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Report: Russia's telecom sector

Three major trends fueled Russian telecom development in 2006: (a) liberalization of the long-distance telecom market and introduction of new operator interconnection regulations, (b) broadband Internet access as the new leading market segment, and (c) the upcoming issuance of third-generation (3G) licenses amid 100 percent mobile-sector penetration and value-added services (VAS)-sector growth.



In 2007, there will be increasing competition in the long-distance market segment. Fixed-line operators will further diversify their services, particularly among broadband and convergent services. Other leading market sectors are digital subscriber line technology, Internet protocol television (IPTV) solutions, next-generation network equipment, and passive optical network technology. The mobile sector will feature increasing competition for subscriber loyalty, offering heavy VAS content (mobile television and interactive games) as operators deploy 3G networks. Cable television, broadcasting, and satellite operators will enrich content and expand their offerings to subscribers.

Market Overview

Russia's steady macroeconomic

performance (6.8 percent gross domestic product growth in 2006) increased government and corporate spending on information and communication technology (ICT) infrastructure and services, and growing regional consumer spending increased telecom-sector growth. In 2006, the Russian telecom-sector revenues reached \$29.6 billion, a 26 percent growth over 2005, as reported by iKS-Consulting. The mobile communications sector grew 34 percent and exceeded \$10.5 billion. However, broadband access showed the largest growth of more than 42 percent.

In 2006, according to the Russian Ministry of Information Technologies and Communications (MITC), the total ICT market exceeded \$40 billion. Local capital investments totaled \$5.6 billion, a 7.1 percent growth over 2005, while foreign investments totaled \$4.1 billion, a 19.5 percent annual growth. The Russian Web user base reached 25 million, and revenues from Internet access and data transmission services reached \$2.1 billion, or 24 percent growth, compared with \$1.7 billion in 2005.

Liberalization of the Long-Distance Market

January 2006 began with a historic event. Rostelecom, the national carrier and dominant player on the long-distance telecom market, awoke to a new competitive reality—the market was liberalized. Actually, more than 20 new operators received licenses to provide long-distance and international communication services. Analysts estimated the Russian long-distance telephony market size at \$1.9 billion to \$2.1 billion in 2006.

The challenges for new players remain high. Owning a license for long-distance services is not a panacea. A new operator must have a nationwide network and an agreement with regional operators for the last mile connection. Moreover, new interconnection regulations divided operators into three major levels: local, zonal, and long-distance. Long-distance operators now must connect to end-users only through regional operators (local level) and pay interconnection fees for every call.



The first contender, Multiregional TransitTelecom (MTT), began providing services in 2006 and was expected to challenge Rostelecom's position. However, with its modernized network, good pricing, and improving customer service, Rostelecom did not yield much ground to MTT in 2006, and the MTT subscriber base reached only 2 million (4 percent). Nevertheless, MTT expects to capture 15 percent of the market share by 2008. With more than 40 million subscribers, Rostelecom gained 60 percent of the market, while the smaller operators, including Internet protocol providers and grey-market operators, fought for the rest.

In January 2007, Golden Telecom (GT), one of the largest alternative telecom operators, launched services. With a strong regional network, developed corporate market segment, and significant distribution network of 30,000 points, GT plans price services at 10 percent less than Rostelecom. GT remains upbeat, expecting to grab some 20 percent of the market share by 2008 and estimating that the market will exceed \$4 billion.

Fixed-Telephony Sector: Broadband Access Boom

The boom of the Russian fixed-telecom market was rather predictable. Russian regions outside the more mature St. Petersburg and Moscow markets demonstrated increasing consumer and corporate spending confidence as broadband Internet usage skyrocketed. No wonder the broadband access market has become the leader of the information technology sector. MITC believes that the data transmission market will grow from \$1.18 billion in 2005 to \$2.8 billion in 2008.

Moreover, the emerging IPTV market is also flexing its muscles. More than 20 Russian operators joined MTU-Intel and other market

leaders in providing video services. According to iKS-Consulting, there were about 150,000 IPTV subscribers in Russia in 2006, and by 2010, that number may reach 1.4 million.

Thanks to the interconnection and the "Calling Party Pays" (CPP) regulations ratified in 2006, Russian fixed operators received a significant financial boost. Long-distance and mobile operators reported that just in the third quarter of 2006 fixed operators earned some \$14 million. Finally, fixed operators shouldered alternative operators in their traditional spheres of influence, Internet access, and cable television market sectors, offering a whole range of new competitive services.



Russia's incumbent telecom operator, SvyazInvest Holding, will probably not be privatized until 2009. Security and military agencies blocked this move in 2006, citing national security reasons. Analysts believe that because of the upcoming presidential election, the decision on privatization will be postponed further. However, SvyazInvest's inter-regional companies showed some good results, appeasing investors in 2006. The results were reached through an effective cut in operational costs and personnel, as well as through the installation of new enterprise resource-planning solutions to improve enterprise management. At the end of 2006, Comstar UTS, Sistema Telecom's major fixed telecom asset, purchased 25 percent of SvyazInvest shares from its owners, Leonard Blavatnik and Viktor Vekselberg, for \$1.3 billion.

In 2006, some 7,000 WiFi hotspots

operated in Russia. J'son & Partners predicts that the number will exceed 9,400 in 2007, growing exponentially in the next five years. Most prominent, however, is the GoldenWiFi network launched by Golden Telecom that added 6,700 hotspots, making it the largest WiFi network in Europe.

Mobile Sector Saturates

In 2006, the Russian mobile market became the third largest in the world by number of subscribers and revenue, after China and the United States. Mobile penetration exceeded 100 percent because some 152 million subscribers (Russia's population is 145 million) used mobile services in 2006. Major mobile operators faced saturation and increased spending on marketing and development of VAS services.

The introduction of the CPP regulations helped Russia's leading mobile operators to soften the gradual fall in average revenue per user. Anticipating a drop in mobile calls, operators quickly moved to ruble-based tariffs, raising average tariffs by 5 to 10 percent. Operators also secured reimbursements of \$0.03 per minute by fixed operators, which resulted in a 5 to 10 percent net profit to major operators.

Leading mobile operators, MTS, Vimpelcom, and MegaFon held 85 percent of the Russian mobile market, while the share of regional operators reached 15 percent (22 million subscribers, 3 percent growth). Tele2, SMARTS, SibirTelecom, and UralSvyazInform demonstrated the most dynamic results.

3G Comes to Russia

3G mobile telephony technology finally arrived in Russia. At the end of 2006, the Russian State Committee on Radio Frequencies approved the allocation of 3 × 15 MHz in 1935–1980 MHz and 2125–2170 MHz fre-



quencies, and 3 × 5 MHz in 2010–2025 MHz frequencies for 3G development. This frequency capacity is sufficient to issue three nationwide licenses. The licenses will cost around \$100,000 and will be issued for a period of 25 years. Operators are expected to “clear” the frequency and to invest millions of dollars into equipment and network construction.

In April 2007, the tender commission will announce winners according to a scoring system for each operator. The scoring system will use major criteria, such as network presence in each Russian region and the

amount of potential investment in new networks. According to analysts, Russian mobile operators will first launch 3G zones in about 20 Russian regions. Although the mobile content market has resurged from its unexpected slump in 2005, the “heavy” content services have

not yet emerged as mainstream. In emerging markets such as Russia, where mobile penetration is uneven and customer preferences are based on purchasing power, it is hard to predict the exact start of 3G.

The Russian telecom market is closely following world leaders in ITC development and expects continued growth. Further information on this dynamic industry, including doing business in the Russian ICT sector, can be found in Andrey Gidasov’s first book, *Riding the Russian Technology Boom*, which will be published by Futuretext in April 2007. ■



VII annual Eurasian Business Summit

Monte Carlo, Monaco
3-9 June 2007



Leading Ventures Associates announces the opening of the registration for VIII annual Eurasian Business Summit which will be held in Monte Carlo, Monaco, 3 - 9 June 2007.

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- Banking and financial section

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For more information, programme and registration please visit

<http://www.lvauk.com/summit/en/index.htm> ■



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- General information on organization

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Secretariat of RusCham is to be moved to Bratislava office from April 1, 2006. Please follow the updates on our web site.

During transition time you may also contact us directly at the following numbers:

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Business News Ticker

Russia, after recalling its animal health inspectors from the European Union, threatened to suspend meat imports from some EU countries unless Brussels provides additional quality control guarantees. The country's animal and plant health watchdog said in a statement that it had asked veterinary services from several EU countries to increase control over exports to prevent violations of Russian safety standards. Russian Railways, or RZD lifted a series of temporary bans on the rail transport of coal to Baltic and Russian ports because the severe congestion of rail cars on lines leading to the ports has now eased, Russian coal exporters said. The temporary bans were imposed from the first week of February at some ports and extended several days at a time.

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A tax amnesty for individuals, designed to streamline relations between taxpayers and tax authorities and to curb capital flight, enters into force in Russia March 1. The amnesty gives individuals an opportunity to declare revenues they have not paid taxes on since 2001 through a simplified procedure, and to then make "declaration payment" worth 13% of the declared sum, which is the flat income tax rate in Russia. People will have until December 31, 2007 to declare revenues they received before January 1, 2006. They will face no tax-related charges after they make the declaration payment. No restrictions are planned on the minimum or maximum amount of declared sums. Finance Minister Alexei Kudrin has said the amnesty is well timed, as it will encourage Russians to legalize their revenues at home. Last year saw unprecedented capital inflows into the country, which stood at over \$41 billion, compared with previous years, which were marked by dramatic capital flight.

Russia's foreign trade hit \$32 billion in January, with a surplus of \$11.2 billion, the economics ministry said. In its economic overview of the country's economic development for January-February, the ministry said that declining world oil prices in January slowed down trade surplus growth. The surplus was 9.5% lower than in January 2006. Exports were \$21.6 billion, a 3.1% growth, year-on-year. Imports totaled \$10.4 billion. "Import growth was 37.5% in January," the ministry said. Import growth was boosted by thriving investment activity and the appreciation of the ruble's real effective rate, 1.5% in January. Investment in Russia's fixed assets grew 23.2% in January, year-on-year, and 13.7% in 2006.

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Russia's Interior Ministry is investigating a criminal tax evasion case involving 243 million rubles (\$9.3 million) and PricewaterhouseCoopers, the auditor who represented the now bankrupt oil company Yukos in 2002-04. PwC is facing its own profit tax claims for 2002, and at the same time is being checked on the Yukos audit case. The Russian Federal Tax Service filed suit against PwC in December 2006, accusing the auditor of covering up Yukos's illegal financial schemes and of drawing up two different audit reports.

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Russia's largest air carrier Aeroflot will soon sign a contract for the delivery of 22 A-350 Airbuses, the company's head told a news conference. The first A-350 Airbuses will be supplied only in 2015, which means that "Aeroflot will continue to buy A-330 liners from Airbus until then under a combined contract," Valery Okulov said. He said Aeroflot was planning to buy 10 A-330s in the fourth quarter of 2008, while the airline needed 12 to 15 aircraft. Although Okulov

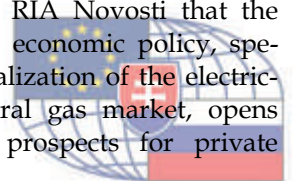
said a contract for the delivery of long-haul Boeing 787 aircraft was "frozen," earlier reports said Boeing had offered its new Dreamliners at a concessionary price of \$15-\$20 million apiece. The official also reported that his company was preparing government instructions to set up a Far Eastern airline, which will be its 100% subsidiary and will unite Dalavia, a 100% state-owned air carrier, Vladivostok Avia (51%) and SAT Airlines. The new airline is designed to handle domestic flights. Earlier, the Russian economics ministry proposed that the transport ministry consider the consolidation of Far Eastern airlines before considering the transfer of a state-owned package in the united airline to Aeroflot.

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The European Commission regards a \$1 billion oil pipeline construction project in the Balkans as an important one. Russia, Bulgaria, and Greece signed a memorandum on the Burgas-Alexandroupolis pipeline in April 2005. Once completed, the pipeline will pump 35 million metric tons of oil a year (257.25 million bbl), a volume that could eventually be increased to 50 million metric tons (367.5 million bbl). EC Spokesman for Energy Ferran Tarradellas Espuny said the project is a good example of cooperation with Russia in the energy sector, adding that investments in the project will be attracted from private investors.

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The Greek prime minister has invited Russian energy companies to invest in the Greek economy. Konstantinos Karamanlis said in an interview with RIA Novosti that the government's economic policy, specifically liberalization of the electricity and natural gas market, opens new, broad prospects for private



investment projects that could be effectively implemented by Russia's energy majors. He said Greece maintains close relations with Russia in the political and economic sphere, adding Russia is the largest natural gas supplier to the country, and also accounts for about 32% of the country's oil imports.

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Tajikistan has introduced temporary restrictions on poultry imports from Russia, Turkey, Japan, China, Thailand, Iran and Pakistan. The decision was made in response to recent outbreaks of the deadly H5N1 virus in those countries. The two-month ban was part of tougher control measures launched earlier this month, and would cover imports of eggs, poultry meat and poultry products. Simultaneously, Ukraine's veterinary control department has banned poultry imports from Russia's Kaluga Region because of bird flu and from Japan's Toyama prefecture following an outbreak of Newcastle bird disease. According to the World Health Organization, the deadly H5N1 strain of bird flu has infected at least 273 people from 11 countries and claimed 167 human lives since it first appeared in Asia in 2003.

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The Russian region of Tver has presented 12 projects worth more than \$1 billion at the international real estate show MIPIM-2007 in Cannes, France, Dmitry Zelenin, Tver's governor, told reporters. He said these projects concerned the use of city areas (housing and office construction) as well as projects aimed at creating resorts for Russian guests. One of these projects is the Zavidovskiye Dali resort and spa, situated some 50 kilometers from the city of Tver on the border with the Moscow Region. A school for children with special needs and guest cottages will be built at the facility, which will have an area of 100,000 square meters. The center's grounds will have a to-

tal area of 54 hectares. The cost of construction, which is expected to begin in 2008 and finish in 2012, is estimated at \$120 million.

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Quotas on Russian steel exports to the European Union are to grow 15% in 2007, an economics ministry official said. Veronika Nikishina, chief expert on access to foreign markets at the ministry's trade negotiations department, said the European Commission's corresponding agreement for 2007-2008 could be signed in April. "We want to sign the agreement in April," she said. "There is understanding between us and the European Union, and we think we should speed up the signing of the agreement." She added that the quota will be up 15% from 2.2 million metric tons of steel products exported last year, and that there would be another increase in 2008. Among other things, the substantial quota increase is possible due to the inclusion of Russia's steel deliveries to its traditional partners, Romania and Bulgaria, new members of the EU.

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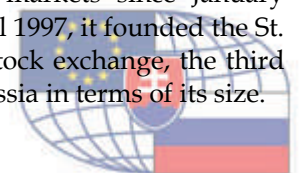


Russia's Security Council will discuss a long-term space program through 2040, President Vladimir Putin said. He said a mid-term development strategy for the missile and space industry (until 2015) had been adopted in February, but Russia's space activity required a long-term strategy to attain specific socio-economic objectives. Putin said it was essential to create a market of space services in Russia, which are

vital for "such sectors as navigation and geodesy, communications and television, ecology and power engineering, healthcare and education, transport and forestry," especially remote earth sensing, environmental monitoring, mapping, and urban development. He also said the Glonass system will be up and running before the end of the current year. Glonass is a Russian version of the U.S. Global Positioning System (GPS), which is designed for both military and civilian use, and allows users to identify their positions in real time. The system can also be used in geological prospecting. A total of 9.88 billion rubles (\$379.7 million) has been allocated for Glonass from the federal budget in 2007, and 4.72 billion (\$181.4 million) in 2006.

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Sweden's OMX, the St. Petersburg bourse and the RX group of venture businesses signed an agreement to establish an international stock exchange in Russia. The international exchange St. Petersburg (IXSP) will grant Russian issuer companies, especially small- and medium-sized entities, access to international capital without the need of undergoing a listing procedure outside Russia. "Each of the companies - the founders of the new exchange, will hold one-third share in the international exchange IXSP," the St. Petersburg bourse said in a statement. OMX, a leading expert in the exchange industry, which owns exchanges in the Nordic and Baltic region, will supply the new bourse IXSP with trading and information systems and share its experience in creating trading floors for small and medium developing businesses. The St. Petersburg bourse is the oldest Russian bourse that has been active on commodity and futures markets since January 1991. In April 1997, it founded the St. Petersburg stock exchange, the third largest in Russia in terms of its size.





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