Economic policy and the future of Russian oil production

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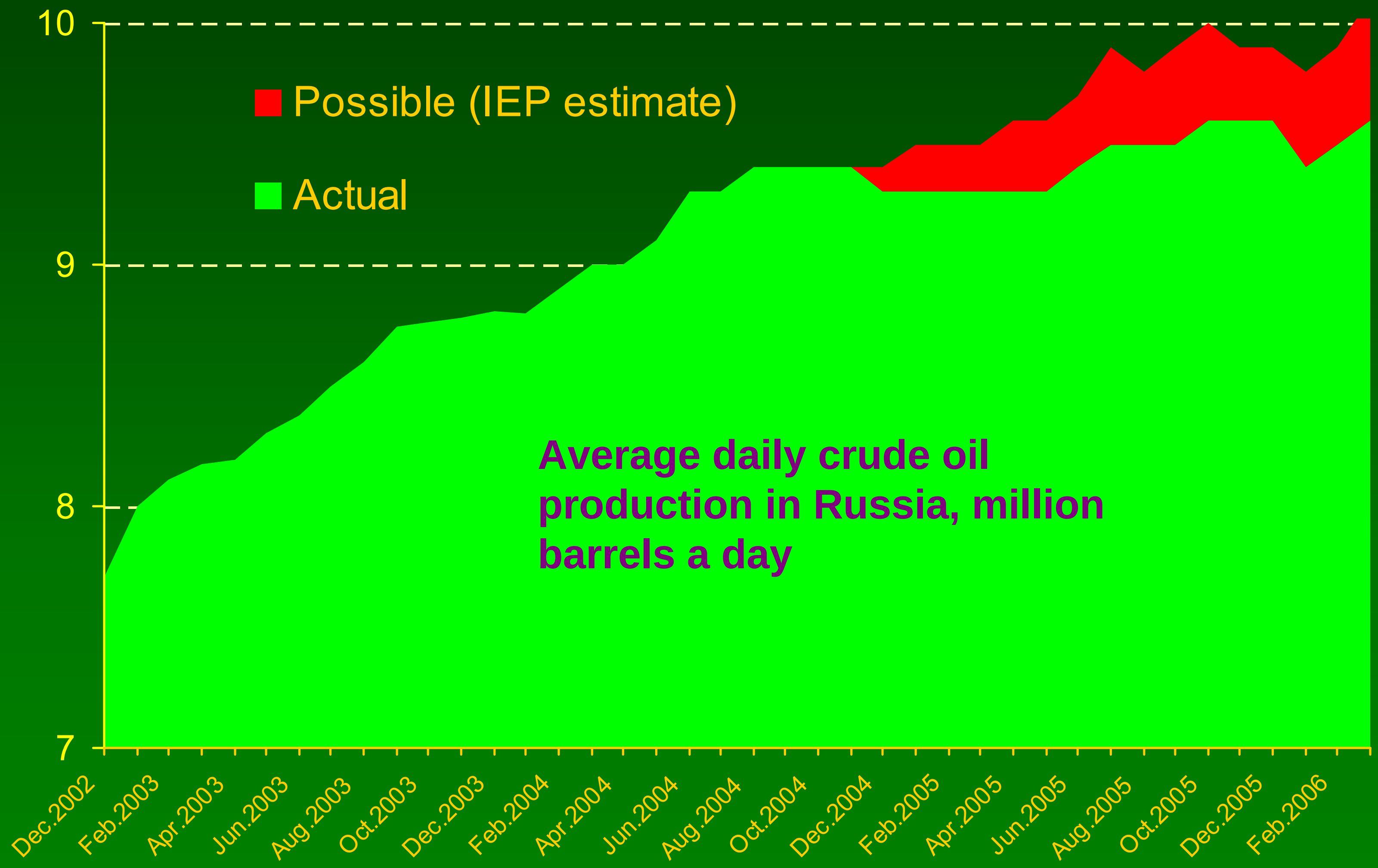
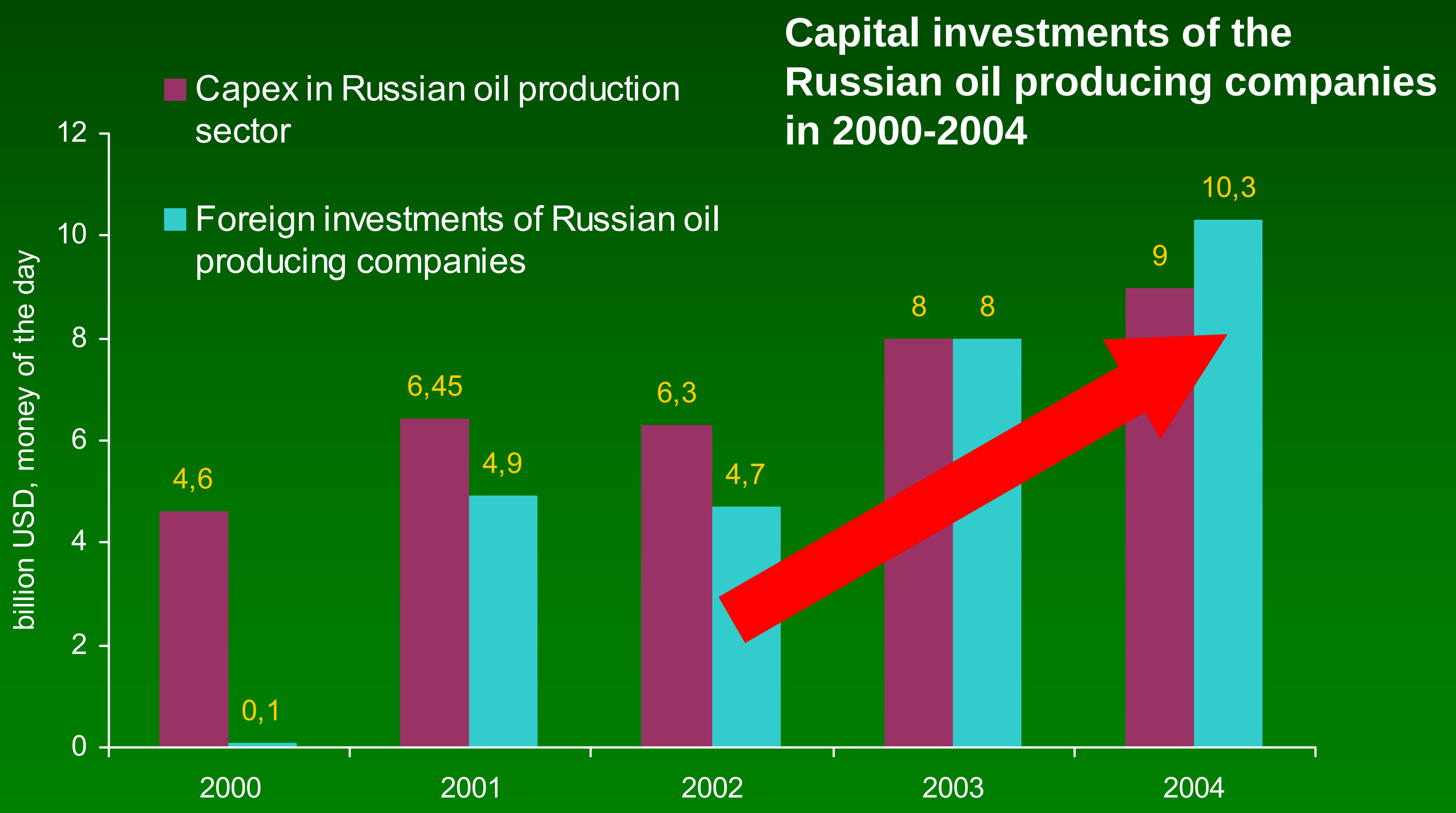
Oil output in Russia: where we are and where we could have been



Source: Oil & Capital, Institute of Energy Policy estimate

If not the political interference, Russian crude oil output could have reached 10 million barrels a day already.

Shift in investments in 2003-2004: from domestic production development to foreign countries

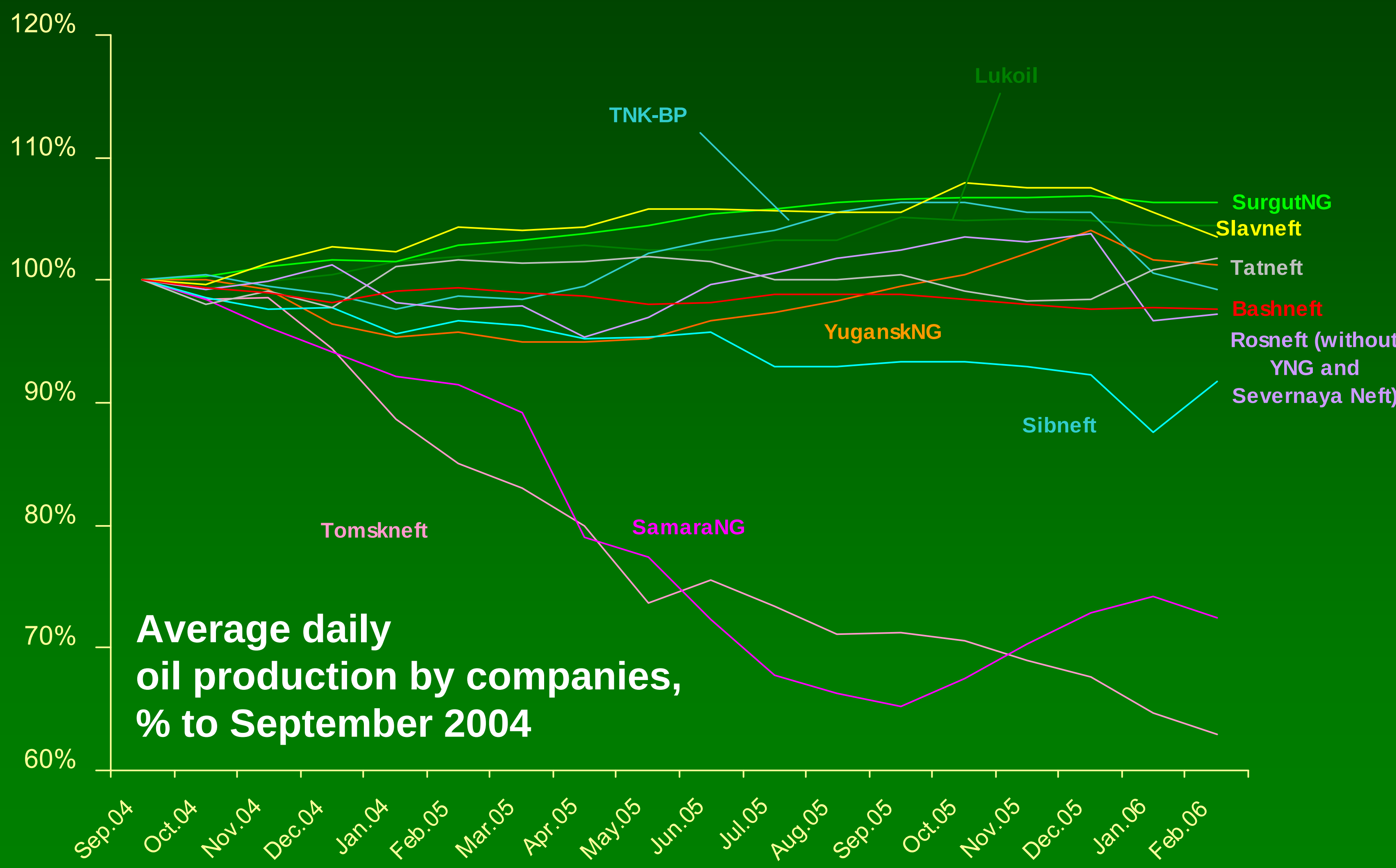


Source: RosStat

What's the reason behind slowdown of crude oil production growth?

- Hostile ownership changes
- Increase of oil export taxes in 2004
- Ban over private oil pipeline Western Siberia-Murmansk and remaining oil export pipeline bottleneck
- Speculation on 'barbaric production practices'
- The Yukos case

Production profiles of the Russian oil producing companies



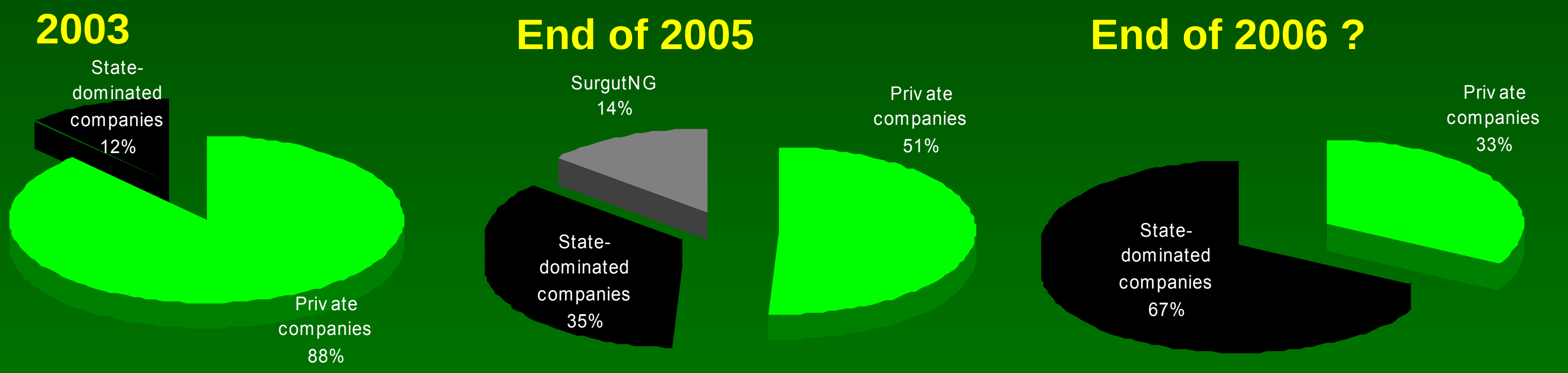
Source: Oil & Capital

How may the Russian crude oil output behave in the short term future?

- Lukoil, SurgutNG, TNK-BP will probably continue moderate climbing
- SamaraNG, Tomskneft, Sibneft will continue to fall
- These two trends will most likely counterweight each other
- YuganskNG is luckily keeping good shape due to continuity of production enhancement practices started by previous owners
- Remaining assets of Rosneft (without YuganskNG and Severnaya Neft), Slavneft, Gazprom, Tatneft, Bashneft and Russneft will show no significant growth
- The resulting picture allows to forecast nearly zero growth in the Russian oil industry in the upcoming 10-12 months

Structural changes: what share of the state can we expect?

The structure of Russian crude production



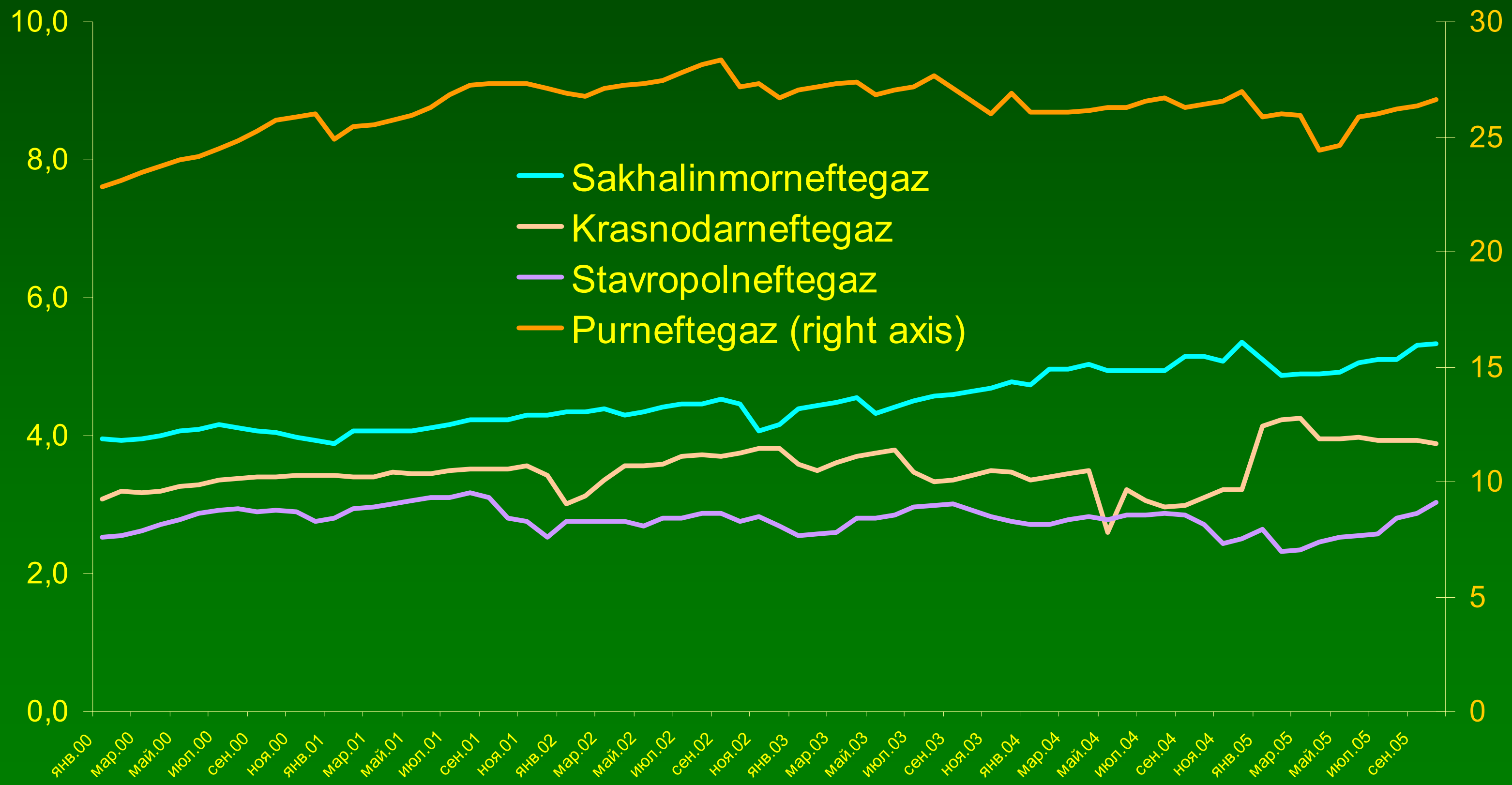
Russian oil industry may in 3 years transform from mostly privately owned to largely controlled by the state.

Who might be the next?

- **It's clear that Gazprom is not demonstrating the ability to efficiently manage Sibneft. In fact, including Sibneft in Gazprom was initially a temporary solution, Gazprom was simply used as a 'money bag'**
- **Sibneft and SurgutNG are managed by the people from the same clan. It is reasonable to expect that they are being prepared for the merger**
- **The 'Big Three' conglomerate establishment is possible, but Rosneft again appears to resist, like in the case of merger with Gazprom**
- **TNK-BP. By now, it seems that the ruling clan is so busy with consolidating already controlled assets, that TNK-BP ownership possibly may not change in the mid-term future**

Rosneft: profile of the new ‘champion’

Average daily crude oil production by major Rosneft subsidiaries in 2000-2005, thousand tons per day



Oil production of the core Rosneft subsidiaries had been stagnating during the whole period of 2000-2005

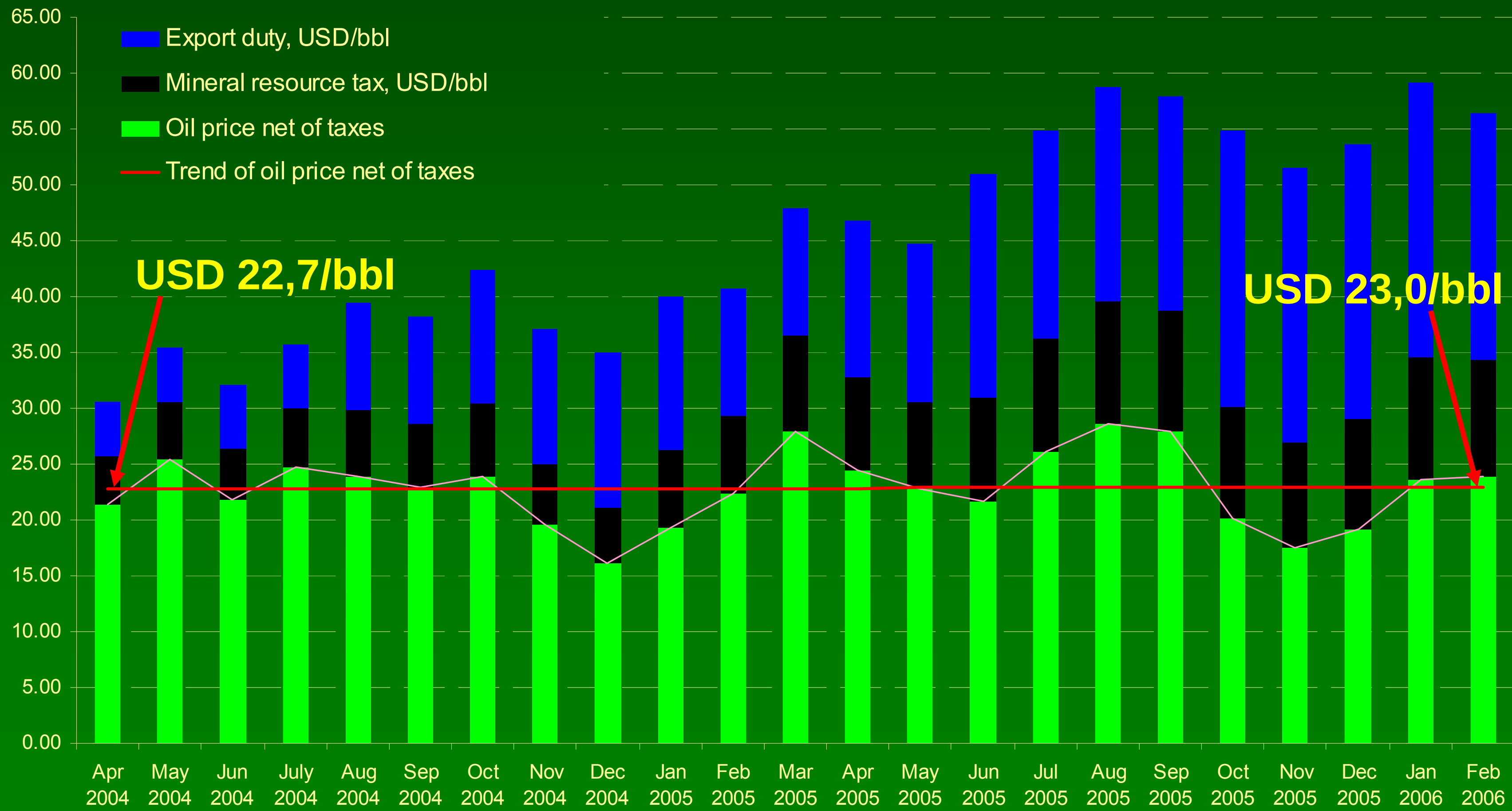
Source: Oil & Capital

Yukos bankruptcy and it's possible consequences

- Apparently Rosneft had bought back USD 482mln of Yukos' payables
- That's not enough for acquisition of key assets, but as YuganskNG auction shows, everything is possible
- It appears that the key areas of Rosneft's interest may be Tomskneft and VostSibNG

Progressive oil exporrt taxation: high oil prices are not visible for companies

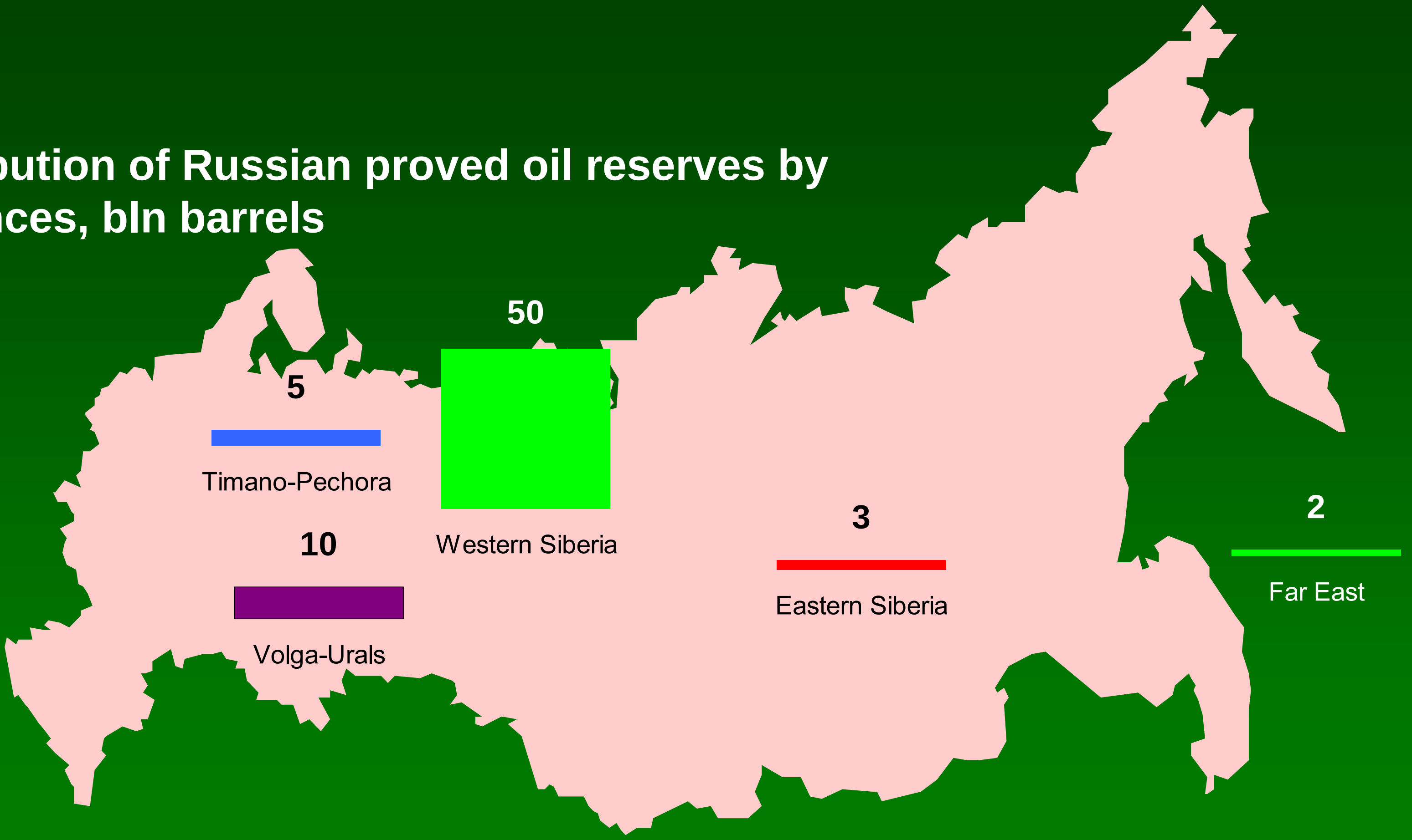
Share of the extraction tax and export duties in the export price of oil, 2004-2006, $/bbl



Source: Federal Taxation Service of Russia (information letters for tax calculations), Russian Federation Government (export tax value)

Where are the largest reserves located?

Distribution of Russian proved oil reserves by provinces, bln barrels

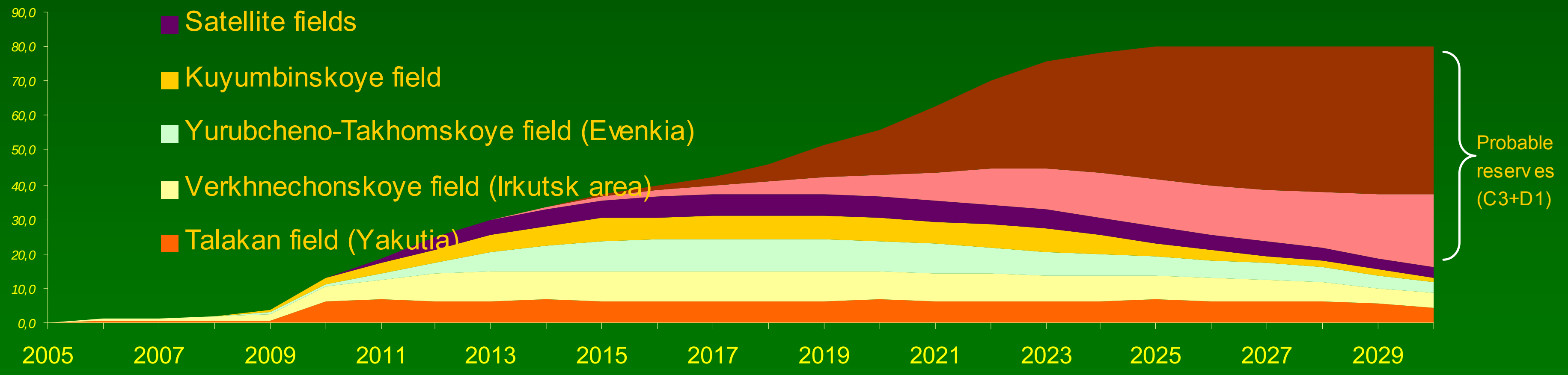


Western Siberia will remain the most important Russian oil producing region for decades.

Source: Oil & Gas Journal

Eastern Siberia: not a very large new province

Forecast for crude production on Eastern Siberian fields, million metric tons a year



Source: Russian Ministry of Economic Development and Trade

New approaches to oil production taxation: a small step in the right direction

Decided by Government

Tax discounts for depleted fields

- The state hopes to save 0.2 kbd of production from depleted fields, that otherwise would be shut down, in 2007-2010
- Fields with depletion rates over 80% will be given certain discounts for mineral extraction tax
- Tax administration mechanism is unclear

Tax exemptions for greenfield provinces

- Exemptions will apply to certain remote provinces (Talakan, Vankor, Yurubcheno-Takhomskaya zone, Verkhnechonsk, Timano-Pechora) identified specifically
- Exemptions may last for 7 years until cumulative production reaches 10-35 mmt (for various provinces)

Still being discussed

Changes in progressive export taxation

- Very sensitive issue for macroeconomics and the future of Stabilization Fund
- Minfin is openly against it, arguing about the good-looking overall sector's profitability numbers
- MEDT can not yet formulate the objective correctly

Changes in petroleum products taxes (domestic market excises, etc.)

- Retail excise taxes for petroleum products may be reduced for high-quality motor fuels
- This is likely to happen not earlier than 2007
- The very idea is too preliminary

Brief conclusions

- Oil production growth era in Russia is over
- This is not due to the ‘plateau’ yet, but is driven by economic policy constraints
- Constraints remain, so the production will be more or less flat in the upcoming months
- Asset redistribution will, in the upcoming period, concentrate around regrouping of companies already linked to the state
- New taxation ideas are positive but rather ‘symbolic’
- Eastern Siberia’s input to the industry’s development is probably overestimated – this is not an oil region
- Like the rest of Russia, oil sector is switching from investment and development model to a model based on rent-seeking behavior and cyclical redistribution of wealth