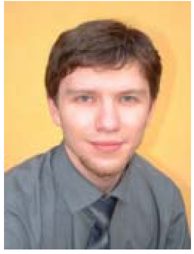
CONCORDE CAPITAL

Vladimir Nesterenko
vn@concorde.com.ua
+380 44 207 5037
www.concorde.com.ua
Bloomberg: CONR<GO>



Analyst's Notebook

Ukraine / Oil & Gas
June 27, 2006

Fuel Import Duties To Return

What's The Point?

The members of the recently formed Parliament coalition agreed to restore import duties for oil products in three months. The size of the duties were not disclosed, but taking into account that the duties are not supposed to be protective, but "stimulate domestic oil processing," we do not expect them to exceed EUR 25 per mt (~USD 0.025/L), which is the level that was suggested earlier this year by the Economy Ministry. Import duties for oil products were cancelled in May 2005, before that they were about EUR 15-40/mt.

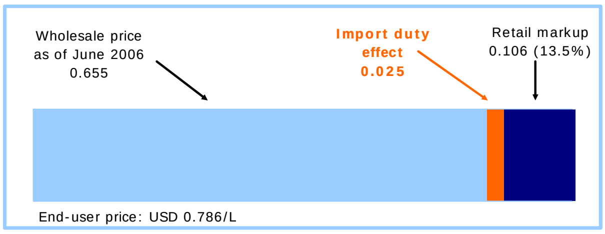
What Does This Mean?

On average, the revival of duties will not spur fuel prices much, 3.7% max. Though, the effect will be unevenly distributed among the market participants. Integrated fuel producers and retailers will benefit from lower competition from imports and higher margins. In contrast, pure retailers will have to accommodate for extra costs with markups, in order to retain their market shares. End consumers also will not welcome the initiative as ultimately they will have to pay more for fuel of inferior, on average, quality. This announcement has not caused us to alter our valuation of the oil & gas names we cover: Galnaftogaz (**GLNG:BUY**) and Ukrnafta (**UNAF:HOLD**), as the effect on their business is likely to be quite small. The move will be positive for Ukraine's oil refineries (Odesa, Galachyna and Kherson) as the duties will increase for domestically processed oil.

The Effect On Fuel Prices Will Be Negligible… On Average

We estimate that, other things being equal, the *maximum possible* effect of the introduction of duties will be a 3.7% one-off permanent increase in domestic wholesale and retail fuel prices, implying about a 1.2% higher yearly average price. In reality the effect may be much smaller due to the competition between local producers and imports and independent retailers.

Net Effect Of Duties On Domestic Fuel Price*, USD/L



** The estimates are based on the average domestic wholesale and retail fuel prices in June 2006 (USD0.655 and USD0.757/L respectively). The average price is calculated by simple average aggregation of daily fuel prices, weighted across the products (high-octane gasoline – 35%, low-octane gasoline – 30%, diesel fuel – 35%).*
Source: UPECO (oil products prices), Concorde Capital estimates

Winners And Losers

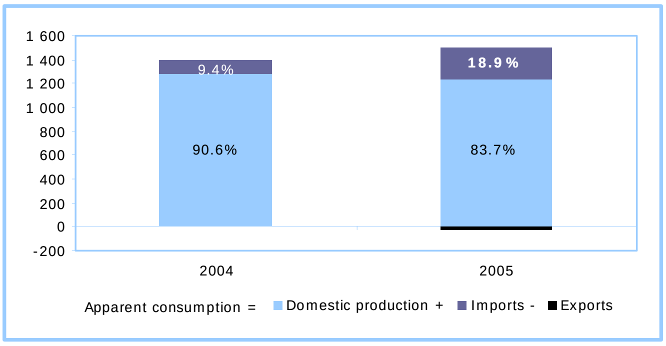
We expect the introduction of import duties to trigger a classical textbook leader-follower price game in the local fuel market. Due to narrow margins and relatively small-sized business, the independent retailers are likely to lead the game and thus lose, both in terms of their market share and profitability. Though, the loss will not be material enough to kill the independents, provided the size of the duty is around the figure suggested by the Economy Ministry. Final consumers will bare most of the economic cost from the new duties.

Domestic Fuel Producers. We believe the introduction of import duties will improve the market power and profitability of domestic oil processing companies. They will be able both to improve margins and to retake some portion of their market share which they lost to imports in May 2005, when the duties where cancelled. We expect the major players, like Ukrtatnafta and LiNOS, to increase their prices only slightly, say by 1.5-2.0%, making imported products less competitive and to push independent retailers to substitute imports with locally produced fuel in their wholesale purchases. As the duties won't affect refining costs, the refineries will definitely benefit from the duties, and possibly will share these extra profits with their retailing affiliates.

Historical Note

Due to their poor efficiency and hence limited ability to undercut prices, combined with the low quality of their products, Ukrainian refineries have been suffering from severe price/quality competition with imports form Belarus and Lithuania since the cancellation of duties in May of last year. In 2005 Ukrainian plants refined 17.8% less oil than in 2004, production of gasoline decreased by 13.4%. In the meantime, imports increased substantially last year. For example, imports of high-octane gasoline almost doubled. The share of imported gasoline in domestic apparent consumption increased to about 16%, from roughly 9% in 2004. This year, imports continued to conquer the Ukrainian market: in 1Q06 oil refining dropped by 31.1% yoy, production of gasoline – by 25.3%, while fuel imports were growing further.

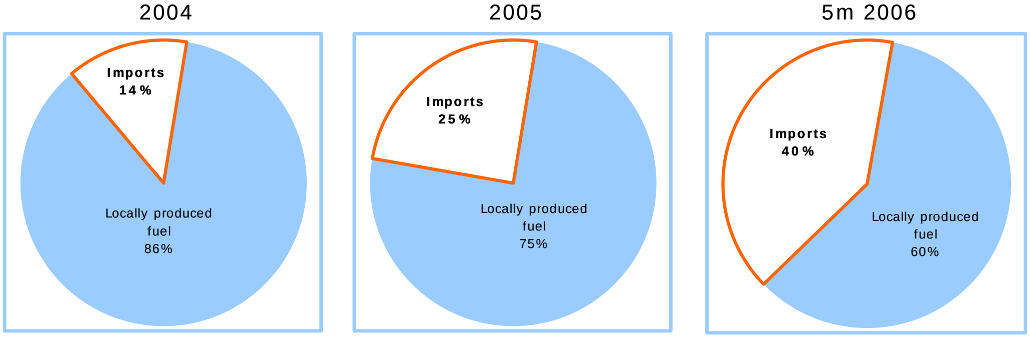
Apparent Consumption Of High-Octane Gasoline: 2005 vs 2004



Source: Energobiznes, Concorde Capital estimates

Independent Retailers. Being smaller and less profitable businesses compared to integrated refining & retailing companies, independent retailers will eventually have to react on import duties by reducing their markups, to be able to stay price competitive. To remain competitive on the quality side, they will also need to retain some portion of more expensive imported products, though their share in sales will decrease. All in all, we expect the market share of independent retailers to decrease slightly, while their gross margins will be down on average to 8-9% from the current 9-10%.

Share Of Imported Fuel In Galnaftogaz* Sales



** Galnaftogaz (GLNG:BUY) is an independent Ukrainian fuel retailer*
Source: Company data

See the Appendix on the next page for more details on Ukrainian fuel producers and retailers.

Appendix. Ukrainian Fuel Producers And Retailers

***Domestic Fuel Producers*:** Kremenchuk Refinery a.k.a. Ukrtatnafta, Lisichansk Refinery a.k.a. LiNOS (TNK-BP), Kherson Refinery (Aliance, **HNPK**), Odessa Refinery (LUKOil, **ONPZ**), Drogobych Refinery a.k.a Galychyna (Privat, **HANZ**), Nadvirna Refinery a.k.a. Naftokhimik Prykarpattya (Privat, **NAFP**). Together with Ukrnafta **(UNAF:HOLD)**, the company engaged in both oil & gas extraction and fuel retail, HANZ and NAFP form the core of Privat Group's oil business.

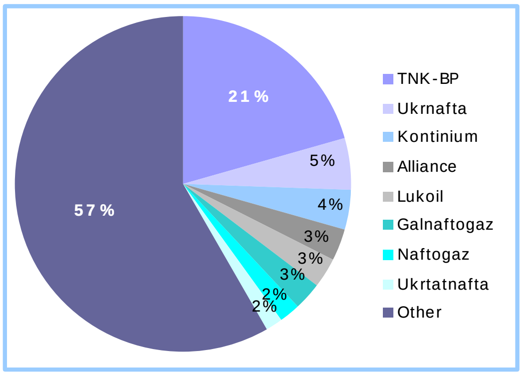
Refinery Roadmap

Company name	Location	Key shareholders	Stake, %	Nameplate refining capacity, mln mt/year	Share in Ukraine's capacities, %	Products refined in 2005, mln mt	Products refined in 2005, as % of 2004	Capacity utilization level in 2005, %	Processing depth in 2005, %
Closed JSC Ukrtatnafta	Kremenchuk	Naftogaz Tatarstan	43% 56%	18.4	35.36%	6.0	91%	32.5%	72.2%
LiNOS Ltd.	Lisichansk	TNK-BP	78%+1	16.0	30.71%	6.0	91%	37.6%	71.5%
Open JSC Kherson Oil Refinery*	Kherson	Alliance Group JSC Ukrnaftoproduct	28% 60%	7.1	13.60%	0.9	56%	32.2%	47.9%
Open JSC Lukoil-Odessa Oil Refinery*	Odessa	LUKOil	93%	3.6	6.89%	1.4	57%	38.9%	54.9%
Open JSC Oil Refining Complex Galychyna	Drogobych	Privat SPFU	73% 25%	3.5	6.72%	1.1	48%	35.7%	62.3%
Open JSC Naftokhimyk Prykarpattya	Nadvirna	Privat SPFU	70%+1 26%	2.5	4.80%	2.1	117%	82.7%	60.6%
Shebelynka Gas Processing Plant	Shebelynka	Naftogaz	100%	1.0	1.92%	0.9	n/a	95.6%	91.0%
Total				**52.1**	**100.00%**	**18.3**	**21.2**	**35.1%**	**68.5%**

** stopped for major overhauls in 2005*
Source: Nefterynok, Concorde Capital estimates

***Independent Retailers*:** Concern Galnaftogaz (**GLNG: BUY**), Kontinium (a.k.a. WOG), Gefest, KOLO, etc.

Retail Market Breakdown by Number of Gas Stations, 2004*



** Independent retailers mostly fall into the "Other" category, except Kontinium group (WOG brand), which sold its refinery (Galychyna) to Privat group in early 2006 and now should be treated as an independent retailer.*
Source: Ukrainian News, RBK, Investgazeta, Dilova Stolytsia, Company data