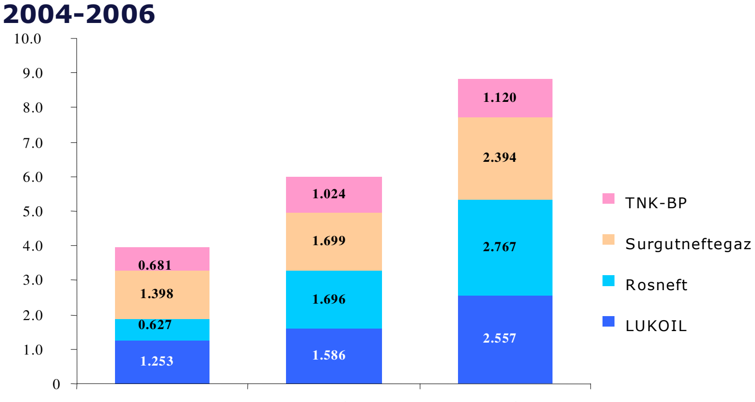
The Russian Oil Independents: Outlook for Growth

The following material is based on the study Independent Oil Producers in Russia: Analysis, Outlook and Assets by RPI to be released in November 2007.

The dynamics of growth in the Russian independent oil producer segment in the short- to mid-term perspective will depend on a combination of factors, internal and external:

- Foremost, growth will depend on energy prices in international markets. Any significant price decrease may affect the attractiveness of business, particularly for small players working with marginally profitable assets.
- Steady growth in the cost of production, from which Russia had been impervious until 2005, have become a reality for all oil companies in Russia, without exception. In the period 2004 though 2006, capital expenditures of the four leading Russian vertically integrated oil companies (LUKOIL, Rosneft, Surgutneftegaz, and TNK-BP) more than doubled, from nearly $4 billion to $8.8 billion.
- Considerable dependency on the proceeds from energy exports limits the government's ability to reduce the tax burden on major producers.
- The political significance of maintaining large quantities of exports: Russia's current leadership views exports as a tool for expanding the country's political influence internationally. In order to use this leverage or demonstrate its potential, the country must maintain – where possible, increase – crude oil production. The independent sector is one of the most promising for boosting production, especially as the government tightens control over the industry.

CAPEX of leading Russian VIOCs (billions of dollars), 2004-2006



Source: TsDU TEK, RPI research

M&A NEWS

StatoilHydro signs Shtokman Agreement with Gazprom

StatoilHydro has signed a frame agreement with Russian leading gas company Gazprom to become partner in the Shtokman field development project, phase 1.

The agreement gives StatoilHydro a 24% equity interest in Shtokman Development Company (SPV) where Gazprom and Total, the two other partners, own 51% and 25% stakes respectively.

Shtokman Development Company will be responsible for planning, financing and constructing the infrastructure necessary for the first phase of the Shtokman gas field development and will own the infrastructure for 25 years from start of commercial production. This includes offshore installations, pipeline to the shore and the onshore processing plants for both liquefied natural gas (LNG) and piped gas.

The implementation of the project is subject to a final investment decision in the second half of 2009.

"This agreement represents an opportunity for StatoilHydro to participate in the development of Shtokman phase 1," says Helge Lund, CEO of StatoilHydro. "We are looking forward to cooperating with Gazprom and Total to realise this frontier project."

The project planning phase aims at establishing an acceptable technical and commercial basis for the final investment decision, which is expected to take place in the second half of 2009. Until the final investment decision is made, StatoilHydro's exposure is limited to the company's share of the cost of planning and studies.

The Shtokman field, located in the Russian part of the Barents Sea, is the world's largest undeveloped offshore gas field with gas initially in place (GIIP) of around 3,700 billion cubic metres (bcm). The annual production is estimated to be 23.7 bcm for the first phase. The basis for phase 1 includes both LNG and piped gas.

25 October 2007

Rosneft gets FAS' approval to sell 50% share in Tomskneft

The Federal Antimonopoly Service approved acquisition by Vnesheconombank (VEB) of 50% share in Tomskneft from Rosneft. The application to FAS was filed by Rosneft but the buyer might refuse to close the transaction.

Rosneft acquired Tomskneft in May this year at YUKOS auctions for US$ 6.8 billion. Later in June it announced the sale of 50% share in the asset to VEB for US$ 3.4 billion. Some of VEB's representatives, however, denied bank's participation in the deal.

Earlier this month Rosneft published its US GAAP financial statements for 2 quarter 2007 in which it states its obligation to sell 50% share in Tomskneft by the end of 2007. The company has already received US$ 3.4 billion as an advance payment for the asset but did not transfer the shares to the purchaser yet. The purchaser's name is not disclosed.

According to Vedomosti, the final purchaser of the asset was supposed to be Gazprom neft, and VEB was involved into the deal as an intermediary. Later it was decided to remove the bank from the scheme. A source of Vedomosti mentioned that another state bank might be involved into the transaction, though neither Vneshtorgbank nor Sberbank could confirm this.

22 October 2007

Increase in costs limits the investment resources of oil companies; it dampens their appetite to "swallow whatever they can" while continuing to sit on undeveloped assets.

Once the sector's principal assets are concentrated in the hands of the government, a large number of less profitable assets will be released. VIOCs will simply not be able to invest in and manage all the assets to come into the market. Although it may sound paradoxical, consolidation will lead to better opportunities for independent players.

Prospects are problematic for the oil sector's growth once prime petroleum assets are concentrated in government hands. Experience worldwide has demonstrated that such concentration causes performance to deteriorate and costs to rise. For the time being, declining efficiency may be smoothed out by high prices for crude oil. When prices in the oil industry drop, we can expect a new turn in the relationship between the government and private business.

Taken together, the factors mentioned above suggest that the Russian independent producer segment is likely to grow in importance. Investment in the segment, domestic and foreign, is likely to increase correspondingly.

While analysis of development trends in the oil production sector over the last few years may at first glance appear to portend further decreases in the role of the independent producer in the medium term, there are adequate reasons, which may be grouped into two categories, to believe otherwise:

- Limitations on further consolidation of marginal assets within VIOCs
- Opportunities available to independent producers to expand their asset bases

Limitations on consolidation within VIOCs

Increases in the costs incurred by major oil companies and their sale of marginal assets

As costs continue to grow and taxes remain high, VIOCs will be forced to optimize assets. This will lead them to divest marginally profitable units in order to free resources for investment. At least some of these assets will end up in the independent oil producer segment. This, in fact, is already occurring.

NOVATEK signs cooperation protocol with TOTAL

OAO NOVATEK and Total E&P Activities Petrolieres ("Total") have signed a Protocol for joint cooperation in exploration and development activities. The Protocol contemplates that the companies will form working groups to define Russian and foreign assets for joint participation in natural gas and gas condensate projects.

The cooperation with Total is supported by one of NOVATEK's main shareholders, OAO Gazprom.

OAO NOVATEK is Russia's largest independent gas producer and the second-largest natural gas producer in Russia. Founded in 1994, the Company is engaged in the exploration, production, processing and marketing of natural gas and liquid hydrocarbons.

The Company's upstream activities are concentrated in the prolific Yamal-Nenets region, which is the world's largest natural gas producing area and accounts for over 90% of Russia's natural gas production and 20% of the world's gas production.

19 October 2007

Volga Gas completes Urozhainoye-2 licence acquisition

Volga Gas Plc, an independent gas exploration and production company, which currently holds four subsoil licences in the Volga Region of the European part of Russia, announced that it has paid the balance due for the Urozhainoye-2 licence. The licence area covers 354 km^2 and is located approximately 15 km to the north of the Company's Karpenskiy licence area and is in close proximity with up to 30 gas/condensate/oil fields. The Company, which on 7 September 2007 won the government-mandated auction for the

In 2006 LUKOIL offered a 100 percent stake in Arktikneft through open tender and Urals Energy paid more than $40 million to acquire the assets. Arktikneft holds rights to several license blocks in the Republic of Komi – Nizhneomrinsky, Verkhneomrinsky and Voivozhsky (residual recoverable reserves – 3.9 million tons) and the Peschanoozersky block on Kolguyev Island in the Barents Sea (residual recoverable ABC1 reserves of 7.5 million tons).

At the end of 2005, Russneft announced it would sell a controlling interest (51 percent) in Volganeft, an oil producer in the Samara Region. Samara-Nafta bought the asset. Since coming under the control of Amerada Hess, Samara-Nafta has been aggressively expanding its resource base and production.

Stronger competition from independent companies for reserves and growth in price of reserves

Licensing auctions in 2005 and 2006 show that the majority of auction bidders in most regions of the country are not affiliated with VIOCs, and in most cases they win the auctions – notable exceptions are auctions for large fields within areas of strategic interest to the majors. Independent companies obtained more than 160 license blocks for their own use during 2005 and 2006. With competition from independent producers intensifying and the price of reserves being bid up during the course of auctions, VIOCs may find acquisition of more and more asset-unattractive compared to investment alternatives.

Higher return on investment

VIOCs often buy rights to new blocks and fields as "spares". Accordingly, they are in no hurry to develop them. Independent producers, however, cannot afford to sit on the blocks they acquire doing nothing, they buy blocks for speculation. Most of the independents have appreciably fewer reserves than the VIOCs; therefore, the problem of resource replenishment for this segment is quite acute. For a company producing, say, 100,000 tons to 200,000 tons (2,000 to 4,000 barrels per day) of oil per year, commissioning even a small field helps – sometimes by tens of percentage points – increase production, dramatically boosting company value or capitalization. As single-commodity companies, the independents have virtually no other opportunities for increasing value (capitalization) than

Urozhainoye-2 licence area with the bid of RUR 44 million (US$ 1.7 million), has made the final payment of RUR 4 million (US$ 0.2 million) and received the licence.

The Company has also acquired some additional data on Sobolevsky Well 11, which discovered the Sobolevsky field and is currently in conservation. The well was drilled to a total depth of 3,307 m and the Bobrikovsky horizon was tested in a cased hole over four separate perforations between 2,647 m and 2,659 m in 1991. It initially produced 193 m^3 of oil per day (1,213 bbl/day) and 55.4 tcm/day (thousand cubic meters per day) of gas on a 8 mm choke. The well produced light oil; 0.845 g/cc (API 35.9). The horizon demonstrated good porosity and permeability (131 mDarcy). Productivity Index was estimated to be 2.67.

The Company intends to acquire the well in order to work it over and start production in 2008. 2-D seismic will be conducted over the licence block to identify further prospective structures to drill.

5 October 2007

FINANCIAL ADVISORY NEWS

Rosneft's Board of Directors Approves Bond Issue and Makes Adjustments to the Company's Business Plan for 2007

On 4 October 2007, Rosneft's Board of Directors held a regularly scheduled meeting where a decision was made to approve the future issue of nonconvertible interest-bearing bonds totaling RUR 45 billion. The bond issue is planned to consist of three tranches of RUR 15 billion each, two of which will be of five-year maturity and the third — of seven-year maturity.

Gazprombank, Vneshtorgbank and Troika Dialog will act as the

investing all available financial resources to expand their resource base and increase production.

Opportunities to expand asset base

Increase in offers of marginally profitable fields from the unallocated fund. Both the quality and structure of oil reserves under exploitation are deteriorating. Meanwhile, some 80 percent of explored oil fields in the unallocated fund contain reserves of the hard-to-recover category and are relatively small – between several dozen thousand to three million tons. Most blocks offered at auctions contain reserves at the lower end of this range. VIOCs have no interest in such fields, but auction activity shows that they could be very attractive to small and medium-sized independent companies.

Greater demand for investment resources to sustain macroeconomic stability. As large state-owned companies continue to expand, their efficiency will decline. As a result, more investment will be required and in the next five to ten years their investment resources may fall far short of requirements. These constraints are already affecting the investment logic of government-owned companies, exemplified by Rosneft's "sale" of 50 percent of Tomskneft to Vneshekonombank, Gazprom's use of Eni to purchase 24 percent of Gazprom Neft, as well as Gazprom's material delays in commissioning new facilities. The greatest threat to the government in this scenario is a decrease in oil production with concomitant declines in revenue. A significant drop in oil prices will threaten macroeconomic stability. The government may respond with mild tax cuts and tax preferences for players who do not control strategic reserves.

Tax breaks for operators of marginal fields. Reduction of the tax burden for the entire industry in order to replenish investment capacity would lower government revenues. Such a step is unlikely. More probable is that the government will offer ad hoc tax breaks to developers of marginal fields. In essence, unfavorable conditions confronting independent producers drive them to improve the efficiency of reserve development, apply technology innovatively, and reduce operating costs.

organisers for the bond issues. The Company plans to use the funds raised through the bond issue to refinance its existing debt obligations into longer term maturities and to further diversify its debt portfolio.

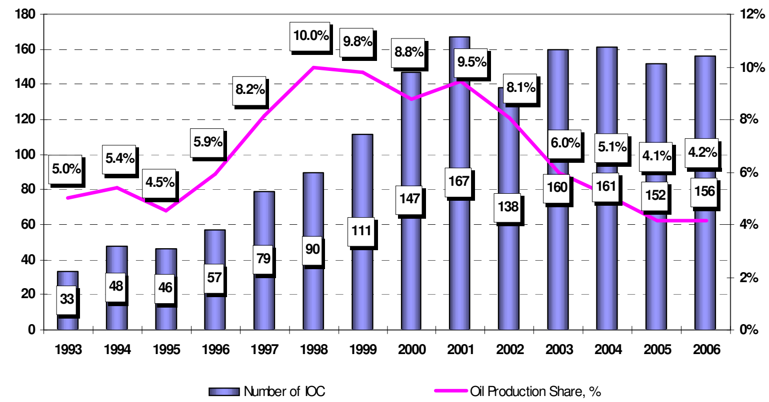
The Board of Directors also considered adjustments to the Company's business plan for 2007. These adjustments are necessary due to the Company's expansion following a number of acquisitions in the first half of 2007, as well as higher growth rates in production at a number of oilfields.

The corrected version of the business plan anticipates oil production in 2007 totaling 100.6 million tonnes, an increase of 24.5% over the previous year. This figure includes 100% of production at Polar Lights and Udmurtneft, 100% of Samaraneftegaz production beginning 1 June 2007, as well as 100% of production at Tomskneft for June 2007 and 50% of Tomskneft's production from 1 July 2007. This growth will be attained both through an increase in production at pre-acquisition assets — from 90.1 million tonnes per the original business plan approved last December to 91.2 million tonnes — and through the contribution of production from the assets acquired in 2007 — 9.4 million tonnes from the moment of their inclusion in the Company's business plan. Excluding the effect of acquisitions completed in 2007, production growth compared to 2006 is projected at 12.9%.

The new business plan also anticipates an increase in oil refining by 43%, a twofold increase in retail sales of petroleum products and a 25% increase in tax payments.

8 October 2007

Quantity of IOCs and their share in the overall crude production, 1993-2006



Source: TsDU TEK, RPI research

Despite the challenges faced by the independent oil producers, their segment remains highly attractive for investment. The expansion of the asset base through licensing and portfolio optimization will contribute to the processes of asset consolidation and divestiture, continually increasing the number of assets changing owners. This activity will be generating value for the industry by raising the efficiency of asset valuation and helping manage risks more effectively. The role of independent oil companies in making this machinery work efficiently is hard to overestimate.

RPI is a research and advisory firm on the energy industry of Russia, CIS, the Caspian region and Central/Eastern Europe. To obtain additional information about the study please address Vsevolod Prosvirnin by phone: +7 (495) 967-0117 or via email: Prosvirnin@rpi-inc.com

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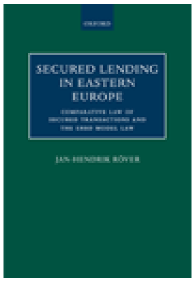

Jan-Hendrik Röver, Secured Lending in Eastern Europe. Comparative Law of Secured Transactions and the EBRD Model Law (Oxford 2007)

This new work is the first comparative study of central and eastern European secured transactions laws to be written in English. It gives a valuable insight into the legal reforms taking place in the transition economies of central and eastern Europe (and elsewhere), by explaining the general mechanics of secured transactions law in a helpful and practical way.

The book explores the characteristics that make security law useful from a practical point of view, the purpose being not merely to describe existing rules on security but to concentrate on the question of how those rules can apply in practice. The author concentrates on seven central and eastern European secured transactions laws in Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Russian Federation and the Slovak Republic. These laws are contrasted with the EBRD's Model Law on Secured Transactions and the EBRD's Core Principles for a Modern Secured Transactions Law. In addition, English, German and US law (which, among others, influenced the EBRD's work) are used as further reference sources.

The descriptions of eastern European laws were reviewed by Nörr Stiefenhofer Lutz, a leading European law firm, thus ensuring an up-to-date introduction to central and eastern European secured transactions laws.

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