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LUKOIL: RUSSIA'S LARGEST OIL COMPANY

BY

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ABOUT THE POLICY REPORT

THE CHANGING ROLE OF NATIONAL OIL COMPANIES IN INTERNATIONAL ENERGY MARKETS

Of world proven oil reserves of 1,148 billion barrels, approximately 77% of these resources are under the control of national oil companies (NOCs) with no equity participation by foreign, international oil companies. The Western international oil companies now control less than 10% of the world's oil and gas resource base. In terms of current world oil production, NOCs also dominate. Of the top 20 oil producing companies in the world, 14 are NOCs or newly privatized NOCs. However, many of the Western major oil companies continue to achieve a dramatically higher return on capital than NOCs of similar size and operations.

Many NOCs are in the process of reevaluating and adjusting business strategies, with substantial consequences for international oil and gas markets. Several NOCs have increasingly been jockeying for strategic resources in the Middle East, Eurasia, and Africa, in some cases knocking the Western majors out of important resource development plays. Often these emerging NOCs have close and interlocking relationships with their national governments, with geopolitical and strategic aims factored into foreign investments rather than purely commercial considerations. At home, these emerging NOCs fulfill important social and economic functions that compete for capital budgets that might otherwise be spent on more commercial reserve replacement and production activities.

The Baker Institute Policy Report on NOCs focuses on the changing strategies and behavior of NOCs and the impact NOC activities will have on the future supply, security, and pricing of oil. The goals, strategies, and behaviors of NOCs have changed over time. Understanding this transformation is important to understanding the future organization and operation of the international energy industry.

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LUKOIL: RUSSIA'S LARGEST OIL COMPANY

Isabel Gorst, Financial Times of London

How does Lukoil belong in a major international study about state oil companies?

Lukoil is not a state oil company although it sometimes talks, acts and looks like one.

Lukoil is the oldest, biggest and best known of the giant corporations that grew out of the ruins of the Soviet Oil Ministry and has long been a flagship of the Russian oil industry both at home and abroad.

At its inception, Lukoil was Russia's first bold experiment with private oil ownership and with decentralised oil industry decision making. But the company, sometimes pioneering oil policy, sometimes following orders, has always acted in close coordination with the government, often presenting itself as a faithful servant of state.

Until recently, Lukoil's Western critics often complained that the company was a dinosaur, rooted in the operational and management practices of the past. But Lukoil is in fact highly adaptive, surviving over fifteen years of tectonic change in the Russian oil industry.

The latest structural upheaval in the Russian oil industry has thrown up a new breed of privileged, state controlled oil and gas giants competing with Lukoil both in terms of size and as agents of domestic and foreign policy. Rosneft, the state oil company has leapt from obscurity to become Russia's third biggest producer in the past two years. Gazprom, always a giant natural gas player, has barged into the oil business since buying Sibneft, an oil major formerly controlled by Russian billionaire Roman Abramovich in 2005. Lukoil may fight for its continued ascendancy or accept a place in the shade. Alternatively it could fragment or merge with a state company. It seems likely that Lukoil will, even if it maintains its private ownership, will increasingly act at the behest of the government. Certainly, the company will avoid crossing swords with the Kremlin. Such compliant behaviour could conceivably become a model for international majors seeking to redefine themselves and their roles in the new global landscape where state oil companies are gaining precedence over private ones.

In the current context of the Russian oil industry, a company that is 100 per cent privately owned is a member of a shrinking club. In the past three years the Russian government has steadily reasserted control over the oil and gas sector. State companies such as Rosneft and Gazprom which function as natural gas monopolies, have built up their oil portfolios largely at the expense of the private sector. Yukos lost almost 60% of its 1.8 million barrels a day production to Rosneft when its West Siberian producer, Yuganskneftegaz, was sold at an auction in December 2004 held to help the federal authorities recover billions of dollars worth of alleged tax arrears. Yukos was officially declared bankrupt in 2006 and is being dismembered. Sibneft, like Yukos, one of the big success stories of the Russian oil industry in the early part of the decade, was taken over by Gazprom in 2005 and now forms the core of the natural gas monopoly's new oil unit Gazprom Neft. State companies appear rich enough to buy any asset

they fancy. The \$13.7 billion Gazprom paid for Sibneft was the biggest ever acquisition in Russian corporate history. International banks, encouraged by Russia's high credit rating, soaring hard currency reserves and buoyant economic growth are eager to lend, particularly to state companies producing oil and gas.

Russia's state companies have turned corporate raiders. Some 1.7 million barrels a day of production moved back into state hands in 2005. The Kremlin's advance on Russian industry has been so relentless that many believe it is simply a matter of time before more big companies fall at least partially under the state yoke. There is intense speculation that in 2007 a deal will be brokered allowing Gazprom or Rosneft to replace Russian shareholders that own 50% of TNK-BP, the Russian British major. Rumours have even circulated that Surgutneftegaz, a Kremlin-loyal producer focused on West Siberia, may soon be victim of state incursion.

So far there have no moves by the Kremlin to retrieve oil properties from Lukoil, which in 2005 accounted for 20% of Russian oil output and 19% of the Russian crude delivered to Western markets. Mr Alekperov claimed in an interview last year that Lukoil was safe from attack. It was not, he said, the government's goal to swallow up the entire oil industry. Gazprom and Rosneft have already built highly promising portfolios. He added that neither he, nor other Lukoil shareholders, were prepared to sell their stock.¹

Lukoil may not be for sale. But the company, once fiercely independent, has begun to work more actively in partnerships with state companies Rosneft, Gazprom and Gazprom Neft, a policy shift that may in future help ensure its survival.

But it is a complicated balancing act. Rival groups in the Kremlin support different state oil companies. Mr Alekperov is said by Western sources to spend 80% of his working hours in and around the Kremlin watching out for any shift in the balance of power.

¹ Vedomosti, August 31st 2006: A5.

Russia's next presidential election in 2008 is expected to involve the smooth transfer of power to a candidate of Vladimir Putin's liking. But there is a risk that a power struggle will break out behind the scenes in the Kremlin between rival oil and gas groups. Lukoil could get caught in the cross fire.

Lukoil may look too solid, too adaptive and too diversified to attack. Arguably the company's best defence is its track record of loyalty to the government and its willingness, when required, to rank its commercial interests below the economic and political imperatives of the state. To a Western outsider that loyalty might look like po-faced pragmatism. But what distinguishes Lukoil from the huge Western majors upon whom it has largely modelled itself is its apparently genuine sense of destiny as a pillar of the Russian nation. In the words of Vagit Alekperov, Lukoil's founder and President,

The efficient development of reserves is directly linked to national security. On the one hand, it preserves the economic integrity of the country; on the other hand, it strengthens national positions in the international arena. The concept has always been the same: in the Russian Empire, in the Soviet Union and in the Russian Federation. It will remain this way, until the 'oil era' is over.²

This statesmanlike declaration makes abundantly clear Lukoil places national loyalty high on the agenda. What is less evident is how Kremlin demands on oil companies will evolve in the coming years and to what extent Lukoil's loyalty to the authorities will cost both in lost opportunities or revenues and ultimately shareholder value. However, rebellion from the private sector is unlikely. The cautionary tale of Yukos' destruction at the hands of federal taxmen will echo in the Russian corporate memory for years.

Russian state social systems fell apart during the economic slump of the 1990's. Today's privately owned companies are increasingly required to take responsibility for public living standards in areas where they operate. Lukoil prioritizes social projects involving children and

² Speech on National Oilmen's Day, September 2005

education, worthy goals that, even if costly, provide valuable benefits in terms of image improvement.

The Russian government's plan to restructure the oil and gas sector around huge state controlled entities that incorporate sizeable, but nonetheless minority private interests, rolls on inexorably. This study focuses on what makes Lukoil distinctive from its Russian competitors and attempts to assess its prospects of remaining, if not the leading Russian oil company, at least a strong, influential player within the new, as yet untested set of parameters set by the Kremlin. Lukoil is, and always has been Russia's biggest oil producer:

- Lukoil appears to be totally loyal to the state and has for long acted as a bridge between the government, industry and foreign companies.
- Lukoil has acted as a pioneer in the Russian oil industry during a period of massive change, moving ahead of the pack into new upstream and downstream areas.
- Lukoil is the only Russian oil company to have built up a diversified business empire that now spans the globe. The company has interests in the Caspian, Middle East, Central Europe, North Africa North and South America. This unique international portfolio allows Lukoil to serve as an oil ambassador for the Russian government overseas.
- Lukoil has established itself as an important independent gas producer forging a rare *modem vivendi* with the Gazprom gas monopoly.
- Lukoil has expanded into the petrochemicals sector which will in the future provide a commercial outlet for its growing gas production.

HISTORY OF A GIANT – SIZE MATTERS

Vagit Alekperov, Lukoil's founder and long time President was a highly successful businessman in the oil industry long before the Soviet Union collapsed. Raised in Azerbaijan,

one of the oldest oil provinces in the USSR, Mr Alekperov moved to West Siberia to begin his oil career working in the Caspian Sea. By the 1970's, he was established in West Siberia where he was named the general director of producer Kogalymneftegaz at just the age of thirty seven. The appointment marked out Mr Alekperov as the boy wonder of the Soviet oil industry – few oilmen achieved prominence so young at the time. It also distinguished him as a pioneer – Kogalym was then a new producer pushing out the boundaries of the West Siberian oil patch.

Mr. Alekperov rose to prominence in an oil industry that was monopoly-owned and controlled by the central government in Moscow. He was used to thinking big and was able to think outside the box. The Soviet Union produced more oil than any other country in the world.. Mr Alekperov told a Western oilman in the early 1990's that his goal was to create Western style oil corporation on a scale to rival ExxonMobil. In terms of size, the dream was beginning to come true.

Lukoil was the first oil company to emerge out of the Soviet Ministry of Oil which began to crumble after the USSR collapsed in 1991. The Ministry monopolised the entire Russian oil business during Communist times. Lukoil broke away in 1992 as a voluntary merger of the three West Siberian producers, Langepas, Urai and Kogalym and two refineries at Volgograd and Perm in the heart of industrialised European Russia. In 1993 this entity was transformed by government decree into Russia's first joint stock oil company. Lukoil's original assets remain to this day the core of its upstream and downstream business.

Little has been disclosed about how Mr Alekperov first grasped and then maintained control over Langepas, Urai and Kogalym, or how he built his own substantial equity stake in Lukoil, the amalgam of the three producers. Certainly, having a top job at the oil ministry just as the industry began to fragment must have helped. As deputy minister – a post he assumed in

1992, Mr Alekperov attended consultations with international bankers who could give advise on the restructuring of the crucial oil sector where the idea of setting up vertically integrated oil corporations in place of the Soviet-style monopoly was, possibly for the first time, aired. Kogalym, his former stamping ground, was a natural choice of asset for Mr. Alekperov. His employment there would have entitled him to some shares during the government's voucher privatisation scheme in the early 1990's which passed much of the state's industrial property into private hands. Investors with insight and the benefit of local contacts were able to build shareholders by buying up vouchers from other beneficiaries of the scheme. It is important to note that Lukoil was established before the government launched the highly controversial loans for shares program of the mid-1990's. Under this program, several huge natural resource companies were passed to then favoured businessmen at low costs in exchange for credits to the government. Companies or individuals earlier involved in the loans for shares scheme now carry political risk. The shares for loans scheme was crafted by businessmen and financiers with close contacts and often jobs in the government.

Mr Alekperov was not without strong support in the Kremlin. Viktor Chernomyrdin, the former head of Gazprom and Russia's prime minister from 1992-1998, is understood to have been a strong Lukoil supporter and possibly even an early shareholder. Mr Chernomyrdin survived as the head of the government far longer than other ministers in Boris Yeltsin's fast rotating administration. Lukoil had a protective godfather at the heart of the government. Mr Chernomyrdin, a career gas man, had founded Gazprom in the 1980's and wanted to see a similar, giant oil company emerge in Russia.

Since its inception, Lukoil has always been the biggest oil producing company in Russia. Size matters everywhere in the oil industry, nowhere more so than in Russia. Yukos fought a

prolonged battle in 2004 to dislodge Lukoil from the top of the Russian oil hierarchy. It came close – the two companies produced almost identical volumes of oil in that year. Competition from Yukos prompted Lukoil to adopt a fundamental restructuring program aimed at cutting costs and improving efficiency. But the company’s operational policy remained unchanged.

Yukos’ biggest production assets have now fallen under the control of Rosneft, the state oil company. Lukoil is once again the unchallenged leader of the producer pack, accounting for just over 19% of the total Russian production and 2% of world oil supplies.

It remains to be seen how long state-owned Rosneft, which tripled its production overnight after acquiring Yuganskneftegaz, will be content to remain in Lukoil’s shadow. Rosneft is still at the stage of increasing production by acquiring additional exploration and production assets. Having built up portfolios in the north Caspian and the Timan Pechora region in the 1990’s, Lukoil is primarily enjoying organic production growth. However, Rosneft is beginning to encroach on areas dominated earlier by Lukoil and may soon usurp the company’s leading role.

Sergei Bogdanchikov, Rosneft’s President, has declared that the company’s goal is to become Russia’s number one producer³. During a meeting with President Putin, Mr Bogdanchikov said that Rosneft planned to produce 104 million tons of oil in 2010 and 125mt – to 128mt in 2015. Informed by Putin that the state had no intention of forming an oil monopoly, Mr Bogdanchikov replied, “we have a normal competitive battle”.

Whatever Mr Bogdanchikov says, the playing field on which Rosneft will challenge Lukoil is unlikely to be level, if recent history is anything to go by.

³ Vedomosti, August 11, 2005: B2.

TABLE 1: RUSSIAN OIL PRODUCTION BY COMPANY IN 2005

Company	Oil Production
Lukoil	1.79 million (b/d)*
TNK/BP	77 mt** (1.548 million b/d)
Rosneft	74.6 mt (1.5 million b/d)
Surgutneftegaz	63.859 mt (1.28 million b/d)
Sibneft	33.04 mt (664,208 b/d)
Tatneft	24.54 mt (493,489 b/d)
Yukos	24.5 mt (492,684 b/d)
Slavneft	24.2 mt (486,652 b/d)
Bashneft	18 mt*** (361,972 b/d)

* (b/d) = (barrels/day)

** mt = million tonnes

*** estimate

(Source: Company archives)

Fourteen years after founding Lukoil, Mr Alekperov has gone a long way towards attaining his vision for the company in terms of size. Lukoil's reserves of 20.07 billion barrels of oil equivalent (boe) are larger than all private companies except for ExxonMobil's 22 billion boe. Recent discoveries in the north Caspian Sea may allow Lukoil to overtake ExxonMobil as the world's richest private oil company in terms of reserves. Lukoil's average daily oil output of 1.9 million b/d in 2006 still has a long way to rise before levelling with the 4.2 million boe that the world's biggest privately owned producer pumps every day. However, Alekperov has not lost sight of his original goal. Lukoil's strategy for intensive growth announced in October 2006

outlined plans to invest \$66 billion boosting combined oil and gas production to 210 million tonnes (4.2 million boe) by 2016.

Lukoil blazed a trail for other Russian oil corporations formed later in the 1990's as the industry shifted into private hands. The company has remained a pioneer and motor for change throughout its fourteen year lifetime during which the world's biggest oil industry has undergone not just one, but two periods of radical restructuring.

While its competitors clung to the rich oil heartlands of West Siberia, Lukoil began an advance into new Russian provinces like the North Caspian and the Timan Pechora Basin in the mid-1990s. Immediate gains in production growth were sacrificed while the company built up new upstream strongholds that would guarantee Russian output growth in coming decades.

This strategy was unfashionable at the time in Russia. Yukos and Sibneft, both applied advanced technology to maximise yields at existing fields and neglected exploration. The two were hailed as the drivers of the Russian oil renaissance as production rose at an astonishing speed. But the mood has changed. Yukos and Sibneft are now being criticised for plundering oil reserves with no care for tomorrow.

Lukoil's unique approach to the upstream sector began to pay off in 2005 when new regions began to contribute more significantly to its production. It was fortuitous that oil production began to build rapidly at a time of record high world prices. Lukoil's West Siberian reserves are of lesser quality than those of some of its competitors, a fact that goes some way to explain the company's early decision to diversify the geography of its upstream operations ahead of the pack. However, a company driven by purely commercial, rather than part national interests, might have focused more sharply on monetising existing upstream assets rather than branching out into new areas, particularly during a time of rising world oil prices.

Lukoil's strategy entailed some risk, but thanks to close links with the government in the Yeltsin era, the company had bagged some choice exploration acreage. The insider advantages enjoyed by Lukoil in the 1990's were lost when Vladimir Putin came to power and began bringing Russia's business oligarchs to heel. Rosneft and Gazprom are now Kremlin favourites. Private oil companies must tow the government line or risk extinction as the Yukos case demonstrated.

INTERNATIONALISING

Russia's goal is to create huge transnational energy companies that can earn significant revenues and bolster its influence on the world stage. But Lukoil is so far the only Russian oil company to have internationalised to any significant extent. The company picked up its first foreign assets in 1996 when it acquired a stake in a BP-led consortium developing three fields offshore Azerbaijan. Lukoil now has operations in the Caspian, Central Europe, Middle East North Africa and South America. Foreign fields account for only 5% of the company's total output. Lukoil's target is to increase that proportion to 20% over the coming decade. Overseas diversification may offer some protection from attack by Russian predators, or in the worst case scenario, a place of safety should Kremlin policies swing against Lukoil.

Downstream, Lukoil has acquired oil processing facilities and gasoline retail networks in Romania, Bulgaria, Ukraine, the Baltics, Finland, Belarus and former Yugoslavia. Lukoil established a foothold in the US downstream in 2000 when it bought a chain of gasoline outlets on the east coast formerly owned by Getty Petroleum.

Lukoil is without question the best known face of the Russian oil industry overseas. Its relatively high profile overseas befits an internationally listed company with a diverse range of foreign and Russian shareholders. Some other Russian oil companies such as Rosneft have at

times acquired foreign assets, but none have remained active for long in the international arena. The official explanation for their retreat home has been that better opportunities exist in Russia. This may be true, particularly for companies that are able to pick up acreage in Russia on favourable terms. But Lukoil may have come close to hitting a glass ceiling in Russia. The company accounts for around 20% of Russian production and may face restrictions if it attempts to gain a larger share of the pie.

There is a marked geopolitical dimension to Lukoil's activities in the international arena where the company was for a long time regarded as Russia's foreign oil ambassador. Boris Yeltsin appointed Lukoil as coordinator of all Russian projects in the Caspian Sea in the mid-1990s. It was a job for a trusted insider. Huge undeveloped oil and gas reserves lay beneath the Caspian. But the offshore, which until the Soviet Union collapse had been controlled by Moscow and Tehran, was now being claimed by five independent littoral states. Lukoil has used its early Caspian privileges to good effect. The company's Caspian portfolio now includes projects off Azerbaijan, Russia and Kazakhstan. Opportunities are being pursued offshore in Turkmenistan and Iran. No other oil company has established such a comprehensive presence in the Caspian Sea.

In return, Lukoil played a stabilising role during the complex Caspian boundary negotiations between Russia, Kazakhstan and Azerbaijan. Demarcation agreements inked in the early part of this decade packaged certain offshore fields for joint ownership by different republics with each government nominating its representative for projects that could eventually yield billions of dollars of revenue. Lukoil was obliged to share two of its offshore discoveries in the Russian sector with KazMunaiGas, Kazakhstan's state oil company. Meanwhile, Kazakhstan has accommodated Rosneft in the highly prospective Kurmangazi exploration project.

Financial aspects of these arrangements have not been revealed. It seems likely that the deals were motivated more by politics than economics, with Lukoil, a private company on paper, acting as a facilitator on behalf of the state. However, there were impressive commercial benefits as well. Lukoil is now involved in more Caspian Sea oil and gas projects than any other oil company.

Similarly, Lukoil's strong foothold in oil and gas fields onshore in Kazakhstan and Uzbekistan has enabled Russia to maintain its strategic interests in former Soviet Central Asia, a vast area stretching from the Caspian Sea to the Chinese frontier that Moscow once considered its own back yard.

The same can be said for Lukoil's downstream activities in Central Europe and the Balkans which have prolonged the region's dependence on Russian energy imports beyond the Soviet era.

As the only Russian oil company actively engaged in the international arena, Lukoil has come to serve as Russia's calling card overseas. However, this unique role will be steadily eroded. Russia's new goal is to form transnational energy corporations that are fully integrated with foreign markets. Both Gazprom and Rosneft are now actively pursuing foreign projects and partnerships upstream and downstream. Rosneft's fledgling alliance with the China National Petroleum Corp (CNPC) may eventually form the foundations of a long term relationship between the world's biggest producer and fastest growing consumer of oil. Meanwhile, Gazprom is forging closer relations with Iran which holds the world's second biggest gas reserves after Russia.

It is possible that Lukoil may either opt or be coerced into joining state companies in certain politically pertinent international projects.

PARTNERING FOREIGN MAJORS

Lukoil has entered partnerships with a number of foreign majors including Atlantic Richfield (Arco) which is now part of BP, Italy's Agip and, most recently, ConocoPhillips. All these relationships have been targeted on defined upstream projects inside or outside the former Soviet Union. It is noticeable that none of Lukoil's foreign partners have gained access to the company's homeland in West Siberia which still forms the core of its upstream portfolio.

Lukoil was the first Russian company to sell stocks overseas and to enter strategic partnerships based on equity sales with foreign oil players. Lukoil placed securities on the American market in December 1995 in the form of American Depositary Receipts (ADR's). The ADR approach was later followed by a large number of Russian companies. In 2000, Lukoil became the first Russian company to list ordinary shares on the London stock exchange.

The purchase in 1995 by US mini major Atlantic Richfield (Arco) of Lukoil of convertible bonds in a \$250 million deal was a groundbreaking deal in terms of Russia's corporate history. Effectively, this deal allowed a US company to acquire a 7.99% stake in Russia's biggest oil company. The Lukoil/Arco partnership enjoyed strong political backing. In February 1997 within the framework of Gore-Chernomyrdin (see footnote) the two companies formed a joint venture dubbed Lukarco to seek upstream opportunities in and outside Russia. Lukarco failed to bag any acreage in Russia. In Kazakhstan the joint venture took a 5% interest in Tengizchevroil (TCO), a ChevronTexaco (now Chevron Corporation) operated group tapping Tengiz, the biggest oilfield development to date in Kazakhstan. Tengiz is the main source of oil transported through the Caspian Pipeline Consortium's (CPC) export line from western Kazakhstan to Novorossiysk on the Russian Black Sea. Lukarco holds 12% of CPC, an interest

that brings preferential access rights to the system. BP took over Arco in 2000 and subsequently sold the Lukoil stake, but retained the Lukarco shares.

Lukoil set up a joint venture with ENI's upstream affiliate, Agip, in 19xx (no date here). LukAgip took a 10% share in the Shak Deniz gas field offshore Azerbaijan and an interest in the Meleiha block in Egypt's Western Desert. In 2005 Lukoil bought Agip out of both projects and the LukAgip venture was closed.

Lukoil began building a partnership with Conoco in the late 1990's within the framework of the Gore-Chernomyrdin Commission.⁴ These efforts reached a climax in 2004 when ConocoPhillips bought a 7.9% packet of Lukoil shares from the Russian government, a \$3 billion deal that moved the Russian company fully into private hands. ConocoPhillips has since acquired more Lukoil shares boosting its holding close to 20%. With regards to the terms set by the strategic partnership arrangement agreed by Lukoil and ConocoPhillips, at the time of the privatisation clamp a 20% ceiling on the amount of equity the US major can hold in Russia's biggest oil company.

ConocoPhillip's at once ambitious but restrained approach to its Lukoil partnership may provide the Russian company with a model for its own future dealings within a state dominated oil industry. ConocoPhillips has accepted that there will always be a ceiling on its ownership of Lukoil and that it will not enjoy management rights over the company.

The U.S. major will however enjoy access to some of Russia's most prospective new acreage. Lukoil and ConocoPhillips have formed a venture jointly to tackle huge oil reserves in the Timan Pechora Basin. In return, ConocoPhillips is opening up downstream opportunities for

⁴ The US-Russian Joint Commission on Economic and Technical Cooperation, a.k.a. the Gore-Chernomyrdin Commission, was set up by US President Bill Clinton and the Russian leader Boris Yeltsin in 1993. The Commission aimed to provide a framework for US/Russian partnerships based on a shared commitment to democracy and human rights, the market economy, rule of law and international peace and stability. The Commission's original mandate was to enhance cooperation in the areas of space, energy, and high technology. Then U.S. Vice President Al Gore and Russian Prime Minister Viktor Chernomyrdin acted as co-chairs.

Lukoil outside Russia. Lukoil bought a network of gasoline stations from the company in 2006 and is hoping to move into the U.S. oil refining business.

LOYALTY

It is largely thanks to its loyalty to the state that Lukoil has remained at the top of the oil hierarchy for its entire 15 year history. The company's influence over the evolution of Russian oil policy throughout this period should not be underestimated.

Lukoil is not slavishly uncritical of government policy, but the company is skilled at voicing oil industry demands without questioning the paramount authority of the government. Lukoil's lobbying style contrasts strongly with that adopted by Yukos under Mikhail Khodorkovsky's leadership. For a while it looked as if Yukos, which raced to profile itself as a western oil corporation after world prices began rising in 1999, might replace Lukoil as the motor for change in the Russian oil industry. But Yukos turned out to be too loud, too brash and too radically westernised for the Kremlin and the Russian oil establishment. With hindsight, it is easy to say that Mr Khodorkovsky erred fatally by concentrating efforts to build a support base not in the Kremlin, but in the U.S. where he was greeted as a hero by a government and oil industry eager to promote energy dialogue with Russia. Negotiations to sell ExxonMobil a substantial stake in Yukos, a transaction that would, if completed, have handed control of 20% of Russian oil production to the US mega major sound, four years later, more like a foolish provocation of fate than the act of a visionary Russian oil reformer. Above all, Mr Khodorkovsky underestimated the state's determination to assert control over the industry. As Nina Pussenkova of the Carnegie Endowment for International Peace, has observed, "Khodorkovsky quite simply forgot which country he was living in."

Both Vagit Alekperov's critics and admirers have at times described Lukoil's long time leader as a megalomaniac. But Mr Alekperov has never gone so far as considering himself powerful enough to challenge the state.

UPSTREAM OPERATIONS BY REGION

West Siberia

Lukoil's three production enterprises in West Siberia, Langepasneftegaz , Uraineftegaz and Kogalymneftegaz, Uraineftegaz form the core of its upstream operations and provide the initials for the company's brand name. Kogalym and Langepasneft, the two biggest, lie in the Tyumen province on the main pipeline linking Noyabrsk with Surgut. Uraineftegaz, the smallest, is located between Surgut and Nizhnevartovsk.

Lukoil's proven reserves in West Siberia amount to 8.05 billion barrels accounting for 55% of the company's total oil portfolio. Some 57.3 million tons (1.15 million barrels a day), or 66% of Lukoil's 86.3 million tons (1.73 million barrel a day) of Russian production originated at fields in West Siberia in 2005, a far smaller proportion than most other Russian oil majors.

Timan Pechora

The highly prospective Timan Pechora Basin in northwest Russia is divided into two regions – the Komi republic in the south and the Nenets region to the north bordering the Barents and Pechora Seas. Lukoil has built substantial portfolios in both areas. The company's total reserves in Timan Pechora amount to 3.29 billion barrels. The bulk of these are located in the north in the Nenets region. Lukoil built up its portfolio in Timan Pechora after acquiring local explorer Arkhangelskgeobycha in 1999. Arkhangelskdobycha held the license to eleven fields in the Varandey block on the coast of the Barents Sea.

Varandey is to be tackled together with ConocoPhillips which formed a strategic partnership with Lukoil in September 2005. ConocoPhillips already has over a decade of experience working in Timan Pechora. In the early 1990's the US major set up Polar Lights, distinguished as the first foreign joint venture to produce oil in Russia.

As part of the strategic partnership agreement, Lukoil and ConocoPhillips formed a joint venture called Naryanmarneftegaz to work at a group of fields in the Nenets region. The American company paid \$500 million for a 30 percent stake in Naryanmarneftegaz. Plans are to build production to a peak of 200,000 barrels a day of oil equivalent. Oil will be exported from Lukoil's terminal at Varandey on the Pechora Sea coast.⁵ (*see section on export terminals*). Varandey is intended as a launch pad for growth in Russian exports to the United States. ConocoPhillips will help design and finance the expansion of the terminal to handle up to 240,000 b/d of exports.

Rosneft has expressed interest in joining Naryanmarneftegaz. The state company broke into the Timan Pechora Basin when acquiring Severnaya Neft in 2000. Oil majors, including Lukoil, complained publicly that the Severnaya Neft tender was unfairly handled in Rosneft's favour. Rosneft went on to acquire Lukoil's interest in the Polar Lights joint venture as part of an asset swap in Timan Pechora. Polar Lights produces 1.4 million tons a year of oil and is now owned by Rosneft and ConocoPhillips jointly in a 50:50 division.

North Caspian

Lukoil is by far the dominant Russian player in the Russian, Kazakh and Azerbaijani sectors of the Caspian Sea and intends also to make its mark offshore Turkmenistan and Iran. Russia's offshore industry is hardly developed. Lukoil began taking an interest in the Caspian long before any of its peers. In the 1990's Boris Yeltsin's government appointed Lukoil to

⁵ See section on export terminals

coordinate all Caspian projects. The company was handed a huge swathe of offshore acreage called Severny (Northern).

Lukoil made a series of discoveries in the north Caspian Sea offshore Russia in the 1990's. An important breakthrough occurred in 2005 when the company discovered the Vladimir Filanovsk field on the Severny block 220km off Astrakhan. Unlike earlier finds in the area which contained mainly natural gas, Vladimir Filanovsk is decidedly an oilfield. Estimated proven and probable reserves amount to an approximated 600 million barrels. In addition, gas reserves are 1.2 trillion cubic feet. Lukoil plans to develop Vladimir Filanovsk in tandem with the nearby Yuri Korchagin deposit. Together the two fields should yield some 160,876 barrels a day of oil, forming the core for large scale development of the north Caspian.⁶

In Russia

Having won the lion's share of opportunities in two of Russia's most important emerging new oil provinces – Timan Pechora and the north Caspian Sea, Lukoil until recently stayed away from the third – East Siberia. However, in 2005 the company announced that the zone covered by its strategic cooperation alliance forged with Gazprom in 2004 would be expanded to include East Siberia.

So far Lukoil has not taken any East Siberian acreage. If it enters the area at all it will lag behind Rosneft and Gazprom which are already actively building portfolios. Both the cost and risk of developing East Siberia will be extremely high. It is likely that big, Kremlin-loyal companies like Lukoil will be encouraged to throw their capital and experience behind the effort. New Russian legislation preventing foreign companies from bidding for certain large oil and gas fields defined as “strategic” will benefit Russian players in the scramble for blocks.

⁶ Lukoil Press Release January 25 2006

**TABLE 2: LUKOIL OIL PRODUCTION
(UNIT: MILLION TONS)**

Year	Oil Production
2001	78.3
2002	79.8
2003	81.5
2004	86.9
2005	89
2006	95.2

(Source: Lukoil)

INTERNATIONAL OPERATIONS

Lukoil has internationalised far more broadly than any other Russian oil company and intends to continue to expand further overseas. Non Russian oil production totalled 5.7 million tonnes (114,624 barrels a day) in 2006, accounting for just over 5% of Lukoil’s total 95.2 million tonnes (1.91 b/d) output. By 2015, international projects should yield some 20% of the total. From the start, Lukoil has served as an ambassador for Russia in the international arena. Selection of foreign assets has been at least in part driven by state interests.

Most of Lukoil’s foreign upstream projects are being managed by its 100% owned affiliate Lukoil Overseas which was founded in 1997. In its early years, Lukoil Overseas incorporated Lukoil Perm, a company with some 10.5 million tonnes a year (211,150 b/d) of production in the Urals region of Russia. Andrei Kuzayev, a former General Director of Permneft, was appointed President of Lukoil Overseas in 2000. During a reorganisation in 2006 Lukoil took back control of Lukoil Perm. At the same time Lukoil Overseas was handed Lukoil’s 54% stake in the LukArco joint venture with BP. LukArco owns a 5% interest in the giant Tengiz oilfield in Kazakhstan and 12.5% of the Caspian Pipeline Consortium (CPC) which owns a pipeline linking Tengiz and other Kazakh fields with export terminals on the Russian Black Sea.

Kazakhstan has bigger oil reserves than any former Soviet republic except Russia and is the most important country in Lukoil's international portfolio. Fields in Kazakhstan are the source of over 90% of Lukoil's non-Russian production and are likely to remain the company's main source of foreign oil for the foreseeable future. Lukoil has thirteen projects in Kazakhstan and is looking for more.

Throughout the 1990's, Lukoil was the only Russian company with significant interests in Kazakhstan. The rise of Rosneft could usurp Lukoil from the role of Russian standard bearer in Kazakhstan. Rosneft has moved into the republic and is planning a series of projects with state KazMunaigas geared to building its annual oil production in Kazakhstan to 15mt-20mt. Lukoil may now find itself competing against Rosneft for Kazakh projects or simply excluded from the race by favoured state giants. Kazakhstan's production sharing law ensures KazMunaigas a minimum of 50% in all new offshore projects. Separate legislation endows the state company with rights to pre-empt the sale of oil projects.

Kazakhstan's oil industry grew up during the Soviet era. After the collapse of the Soviet Union, Kazakhstan turned swiftly to US oil majors to help tap huge reserves that would provide an economic foundation for the newly independent state. Russian oil companies were initially not represented in the foreign consortia formed to tackle the vast Tengiz and Karachaganak fields. However, Lukoil eventually acquired a minority stake in Tengiz and replaced Gazprom at Karachaganak.

Lukoil has aggressively built up a portfolio in Kazakhstan and is still on the lookout for more opportunities. In October 2005, Lukoil invested \$2 billion in the acquisition of Nelson Resources, a Canadian listed independent with interests in four joint ventures in western Kazakhstan. Nelson Resources also has an option on two offshore blocks in the Caspian

including South Zhambai and South Zaburny. Late in 2006, Lukoil sold 50% of its share in Nelson Resources – renamed Caspian Investments Resources – to Mittal Investments, part of the Mittal Group owned by Lakshmi Mittal, the steel tycoon.

One of the biggest new oil provinces in the world is opening up in Kazakhstan's sector of the Caspian Sea. Largely due to terms of an offshore boundary accord between Russia and Kazakhstan, Lukoil has gained a strong position in the area. The accord, finalized in 2002, designated three offshore structures for joint exploration and development by the two republics. Lukoil was named Russia's representative at the Khvalinskoye and Tsentralniye projects which are being tackled in partnership with KazMunaigas, Kazakhstan's state oil company.

Separately Lukoil won two exploration blocks in the Caspian at Tyub Karagan and Achinsky. These projects both lie fairly close to the offshore boundary with Russia and are being carried out in partnership with KazMunaigas.

In south central Kazakhstan Lukoil is producing oil from the Kumkol field where it holds a 50% interest in the Turgai Petroleum joint venture. China National Petroleum Corp (CNPC) Lukoil's partner in Turgai Petroleum bought its stake in the project from the Canadian-listed independent PetroKazakhstan in September 2005. KazMunaigas later exercised its preemptive right to muscle into the deal.

Lukoil bought Nelson Resources, a Canadian-listed independent with interests in four Kazakh joint ventures in 2005 for \$2 billion. Analysts at the time complained that the assets, partly owned by the Kazakh elite, had been sold too cheaply. The following year, 50% of Nelson, renamed Caspian Investments Resources, was sold to Mittal Investments, a company owned by Lakshmi Mittal, the Indian steel tycoon, for \$1 billion. Arguably Caspian Investment Resources's best asset is an option on the South Zhambay block in the Caspian Sea. A

production sharing contract at South Zhambay is expected to be inked shortly by the company in a group with Repsol of Spain and KazMunaiGas furthering bolstering Lukoil's presence in the Caspian Sea.

Lukoil's strong presence in Kazakhstan has helped shore up Russia's influence lost when the USSR collapsed in 1991. Russia is eager to align its oil industry with that of Kazakhstan which, by 2015, is expected to be exporting at least 3 million barrels a day. Although Kazakhstan is diversifying its export routes, the bulk of its foreign sales are likely to continue to flow across Russia. Combined, Kazakh and Russian crude exports moving via Russian territory are likely to top 9 million barrels a day by 2015, enough to ensure the region a key role as a counterweight to OPEC on world markets.

Elsewhere in the former Soviet Union, Lukoil is active in Azerbaijan, Mr Alekperov's home republic, where it is an investor in both of the two big foreign projects underway in the Caspian. Lukoil has a 10% stake in the BP-operated Azerbaijan International Operating Company (AIOC) developing some 3 barrels of reserves at the Azeri and Chirag fields plus deep water sections of the Guneshli deposit. Lukoil is also a partner at BP's Shah Deniz natural gas and condensate field. Shah Deniz came onstream in December 2006. On the west coast of the Caspian, Lukoil is exploring at the D-222 block (formerly Yalama) in a partnership with Azerbaijan's state oil company Socar.

Lukoil did not invest in either the Baku-Tbilisi-Ceyhan oil pipeline carrying AIOC crude to the Turkish Mediterranean or the South Caucasus gas pipeline linking Shah Deniz with eastern Turkey, both of which began commercial operations in 2006. The twin pipeline projects form a central plank of US Caspian policy to reduce regional dependence on Russian export routes and to discourage investors from building pipelines to Iran. Politically it was probably made

impossible for Lukoil to invest in the pipelines although it like any significant producer in the Caspian region, is under pressure to secure additional export outlets.

In Uzbekistan Lukoil signed a production sharing agreement (PSA) for the Kandym-Khauzak-Shadi-Kungrad gasfields in 2004. State Uzbekneftgaz is Lukoil's partner in the project where some \$1 billion will be invested. Gas will be sold to Gazprom at the Uzbek frontier.

All Lukoil's existing foreign upstream projects will be thrown in the shade if the company's plans to develop huge reserves in Iraq materialise. Much of Iraq's oil industry was developed with the help of Soviet oilmen and equipment suppliers. Lukoil's role has been to keep former contacts alive. The reward could be access to one of the world's biggest untapped oilfields.

Lukoil entered a production sharing agreement (PSA) in 1998 to tap West Qurna, a field capable of producing as much as 3 million barrels a day of oil in southern Iraq. However, the agreement was annulled during the closing months of Saddam Hussein's regime in what was seen as retaliation for Russia's refusal to block US plans to attack Iraq. Lukoil insists that its contractual right to West Qurna remains in tact.

However, the company has indicated willingness to share the field with others whenever the tendering of major Iraqi oilfields becomes possible. A strategic partnership agreement agreed with ConocoPhillips in 2004 called for Lukoil to tackle West Qurna together with the American company.

Lukoil has secured a number of contracts in other OPEC countries including Saudi Arabia, Iran, Egypt and Venezuela. These bring the company into working contact with some of the world's most powerful NOCs.

In Iran Lukoil has a 25% stake in an exploration venture Norway/s Norsk Hydro at the Anaran block. An oil field was discovered in the area on the Azar structure in 2005. Estimates are that the field could yield as much as 100,000 b/d of oil.

In Saudi Arabia Lukoil is exploring on Block A in the Rub al-Khali basin under terms of a contract signed in January 2004. If hydrocarbons are found, Lukoil will have the right to produce and market gas and condensate only.

In Egypt, Lukoil is exploring on the North east Geysum block in the Red Sea. Elsewhre in North Africa the company is negotiating an upstream deal with Sonangol in Angola.

In South America Lukoil is exploring in Colombia in a partnership with state Ecopetrol on the 3,089 sq km Kondor block. A first oil discovery was made at a depth of 4,500 metres on Kondor early this year. Production from a test well is already being sold to the US which will be the likely market for any crude Lukoil produces in South America. The company is actively seeking refining assets in the US. In Venezuela Lukoil plans to develop oil reseves in the Orinoco basin.

TABLE 3: LUKOIL OVERSEAS – UPSTREAM PROJECTS

Country	Project	Lukoil Percent Status
Azerbaijan	Azeri/Chirag/deep water Guneshli	10% Producing oil
	Shak Deniz	10% Producing Gas
	D-122	80 % Exploration
Kazakhstan	Tengiz	2.7% Producing oil
	Karachaganak	15%Producing oil and gas
	Khavalinskoye	50% Exploration
	Tsentralniye	50% Exploration
	Tyub Karagan	50% Exploration
	Caspian Investments	50% Producing at five fields
	Turgai Petroleum CNPC	Producing oil
	Uzbekistan	Kandym-KhauzakPSA
Iraq	West Qurna PSA	68.5% on hold
Iran	Anaran	25% exploration
Saudi Arabia	Block A (Riyadh)	80% first drilling
Egypt	NE Geysum	100% Exploration
	West Geysum	100% Exploration
	Meleya	24%
Colombia	Kondor block	70% Exploration
Venezuela		Negotiating for acreage in Orinoco basin
Angola		Negotiating for acreage with Sonangol

RUSSIAN DOWNSTREAM

When Lukoil was founded in the early 1990's the Russian refining industry was in a state of decay. Processing capacity was far larger than the country's requirements. Most plants were old and in poor conditions and located at great distances from oil production centers.

Lukoil was the first Russian oil company to fully grasp the potential of the refining business, both in Russia and abroad. Early on, the company began investing into extensive plant upgrades and expanded capacity via new acquisitions such as the Ukhta refinery in the north west and Norski in Nizhnenovgorod in central European Russia. The company is now well placed to profit from an increase in product demand and prices in Russia and in southern Europe where it has built sizeable processing and gasoline retailing networks.

While the profitability of downstream operations is sometimes less spectacular than upstream, Lukoil's growing reliance on refining and product retailing is providing a steadier revenue stream than the volatile crude oil trading business. Lukoil's focus on the downstream also fits perfectly with the state's current policy to diversify the economy away from natural resource production towards manufacture of value added and high tech products.

Lukoil is taking the lead in articulating a new refining policy for Russia to reflect the new market realities. At a meeting of Russian industrialists hosted by Vladimir Putin in February, Mr Alekperov urged Russian oil companies to increase refining operations, a message that echoed calls by Putin for economic diversification away from natural resource extraction. Mr Alekperov called for greater investment in the upgrading of domestic refineries to produce environmentally friendly gasoline and in installing of new petrochemicals capacity.⁷ These are both paths Lukoil has already embarked upon.

⁷ RBK Daily, February 7, 2007, Page 1.

All four of Lukoil's Russian refineries are located in the populous and industrialised European part of the country where demand for products is highest. Lukoil owns refineries at Volgograd and Perm in the Volga/Urals region, at Ukhta in the North West and at Nizhnenovgorod some 300 km east of Moscow.

Most Russian refineries are old. Lukoil was among the first Russian companies to launch projects to upgrade and modernise its processing capacity. This strategy has paid off handsomely. Demand for oil products in Russia is now rising rapidly along with economic growth. In addition, due to the vagaries of Russian oil taxation, exporting products is now more profitable than exporting crude which is subject to punitive customs duties. Lukoil began taking an interest in exporting products before its peers and has built a terminal to handle foreign sales on Vysotsky Island in the Gulf of Finland.⁸ (*See section on terminals* .

Lukoil has built up a network of 13,000 service stations in Russia where gasoline retailing margins are far fatter than in Europe. The company expects to grow its 5% - to 6% share of the domestic gasoline market. Around half of the Russian gasoline marketing business is controlled by independent companies and the industry is ripe for consolidation.

Lukoil's cooperation with the Kremlin over gasoline pricing may help the company get ahead in the race to win new retailing outlets. During a meeting with Putin in 2005, Mr Alekperov agreed to refrain from sharp hikes in gasoline prices which are politically unpopular in Russia. Such cooperation with the state represents a commercial sacrifice that goes beyond the conventional boundaries of corporate social responsibility. It is not impossible that the publicised meeting between Putin and Mr Alekperov was intended to send a signal to other Russian petrol retailers that it was the Kremlin and not the market that would in future determine pricing parameters.

⁸ See section on terminals

INTERNATIONAL DOWNSTREAM

Lukoil began buying refineries in Central Europe in the 1990's and now owns a combined 17.8 million tons of oil processing capacity in Bulgaria, Romania and Ukraine. More than half of the \$3 billion Lukoil has invested so far in Central European refineries has been spent on plant modernisation. Lukoil paid what in today's terms looks like a tiny sum to acquire refineries that formed the core of a strategy to build a widespread gasoline and product retailing empire in Europe where the company now owns over 2,000 service stations. Western majors were for the most part not interested in competing for the Central European refineries, not least because of environmental deterioration in the vicinity of plants that often held large debts.

Lukoil's Central European refinery buying spree was driven by both commercial and political interests. Plants in the area were configured to process Russia's Urals export blend and were historically dependent on Russian feedstock delivered via the Druzhba pipeline system. After the fall of the Soviet Union, refineries began seeking to diversify their sources of supply. Lukoil's ownership of plants constrained the advance of Western investors into the region.

Lukoil bought a 58% stake in Bulgaria's Neftokhim Bourgas refinery in 1999. Lukoil paid \$360mil for the plant including tax arrears. In addition the company committed to invest over \$408 million to modernize the plant. With a capacity of 7 million tons a year, Neftokhim Bourgas is one of the biggest refineries in Central Europe and also has petrochemicals capacity. Lukoil has invested over \$400 million in Neftokhim Bourgas since 1999 and is considering a major expansion of the plant. A nation wide network of Lukoil gasoline stations has been established in Bulgaria. The company's target is to establish 150 retailing outlets in the country.

Lukoil bought a controlling stake in Ukraine's Odessa refinery on the Black Sea coast in 1999 for just \$7.2million. The following year the company built up its interest to 99% in the

plant. Lukoil has over 180 gasoline stations in Ukraine. In 2005⁹ Lukoil embarked on a modernisation program at Odessa to boost yields of light products at the plant to 65% from 43%. Lukoil plans to complete the Odessa upgrade this year, 12 months ahead of schedule and has applied to the Ukrainian authorities for permission to expand capacity at the plant.

Lukoil bought a 51% stake in Romania's biggest refinery Petrotel in 1998. The interest has since increased to 93%. Located in Ploesti, Petrotel is the largest of 11 refineries in Romania. Lukoil paid \$56 million for its Petrotel stake and pledged a further \$300 million in investment in the plant. A \$120.7 million modernisation program completed in 2004 has boosted yields of light produces to 81.7% from 73.3% and has allowed the plant to begin producing products to conform with Euro 3 and Euro 4 standards. Petrotel is processing around 2.4 million tons a year of crude. Lukoil controls nearly 20% of the petroleum products market in Romania.

Lukoil's refineries in Ukraine, Bulgaria and Romania provide the company with a strong presence in the Black Sea region which increasingly will become a processing centee and market for the company's Caspian and Central Asian oil production.

Lukoil outlined aggressive downstream expansion plans in its strategy for intensive growth announced in October 2006. Lukoil's official goal is to increase its refining capacity to 100 million tons a year (2 million barrels a day) by 2017 – a 70% increase on current levels. Growing volumes of crude will be processed at plants outside Russia closer to end markets.

⁹ Lukoil press release July 26 2005

TABLE 4: LUKOIL REFINERY THROUGHPUTS ***
(UNIT: MILLION TONS)

	2002	2003	2004	2005	2006
Refinery Throughputs Total, Including:	41.2	42.1	43.62	47.28	48.88
Russia	33.95	34.31	35.55	37.30	39.5
International projects	7.25	7.79	8.07	9.98	9.38

* Conversion ratio (tons to barrels) characterizes the density of oil from each of LUKOIL oilfields.

** Includes gas available for sale and gas for internal consumption as well as technological losses. Conversion ratio from m³ to barrels of oil equivalent is 1,000 m³ = 5.885 boe.

*** Includes mini-refineries, excluding fuel oil processing at Burgas Refinery.

(Source: Lukoil)

Lukoil plans no further refinery acquisitions in Russia. Instead, existing plants at Perm and Volgograd will be upgraded to handle as much as 30% more crude. Outside Russia, Lukoil is actively hunting for additional oil processing facilities in Europe and the US and is considering downstream investments in the Far East. Competition for European refining assets is intense. Lukoil has tried without success to buy Polish and Lithuanian refineries and is now negotiating the possible purchase of a stake in a Ceska Rafinerska, which owns the Litvinov and Kralupi plants in the Czech Republic from ConocoPhillips, its strategic partner. ConocoPhillips has already agreed to sell Lukoil 376 gasoline stations in the Czech and Slovak republics, Hungary, Poland, Belgium, Finland.

In Belarus Lukoil owns 45 service stations and accounts for 13% of the local retail gasoline market.

In the Balkans Lukoil has already established itself in the downstream via a joint venture formed with Petrol, a state owned Slovenian products trader last year (2006). Petrol owns a chain of 346 gasoline outlets in Slovenia, Bosnia, Croatia and Serbia. Lukoil plans to bid for oil processing plants owned by Naftna Industrija Srbije (NIS) in Serbia.

In Turkey, Lukoil is eager to buy or build a refinery to handle growing volumes of oil production from its Caspian and Central Asian projects. A bid in 2004 for a 66% stake in state-owned Tupras which owns four refineries failed. Since then Lukoil has bought oil product storage units in Turkey prompting speculation that the company will soon either acquire an existing refinery or win approval from the government to build a new plant.

Rosneft's recent announcement that it would seek to buy European refineries could in future narrow Lukoil's opportunities in the region. Bidding against Russia's state oil company for assets could be politically inept.

Lukoil is seeking to buy a refinery in the U.S. to handle crude from fields in Venezuela where the company is negotiating for rights to develop oil reserves in the Orinoco basin and from Colombia, where the company recently struck oil for the first time. Ownership of a U.S. refinery would allow Lukoil to feed its own chain of service stations on the east coast purchased from Getty Petroleum in 2000-2001. Western analysts questioned the sense of the \$53 million Getty acquisition at the time. Gasoline retailing is not the most profitable end of the oil business in the U.S. But by hoisting its flag at service stations in a large and populous swathe of the U.S., Lukoil was able to establish a highly visible footprint in North America which would stand it in good stead when it came to list on the London Stock Exchange two years later. It is possible that the Kremlin then at an early stage of planning Russia's emergence as a global energy super power encouraged Lukoil to invest in the Getty stations.

The 2006 launch of the new pipeline to bring West Siberian crude across East Siberia to export terminals on the Pacific Ocean has turned the attention of Russian oil companies' to opportunities in the Far East, particularly China.

Nonetheless, Lukoil announced late last year that it would invest in the construction of a new refinery in Vietnam where there is a long history of Soviet and Russian oil cooperation.¹⁰ Lukoil is also considering a joint refinery project in China with Rosneft.

**TABLE 5: LUKOIL'S OIL RESERVES
(UNIT: MILLION BARRELS)**

Region	2001		2002		2003	
	Proven	Probable	Proven	Probable	Proven	Probable
Western Siberia	8,052	4,749	8,266	3,593	8,421	4,253
European Russia*	2,354	338	2,624	319	2,731	344
Timan Pechora	3,291	1,103	3,478	1,654	3,953	1,826
Yamal	234	113	193	322	216	446
Northern Caspian	98	181	172	182	185	298
International Projects	547	173	525	124	471	71
Total:	14,576	6,657	15,258	6,194	15,977	7,238

* European Russia includes Perm, Volga and Kaliningrad regions
(Source: Lukoil)

NATURAL GAS

Lukoil's ambition is to grow into Russia's biggest gas producer after Gazprom, the state gas monopoly. It will be a long journey to the top. Gas currently accounts for just 6% of Lukoil's total hydrocarbons output. By 2017 that share is to grow to 33% or around 70 billion cubic metres a year.

Gazprom controls all Russia's gas trunklines and refuses to share routes to lucrative European gas markets with competitors. Independent producers must therefore sell gas on the Russian markets at comparatively low, state regulated prices..

However, the complexion of the domestic market is changing dramatically for the better. Russian gas demand is growing rapidly. Regulated prices are rising steadily and are expected to

¹⁰ RBK Daily. December 18 2006 No.060. page 4

leap after the presidential election in 2008 when the government plans to begin eliminating controls.

Lukoil will face strong competition in the gas business from other oil companies, especially Rosneft and TNK-BP. The ability to build and maintain cooperative relations with Gazprom, which fiercely guards its monopoly over the gas business, will be the key to success.

In 2003, Lukoil signed a strategic gas alliance with Gazprom covering a large block in the gas rich Yamal region of West Siberia and the north Caspian. Yamal reserves are mainly controlled by Gazprom. Lukoil is so far the biggest Russian player in the Caspian Sea and has more experience operating offshore than Gazprom.

While Lukoil's oil production is spread across nine countries, the company has gas output in just three, Russia, Kazakhstan and Azerbaijan (2006). Lukoil ranks third in the hierarchy of Russian independent gas producers after Surgutneftegaz and Rosneft. Its output totalled 7.6 billion cubic metres in 2005, far less than that of most international oil majors.

Lukoil's gas production more than doubled in 2006 to reach 15.8 billion cubic metres largely due to the start up at the Nakhodkinskoye field in the north of West Siberia. Nakhodkinskaya lies on a large block in the Bolshekhetskaya Depression acquired by Lukoil in 2004. More than half of the company's 24 trillion cubic feet of gas reserves lie in the area.

Nakhodkinskaya lies around 150km to the north of Yamburg, one of Gazprom's biggest producing fields, which is linked by trunkline to markets in European Russia. Lukoil has built a pipeline from Nakhodkinskoye to Yamburg where it sells gas to Gazprom. Last year Gazprom agreed to raise the price paid for Nakhodkinskoye gas to \$40 per 1,000 cubic metres from an earlier \$20 per 1,000 cubic metres. The price hike sent out a positive signal about Lukoil's cooperative relationship with Gazprom, a prerequisite for success of an independent gas

producer in Russia. While a \$40 price would hardly be commercially acceptable to a Western company, the Lukoil deal may prove to be a benchmark for other Russian independents seeking access to big gas plays. Lukoil evidently saw that the prospects were dim of arranging cost effective gas processing and transportation agreements with Gazprom. The deal moreover reflects Lukoil understanding that it is politically inadvisable to compete against Gazprom in the gas market.¹¹

Lukoil's exploration in the Russian sector of the Caspian has yielded more gas than oil finds. The area is likely to be developed in partnership with Gazprom or Kazakhstan's state oil company, KazMunaiGas reserves. Bolstering its position as a future gas player in the Caspian area, Lukoil acquired a controlling stake in the huge Central Astrakhan field in the Volga River Delta just north of the Caspian coast in early 2006. Central Astrakhan holds 1 billion barrels of gas condensate reserves and 270 billion cubic metres of gas.

Lukoil's gas projects in Central Asia are also being carried out in cooperation with Gazprom. It has been agreed that all gas produced by Lukoil in Uzbekistan where the company inked a PSA in 2004 will be sold to Gazprom at the Uzbek frontier.

¹¹ Jonathan Stern, *The Future of Russian Gas and Gazprom* (Oxford: Oxford University Press, 2005), p. 20.

**TABLE 6: LUKOIL'S GAS RESERVES
(UNIT: BILLION CUBIC FEET)**

Region	2001		2002		2003	
	Proven	Probable	Proven	Probable	Proven	Probable
Western Siberia	1,236	724	1,082	468	1,284	647
European Russia*	488	56	737	44	737	76
Timan Pechora	488	118	460	64	577	194
Yamal	8,223	2,005	13,822	3,108	13,806	3,124
Northern Caspian	957	344	6,331	5,028	5,763	10,412
International Projects	1,824	277	1,732	248	2,306	163
Total:	13,216	3,524	24,164	8,960	24,473	14,616

(Source: Lukoil)

TRANSPORT

Lukoil has invested in a number of oil transport and export projects to help ease transport Caspian constraints that have kept a lid on Russian oil production in recent years.

Varandey: An offshore loading facility was first installed at Varandey 4km off the coast of north west Russia in 2000. The terminal is connected by subsea pipeline to oil fields near the coast. Plans are to install deep water ice-resistant terminal in the area. Oil from Varandey will be shuttled to Murmansk on the Kola Peninsular for transfer to larger tankers suitable for trans-Atlantic crossings.

Vysotsk: Lukoil started exporting from a new terminal on Vysotsk Island in the Gulf of Finland in 2004. Crude and products are delivered to the terminal by rail. Vysotsk can service tankers up to 47,000 dwt.

Izhevsk: On the Baltic Sea Lukoil has established a terminal to handle production from its D-6 oilfield Russia's offshore Kaliningrad province. Izhevsk terminal is located 20km from the city of Kaliningrad. The terminal is accessible to 20,000DWT tankers. Plans are to boost annual throughput to 4.5 million tons.

Ilynka: Lukoil has installed a terminal at Ilynka in the Astrakhan region near the north coast to transfer crude and product onto tankers for transport across the Caspian Sea. Oil is delivered to Ilynka by rail or down the Volga river by barge. Iran is an important outlet for Lukoil products processed at the Volgograd refinery.

PETROCHEMICALS

Lukoil moved into the petrochemicals business in 1997 and now owns processing plants in Russia and in Central Europe. Core assets include Lukoil-Neftexhim in Bulgaria, Petrotel in Romania, Lukor in Ukraine, Stavropolen in Budyennovsk and Saratovorgsintez both in the north Caucasus.

Petrochemicals plants will provide an important outlet for the growing volumes of gas Lukoil plans to produce in the coming decade. The company is considering investing several billion dollars in construction of petrochemicals plants near Astrakhan on the north coast of the Caspian to process offshore gas.

It is not yet clear how ownership over Russia's petrochemicals business will be divided between state and private investors.

LUKOIL'S MANAGEMENT

Lukoil's eleven strong board of directors are responsible for all decision-making at the company. The company claims that all decisions are taken according to strict commercial criteria including a refusal to accept any rate of return below 15%.

Lukoil has appointed two independent directors to its board including Richard Matzke, a former vice chairman of Chevron and Kevin Myers, the president of Russia and the Caspian region at ConocoPhillips.

Mr Alekperov is president of the board, but has surrendered the position of chairman in 2000 to comply with Western standards.

LUKOIL'S BOARD

Vagit Alekperov, President

Ravil Maganov, First Vice President for exploration and production

Sergei Mikhailov, Chairman of Upravlayushchaya Kompaniya management company

Vary Grayfer, General Director of RITEK

Mikhail Berezhovoi, General Director of Lukoil Garant pension fund

Richard Matzke, former Vice Chairman of Chevron corporation

Nikolai Tsvetkov, Chairman of the management committee at Nikoil Investment Banking Group

Alexander Shokhin – President of the State University Higher School of Economics

Oleg Kutafin, Rector of the Moscow State law academy

Kevin Meyers, President of Russia/Caspian region at ConocoPhillips

Igor Sherkunov, Chairman of Investment Group Capital.

BIOGRAPHY OF VAGIT ALKEPEROV

Vagit Alekperov was born the son of an oilman in Baku, Azerbaijan on September 1st 1950. He studied at the Azerbaijan Institute of Oil and Chemistry before taking up a job on the oil rigs in the Caspian Sea. In 1979, Mr Alekperov moved to West Siberia where he worked for various production enterprises until being appointed General Director of a new producer, Kogalymneftegaz in 1987.

Mr Alekperov served as Deputy Minister of Oil and Gas in 1990-1991 just as the Soviet Union began to unravel. At the ministry, Mr Alekperov participated in early discussions with international advisors about the future reorganization of the oil industry around new, vertically

integrated oil companies. Ownership of the world’s biggest oil industry was coming up for grabs. It was an opportunity that Mr. Alekperov was quick to grasp. In 1992, he became president of a new company, Langepasuraikoagalymneft, an amalgamation of three West Siberian producers, Langepasneftegaz, Uraineftegaz and Kogalymneftegaz. Langepasurakogalymneft was renamed Lukoil in 1993 and has been Russia’s biggest oil producer ever since.

TABLE 7: LUKOIL OWNERSHIP STRUCTURES - SHAREHOLDERS

OAo Lukoil Shareholders and Nominees as of January 31, 2007			
	Equities		
	Quantity of Shareholders	Quantity of Shares	% of Charter Capital
Foreign Entitites	13	99,791	0.01%
Russian Entitites including:	170	824,522,152	96.94%
ING Bank Eurasia ZAO (nominee)		547,592,116	64.38%
Garant SDK (nominee)		75,363,826	8.86%
URALSIB Depository Company (nominee)		60,529,689	7.12%
Depository and Clearing Company (nominee)		38,799,453	4.56%
National Depository Center (nominee)		30,887,888	3.63%
ZAO KB Citibank (nominee)		67,231,930	7.90%
Private Investors	55,471	25,941,312	3.05%
Total:	55,654	850,563,255	100.00%

(Source: Lukoil)

Lukoil is the only privately owned Russian oil company whose share structure is dominated by minority shareholders.

The official table published in this study detailing ownership of Lukoil is not particularly revealing, but is the only information the company is allowed to collect under Russian law.

ConocoPhillips has built a 20% stake in Lukoil and holds an equivalent proportion of voting rights in the Russian company. ConocoPhillips has built its Lukoil ownership both via the

purchase of shares from the Russian government in 2004 and from additional buys on the secondary market. The terms of a strategic accord inked with Lukoil in 2004 clamp a 20% ceiling on ConocoPhillips' ownership of the Russian company. This ceiling was reached in January 2007.

Lukoil's management is understood to control between 20% to 30% of the company. Russian media frequently reports or speculates on the size of Mr. Alekperov's share in the company he founded. It is understood to be in the region of 13%. Leonid Fedun, the company vice president, and head of strategic planning, is also understood to be a major shareholder. Mr Fedun has said that 99% of his net worth – estimated at \$1.7 billion by Forbes Magazine - is made up of Lukoil shares.

In any case Lukoil's ownership is in a state of flux. In April 2006, the company launched a \$3 billion share buy back program of the company which is considered to be significantly under valued.

LUKOIL'S FINANCIALS

Lukoil has profited greatly from record high prices particularly in the past year or so as its own production has begun to revive. However, high Russian oil taxation, particularly export duties which are indexed to world prices, moderate financial gains. Sweeping cost-cutting measures first implemented in 2004 have also helped improve Lukoil's financial position.

Lukoil's net income was \$6.44 billion in the first nine months of 2006, a 34.2% increase on earnings in January – September 2005, according to US GAAP accounts published by the company. EBITDA was \$10.12 billion, a 32.9% increase on levels in the first nine months of 2005. Revenues from sales rose by 27.9% to \$51.46 billion.

Lukoil's operating expenses are climbing sharply in largely due to the appreciation of the Russian rouble against the US dollar. The company's oil lifting costs have also climbed partly because production is growing.

Taxation eats into company earnings. The crude oil export duty rose by 51% in 2006. Taxes on foreign sales of light oil products rose by an even sharper 55%. The mineral extraction tax levied at oilfields climbed to 20%.

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