



HERMITAGE CAPITAL MANAGEMENT

Reforming The Gas Sector in Russia Myths versus Reality

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Myths vs. Reality

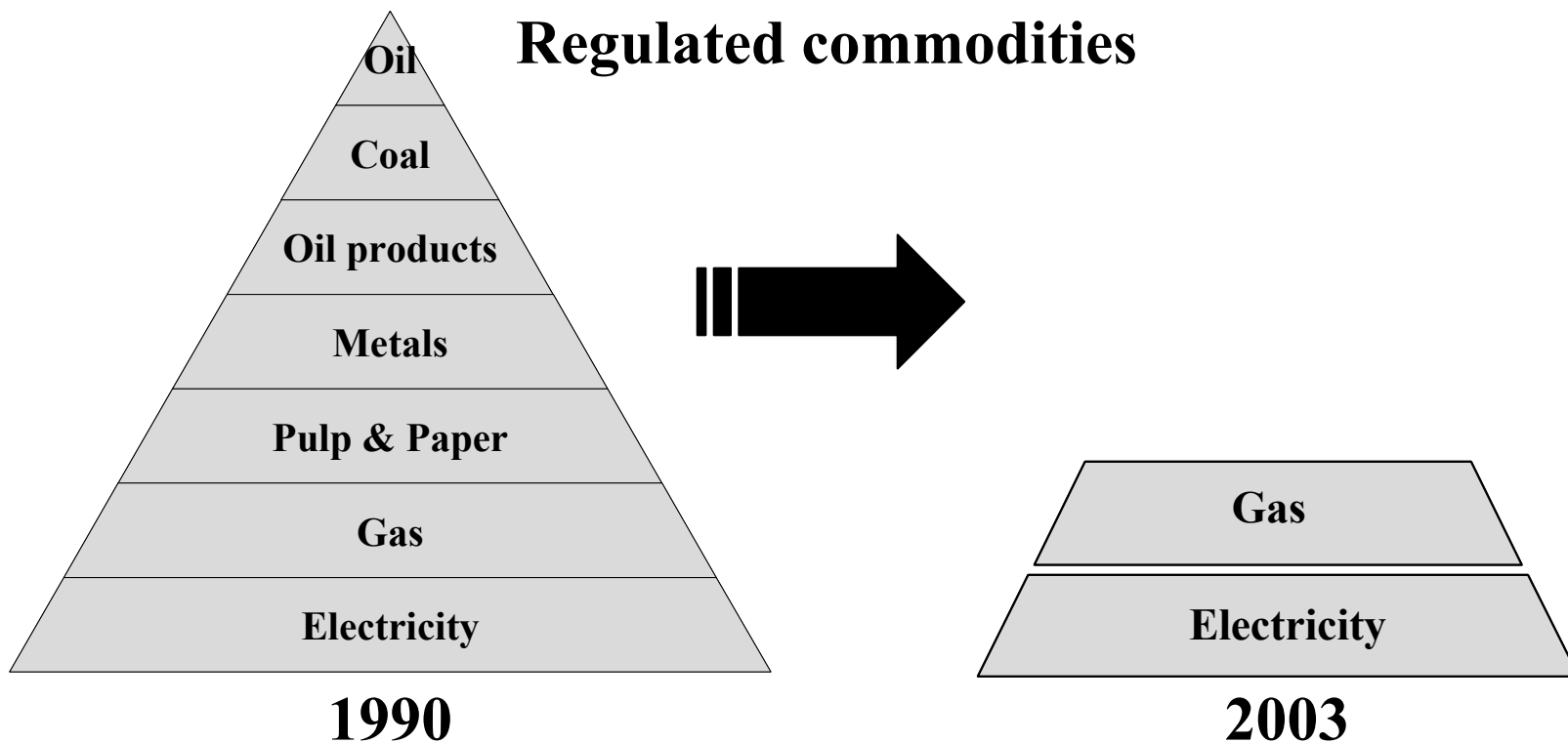
Background:

- On January 27, 2003, Hermitage Capital Management met with Igor Yusufov, Russian Minister of Fuel and Energy, who posed a number of questions about the myths of reforming the Russian gas industry
- Hermitage Capital Management engaged the Boston Consulting Group (BCG) to analyze the myths of the Russian gas market and present the reality
- The BCG study was presented to the Minister of Fuel and Energy on March 31, 2003
- The following is a summary of the Myths vs. Reality of from the BCG study. The findings are BCG's. Some of the interpretations are Hermitage's



Myths vs. Reality

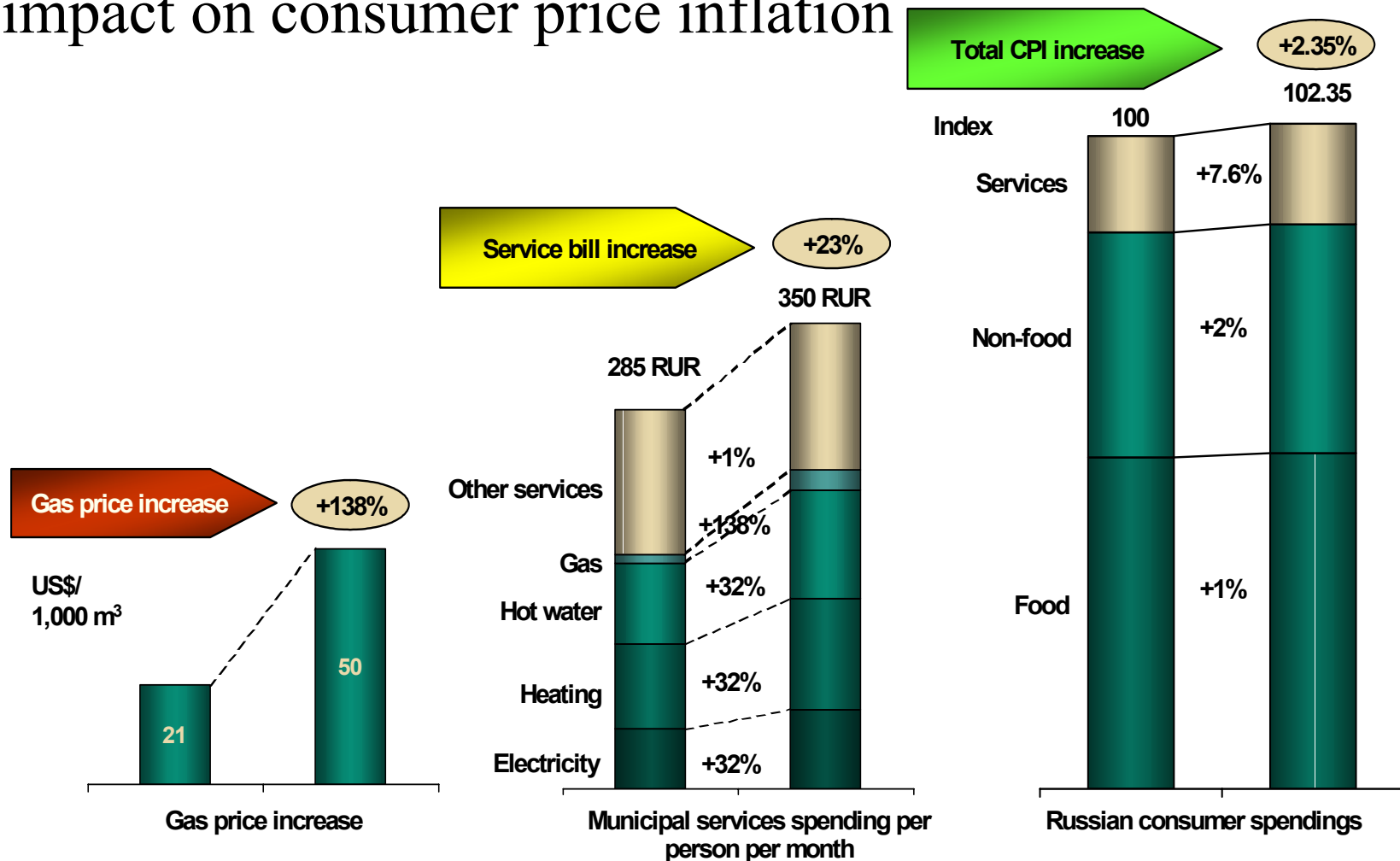
Commodity price deregulation in Russia is almost finished except for gas and electricity sectors





Myth #1: Raising gas prices will create runaway inflation

Reality: Raising gas prices will have only a marginal impact on consumer price inflation





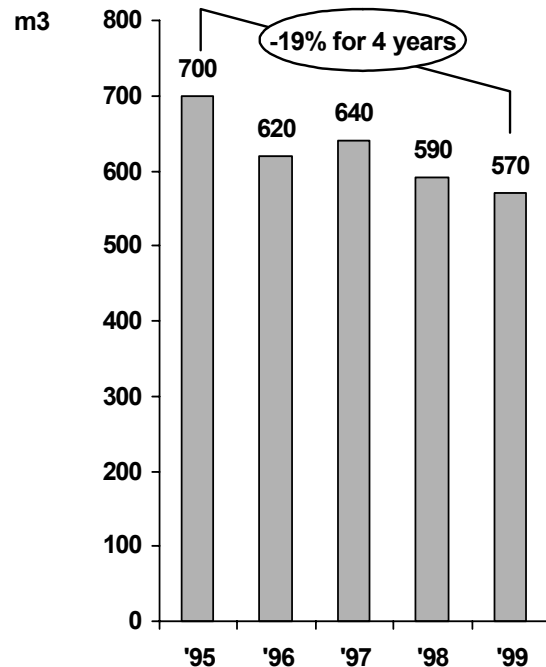
Myth #1: Raising gas prices will create runaway inflation

Reality: Experience in Europe shows significant energy savings from introducing efficiencies

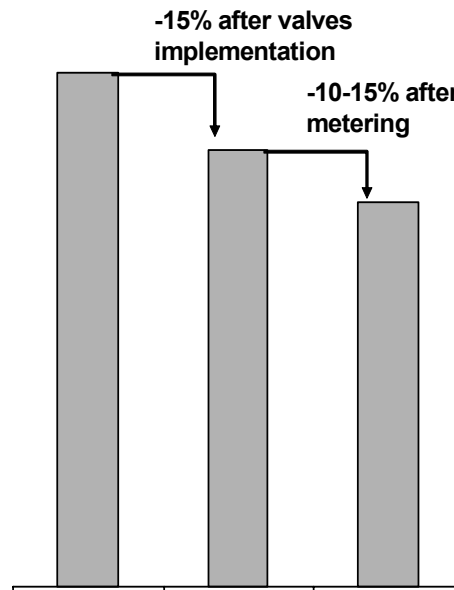
Price increase => 20% savings

Automatic valves =>15% savings
Meters installation =>15% savings

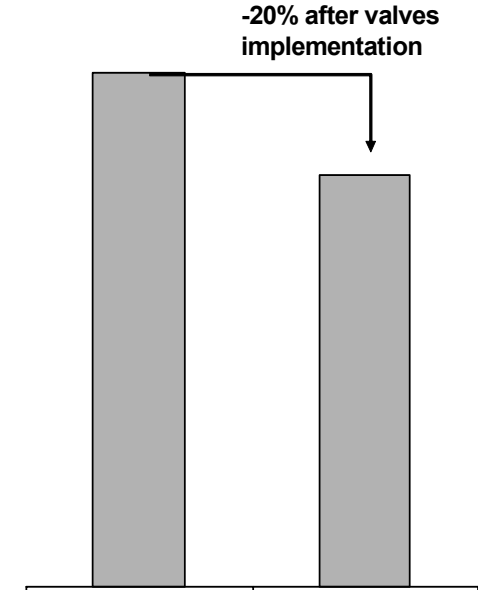
Introduction of valves



Poland gas consumption per household after price increase



Heating consumption in Western Germany

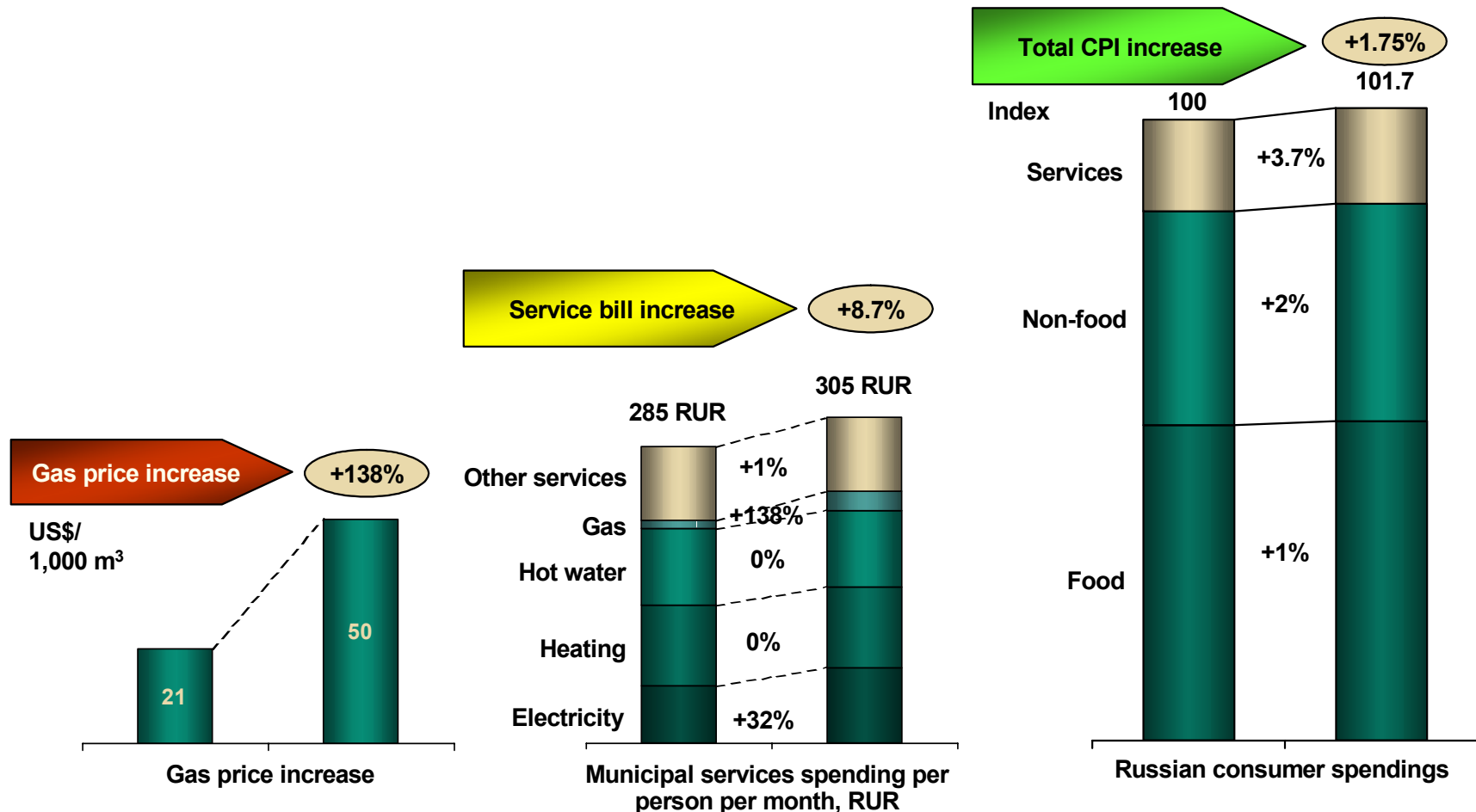


Heating consumption in Eastern Europe



Myth #1: Raising gas prices will create runaway inflation

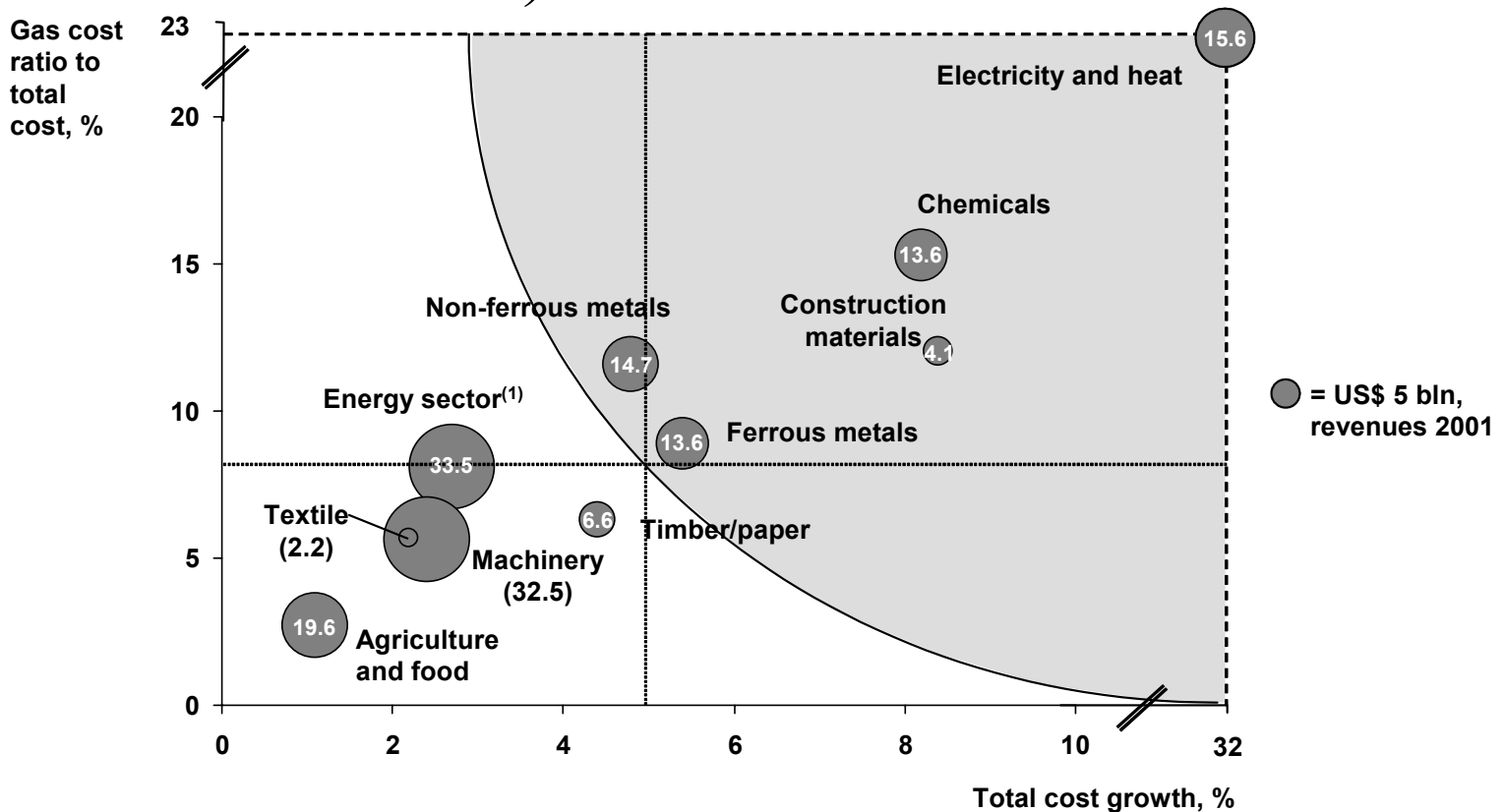
Reality: With decreased consumption, raising gas prices by 138% will only create 1.75% inflation





Myth #2: Raising gas prices will destroy Russian industry

Reality: Only a small part of Russian industry will feel the effect of raising gas prices (electricity, chemicals and construction materials)

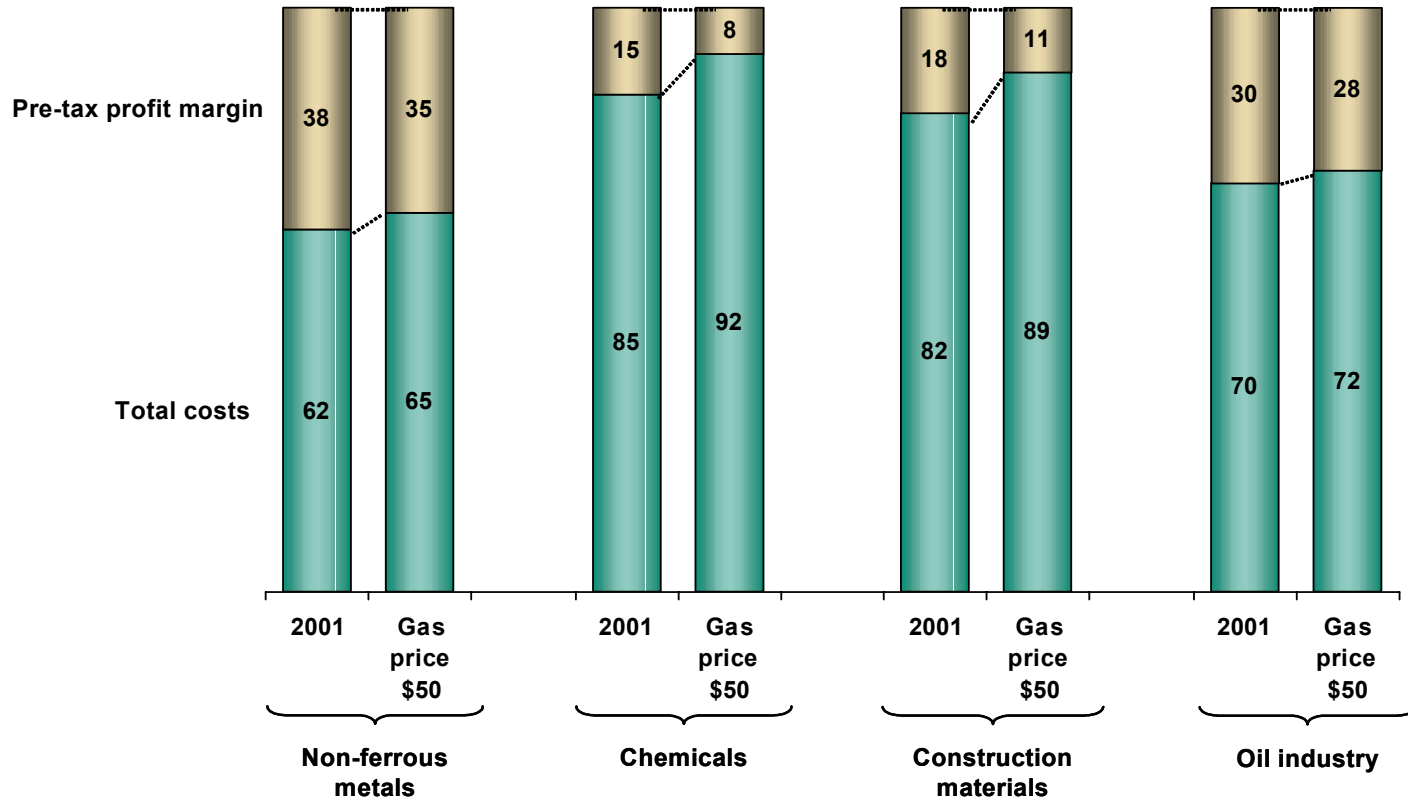


(1) Exp Gazprom self-consumption and transport losses
Source: Goskomstat; BCG estimates

Myth #2: Raising gas prices will destroy Russian industry

Reality: These same industries have had the highest margins because of massive gas subsidies in the first place

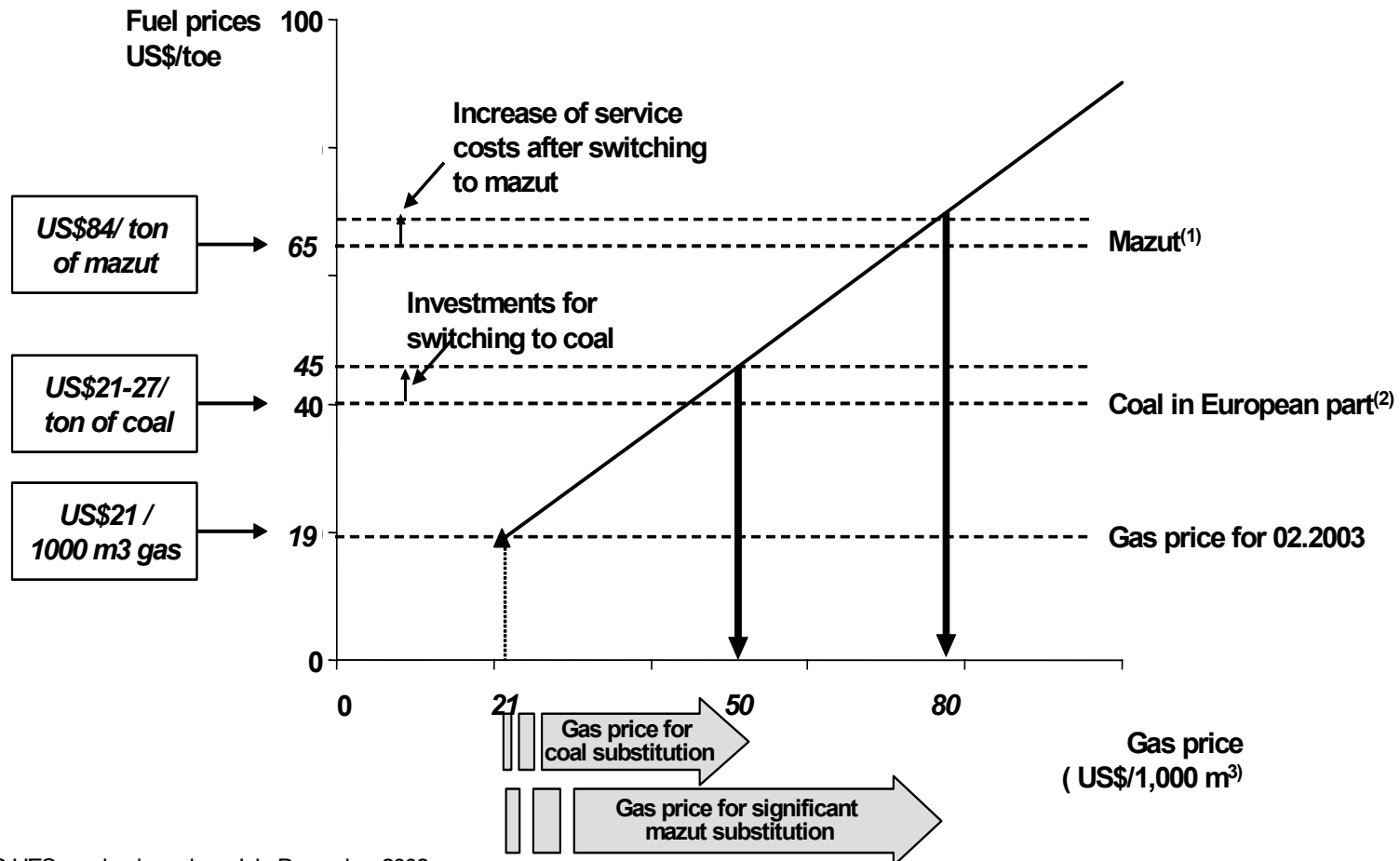
Pre-tax margin by industries in 2001 (actual) and estimated pre-tax margin at gas price \$50/1,000 m³





Myth #2: Raising gas prices will destroy Russian industry

Reality: In addition to certain industries losing, the Russian coal industry would gain



(1) RAO UES purchasing prices July-December 2002

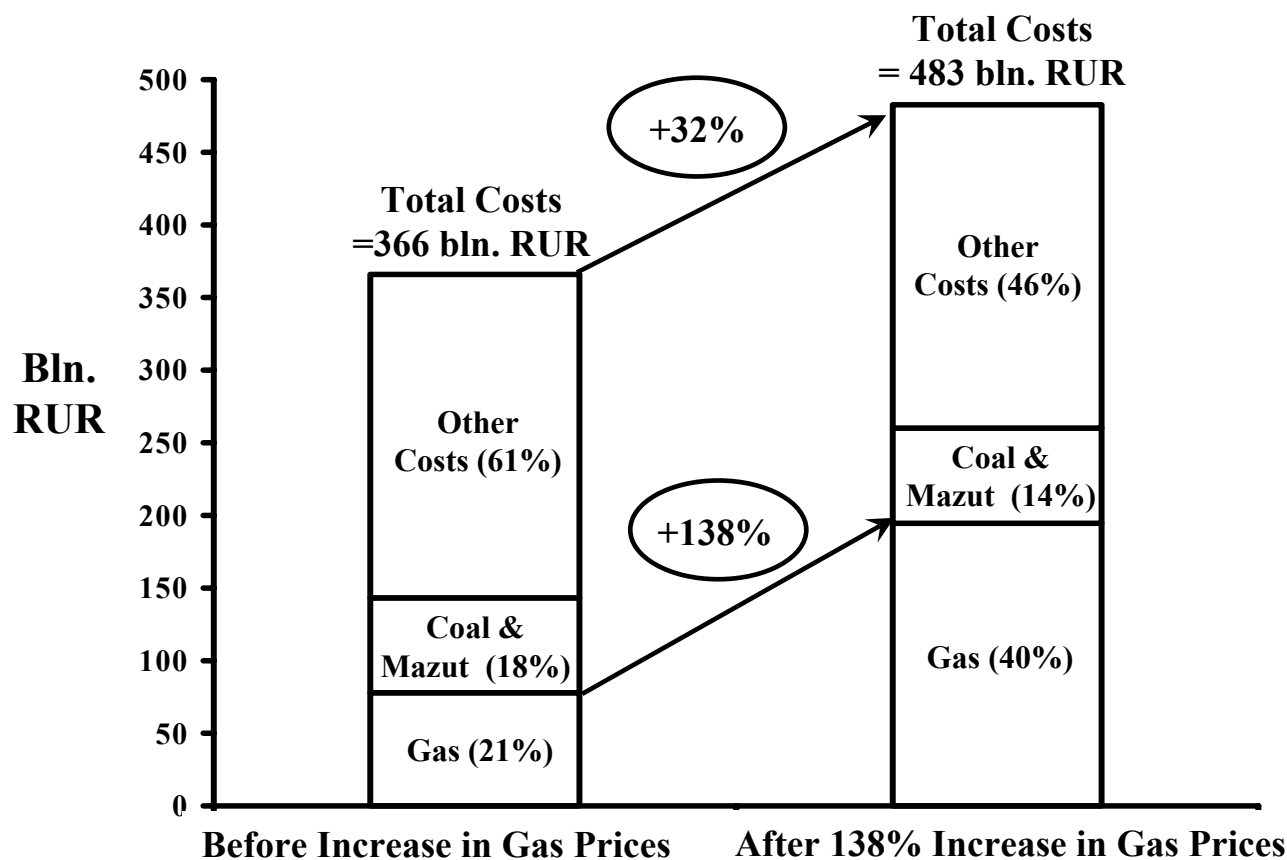
(2) BCG estimation



Myth #3: Electricity prices will need to increase by the same amount as gas prices

Reality: If gas prices are raised by 138%, Mr. Chubais can only justify a 32% increase in electricity

Cost Structure of Unified Energy (%)

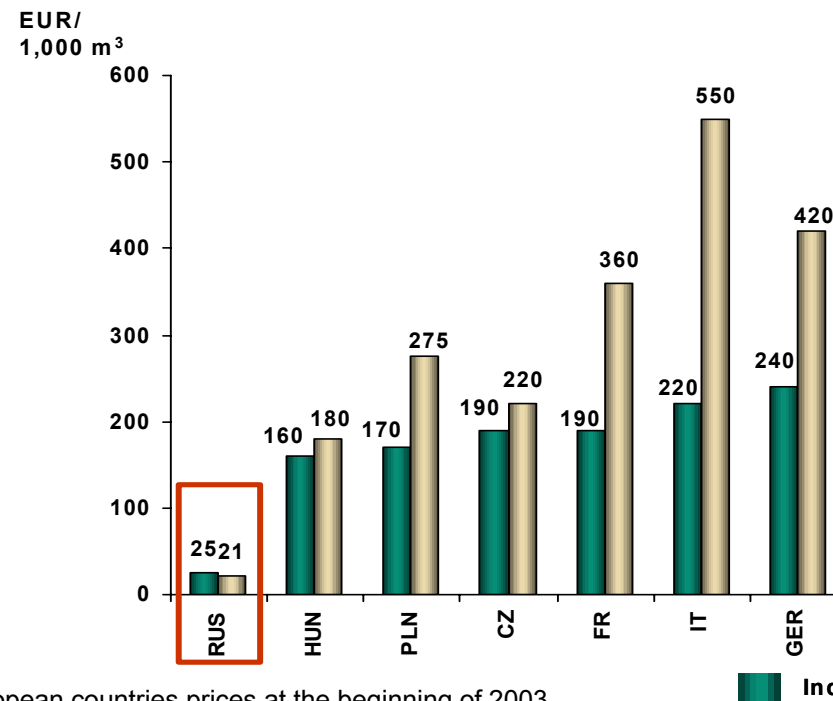




Myth #4: Low Russian gas prices are correct because of high transportation costs to Europe

Reality: Even adding \$60 per 1000 cubic meters for transportation, Russian gas prices would have to go up 5 times (!) to match European prices

Gas prices for households and industry in October 2002⁽¹⁾



(1) For Russian and Eastern European countries prices at the beginning of 2003

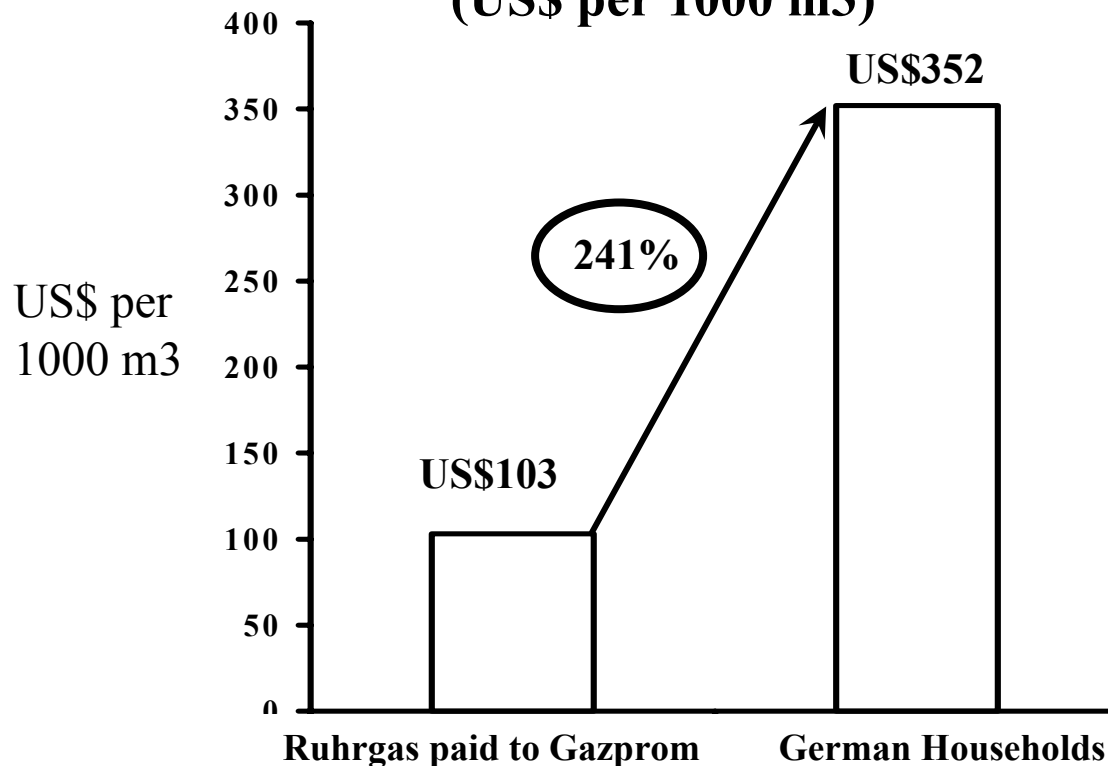
Source: Energy Advice Ltd; BCG Analysis



Myth #5: Ruhrgas is a good partner because Russia makes a lot of money on its exports

Reality: Gazprom leaves a lot of money on the table with Ruhrgas

**Purchasing prices of Gazprom gas by German customers*
(US\$ per 1000 m3)**



Source: European Gas Markets Issue 10.02.1, Eurostat "Gas prices for EU householders on 1 July 2002"

* All prices exclude taxes, ** 50 mln m3 per year, *** 10 mln m3 per year, **** 1 mln m3 per year, ***** 2,025 m3 per year

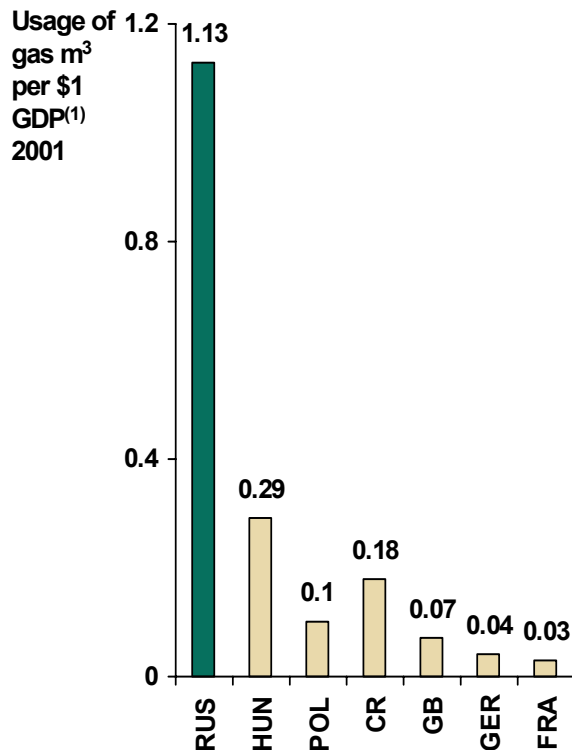
Myth #6: Cheap gas is Russia's national advantage



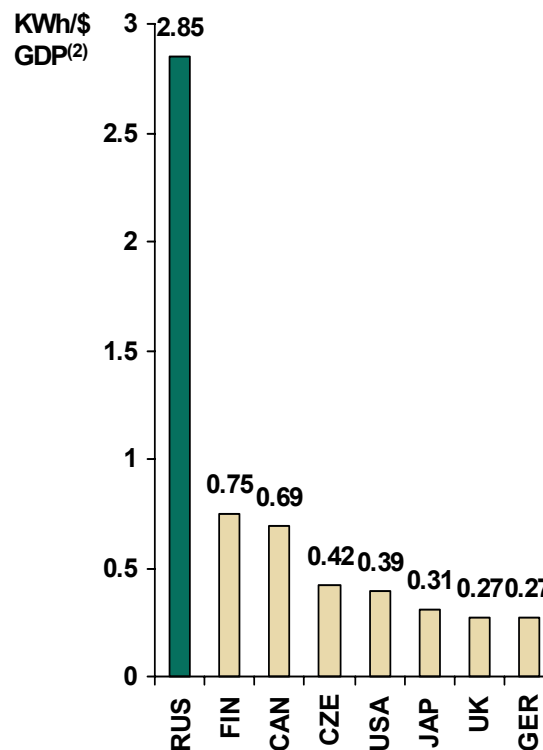
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Reality: Cheap gas is Russia's national opportunity to waste a valuable resource

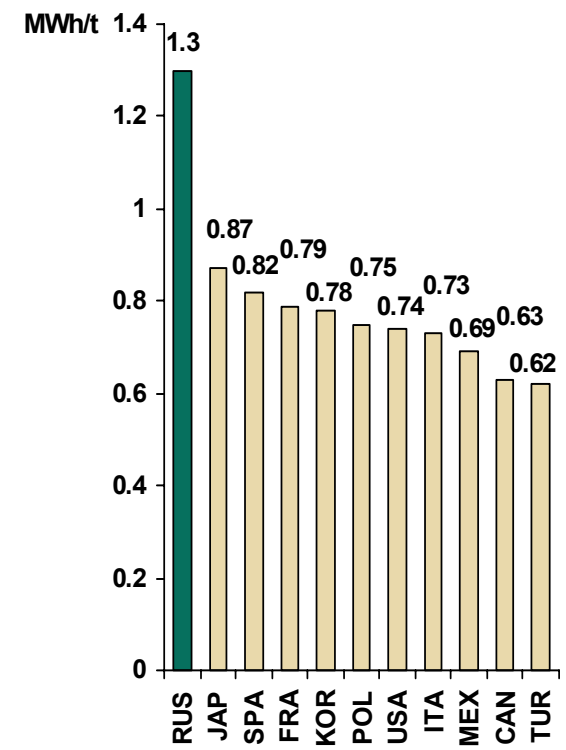
Usage of gas



Electricity consumption



Electricity consumption per ton of steel produced⁽¹⁾



(1) Data for 1999



Myths vs. Reality - Conclusion

By raising gas prices, Russia will eliminate one of the last barriers to WTO entry

Issues Resolved:

- Customs code
- Currency regulations
- Antidumping regulations
- Access to telecom services market
- Export of ferrous metals
- Tariffs for imported electronic goods
- Import of medical equipment
- Import of beer
- Clothes and textile
- Fish markets
- Tariffs for alcohol
- Import of pharmaceuticals

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8,250 (75% of all) tariffs on various goods and services

Issues still under Discussion:

- Domestic price of gas
- Domestic price of electricity
- Tariffs for imported cars
- Tariffs for imported aircrafts
- Subsidies to agriculture
- Access to financial services market



Myths vs. Reality - Conclusion

Effects on economy:

Higher efficiency of domestic energy usage

- Households' energy consumption- 30%

Russian coal industry gets additional growth

- +50 mln t/yr = 1 bln. \$

Additional gas available for export

- ~30 bln m³ = \$3 bln

Raising Gazprom profits allowing for investment in gas industry

- ~\$7 bln

Tax collection increase

- ~\$2.2 bln (+3% to federal budget)



Disclaimer

The information is based on data obtained from publicly available sources, which have not been verified by Hermitage Capital Management Limited, or any of its respective associates or affiliates. As a result of the difficulty in obtaining reliable data in Russia, we do not represent this information to be accurate and complete and we do not accept any responsibility for the reasonableness of any conclusions based upon such information.