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Analyst's Notebook

Ukraine / Oil & Gas
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Ukrnafta To Suffer From Another Royalty Hike?

5% Of UNAF's Value At Risk

On June 5, 2006, the Cabinet changed the formula for royalty calculation. Provided the new formula holds throughout our forecast period (2006-2015), higher royalty payments would lead to about 5% erosion of Ukrnafta's (UNAF) fair value. At this point, however, we are waiting to see whether the government's decision is supported by the Rada, which is yet to vote on the changes to the State Budget Law '2006. We maintain our target (USD 62.6) and recommendation (**HOLD**).

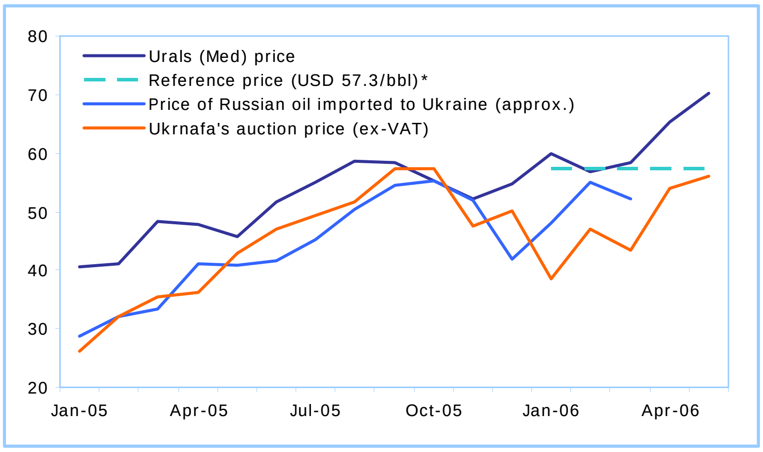
Oil Royalty Now Pegged To Russian Oil Prices

In order "to eliminate the possibility of artificial royalty reduction by manipulating auction prices," the Cabinet decided to peg royalties to the highest price from either the domestic oil auction price, or the price of Russian oil imported to Ukraine.

Royalty To Increase, Gross Sales Will Not Be Affected

In the short term, the government's initiative is likely to result in roughly 10% higher royalties for UNAF compared to our forecast (see our report from May 11, 2006). We expect UNAF's royalty payments to increase proportionally to the gap between Russian and Ukrainian oil prices. In 1Q06 the gap was about 17.2% on average, much larger than 7.8% in 2005, though we believe the gap won't exceed 10% on average this year.

UNAF Auction Price Gap To Russian Oil (USD/bbl, ex.VAT)



Source: Company data, Ukrainian News agency, Bloomberg, Concorde Capital estimates

UNAF's auction prices and gross sales will not be affected. As we demonstrated in our report from May 11, 2006, the idea of economizing on royalties by selling oil cheaper contradicts profit maximization behavior. Instead, UNAF's auction price is determined by the required margins of Privat's refineries.

For Geeks: The New Royalty Formula

The previous formula, introduced by the State Budget Law '2006, pegged royalties to the price at the latest oil auction:

$$Royalty_{t1} = Royalty_{base} \times (Pa \,/\, Reference\ price_{t0})$$

where t1 – current reporting period, t0 – October 2006, Pa – latest auction price. The base period is fixed by the law, as is the reference price, which is the price of oil sold at the October 2005 auction (USD57.3/bbl, ex. VAT).

The new formula pegs the royalty to the highest of the two oil prices: auction price and the price of Russian oil imported to Ukraine:

$$Royalty_{t1}^{new} = \begin{cases} Royalty_{base} \times (Pa_{t1} \,/\, Reference\ price_{t0}), & \text{if } \mathbf{Pa_{t1} \geq Pi_{t1}} \\ Royalty_{base} \times (\mathbf{Pi}_{t1} \,/\, Reference\ price_{t0}), & \text{if } \mathbf{Pa_{t1} < Pi_{t1}} \\ Royalty_{base} \times (\mathbf{Pi}_{t1} \,/\, Reference\ price_{t0}), & \text{if } \mathbf{Pa_{t1}} \textbf{ does not exist*} \end{cases}$$

** that is, if there were no auctions in the current reporting period (t1).*

where Pa_{t1} – auction price in the period t1 (current reporting period), Pi_{t1} - weighted average price of Russian oil imported to Ukraine. The price is to be provided to the Ministry of Economics by the customs services.