



# RUSCHAM NEWSLETTER

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MONTHLY ISSUE

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## Russian Far East railroad system—part II

**Modernization Projects.** The Russian Federal Government retains ownership of the main railroad network and the infrastructure related to passenger and freight services, including infrastructure, railway data communication networks, traffic control systems, and locomotive stock. The concept for the restructuring of railways proposed a 49% privatization of companies providing freight forwarding services; other 51% of share should be state-owned. In 2003, a 100% state-owned company Russian Railways (RZhD) was formed out of the assets of the former Ministry of Railways (MPS) to carry out commercial and operational functions of MPS.

Privatization procedures will also apply to enterprises engaged in the repair of rolling stock and the production of spare parts and other products of railway transport. At the same time the concept confirmed that the railways were a natural monopoly with direct control from the state. Given the fact that the restructuring concept was announced in 1998 and so far very little has changed, even limited privatization will be a long process. In 2004, MPS was restructured to the Federal Agency of Railway Transport within the RF Ministry of Transport. The Russian railway continues to be a “state within a state,” controlling the Russian economy, but there are indications that this status is beginning to change.

Priority projects include the upgrade of telecommunications systems, improvement of traffic control and wagon tracking systems including satellite systems. Currently, the Ministry of Railways is actively working with a number of American companies especially in telecommunications (IBM, Microsoft, Lucent Technologies, Cisco Systems). Other modernization projects

include gradual rolling stock replacement. During 2003-2006, a massive campaign began to reequip and replace aging locomotives.

In 2004, the Far Eastern Shipping Company (FESCO) developed a partnership with RZhD to create a Russian Troika LTD. company, which alone can handle up to 300 thousand TEU annually via the TransSib. In March 2005, within 11 hours, Russian Troika LTD. started with a delivery of a full block train consists of 38 80-foot fitting platforms accommodating 152 TEU with assembly parts from South Korea to a Hyundai automobile assembly works in the city of Taganrog on the Azov sea. In 2005, Russian Troika LTD. handled about 28 thousand TEU.

### Need in additional container fleet

In 1997 the Russian Ministry of Railways and Far Eastern Shipping Company (FESCO) signed a container interchange Agreement allowing usage of each party's containers thus reducing shippers' costs by \$100-150 US per 20' container. In

1999 the Russian Ministry of Railways and Hyundai Merchant Marine Company signed a similar Agreement. Also, in 1999, the Russian and Chinese Railways signed a container interchange Agreement. The purpose of this Agreement is intended to increase cargo flow between Russia and China, to use containers more effectively and to reduce dispatch time.



### Problem of Attracting Cargo Volumes to the RFE Railroad

In 2002-2003 the RZhD's officials said that the container volumes had more than doubled, as shippers in Japan, Korea and Vietnam opt for the land route instead of by sea, through the Suez Canal, and that the war in Iraq was driving cargo

shippers in Asia to stay as far away as possible from the conflict zone. Federal rail sources told that they had to add an extra third container train per day from the Nakhodka-Vostochnaya railway station alone. However, today, the volume of containers that can be shipped via Russian railways transit corridors decreased up to 300 thousand/ year -- it is minuscule when compared with ocean shipping capacity. The Vostochny port is designed to process over 50 million tons of cargo annually, but the single-track rail line serving the port has an annual throughput capacity of but 25 million tons. RZhD itself states that its throughput capacity is utilized at only 60%, which influences the ports productivity. TransSib turned to be a bottleneck of the RFE's rail system, due to poorly developed rail spurs and limited throughout capacity in ports and boarder crossings, shortage of rail wagons, and uncompetitive rail tariffs, which were raised recently.



Short supply and poor condition of wagons and inappropriate fleet management result in erratic freight delivery schedules and unwanted delays in transit and generate dissatisfaction of clients and failures to high-value and time-sensitive consignments deliveries, such as just-in-time ones between manufacturing and assembly plants. Over 50% of Russia's rolling stock is considered to be operating beyond its effective service life; also there is a shortage in container platforms at stations, where demand is traditionally high (in ports). There are only 13,000 platforms in all of Russia,

and 7,000 are processed monthly in Vostochny alone. The rail wagons deficit may reach over 25% per day in Vostochny International Container Services only. Also, few of the RZhD container terminals have equipment/ cranes to clear access to railways from wagons on a timely basis.

Freight flows to and through the RFE are largely of a transit nature with a major imbalance depending on the raw materials exports oriented Russian economy. There is a problem of minimizing the volume of empty back-hauls in transit cargo handling --half of its containers are empty upon return. The proportion may not be so extreme for transit traffic destined for other parts of Russia, but the situation is much the same.

### **Railway Control Standards and Risk Assessment**

Cargo safety has always been a major concern of freight forwarding in Russia, and the RZhD had to develop solutions for protecting cargo: discover the insurance breaks; identify reliable and cost efficient container tracking/ monitoring and security technologies and devices on port-to-rail and rail-to-destinations; ability to quickly identify time-sensitive shipments and help those shipments move first. Also, every block train moving via the TSLB is accompanied by armed security guards. The former RF Ministry of Railway Transport created several Centers for Transportation Safety throughout Russia in order to secure door-to-door delivery, control cargo safety, and continually monitor cargo location. TransTelecom installed a digital communication line along the TransSib. Digital fiberglass telecommunication network through TransSib allows conducting a real time efficient container tracking/ monitoring and implementing modern security technologies.

In terms of Russian Federal Program on Enhancing Railway Safety, in 2005-2006, RZhD re-equips over 70 (of 550 total) railway/highway crossroads on TransSib with crossing warning products --electric signs, busy signals, and automatic road barriers to avoid collisions.

### **Best Prospects**

The Russian rail sector represents one of the world's largest and potentially lucrative markets for supplying equipment (rolling stock and components), track maintenance, telecommunications and information technologies, rail management systems, and safety equipment. Industry experts note that the foreign can offer Russia the best model for freight railroading based on similar distances, volumes and climate conditions within the countries.

Solutions to meeting the equipment needs may come from integrating foreign technologies into Russian manufacturing processes and management techniques in freight and passenger transportation. The need for new generation diesel locomotives (with AC/AC transmission), freight wagons, and components to upgrade the existing rolling stock offers opportunities for foreign firms to enter the market. However, the emphasis will be made on developing domestic production with participation of foreign partners.

The best sales prospect for foreign companies in the RFE is developing smooth, flexible, cost-effective cargo and passenger transportation services for both local and international users:

- Improving logistics services through local freight forwarders for both Russian and foreign intermodal operators;
- Creating multimodal logistic centers, perfecting the opera-

tional system, cargo/container/wagon fleet handling and distribution;

- Human resources management;
- Transportation services marketing;
- Insurance services brokering;
- Safety system for transit cargo monitoring;
- Development of infrastructure of the transit cargo checkpoints;
- Marketing of SABRE/ GALILEO/ other IT global booking system.

### Prospective Buyers

As said before, the Russian railway is a "state within a state". A 100% state-owned company Russian Railways (RZhD) supervises its affiliate offices in the RFE. Daughter companies, as Russian Troika LTD. company, JVs, as a newly formed one between RZhD and German Deutsche Bahn AG, VICS/VFS, and freight forwarders locked at providing services to railway clients can be potential buyers of foreign products in the railway sector. There are few key local players in the RFE providing reliable railway transportation services. VladivostokVneshTrans, Ltd. is a leading railway transportation company, a member of the Russian Association of International Forwarding Agents. The major service of VladivostokVneshTrans is containerized cargo forwarding via the TransSib from the ports of Vladivostok, Posyet, Zarubino, the TransSiberian railway station of Khasan (Zarubino). The densest concentration of railway transportation companies serving export/import and transit cargo shipments via the TransSib is in Khabarovsk. Transport-Service-Transit, East-by-West, DTK-Freight, MCh-1, DalVneshTrans, and TransRail-Vostok provide containerized and bulk cargo transportation, and loading/unloading, and warehouse-to-warehouse delivery.

### Market Entry

Based on the current situation in the RFE railroad equipment market, the recommended strategy for expand to the market is to establish a relationship and attempt to directly sell diesel locomotives, freight wagons, and components directly to the Far Eastern and Sakhalinskaya railroad head offices, their daughter companies, rail freight forwarders, and their clients. These contacts may have a capacity for service station operations and a distribution network for spare parts sales. It is preferable that the local contact has a good record with the banks, so that he can get a bank loan or leasing agreement. This strategy will allow for considerable market share for the foreign products for railroad within a short period of time. The sale of spare parts, accessories, and service equipment can be handled through the official agents or dealers of manufacturers/exporters or through companies involved in import and distribution of spare parts and special railway equipment in Russia or Southeastern Asia.

### General Tips for Entering the Market.

Today, the business environment and economic situation are beneficial for foreign companies to enter the RFE market. Ruble is becoming stronger against the foreign dollar and EURO continues growing, which makes European products less competitive. This results in increased buying capacity for local companies and growing price competitiveness of foreign products. Also, domestic manufacturers can use the current downturn in the foreign to consider new markets. Interested foreign companies seeking to penetrate the RFE building products market are encouraged to use the following tips:

- 1) Pricing strategy;
- 2) Financing considerations, e.g., extension of credit;

- 3) Willingness to invest in training of potential dealers and customers;
- 4) Participation in tenders;
- 5) Direct contacts with local railroad decision makers;
- 6) Participation in exhibitions at national and local levels;
- 7) Presentations and seminars. The availability of technical information in Russian language is very important for such seminars.

### Market Issues & Obstacles

It is not easy to get in the door of RZhD, which is a semi-military organization. Almost 90% of decisions to purchase some product or establish partnership will be approved by RZhD's Moscow headquarters.



There are few options for a FOREIGN-based company to enter the RFE railroad sector market -- direct access, a joint venture, or access through a broker or agent. Direct access is the most complicated way to enter the market. First, a foreign company has to open an office in Russia. Then it has to obtain a license for providing transportation services in Russia.

Joint Venture (JV) is a popular vehicle to enter the RFE market, but is associated with considerable risk. The usual practice is that a foreign company provides investments and management expertise while a Russian partner provides licenses, certificates and permits. Low overhead and labor costs, some tariff reductions, and large market potential make these joint ventures profitable. Partner selection is the most crucial issue. A positive example of JV operations in the RFE is VICS and VIFS. In most cases, our office would recommend against the JV

approach in this industry, due to poor legal protection for foreign investment in Russia.

Entering the local railway market through a local freight forwarding/logistics agent is the most reliable and cost-effective access. A local agent better understands the local business environment, is flexible in developing transportation routes, and can provide better and faster access to any destination in the local market. A foreign partner is expected to provide promotional support, training, and clarification of his requirements to avoid misunderstanding in different business environment.

Direct sale of foreign railway equipment/products, if delivered directly, may be too expensive to be sold in the RFE as customs costs increase the price substantially. Moscow and St. Petersburg, which have privileged customs regimes, appear to be the major "gateways" for foreign products into Russia. It is much cheaper to buy goods certified according Russian standards from a warehouse in Moscow and deliver them to the RFE than to

bring them directly. However, other obstacle is the fact that such specific equipment as railway fleet cannot find its distributor in Russia.

The limitations for a direct sale approach will be the lack of import experience on the part of the buyer and the financing of the deal. Russian companies can not afford to take cash out of working capital to prepay for such a costly product as diesel locomotives, freight wagons, and components, wait 30 days for delivery of the products, and pay custom duties and VAT before the machinery/equipment even start working. Russian bank loans are mostly short-term (up to 1 year), med-term (3-5 years) are available only to big and well-established companies, and expensive (at least 9-12% for US dollar loans). Also, the companies exploiting railway fleet will need spare parts and after sale services, which may be difficult to provide to the clients in the RFE from the foreign countries.

### Trade Events

A trade show is an important promotion technique in Russia,

which local industry professionals use as an educational opportunity to learn about new technologies and products. This is a low cost, but effective and easy way for a foreign company to evaluate market potential, gain exposure and explore opportunities in this market. Foreign companies may consider participating in the international annual event

#### Event: TransRussia-2007

Annual International Transport and Logistics Exhibition and Conference  
Dates: March, 2007

Location: Moscow, Russia

Organizer: ITE LLC Moscow

Phone: (495) 935 73 50

E-mail: [transport@ite-exhibitions.com](mailto:transport@ite-exhibitions.com)

<http://www.transportshows-ite.com/pages/ExhibitionInfo.htm>

Focus: latest transport, information and logistic technologies, improvement of the Russian transport infrastructure and the provision of high-quality services to consumers of transport products. ■



## EU-Russia Summit

A deal on airspace access appeared to be of little importance as a Russian-Polish trade row lingered on and President Putin faced death-bed accusations from a former spy who died mysteriously in London.



European leaders arrived divided on 24 November in Helsinki for a summit that was intended to mark the start of a new phase in EU-Russia relations.

Poland had vetoed the renewal of a wide-ranging EU-Russia partnership and co-operation agreement (PCA), marking the start of negotiations conditional upon Moscow lifting a ban on Polish meat imports introduced a year ago.

The renewal of the PCA offers the EU the prospect of agreeing on the objectives and basic principles of energy co-operation with Russia as Moscow continues to refuse to ratify the Energy Charter Treaty that would open up its energy mar-

ket to foreign investors.

The EU and Russia underlined "the positive way" that their co-operation had developed over the past six months at the end of a summit hosted by the EU Finnish Presidency in Helsinki on 24 November.

An agreement to phase-out Siberian overflight charges for European airlines was the main outcome of the summit. "This will make European carriers significantly more competitive on routes be-

tween Europe and Asia," said the Finnish Presidency.

But Poland maintained its veto to start negotiations for a new co-operation agreement with Russia as Moscow refused to consider lifting a year-long ban on Polish meat over hygiene concerns.

Commission President José Manuel Barroso asked Russia to lift the ban, saying that the measure was "disproportionate". Three-way talks involving Moscow, the EU and Warsaw may be able to solve the issue - the two sides agreed that talks would start as soon as the Polish veto is lifted.

Ahead of the summit, Russia

threatened to extend the ban to the whole of the EU over concerns about swine fever in Romania and Bulgaria, which are set to join the bloc on 1 January 2007.

"We are sending a team of experts on Monday where they will explain the transitional measures which the EU intends to put in place regarding Romania and Bulgaria and try to calm Russian fears," said Commission spokesman Philip Tod.

But even the meat row was overshadowed by news that Russian former spy Alexander Litvinenko had died in London, from mysterious radioactive poisoning. On his deathbed, Litvinenko made a statement accusing the Kremlin of

being involved in his poisoning.

Putin rejected the accusations, saying Litvinenko's death was "being used for political speculation".

On energy, the summit made little progress due to the blocking of negotiations on the PCA. In a statement, the Finnish Presidency said energy co-operation between the EU and Russia is "based on a positive interdependence".

"The energy sector needs to function in a transparent, predictable way, based on reciprocity," it said. ■

## Business News Ticker

Russia's VimpelCom has finalized a deal with Hellenic Telecommunications Organization SA (OTE) to buy from the Greek telecoms group its 90% stake in Armenian telephone company Armentel for 341.9 million euros (\$440 million). Armenia's public services regulation authorities approved the sale on November 14. Through the deal VimpelCom, best known for its Beeline brand, will also take on Armentel's debt totaling around 40 million euros (\$51 million).

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Branches of foreign insurance companies will be allowed to operate on Russia's market in nine years' time, the country's economics minister said. Speaking to reporters in Hanoi, where he had attended Asia-Pacific Economic Cooperation (APEC) summit, German Gref said, "We will open our insurance market to branches of foreign companies, but not until a nine-year transition period is over." "Subsidiaries 100% [foreign owned] will be allowed into the Russian market with a 50%

[investment] quota," he added. Access of foreign companies to Russia's insurance and banking sectors was one of the main stumbling blocks in bilateral U.S.-Russian talks on the country's bid to join the World Trade Organization.

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Pulkovo (St. Petersburg) airport may be sold off in late 2007-early 2008, the head of the Economic Development and Trade Ministry Property and Land Department said. Igor Grechukhin said the timeframe for the sell-off of the airport, which is 100% owned by the state, will be set in the second quarter of 2007. He said the airport will be sold through an auction, adding

two auctions will be held, the first with the participation of the St. Petersburg city administration.

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Heineken has invested 1.2 billion euros in Russia between 2002 and 2006, Rolan Pirmez, president of Heineken in Russia, said. Heineken spent 80 million euros on upgrades to its Volga Brewery in 2005, he said. The company also spent large amounts of money on an increase in production capacity at its Siberian brewery.

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Russia and Latvia have resolved the problem of poor quality canned sprats imported from the Baltic republic. Russia imposed a temporary ban on deliveries of canned fish produced by two factories in Latvia, Brivais Vilnis and Gamma-A, in late October saying their canned sprats contained high levels of benzopyrene, a carcinogenic substance. A Latvian delegation arrived in Moscow last week to meet with

Russia's consumer rights' watchdog, the Federal Service for the Oversight of Consumer Protection and Welfare. A working expert group had been set up.

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Russia's veterinary watchdog has warned the European Commission of possible restrictions on products of animal origin as of next year, an EU representative said. Philip Tod said the Russian authorities will hopefully accept the EU's assurances that the necessary measures have already been taken in Brussels. A spokesman for the Russian Federal Service for Veterinary and Phytosanitary Oversight confirmed that Russia will possibly introduce restrictions if the European Union fails to provide extra security and quality guarantees in regard to some countries.

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Russia has agreed to phase out over the next seven years over-flight charges for Asia-bound European airliners using Russian airspace. At an EU summit in Helsinki, Russian Transportation Minister Igor Levitin and European Commission President Jose Manuel Barroso signed an agreement to gradually reduce the charges in the years leading up to 2014, when they will be scrapped altogether. Until now, European carriers have had to pay more than \$300 million a year for flights over Siberia, the fastest route to destinations in China, Japan and Southeast Asia.

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The head of Gazprom discussed with high-ranking Egyptian officials prospects for Russian-Egyptian cooperation in the natural gas sector within the framework of a joint memorandum, the energy giant said. In March 2005, Gazprom, as part of its overseas expansion, signed a memorandum of under-

standing with the Egyptian Natural Gas Holding Company (EGAS) that provided for Gazprom's possible involvement in existing projects for hydrocarbon production, transportation, processing and marketing, including liquefied natural gas (LNG).

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MOL Hungarian Oil and Gas Plc plans to buy an unspecified oil asset in Russia as part of its business expansion strategy. Hungary's top oil and gas producer said it had bid Friday for a 100% stake in a company based in a major Russian oil-rich region with developed pipeline infrastructure. MOL did not specify the acquisition target or financial details but said the company owned an oil field, which currently yields 1,800 bbl/d and has proven reserves of 60 million bbl of oil equivalent. The Hungarian company said the Russian asset had vast potential and would fit well into the company's business strategy of expanding into Russia's oil and gas sector.

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The heads of leading Russian electronics chains have called Panasonic's business in Russia unfair and have announced plans to remove Panasonic products from the assortment of goods they offer. A joint statement on this issue, which was distributed in Moscow, was signed. The decision to remove Panasonic products from Russian store shelves "was caused by the unfair, and at times illegal, operation of Panasonic's business on Russian territory," the statement says, noting that market players have pointed

out the company's unacceptable actions in written form on several occasions.

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Foreign companies will be able to participate in Russian energy giant Gazprom's ambitious Shtokman project off Russia's Arctic coast. Gazprom announced in October it would proceed with the development of the natural gas deposit on its own because foreign companies had failed to make "satisfactory proposals on assets." Gazprom might involve foreign companies in the project, but not on the conditions initially proposed. Gazprom's announcement that it would develop the Shtokman deposit on its own, was a move that stunned Norway's Statoil and Norsk Hydro, France's Total, and U.S. giants Chevron and ConocoPhillips, all companies previously on a short-list of contenders for the project. The offshore deposit is the only source of natural gas for the ambitious Nord Stream gas pipeline that will soon link Russia to Germany along the Baltic seabed. Gazprom controls a project to develop the giant Shtokman field, which holds an estimated 3.2 trillion cubic meters of natural gas and 31 million metric tons of gas condensate in the Barents Sea, and plans to build an LNG plant there. Some \$12-14 billion will be invested in the project's first phase, and production will start in 2011.

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Russia is planning to set up seven tourist and recreational special economic zones (SEZ) in the initial stage. Two zones are scheduled to be built around Lake Baikal in Irkutsk region and in Buryatia. Another two will be built in the Altai territory and in the Altai republic, two more in Stavropol region and Krasnodar territory and one in Kaliningrad region, he said.

## Upcoming Events

- Dec 12: Federal Tariff Service to consider 2007 natural gas tariffs
- Dec 13: Government Investments in Russia conference
- Dec 22: Russian President Vladimir Putin, Ukrainian President Viktor Yushchenko to meet in Kiev for gas talks

### 2007

- Jan 1-Jan 8: All markets closed for New Year and Russian Orthodox Christmas public holidays
- Jan 1: Taimyr, Evenkia autonomous districts merge into Krasnoyarsk Region, number of Russian regions down to 86 from 88
- Jan 18-19: Investment Forum: Structured Financing in Russia & CIS conference in Frankfurt, Germany

## Financing Real Estate Markets in CEE and CIS: Capitalizing on Great Opportunities in Real Estate

The conference took place in Bratislava, Slovakia 29.-30. November at Crowne Plaza Hotel. Participants have enjoyed excellent presentations from real estate CEE markets specialists from such companies and organizations as NARKS (National Association of Real Estate Offices in Slovakia), Colliers International Slovakia, Czech Invest, CA Immobilien Anlagen, ECE Projektmanagement, Mayor of Industrial Park Kechnec, Commercial Councillor at Austrian Embassy in Slovakia, Spiller Farmer, HVB Bank Slovakia, FK Finance, Peterka & Partners, IPEC Management, Prva Stavebna Sporitelna, Accace. Networking discussions covered current status of a region with fast changes in Real Estate sector structures, economics, ownership regimes and investment opportunities.

RusCham would like to thank conference's supporters, sponsors: Peterka & Partners, Accace.eu, HVB Bank, Calyon corporate and investment bank and media partners: ISI Emerging Markets, Hospodarske Noviny, Czech Business Weekly and The Slovak Spectator.





## BECOME A MEMBER OF RUSSIAN CHAMBER OF COMMERCE IN EUROPE

In support of the RusCham's core activities, which actively work to improve the business environment for businesses in Russia and Europe, the Russian Chamber of Commerce in EU also provides valuable business networking opportunities for members.

Russian Chamber of Commerce in EU serves as a center for assistance and information, keeps members apprised of rapidly evolving government laws and regulations, and organizes meetings for representatives of member businesses.

RusCham is an information center that gives much-needed information and contacts to visiting delegations, fosters co-operation between potential investors and established businesses, and encourages businesses to take advantage of business opportunities in the Russian Federation or Europe.

Also RusCham is enabling business representatives to air their grievances and create a common agenda of needs and concerns, to act as one voice in presenting that agenda to the governments and local business communities enable member businesses to collectively lobby for legislative and regulatory changes.

The Chamber's most important assets are its members. They are our clients, our workforce and our strength. Our mission is to promote the development of commercial relations between the Russian Federation, EU and the international community.

RusCham membership is made up of enterprises and entrepreneurs from the member states of the European Union (EU) and the Russian Federation, which have business activities with and in the Russian Federation, NIS and Europe. These members determine the overall strategy and policies of the organization.

To become a member of RusCham please send an e-mail to [membership@ruscham.com](mailto:membership@ruscham.com) or contact us at +421 55 728-9267

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