

Liberalization and Privatization Reforms in Russian Telecommunications

Strategy for Quantum Investment Fund

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SCENARIO

In my Masters' project, I assume the role of consultant to George Soros' Quantum Fund. Quantum Fund helped initiate the privatization of the Russian telecommunications holding company "Svyazinvest." The management of Quantum Fund requested that I prepare a strategy to convince Russian authorities to promote the privatization and restructuring of Svyazinvest. These moves would be part of a larger process of liberalizing the telecommunications sector, and would help economically integrate Russia with the world.

EXECUTIVE SUMMARY

Quantum Fund is owned and managed by George Soros, a businessman and philanthropist committed to free market reforms. Quantum Fund owns 53%¹ of Mustcom Consortium, which owns 25% of Svyazinvest, the state-run Russian telecommunications holding company. The Russian government owns 75% of Svyazinvest, and is considering selling a 25% stake. By supporting further privatization of Svyazinvest, Quantum Fund would protect its original \$1 billion investment. Political reality dictates that sufficient privatization will only occur concurrently with liberal market reforms in the telecom sector. Thus, Quantum should advocate both privatization and liberalization simultaneously.

From a commercial standpoint, Quantum Fund should support liberalization reforms in the Russian telecommunications sector to increase competition, transparency, and predictability, and promote a level playing field for private, foreign, and state companies. The current telecom regime and government control over Svyazinvest's subsidiaries constrain the company's market potential. Quantum Fund can achieve better long-term profitability in a free market environment, where profits are determined by market forces rather than arbitrary non-transparent regulatory decisions. These reforms will meet WTO provisions on cross-subsidization, interconnection, and monopolistic regulations. Conforming to these provisions will accelerate Russia's accession to the WTO.

Privatization and liberalization in Germany and Chile expanded the telecom market, and increased profits of dominant providers.² Financial projections show that Svyazinvest profits will increase to \$1.7 billion in 10 years, making it possible for Quantum Fund to recuperate its investments entirely in 8 years, as opposed to 25 years under the current regime. Quantum Fund is convinced that reforms will result in higher profits, and will increase the value of Quantum's shares in Svyazinvest. Privatization will protect Quantum's existing investment, increase its share of ownership and control, and attract more operating capital.³ Liberalization will allow Svyazinvest to compete under free trade where prices are determined by market forces.⁴ Reforms will remove heavy social obligations from Svyazinvest subsidiaries. As a result of reform, Svyazinvest subsidiaries will be able to expand their market shares to data transmission, Internet, and mobile services. Quantum Fund's manager, George Soros, is committed to both privatization and liberalization in spreading free market reforms in emerging markets. Mr. Soros would not seek privatization alone, simply buying into a monopoly, and relying on continued monopoly protection.

The government sale of 25% of Svyazinvest, along with telecom liberalization, will ensure the continuity of reforms both in the telecommunications sector and in Russian industry as a whole. The Russian government should proceed with the next bidding contest as soon as possible. By giving private companies a larger stake in Svyazinvest, the government will attract private and foreign capital, investments, and credits. Privatization will help cure the underdevelopment of telecommunications, and the financial demise of the regional Svyazinvest subsidiaries.

¹ Svyazinvest's Annual Report 2001.

² See profit projections on p. 35.

³ See p. 28.

⁴ See p. 43.

The government will be reluctant to privatize Svyazinvest and open Russia to foreign telecom companies unless liberalization also takes place. Liberalization will increase competition and transparency, create a level playing field among foreign and domestic companies, and encourage new entrants into the market. Experience in such countries as Germany and Chile demonstrates that telecom market reforms attract foreign and domestic capital, and improve telecommunications infrastructure.

Telecom liberalization is closely related to the issue of sectoral monopolization. In Russia, regional telecommunication providers obtain control over local line networks. However, their small size and scales of operation are responsible for a low rate of capitalization. Low capitalization dissuades needed investments, which are essential for expansion to the more lucrative and value added services. This results in monopolization of fixed line services, and of mobile phone service in some regions.

Often the government uses its control over Svyazinvest to achieve social objectives at the expense of the company's profits. Pricing regulations imposed by the federal body reinforce the monopolization of the sector, since cross-subsidization is not prosecuted, and reasonable interconnection rates are hard to enforce. Cross-subsidization occurs when monopolies cover losses in local calls by increasing fees for long distance calls. Enforcement of an adequate pricing policy is hampered by local authorities, and by the difficulty in controlling the large number of telecommunications providers. Cross-subsidization helps preserve a state run monopoly in Russia. All of these practices are outlawed under the WTO provisions; therefore they will raise serious concerns of Russia's partners at the accession negotiations. Russia will be required to comply with WTO provisions on regulation in telecommunications. These provisions correspond with interests of potential investors and service providers, and with Russia's long-term interests.

An effective pro-competitive policy in the Russian telecommunications sector is crucial for the country's overall economic development, and for Russia's successful completion of WTO accession procedures. To ensure that such policy is implemented, the country must revise some regulatory aspects of its legal framework and launch a comprehensive sectoral reform of telecom regulations. This reform will attempt to make the legal and regulatory framework more transparent and secure for investors, and provide the public with better service at a reasonable price. New regulations should be compatible with the WTO principles outlined in the General Agreement on Trade in Services.

Specifically the reform should include the following components:

- A transparent regulatory regime for licensing to promote foreign and domestic investments efficiently and expediently
- A viable competitive environment through consolidation of local telecommunication monopolies
- Protection and promotion of consumer interests
- Enhanced management of telecommunications through sectoral privatization
- Harmonization of domestic regulations with internationally accepted standards in telecom policy, bringing the country's laws in compliance with the WTO provisions

- A presidential veto of the bill “On the Protection of the Economic Interests of the Russian Federation...” and Duma’s version of the bill “On Privatization”. These bills would severely hamper foreign investments in telecommunications companies.

The following legal reforms should be proposed in a package:

- Amendments to the existing federal law “On Communications” to comply with the WTO GATS Agreement, and Agreement on Basic Telecommunications Services
- Adoption of the “Federal Budget Law” for the Year 2002, including provisions on the sale of 25% shares of Svyazinvest
- Legislation for the education and retraining of workers unemployed from the telecom industry, to reduce negative social impacts of the reforms
- An ordinance to complete the consolidation of smaller local telecommunications carriers
- A decree to establish an independent regulator in the telecommunications sector
- Simplification of licensing regulations in telecommunications.

Despite advantages to investors, common citizens, and key Russian sectors as a whole, reform implementation will face the following obstacles:

- Bad publicity of previous privatization attempts, whose results were invalidated by major players and media outlets due to lack of transparency
- Opposition of conservative parties and politicians to liberalization and privatization in any sector of the economy, especially involving foreign investments
- Ignorance and apathy of the general public.

Although the demand for high quality telecom services is high, liberalization and privatization in telecommunications is of little public interest. Many are wary of the economic liberalization of the last decade, and are prejudiced against further liberalization efforts. The public needs to be convinced of the advantages of liberalization and privatization.

Regarding the legal aspect of privatization, Quantum Fund and its allies must address a new federal bill on a dispute between the State Duma and the government. The State Duma is attempting to control the privatization of large state-run enterprises significant to the Russian economy. The dispute is an obstacle to privatization and may delay the bidding contest on Svyazinvest.

Since Quantum Fund is a foreign company, it should base its strategy on telecom reforms to build a coalition of like-minded Russian interest groups that favor free market reforms in telecommunications. The proposed organization, the Coalition for Reforms in Russian Telecommunications (CRRT), should include the Interros Group, a group of Russian companies with extensive private holdings in media and manufacturing. Interros owns 10.7% of Mustcom, and shares Quantum’s interest in Telecom privatization for increased control of the telecom sector. Interros has developed extensive relations with politicians, the executive branch, and legislators. Together with Interros and the Quantum Fund, the CRRT should implement the following comprehensive strategy:

- *Strategy for the executive branch* will ensure the support of Russian Ministries and the Presidential Administration of privatization and liberalization of telecommunications. Once the support is confirmed the Coalition must ensure that the issue remains at the top of the agenda.
- *Strategy for the legislative branch* will focus on building support for the reforms by the majority in the State Duma and Federal Assembly. The Coalition needs to communicate the advantages of reform to the constituents of every senator and congressman, and ensure that proposed bills are put to a vote as soon as possible.
- *Media and public relations strategy* will emphasize the need for broad public support for the reforms. Along with local efforts, this will comprise the core of the grassroots strategy. The benefits of reform can be trumpeted through statements, testimonies, press releases, articles, advertisements, and other means of media.
- *International strategy* of the Fund will be built on Russia's aspiration to join the WTO and integrate into the world economy. Countries interested in investing in the Russian telecommunications sector must raise the issue of Russia's accession to the WTO. Media and public relations efforts on the international level should inform interested parties abroad about reforms in Russia, and how the reforms will benefit foreign businesses. The campaign will encourage telecom providers abroad to be proactive and lobby their governments to work for early implementation of Russian telecom reforms.

BACKGROUND ANALYSIS

Quantum Fund and its Mustcom partners own 25% of Svyazinvest. The remaining 75% of shares are in government possession. Svyazinvest subsidiaries control over 90% of the Russian telecom sector, which is largely underdeveloped due to monopolization and lack of transparency. Low phone line penetration and poor service quality stall business transactions, and create a significant barrier to trade development. The current non-transparent regime and weak legal regulations create opportunities for corrupt practices, posing an obstacle to Russia's WTO accession.

History of the Privatization and Restructuring Process

Until 1993, the Russian telecommunication network was fully controlled by the Russian Ministry of Telecommunications. In 1993, local network operators were privatized so that each region received at least one telecommunication provider, and more than 80 companies were established. A Russian telecommunication holding company "Svyazinvest" was formed in September 1995. The main objective of the company is to attract investments to develop the regional telecommunications networks, and improve the competitiveness of local providers. Svyazinvest controls 89 regional telecommunication providers ("electrosvyaz" companies), 3 municipal networks, 3 long distance and international telecommunication providers, telegraph companies, and the international telecommunication provider "Rostelecom". This makes Svyazinvest the largest shareholder of one of the largest telecommunication networks in the world. In the first round of telecom privatization, the Russian government is supposed to keep 50% of the Svyazinvest shares, with the remaining shares intended for sale at the auctions.

Despite Svyazinvest being presumably an independent company, the government, as the largest shareholder, has great influence on its policy, decision-making, and management strategy. In July 1997, the government sold 25% shares of the Svyazinvest holding for \$1.875 billion. The tender was won by the Cyprus based consortium, Mustcom, which included George Soros' Quantum Fund, Russian Uneximbank (owned by Interros Group), MFK, the Renaissance Capital Investment Fund, Deutsche Morgan Grenfell, and Morgan Stanley. The money raised went almost entirely to the government budget, with Svyazinvest retaining only \$95 million.

In June 1998, the Russian government announced a decision to sell another 25% (minus two shares) of Svyazinvest stock. The government would retain controlling interest, owning slightly over 50%. The Commission hoped to sell it for \$1.1 billion and attached investment obligations of \$400 million, making the total price of \$1.5 billion. At that moment, Svyazinvest was among the most profitable Russian companies, with a net profit of \$1.2 billion in 1997. However, as a result of the August 1998 financial crisis in Russia, the tender was cancelled. Telecommunication providers' debts were increasing, and the fall in the dollar/rouble rates resulted in a major devaluation. Russian carriers were not solvent to pay foreign producers for imported equipment. At the end of 1998, 35 of 89 Svyazinvest companies finished the year in the red.

Quantum Fund presently owns 53% of Mustcom. Quantum Fund has been increasing its share of Mustcom by buying shares from partners, most recently in August 2001. This demonstrates Quantum's commitment to the Russian telecommunications market, and confidence in liberalization and privatization reform. Mustcom presently owns only 25% of Svyazinvest, making it a minority shareholder dominated by the 75% share of the government. However, if the government agrees to sell an additional 25% (minus two shares), Mustcom will attempt to buy them. In that case

Mustcom, while not having controlling interest, would be a near equal partner, with an investment that yields significant influence.⁵

Sectoral Overview

The telecommunications infrastructure of Russia is not sufficient to handle the demands of the country's population. Over 6 million Russians are currently on the waiting list to receive phone lines. By the year 2005, the list will rise to 8 million⁶. The telecom infrastructure is characterized by inadequate capacity, low penetration (21.3%), poor call completion rates (56% of long-distance calls are incomplete)⁷, and a lack of modern communications services. The Russian economy has inherited a telecommunications infrastructure in urgent need of modernization.

Inadequate Capacity

Prior to 1992, a mere 0.15%⁸ of GNP was devoted to telecom infrastructure investment. The network has weak intercity, interregional and international connectivity, trunk line bottlenecks, and limited regional interconnectivity.

Low Penetration and Call Completion Rates

Main line penetration is low throughout Russia, and telephone densities are considerably lower than those of most other European countries. The basic network has roughly 22 million telephone lines and 34,000 switching stations. The national penetration rate is about 21.3 lines per 100 people. Only 2.5 million lines have digital switches, the rest are served by outdated crossbar technology.⁹ The network is still poorly prepared to serve the needs of the general population or the emerging business community.

Lack of Modern Communication Services

Until recently, the Russian public network had only one significant international exchange in Moscow. Although access can now be made through one of three gateway switches, they are insufficient to handle the current load of 110 million calls per year¹⁰. Businesses used to enjoy many international service options, and many companies used to hold licenses from the Ministry of Telecommunications for international communications in European Russia. Unfortunately, the Ministry of Telecommunications has recently dictated that this service can only be provided via Rostelecom, the Russian long distance carrier.

The long-distance network for calls within Russia is a mixture of radio relay, cable and satellite. Of the 1.2 billion long-distance calls made annually, only about 44 percent of domestic calls are successfully completed. In Moscow, the city network (MGTS) and intercity telephone network (MMT) have long been inadequate for international business. This condition is changing with the

⁵ Ingram, R., *Accounting: Information for Decisions*, 2nd edition, South-Western College Publishing, 2001, p.415.

⁶ Svyazinvest's Annual Report 2000.

⁷ Report on Indicators of Service Quality 1995-2000. Ministry of Communications. www.minsvyaz.ru

⁸ Neuman, W., *The Future of Russia's Telecommunications Infrastructure: Toward an Open Communications Environment*. Research Program on Telecommunications Policy, Massachusetts Institute of Technology, June 1995.

⁹ Neuman, W., *The Future of Russia's Telecommunications Infrastructure: Toward an Open Communications Environment*. Research Program on Telecommunications Policy, Massachusetts Institute of Technology, June 1995.

¹⁰ Kazachkov, Mikhail, On Certain Problems in the Russian Communications Sector, 14 May 1998.

introduction of newer technological equipment and foreign investment. However, these changes are slowed by investment risks associated with non-transparent and arbitrary policy in telecom.

Initially, foreign joint venture participants in Russia were mainly European (British, Belgian, Scandinavian). However, such American providers as Direct Net Telecommunications, Americom Business Centers, and Global TeleSystems Group have also attempted joint ventures. AT&T and Sprint offer calling card and E-mail/Internet services. The Moscow market is clearly more competitive, with rates leveling. Outside of Moscow, the situation is quite different. While some larger cities are following Moscow's footsteps, most of the country has difficulty communicating with Moscow and other Russian cities. Areas outside Russia are virtually inaccessible.

To improve the situation, new telecom technologies, such as VSATs (small stand-alone satellite trans-receivers) could be used to provide private telecom services to offices, factories, and areas unreachable via existing networks. These technologies require significant investment, which the Svyazinvest subsidiaries lack.

Recent Introduction of Western Technology

The first cellular system appeared in the early '90s. The lifting of COCOM restrictions initiated these changes. Recently, such new technologies as fiber optic and radio relay transmission, high-speed digital switching, and communication privacy have become available to support the development of the Russian telecommunications infrastructure.

Sectoral characteristics

The present Russian telecommunications sector is comprised of relatively independent regional providers. The traditional Russian telecom carriers, called "electrosvyaz", offer local, long distance and international services, data transmission, and telegraph services in specific regions. As a result of previous structural reforms, local providers of fixed services became monopolies in their respective regions. They control access to the fixed lines, which prohibits other providers from competing in the market.

During the last five years the share of telecom services of the Russian GDP increased by 1%. This is much lower than in major developed countries, where it is around 5%. The financial crisis and Russia's default on its external debt slowed telecom development.¹¹ The main investments are made in:

- financing local telecommunications networks
- developing private phone lines
- installing digital telecommunication equipment
- introducing new telecommunication services.

Eighty-nine main telecommunication carriers were established from privatizing regional telecommunications providers. Only three regional telecommunications providers and "Space Telecommunications" are now run completely by the state.

The following market segments illustrate Russian telecommunications:

¹¹ Goskomstat, the State Statistics Committee.

- There are more than 30 million lines for fixed line services. The average density of phone lines in Russia is 21.3 lines per 100 citizens
- mobile services are used by only 1.4 million and is growing 40% annually
- the Internet and data transmission are used by 2.5 million, and is growing at 50% a year.¹²

These peculiarities of the telecom sector affect the following development trends:

- Traditional electrosvyaz carriers form 87% of telecommunication infrastructure, but capture only 49% of all sectoral incomes. Their cumulative capitalization is \$2 billion, less than the capitalization of the three largest new entrants, MTS, Vypelcom, and Golden Telecom¹³.
- Six million customers currently demand phone lines. 54,000 rural settlements have no access to them.¹⁴ Traditional telecommunications carriers contribute 75% of all the input to telecommunications development.
- Fees for local telecommunication services are lower than their real cost; the capital invested in telecommunications will yield returns in 25–30 years.

Fixed telecommunications network

Most local telecommunication services are provided by 89 traditional carriers. Due to poor development of telecommunications networks, and the inability of people to pay higher value added services, the number of new entrants outside St. Petersburg and Moscow remains low.

Regional telecommunication service providers were crippled in the early '90s, when the sector was almost entirely deprived of any state investments. Regional telecommunication companies, especially ones serving large rural areas, were unprofitable, and required outside capital inflow to upgrade their outdated equipment. Capital earned by those companies was their major source of investments. Foreign investments were mostly devoted to buying new equipment, which helped advance Russian telecommunication services.

In 2000, the number of lines grew due to the adoption of such new technologies as digital and fiber optics, and radio rally lines based on SDH standards. The main current objective for telecommunication development is comprehensive digitalization. To accomplish this goal, providers must substitute 15% of outdated electro-mechanic telecommunication equipment, including cross-bar technology.

Although existing technology permits the provision of telecommunication services to any part of the country, remote and rural areas do not attract investment due to their low fixed fees for services. Development of rural and periphery telecommunications is key for promoting economic and agricultural reform. The Ministries of Agriculture and Communications have requested the Government prepare a new federal program on the development of rural telecommunications

¹² Conceptual Plan for Development of the National Telecommunications Services Market.

¹³ According to stelcom.ru, their capitalization reaches \$2.9 billion.

¹⁴ Conceptual Plan for Development of the National Telecommunications Services Market.

through the year 2010. The sources of financing for this program are local telecommunication carriers, private loans, and transfers from local and federal budgets.

Mobile telecommunications services

Mobile telecommunications comprise only 2% of all services, and are unaffordable to most Russians. However, in 2000, the number of mobile lines grew 156% from the number in 1999.¹⁵ This impressive growth was captured mostly by three Moscow based mobile telecommunications carriers. In 2001, two basic standards will merge into a third generation standard. This technological development will propel the national trend towards a national mobile carrier. If current government policy in telecom remains unchanged, Svyazinvest subsidiaries will be unable to participate in this profitable market.

Internet

Internet services was one of the fastest growing sectors in the end of 1999. However, underdevelopment of e-commerce and poor digitalization of the telecommunications network impeded even better growth. On the other hand, popularity of the Internet was sustained due to the activities of content-providers and new abilities to expand IT resources. Customers in Russia and in the rest of the world are shifting demand from simple phone calls to IP and multimedia services. Svyazinvest must develop its networks to enable its companies to offer high value Internet services.

A national Internet provider will soon be established in Russia, and since Svyazinvest plans to retain 20% of the market share, it must participate in the process. The spread of Internet services is not equal. Most Internet users are located in Moscow and St. Petersburg (See Chart 1).

Sectoral Reform Priorities

Communications infrastructure must become a top priority for the Russian government. As the market economy develops, the impact of the communications infrastructure is more important. There is great demand for upgraded telecom networks that enable commercial enterprises to react promptly to changes in the world. Inadequate telecom services are a significant obstacle to international businesses.

The development of the telecommunications network is directly linked to overall economic and societal development in Russia, and Russia's integration into the world economy. Fast development of telecommunications increases national welfare and security, encourages GDP growth, and promotes progress in science, health care, culture, and industry. As a result, Russia could easily become one of the largest world markets for telecommunications goods and services.

Monopolization Issues of the Sector

The present organization of Russian telecommunications reinforces natural monopoly over competition. Any time a new market opens there is a tendency for firms entering the market to aspire to monopoly. Each firm assumes it will do best by controlling the entire market. When the market is large and the number of competitors is small, there are incentives for competitors to divide the market among themselves and agree not compete with each other. This type of anti-

¹⁵ mis.ru/archiv/990225.htm

competitive collusion is occurring in Russia. The uncompetitive behavior can be seen in the three kinds of monopolies that have developed in Russia:

Monopolies by Geographic Area

Each region has established its own monopoly service provider for telecommunications, and some local authorities have even passed laws allowing the local government to re-nationalize the telecommunications provider. Outside of Moscow, local authorities often establish exclusive franchises for overlay and data communications services.

The difficulties with these monopolies are both administrative and technological. Relationships with different carriers vary, requiring new negotiations at each level for companies wishing to gain access to telecommunications services in Russia. Additionally, the quality of the infrastructure varies from region to region, sometimes requiring different technological solutions for interconnection between the individual monopolies. Economic inefficiencies, increased costs, and business failures result.

Monopolies by Closed Access

Service providers can refuse a request for interconnection from another carrier or company trying to gain access to telecommunications services. Since there is no open regulatory basis to mandate interconnection between networks, such conflicts are usually resolved through the political process. No attempt to create a broad standard for interconnection has yet been made by the legislature or Ministry of Communications.

Monopolies by Service

In major cities, there is a division of digital services by bit rate, which is the established measure for the volume of information that can be transmitted through a telecommunications network. Various carriers have reserved communications links with a particular speed, such as the standard phone line for voice (1–2 kilobits per second), voice network modems (9600 bits per second), and various higher speeds (predominantly at 64 kilobits per second and at 2 megabits per second). By fixing a bit rate, service providers often make it impossible for interconnection to occur with a transmission system at a different rate. The opportunity for “bandwidth on demand”¹⁶, which would allow users to choose the rate of data transmission to meet their needs, does not exist.

Service providers attempt to achieve a competitive advantage in niche markets or through monopoly licenses provided by a local or the national government. This arrangement results in a closed access, and defeats attempts to bring networks together.

The monopoly strategy makes sense for a single firm, but not for the society as a whole. The Ministry of Communications and the local authorities should resist the establishment of little monopolies. If Russia is to foster a unified and open communications environment, it must cultivate competition and open access, not monopolies.

Preserving the current monopolistic regime is not even in Quantum Fund interests, since the regulatory policy punishes local Svyazinvest monopolies with social obligations imposed by the

¹⁶ Wiltshire, W., “United States: Capitalizing On A Window Of Opportunity For Reform Of Telecommunications Regulation In The Russian Federation,” April 1998.

government. Although the government is supposed to cover the difference in cost and price of service provided to eligible citizens, in practice it does not. This results in a loss of profits for Svyazinvest, and ultimately, results in a loss of potential service markets.

Developing a Competitive Market for Services: Establishing the Economic Incentives

The incentives for a monopolist and a competitive provider are entirely different. A monopolist maximizes profit by investing in the most profitable areas; a competitive provider invests wherever there is the possibility for revenue. The basic difference lies in how profit is generated. The price level set by the monopolist is the marginal cost plus a markup, which includes the price elasticity of demand. The price elasticity of demand for advanced telecommunications services in Russia is low. That means that profits are to be gained by monopolists, but the prices will remain high, and the amount of services offered will be low, so long as monopolies dominate.

A competitive firm seeks profitability at market prices, and is encouraged to innovate for market advantage and to seek new markets. The government is challenged with developing the appropriate regulatory framework to encourage existing telecommunications entities to move from monopolistic to competitive practices. The government must focus on bringing competitors into the open market and establishing the framework where supply meets demand.

Licensing to promote competition

The federal government currently grants many licenses for exclusive franchises. This type of licensing is used to establish monopolies, and creates incentives for corruption. The benefits to society in this case are dubious. Monopolists make small-scale investments in the most profitable regions and technologies, with no economic incentives to lower prices or service smaller customers.

The role of licensing should not be to limit the number of firms operating in the market by creating monopolies. Rather, licensing should ensure adherence to the ground rules of the Russian telecommunications regulatory authorities. The ground rules should include pricing policies, interconnection to competitors, and infrastructure development.

The value of a license depends on the amount of funds a provider is willing to invest. Open access through low-cost licensing results in greater levels of investment, more competition among service providers, and lower cost service to a larger number of consumers. Licensing can help overcome the positions of monopolists. For example, licenses for data transmission should contain provisions to ensure that a wide range of rates are available and, if multiple rates are not provided, that the license be revoked. This type of license provision would force providers to offer demanded services, or variable rates.

Licenses should be flexible enough to allow service providers in one area to compete with licensees providing similar services. For example, a provider of wireless services is a potential competitor with wire line local service providers. By constraining cellular providers to specific technologies and specific service models, the government has effectively prevented the entry of a wireless access provider into the market for local services.

Establishing Interconnection to Promote an Open Communications Environment

An important goal of all Russian providers is to prevent access to their network by competitors. Dominant carriers can deny interconnection. Without regulatory intervention, they can force

potential competition out of the market. If the goal of government policy is to promote competition and lower prices, an effective and fair regulator must enforce interconnection.

Interconnection suits the long-term interest of providers, because it increases the value of communications services to consumers.¹⁷ When consumers see value in a service, demand increases, the market grows, and all competitors benefit. From the national perspective, it is important to increase networking to improve consumer welfare and expedite market development.

Network operators always want to charge more for access to their own networks, and be charged less for access to other networks. A regulatory regime for fair and reciprocal access will facilitate the flow of traffic across network boundaries and speed the growth of open communications. Reciprocity, where all traffic is equal, has been suggested by a number of experts, but has not yet been fully implemented.¹⁸

The government should enforce interconnection policy consistently. The challenge is to convince the government to agree at each level to ensure a uniform application of regulation across all monopolies.

WTO regulations on telecommunications

Russia's accession process to the WTO

To attract foreign capital, enhance competition, and develop its telecommunications sector, Russia must bring its regulations in line with WTO requirements. These telecom reforms will be a prerequisite for Russia's accession to the WTO. They simultaneously will improve the telecom sector at home.

Russia submitted an application to join the WTO in 1994, and offered specific proposals for trade in services in October 1999. To promote WTO accession, Russia is negotiating trade agreements with such major partners as Canada and the EU. In August 2001, the Government directed the Ministries to monitor the implementation of measures bringing Russian legislation in compliance with WTO norms. As part of these efforts, Russia must bring its legislation in compliance with the WTO General Agreement on Trade in Services and Basic Telecommunications Agreements (BTA).

The BTA stipulates that investors from one country-signatory can acquire and establish telecommunication companies in another. It also requires signatory countries to implement pro-competitive telecommunication regulations. Parties schedule binding, most-favored-nation commitments concerning market access, investment, and regulatory principles. Telecommunication carriers of signatories should also be able to access local, long-distance, and international services through all means of network technology, including wire line, cellular, and satellite technology.

The BTA includes the following documents:

¹⁷ Smith, Peter. *Subscribing to Monopoly: The Telecom Monopolist's Lexicon—Revisited*. Public Policy for the Private Sector, N. 53, The World Bank, September 1995.

¹⁸ Smith, Peter. *Subscribing to Monopoly: The Telecom Monopolist's Lexicon—Revisited*. Public Policy for the Private Sector, N. 53, The World Bank, September 1995.

- 4th Protocol to the General Agreement on Trade in Services (GATS)
- Lists of most-favored nation (MFN) exemptions
- Supplementary schedules of commitments
- Reference Paper on Pro-competitive Regulatory Principles
- Two notes on scheduling methodology of the Chairman of the WTO's Working Group on Basic Telecommunication

General Agreement on Trade in Services (GATS)

The GATS is an annex to the Agreement Establishing the WTO. The GATS has three main parts:

- a framework of general obligations and disciplines for government regulations on trade and investment in services
- annexes and ministerial declarations that complete rules mentioned in the framework, and define the timetable for follow-up activities and additional negotiations
- country schedules in which members agree to accord foreign service providers with market access and national treatment

The GATS lists countries' obligations to facilitate trade and investment in telecommunication services. The obligations included in the Telecommunications Agreement are as follows:

- *Most Favored Nation (MFN) Treatment*, which obliges WTO members to provide other members treatment no less favorable than that to any other country
- *Transparency*, which requires that measures related to trade and investment in services should be publicized, and that public notice should be given of any changes in these measures
- *Domestic Regulation*, which requires that all measures affecting trade in services be administered in a reasonable, objective and impartial manner
- *Monopolies and Exclusive service providers*, which requires signatories to ensure that monopolies and other firms with market power act in a manner consistent with scheduled commitments.

GATS Annex on Telecommunications

The Annex provides that all firms requiring telecommunication networks have adequate access to national telecom infrastructures. It stipulates that negotiations will be concentrated in "public telecommunication transport networks and services," indicating that WTO members would negotiate conditions of access to telecommunication facilities. The Annex requires that foreign firms be ensured the use of public telecommunication networks (PTNs) on a reasonable and non-discriminatory basis.

The two Ministerial Decisions and the Fourth Protocol to the GATS

The two Ministerial Decisions incorporated in the Telecommunication Agreement include:

- The Ministerial Decision for Negotiations on Basic Telecommunications, which stipulates that negotiations on telecommunication services be conducted on a voluntary basis.
- The Ministerial Decision on Commitments in Basic Telecommunications, which provides for the adoption of the "Fourth Protocol to the General Agreement on Trade in Services."

Schedules of Commitments and 9 lists of MFN exemptions

These Schedules of Commitments provide information on market access and national treatment in the signatory countries. The nine lists of MFN exemptions outline the exemptions of WTO countries from MFN treatments. They also list commitments on pro-competitive regulatory principles found in the Reference Paper.

Reference Paper on Pro-Competitive Regulatory Principles

This Reference Paper obliges governments to regulate “major suppliers” of telecommunications services, meaning dominant incumbent carriers. It commits signatory countries to ensure the following pro-competitive and non-discriminatory regulatory principles:

- 1) Governments must take measures to assure that major suppliers not engage in anti-competitive practices, such as the use of anti-competitive cross-subsidies, the use of information obtained from competitors, or the withholding of timely technical information needed by competitors.
- 2) Governments will assure competitors’ interconnection with a major supplier at any point in the network. The terms, conditions, and quality must be non-discriminatory. Interconnection must be timely, and its rates must be transparent, cost-based, and economically feasible.
- 3) Governments may maintain policy measures to achieve universal service. However, they must be administered in ways that are transparent, non-discriminatory and competitively neutral. They should not be more difficult than necessary to achieve universal service.
- 4) The regulatory body must be separate from the operators, and must employ procedures that assure impartiality.
- 5) Governments will use procedures to allocate and use scarce resources, including frequencies, that are timely, objective, transparent and non- discriminatory.

Chairman’s Notes

In 1997, the Chairman of the Group on Basic Telecommunication issued a note indicating that a country’s commitments on basic telecommunications would apply to three areas:

- Fixing local, long-distance, and international services for public and non-public use
- Networks based on all transmission technologies (e.g. wire lines, cellular and satellite networks)
- Facilities based and resale services

Each schedule will indicate the extent to which foreign firms may acquire a significant share in national telecommunication firms.

International regulations in telecommunications

The objective of telecommunication regulations varies from country to country. Governments in most countries continue to see telecommunications as an essential public service. Even when telecommunication networks are no longer run by governments, they retain a regulatory role to ensure public interest.

WTO regulations tend to reduce government involvement and deregulate the telecommunications sector. The WTO established certain widely accepted regulatory objectives, including:

- promoting universal access to basic telecommunications services
- meeting the demand for telecommunication services of good quality, value added services for affordable prices
- preventing abuses of market power such as excessive pricing and anti-competitive behavior of dominant firms
- creating a favorable climate for investment to expand telecommunications networks
- promoting public confidence in telecommunications markets through transparent regulation and licensing processes
- protecting consumers' rights
- increasing telecommunications connectivity through efficient interconnection arrangements
- using scarce resources, including a radio spectrum, numbers and rights of way efficiently

The privatization and liberalization of telecom sectors led to the re-organization of government regulatory bodies. Most nations that have carried out telecommunications reforms have established a separate national regulatory authority, which is required by WTO provisions. This institutional structure ensures that telecommunication operators are independent from the regulator. In Russia, government social policy often influences the pricing policy in the telecommunications sector. The policy of local authorities often makes it hard to enforce international regulations. An independent regulator could resolve existing cross-subsidization and interconnection disputes.

International implications of the privatization and liberalization plan in Russian telecommunications

Liberalization of the Russian telecommunications sector is consistent with countries' aspirations to integrate into the world economy and obtain membership in the WTO. To become a member of the WTO, Russian regulatory policy should comply with the following key principles outlined in the GATS and BTA provisions:

- most-favored nation and national treatment, which stipulate that all partners are treated equally, and that foreign providers or investors not be discriminated against
- a non-discriminatory, competitive environment for the entrants
- prosecution of cross-subsidization and high interconnection fees
- regulations of telecommunication policy are conducted by an independent body.

These WTO provisions show that Russia must reform its telecommunications sector to gain membership. Some who resist rapid reforms argue that Russia could merely provide a commitment to bring its regulations in compliance with the WTO agreements after accession. However, this strategy has the following disadvantages:

- The accession requirements for Russia as a large trading entity contain a number of complicated issues and may hamper its accession. The restructuring reform will reduce a number of main issues to negotiate. Voluntary telecom reform will demonstrate to negotiators that Russia is ready to liberalize its economy to become a WTO member. This step will make it easier for

Russian negotiators to obtain concessions on important trade issues like opening foreign markets to Russian steel.

- Countries with transitional economies (Hungary, Czech Republic, and Baltic States) that have recently become WTO members have committed themselves to these principles and experienced a growth in telecommunications. If Russia fails to reform its telecommunications market, it will remain a country with underdeveloped infrastructure. In the long run, this will result in a further demise of the economy and a loss of potential investments.

The liberalization of the sector will resolve the following issues:

- establishment of an independent regulatory body
- change in the pricing policy to prevent cross-subsidization and high interconnection fees
- introduction of competition through the restriction of local monopolies.

Russia should enact telecommunications reforms prior to joining the WTO. The implementation of this plan will bring Russia in compliance with WTO agreements, and put the Russian delegation in a more favorable position at the accession negotiations.

ANALYSIS OF POLICY ISSUES IN THE RUSSIAN TELECOMMUNICATIONS SECTOR

The current telecom regime has failed to address adequately the issues of cost-based inter-connection fees, cross-subsidization, and monopolistic regulations. Furthermore, Svyazinvest subsidiaries cannot take full advantage of their monopolistic positions in providing services, since they are excessively burdened by governmental social obligations. To cover the difference in service fees and costs, they are forced to engage in cross-subsidization, resulting in lost profits for Quantum Fund and other Svyazinvest investors. Current government telecom policy will raise great concerns at WTO accession negotiations and slow Russia's integration into the world economy. Telecom underdevelopment is better addressed through free market reforms than through continued monopoly protection.

Policy and Principles of Quantum Fund and George Soros

One of the main reasons Quantum Fund advocates free market reforms in telecommunications is that George Soros is philosophically and politically committed to economic liberalization. Mr. Soros, the founder of the Open Society Institute, established a series of programs supporting democracies and market economies in Eastern Europe and the former Soviet Union. Advocating liberal reforms in Russian telecom is consistent with Mr. Soros' intentions to promote a free democratic society with open access to all kinds of information.

Strategy dictates that Quantum Fund pursues market reforms. Privatization, especially with foreign participation, cannot realistically be obtained without market liberalization. The government will not turn over the monopoly to private hands while protecting its monopoly privileges. Commercial Analysis shows that Quantum Fund prefers to operate in an open market where profits are driven by market forces rather than unpredictable, non-transparent regulatory decisions.

Quantum Fund prefers to push for free market reforms rather than buying shares in a protected monopoly. Mr. Soros is deeply committed to liberal market reforms in emerging economies. He wants to multiply his capital, but not at the cost of his reputation. He is committed to earn money in a free market, capturing market share and defeating competitors by offering better service rather than using political connections. An open market and Svyazinvest's privatization will free the company from burdensome social obligations imposed by the government.

Mr. Soros' Open Society Institute promotes free market reforms and democratic values around the world. Through government grants, Mr. Soros can administer programs that advance these ideals. Advocating market reforms as a businessman, managing the Quantum Fund, is consistent with the work of his foundation and his philosophy.

Telecom reforms will involve the following policy objectives:

- Establishing of a transparent and efficient regulatory, pricing, and licensing policy
- Establishing an independent regulatory body to monitor the sector
- Promoting foreign and domestic investments in telecom infrastructure

- Bringing domestic legislation in compliance with existing internationally accepted practices and standards. This involves making domestic telecom regulations compatible with the WTO to accelerate the accession process.

Since telecommunications affect banking, tourism, information technology, and other vital industries, these changes will greatly impact Russia. The opposition will put forth arguments to hamper sectoral reform. To counter their arguments, supporters of reform need to recognize the legitimacy of the opposition's concerns, and point out that free competition is the best way to resolve the industry's problems. Supporters of reform should be prepared to respond to the following policy issues:

The reform is beneficial for consumers, investors, operators, and the government

Reform is consistent with the Conceptual Plan for National Telecommunications Policy recently adopted by the government. This document set ambitious objectives for increasing teledensity, and attracting \$33 billion in investment to the sector in the next 10 years. Special attention was paid to extending telecom service to remote and rural areas. These challenging goals can be implemented only if the government supports its declaration with regulatory reforms to attract new investments.

Consumers will benefit through access to new competitive services. Companies presently lack resources to develop their networks and maintain existing lines. Investors will bring new technologies, appreciation for good engineering and managerial skills, and further development of infrastructure. A competitive market will increase tax revenues for the government and provide consumers with a choice of services at lower prices.

On the international level, the implementation of pro-competitive reforms will help Russia in WTO accession negotiations. Given that the GATS provisions are binding for all WTO members, the compliance of Russian policy in telecom with GATS Annex on Telecommunication will be the main subject at the negotiations. Although provisions of the Reference Paper on Telecommunications are not binding, the issues of Russian transparency, pricing policy, and market access are likely to arise in bilateral negotiations. It will take Russian authorities much time to bring legislation in accordance with the WTO provisions. If Russian authorities commit to reform in advance, a significant problem will be removed from the legal agenda, which otherwise would create an obstacle to entry. Russian attempts to resolve the regulatory issues in advance would be well received. Russia would appear as a serious negotiating partner determined to support world initiatives for telecom deregulation.

Maintaining natural monopolies in the sector benefits neither customers nor industry

Svyazinvest is a telecom holding controlling regional telecom providers that are considered natural monopolies in those areas. Through Svyazinvest, the state has controlling shares in more than 90% of all operators. Economic inefficiencies hurt investments and customers, and hamper development of the industry.

Overstaffing is one of the problems that have prevented the operators from developing successfully and making profits. Data show that 17 people are required to service 1000 phone lines in Russia,¹⁹ which is six times the staff required in the US. This difference reflects the relative quality of

¹⁹ Mikhail Kazachkov, *On Certain Problems in the Russian Communications Sector*, 14 May, 1998

personnel skills. If the market opens, current Russian employees may struggle to maintain positions, as new entrants bring new technologies and stricter working requirements. The government can address the needs of laid off workers through education and retraining programs, to help them find jobs in the modernized telecom industry or other sectors of the economy.

Despite the government's goal for exponential growth of phone lines,²⁰ teledensity in Russia remains low. The state-owned providers have been unable to meet the demand for phone lines. Russian teledensity is only 21.3%, and the growth of new lines is weak.²¹ Clearly existing operators cannot meet a growing demand for phone lines.

Disruptive Monopoly Tactics

To support the dominant position of natural monopolies, policy makers had to ensure that providers are operating in a non-transparent and non-competitive environment. These uncompetitive measures include:

1. Cross-subsidization

Monopolies cross-subsidize by charging low fixed prices for local services and unreasonably high fees for international and long-distance calls. They also cross-subsidize by charging higher service fees for businesses than for residences. Exorbitant profits in business services make up for losses in local services. In Russia, where the Internet remains underdeveloped, there are no feasible substitutes for long distance telecommunications.

Proponents of monopolistic cross-subsidization argue that the size of Russia's territory and uneven density of Russia's population force the country to apply cross-subsidization. They claim this makes it possible for companies to provide universal services in remote and rural areas.

This argument is flawed for the following reasons:

- ***Many remote areas remain without telecom services.*** Despite the goal of universal services, about 54,000 settlements²² have no telecommunications lines. Many remote areas have unsatisfactory services based on outdated technology. Therefore, free market is the only solution for resolving their communication issues.
- ***Cross-subsidization does not ensure universal services.*** Competition and free market are better tools for providing universal services than cross-subsidization. Cross-subsidization targets the demand side of the equation, not the supply side, as it is the case with competitive markets. Investments, new technologies, and new infrastructure may not result in universal services, but they will definitely decrease prices and the cost of services. This will allow companies to service a large number of customers without violating internationally accepted norms.²³

²⁰ Conceptual Plan for Development of the National Telecommunications Services Market.

²¹In 2001, there were added only 1.25 million new lines, which comprises only 4% of existing lines.

²² Data from the website of the Ministry of Communications.

²³ Canadian Minister of Supply and Service, 1986

- ***Cross-subsidization deprives companies of their steady incomes.*** Charging residential customers fixed fees results in lost revenues for telecom operators. The demand and market share of local services is much larger than the demand for business and long-distance services. The discriminatory policy of monolithic operators may cause a business to leave the area.

2. Interconnection

Telecom monopolies are common in fixed phone line services. Unlike mobile service, fixed lines require development and maintenance of the cable, which raises the cost of a telecom investment project. Interconnection would allow new entrants to expand their businesses for a rent payment to the owner of the cable. However, local telecom monopolies may set unreasonably high fees for interconnection, which defeat efforts to expand services to Russia.

- ***High interconnection fees create a barrier for new entrants.*** As a result of this non-competitive behavior, customers suffer a lack of choice. To keep competitors away, a telecom monopoly sets a service fee much higher than the quality or cost of the service. Competition would increase efficiency of telecom operators and promote new technology and investments.
- ***High interconnection fees are not in the long-term interests of citizens and policy-makers.*** By keeping potential operators from the Russian market, interconnection barriers prevent federal and local officials from collecting extra revenue from increased operations. This revenue could have been channeled to universal services for remote areas, or towards infrastructure to make lines compatible with new technologies.

3. Skimming

Skimming means providing service only to areas where operators are ensured the highest profit margin. Russian policy makers who oppose liberal reforms in telecom argue that foreign providers will target only lucrative, easy-to-reach areas, leaving out remote and rural areas. However, skimming is most appropriate for high-end value added services. These services are frequently not provided by local monopolies, which lack sufficient resources to invest in high technologies. Even if the provider sets the price too high for larger profit margins, its competitors will claim market share with lower service prices. Additionally, skimming will only be possible in the introductory phase. Under competition, price distortion caused by skimming will disappear. According to World Bank data, the open telecom market in Chile resulted in bringing telecom service to a third of the remote rural population that previously lacked it.²⁴

The government can control skimming practices. Punishment of cross-subsidization will equalize the providers and make uncompetitive behavior more difficult. Deregulation and reforms will hasten the expansion of the telecom market to rural areas, if urban residents and city businesses pay equal fees.

Unemployment

Opponents of reform argue that liberalization will result in significant layoffs. However, the employment analysis of Asian and Latin American countries that conducted liberal telecom reforms

²⁴ Wellenius, Björn, "Extending Telecommunications beyond the Market: Toward universal service in competitive environments", *Public Policy for the Private Sector*, World Bank Group

show a higher job growth under competition than under monopolies (20.8% vs. 3.2%)²⁵. The penetration of new providers will increase the demand for telecom workers. According to projections based on data from liberal reforms in Chile, Russian telecom operators will be able to employ as many workers as in 2000, by the 15th year of the reforms.

Opponents may argue that some former employees have low skills, and are bad prospects for reemployment. In response to that argument, the Fund may suggest that the government launch a retraining program to ensure that this work force is utilized. Besides, Russia is currently experiencing economic growth (5.5% growth of GDP in 2001), which means that the unemployed will likely be captured by expanding industries. This is another argument to accelerate reforms, when Russia can deal with negative consequences of liberalization more successfully under economically favorable conditions. While retraining may be expensive, it is far less costly than keeping employees in their current jobs by protecting inefficient monopolies that hurt the economy.

The independent regulator

An independent regulator is crucial in the development of virtually every market. A regulator with expertise in the industry can aid the transition from a market with one firm to a market with healthy competition.

Proponents of establishing an independent regulator must emphasize the following:

- ***The Government will not lose control over the sector.*** Opponents of reform may argue that the government will lose control over the sector if policy is regulated by an independent body. Under the proposed reform, the Ministry of Communications would retain its responsibility for making broad telecommunications policy and participating in international negotiations. A separate and independent regulator would implement that policy by adopting rules and regulations, processing licensing applications and awarding licenses, resolving disputes among providers, handling complaints from the public, ensuring compliance with licensing terms and conditions, setting standards and approving equipment specifications. An independent regulator will ensure that industry policy is conducted in an impartial manner.
- ***The independent regulator will not require significant allocations of budget money.*** To increase its independence from interest groups the regulator would fund its operations from its own consulting fees as much as possible. That will reduce the amount of budget money the government will have to allocate to form and finance this new federal agency.
- ***The independent regulator will instill confidence in investors.*** Even after the proposed privatization, the government will retain controlling shares of telecom operators. Therefore, prospective investors will require assurance that their investments are secure. The independent regulator's policy will protect its operations from the financial pressure of the state-run enterprises and political pressure. Decisions managing the competitive market will turn neither on the government's desire to promote proprietary interests, nor on political influence. This will

²⁵ Wellenius, Björn, *Telecommunications Reform—How to succeed*. Public Policy for the Private Sector, The World Bank, October 1997.

make investments in the Russian telecom sector more attractive, contributing to stronger market competition.

- ***Public participation and influence on telecom policy will increase.*** Telecommunications reform will promote public needs and enhance consumer welfare. Under present telecom policy, regulators hear mostly from large operators, losing sight of public needs and other players in the industry without strong support in the political hierarchy. A regulator will address this issue by offering proposed regulations for public comment and simplifying the process for providing input. The regulator would also solicit input from industry and end-users of telecommunications services to ensure that regulation is achieving its objectives. The transition will take time and necessitates public commitment to the process.

ANALYSIS OF COMMERCIAL ISSUES

Though Svyazinvest would lose a monopoly from telecom reform, Quantum Fund would benefit by becoming less dependent on the government in its pricing and investment policy. Reform will remove social burdens which have pushed Svyazinvest to cross-subsidization and have resulted in a low level of capitalization and investments. Experience in such countries as Chile and Germany shows that privatization and liberal market reforms have allowed dominant carriers to offer more lucrative value-added services, such as Internet provision and mobile telecommunications. Due to reforms, the dominant carriers in those countries increased their profitability. Svyazinvest also will increase its customer base and maximize profits. Quantum will be able to recuperate its original investment three times faster than under current conditions. Telecom reform reflects Quantum President George Soros's advocacy of liberal market reforms in emerging economies.

The commercial and economic goals of proposed liberalization and privatization reforms are:

- to increase the value of Quantum's shares in Svyazinvest by improving Svyazinvest's profitability, revenue, and customer base
- to increase Svyazinvest's revenues and profits through further expansion to mobile and value added services
- to increase Svyazinvest's operating efficiency
- to promote new technologies and markets for Svyazinvest
- to ensure further investments in the company's subsidiaries

Commercial interests of the Quantum Fund in privatization

Quantum Fund presently owns 53% of Mustcom. It has increased its share of Mustcom by buying shares from partners, most recently in August 2001. This demonstrates Quantum's commitment to the Russian telecommunications market, and confidence that liberalization and privatization reform will proceed. Mustcom presently owns 25% of Svyazinvest, making it a minority shareholder, dominated by the 75% share of the government. Through Mustcom, Quantum Fund indirectly owns 13% of Svyazinvest stock. If the government agrees to sell an additional 25% (minus two shares) Mustcom will attempt to buy it. In that case Mustcom, while not having controlling interest, would be an almost-equal partner. Quantum Fund would then own, indirectly through Mustcom, 26% of Svyazinvest. Since this share amounts to more than 20%, Quantum Fund's investment would yield significant influence.²⁶ With over 25% of the shares, Quantum Fund would get two seats on the Board of Directors of Svyazinvest. Quantum Fund is convinced that further privatization is necessary to protect its original \$1 billion investment, increase the value of its shares in Svyazinvest, and increase its long run profit potential.

Commercial interests of the Quantum Fund in open market reforms

Privatization and economic liberalization in telecommunications should take place simultaneously. As a private foreign company, Quantum Fund is not in a strong position to argue for privatization while maintaining monopoly privileges. The government simply will not want to put its state run monopoly into private hands, especially to those of a foreign company. Realistically, Quantum Fund can only achieve the privatization it needs if it accompanies free market reforms.

²⁶ Ingram R., "Financial Accounting: Information for Decisions, South-Western College Publishing, 2001, p.415.

The reason for combining privatization and liberalization is not just strategic. Open market reforms are in Quantum's best commercial interests of long-term profitability. Quantum can compete best in a free market environment, where profits are dictated by market forces rather than regulatory decisions.

Well-regulated monopolies can operate efficiently, make profits, and serve the interests of consumers. However they require the type of honest, transparent, and effective regulatory system that is lacking in Russia. Monopoly profits are dependent on rulings of regulators, who in Russia are non-transparent and often corrupt. It is best for investors, such as Quantum Fund, to invest in a company whose profits are based on market performance, rather than on the unpredictable, arbitrary, non-transparent decisions of regulators. Rather than investing in a non-transparent, poorly regulated monopoly, Quantum Fund's interests are best served by investment in a more openly competitive Russian telecom market. Quantum Fund supports liberalization reforms in the Russian telecommunications sector to increase competition, transparency, and predictability, and promote a level playing field for all private, foreign, and state companies. These reforms will meet WTO provisions and allow Russia to join the WTO.

Reasons for further privatization of Svyazinvest

The reasons for the sale of the remaining 25% of Svyazinvest shares are:

- to raise money for the development of the telecom networks (additional loans)
- to help Svyazinvest subsidiaries enter new markets
- to spur demonopolization of the local telecom markets
- to help new operators penetrate the local markets

Stakeholders' potential benefits from proposed reforms will include:

Svyazinvest:

- access to new technologies, networks, and investments
- increased efficiency and operating quality
- improved price re-balancing
- larger market capitalization, more liquid stock in the future
- improved transparency and regulation of regional telecom policy
- faster elimination of traffic bottlenecks caused by local infrastructure

Businesses, citizens and industries:

- choice of telecom providers and services to fulfill their needs and match their budgets
- considerable savings on VAT and revenue-based taxes on intra-industrial transactions

Government:

- ensure telecom services for lower prices
- increase phone line penetration
- meet a growing demand for new phone lines
- attract new investments and new telecom technologies
- ensure development of the Internet and e-commerce

The restructuring of Svyazinvest and telecom liberalization will increase its revenues

Restructuring Svyazinvest by consolidating the company's regional operators into seven interregional operators will generate about \$200 million in extra revenue. Earnings before interest, taxes, depreciation and amortization are expected to grow by 32%.²⁷ The combined revenues of Russian communications companies and Svyazinvest have fallen in the past three to four years, as have their capitalization and investments. The country's telecom market shrank to over \$5 billion during this period. The market has undergone structural changes, with revenues and capital investment moving from traditional providers of fixed line services (the domain of Svyazinvest's subsidiaries) to mobile operators. Traditional operators currently have only 49% of revenues, while new operators, largely cellular companies, earn 51% of revenues. The Svyazinvest restructuring strategy for the telecom market will help eliminate this disproportion.

Svyazinvest will be able to offer mobile phone service to protect against market share encroachment

Provision of fixed phone line service will be profitable for Svyazinvest and Quantum Fund. Privatization will lead to capital improvements in fixed line service, which will attract customers. As experience shows, former telecom monopolies in fixed line services were able to capture mobile services and turn into strong telematics companies as a result of liberal reforms.²⁸ Svyazinvest can profit from mobile telephones as well. With reform, operation in the mobile services segment will no longer hurt Quantum Fund and Svyazinvest's profitability for the following reasons:

- Expansion of Svyazinvest operations to mobile services is largely hampered by arbitrary, non-transparent policy of the Ministry of Communications. Reforms will allow Svyazinvest to offer services through its local providers and compete in the mobile telecom market.
- Mobile service will be slow to develop in parts of Russia because many consumers will continue to rely on fixed lines. By improving fixed lines with additional capital acquired through privatization, Svyazinvest can profit from them. The experience of Chile, which had similar underdevelopment, shows that the dominant carrier managed to entirely digitalize its fixed lines five years after the introduction of liberal reforms.²⁹ Establishing a network of mobile service will require a large capital investment. Significant problems of compatibility between the Asian, European, and American systems will take time to resolve.
- Providers of fixed line service, like Svyazinvest, will be able to offer their customers mobile service. Svyazinvest subsidiaries will have a leg up on offering national mobile services because they already have a solid fixed line customer base.

To a certain degree mobile phones will take market share from fixed line providers. Svyazinvest and Quantum Fund can protect themselves from this trend by offering mobile phone service through their subsidiaries. In Kuzbass, for example, the local telephone provider, which is 54% owned by Svyazinvest, provides 32% of mobile phone service in the region it serves.³⁰ Privatization will enable Mustcom and Quantum Fund, through Svyazinvest subsidiaries, to develop and offer mobile phone services and capture market share. The liberal market in mobile phone services will

²⁷ Interfax News Agency, *Communications & Electronics Report*, April 16, 2001.

²⁸ DTAD Annual Report 2000.

²⁹ CTC Annual Report 1996.

³⁰ Kolpakov, K., "Expansion Strategies for "Kedr", *Capital*. 11 December 2000.

allow entry to Svyazinvest subsidiaries with an existing fixed line customer base, provided they are prepared to compete.

Quantum Fund should use its position on the Board of Directors of Svyazinvest to argue that the holding company should follow the example set by its subsidiary in Kuzbass.

Projections on Svyazinvest's revenues, profits, and investments

Profits will rise from privatization and liberalization

Presently, Quantum Fund owns 53% of Mustcom. Mustcom owns 25% of Svyazinvest, meaning Quantum Fund owns 13% of Svyazinvest. If Mustcom buys another 25% of Svyazinvest at the next auction, Mustcom will have slightly less than 50% of Svyazinvest, meaning Quantum Fund will increase its share to 26% of Svyazinvest. This investment would give Quantum Fund significant influence.

The financial projections of returns from privatization and liberalization in Russia are proprietary information belonging to Quantum Fund, Mustcom, Svyazinvest and other interested companies. However, projections and generalizations can be based on the experience in other countries. While none of these countries will produce the exact results as Russia, they are a valuable indicator.

Telecommunications privatization and liberalization in Germany and Chile have had positive results. From examination of this data, it can be inferred that similar trends would occur in Russia.

Revenues of Deutsche Telekom from 1994–1996, prior to liberalization and privatization, declined 1% per year.³¹ During this time management was unable or unwilling to expand the market. During market privatization and liberalization in Germany from 1996 to 2001, revenues increased by 15 to 18% per year. Earnings estimates for the next five years project a growth rate of 14.5% per annum.³²

While Germany and Russia differ in size, infrastructure development, and population density, there are nevertheless similarities that make a comparison in the telecommunications industry valuable. Germany is analogous to Russia in that it is a European country with certain regions (East Germany) with significantly less economic development and telecommunications infrastructure. East Germany faced the transition from communism to a capitalist market economy; West Germany faced the privatization and liberalization of its state run telecom monopoly. Germany is especially useful for an analysis of the effects of privatization and liberalization because in Germany they took place simultaneously. Deutsche Telekom privatization lasted from 1996 to 2000, with open market liberalization taking place in 1998. As in Russia, the German government controlled over 75% of Deutsche Telekom at the beginning of reform. The government retained the majority interest during the first part of the reform, while the shares were constantly decreasing.

Last year, Svyazinvest sales revenues were \$2.3 billion, expenses were \$1.8 billion, and operating profits were \$400 million. Increased privatization will result in an additional \$2 billion investment in Russian telecommunications development, assuming the second tranche of Svyazinvest shares

³¹ www.totaltele.com

³² Zachs Investment Research

are sold to Mustcom at almost the same price as the first tranche. Privatization will also result in additional capital revenues becoming available in the form of loans and corporate obligations.

Assuming a similar growth rate in revenues as in Germany after the privatization of Deutsche Telekom and German market liberalization, Svyazinvest revenues and profits over the next 3 years should be as those in Chart 3 in the Exhibits Section.

Projections show that this will result in an increase in the number of fixed phone lines of Svyazinvest by 8.9 %.³³ An additional 1.058 million lines³⁴ will be created through reinvestment of the privatization proceeds. 32.2 million lines cost \$6.8 billion over a period of 3 years.

Sectoral liberalization will result in a 60% increase in mobile lines each year. The private Russian company Vypel, whose market is limited mainly to Moscow and St. Petersburg, shows projected earnings growth rates of 180% in 2001 and 100% in 2002.³⁵ Unlike Vypel, Svyazinvest can offer mobile telephone services through its local subsidiaries throughout Russia, as it is beginning to do so now. Svyazinvest should make mobile service expansion an integral element of its business plan.

Deutsche Telekom's experience shows that Svyazinvest can establish leadership in the mobile telecom market. Svyazinvest is currently established in the mobile market through subsidiaries of its local monopolies. The mobile share of Svyazinvest is 476 thousand subscribers (41.7%). Given the predicted pace of sectoral expansion, the company may attract 3.8 million additional subscribers in 3 years.³⁶ The total market of the mobile telecom services may reach 5.3 million subscribers in 2004, a 450% growth from the current number of mobile telecom subscribers.³⁷

The overall number of phone lines served by Svyazinvest may increase 26% to 36.1 million, an increase by 26%. This will raise teledensity in Russia to 24.3% in three years.

The table below shows financial projections for Svyazinvest over the next three years. Projections show a rise in revenues of 13%, 18%, and 21% in 2002, 2003, and 2004 respectively, and a rise in profits of 14.5% in 2002, 2003, and 2004. These projections take into account the growth rates of revenues and profits projected for Deutsche Telekom, and the potential for development of Svyazinvest's fixed line and mobile telephone services (in billion \$).

	2000	2001	2002	2003	2004
Revenues	2.3	2.3	2.7	3.2	4.1
Expenses	1.9	1.9	2.24	2.67	3.5
Profit	0.4	0.4	0.46	0.53	0.6

³³ "DTAD Statistics at Glance".

³⁴ Annual Financial Statement of Svyazinvest 2000.

³⁵ Zack's investment research.

³⁶ Gradskiy P., "Russian Mobilization?", SPB Review, 12.21.01.

³⁷ "DTAD Annual Report 2000"

Financial projections show that Svyazinvest revenues will increase from \$2.3 billion (2001) to \$4.1 billion, or 69% over a period of 3 years.³⁸ Svyazinvest expenses will rise by \$1.9 billion to \$3.5 over 3 years, an increase of 84%. Svyazinvest profits will increase from \$400 million to \$601 million over 3 years. Profits from 2001 to 2004 will total \$1.6 billion.

Twenty-six percent of these profits will flow through Quantum Fund. This amounts to a total net profit of \$416 million over three years by end of 2004. Quantum Fund's original investment was \$980 million. Subsequent investments in Mustcom are estimated at another \$1 billion, bringing the total to \$1.98 billion. This translates to a 21% return on investments for the Quantum Fund. Under these projections, Quantum Fund will recapture almost a quarter of its original investments in Svyazinvest in 3 years.

Quantum Fund will recapture its entire original investment in 9 years. This is a significant improvement, given that it currently takes over 25 years to recuperate investments in Svyazinvest.³⁹

The disadvantages of non-transparent regime in mobile telecom services

If liberal reforms do not take place, Svyazinvest will not be able to expand its mobile telecom services and capture a potential additional \$106 million in revenues and \$85 million in profits.

Projections based on Chile's experience: Svyazinvest and Quantum Fund profits will rise as a result of liberalization

Liberal telecom reforms in Chile resulted in substantial industry development. The Chilean example is useful to Russia for the following reasons:

- Liberalization reforms in Chile followed the implementation of sectoral privatization plans.
- Chile is analogous to Russia in its uneven population distribution, and underdeveloped pre-reform telecommunications infrastructure. The sector was dominated by a state run monopoly prior to reform. Chile also shares Russia's underdevelopment and telecom problems in rural areas.

Given the greater initial demand for telecom services and lower overall development of the Chilean telecommunications, the time span 1994–1997 was chosen for analysis. In the Chilean projection the following constraints should be taken into account:

- Chile does not enjoy the same economies of scale as Russia⁴⁰
- At the beginning of reform, the sector was less developed than in Russia
- Chile has more serious problems with external debt and inflation
- Chile does not have to deal with issues from the size of the territory to cover

In recent years of market liberalization in Chile, revenues have increased by an average of 9% (\$230 million annually) and profits have increased by 20% (\$97 million)⁴¹.

³⁸ Projection is made based on the DTAD data.

³⁹ Conceptual Plan of Telecom Market Development.

⁴⁰ CIA World Factbook

⁴¹ Form F-20. CTC Annual Report 1998

Market privatization and liberalization in Chile have increased revenues by 53% overall (and 32% by the dominant carrier CTC). Profits in Russia will increase by 73% ⁴² by the 3rd year, given similarities in the size of the countries and underdevelopment of telecommunications due to state run monopolies.

If we assume similar effects of liberalization in Russia, market reforms will result in the following projected profits for Svyazinvest and Quantum Fund.

Below is a projection for Svyazinvest growth indicators (in \$ billion):

	2000	2001	2002	2003	2004
Revenues	2.3	2.3	2.42	2.84	3.03
Expenses	1.9	1.9	1.96	2.26	2.34
Profits	0.4	0.4	0.46	0.58	0.69

Estimates show that market reforms will bring an additional \$3.8 billion in investments (excluding proceeds from privatization) in Russian telecommunications by new and existing participants. This will result in an increase in the number of phone lines in Russia by 89% (53 million subscribers) over a period of 3 years.

According to the projection in Chile's telecom, Svyazinvest's share of the fixed phone line market should decrease to 74% in 3 years (45.7 million overall including 33.8 million of subscribers by Svyazinvest subsidiaries).⁴³

Svyazinvest's share of the mobile phone market should increase to 57% (16% increase), which will constitute 3.9 million subscribers (7 million overall).⁴⁴

Despite the decrease of the market share of fixed lines, financial projections show that due to the overall increase in phone lines, reform will result in a \$730 million (31.7%) increase in revenues for Svyazinvest, to \$3.03 billion over a period of 3 years.

Financial projections show that Svyazinvest expenses will rise by \$440 million (23%) to \$2.34 billion over 3 years.

Svyazinvest profits will increase \$300 million (73%) to \$690 million over 3 years.

Twenty-six percent of these profits will flow through Quantum Fund. This amounts to a total net profit of \$450 million over 3 years.

Quantum Fund's original investment was \$1 billion. Subsequent investment in the purchase of additional shares of Svyazinvest through Mustcom is estimated at an additional \$1 billion.

⁴² Form F-20. CTC Annual Report 1998.

⁴³ CTC Annual Report 1997.

⁴⁴ Subtel, 2001.

This translates into a 24% return on investment. The entire investment will be recuperated in less than 8 years.

Reform's Impact on Employment

In the employment projections, the following assumptions were taken into account:

- Given the lack of data on CTC's employment before reform, the projections assumed that CTC had the same ratio of lines per employee as Svyazinvest's subsidiaries.
- Russian telecom will experience the same percentage growth in teledensity and lines per employee ratio ten years after the reforms are launched.

Employment Projections in the Russian Telecom Industry (thousands)

	2001	2004	2005	2006
<i>Svyazinvest</i>	392	240	187	155
<i>Others</i>	29	35	43	53
<i>Total</i>	421	275	230	208
<i>Lines per Employee</i>	73	177	208	235

Though these projections reveal the potential effects of proposed reforms, results in Russia may differ, since the starting conditions are different. Results depend in part on the current economic environment and the government's efficient implementation of reforms. Though Quantum Fund will influence government policy, the macroeconomic situation is impossible to control.

Consolidation of Svyazinvest will cut costs

Consolidation is aimed at cutting costs for companies in the industry, which would increase profitability and earnings.⁴⁵ Mergers centralize financial resources and facilitate tax payments. Consolidation will lead to coordinated policy on modernizing equipment and optimizing the regional infrastructure of telecom enterprises. By creating a centralized regional telecommunication infrastructure, services will be provided at the highest possible quality. Mutual settlements and relations between telecom companies licensed for various services will be simplified, which will reduce a number of mutual claims and receivable accounts.

In addition to optimizing costs, decreasing regional fragmentation will help end the imbalance in local and long distance tariffs, which will increase industry profitability. Tariff re-balancing will shift the revenue base from long-distance to local traffic, thus stabilizing earnings.

Before privatization, the Svyazinvest structure must be reformed to attract potential investments in Russia's public telecom sector.

Sectoral reforms will promote development of the Internet and E-Commerce

The number of Internet users in Russia remains low for the following reasons:

⁴⁵ Arthur Andersen Consulting

- The access cost is simply too high. The average income of Russians is \$200 per month, and Internet services are beyond many households' budgets. Internet services and installation fees are much higher than in most Central and Eastern European countries.
- The telecommunication infrastructure of Russia is not sufficiently developed. To date, only 21 of 100 Russians have access to a telephone. Despite the significant share of carriers' investments in upgrading, 60% of telecommunications equipment must be modernized to provide high quality services, including Internet and other value added services. Some crossbar equipment, which constitutes 14% of telecommunications equipment, is completely incompatible with the new Internet technology. All these factors have resulted in low Internet penetration. Given that Internet access is vital for developing e-commerce, Russia will lag behind the rest of industrialized countries until Internet technology is fully introduced.

The proposed reforms, by developing Russia's telecommunications infrastructure, spur Internet services and Internet-related activities develop further. Large carriers will have less difficulty and more incentive to capture new markets. Once competition is introduced among large carriers, costs will decrease and consumers will have a broader choice of services. Russia will be able to catch up with other industrialized countries in the development of e-commerce. Russian companies will have the tools to reach remote domestic customers, to compete with partners in the regional and international markets, and to learn more about foreign markets. Russia will be able to further expand its trading and commercial activities, and develop its economy.

Liberalization will benefit foreign providers, Russian citizens, and Russian telecom providers

With the liberalization of the telecom market, foreign companies can pose a serious competitive threat to domestic telecom providers. However, domestic operators that possess competitive technology, highly qualified staff, and superior management have a good chance to retain and expand their market share. Even companies not as well adapted can gain by positioning themselves in a market long before foreign competitors. Familiarity with the local market, strong distribution network, valued customers, and strong reputation are assets that an average domestic telecom provider may already possess. Domestic providers have a head start over their foreign counterparts, which still must prove their reliability and pay necessary transaction and information costs. Domestic providers clearly have that first mover advantage.

Telecom reform not only improves Russia's chances of early integration to the WTO, but also benefits common Russian citizens. Russian telecom companies will benefit from the liberalization as well. Citizens' well being is a primary cause for WTO accession negotiations. New entrants will bring new investments, which will contribute to telecom infrastructure. Russian telecom providers will become familiar with western management skills and cutting edge technology.

The negative effects of the proposed telecom reform have been noted.⁴⁶ These negative effects can be reduced by gradual implementation of the reforms. Companies will have time to restructure operations to become more competitive.

⁴⁶ So-called "shock therapy" and "voucher privatization" were unpopular due to their adverse effect on the general population. The shock therapy is associated with uncontrollable price rise. The voucher privatization is related to the division of all state property among the Russian citizens. Every citizen was granted a voucher worth 10,000 RUR, which he could dispense only by buying stocks in privatized enterprises. The issue was that none of significant state owned enterprises was put for privatization. People could only buy share of insignificant enterprises, which had no chance to be profitable in market economy.

ANALYSIS OF ECONOMIC ISSUES

Telecom liberalization and privatization reform in Russia will positively impact the overall economy, expanding international and domestic business and trade. Telecom reform will enable Russia to address the underdevelopment of its telecom infrastructure and insufficient phone lines. Service quality will improve, and competition and investment will increase the number of phone lines. As a result of reform, Russia will access new technologies and services. Reform will boost the development of e-commerce. Service costs and prices will decrease, which is essential for business development and entrepreneurship. Experience in other countries shows that telecom reforms will spur economic growth in downstream and upstream sectors, resulting in higher revenues, wages, and employment. However, reforms will also result in short-term unemployment in the telecom sector itself. Nevertheless, negative impacts will be more than offset by job creation in other sectors. In the long run, the telecom sector will also experience employment growth.

The telecommunications sector plays an important role in the growth of every economy. Liberal reforms and privatization of Svyazinvest shares will create better conditions for trade expansion in the sector. However, Russian opponents of telecom reforms have the following concerns:

- How liberalization and the privatization of Svyazinvest will affect economic development
- How reform will provide incentives for foreign investors to operate in the Russian market
- How reforms will impact other sectors of the economy

This analysis of economic issues will provide arguments and data that reforms in telecom will accelerate economic growth in Russia, and will benefit other economic sectors of the country. The economic effects of both privatization and liberalization efforts will be analyzed.

Overall macroeconomic consequences of reform

In Germany, telecommunications reform led to 6.9 million additional fixed lines (a 17% increase). If the same conservative projection is applied to the Russian sector, reform would result in 35.4 million additional fixed lines. With 5.3 million projected mobile lines, 40.1 million new customers would be served overall, a 27% increase in telecom lines over three years.

In Germany, prices for telecom services dropped by 11% for local and by 30% for long distance calls. This results in a 32 cents decrease in prices per line.⁴⁷ According to the conservative German projections, this will translate into \$11 million of customer savings in 3 years.

With liberalization and privatization reform, overall investment in Russian telecom would be an additional \$8.77 billion over the next 3 years.

Economic Effects of Privatization

Development of the overall economy from development of the telecommunications sector

New competition and the incorporation of local carriers into seven regional telecommunication providers will improve efficiency, reduce price distortion, improve competitiveness of Svyazinvest's subsidiaries, and promote the development of the telecommunications sector.

⁴⁷ Consolidated Data on Svyazinvest's Subsidiaries.

Privately owned providers of telecommunication services are more interested in attracting customers than state run corporations. They offer a wider range of telecommunications services, better quality, and lower prices. These elements will increase demand in the sector, benefiting the whole economy.

With privatization and restructuring in Russia, domestic trading companies will expand their activities. As a result of restructuring, Russian industry will increase its productivity. With better communications Russian manufacturers will discover new markets domestically and abroad. With foreign investment, Russian telecom service providers will access new technologies and methods of production, and Russian customers will obtain better services.

As trade increases, Russian consumers will have more bargaining power. With greater access to information, they will be able to make informed choices. Reform will provide further opportunities for foreign companies to invest in the Russian telecommunication market. Foreign companies will try to invest more to increase their returns on capital. In Russia, Quantum Fund has increased its holdings in Svyazinvest by increasing its stake in Mustcom to 53%. The most recent purchase was made in August 2001, after President Putin indicated a commitment to telecommunications reform.

Reform will enhance the credibility of the Russian government in the eyes of foreign telecommunication companies. It will ensure foreign investors that social and political volatility will not change the regulatory framework in telecommunications. By consolidating existing providers and opening the market to foreign investors, Russia will attract investment not only in the telecom sector, but also in such telecom related fields as construction, information technology, and software development. The new investment flows will help the Russian economy.

Russia should follow the positive example of Brazilian telecom reform

The proposed restructuring and privatization reform in Russia is similar to that already implemented in Brazil. Brazil had similar problems of telecom development (a dominant carrier, low level of capitalization, and underdevelopment of rural areas). After the successful privatization of Telebras, and the integration of local, interstate and international networks in 1997, the sector still continues to absorb new technologies as new investors meet expansionary targets. By December 1999, more than 27 million lines had been installed, a 22% increase from one year prior. Anatel estimates that the availability of phone lines has doubled, and anticipates that 28% of the country's population will have lines by 2003. Telephone expansion has contributed to a strong growth in Internet service and cell phone use (1,328% over the last three years).⁴⁸ If these data are projected on Russian telecom, the result would be 34.1 million new lines and 18.5 million new mobile phone subscribers in three years.

In general, privatization and restructuring of telecommunications has positively impacted the telecommunications sector and the overall economy of those countries that conducted sectoral reforms. Russia's government should be confident that its reform would create the same positive effects. Reforms will give incentives for domestic and foreign companies to operate in the Russian market.

As the Chile projections show, reform will help:

⁴⁸ Boreiko, A., "Restructuring Reforms in Telecom: Brazil's Experience.", *Segodnya*, November 28, 2000.

- decrease operating costs by 33%, from \$66 to \$44 per line
- increase investments in the telecommunications infrastructure
- provide easier access to the Internet

Reforms will allow both domestic and international companies to reduce costs. Costs for telecommunications services are a significant portion of company expenses. As companies broaden their market share, telecommunications play an ever increasing role in the exchange of data and information with business partners and customers.

Telecom liberalization and privatization of Svyazinvest will stimulate the telecommunications sector, bring investments in the form of new technology, and facilitate information flows in and out of the country. A better exchange of information can promote both domestic and international trade. Domestic producers will quickly respond to changes in market demand. Russian goods and services will have a better comparative advantage in the market. Foreign producers will be able to learn more about the needs of the Russian market through more efficient information flows, giving them a greater opportunity to penetrate the market. Increasing commercial transactions will make all participants in the market, including Russian consumers, better off.

An enhanced exchange of information will improve distribution channels in domestic and international trade. Sellers and buyers will have more opportunities to keep track of their goods, and make necessary changes in case of disruption of the system. This will help transform Russia to a more attractive destination for goods and services.

Economic benefits of regional integration of subsidiaries as a part of the restructuring policy

Consolidation of the regional telecom providers, which will result in reorganization in the management sphere, will yield savings of up to \$200 million per year.⁴⁹ These savings would free resources for more capital investment and more rapid development, passing on the lower cost of services to consumers. Svyazinvest's investment needs are \$33 billion for the next 10 years, according to the strategy of development of telecom networks approved by the government in December 2000.⁵⁰

Liberalization and privatization will increase wages and reduce unemployment in the long run (See Chart 5)

Reform is likely to bring Russia increased unemployment in the telecommunications sector. Inefficient managers will be replaced by more experienced managers hired by new owners. Data shows⁵¹ that the productivity of privatized enterprises in Eastern Europe is much better than the productivity of state run enterprises. The size of the Svyazinvest staff is a primary indicator of its inefficiency. Svyazinvest has 392 thousand workers. Deutsche Telecom, whose scale of operations is much larger, has only 200 thousand employees.⁵²

⁴⁹ RosBusinessConsulting

⁵⁰ Conceptual Plan Of Development of Telecom Services In the Russian Federation.

⁵¹ Kolpakov S., "Privatized communications", *Itogi*, June 2000.

⁵² Kolpakov S., "Privatized communications", *Itogi*, June 2000.

Foreigners are the main investors in Russian telecommunication. New managers and entrants will contribute to the successful development of the industry through their business skills. Since Russia is in the process of integration into the world market, this foreign expertise will be especially useful.

In a long run, sectoral liberalization reforms and increased competition will increase employment. Inefficient telecom providers will leave the market, giving way to more competitive operators. Average wages will increase by 17% in 3 years due to the improvement of productivity in Svyazinvest's holdings.⁵³ The negative social effects of liberalization will be countered by the expansion of services by new entrants. Former managers and specialists of Svyazinvest may be hired by more efficient telecom providers, or other industries where their skills will be utilized. The booming Russian economy offers good opportunities for absorption of the freed working force. To decrease the negative effects of liberalization, the government may offer retraining programs and provide other social benefits to the former employees of the sector.

Liberal reforms will increase investments in Russian telecommunications (See Chart 6)

Problems with currency convertibility, underdeveloped capital markets, and the lack of an adequate banking structure continue to plague financial investment possibilities. The Russian Federal Budget funds for government investment projects have decreased over the years. In the first half of the '90s, before the financial crisis, the share of state investments in the telecom industry decreased from 40 percent to less than one percent. However, direct foreign investment has increased from zero to over 40 percent.⁵⁴ Private funds raised from the domestic market have increased in recent years. Budgetary constraints and tight fiscal policies have forced Russians to turn to foreign companies as the major source for modernization and expansion.

All technology overlays, infrastructure improvement, and advanced technology installation require significant investment. To achieve a modern telecommunications infrastructure, the Russian authorities have called for telecom investments to double from the early 90s. Despite government rhetoric, Russia lacks funds for many development projects. The sale of 25% of Svyazinvest shares and liberalization will ensure these funds. A profit driven strategy of new managers will ensure a consistent flow of investments, since the telecommunications industry represents one of the most promising sectors in Russia.

Economic Effects of the Liberalization Reform

The reform promotes the development in other sectors of the Russian economy.

Telecommunications services are closely linked to financial services, insurance services, banking, and information technology services. With improved telecommunications, these sectors will improve their efficiency, reduce costs, and improve ties with customers and business partners.

To develop the infrastructure for telecommunications, new entrants will need the assistance of the construction industry and telecommunications equipment producers (See Chart 6). This could create new well-paid jobs in these sectors, and generate income for the overall population. The producers

⁵³ Chile projections.

⁵⁴ *Russian Journal*, "Telecom Grows 13% in Russia in 2000", February 2001.

of complimentary goods, including advanced telecommunication equipment, semiconductors, and fiber optic components, will benefit from telecommunications development.

The development of telecommunications will increase trade and commerce. The growth of trade in those fields will lead to higher wages and incomes in downstream and upstream industries.

Reform attacks cross-subsidization, which distorts sectoral competition and empowers monopolies

The Russian government wants to ensure that all people have access to affordable telecommunication services. It is not profitable to provide services to low-income populations in many remote regions in the country. To make up for the difference in cost of service and its price, Svyazinvest holdings resort to cross-subsidization. The government and Svyazinvest might argue that in order to maintain a reasonable price for the Russian citizens, cross-subsidy should be applied. Cross-subsidies often transfer costs from international and national long-distance calls to local fixed calls, from business services to residential services. Dominant telecom providers might argue that the monopoly structure is needed to ensure that this model works, and that it generates sufficient profits to fund subsidization. Nevertheless, cross-subsidy is not beneficial for the economy for the following reasons:

Competition can lead to universal service: Maintaining the monopoly and a cross-subsidy model is not the best way to attain universal service. Since the country lacks technological and financial capacities to meet the demand for telecommunications, the solution is to improve the supply side. A pro-competitive approach will promote new technologies, increase investment, and decrease telecommunications costs and prices. These price decreases are at least as important as subsidies in making telephone services more affordable.

Changes in the structure of customers: In recent years, demand for telecommunications services has increased dramatically. Given that incomes are not equally distributed throughout the country, the government tends to charge higher prices to foreigners, businesses, and urban areas. For this reason international and national long-distance calls are often much more expensive. However, in the Russian rural areas, there has always been a high demand for telecommunications services. The assumption of non-profitability of certain market segments may no longer hold true.

When industry is liberalized and companies are consolidated many services will transfer from long-distance to local calls. This will reduce the chance of cross-subsidy. Although regions will retain their own dominant carriers, those carriers must compete in a long-run, due to the higher rate of capitalization and economies of scale. Increasing economies of scale will enable providers to compete in more lucrative market segments, such as cellular and mobile communications.

Restructuring Svyazinvest involves a change in the pricing policy

The restructuring of Svyazinvest will not yield the desired results if the government fails to update its pricing policy. The current pricing regime forces Svyazinvest to annually forego \$70 million of potential profit.⁵⁵ The government must establish an independent body to regulate the price of services and bring it in conformity with cost. This reform will be consistent with international trade practices and service regulations.

⁵⁵ Kazachkov, Mikhail, *On Certain Problems in the Russian Communications Sector*, 14 May 1998

The present skewed pricing policy is preventing the growth of market capitalization. 53% of customers have some kind of discount, while the government compensates only 15% to 20% of the costs. Bringing charges for services to households up to cost would increase investments in Svyazinvest holdings from \$400 million to \$700 million.⁵⁶

Prospective entrants suffer greater costs if charges for services are based on regulations rather than market prices. If the government subsidizes fewer customers, there will be less chance of the embezzlement of compensation intended for providers. Liberalization will simplify the relationship between dominant providers and new entrants with the government or local authorities, and add more transparency. Though this step may be painful for some customers in a short-run, everybody will benefit in the long run. Existing services cannot ensure proper maintenance of telecom networks. If the government and customers are unwilling to pay for services, they may lose them all together.

The policy of price fixing for local services pushes regional telecommunication providers to resort to practices considered illegal by WTO regulations. Since regional telecommunication providers cannot raise the price for local calls, they practice cross-subsidization through high fees for long-distance and international calls. This may create a snag for Russia in its accession negotiations, therefore it is best to reconsider the pricing policy in advance.

⁵⁶ Kazachkov, Mikhail, *On Certain Problems in the Russian Communications Sector*, 14 May 1998.

REGULATORY AND LEGAL ANALYSIS

Russia suffers from complex telecom regulations that are inconsistent with internationally accepted norms. This regime prevents the government from modernizing the telecom infrastructure, providing adequate service for reasonable prices, and ensuring sustainable economic growth. Russia suffers a weak law enforcement mechanism and is rife with corruption, which creates uncertainty and drives away investors. Russia must remove obstacles to privatization, and harmonize laws and regulations with WTO provisions to accelerate its integration into the world economy.

Until the year of 2000, the Russian government was not proactive regarding development of its telecom industry. In 2000, the government adopted the “Conceptual Plan of Telecommunications Market Development in the Russian Federation,” which outlined its main objectives in the telecom industry. These objectives include:

- a pro-competitive environment in telecom services through equal treatment of all operators
- decreased cross-subsidization
- ensured mandatory interconnection services without discrimination
- improved pricing policy by basing fees for unprofitable services on costs
- transparent and public licensing procedures
- foreign and domestic investments to modernize Russia’s telecom networks
- increasing phone line penetration though higher teledensity and service quality in the rural and remote areas, and ensuring universal services
- restructuring and privatization of Svyazinvest to increase liquidity and capitalization, and improve management efficiency
- introduction of new technologies and development of Internet networks and e-commerce
- integration of the Russian telecom sector into European and global telecom systems

These objectives are not supported by the outdated legal environment. The most recent regulations on telecom policy were adopted in mid ’90s, and fail to solve current telecom issues. The main documents, including the 1995 Federal Law “On Communications” are outdated and vague in their content. They give legitimacy to regulators’ arbitrary and non-transparent policies and justification for uncompetitive behavior. Though Russia’s application for membership in the WTO was formed in the ’90s, the WTO main issues are not adequately addressed in the existing law “On Communications”. The law even fails to declare Russia’s intention to comply with internationally accepted policies in telecom.

Given Russia’s aspirations for WTO membership, reform in the telecommunications sector should comply with WTO provisions. These provisions require:

- transparent and non-discriminatory treatment for all players in the Russian telecom market
- better market access for foreign service providers
- increased competition among providers for market share
- enhanced ability to monitor the activities of providers

Proposed privatization of Svyazinvest will cement the support for reforms in the sector, and increase foreign confidence in Russia’s liberalization policy.

Regulations in telecommunications policy

The Constitution of the Russian Federation authorizes federal government agencies to regulate the telecommunications industry. The following laws and regulatory practices stifle the industry's growth:

- limitations on the market potential of traditional operators
- unfair treatment of new entrants
- lack of effective mechanisms to enforce and implement regulations
- inconsistent pricing policies

Proposed Amendments to the law "On Communications"

Regulatory reform in the telecom sector should be based on the WTO/GATS Agreement and Annex on Telecommunications. Close attention should be paid to the 1995 Law "On Communications." The existing Law "On Communications" does not address the essential issues of the WTO provisions on trade in telecommunications. These include:

- regulations on interconnection policy
- enhancement of licensing procedures
- regulations on competition issues
- an independent industry regulator
- regulations on universal service

Specific drawbacks of the Law "On Communications" include:

The Law does not clarify procedures for granting licenses to provide telecom services

Lack of transparency in pricing policy, licensing, and application procedures drive away potential investors. Investors must be sure that licensing is conducted impartially. In Russia corruption and collaboration of industry executives and decision-makers are frequent, which make investments even riskier.

The Law fails to regulate anti-competitive behavior, and fails to address unfair competition between old providers of telecom services and new market entrants

The present Law "On Communications" fails to address the provision of interconnection services to new entrants. The old "traditional" providers have significant control over the telecom networks in separate regions. Dominating providers in every region enjoy monopolistic pricing. The local monopolies are not interested in ensuring equal access to competitors, and instead use their networks to drive them away. Monopolies set high interconnection fees for competitors' right to use the network. This policy clearly impedes innovative and efficient sector development.

The Law allows the government to regulate service fees of large groups of citizens with privileges

Government price setting violates WTO provisions. In Russia the number of citizens eligible for preferential prices is so great that it endangers the viability of the sector. Proponents of reform need to convince the government that competition is the necessary means for resolving price distortion. Competition promotes innovations and efficiency of telecom providers, ensuring that most citizens

receive quality service for an acceptable price. Subsidization of fees for some citizens diverts funds from the federal and local budgets. A more competitive environment will make the pricing policy more flexible, and allow the telecom providers more profits. This will result in funds for federal social programs that promote broader assistance for the underprivileged.

Liberalization and competition in the telecom sector will promote foreign investments and lower prices for all. Excessive government interference in telecom policy is damaging to foreign and domestic investors. The price of investing can be too high to justify the risk of investing in the sector, which is heavily influenced by government regulations.

The proposed amendments to the 1995 Law should cover:

- ***Interests of foreign investors and telecom providers***

Foreign investors and telecom providers must be guaranteed that their interests are respected by lawmakers and regulators. They should be given access to the Russian telecom sector, without discrimination in favor of domestic players.

- ***Universal service***

The legislation should determine minimal telecom services offered by any Russian telecom operator. It should also emphasize conditions for consumers' right to universal service.

- ***Establishment of an independent regulator***

Competition works best with a framework of pro-competitive laws and independent oversight. An independent regulator can oversee the relationship between incumbent providers and new competitors. A stronger market will develop only if participants feel confident that the regulator does not face significant conflicts of interest. The regulator should be protected from the financial pressures of a state-owned enterprise, and the political pressures of either election or reliance on political leaders to make or enforce decisions. Allocating scarce resources and managing the competitive market should turn neither on the government's desire to promote its proprietary interests, nor on its political influence. The country should establish a regulator that can independently follow rules of law and pursue the public interest.

- ***Establishment of a fair and transparent regulatory process***

A fair, transparent, and predictable regulatory process is necessary for stability in the telecommunications industry. Such a process must include notice of any proposed action and an opportunity for interested parties to comment on the proposal. Applications and petitions must be subject to public scrutiny, and submissions must be publicly available to promote full participation in the final decision. The process must include explanations for all regulatory decisions, and judicial review. Equitable regulation of the industry requires that operators know what to expect. If companies seek a license to provide a service, the process for granting that license should be fair and predictable. Licensing criteria should be made

publicly available before the process begins. A transparent process creates confidence in the system, a prerequisite for successful investments and industry development.

- ***Resolution of interconnection disputes***

New entrants and new systems must be able to operate with existing facilities at fair prices. Forcing new entrants to establish a complete national or regional network would limit entry, and deny the benefits of innovative services that could be provided by interconnected networks. Under the new legislation, incumbent operators may be required to provide interconnection equal in type, quality, and price to that which the incumbent provides to its own operating subsidiaries. Interconnection pricing should be cost-based to ensure that new entrants bear only their fair share of operating expenses. The independent regulator should establish and publish interconnection standards.

Quantum Fund will benefit from regulations encouraging competition in the sector

Risks associated with non-transparent, non-competitive, arbitrary, and discriminatory regimes are great for Russian investors in the telecom sector. Quantum should propose amending current law to bring Russia in compliance with internationally accepted regulations. This would help investors ensure their returns.

Without competition, benefits from increased private participation cannot be fully realized. When the governments of Argentina and Mexico granted monopoly privileges to privatized state owned enterprises, the connection rate grew only 1.5 times. This was half the rate in Chile, where the government issued competing licenses quickly.⁵⁷ A non-competitive environment in the telecom sector burdens investors with regulatory uncertainty, unrealistic service obligations, rigid tariffs, and employment rules.

Russia and investors in Russia will benefit from WTO provisions on telecom

To join the WTO, Russia must comply with basic WTO Agreements, which include the GATS and the Annex. Unlike China, Russia decided to bring its legislation in compliance with WTO by its accession. That means that the application process for Russia will take much longer if the country does not change its laws expeditiously. Legal reform in telecom will signal to accession negotiators Russia's commitment to accept international trade principles and embrace trade liberalization. This will help ensure that the negotiations are held in good faith.

Finally, regulations of telecom policy according to international norms will attract more investments in the sector. The WTO provisions ensure cost-based pricing and a competitive, fairly regulated market for telecommunications.

Development in privatization legislation

Recent developments in privatization regulations are not favorable for the privatization schemes of Svyazinvest. The unresolved conflict between the government and the State Duma over what body

⁵⁷ Wellenius, Björn, "Telecommunications Reform- How to Succeed", *Public Policy for the Private Sector*. World Bank Group.

has supremacy in approving state enterprises for privatization continues to hinder the privatization of state owned enterprises. The need for new legislation was caused by ambiguities in the old 1991 privatization law, which was confusing on the issue of investment tenders with foreign participation. In March 2001, the Ministry of Management of State Property prepared a list of companies offered for privatization. The Government wished to sell its 50 percent minus one share stake in companies relying on foreign strategic investors. This was blocked by legislative initiatives of the Duma that restricted the action of the Government.

A New Bill On Privatization

Currently there are two versions of a new privatization bill in the Duma, one prepared by lawmakers, and the other by the Ministry of State Property. Quantum Fund should oppose the Duma's bill, and support the Ministry's bill.

The Duma Bill on privatization

In March 2001, the Duma approved a bill that forbids the sale of any stake in a state enterprise, including subsidiaries and affiliated companies, with assets of more than \$350 million. If it becomes law, the sale of the second tranche of the Svyazinvest shares will be put on hold, since the company's assets are over the threshold limits. Therefore, Quantum Fund must lobby against this bill in the State Duma, Federal Assembly, and Presidential Administration.

The Ministry of State Property argues that the Duma's attempts for a final say on privatization is unconstitutional. Article 114 of the Russian Constitution vests the executive branch of the government with power to manage federal property.⁵⁸

Many congressmen insist that the Duma must participate in approving the list of companies designated for privatization. Among the Duma's opposition to a governmental position are Communists, the Agrarian Party, and independents. The issue of privatization is highly sensitive for these political movements who consider earlier privatization attempts a betrayal of state interests. On the other hand, a powerful pro-president political coalition of the Union of Right Forces and "Unity" ensures the congressional support of liberal government initiatives.

The Duma is primarily concerned that the strong economic incentive for others to participate in the privatization process will cause the Duma to lose control over privatization. However, the government believes that the Duma can maintain oversight over the privatization process through provisions of the Federal Privatization Law, the Audit Chamber, and special committees.

Ministry's Bill on Privatization

The Ministry of State Property sponsored legislation to counter attempts of the Duma to intervene in privatization. The Ministry's bill to the Duma would weaken the Duma's control over state property sales. The new bill contains innovative approaches that succeeded in Eastern Europe. Its rules would make future privatization sales fairer and more transparent. Specific criteria give the right to a designated investor to conduct direct privatization sales. The new bill allows the State to sell companies at par value prices to an investor ready to meet the terms of the investment. Large assets would be sold through open auctions or through initial public offerings. Separate rules would apply for small and illiquid assets.

⁵⁸ Article 114 of the Constitution of the Russian Federation.

According to the Ministry's bill, the \$350 million cap would be removed, and the government would be required to attach a detailed annual privatization program to the federal budget. This would enable the government to offer shares of Svyazinvest to the market next year, raising more than \$1 billion for the federal budget.

The new privatization bill was set to be debated in parliamentary committees, at the beginning of 2002, before going to a vote. All 450 congressmen have opportunities to lobby either for speeding up privatization or, on the contrary, to delay it, which would create an obstacle for Svyazinvest's privatization.

The Ministry of State Property and the Government must ensure acceptance within the Duma on the general principles of the new bill. The government may be within 20 votes of the majority needed for passage, which could be procured through a careful lobbying strategy. The opposition is determined to fight the bill. They will either turn the bill down, or pass it with amendments that are unacceptable to the cabinet. To tone down the rhetoric and show respect for law, the government published a list of privatizations planned for the first half of 2001, designed to stay within the current Duma limit.

Quantum Fund and its allies should join lobbying for the passage of the Ministry's bill on privatization.

The Bill "On the Protection of Economic Interests"

The Bill "On the Protection of the Economic Interests of the Russian Federation During the Disposal of Shares of Joint Stock Companies Producing Products (Goods or Services) With Strategic Importance for State Security" was passed by the State Duma in June 1999. The legislation as it stands would complicate the government's privatization plans.

The bill lists 737 companies with state ownership that may be privatized only by means of a special law. An initial version had listed 2861 such enterprises, but the Duma and Federation Council representatives pared it down. On the list are many companies that the government wants to sell off in the near future, including Svyazinvest. The bill covers not only the sale of such enterprises, but also covers the transfers of shares. The government is pressuring the Duma by withholding funds for operation, stating that it must sell shares in state-owned enterprises to fund the Duma.⁵⁹

The lobbying objective of Quantum Fund and its allies will be to ensure that the bill is declined by the Federal Assembly, so that they do not have to convince the president to veto it.

Bill On Social Protection for Unemployed Workers in the Telecom Industry

To ensure support of regulatory reform by broad political and public forces, the legal package should include a bill on social protection for laid-off workers. This bill will outline concrete steps to accommodate the rights of unemployed in the telecom industry. The legislation should cover the following main elements of the remedy program:

⁵⁹ "Russia and Commonwealth Business Law Report", *LRP Publications*, July 1, 1998.

- ***Launching a training program to employ the laid-off in other developing sectors.*** The government must ensure that formerly employed workers have an option of retraining. This retraining program should enable the workers to seek jobs in the same industry or comparable industries. The government constantly emphasizes support for small businesses and entrepreneurship. Former employees in telecom may be retrained as small business entrepreneurs.
- ***Providing severance payments for the unemployed.*** The government needs to ensure that the unemployed from the telecom industry receive severance payments. The government may also instruct local state employment bureaus to assist former employees in finding new jobs.

The initiative for social assistance to the unemployed in the telecom sector will raise some opposition to liberal reforms. The opposition may use government payouts for retraining of the unemployed as another excuse to stall reforms. They may complain that the government should be prudent with taxpayer money, and spend conservatively. However, the price the government and taxpayers will have to pay is lower than the price they currently pay for keeping inefficient operators afloat. The current uncompetitive environment results in lost revenues and high service prices for customers. It is preferable to pay for proper reallocation of labor resources than to continue losing funds to non-competitive providers.

Russian society still must accept the idea that a mobile work force is an inseparable element of a free market, to which Russia aspires. It is more costly to keep inefficient forces in place than to relocate them to sectors where they will be better utilized.

The gradual implementation of regulatory reform will decrease the negative effects of liberalization and promote better tracing of allocated funds.

To ensure a broad coalition for reform, Quantum Fund and its allies should support efforts by the government to retrain workers. This would alleviate the short-term negative effects of reform.

POLITICAL ANALYSIS OF STAKEHOLDERS

Given the importance of telecommunications for Russia's security and economic development, many influential parties have specific opinions on how to proceed with sectoral reform. Liberalization and privatization reform will face the strongest opposition from conservative politicians and regional authorities. President Putin is the political stakeholder with the greatest influence. Since he has declared his support for liberal reforms and WTO accession, he is potentially the reform coalition's most valuable political ally. The conservative part of the State Duma will attempt to block liberal legislative initiatives or to amend proposed bills to upset reform efforts. Despite President Putin's significant political power and broad public support, conservative members of the Duma may still attempt to override a presidential veto.

In the early '90s, government policy was to retain ownership of traditional telecommunications operators. The creation of Svyazinvest as a holding company of the state-owned shares represented a continuation of ownership as a means to regulate sector activity. Local telecom providers controlled by Svyazinvest were often used as a vehicle for the implementation of government's social policy. The following is an analysis of the current stakeholders in telecommunications reform, their relative political power and influence, and their roles in the reform process. Their roles in promoting reform are discussed briefly in this section, and in more detail in the Strategy Analysis section.

Stakeholders

1. Quantum Fund and Mustcom Limited

The Mustcom consortium is led by Russia's Uneximbank (Interros Group) and includes Moscow-based Renaissance Capital, Investment bank Deutsche Morgan Grenfell, Morgan Stanley Asset Management, and George Soros's Quantum Fund. Although the consortium is led by Uneximbank (Interros Group), most of the funds for the contests were provided by Quantum Fund. Quantum Fund presently owns 53% of Mustcom, which translates to a 13% control of Svyazinvest. The Quantum Fund has even provided a collateral loan to Uneximbank, so that Interros could participate in the bidding process.

Quantum Fund supports increased privatization of Svyazinvest to protect its original \$1 billion investment. Sufficient privatization will only take place concurrently with liberal market reforms in the telecom sector. From a commercial standpoint, Quantum Fund supports liberalization in the Russian telecommunications sector to increase competition, transparency, predictability, and promote a level playing field for all private, foreign, and state companies.

Russian government policy towards Svyazinvest subsidiaries was largely influenced by social economic considerations towards selected groups of citizens. Subsidiaries were obliged to provide services below their costs, which meant lost profits for investors. Quantum Fund can achieve better long-term profitability in a free market environment, where profits are determined by market forces rather than by arbitrary non-transparent regulatory decisions. These reforms will meet WTO provisions and allow Russia to join the WTO. Quantum Fund is convinced that privatization and liberalization will increase the value of its shares in Svyazinvest, and increase its long run profit

potential. Finally, Quantum Fund supports privatization and liberalization because its founder George Soros who was dedicated to free market reforms in emerging economies.

Telecom restructuring and liberalization will allow regional providers to capture new market shares, including profitable cellular and mobile segments. Privatization and liberalization will boost the value of Mustcom, which is consistent with the interests of the shareholders.

The process of privatization will offer the consortium a possibility of increasing shares in the company, which will enhance Quantum's control over company management and decision-making. To preserve Quantum's influence over Svyazinvest, participants have recently reversed the initial decision to liquidate the company by August 2001. The shareholders of Quantum have agreed to extend their cooperation contract until 2007.

Since Quantum Fund is a foreign company, its ability to lobby Russian ministries, politicians, and public opinion is limited. Therefore, Quantum Fund should help form a coalition of like-minded Russian businesses, political movements, and public interest groups to promote telecommunications liberalization and privatization. The proposed organization is called Coalition for Reforms in Russian Telecom (CRRT). Targeted and personal lobbying of policy makers may yield the greatest success towards promoting reforms.

Quantum Fund and its allies have a considerable influence over the liberal wing of the Russian political establishment. Liberal politicians and movements recognize that liberal reforms in telecom will be advantageous for their electors, many of whom are educated people and businessmen, and frequent users of value added services and the Internet. George Soros' contribution to developing democracy in Russia is highly valued by this political power, which advocates closer ties between Russia and western democracies.

2. Presidential administration

During the presidential elections, President Putin indicated his support for further market liberalization and Russia's integration into the world economy. Since the primary goal of Svyazinvest privatization will be to promote restructuring of the sector, the Presidential Office will uphold the company's consolidation as a part of the privatization process. The consolidation of regional telecom carriers is in accordance with the government's general policy of improving federal control over the regional authorities. Previous federal reform divided the country into seven federal districts, which strengthened the political influence of federal executive power, and improved the federal oversight over local processes.

Support from President Putin's administration is essential for passing reforms through the Duma. The administration has assigned ministries to prepare and introduce reform legislation. President Putin will need to veto the Duma's legislation that restricts privatization. His full commitment to privatization and liberalization reforms is needed. Existing bureaucracies in Russia are slow-moving and reluctant to change, and only a strong push from the top will result in the effective legal implementation. President Putin has considerable influence in ensuring the support of regional governors or neutralizing their opposition to reform. He is supported by 60% of Russian citizens,⁶⁰ which indicates significant popular appeal and political influence.

⁶⁰ www.vesti.ru

Administration plans to better integrate in the world economy

President Putin identified improved economic cooperation with the rest of the world as one of his priorities at the beginning of his term. Special emphasis was placed on Russia's accession to the WTO. Soon after Putin became president, WTO negotiations for Russia's accession were reinvigorated. Since 1999, the WTO Working Group on Russian accession has met 4 times and launched a round of bilateral and multilateral negotiations, which demonstrates the importance the new Cabinet attaches to the WTO accession issue.

Since President Putin supports Russia's WTO membership, Quantum Fund and its Coalition should emphasize how telecom reform will benefit Russia's WTO accession negotiations. Quantum Fund can discreetly encourage foreign companies and WTO member governments to pressure President Putin on telecommunication reforms.

New federal districting and telecommunication companies' consolidation

On May 13, 2000, President Putin issued a decree that divided the country into seven federal districts, each with its own federal representative. According to this reform, Russia's 89 regions will be grouped under the new system to "help increase effectiveness of federal bodies of power and improve control over compliance with decisions."⁶¹ According to the decree, the appointed representatives will help implement federal legislation and report back to Moscow on "providing national security in the federal district, and also about the political, social, and economic situation in the district."⁶² Putin also ordered several regions to rescind legislation that contradicted or defied federal laws.

Former President Yeltsin's system, where the President had representatives in each of the 89 districts, effectively diluted control and often made representatives align with local governors. Under the present scheme, Putin aims to increase federal control over the territories and strengthen power of the president's representatives.

The borders of the seven federal districts coincide with the borders of planned regional providers. The Presidential Office expects that the breakup of other natural monopolies, such as railways and electrical networks, will be conducted according to the new initiative of federal districting.

Political stability and telecommunications

Development of the telecommunications network through privatization and liberalization will result in greater private investments in telecommunications, and will help the administration retain political stability in the country. The relationship between the lack of telecommunications investment and political instability in transitional economies is a vicious circle: political and economic instability prevents foreign investment in telecommunications, while the lack of investment in telecommunications fosters political and economic instability.

⁶¹ Protassov, V.N., "Russia Splits into 7 Districts", *Capital Markets in Russia*, May 18, 2000.

⁶² Protassov, V.N., "Russia Splits into 7 Districts", *Capital Markets in Russia*, May 18, 2000.

3. Ministry of Communications and Information Technology

Despite the importance of Russia's accession to the WTO, the Ministry has only recently indicated its support for membership. An analysis of the Ministry's activities to promote liberalization reforms shows that the agency has not yet finalized its position and strategy. Ministry officials are not speaking with one voice, and often make contradictory statements in public.

The Ministry's main interest in telecom reforms is to provide the best possible service for Russian citizens, and to monitor practices in the telecom sector. Its goals are to create a fair competition environment and increase the efficiency of telecom operators, making the industry attractive to investors. The Ministry declared that previous telecom reforms have made it more efficient and profitable, but its own analysis of traditional operators' performance shows weak competitiveness and investment appeal. The Ministry's new development plan adjusts its regulatory policy to allow for further growth.

In the "Conceptual Plan of Development of the National Telecom Services Market," the Ministry is authorized to prepare for the sale of Svyazinvest shares. The agency is also charged with accelerating the consolidation process to boost the price of the shares and attract the maximum number of possible investors. According to the arrangements with the Ministry of Trade, the Ministry officials must participate in preparing the bill "On Amendments and Additions to the Federal Law On Communications" of 1995 N FZ-15 ("On Communications"). This bill intends to bring Russia's telecom legislation closer to WTO provisions, and fill in gaps of existing legislation.

The Plan sets objectives for further industrial development, and outlines initiatives to improve the telecom infrastructure and market access, such as the elimination of cross-subsidy pricing and increased network transparency in interconnection. The Ministry hopes to attract \$33 billion of investment in the industry in the next 10 years. To meet this goal the Ministry must attract foreign investment through Svyazinvest's bidding contest and sectoral liberalization.

The Ministry of Communications regulates market entry through licensing. The Ministry does not formulate licensing policy independently, however the State Telecommunications Commission, made up of various representatives of state bodies and incumbent operators and chaired by the Minister of Communications, is responsible for policy. In the 1990s licenses were usually not issued to enterprises in direct competition with traditional operators or operators affiliated with the Ministry.

The Ministry stated that it has no plans to impose direct restrictions on the number of shares a foreign investor may purchase in a Russian telecom company. However, the Ministry wishes to impose restrictions on participation of foreign companies in operational management. It is trying to prevent foreigners from becoming majority shareholders, since it considers this undesirable for national security interests. This position may worry foreign investors, as it shows that the Ministry seeks foreign capital but not foreign partners.

Minister Reiman indicated that such restrictions are not the subject of WTO and ITU (International Telecommunication Union) complaints. Minister Reiman said the Ministry does not intend to ban majority ownership for foreign investors, but by restricting foreign ownership simply wishes to

create a level playing field. It still unclear how this position is consistent with Ministry's attempts to attract more investments, given that most domestic investors are unable to commit sufficient funds.

The Ministry is an essential government agency for carrying out and implementing telecom reforms. Therefore, it is crucial to have the Ministry's support. To ensure the Ministry's support, Quantum Fund needs to emphasize that reforms are in line with the Conceptual Plan that the Ministry is responsible for implementing. The main objectives of the Ministry's plan are to increase investments in the industry, liberalize the telecom market and pricing policy, and improve telecom service in rural areas. If the Ministry tries to circumvent reforms, it will upset its own efforts to implement the objectives of the Conceptual Plan.

4. Regional Authorities

Proponents of liberalization and privatization must address the concerns of regional governors to ensure their support for reform measures. Many regional governors oppose the restructuring plans, fearing a loss in tax revenue, since most taxes will be paid in the headquarters of new companies. Svyazinvest's General Director Yashin must compromise to bring regional governors to his side.

Regional operators also expressed concern over resource allocation. They anticipate capital staying in the headquarters at the expense of telecommunications network development in other regions. Another concern is the uneven playing field. In the 1990s, some regional operators invested heavily in network upgrades, while others paid higher dividends. An effort to unify the technological level in a consolidated company may cause companies that were planning long-term to receive fewer resources, preventing them from reaping the benefits of previous investment. However, the companies that invested in their development and managed the company according to long-term objectives will likely succeed most. According to the restructuring plan, these companies will be the core of new regional telecommunication providers.

Since governors provided tax breaks for telecommunication providers in mid 90s, they believe that they should also have an opportunity to influence the decision to integrate Svyazinvest subsidiaries. Moreover, since Yeltsin's government transferred some shares of local Svyazinvest's subsidiaries, many regional administrations became large shareholders. Apart from the Ministry of Communications, local authorities often have an important say in who enters the market in their regions. Coordinating Councils for telecommunications exist in every federal area that sends recommendations to the Ministry. In regions, there is a general consensus that as long as local enterprises of *electrosvyaz* are doing their jobs adequately, there is no reason to undercut their revenue potential by giving markets to outsiders.

Many governors have considerable political leverage over their regional representatives in the Federal Assembly and State Duma. Given the overall weakness of the fragmented political parties in Russia, the endorsement of a candidate by local authorities often becomes the only sound guarantee for election to the federal legislative bodies.

Support for reforms from regional governors, or at least their non-opposition to reforms, is vital. The best way to appeal to governors is through their constituents. Local businesses and constituents must inform the governors of the inadequacy of existing services, and argue for reforms to solve the problem. Since Quantum Fund is a foreign company, the formation of the broad-based Coalition for Reforms in Russian Telecommunications (CRRT) is a crucial element of lobbying efforts. The

Coalition should include regional businesses and citizens groups that take the lead in lobbying local governors and politicians. The CRRT can co-operate with these local constituencies by providing them with information and organizational support.

The Coalition must demonstrate to governors that reforms will result in increased investment and improved telecom services in the rural areas. Proponents of reform must allay governors' fears of loss of tax revenue by pointing out that larger investment in the regions, and improvement in telecom services, will result in increased economic activity and boost local government revenues.

5. Svyazinvest

Svyazinvest is 75% owned by the government and 25% owned by the Mustcom Consortium. The government sale of an additional 25% will result in needed foreign investment and increased capitalization. As the commercial analysis shows, Svyazinvest will benefit from the proposed reforms through increased revenues, profits and capital investments. Restructuring will bring Svyazinvest shares of seven solid regional telecommunications providers, which will ensure healthy competition in the future. The holding company will have an easier time attracting investments to its subsidiaries, and developing telecommunications networks. The company will increase its productivity through better management and investments in up-to-date technologies.

Svyazinvest's political leverage is not strong. Management decisions are subject to government endorsement. However, the management of Svyazinvest can resort to lobbying representatives from the Ministry of Communication and local governors to increase political influence and protect their interests. Local governors and authorities can also provide broad support to the management of the local subsidiaries, given that these telecom providers are valuable employers and taxpayers.

6. Ministry of Trade and Economic Development

This Ministry is responsible for preparing surveys and analysis and monitoring privatization in Russia. The Ministry does the research, and together with other federal bodies, submits recommendations to the government on how to proceed with further market liberalization.

According to the Ministry, telecom liberalization and Svyazinvest's restructuring is the means to enhance productivity and improve competitiveness in telecommunications. The Ministry claims that the reform should:

- meet the growing demand in telecommunications services
- enhance the development of national infrastructure
- provide telecommunication services across the country
- promote the effective use of existing infrastructure
- promote investments in the sector
- accelerate Russia's entrance to the WTO

The Ministry states that telecommunications reforms have the following objectives:

- create a favorable environment for operations of telecommunications providers
- develop competitiveness in the sector
- attract investments

- promote development and research of new technologies
- ensure integration of the telecommunications sector in Russia and compliance with European and world standards
- implement cost based regulations on pricing policy in Russia by 2002

In the Russian power hierarchy, the Ministry is one of the most liberal federal agencies. Close personal relations between Minister German Gref and President Putin, and Gref's affiliation with the so-called "St. Petersburg political club," help ensure progress in liberal and restructuring reforms. The Ministry's strong advocacy for restructuring reforms in Russian railways and electric utilities put these reforms at the top of the agenda. However, on telecom reforms, the Ministry may be outnumbered in the Cabinet by federal agencies subject to the influence of moderate interest groups. The Ministry can overcome the opposition by ensuring the support of the President or Prime Minister, and building a consensus within and outside the government.

7. Ministry of Anti-Trust Policy

The Ministry of Anti-Trust Policy oversees the competition policy of telecommunications providers through a network of local Committees of Anti-Trust Policy. The role of the local division of the Committee on Anti-Trust Policy is to prevent anti-competitive behavior. Besides price exultations, the Ministry investigates alleged abuses of monopoly power, such as unjustified price discrimination. In regions, the Committees investigate complaints on the exorbitance of installation charges for businesses and residences, the requirements of advance payments for services, and the method of compensating operators for required discounts extended to special social groups.

Since regional telecommunications providers remain monopolies, their activities are regulated by the Ministry on Anti-Trust Policy. The primary objective of the Ministry is to observe that local monopolies do not increase fees for their services to the population at large. Proposed telecom reforms require changes in pricing policy, which directly affects the Ministry. Under current pricing policy, the Ministry can influence monopolistic prices for telecom providers in the regions, which often are natural monopolies. Currently, the fee-setting process for local telecom services is subject to the political consideration of local authorities, rather than economic reasoning. Services by a local operator are provided below cost, which lowers profitability. The matter is complicated by a number of categories of citizens whose telecom expenses are subsidized by the federal government. Telecom carriers offer services to those citizens, but often the government does not provide the carriers full compensation.

The Ministry is frequently subject to political pressure from federal and local establishments in its price setting policy. Pricing, cross-subsidization and interconnection issues are crucial for Svyazinvest. Quantum Fund and CRRT must ensure that the Ministry provides cost-based service fees, and stimulates free market behavior. In lobbying efforts, the Coalition should emphasize to the Ministry that reform will promote a free market in telecom through sectoral demonopolization.

8. Ministry of State Property

This Ministry of State Property participates through the Federal Property Fund in the management and privatization of state owned companies. The Ministry sets management and privatization objectives of specific companies, including Svyazinvest. The Ministry also analyzes how much the

government gains from controlling the majority of shares, and if some shares should be privatized or transferred.

The Ministry is determined to continue the process of privatization. The Ministry suggests reducing the number of state controlled companies through a new round of privatization in Russia. The main objectives of a new privatization round are to raise funds for the federal budget, provide companies with an efficient management team, and encourage investments.

It is important that Quantum wins the Ministry's cooperation to expedite restructuring and privatization.

9. Ministry of Agriculture

The Ministry of Agriculture is interested in privatizing Svyazinvest to raise funds for the development of telecommunication networks in rural areas. The teledensity there is much lower than in cities, but the need for telecom services is still high. Many rural telecommunications providers operate outdated analogue equipment, which is poorly maintained. The newly adopted strategy for telecommunication services emphasizes development in rural and remote areas. However, the state cannot ensure sufficient financing of those projects. Restructuring reforms and privatization of the company will provide the necessary funds. Liberal reforms may result in more telephone lines for rural areas too, as was the case in Chile.⁶³

The Ministry of Agriculture can help generate support in rural communities for reform. It also can help neutralize opposition to reform from politicians and constituencies that would otherwise support the conservative political forces and fight any efforts at liberalization.

10. Citizens

Russian citizens will benefit from restructuring and privatization, since they will have more choices and be able to pay market prices to local telecommunication providers. The federal regulator maintains high fees for long-distance calls to allow the telecom monopolies to subsidize local services. Due to the lack of competition and investments, citizens must pay higher fees to install new lines. Most of the population does not have affordable phone lines. There are federal social programs that allow specific categories of citizens to pay lower fees for provided services. However, since the government contests or delays payments of subsidies for those categories, many citizens must cover expenses of providers themselves.

Although common citizens are the largest interest group, their position may not be clearly conveyed to the political establishment. Citizens can best influence policies of local and federal agencies by communicating with local authorities, federal Ministries, and congressmen. Consumer interest organizations can help their cause. Though citizens and consumer interest organizations are traditionally weak, the effectiveness of any step they take will be magnified if their efforts are made as a group rather than as separate entities. Consumer rights advocates may also establish a broad public relations and lobbying campaign. Raising reforms with candidates running for election to a local or federal office may be the most effective means of promoting citizens interests.

⁶³ Wellenius, Björn, "Extending Telecommunications beyond the Market: Toward universal service in competitive environments", *Public Policy for the Private Sector*, World Bank Group, October 1997.

11. State Duma

The Communist majority of the State Duma opposes sectoral liberalization and Svyazinvest privatization by foreign investors. The Communists and opposition, which are sympathetic with the Russian military, may use security arguments to support their position. There is also an outstanding concern that criticism that the Communist Party does not take advantage of their majority in the parliament may push the Communists to block Svyazinvest privatization. The Communists require that the government increase spending, but do not favor raising the necessary funds for federal programs through privatization. The Duma's Agrarian Party, a traditional supporter of the Communists and promoter of broader state control, also opposes privatization. Together with the Agrarian Party, the Communists may sway the majority to block the initiatives.

Currently, the State Duma is in the center of the legislating policy. Functions of the upper Chamber of the Russian Parliament are being reshaped due to the reforms in the Federal Assembly. The State Duma and President Putin have managed to preserve efficient business relations since the start of the President's term. This has allowed them to pass a number of important laws in 2001, including the Federal Budget 2001, and a legislation package on intellectual property rights protection. Although the Russian president has significant power under the Russian Constitution, a presidential veto can be overridden by two thirds of congressmen.

RECOMMENDATIONS AND STRATEGY

Given that Quantum is a foreign investment company the effectiveness of its efforts alone to implement telecom reform will be limited. Quantum should concentrate on building a coalition with like-minded Russian interest groups, to be called the Coalition for Reforms in Russian Telecommunications (CRRT). They must ensure that the Interros Group, Quantum's partner in Mustcom Consortium, becomes a member and leader of the CRRT. Interros has extensive contacts in the executive and legislative branches, and the Presidential Administration, and can exert significant influence on local authorities. At the international level, Quantum should inform foreign governments and businesses of progress in Russian telecom reform, and emphasize the necessity of a realistic timetable for implementing WTO accession requirements. The CRRT needs to mobilize broad public support for reforms by crafting efficient media and grassroots strategies.

The implementation of liberal law is especially important for Russia, given its bid for WTO membership. Quantum Fund should employ a two-tier strategy to advance its interests in the sectoral reforms:

- Ensure early privatization of the second package of 25% share of Svyazinvest
- Ensure the implementation of regulations to liberalize the telecom sector

Form a coalition with Russian companies to promote telecommunications reform

Given the sensitivity and significance of the telecommunications sector for Russia's security and industrial development, Quantum should employ a cautious approach. Since Quantum Fund is a foreign company, direct lobbying strategy alone will have little effect on Russian politicians and citizens. The Quantum Fund needs to build a coalition with Russian companies and interest groups.

The main target of Quantum's coalition building efforts should be the Interros Group, an industrial coalition of Russian companies that have extensive holdings in printing, television media, and manufacturing. This Group joined with Quantum Fund and a number of other companies under the offshore consortium Mustcom in a bidding contest for the first tranche of Svyazinvest shares. The Quantum Fund should use its ties with the Interros Group to push for telecommunication reforms, and encourage Interros to play the leading role in lobbying.

To encourage Interros to promote reforms, the Fund can write off a collateral loan that it provided to Interros to participate in the first bidding contest of Svyazinvest. The Interros Group will be an effective lobbyist, since it has close relations with the new Putin administration, and controls shares of other large Russian enterprises. Control over several Russian manufacturers gives Interros leverage for influencing the policy of regional governors.

To achieve its interests, Quantum should take the following steps:

- Build a coalition of the like-minded interest groups
- Ensure presidential support for reforms
- Build consensus among the Cabinet of Ministers
- Build consensus among the political parties in the legislative branch

Primary objectives of Quantum Fund's strategy

The joint strategy of Quantum Fund, Interros Group and their allies to privatize the sector and liberalize Svyazinvest should include the following steps:

- Ensure that the bill “On the Protection of the Economic Interests of the Russian Federation During the Disposal of Shares of Joint Stock Companies Producing Products (Goods or Services) With Strategic Importance for State Security” is defeated by the Federal Assembly or vetoed by the president. A veto could lead to an override vote by the Duma, so Quantum should try to ensure that the bill does not pass. From the governmental position, it is best to tie funding for the State Duma to the passage of amendments that give more administrative discretion for privatization of strategic enterprises. Quantum should encourage the Ministry of Finance and State Property to remove Svyazinvest from the list of companies that require Duma's approval.
- Pass the bill “On Amendments and Additions to the Federal Law ‘On Communications’ of 1995 N FZ-15 (“On Communications”)”. Quantum and its allies must base its lobbying campaign on the drawbacks of the existing Law “On Communications”. These drawbacks are costly for further Russian integration into the world economy. Additionally, non-transparent policy hurts Svyazinvest's profits and market potential, and the economic development of the country.
- The Russian government and the Ministry of State Property need to steer a new privatization law through parliament despite potential opposition in the Duma. The new law should weaken the Duma's direct control over state property sales. The sale of individual state assets worth more than 350 million dollars is currently prohibited without the Duma's permission.
- To speed the process of consolidation, the government should use its leverage as a controlling shareholder to urge local telecommunication providers to approve the Svyazinvest plan of regional consolidation. At the Svyazinvest shareholders' meeting, the shareholders need to assign financial consultants to audit the companies and prepare those companies for the restructuring.
- To avoid political risks, the Ministries of Communications and State Property must ensure that information packages on the interregional mergers are sent to regional governments and presidential representatives in the seven federal districts. The federal government should initiate negotiations and correspondence with regional leaders to address their concerns.
- The President needs to issue an ordinance on the terms of privatization of the 25% minus 2 shares stake.
- Pass a bill or presidential decree for an independent regulator of telecommunications services to preclude unfair pricing practices and violations of international and domestic regulations.
- Prevent a coalition that would override the possible presidential veto of the Duma's bill on privatization
- Prevent the coalition from blocking the new bill on communications.

Directions of the strategy

Quantum Fund should adopt a strategy for telecom reforms. The strategy should incorporate the following components:

- cooperative efforts of proponents of the reforms
- legislative lobbying strategy
- media and public relations strategy
- cooperation with businesses to lobby local and regional officials
- cooperation with academicians, specialists, and think tanks

1. Cooperative and coalition building efforts

Quantum must identify the interests of the main groups on the reform issue. The Fund should ensure the support of groups that have vested interests in liberalization and privatization. In coalition-building efforts, Quantum must ensure that its allies recognize the importance of reforms for Russia's accession to the WTO. The Quantum's main supporters include:

Interros as Quantum's key ally

The Interros Group is a key to Quantum Fund's coalition building efforts. It should take the lead in lobbying government officials at the national and regional levels.

Coalition for Reforms in Russian Telecommunications (CRRT)

Together with its main allies, Quantum can establish the Coalition for Reforms in Russian Telecommunications (CRRT). The membership of the Coalition will include domestic and foreign companies and corporations, think tanks, associations, and political entities. The main benefits of a Coalition are:

- Enhancing the force to the argument
- Distributing responsibilities
- Sharing the expenses for the lobbying, media and PR campaign

The following agencies, organizations and companies are possible members of the coalition:

Domestic Corporations

- Gazprom
- AO UES
- Norilsk Nickel
- Siberian Aluminum
- Evraz-Holding
- Alrosa
- Ural-Siberian Mining and Steel Company
- Vimpelcom
- Bee Line
- MTS

- Russian Railways

Foreign Corporations

- Deutsche Telecom
- Italtel
- France Telecom
- British Telecom
- Microsoft
- AT&T
- MCI
- Telestra
- Alcatel
- US West
- Sprint
- Sonera (Finland)
- STET
- Lucent

Trade Associations and Organizations

- Russian American Chamber of Commerce
- Foundation for Russian American Economic Cooperation
- Russian Chamber of Commerce and Industry
- Russian Union of Manufacturers and Entrepreneurs
- Tacis
- Open Society Institute
- World Bank
- WTO
- ITU

Think Tanks

- Russian-European Institute for Economic Policies
- Center for Economic and Financial Research
- St. Petersburg Institute of Economics and Finance
- MGIMO
- MGU-Moscow State University
- Center for Economic Policy Research
- Institute for Economies in Transition

Before the Coalition becomes engaged in any activity, it must prepare “leave-behinds”. “Leave-behinds” are model documents that the Coalition can leave after meetings with the president, senators, public or interested parties. They may include:

- White papers, which identify the issue of the reforms, its main obstacles and benefits

- Position papers of the coalition on the reform
- Briefing memoranda
- Articles, op-eds, letters to editors, etc.

It is important that members of the Coalition gain leverage over the main players, such as the Russian Presidential Administration, legislators, ministers, media, and public. Obviously, Quantum Fund's share of the management of the Coalition will decrease as the size of the Coalition increases. Therefore, Quantum should closely coordinate its actions with like-minded stakeholders in the following activities:

- ensuring support of the executive branch
- building consensus between the key Ministries
- ensuring support of the legislators
- initiating a massive media and PR campaign
- lobbying executives and legislators to advance reforms
- mobilizing the grassroots
- lobbying for the reforms abroad

2. Strategy for the Executive Branch

Since President Putin has significant power and enjoys high popularity among Russian citizens, winning presidential approval for the liberalization and privatization reforms is a necessary component of the strategy. In general, President Putin aspires for a more predictable and liberal policy.

Engage Interros high management in building a consensus with President

In lobbying the president, the CRRT and Quantum Fund should take advantage of close relations between President Putin and Vladimir Potanin, the head of Interros Group. As a part of lobbying strategy, the CRRT and Interros can take the following steps:

- Send a letter to the president emphasizing the necessity of further reforms. Indicate the benefits of privatization and liberalization of telecommunications in Russia's bid for WTO membership.
- Attempt to arrange a meeting with the President. The CRRT should rely on Vladimir Potanin to arrange a joint meeting. Given that the President supports Russia's negotiation on membership to the WTO, emphasizing international implications of liberalization will help the cause.
- Submit documents identifying the position of the coalition (briefing memos, position papers, etc.).

Promote consensus with Ministries

In its consensus building efforts in the executive branch, the Quantum Fund and the CRRT should identify the positions of the key Ministries on the reform issue. The CRRT's supporters in the administration include:

- Ministry of Communications
- Ministry of Trade and Economic Development
- Ministry of Agriculture
- Ministry of State Property

The Coalition should send memoranda to the ministries that include arguments for privatization and liberalization in the telecommunication sector. These memoranda should emphasize benefits of liberalization for each particular ministry. The memoranda should refer to empirical data and positive results of reforms in other countries (such as Poland, Germany, Chile, Brazil, and Hungary). Special attention should be paid to opposing arguments, and how the CRRT will counter those concerns.

Most efforts in the executive branch strategy will be dedicated to cooperation with the Ministry of Trade and the Ministry of Communications.

- For the Ministry of Trade and Economic Development, which is handling Russia's negotiations on WTO accession, it is important to stress how liberalization will influence the WTO negotiations. The CRRT needs to emphasize that the failure of Russia to proceed with reforms will damage Russia's image and make its partners at the negotiating table more cautious.
- For the Ministry of Communication, it is important to emphasize that the Ministry needs to reiterate its position on telecom privatization and liberalization. The CRRT may need to arrange a meeting of the ministerial officials to exchange views on reform. The Coalition should encourage the Ministry to promote the new amended Law "On Communications".

The CRRT should ensure a ministerial consensus on telecommunications reform. Effective coordination of different Ministries' activities is also crucial.

The CRRT can also request that foreign agencies and international organizations assist in lobbying efforts. They may include:

- Russian American Chamber of Commerce
- US-Russia Business Council
- Foundation for Russian American Economic Cooperation
- Tacis
- Open Society Institute
- World Bank
- ITU

Through consultations with the government these organizations may:

- Illustrate successful implementation of reforms in other states
- Emphasize long-run benefits of the reforms
- Underline the positive effect on the investment climate in Russia
- Indicate the benefits in terms of Russia's accession to the WTO

On the local level, the coalition should ensure local executives' support and demonstrate opposing governors the benefits of proposed reforms for their region.

Lobbying the legislative and executive branches to ensure that regulatory and privatization reforms remain a top governmental priority should be a continuous process.

3. Strategies for the Legislative Branch

CRRT's strategy in the legislative branch will encompass the following objectives:

- Convince legislators of the benefits of reform for their home constituents. This will be difficult when dealing with representatives from regions opposing consolidation and liberalization efforts.
- Inform congressmen on the benefits of WTO accession. The CRRT needs to emphasize the overall objective of Russia's leadership to integrate into the world economy.
- Build a coalition of the like-minded political parties and factions. The CRRT must ensure their votes for amendments on privatization and liberalization laws. The key allies of the CRRT in the Duma are Yabloko, OVR, pro-presidential SPS, and Yedinstvo.

Major instruments for the lobbying in the legislative branch will include:

- *white papers* to explain the benefit of restructuring and privatization of Svyazinvest
- *testimony at parliamentary hearings* to convince congressmen to support for the reforms
- *letters* to congressmen and senators
- *appointments* with congressmen and senators. At the meetings Interros, Quantum, and allies need to connect the Svyazinvest issue with concerns of particular congressmen or senators. Benefits to senators' or congressmen's home industries and their general populations must be emphasized. The CRRT may also invite constituents to meet with congressmen to lobby for reforms.

The main objective of the Coalition's strategy in the legislative branch is to pass the bill "On Privatization" and the bill "On Amendments and Additions to the Federal Law 'On Communications' of 1995 N FZ-15 ("On Communications")".

Ensuring the passage of the government version of the bill "On Privatization"

The CRRT should lobby the parties and individual members of the Federal Assembly and Duma to introduce the government version of the bill on privatization. The government's bill on privatization removes the requirement stated in the previous bill of obtaining Duma approval for privatization of state property with a cost of over \$350 million. The potential supporters of the bill are the Coalition of Right Forces, Yabloko, and "Unity."

At the hearings, Quantum and its allies in the Coalition should prepare testimony in support of privatization, outlining the benefits for Svyazinvest operations and telecommunications development. Quantum needs to ensure that supporters secure necessary votes for the bill as it stands. To increase the chances of passage, the CRRT may lobby the government to introduce the bill in the package with the budget law. Congressmen will be hesitant to defeat the privatization bill together with the federal budget because their salaries depend on the approval of the federal budget.

Ensuring the passage of the bill “On Amendments and Additions to the Federal Law ‘On Communications’ of 1995 N FZ-15 (“On Communications”)”

The main targets of lobbying for the bill “On Communications” will include the members of the following Duma committees:

- Committee On Energy, Transportation and Communications
- Committee On Economic Policy and Entrepreneurship
- Committee On International Affairs

The members of these Committees are most knowledgeable on the subject of telecom reform and the process of Russia’s accession to the WTO. They should realize the repercussions of failing to adopt the law in terms of accession prospects. They should also see the economic and social benefits of reform, and how the bills passage promotes the implementation of the Conceptual Plan of Telecom Development adopted by the Government.

The CRRT should include the following steps in promoting the bill in the State Duma:

- ***Consultations with political factions and parties.*** These consultations should attempt to break the traditional coalition between the Communist Party and the Agrarian Party. The allies need to show the Agrarian Party that reforms will provide funds to develop telecommunications networks in rural areas. The Coalition must convince the Agrarian Party that regarding the issue of reforms in telecommunications, the interests of the Communists and Agrarians are not compatible.
- ***Private meeting with congressmen and senators.*** A private meeting with the key politicians from the Federal Assembly and State Duma should be arranged when the bill on telecom policy is scheduled for voting. At the meeting, the CRRT should communicate the benefits of reform and the importance of furthering the accession process. They should attempt to sway the undecided and build support for the approval of the reforms.

4. Media and Public Relations Strategy

After each of the legislative initiatives is introduced in the Parliament, the CRRT should implement its media and public relations strategy. As soon as a critical public awareness of the benefits of proposed reforms is achieved, it will be hard for the political establishment to deny these benefits to citizens.

The influence on the public will be most effective if some respectable politicians, public leaders and economists speak out. These people can influence the public through roundtables, interviews on TV and in newspapers, meetings, conferences, press conferences, and seminars. The CRRT can also request that think tanks conduct an economic and social analysis of the consequences of telecom reforms. Respected Russian think tanks (with their directors in brackets) are:

- Institute of International Economics (Yevgeniy Yasin)
- Center of Strategic Modeling
- Center for Strategic Research (Andrey Piontkovski)
- Institute for Globalization Issues (Mikhail Delyagin)
- Russian-European Institute for Economic Policies
- Center for Economic and Financial Research

- RosBusinessConsulting
- Moscow State University
- St. Petersburg Institute of Economics and Finance

Television and Radio:

Television and radio are equally popular and accessible in Russia. The media strategy of CRRT for television and radio can include:

- short advertisements on the benefits of legislative initiatives on sectoral reforms
- interviews with influential members of the government and the parliament on the issues
- talk shows and press conferences on the necessity of adopting the proposed reforms

Talk shows can be especially effective due to their high popularity in Russia.

Newspapers and magazines:

Newspapers and magazines can promote Quantum and CRRT interests through:

- articles on economic and social impacts of the present demise in telecommunication services, on the benefits of Svyazinvest privatization plan and legislation, the importance of WTO accession, and how a closed service sector impedes accession negotiations
- interviews with politicians and respectable economists
- paid advertisements
- unpaid media vehicles, such as op-eds and letters to the editor

Interros owns a large media corporation “*Prof-Media,*” which has several outlets. This will save the Coalition funds for other campaign expenses and make the strategy more effective. Some of Interros’ media outlets are national media channels with a broad audience. Interros controls the following national outlets:

Newspapers:

- Izvestia
- Komsomolskaya Pravda
- Antenna
- Express-gazeta

An Analytical Journal:

- Expert

TV-Radio companies:

- Severnyi Gorod
- Puls
- Prime-TASS

Radio:

- Autoradio

Advertisement Agency;

- Alpha

The Coalition may also concentrate on other media outlets:

Mainstream Newspapers

- “Argumenty & Fakty” – a liberal newspaper with the largest number of subscribers
- “Izvestia”
- “Kommersant”
- “Kommersant-Daily”
- “Nezavisimaya Gazeta”
- “Segodnya”

Business Journals

- “Delovoi Mir”
- “Dengi”
- “Economika & Zhizn”
- “Itogi”
- “Sem’ Dnei”
- “Mir Svyazi”
- “Connect”

The Internet should not be underestimated by the campaign managers. The Internet is especially useful for obtaining the support of young, educated, and professional people. Quantum and the CRRT can establish a website or rely on Interros’s website to communicate their position. Coalition members should be encouraged to use their own websites to promote sectoral reforms and Russia’s accession. The Coalition can also cooperate with companies that manage other trade websites, such as RosBusinessConsulting.

International media strategy through Ministries

CRRT should lobby the Ministry of Trade and Economic Development and the Ministry of Communications to engage in an active international media strategy. The objectives of the international media strategy are the following:

- informing international partners about privatization and liberalization reforms in Russian telecommunications
- attracting foreign investments in present and future telecom projects
- forming a positive image of the Russian economy and democracy
- promoting Russian accession negotiations to the WTO

The Ministries can achieve these goals through the following tools:

- press conferences, when the Ministries’ representatives can report on the development of telecommunications in Russia and reform prospects
- articles in international newspapers and magazines; letters to the editor; op-eds

- bilateral contacts with foreign trade agencies, speeches at official receptions

5. Grassroots Strategy

The CRRT grassroots strategy should mobilize consumer and business groups to support privatization and liberalization to improve the quality of telecom services. The CRRT should:

- educate large groups of citizens
- sway public opinion to support the proposed reforms
- encourage the public to take a proactive position on the issues
- organize consumers and businesses to convince government officials at the federal and local levels to support reforms. This strategy can be especially effective in rural regions.

Domestic national media outlets are an important vehicle for advancing the arguments for reform. The CRRT should identify a list of national media outlets with large national audiences.

The national media outlet targets are:

- *On television:*
ORTV, NTV, TV-6, RTR
- *On the radio:*
Radio Mayak, RTR
- *In printed media:*
Newspapers:
Izvestia, Nezavisimaya Gazeta, Komsomolskaya Pravda, MK, Rossiyskaya Gazeta, Pravda, Novaya Gazeta, Trud

Journals and Magazines:
Itogi, Profil
- *Web resources:*
CEFIR.RU, LENTA.RU, VESTI.RU, POLIT.RU, FLB.RU.

The main channels to convey the message will be:

Short paid ads, interviews, coverage of press conferences, reports, and talk shows

Launching a massive media campaign will educate both the public and decision-makers on the benefits of liberalization and privatization reforms. The media messages should encourage the public to take a more proactive position by:

- sending collective letters or making a call to Federal Assembly and State Duma representatives, local governors, and Russian federal Ministries
- participating in meetings and other events
- collecting signatures in support of the reform

Grassroots strategy will be especially effective in regions where reforms may face strong opposition from governors or other local officials. Such grassroots campaigns will be more focused and will require fewer funds to implement. The steps of the grassroots strategy will include:

- *targeting local media to disseminate information on the benefits of the reforms*
- *encouraging political parties to mobilize their local membership for support of reforms*

These parties include:

Yabloko, SPS, Yedinstvo, and OVR

Local members of these parties are more experienced with the local political landscape. Engaging the local membership will make the Coalition's efforts more effective.

- *using libraries and schools as centers for disseminating information*

In the '90s, Russian higher education and libraries were hit by cuts in federal and municipal spending. George Soros' Open Society Institute granted funds to Russian libraries and schools to buy new books and periodicals. Libraries remain major cultural and information centers in many Russian cities. As a part of the grassroots campaign, the Quantum Fund and the CRRT can agree with libraries to hold conferences and presentations for clubs and the general public.

Soros' Institute launched a program to provide Russian universities with access to the Internet. These universities can help facilitate and prepare conferences, presentations, and other events. University students can also be engaged in distributing information on presentations and conferences.

6. International Strategy

At the international level, Quantum Fund should:

- stand ready to brief foreign governments on the political situation in Russia and the progress of telecom reforms
- inform foreign governments of the Coalition's efforts to achieve reforms
- encourage countries involved in Russia's WTO accession negotiations to accept a reasonable timetable for implementing telecom privatization and liberalization
- encourage foreign companies to invest in Russia and keep them posted on the progress of reforms

Quantum must be careful not to be perceived as urging foreign governments to pressure Russia to enact reforms. Governments will do this anyway at WTO accession negotiations. Such direct efforts by Quantum Fund could create a nationalistic backlash against the company.

The objectives of Quantum's international campaign are:

- informing foreign authorities, businesses and public on how the current regime in Russian telecom hurts their trade interests
- preparing an appropriate background on Russian telecom issues at the WTO accession negotiations

To pursue its international strategy, Quantum Fund can co-ordinate with the following companies:

- France Telecom
- US West
- Sprint
- Deutsche Telecom
- Sonera (Finland)
- Telia (Sweden)
- STET

and the Mustcom partners:

- Investment bank Deutsche Morgan Grenfell
- Morgan Stanley Asset Management Fund

The targets of Quantum's international strategy should include:

- foreign governments and national agencies responsible for trade negotiations and international relations (European Ministries of Trade, Foreign Affairs, the USTR, and State Department)
- IMF
- World Bank

Quantum's international coalition must draw the attention of western governments to Svyazinvest's reform plan. Quantum should prepare a media event, such as a press conference as a vehicle to gain publicity.

A press conference is an appropriate instrument to create publicity for the issue. Prior to the press conference, Quantum needs to prepare the list of media outlets that can convey effectively the information and their contacts. Given the international scope of the issue, Quantum Fund should rely on outlets that have a broad national or international audience. The media outlets should be sent an advisory that informs newsmen on the place, time, and subject of the press conference. Quantum should also follow-up on the media advisory to ensure its delivery.

Previous relations with newsmen can be a part of the press conference's success. Therefore, it is important for Quantum to maintain good business relations with media outlets.

Other Quantum Fund activities on the international level may include:

- sending letters to the US and EU governments and congressmen. The letter should describe the need for telecom liberalization in Russia, identify reform priorities and explain progress that is being made.

- contacting foreign governments involved in the negotiations on Russia's WTO accession, informing them about issues and progress, and urging them to adopt a realistic timetable for reforms.

EXHIBITS

Questions and Answers

1. How can a transparent policy in telecommunications benefit common citizens?

Customers benefit from competition among telecom providers. Implementing transparent and non-discriminatory policies in regulatory reform is the only way to ensure that conditions for healthy competition for all operators are satisfied. The present non-transparent and arbitrary sectoral regulations in Russia drive new entrants away, keeping prices high and quality poor. A non-transparent and non-competitive environment harms both telecom operators and customers who are denied choice among providers and quality services.

2. How can Russia's accession to the WTO benefit the Russian telecommunications sector?

First, accession will give Russia a chance to harmonize regulations and practices in the telecommunications sector with those of the rest of the world. Second, it will enable Russia to use the WTO dispute settlement mechanism. This will ensure that Russian and foreign countries' practices are subject to the same treatment. Third, acceptance of the WTO provisions on telecommunications will help Russian economic growth and development. Competition in the sector will allow common people to purchase quality services at a lower price. Providers of telecom services will benefit from open access to the Russian and foreign telecom sectors.

3. How will Russia reduce the negative effects of liberalization in the telecom sector?

Russia's accession has its benefits and costs. Open competition will lead to shutdowns of inefficient telecom providers. There are several ways to address this issue:

- Developing compensation and rehabilitation measures. The government can provide a special program to assist employees from enterprises that will go out of business to find new jobs.
- Lobbying for a longer period for Russia to comply with WTO provisions. During this time, Russia could use temporary protectionist measures to defend its telecom industry. The government can also subsidize social programs for the telecom industry.

Given the underdevelopment and potential of the industry, benefits from Russian accession will outweigh short-term costs.

4. How do you assess the prospects of the current State Duma passing the necessary telecom reform legislation?

Russian reforms in the service sector have moved much more slowly than reforms in the production of goods. Nevertheless, the process of negotiating changes in regulations both in goods and services are under way. Much work still needs to be done by the current Duma in both areas. Given that the current Duma is more realistic and less partisan, the prospect of adopting a good law in telecommunications regulations is increasing. Many of today's Duma members are practical people from large enterprises and corporations. Many are economists and specialists in related fields. They have already passed a

large package of regulations to bring Russian legislation in compliance with the WTO requirements, including TRIPS. This indicates that there may not be a major problem passing new legislation.

5. Will WTO accession influence further investments in the Russian telecom sector?

International experience shows that the process of WTO accession is generally accompanied by the inflow of foreign investments. In Bulgaria foreign investments grew by 500% after its accession. The WTO accession will allow Russian telecom providers to maintain, and even expand their market shares. If the Russian government resolves issues of sectoral transparency and takes steps to defend the rights of investors, investments will follow. Improving the investment environment is a precondition for steady economic growth in Russia.

6. Why does Quantum Fund advocate better competition in the telecom sector?

Quantum Fund recognizes that privatization, especially with foreign participation, probably cannot be obtained without market liberalization. Additionally, Quantum Fund prefers to operate in an open market where profits are driven by market forces rather than unpredictable, non-transparent regulatory decisions. Quantum Fund believes it can increase share value and maximize profits in a privatized open market environment that adheres to international norms. Finally, Quantum Fund is run by George Soros, who is deeply committed to liberal market reforms worldwide. It is simply not Mr. Soros' style to invest in a controlled monopoly and fight against market reforms. Without competition in the telecom sector, benefits from increased private participation will not be realized. Investors are not opposed to competition. Regulatory uncertainty, unrealistic service obligations, and rigid tariffs in the sector are more troublesome for them. Lack of clarity in sectoral policy drives investors away.

7. What are the objectives and reasons for Russia's accession to the WTO?

Russia seeks WTO membership to obtain the following benefits:

- Improved conditions for access of Russian products to foreign markets and the non-discriminatory treatment for Russian exporters
- Access to the international dispute settlement mechanism
- Creation of a more favorable climate for foreign investments
- Expanded opportunities for Russian investors in WTO member-countries
- Increased domestic production and competitiveness as a result of increased flows of foreign goods, services and investments to the Russian market
- Participation in negotiations of international trade agreements
- Improved image of Russia as a competent international trade participant

The objective of accession negotiations is to achieve the most favorable conditions for Russia's joining the WTO, and balancing the benefits of accession and the concessions of opening the market. According to German Gref, The Minister of Economic Development and Trade, balanced rights and obligations of Russia during its accession to the WTO should contribute to its economic growth.⁶⁴

⁶⁴ <http://www.wto.ru>

8. Why does it benefit the Fund to liberalize the Russian telecom industry?

Contrary to the views expressed by some financial advisors, investors are not opposed to competition. In today's Russian telecom sector, Quantum Fund is burdened with regulatory uncertainty, rigid restrictions and barriers. Lack of clarity regarding competition drives prospective investors away. Partial privatization of Svyazinvest in 1996 failed shortly before closing. The winning bidder realized that the government did not intend to grant Svyazinvest a license to build its own long-distance network. This illustrates how costly the lack of transparency can be for foreign investor. A cost-benefit analysis for regulatory reform demonstrates that the benefits of liberalization will outweigh its cost. Liberalization of the telecom industry is in line with the philosophy of our founder, George Soros, who sees the expansion of democratic and liberal values in the former Communist block as one of his objectives.

9. Will liberal reforms in Russian telecom result in an economic crisis similar to what Argentina is experiencing right now?

Telecommunications reforms were not the source of current economic demise in Argentina. The economic crisis in that country has more profound long-standing reasons. They include:

- running a large budget deficit
- running a large external debt
- pegging currency to the dollar to combat inflation resulted in lower exports

In Russia, the government has harnessed inflation. In the last few years, inflation in Russia has been around 14% a year. The Russian government has declared a policy of conservative and responsible spending. Due to high prices for traditional Russian exports, the country was able to quickly recover from the 1998 financial crisis, and collect significant tax revenues, which helped the government to cover its expenses and establish an emergency fund for future expenses. Russia has succeeded in negotiating the deferral of its debt payments for foreign creditors. In 2001, Russia made all due payments in time; it even was ahead of schedule. Argentina has run as large an external debt as Russia, yet is unable to repay it. However, the ratio of external debt per capita is much higher in Argentina.

10. Why is it necessary to develop fixed line services in Russia rather than mobile telecommunications?

Arguments for the development of mobile communications are valid given the uneven distribution of population in Russia. However, there are strong arguments against adopting exclusively mobile communications:

- The cost of data transmission over the mobile line can be much higher than the long-run cost of similar services provided by fixed line operators
- Fixed lines ensure more reliable communications services. In many instances, mobile communications require more research and improvement than fixed lines.
- Although Russian telecom is largely outdated, significant investments have already been made in the development of modern fixed line communications. In the mid '90s the trans-Russian fiber optic line was completed. It would be natural to develop local lines around this line.

- Absence of mobile systems' compatibility in Russia makes fixed lines more preferable to develop. GSM and CDMA platforms are adopted by different providers, and only fixed lines can ensure services to users of both systems.

The issue of what communications Svyazinvest should develop is not as important as the issue of telecom providers' ability to fulfill its objectives. Present capitalization will not allow many operators to develop either mobile or fixed lines. Liberalization and privatization reforms will help to resolve this issue by increasing investments and capital. The question of whether to invest in fixed or mobile lines is a business decision to be made by the providers based on what is more economical to implement in Russia.

SAMPLE MEDIA ADVISORY

Coalition for Reforms in Russian Telecommunications

MEDIA ADVISORY

For immediate release:

October 21, 2002

CONTACT:

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Tel. (800) 321- 4- RUSSIA

RUSSIAN TELECOM REFORMS CREATE OPPORTUNITIES FOR AMERICAN BUSINESS

A press conference of Quantum Fund on progress towards Russian telecom reforms and WTO accession

When:

Where:

Speakers: President of the Coalition for Reforms in Russian
Telecommunications (CRRT)
President of Quantum Emerging Markets Fund
USTR telecommunications advisor;
FCC representative.

Agenda: 10:00 Report on the research findings
10:30 Questions from the audience

At the press conference, speakers will report on the progress of reforms and market liberalization in the Russian telecommunications sector. The Russian leadership has declared its commitment to telecom reform and WTO membership, and progress is being made.

The US is still unable to expand its telecom sector abroad as long as promising markets, like Russia, remain closed to US operators. "Russian telecom reforms and WTO accession is a two-way street," says the President of CRRT. "WTO partners are looking for Russia's reciprocity in telecommunications, which is necessary to join the WTO. When reforms are implemented, there will be tremendous incentives for foreign companies to invest in Russian telecom, and in other sectors."

Coalition for Reforms in Russian Telecommunications is an association of organizations, which promote better transparency and predictability in the Russian telecom sector.

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SAMPLE PRESS STATEMENT

Telecommunications is one of the fastest growing industries in the world. The US spent significant resources and energy convincing its trade partners to discuss telecom trade issues in the WTO and for the GATS and Basic Telecommunications Agreement. US investments in Russian telecom reached \$84 million in 2000. It is by far the largest investor.

Unfortunately, this Agreement does not apply to non-WTO members, such as Russia. This has cost US providers lost revenues, but most importantly lost jobs. Since Russia is not subject to WTO provisions, the environment in the telecom industry is uncompetitive and non-transparent. The sector is highly dominated by local monopolies that deny access to public lines. This deprives US telecom providers of a substantive market, amounting \$33 billion.

US customers suffer too. The Russian monopolies charge unreasonably high fees to complete international phone calls. By our estimates, if these charges are removed, US customers will save 11–30 % of their call charges, as Germany's experience shows.

The US providers are also kept from the Russian market by the fear of arbitrary policies by federal and local regulators. Non-transparent policies in licensing procedures remain a significant obstacle for trade.

Producers of telecom equipment in the US suffer as well. Revenues from exports of telecommunications equipment to other countries amount to \$20 billion. According to the ITA data the fraction of US telecom services to Russia is miniscule. It comprises only 2% of US exports, equal to US exports to Columbia and Venezuela.

In the process of accession negotiations, Russia must comply with WTO requirements. The objective of US telecom providers is to ensure that the issues of sectoral trade discrimination, non-transparency, and demonopolization are addressed.

TIME FRAME

To assess progress of implementation of liberal reforms in the Russian telecom sector, the Quantum Fund can use the following time frame:

January 2002

- Quantum intensifies its coalition building efforts through establishment of the Coalition for Reforms in Russian Telecommunications (CRRT).
- CRRT intensifies its lobbying campaign of the State Duma. Federal Assembly to pass amendments to the law “On Communications.”
- The State Duma passes the Law “On the Federal Budget for the fiscal year of 2002,” which obliges it to put 25% of shares of Svyazinvest for sale.

February 2002

- Quantum and CRRT intensify pressure on the local and federal governments to support privatization and liberalization efforts.
- The State Duma and Federal Assembly pass amendments to the Law “On Communications” to bring Russian telecom laws and regulations in compliance with WTO provisions.

March 2002

- The consolidation of Svyazinvest holdings is completed.
- The Ministry of Communications confirms the date for the auction of 25% of Svyazinvest shares.
- By March 2001, the Ministry of Trade notifies its WTO negotiators on government’s efforts to open the telecom market at a Working Group meeting.
- The Ministry of Communications conducts the auction.

April 2002

- The Trade Ministry receives comments on regulatory sectoral reforms from its negotiating partners.
- The Trade Ministry finalizes accession negotiations on the telecom sector.

April 2002 – November 2003

- The Ministry of Trade holds meeting and consultations under the WTO Working Group on Russia’s accession to reconcile the position of Russian with foreign manufacturers and service providers.
- The terms of Russia’s accession to the WTO are finalized

December 2003

- Russia’s candidacy is approved by the member countries
- Russia officially becomes a member of the WTO

BUDGET ESTIMATES

	<u>1st year</u>	<u>2nd year</u>
Personnel expenses		
Director	\$75,000	\$75,000
Staff:		
Assistants	\$45,000	\$45,000
Media consultants	\$50,000	\$50,000
Legal consultants	\$60,000	\$60,000
PR consultants	<u>\$50,000</u>	<u>\$50,000</u>
<i>Subtotal for personnel</i>	<i>\$280,000</i>	<i>\$280,000</i>
Office expenses		
Rental expenses in Moscow	\$34,000	\$56,000
Rental expenses in Washington	\$55,000	\$70,000
Equipment and supplies	\$31,000	\$15,000
Transportation expenses	<u>\$11,000</u>	<u>\$24,000</u>
<i>Subtotal for office expenses</i>	<i>\$131,000</i>	<i>\$165,000</i>
Campaign expenses		
Printing production:		
Brochures	\$22,000	\$35,000
Posters	\$10,000	\$25,000
Advertisement production:		
Payments to national channels	\$40,000	\$65,000
Payments to regional channels	\$14,000	\$25,000
Conferences and interviews	\$12,000	\$20,000
Meetings	<u>\$8,000</u>	<u>\$13,000</u>
<i>Subtotal for campaign expenses</i>	<i>\$106,000</i>	<i>\$183,000</i>
Other expenses	<u>\$19,000</u>	<u>\$25,000</u>
 Total	 <u>\$517,000</u>	 <u>\$653,000</u>

PROPOSED REVENUE SOURCES (FIRST YEAR)

Quantum Fund	\$32,000
Interros	\$32,000
Coalition revenues from	
Coalition members (\$13,000 x 30 members):	\$390,000
Coalition supporters (\$2,200 x 20 entities):	\$44,000
Coalition contributors (\$950 x 20 entities):	<u>\$19,000</u>
<i>Total</i>	<i>\$517,000</i>

PROPOSED REVENUE SOURCES (SECOND YEAR)

Quantum Fund	\$32,000
Interros	\$32,000
Coalition revenues from	
Coalition members (\$13,000 x 40 members):	\$520,000
Coalition supporters (\$2,200 x 30 entities):	\$66,000
Coalition contributors (\$100 x 30 entities):	<u>\$3,000</u>
<i>Total</i>	<i>\$653,000</i>

In the second year of the campaign, the Coalition will have more members, and become more reliant on membership fees than donations.

CHART OF INTEREST GROUPS

People	Interests	Options	Objective Criteria	BATNA
Quantum Fund	<ul style="list-style-type: none"> - Ensure Quantum's profitability and return on equity - Protect original investment - Ensure stability in the Russian economy and telecom sector - Maintain controlling interest in Mustcom - Promote privatization to increase stake in Svyazinvest - Promote telecom liberalization - Promote privatization and market liberalization consistent with owner George Soros' philosophy - Increase business presence in former Communist countries 	<ul style="list-style-type: none"> - Lobby for privatization and liberalization simultaneously - Convince the government to proceed with privatization first, and liberalization later - Lobby the US and European governments to include reforms on telecom regime in the list of the WTO accession requirements - Lobby Russian government to liberalize telecom at the WTO accession negotiations - Prepare documents and policy papers - Consolidate interest groups who share Quantum's objectives - Ensure participation of Russian partners in the 	<ul style="list-style-type: none"> - Successful privatization in telecommunications sector in Germany, Chile, Poland, and Hungary - Successful consolidation reform in Brazil - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services - ITU's annual report on telecommunications in emerging economies - World Bank's working papers on benefits of telecommunications liberalization - Conceptual Plan On Development of Telecom In the Russian Federation. 	<ul style="list-style-type: none"> - Convince the government to sell an additional 25% of Svyazinvest shares - Convince the government to proceed with privatization first, and deal with market liberalization later - Continue to lobby the US and European governments - Lobby the Russian President Administration - Stop or reduce financing the educational and cultural project - Continue effort to mobilize grassroots - Continue a media campaign - Work with Russian partners to elect agreeable members to Congress.

		<ul style="list-style-type: none"> campaign - Grassroots campaign in provincial areas - Strengthen the Mustcom Consortium - Make support of Russian provincial, cultural, and educational centers contingent on progress of reforms - Launch a media campaign. 		
<p>Ministry of Economic Development and Trade (Minister German Gref)</p>	<ul style="list-style-type: none"> - Represent the interests of Russian manufacturers abroad - Represent the interests of Russian industries at the WTO accession negotiations - Promote predictable business environment favorable for investments - Promote expedient restructuring and reforming of state controlled sectors - Ensure 	<ul style="list-style-type: none"> - Lobby Russian President - Lobby the Federal Assembly and State Duma to pass required laws - Build a grassroots and media campaign - Prepare modal documents - Propose required bills to the Russian legislators - Ensure the support of Russian exporters and corporations - Publicize the 	<ul style="list-style-type: none"> - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services -World Bank's working papers on benefits of telecommunications liberalization - Successful privatization in telecommunications sector in Chile, Germany, Poland, Hungary - Successful consolidation reform in Brazil - ITU's annual 	<ul style="list-style-type: none"> - Continue lobbying efforts - Maintain grassroots campaign - Threaten to retaliate - Intensify negotiations with other trade forums including ASEAN - Conclude bilateral agreements.

	<p>Russia's compliance with its international obligations</p> <ul style="list-style-type: none"> - Facilitate the implementation of the Conceptual Plan. 	<p>advantages of reforms and WTO membership for public</p> <ul style="list-style-type: none"> - Obtain infant industry protection - Downplay the concerns of local authorities and conservative opposition - Coordinate effort to promote the reforms. 	<p>report on telecommunications in emerging economies</p> <ul style="list-style-type: none"> - Conceptual Plan On Development of Telecom In the Russian Federation. 	
<p>Ministry of Anti-Trust Policy</p> <p>(Minister Iliya Yuzhanov)</p>	<ul style="list-style-type: none"> - Ensure impartial compliance with federal laws on monopolistic regulations - Promote entrepreneurship and free trade - Monitor price setting policy for Russian monopolies - Preserve control over telecom in monopolistic pricing - Punish the violators of the federal anti-trust legislation - Implement country's 	<ul style="list-style-type: none"> - Lobby the presidential administration and legislators to constrain local monopolies - Lobby for consolidation of local providers to increase control over the sector - Lobby the legislators to support the Ministry's bill on privatization through meetings and coalition building efforts - Arrange consultation with other interested 	<ul style="list-style-type: none"> - World Bank's working papers on benefits of telecommunications liberalization. - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services - Conceptual Plan On Development of 	<ul style="list-style-type: none"> - Continue lobbying efforts - Maintain grassroots campaign - Continue to monitor activities of individual providers - Concentrate on privatization reforms first and deal with liberalization thereafter.

	strategy in the area of telecom monopoly's regulations.	ministries - Participate in international strategy - Participate in the activities of the CRRT - Participate in the grassroots and media campaign.	Telecom In the Russian Federation - ITU's annual report on telecommunications in emerging economies.	
Ministry of Communications and Information Technology (Minister Leonid Reiman)	- Ensure efficient functioning of national telecom networks - Policy making functions in the sector - Retain control over the sector - License distribution - Monitor the implementation and compliance of telecom providers with the principles of national telecom policy - Successfully privatize the state owned enterprises - Monitor licensing compliance - Ensure the quality of telecom services.	- Coordinate its actions with the Min. of Trade - Draft a bill to expedite the reforms - Lobby the Federal Assembly and Presidential Administration - Establish a working group to research the effects of reforms - Build a coalition of like-minded interest groups - Sponsor a bill on defending the rights of telecom investors.	- Conceptual Plan On Development of Telecom Market in the Russian Federation - World Bank's working papers on benefits of telecommunications liberalization - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - ITU's annual report on telecommunications in emerging economies.	- Continue lobbying efforts - Continue to monitor activities of individual providers.

Svyazinvest Management	<ul style="list-style-type: none"> - Ensure profitable functioning - Ensure that do not get unemployed - Promote proper implementation of decisions by the Board of Directors - Preserve good relations with federal officials responsible for telecom management and policy making. 	<ul style="list-style-type: none"> - Lobby the Ministry of State Property and Communication to delay the reforms - Lobby the future owners to reserve work places for present managers in a new management group - Lobby the local authorities for protection in case of layoffs. 	<ul style="list-style-type: none"> - Scandal privatization experience in the mid 90s - Liberalization and shock therapy hurt the most defenseless groups 	<ul style="list-style-type: none"> - Delay the privatization - Lobby the government to provide special severance payments - Look for positions with a new management
Presidential Administration	<ul style="list-style-type: none"> - Ensure country's political and economic growth and stability - Strengthen the power of the federal bodies - Promote predictable business environment favorable for investments - Ensure an early entrance of the country to the WTO on the most favorable conditions - Ensure that Russian 	<ul style="list-style-type: none"> - Authorize the Min. of Trade to prepare Russia's new offers for accession negotiations - Assure local officials that their concerns about a social impact of the reform will be addressed - Look for a compromise at the accession negotiations - Launch a grassroots campaign. 	<ul style="list-style-type: none"> - Conceptual Plan On Development of Telecom In the Russian Federation - WTO Agreement on Basic Telecommunications Services - ITU's annual report on telecommunications in emerging economies - World Bank's working papers on benefits of telecommunications liberalization. 	<ul style="list-style-type: none"> - Threaten to pull out of the accession negotiations - Threaten to retaliate - Intensify negotiations with other trade forums including ASEAN - Authorize Min. of Trade to engage in negotiating bilateral agreements.

	manufacturers' interests are satisfied.			
Local Administrations	<ul style="list-style-type: none"> - Ensure that local citizens and businesses have quality telecom services at a reasonable price - Maintain maximum independence from the federal center - Curtail unemployment. - Ensure local control over communications - Ensure that telecom pay taxes to the local government rather than the budget of some. 	<ul style="list-style-type: none"> - Lobby the conservative political forces to oppose liberalization and consolidation - Lobby the local representatives in the Federal Assembly and State Duma - Launch a grassroots campaign - Lobby regional presidential representatives - Build up a coalition with like-minded governors. 	<ul style="list-style-type: none"> - Federal agreements on distribution power of and obligations between regions and Moscow - Individual arrangements with local governments to leave taxes of local federal enterprises in regions - Scandal privatization experience in the mid 90s - Liberalization and shock therapy hurt the most defenseless groups. 	<ul style="list-style-type: none"> - Continue lobbying - Maintain governors' coalition - Refuse to follow the federal instructions - Seek meeting with President
Small telecommunications providers	<ul style="list-style-type: none"> - Ensure a fair treatment on the market - Ensure a non-discriminatory access to telecom facilities - Maximize profits - Increase market share. 	<ul style="list-style-type: none"> - Lobby the federal agencies and ministries - Lobby foreign governments - Form a coalition with a like-minded interests groups - Establish an association of small telecom providers 	<ul style="list-style-type: none"> -World Bank's working papers on benefits of telecommunications liberalization - Successful privatization in telecommunications sector in Germany, Poland, Hungary 	<ul style="list-style-type: none"> - Continue lobbying Russian and foreign governments - Maintain an association ties - Continue grassroots efforts.

		<ul style="list-style-type: none"> - Launch a grassroots and media campaign - Lobby the State Duma political faction of Russian manufacturers. 	<ul style="list-style-type: none"> - Successful consolidation reform in Brazil - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services - Conceptual Plan On Development of Telecom In the Russian Federation - ITU's annual report on telecommunications in emerging economies. 	
Telecommunications equipment manufacturers	<ul style="list-style-type: none"> - Ensure that the partners are solvent - Ensure a fair treatment on the market - Ensure a non-discriminatory access to telecom facilities - Maximize profits - Increase market share. 	<ul style="list-style-type: none"> - Lobby Russian and foreign governments - Join small manufacturers' campaign for reforms - Lobby the State Duma political faction of Russian manufacturers. - Grassroots campaign. 	<ul style="list-style-type: none"> - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services - ITU's annual report on telecommunications in emerging 	<ul style="list-style-type: none"> - Continue lobbying Russian and foreign governments - Maintain an association ties - Continue grassroots efforts.

			<p>economies</p> <ul style="list-style-type: none"> -World Bank's working papers on benefits of telecommunications liberalization - Conceptual Plan On Development of Telecom In the Russian Federation. 	
WTO members	<ul style="list-style-type: none"> - Expand trade liberalization to other countries - Increase the scope of liberalization - Ensure rule of law and transparency - Encourage development of democratic freedoms - Promote higher living standards through free trade. 	<ul style="list-style-type: none"> - Seek more substantial offerings in the telecom sector - Set a deadline for negotiations - Form a coalition - Conduct multilateral consultations with Russian negotiators - Encourage interested domestic industries to pitch in. 	<ul style="list-style-type: none"> - ITU's annual report on telecommunications in emerging economies - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services -World Bank's working papers on benefits of telecommunications liberalization. 	<ul style="list-style-type: none"> - Threaten to retaliate - Continue to exert pressure on Russian negotiators - Delay Russia's accession to the WTO - Slow down the pace of negotiations in other areas - Switch to negotiating other countries candidates - Agree on special provisions for Russian telecom.

<p>Common citizens</p>	<ul style="list-style-type: none"> -Satisfy the demand for more phone lines and Internet access - Satisfy the demand for good quality affordable telecom services - Preserve benefits and privileges in paying for telecom services. 	<ul style="list-style-type: none"> - Lobby the local and federal legislative bodies - Intensify the grassroots efforts. 	<ul style="list-style-type: none"> - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - Conceptual Plan on Telecom Development in the Russian Federation. 	<ul style="list-style-type: none"> - Continue lobbying - Continue the grassroots campaign.
<p>Ministry of Federal Property (Minister Farit Gazizullin)</p>	<ul style="list-style-type: none"> - Management and preparations for privatizations of state controlled companies - Ensure that the companies are managed according to objectives of the government - Raise the maximum funds from auctions. 	<ul style="list-style-type: none"> - Launch a new round of privatization of state controlled enterprises - Convince the government to put 25% of shares for sale - Lobby the government to conduct reforms in the sector prior to the privatization. 	<ul style="list-style-type: none"> - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - WTO GATS provisions - WTO Agreement on Basic Telecommunications Services - ITU's annual report on telecommunications in emerging economies -World Bank's working papers on benefits of telecommunicat 	<ul style="list-style-type: none"> - Continue lobbying the Federal Assembly and State Duma - Change the management of Svyazinvest - Maintain coalition with other like-minded groups.

			<p>ions liberalization - Conceptual Plan On Development of Telecom In the Russian Federation.</p>	
<p>Ministry of Agriculture (Minister Aleksy Gordeev)</p>	<ul style="list-style-type: none"> - Promote the interests of agrarian regions - Promote a larger market share for Russian farmers - Ensure a larger proportion for agricultural industries in the federal budget - Develop and implement the program to revive Russian country site - Lead country site related social programs. 	<ul style="list-style-type: none"> - Lobby the government for greater allocation of budget funds to develop phone lines for agrarian regions - Lobby the President and Ministry of Communications to promote the development of telecom services - Build coalition with traditional allies (Agrarian and Communist Parties) to put communications issues of villages on the agenda. 	<ul style="list-style-type: none"> - Conceptual Plan on Telecom Development in the Russian Federation - Scandal privatization experience in the mid 90s - Liberalization and shock therapy hurt the most defenseless groups. 	<ul style="list-style-type: none"> - Continue to lobby the federal officials to ensure that remote regions' interests are satisfied - Maintain grassroots efforts; - Lobby the agrarian party to sponsor a new bill.
<p>Russian corporations</p>	<ul style="list-style-type: none"> - Profit maximization - Increase market share of Russian exports - Ensure steady foreign and domestic 	<ul style="list-style-type: none"> - Lobby President and the Federal Assembly to liberalize telecom - Exert pressure on the local 	<ul style="list-style-type: none"> - WTO Agreement on Basic Telecommunications Services - Successful privatization in telecommunication 	<ul style="list-style-type: none"> - Threaten to remove their headquarters to other FSU republic - Continue to lobby the officials

	investments in corporations' projects	governors who oppose consolidation - Join the coalition of Quantum Fund - Lobby the State Duma political faction of Russian manufacturers - Launch a media campaign.	ions sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - WTO GATS provisions - ITU's annual report on telecommunications in emerging economies -World Bank's working papers on benefits of telecommunications liberalization.	- Continue a media campaign.
Conservative political parties Communist Party (leader: Gennadiy Zyuganov) Agrarian Party (leader: Mikhail Lapshin)	- Appeal to the public - Ensure reelections of party representatives on the federal and local level - Preserve close relations with local authorities - Ensure campaign donations from corporations - Delay liberalization and privatization reforms - Ensure affordable services for low	- Mobilize the membership - Lobby the federal authorities - Launch a grassroots campaign - Mobilize the opposition to the proposed amendments and bills - Propose its own amendments - Disrupt the quorum for voting - Ensure the support of the majority in the State Duma.	- Individual arrangements with local governments to leave taxes of local federal enterprises in regions - Federal agreements on distribution and power of obligations between regions and Moscow - Scandal privatization experience in the mid 90s; - Liberalization and shock therapy hurt the	- Continue lobbying the federal authorities - Continue the grassroots campaign - Launch a campaign of civil disobedience.

	income and rural communities.		most defenseless groups.	
<p>Centrist and Liberal political parties</p> <p>Yabloko (leader: Yevgeniy Yavlinskiy);</p> <p>Yedinstvo (Unity); (leader: Sergey Shoygu);</p> <p>OVR (leader: Vyacheslav Volodin);</p> <p>SPS (Coalition of Right Forces);</p>	<ul style="list-style-type: none"> - Appeal to the public - Ensure reelections of party representatives on the federal and local level - Ensure campaign donations from corporations - Promote liberal reforms - Promote development of the Internet - Promote value of western democratic freedoms. 	<ul style="list-style-type: none"> - Mobilize the membership - Lobby the federal authorities - Launch a grassroots campaign - Mobilize the opposition to the proposed amendments and bills - Propose its own amendments - Ensure the support of the majority in the State Duma. 	<ul style="list-style-type: none"> - Successful privatization in telecommunications sector in Germany, Poland, Hungary - Successful consolidation reform in Brazil - ITU's annual report on telecommunications in emerging economies - Conceptual Plan On Development of Telecom In the Russian Federation. 	<ul style="list-style-type: none"> - Continue lobbying the federal authorities - Continue the grassroots campaign.

SAMPLE TESTIMONY

Testimony of Vladimir Gololobov
Chief Legislative Specialist of the
Coalition for Reforms in Russian Telecommunications
*State Duma Hearings on
Amendments to the 1995 Law “On Communications”*

Honorable Speaker and Members of the State Duma, I am Vladimir Gololobov, a chief legislative specialist from the Coalition for Reforms in Russian Telecommunications (CRRT). I appreciate the opportunity to set forth the arguments for support of liberal regulatory reforms.

CRRT is an organization that advocates further liberal reforms in Russian telecom. The organization’s membership includes Russian industrial groups, small businesses, trade promoting associations, representatives of exporting industries, liberal political movements, consumer groups, think tanks and research institutes. Despite our organization’s diverse structure, all our members agree on the necessity to launch a regulatory reform in telecom to expedite Russia’s integration into the world economy.

Russia needs legislative, rather than administrative regulation for the industry.

Telecommunications used to be seen worldwide as a non-transparent natural monopoly. However, new technologies offer the consumer many choices. Telecom sectors in many countries have already undergone necessary sectoral changes, and now enjoy the benefits of free trade. Growth, economic and infrastructure development in Eastern Europe and Latin America due to liberal reforms show us the solution to our telecom problems: Market forces rather than bureaucratic regulation should protect and promote consumers’ and investors’ interests. Open markets facilitate the competitiveness of the existing providers, and enable customers to purchase quality services for fair prices. New providers encourage existing providers be competitive in terms of marketing and management skills.

Liberal reforms will increase sectoral efficiency. Many opponents of sectoral liberalization claim that reforms will lead to increased unemployment. This is a temporary consequence. Many highly qualified jobs will actually be created in Russia as a result of service expansion by new operators. Liberalization will increase the employment of people with university degrees in the new expanding telecom companies. We also support efforts to retrain and find jobs for those who became unemployed due to sectoral reforms.

Maintaining inefficient service providers will be costly for the whole economy in the long run. Under open market conditions inefficient providers defended by non-transparent, non-competitive regulations will have a real incentive to reconsider staffing and management policies.

Sectoral liberalization will promote investments. Potential investors need assurances of the transparency of regulations in the sector to help secure their returns. The Russian telecom industry requires investment on a large scale. According to the World Bank, the world will spend at least

\$33 billion on telecom development over the next ten years. Even such nations as Germany, the US, and France cannot rely exclusively on domestic financial markets in planning their national telecom futures. Russia urgently needs a more transparent regulatory process to be a more attractive place for investments.

In 1997, 69 countries signed the WTO Agreement on Basic Telecommunications. Each of these nations had to sacrifice some domestic politics for the agreement to be signed. So what motivated them to let foreigners acquire control over their telecom sectors? The answer is: competition for international investment resources, which are indispensable for keeping national telecommunications ahead of the rest of the world. While Russia is not yet a WTO member, it is best that Russia implement reforms now to facilitate WTO accession.

Telecommunications and information technologies have a direct bearing on national security. In the midst of a technological revolution, national security can and should be protected by the most advanced technologies. These technologies will only come with new entrants. A more competitive environment will lure the providers of services based on high tech.

Reform will facilitate growth in other industries. All businesses, especially international ones, demand high quality communications services that current operators may not be able to offer. Without high quality communications, transactions costs of doing business may be so high as to make projects uneconomical. Modern banking, transportation, and high tech industries are the greatest beneficiaries of liberalization of telecom services. New technologies and infrastructure brought by liberal reform will open new markets and horizons for these industries' development. Liberal reforms, which will increase the speed of data transmission and reduce service costs, will make these industries more competitive in the world market.

Russia can implement investment objectives of the "Conceptual Plan for Development of the National Telecommunications Services Market" only by proceeding with telecom reform. In light of Russia's negotiations to join the WTO, regulatory reforms should be based on the WTO Annex on Telecommunications and other telecom related provisions. This way, Russian legislators will assist the Ministry of Trade in its difficult task to obtain Russia's membership as soon as possible. However, the reforms are not initiated only to gain WTO membership. The well-being of common Russians is the primary objective of the reforms. Clearly, Russian consumers and businesses will reap most of the benefits.

In conclusion, I urge congressmen to vote for the proposed amendments to the current Federal Law "On Communications".

SAMPLE LETTER TO CONGRESSMAN MEDIKOV (KUZBASS)

Dear Congressman Medikov:

Despite the obvious benefits of telecom reform, government efforts to liberalize the sector have faced formidable opposition in some industry and political circles in Russia.

The current non-transparent, discriminatory, and non-competitive environment has negative repercussions for our country. Most importantly, it is costly to your constituents to pay for the inefficiency of the management headquarters from Moscow. The people of your district are held hostage to this unfair policy. Kuzbass steel exporting businesses incur losses from the lack of competition in the telecom sector. They have no opportunity to choose a provider, and they cannot obtain needed services for a reasonable price.

Opponents' arguments that liberalization will result in heavy job losses are inaccurate. Liberal reform will in fact create jobs for highly qualified specialists. These are the people who were laid off by universities and research institutes in your district.

In your district, demand for phone lines is growing. The current telecom provider is incapable of serving such a large group of customers. However, they should not suffer due to the provider's lack of capacity. It would be beneficial for most of your constituents if other more efficient operators enter the service market.

Given all the reasons for reform, we ask you to support the interests of the vast group of telecom customers for better services at more affordable prices. By doing so, you would address the demand of your people, give them new opportunities for jobs, and promote the interests of your businesses.

Please join us in supporting amendments to the 1995 Law "On Communications" to promote telecom reforms. I will contact you next week to learn if you have any questions and I encourage your support.

Sincerely,

SAMPLE LETTER TO THE EDITOR OF PRAVDA MR. GORSHENIN

Mr. Gorshenin

In response to the article on liberalization of the telecom sector in your December 5, 2001 issue, I would like to indicate the benefits of the proposed reform.

In light of Russia's WTO negotiations, it is necessary to expedite the process of overall liberalization. Without sound evidence of good faith at the negotiations, our partners will have difficulty convincing their domestic constituencies that Russia is serious about free trade.

We also need to realize that liberalization is beneficial for us as well. All across the country we hear that people wait a long time to install phone lines for very high prices. The lack of competition in the sector is to blame for the poor quality of service and inconvenience to customers.

Liberalization and privatization are misunderstood by the public due to bad experience in other sectors in the past. However, liberal reforms in telecommunications are quite a different case. It will cause prices to fall, and the quality of service to improve. Additionally, the pace of Russia's integration in the world economy will accelerate when our trade partners see that we take our commitments to reform seriously.

Sincerely,
President of the Coalition for Russian Reforms in Telecom

SAMPLE OP-ED

RUSSIA NEEDS TELECOM REFORM NOW

Although Russia made some progress in trade liberalization as a result of seven years of negotiations to enter the WTO, Russian policy continues to suppress competition and investments in the telecom sector. The sector is underdeveloped, and consumers are suffering as a result. The treatment for these ailments is a well-tried medicine called liberalization and privatization.

People may say: “Not again! We saw both privatization and liberalization. They did not bring anything good, and only a limited number of people benefited from them.” However, the success of liberalization and privatization reforms depends on how well they are planned and implemented. A free and open market will cause prices to fall, accelerate innovation, and bring a phone to every home. This is important for the overall economic development of Russia.

The WTO accession process will inevitably raise the issue of telecom liberalization. Therefore, Russia must support its declaration to open the market by its deeds. By opening the telecom market, Russia will create a favorable background for further negotiations and establish the image of a reliable partner.

SAMPLE WHITE PAPER

To meet WTO accession requirements, Russia must open its telecom market. The Annex on Telecommunications is one of the focal points of the accession negotiations. More than 50 countries are committed to the Basic Telecommunications Agreement, and Russia should be ready to adhere to it. The process of the negotiations may be expedited if Russia starts implementing the telecom reforms in advance, rather than delaying them to the latest possible date. By doing so, Russia will indicate that it is serious about integrating into the world economy and opening its market. Russia will then be able to attract the necessary foreign and domestic investments to bring its telecommunications system into the modern era.

Russia's Benefits from Liberal Reforms

International experience demonstrates that countries which opened their markets for trade in telecommunications are enjoying the benefits. In Russia, liberalization and privatization reforms will result in lower prices, improved technology, and further development of outdated infrastructure. By opening the Russian telecom market, Russian businesses will gain access to state-of-the-art services and technologies, which will enhance their competitiveness. A transparent environment in the sector is also essential to promote additional investments. Foreign investors are reluctant to invest in Russia due to regulatory uncertainty that creates excessive risk. Sectoral liberalization could serve as sound evidence of Russia's commitment to proceed with reform, which will increase its chances to obtain early WTO membership. The WTO/GATS agreement contains the Annex on Telecommunications, which is binding on WTO members. Russia could dramatically reduce the number of issues on the negotiation agenda by starting the telecom reform now.

Sectoral Issues and Opposition Arguments

Despite the potential benefits of liberalization, the Russian telecommunications sector remains non-transparent, discriminatory, and anti-competitive. The monopolization of the sector did not reduce the demand for phone lines, failed to lower the price for service, and failed to upgrade the outdated infrastructure. To support the dominant position of those operators, the government had to ensure a non-transparent and non-competitive environment. These uncompetitive measures include:

1. Cross-subsidization. Under these arrangements, monopolies can charge low fixed prices for local services and unreasonably high fees for international and long-distance calls. Another type of cross-subsidization is covering losses from services provided to residential customers by charging higher service fees to businesses. This practice allows monopolies to earn exorbitant profits in business services to make up for losses in local services. In Russia, where the Internet remains underdeveloped, there are no feasible substitutes to long distance telecommunications.

The proponents of monopolistic cross-subsidization argue that the size of Russia's territory and uneven density of Russia's population force the country to apply this practice. They claim that this makes it possible for companies to provide universal services in remote and rural areas.

This argument is flawed for the following reasons:

- ***Many remote areas remain without telecom services.*** Despite the argument of providing universal services, there are about 54,000 settlements with no telecommunications lines at all. Many remote areas are provided unsatisfactory services based on outdated technology. Free and increased trade is the only solution for these regions to resolve their communication problems.
- ***Cross-subsidization does not ensure universal services.*** Competition and free market are more effective tools to provide universal services. The problem with cross-subsidization is that it targets the demand side of the equation, not the supply side, as is the case with competitive markets. Investments, new technologies, and new infrastructure are more likely to result in universal services. These improvements and investments will take place if telecom reform is implemented.
- ***Cross-subsidization deprives companies of their steady incomes.*** Charging residential customers fixed fees results in lost revenues for telecom operators. The demand and market share of local services is much larger than the demand for the business and long-distance services. The discriminatory policy of monolithic operators may cause businesses to leave the area.

2. Interconnection. Telecom monopolies are common in fixed phone line services. Unlike mobile service, fixed lines require development and maintenance of the cable, which raises the cost of telecom investment projects. Interconnection would allow new entrants to expand their businesses for a rent payment to the owner of the cable. However, local telecom monopolies set unreasonably high fees for interconnection, which defeat efforts to expand services to Russia.

- ***High interconnection fees create a barrier for new entrants.*** As a result of non-competitive behavior, customers suffer from the lack of choice. To keep competitors away, a telecom monopoly sets a high service fee, which does not correspond to the quality or cost of the service. Competition would increase efficiency of telecom operators and promote new technology and investments.
- ***High interconnection fees are not in the long-term interests of the citizens and policy-makers.*** By keeping potential operators from the Russian market, interconnection barriers prevent the federal and local officials from collecting extra revenues from increased operations. These revenues could be channeled to social programs to provide universal services to remote areas, or further develop infrastructure to make lines compatible with new technologies.

Other arguments against the telecom reforms include:

Skimming

Opponents are convinced that the foreign providers will target only lucrative, easy-to-reach areas, leaving out remote and rural areas. This practice, called “skimming” will be most appropriate for high-end value added services. These services are frequently not provided by the local monopolies, which lack sufficient resources to invest in high technologies. Even if the provider sets the price too high to earn larger profit margins, its competitors will see a chance to claim a market share by pricing the service lower. Skimming will be possible only for a limited time. Under competition,

price distortion caused by skimming will disappear. Competition in lucrative niches will be so rigid that new entrants may set their eye on other areas and social groups. World Bank data shows that the open telecom market in Chile brought telecom service to a third of the remote rural population that was previously lacking it. Skimming was not an issue there.

The government can control the practices of skimming. Punishment of cross-subsidization will equalize customers and make uncompetitive behavior more difficult. Deregulation and reforms will hasten the expansion of the telecom market to rural areas, if urban residents and city businesses pay equal fees.

Job Losses

Opponents of reform argue that liberalization will result in significant layoffs. However, the employment analysis of Asian and Latin American countries that conducted liberal telecom reforms show a higher job growth under competition than under monopolies (20.8% vs. 3.2%).⁶⁵ The penetration of new providers will increase the demand for telecom workers.

Opponents may argue that some of the former employees have low skills, and would have bad prospects for reemployment. In response to that argument, the Coalition should support the government launching a special retraining program to ensure that this work force is utilized. Russia is currently experiencing rapid economic growth (5.5% in 2001), meaning that the unemployed are likely to be captured by expanding industries. This is another argument to accelerate the reforms, so that Russia can deal with short-term negative consequences of liberalization under economically favorable conditions.

Independent Regulator

An independent regulator is crucial for the development of every market. A regulator with expertise in the industry can pave the way for the transition from a market structure dominated by one telecom provider, to a healthy competitive market.

Proponents of establishing an independent regulator must emphasize the following points:

- ***The Government will not lose control over the sector.*** Opponents of reform may argue that the government will lose control over the sector if the policy is regulated by an independent body. The proposed reform offers a system in which the Ministry of Communications would retain its responsibility for making broad outlines of telecommunications policy and participating in international negotiations. A separate and independent regulator would be charged with implementing that policy by adopting rules and regulations, processing licensing applications and awarding licenses, resolving disputes among providers, handling complaints from the public, and ensuring compliance with licensing terms and conditions. The independent regulator will ensure that the industry policy is conducted in an impartial manner.
- ***The independent regulator will not require significant allocations of budget money.*** To increase its independence from interest groups, the regulator should fund its operations out of its

⁶⁵ Wellenius, Björn, *Telecommunications Reform—How to succeed*. Public Policy for the Private Sector, The World Bank, October 1997.

own fees and auction revenues as much as possible. This way, the government will not have to allocate significant budget money to form and finance a new federal agency.

- ***The independent regulator will instill confidence in investments.*** Even after the proposed privatization, the government will retain its controlling shares of telecom operators. Prospective investors will require assurances that their investments are secure. The independent regulator's policy will protect its operations from financial pressure of the state run enterprises and political pressure of elections. Decisions managing the competitive market will turn neither on the government's desire to promote its proprietary interests, nor on political influence. This will make investments in the Russian telecom sector more attractive, which will contribute to even stronger market competition.
- ***Public participation and influence on telecom policy will increase.*** Reforms in telecommunications intend to promote the needs of the public and enhance consumer welfare. Under present telecom policy, regulators hear mostly from large operators, and lose sight of the needs of the public and other players in the industry who have less political influence. To combat this problem, a regulator will promote public participation in the decision-making process by offering proposed regulations for public comment. The regulator should actively solicit input from the industry and consumers of telecommunications services to stay ahead of developments and ensure that regulation is achieving its objectives.

To enjoy the expansion of global services and technological breakthroughs, Russia must open its telecom market. Otherwise, it will have difficulty catching up with other countries in its infrastructure development.

Sophisticated telecom networks and technologies are essential to a functioning economy. Information based industries, such as banking, insurance, and transportation services are becoming more reliant on fast and secure means to transmit information. Some of them require services that are not available from current monopolies. The current high cost of communication hampers the profitability and competitiveness of businesses.

The transition will take time and require public commitment to the process. Anything less could impede reform by giving hope to those with vested interests in the current regime who might seek to obstruct change. Russian businesses and citizens need to ensure that federal and local officials are committed to the reform. Public participation will show officials that the authorities are being monitored. This will push the authorities to conduct reform in the best public interest.

Russia should move towards an independently regulated open market in telecom to improve service quality, meet the urgent needs of consumers, businesses and expanding economy, and accelerate Russia's integration into the world economy.

Table 1. Consolidation

Svyazinvest plans to consolidate the 89 regional operators in which it has a stake into seven large regional telecommunications companies. The following seven companies were selected to become the core of new consolidated regional operators⁶⁶:

Region	Core Telecom provider	Consolidated providers, regional electrosvyaz and svyazinform companies	Already consolidated	Lines millions.
Central	Moscow region electrosvyaz	Belsvyaz, Bryansk, Voroneszh, Smolensk svyazinform, Ivtelecom, Kostroma GTS, Lipetsk, Tambov, Vladimir, Kaluga, Kostroma, Kursk, Orel, Ryazan, Tver' electrosvyaz, MGTS		4.9
North West	PTS	Artelecom, Lensvyaz, Murmask, Pskov, Cherepovets, Vologda, Kaliningrad, Karelia electrosvyaz, Novgorodtelecom, Komi electrosvyaz	SPb MMT, SPb telegraph	3.3
Ural	Uralsvyazinform, Perm City	Chelyabinsk, Kurgan, Yamal electrosvyaz, Tyumen, Ural and Khantyanskiy telecom	Ekaterinburg GTS, MMT, telegraph	2.5
Northern Caucasus	Kubanelectrosvyaz	Volgograd, Cherkessk, Adygeya, Kalmykia, Rostov, North Ossetia and Stavropol electrosvyaz, Dag and Astrakhan svyazinform,	Rostov telegraph	3
Volga	Nizhegorodsvyazinform	Kirov, Saratov, Orenburg, Pensa, Samara, Ulianovsk electrosvyaz, Mar and Udmurt telecom, Mordovia, Chuvashia telecom		3.3
Siberia	Novosibirsk region electrosvyaz	Altai, Tomsktelecom, Altai, Buryatia, Khakassia, Kemerovo, Irkutsk, Omsk, Chita, Krasnoyarsk electrosvyaz	Novosibirsk GTS	3
Far East	Khabarovsk region electrosvyaz	Magadan, Kamchat svyazinform, Yevrei TTK, Amur and Sakhalin svyaz, Khabarovsk electrosvyaz		0.9

The Ministry of State Property should approve the restructuring program before Svyazinvest can proceed with reforms. Svyazinvest's General Director Yashin would like to see it happen by the middle of 2002. Current shareholders of regional operators will be offered shares in a consolidated company. After restructuring is completed in 2002–03, new companies will sell shares to raise funds for network development.

⁶⁶ Ministry of Communications website.

Table 2. Employment in Telecom Sector (per 1000 phone lines)

Country	Number of employees in the sector (1000s)	Number of telephone lines (1000s)	Number of employees per 1000 lines
USA	625	164,624	3.8
Japan	221	61,106	3.6
Germany	213	40,400	5.3
Russia	442	25,019	17.7

Source: Mikhail Kazachkov, *On Certain Problems in the Russian Communications Sector*, 14 May 1998

Table 3. Investments in the Russian Telecommunications Sector:

	Number of telephone lines (1000s)		Lines per 100 inhabitants		Volume of investment for the period 1996-2000 (\$M US)	
	1995	2000	1995	2000	Total	Yearly
Russia	25019	30239	16.99	20.16	7830	1566
Brazil	12083	17175	7.48	9.99	7639	1528
South Korea	18600	26059	41.47	55.44	11188	2238
Mexico	8801	14466	9.58	14.61	8497	1699
Indonesia	3291	10157	1.69	4.93	10299	2060
Iran	5090	11782	7.57	15.71	10037	2007
Thailand	3482	9154	5.86	14.08	8508	1702
Turkey	13228	25501	21.16	37.50	18410	3682
China	40706	241884	3.35	19.27	301767	60353
Germany	40400	51186	49.35	63.19	16179	3236
France	32400	37378	55.80	63.35	7467	1493
Japan	61106	68477	48.80	53.92	11057	2211
USA	164624	198781	62.57	72.02	51235	10247

Source: Mikhail Kazachkov, *On Certain Problems in the Russian Communications Sector*, 14 May 1998

Table 4. Financial Indicators for the Three Largest Companies in Svyazinvest
(In millions rubles)

Company	Official profit for 1997	Official losses for 1998
Rostelecom	2,626.7	-3,400
Moscow City Telephone Network (MGTS)	805	-1,847.9
St. Petersburg Telephone Network	250.3	-513.1
Exchange Rate	6.21	16.7

Sources: Interfax information agency and Business in Russia report of the *Delovye Lyudi Magazine* N3, March 1999.

Chart 1. Internet Users in Russia in 2000⁶⁷

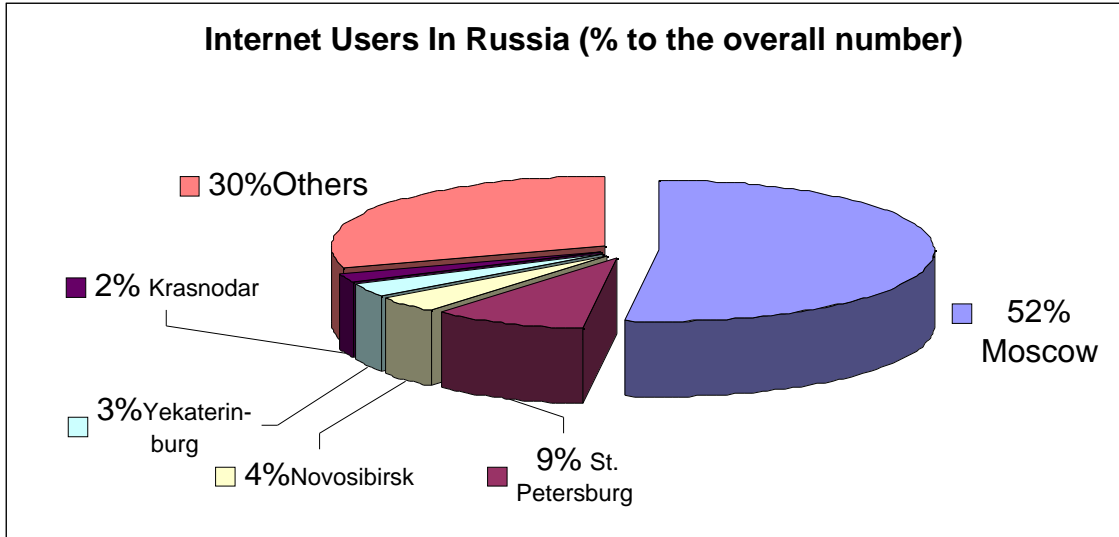
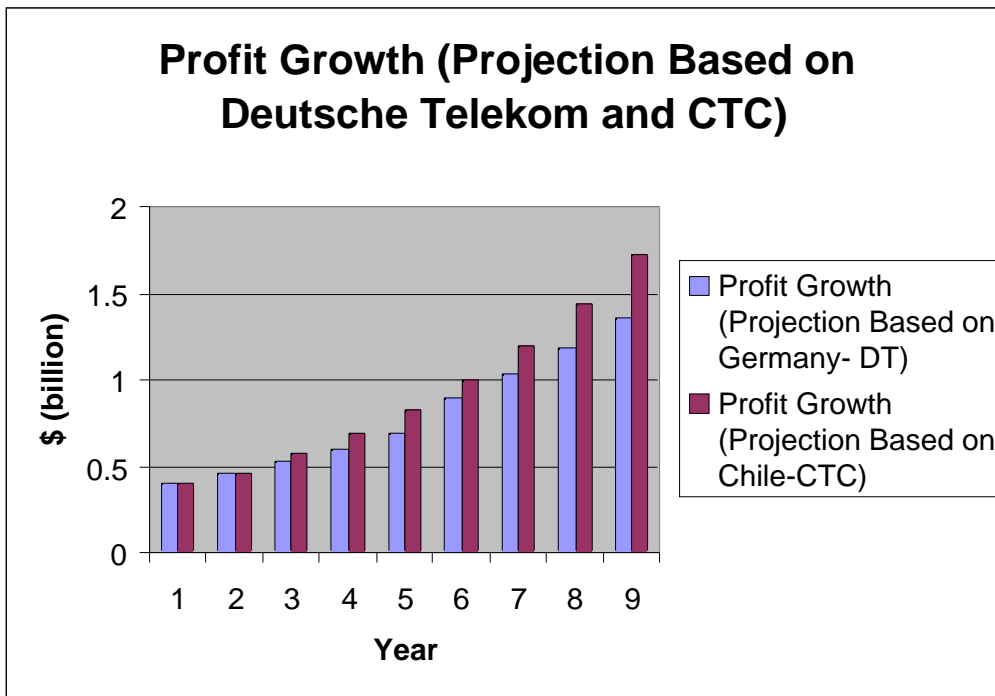


Chart 2. Svyazinvest's Profits: Projections Based on Deutsche Telekom and CTC



⁶⁷ mis.ru/archiv/990225.htm

Chart 3. Svyazinvest Revenues and Expenses: Projections Based on Deutsche Telekom

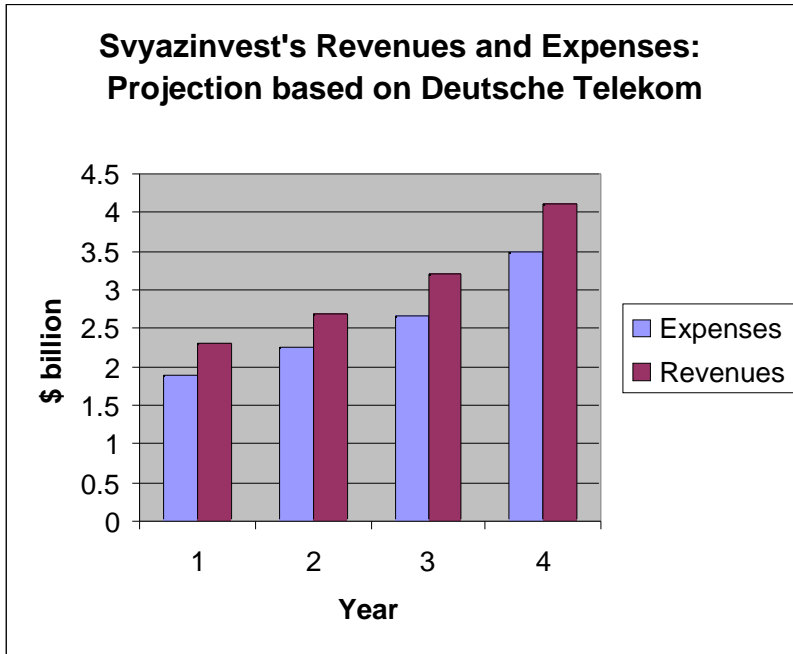


Chart 4. Svyazinvest Revenues and Expenses: Projections Based on CTC

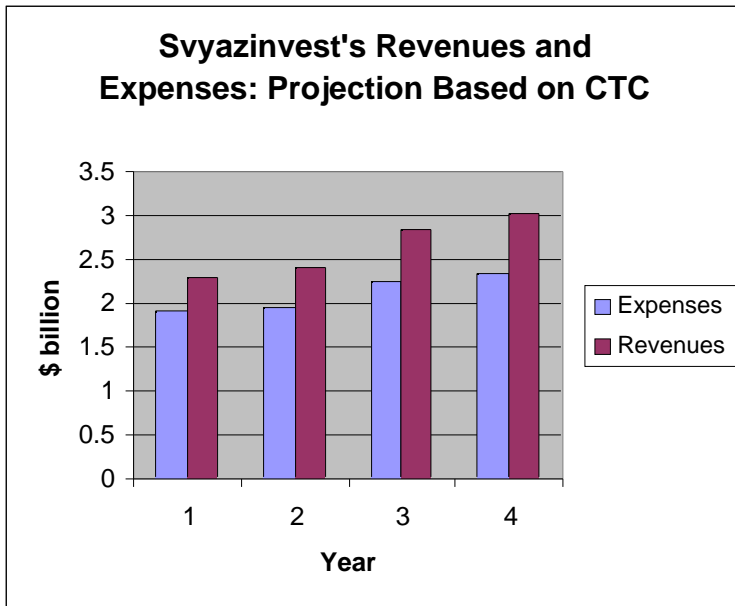


Chart 5. Russian Employment in the Telecom Sector: Projection Based on CTC

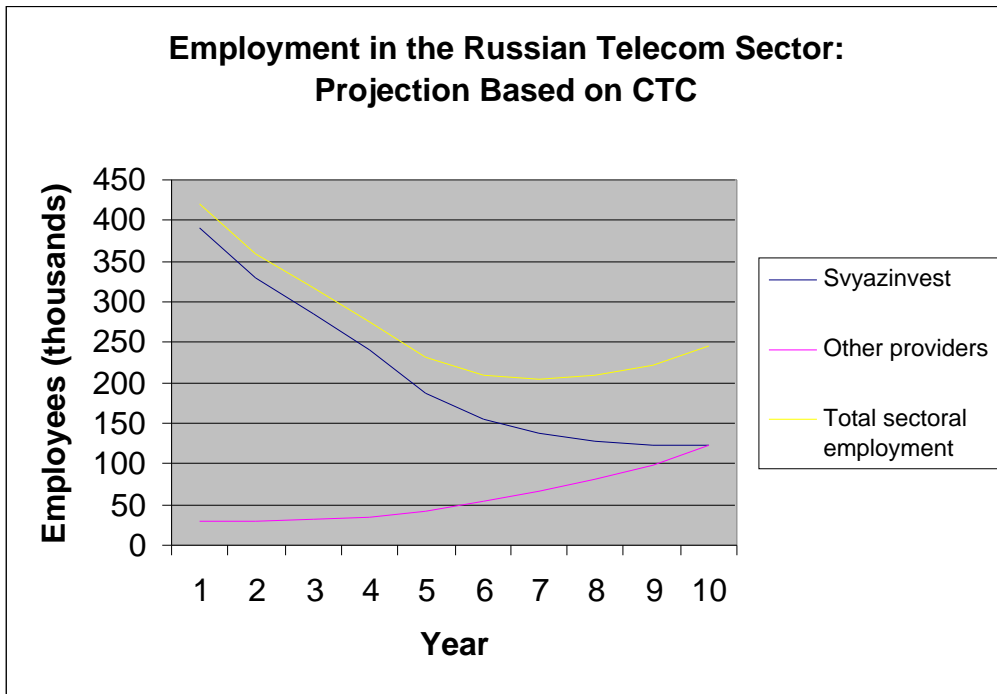
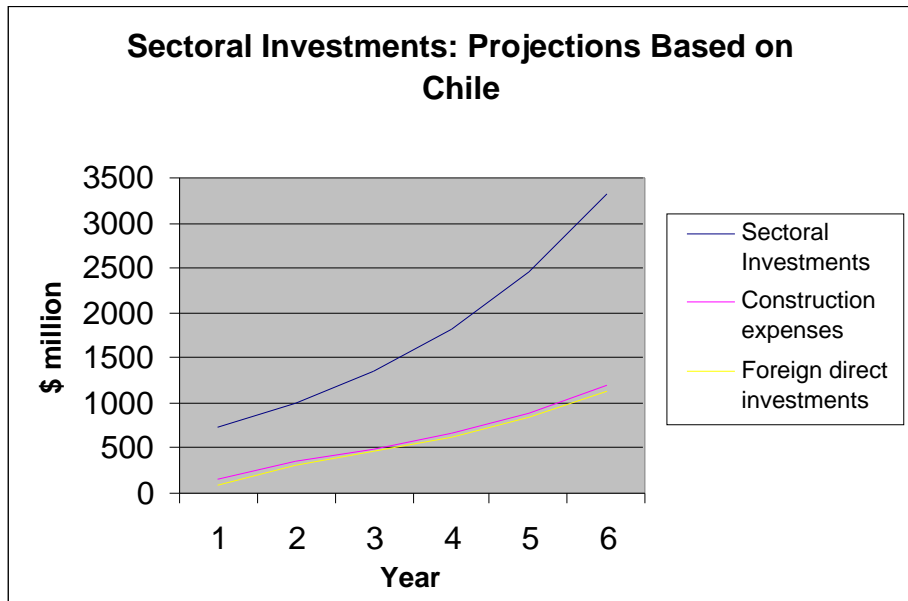


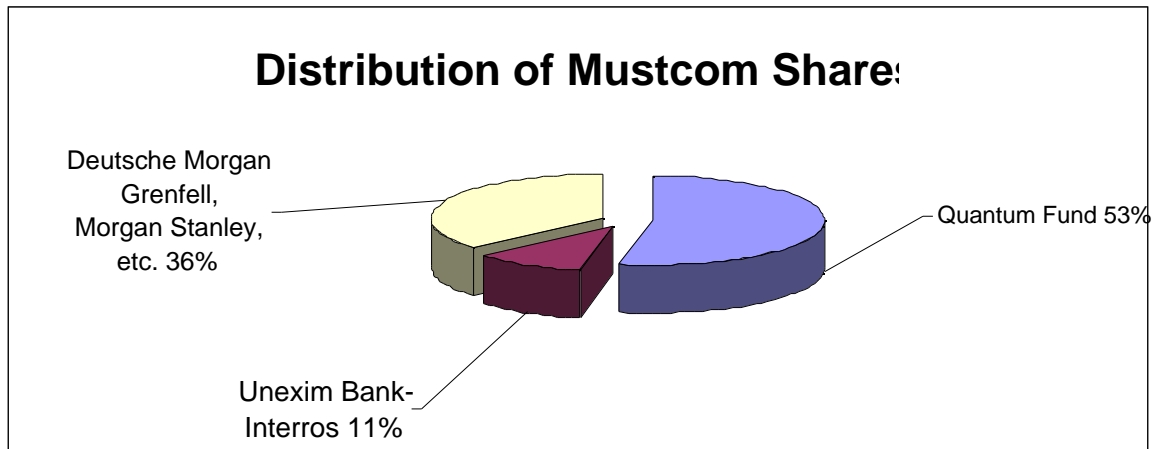
Chart 6. Sectoral Investments: Projections Based on Chile⁶⁸



According to the Sectoral Report of the Ministry of Communications:

- the share of foreign direct investments from 1995 to 2000 was 34% of all investments
- construction expenses from 1995 to 2000 were 36% of all investments.

Chart 7. Mustcom Shares Distribution



⁶⁸ Betta, D., *Telecom Reforms in Latin America*, Telecommunications, N3, March 1994, p.61.

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