and St. Petersburg, but not yet in the rural areas. A number of players employ a variety of technologies. However, consolidation seems to have started already.

2. Energy

Natural Resources
Market structure: *Large*
Market institutions: *Large*

Key challenges: (i) reducing state interference and control in the extractive industries and the transport and distribution networks for oil and gas; (ii) taking steps towards the liberalisation of the gas sector; (iii) improving transparency and regulation in the extractive industries sector; and (iv) removing trade barriers and overcoming infrastructure bottlenecks in the mineral sector;

Russia holds 21 per cent of the world's natural gas reserves and around 5 per cent of the world's oil reserves. Moreover, the country holds the world's second largest recoverable coal reserves and has large reserves of iron ore, nickel, copper, lead, tin, chromium, titanium, tungsten, manganese; industrial raw materials (diamond, platinum); non-fuel minerals (potash and phosphate). There is low government ownership and participation in ores and metals production, however there is a high degree of concentration and vertical integration along the value chain. Russia also has very significant trade restrictions on metals and minerals considered strategic. In the gas sector, market liberalisation is hampered by Gazprom's de facto monopoly in the downstream sector, depressed domestic tariffs and constrained third party access to the gas infrastructure network. A plan has been approved to gradually liberalise natural gas prices paid by industrial users but household tariffs will remain subsidised until at least 2015 - the plans to increase tariffs by 2011 faced strong public opposition. In 2010, the Russian government endorsed a privatisation action plan for 2011-2013 which included the sale of minority shares in a number of large energy companies including Rosneft. In August 2011, the government announced an extended privatisation programme under which it would notably sell, over the next 6 years, its entire stake in Rosneft as well as a 28 per cent stake in Transneft. Although the likelihood of completing this privatisation within the next few years remains low, successful implementation would represent a significant step forward in terms of private sector participation. Another challenge in the energy sector is that the Federal Tariff Service (formerly, the Federal Energy Commission) is not a fully independent regulator, as it notably depends financially on the government budget and its appointment is made directly by the government for indefinite tenures. There are concerns over the security of licensing and the even-handed enforcement of legislation in the oil and gas sector.

Sustainable Energy
Market structure: *Large*
Market institutions: *Medium*

Key challenges: (i) introducing cost reflective tariffs for end consumers; (ii) strengthening the legal and institutional framework for supporting sustainable energy; and (iii) switching from norm based to metered billing for end user consumers.

Russia shows an increasing commitment to promoting energy efficiency and putting in place relevant supporting institutional framework. The basic primary legal and institutional setup for energy efficiency is already in place (including targets for energy savings), but the absence of secondary legislation and inexistent or weak related institutions hinder the effective operation of the institutional support for sustainable energy. In October 2010, the Russian Government approved the Energy Efficiency Program until 2020, allocating 9.5 trillion roubles (US $3 billion) to energy saving programs. Energy tariffs are significantly below the cost of provision and do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently and to invest in RES projects. The lack of adequate price signals, weak institutional capacity and the legacy of inefficient heavy industries translate into very high energy and carbon intensity. The RE sector is at an early stage of development and adequate institutional and regulatory mechanisms (e.g. secondary legislation to complement the RE related) are yet to be implemented. Renewable capacity is confined largely to Soviet-era large hydro plants. Russia ratified the Kyoto protocol in 2004 and is Annex 1 party. Some initial steps have been taken in developing the institutional framework, but there has been only limited progress in implementing Kyoto-based JI projects and there has been limited interest in AAU trading.

Power
Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) increase in private sector participation in generation and supply of retail energy supply; (ii) improvement the capacity market rules; (iii) strengthen the functioning of the sector regulators; and (iv) increase cross border energy trading and inter-regional integration.

Progress has been made in reforming the Russian power sector but state involvement continues to be high. The former state-owned, vertically integrated utility company, RAO UES, was unbundled and ceased operations in mid-2008. Legal and functional unbundling is in place, albeit with continuing strong state involvement, and the RAB methodology has been in place since 2009. A bilateral power market is operating and wholesale electricity markets have been liberalised. A 50 per cent market opening came into effect in July 2009, which was increased to 100 per cent in January 2011, excluding volumes sold to the population. From 2011, regulated contracts will only cover electricity volumes supplied to the population, which account for roughly 20 per cent of total electricity consumption. These volumes are expected to be liberalised by 2014. Low energy efficiency in power generation, network losses in transmission and distribution, regulated prices and developing regulations for the retail market remain significant challenges.

3. Infrastructure

Water and wastewater

Market structure: *Medium*
Market institutions: *Medium*

The key transition challenges : (i) improving tariff setting (more objective and economically based cost recovery tariffs allowing for investment recovery including through a well deployed RAB methodology), (ii) restructuring the utilities including those in medium and smaller municipalities, (iii) metering and demand side measures, (iv) increasing private sector participation through the properly organised and managed competitive process to accelerate the pace of restructuring and deploy investments; and (v) introducing formal arms-length relationships between municipalities and their operators.

Water services are decentralised. About a quarter of water operators are fully corporatised (joint stock companies), more than half of operators are organised as municipal and sometimes state regional enterprises (semi-corporatised) with *de jure* management independence, but *de facto* heavily dependence on the local/regional administration. Private sector participation is significant (about 20 per cent of the market). The tariff setting has been shifted in 2011 from municipalities to regions with the Regional Tariff Services (RST). The current legislation allows for cost reflective tariff setting, including investment financing. However, federally imposed caps on tariff increases in the regions, the absence of independent tariff assessors for defining costs and affordability concerns often hamper tariff setting at adequate levels in most municipalities.

Urban Transport

Market structure: *Small*
Market institutions: *Medium*

The remaining transition challenges include (i) approving an improved regulatory framework allowing for the introducing of competitive route tendering and PSCs; (ii) further integrating urban transport planning, particularly more widespread use of economic tools; (iii) improving the procurement of urban transport services; and (iv) restructuring municipally owned operators.

Urban transport services are devolved to municipalities. Planning capacity remains relatively weak and the legacy of administrative regulation both at the federal and municipal level leaves relatively little scope for economic regulation of urban transport. The typical municipally-owned urban transport operators are organised as municipal enterprises (semi-corporatised) with *de jure* management independence, but *de facto* dependent on the local administration, especially in smaller cities. Private operations are common in urban transport (mini buses and some large bus operators in bigger cities) and only require basic licenses for operation, but the sector is fragmented and often offers poor quality services. While operating subsidies are not allowed, municipally owned operators get subsidies in the form of capital grants for investments and equity injections. Urban transport tariffs are set by municipalities but reviewed by regional (oblast) authorities corresponding to the federal government, and remain under strong political and administrative influence.

Roads
Market structure: *Medium*
Market institutions: *Medium*

The remaining transition challenges: (i) further improving road user charges including through incorporating some of the negative externality costs; (ii) developing project preparation processes with adequate public consultations with stakeholders (including on environmental issues) and performance-based contracts for road maintenance with deeper private sector involvement; (ii) deploying PPP projects in line with international best practice; (iii) improving governance and accountability in road agencies.

The Ministry of Transport is responsible for transport policy development and transport sector regulation. Rosavtodor, the Federal Highway Agency, is the executive authority responsible for public service delivery and public property management in the road assets and road transport. The responsibilities for regional road networks were transferred to regions and municipalities. The concession law approved in 2005 (then amended in 2008 and 2010) enables the preparation and implementation of PPP projects in the infrastructure sector. Two major motorway concession contracts reached financial close (Odintsovo Bypass and Moscow-St Petersburg motorway first segment) and are under construction. Road user charges have increased moderately but are insufficient to cover operational costs.

Railways
Market structure: *Small*
Market institutions: *Small*

The remaining transition challenges include (i) improving the independence and governance of RZD and focus on its core business of infrastructure provision; (ii) separating railway infrastructure into a separate company with transparent management and cost accounting; (iii) privatising Freight Two ; (iv) introducing transparent PSO contracts and PSO-based payment for passenger services; (v) eliminating subsidies for freight services; (vi) establishing a single economic regulator for the railway sector to ensure equal track access and effective competition; (vii) strengthening the private freight service providers and introducing private operators in traction and passenger services to enhance competition in the sector; (viii) eliminating discriminatory and uneconomic tariffs on certain routes; (ix) divesting non-core RZD assets.

Russia is currently implementing the most difficult phase of a standard railway liberalisation reform package. Operating and policy setting functions have been separated: policy making remains within the Ministry of Transport, whereas infrastructure and operations are undertaken by the state-owned incumbent Russian Railways (RZD), its subsidiaries and private sector companies. Over the past two years the operations of RZD were further restructured, with freight operations now organised in two main subsidiaries (Freight One and Freight Two) and a specialist company (Transcontainer); and a separate federal passenger company for long-distance and international passenger traffic. Competition in freight is relatively intense, although RZD continues to retain a monopoly on traction. The railway infrastructure is now handled by the RZD holding, which nevertheless continues to hold many non-core assets (e.g., welfare institutions, telecoms, banking) and rolling stock. Freight One was privatised at the end of 2011.

4. Financial institutions

Banking

Market structure: *Medium*
Market institutions: *Medium*

Key challenges: (i) broadening access to finance in regions with particularly low banking penetration; (ii) improving competition in the sector through strengthening of the role of private banks, both in the regions and on a federal level; (iii) facilitating improvements in equity capital base of federal and regional banks, particularly through facilitating IPOs and attracting new third party financial and strategic investors; (iv) improving the effectiveness of the regulatory framework in the sector; (v) developing and facilitating growth in new innovative products (eg, Residential Energy Efficiency and Carbon Finance lines).

The banking sector in Russia is reasonably well-developed; however, dominance of the sector by several large state-owned banks is hindering competition and thereby the improvement of business practices and sustainable growth of the sector. Access to finance remains low in some of the more underdeveloped regions, particularly for MSMEs. Banking system assets-to-GDP ratio stood at 76.3 per cent at the end of 2011. There were 978 banks as of end 2011, around 12 per cent of which are foreign owned. The sector remains overly concentrated, with the top three banks accounting for 48 per cent of total assets. As of end 2011, 6 out of the top 7 banks were state-controlled and they account for almost 60 per cent of total assets. Dollarisation remains low at 25 per cent of deposits and 19 per cent of private sector loans as of end 2011. The previous global financial crisis had a significant impact on the sector affecting capital positions and profitability of banks, although the sector has remained fundamentally sound. Capital adequacy ratios remain adequate but have fallen to around 15% (from 18.4% in Q3 2010). Any further deterioration in capital adequacy would require further capital injections across the banking sector.

Insurance and other financial services

Market structure: *Medium*
Market institutions*: Medium*

Key challenges: <u>Insurance sector:</u> (i) broadening access to non-mandatory non-life and life insurance products, particularly in underserved regions; (ii) strengthening federal and regional non-life and life insurance companies, including small insurance companies; (iii) expanding re-insurance activities. <u>Private pension sector:</u> (i) improving corporate governance and business conduct, particularly outside the existing EBRD partner institutions; (ii) improving the regulatory framework (including in relation to asset allocation restrictions, mark-to-market rules and legal status of the private pension funds). <u>Leasing sector:</u> (i) broadening access to leasing *in particularly underserved regions; (ii) facilitating reduction of state dominance in the leasing sector through developing and strengthening private leasing companies, both in regions and at the federal level*

The non-life insurance segment in Russia is reasonably developed, but access to and quality of non-life insurance services varies significantly across Russian regions. The life insurance segment remains practically non-existent. The value of insurance premia to GDP is around 2.5 per cent. Many of the largest companies in the sector (including Rosgosstrakh, Ingostrakh) are under formal or informal state influence. Sophistication of the sector with respect to skills, including risk management, varies across companies, and significant gaps in practices remain. Insurance legislation and regulation have been enhanced, but they require further improvement. In March 2011, all functions of the Federal Service for Insurance Supervision were transferred to the Federal Financial Markets Service. Privately managed pension funds operate both mandatory and voluntary schemes, and pension fund assets to GDP remain low at 2.3 per cent. The basic Pilar II legislation and regulatory framework is in place, but there are significant shortcomings that constrain development of the sector.

Micro, Small and Medium-sized enterprises
Market structure: *Large*
Market institutions: *Large*

Key Challenges: (i) lifting constraints on MSME development by improving bank lending practices, (ii) expanding lending in underdeveloped regions and developing other sources of finance for SMEs; and (iii) improving institutional environment that supports SMEs access to finance.

Russia features a range of banks and other institutions offering MSME finance, although the demand is still far from being met. Few banks in Russia are organisationally geared towards MSME lending, reflecting their perception that this is a high risk and high cost activity. The crisis has further affected banks' lending to MSMEs, which accounted for only about 27 per cent of total domestic credit to the private sector, or about 9.3 per cent of GDP in 2011. Many MSMEs do not have bank accounts or access to bank loans, and over 40 per cent of them perceive access to finance as a major obstacle to doing business. In terms of regulatory and legal matters, both credit registry and private credit information bureaus are in the early stages of development. Collateral and bankruptcy legislation is supportive of MSME lending, but the cost of registering collateral for MSMEs remains more than twice the OECD average. However, registering property transfer has recently become easier by eliminating the requirement to obtain cadastral passport on land plots.

Capital markets
Market structure: *Small*
Market institutions: *Medium*

Key challenges: (i) facilitating increase in liquidity in public equity markets (particularly for medium-sized stocks) and bond markets, including by developing local institutional and private investor base; (ii) developing regulatory framework (and trading mechanisms) that are conducive for improved secondary market liquidity *for medium-sized companies and therefore increased attractiveness for such companies willing to raise capital.*

Securities legislation has adopted most of the IOSCO principles, although further improvements to some elements of the legislation and its enforcement are required. A major development has been the Insider Trading Law, which has been enacted in 2011. Certain relevant provisions regarding the definition of insider information as well as maintenance of insider lists at companies have followed suit in January 2012, including those setting out what data constitutes inside information and regulating the maintenance of the insider lists at companies. However, other provisions will only become effective in 2013. The market capitalisation in 2011 is 42 per cent of GDP (versus 69 per cent in 2010), and there are 327 companies listed. Russia's government bond market is well developed, with a liquid secondary market. The corporate bond market is still underdeveloped. Money markets are well developed, and they have adequate levels of liquidity.

ANNEX 3 – DEVELOPMENT OF CAPITAL MARKETS

Market Infrastructure

The MICEX-RTS merger was an important step in the strategic transformation of Moscow's market infrastructure by creating a single Russian exchange for local and international market participants. In addition to the significant efficiency gains in terms of reduced transaction costs and improved liquidity in the local market, the merger also acts as a catalyst for further infrastructure improvements as evidenced in the reform of the Central Depository. The law on central securities depository was adopted in late 2011 and will be fully in force by January 2013.

Improvements that have been made to the rouble payment system with the introduction of RTGS need to be adopted more widely so that all institutional payments are processed within the same day through the continuous settlement system, with the greater usage of intraday credit limits. The system of multiple discontinuous payment sessions in which only funds received in the first few sessions are usable for same-day payments combined with limited or no intraday credit availability restricts volumes and drives up the costs of executing onshore transactions by creating a requirement to pre-fund.

Expanding the list of foreign entities that can open accounts with the National Depository (such as Euroclear, Clearstream and DTCC) should improve the liquidity of the bond market by conjoining onshore and offshore demand. The merging of onshore and offshore Rouble liquidity would be further aided by adoption of international securities settlement timing (with the settlement date 3 business days after the trade date). Ensuring that all domestic securities can benefit from these developments will improve the consistency and continuity of issuance.

Institutional Investor Base

Recent growth of the private pension sector is welcomed and further initiatives in this area should be encouraged. At present the state sponsored pension system is inadequate to meet citizen's retirement needs in the medium term and the government needs to make a clear commitment to privatize the Russian 2nd pillar system and launch a second wave of pension reforms to stimulate local and foreign investment.

Fundamental change is required to the way the private pension system is run if it is to serve as a complimentary tool to the current state system. Key areas to be addressed include:

- **Expanding the list of investable securities for pension fund managers** would benefit both the pension fund sector and the securities markets and create a coherent framework that governs how the regulator decides on which securities can be added to the list.
- **Clarify the guarantees required** by both non-state pension funds and by asset managers in terms of mandatory and voluntary pension assets. The recent financial crisis has clearly demonstrated that the market is too thinly capitalized to shoulder guarantees protecting the clients from investment risk, especially in a volatile and risky capital market such as in Russia.

- **Discipline transfers at the state pension fund**. Before 2011, there were incidents of transfers taking up to one year. Despite recent improvements, transfers from the state pension funds to non-state pension funds of obligatory pension saving (OPS) assets remain non-transparent, delayed, erratic and unpredictable.
- **Create a system to monitor, register or license pension agents** to help curb fraudulent activity. The lack of a country-wide system complicates the task of completing background checks on pension agents. Disclosure requirements on agent's incentives and fees derived from switching contributions could be introduced. Asset management companies should be held accountable for the actions of agents retained exclusively by them.
- **Involve the insurance industry** which traditionally has expertise in the areas of pensions and Unit-linked/annuities. The absence of unit linked legislation compromises insurance company entry.
- **Attracting wider investor activity** by transforming the legal form of pension funds and changing the current reporting requirements from the current annual reporting based on market-to-market which discourages pension funds from investing in instruments with a long-term investment horizon.

The insurance sector faces a number of specific impediments that need to be addressed, many of which stem from the protection of Russian entities in the sector. Some Russian insurers lack sophistication and expertise, especially in investing premiums, leading to underperforming portfolios in some cases. Foreign entrants could promote new technologies, improve expertise and market efficiency, while increasing the quality and range of insurance services on offer. Significant barriers to foreign entry exist, which impede skills transfer and stifles development of the insurance sector. These include:

- **Restrictions on foreign capital:** The 25 per cent cap on foreign capital in the overall Russian insurance market will increase to 50 per cent as part of the WTO admission process. Presently there are a number of restrictive trade practices affecting insurance companies that may be relaxed at the discretion of the regulator but the transparency of the process needs to be ensured.
- **Discriminatory treatment in licensing:** Foreign insurers must operate as minority shareholders for two years before they apply for an insurance license independently. Foreign participants are required to operate for 15 years in their domestic markets before expanding into Russia.
- **Federal regulation not enforced at the local level:** Some foreign insurance companies have suffered discriminatory actions by local officials who have power to restrict market access of non-local insurance providers, which are not authorized by them. Federal authorities must ensure consistent enforcement of federal regulations at the local level.
- **The absence of acquired rights protection:** The current regime does not provide for protection of existing rights in the insurance market.

The tax treatment of investments in general needs to be addressed. Clarification is required from the central government in relation to what tax incentives are appropriate to help in the development of the institutional investor base. Classic tax incentives may prove difficult in Russia given the low tax rate but can be successful as seen in the case of Asia. Alternative incentives such as income forgiveness or moratoriums from taxes associated with employment may also be considered. Any incentive programme must ensure that the policy is designed to achieve the desired goal and not to be used for manipulative practices such as tax avoidance.

Additionally, concurrent work could be undertaken to improve the reputation of the local institutional investor base and restore public trust and confidence, which has been damaged by on-going corruption concerns. Asset management companies fall under the jurisdiction of FSFM and there is a strong case for tightening the rules and ensuring regulatory clarity in this sector. Enforcement and investigative procedures for wrongdoing need to be improved. In cases of wrongdoing and fraud, the liability of natural persons working for the asset management companies is currently ill defined, although recent amendments to the law are a positive step. Efforts to address the issue of insider trading are already underway and further regulation which includes strong powers of enforceability and a genuine willingness by regulators to pursue legal remedies against wrong doers should be considered. There also needs to be clearly defined accountability in the civil code for investment managers.

Financial Products

Growth in the capital markets will be greatly assisted by extending the range of debt instruments in the domestic rouble bond market. The first stage of this was achieved through the creation of MosPrime-index-linked bonds that provided a liquidity management tool for banks, as well as the issuance of structured notes linked to equity and commodity indices that could offer institutional investors positive real yields. The further development of the money-markets, through the introduction of RUONIA and Roisfix, which seek to limit the credit risk component of money-market indices by focusing on transactions executed in the overnight market, will give rise to new liquidity tools for the banking sector. The Bank will be looking at expanding the range of financial instruments, to include securitisation and covered bonds, available in Russia by working with both banks and non-bank financial institutions in the areas of leasing and insurance. Fostering business diversification and capitalisation, thereby increasing risk taking capacity as well as stimulating and assisting in these sectors' consolidation, will be the priorities in working with non-bank financial institutions.

As the Russian market only allows securities to be issued and traded in the domestic market that are expressly contemplated under Russian law, the range of securities offered has been circumscribed. Notable gaps in the market include asset backed securities, (other than mortgage-backed bonds that are currently permitted), such as securities backed by auto-loans, consumer loans, credit cards receivables and lease payments. Although there has been much controversy in relation to asset-backed securities since the financial crisis of 2008-09, there has also been a general recognition among policymakers that a well-functioning asset-backed securities market is crucial for a recovery from the current period of stagnant economic growth. As the securities market develops and matures other instruments such as revenue / infrastructure bonds may become viable sources of funding.

While it is legally possible for Russian issuers to issue convertible bonds, in practice this rarely happens, and no such bonds are currently outstanding on the MICEX-RTS exchange. The problem stems from the mandatory process of conversion of bonds into shares, which requires a corporate resolution of the issuer. The protracted procedure for introducing such a resolution is inimical to convertible bond issuance, and will need to be addressed if the convertible bond market is to offer corporate issuers new lower-cost issuance opportunities while providing investors with upside exposure to equities with limited risk.

An important factor in developing local capital markets is investors' confidence in their rights as noteholders, and clear mechanisms by which they can voice their views, in particular through decisions taken in debt securities holders' meetings. At the moment, Russian law does not recognize the concept of representative of noteholders and does not provide for class actions for noteholders. This absence of a legislative and regulatory framework for bondholders meetings was also deemed responsible for technical defaults in the bond market at the onset of the financial crisis in 2008-2009.

A simplified process for issuance in the domestic market, which authorises shelf registration thereby limiting the obstacles to successful fixed rate financing through the domestic bond market, governs the Commercial Paper (CP) market (also known as Stock-Exchange Bonds,) for public issuance up to three years. Extending the use of shelf programmes for longer term transactions would enhance the attractiveness of the domestic bond market. Additionally, the bond issuance process should be simplified to allow long-term issuance by large, rated, frequent issuers (including foreigner issuers) targeted to both domestic and international institutional investors as well as private placements to be executed without registration or similar requirements.

Hedging Instruments

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

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

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

Overcoming the remaining obstacles to swift development of markets in futures and derivatives is a clear priority. Active participation of both domestic and international banks will be essential as they will from the outset be the core providers of market liquidity in both exchange traded futures and OTC derivatives. To facilitate the broader use of the derivative markets as risk management and trading instruments, the remaining obstacles to effective netting and collateralisation need to be removed, thereby enabling counterparties to minimise and mitigate the counterparty credit exposures inherent in the derivative markets.

The concept of close-out netting was introduced in Russia by recent amendments to Russia's securities and bankruptcy legislation (Federal law "On Amending certain legal acts of the Russian Federation following the enactment of the Federal law "On Clearing and Clearing Activities"" No. 8-FZ dated 07/02/2011). These amendments came into effect on 11 August 2011 and should become fully operational upon the enactment of certain implementing regulations by the FSFM. Additional regulations on Trade Repositories are yet to be fully in force.

Effective collateralisation is essential for reducing counterparty risks, in particular in the markets in futures and derivatives. The accounting and tax treatment for derivative hedges must also be addressed. To enable the rouble financial markets to form part of the international capital markets, the respective legislation and regulation ought to be consistent with international standards to enable the effective use of rouble instruments alongside those in other international currencies.

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

ANNEX 4 – LEGAL TRANSITION

EBRD has continued to support Russian policy-makers in their efforts to improve legal and regulatory frameworks for business. Despite recent legislative changes, there remain some significant areas of concern for investors, in various parts of private-sector supporting legislation, as well as in legal areas which support the development of infrastructure projects. This annex concentrates on legal areas directly relevant to the Bank's investment strategy for the new period, and where the Bank is currently assisting or offering to assist the Russian authorities in their reform efforts. These include secured transactions, corporate governance and insolvency law, concessions/public-private partnerships and public procurement.

I. Private-sector supporting legislation

Secured transactions

Pledge law

Pledge law remains one of the most serious bottlenecks in the functioning of Russian financial markets, and an obstacle to their further development. At the end of 2009, the Bank started cooperating with the Ministry of Economic Development (MED) to undertake a complete review of the 1992 Pledge Law and the 1998 Mortgage Law with a view to making them more coherent, comprehensive, legally efficient, and market-oriented. The Bank assisted the MED in preparing a Concept Paper reflecting the views of market players. The *Concept for reform of the Russian security legislation* (October 2010) became the blueprint for the subsequent work.

The reform of the Civil Code provisions on secured transactions was undertaken by the Council for Civil Law Codification and Enhancement of the President of the Russian Federation. The Bank has commented on the draft revisions to the code and made the following observations and recommendations:

1. The statutory contents of pledge agreements should be further liberalised, in terms of scope of assets to be used as security and scope of transactions that may be secured.
2. The certainty of secured creditors as to their priority over the pledged assets should be increased.
3. The provisions governing pledges of specific objects (in particular, claims (rights) and bank accounts) should be strengthened.
4. The procedure of levy of execution should be further simplified and liberalised to meet market's expectations.

The EBRD also has become an active part of the MED Working Group on the development of the pledge register – a key component of the reform. The MED is preparing a Law on the Recording of Pledges and the EBRD has provided full technical assistance in its preparation. It is expected that the draft will be sent to the Duma very soon. The EBRD has been also working closely on this aspect of the reform with the Legal Department of the Presidential Administration.

Warehouse Receipts Law Reform

The EBRD, together with the UN FAO, has been supporting the Ministry of Agriculture on the development of a long overdue legal framework for grain warehouse receipts. The reform's objective is to enable grain producers to safely store their crops in public warehouses that are properly managed and financially sound and, if they wish so, mobilise the grain as collateral to raise finance. The draft law is now nearing finalisation and it is anticipated that it will be approved by the Government and submitted to the Duma by the end of 2012. It represents significant progress in a reform that has been in the making for the last decade or so.

The remaining challenge will be to implement the new Law on Public Grain Warehouses, once adopted. This will rest in part with the newly created Self-Regulated Organisations of Public Warehouses (SROs) which will be formed in accordance with the new law. These SROs will be responsible for developing internal rules and mechanisms to ensure that the warehouses meet all technical and financial requirements imposed by the SRO, operate as intended by the law, and contribute to an indemnity fund also run by the SRO. The Ministry of Agriculture will also remain instrumental in ensuring the proper implementation of the law and encourage its use.

The EBRD will actively seek means by which it can support the adoption of the draft law and also contribute to the effective implementation of the law by providing further technical assistance.

Crop Receipts

The Bank is also considering assisting the Ministry of Agriculture with the launch of a new initiative aiming at providing a legal framework for the issuing of so-called 'crop receipts' by farmers – a note undertaking the delivery of agricultural products or a financial obligation vis-à-vis a creditor secured by a pledge over future crops. This instrument, inspired by the very successful Brazilian experience, would represent an important alternative mode of financing for crops producers in Russia. The Ministry of Agriculture has expressed an interest and it is hoped that work will start in the second half of 2012.

Corporate Governance Code

In 2002 the Federal Commission for the Securities Markets issued a Corporate Governance Code developed with the technical assistance of the EBRD. The Code is voluntary but listed companies are required to report compliance with the Code's recommendations, according to the "comply or explain" mechanism. The Bank is currently considering assistance to the Federal Financial Markets Service or Moscow Stock Exchange with a possible technical assistance project dedicated to the revision and implementation of the Russian Corporate Governance Code. The code has not been updated since 2002. As a result, some of its recommendations are now outdated and not in line with the legal framework. Further, the "comply or explain" mechanism should be re-visited to improve its effectiveness.

Insolvency

Basic legal provisions on insolvency are contained in the Civil Code. The main source of legislation regulating corporate insolvency and individuals registered as entrepreneurs with the tax authorities is contained in the Bankruptcy Law, adopted in 2002, as amended. The EBRD Insolvency Sector Assessment completed in late 2009 concluded that Russian insolvency law was of a generally acceptable standard. The existing Russian insolvency framework is relatively comprehensive; however there are a number of areas where improvements could be made, including as regards the mechanisms triggering bankruptcy, the availability of restructuring tools and the disclosure of information to insolvency office holders in the context of bankruptcy proceedings.

According to the Bankruptcy Law, decisions of foreign courts on bankruptcy are recognised in Russia as provided by the international treaties of the Russian Federation. To date no such treaties have been put in place and this area of the law may soon be reformed.

Russia has a somewhat unique system for regulating insolvency practitioners whereby such practitioners must become members of a self-regulating organisation ("SRO"). A Union of SROs exists, which may provide some uniformity amongst SROs by establishing common professional standards and ethics. However there is no requirement for SROs to be members of the Union and a number of SROs are not members of it. EBRD has been assisting the Ministry of Economic Development for some years on this issue, as well as commenting on draft standards prepared by the Union. Such standards require the approval of both the Union and the Ministry of Economic Development to come into force. Further work is required to strengthen the profession as a whole.

A number of amendments have been proposed by the Russian government to the Bankruptcy Law. These include introducing rules on cross border insolvency aimed at determining the jurisdiction of the Russian courts to hear cross border insolvency proceedings, identifying the law to be applied in the event of cross border insolvency proceedings, establishing rules on recognition and enforcement of foreign court judgements on insolvency cases and addressing issues arising in the event of initiation of conflicting insolvency proceedings against the same debtor in different jurisdictions. Other amendments proposed would, if implemented, introduce new rules for financial rehabilitation with the purpose of expanding the role and use of such procedure for restoring a debtor's solvency as well as establishing rules on out-of-court settlement of creditors' claims by imposing the institution of standstill agreements. Many of the proposed amendments would, if adopted, address gaps in the existing Bankruptcy Law. As such, they represent an important step towards introducing greater legal certainty into Russia's insolvency system. Another area of proposed reform on which EBRD has commented is reform of the powers of insolvency office holders. At the moment these amendments have not been presented to the State Duma and are still in the process of discussion and further development.

II. Legal reform supporting infrastructure development

Public-private partnerships and concessions

The main source of federal legislation relevant to PPPs is the Concessions Law adopted in 2005, as amended. The Concessions Law operates under the general Russian statutory framework, meaning that it is intended to cover concession-specific aspects of projects only, and does not create a special (more favourable) legal regime for concessions. The Concessions Law expressly refers to the land, subsoil, budgetary, tax, environmental and other legislation. It applies to all federal, regional and municipal concession projects. Regional and municipal authorities are not entitled to pass concession-related laws and regulations. They may, however, enact laws and regulations on other non-concession forms of public-private partnerships (PPPs).

The Concession Law regulates only one specific form of PPP, the build-operate-transfer (BOT), which was designed for the use of the Federal Investment Fund. For road projects only, an “availability payment” option has also been made possible. Otherwise it is possible to use the more flexible and investor-friendly regional PPP laws for similar projects providing for non-concession forms of PPP. As of September 2011, regional (sub-sovereign) PPP laws, regulating BOT and other non-concession PPP forms exist in more than half of all the regions of the Russian Federation. Their quality and importance are increasing.

Generally speaking, the Concession Law and regional PPP laws may constitute a solid basis for the development of PPP in the country, but the system needs some significant improvements when compared to international standards, as well as increased predictability and reliability to become more attractive to lenders and sponsors. The use of PPP structures is still not possible in many sectors (e.g. non-cash-generating social infrastructure concessions) and is limited in practice to transport and municipal infrastructure, with only few exceptions still at the preparation stage.

A draft federal PPP law and a set of amendments on the Concession Law have recently been prepared by the MED aiming at broadening the application of the laws, but these are yet to be finalised before their submission for approval.

Over recent years, the institutional base of PPP in Russia has also improved. A number of PPP departments have been established in the federal and regional governments and its sub-divisions. PPPs are also noted in some of the regional strategy policy documents. Capacity building and various training initiatives have been launched by a number of institutions.

The key focus of the Bank’s efforts in recent years has been to enhance the bankability of PPP projects. It has done so by promoting the application of standards of best practice in PPP/concessions and in the award of public contracts. The EBRD active participation in the MED Working Group on Municipal Utilities led to the enactment in the summer 2010 of important amendments to the Concessions Law, including the recognition of direct agreements with lenders. Other efficient platforms for EBRD policy dialogue are the PPP Development Centre and, more recently, a PPP Sub-Committee of the Russian Chamber of Commerce and Industry, the Ministry of

Transport's corresponding working group, and the PPP Experts Council of the Russian Duma Economic Policy Committee, with which the Bank has co-published two PPP-specific books of legal materials, in 2009 and in 2011, for the use of public officials in Russia.

More recently, the Bank has initiated technical cooperation aimed at regional/sub-sovereign legislation review and the drafting of regional PPP laws for the Perm Krai and for Moscow City; the Bank will disseminate the major documents developed in that context for the use of other regions interested in upgrading their PPP laws.

In the future, it will be crucial to maintain momentum and advance the development of concession/PPP projects following the economic downturn, which caused many concession/PPP projects to be abandoned. With this objective in mind, the Bank intends to focus its efforts on three main directions:

1. Enhancing the bankability of PPP/concessions: working with Roads of Russia on the development of federal PPP projects and with the Vnesheconombank PPP Centre on promoting PPPs in the regions;
2. Developing methodology and guidance for officials handling PPPs; and
3. Developing adequate tariff regulation, which remains a key prerequisite for attracting private sector entities to municipal services markets.

Public Procurement

Public procurement in Russia is regulated by the Law On Procurement of Goods, Works and Services for State and Municipal Needs, adopted in 2005 (the "PPL"). The PPL has been substantially amended in 2009 in order to introduce mandatory electronic reverse auctions. Currently, a major reform of the public procurement system is in progress: the Russian parliament completed a first reading of a draft public procurement legislation based on the 2011 UNCITRAL standards, intended to replace current laws by the end of 2012.

In the EBRD 2010 assessment the existing Russian legal and regulatory framework for public procurement scored medium to high compliance with international standards; however, it displayed no major strengths, since it did not score high in any of the assessment benchmark indicators. Good compliance has been recorded in indicators for uniformity and enforceability of the legal framework. The institutional framework is well developed, but it is complex and contains overlapping duties among institutions. In addition, there is no independent dedicated review and remedies function: the review process is conducted by the Federal Antimonopoly Authority, with no procedures ensuring procedural fairness to private sector enterprises complaining against public entities. In addition, Russian public procurement legislation is far from stable – frequent amendments and complex enforcement mechanisms result in the general perception that public procurement laws and their application in practice are unpredictable.

Until the end of 2010 Russian laws allowed for preferences for domestic tenderers. Since 2009 all public procurement procedures in Russia are conducted as electronic reverse auction; tendering has been abandoned. Due to the lack of procurement planning and to interconnectivity problems, within different platforms providing auction services (suppliers have to register with each of 18 active platforms, no data exchange takes place) very limited competition has been recorded. All these problems provided an incentive to overhaul the regulatory framework, leading to the reform process initiated in 2011.

The EBRD-UNCITRAL Initiative[10] for Enhancing Public Procurement Regulation in the CIS countries and Mongolia has been designed to support governments in the CIS region in their reform efforts. Under that initiative, the EBRD could contribute, if requested by the Russian authorities, to the development of the new legal and regulatory framework for public procurement in the Russian Federation.

[10] http://www.ppi-ebrd-uncitral.com/

ANNEX 5 – SMALL BUSINESS SUPPORT

The Small Business Support Team (SBS) supports economic transition by achieving enterprise change in potentially viable micro, small and medium enterprises (MSMEs) and contributing to the development of a sustainable infrastructure of MSME support and local business advisory services. This is achieved through two complementary instruments, the Enterprise Growth Programme (EGP) and Business Advisory Services (BAS).

Previous SBS experience in Russia

To date €16 million of donor funding have been committed by **EGP in Russia** since inception in 1998. EGP has carried out 262 projects throughout all Federal Districts, 19 of which are still in progress in Far East Russia, the Urals and the North Western Federal Districts. The largest donors of EGP projects have been Japan, the EU (under TACIS), the Russian Privatisation Center, the UK, the Nordic Council, Finland, the US and Sweden. Other important donors include Denmark, Italy, Taiwan, Switzerland and Ireland.

BAS in Russia was established in 2000 and implemented in the North-West and Far East federal districts with funding from Finland, Denmark, Luxembourg, Norway, Sweden, Switzerland, Japan, the United Kingdom and the EBRD. To date €9.3 million of donor funding has been matched by €5.5 million in enterprise client contributions. 790 projects with MSMEs, engaging 280 local consultants, have been implemented with improvement of market performance and management effectiveness the most common types. The industry spread has been wide, with wholesale & retail distribution, food and construction & engineering being the most common sectors. BAS has also carried out 25 market development activities including trainings for local consultants and MSMEs.

In terms of cross-cutting issues, SBS Russia has in particular focused on facilitating rural development, with over 40 EGP beneficiaries and 50 per cent of BAS projects located in rural areas. EGP has implemented a number of projects to improve energy efficiency in the Urals in the last two years. In addition, SBS strongly promotes gender equality and help facilitate female and young entrepreneurship through training and direct assistance.

MSME and Consulting sector in Russia

The MSME sector

The full potential of the MSME sector remains untapped, with its share in GDP remaining low at around 11 per cent. Starting from a low base, the MSME sector in Russia has however gradually gained importance. According to the last World Bank Doing Business report conducted in 30 regions, there have been significant improvements in a number of regions in different areas of the business environment that made it easier to start a business, to deal with construction permits and register property. Significant challenges to conducting business in Russia remain.

The latest EBRD Business Environment and Enterprise Performance Survey (BEEPS V) indicated that around 25 per cent of MSMEs consider availability of skilled labour to be a major or very severe constraint to development. MSMEs find it difficult to afford qualified and trained personnel. Improving business skills and management quality would have a huge impact on the growth prospects of companies.

Management practices in Russian enterprises require further development. The recent EBRD Management, Organization, and Innovation (MOI) survey on management practices in developed and developing countries ranked Russia towards the bottom of the rating, only in front of Kazakhstan and Uzbekistan. The management score was on average lower than that for Belarus, Ukraine, Romania, Serbia, and China. Firms in the Far East Federal district however appear to be better managed than in other parts of Russia in terms of operations, monitoring and incentives management.

Given the current low level of national and international competitiveness of MSMEs, there is a pronounced need for the provision of high-quality business advisory services and targeted enterprise training. This will play a crucial role in helping MSMEs increase competitiveness and introduce upgrades in technology.

The consultancy market

The local consultancy sector serving MSMEs in Russia is generally underdeveloped. Although well developed in the main cities, the market remains fragmented and immature in the more remote regions and mostly offers standardised advisory services aimed at medium-sized companies. The local consultancy market in the regions is principally characterised by auditing, information services, or software companies that offer consulting services in addition to but not as a primary business. They fail to respond to the needs and demands of both start-ups and established companies. A large majority of consultants offer mainly advice in the area of development planning, quality management and certification as well as market analysis and planning. Conversely, there is a lack of expertise in computerised manufacturing systems and partner search.

Infrastructure of SME support

In the past five years, the government has increased its support for MSMEs following the July 2007 SME strategy, ‘Developing Small and Medium Scale Entrepreneurship in the Russian Federation’, allowing for better SME regulations and providing support to the growing number of MSMEs. The government is committed to raising the share of GDP generated by the sector. Various government programmes focus on the SME sector, ranging from facilitating administrative procedures to providing funds to alleviate financial constraints of the crisis on SMEs. However these efforts are not accessible to remotely located entrepreneurs and there is a lack of funding available to promote new SMEs and encourage young people to stay, invest and do business in Russia.

Russia features a range of banks and other institutions offering MSME finance, though the demand is still far from being met. Few banks in Russia are organisationally geared towards MSME lending, reflecting the fact that setting up the infrastructure needed to reach the clients and the perception of lending to this economic segment is perceived as a high risk and high cost activity. The crisis has further affected banks' lending to MSMEs. Only about 27 per cent of total domestic credit to the private sector is estimated to go to MSMEs. Lending to SMEs accounted for 9.3 per cent of GDP in 2011. Many MSMEs do not have bank accounts and access to bank loans, and over 20 per cent of small and medium firms named access to finance as a major obstacle to doing business, according to BEEPS V round conducted recently.

In terms of regulatory and legal matters, both credit registry and private credit information bureaus are in the early stages of development. Collateral and bankruptcy legislation is 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 the MSME segment. However, Russia has recently made registering property transfer easier by eliminating the requirement to obtain cadastral passport on land plots.

Continuation of SBS in Russia

With Russia having grown into a middle income country, the number of donor programmes and the extent of assistance have significantly declined. The country has emerged as a donor itself and has expressed an interest to support SBS activities in Russia. Funding from the Government of Russia will enable SBS to expand its current portfolio of activities and will be implemented in close cooperation with stakeholders including OPORA and Vnesheconombank (VEB).

In this new phase, SBS will continue to support SMEs through direct enterprise assistance in order to contribute to the development of a competitive and sustainable private sector in Russia. SBS will launch programmes in the Southern, Siberian and Urals Federal Districts in addition to the on-going programme in the Far Eastern Federal District. SBS will focus on activities in priority sectors such as agribusiness, building materials, machinery, wood processing and ICT in the Siberian Federal District; agribusiness, construction and engineering in the Southern Federal District; metalwork and machinery and also ICT in the Urals Federal District; construction materials, wood processing, logistics and transport in the Far-Eastern Federal District.

SBS will facilitate client access to finance through the EBRD and its partner financial institutions. Cross-cutting issues such as rural development, gender equality and environmental improvement will also be addressed.

EGP plans to further support the transfer of management skills. EGP will work with enterprises which have a potential for import substitution and to become major suppliers for the domestic market. In addition, it will focus on export-oriented companies helping them to internationalise their products and enhance their exposure to international best practices. EGP will focus on specific types of advice such as strategic planning, product development, financial management and sales and marketing. All projects will be carefully selected in close collaboration with the EBRD Resident Offices in the regions.

BAS plans to further enable MSMEs to access advisory services by facilitating projects with local consultants. A flexible grant scheme will be applied through annual updates of the Grant Guideline Matrix to prioritise intervention and avoid duplication of efforts with international donors and governmental organisations. Typically, higher grants will be allocated for smaller enterprises, for enterprises located outside of major cities, for more complex consultancy services and for projects involving services where market demand is less mature, including environmental management and advanced quality standards.

At the market level, SBS will promote best international practices in priority sectors through dissemination of successful showcases and trainings, creating a platform for dialogue amongst SMEs and public/private business development organisations. SBS will promote the use of business advisory services to stimulate demand and enhance the professionalism of the local consultancy sector in the regions. SBS will seek to develop a sustainable MSME support infrastructure through support to existing local institutions.

ANNEX 6 – TECHNICAL COOPERATION

TC COMMITMENTS BY DONOR THROUGH EBRD, 2009-2011

Donor	TC Commitments (€)
Austria	1,682,110
Canada	674,063
EBRD Shareholder Special Fund	10,278,240
EU	881,460
European Commission	2,645,437
Finland	1,967,860
Finland	635,532
Germany	3,951,754
Global Environment Facility	5,608,033
Japan	2,913,759
Netherlands	799,400
Nordics	4,494
Northern Dimension Environmental Partnership	598,000
Norway	330,000
Private Donors	39,130
Russia Small Business Programme	9,906,126
Spain	100,000
Sweden	72,750
Sweden	902,250
Taipei China	97,709
Grand Total	**44,088,107**

TC COMMITMENTS BY SECTOR THROUGH EBRD, 2009-2011

Sector/Team		TC Commitments (€)
SME Development*	Agribusiness	275,492
	Enterprise Support	361,290
	SBS (formerly TAM/BAS)	3,656,687
Chief Economist	Chief Economist	1,072,742
E2C2	E2C2	10,448,825
Environment	Environment	168,460
Financial Institutions	Financial Institutions	13,882,462
LTT	LTT	1,143,909
Infrastructure	Infrastructure	12,922,535
Other	Other	155,705
Grand Total		**44,088,107**

Note: Commitment values based on year end or period end data for each year.

* This sector category encompasses direct assistance to SMEs and indirect assistance through policy dialogue between the EBRD, the authorities and commercial/business associations (e.g. Investment Councils).

ANNEX 7 – SELECTED ECONOMIC INDICATORS

	2006	2007	2008	2009	2010	2011 *Estimate*	2012 *Projection*
Output and expenditure				*(Percentage change in real terms)*			
GDP	8.2	8.5	5.2	-7.8	4.3	4.3	3.2
Private consumption	12.0	14.2	10.5	-5.1	5.2	6.8	na
Public consumption	2.3	2.7	3.4	-0.6	-1.4	1.5	na
Gross fixed capital formation	18.0	21.0	10.6	-14.4	5.8	8.0	na
Exports of goods and services	7.3	6.3	0.6	-4.7	7.0	0.4	na
Imports of goods and services	21.3	26.2	14.8	-30.4	25.8	20.3	na
Industrial gross output	6.3	6.3	2.1	-10.8	8.2	4.7	na
Labour Market[1]				*(Percentage change)*			
Gross average monthly earnings in economy (annual average)	24.3	27.8	27.2	7.8	12.4	11.5	na
Real LCU wage growth	13.3	17.3	11.5	-3.5	5.2	2.9	na
				(In per cent of labour force)			
Unemployment rate (end-year)	7.2	6.1	6.4	8.4	7.5	6.6	na
Prices				*(Percentage change)*			
Consumer prices (annual average)	9.8	9.1	14.1	11.7	6.9	8.4	5.1
Consumer prices (end-year)	9.0	11.9	13.3	8.8	8.8	6.1	6.8
Fiscal Indicators[2]				*(In per cent of GDP)*			
General government balance	8.4	6.0	4.9	-5.9	-4.0	0.8	na
General government revenues	39.5	40.2	38.8	35.0	35.5	38.2	na
General government expenditure	31.1	34.2	33.9	41.4	39.0	36.6	na
General government debt	9.0	8.6	8.0	11.3	12.4	14.0	na
Monetary and financial sectors				*(Percentage change)*			
Broad money (M2, end-year)	48.4	43.5	0.8	17.7	31.1	22.6	na
Credit to the private sector (end-year)	48.7	50.8	36.5	2.4	12.9	26.4	na
				(in per cent of total loans)			
Non-performing loans ratio	1.5	1.5	2.5	6.2	5.5	4.7	na
Interest and exchange rates				*(In per cent per annum, end-year)*			
Deposit rate[3]	4.0	5.2	7.0	8.2	4.9	4.4	na
Lending rate[3]	10.5	10.8	15.5	13.7	9.1	8.5	na
Money market rate / Discount rate/ Policy rate	11.0	10.0	13.0	8.8	7.8	8.0	na
				(Ruble per US dollar)			
Exchange rate (end-year)	26.3	24.5	29.4	30.2	30.5	32.7	na
Exchange rate (annual average)	27.2	25.6	24.9	31.7	30.4	30.3	na
External sector							
				(in per cent of GDP)			
Current account	9.6	6.0	6.2	4.0	4.7	5.3	na
Trade balance	14.1	10.1	10.8	9.1	10.2	10.7	na
Merchandise exports	30.7	27.3	28.4	24.8	26.9	28.1	na
Merchandise imports	-16.6	-17.2	-17.6	-15.7	-16.7	-17.4	na
Foreign direct investment, net	0.7	0.7	1.2	-0.6	-0.6	-0.8	na
Gross reserves, excluding gold (end-year)	30.7	36.8	25.7	35.9	32.2	26.8	na
External debt stock	31.6	35.7	28.9	38.2	32.9	29.4	na
Public external debt	4.9	3.0	1.9	3.8	3.1	2.5	na
Private external debt	26.7	32.7	27.0	34.5	29.7	26.9	na
				(In months of imports of goods and services)			
Gross reserves, excluding gold (end-year)	12.9	15.6	20.2	16.4	13.9	13.6	na
Memorandum items				*(Denominations as indicated)*			
Population (end-year, million)	142.2	142.0	141.9	143.0	142.9	143.1	na
GDP (in billions of Rubles)	26,917.2	33,247.5	41,276.8	38,807.2	45,172.7	54,585.6	59,058.6
GDP per capita (in US dollars)	6,960.5	9,152.3	11,704.0	8,552.2	10,412.0	12,986.3	na
Share of industry in GDP (in per cent)	32.9	31.8	30.6	28.2	28.2	25.9	na
Share of agriculture in GDP (in per cent)	4.8	4.7	4.8	4.5	4.5	3.4	na
FDI (In million of US dollars)	6550.4	9157.6	19408.9	-8125.0	-8599.0	-14342.0	na
External debt - reserves (in US$ million)	-171630.7	-15472.8	62268.7	72314.7	43790.7	46701.0	na
External debt/exports of goods and services (in per cent)	96.6	122.8	77.7	142.2	109.3	94.7	na
Broad money (M2, end-year in per cent of GDP)	33.3	38.7	31.4	39.3	44.3	45.0	na

[1] Figures do not include emigrant workers abroad.

[2] General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign financed public investment programmes and net lending.

[3] Weighted average rate overall maturities from IMF International Statistics

ANNEX 8 – GENDER EQUALITY

Gender Inequality and Human Development

According to the UNDP 2011 Human Development Index (HDI), Russia is amongst the countries with a high human development index. It is ranked 66th out of 187 countries, which is around the regional average for Europe and Central Asia. The HDI is comprised of three dimensions: health, education and decent standard of living. The country ranks slightly lower in terms of the UNDP Gender Inequality Index (GII), at 59th globally. The GII is a composite measure, which captures the loss of achievement within a country due to gender inequality, and uses three dimensions to do so: reproductive health, empowerment, and labour market participation.

Labour force participation and gender pay gap

Women's employment rates in Russia are lower than men's. According to the Federal State Statistics Service of Russia, in 2009 the proportion of women aged 15 and older in the labour force was 57.6 per cent as compared to 67.5 per cent for men. The gender gap in employment may have a number of explanations, including the higher share of females in tertiary education as compared to that of males, and the difference in retirement age for men and women (60 years for men as compared to 55 years for women, according to the World Bank).Women earned on average 35 per cent less than men, when median monthly earnings were taken into account, according to the Federal State Statistics Service. This compares to an average 25 per cent in the EBRD[11] region.

According to UNECE, the proportion of women in 2010-2011 in Russia in tertiary education was much higher as compared to that of men (55.4 per cent for women and 44.6 per cent for men). Of note, however, is that 75.1 per cent of all graduates in the field of education were female whereas only 30.6 per cent of graduates specialising in subjects such as engineering, manufacturing and construction were female. This trend of gender differences in the fields of study has been observed for at least last decade for which data are available. This gender segregation in education results in occupational segregation in the labour market, as the table below shows.

[11] The averages reported are based on GPG estimates for the following 24 countries: Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Egypt, Estonia, Georgia, Hungary, Jordan, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan and Ukraine.

Russia: total employment by economic activity	Male	Female
Construction	83%	17%
Mining and Quarrying	78%	22%
Transport, Storage and Communications	72%	28%
Electricity, Gas and Water Supply	72%	28%
Agriculture, hunting and forestry	61%	39%
Manufacturing	59%	41%
Real Estate, Renting and Business Activities	56%	44%
Financial Intermediation	31%	69%
Hotels and Restaurants	21%	79%
Human health and social work activities	20%	80%
Education	19%	81%

Source: Laborsta, International Labour Organisation, 2008

According to the 2012 Women's Economic Opportunity Index of the Economist Intelligence Unit that ranks 128 countries on their ability to support economic advancement of women, Russia is ranked 66th globally and 24th in the EBRD region, which includes the countries of the southern and eastern Mediterranean (SEMED) region. Russia ranks particularly poorly in the areas of labour policy and practices relating to maternity and paternity leave, availability, affordability and quality of childcare services and legal restrictions on job types.
The mandatory minimum length of paid (fully) maternity leave is 140 days. The law does not provide for paid or unpaid paternity leave. Mandatory minimum length of parental leave is 955 days (until the child is three years old), which is partially paid.

Entrepreneurship, access to finance

There is no significant gender difference reported in access to formal financial services in Russia. According to the World Bank's Global Financial Inclusion database, (surveying approximately 1, 000 people using randomly selected, nationally representative samples) in 2011 48.8 per cent of male adults and 47.7 per cent of females owned an account at a formal financial institution.

According to the 2009 Business Environment and Enterprise Performance Survey (BEEPS), 33 per cent of 1,004 firms surveyed in Russia had women among its owners and 14.3 per cent had a female in top management. Of the firms surveyed, women comprised 41.6 per cent of full time workers. However, only 14.5 per cent of women were non-production workers. Of the 36.3 per cent of firms within the BEEPS survey sample that applied for a loan in Russia and had a woman among its owners, 15.3 per cent of these firms were rejected for loans. In comparison, 19 per cent of the 60.5 per cent of firms with no female owners that applied for loans were rejected.