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Report Highlights:

Historical over-production of tobacco products in Russia is forecast to lead to a second straight year of declining output, as producers try to adjust production to the complex consumption and trade situation. Russia continues to be a world leader in tobacco imports, though imports are forecast to fall in 2004 as stocks are drawn down.

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Executive Summary

Russia remains one of the world's largest markets for tobacco products. However, recent over-production of tobacco products in Russia is forecast to lead to a second straight year of declining output, as producers try to adjust production to the complex consumption and trade situation. Russia continues to be a world leader in tobacco imports, though imports are forecast to fall in 2004 as domestic stocks are drawn down. Exports are forecast to rise as Russia is used as a production and distribution base for companies working in the Eastern Europe and Central Asian markets.

Industry Overview

Russia is the world's second largest leaf tobacco importer and the third largest market for tobacco products, after the United States and China. The tobacco industry (tobacco growing, manufacturing, distribution and retailing) accounts for a little over one percent of Russia's GDP and is an important source of tax revenue. There are more than 80 licensed tobacco producers, 350 large and medium-sized wholesalers, and more than 350,000 retailers of tobacco products in Russia. The industry generates nearly 200,000 direct and indirect jobs.

The tobacco industry is also a source of major foreign investment, as large international tobacco manufacturing companies have plants located throughout the country. Russia is also becoming a growing base for exports of tobacco products. These enterprises paid more than \$900 million in taxes during 2000-2002. The tobacco industry is currently facing a process of higher concentration and introducing new investments in modern technology.

Production

Unmanufactured Tobacco

Domestic production of unmanufactured tobacco accounts for less than one percent of consumption, which makes the Russian tobacco industry heavily dependent on imported leaf tobacco. Official statistical data shows that production of unmanufactured tobacco in Russia increased by 500 tons in 2003 due to higher planted area and improved yields.

Russian production of unmanufactured tobacco in 2004 is also forecast to increase by 30 percent, to 2,600 MT (farm sales weight basis), due to increased planted area and yields. Nearly 90 percent of tobacco production in Russia is concentrated in Krasnodar Krai and producers have reported good weather conditions in the area that will likely lead to higher productivity and better quality leaves. Domestic production of unmanufactured tobacco is composed mostly of Oriental-type tobacco, which is traditionally preferred by Russian smokers, and also accounts for most of Russia's tobacco imports.

Table 1. Tobacco: Area and Production, by Type

Products	Area Planted			Production		
	HECTARES			Metric Tons		
Year	2002	2003	2004	2002	2003	2004
Burley	0	0	0	0	0	0
Dark Air Sun	0	0	0	0	0	0
Dark Air Cured	0	0	0	0	0	0
Dark Fire Cured	0	0	0	0	0	0
Flue Cured	0	0	0	0	0	0
Light Air Cured	0	0	0	0	0	0
Oriental	2100	2200	2350	1500	2000	2600
Total	2100	2200	2350	1500	2000	2600

Cigarettes

Post cigarette production estimates for 2003 were adjusted to reflect the latest data obtained from the State Statistics Committee of the Russian Federation (Goskomstat). Cigarette and papirosas production in 2003, at 385 billion pieces, was down 1.3 percent from the previous year.

Russia's 2004 production of cigarettes and papirosas is estimated to decline marginally because of the continued over-production of tobacco products and market saturation. However, production of cigarettes remains high in Russia, driven by higher production of filter cigarettes, investments in premium brands, and booming exports.

Production of filter cigarettes continues to increase at the expense of non-filter cigarettes. This is a reflection of concentration of filter cigarette production at a few modern enterprises and more developed marketing and distribution for filter brands. The share of non-filter cigarettes is declining rapidly due to growing competition from inexpensive filter cigarettes and consumer health concerns. According to market analysts, the market share for papirosas in the Russian market before the 1998 ruble devaluation was 50 percent and it is currently estimated at a little over 20 percent ("Business Analytica " data published in Izvestiya in April, 2003).

Consumption

Unmanufactured Tobacco

Consumption of unmanufactured tobacco decreased from 319,900 metric tons in 2002 to 293,100 metric tons 2003, down nearly ten percent due to recent oversupply of unmanufactured tobacco. This situation is expected to continue in 2004, but with a smaller decline in the consumption of leaf tobacco.

Cigarettes

Consumption data for cigarettes and papirosas in 2003 was revised to reflect the latest official data. Domestic consumption of cigarettes is estimated to have declined to 384.5 billion pieces, down 2.3 percent from the previous record production year. A continued drop in consumption of cigarettes and papirosas in 2004 is forecast, although at a smaller rate than in the previous year. This decline in overall domestic consumption reflects higher tax rates negatively affecting consumption by the lower income class and overall consumer health concerns.

Russia is now considered to be the third largest cigarette market in the world after China and the United States, with an estimated 45 million smokers. A recent worldwide survey indicated that 36 percent of the adult population of Russia smokes some type of cigarette, with consumption increasing among young consumers. It is also estimated that about 20 million smokers consume cigarettes from the low price product segment.

Trade

Unmanufactured Tobacco

According to preliminary trade data, Russia imported 293,202 metric tons of unmanufactured tobacco in 2003, a decrease of seven percent from the previous year. The decrease in leaf imports is due mostly to the oversupply of tobacco products in Russia. Two-thirds of all imported tobacco is of the oriental type, the other portion consists of essences and extracts. Nearly 50 percent of Russia's leaf imports originate from five major suppliers: Brazil, India, China, Italy and Kyrgyzstan. In 2003, Brazil and Italy increased their market share of Russia's imports at the expense of China and Kyrgyzstan. Imports of unmanufactured tobacco from the United States dropped by nearly 50 percent, from 20,029 metric tons in 2002 to approximately 10,000 metric tons in 2003. Total imports of leaf in 2004 are forecast to drop by six percent from last year's level due to the continued over supply situation of tobacco products in Russia.

Exports of unmanufactured tobacco in 2003 are estimated to increase by 76 percent from 2002. A further export increase of almost 30 percent is forecast in 2004. The most important export destinations of unmanufactured tobacco are Ukraine, Belgium, and Turkey.

The total value of imports of tobacco and tobacco products (chapter 24 HTS) in 2003 is estimated to have dropped by four percent (to \$723 million), while the export value is estimated to have increased to \$90 million (35 percent higher).

Cigarettes

Preliminary data for 2003 shows a decrease of about 35 percent in the volume of cigarette imports due to market saturation and over production of tobacco products in Russia. Another significant drop in cigarette imports is forecast for 2004, but at a smaller rate. The major suppliers of tobacco products to Russia are the United Kingdom and Germany (with a market share of over 70 percent), followed by the United States, Japan, and France. All suppliers experienced a drop in exports to Russia last year, except for France.

Exports of tobacco products more than doubled in 2003 compared to the previous year. The increase in exports is attributed to higher availability of new brands, better quality filtered production (design and special lighter filters), and increasing investments in the modernization of processing facilities. According to the Department of Food Industry at the Ministry of Agriculture of the Russian Federation, since the beginning of the 1990's about

\$2.5 billion have been invested in the tobacco industry, including \$1.5 billion of foreign investment. The most important destinations for tobacco products from Russia are Georgia, Moldova, Ukraine, Armenia, and Mongolia.

Stocks

Unmanufactured Tobacco

Official data on stocks of unmanufactured tobacco is not available. However, a decline in ending stocks is forecast in 2004 to 8,391 metric tons, reflecting the industry strategy to adjust supply and demand.

Cigarettes

According to the trade association "GrandTabak", domestic consumption was estimated at 305 billion pieces in 2003. The difference between Post's domestic consumption estimate of 385 billion pieces and the reported consumption of cigarettes and papirosas in Russia is due to unreported imports from Ukraine and Belarus.

Policy

Excise Taxes

In 2003, a new official state standard (GOST) was introduced that divides cigarettes by only two classes (filtered and non-filtered cigarettes) and specifies duties for only these two groups.

The introduction of new combined excise duties on tobacco products in March 2003 has increased the state budget revenues to 15.9 billion rubles in 2003 versus about 10 billion rubles in 2002. According to the Audit Chamber, this value is still below the target revenue of 20 billion rubles.

Market analysts have different views on the effectiveness of the combined system of tobacco excise taxes introduced in 2003. This was particularly evident during the recent meeting of the Federation Council's temporary tax policy committee.

Under the current tobacco excise system, the producer pays a specific component (60 rubles per 1,000 filter cigarettes or 23 rubles per 1,000 non-filter cigarettes) and an ad valorem tax (five percent of factory gate price). Before 2003, the country had a specific system for excising tobacco that considered not only quantity, but also class (quality) of cigarette.

According to auditor Vladimir Panskov of the Audit Chamber, the Chamber's checks on the completeness and timeliness of tobacco product excise receipts in 2002 and the first three quarters of 2003 showed that the combined excise rate was ineffective. If the specific rate from the earlier system had been raised by 70 percent instead of introducing the combined tobacco product excise rate, the excise collection target for 2003 would have been exceeded.

According to Ivan Savvidi, a State Duma deputy and controlling shareholder of the Donskoy Tabak cigarette factory, the ad valorem component of tobacco excises should be increased from five percent to 15 percent and the fixed amount in rubles should be kept unchanged. By increasing the ad valorem component, producers of cheap cigarettes would gain a price advantage and the federal government would still meet targets for excise revenues.

Executives at the Nevo-Tabak and Pogarskaya cigarette factories also indicated that the combined excise system should be preserved and called for an increase in the ad valorem component. They commented that it should not be charged on the factory-gate price, but on the retail price as in most European countries.

According to Leonid Sinelnikov, board of directors chairman at British-American Tobacco/Yava, the introduction of this new system has made it possible to avoid market upheavals and maintained the proportion of excise in the cost of cigarettes of various quality. Under the earlier system, producers of cheaper cigarettes were at a disadvantage, as excises represented nearly half of the cost of their products. However, he did not speak out in favor of a system that goes further to promote the production of low quality cigarettes.

According to a Philip Morris representative, calculating the ad valorem component from cigarette retail price will not change the situation regarding excise collections, as more than 20 percent of the cigarettes sold in Russia are sold at open markets and by street vendors that do not maintain standard pricing. The ad valorem rate is applied only to tobacco products, while all other excisable goods are subject only to a specific excise (in rubles per unit of product).

Other tobacco producers in the country believe that it is necessary to keep the existing excise system, particularly because the previous system was disadvantageous to producers of cheaper cigarettes because the excise was nearly 50 percent of production cost. Those favoring the mixed system hold that the ad valorem component should be increased from five percent to 15 percent and figure out later the specific cost component on retail prices. At this point, foreign multinationals and domestic companies generally favor the current system, while domestic producers of cheap cigarettes would like a system that reduces the tax on their products relative to higher priced cigarettes.

Other government measures

State Customs Committee Order #973 dated December 9, 2003, limited the number of customs points available for alcohol and tobacco imports. This order has the objective of reducing unofficial trade of tobacco products. The "shadow" market in Russia for tobacco and tobacco products is estimated at over \$2 billion (nearly ten percent of the total market).

Another government Customs Committee order, dated July 2003, was issued with the purpose of protecting domestic producers of tobacco products and combating unreported trade. According to this order, Russian and foreign citizens are limited to bringing in specific quantities of tax-free tobacco products into the country. However, since confiscation procedures proved to be costly, the State Customs Committee issued a second order so that cigarettes and alcoholic beverages can come into the country after paying a 30 percent tax.

Table 2. New and Old Excise Taxes for Tobacco Products, 2000-2004

Commodity	HS codes	Excises (2000)	Excises (2001)	Excises (2002)	Excises (2003)	Excises (2004)
Smoking tobacco, except tobacco which is used as raw material for manufactured tobacco products	From 2403 10 100 0	144 Rubles per 1 kg	166 Rubles per 1 kg	N/A	N/A	235 Rubles per 1 kg
Pipe tobacco (except pipe tobacco)	from 2403 10 100 0 to 2403 10 900 0	336 Rubles per 1 kg	405 Rubles per 1 kg	N/A	N/A	574 Rubles per 1 kg
Cigars	from 2402 10 000 0	7.2 Rubles per piece	10.0 Rubles per piece	11.2 Rubles per piece	N/A	14 Rubles per piece
Cigarillos and filter cigarettes over 85 millimeters long	from 2402 10 000 0 from 2402 20	60.0 Rubles per 1,000 pieces	75.0 Rubles per 1,000 pieces	84.0 Rubles per 1,000 pieces	50.0 Rubles per 1,000 pieces plus 5% of value	157 Rubles per 1,000 pieces
Filter cigarettes	from 2402	41.0 Rubles per 1,000 pieces	55.0 Rubles per 1,000 pieces	61.6 Rubles per 1,000 pieces	50.0 Rubles per 1,000 pieces plus 5% of value	60.0 Rubles per 1,000 pieces plus 5% of value
Cigarettes a without filter	from 2402 20	7 Rubles per 1,000 pieces	10.0 Rubles per 1,000 pieces	11.2 Rubles per 1,000 pieces	19.0 Rubles per 1,000 pieces plus 5% of value	23 Rubles per 1,000 pieces plus 5% of value
Papirosas	from 2402 20	4.8 Rubles per 1,000	10.0 Rubles	11.2 Rubles	19.0 Rubles	23 Rubles per 1,000 pieces plus

	2402 20	pieces	per 1,000 pieces	per 1,000 pieces	per 1,000 pieces plus 5% of value	5% of value
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Marketing

Currently there are 350 large and medium wholesalers of both domestic and foreign ownership in the Russian tobacco market. The Russian tobacco products market is not homogeneous and is divided into six major price segments listed in the table below.

Price segment	Price range, per pack, Rubles	Market Share (%)
Low price without filter	Up to 4	15.3
Low price with filter	4-8	31.7
Economy	8-13	27.1
Medium	13-18	17.1
Premium	18-30	6.3
Elite	Higher than 30	2.6

1 US = 28.5 RU

Source: Tobacco Association "Donskoy Tabak"

International tobacco companies located in Russia are investing more in their production capacity to produce better quality products, partly as import substitution strategies. The marketing strategies are focused on product differentiation in order to boost profit margins and maintain customer loyalty.

According to "Business Analytica" data, the 2003 market share of tobacco products held by multinational companies in Russia was estimated at 87.6 percent. The leading tobacco manufacturer in Russia is Philip Morris, with a 24 percent market share of the total Russian production of tobacco products.

The other companies with a significant reported market share of tobacco products in Russia are: JTI (15 percent), BAT (14.3 percent), Gallaher (14.2 percent), "Balkanskaya Zvezda" (7.6 percent), "Donskoy Tabak" (7.4 percent), and Imperial Tobacco (4.9 percent).

The Philip Morris company announced that it will be investing \$296 million in the development of tobacco production in the Leningrad region, boosting production capacity to 70 billion cigarettes a year (PM output in 2003 is currently reported at 40 billion). The company has two major plants in Russia: Philip Morris Izhora (Leningrad region) and Philip Morris Kuban (Krasnodar territory). The association Soyuzkontrakt Tabak also plans to begin operations of a \$68 million tobacco plant in the Kaluga region in September of 2004. This enterprise will have a cigarette packaging shop and is also looking to make lighters and nicotine chewing gum. Soyuzkontrakt Tabak has a joint venture (SK-Bulgartabak) and a subsidiary company (Metatabak) in the Moscow region town of Podolsk that produces roughly eight billion cigarettes annually.

The process of liquidation of smaller domestic tobacco companies is intense due to strong competition from Western companies. The other factor that contributes to elimination of smaller tobacco companies is their lack of diversified distribution chains and dependency on

local and regional wholesale companies. Smaller companies will slowly be exiting the market due to intensifying competition from the transnational companies.

According to trade sources, the two tobacco giants, Philip Morris and JTI, are likely to change their distribution strategy in Russia by reducing the number of direct distributors in the country. According to private sources, decreasing the number of distributors will enable these companies to have a better oversight over the price situation in the various regions of the country.

Quality, Safety and Health

On May 17, 2002 the Ministry of Health has issued a list of warnings that must be on the cigarette pack. In addition to the main warning, which reads "Ministry of Health warns that smoking is harmful to your health", there are five more warnings included: "Smoking is a cause of cancer"; "Smoking is a cause of life threatening diseases"; "Protect children from smoke"; "Smoking causes nicotine dependence"; and "Smoking is a cause of heart disease".

During one of its first session in 2004, the State Duma approved additional proposed amendments to the Federal Law "On Limiting Tobacco Smoking" from January 2002.

The proposed amendments are aimed at fighting teen smoking and were developed by the Committee of Health and Sport of the State Duma. The major amendments approved are: a) to ban cigarette sales in areas within 100 meters from schools or other educational establishments; b) to ban any kind of cigarette advertising, excluding advertising in specialized stores; c) to increase the minimum age to buy cigarettes from 18 to 21; and, d) to enlarge the letters of warning "Smoking is harmful to your Health" on the cigarette pack up to 50 percent of the pack size.

Russia's Public Council for Youth Development, called "Your Choice", has also announced a program to fight teen smoking. The program has targeted several cities in Russia with the objective of reducing the incidence of smoking in the next generation and the future economic burden of higher health care costs.

According to high-level managers from large tobacco companies and the President of the National Trade Association, these initiatives would not tackle the problem of reducing smoking among the teenagers, but rather create additional administrative burdens for the retail sector.

According to a survey conducted by the Institute of Comparative Research, almost one third of the Russian teenagers (32 percent) consider smoking one of the most serious problems after drug and alcohol addiction (35 percent and 54 percent respectively). Nevertheless, the number of teenagers smoking is still extremely high in Russia. According to the same source, 30 percent of teenagers smoke their first cigarette before 12 years old and 80 percent of Russian kids have tried to smoke before they reach 17 years old. As to the data published by the Russian Social Council, 25 percent of girls and 36.6 percent of boys up to 15 years are smokers. An international survey has placed Russia in third place worldwide, with 36 percent of the adult population as smokers.

Tobacco publicity in Russia is prohibited on television, daytime radio, and on sites within 100 meters from public and private schools. Despite these prohibitions, tobacco publicity remains the largest category of outdoor advertising in Russia, accounting of nearly 40 percent of all spending on publicity in general. However, the Russian government may soon impose further restrictions on tobacco publicity, which may affect the premium cigarette brands, a driving force of cigarette consumption in Russia.

Table 3. Unmanufactured Tobacco Supply and Demand, Hectares and Metric Tons

PSD Table								
Country	Russian Federation							
Commodity	Tobacco, Unmfg., Total							(HA)(MT)
	2002	Revised	2003	Estimate	2004	Forecast	UOM	
	USDA Official	Post	USDA	Post	USDA	Post		
	[Old]	Estimate	Official	Estimate	Official	Estimate		
		[New]	[Old]	[New]	[Old]	[New]		
Market Year Begin		01/2002		01/2003		01/2004	MM/YYYY	
Area Planted	2100	2100	2200	2200	0	2350	(HA)	
Beginning Stocks	15000	15000	15000	10985	25800	14391	(MT)	
Farm Sales Weight Prod	1900	1900	2000	2000	0	2600	(MT)	
Dry Weight Production	1800	1800	1900	1900	0	2470	(MT)	
U.S. Leaf Imports	25200	20029	1700	10000	0	6000	(MT)	
Other Foreign Imports	282300	295243	301700	283202	0	269042	(MT)	
TOTAL Imports	307500	315272	303400	293202	0	275042	(MT)	
TOTAL SUPPLY	324300	332072	320300	306087	25800	291903	(MT)	
Exports	0	1187	1400	2096	0	2725	(MT)	
Dom. Leaf Consumption	1500	1500	1900	1600	0	2000	(MT)	
U.S. Leaf Dom. Consum.	23400	18000	1200	8000	0	4000	(MT)	
Other Foreign Consump.	284400	300400	290000	280000	0	274787	(MT)	
TOTAL Dom. Consumption	309300	319900	293100	289600	0	280787	(MT)	
TOTAL Disappearance	309300	321087	294500	291696	0	283512	(MT)	
Ending Stocks	15000	10985	25800	14391	0	8391	(MT)	
TOTAL DISTRIBUTION	324300	332072	320300	306087	0	291903	(MT)	

Table 4. Unmanufactured Tobacco Prices

Prices Table

Country	Russian Federation			
	Commodity			
	Tobacco, Unmfg., Total			
	Prices in	US Dollars	per	Metric Ton
Year	2002	2003	% Change	
Jan	1752	1960	12%	
Feb	1729	2020	17%	
Mar	2330	2140	-8%	
Apr	1977	2030	3%	
May	1833	2360	29%	
Jun	1867	2160	16%	
Jul	1801	2250	25%	
Aug	2010	2250	12%	
Sep	2073	2130	3%	
Oct	1719	1900	11%	
Nov	1914	1920	0%	
Dec	1863	1900	2%	
Exchange Rate	28.4		Rubles/US \$	
Date of Quote	4/7/2004			

