



**Group Members:**  
**Violetta Abramova**  
**Dennis Hwang**  
**Luba Jacobson**  
**Valerie Kritsberg**  
**George Oka**

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## **Executive Summary:**

### *Why Russia?*

As one of the largest emerging markets, Russia's current and future economic prospects are highly dependant on the state of their energy market including oil, natural gas, and other forms of natural resources. Russia is fast becoming the second largest oil producer in the world and the development of the Caspian region by Russian oil companies will increase the country's share of oil stock and production even further. There are other social, economic, political, geographic and financial reasons that Russia is a market we believe will be highly profitable now and in the future. As long as corruption is kept at a minimum, and President Putin continues his economic development course, Russia is likely to be a major player in the world market within the next fifty years.

### *Why LUKoil?*

Given the current economic and political conditions in the world as a whole and the current military conflict that the coalition forces are undertaking in Iraq, the future state of the oil industry affects us all. LUKoil is a large multinational corporation and fifth largest supplier of oil, with Exxon Mobile leading the field as number one. LUKoil's high rates of growth, deal to develop the Caspian region, improvement of corporate governance control and the relative financial strength of its equity shares, in both the local Russian market and international exchanges such London and NYSE, put the company in a strong position to prepare for whatever surprises the future may hold. LUKoil is also an interesting choice because it is part of only a handful of Russian companies that fared well during the Russian default crisis and therefore it's cost of debt is lower that the cost of debt of comparative firms, as well as the Russian government.

### *Evaluation and Solution:*

The most interesting part of this project was the valuation portion. Conducting a type of sensitivity analysis with two underlying factors led us to forecast nine possible scenarios for LUKoil's revenues, costs, and cash flows in the next five years. The first factor, being the affect the war in Iraq will have on future oil prices, and the second factor, being the affect LUKoil's exploration and production of the Caspian region, will inevitably have an impact on LUKoil's overall oil production and reserves. Running best, intermediate, and worst case scenario for each factor, we predicted future cash flows by mixing and matching the two underlying factors and then ultimately choosing the scenario we believe to be most likely in the next five years.

After analyzing the factors, we have concluded that the most likely scenario that will occur in the next few years is that price fluctuations will be comparable to those for the past 20 years (best prices-lowest) and LUKoil's production will be below their forecasts, as the Caspian project may not prove to be as profitable and closing of 5000 unproductive wells may not be cost-conscious.

Based on those assumptions, we have forecasted cash flows to the firm, applying certain growth rates to each component of free cash flows, based on historical performance and future-looking reports. As predicted, there will be a decline in cash flows to the firm, as expenditures are increased to facilitate production growth, and will increase after approximately 7 years, as revenues from development projects are realized.

## **POLITICAL CONDITIONS:**

### **History of Political Structure**

After Russia was declared one of the 15 newly independent former Soviet republics, it elected Boris Yeltsin as its first president in June 1991. Yeltsin and his economic reforms were met with opposition from the communist "old guard" in the Congress of People's Deputies (CPD) due to Yeltsin's role in the break-up of the Soviet Union. Yeltsin swiftly decided to institute direct presidential rule along with the initiating the dissolution of the CPD in September 1993. Thereafter, Russia adopted a new constitution and elected a new parliament in December 1993.

Although Yeltsin pursued an intensive allegiance to economic reform following his re-election, it was severely overshadowed by his increasingly erratic behavior and poor health. Furthermore, the failure of the government's macroeconomic policies diminished most of Yeltsin's credibility and authority. Vladimir Putin, former Prime Minister, took over the presidency from Boris Yeltsin at the beginning of 2000, and is pursuing policies designed to strengthen the powers of the state and of the federal government in particular. For the first time in Russia's post-Soviet history, both houses of parliament are supportive of the president and his policies.<sup>i</sup>

During Putin's first year as President, his strategic efforts focused less on economic reform, and rather more on developing his level of power. This was evident through his placement of former colleagues from the St. Petersburg administration into new key positions, while also limiting the powers of business oligarchs and shortening the powers of Russia's regional leaders.

Putin's newly found strengthened position permitted the President to move forward with much needed economic reforms, including the cleansing of rampant corruption. The focus of dismissals was targeted to the corrupt members of the "old guard". However, a complete removal of all Yeltsin-era holdovers has not been instituted, resulting in several groups vying for access to and influence over the president behind the scenes. The most prominent are the remaining members of the Yeltsin-era faction known as "the family"; the "Chekists" who are mainly drawn from the security services and affiliated organizations; and the St Petersburg liberals, a group of high-level economic policymakers and advisors that have prospered from support of President Putin.

A critical agenda for the government has been the pursuit of restoring Russia's international image as a great power. Although, it is clear that the leadership has an overwhelming opportunity to establish this goal, it has been hindered by its lack of focus in foreign policy. The decision to either ally with the West or build up alliances to counter the US's dominating world power has torn the Russian government. Existing differences with the West - over issues such as NATO enlargement, Russia's military campaign in Chechnya, and Western policies towards Iran, Iraq and Yugoslavia - were exacerbated by Moscow's support for "rogue" states such as Iraq and North Korea.<sup>ii</sup>

The events of September 11th were promptly followed by Russia's offering of full support to the US-engineered effort against international terrorism. Putin even accepted a Western military presence in Central Asia and provided unequivocal support for the US war in Afghanistan. These acts of good faith were enacted with hopes to be rewarded with an

acceptance within the club of Western great powers. However, it was clear that these hopes would not be met when the US notified Russia that it would unilaterally abrogate the 1972 anti-ballistic missile (ABM) treaty to clear the way for unrestricted testing for a comprehensive missile defense system - a development that Russia fears may eventually undermine the deterrence of its nuclear arsenal and thus its last remaining claim to great-power status.<sup>iii</sup>

Nevertheless, Putin had firmly stuck to his pro-Western stand, which had brought forward vocal criticism from his own military and security establishment. In May 2002, Russia signed a bilateral strategic arms reduction agreement with the US, and agreed on the creation of a Russia-NATO Council designed to achieve closer co-operation with Russia in non-defense related matters. While these two deals did not achieve major gains for Russia, Putin's hope was that it would accumulate over time and eventually support the cause for establishing Russia as a world power.

### **Implications of Impending War**

The impending war concerning US and Iraq had raised significant concerns for the Russian government. Russia was debating on how to approach the situation without potentially placing itself in an objectionable position. Russia could simply side with the United States without incurring losses for its own economic policies. Russia had already signed large-scale oil contracts with the Iraqi government. In addition, Putin had to consider the implications for the country's aim at political and economic integration with the European Union. Although, Europe, in general, is split on the issue; France and Germany had vocalized their opposition against the US's plan for war. Furthermore, the EU political and economic engine is represented precisely by France and Germany rather than by feeble East European countries. Therefore, increased support for US military efforts would hinder Russia's implication with the EU.

However, taking into consideration all the efforts Putin and his administration had exhausted into building optimal relations with President Bush and the US, a stand against the US on the Iraqi issue would potentially devastate the progress made over the past few years. Therefore, any radical decisions, like the veto right at the UN Security Council against the military action, were undesirable for Russia for the simple fact of maintaining the high personal relations with the US. Paris could threaten with such a veto because of the fact that France was an old-standing US ally and also a NATO member. However, the situation was different with Russia for it is not a NATO member and its direct confrontation with the USA on the issue of Iraq would be very costly.

The emergence of the French-German plan of Iraq's peaceful disarmament with the assistance of the UN blue helmets, provided the optimal option for Russia to partake. Although it was likely that the US would not appreciate this particular stand, Russia could not count on the US for any guarantees concerning the division of Iraqi oil. For the most part, the US could not assure specific distribution amounts in the case of victory because the US did not know itself how the situation would develop in Iraq after the war. Putin had to also keep in mind that in the case of US victory, the US would eagerly strive for full control of the Iraqi oil. Thereafter, the US Presidency will be faced with expectations of lower oil prices, which would most likely be met. Considering these factors, along with the popular agendas within the European Union, Putin had to decide on a balanced approach to either disrupt either side or place Russia in an unfavorable situation. Therefore, the French-German plan provided the best opportunity at that point for Russia to maintain proper balance.

### **Political implications during War**

As the war began with the US invasion in Iraq, it was clear how the US viewed all countries that were not members of the coalition; if a country was not on the same side, it was no longer an ally. Russia, France, and Germany's opposition to the war was apparent, and in turn, the US made it clear that relations were no longer the same. It is now likely that if the United States takes over Saddam Hussein's regime it will take a leading role in the post-war Iraqi government. For most of the world, the issue that has come to the forefront is control over post-war Iraq. The general European consensus wants a strong U.N.-role in postwar Iraq, partly as a way to prevent U.S. dominance and protect their own financial and political interests in the region, such as Russia's major oil contracts with Iraq. The US is unwilling to pass on the leading-role, however is claiming that the U.N. will take on a very important role.

The US has been tight with controlling this campaign, and seems relentless in easing over control to the U.N. If the U.N. were not able to establish lead-command over the post-war Iraqi government, the Russian contracts with Iraq will unlikely be enforced in favor of US and allied forces divvying up the Iraqi oil industry revenues in order to fund the war campaign. Furthermore, on April 6, 2003, the US House of Representatives passed an amendment to the law on financing the war in Iraq, which bars Russia, France, Germany, and Syria from participating in contracts on Iraq's postwar restoration, financed by Washington. Under the amendment, Russian, French, German, and Syrian companies will be barred from taking part in such contracts, as well as from getting access to information about them. Therefore, current contracts such as LUKoil's would be in jeopardy of falling through.

This type of reaction from the US government has made the upcoming meeting with the U.N. Security Council of utmost importance concerning the future economic interests for Russia. The U.N. Security Council controls Iraq's oil revenues - and hence the country's purse strings - with its oil-for-food program. To free up Iraq's oil money, the United States and Britain will have to prod the other three permanent members of the Security Council - Russia, France and China - to lift the sanctions and revise, or eliminate, the oil-for-food program. The issue could come to a head as early as next month, when the current phase of the oil-for-food program expires. The Security Council will have to decide whether to extend or alter it. Russia will obviously stand opposed to the US's interest in dismantling the program, for the fact that the allied coalition would be willing to tear up most or all Saddam-era deals. The avid position the US has upheld has even led Putin to declare that it would be in the best interest for the US to end up non-victorious in the war.

In addition to the concerns of the leadership of the post-war Iraqi government, Russia's government has faced strained political relationships with the United States as a result of accusations made on both sides. First, the US accused Russian companies of providing Iraq with anti-tank guided missiles, night-vision goggles, and satellite jamming devices in violation of U.N. embargo. Moscow has firmly denied the allegations. The Lytkarino Optical Glass Factory near Moscow, one of the firms in question, would have needed the Defense Ministry's permission to sell any of its products to Iraq; which had never received such permission according to technical director Viktor Rummyantsev. Russia also rebutted by accusing the US of "trying to find a scapegoat because their bombs are not falling as accurately as they want."

Russia, however, has also raised allegations reporting that the US troops shot at Russian diplomats trying to flee Iraq amid fighting in Baghdad. Ambassador Vladimir Titorenko said US

forces fired on the convoy, which was carrying Russian diplomats and journalists toward Syria on April 6, 2003, despite clear markings; this resulted in one Russian diplomat undergoing surgery at an Iraqi controlled hospital. A US official says Condoleeza Rice told Mr. Putin it was unclear whether it was the Americans or Iraqis who had shot at the Russian convoy. Meanwhile, Russian officials say they are convinced US troops purposefully attacked the diplomatic convoy. The visible strains between Moscow and Washington have only widened since the attack and accusations have been made against the Russians.

US-Russian relations, although still committed to long-term strategic partnerships, face heavy pressure with the ongoing events associated with the war. And US-Russian relations could come under greater strain if Washington pushes ahead to challenge its other “axis of evil” foes, Iran and North Korea, with whom Russia shares longstanding political and economic ties. If the US attempts to deal with either of the two countries in any way that angers the Kremlin, then “Russia will hardly exercise restraint, including in its supplies of technologies,” says Sergei Rogov, head of the USA-Canada Institute in Moscow. “If America decides to repeat the Iraqi precedent, the fragile Russian-American partnership will fall apart for good.” Putin has had to begin dealing with anti-American sentiment among the public and parts of the elite, as polls indicate strong anti-war or anti-US feelings. With an election looming, public opinion has become important. The parliamentary election is set for December, and the campaign has begun. The competition will be between the Communists and the pro-Kremlin party. The Kremlin manipulators need a solid victory over the Communists in order to avoid the perception that Putin’s much-vaunted stability and claims to economic progress have not made much of a difference. The Communists are capitalizing on the anti-US feeling, leaving the Kremlin at a disadvantageous position for its earlier downplaying of the US stand-off with Iraq. It is likely that the Kremlin will decide to play to a receptive home by taking shots at America to gain support.

Both presidents now face a choice: abandoning partnership in a huff or redoubling efforts to find common ground. Doing the latter in the current political climate will be difficult. The American public is casting a suspicious eye on what it sees as fair-weather allies who oppose the war. Russians, meanwhile, have grown increasingly wary of American might. In an opinion poll of 1,600 Russians, 55% said they viewed the US negatively, compared with just 15% a year ago.

Due to current deteriorating relations and conflicting interests of both countries in the world affairs, Russian economy can be negatively affected, with the Western world retaliating to Russia’s opposition. This retaliation can come in the form of embargoes and trade restrictions, as it has happened in the Cold War. U.S. investors may become weary of investing in the market and thus stifle economic and political development in Russia. Specifically, LUKoil may be negatively affected by damaged political relations of its country with that of the world, especially since it has close business relations with governments in the regions it invests in. The oil industry is reliant on political relations and any local firm may face hardships in obtaining contracts with foreign nations.

## **MACROECONOMIC CONDITIONS:**

Russia is richly endowed with both human and natural resources and therefore has the potential to become a very rich economy.

### **The Core of the Soviet Economic Policy:**

The Soviet Union used centralized planning to distribute resources throughout the country. This process was extremely inefficient because developed was skewed in favor of energy and raw material intensive heavy industrial branches as well as defense production. Consumer goods sectors was however, grossly neglected. Due to the countries isolation, and the inferiority of central planning to a market driven economy, the country's infrastructure and technology was poorly developed. Telecommunications is a prime example of where the Soviet policies failed.

### **The Aftermath:**

Since the fall of the Soviet Union and the rapid transformation from a centrally planned economy to a market economy, the country has been in chaos. Technology, telecommunications, and other forms of innovation are directly associated with a free market driven economy where the transport of information quickly and reliably is extremely important. The former Soviet Union neglected the development of these sound infrastructures and promotion of innovation and technology and therefore these industries have experienced higher growth within the past decade. Even though market mechanisms are redefining the way factors of production are distributed among sectors, and allowing the demand and supply to rule the hand of this distribution, in 1996, industry still accounted for about 60% of GDP while agriculture accounted for only about 10%. However, since 1991 (the fall of the Soviet Union), retail, trade, and services (particularly financial sector) have been radically transformed experiencing turbulent rates of growth and accounted for nearly 20% of the total GDP in 1996.

Engineering and metalworking is the single largest industry and fuels, petrochemicals, and electricity make up the rest of the industrial output.

#### **A. Summary of Major Policy Changes Within the Last Decade:**

1. Prior to the collapse of the Union, several policies were designed to try to transform or reform the centrally planned system but all were unsuccessful until after the fall of the Soviet Union in the early 1990's.
2. In 1992, two significant changes were made. First price controls were lifted which threw the economy into massive inflation while reducing total output. Second, a privatization plan was introduced that was successful in privatizing about 70% of the industrial enterprises by mid 1994.
3. In 1993 Russia introduced its own currency but still faced massive inflation with insufficient monetary policy until 1994, Tatiana Paramonova decreased the money supply in an attempt to stabilize the currency. Due to these monetary controls the IMF granted Russia a lone exceeding 10 billion dollars in 1996.
4. In 1996 Russia agreed upon a three year program where the IMF would loan the Russian government 10.2 billion dollars in aid in the form of a repayable loan.
5. In 1997 a renewed budget crisis threatened to undermine the process of stabilization, damage relations with the IMF and stifle weak signs of renewed economic growth. Continuing revenue shortfalls and the Asian financial crisis put pressure on the ruble (which is moved to an adjustable peg with wide fluctuation

bands), and spurred a renewed drive to strengthen the government's fiscal position.

### **Most Recent Structural Reforms (2000-02)**

Under the administration of President Vladimir Putin several structural changes were implemented with the goal of improving the economic structure of the business environment. The main caveat is that implementation and enforcement are still severely lagging behind legal changes. The following measures were adopted:

**Corporate governance:** Amendments to the law on joint stock companies, disclosure, and accounting practices are aimed at improving the protection of minority shareholder rights.

**De-bureaucratization:** A package of laws designed to reduce red tape is scheduled to enter into force in July 2002. These laws will simplify registration and licensing requirements and reduce the amount of inspections companies have to endure.

**Bankruptcy reform:** In July 2002 the State Duma (the lower house of parliament) approved a bill protecting companies from false bankruptcy proceedings.

**Tax reform:** The personal income tax is reduced to a flat rate of 13%. Corporate profit tax falls from 35% to 24% and is simplified. Taxation of the oil sector is simplified.

**Land reform:** The new land code allows, for the first time in Russian history, private ownership and free trade in urban and commercial land.

### **Privatization:**

Russian privatization has proceeded far more rapidly, but in a much more disorganized fashion than in most other transition economies. The initial phase, which relied on vouchers issued to all citizens, resulted in widely dispersed ownership, which left most enterprises under the control of their existing management. From 1995 emphasis shifted to using privatization to concentrate ownership, often through the sale of valuable assets at very low prices to financial groupings with close links to leading members of the cabinet. By 1997 the competition among the dominant financial-industrial groups (FIGs) for control of the last few real assets to be sold off was intense, leading to the eruption of scandals. It remains to be seen whether the Putin administration would execute plans for oil and telecommunications privatizations in a less political fashion.

A related long-term challenge is to tame the form of crony capitalism unleashed by the initial rush to privatize. A group of well-connected businessmen, colloquially known as the "oligarchs", used the privatization process-in particular the notorious "loans for shares" deals in 1995, whereby they financed Boris Yeltsin's 1996 presidential election campaign in return for shares in valuable state companies-to amass controlling stakes in some of Russia's largest companies at bargain prices. As a result, much of the companies in the oil, gas, metals and financial sector, such as LUKOIL which had been a government owned company, have since been controlled by a small number of powerful individuals who have generally been more interested in channeling

assets abroad than in restructuring and investing at home. They have also acted as a powerful impediment to structural reform.

When Mr. Putin came to power he promised to eliminate the oligarchs "as a class", indicating that he would move away from the "divide and rule" strategy of his predecessor, Mr. Yeltsin, and towards an economy where transparency and market forces ruled, rather than political connections. Although the direct influence of the oligarchs on policymaking has diminished since then, their economic power remains formidable.

### **Corporate Governance**

The rapid privatization of the Russian economy mentioned helped to establish an atmosphere with an array of corporate governance issues that caused the scandals of the 90's. Lacking a firm set of laws, the FIGs were able to create problems such as lack of disclosure and transparency, the use of poor accounting measures, and the use of other unfair practices to their shareholders.

Recently however, the realization of the benefits of corporate governance has surfaced as managers have begun to realize that they could increase the market value of their companies. LUKOIL is one of these firms, as in one of its press releases in first quarter 2003, it makes specific mention of its desire to improve its own level of corporate governance by establishing an internal audit division and restructuring its corporate management center.

Several attempts have been made by the government to correct the wrongs in the mid 90's, however most have not met with a great deal of success. There is some belief that the collapse of the ruble in 1998 was the initial ushering for the first true corporate governance reform. However, the aforementioned issues were still present and government attempts to solve the issues were unsatisfactory, such as in 2001 when a corporate governance code was implemented, but was voluntary for companies.

Within the past year however, further attempts at reform have improved the state of corporate governance. A series of victories on the part shareholders over large firms has strengthened the position of both domestic and foreign shareholders. While for their part, the government has established a parliamentary committee to improve the protection of investors' rights, while the State Duma is increasing its efforts to put in place an improved Corporate Governance code, in an effort to help draw more investors.

### **Foreign and Domestic Debt**

The collapse of the Soviet Union in 1991 gave its Western creditors a major problem, requiring quick decisions on the means of managing repayment of the huge Soviet foreign debt. In agreement with the other successor states, Russia assumed responsibility for the repayment and servicing of former Soviet debt. However, Russia was in no position to stick to its obligations, and in January 1992 it secured a deferral of principal payments due that year. A succession of rollover agreements was negotiated between 1993 and 1995, while the government negotiated a comprehensive rescheduling. In October 1995 it reached a preliminary agreement with the London Club of bank creditors on restructuring the US\$32.5bn commercial debt over 25 years with a seven- year grace period. The London Club deal recognized that Russia was not meeting

its debt-service obligations anyway. The postponement of a portion of debt service will alleviate one source of balance-of-payments pressure, reducing the debt-service burden in 1998-2002 so that full repayments can then resume out of a larger and fast-growing GDP.

Following mounting financial pressure, on August 17th 1998 Russia defaulted on its domestic debt-mainly on short-term Treasury securities (GKOs). Moreover, the 1998 ruble devaluation greatly inflated the ruble value of Russia's external debt, making it all the more difficult for Russia to continue servicing its foreign debt, even on restructured terms. In late 1998 the government gave notice that it would seek a further restructuring of inherited Soviet debt. On February 12th 2000 Russia and its London Club creditors announced that they had reached a deal offering the Russian Federation a combination of forgiveness and restructuring on its US\$32bn debt to the Club.

### **Foreign Direct Investment:**

Foreign capital inflows since the break-up of the Soviet Union have been meager compared with Russia's size and economic potential. This mainly reflects continued political instability and legislative confusion, especially in relation to production-sharing in natural resource extraction. From a very low base, FDI started to rise rapidly from 1996 -- an apparent reward for the gradual clarification of commercial laws and regulations, and the greater price and exchange-rate stability.

Russia's relatively poor performance in attracting FDI must be seen against the background of massive capital flight from the country, which appears to have been equivalent to about 3% of GDP in 1995-96, rising to 9% in 1998 and 13% in 1999. By country of origin, the US has been the largest foreign investor in Russia, accounting for around one-third of the cumulative total in 1990-2000. This was followed by Cyprus (20% of the total), Germany (around 8% of the total) and the Netherlands (7%). Since Cyprus is host to many Russian offshore companies, this implies that total FDI figures include sizeable amounts of what are in effect Russian repatriated profits. Indeed, the Netherlands is another preferred target of Russian flight capital.

Among the deterrents have been an inadequate legislative framework and the reluctance of Russian oil companies to accept Western competition and governance constraints. Some significant partnerships were launched in 1997-98, but there were numerous rows over corporate governance and investor protection in the sector in 1998-99, prompting many Western investors to think again. The political and economic stability achieved since then has improved the investment climate, as has the recovery of oil prices. Nonetheless, Western investors would adopt a cautious stance, in particular with respect to deals involving Russian oil companies that have defaulted on loans and violated shareholders' rights in the past.

Progress in this area is going to require a great deal of continued effort on the part of Mr. Putin and improved legislation. As of recently though, as noted, the government has made steps to improve in the area of corporate governance and investor protection, paving the way to civilizing Russia's business environment. Also as noted, individual corporations themselves have been proactive, such as LUKOIL in instituting the necessary reforms to attract foreign investors to invest in these corporations. Continued change in the long standing elite attitudes and behaviors

will still need to be improved upon by Mr. Putin before the attitude of the foreign investor changes from a short-term, asset stripping, and they begin investing and restructuring for the long-term.

### **Financial Markets:**

Most of Russia's prices are now set in markets, the private sector accounts for the bulk of output and employment, and there is now a wide range of market institutions (particularly in finance and commercial law). Basic financial markets -- in foreign exchange, bonds and shares -- are functioning, although their development suffered a massive setback following the devaluation and government default of August 1998. Even before the collapse, Russian financial markets were illiquid, unstable, poorly regulated and lacking in transparency. Nevertheless, they are likely to play an increasing role in the coming years.

### **Banking**

Macroeconomic stabilization came as a shock to most banks, depriving them of easy speculative profits without creating conditions conducive to traditional lending or investment operations. The Central Bank went to great lengths to keep most banks afloat in the months following the crisis, and by mid-2000 its rescue efforts appeared to have restored the sector to stability without the disappearance of many banks. The bail-out of the sector, financed chiefly by taxpayers and the banks' creditors, did not, however, create conditions for banks to engage in real financial intermediation. Instead, Russia's major banks in early 2000 were rapidly accumulating capital and excess reserves but doing very little lending. At the end of March 2000 it was estimated that two-thirds of the top 100 banks' assets took the form of highly liquid reserves.

Most of the protectionist measures adopted in 1993 to restrict foreign banks' activity in Russia expired in 1996. Banks are heavily oriented towards servicing foreign rather than local clients. The government is anxious to increase the role of foreign banks in Russia, but foreign banks have no incentive greatly to increase their commitment to Russia

From 1993 to 1997 Russia's leading banks used the privatization process and personal links with key officials to construct large, multi-branch commercial empires. The largest of them owed their influence in government to strategic alliances and acquisitions and public opinion. Leading resource companies, such as Gazprom and LUKOIL, did the same in reverse, creating their own groups of banks and media interests.

The sector has been held back by a number of problems, including the lack of transparency in the enterprise sector, which rendered assessing creditworthiness extremely difficult; a legal framework that creates insecurity for creditors, even in cases where loans have been secured by collateral; and last a lack of capital, since most Russians prefer to keep their money outside the banking sector.

However, recent improvements to the banking system, including the bill signed by President Putin in 2001 to clear up Russia's money laundering reputation, have been made to the point that the Council of Russian Regional Banks have declared that the Russian Banking System was back to pre-crisis levels. The bill passed in 2001 created an agency that monitors transactions over 600,000 rubles or \$USD 20,700. As for the lack of capital issue, it has also been rectified to a point where there is a solid concentration of capital within the main Russian banks. Despite the strong growth in the banking industry currently though, Alexander Murychev, President of the CRRB believes that it will not continue due to domestic conditions, including further reforms of the tax system to reduce incentives to underreport wages and income.

### Stock market

The range and volume of securities traded has expanded rapidly, outpacing the development of regulation, shareholder protection, registration and custody arrangements, whose inadequacy has subsequently hindered market development. With the mounting pressure in the months leading up to the financial collapse in August 1998 share prices steadily lowered. Shares in blue-chip companies have, however, rebounded substantially since early 1999.

The Moscow market's "freely floating" equity is smaller even than aggregate figures suggest: many companies' shares are not ordinarily traded, and only a handful trade actively on markets that can be regarded as transparent and liquid. Stock markets are still not important channels for mobilizing new investment funds in Russia, nor for enforcing improved corporate governance through the active oversight of management by main shareholders.

A related long-term challenge is to tame the form of capitalism unleashed by the initial rush to privatize. Bitter controversies over shareholders' rights, particularly those of minority shareholders, have drawn much attention to continuing doubts about the security of property rights in Russia. Recent attempts at shareholder reform by the government hold promise of improving weak property rights, pervasive corruption and poor contract enforcement that could have been a long-term drag on investment.

### **Inflation:**

Stabilization was finally achieved in 1997, when consumer price inflation slowed to a year-end rate of 11%, compared with rates as high as 2,500% in 1992. With the financial collapse of August 1998, this achievement, won at a high cost over several years, was lost almost instantaneously. Twelve-month inflation, which had fallen to a post-Soviet low of 6.4% at the end of June 1998, reached 84.5% by the end of the year. However, the feared return to hyperinflation did not materialize. Annual consumer price inflation fell to 36.5% at end-1999, and further to 20.2% at end-2000.

However, rapid money-supply growth-boosted by large unsterilized foreign-exchange inflows-as well as upward adjustments in administrative prices (housing, transport, energy) have kept inflationary pressures high since 2001, with consumer price inflation still at 15.1% year on year for 2002. As of March of this year however, there have been signs of a return to pre-crisis levels,

as the Chairman of the Central Bank of Russia believes that it will not top 12% for 2003. Inflation since 2001 would have turned out significantly higher, had it not been for two factors.

### **Exchange Rate and Foreign Exchange Reserves:**

After several years' struggle against triple-digit inflation, Russia achieved a degree of macroeconomic stability in 1995 and maintained it until mid-1998. However, this stability proved to be quite fragile for three major reasons:

1. It depended too heavily on monetary policy alone, principally the ability of the RCB to stabilize the exchange rate. The government's inability to put state finances in order led to a rapidly growing debt burden that undermined the RCB's efforts.
2. Macroeconomic stability was not accompanied by the microeconomic changes that might have made it sustainable, especially the imposition of hard budget constraints on enterprises.
3. In 1997-98 falling prices for Russia's major export commodities (mainly oil) and growing investor doubts about all emerging markets in the wake of the Asian crisis combined to deliver a powerful external shock to the Russian economy. This greatly exacerbated the problems arising from rapidly rising indebtedness and a lack of structural change at the micro level. The result was a forced devaluation of the ruble and a default on domestic government debt.

The authorities resisted the temptation to resort to uncontrolled monetary emissions, and a return to hyperinflation was avoided. The ruble's nominal exchange rate continued to decline, but at a slow enough pace to allow some predictability.

The first half of 2001 brought clear signs of slowdown, partly because of the higher base period in 2000, but also because the external factors that had powered the recovery were weakening, namely: strong export demand from a rapidly growing world economy; high international oil prices-which helped to reduce the money supply in the economy and boost investment demand; and most importantly the cheap ruble.

The government and its successors continued to hold down federal spending in the wake of the financial collapse. The ruble value of export receipts soared and many industrial sectors took advantage of the import-substitution opportunities offered by the devaluation. The result was real GDP growth of 3.2% in 1999, together with falling inflation and a sharp improvement in public finances. The federal deficit fell from 5% of GDP to just 1.7%. The sustainability of the recovery remained open to question, as little had been done to rectify the economy's structural and institutional defects.

### **Foreign Reserves**

Foreign reserves were drained by the trade disruption and capital flight caused by the disintegration of the Soviet Union, but steadily recovered between 1994 and 1997, helped by the persistent current-account surplus and the build-up of inward investment and multilateral lending. The floating of the ruble in August 1998 allowed the RCB to avoid the complete

depletion of its reserves. Foreign-exchange reserves began to recover strongly again in 2000, rising from US\$8.5bn at the start of the year to US\$24bn in December further to almost US\$30bn by mid-2001 and reaching a current high point of US\$50.2bn in February 2003 according to the Central Bank of Russia.

### **Tax System:**

Russia's burdensome and complicated tax system has been one of the main impediments to investment and growth. Despite the fact the nominal corporate profit tax rate is not much higher than in the fast-growing transition economies of east-central Europe, the lack of provisions for tax deductibility, and the way in which the tax base is calculated is unfavorable. As a result, tax evasion had become quite popular during the 1990s, and the tax payments of Russia's largest companies became a matter of negotiation between the respective managements and the tax ministry.

As soon as his appointment as prime minister was announced, Mikhail Kasyanov indicated that his government would make tax reform its immediate priority. A raft of new tax legislation was submitted to the State Duma. Although fiscal performance has improved dramatically, there is little doubt about the need for a comprehensive tax reform. Fiscal pressures have compelled successive cabinets to shelve ambitious tax reform plans in order to cope with immediate fiscal tasks. The critical task for Mr. Kasyanov will be to continue to maintain a focus on long-term issues despite the pressure of current fiscal demands.

Among the tax changes that came into force at the start of 2001 included: the introduction of a flat personal income- tax rate of only 13%; the replacement of various social levies with a unified, highly regressive social tax; and the abolition of turnover taxes with the exception of a 1% levy on road use, which was to be phased out in 2003. The beginning of 2002 saw the new corporate tax law come into force, which reduced the maximum corporate profit tax from 35% to 24%. A reduction of this size, greatly impacts a corporation the size of LUKOIL, as it is now able to turn around and use the amount of money that it has saved and use it to create greater opportunities for reinvestment, inferring that the tax plan will promote greater economic growth. It has also abolished numerous loopholes while at the same time improving the deductibility of regular business expenses, which makes the overall impact on the tax burden difficult to calculate. And beginning 2004, the sales tax was to be eliminated, while the Added Value Tax was to be reduced between 15-17%. Although Russian business has welcomed these tax reforms, the need for further reform still remains.

### **Trade Accounts:**

Outside the Soviet Union, most of Russia's communist-era trade was with client states within Comecon. Trade with the West was limited and sometimes involved the barter of raw materials for manufactured products. In addition, a collapse in domestic demand led to rising exports of energy, minerals and semi-finished goods to non-CIS countries. Russian imports from non-CIS countries also grew rapidly, prompted by the new demand for consumer and capital goods not available in Russia, and assisted by the ruble's real appreciation against the main currencies of the West in 1992-97.

In 2001 non-CIS countries accounted for 85% of Russia's exports and 76% of its imports, with the EU accounting for around 40% of Russia's foreign trade. However, CIS markets remain important for exporters in such sectors as machine-building, where products are not competitive in the West. Trade with former Comecon states, which fell sharply in 1992-94, has also begun to recover.

Also of note, with the current war with Iraq, many Russian businesses have suffered even greater than they had before including LUKOIL. In the likely event that the Hussein regime falls, the lucrative contact that has been on and off and on again would likely fall through as the United States would assume a leading role in post-war Iraq. Trade with Iraq as a whole, consisting primarily of arms sales accounted for \$USD7.5bn in debt owed to Moscow, and overall trade has shrunk eightfold from 1989 to today.

Oil and oil products are now the largest export category, owing to a boost in revenue from the switch to dollar pricing as sales are diverted to non-CIS states. Ferrous and non-ferrous metals are the second largest export item, accounting for 22.1% of total exports in 1998. The share of machinery and equipment rose by around 0.8 percentage points to 11%.

### WTO Membership

In July 1995 Russia signed a trade agreement with the EU, which took effect in February 1996. The trade agreement forms part of a full-scale Partnership and Co-operation Agreement. The trade agreement abolishes EU quotas on most industrial imports from Russia (with the exception of textiles, steel and nuclear materials) and stipulates compliance with World Trade Organization (WTO) anti-dumping procedures. The EU is to end its categorization of Russia as a non-market economy, which puts Russian exporters at a disadvantage when contesting anti-dumping actions.

## **SOCIAL CONDITIONS:**

### **Declining Population**

While in 1970's and 1980's Russia's population was declining by 0.6-0.7% on average, it moved close to zero in the early 1990's. It was stated in 1997, that since 1991 Russian population declined by 1.3 million to 147.5 million. In addition to that, in year 1994 the number of deaths in Russia surpassed the number of births by 65%. Environmental degradation, stress, high alcohol and cigarette consumption, deteriorating healthcare system, and a decline of housing and public health standards has led to a spread of cholera and diphtheria, which are all an underlying cause of the rising death rate. The birth rate began to recuperate in 1995, nonetheless continued to report 1.2 children per household. Primary reasons behind the low birth rate continue to be - depressed household incomes and an economic uncertainty. If the decline in population continues forward, with birth rate being low and death rate being high, it is estimated that in thirty years, Russia's population could drop to 100 million. President's cabinet recognizes that the population decline is due to social problems prevailing in the country, but it is not capable of putting a stop on the trend.

### **Pension System**

The aging population ultimately brings us to the discussion of the pension system in Russia. Most Russian men retire at the age of 60 and women at 55. In addition, coal mine workers and individuals who suffered through life threatening labor are entitled to retire at an earlier age. Moreover, a big portion of the population is retiring even before reaching the minimum age due to an increased unemployment in recent years.

The Russian government employed the so-called Pay As You Go system (PAYG), which means that the pensions are funded from the taxes levied on the salaries of the working class. This system has been passed down from the Soviet Regime, which has always worked by the principle – too little for too many. The system is also constantly short on cash. The pensions are modest and provide very little for the retirees.

### **Living Standards: Earnings, Income and Inequality**

In the early 1990's, after the collapse of the Soviet Union rising prices and high unemployment had a devastated effect on the living standards of people. As unemployment increased and income fell sharply, income inequality increased tremendously. Top 10% of the population accounted for one third of the total income, and the rest was spread to the remaining 90%. It is also very common among Russians to underreport their income hence evade taxes. Some surveys have actually indicated that living standards of people were far better than the official data reported. People were interviewed at the markets in Moscow, where all of the sales were made in cash and were not reported in the total income.

Despite these facts, Russian people were roughly affected by the market transformation. Even though real income among the Russian population began to increase in 2000, Goskomstat still reported that in 2001, 44 million Russians, which made up 30% of the total population, were still living below the official poverty level.

Reforms are constantly being implemented to increase the wages and pay state workers on a regular basis. Unfortunately nobody knows how long more the population's patience will be tested while the DUMA takes several years to implement one reform.

There were also constant strikes reappearing from year to year from the coal mine workers who were owed their 6-12 months pay. The major one began on December 2 of 1996. The financial crisis of the mines was due to the massive defaults by customers on their bills and the state's unpaid subsidies. In April of 1997 a temporary regulation was prescribed where 50% of Russian coal companies would be allocated to payments and wages. Finally, the protest was settled in April of 1998.

### **Education System**

One thing the Soviet Union should get a credit for is the development of an adequate education system that was fully paid for by the state, which produced intelligentsia. Sadly enough due to the emerging class of businesspeople in the early 1990's most of the privileged and educated professionals, scientists and engineers have lost their jobs and social statuses. Granted half of them became entrepreneurs or are working for some, there is the other half that is still struggling to survive. It has been estimated in 1998 that about 50% of the business people in Russia is made up of former engineers, professors, and scientists. After the fall of the Soviet Union there was a high demand for people with entrepreneurial and commercially oriented background,

which gave rise to higher education places with an emphasis on economics, business, finance and accounting.

### **Healthcare System**

The healthcare system in Russia during the Soviet times was very similar to the education system. Healthcare was accessible to all and was free of charge. Nonetheless after the fall of the Soviet Union, the state funding has declined sharply and the services deteriorated to all but the ones who could afford it. Bribes also became even more common than in the Soviet times and were necessary to get a good treatment. A system of mandatory insurance payments was introduced in 1994 and account for 20% of the healthcare expenditure. As many as 20% of the hospitals are reporting no hot water, and 18% of the hospitals in the country have no sewage system. Due to these deteriorating conditions in the health care sector, incidents of serious infections and decease has increased tremendously in the recent years. Low salaries in this sector caused the staff to become very apathetic unless the hospitals are privately owned. Since the Russian healthcare system is missing clinics an unusual number of patients are being hospitalized where as their conditions can be treated on the out-patient system.

## **OIL AND RELATED INDUSTRIES:**

Currently 10% of the world's proven reserves of oil are in Russia and even after the recent decline in production the country accounts for about 10% of world output of oil. At the end of 1999 Russia was estimated to account for 4.7% of the world's proven oil reserves. One of the results of this plentiful supply is that Russia's production, distribution and consumption of energy are extremely wasteful by OECD standards, a problem that has been exacerbated by subsidized prices and lax environmental regulation. In the late 1990s the consumption of energy per unit of GDP was several times higher than in the West, and the discharge of pollutants was similarly excessive.

### **Industry Performance**

The industry has been constrained both by collapsing industrial demand after 1992 and lack of funds to develop supply in the past. The decline in production that had occurred since 1990 had been attributed mainly to the depletion of existing oilfields, and the deterioration in transport infrastructure and an acute shortage of investment. New capital is needed not only to develop the massive new fields that have recently been the focus of press and multinational interest, but also to extend the productive lives of existing fields. Poor Soviet oilfield practice, and lack of access to the latest extraction technology, meant that the full potential of many fields was not realized. In 1999 record-high international oil prices in 1999-2000 financed a recovery in investment spending.

Even if the current growth rates, 8.9% in 2002 (an increase of 4.9% for LUKOIL from 2001) and a projected 7.8% in 2003 were to be sustained, there are doubts whether the Russian economy can produce these high growth rates on a sustainable basis, since much of the recent recovery was driven by high international oil prices. High oil prices helped to add to the monetary supply and stabilize the economy and fuelled a rapid recovery in investment. As a result, however, Russia's economy is now even more dependent on volatile international commodities markets than it was before the 1998 crisis. Oil and gas now account for 60% of all exports, around one-quarter of budget revenue and at least half of all investment spending. A sharp and prolonged fall in international oil prices would result in the return of severe imbalances in the Russian economy.

Oil exports held up better throughout the 1990s, at around 130m t/y, and in 2001 Russia became the world's second largest oil exporter after Saudi Arabia. Russia's importance as a global supplier has put it in conflict with OPEC. Whereas OPEC has cut output to stabilize prices, Russia has continued to expand its global market share, arguing that its exports are still well below Soviet-era levels. When oil prices dipped in the aftermath of the September 11th terrorist attacks on the US, Russia promised OPEC to cut crude oil exports by 150,000 b/d from the start of 2002. Although the agreement provided ample room for evasion, the lack of export opportunities at a time of rapid output growth pushed domestic oil prices to below US\$5/barrel in the first quarter of 2002. These prices rose back up to US\$18/barrel later in the third quarter of 2002, but have fallen back to US\$5/barrel as of first quarter 2003. As a response, many Russian oil companies have put their ambitious investment and growth plans on hold. But given the

current instability in the Middle East, Russia's role as a global supplier, and more specifically, LUKOIL's role looks to increase in the near future.

### **Oil "Majors"**

Privatization has resulted in the creation of a group of large oil companies operating in an increasingly competitive market. The largest include LUKOIL, Surgut Holdings, Yukos, Tatneft and Sidanco. LUKOIL, with estimated reserves of over 16.6bn barrels, is the largest producer by far (2.3bn tones in 2001), and is also the best-integrated of Russia's major oil producers, having led the way in consolidating the many different companies from which it was assembled. The government in early 1999 unveiled plans to create a new Russian National Oil Company on the basis of the still state-owned Rosneft, by merging a number of smaller state-owned oil companies into Rosneft. The new structure would have dwarfed even LUKOIL and possessed the largest proven oil reserves of any company in the world. However, the plans met near-universal opposition within the industry and widespread opposition outside it as well, causing many to doubt that the new company would ever be formed, which has not been mentioned again to this day.

### **Foreign Investment in the Industry**

Despite the mineral riches on offer, foreign investment in Russia's energy sector has been slow to arrive. Among the deterrents have been continued political instability, an inadequate legislative framework and the reluctance of Russian oil companies to face Western competition and governance constraints. This is changing, and some significant partnerships were launched in 1997-98. Low oil prices and the instability following the 1998 financial collapse further dampened Western investors' enthusiasm for the sector but also prompted the government to take further steps in liberalizing foreign entry.

The political and economic stability achieved through government reforms in the last few years has improved the investment climate, as has the recovery of oil prices. And although Western oil majors remained cautious, as evidenced by BP Amoco's selling of its stake of LUKOIL in 2001, the depletion of their Western reserves and increased international interest in Russia as an alternative supplier to Middle Eastern oil should lead to a steady rise in investment. As evidence, the decision by BP Amoco in early 2002 to pay US\$375m for another 15% share in Sidanko, an oil production firm, was hailed as a sign of confidence. And with the emergence of the Iraqi War, international interest in Russian oil is likely to increase further, despite claims by OPEC that their reserves will be sufficient enough to meet any demands.

## **LUKOIL: COMPANY DESCRIPTION & HISTORY**

LUKOIL is a global player, Russia's number one oil producer, one of the world's top five publicly traded oil companies and the most internationally diversified oil company in Russia first emerged on November 25, 1991. LUKoil was born from a consolidated venture of three production associations – Langepasneftegas, Uraneftgas, and Kogalurneftegas. The operations of LangepasUrailKogalymneft, where acronym LUC results from, were reorganized into an open joint stock company by the decision of the Council of Ministers of the Russian Federation on April 5, 1993. To stay in compliance with the regulation decree the government assigned 38% (which sums up to 51% of the voting shares) of the ordinary sales of the three production associations, two refining companies, seven wholesale and retail distribution companies and three-oil industry related companies. Finally, after all the transfers had been completed, the Company LUKOIL was registered at the Moscow Registration Chamber on April 22, 1993.

In the early 1994 LUKOIL was finally reorganized into Open Joint Stock Company. The management found it to be more efficient to consolidate the ownership of the subs to improve organization, hence allowing the company to reduce its effective tax burden. As a result, the legal organization emerged in OAO LUKOIL to exchange the shares of other companies for newly issued shares of LUKOIL, until they held 95% stake of the ownership. To perform a stock acquisition of its now fully owned subsidiaries LUKOIL issued approximately 55.4 million of ordinary shares and 49.4 million of preferred shares. The stock acquisition of its subsidiaries was finally completed in the year 1997 contributing to expanding the Group's shareholder base, streamlining its management structure and increasing liquidity.

After it had become a strong consolidated venture, a line of acquisitions continued in LUKOIL. In 1999 LUKOIL acquired OAO Oil Company KomiTEK, which symbolized the first post privatization corporate merger in the Russian oil and gas industries. In addition the Company also acquired Saratov petrochemical plant, and also oil refineries in Ukraine (Odessa) and in Bulgaria (Neftechim-Bourgas). In the following year, LUKOIL moved its operations beyond the Atlantic Ocean, and acquired Getty Petroleum Marketing Inc., which is an American company controlling petrol stations in 13 Northeastern states of the USA and covering such areas as NY and NJ. The flow of acquisitions did not halt and every year there were new acquisitions. In 2001 LUKOIL acquired a major voting right control (60%) of the NORSI-OIL (Nizniy Novgorod Refinery).

LUKOIL's domestic operations are conducted with the help of five production subsidiaries – wholly owned LUKOIL Western Siberia, LUKOIL Permneft (100%), LUKOIL – Perm (73%), LUKOIL Komi (100%), and AGD (Arhangelskgeologiya -74.1%). In terms of refining subs, LUKOIL fully owns Perm, Volgograd, and Ukhta, and 60% of Norsni. The three marketing and distribution subs are wholly owned by LUKOIL and those are LUKoil Arctic Tanker, LUKoil Nefteproduct, and LUKoil Holding Service/Nefteproduct.

In addition, LUKoil International GmbH and LUKoil Overseas Holding Ltd. are mainly in charge of marketing and refining activities, while LUKoil Overseas is responsible for exploration and production activities.

LUKoil holds around 2% of the entire world output of oil. The crude oil reserves in the past years have increased roughly by 14%, the production remains stable as in the previous years, where as the natural gas production went up by 11% and oil refining volume increased by 18%. LUKoil's proven reserves are mainly located in Western Siberia and have a life span of 30 years. The past and recent budgets allocate about 45% of the money to the Western Siberia, 25% to the European Russia, 25% to the Timan-Pechora and 5% to the northern Caspian region. LUKoil is also one of the most internationally diversified oil companies with 30% of its refineries located abroad, over 60% of its retail network being abroad and 4% of its resources base positioned abroad.

Over the past year, LUKoil has been penetrating and exploring the North Caspian Region. This is a big sign of the company's upstream development strategy, where LUKoil is shifting the pressure from its already worn out and mature fields in Siberia that accounts for 71% of domestic production of LUKoil to new and underdeveloped fields in the North Caspian Region. While exploring the Caspian Region LUKoil had discovered hydrocarbon deposits in the fields as well. Hence in October of 2000 a Caspian Oil Company was formed together with Gazprom and Yukos for the exploration and the development of oil and gas reserves in the North Caspian Region.

Oil Refining is a big part of LUKOIL's operations as well. As LUKOIL is striving to increase its hydrocarbon production, the management is also intending to increase the refining capacity in both Russia and internationally. They are intending on upgrading their products to produce higher volumes of higher value light products such as gasoline, jet fuel and diesel fuel, and also expand in the petrochemical section. Currently LUKOIL has oil refineries in Perm, Volgograd, Ukhta, and Nizhni Novgorod. LUKOIL also holds refineries in Ukraine, Bulgaria, and Romania. Presently LUKoil is also implementing international refinery upgrade programs to meet the American and European standards. LUKOIL's management believes that the Eastern European markets provide for low cost and retail sales growth opportunities, hence is the implementation of refinery upgrade programs.

LUKOIL also operates its own service stations, through which it had sold 19.8 mbls of its own oil products through such service stations located in Russia, Commonwealth of Independent States (CIS) and Eastern Europe. LUKoil is planning to further expand its retail-marketing sector and is planning to hold up to 8,000 stations all over the world by the year 2010.

LUKOIL is also currently trying to expand its petrochemical production through a joint venture of Lukoil plant in Ukraine and other smaller petrochemical companies. LUKOIL's management believes that expanding the gas sector will ultimately bring LUKOIL to the expansion of the petrochemical operations.

### **International exploration and production**

Currently, LUKOIL has reserves in Azerbaijan, Kazakhstan and Egypt through participation in international joint ventures. In addition, the company has an interest in a development project in Iraq, where it has limited activities to comply with applicable international sanctions as interpreted by the Russian Federation, and the company has recently acquired interests in Colombia. The company is looking to increase its reserves and production from international

operations to diversify geographic and transportation risks and cost base. It has a long-term goal of increasing its share of international reserves and production to 20% of our total reserves and production by 2010.

The following is list of projects that are in the exploration stage:

#### LUKARCO:

In early 1997, LUKoil entered into a joint venture agreement with Atlantic-Richfield Company, or ARCO, which is now a subsidiary of BP plc. The purpose of this joint venture was to enable the two companies to co-operate in various exploration and development projects and in the development of related infrastructure in certain areas of Russia (including the northern Caspian region) and in other states of the former Soviet Union.

BP's decision to invest a huge sum of money in Russian oil firms is a political decision not an economic one, the Russian business daily, Kommersant, says. This investment is a down payment for Russia's compliance on a war against Iraq.

On January 30, 2001, BP AMOCO sold its 7pc stake in LUKoil, Russia's biggest oil producer, for \$657m (pounds 449m). The British oil giant sold \$237m in the form of LUKoil American Depository Receipts (ADRs) at \$40.375 each, with the remaining \$420m sold in bonds guaranteed by BP and exchangeable into LUKoil ADRS. The sale by BP of its 7 per cent stake in LUKoil will in no way affect the Russian oil major. BP 's decision to sell will not affect joint ventures of the two companies, such as the LukARCO project in Azerbaijan

#### LUKAgip:

In 1994, LUKOIL entered into a joint venture agreement with Agip International B.V., or Agip. The purpose of the agreement is to facilitate joint participation with respect to various exploration and production projects in the former Soviet Union and other areas.

#### Azerbaijan:

The Azeri, Chirag and Gunashli fields, or the ACG fields, are located in the Azerbaijan sector of the Caspian Sea. The fields are currently operated under a production sharing agreement, or PSA, by the Azerbaijan International Operating Company, or AIOC. AIOC delegated its responsibilities to BP, which manages the operations.

Together, the ACG fields are believed to be among the largest in the world. To produce the reserves believed to exist within the time period of the contract will require a combination of 222 additional wells and recompletions to occur in respect of the proven reserves and 266 additional wells to be drilled in respect of the probable reserves.

The PSA consortium has completed a four-year exploration phase involving a three-dimensional seismic survey and the drilling of three exploratory wells. Gas and condensate were encountered in the first exploratory well drilled in 1999. Further successful gas condensate wells were announced in early 2000.

## Kazakhstan

The Tengiz field was discovered in 1979 and has been operated under a project agreement by the Tengizchevroil, or TCO, joint venture since 1993. LUKARCO has a 5% interest in the project agreement which has a term of 40 years. TCO partners include ChevronTexaco, Exxon Mobil, and The Republic of Kazakhstan.

## **Other International Projects:**

### Egypt:

The Meleiha field consists of eight oil fields located in the western desert of Egypt. LUKAgip acquired a 24% interest in the Meleiha field on September 1, 1995.

### Iraq:

The company has a 68.5% interest in a PSA relating to the development of the second stage of the West Qurnah oil field. Other parties involved include the Russian Foreign Economic Association Zarubezhneft, the Russian State Foreign Economic Association Machinoimport and the Iraqi Oil Ministry. The agreement terminates in 2020 and contemplates that the parties will invest a minimum of \$6 billion on a pro rata basis. To date, LUKOIL has limited our activities in Iraq to comply with United Nations sanctions as implemented and followed by the Russian Federation and have delayed our performance of certain obligations under the agreement. LUKOIL will continue to abide by such sanctions and do not currently anticipate any capital expenditures for such project.

### Colombia:

In April 2002, LUKOIL signed a joint exploration agreement with Ecopetrol, Colombia's state-owned oil company, for the exploration and development of the Condor block in eastern Colombia. LUKOIL believes that the Condor block has substantial recoverable reserves located in up to seven separate structures.

Abiding by sanctions levied in Iraq by UN is critical for the company and the Russian Federation, who is seeking to improve and preserve relations with US and especially the UN, whose members are close neighbors and strategic partners of the Russian Federation. In recognition of Iraq's internal instability and the war with U.S., LUKOIL must monitor all of its assets and projects abroad, since most of the development is located around the volatile region. Some of the development project sights might be destroyed by Iraqi or U.S. forces, intentionally or not. Also, Iraq's possible retaliation tactics may include the freezing of all assets with in the region, as it has been during the Gulf War, with LUKOIL standing to lose capital investments and projected oil reserves.

## **Oil transportation**

### **Transneft**

Transportation of most of crude oil is conducted through the trunk pipeline system operated by Transneft, Russia's biggest pipeline operator. The Ministry of Energy allocates usage of the pipeline network for domestic deliveries to oil producers on a quarterly basis. The Ministry's allocation of pipeline capacity for export deliveries is supervised by a Russian government commission, the Pipeline Commission, with overall responsibility for the distribution of pipeline export capacity to producers on a pro rata basis based on output and delivery to the Transneft system.

### **Potential Domestic Pipelines**

The company has a memorandum of understanding with Conoco to prepare and submit to the Government of the Russian Federation a feasibility study relating to a pipeline system from western Siberia to our temporary terminal at Varandei on the Barents Sea.

### **Potential International Pipelines**

The Caspian Sea is land-locked. The export of oil is therefore dependent on onshore pipelines. Currently, hydrocarbons are exported from the Caspian Sea via the northern route through Azerbaijan and Russia to the Russian Black Sea port at Novorossiisk and via the western route through Azerbaijan and Georgia to the Black Sea port at Supsa. As the production volumes increase as a result of development of the ACG and other fields, the export capacity of the current infrastructure will be insufficient. Current pipeline projects include:

- ▶ a southern route from Baku through Tbilisi, Georgia to the Mediterranean port of Ceyhan, Turkey; and expansion of the capacity of the northern route to Novorossiisk.

## THE WAR WITH IRAQ AND ITS EFFECTS ON OIL PRODUCTION AND SUPPLY:

### *OPEC*

- OPEC's spare capacity 2.0 million barrels a day (2.6% of the world's output) which is less than Iraq's daily output of 2.5 million barrels which means that as Iraq's output is halted as a result of a war the spare reserves...even if completely released by OPEC will not be able to cover the loss of output from Iraq.
- OPEC members agreed to restrain oil supply to increase prices. However, quotas were increased twice this year because of the cold winter and the strike in Venezuela.
- OPEC has lifted all quotas on output (problem is that most likely it will not be enough).

### Oil Prices

- Oil prices have surged 63 percent in the past year and approached \$US40, the highest since the 1990-91 Gulf War, as the war continues and after US inventories fell to among the lowest level in three decades.
- US gas futures prices rose to more than \$8 per million British thermal units, or more than four times the average gas price during most of the 1990s.

Drivers of Prices:

- High demand for heating oil, a severe winter in the north-east, the disruption in oil supplies from Venezuela and a shortage of gas are the causes for some users switching to oil at a time when inventories are at 27-year low.

### Iraq

- The supply of Iraqi oil to the world oil market is very small (supplies only 2% of world production and very little for export.) It is on the order of one million barrels per day. That could be very easily supplied by OPEC and non-OPEC countries. But if the situation extends beyond that in the (Iraqi) neighborhood and disrupts ports and transportation, then we could see a different situation.
- Saddam Hussein could very easily do what he did in the Gulf War by destroying some of his own oil fields or the Kuwaiti oil fields, and attempting to hit the Saudi oil fields, creating a huge disruption that can go on for a long time, and that instability can cause oil prices to go up and stay up.
- A petroleum expert in Vienna says if Iraq were to sabotage oil fields in Kuwait or Saudi Arabia, the extra four million barrels a day that OPEC says it can supply may not be enough.

### Key Alternative Producers:

Saudi Arabia, United Arab Emirates and Iran

- According to several analysts OPEC is actually irrelevant at this point and the only countries that matter are Saudi Arabia (produces 10% of the world supply) and the United Arab Emirates.
- Saudi Arabia may already be pumping 9 million barrels a day. The kingdom says it can raise output to 10.5 million barrels a day within 90 days.

- Saudi Arabia had been furnishing about 8.5 percent of world oil output prior to the war, and Iran had been producing an additional 5 percent.

#### Russia and Oman

- Russia has now become the world's largest producer of oil, producing about 7.5 million barrels of day, almost 10% of world supply
- The expert also doubts that the non-OPEC oil producing countries, such as Russia, Norway and Oman would be able to increase their oil production to meet any long-term shortfall. But a spokesman for the Oman Embassy in Vienna said his country would not have a problem increasing supplies.
- Russia has little spare capacity. Few countries beside Saudi Arabia and Kuwait have the ability to provide additional supply.
- Regardless whether there's prolonged war or drastic economic slowdown, oil analysts seem united in their belief that demand for oil is growing rapidly, particularly in China and India, which will keep prices from collapsing in the coming years.
- Russia has nearly allied relations with the USA, cemented by the personal friendship of their presidents. It also has pragmatic relations with the EU, which are seemingly progressing towards economic integration, as seen by the favorable talks about potential humanitarian integration and the simplification of the visa regime.
- Russia has already signed large-scale oil contracts with the incumbent Iraqi government. It is not clear whether these contracts will remain valid under a new Iraqi government, in the event of the US victory in the war. However, most likely, these contracts will hardly survive.

#### Kuwait

- Gulf OPEC producer Kuwait may have to close in 700,000 barrels per day (bpd), or one third, of its overall crude output if war breaks out on neighboring Iraq, an official from the Kuwait Oil Company said.
- KOC Chairman Ahmad Rashid al-Arbid told the official Kuwait News Agency (KUNA) that Kuwait would try and compensate for the shortage from other western and southern oilfields.
- Kuwait has already closed two small northern oilfields -- totaling 25,000 bpd -- near its border with Iraq as a safety precaution.

#### Nigeria

- Nigeria is the other oil country that is witnessing continued political instability and security tensions that affect oil refineries and the oil sector. Thus, a number of questions concern Nigeria's oil production capabilities in the future.

#### **Affects of Reduced Supply:**

##### Oil Production

- Because of the likelihood that the American economy might weaken further and the global impact of this, some oil-producing nations feared a large decrease in the demand for oil.
- Non-OPEC oil producing countries have therefore failed to abide by OPEC quotas on their production caps. They now, however, can use the pretense of political developments in Iraq, Venezuela, and elsewhere to raise the official production cap in such a manner

that it will resemble actual production rates, which is recommended during tense political times.

- Raising the production cap upward of 1.5 million barrels a day can create a feeling of confidence in the markets.

### Economy and Energy Prices

- Every time that oil prices have risen by at least 60 percent since World War II, a recession has occurred in the United States, with the exception of a one-month blip in oil prices in 1987. The current annual increase is similar in size to the jumps of late 1990, when a recession was starting, and the summer of 2000, nine months before another began.
- Energy prices affect Europe and Japan even more severely than the United States, which produces more of its own oil and natural gas.
- In recent weeks, a number of big U.S. manufacturers have blamed higher energy costs for cuts in their earnings forecasts. A few have cited oil prices while postponing new investments that could add jobs, even as an overall rise in business spending has suggested that the economy might be picking up speed were it not for energy.
- The importance of the war's threat to this oil lay in the fact that *current* supplies of goods depend on expectations about *future* prices; the hostilities raised the chances that the Saudi and Iranian oil would be cut off in the near future, an event that would raise future oil prices.
- Efforts to stockpile oil in anticipation of this potential price rise thus caused a reduction in supplies *currently* available for consumption. Again, the effect was a reduction in aggregate supply, and thus upward pressure on the price level, and downward pressure on the output of goods and services.
- The war reduced both current and potential future oil supplies, in turn reducing aggregate supply, thus causing total output to decline.
- This unanticipated reduction in world petroleum supplies, which we suffered in 1990, is what might be termed an indirect effect of the war against Iraq. There was also a direct effect of the war on the economy, of the type that has long been recognized.

### **History Repeats Itself:**

- In 1980, the combination of the Iranian revolution and war between Iran and Iraq caused oil prices to more than double to \$40 a barrel. Oil briefly went to \$40 a barrel again after Iraq invaded Kuwait in 1990 and destroyed Kuwait's oil fields.
- If oil goes to \$40 a barrel, many feel it's unlikely to stay there for long. In 1990, oil did hit \$40 and two things happened. First, the United States released oil from its strategic petroleum reserve, and second, OPEC producers increased production, even though Kuwait's oil fields were devastated.
- The result was that oil quickly went back down to about \$18 a barrel. The key, everyone agrees, is maintaining a stable supply of oil. Saudi Arabia, not Iraq, is the key to this.

### **United State's Possible Motives:**

- Some believe the United States, Britain, France and China, all permanent members of the United Nations Security Council, are determined to get Iraq's oil supply, estimated to be worth in the billions of dollars.
- Some say the only reason for wanting to go to war is the U.S. desire to establish full control over the oil-gas complex of Iraq, while Bush administration denies this claim.

**Other Nation's Stake in Iraq:**

- British and U.S. companies dominated Iraq's oil industry until it was nationalized in the 1970s. British Petroleum held nearly one-quarter of the shares of Iraq Petroleum Co.
- Russia's LUKoil Company has the largest stake in Iraq, having signed a 23-year, \$3.5 billion contract in 1997 to develop the giant West Qurnah oil field.
- TotalFinaElf, a French state-owned company, has been negotiating to explore the Majnoon field, where reserves are estimated at 20 billion to 30 billion barrels.
- China National Petroleum Corp. has a contract to develop part of the Rumaila area of Iraq, which was substantially damaged during the 1991 Persian Gulf War.
- Iraq has turned to Russia and France for help in restoring an oil sector damaged by war with Iran, the Persian Gulf War and more than a decade of economic sanctions.

## **PRODUCTION VALUATION:**

### **Current Projects and Growth Projections:**

By expanding, LUKOIL is beginning to shift the balance of its production away from its mature fields in Western Siberia, to untapped reserves in the Caspian, and especially the Timano-Pechora province, where its acquisition of KomiTEK in late 1999 gave it a firm foothold. It has also secured control over numerous joint ventures and small producers operating in the region. The company considers Timano-Pechora development key to ensuring growth in the coming decade. Consequently, LUKOIL plans to invest \$3.5-4 bn in the province, which harbors up to 15 bn bbl of recoverable crude. These investments will help the company to increase output by 2010 in Timano-Pechora from 215 kbpd currently to 500-600 kbpd. LUKOIL's 20% participation in the Kharyaga project will further strengthen its position in the region.

LUKOIL is widely represented in various upstream projects in the Caspian, with stakes in the BP-led Azerbaijan International Operating Company, the Karachaganak project, the BP-led Shakh Deniz venture, and Azerbaijan's off-shore Yalama block. The company also has lucrative stakes in the Chevron-led Tengizchevroil project, in western Kazakhstan - held through its LUKARCO joint venture with BP - and is jointly developing the Kazakhstan-based Kumkol field with Hurricane (Canada). LUKOIL plans to invest a total of \$18-20 bn in upstream projects over the coming decade.

### **Capital Expenditures, Exploration and Investment Programs:**

- Under the terms of the purchase agreement, the Group is required to invest \$268 million in the Neftochim Burgas AD refinery prior to 2005. As of December 31, 2001 the Group's commitments under this agreement were \$184 million.
- Under the terms of the purchase agreement, as amended, the Group is required to invest \$200 million in the Petrotel SA refinery prior to 2008. As of December 31, 2001 the Group's commitments under this agreement were \$114 million.
- Group companies have commitments of \$39 million in 2002 and \$6 million in 2003 for the construction of oil tankers.
- Group companies have exploratory and development drilling commitments under the terms of exploration and development license agreements in the Russian Federation of \$471 million over the next 5 years.
- Group companies have commitments for capital expenditure contributions in the amount of \$1,008 million to be spent in the Caspian region over the next 29 years.
- Group companies have investment commitments relating to oil deposits in Iraq of \$495 million to be spent within 3 years from when exploitation becomes possible.

### **Oil Production Growth:**

- In 2000, LUKOIL, including its subsidiaries and joint ventures, produced more oil than ever - 77.7 million tons.
- Compared to the year 1999, oil and gas production grew by 2.8 and 6.1 %, respectively.

- The Company accounted for 23.4% of Russia's overall oil production in 2000. Within Russia, the Company produced 75.6 million tons (an increase of 2.5%) and beyond its borders, 2.1 million tons (an increase of 17.8%).
- In 2000, oil and gas production from LUKOIL's foreign projects continued to rise. LUKOIL's share of such production constituted 2.1 million tons of oil.
- Crude production was up every year since 1995, with 33% increase over 5 year period. Production in 1997 more than tripled.
- Production from application of new technologies increased 2.5-fold
- Incremental production from application of new methods and technologies amounted to more than 70 million bbl in 1999 and 90 million bbl in 2000
- Average daily well output increased 5-10% over the last years
- Lower production costs
  - ▶ Improve efficiencies in existing operations
  - ▶ Production expansion in lower cost regions (Timan Pechora, Caspian and Middle East)
- Strengthen netbacks: Shifting production will
  - ▶ lower transportation costs
  - ▶ increase proportion of sales in international market
  - ▶ improve quality of crude

In the coming years, non-OPEC supplies will continue to increase strongly, rising by an estimated 1.2 million barrels per day, with more than half of the gain expected to come from Russia. Even though oil prices are projected to decrease in the coming years, LUKoil will have higher operating income than its foreign competitors. As long as LUKoil at least maintains its current position as number 1 oil producer in the Russia and maintains its market share, the decrease in oil prices will be more than offset by the increase in production and sales.

Oil prices are expected to decline from \$25 per barrel in 2002 to \$23 per barrel in 2003 as a result of rising supply competition and below-trend growth in demand. By mid-decade, prices are expected to fall below \$20 per barrel. A risk to the forecast is that OPEC could maintain strong production discipline over the next few years to keep prices at or above \$25 per barrel. If such efforts prove successful, they would add to the growing pressures on prices—by negatively affecting demand and by stimulating competing supplies—and prices would still be expected to fall below \$20 per barrel by mid-decade. By 2005–06, significant new supplies from West Africa, the Caspian Sea, and elsewhere are expected to become available. Since LUKoil has a great stake in the Caspian region, its production and sales will be in line with projected forecasts.

Coupled with rising capacity within OPEC, those supplies will put downward pressure on prices. In the long term, growth in demand will be only moderate, as it has been for the past 20 years. But new technologies, environmental pressures, and government policies could further reduce this growth. Prices somewhat below \$20 per barrel are sufficiently high to generate ample development of conventional and unconventional oil supplies, and there are no apparent resource constraints far into the future. In addition, new areas continue to be developed (for example, deep water offshore and the Caspian Sea), and development costs continue to fall from new technologies (shifting supply curves outward). In addition, OPEC members are increasing capacity and will add to the supply competition in the coming years. Consequently, real oil prices are expected to continue their long-term decline.

## **SENSITIVITY ANALYSIS:**

### **Best case scenario: World Bank**

The US invasion of Iraq meets with stiff resistance by hard core Republican guards and although WMD are not used in this scenario, there are considerable numbers of military and civilian casualties. While major battles come to an end within a few weeks, continued sporadic attacks on US forces and acts of sabotage against the Iraqi oil infrastructure, keep Iraqi oil off the market for at least six month. Moreover, popular sentiment prevents governments in GCC countries with spare capacity, to increase production to make up for lost Iraqi supplies.

Despite these measures, global stocks remain tight through the first half of 2003. Lower economic growth and subsequent lower oil demand growth, coupled with higher non-OPEC oil production and a gradual easing of Middle East oil production towards the fourth quarter, causes prices to fall. Supply uncertainty in 2004 prevents a return to normal OPEC supply conditions leaving global commercial stocks fairly tight through 2004 and IEA countries increasingly exposed due to declining strategic stocks.

The demand for OPEC oil is expected to rise only modestly in 2003. An increase in non OPEC supply of 1 mb/d is expected to capture the bulk of the growth in world oil demand. Rising capacity within OPEC, requests for higher quotas (from Algeria and Nigeria), and a recovery of Iraq's exports could strain OPEC's efforts to support higher prices. But as long as the risk of a supply disruption hangs over the market, prices are likely to remain well within OPEC's target range.

In the coming years, non-OPEC supplies will continue to increase strongly, rising by an estimated 1.2 million barrels per day, with more than half of the gain expected to come from Russia. Even though oil prices are projected to decrease in the coming years, LUKoil will have higher operating income than its foreign competitors. As long as LUKoil at least maintains its current position as number 1 oil producer in the Russia and maintains its market share, the decrease in oil prices will be more than offset by the increase in production and sales.

Oil prices are expected to decline from \$25 per barrel in 2002 to \$23 per barrel in 2003 as a result of rising supply competition and below-trend growth in demand. By mid-decade, prices are expected to fall below \$20 per barrel. A risk to the forecast is that OPEC could maintain strong production discipline over the next few years to keep prices at or above \$25 per barrel. If such efforts prove successful, they would add to the growing pressures on prices—by negatively affecting demand and by stimulating competing supplies—and prices would still be expected to fall below \$20 per barrel by mid-decade. By 2005–06, significant new supplies from West Africa, the Caspian Sea, and elsewhere are expected to become available. Coupled with rising capacity within OPEC, those supplies will exert severe downward pressure on prices.

In the long term, growth in demand will be only moderate, as it has been for the past 20 years, but new technologies, environmental pressures, and government policies could further reduce this growth.

Prices somewhat below \$20 per barrel are sufficiently high to generate ample development of conventional and unconventional oil supplies, and there are no apparent resource constraints far into the future. In addition, new areas continue to be developed (for example, deep water offshore and the Caspian Sea), and development costs continue to fall from new technologies (shifting supply curves outward). In addition, OPEC members are increasing capacity and will add to the supply competition in the coming years. Consequently, real oil prices are expected to continue their long-term decline.

It should be mentioned that “best” case scenario is most beneficial to the markets, and not LUKoil, given that these are the lower prices among the three presented scenarios. Nevertheless, it is the most probable outcome of the current circumstances, historically and strategically (as per OPEC).

### **Worst Case Scenario: Prolonged War and Insufficient Oil Supplies**

The Invasion meets stiff resistance and Iraq succeeds in using WMD in a last ditch effort to cause as many US casualties as possible. Iraq also succeeds in either firing a Scud missile with a chemical warhead on a crowded area in Israel or, manages to use terrorists to explode a WMD (chemical or bacteriological) in an Israeli city. In either case, the resulting high Israeli casualties will result in massive retaliation by Israel which widens the conflict considerably. Tension reaches a boiling point throughout the Arab and Islamic world.

Retreating Republican Guards manage to set most oil wells in Iraq’s producing fields afire, disabling Iraq’s ability to produce any oil in 2003. Acts of sabotage by terrorists reduce oil exports in other Middle East oil producing countries and, the spreading conflict leads to serious discussions in the Arab League of using the oil weapon against the US and its allies. The above events cause a major oil supply disruption of perhaps 5-6 mbd. Despite a quick release of 2 mbd of SPR oil and after a few weeks of discussions an additional 1 mbd of other IEA strategic stocks, the combination of oil supply cuts and the psychological impact of a spreading war with no end in sight, causes oil prices to rise.

Equities fall sharply on OECD exchanges; housing prices decline; consumer confidence collapses; economic activity declines and unemployment rises noticeably. Higher oil prices combines with the recession impact results in sharply reduced oil demand by the end of the second quarter. Although oil stocks remain tight throughout 2003 and into much of 2004, collapsing oil consumption brings oil prices down to \$ 60/bbl average in the second and \$ 50/bbl in the third and fourth quarter. Continued turmoil throughout the region keeps Middle East oil production in 2004 below a level needed to bring prices down to a long term equilibrium price range in the low twenties. Instead, oil prices average around \$ 40/bbl in 2004, well above a price level required to return the global economy to positive growth.

On the demand side, the extremely high prices lead to considerable reductions in consumption but again well short of balancing supply and demand. There is consumer hoarding of oil supplies at all levels—by nation-states and by individual consumers—that further exacerbates the supply situation, although the real extent of the hoarding is difficult to measure.

With the passage of time, the eventual defeat of Saddam Hussein becomes more evident. The oil supply-demand situation continues to improve, but slowly, allowing prices to continue to moderate throughout the year 2004, resulting in an average for that year of \$40 per barrel, but still substantially above prewar levels.

### **Intermediate Case Scenario: Comparison to the results of the Gulf War**

When Iraq invaded oil-rich Kuwait in 1990, five million barrels of oil disappeared from a market that had been delivering 66 million barrels a day to consumers worldwide. Some countries reacted by purchasing additional oil, further driving up demand. Oil prices nearly doubled between August and October of 1990. Because of uncertainties about whether Iraq would also invade Saudi Arabia and take control of its oil and initial doubts about whether western nations would respond to the threat, prices stayed high (over \$30 a barrel) from October to January 1991. When the U.S. and other nations launched Desert Storm, the military campaign that drove Iraqi troops from Kuwait, crude oil prices fell sharply to \$21 a barrel. But the higher prices rippling through the American economy helped tip the U.S. into a recession that lasted through most of 1992.

- Similarities with the Gulf War
  - Prices rose sharply in 1990, and then fell when the Allies attacked Saddam Hussein's forces. Today, a number of issues are joining to raise prices and rattle oil markets.
  - Saudi Arabia stepped up production in 1990 to make up for oil lost from Iraq and Kuwait. This time, the Organization of Petroleum Exporting Countries led by the Saudis has already increased production as a way to calm oil markets. That may work in the short term, but once the war progresses, no one can predict where prices and supplies will go.
  - On the way out of Kuwait in 1991, Saddam Hussein ordered his forces to blow up oil wells and equipment, setting fires that burned for months. Now, there is fear that he will do the same thing in his own country if confronted with military defeat, or removal from office.
- Differences with the Gulf War:
  - Compared to 1991, the sources of oil worldwide are far more diverse. Additionally, because U.S. industries are so much more efficient and technology-driven than a decade ago, oil makes up a smaller portion of the American economy, so the impacts of increases or decreases in price and supply are proportionately lower.
  - Disruptions caused by war may be short.
  - If the war is over quickly, the oil markets may stabilize and there may be less of an impact on the economy, but it is not certain.
  - Iraq produces less oil and so is far less important as a player in world oil markets than it was in the early 1990s.

### **Production Scenarios: Caspian Exploration and Closing of Unproductive Fields**

LUKoil has obtained a license to explore and develop the Severni block of the Russian portion of the Caspian Sea. The licensed area is approximately 8,000 square kilometers. As of April 2002, the company had drilled a total of six exploratory wells on the Khvalynskoye and Korchagina fields and discovered hydrocarbon deposits in both. LUKoil intends to continue drilling exploratory wells and to begin developing our new reserves in the near term.

In 2001, LUKoil has identified the following parameters for its Caspian development project:

- Identified over 3.3 bn boe of extractable reserves with potential for significant increases
- Significantly larger potential for the whole license area
- LUKOIL has undertaken significant seismic work, on the basis of which 6 wells have been drilled. All were successful
- The Company has created its own production infrastructure. It has its own Astra jack-up rig, a fleet of support vessels, and has created on-shore infrastructure

In October 2000, LUKoil formed the Caspian Oil Company, or COC, pursuant to a joint venture agreement with Gazprom and YUKOS for the exploration and development of oil and gas reserves in the northern region of the Caspian Sea. Each of the partners originally had an equal share in COC but following a share issuance in 2002, LUKOIL and YUKOS owns 49.6% each of the equity interest in COC and Gazprom owns the balance. COC obtained a license to explore and develop an area in the Russian region of the Caspian Sea adjacent to the Severni block that included the Kurmangazy field, which is believed to have substantial recoverable reserves.

However, in April 2002 Russia and Kazakstan signed an agreement that divided ownership of a portion of the northern Caspian that included the COC license area. Pursuant to that agreement, Kazakstan obtained ownership of the Kurmangazy field, which was the only known field in the COC license area. In light of these recent developments, LUKoil is reviewing the options and future prospects of the COC together with our partners in the COC. The chart below shows a decreasing percentage of capital expenditures being allocated to the Caspian development project, reflecting the uncertainty of capabilities in the region. This trend is not likely to continue, as strategic alliances with both Russian energy giants (Gazprom) and Western (Exxon-Mobile) oil majors will expand their bargaining power and productivity in the region, thus expanding their area of exploration.

LUKARCO has a 12.5% interest in the Caspian Pipeline Consortium, or CPC, which has completed construction of a 1,500 kilometer (932 mile) oil pipeline to transport crude oil from the Tengiz field in Kazakstan to the Black Sea port of Novorossiisk in Russia.

Year	Total Cap Ex (\$ m)	Caspian Cap Ex (\$ m)	Percent of Total Cap Ex
1999	310.3	184.3	59.4%
2000	632.9	229.1	36.2%
2001	814.4	244.9	30.1%

The pipeline currently has an initial capacity of approximately 600,000 barrels (82,192 tons) per day, which is anticipated to be expandable to approximately 1.5 mmbbls (0.21 million tons) per day through the addition of pump stations, tankage and marine loading facilities. Oil from the Tengiz field was first fed into the CPC pipeline on March 26, 2001.

LUKoil is currently actively monitoring the efficiency of its oil wells. Some 80% of the company's production comes from about 8,500 highly productive wells. The company is considering closing up its some 5,000 wells, which have proven to be unproductive, accounting for about 3% of total production. This will decrease operating costs, which include repair and maintenance of wells, a strategy that complies with the company's goal of reducing operating costs.

#### **Reasons for Choosing Scenario 4 for Basis of Analysis and Valuation**

##### Production:

- Since a lot of the projections were heavily dependent on the development of the Caspian region, Caspian project, as it is looking now, will not be as successful as earlier predicted, thus making LUKoil's projections a bit too ambitious.
- Even though possibilities for exploration and reserves to be found in Caspian region are great, there is a chance of continued acquisition of potential reserves by the Kazakhstan government. In that case, LUKoil will have to create strategic partnership and deals with Kazakhstan government in order to access the region, which may be difficult due to Kazakhstan's current economic peril.
- The closing of 5,000 unproductive fields may not be possible, due to the high environmental and operational costs of doing so. This can create idle capacity on LUKoil's balance sheet and income statement, thus reducing net income and productivity measures. The possibility of closing a smaller amount of unproductive fields may be more realistic. This number should be equal to the amount needed to break even between costs and revenue (in form of decreased expenses and idle capacity) generated by reduction in unproductive oil fields.

##### Prices:

- As we have seen so far, global stocks remain tight through the first half of 2003. Lower economic growth and subsequent lower oil demand growth, coupled with higher non-OPEC oil production and a gradual easing of Middle East oil production towards the fourth quarter, causes prices to fall.

- Supply uncertainty in 2004 will prevent a return to normal OPEC supply conditions, as the war is likely to continue into the next year. Commercial stocks are fairly tight through 2004 and IEA countries increasingly exposed due to declining strategic stocks.
- In the coming years, non-OPEC supplies will continue to increase strongly, rising by an estimated 1.2 million barrels per day, with more than half of the gain expected to come from Russia. This has already begun, with Russia increasing investments in international development of oil fields.
- Oil prices are expected to decline from \$25 per barrel in 2002 to \$23 per barrel in 2003 as a result of rising supply competition and below-trend growth in demand. By mid-decade, prices are expected to fall below \$20 per barrel. A risk to the forecast is that OPEC could maintain strong production discipline over the next few years to keep prices at or above \$25 per barrel. If such efforts prove successful, they would add to the growing pressures on prices and prices would still be expected to fall below \$20 per barrel. This has been a recurring trend in oil prices after conflicts in OPEC's participating countries. The last 20 years have shown that oil prices follow a downward trend after the end of war and stabilize within 5 years, given that all other factors remain constant.
- By 2005–06, significant new supplies from West Africa, the Caspian Sea, and elsewhere are expected to become available, as production is currently increasing in those regions.
- In the long term, growth in demand will be only moderate, as it has been for the past 20 years, but new technologies, environmental pressures, and government policies could further reduce this growth.

As depicted by Graph 4, the revenues generated with scenario 4 show least volatility. By adapting this scenario as the likely outcome and valuating decisions based on those variables, LUKoil will be able to control volatility and make proper decisions to hedge their position in the market should the future outcomes show deviation from Scenario 4.

## **RATIO ANALYSIS**

### **Current Ratio**

LUKoil's current ratio rose from 0.88 to 1.65 from 1998 to 2000, thereafter meeting a slight decline in 2001 to 1.48. As of 2001, the company would be close to the threshold of 1.5 that indicates the company's ability to meet operating needs. Potential creditors during or after the war, which could include the United States, will require that the ratio increases in order to be assured that the company would be able to pay off its short-term debts.

### **Quick Ratio**

The quick ratio, which measures the company's liquidity without taking into account its inventory, rose from 0.75 to 1.46 from 1998 to 2000 before dropping to 1.27 in 2001. Needing to reach a ratio of at least 1.0 to ensure sufficient liquidity, LUKoil assures creditors that the company has enough cash on hand, and is not highly leveraged.

### **Inventory Turnover Ratio**

A high inventory turnover ratio indicates management's efficiency and speed in turning over the company's inventory. The ratio from 1998 to 2001 rises and declines between each year, from 19.47 in 1998 down to 16.20 in 2001. The inconsistency suggests that LUKoil has not been able to effectively increase turnover rates for which would be necessary for the company's growth. However, the potential war in Iraq could initiate a great demand for LUKoil's presence, and therefore set-off a significant rise in inventory turnover for a long period of time.

### **Days Sales Outstanding**

The DSO ratio, which measures how long it takes a company to collect its receivables, demonstrates a weak trend for the company. From 1998 to 2000, the DSO ratio increased from 65.56 days to 80.35 days. Taking into consideration the principles of the time value of money, the continuous rise indicates that LUKoil lost income that could have appreciated its bottom line. However, in 2001 LUKoil saw a decrease down to 59.80 days from 80.35 days. The company must enforce this improvement into a trend that continues into the future. The potential of high voluminous sales for the US in the event of war is likely, and therefore must be accounted for within a rapid collection period to ensure optimizing the value of the generated revenue.

### **Fixed Assets Turnover Ratio**

LUKoil has had a generally consistent fixed assets turnover ratio from 1998 to 2001, in which it rose only from 0.98 to 1.09. This indicates that the company is efficiently managing its fixed assets to generate sales. Furthermore, it suggests that the firm is not using its fixed assets more intensively than other firms. It will be important to monitor this ratio once the potential war breaks out due to the expected high rise in sales, which is represented in the numerator of the ratio.

### **Total Assets Turnover Ratio**

The total assets turnover ratio has also been consistent through the period between 1998 to 2001. This ratio measures the turnover of all the company's assets. From 0.69 to 0.67 throughout the four years, the level ratio indicates the company has been effectively adjusting the asset's turnover in accordance with its yearly sales.

### **Debt Ratio**

LUKoil's debt ratio has declined each year from 1998 to 2001, indicating that the firm is becoming less reliant on financing through debt. At the level of 0.17, the firm is not highly leveraged, and also suggests to potential creditors that historically the firm has been able to efficiently finance primarily through its own capital. This makes the firm look attractive to any potential customers, including the US in the event of war. The US, likely to seek foreign oil companies, will require conducting business with a company that has demonstrated ability to sustain its business without heavy reliance on debt.

### **Times Interest Earned Ratio**

The times interest earned ratio provides an indication of a company's ability to meet its interest payments. LUKoil's TIE ratio has sufficiently increased from 1998 to 2000, specifically from 10.19 to 45.38. Although, the ratio declined in 2001 to 34.07, the company displays the ability to pay off its interest payments at an above normal rate.

### **Profit Margin on Sales**

LUKoil's profit margins should indicate to management that the company is headed in the right direction. From 1998 to 2001, the profit margin on sales has increased from 11% to 21%. This significant increase in the profit margin suggests the company is successful, and at a high level as 21%, also indicates that it is performing at above average levels as well.

### **Basic Earning Power**

This ratio displays the raw earning power of the firm's assets, before the influences of interest and taxes. From 1998 to 2000, the firm's earning power rose from 0.23 to 0.53 before falling to 0.44 in 2001. The high growth from 98-00 can be attributed to its significant rise in sales in those corresponding years. LUKoil will hope to renew the rise from 2001 with high expected sales due to the prominent positioning it will retain as a result of the war.

### **Return on Total Assets**

The sufficient difference in ROA from 1998 to 2000 consists of a rise of approximately 22.70%. This demonstrates that LUKoil has been effectively using its assets within that time period. The generally high level of returns (30.30% in 2000) will be difficult for LUKoil to continue, as evidenced in 2001 where the ROA dropped to 19.00%. However, the potential war in Iraq could generate similar results as that of 2000 with greater sales that could sustain longer than the three year period.

### **Return on Equity**

The ROE measures how well a company used reinvested earnings to generate additional earnings. LUKoil's return on equity rose dramatically from 1998 to 2000, from 12.86% to 31.49%. To investors, this level of increase seemed very promising for they are always looking for companies with ROE that are high and growing. However, in 2001, ROE dropped to 17.03%. Regardless of the drop, investors should keep an eye on the company as the looming war draws near, and ROE will expect to rise to levels of the year 2000.

### *Price to Earnings Ratio*

This ratio compares a company's earnings to its market price, enabling the public to compare a company to its competitors. LUKOIL's P/E ratio over the four years fluctuates greatly from 13.48 in 1998, to 23.67, down to 7.40 and finally to a value of 17.86 in 2001. Among the reasons for the fluctuation include two factors, first from 1999 to 2000, LUKOIL's earnings per share jumped from a value of 1.69 to 4.73. As this is the denominator for the ratio, this significantly decreases the value of the P/E ratio. Secondly, besides the fluctuation of the EPS, the value of LUKOIL's price per share also fluctuates greatly as well. Starting from the beginning of 1998, it starts at a high of 75, falls to a value under 10, before rising again to the value of approximately 50 at the end of 2001. **Note:** Comparable numbers for the rest of the Russian oil industry were not found.

### *Market/Book Ratio*

This ratio indicates how much the public values a firm as opposed to how much the company is actually worth in book assets. Based upon the numbers that we acquired, which are based upon ADR shares outstanding rather than number of shares, it would appear that the market does not value LUKOIL to be worth as much as it is actually worth in the books. The ratio is consistently in the low decimals, never rising above the value of .204 in 1999. These numbers would seem to indicate that investors as of 2001 are less likely to pay more than face value for a share (ADR) of LUKOIL than other companies. **Note:** Comparable numbers for the rest of the Russian oil industry were not found.

## **TEACHING NOTE**

### **Summary**

LUKoil, the number 1 oil production and refinement company in the Russian Federation is seeking expansion in its project coverage area and continuous growth through improved technological capabilities and strategic business alliances with institutions within the industry, as well as foreign governments. It hopes to achieve its goal of expansion through the strategy of cost-cutting, increased R& D and acquisition of lucrative development sites to increase production.

With the current world affairs in the Middle East, the largest source of oil, and U.S., the largest world economy, LUKoil can benefit from the outcome of the conflict and achieve its strategic growth objective if the war's outcome involves lost oil reserves for OPEC countries and increased sanctions against current and future opposition. Russia, and specifically, LUKoil will become the largest supplier of oil in Europe and U.S., visa-vis the help of its current business plans mentioned above.

### **Learning Objectives**

This case serves as an analysis of an emerging market. It enables helps students to evaluate multiple factors that affect valuation of a company and its business environments, based on such parameters as country risk, economic stability, and world affairs and supply and demand factors.

LUKoil case and its analysis will be beneficial to Senior Undergraduate students because it will be instrumental in helping to

- Forecast free cash flows to the firm and finding firm value
- Understand how country-specific risk, such as political and economical instability, can affect a company and its shareholders
- Perform sensitivity analysis to evaluate possible outcomes of variables included in the company's performance valuation
- Determine certain discount rates used in evaluating cash flows

The ultimate goal of solving this case is gaining an understanding and skills in incorporating various factors, such as world affairs, country risk and economic status, in the evaluation of a company operating within a volatile environment, namely an emerging market.

### **Issues to be considered by foreign investors**

From a point of view of a foreign investor, there are reasons one should consider LUKoil a lucrative investment and at, the same time, be cautious in overexposure and risk associated with the firm's stock.

- Russian Oil Industry

### Pros

- About 10% of the world's proven reserves of oil are in Russia, and even after the recent decline in production the country accounts for about 10% of world output of oil.
- Oil exports held up better throughout the 1990s, at around 130m t/y, and in 2001 Russia became the world's second largest oil exporter after Saudi Arabia.
- Russia has continued to expand its global market share
- Nevertheless, Russia's role as a global supplier is likely to be reinforced by heightened instability in the Middle East and by Russia's strategic role in the Caspian region.
- Although Western oil majors remain cautious, the depletion of their own reserves and increased international interest in Russia as an alternative supplier to Middle Eastern oil are likely to lead to a steady rise in investment.
- High oil prices helped to add to the monetary supply and stabilize the economy and fuelled a rapid recovery in investment.

### Cons

- One of the results of the plentiful supply of oil is that Russia's production, distribution and consumption of energy are extremely wasteful by OECD standards, a problem that has been exacerbated by subsidized prices and lax environmental regulation.
- The decline in production since 1990 has been attributable mainly to the depletion of existing oilfields, the deterioration in transport infrastructure and an acute shortage of investment.
- Poor Soviet oilfield practice, and lack of access to the latest extraction technology, meant that the full potential of many fields was not realized.
- Volatility of the Russian oil industry, specifically concerning the fluctuation of oil prices, has had a dramatic effect on returns for Russian oil companies.

## • Global trends

### Pros

- OPEC becoming less of a depended-upon source for oil, while Russia is becoming extremely instrumental in providing sufficient supplies.
- Increasing confidence in the Russian economical and political system, as reforms are implemented by the authorities to create a more favorable investment environment
- Growing number of strategic alliances among countries in the development of promising oil fields.
- Increasing globalization has lead to fierce competition in the industry to cut operational costs and provide high grade oil on the market.

### Cons

- Increasing importance on environmental consequences of oil drilling causes increase in costs fort oil companies
- Large oil companies engage in M&As and consolidations which results in reduction in competition in the market.

## Focus of Analysis

The focus of the analysis concentrates on the conflict in Iraq and its effects on the Russian oil industry. The following parameters and issues identify possible outcomes and consequences of the conflict on the Russian oil industry and inherently LUKoil.

## OPEC

- OPEC's spare capacity 2.0 million barrels a day (2.6% of the world's output) which is less than Iraq's daily output of 2.5 million barrels which means that as Iraq's output is halted as a result of a war the spare reserves...even if completely released by OPEC will not be able to cover the loss of output from Iraq, thus allowing Russia to supplement the gap between supply and demand.
- OPEC members agreed to restrain oil supply to increase prices. However, quotas were increased twice this year because of the cold winter and the strike in Venezuela, strengthening Russia's position as the world supplier.

## Oil Prices

- Oil prices have surged 63 percent in the past year and approached \$US40, the highest since the 1990-91 Gulf War, as the war continues and after US inventories fell to among the lowest level in three decades. This can create the need for Russian oil and increase demand for the development of new oil fields, which LUKoil can obtain in form of contracts.
- US gas futures prices rose to more than \$8 per million British thermal units, or more than four times the average gas price during most of the 1990s. This could mean that the market sentiment is hinting that LUKoil's share price will increase as the war progresses.

Drivers of Prices:

- High demand for heating oil, a severe winter in the north-east, the disruption in oil supplies from Venezuela and a shortage of gas are the causes for some users switching to oil at a time when inventories are at 27-year low.

## Iraq

- The supply of Iraqi oil to the world oil market is very small (supplies only 2% of world production and very little for export.) It is on the order of one million barrels per day. That could be very easily supplied by OPEC and non-OPEC countries. But if the conflict extends beyond that in the (Iraqi) neighborhood and disrupts ports and transportation, then we could see a different situation. This puts LUKoil in the position to meet the demand utilizing its resources from increased production derived from large development projects (Caspian, Azerbaijan)
- Saddam Hussein could very easily do what he did in the Gulf War by destroying some of his own oil fields or the Kuwaiti oil fields, and attempting to hit the Saudi oil fields, creating a huge disruption that can go on for a long time, and that instability can cause oil prices to go up and stay up. A petroleum expert in Vienna says if Iraq were to sabotage oil fields in Kuwait or Saudi Arabia, the extra four million barrels a day that OPEC says it can supply may not be enough. This will increase share price for LUKoil, as it

becomes depended-on for oil supplies, and increase its revenue through rising production coupled with rising oil prices.

### Key Alternative Producers:

#### Saudi Arabia

- According to several analysts OPEC is actually irrelevant at this point and the only countries that matter are Saudi Arabia (produces 10% of the world supply) and the United Arab Emirates.

#### Russia and Oman

- Russia has now become the world's largest producer of oil, producing about 7.5 million barrels of day, almost 10% of world supply
- The expert also doubts that the non-OPEC oil producing countries, such as Russia, Norway and Oman would be able to increase their oil production to meet any long-term shortfall. But a spokesman for the Oman Embassy in Vienna said his country would not have a problem increasing supplies. If LUKoil proves to be successful in its strategic development projects and alliances, doubts about Russia's potential can be eliminated.
- Russia has little spare capacity. Few countries beside Saudi Arabia and Kuwait have the ability to provide additional supply. That is why it is crucial that LUKoil, being the largest company in Russia, continue analyzing possible development projects and obtain government backing in order to increase reserves so as to take advantage of worldwide oil shortages.
- Regardless whether there's prolonged war or drastic economic slowdown, oil analysts seem united in their belief that demand for oil is growing rapidly, particularly in China and India, which will keep prices from collapsing in the coming years. Through development of pipelines that will be able to connect Russia and the Far East, LUKoil can become key supplier in the region, gaining a stronghold in the markets.
- Russia has already signed large-scale oil contracts with the incumbent Iraqi government. It is not clear whether these contracts will remain valid under a new Iraqi government, in the event of the US victory in the war. However, most likely, these contracts will hardly survive. Here, LUKoil stands to lose a substantial investment in the region, facing a struggle to convince the government of its intention in and possible contributions to the region. Specifically, if U.S. takes control of the oil industry in post-Saddam Iraq, Russia will probably be phased out of the region, with U.S. and coalition forces taking the bulk of development projects.

#### Kuwait

- Gulf OPEC producer Kuwait may have to close in 700,000 barrels per day (bpd), or one third, of its overall crude output if war breaks out on neighboring Iraq, an official from the Kuwait Oil Company said.
- KOC Chairman Ahmad Rashid al-Arbid told the official Kuwait News Agency (KUNA) that Kuwait would try and compensate for the shortage from other western and southern oilfields.
- Kuwait has already closed two small northern oilfields -- totaling 25,000 bpd -- near its border with Iraq as a safety precaution. As fears mount on the suspicion that Saddam will repeat his Gulf War tactics, Kuwait will be more hesitant to openly disclose their reserve

capacity and production in fear of it being sabotaged. Exports from Kuwait may be halted as the country becomes considered Saddam's target.

### Nigeria

- Nigeria is the other oil country that is witnessing continued political instability and security tensions that affect oil refineries and the oil sector. Thus, a number of questions concern Nigeria's oil production capabilities in the future. As these factors prevent Nigeria from becoming a prominent world supplier, Russia on the other hand, is increasingly concerned and involved in creating a stable environment, solidifying its position in the world market.

### **Effects of Reduced Supply:**

#### Oil Production

- Because of the likelihood that the American economy might weaken further and the global impact of this, some oil-producing nations feared a large decrease in the demand for oil. This can potentially create a negative effect on LUKoil, leaving it with idle capacity and increased reserves, damaging its financial situation and making it unable to meet revenue projections.
- Non-OPEC oil producing countries, such as Russia, have therefore failed to abide by OPEC quotas on their production caps. They now, however, can use the pretense of political developments in Iraq, Venezuela, and elsewhere to raise the official production cap in such a manner that it will resemble actual production rates, which is recommended during tense political times.

#### Other Nation's Stake in Iraq:

- British and U.S. companies dominated Iraq's oil industry until it was nationalized in the 1970s. British Petroleum held nearly one-quarter of the shares of Iraq Petroleum Co. Having experience in the region and involvement in the war, Britain may again take a dominant stake in the region's oil industry after the war, isolating Russia and other nations from the region
- TotalFinaElf, a French state-owned company, has been negotiating to explore the Majnoon field, where reserves are estimated at 20 billion to 30 billion barrels. With France objecting to the war in Iraq, it may get favoritism after the war if U.S. efforts were to fail, with France stepping in as an important partner with Iraqi and OPEC oil producers.
- Iraq has turned to Russia and France for help in restoring an oil sector damaged by war with Iran, the Persian Gulf War and more than a decade of economic sanctions. This may benefit Russia if history is to repeat itself, with LUKoil stepping in to take lucrative oil production contracts.

### **Solution: Sensitivity Analysis using Production and Price Factors**

#### **Best Case Prices (World View) and Intermediate Production:**

The combination of the two factors was chosen as the most optimal and probable projected outcome for LUKoil. This evaluation was based on the following premises:

- Production capacity in the Caspian region, as projected by LUKoil, may have been overzealous, as factors such as Kazakhstan obtaining ownership of an important oil field, diminish Russia's stake in the region.
- The closing of 5000 unproductive oil wells may not be cost effective, conflicting with LUKoil's strategy to cut operational and maintenance costs, thus mandating the reduction of a smaller number of unproductive fields. The reduction of 5000 wells may cause the company to incur higher costs than the savings in costs when closing the wells.
- Projected prices chosen were those that have been the norm for the past 20 years, based on world Bank estimates. These prices are the lowest among the three scenarios, which may not be beneficial to LUKoil when considering revenue effects in the short run. But among the possible scenarios, this is the most probable case and one that is most beneficial to the world economy, in the long run. If price projections materialize, world economy, and especially U.S. economy, may improve and production across industries may reach pre-2000 levels. This will increase demand for oil, thus increasing demand for Russia's reserves, making a large impact on the company's bottom line.

The following assumptions were made in regards to other components of Free Cash Flows to the Firm:

- Operating expenses will decrease 1.5% annually, as LUKoil closes some unproductive oil fields.
- An increase of 15% in selling, administrative and general expenses due to increase in exports to the West and the rest of Europe.
- Historically, depreciation, amortization and depletion and excise and export tariffs have been increased by 5% and 4%, respectively.
- Historical increase of 21.2% in current liabilities was used when calculating Networking Capital. Growth rate of 13% in current assets was taken from YUKOS financial statements, as it is LUKoil's most comparative and direct competitor. LUKoil's growth in current assets, as seen from years 1999 and 2000, cannot be sustained in the long run. Average Working Capital rates of 3-5% for U.S. companies would not be sufficient since working capital in emerging markets would need to be higher due to the higher volatility of projects in those markets.
- Decrease in networking capital is consistent with productivity and development projection. As projects mature and approach completion, confidence in future cash flows will increase, requiring a smaller cushion in capital needed to protect the company from unpredicted cash flow shocks.
- An increase of 30% due to increase in sales and increase in exports as Russia and, specifically, LUKoil grows as a supplier of oil worldwide.

- Corporate Taxes were reduced from 35% to 24% in 2002 per government tax reform.

***FCFF Model and Discounted Cash Flow Analysis:***

As can be seen from the FCFF valuation, free cash flows are decreased after year 2003. This is largely due to increased capital expenditure in short-term projects (2 to 7 years), such as oil tankers, refineries and projects within the Russian Federation. The projections in increasing production were made largely based on the success of the northern Caspian development project. As it has been proven, the project will not be as productive as originally projected. Given that the majority of the short-term projects will be completed by 2007, revenues from the developments will not be realized until 2010, which is outside the scope of time projections. On the other hand, the Caspian development project is one that will take 29 years to complete and even longer to realize returns. Therefore, the estimate in increasing production is overstated and a more conservative number should be adopted to properly evaluate the firm. The marginal increase in revenue from 2002 to 2003 is largely due to increase in oil prices, affected by the war in Iraq and the Venezuela oil strike.

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## **RECENT DEVELOPMENTS AND THE WAR ON IRAQ**

### **Gasprom and Lukoil Considering a Strategic Alliance**

In October of the year 2002 Russia's biggest oil producer and the world's biggest gas company were considering forming a strategic partnership, which would affect the domestic companies' approach to hydrocarbon's projects. Gasprom, Yukos and Lukoil together sponsored the Caspian oil Company for the exploration and the development of oil and gas reserves in the North Caspian Region. Even though Russian companies hold a mentality of concentrating on their own operations both the CFO of Gasprom and Lukoil had reached a common understanding on the issue of exploring, producing, refining, transporting and marketing natural gas, gas products, chemicals and petrochemicals. Both Lukoil and Gasprom wasted no time and signed a letter of intent on launching their partnership.

Looking at the situation from the point of view of an outsider it seems that the venture would be more beneficial to Lukoil rather than Gasprom. Lukoil is determined on expanding its gas sector. It has been estimated that Lukoil's gas production will only reach Gasprom's half gas production by the year 2010. Nonetheless, nothing is stopping Lukoil, it is investing in gas developments and by signing the alliance it wants to make sure that it will be able to access Gasprom's pipelines, because the tariffs on using those are too high and the terms are very vague. In addition, after finding an immense amount of gas deposits in the North Caspian Region Lukoil is also hoping that it will be able to use Gasprom's pipelines in that sector as well. The government is also encouraging the oil firms to enter the gas sector, because it wants to break up Gasprom's monopoly in the gas sector.

On November 18<sup>th</sup>, 2002, the strategic partnership agreement for 2002-2005 with Gasprom was signed. Gasprom had finally given up its unwillingness to give access to other gas producers. In addition to all partners have expressed their interest in promoting hydrocarbon exploration also outside of the Russian Federation and they will also coordinate together the foreign economic activities and research programs.

### **Lukoil tripled investment in Southeastern Europe**

In November of 2002 Lukoil announced that it had tripled its investment in southeastern Europe and will increase imports to Europe and the United States. Lukoil owns its largest oil refinery in the Balkans, southeast of Sofia, Bulgaria. Its investment in Bulgaria, makes up 7% of the country's GDP, and the taxes paid by Lukoil made up  $\frac{1}{4}$  of the country's budget revenue last year. By increasing its investment in Bulgaria, and expanding its oil refinery, Lukoil is planning to increase its imports to both Europe and United States.

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### **The State sells its Stake in Lukoil**

In the beginning of December of last year, the Russian government launched one more time its sale of 5.9% of its stake in Lukoil. Four months prior the government postponed the sale because of the low share price of Lukoil. The deal could generate up to \$800 million based on Lukoil's share price. The offer was made through Morgan Stanley, who have been working intensively on the issue for the past 2 ½ years. Finally on December 5<sup>th</sup>, 2002 5.9% of government's stake in Lukoil was sold on the London Stock Exchange for \$775 million, leaving the government with 7.6%. Much has been done to improve Lucoil's disclosures and corporate governance, to meet the London Stock Exchange Regulations. For Lukoil and Russia this sale signaled that Lukoil had come of age, and is able to meet the highest international standards. The demand for the shares far outweighed the supply of the shares, signaling growing investor interest and trust in the Russian oil companies and also corporate governance has improved in the past years and the production has rocketed. Everybody is confident that Lukoil's recent trend toward better and improved corporate governance will continue even if the oil prices fall, because the management knows that their personal wealth is tied to the market value of these companies. It is highly doubted that Lukoil's CEO Vagit Alekperov or Nikolai Tsvetkov would want to jeopardize their 10.38 and 5.26 (respectively) stakes in the company. In the middle of December, Prime Minister of Russia, Mikhail Kasyanov said that the sale of the government shares in Lukoil will help the Russian government to pay off billions of dollars in foreign debt payments that are due this year (2003).

### **Baghdad Cancels Lukoil's West Qurna Contract**

At the beginning of the month of December of the year 2002, Baghdad has hindered itself of good relationships with Moscow. Iraq's Oil Ministry has terminated the contract with Lukoil to develop the West Qurna oil field, which would bring Lukoil \$70 billion worth of oil, 7.3 billion barrels of recoverable reserves. If Baghdad had not deprived Lukoil of the offer, Lukoil would own one of the biggest oil fields Baghdad has ever offered to a foreign oil company.

A contract to develop the West Qurna oil field was signed in March 1997 under a production sharing agreement, or PSA. The entire life of the project would be 23 years, with a possible extension of 5 years. Lukoil would hold a 68.5% share of the output, and the state owned Mashinoimport (Machinery Import) and the Zarubezhneft (Foreign Petroleum) foreign trade associations would each hold 3.25% share of the output. Development costs were estimated to be \$4 billion, and the project would pay itself off in six to seven years. This contract was the first oil agreement between Iraq and a foreign company after the Gulf War in 1991.

A formal letter was sent by the Iraq's Oil Ministry to the CEO of Lukoil Vagit Alekperov. In the letter it was said that one of the main reasons the contract is being terminated is because of Lukoil's failure to fulfill its obligations under the agreement. The main purpose for the agreement was the production and development from the West Qurna field to expand the oil production capacity of Iraq. Unfortunately, as the Iraq's Oil Ministry states in the letter, the non-

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performance of Lukoil in the oil field had in effect resulted in a substantial harm to the economic interests of Iraq. Iraqi authorities repeatedly warned the Russian firm that they would declare the accord null and void the contract if they did not carry out their obligations in accordance with the term of the contract. It is very unlikely that Iraq was trying to do everything possible to make the Russian partners violate the contract.

There is another reason behind the termination. The complaints against Lukoil arose a couple of times before in 1999 and 2001 when Baghdad needed to gain Russian support in its fight against the “unjust embargo”. Nonetheless after Russian efforts helped to soften the world community’s attitude toward the Baghdad regime, the criticisms against Lukoil were instantly dropped.

Perhaps the same plot is being used in this case, although this time Iraq is not only threatening but is also acting on their disapproval of Lukoil. One of the main drivers that caused Iraq to withdraw is Lukoil’s connections with the United States, and company’s two faced stand, which states that the company is hoping to preserve its position in Iraq even after the collapse of Saddam’s Regime. The behind the scene negotiations with the US Secretary of Energy Spencer Abraham on oil activities in post Saddam regime in Iraq were a major wound to the Baghdad Lukoil relationship.

Lukoil’s CEO, Vagit Alekperov, strongly believes that his company has not breached an oilfield development agreement and that the contract is still not terminated. He thinks that Iraq’s talks on canceling the contract are just a mere intention. He strongly believes that the government and the Foreign Ministry should try to solve the problem, and settle through mutual efforts. When the war on Iraq is almost ready to erupt and is around the corner, Iraq needs to push further on Russia’s political view towards Iraq. Regardless of the Iraqi influence, Russian government has been trying to resolve the tense situation with regard to Iraq and is determined in conjunction with the Iraqi government, to guarantee that the Iraqi problem is solved through peaceful and political means, and that it does not lead to a large scale war in the region, and to a change of government in the country.

Iraq several times stressed that through the termination of the contract they were punishing Lukoil and not Moscow. The Iraqi Oil Ministry has announced that since they have take the West Qurna from Lukoil they might transfer the oil fields to another Russian company. As of February 11, 2003 Baghdad has awarded the West Qurna contract to the state-owned Stroitransgaz to develop the field. Iraq is also negotiating agreements with Zarubezhneft (Foreign Petroleum - a state owned holding company for foreign projects).

According to the agreement, the contract’s terms mean that it cannot be terminated unilaterally. Any termination from both sides should come with a complicated procedure of three months’ warnings and reexamination and only termination after the expiration of the three months. Since the company strongly believes that it has not breached the oilfield development agreement, in case if events unfold unfavorably for Lukoil, the company has every right to bring a complaint against Iraq in a court of arbitration in Geneva.

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# Foreign Oil Firms to Stop Receiving Perks in Russia

## Moscow Decides Against Tax Breaks, Special Legal Status to Lure Investment

By JEANNE WHALEN  
Staff Reporter of THE WALL STREET JOURNAL

MOSCOW -- In a blow to foreign oil companies, Russia said it has decided not to grant special legal protections to dozens of energy projects in which large Western oil companies had planned to invest billions of dollars.

Russia said the oil companies should trust their investments to the country's existing legal regime.

The news will frustrate but probably not surprise companies from [ConocoPhillips](#) Co. of the U.S. to [Eni](#) SpA of Italy. They have been waiting in vain for years to receive special contracts called production-sharing agreements, which guarantee tax breaks and stable investment terms over the life of long-term oil projects. Wary of outsiders, Russian legislators have dragged their feet approving the deals.

[BP PLC](#)'s decision in February to pay \$6.75 billion (€6.19 billion) for half of a Russian oil company appears to have delivered a death blow to PSAs, allowing Moscow to argue that it can attract big investments without offering the tax breaks and other perks of a PSA. But BP said Tuesday it would still be disappointed by the cancellation of the PSA regime, under which it had been planning to develop a giant gas field and other capital-intensive projects.

Deputy Prime Minister Viktor Khristenko said the government would later this week propose amending legislation to preserve five existing PSA projects but scrap the majority of 33 additional projects still in the planning stages. "There will be a very limited list of fields which should be developed [under PSAs] ... because of [existing] intergovernmental agreements, or because of exceptionally tough conditions, in particular in offshore zones," the Interfax news agency quoted Mr. Khristenko as saying.

Russia's soaring oil production, along with the BP deal, appears to have given the government the confidence to abandon production-sharing agreements. The contracts never enjoyed much support in the government or Parliament but were tolerated in the mid-1990s, when Russia's oil production was falling because of a lack of investment. Seeking to attract foreign money, the state approved four PSAs for the oil and gas sector and one for a gold mine.

Thanks to the political stability that has set in since President Vladimir Putin came to power in 2000, Russia's own oil companies have dramatically boosted investment and sent output

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climbing. Some of the biggest companies, such as OAO [Yukos](#) and OAO [Sibneft](#), have lobbied legislators to kill PSAs once and for all, arguing that foreigners shouldn't be given an edge.

But many foreigners argue that canceling PSAs would be a mistake if Russia is to keep production growing over the long term. Most of the production growth over the past three years, they note, has come at relatively little cost and during a period of high oil prices.

"PSAs should play a role in the investment mix in Russia for ... large, capital-intensive projects that require long lead time," said Peter Henshaw, a BP spokesman in Moscow. The company was confident enough in Russia's investment climate to buy half of a new company called TNK-BP, but says it wants a PSA in hand before tapping a giant Siberian gas field. BP and its partners have "invested and carried out activities on the basis that any development would take place under PSA" and would be disappointed by the regime's cancellation, Mr. Henshaw added.

Other companies likely to suffer include Conoco, which had been hoping to win a PSA to jointly develop Arctic oil reserves with Russia's OAO [Lukoil](#), and Eni, which had planned to tap a southern gas field under the special legal regime. A spokesman for Conoco couldn't be reached for comment, while a spokesman for Eni declined to comment.

Existing PSAs that Mr. Khristenko said would be allowed to continue include two offshore projects off the coast of Sakhalin Island, led by [Exxon Mobil Corp.](#) and [Royal Dutch/Shell Group](#); a Siberian oil project led by [TotalFinaElf](#); and a Siberian oil field owned by TNK-BP.

## **The Real Energy Solutions Are Not in Iraq**

By VLADIMIR SOCOR

Three emerging trends in the East, of which the war in Iraq is a part, add urgency to the goal of bringing Caspian oil and gas westward, directly to consumer markets. This is a major shared interest of the Western economies, the new democracies now joining the enlarging West, and the Caspian-South Caucasus producer and transit countries. Those three trends underline the need for faster movement on the construction of westbound pipelines from the Caspian basin. But even that won't forestall serious trouble ahead unless the European Union develops an energy sector investment strategy, and a supply diversification strategy for the enlarging EU's new member countries.

The first of those trends concerns the need to pacify and reorder the Middle East. The effort is only beginning with the U.S.-led war to rid Iraq of Saddam Hussein and weapons of mass destruction. It will be a protracted effort, which may well require further operations against terrorist groups and rogue-state WMD proliferators elsewhere in the Middle East in the years ahead. The effort is also likely to entail nation-building as a stabilizing factor. Only then will the sources of volatility subside in the region. Meanwhile volatility may even increase if radical anti-

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Western elements in the region react spasmodically in the initial stages of the anti-terrorist, anti-rogue-WMD operations.

As regards Iraq's oil output, it will take years to reach the pre-1991 levels. But even substantial progress on security, reconstruction and nation-building in the Middle East will not erase two known imperatives of energy security and economics: first, to diminish the already excessive share of world oil supply transiting the Persian Gulf and adjacent areas; and, second, to significantly reduce dependence on OPEC oil.

The second trend is a growing imbalance between Russia's oil output and export infrastructure capacity. While output is growing rapidly, the internal pipeline and maritime terminal construction advances at snail's pace. Pipeline and terminal bottlenecks have already created a large and growing oil glut in Russia. Consumer countries -- the United States especially -- want that oil on the world markets. The Kremlin, however, says *nyet* -- not only to U.S. and other consumer countries, but also to Russia's own producing companies, which are anxious to sell their oil while world prices are high.

Russia's major oil producing companies propose to use part of their recent windfall profits for building pipelines and terminals, of which they would be owners -- or at least part-owners in partnership with the Russian state. The Russian state, however, insists on retaining a virtual monopoly on the export infrastructure, apparently even at the cost of foregoing multibillion-dollar profits for the private industry and corresponding tax revenue for the state. The Russian state seeks to interpose itself for the long-term between Russian private producing companies and Western consumers. Supply contract fulfillment would depend on Russian state approval, government-allocated pipeline access quotas, and, very possibly, politics.

The reason behind this policy seems clear: the Russian state intends to keep a firm hand on the oil export valve, reserving for itself the option to exert supplier's leverage on the consumer countries, whether for political or other considerations. This approach is already clearly emerging in Russia's boycott of Latvia's oil port Ventspils, the largest export terminal for Russian oil in the Baltic region. The Russian state pipeline monopoly Transneft seeks to force Ventspils into bankruptcy and seize it. For this predatory purpose, it compels Russia's own oil-producing companies to forego exports of almost 16 million tons of oil annually (that's Ventspils' capacity), as well as withholding that amount from Western consumer countries, and of course adding to Russia's useless oil glut. According to many experts, it would take about ten years -- as well as massive Russian and international investments -- before Russia's export pipeline and terminal capacity is brought into balance with the country's extraction capacity.

The third trend consists of an accelerating effort by Russian energy companies -- in this case, mainly the state-connected Gazprom and **Lukoil** -- to buy up strategic energy enterprises of Central and East European countries, offering them long-term supply contracts for Russian oil and gas. Those Russian companies seem to have embarked on a race against the clock for dominance in these countries' energy sectors. Indeed, they appear to follow a strategy of preemption, so as to confront the European Union with *faits accomplis* in the accession countries and in the EU's new eastern neighborhood.

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The European Union does not seem to be responding to this grab. Yet if Russian takeovers and EU passivity continue, the consequences can be serious indeed for the long term. The enlarged EU may find itself divided into two zones with very unequal levels of energy security. In the West, Russia will be one among a number of energy suppliers to the EU's old member countries. There, the principles of diversified sources of energy supply will remain in force, even if Russia will be one of major suppliers. In Central-Eastern Europe, however, the EU's new member countries will find themselves overwhelmingly dependent on Russian energy supplies.

While Russian energy giants function mainly as commercial suppliers in the West, they take over a wide and growing range of roles in the Central and Eastern Europe. There they also own and operate refineries and other processing plants, distribution systems, transit pipelines and storages, port terminals, and other key assets. Such a situation would be deemed unacceptable in Western Europe. If allowed to develop in Central-Eastern Europe, this situation can generate long-term internal and external risks to the newly free countries, and to the EU as a whole.

The European Union must devise measures to halt this potentially dangerous trend on an urgent basis. Some suggestions: Together with the accession countries, the EU should work out targeted investment programs in these countries' energy sectors. It should at last activate the long-dormant proposals to bring North Sea oil and gas to the accession countries, and should link their pipeline and electricity networks with those of the EU's old member countries. The new countries lack the investment funds for these tasks. The EU must step in now, and assist its new members to observe the EU's own norms in terms of energy supply diversification.

EU countries, old and new, are natural consumers of Caspian oil and gas. Yet the EU's decade-old TRACECA and INOGATE transit programs lag behind schedule, underfunded and bereft of the political attention they deserve. The New Europe's energy diversification requirements, along with the Middle East situation and with Russia's infrastructure problems (as well as larger political and economic problems), underscore the growing importance of the Caspian basin. Both the EU and also the enlarging NATO need to discharge their responsibilities in terms of regional security there.

For years, the United States, seconded by Turkey, has been bearing Europe's burdens in the South Caucasus-Caspian region. That's the kind of American "unilateralism" that benefits all concerned. Some West Europeans did not seem to have taken notice. Will they now, and will they join with the U.S. in bearing their fair share in terms of economic and strategic initiatives?

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## Russia's Gazprom, **Lukoil** Create JV In Caspian Sea

DOW JONES NEWSWIRES

MOSCOW -- Russia's natural gas giant OAO Gazprom (R.GAZ) and second-largest oil producer OAO **Lukoil** (R.LKO) will create a joint venture to develop Centralnoye oil structure in the northern Caspian Sea, Gazprom said Wednesday.

The chairman of Gazprom Alexei Miller and president of **Lukoil** Vagit Alekperov have also discussed a wider co-operation in oil and gas with a view to signing an agreement soon, Gazprom said.

"The idea of co-operation between Gazprom and **Lukoil** has been discussed for a long time and co-operation is taking shape now," **Lukoil** spokesman said.

He added that more details on joint projects might be announced next week.

The two companies signed a strategic deal November 2002 which gave Lukoil's natural gas access to Gazprom's pipelines.

## Russia Denies Iraq Arms Sales; Analysts Suspect Leakage

DOW JONES NEWSWIRES

(This story was originally published Monday)

By Geoffrey T. Smith

Of DOW JONES NEWSWIRES

MOSCOW -- A week after President Vladimir Putin described as "illegal" the U.S. decision to go to war in Iraq without U.N. approval, his own government faced accusations of having undermined U.N. sanctions by allowing sales of military equipment to Saddam Hussein.

U.S. allegations that Russian equipment capable of jamming Global Positioning Systems used in bombs and aircraft met with a full chorus of denials Monday - from the government, from arms exports agency Rosoboronexport and from Aviakonversiya, the company that makes the equipment.

"Russia strictly observes its international obligations," Foreign Minister Igor Ivanov was quoted by local news agencies as saying. "It didn't sell any equipment, including military equipment, in violations of the sanctions regime."

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Under sanctions approved by the U.N. Security Council, Iraq's foreign trade is governed by the U.N.'s oil-for-food program limiting imports to food, medicine and a restricted list of other nonmilitary goods.

Rosoboronexport was just as adamant, with a spokesman saying it "had nothing to do with any such sales, and we have no information that such sales took place."

Rosoboronexport is the sole state intermediary agency for Russia's military exports and imports. Its lack of involvement would normally imply that the exports bypassed official channels.

Such a scenario is possible, but would reflect a failure by Putin to bring a chaotic military procurement system back under central control, analysts said.

"One should acknowledge that they've done an awful lot to develop export control in the last few years," said Ian Anthony, project leader for arms transfers with the Stockholm International Peace Research Institute.

He noted that Putin two years ago gave the defense ministry direct responsibility for licensing arms transfers in an attempt to stop unauthorized shipments, something that "may have been a response" to initial reports of Russian equipment finding illicit ways to Iraq.

U.S. and U.K. air forces were already complaining in summer 2000 of interference with their GPS in enforcing the no-fly zones in southern and northern Iraq. At that time, Kuwaiti newspapers asserted that Aviakonversiya had sold its systems to Iraq through radical politician Vladimir Zhirinovskiy. Aviakonversiya Chief Executive Oleg Antonov had countered that "nobody among the Iraqi leadership wants to buy such things."

Antonov was quoted by Interfax news agency Monday as saying the U.S. had resumed protests about Aviakonversiya in September, adding that "tests of American high-precision armaments revealed the total loss of their efficiency against our jamming."

However, Antonov also claimed that the jamming equipment currently being used by the Iraqi forces was probably made either in Iraq "or with the assistance of the Yugoslavs."

Analysts at SIPRI noted that Russia has no record under Putin of undermining U.N. sanction regimes. As such, they doubted he would risk his relationship with the U.S. by making an exception for Aviakonversiya, a small company run by a few ex-Soviet Union army commanders who grew rich on a government monopoly for processing scrap metal from Soviet military hardware.

Unlike any of the country's major shipyards, no local economy is dependent on Aviakonversiya for employment, nor is it a valued beacon of Russian technological pride, like aerospace groups Sukhoi or MiG. Ironically, the spat threatens to overshadow a notable recovery in the past two years by the likes of Sukhoi, which has led a resurgence of big ticket export items such as tanks and fighter aircraft.

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However, the Cold War-era friendship between the Soviet Union and Iraq has left a legacy of issues that need official engagement, such as the \$8.5 billion in Soviet-era debt owed to Russia, largely for arms.

More extensive ties survive on a commercial level, even under the strictures of oil-for-food, and include contracts signed with Russian oil companies such as OAO **Lukoil** Holdings (R.LKO) to develop Iraqi oil reserves.

A company like **Lukoil**, which is now courting the international capital markets, can barely afford to fall foul of U.S. opinion. However, a number of Russian trading companies have made good business out of the oil-for-food program, buying nearly 40% of all the Iraqi oil exported under it last year, according to economics ministry data.

Many of these purchases included a surcharge paid to a separate Iraqi government account - a system that the U.N. said broke the rules of the oil-for-food program. The U.N. subsequently adapted its pricing formula for Iraqi oil to make the surcharge system unworkable.

Many of the Russian intermediaries active under the oil-for-food program are alleged to be former Soviet Union commanders, like Aviakonversiya's founders.

-By Geoffrey T. Smith, Dow Jones Newswires (+7 095) 974 8055;  
geoffrey.smith@dowjones.com

## **Russian Oil Industry Has Jump On Any Iraqi Competition**

DOW JONES NEWSWIRES

(This story was originally published Thursday)

By Anna Raff

OF DOW JONES NEWSWIRES

MOSCOW -- Russia's oil industry will remain the favorite of the international investment community despite the likely emergence of new opportunities in Iraq, analysts and fund managers say.

Even if Iraq's oil wells survive the war unscathed, it will take years - and billions of dollars - before the Middle Eastern country will provide Western oil majors with the returns that Russia does.

"Russia is much further along the curve compared to Iraq," said Paul Collison, a global emerging markets oil and gas strategist at UBS Warburg.

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Russia's largest oil producers such as OAO Yukos (R.YUK) and OAO **Lukoil** Holding (R.LKO) have posted double-digit production growth during the past three years as they become more financially transparent and reveal beneficial ownership. And as countries look to diversify away from Middle East crude, Russian oil has become an attractive option.

Multinational oil companies have taken notice.

Russia's oil industry was given a de facto promotion to investment grade when BP PLC (BP) last month said it would invest \$6.75 billion as a partner in what is to become Russia's third-largest oil producer.

Exxon Mobil Corp. (XOM) Chief Executive Lee Raymond said earlier this month the company will consider strategic partnerships with local Russian producers, along with Russian projects it could develop independently.

Russia has proved itself to be a stable political and economic regime, which is what Iraq needs before money will start flowing there, Raymond said.

The relatively cheap reserves in Russia fueled the BP deal, but now that Iraq's 120 billion barrels of proven reserves will be opened up to development, does that mean that global oil majors will stop sniffing around for other Russian acquisitions?

Probably not, Collison says.

"Even if you assume damage from the war will be minimal, then capital costs in Iraq are still going to run into the billions of dollars," he said. "It's not like turning on a faucet. And when more Iraq oil comes onto the market, it'll displace expensive production in the North Sea, Alaska and on-shore China."

Iraq produces 2 million barrels a day compared with Russia's 8 million b/d. Iraq exports 1.7 million b/d while Russia exports 3.5 million to 4 million b/d.

Any substantial output boost in Iraq will take four to seven years, taking into account the time it would take for the new government to settle and for project, contracting and subcontracting tenders to be conducted.

Meanwhile, major oil consumers such as U.S., China and Japan continue to actively court Russian officials as they move to diversify their crude imports.

Despite the disagreement between the U.S. and Russia over Iraq, the U.S. still wants Russia to be strong oil producer, U.S. Energy Secretary Spencer Abraham said during last week's visit.

"Of course, we can't tell our companies where they should buy their oil" but the U.S. is looking at ways to aid Russia's expansion of oil export capacity, Abraham said.

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He said he discussed a planned \$5 billion pipeline from Siberia to Murmansk - which will make direct exports to the U.S. feasible - during a meeting with Russian Energy Minister Igor Yusufov.

Such projects will be feasible only if oil prices stay above a certain threshold.

Most Russian oil companies plan their capital expenditures and rate of return on equity based on an oil price of \$16-18 a barrel and are safe bets at or above that range, said William Browder, Chief Executive of the Russia-dedicated Hermitage Fund.

The Organization of Petroleum Exporting Countries said Wednesday it would cut output if its basket price fell below \$22 a barrel. It currently is at \$27.18.

## **Saudis Interested In Working With Russia Oil Cos -Tass**

DOW JONES NEWSWIRES

MOSCOW -- Saudi Arabia is interested in the development of cooperation with Russian oil and gas companies, Saudi Minister of Oil and Mineral Resources Ali Naimi said in Moscow on Friday, Prime-Tass news agency reported.

Nami said he had met with representatives of Gazprom, Rosneft and Zarubezhneft, who showed interest in the market of Saudi Arabia. "We would like Russian companies to be present in Saudi Arabia, the same as our concerns to be present in Russia," the minister said.

Meanwhile, a number of Russian companies have made their presentations to Saudi colleagues. In addition, Lukoil and Neftegazstroj have shown the largest interest in such contacts, Co-Chairman of the Russian-Saudi Business Club Yuri Shafranik told Itar-Tass. The cooperation is beneficial for both countries, he said.

## **Russia Looks East To Find Markets For It Oil**

DOW JONES NEWSWIRES

MOSCOW (AP)--The Russian government has an enviable if ticklish dilemma to consider this week: Two Asian powers are lobbying for a first crack at eastern Siberia's oil, and Moscow must decide which gets preferential treatment.

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The Kremlin is expected to try to satisfy both China and Japan, an approach reflecting both a delicate geopolitical compromise and Russia's insatiable ambition when it comes to its key export commodity.

The Russian Energy Ministry plans to recommend to the Cabinet on Thursday that the Japanese and Chinese proposals be combined into one project, said spokesman Yuri Nogotkov.

The pipeline would eventually pump 1.6 million barrels of oil a day from fields near the shores of Lake Baikal, north of Mongolia, to Nakhodka on the Sea of Japan, but first a spur would be built to Daqing, the Chinese oil production center.

The pipeline to Nakhodka, which would run entirely through Russia, would be about 4,000 kilometers (2,500 miles) long. Daqing is about 320 kilometers (200 miles) south of the Russian border.

The huge project would give Russian oil companies a major boost in export capacity. It also would position Russia to become a sort of filling station for the east, which could bring significant geopolitical clout.

Success depends on scraping together enough money to finance the multibillion-dollar construction and tapping into sufficient oil reserves to make it worthwhile.

"The projects are being viewed as complimentary, but I'm very sure that the line to China will be given first blessing," said Adam Landes, an oil analyst with Renaissance Capital in Moscow. "There is sufficient oil and sufficient buying commitment. The other (link) is a much bigger and more ambitious project."

After years of post-Soviet decline, Russia began sharply increasing its oil production in 1999, led by a small brigade of privatized oil companies.

Home to about 10% of the world's proven oil and gas reserves, Russia upped its oil production again last month to 8.04 million barrels a day, according to the Energy Ministry.

Moscow is eager to provide an alternative to the turbulent Middle East, but it lacks the pipelines and port facilities to get all of its oil onto the world market. Storms on the Black Sea and freezing temperatures in the northern Baltic ports - here Russian oil pumped out of western Siberia begins its trek west now - have further choked exports, creating a glut in Russia's domestic market.

The domestic price hovers around \$4.50 a barrel, compared with the international price of \$33, said James Fenkner, an oil analyst with Russia's Troika Dialog investment company.

Oil companies are getting desperate.

But reaching agreement on the Far East pipeline has not been easy, and the Energy Ministry's Nogotkov said it was unclear whether a final decision would be made Thursday.

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The Japanese proposal would cost more than \$4 billion, almost double the price of a pipeline to China, and stretch nearly twice the length. But the Japanese have been lobbying hard, promising aid and technical assistance.

The Chinese have also been aggressive, persuading Russian President Vladimir Putin to sign a feasibility study last year and securing the support of Yukos (R.YUK). Russian No. 2 Lukoil (R.LKO) backed the Chinese project.

But not every Russian oil company is convinced that building an estimated \$2.4 billion pipeline directly to Russia's giant communist neighbor makes good business sense. State-owned Rosneft criticized the plan because the price of Russian oil in China would not be determined by the market.

The principal opponent of the China pipeline had been Transneft (R.TRN), the state-owned pipeline company that up to now has had a monopoly on Russia's aging and inadequate network.

However, Transneft appeared to drop its opposition last week, saying it was ready to fulfill any government decision.

It is unclear how China and Japan would respond to the proposed link between the projects. China is unlikely to raise any objections -oil could be flowing its way some three years before the other line is even completed.

But Japan might have something to fume over, particularly if it turns out, as feared, that oil fields along the planned route don't hold enough to continue the link.

Whichever path is chosen, analysts agree a new outlet will be good news.

"Russian oil companies will be outproducing Transneft's capabilities by the end of 2004," Fenkner said. "They need to figure out how to get this oil out of Russia."

**01/29/2001**

**BBC Monitoring**

**Source: Interfax news agency, Moscow, in English 1455 gmt 29 Jan 01/BBC Monitoring/(c) BBC**

Text of report in English by Russian news agency Interfax

Moscow, 29 January: The sale by BP of its 7 per cent stake in LUKoil will in no way affect the Russian oil major, Leonid Fedun, a LUKoil vice-president, told Interfax.

Fedun said LUKoil knew that BP intended to do something with the shares when it acquired them last year, as BP would have no reason to hold on to minority stakes in large projects.

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Nor will the sale of the 7 per cent affect the government's plans to sell 6 per cent of **LUKoil** shares for ADRs this year. Only a small amount of the **BP** 7 per cent will be sold for cash, Fedun said.

"We understand **BP** 's decision to sell and will preserve our relations in joint projects, such as the LukARCO project in Azerbaijan," he said.

Fedun also said **LUKoil** had paid for its 100 per cent of Getty Petroleum Marketing, which owns 1,300 filling stations in 13 states of the northeastern USA. As per an understanding, **BP** has started to supply Getty with enough oil products.

BP sells Lukoil stake to focus on Siberia gas  
By Sophie Barker (Filed: 31/01/2001)

BP AMOCO yesterday sold its 7pc stake in Lukoil, Russia's biggest oil producer, for \$657m (£449m).

The British oil giant sold \$237m in the form of Lukoil American Depositary Receipts (ADRs) at \$40.375 each, with the remaining \$420m sold in bonds guaranteed by BP and exchangeable into Lukoil ADRS. The ADR placement and bond offering were priced at close of trade in New York on Monday, the day BP unveiled its plans to sell the stake.

Tony Hayward, BP's vice-president for finance, called the sale as "a tremendous success", claiming a "substantial, high-quality demand for both the placement and the offering". BP inherited a stake in Lukoil from Arco, the American company it acquired last year.

The sale means BP's Russian interests are concentrated in the Kovyktinskoye gas field in eastern Siberia. BP owns a 10pc stake in Sidanko, a rival oil major to Lukoil and one of the partners in the gas field.

Steve Turner, oil analyst at Commerzbank, said BP had "almost got into Lukoil by accident", through Arco, and added that "BP never regarded Lukoil as core in the past", largely because of its interest in Sidanko, where BP has "an element of management influence". He said: "The logic for selling the stake is impeccable." BP shares fell 11.5 to 578.5p.

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