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SHAREHOLDER RIGHTS, EQUITABLE TREATMENT AND THE ROLE OF THE STATE

*Case Study : Impact of the State on Corporate Governance Practices
at Ukrnafta*

By

Mr. Andrey Bespyatov
Analyst
Dragon Capital

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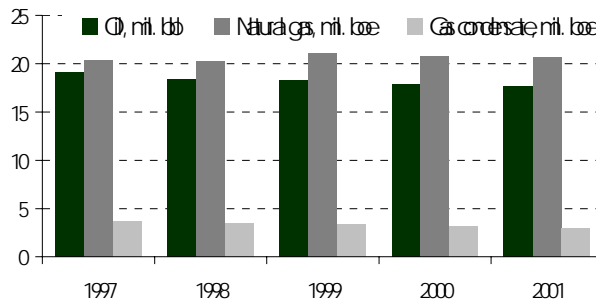


**The Global
Corporate
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Profile

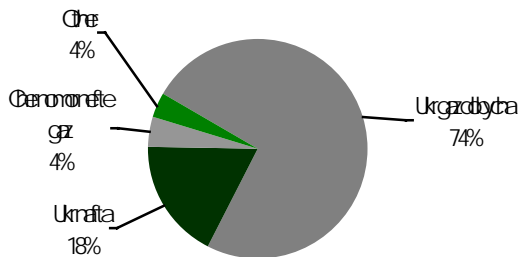
1. The joint stock company Ukrnafta was established in February 1994 from the state production association Ukrnafta. Employing 26.4 ths. people, the company includes 43 fully owned subsidiaries located in Poltava, Chernihiv, Ivano-Frankivsk and Lviv regions.
2. Production



Ukrnafta's Output (1997 - 2001)

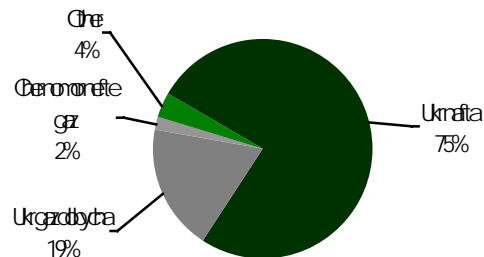
Source: Ukrnafta

3. Market Share:



Natural Gas Production in Ukraine in (2001)

Source: Energobusiness



Oil & Gas Condensate Production in Ukraine (2001)

Source: Energobusiness

4. Ukrnafta has been trading at a huge discount to the Russian peers (Lukoil, Yukos, Sibneft, Surgutneftegaz, Tatneft), which was 80% in 2000 and 79% in 2001 based on EV/EBITDA, EV/Sales, EV/Output, EV/Reserves, P/E and P/Sales.

Case Study

5. When Ukrnafta was created in 1994, its share allocation plan envisaged retaining a 30% stake in the state hands and selling the rest to international and local investors. However, the state ended up controlling a 50% stake plus one share, which was transferred to the state oil and gas monopolist, Naftogaz Ukrainy. The decision to retain control over Ukrnafta was explained by the company's strategic importance to Ukraine. . Therefore, it is unlikely that the government will sell its holding in Ukrnafta in the near future.
6. Ukrnafta is Ukraine's largest blue chip and the local market's most liquid stock. The government thus should understand that any harm to the company's reputation, resulting from any infringement of minority shareholders' interests, will inevitably spread to the whole stock market.
7. Ukrnafta's minority shareholder group includes Alfa Nafta, Privatbank, Ukrsybbank and affiliated companies, such as Copland Industries S.A., Watford Petroleum Ukraine, Occidental Management Co. Ltd. and others. Alfa Nafta is a large trader with about 300 gasoline stations, while the Privatbank-affiliated -controlled company Sentosa has about 400 stations. Besides, those companies also own large stakes in the refineries Galychyna and Naftokhimyk Prykarpattya.
8. Given Ukrnafta's important role in the oil market, Alfa Nafta and Privatbank collectively acquired about 30% of the company, which enabled them to block uninvited changes to the Charter. What is more important, the minority group wanted to secure supplies of oil to their refineries and oil products to their retail networks. However, the minority shareholders didn't receive the power to influence the way the company was run. Thus the scene was set for a lasting conflict between the state, the controlling shareholder, and the minority group. At first, the minority shareholders expressed dissatisfaction with the newly elected supervisory board and blocked creation of Ukrnafta's subsidiary, Ukrinternafta. The subsidiary was to operate in Yemen extracting 7.33 mil. bbl of oil annually, or 42% of Ukrnafta's current output.
9. Last year the minority shareholder group, which now also includes Ukrsybbank, increased its stake to over 40%, thus getting a legitimate right to block AGMs.
10. Following consolidation of the minority stakes to over 40%, the shareholder conflict at Ukrnafta became even more visible. The minority shareholders insisted on more transparent decision-making process, demanded that they be allocated 5 out of 11 seats on Ukrnafta's

supervisory board and that the company's registrar be changed. Most lately, the minority group started inquiring about transparency of Ukrnafta's gas sales to Naftogaz Ukrainy after Naftogaz's debt to Ukrnafta for purchased gas increased dramatically last year. Naftogaz refused to compromise, and the minority shareholders blocked Ukrnafta AGMs three times: on August 28, 2001, November 15 and February 12. The same thing could happen next time, on May 23, unless the parties involved find a solution.

11. Ukrnafta's supervisory board has the authority to control operations with retained earnings; approve creation of JVs, affiliated companies, etc; approve quarterly and annual targets for oil and gas extraction, processing and sale of gas and oil products; approve share buybacks; approve operations with real estate which are valued from 5% to 25% of the residual book value of PPE; approve other decisions valued at over UAH 25 mil. (USD 4.7 mil.). The key issue is the 60% quorum for supervisory board meetings. This explains why the state is so reluctant to yield to the minority group's demand to have five seats on the supervisory board, as it amounts to giving the minority shareholders the right to invalidate the board's meetings. However, even with three seats the minority shareholders will be able to block such issues as approval of operations with real estate valued from 5% to 25% of the residual book value of PPE, share buybacks and approval of charters for Ukrnafta's branches and affiliated companies (which require 75% of the vote). As the supervisory board wants to increase the quorum to 2/3, four seats could be a partial solution to the problem.
12. The average price of natural gas in Ukraine totals USD 59/th. cu. m., while Ukrnafta was selling its gas to Naftogaz Ukrainy at an average price of USD 24.6/th. cu. m. in 2001 and expects to sell it at USD 22.3/th. cu. m. in 2002. Since a sharp increase in Ukrnafta's gas price could unsettle the domestic energy balance, the minority shareholders accepted the current price on condition that all payments are made on time and in cash. However, by end-2001, Ukrnafta's receivables grew by 36% y-o-y, to USD 124 mil., with the state's debt for gas and oil accounting for about 90% of that sum. Moreover, in 2001 the gas debt to Ukrnafta doubled to USD 70 mil. (with Naftogaz accounting for 94% of it), as the company received money for only 16% of the gas it sold, down 61 percentage points y-o-y.
13. The government recently has been actively promoting integration of Ukrnafta with Ukraine's largest refinery, Ukratnafta, in which the state holds a 53% stake. The agreement is not expected to disrupt oil auctions, as Ukrnafta will be selling oil to its subsidiary or buy it itself

via auctions only. The oil will be processed at Ukratnafta and then wholesaled to traders, as Ukrnafta does not have its own retail network.

14. Although Ukrnafta's minority shareholders have own oil product retail networks, according to Ukrnafta's CEO, Oleg Salmin, the company does not count on their trading business in its vertical integration project. Moreover, it is becoming evident that, although the state holds stakes in both Galychyna Refinery and Naftokhymyk Prykarpattya, it is intent on integrating Ukrnafta with Ukratnafta.
15. Besides the unwillingness to jeopardize the supervisory board's activity by allocating 5 of its 11 seats to the minority group and thus effectively giving it more decision-making authority, there are other reasons for the state (read Naftogaz Ukrainy) to refuse to compromise. Naftogaz is pushing forward with Ukrnafta's vertical integration with Ukratnafta, something the minority shareholders will probably want to change to account for, at least partially, their own interests. Additionally, the state is wary about any potential reduction in tax flows from such a big taxpayer as Ukrnafta, which last year paid USD 232 mil. to the budget. But it is obvious that if the current conflict continues, Ukrnafta's development plans, sales growth and, consequently, tax payments will all suffer.
16. The continuing disagreement already prevented the state from receiving USD 7.4 mil. from Ukrnafta in 2000 dividends. Accounting for 2001, the state stands to lose USD 15 mil. in planned dividend payments from Ukrnafta, which account for 19% of total dividend revenue the State Property Fund (SPF) plans to collect this year.
17. Last year the VR unsuccessfully voted on a motion to change the quorum for shareholder meetings from 60% to 50%, which we believe is directly related to the Ukrnafta case. This is another example of the state's reluctance to negotiate.
18. The SPF is another state representative in the company besides Naftogaz, with a 0.03% stake. This minuscule holding, however, gives the state more leverage. As this stake is considered not privatized under Ukraine's privatization law, Ukrnafta is prohibited from the following operations: asset-stripping, share capital increase, factoring, change of the company's structure via M&A or splitting. As a result, Ukrnafta is limited to borrowing on the domestic or external markets, which is so popular among Russian companies and has been used by such Ukrainian oil companies as LiNOS.
19. As the dispute continues, Ukrnafta management is prevented from developing long-term strategies and negotiating foreign projects, which must be approved by a shareholder

meeting. Thus, the conflict has virtually suspended Ukrnafta's foreign activities, particularly a planned JV with Libya's National Oil Corporation, which was to have been discussed at the failed AGMs. Ukrnafta lacks financial or technological resources to participate in M&A activities, widespread in the sector, or explore oil and gas fields abroad on its own. Therefore, Ukrnafta's major valuable resource is its employees, who have experience working with highly depleted oil fields. Hence, together with the vertical integration, international projects offer the most promising way for diversifying Ukrnafta's business.

20. Almost all of the minority shareholders' requirements have much in common with the corporate governance principles adopted by OECD. By receiving a blocking share of seats on Ukrnafta's supervisory board, the minority shareholders will not only get information about the company's activity but will be able to influence decision-making process, including participation in the election of the Board of Directors and control of other important decisions that may have a significant effect on the company's overall performance. One of such issues is Ukrnafta's business with Naftogaz regarding the sale of gas and payment for it.

Conclusions

Having studied the above case, the following conclusions can be drawn:

Ukrnafta is the leading Ukrainian stock and any problems with it will affect the whole stock market.

The state is represented in Ukrnafta by Naftogaz Ukrainy and the State Property fund. They have their own view of how to manage and develop Ukrnafta, and have been unwilling to share it with anyone up until now.

The minority shareholders consolidated their stakes in order to have more influence over the company's management, be able to elect members of the board (I.A of the OECD Principles of Corporate Governance) and to control material foreseeable risk factors (IV.A.5).

The shareholder conflict at Ukrnafta has adversely affected the company's international expansion plans, namely projects in Yemen and Libya.

We believe that after the parliamentary elections negotiations between the conflicting sides will bear fruit. Political tensions ahead of the vote left little room for constructive talks as the parties involved were also active participants of the election race. Therefore, we expect agreement to be reached before May 23, as economic reasoning should finally prevail. Eventually, both Ukrnafta and the minority shareholders stand to benefit from the company's

vertical integration, as unification of production, processing and trading facilities will turn Ukrnafta into a strong competitor of Russian oil companies actively expanding in Ukraine, such as Lukoil and TNK.