Vladimir Matias
Managing Partner
ASSET CAPITAL PARTNERS
/an investment banking and financial advisory company/

Citius, Altius, Fortius!

(this article was published by RPI Inc. (http://www.rpi-inc.com) as an introduction to their report
"The Independent Oil Producers in Russia: Companies and Assets", October 2005)

This RPI report comes right on time. Today we are becoming both witnesses and architects of the most exciting times in the history of private oil companies. Unprecedented oil prices together with a favorable macroeconomic climate in Russia result in the rapid growth of Russian vertically integrated oil companies (VIOC) and at the same time change the situation of medium and small producers. We see a rapidly changing picture, where almost like in sports, new players appear suddenly and advance quickly (like RUSIA Petroleum), while others leave the stage mainly due to dynamic consolidation of the sector.

Compared to the 1990s situation of falling production and an almost total lack of investment in the oil industry, today's situation is totally different. There's no longer a lack of capital inflow, in many ways thanks to the improving investment climate in the country and major upgrade of Russia's credit rating. What we have today is almost unlimited access to both Russian-source capital and Western investors and lenders. The sole decisive criteria now are access to promising, quality fields, the government political will in the case of strategic assets and the art of management that is needed for success.

Unlike certain other government-regulated oil-producing regions (North Africa, Near East, Latin America), Russia with its more private-oriented ownership of the oil sector is experiencing two main market trends. On one hand, VIOC efforts result in **consolidation** of the market in the hand of oil majors. This means that young market players "dissolve" in the general mass of the vertically integrates companies. Companies act according to the principle of 'buy everything that has good proven reserves" and, possibly, production. On the other hand, high oil prices draw **new players** into the market: private investors and independent oil companies (IOC). At present, there are about 150 IOC in Russia that account for about 7 percent of the country's oil production. Acquisition of developed fields is attractive to Russian as well as foreign oil majors that need to replenish their reserves. Takeovers of IOC with producing assets allow them to put increased reserves and production on their balance sheets. Due to the fact that well-developed oil assets are becoming increasingly rare, foreign investors' interest in Russian IOC will only grow in the future. This attracts additional capital to the country and improves the economy of both the industry and the country.

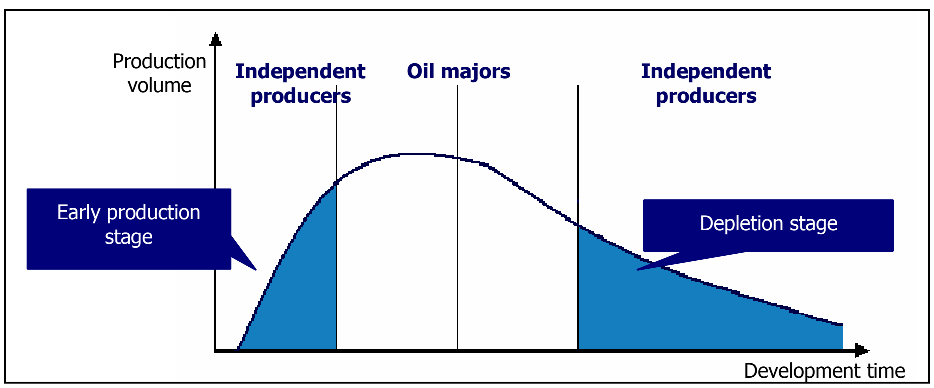
Russian IOC face the following types of difficulties:

- Dependence on one type of product; limited or no access to refining facilities that are entirely controlled by the majors;
- Limited access to pipeline systems and, as a result, difficulties with oil exports;
- Complex reservoir geology, including inferior production conditions, resulting in lower flow rates and higher production costs;
- Lack of modern technology;
- Limited financing opportunities due to the overall lesser transparency and lack of IAS or US GAAP accounting;
- No international reserves audits;
- Greater competition due to improved efficiency of the Russian oil majors.

Typical segments of IOC involvement in the field development process:

a) Early production stage at new fields (with appropriate exploration risks and investments in infrastructure) and

6) Falling production stage (see diagram)



Source: AssoNeft

Russian VIOC (such as LUKOIL, TNK-BP) are paying increasing attention to overall business efficiency and are implementing so-called portfolio asset management, i.e. dispose of non-core-business assets and subsidiaries, where production level and profitability are not up to their standards. These assets may be of interest to both Russian and foreign IOC, simply because these companies have lower management costs and more opportunities to control their cost structures compared oil majors.

Obviously, small companies are in a more difficult situation compared to VIOC. Due to the lack of or insufficient own resources and, as a result, limited access to capital markets, IOC are unable to compete with oil majors for the most promising fields at licensing auctions. Therefore, they can develop only less attractive fields with lower reserves and undeveloped infrastructure. If they successfully implement their business plans and become well-established producers, these companies often pursue takeovers by larger players. In this case, shareholders get higher profits that cover the greater risks inherent in that strategy. This type of IOC behavior is typical not only for Russia but also for foreign oil-producing regions.

In the immediate future, one should expect the advent of a different type of players. Some potentially attractive assets (a) are currently in the exploration or early production stage and/or (b) blocks are licensed after certain breaks are offered by the government at open licensing auctions. Most likely, these assets soon will be able to go over the 1,000-barrels-per-day production mark and be added to the list of 43 companies covered in this RPI report.

For successful and rapid growth, IOC will need access to loans and new oil assets. Recently, this is occurring more frequently due to high oil prices and gradual improvement of the investment climate in the country. In this situation, Western financial institutions and both Russian and foreign private investors are willing to take non-conventional risks and lend even to the smallest companies, provided that the latter have proven reserves and good business plans.

The new version of the law "On Subsoil," which provides for auction-type licensing, will also improve development of the oil sector. Switching from license authorization to a contract type of licensing, including the ability to transfer subsoil-use rights and use them as collateral will create better financing opportunities (including loans from foreign banks). All this, even despite certain limitations on foreign participation, should positively affect the liquidity of these hydrocarbons assets in Russia.

This report comes exactly on time, when independent oil companies' issues are becoming very relevant. As the first document of this kind on the subject, the report is professionally done and very well fills the vacuum of information for the market players as an excellent analytical database. For each company, the report provides substantial information in terms of its history, ownership, available licenses, reserves, production, crude quality, sale volumes and routes. A clear and systematic approach to the valuation of companies and individual assets, plus a simple and concise manner of presentation make this report a reference book for professional oil producers and private investors, consultants and investment bankers.