Russian Energy policy and the current investment environment

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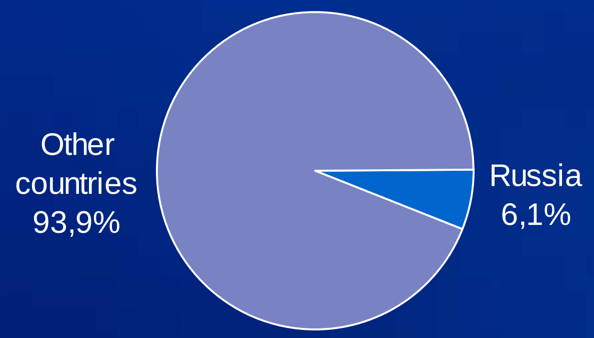
Importance of Energy Resources for Russia and the world

- **For Russia**
  28% of GDP, 48% of Federal budget

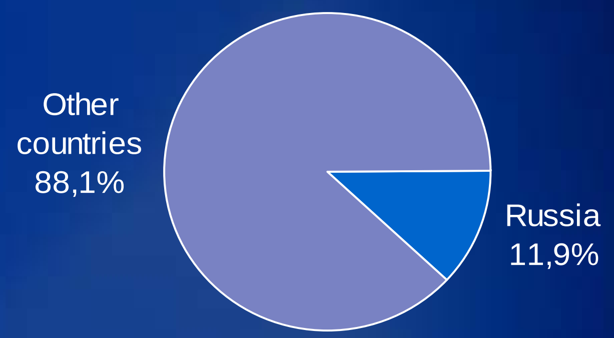
- **For the world**
  1/3 of natural gas, 1/5 of coal, 1/6 of Uranium of world reserves and 11,9% of the world oil production

Shares of known Gas&Oil Reserves and production in Russia

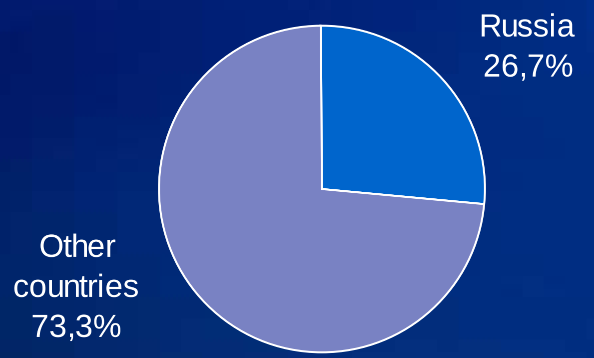
Russia's share in world oil reserves*



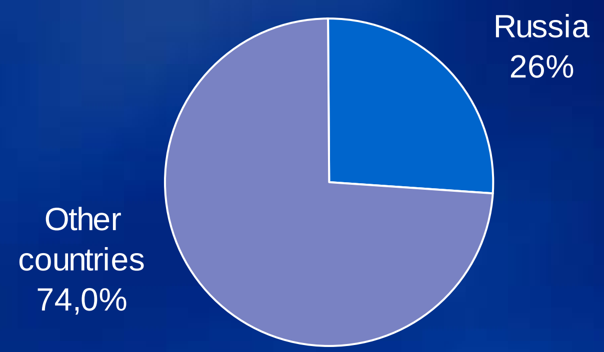
Russia's share in world oil production, 2006



Russia's share in world gas reserves*



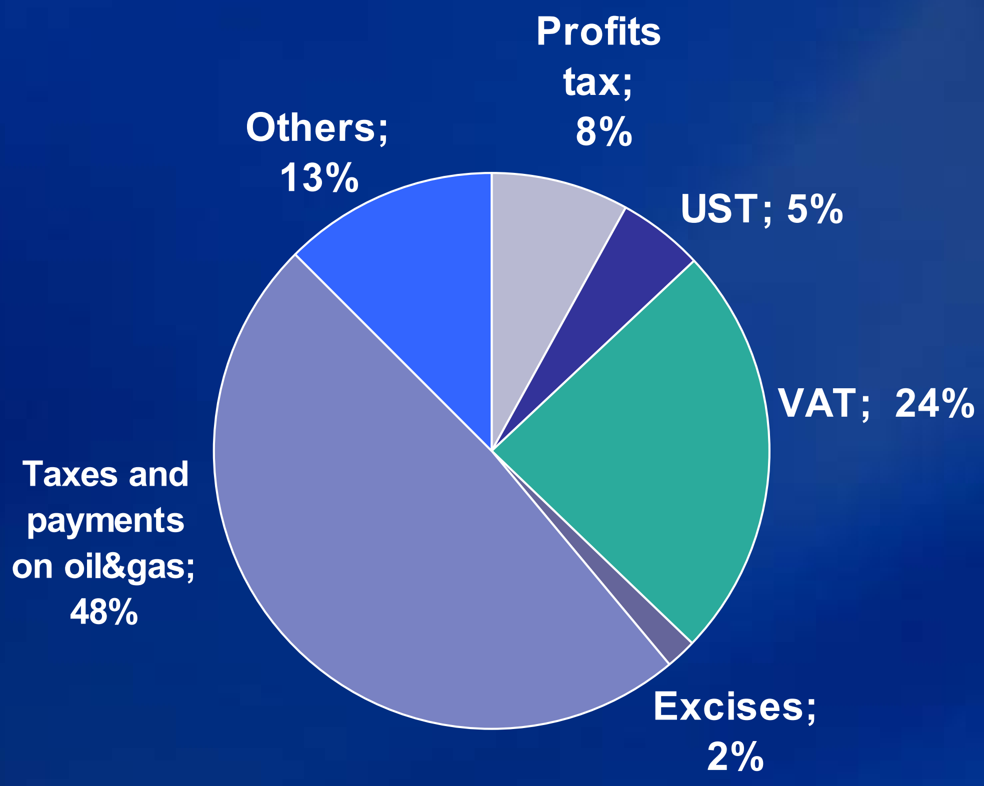
Russia's share in world gas production, 2006



* **Estimated proven**

Share of taxes, obligatory payments and export customs duties on oil and gas in the Russian budget

48% of federal budget in 2006



Resource nationalism in Russia(1)

<Background>

Disappointment with economic, social and political chaos caused by unconditional imitation of the Western model and freedom without control during Gorbachov's and Yeltsin's presidential terms

Putin created the new image of Russia as "Strong Russia" led by a strong government .

The government of Putin had two major tasks:

1) Integration into the world's globalization process

2) To maximize the natural resources as a tool for developing the economy of the country and getting back the previous hegemony in the international society

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Resource Nationalism of Russia (2)

Before 2003

(after the “perestroyka” till the end of Putin’s first presidential term)

- Liberalization of public sectors+ reform of state-controlled monopolies
- Abolition of various limitations
- Reduction of the government’s expenditures
- Support for FDI

After 2003

(starting from the end of Putin’s first presidential term)

- Reversed much of prior liberalization – “integrating and creating state-mega companies”
- Reimposition of limitations
- Increase of government’s expenditures
- Imposing limitations on FDI

Final objective:

to create conditions favorable to state-owned companies, allowing them to expand their market share

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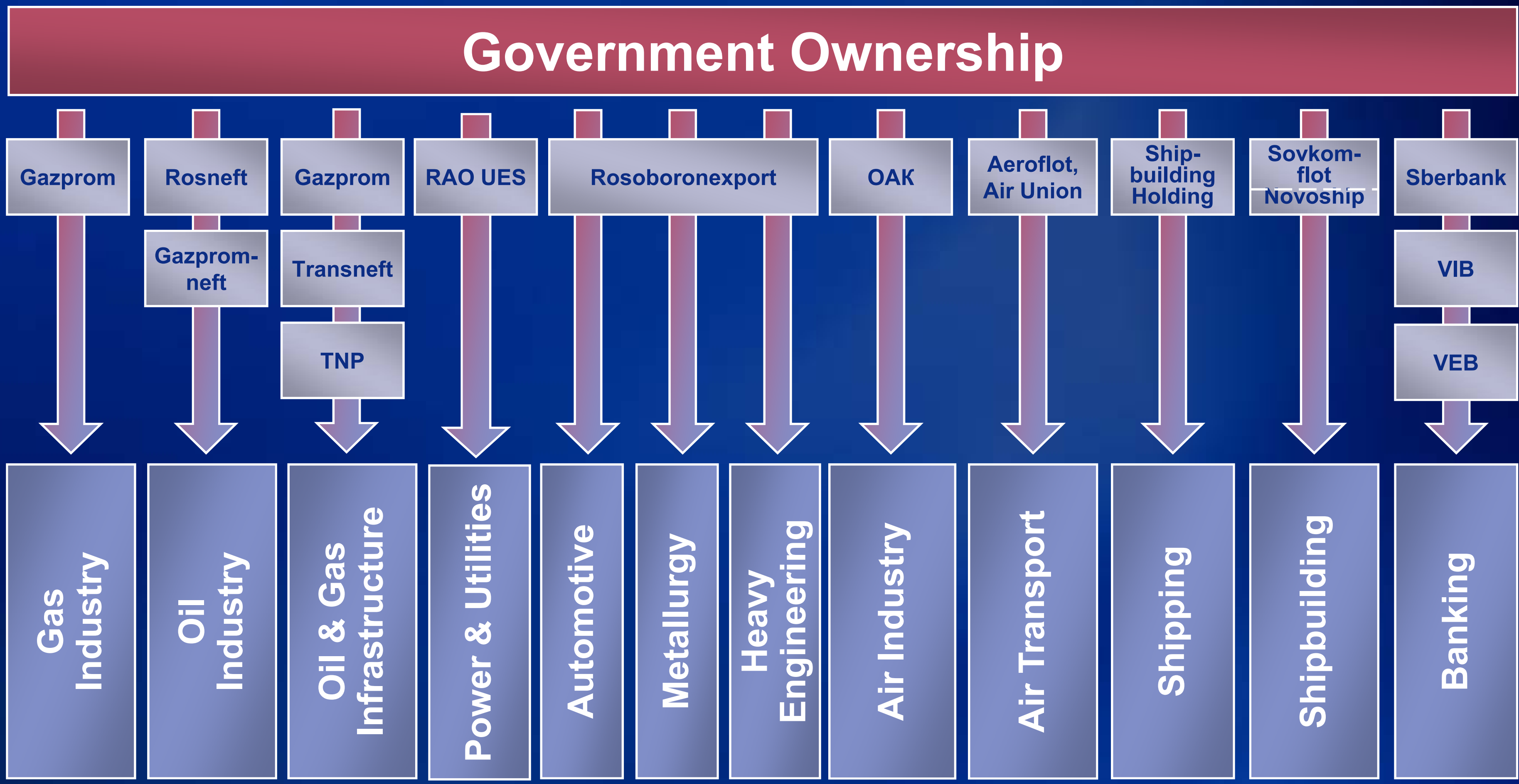
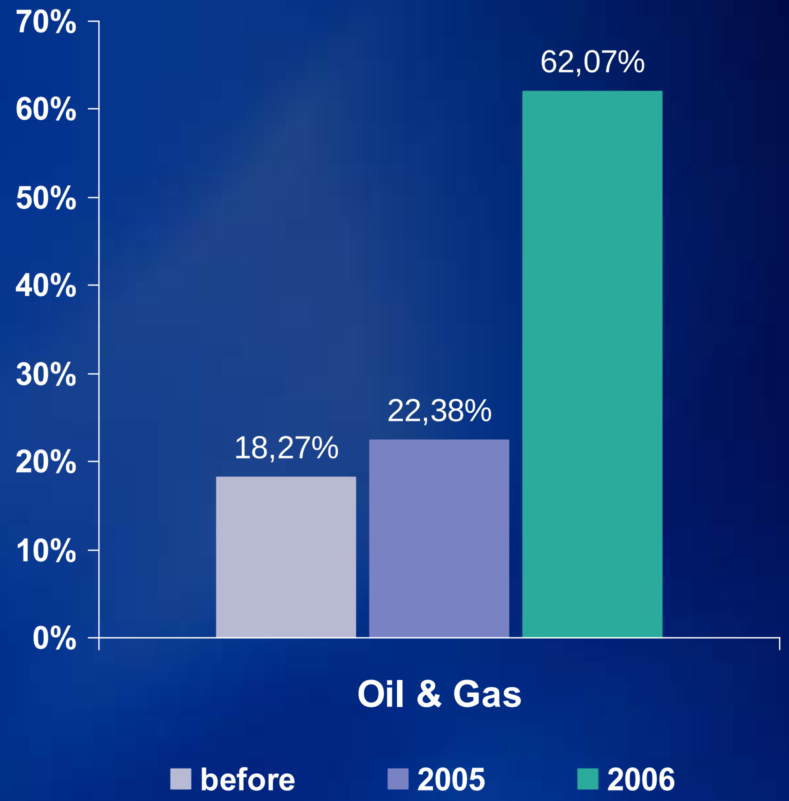
Government Involvement in Strategic Industries



IPO in oil & gas industry 2005-2006

- Capitalization of Russian oil & gas companies has increased by 8 times from 2001 till 2006
- Leader in terms of the amount of funds attracted through IPO in 2006
- Russian oil & gas companies are still undervalued in comparison with Western companies approximately by 20% (as per capitalization and net assets ratio in 2006)



Source: Infotec

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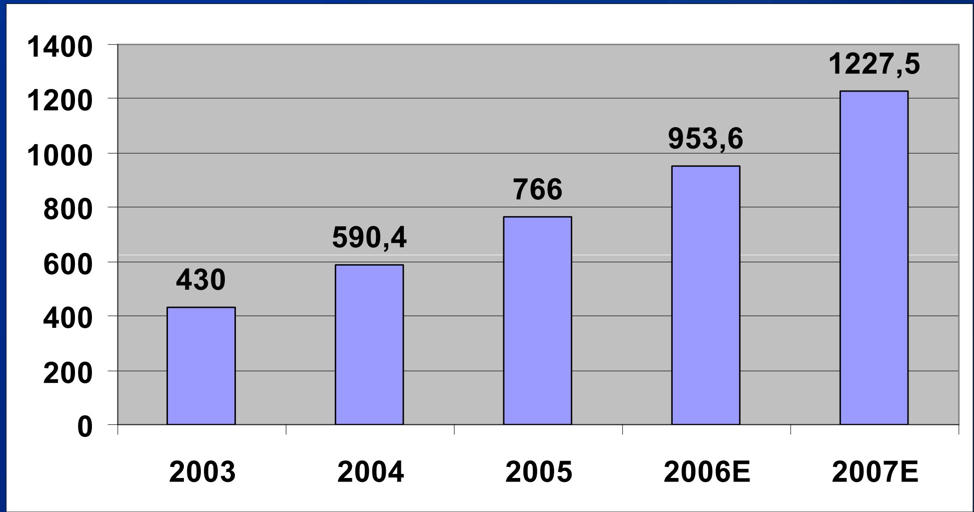
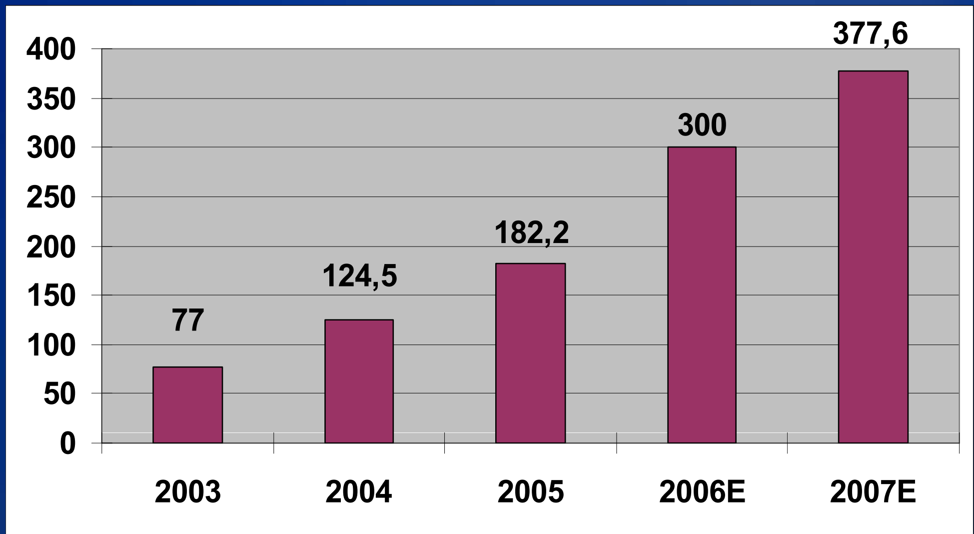
Macro-economic trends 2003-2007

GDP, billion USD



Central Bank reserves,

billion USD



Source: Deutsche UFG, e = estimates

Russian policy in the energy & natural resources sector – in general

Russia has applied a *differentiated policy* depending on the sector and the volume of investments required:

- **In the oil & gas sector, the Russian Government has favored state-controlled national champions**
- **In the metals sector, the Russian Government has supported primarily Russian state-owned firms**
- **In the power sector, the Russian government has implemented wide-ranging reforms and is allowing foreign firms to take full control of power-generating assets**

Russian policy in natural resources sector –
Draft law on “strategic” sectors

- Russian policy in the oil & gas and metals sector has been outlined in a draft law on “strategic” assets.

  But, now the situation with the draft law remains unclear, as the Russian Government decided on 15 October 2007 to delay adoption of a new law on strategic sectors

- In these areas, foreign investment will be subject to significant restrictions and control

Russian policy in natural resources sector –
Draft amendments to the Law "On subsoil" (1)

Current legislation – the law on "Subsoil" of 21 February 1992

- Russian and foreign companies can obtain licenses for extract of natural resources
- No limitations are provided for participation of the foreign companies in Russian companies operating natural resources wells
- The licenses are granted on the basis of results of tender (auction) organized by Federal agency for natural resources

Draft amendments to the Law "On subsoil" – to be considered by State Parliament

- Russian and foreign companies can obtain licenses for extract of natural resources
- License can only be obtained by Russian companies
- Rights to extraction of mineral resources can also be obtained on the basis of agreement with State authorities, rights under such agreement can be subject to assignment or mortgage

Russian policy in natural resources sector – Draft amendments to the Law “On subsoil” (2)

- For deposits situated on continental shelf or under territorial waters of the Russian Federation – only Government grants rights for extract of natural resources
- A license can only be assigned in the course of reorganization, from parent company to Russian subsidiary, from subsidiary to Russian parent company or in the course of acquisition of assets of a bankrupt company – holder of license

- A foreign investor cannot hold more than 50% of voting shares or voting rights that allow to foreign investor to appoint the CEO of the company and/or appoint more than 50% of members of the Board of Directors, if the Russian company holds license or participates in tender (auction) for obtaining the license for “strategic” deposits (subsoil)

“Strategic deposits” **are:**

- Containing more than 70 mln tones of oil or more than 50 billion m3 of gaz
- All deposits on continental shelf of the Russian Federation

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Russian oversight of the oil & gas resources sector

Over the past year the Federal Service for Sub-Soil Use, part of the RF Natural Resources Ministry, has sought to enforce environmental regulations, alleging that foreign investors have breached regulations

- **In the Sakhalin-2 project Shell, Mitsui and Mitsibushi compelled to change the project terms and accord Gazprom a majority stake. And then the environmental allegations were dropped.**
- **The Sakhalin-1 project, led by ExxonMobil, has been informed that the project's output – gas should preferably be sold in Russia and not exported.**
- **TNK-BP's Kovytka project was put on hold owing to licensing violations. BP sold its stake to Gazprom earlier this year. Now it appears that the project may proceed.**

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Russian oversight of the power sector

- In general the Russian Government has applied a more liberal regime in the power sector.
- At the same time, foreign investors have been encouraged to participate in the tender sales of stakes in utilities spun off from RAO UES of Russia
- It should be noted that the Russian Government sets limits on the tariffs that utilities may charge to certain consumers

Rules of the game - foreign investment is welcome – oil & gas sector

Foreign investment is welcome,

- if it does not hold a controlling stake in a Russian oil and gas firm (for example, ConocoPhillips - 20% of LUKOIL)
- if it is on the basis of reciprocity:

  example (1) - BP has set up a JV with Gazprom, in which it will contribute foreign assets in exchange for the right to develop gas fields in Russia

  example (2) - After ceding a stake in Sakhalin-1 to Gazprom, Shell has signed a groundbreaking partnership with Rosneft to cooperate on oil & gas projects
- if foreign companies offer know-how.

  (for example, on 4 October Shell signed an agreement with Tatneft to develop oil-bearing tar sands in central Tatarstan)

Background : Issues that Russia faces

- Industry is expected to grow via expansion of domestic supply rather than export
- High concentration of the industry, creation of vertically integrated companies - low productivity
- Slowdown of increase in crude oil production over last years
- Non sufficient quality of oil products
- High depreciation of equipment engaged in oil and gas extraction and processing
- Reserves are located in regions difficult to access with complex mining and geological conditions and comparatively low quality of oil

Ownership of Russian Oil & Gas Companies (reference 1)

Company	Direct & indirect State control	Shareholders
LUKOIL	-	Conoco-Phillips (20%)
TNK-BP	-	BP (50%)
Rosneft	85,05%	BP (1.5%) Petrobras (1.5%)
SurgutNG	-	Information is not available
GazpromNeft	-	Gazprom (55.99%) Deutche Bank (20%) Gazprom Finance(16.66%)
Tatneft	34%	ING Bank (Eurasia) (22.99%)
Slavneft	29%	TNK/BP (50%)
Russneft	-	During the transfer process from Gutseriev to Basel
Bashneft	-	Information is not available
Gazprom	49,11%	E.ON Ruhr Gaz (6.5%), Deutche Bank (3%) Vostok Nafta (1.7%)

Foreign Investments in Russian Oil & Gas Sector - (reference 2)

TNK-BP

- Investment program for 2007 - $ 4 bln.
- Development of the Uvatskaya group of fields (2007-2009) > $2.5 bln.
- $1 bln. will be spent each year on drilling until 2011
- $3.8 bln. will be spent on acquisition of licences to develop new oilfields
- Plans to achieve 95% utilization of casing-head gas until 2010 by investing $250mln. in processing facilities

ConocoPhillips

- Total amount of investments since 1990 – over 11bln.
- > $ 7.5bln. invested since 2004 in acquisition of 20% shares of LUKOIL
- 50% share in the JV with Rosneft (Polyarnoe Siyanie LLC):

Ardalinskoe field – 1,2 mln of tons/ year

Foreign Investments in Russian Oil & Gas Sector – (reference 3)

Shell

- Sakhalin-2 PSA: total investments over $20 bln. The project is led by Sakhalin Energy Investment Company - Gazprom (50% + 1 share), Shell (27.5%) Mitsui (12.5%), Mitsubishi (10%)
- Salymskaya group of oilfields: planned investments > $1 bln. (JV with Russian oil company "Evikhon")
- Zapolyarnoe field: preparation for extraction (with Gazprom)
- Participation in the Caspian pipeline consortium

Total

- Investment program for Stockman gas condensate field – $ 4-5 bln.
- Kharyaga PSA - $ 450mln. have been invested and $ 800 mln. are expected to be invested during next stage

Foreign Investments in Russian Oil & Gas Sector – (reference 4)

ExxonMobil

- Sakhalin-1 PSA: total investments over $12bln. made by the Consortium (ExxonMobil – 30%, Rosneft – 20%, ONGC – 20%, SODECO – 30%)

ENI

- 50% share in the “Blue Stream” project (Russia-Turkey gas pipeline) completed with Gazprom - $ 3.2bln. investments by ENI and Gazprom
- $ 5.8bln. invested in 2007 together with Enel in acquisition of the gas companies owned by Yukos and 20% shares in Gazpromneft (the latter will be sold to Gazprom).

Enel

- Purchase of 25% of OGK-5 (Russian energy company) for $ 1.5bln.
- Planned investment in acquisition of OGK-3 - $ 1bln.

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Rules of the game - foreign investment is welcome – power sector

- Russia's electricity infrastructure is in dire need of capital investments. Half the country's 29 nuclear power plants use the design of the ill-fated Chernobyl plant. Approximately 60 percent of Russia's 256 hydro-electric power plants are over 25 years old.
- Investment needs have been estimated at USD 5-10 billion a year for next 10 years
- The sector is attracting significant investment:

1) On 4 October Italy's Enel announced plans to expand operations in Russia by investing up to USD 9 billion in power generation.

2) In June Enel acquired 25 percent of wholesale power generating company OGK-5 from UES for USD 1.5 billion

3) On 15 October Germany's E.On signed a contract to acquire a 69 percent stake in wholesale power generating company OGK-4 for EUR 4.1 billion

Conclusion – understanding of Investment environment

- Foreign oil & gas firms limited to minority stake
- Foreign Investment is welcome, if investors accept Russian "rules of the game"
- In spite of fact that foreign major companies can face regulatory uncertainty in Russia, they continue investing on the bilateral basis with Russian state-owned companies.
- Now the observance of the law(in tax or ecological issue) became the basic and essential tip to secure the stability of business

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