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Editor's note

Russia's newly extended New Year holidays, which brought most of Russia to a standstill for nearly two weeks in January, ended with a bang. Apart from the protracted break, one of the questionable consequences of a raft of new laws that took effect on Jan. 1, giving working Russians an extra ten days for state-sanctioned drinking and truancy - an unheard-of extravagance for a transitional economy - two other laws also deserve a special mention. These are the highly controversial legislation that has de-facto and de-juror revoked popular vote for regional governors, and the 'monetisation' of Soviet-era subsidies and privileges.

These new laws, according to the country leadership, were enacted solely in the interests of the people. Keeping the current system of electing regional governors without the Kremlin's stringent oversight does not only constitute a weak spot in President Vladimir Putin's power vertical, but also poses tangible dangers that could threaten the country's fragile territorial integrity and sovereignty in the future. And going to work after three-four days of nonstop vodka drinking during the New Year festivities only constitutes a health hazard with little or no economic productivity - hence the logic for extending the holidays. The subsidy-monetisation law is expected to provide real cash in place of a battery of largely vestigial subsidies which, without due financial backup, have long become mere legislative declarations on paper.

Though these legal changes had been announced much earlier, they were not instantly noticed by the citizens who were busy toasting the arrival of the New Year. But the lethargy ended abruptly, when millions of pensioners and other beneficiaries of state subsidies blocked traffic in major cities in nationwide-street protests against the Kremlin's plans to revoke their Soviet-era subsidies. As usual, the government's good intention was defeated by the so-called unique Russian approach, which, in former Prime Minister Viktor Chernomyrdin's words, "always makes the authorities' best intentions end up producing the worst results." It is, therefore, not surprising that the government's new initiatives have produced exactly the opposite effects, prompting the largest anti-Kremlin public protests since President Putin took over the nation's political leadership in late 1999.

Major feature articles in this edition highlight the Kremlin's tax-recovery policies, the Kremlin's unrelenting drive to rid the country of its 'knighted oligarchy' and major problems in the energy sector. Our traditional spotlight focuses on initial public offerings by Russian companies as they seek access to local and international financial markets for capital needed to boost growth and expansion.

Christopher Kenneth
Managing Editor

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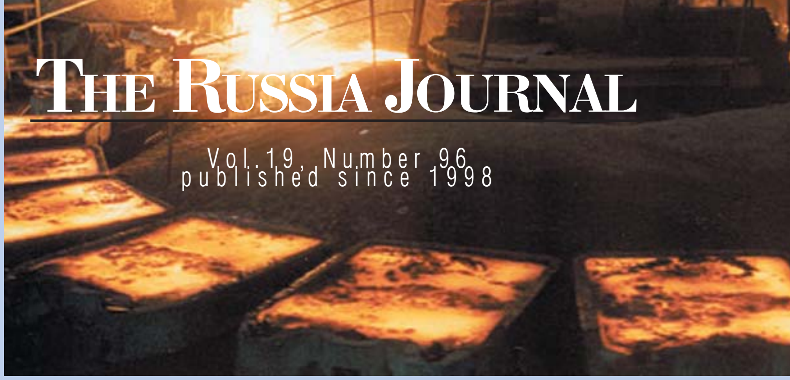
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Aton: Russia could contract 'Dutch Disease'

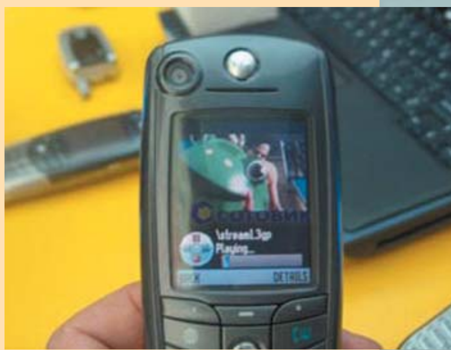
Soaring world-commodity prices mean Russia is a textbook candidate to contract the Dutch Disease, Aton said in a report dedicated to an in-depth analysis of the disease's increasing threat to the economy and the types of problems a full-blown disease will wreak on the country. The disease - first discovered in the Netherlands in the 1970s, hence the generic name - usually develops in an economy where a boom in natural resources leads to a marked appreciation in the national currency, and consequently, makes locally produced goods less competitive inside and outside the country. In its full manifestation, the disease lopsidedly favors imports, while exports are stifled up to the point of de-industrialization.

Aton says while its extensive study has revealed some of the classical symptoms traditionally associated with the ailment, a full-blown disease has yet to occur in Russia. [So far] there are no signs of a decline in manufacturing capacity - the most negative symptom of the disease. The ruble appreciation since 2000, another obvious symptom, could be seen as a danger sign, but the currency still remains largely undervalued, while the country's overall economic development has been moving ahead of import growth, the report said.

Aton, however, noted that Russia stands a high chance of contracting the disease in the long-term perspective because its 5 million bpd oil and 150 bcm gas export habit is likely to get even stronger as export volumes rise amid continued high oil prices - a scenario that will greatly increase the risk of ultimately contracting the disease. Aton prescribes large doses of economic diversification and continued fiscal prudence such as the ongoing build-up in the Stabilization Fund reserves.

Alfa Bank positive on VimpelCom's Kar-Tel, despite Turkish debt claim

Kar-Tel received a payment order of about $5.5 billion in mid-January purportedly issued by the Turkish Savings Deposit Insurance Fund. VimpelCom, the owner of the Kazakhstan-based firm, said the nature of the claim was unclear. But Alfa Bank suggests the claim could have stemmed from the fact that 60 percent of Kar-Tel was owned by two Turkish companies - Rumeli Telecom and Telsim. These entities were later redeemed on a mandatory basis for their nominal value in Kar-Tel by several court decisions, including that of the Kazakhstan Supreme Court. Besides, similar pay orders were reportedly sent to more than 200 other companies where the Turkish Uzan family, which previously controlled Telsim and Imar Bank in Turkey, had equity interests in the past. "Based on the current information, we agree with VimpelCom's statement that the pay order is 'completely without merit' and do not think that it represents a threat to VimpelCom's business in Kazakhstan," Alfa Bank said.



Aton says fears of state intervention aggravate capital flight

The volume of foreign direct investment (FDI) into Russia declined in 9M04, with the $6 billion reportedly invested in the country representing a year-on-year fall of 30 percent, Aton said in a report. While the Central Bank has yet to provide a full-year estimate, Aton puts its tally of Russia's FDI in 2004 at $7 billion-$8.5 billion, compared to $8 billion in 2003. Meanwhile, net private-capital outflow increased from $2.2 billion in 2003 to $6.5 billion in 2004, with the bulk leaving the country in 9M04, the report said. "Both banks and enterprises drove capital flight in 2004. In particular, the volume of non-repatriated export revenues increased dramatically amid renewed fears of state intervention."

Brunswick UBS: CBR's BoP results disappointing, but not surprising

The Central Bank's revised balance of payments (BoP) results for 9M04 point to a substantial increase in capital flight from the private sector, a

Market review

Market review

sharp decline in FDI in the second and third quarters, and quarterly values of portfolio investment remaining quite volatile. This is disappointing, but not surprising news, given increased political risks, UBS Brunswick said. "We believe the data is evidence of a worrying trend on the capital account side, driven by prevailing uncertainty on the future policy direction, though counter-weighted by currency markets favoring an appreciating ruble."

Aton optimistic on Sistema's pending IPO

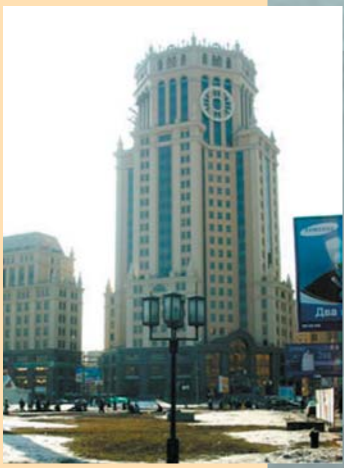
Sistema's pending IPO is undoubtedly welcome news for a market suffering from insufficient depth (low free floats) and breadth (excessive concentration in commodities), Aton said in a report. One of the major problems is the issue of valuation, considering the holding structure of the company. However, Aton argues that getting the price right need not be a problem, given the value of the company's assets concentrated in telecommunications (99 percent of 9M04 consolidated EBITDA). It puts its back of the envelope SOP valuation of the company at about $8.2 billion or $20.3/GDR, taking into consideration only key assets and total equity of $7.5 billion or $18.6/GDR. These include its stakes in MTS and MGTS, estimated at $7.5 billion ($18.6/GDR), other telecom businesses valued at about $400 million ($1.0/GDR), and real estate and retail holding estimated at $300 million ($0.7/GDR). Aton noted that this estimate only reflects how Sistema would trade if it were on a par with key subsidiaries. "To make the issue attractive, we believe Sistema's IPO should be priced at a sensible discount to market-implied SOP levels. More aggressive pricing would limit the scope of future performance, making the already-traded alternatives more interesting."

UFG positive on TNK-BP restructuring terms

TNK-BP has outlined restructuring plans aimed at consolidating most of its oil and gas assets in Russia into a single company. TNK, Onako and Sidanco and 14 other subsidiaries would be consolidated into a recently created entity - OAO TNK-BP Holding - by the end of 2005. The consolidation program also includes details of the pending swap and/or buyout proposals for minority shareholders on March 1 and between March-May 2005. TNK-BP's Ukrainian assets, Rusia Petroleum, a near 50 percent stake in Slavneft and BP-branded Moscow retail chain will not be included in the new legal entity. UFG puts the new company's equity value at $18.5 billion with free-float of about 7 percent, up to $1.3 billion. The company's shares will be traded on the RTS, but there are currently no plans for a depositary receipt program. "This will provide a new blue-chip investment opportunity in the oil and gas sector and, as such, is highly welcome," UFG said.

Brunswick UBS bullish on fixed-line telecom firms

Brunswick UBS has reviewed its ratings on leading telecom companies in its report on Russia's fixed-line telecommunications sector with a special focus on the 3Q04 results. Uralsviazinform's price target was raised from $4.30 to $4.35 and Center Telecom's from $0.34 to $0.38 (both upgraded from Neutral 2 to Buy 2). Northwest Telecom's price up from $0.70 to $0.74, Volga Telecom's from $4.40 to $4.62 and Siberia Telecom's from $6.40 to $7.23 (recommendation remains Buy 2 for all), while MGTS' price target was lowered from $17.60 to $17.10 (recommendation remains Buy 2) and Far-East Telecom's from $1.11 to $1.07 (upgraded from Reduce 2 to Neutral 2). Brunswick UBS senior telecoms analyst Vladimir Postolovsky noted, "We remain positive about the medium-to-long term prospects for Russia's local wireline incumbents, and this is reflected in our 12-month forward-looking target prices and investment ratings. The central pillar of their investment case remains the Sviazinvest privatization scheduled for 2005, which we believe will be the key catalyst for their re-rating."



Russians see 2004 as an unsuccessful year

Over 56 percent of respondents have declared 2004 as an unsuccessful year, characterizing the "leap year" as a very difficult, and even a very bad year, according to a poll result published by VTsIOM in December. The poll was devoted to a roundup of Russians' opinions on 2004 events and their expectations for 2005. This year's result contrasted sharply with that of 2003, which 55 percent of respondents described as a good one. The pollsters did not state the margin of errors.

Pessimism on the rise in Russia

Optimism seems to be giving way to pessimism as the number of Russians voicing "pessimistic expectations" in 2005 almost doubled to 39 percent in a poll conducted by VTsIOM in December 2004 from 21 percent in December 2003. The number of optimists dropped to 55 percent from 74 percent recorded in a similar poll in December 2003.

Russia discloses its diamond output

The Finance Ministry has released official data on Russia's diamond activities - production outputs, exports and imports starting from 2003 - in line with the Kimberley Process membership requirements.
According to the report, Russia produced diamonds worth $1.676 billion, or 33.019 million carats in 2003. The production volume stood at $948 million, or 17.763 million carats in the first half of 2004. Russia's volume of exports of rough diamonds in 2003 pegged at $883.4 million (about 37.83 million carats), while imports totaled $18.332 million (33,164 carats).

Customs revenues up by 2.5 percent to 1.2 trillion rubles

The volume of revenues collected in 2004 by the Federal Customs Service rose to 1.217 trillion rubles ($43.8 billion), or 2.5 percent higher than the forecast value for the year, according the agency's official statement. The Federal Customs Service and its affiliated agencies collect and funnel about $170 million to the state coffers every day. Customs-related earnings account for about 40 percent of the annual budget, or about 8 percent of the country's annual GDP.

Minimum wage increases to 720 rubles in Jan. 2005 and 1,100 in May 2006

President Vladimir Putin has finally endorsed amendments to the law on minimum wages in the country. According to the new version, the minimum wage will be 720 rubles ($25.95), effective from Jan. 1, 2005, and then rise to 800 rubles on Sept. 1, 2005 and 1,100 rubles on May 1, 2006. The federal budget has earmarked 19.8 billion rubles for propping up federal government workers' wages by 1.5 times on Jan. 1, 2005 and additional 8.3 billion rubles to increase it further to 800 rubles on Sept. 1, 2005.

A six-percent growth rate expected in 2005

The Russian economy is expected to grow by about 6 percent in 2005, Trade and Economic Development Minister German Gref has said. "The economy developed steadily and dynamically in 2004, ending the year at about 7 percent. We don't expect a bad situation in the economy in 2005 either, though the growth rate will be around 6 percent," he added. Gref, however, noted that the optimistic forecast depends, among others, on a quick end to current negative tendencies in the economy and the speed of liberal reforms in the country.

Defense Ministry to spend 40 percent of its budget on weapons

Russia has set aside 40 percent of its defense budget for the procurement of military equipment in 2005, Defense Minister Sergei Ivanov said. Staying within the allowed disclosure limit on defense expenditures which are jealously guarded by the State Secrecy laws, Ivanov noted that 20 percent of the budget will be spent on buying military equipment for the Air Forces and 20 percent more for the Navy.

Russia's external debts fall to $112.9 billion and 91.7 billion euros

Russia's sovereign, U.S.-denominated-external debts fell to $112.9 billion on Oct. 1, 2004 from $119.7 billion on Jan. 1, 2004, while its euro-denominated debts fell from 95.7 billion euros to 91.7 billion euros during the same period, the Russian Finance Ministry said. Volumes of other debts such as the Soviet-era commercial debts, Paris Club of creditors, International Monetary Fund and World Bank also fell in the same period.

Political news

Putin's rating still high, despite rising social protests

President Vladimir Putin's job-approval rating stood at 64 percent, against 27 percent of respondents who disapproved of his politics, according to poll results on approval ratings of key Russian political figures and institutions conducted by the All-Russia Center for Public Opinion Studies' (VTsIOM) in February 2005. High-income earners and young citizens fueled Putin's positive rating, while those expressing their disapproval were mainly middle-aged and pensioners who are more likely to be negatively affected by the latest social reforms, which have generated street protests across the country. Job-approval ratings of political institutions were much lower. The ratings for State Duma and the Cabinet in February, were respectively 18 percent and 25 percent, down respectively, from 23 percent and 27 percent in January.

Fradkov survives a no-confidence vote, accepts responsibility

Prime Minister Mikhail Fradkov went through the State Duma no-confidence proceedings in February almost unscathed, calling the meeting with the legislators a useful lesson. The motion gathered only 112 out of a simple majority of 226 votes needed to succeed in the 450-member parliament. The opposition had taken the Cabinet to task for botching important reforms in the country, including the welfare, pension and other social and administrative reforms. The no-confidence vote initiated largely by the opposition parties was doomed to fail from the start as pro-Kremlin United Party had been against such initiative. Addressing the State Duma prior to the vote on Feb. 9, Fradkov said he had intentionally come to the meeting without other Cabinet members as "a sign of his readiness to personally accept the full responsibility".

EU to finance human right projects in Russia

The European Union (EU) plans to finance projects, which can help uphold human rights in Russia, Marc Franco, the head of the European Commission in Moscow, said at an EU and Human Rights conference. In all, EU will spend about 870,000 euros for the projects, while the grants, which will be awarded on a competitive basis, can range from any sum to 100,000 euros. Applications will be accepted from March 10 through May 17. According to Franco, four main criteria will guide the award of the grants to successful applicants. These include using innovative approaches to encourage young people to participate in human rights activities in the country, more active information-related work designed to prevent illegal actions by the law enforcement agencies, support of freedom of speech and independent media, and the struggle against human rights violations in the North Caucasus.

Amendments to the state secrecy law

President Vladimir Putin signed an amendment decree that introduces changes to the list of data considered state secrets, the presidential press service reported in March, without detailing the nature of the changes.

State Duma ratifies Vienna Nuclear Damage Convention

The Russian State Duma has ratified the Vienna Convention on Civil Liability for Nuclear Damage. Three hundred and forty four legislators voted for the ratification of the document, which was signed in Vienna in May 1996, and creates an international legal system of liability for nuclear damage resulting from incidents at nuclear power installations. The convention also regulates the procedures, terms and principles of damage indemnity in the event of an incident at a nuclear facility.

August Summit to determine the CIS future

Vladimir Rushailo, the executive secretary of the Commonwealth of Independent States (CIS), said in March that the CIS summit, which will be held in Kazan, Russia, in August 2005, will determine the future of this organization. "We are currently analyzing matters related to reforming the CIS. Also, work is in progress to increase the effectiveness of the CIS structures," Rushailo said in Yerevan, according to Interfax.

Anti-terrorism funding measures key to curbing terrorism

Addressing a conference on terrorism in Novosibirsk in March, Nikolai Patrushev, director of the Federal Security Service (FSB), praised measures directed against funding terrorism, saying such steps are a key to curbing terrorist acts. "Special services and law enforcement agencies in many countries see anti-terrorism-funding measures as a key factor in the fight against terrorism," he added. Other issues tackled in the conference include drug trafficking, which many participants see as a major terrorism-funding source as well as measures to curb drug trafficking, especially from Afghanistan, currently seen as one of the biggest sources of illegal drugs in Europe.

Politics

Kasyanov resurfaces from hibernation with far-reaching political agendas

By Christopher Kenneth

Flashing his trademark boyish smile, ex-Prime Minister Mikhail Kasyanov emerged from self-imposed political inactivity in February to tell the nation and the world at large that he does not rule out the possibility of running for Russian presidency in 2008, when the incumbent president's second term expires in the Kremlin.

"Everything is possible," Kasyanov told a packed press conference on February 24, while feeding questions about his future political ambitions, including running for the nation's No. 1 post in 2008. "The most important thing is not who will be elected in 2008, but that that person is able to lead Russia back to a democratic path of development."

"My analysis of the prevalent trends in the country has me to an unequivocal conclusion: Russia is not honoring democratic values."

In the meantime, Kasyanov, who was making his first official public appearance since being fired from Russia's No. 2 post a year ago, said he plans to bring his mammoth economic, financial, and political wealth of experience, spanning over 25 years of public service, into the private sector. He has accordingly set up a new business venture, MK Analytica, a consulting, advisory, and research outfit that will help improve the Russian image abroad and its investment climate at home. "Our potential clients will be companies that already have operations in Russia, and our goal is to help them minimize the level of risks they face," he added.

These announcements about his short- and long-term business and political agendas put an end to rife speculations over the next port of call of a prime minister whose fast-track career was cut short by President Vladimir Putin on the eve of the presidential election on March 14, 2004. Since then, Kasyanov has been tooted to head several organizations, including a yet-to-be formed intergovernmental bank, potential candidacy for the Moscow mayoral office and several other employment proposals from Russian and international business and political structures. "After 25 years of public service, during which I held almost all possible posts in the country, I've decided to dedicate myself to private business," Kasyanov said.

"[And], if people are suffering from a reform, that is an obvious proof that such reform is entirely wrong, incorrectly drafted and being poorly executed."

But that does not mean that Kasyanov is going out of public politics for good, going by a series of far-reaching statements he made on the nation's current political, economic and social policies and acrid criticisms he poured on those behind them. "Russia has diverged from democratic values. Our country is heading in the wrong direction because the vector of reforms has changed. The new vector is wrong and this impacts negatively on the political, economical and social development of the country," he added. Kasyanov seems to be sending a strong message to the Kremlin that he has already secured the support of some Western governments, especially evident in mentioning of his visits to the United States in the past year and the broad support he had received both from political and business establishments there. "On my visits to the United States, I met a lot of people in the political and business circles, with whom I analyzed all events in the in Russia and the world at large," he said. Some Russian media outlets even went further to quantify the nature of the support, with one expert telling TVC's Post Scriptum program that Kasaynov has already secured about $6 million to run his media operation. Others have already started comparing him with Ukrainian President Viktor Yushenko, who used Western support, including huge financial backing and political arm twisting, to seize power through the "Orange Revolution" and nationwide street protests in Kiev in late 2004.

Elaborating on the political vector change in the country, Kasyanov noted, "my analysis of the prevalent trends in the country has me to an unequivocal conclusion: Russia is not honoring democratic values, which include independence of the judicial system, press freedom, a developed market economy, free entrepreneurship, protection of private property, political pluralism, democratically elective posts and separation of power."

He also criticized the Kremlin for replacing direct gubernatorial elections with de-facto appointment of regional leaders from Moscow. "The work of the federal government with regional governors calls for patience, and revoking gubernatorial elections is simply too simple a solution to such issues," Kasyanov said. "And, if people are suffering from a reform," he said in reference to the highly controversial monetization law, "that is an obvious proof that such reform is entirely wrong, incorrectly drafted and being poorly executed." He called for consolidation if all democratic and liberal 'progressive forces' in the society to help change the situation for the better.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Over Rub522 billion in Stabilization Fund

Russia has accumulated about 522.3 billion rubles in the so-called Stabilization Fund specially set up by the government in early 2004 to hold excess revenues from sky-high oil prices. The aim is to help cushion economic vagaries if the oil prices go down in the future. The new level is very vital as it has overshot the 500 billion-ruble benchmark, over which the government can start investing parts of the accumulated reserves in economic sectors within and outside the country to generate more funds. The fund was started on Feb. 1, 2004 with surpluses of about 106 billion rubles from the 2003 budget.

Russia grosses over $73 billion in foreign investments

The gross volume of foreign investments into the Russia's economy as of the end of September, when the latest tallies were made, stood at $73.43 billion, according to the Trade and Economic Development Ministry. According to documents on Russia's Social and Economic Developments in 2004 which was tabled by the ministry at a Cabinet meeting in December, about $29.14 billion of this sum was invested into the economy between January-September 2004, while about $17.93 billion was shipped out of the country during the period. Topping the lists of largest investors are the Netherlands, which accounted for $10.68 billion, Luxembourg with $10.56 billion, Cyprus with $9.58 billion, Germany with $9.38 billion, the Great Britain with $7.42 billion, the United States with $6.67 billion and France with $4.21 billion.

Budget 2004 surplus tallies over Rub 690 billion

Preliminary evaluation of the execution of budget 2004 has put the surpluses accumulated between January and October 2004 at about 690.1 billion rubles, up from a surplus of 287.7 billion rubles in 2003, according to the Federal State Statistics Service. Government's gross revenues in the same period amounted to 2.744 trillion rubles against expenditures of 2.065 trillion rubles, compared respectively, to revenues of 2.128 billion rubles and 1.840 trillion rubles in 2003.

Russia's fixed capital investments surge

The volume of fixed capital investments in Russia increased to 258.3 billion rubles in November, a cumulative increase of 11.1 percent from January to November 2004, or a year-on-year hike of 12 percent, according to the Federal State Statistics Service.

Investments into construction surge by 11 percent

The volume of investments funneled into the construction industry rose to 2.29 trillion rubles ($82.52 billion) from January to November 2004, or about 11.1 percent compared to the corresponding period in 2003, according to the Federal State Statistics Service. The volume of work under construction rose year-on-year by 10 percent to 1.3 trillion rubles in the first 11 months of 2004, and month-on-month increase of 8.8 percent to 142.6 billion rubles in November 2004.

Foreign investments in Russia's IT sector rises to $1.1 billion

The volume of foreign investments in the Russian IT sector surged by 60 percent to $1.1 billion in 2004, Russian Information Technologies and Communications Minister Leonid Reiman said. At the same time, local investments increased by 24.5 percent to $4 billion.

Sale of carbon-dioxide quotas to fetch billions of dollars

Russia is likely to earn between $1 billion and $3 billion from sales of its carbon-dioxide quotas under the Kyoto Protocol to willing buyers, Vsevolod Gavrilov, deputy director of Nature and Land Use Department of the Trade and Economic Development Ministry said, according to Interfax. The first carbon-dioxide quota sales may be signed as early as in the second quarter of 2005, he added.Under the Marrakech agreements, a country cannot sell more than 10 percent of its reserve, he said. Our 2008-2012 reserve totals 5 billion tons. Consequently, we may sell within 500 million tons," Gavrilov said. "The sale of quotas is expected to take place in two stages - the so-called truncated version, and the subsequent period. Truncated version deals are not likely to fetch more than hundreds of millions of dollars, while those of the subsequent period can fetch from $1 billion to $3 billion," he said.

Putin to restore order in Russia after a decade of 'knighted oligarchy'

By Ajay Goyal

Multinational corporations and Russian oligarchs should be making bonfires out of their external-relations strategies in Russia over the holiday season.

So many companies and their advisers had based their strategies on blatant defiance and absolute disrespect for the law, sponsoring corruption and funding political opposition, that the new Russia with enforceable laws under President Vladimir Putin seems an alien place they will have to get used to fast. Russian corporate public-relations agencies and executives who took on the role that the electorate deprived the Yeltsin power elite of by voting it out of parliament in 2003 will have to assume lesser roles of being corporate executives with commercial aims only. Anything more - any political games, meddling with sovereign affairs and fuelling anti-Russia fires - will put their businesses at immeasurable risks.

The Russian government, after a series of legal maneuvers, privatized Yugansneftegaz, a major oil company, which had previously belonged to a group of people that are currently facing serious criminal charges. State-controlled Rosneft will pay over $9 billion for the company in lieu of parts of Yukos' back taxes to the government. Yugansneftegaz - which accounts for nearly 60 percent of Yukos' oil production and nearly 17 percent of Russia's total oil reserves, was privatized for a meager $350 million a decade ago by Yukos owners who are currently in custody facing charges of aggravated fraud, forgery, and tax invasion in unprecedented proportions. To most Russians, the reacquisition of this company by the government is akin to the police walking into the homes of robbers, catching them red-handed and returning the loot to previous owners - with interest.

Russian prosecutors have gathered and taken to court formidable evidence of what they call "running criminal gangs" against Yukos former owners. Opposition to Russian prosecutors has been strident from the U.S. government, diplomatic circles and 'pink press'. Companies that have based their Russian strategies on calculations that Putin and the Kremlin would buckle and cede sovereignty to foreign powers on strategic economic issues as it was the case in the past decade will soon find out that their calculations were wrong. The 're-nationalization' of Yugansneftegaz and court cases against the owners have sent shudders down the spines of Russian oligarchs - the people who were knighted to oligarchy by Boris Yeltsin after they stole the nation's sub-soil resources and other vital assets during the scam privatization sprees in the mid-1990s.

Tax-evasion charges throw oligarchs into a bad mood

Russian oligarchs are in a grim mood this holiday season. Many of them have been handed back-tax bills from 2000 and 2001 that run into the hundreds of millions of dollars. The Russia Journal has reported that the oligarchs will be asked to hand over the money to treasury that Putin suspects they have avoided paying using illegal tax shelters, transfer pricing and corrupt relations with previous governments. The access that Russian oligarchs and their Western partners enjoyed in the Russian 'White House' and the Kremlin is a thing of the past, especially since Putin's re-election.

> "Putin has changed Russia and its government fundamentally and steered it away from years of blatant looting and corrupt rule. The extent of change may not be visible on the surface and the outcome is yet uncertain, but the direction Russia will take in the next four years is now certain."

The Russian cabinet of Prime Minister Mikhail Fradkov is no longer beholden to the "Family" and, while it still listens to all, it acts only on instructions from the Kremlin, which has been imbued with a new sense and strategy to serve and protect the Russian national interests. While the Russian legal framework has

become increasingly business-friendly, providing a tax-incentive-filled environment favoring business over bureaucracy, Putin is likely to be unrelenting in his assault to ensure that those who fail to pay taxes on the super profits made during the commodity-price windfall will lose control of their companies. Foreign corporations have often depended on international accountants, auditors and law firms for their Russian strategies. Their main business activity has been disbursing advice and certification of accounts of Russian companies that have siphoned off nearly $200 billion from the country over the past decade, according to estimates from international banks.

Accounting firms that have been tainted in corporate scandals such as Enron, WorldCom, Parmalat, Fannie Mae and the downfall of other giants of U.S. and European businesses have not been charged publicly of any wrongdoing in Russia. There have been accusations of wrongdoing from minority investors and the latest class-actions suits in New York that will force them to tone down their aggression and creativity in enabling Russian natural resource monopolies to blatantly strip the country of its assets. If the Russian government and its financial watchdogs, restive but poorly trained and lacking in resources, fail to diminish these financial planners' creativity in devising ways of tax avoidance, class-action suits in the United States definitely will. Russian prosecutors however, may not wait for either and will pursue criminal charges against all those that evade taxation. Two major Western accounting and audit firms have been investigated in recent years in Moscow, while incriminating evidence of their wrongdoings in the United States and Europe is closely followed by Russian watchdogs, who will bring pressure on the firms to show respect for Russian laws and the rights of minority shareholders. At Russian economic forums, auditors will have to be careful not to solicit business on promises of tax minimization; economic security and sustainability will be atop of foreign investors' minds.

New business and PR strategies required

Russia's post-2004 business strategies will have to consider commercial aims and economic security being risked by accounting and legal advisers who fail to extract their clients from trouble at the hands of a government that is unwilling to compromise on these issues. Law firms and public-relations agencies that have taken the role of political opposition to Putin should be getting the message that business must not overstep its bounds. Mikhail Khodorkovsky and his public-relations managers, as with other oligarchs, have been running their own image-building campaigns on themes of their paymasters being diehard entrepreneurs in "bad Russia under bad Putin." Many of them have run parallel foreign policies, not always in tune with Russian national interests, and at times even blatantly against them. They paint themselves as entre-

> "The 're-nationalization' of Yugansneftegaz and court cases against the owners have sent shudders down the spines of Russian oligarchs - the people who were knighted to oligarchy by Boris Yeltsin after they stole national sub-soil assets during the scam privatization sprees in the mid-1990s."

"Yugansneftegaz, which accounts for nearly 60 percent of Yukos' oil production, was privatized for a meager $350 million a decade ago. To most Russians, the reacquisition of this company at over $9 billion in December is akin to the police walking into the homes of robbers, catching them red handed and returning the loot to previous owners - with interest."

preneurs and free-market promoters and fighters who are pitted against a government and state stifling businesses.

The government is intent on pulling down the falsehoods of this facade. U.S.-based think tanks that sold the criminality of the Yeltsin years to the West and have been vocal in opposition to Putin no longer carry weight in Moscow. Businesses will soon find out that Western lobbyist groups and think tanks cannot return Russia to the days of Byzantine customs, tax and corporate codes that could be exploited through their links with corrupt politicians and bureaucrats. Instead, Putin has given a framework of low taxes, straight and simpler legal codes, simplified customs procedures designed to make business more transparent and make crooked deals impossible in the country. New Russian strategies will have to be in compliance with the laws and engagement in constructive dialogue for change. The PR agents of Moscow that have fed anti-Russia, anti-Putin bile to the handful of Western reporters stationed in Moscow will have to eat their words. Companies will find that their PR agents can be a drag on their own reputations and the baggage of past affiliations they bring, although severed, can have negative implications. PR agencies' ability to plant stories may be undiminished, but such plants generate cynicism and attract notice of law enforcers.

Corporate executives will demand that PR agencies distance themselves from politicians and do not compromise their commercial interests by indulging in political and power play which has been the hallmark of the Moscow public-relations profession. Khodorkovsky made a brave stance at the residence of U.S. ambassador in the summer of 2003 before he was dragged a plane by FSB agents and sent off to prison. Foreign companies and Russian oligarchs have now recognized that there is no diplomatic protection from financial crimes. The days when banks could operate inside Baltic embassies and take diplomatic immunity for money laundering are long gone. Political activism and interference in Chechen affairs from European ambassadors has caused lost opportunities for companies closely tying themselves to their governments' policies.

No more sale of strategic assets without Kremlin's approvals

Corporations will have to distance themselves from individuals and institutions that show disdain for sovereignty of foreign nations in times of crisis. Global oil giants that struck some deals with Russian oligarchs and had come to realize that Kremlin sanction was essential for all such deals to go through and remain valid. Weeks before his arrest, Khodorkovsky had arranged for then-Prime Minister Mikhail Kasyanov to give a green light to the sale of a strategic stake in Yukos to a U.S. oil firm. Since then, two major oil deals involving LUKoil-Chevron and Total-Gazprom

have been approved, each by Putin. Oil majors will learn that while the Kremlin will welcome strategic investments to develop new fields, "the sale of Soviet-era finds, even at best valuations to Western companies, will be off the agenda. U.S. companies, and some Europeans with them, find this a new circumstance incomprehensible after years of dealing with Russian ministers and members of Yeltsin coteries that were willing to sell nearly anything to anyone. American lobbyist groups with access to high offices in Moscow are finding themselves irrelevant. Business lobbyist groups such as USRBC of Washington, D.C., find out that they no longer have any influence in Moscow and their friends in Washington cannot call the shots they could until five years ago. Their endorsement can cause problems rather than quick facilitation.

Harvard University, whose former employees have been accused of wrongdoing in Russian privatization, was the host of a celebrated Russian forum for many years. The forum decorated George Soros, a man who has made himself as unwelcome in Moscow as in the White House before falling into irrelevance when Russians stopped making more than a cursory presence. The American Chamber of Commerce in Moscow held its Christmas eve-networking event at a Turkish-owned supermarket, pointing to a new low in its status. The biggest pressure will be on U.S. companies to find new channels of communication and build new strategies on the Russian market. For over a decade, the balance of foreign business in Russia and the bulk of external commercial activity has focused on dealings with oligarchs. Now many of them are being chased by international arrest warrants. Private banks and investment funds will have to commission new diligence processes of their Russian clients whose billions no longer keep them safe from prosecution in Russia.

"U.S.-based think tanks that sold the criminality of the Yeltsin years to the West and have been vocal in opposition to Putin no longer carry weight in Moscow. Businesses will soon find out that Western lobbyist groups cannot return Russia to the days of Byzantine customs, tax and corporate codes."

Reform also targets official corruption

The new assertive style of President Putin is equally hard on internal corruption, which flourished during the years of oligarchy. Putin is now going forward with the administrative reform and exclusion of bureaucracy from business processes that are better regulated by the market. Putin has changed Russia and its government fundamentally and steered it away from years of blatant looting and corrupt rule. The extent of change may not be visible on the surface and the outcome is yet uncertain, but the direction Russia will take in the next four years is now certain.

Putin has repeatedly called for business to be more responsible toward the community. This call has been directly contradicted by some of Russian oligarchs, and specifically given vocal opposition by Pyotr Aven of Alfa Bank, who has countered the tenets of corporate citizenship proposed by Putin. Oligarchs, who have paid self-imposed taxes and thrown some 'small changes' at sports and charity so far, can no longer expect diversion of scrutiny by obtaining "diplomas of good behavior from audit firms". An audit firm of international status is offering an audit certification of charity and corporate citizenry to companies in Russia for a six-figure sum, but such certifications will not save companies and their owners and/or CEOs from facing up to real challenges of corporate social responsibility. The task of Putin's Perestroika is by no means complete, but Putin has preference for fundamental change rather than revolution. In this new assertive Russia, an increasingly business-friendly country, foreign companies will find an all-new challenge of formulating and adhering to high ethics, corporate citizenship and external relations.

MTS subscriber base hits 34.2 million

Mobile TeleSystems (MTS), the NYSE-listed and Russia's largest mobile services provider, attracted 17.5 million new clients in 2004, bringing its end-2004 subscriber base to 34.2 million, according to the company's press service. Russia led the pack with about 26.5 million subscribers, followed by Ukraine with 7.4 million and Uzbekistan with about 300,000.

New differential regressions in Unified Social Tax rates

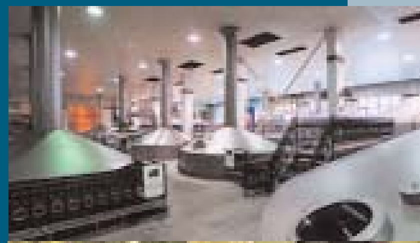
The new Unified Social Tax rates will henceforth range between 26 percent and 2 percent from the previous flat level of 35.6 percent, according to the new differential regressive scales in the federal law, which took effect Jan. 1, 2005. The rates are inversely proportional to the annual sum of employees' wages paid by a company. The highest rate - at 26 percent per annum - will apply to companies whose annual gross sum of employees' wages equals or is less than 280,000 rubles. Annual sum of employees' wage packages higher than 280,000 rubles, but less than 600,000 rubles, will attract 10 percent tax rate, while gross salary packages exceeding 600,000 rubles will attract only 2 percent rate.

ConocoPhillips boosts its LUKoil stake to over 10 percent

Springtime Holdings Limited, a subsidiary of U.S.-based international oil major ConocoPhillips, has boosted its stake in LUKoil to 10.1 percent for an undisclosed sum from 7.59 percent stake it had already acquired in the oil company. The official announcement followed an earlier statement on the issue made by LUKoil President Vagit Alekperov when he said ConocoPhillips had increased its stake in Russia's No. 1 oil company to over 10 percent.

ConocoPhillips bought the 7.59 percent stake for about $1.988 billion in a tender on Sept. 29, 2004, which was seen as the best conducted tender in the 15-year history of Russian privatization.

Baltika posts 23 percent-sales growth



Baltika Brewery Co., the nation's No.1 beer producer, reported a 23 percent increase in its sales figures in 2004, pushing the end-of-year gross sales volume to 20 million hectareliters of beer. Company management has attributed the higher sales volume to a new marketing strategy which has focused on the brands' restyling and independent positioning of core products on the market, according to AK&M. Baltika Brewery Co. has five breweries, producing 30 types of beer and mineral water, and 29 distribution centers.

AvtoVAZ's production up by 2.5 percent

AvtoVAZ, Russia's largest car manufacturer, produced 718,000 automobiles in 2004, or an increase of 2.5 percent over 2003's data. About 615,000 cars were sold on the domestic market, up by 1.1 percent from 2003, while 92,000 cars were exported to other countries, the company said. Preliminary plans envisage keeping production at the same level in 2005.

LUKoil's revenues up 50 percent

LUKoil's consolidated revenues calculated under U.S. GAAP soared by over 50 percent in the first nine months of 2004 to peg at $24.431 billion, while its net profit rose to $3.095 billion, or just one percent higher than similar data in 2003, the oil major said.

Corporate tax

Oligarchs
on the search for hide-outs as Kremlin intensifies its tax-recovery warrants

By John Helmer

Amid signs that the Kremlin is behind the growing pressure of large back-tax claims that have been lodged against oligarch-owned businesses in Moscow, Norilsk Nickel has issued a $750 million share buyback offer, which has convinced Moscow brokers that it is a cash-out scheme to put at least half a billion dollars in the offshore pockets of Vladimir Potanin and Mikhail Prokhorov, the co-owners of the company.

One implication is that, if they are feeling the heat and in a hurry to expatriate cash, prolongation of the fight in South Africa between gold-mining companies Gold Fields and Harmony Gold could accelerate disposal of their 20 percent Gold Fields stake, unraveling the October 16 pledge that Potanin and Prokhorov gave Harmony Gold to support its takeover.

The Kremlin tightens its tax-recovery policies

A summary of pending tax claims indicates the rising temperatures against oligarchs in Moscow at the moment. The tax authorities have already descended on Roman Abramovich, Mikhail Fridman, Viktor Vekselberg, and the steelmaker, Mechel.

Sibneft, which has been returned to Abramovich after the Russian courts nullified the Yukos takeover of last year, has been charged with a back tax claim for 21 billion rubles, or $733 million. Fridman and Vekselberg are two of the three original owners of Tyumen Oil Company (TNK); the third owner was Len Blavatnik. At the beginning of 2003, this trio sold TNK to British Petroleum (BP) on terms that deferred BP's payments over several years, and would indemnify BP in the event the Kremlin hit the company with back taxes and other claims. The first back-tax claim against TNK estimated at $89 million was handed to the company in late 2004. TNK's response was that "we don't regard this as a back-tax claim. We regard it as a preliminary assessment, and we are in negotiations [with the tax authorities]." BP's reaction was a little different. It said it was "too early to tell" what would happen in the tax negotiations, but that whatever the outcome, BP was relying on the indemnity.

Later, VimpelCom, a NYSE-listed mobile telecommunications operator controlled by Fridman, was served with a $158 million tax claim for 2001. The company's stock lost more than a quarter of its value, and the Russian stock index (RTS) dropped 5.5 percent on market sentiment that the move was aimed by the government at the oligarch, and that other claims would follow. VimpelCom responded publicly, saying it would appeal the claim. Privately, it fostered the interpretation that the claim was a revenge by members of the government, led by Communications Minister Leonid Reiman, whom Alfa Group has attacked in a court battle in the British Virgin Islands, where the two are fighting over a stake in another Russian telecommunications operator. Responding to the Alfa Group attack, Reiman said last month: "Blackmailing officials is the way Alfa Group got used

Corporate tax

to doing business in the 1990s. It should realize time has moved on." Official corruption and commercial rivalry were also claimed by the Russian steel and coal group, Mechel, as the reason for a weekend raid on their offices in Moscow by Interior Ministry officers, purportedly pursuing a tax audit. In September 2004, the Tax Ministry sent an official letter to the Cabinet that Russian metals exporters were underpaying tax by large amounts through transfer pricing, regional registration and tolling schemes. Mechel was not named in the report, which identified below-norm tax payment rates for the three largest mills - Magnitogorsk, Severstal and Novolipetsk.

"Norilsk Nickel's tax position with the Kremlin has been visibly insecure ever since President Vladimir Putin said, while on a visit to the region three years ago, that the company wasn't paying enough tax."

Mechel Group issues warnings to investors

In its prospectus for a share offering on the NYSE in October, Mechel warned U.S. investors that it might face "significant losses" if Russian tax authorities "challenge our prices and proposals adjustments". The warning is contained in the F-1 registration statement, presented on Oct. 4, 2004 to the U.S. Securities and Exchange Commission (SEC). According to consolidated financial data presented in the prospectus, the Mechel Group paid income taxes of $74 million in the first half of 2004, reflecting a rate of 4.5 percent of revenues totaling $1.6 billion. In 2003, according to the U.S. data release, the income tax payment rate was 2.3 percent, and in 2002, 0.2 percent. In a listing of risk factors associated with the offer of the group's shares, Mechel says that Russian transfer pricing rules, which took effect in 1999, empower the tax authorities to impose additional tax on companies when transfer pricing between related entities, or in foreign trade transactions, is found to differ from market pricing by more than 20 percent. The rules, according to Mechel, "are vaguely drafted, leaving wide scope for interpretation by Russian tax authorities." Acknowledging the risk of a challenge, the prospectus says that "if such price adjustments are upheld by the Russian courts and implemented, our future financial results could be adversely affected. In addition, we could face significant losses associated with the assessed amount of prior tax under-paid and related interest and penalties."

"Russian transfer pricing rules, which took effect in 1999, empower the tax authorities to impose additional tax on companies when transfer pricing between related entities, or in foreign trade transactions, is found to differ from market pricing by more than 20 percent."

According to the prospectus, "widespread tax evasion" is noted as a general factor in Russia's economic instability. But Mechel also suggested that the Tax Ministry's "crackdown on certain Russian companies' use of tax optimization schemes" may be "selective". Mechel claimed the weekend tax raid was intended to scare the company out of the bidding for a 17.8 percent-state stake in Magnitogorsk Metal Plant, Russia's largest steelmaker slated for auction on December 22. Magnitogorsk's management, which already controls a majority of the shares, is favored to win. But if Mechel is deterred, the auction price could be more than $100 million cheaper. "Somebody is insisting on checks at Mechel Trade House to prevent their bid for Magnitogorsk Metallurgical Plant," Alexei Sotskov, Mechel's spokesman, said. "Currently, we are appealing against the checks." The Tax Ministry responded: "We don't have information about that check. The Tax Ministry didn't initiate it." A spokesman for the Interior Ministry added: "In the Moscow head office we didn't hear about that yet." The lack of confirmation of a tax probe at the federal level could indicate that someone has paid regional officials to launch the raid. What difference it would make to the bidding for Magnitogorsk is another question, especially since Magnitogorsk could face serious tax claims itself.

Norisk Nickel's shaky position on tax issues

Norilsk Nickel's tax position with the Kremlin has been visibly insecure ever since President Vladimir Putin said, while on a visit to the region three years ago, that the company wasn't paying enough tax. Two months ago, Norilsk Nickel was identified in the Tax Ministry report on metals exporters as paying tax at a rate of 19 percent of revenue, well below the oil company norm. A report by the state auditor, the Audit Chamber, is expected to throw light on the legality of the privatization schemes, which were used by Potanin and Prokhorov to take control of the company almost a decade ago. To local investment banker Brunswick UBS, the share buy-back proposal from Norilsk Nickel is a sign of "concerns regarding the potential political risks surrounding Norilsk Nickel and the long-term strategy of its core shareholders."

According to Dmitry Usanov, the company's head of investor relations, the company is proposing to buy up to 12.5 million shares for a price of 1,680 rubles. The offer period will be from December 15 to January

15. At the U.S. dollar-ruble current exchange rate, the offer price is $60 per share, representing an 8 percent premium on the market price on December 1. But the share price has been slipping fast, and so the generosity of the premium has grown proportionately. It is now 28 percent. Usanov has declined to respond to questions.

Potanin, who controls the Moscow-based Interros holding, and Prokhorov, the CEO of Norilsk Nickel, have reported to the U.S. SEC that they each control 25 percent of the company's shares, with Interros controlling another 9 percent, according to a recent report by Brunswick UBS. Renaissance Capital, another Moscow investment bank, estimates that the two men control directly and indirectly up to 59 percent of Norilsk Nickel shares. Another 29 percent of the shares are controlled by foreign investors through American Depositary Receipts, with 12 percent attributed to other unidentified beneficiaries.

"Potanin and Prokhorov have been expecting a downturn in their share price, and were frightened to take their cash in the form of a larger dividend. Dividends are taxable, according to the Russian tax code, while capital gains on a share sale are not."

According to Brunswick UBS, technical, tax and pricing issues suggest that "core shareholders are likely to be the key sellers in the tender." According to a source close to the company, a normal plan for a share buyback in the West would involve share purchases in the market, at market pricing. The normal method for returning cash to shareholders would be a special dividend. Why Norilsk Nickel would propose a tender with a price cap that creates, the source said, "universal suspicion. Why are the core shareholders taking the money off the table?"

Fedor Tregubenko, metals analyst at Brunswick UBS, believes that Protanin and Prokhorov have been expecting a downturn in their share price, and were frightened to take their cash in the form of a larger dividend. Dividends are taxable, according to the Russian tax code, while capital gains on a share sale are not. The official proposal aims at a buyback of 5.8 percent of the equity, for a total outlay of $750 million. So far this year, the company has announced an interim dividend for the nine-month period to September 30 of $305 million.

According to evidence of communication between Norilsk Nickel and Gold Fields in August and September, the Russian company knows it is under investigation for its Gold Fields purchase, and is worried. Russian Central Bank and Kremlin sources have told Mineweb that the investigation of that transaction is focusing on violations of Russian capital control laws, and on return of the funds to Russia.

According to Brunswick UBS, the likely outcome of the buyback scheme is that Potanin and Prokhorov would "sell roughly 9.7 million shares, or 78 percent of the total offer, and receive roughly $585 million. Under this scenario, core shareholders would just marginally dilute their ownership [of Norilsk Nickel] from 58.5 percent to 57.3 percent."

Minister calls for a new law to regulate tax-arrears issues

Trade and Economic Development Minister German Gref has called for the adoption of a new law to protect businesses against unjustified tax claims. The adoption of the new law, according to Gref, would reflect international standards, which will allow a company to demand an audit of its tax payments and block further tax claims by the government.

Gref said the measure would declare a company that successfully goes through the audit process free of tax arrears. "It is very important to put in place a legal mechanism to protect taxpayers. At present, no such guarantees exist in Russia."

Gref's statement came on the wake of huge, back-tax claims against VimpelCom, the nation's No. 2 largest mobile operator, which has been handed down a multibillion-ruble, tax-arrears bill for 2001 in late 2004. Specifically, Russian tax authorities are demanding 4.4 billion rubles from VimpelCom - 2.5 billion rubles in back taxes for 2001 and 1.9 billion rubles in unpaid interest and fines. VimpelCom Vice President Valery Goldin said the local telecom giant could also face back-tax claims for 2002 and 2003.

Gref said the Trade and Economic Development and Finance ministries planned to discuss the tax claims against VimpelCom. Deputy Finance Minister Sergei Shatalov has been tasked with studying the company's tax documentation, he added.

Spotlight

By Christopher Kenneth

IPO bandwagon gathers speed as the economy enters sixth year of growth

Three successful initial public offerings (IPOs) were executed in as many weeks in November 2004, and more IPO launches are expected in 2005-06 as owners and CEOs of Russian companies go to financial markets in search of capital. These companies are expected to reap, at least, about $30 billion from IPO and other similar programs by the end of 2006.

IPO club expansion

The troika of newcomers to the Russian IPO club in late 2004 included Sedmoi Kontinent, a Moscow-based grocery retail giant, which floated 13 percent of its stake for about $80.7 million on the Russian Trading System (RTS) on Nov. 12, 2004. Sedmoi Kontinent was founded in 1994 as a 100 percent subsidiary of Sedmoi Kontinent Investment, a holding company. It is currently ranked seventh largest retail outlet in Moscow with 63 outlets in the capital. It posted a turnover of about 10.5 billion rubles in 2003 and 6.6 billion rubles in the first half of 2004.

"We expect a boom of IPOs in the country in 2004-05 as more Russian companies enter the local stocks market, which is expected to grow at about 40 percent in the next two years."

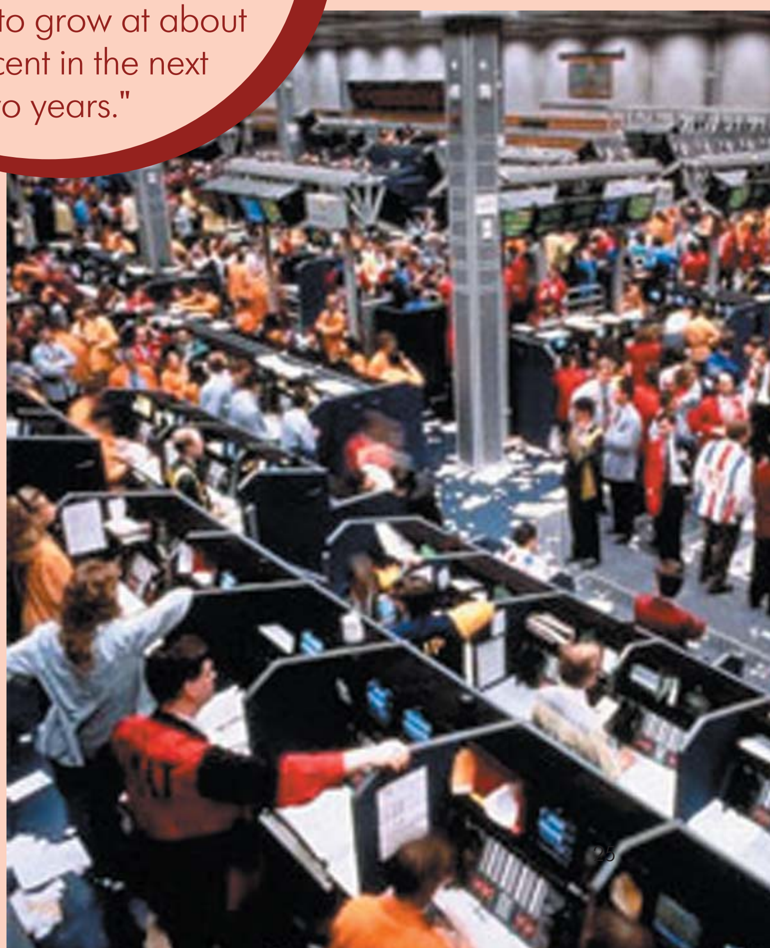
Others were Open Investments, an elite, luxury real-estate properties development company, which raised about $69 million in IPO, offering about 38.5 percent stake at $49.75 per share on the Moscow exchange. Open Investments was founded in 2002, and currently worth about $180 million, according to its IPO prospectus. Its assets in the city include an eight-story business center, a hotel with over 250 rooms. Projects in the pipeline include over 200 gated elite cottages outside Moscow, scheduled for completion in 2006, and a 45,000 sq. meter business center slated for delivery in 2007. And Mechel Group, the nation's fifth largest steelmaker, also raised about $291.4 million in an IPO project in November.

Just the tip of the iceberg

Experts say the number of companies that have so far gone public in the country is only the tip of the iceberg, with an IPO boom looming in the corner as more Russian companies are on the way to public markets. According to a report compiled by investment firm Troika Dialog in 2004, these companies are just a few in a growing number of Russian companies, which are expected to raise over $4 billion on the IPO market between 2004 and 2005. Other investment banks put the end-2006 IPO and other pubic-listing estimates at about $30 billion.

Key market experts have also echoed similar views on an IPO boom. Alexander Kandel, general director of Aton, said in an interview with Prime Tass that Russian companies are on the threshold of an IPO boom. "We are expecting a boom of IPOs in 2004-05 as more Russian companies enter the local stocks market, which is expected to grow about 40 percent in the next two years, thanks to a huge influx of Western investments," he said. He noted that the huge interest on IPO programs is dampened by the efforts and amount of preliminary work needed to launch them. "However, judging by the level of interest and discussions on this issue, we know that some companies have already started this process."

Experts' estimates differ on the boost in size of market capitalization and volume of stocks in free float of companies that will go public between now and 2006, but most investment banks put these indices, respectively, at between $25-30 billion and $6-9.5 billion. For instance, according to Brunswick Asset Management's data,



companies with gross market capitalization of about $30 billion are expected to enter the stocks market by 2006, with volume of free float of about $9.5 billion, while Troika Dialog pegs these indices, respectively, at $27.7 billion and $6 billion. Sectors expected to lead the cash windfall include metallurgical companies with about $1.7 billion, banking industry with $1.3 billion, consumer-goods companies with $1.1 billion and telecom sector with $500 million.

"Going public makes IPO aspirants transparent not only to potential investors, but also to the law-enforcement agencies. This raises the issues of legality of all operations, especially those involving the so-called questionable tax-optimization schemes, to a new level of corporate responsibility."

A reflection of a sound economy

The beefed-up activities among Russian companies searching for capital through public offerings stem from the huge rebound in the economy, which is in its sixth year of continuous growth. These positive trends are evident in all sectors of the economy, including the equities market - pushing up its indices to unprecedented levels. Indeed, RTS Index, the indicator of Russian stocks-market performance, was on a well-footed track to hitting a record height, at over 700 points, before the Yukos tax-evasion case hit the headlines in late 2003, and then grew worse in 2004, when official criminal charges were brought against the company's principal shareholders.

"The Yukos case and other negative phenomena in the local economy notwithstanding," Aton noted, "the RTS index had risen by 16 percent by the end of October, or by 40 percent, if the Yukos factor is excluded - making it one of the strongest showings on emerging markets in 2004."On the whole, RTS closed the year at 614.11 points, continuing the fantastic growth rates it has been displaying since 2001 when it posted a 98.5 percent rate. The positive trend continued in 2002, when it soared again by 34.1 percent and further by 56 percent in 2003. Aton expects the RTS Index to overshoot the 700 point-benchmark to peg at 773 points by the end of 2005, putting the market growth potential at around 18 percent.

Advantages of IPOs

The beauty of IPOs, according to financial experts, is that it provides a reliable source of huge investment capital which fast-growing companies need to sustain the double-digit-growth dynamics in their industries. IPO helps to gauge the investment community's interest in corporations whose shares are on sale on the stocks markets and offers an opportunity to know the exact market value of a company that has undertaken the program. For instance, about 23 percent of Irkut's stake attracted $127 million, putting the company's market value at about $552 million in 2004. Similar indices can be used to calculate the market values of Russian companies that have undergone IPOs, help increase liquidity and their attractiveness, thus enabling their CEOs to bring strategic investors on board. For example, French dairy giant Danone acquired about 4 percent of WBD stake after it went public in 2002, raising market expectations of a possible WBD acquisition by the dairy giant.

Besides, successful IPOs reflect growing maturity of the Russian equities market in general, and also an indication that transparency, corporate-gover-

Rating of Russian companies by volumes of shares floated in IPO

Nos.	Companies	IPO volume	Size of stake (%)	Exchange platform
1	**Mobile TeleSystems**	322,727,158	15.4	NYSE
2	**Mechel Steel Group**	291,389,511	10.0	NYSE
3	**Wimm-Bill-Dann Food Products**	207,090,020	25.0	NYSE
4	**Irkut Corp.**	126,914,000	23.0	MICEX, RTS
5	**VimpelCom**	110,815,948	30.0	NYSE
6	**Sedmoi Kontinent**	80,668,223	13.0	RTS
7	**Open Investments**	68,822,061	38.5	RTS, LSE
8	**Kalina**	51,864,151	28.0	MICEX, RTS
9	**RBC Information Systems**	13,282,100	16.0	MICEX, RTS
*	**36.6 Pharmacy Chain**	$14,400,000	20.0	MICEX Jan. 29, 2003

**Not included in general ratings as its stocks were available only to a limited number of Russian and foreign investors (so-called private placement).*

(Sources: M&A Agency, companies' corporate materials and press reports)

nance principles and other positive attributes of modern corporations are finally taking root in the country.

These positive signs are becoming more evident everywhere on the Russian corporate turf. This is because the stringent requirements which IPO aspirants must meet before they get their stocks listed on both local and foreign stock exchanges usually force owners and/or CEOs of these companies to go the extra mile necessary to crown their efforts with success when their cases come up before the listings approval commissions inside and outside the country. These include conscientious striving for maximum transparency, including full disclosure of ownership structures, thus eradicating the troublesome signs of opacity that had made most Russian companies untouchable to local and, especially, foreign investors for over a decade.

Other positive aspects of preparation for IPO programs on the local economy include aspirants' adoption of an institute of independent directors and enhanced protection of minority shareholders' rights, formation of positive corporate image, including abandoning shady practices and questionable tax-optimization schemes. This is because going public makes IPO aspirants transparent not only to potential investors, but also to the law-enforcement agencies. This raises the issues of legality of all operations, especially tax payments and different types of so-called tax-optimization schemes, to a new level of corporate responsibility. Another positive side of IPO is that it immunizes companies against unfriendly takeovers by competitors, especially by organized crime, whose representatives do not like to deal with public-listed companies.

The issue of where to go public

Most companies prefer international stock exchanges to Russian exchanges as the platforms for launching their IPOs, with the New York and London stock exchanges as default choices for bigger and relatively better financially anchored Russian IPO aspirants. This stems from the more developed nature and bigger size of Western capital markets compared to the Russian stocks market, and consequently, offering a larger number of investors and potential buyers for the floated stocks. The pool of a larger number of deep-pocketed investors on a single platform significantly increases the probability of attracting more capital on foreign exchanges, compared with what is available on the home turf exchanges in Moscow.

Besides, most U.S. and European investors will not touch companies from other countries unless their stocks are listed on their stock exchanges. Stocks are listed only after securing approval, for instance, from the U.S. Stocks Exchange Commission - which rigorously scrutinizes applicants' bidding for listing on U.S. exchanges. The ability of companies to meet the strict listing requirements on these platforms are one of key factors investors consider before committing their hard-earned capital to buying such stocks. This is because getting through the rigorous listing procedures boosts investors' confidence in companies whose stocks are traded on such platforms.

"Listing stocks successfully on developed capital markets in other countries comes with the added advantage of getting a seal of internationally traded companies. For instance, Russian companies listed on the NYSE usually add their NYSE tickers to official corporate documents - thus displaying their international status to potential investors."

Though launching IPOs is much cheaper on the home platform than on international exchanges, listing stocks successfully on foreign markets comes with the added advantage of receiving a seal of internationally traded companies. For instance, all Russian companies listed on the NYSE usually add their NYSE tickers to their formal letterheads and other official corporate documents, thus dis-

Rating of Russian IPO issuers in terms of attracted capital

Position	Companies	Attracted capital (in millions of USD)	Float date
1	**Mobile TeleSystems**	322.73	June 30, 2000
2	**Mechel Steel Group**	233.11	Oct. 29, 2004
3	**Wimm-Bill-Dann Food Products**	145.86	Feb. 8, 2002
4	**Sedmoi Kontinent**	80.67	Nov. 12, 2004
5	**VimpelCom**	71.03	Nov. 20, 1996
6	**Open Investments**	68.82**	Nov. 29, 2004
7	**Irkut Corp.**	54.04	March 26, 2004
8	**Kalina**	25.40	April 28, 2004
9	**RBC Information Systems**	13.28	April 18, 2002

***Could change at the end of emission.*
(Sources: M&A Agency, companies' corporate materials and press reports)

Spotlight

playing their international status to potential investors and/or other interested parties.

The pioneers

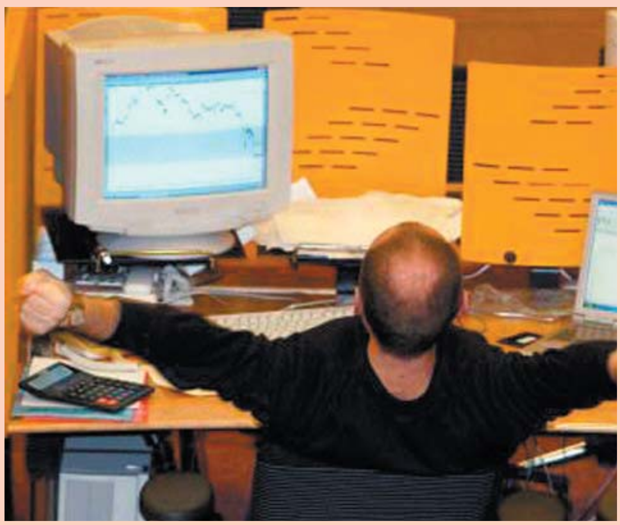
The 'going-public frenzy' among Russian companies started on Nov. 15, 1996, when VimpelCom, the owner of the Beeline mobile-phone-service brand, floated a part of its stake on the NYSE for about $110.8 million. Since then several Russian companies have successfully undergone IPOs or similar procedures for attracting public funds on the Moscow and foreign exchanges.

Mobile TeleSystems, the nation's No. 1 mobile-services providers, went public on the NYSE in June 2000, offloading parts of its stocks for about $300 million, while juice giant Wimm-Bill-Dann earned about $200 million from a similar procedure in 2002. "When a company has reached a certain level in its development, IPO becomes the most attractive alternative way for boosting further expansion, and clearly represents one of the most rational ways for attracting more capital," said WBD board chairman David Yakobashvili. Other Russian, NYSE-listed corporations include Rostelecom, the operator of national fixed-line telephone networks and oil major Tatneft.

Most of these public offerings were generally seen as a huge success on the U.S. exchange, a trend that brought top NYSE executives to Moscow in late 2002 to canvass for more IPO projects from top Russian companies. "The level of interest generated by Russian companies' IPOs on the NYSE has made them something of a local success story, and it is now a priority for NYSE management to attract more Russian companies to the U.S. market," David Griffith, a London-based NYSE senior managing director for Africa, Europe and the Middle East, told an Association of Investor Relations Professionals' forum on IPOs. He was specially invited to Moscow to brief CEOs of Russian companies contemplating on IPO and other public offering schemes about the latest changes in the NYSE, including the impact of the Sarbanes-Oxley Law and the corporate governance code as U.S. market regulators adopt more stringent measures to prevent a repeat of debacles such as Enron and WorldCom.

"The level of interest generated by Russian companies' IPOs on the NYSE has made them something of a local success story, and it is now a priority for NYSE management to attract more Russian companies to the U.S. market."

However, the first IPO on the Russian exchange, precisely on the RTS, took place in 2002, when RosBusinessConsulting floated 16 percent of its stake on April 18, 2002 at $0.83 per share, attracting revenue of about $93 million. It was later followed by 36.6 Pharmacy chain, which put up a 20 percent stake at $9 per share in IPO on Jan. 30, 2003, and grossed about $14 million in revenues. Irkut Corp. followed suit on March 26, 2004, floating about 23 percent stake at $0.6 per share and boosted its capital by over $127 million. Kalina jumped on the IPO bandwagon on April 28, 2004, offloading a 28 percent stake of its shares at 550.62 rubles per share, to take home about $53 million in revenues.



Russians' banking savings top 1.85 trillion rubles

The volume of Russians' ruble- and forex-denominated savings stood at 1.854 trillion rubles as of Nov. 1, 2004, an increase of 20.4 percent since January 2004, according to the Federal Statistics Service. Broken down, the volume of ruble-denominated savings amounted to 1.342 trillion rubles, up from 940.1 billion rubles from the beginning of 2004, while the volume of forex-denominated savings (in their ruble equivalent) stood at 511.6 billion rubles, compared to 471.8 billion rubles registered at the beginning of the year. Sberbank maintains its hegemony in the savings segment, accounting for 61.6 percent of the market share in 2004, which reflects a slight decrease from the 63.9 percent it occupied in the segment in 2003.

Sberbank and VtB accepted in CB's deposits-insurance system

Two government-owned banking behemoths, Sberbank and Vneshtorgbank, and 40 other commercial banks have been accepted in the Central Bank's deposits insurance system, bringing the number of banks in the system to 420 in December 2004. Other newcomers include Moscow-based Absolut Bank, BIN Bank, Globex Bank, Petrocommerce Bank, TransCredit Bank and St. Petersburg-based Promstroibank and Menatep, Central Bank said. According to CB's data, 1137 banks have applied for admission into the deposits insurance system, which was set up in mid-2004 to shelter depositors from negative banking issues and/or help them recover assets when banks are in danger of failures or outright bankruptcies.

China opens an $800 credit line for Russia-bound exports

Chinese banks have opened credit lines totaling $800 million to help Russian companies finance machinery and other equipment shipments from China. The step reflects an increasing interest among CEOs of Russian enterprises in importing Chinese-made machines and equipment, according to Sergei Tsyplakov, Russian trade representative to China. Tsyplakov, however, noted that these credit lines are not being put to maximum use at present, partly because China wants to shift the risks inherent in financing equipment shipments to the Russian side.

Russia to receive a $400 million grant for gas-emissions reduction

Russia may receive about $400 million in grants from the World Bank to acquire technologies for reducing the emission of greenhouse gases into the atmosphere, said Kristalina Georgieva, World Bank Director for Russia, according to Interfax. With its accession to the Kyoto Protocol, Russia can get about half of $800 million set aside by the World Bank in grants for promoting environmentally friendly technologies, she added.

Inflation rate veers off target

The inflation rate finally pegged at 11.7 percent in 2004, veering wide off the official target of 10 percent which was forecast at the beginning of the year, and later upgraded to 11.5 percent in November, according to the Federal State Statistics Service. Consequently, the average consumer price index (CPI) nationwide rose by 10.3 percent. Prices on food items increased by 12.3 percent, non-grocery goods by 7.4 percent and services by 17.7 percent.

Finance

Russia leads G8 in GDP growth, posts unprecedented volume of foreign investments

By Anna Firzon

Russia maintained its first position in terms of real growth in gross domestic product (GDP) in the third quarter of 2004, leaving behind other members of the elitist G8 Club, according to a report compiled by the Federal State Statistics Service (FSSS), the organ shouldered with the compilation of official statistics in the country.

The study was based on reports, publications and data compiled by leading international financial organizations such as the International Monetary Fund (IMF), Organization for Economic Cooperation and Development as well as national statistics agencies' data which are made available for public use on the Internet in line with the IMF's requirements on Special Data Dissemination Standard.

According to the FSSS report, which was released on March 1, Russia's GDP growth rate increased by 7.1 percent, compared to the third quarter of 2003. The United States and Canada occupied the second and third positions, respectively, with GDP growth rates of 4 percent and 3.3 percent. The Great Britain followed with a growth rate of 2.9 percent, Japan with 2.5 percent, France with 2 percent, Italy with 1.3 percent, while Germany closed the list with just a 1.2 percent-growth rate.

Russia's spectacular performance in 2004 was a continuation of what is gradually becoming a good and enviable tradition in the national economy. Russia's leadership in GDP growth rates started five years ago in 2000, when it posted a growth rate 10 percent, an unprecedented performance among G8 members. Though the rate dipped to 5.1 percent in 2001, which was half the rate of the previous year, it was nevertheless enough to help Russia maintain its first position among the world's most developed nations. The same position was maintained in 2002 and 2003, when Russia's GDP growth rates were, respectively, 4.7 percent and 7.3 percent.

The positive GDP growth dynamics has long spilled over to other sectors of Russian life. For instance, Russia's per-capita expenditure, growth rate in the third quarter of 2004, compared with the index of the previous year, was also the highest among the G8 countries. This index in Russia stood at 12.1 percent, while the United States and Canada with the second and third highest indices, increased their per-capita expenditures, respectively, by 3.6 percent and 2.9 percent. Similarly, Russia also led its G8 peers in terms of industrial production-growth rates. This index in Russia increased by 6.1 percent in 2004, compared with the index for 2003, and was also the highest in the G8 Club. Japan and the United States with the second and third best results, increased their industrial outputs, respectively, by 5.5 percent and 4.3 percent. Other G8 members' growth rates of industrial outputs were a lot less. Germany posted 2.3 percent, France 2 percent and the Great Britain 0.1 percent, while Italy's industrial output even decreased by 0.2 percent.

Russia also kept the first spot in terms of consumer-price growth, which increased in the country by 11.7 percent as of December 2004, compared with December 2003's data. A similar index in the United States rose by 3.7 percent, Canada, Germany, Italy, receptively, by 2.2 percent, 2.1 percent, 2 percent, France 1.9 percent and Great Britain 1.6 percent. In terms of unemployment, however, Russia was in the third position with 8.5 percent of its active and able-bodied citizens officially unemployed in 2004, ceding the top spot to Germany whose unemployment index stood at 11.9 percent in 2004. France was second with 9.9 percent, Canada with 8.5 percent, Italy with 8.1 percent, the United States with 5.4 percent, the Great Britain with 4.7 percent and Japan with 4.1 percent

The increase in GDP along with the overall improvement in the economy has led to a significant boost in the volume of foreign investments flowing into the country. For instance, Russia received $40.509 billion in foreign investments in 2004, an increase of 36.4 percent over 2003's tallies, while the gross accumulated sum of all foreign investments in the country as at the end of 2004 stood at $82 billion, or increase of 43.8 percent from January 2004, according to the FSSS. Most of these investments came from the Netherlands, Luxembourg, Cyprus, Germany, the Great Britain, United States and France, which collectively accounted for about 79.7 percent of the accumulated sum of foreign investments in the Russian economy.

Foreign direct investments (FDIs), or strategic, long-term investments, flowed into Russian companies with effortless ease to peg at $9.42 billion, or 23.3 percent of the gross total of foreign investments in 2004, and about 39 percent higher than corresponding sum in 2003. Broken down, these included about $7.31 billion foreign investments funneled into charter capital of companies, $1.70 billion of loans received from foreign co-owners of Russian companies and $23 million in form of leasing.

On the other hand, the gross volume of portfolio investments (PIs), or short-term investments into fast-profit yielding assets, went down to peg at $333 million in 2004, or a decrease of 17 percent, compared with 2003's data. Of this sum, about $301 million, or about 90.6 percent, was invested in stocks of Russian companies, while about $31 million were invested in companies' bonds and debt securities. These represented a decrease of 18.2 percent and 3.3 percent, respectively, compared with similar data in 2003.

Other forms of investments (excluding FDIs and PIs) amounted to $30.756 billion or about 36.6 percent over 2003's data. At the same, the volume of Russian investments abroad rose to $33.77 in 2004, an increase of 45.2 percent over 2003's data.

Major economic indices of Russia and developed countries*

Dynamics of real growth (in %) in volume of GDP [net increase, (decrease]

	2000	2001	2002	2003	Q3 004/ Q32003
Russia	10,0	5,1	4,7	7,3	7,1
Great Britain	3,8	2,1	1,7	2,1	2,9
Germany	2,9	0,8	0,2	-0,1	1,2
Italy	3,0	1,8	0,4	0,3	1,3
Canada	5,3	1,9	3,3	1,7	3,3
United States	3,7	0,8	1,9	3,0	4,0
France	3,8	2,1	1,2	0,5	2,0

Dynamics of industrial output [net growth (decrease)]

	2000	2001	2002	2003	2004г.[1)]
Russia	11,9	4,9	3,7	7,0	6,1
Great Britain	1,9	-1,6	-2,4	-0,2	0,1
Germany	5,6	0,3	-1,1	0,4	2,3
Italy	4,2	-1,1	-1,3	-0,5	-0,2
Canada	7,5	-3,2	2,0	0,7	3,1[3)]
United States	4,4	-3,4	-0,5	0,2	4,3
France	3,9	1,1	-1,4	-0,3	2,0
Japan	5,5	-6,3	-1,2	3,0	5,5

[*Source: Federal State Statistics Service]

Expert's corner

Russians advised to keep savings in rubles as the future of U.S. dollar remains grim

Though the U.S. dollar made an unexpected rebound on currency exchanges across the globe from its over two-year downward slide at the start of 2005, a top Cabinet member has recommended Russians to shun the U.S. greenback and keep their savings in ruble-denominated accounts. The advice, if taken by the residents, will help immunize incomes worth several billions of U.S. dollars against the increasing negative impacts of the dollar-ruble-euro exchange-rate volatility and its associated financial vagaries on their expenditures and savings.

Speaking in a televised interview in January on major economic trends and forecasts on the national and global economies in 2005, Russian Finance Minister Alexei Kudrin said the U.S. dollar is expected to continue its downward slide against major global currencies, including the ruble, because of the objective economic fundamentals currently at work in the U.S. economy as a whole. "The U.S. dollar's downward slide stemmed from objective factors prevailing in the U.S. economy," Kudrin said, specifically naming its huge deficits in balance of payment and ballooned budget-2005 as some of the major problems. "The U.S. dollar will either continue to remain very weak as it is today, or even depreciate further against major currencies as these and other negative issues in the U.S. economy are unlikely to be resolved in 2005."

A further depreciation of the U.S. dollar against major currencies, including the ruble, portends badly for Russians who traditionally keep all or most of their savings in U.S. dollars as a tested measure against the galloping inflation rates and economic instability that characterized the country soon after the collapse of the Soviet Union in the early 1990s. Consequently, between $80 billion and $100 billion - the largest pool of U.S. greenback outside of the United States - are reportedly stashed away today under mattresses and in all possible crevices across Russia. Though most Russians with economic education or above-average knowledge of the financial markets are diversifying their savings portfolios into euros and other major currencies - which have significantly

"The U.S. dollar's downward slide stemmed from a myriad of objective negative factors currently at work in the U.S. economy which are unlikely to be resolved in 2005. Consequently, the U.S. dollar will either continue to remain very weak as it is today, or even depreciate further against major currencies."

Russian Central Bank Official Currency Exchange Rates (09.02.2005)

Currency	Exchange rate, rub	chan.
USD CB RF	28.1872	0.0635
EUR CB RF	35.9781	-0.1524

USD CB

USD tom

USD tod

EUR/USD

appreciated against the U.S. dollar in the past two years - the urge to keep savings in the U.S. legal tender has continued unabated, especially among ordinary citizens.

Kudrin obviously directs his recommendations at this class of Russians, who have long been won over by the U.S. dollar's over 200-year-history of stability. "It is more profitable," Kudrin noted, "to keep savings in rubles in these circumstances." "Considering the current exchange-rate dynamics and the prognosis on the euro, U.S. dollar and ruble, I'm absolutely certain that it will be most profitable to keep savings in ruble-denominated bank accounts," he said. "The ruble will not be weakened in relationship to the U.S. dollar and euro. On the other hand, it might even appreciate against them. Besides, ruble-denominated savings attract higher interest rates in banks than accounts denominated in euros or U.S. dollars. Therefore, in either case, the ruble turns out the winner," he added.

Commenting on other economic issues of national importance, Kudrin said Russia is poised to pay about $10 billion of its foreign debts ahead of laid-down debt-repayment schedule in 2005 and save millions of dollars on interest payments on these debts to creditors. "Negotiations on this issue are currently underway within the framework of the Paris Club. A successful outcome of these negotiations will enable us to save millions of dollars just on interest payments," he added.

The optimistic tone stems from the enormous amounts of cash stashed away in the so-called Stabilization Fund, which is being formed from excess profits from the sky-high prices on oil exports. The possibility of making this early payment is provided for in a law governing the management and use of the Stabilization Fund, which envisages using money from the fund to foot approved tasks, if the fund contains more than 500 billion rubles ($18.02 billion). Kudrin said the fund has already overshot this limit, standing at about 553 billion rubles. "At present, I can confidently say that in the event of a decrease in oil prices to $15 per barrel, Russia will still be able to fulfill all its budgetary obligations, maintain macroeconomic stability, decrease inflation and support economic growth for the next two years."

Gazprom to finalize Rosneft acquisition in June

Alexei Miller, CEO of Gazprom, Russia's No. 1 gas giant, told a Cabinet meeting in March that he intends to close the deal to acquire Rosneft, a state-owned oil company, by June. The deal, which was given the green light on March 2, envisages swapping all of Rosneft's assets for a 10.7 percent stake in Gazprom. However, Yuganskneftegaz, the oil company expropriated from the embattled Yukos and later bought by Rosneft in a highly controversial tender last December, will not be included in the acquisition deal, which is expected to make Gazprom one of the biggest energy companies in the world. The consolidation of the assets of the two state companies also serves another purpose. It will give the government a controlling stake in Gazprom, which will enable it to liberalize the sale of the gas giant's stocks at home and foreign stock markets without fear of losing control over one of the nation's strategic companies.

Russian drivers protest against uncontrollable fuel price hikes

Over 500,000 drivers and vehicle owners took part in nationwide demonstrations against drastic increases in the prices of petrol and other related products in February. Carrying placards with a slogan, "No to fuel hike," several columns of cars, trucks and other categories of heavy-duty vehicles filed across Russia's major highways and streets on Feb. 10 and 12. The organizers, which included the Russian Union of Transporters, the Association of International Goods Carriers, the Russian Autotransport Union and the Russian Union of Vehicle Users, were later met by Deputy Premier Alexander Zhukov, who promised to look into the issue and find solutions to their problems. However, the organizers warned that much larger protests will follow if the authorities fail to meet their demands.

Gazprom eyes French gas market

Gazprom is studying the possibility of supplying gas to French companies, and if everything goes as planned, the first gas shipment contracts are expected later this year, RBC quoted a top company official as saying. Gazprom currently supplies gas to France under an agreement with Gaz de France, but it could increase the number of consumers due to liberalization of the European gas market. France is a net natural gas importer, with gas being supplied by Norway, Algeria, Russia, the Netherlands, Great Britain, Nigeria and Belgium.

LUKoil to return to Iraq's West Qurna oil field

LUKoil plans to enter into negotiations to participate in the development of the lucrative West Qurna oil field in Iraq, as soon as the country's government has been formed, company president, Vaghit Alekperov, said. LUKoil owns 68.5 percent shares in the project to develop West Qurna, one of the world's largest oil fields with oil reserves estimated at 20 billion barrels.

Transneft to take over Yukos' stake in Slovakia

Transneft, the Russian government-owned oil pipeline operator, plans to acquire Yukos' 49-percent stake in Transpetrol, President Vladimir Putin said at press conference in Bratislava dedicated to his official visit to the Balkan state in February. Transpetrol is the exclusive operator of the Slovakian oil pipeline networks, which cover about 1,032 kilometers and have a capacity of 21 million tons. The stake was sold to Yukos in 2002, but the Slovak government informed the Russian government in November 2004 that it would regain its control over the stake from the Russian oil giant.

Yukos to pump 250,000 tons of oil to China in March

Yukos plans to export 250,000 tons of oil to China in March 2005, company board chairman Viktor Gerashchenko said. He also noted that Yukos met its obligations to China in February by sending a similar amount of oil. Yukos, previously the only Russian oil company supplying to China, shipped about 5.4 tons of oil to China in 2004. However, other Russian oil majors have come onboard the lucrative Chinese route - LUKoil since November 2004 and Rosneft since Feb. 1, 2005. Yukos-Transservis handle all the shipments, according to Khasyan Zyabirov, Russian Railways senior deputy president.

Independent gas producers to gain access to state pipelines

Addressing a Cabinet meeting in March, Prime Minister Mikhail Fradkov told government officials overseeing the energy sector that it is very necessary to make sure that independent gas producers in the country have a non-discriminatory access to the state-owned, gas transportation system. The meeting was dedicated to investment programs in the nation's gas industry in general, and Gazprom's financial plan for the year, in particular.

Energy

Time to find urgent solutions to mounting problems in the energy sector

By David Cameron Wilson

Decision time is fast approaching for the Russian government. It must decide, sooner rather than later, whether it is going to continue over-taxing the oil and gas industry while avoiding the much more laborious task of collecting taxes from a multitude of other sectors of the economy. Or, whether it is going to allow oil companies to retain enough of their earnings to provide for much-needed investment in drilling and oilfield infrastructure. It must also decide how it is going to offer incentives for the oil oligarchy to invest at home rather than send their money abroad.

The urgency stems from the fact that the three big problems facing the Russian oil industry could be coming to a head sooner than expected. Oil production fell to 9.29 mn b/d in December and has now fallen for three successive months from the high point of 9.38 mn b/d in September, suggesting that the recent rapid rise has started to go into reverse. Output in 2004 amounted to 458.8 mn tons, 8.9 percent up on 2003 and less than the 462 mn tons officially predicted only a few months ago.

The problems at Yukos, which suffered a decline to 1.655 mn b/d in December compared with 1.715 mn b/d in the first 9 months of 2004 (9M04), are partly to blame, but output by several other companies has also fallen. If the oil industry stagnates, then the rest of the economy will follow it because almost all of Russia's impressive economic growth over the past two years has been oil-driven. In fact, industrial output has not grown since August 2004.

The traditional blame game has already started. The oil companies blame the government for increasing taxes to an unduly high level, while the government blames the companies for not investing enough of their profits. At the beginning of June, the rate of export duty was $41.6 a ton. It had increased to $87.9/ton by October and was raised again to $101/ton in December. The oil companies say that they are now paying 90 percent of their profits in tax, and cannot afford to sustain existing investment levels, let alone beef up the exploration effort.

Drilling

The latest data for 9M04 highlight the decline in drilling activity. When compared with the peak 37 mn metres a year during the Soviet period, the 6.79 mn metres drilled in 9M03 looks pretty miserable. Yet footage has continued to decline to only 6.44 mn metres in 9M04. The main culprits are Yukos, whose well-known money problems led to a 32 percent decline to 645,000 metres and state-owned Rosneft with a 12 percent decline to 363,000 metres. The small independents and joint ventures managed a 29 percent fall to 354,000 metres. The only bright spot was Tyumen Oil Company (TNK), where the new managers from British Petroleum (BP) may have been instrumental in boosting drilling by 34 percent.

The exploration record is even worse, with exploratory drilling falling by 19 percent to 460,000 metres in the first half of 2004. While TNK nearly trebled its footage, albeit from a very low base, LUKoil recorded a decline of 27 percent, while Sibneft's exploration footage fell by 76 percent. The oil companies are blaming the government's punitive rates of taxation for the collapse in exploration.

Yuri Shafranik, president of the Union of Oil and Gas Industrialists, says that the impending shortage of easily producible reserves could stabilize the level

of oil production in the next two years and push exports into decline. Andrei Klepach, director of the Macro-Economic Forecasting Department at the Ministry of Trade and Economic Development, believes that oil production will rise slowly from 458.8 mn tons this year to 530-550 mn tons/yr by 2015. He, however, noted that the forecast is dependent on the construction of new export pipelines such as the proposed route between Taishet and Perevoznaya on the Pacific coast, and the route from Western Siberia to Murmansk. Klepach says once these pipelines are built, then the oil companies will produce enough oil to fill them.

"[The government] must decide, sooner rather than later, whether it is going to continue over-taxing the oil and gas industry while avoiding the much more laborious task of collecting taxes from a multitude of other sectors of the economy."

Prime Minister Mikhail Fradkov is becoming increasingly concerned about the prospects for the oil and gas sector. He told a Cabinet meeting, called to discuss the long-term future of the exploration sector last year, that it would be impossible to meet the target of doubling the nation's GDP by 2010 without expanding the oil and gas industries. He also noted that the resource-exploitation sector as a whole paid taxes of over 1 trillion rubles ($35 bn) in 2004, accounting for 50 percent of budget revenues and 70 percent of foreign currency acquisitions.

The Iran connection

The other major problem, the lack of spare pipeline capacity, remains as acute as ever, although Transneft, the state-owned monopoly pipeline operator, says that there is plenty of capacity to spare. In fact, Transneft President Sergei Vainshtok has accused the oil companies of failing to make full use of the export pipeline quotas of 14 mn tons offered to them in 2004.

Most of the spare capacity is in the "Druzhba" export pipeline to Eastern Europe (2 mn tons/yr), the pipeline running to the Odessa and Yuzhny port terminals in the Ukraine (4.5 mn tons/yr) and the pipeline which carries Siberian oil from Omsk to Pavlodar in Kazakhstan (6.8 mn tons/yr). Kazakhstan does not need to import Russian oil with its own output growing by 15.4 percent in 2004 to 59.2 mn tons and exports rising 20 percent to 51.2 mn tons. Vainshtok is actually looking further afield

than Kazakhstan to the Persian Gulf, from where Russian oil could be exported to the Pacific Rim countries.

The Omsk-Pavlodar pipeline was built by the Soviet Union to serve the Pavlodar and Shymkent (Kazakhstan) refineries and continues down to Seidi refinery in Turkmenistan. For a number of years, Russian and Kazakh officials have been talking to the Turkmens about extending the pipeline to Iran, so that Russia and Kazakhstan can deliver oil to northern Iran, while the Iranians export an equal value of their own oil on Russian and Kazakh account to Japan, China and other Pacific Rim countries from the Persian Gulf. About 2 mn tons/yr are already tankered across the Caspian to Neka and then pipelined to Tehran, but the Iranians would like to see the swap arrangement greatly expanded.

Pipelines

Tax rates and encouragement for the exploration sector are not the only issues on which Prime Minister Fradkov's strangely inactive government must make big decisions. One of the factors exerting upward pressure on world oil prices is the competition between Japan and China for oil, and there are huge possibilities for Russian oil companies on these markets. However, the government's dithering over a plan to build an 80 mn tons/yr pipeline to Russia's Pacific coast has created opportunities for other countries. Only at the end of December was the final decision taken to build this pipeline, although another study must be carried out and there is no indication when construction will start

"The oil companies say that they are now paying 90 percent of their profits in tax, and cannot afford to sustain the existing investment levels, let alone beef up the exploration effort."

In 2003, Yukos published a proposal to build a pipeline from Angarsk in Eastern Siberia to China. Its route through a nature reserve attracted environmentalist objections, and the oil giant's 'little tax problem' finally killed the project.

The other proposal, by Transneft, was to build a 4,130-km pipeline from Angarsk to Perevoznaya near Vladivostok with a branch line to Daqing in China. The environmentalists objected to this proposal because the route was too close to Lake Baikal, and an amended route sees it originating at Taishet, and passing round the northern end of the lake. The cost of the pipeline has been estimated at $16bn if it has a capacity of 80 mn tons/yr to Perevoznaya, or $11bn if it carries 50 mn

t/yr to Perevoznaya and 30 mn tons/yr to Daqing. The 80 mn-tons/yr pipeline will eventually carry 24 mn tons/yr of oil from Western Siberia and 56 mn tons/yr from oil fields in Irkutsk, Krasnoyarsk Provinces and Yakutiya.

In the meantime, the Chinese are getting increasingly irate over the possibility that the promised branch line to Daqing may be cancelled. They have thrown their support behind a plan by Kazakhstan's KazMunaiGaz to build a pipeline over 988 kilometers from Atasu on the Omsk-Pavlodar-Shymkent pipeline to Alashankou on the Kazakh-Chinese border, and on to a refinery at Dushanzi. It will initially carry 10 mn tons/yr and, when all the pumping stations have been installed, its capacity will rise to 20 mn tons/yr by 2011. Khristenko says that the capacity of pipelines serving Russian oil export terminals is likely to be increased to 433 mn tons/yr by 2020.

"If the oil industry stagnates, then the rest of the economy will follow it because almost all of Russia's impressive economic growth over the past two years has been oil-driven. In fact, industrial output has not grown since August 2004."

Baku-Tbilisi-Ceyhan pipeline

Natig Aliev, president of Azerbaijan's state-owned SOCAR oil company, says that he is expecting the construction of the Baku-Tbilisi-Ceyhan pipeline to be completed in May 2005. The Azerbaijan section was completed in December 2004. A number of crossings under railway lines and under the Kura River remain to be built, and testing work on the compressor stations has yet to take place. About 3 kilometers of pipe remain to be welded in Georgia and builders of the Turkish section say they will complete the job in March 2005. But Aliev thinks mid-May is more likely. He also says that the cost of building the pipeline could overrun the projected cost of $2.95 bn by 5-7% because $3 bn has already been spent with about 98% of the work done. The overrun is said to be due to delays in construction works in Georgia and Turkey.

Other reports say that an overrun of 10% is more likely.

David Woodward, president of the Azerbaijan International Operating Company, plans to increase oil production from 6.57 mn tons in 2004 to 11.25 mn tons in 2005, consisting of 6.75 mn tons from Chirag and 4.5 mn tons from the Azeri field. Oil production at Chirag started in November 1997, and a cumulative

37.5 mn tons had been produced by the end of 2004. The Azeri field was due to start production at the beginning of 2005, when Stage 1, which involved the development of the central part of the field with the drilling of 48 wells from one platform, was expected to come on-stream. Stage 1 will produce a total 193 mn tons with output reaching a peak of 18.7 mn tons /yr. Stage 2, involving the development of the western and eastern sections of the field, will begin production in 2007, and eventually reach a peak output rate of 20 mn tons/yr.

Oil from Chirag is exported through the 6.5 mn tons/yr pipeline which runs from Baku to the Supsa export terminal in Georgia. SOCAR's exports of 2.5 mn tons/yr are delivered through the 9 mn-tons/yr pipeline from Baku to the Novorossiisk terminal in Russia. When Baku-Tbilisi-Ceyhan comes on-line, Azerbaijan will have a total 65.5 mn-tons/yr-export capacity, but is unlikely to produce this much oil for a great many years, if ever. That is why frantic efforts are being made to tie Kazakhstan into a long-term contract for the use of Baku-Tbilisi-Ceyhan.

"It would be impossible to meet the target of doubling the nation's GDP by 2010 without expanding the oil and gas industries."

Kazakh Energy Minister Vladimir Shkolnik knows that he has a very strong card to play, and is resisting pressure to sign a contract. Kazakhstan has a wide range of actual and potential options for exporting its oil - westwards and northwards through Russia, eastwards to China and southwards through Iran. Production is planned to grow from 59 mn tons in 2004 to 69 mn tons in 2007, and then start to rise very rapidly as the Agip KCO consortium brings the super-giant Kashagan field on-stream in the Caspian.

At present, Kashagan is planned to increase output to 45 mn tons/yr by 2013, but there are indications that the start date - already delayed from 2005 to 2007 - could be put back to 2008. The aim is to pipe the oil to a coastal treatment complex at Bautino, then tanker it across the Caspian for export through the Baku-Tbilisi-Ceyhan pipeline. But it could be a long time before the pipeline carries its rated 50 mn tons/yr.

In the meantime, the Caspian Pipeline Consortium, which operates the 28 mn-tons/yr pipeline from Tengiz oilfield in Kazakhstan to Novorossiisk export terminal in Russia, has brought forward plans to expand it to 67 mn tons/yr by building more pumping stations. The consortium expects to carry Kashagan oil to Novorossiisk and the BTC Co., which operates the Baku-Tbilisi-Ceyhan pipeline, is becoming increasingly nervous about the prospects for filling it.

Moscow's traditional downtown landscape to assume a new look as Soviet-era hotels give way to modern facilities

By Christopher Kenneth

Downtown Moscow is expected to assume a totally new look soon as several Soviet-era, epoch-marking hotels are being pulled down for modern facilities. The gradually unfolding changes are the result of City Hall's highly ambitious multibillion-dollar-development policy meant to radically transform the hospitality infrastructure and other social amenities in the heart of the Russian capital and beyond.

The first of these assets to go down was Intourist Hotel on Tverskaya, one of the most popular streets and business centers in the capital. The hotel was finally shut down for reconstruction in January 2002. The 24-story, glassy highrise that had accommodated millions of mostly foreign tourists since it was built in 1970 will be upgraded into a modern, five-star Hilton that will meet all international standards on quality and services, according to the Liquidation Commission, an official agency specially set up to oversee the demolition and reconstruction of the old hotel.

Staunch critics of the old Intourist said the "hotel's monstrous design had never fitted into

Tverskaya Street's historical and architectural landscape, and therefore constituted an eyesore in the area." The ongoing reconstruction plan is expected to rectify these architectural shortcomings in the new, 4,500 sq.-meter hotel, which will sit on 11-floors and offer 332 rooms of prime and exclusive quality for top-market clientele. It will also offer a parking for 372 vehicles, thus solving the perennial parking problems at and around the premises of the old hotel.

Moscow Mayor Yuri Luzhkov - the brain and locomotive force behind the monumental changes in downtown Moscow and other parts of the capital - said the new and expensively upgraded Intourist Hilton will start functioning by the end of 2005. "It is going to be a real beautiful, high quality, five-star hotel. The delay in the project's delivery timetable, and the consequent postponement of the completion date from 2004 as earlier planned to late 2005, was due to the highly complicated nature of the engineering and telecommunication networks in this part of the city."

Controversies engulf other landmark reconstruction projects

While the Intourist Hotel reconstruction has met with praises from both experts, ordinary Muscovites and staunch critics of Luzhkov's architectural taste, the City Hall's reconstruction plans for Moskva and Rossiya - two other Soviet-era monumental hotels which are also located a few meters from the Kremlin - have generated heated debates and acrimonious controversies in the city. Luzhkov started the row, when he suddenly said he would not go ahead with the previously laid-out plans to rebuild the Moskva Hotel after its demolition earlier this year. Instead, he said the liberated spot would be turned into a recreational square.

A relic of the Soviet era on Manezh Square - just opposite the State Duma building and a few meters from Red Square - the Moskva's design once served as the best visual manifestation of Soviet monumental architecture when it was erected in the late 1960s. It was to be torn down and rebuilt at a cost estimated at between $500 million and $600 million. Luzhkov's sudden change of mind has prompted a lot of discussions among architects and other property-development experts, and even led to public protests from leading Muscovites. Some have sided with the mayor's new proposal, while others have staunchly condemned it.

> "The reconstruction issue ought to have been discussed publicly with all the interested parties. But so far, this has not been done. Therefore, everything at our disposal will be thrown in to thwart the city government's development policies that are destroying the traditional landscape of Moscow."

To diffuse the rising social tension on the issue, the City Hall said no final decision had been made

"The City Hall's reconstruction plans for Moskva and Rossiya - two other Soviet-era monumental hotels which are also located a few meters from the Kremlin - have generated heated debates and acrimonious controversies in the city."

on the issue. "There are a variety of solutions under contemplation on how to use the spot made vacant by the demolition of the hotel. No final decision has been reached on the issue," City Hall Press Secretary Sergei Tsoi said.

However, the 'olive leaf' from the City Hall has not been accepted by all. Sergei Mitrokhin - chairman of the Moscow City Committee on Protection of Muscovites' Interests, a non-government organization of concerned Moscow residents - has said the committee will do everything to make sure the City Hall and its crony property developers do not build another 'stony monstrous project' on the historical spot. "The reconstruction issue ought to have been discussed publicly with all the interested parties. But so far, this has not been done. Therefore, everything at our disposal will be thrown in to thwart the city government's development policies that are destroying the traditional landscape of Moscow."

The issue attained national status in late-January when the Rodina faction tabled it at a State Duma session, asking the parliament to support the City Hall's plans to transform the liberated spot into a square with a pedestrian zone, instead of rebuilding the hotel or any other facility on the spot. However, other legislators refused to support the motion, arguing that a square with a pedestrian zone will distort the historical spot that has housed several architectural buildings in the very heart of the capital from time immemorial.

Dekmos, a City Hall-affiliated development company that had won the tender to demolish the hotel and rebuild another one of higher quality and standards on the spot, has yet to express its position on the issue. This is despite the fact that the company had reportedly spent over $50 million on demolishing the sprawling hotel and evacuating the debris from the liberated spot. Dekmos' rather cool reaction to the news has been attributed to its ownership structure. Moscow city government owns about 49 percent stake in the company - a stake, which when combined with the huge political clout of the city's mayor in and outside the capital - is enough to generate the required reaction from any developer willing to remain in active business in Moscow and beyond. Andrei Berezkin, Dekmos public-relations director, has dodged the issue, calling the demolition and reconstruction of Moskva a very lucrative investment project. "From purely investment point of view, this is a highly attractive project, where there are no rooms for emotions, especially the type generated by the issue of whether or not to rebuild the hotel," he said, according to local press reports. "This is a business, and not emotional, issue. Consequently, the problem will be resolved in that context."

In a similar development, the plans to reconstruct the Rossiya - a three-star hotel sprawling on a 13 hectare plot near the Kremlin, and slated for demolition in 2006 - has also become engrossed in a heated controversy, caused in part by the way the reconstruction tender was conducted in November 2004. Rossiya was built in 1967 and instantly became the largest one-spot hospitality facility in Europe with an area of 225,000 sq. meters and 3,070 rooms. The new hotel complex, expected to sprout on the liberated spot in late 2006 and receive its first guests on completion in 2008, will offer a usable space of 410,000 sq. meters, including a 2,000 room, five-star hotel and a 56,000 sq. meter cinema hall.

A 25-member commission was set up to run the tender to build the new hotel complex, estimated at between $2 billion and $2.5 billion, including additional $500 million for demolishing the existing hotel and its outdated infrastructure. According to the tender terms, the developer of the new hotel will cede a 49 percent stake in the hotel and the cinema hall to the city government. The commission was also tasked with studying the financial feasibility of each bidder's proposal, and evaluating the soundness of each project's architectural design, including among others, its relevance to and harmonization within the existing social and historical infrastructure in this part of the capital.

Choice of Rossiya tender winner baffles experts

However, the plans took an ugly turn in late November, when ST Development,

a construction and development firm, won the tender rights, despite offering a relatively poorer architectural design and the lowest investment package - valued at $830 million - for the $2 billion-plus project. ST Development's success in the tender has been attributed to its affiliation to business structures owned/or controlled by Shalva Chigirinsky, a highly connected business tycoon with direct links to top City Hall officials. Other top bidders with significantly better investment offers were left out in the cold, without any cogent explanation to go home with. These included Bauholding Strabag AG, an Austrian development

"Typical of Russian tenders, 18 out of 25 tender-commission members, who awarded the project to ST Development, refused to explain why a bidder with an obviously smaller financial proposal and relatively weaker architectural concept got the lucrative project."

company, which had offered a more generous investment package valued at $2 billion for the tender rights on the project and Monab which backed its reportedly better architectural design by $1.45 billion.

Typical of Russian tenders, 18 out of 25 tender-commission members, who awarded the project to ST Development, refused to explain why a bidder with an obviously smaller financial proposal and relatively weaker architectural concept got the lucrative project. Vladimir Resin, a tender-commission member and deputy major in charge of property development in the City Hall, offered a very weak explanation, saying the results reflected the commission's expectations. "We got the result we wanted. None of the contenders' projects completely met all our stipulations, therefore, the commission chose the cheapest proposal offered for the development of the project," he said. Moscow chief architect Alexander Kuzmin also echoed the same view. "I'm not satisfied with any of these proposals, as none offered a good architectural design. Even the tender winner's project will have to be seriously reconsidered with the aim of reviewing and improving it."

According to independent experts, ST Development was odd-on-favorite to win the tender, because Chigirinsky's other firm, Moscow Development Company, which he jointly owns with the City Hall, drew up the reconstruction plans several years ago and further took part in drafting the tender terms. "The economics of all bidders' proposals was shaky, the projects' architectural concepts in dire need of radical improvement, while plans for solving the transportation problems at and around the hotel were all equally bad," a tender commission member who claimed he voted against ST Development, said on condition of anonymity.

A disappointed Bauholding Strabag AG representative in Russia did not hide his dismay at the tender results. "Though we will not go to court to contest these results, said Gerhard Gritzner, who represented Bauholding Strabag AG at the tender, "I've to note, however, that we are both disappointed and completely surprised by the outcome of this tender." "We've invested over $150 million in the Moscow economy, but we have to seriously reconsider participating in future tenders in Moscow." Monab was equally disappointed, with company press secretary Andrei Galiev quoted as saying his firm's lawyers would seriously review the tender results and contest them in courts, if necessary. "We don't exclude the possibility of challenging these results in courts," he noted.

By Christopher Kenneth

Antitrust Ministry threatens Kremlin's plans to form unified gigantic aviation holding

The Federal Antitrust Agency (FAA) has questioned the aviation-reformation plans adopted at a State Council session late February which envisages merging government and private plane-manufacturing plants in the country into a unified super holding, noting the realization of such project will highly undermine competition in the local aviation industry.

The agency's negative stance on the issue runs counter to that of the Kremlin, which oversees the activities of the State Council - a consultative organ, which comprises the president as chairman and 89 regional leaders as members - and, meets regularly to deliberate on issues of vital importance to the nation. It was at one of such sessions in February that the "questionable final decision" was taken to rejuvenate the flagging aviation industry through consolidation of whatever is left of the Soviet-era's once vibrant aviation might. "This is a final decision," President Vladimir Putin told the council members at Zhukovsky, a scientific city outside the capital, on February 23, and ordered his legal team and related ministries to draft a decree setting the legal ground for setting up the company. "It's only muscling up such a strong, powerful fist," Putin said, while adopting the proposal to merge major plane manufacturing plants into a single entity, "that will enable us to achieve these stated goals." "The concentration of all resources on realization of really prospective projects will help us achieve tangible results now, and not sometime in the distant future."

But commenting later on the issue, FAA director Igor Artemyev noted that his agency would never come to terms with such arrangements, because his main tasks are to safeguard antitrust regulations that ensure free competition among all market participants in all sector of the economy. "The new company, which is expected to control just 10 percent on the world market, will not be a monopolist on the global arena, unlike on the home turf, where it will be an absolute monopolist, because it will control 100 percent of the local industry," he said.

A group of experts headed by Industry and Energy Minister Viktor Khristenko worked out the

concept, which envisages setting up a Unified National Aviation Building Company, through merging assets of all aviation construction plants in the country, irrespective of current ownership structures. Major local plane manufacturers such as leading manufacturers of defense-related craft MiG, Sukhoi, Irkut Corp. and civil aviation makers such as Tupolyov, producer of TUs and Ilyushin, which makes the IL jets, scientific institutions, design bureaus and air-leasing companies, have already agreed to relinquish their entities in favor of the new legal entity, which will be executed in three stages.

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The first stage is restructuring of major aviation-construction companies and hammering out terms on which the merging of assets will take place. This stage envisages setting up a joint state and private consortium by mid-2005, which will draft up an aviation policy for the whole industry. At the second stage, the assets of all participating companies will be merged to form one

company. The structure of the resulting company will be mixed - state and private - with the state holding a majority stake, at least, more than a 50 percent stake. The third stage will see the company going fully public. Its capitalization will be boosted and all measures taken to make it attractive to private investors, the strategists said. The company will be set up on Dec. 31, 2006, and is expected to become the most dominating leader on the Russian aviation-production market by 2015, when it is also expected to control over 10 percent of the global aviation-products market. Optimistic scenarios see the new super aviation giant at par with U.S. Boeing and EU Airbus, the current leaders in the global aviation-construction industry, which is currently valued at $1.7 trillion, they added.

"The novelty of the concept - which envisages a total eradication of competition and concentration of all major aviation-construction plants' assets and technological know-how in a single entity - is also its weakest point, because the eradication of competition places the yet-to-be launched project on a head-on-collision path with the antitrust regulations in the country."

To achieve these goals, Khristenko said government promises to offer more significant aid to the new structure that was the case in the past. For instance, the government plans to pump 15 billion rubles into the project in 2005, which will be about five times the sum it disbursed to the whole industry in 2004, while annual budgetary financing will be in the region of 60 billion rubles (or about $2 billion) and government's order expected to reach 138 planes by 2008.

The novelty of the concept - which envisages a total eradication of competition in the country and concentration of all major aviation-construction plants' assets and technological know-how in a single entity - is also its weakest point, because the eradication of competition places the yet-to-be launched project on a head-on-collision path with the antitrust regulations, which envisage a broad presence of different companies and free competition among them. These aberrations, according to Artemyev, will make the new company a defendant in a series of legal battles, because words such as "competition and economic freedom" are enshrined in the Russian Constitution. "Therefore, I do out rule out going all the way to the Constitutional Court, if necessary, to overturn the decision, "because if any business structure is founded unconstitutionally, then, there is always the Constitutional Court to determine the legality and constitutionality of such formations."

Irkut Corp. acting president Valery Bezverkhikh, who has been appointed to head the workgroup tasked with preparing the preliminary documents for setting up the new holding, shook off FAA's apprehensions. "It's completely senseless to talk about monopoly in the context of Russia's internal aviation-construction market, which at the moment, simply does not exist, at least in the traditional sense of the term. "Most revenues earned by Russian airplane-building enterprises today come from exports, while on the international markets they compete with such super giants such as Boeing and Airbus."

However, not all regional leaders, share the optimistic views emanating from key Kremlin officials and top aviation industry executives. Some of the dissenting voices say the creation of such a super giant will give rise to a monopolist which will become inefficient in the future, partly because of no real competition on the internal market, while others even see the proposal as a drawback on the technological advancements made by aviation firms in their regions. "The setting up and concentrating all resources in one entity will mean some companies that are successfully run at the moment and profitable in their operations will have to destroyed in order to create a totally new company, whose future is not entirely clear," noted Mitimer Shamiev, president of Tatarstan. Alexei Fyodorov - president of MiG, and former president Irkut Corp, which was built by merging different companies several years ago - proposes taking a more cautious step in the realization of the project, "because it is not easy to set up a new national aviation-construction company." "This is because it is necessary to consolidate all production assets, scientific and technical capabilities, take into consideration a lot of regional and corporate interests, review a myriad of contrasting views as well as choose the correct projects that can be competitive on the market.