Energy Sector Operating Risks Rise In Line With Oil Price Expectations

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Fitch Ratings-London-09 July 2004: Fitch Ratings, the international rating agency, said today operating risks in the energy sector have risen alongside oil price expectations, with record profitability at major players being accompanied by creeping expropriation, through taxation increases or political interference, or a detrimental operating environment where governments push for a greater take of the increased value added per barrel. Oil prices have been volatile over the past four years but have broadly risen from lows of Q1 1999, most steeply over the last 30 months in USD terms, reaching recent 20-year highs. This has been transposed into forward prices, which reflect a market view that prices may remain between 50 - 80% higher than median and average prices seen during the 1980s and 1990s. As a result major upstream players have seen record profitability and in many cases returned capital to shareholders, as development criteria deter reinvestment. However, beneath these top-line benefits underlying longer term risks to international operations are developing. In Russia, Yukos is likely to become insolvent, as part of an ongoing back tax reassessment, or provide an as yet unidentified concession to the tax authorities. The range of possible outcomes is complicated by the superior ranking of secured creditors above taxation creditors in insolvency, licence conditions in relation to solvency and the widely speculated political issues relating to the imprisoned former CEO. However, it now seems increasingly likely that a degree of state ownership will result from some form of debt-for-equity swap. Operating frameworks for major international oil companies in the development of the resource-rich Sakhalin area have also been detrimentally affected by a decision by the Natural Resources Ministry to back the cancellation of a 1993 tender for the Sakhalin 3 development. This will result in a consortium including Exxon Mobil ('AAA' / Outlook Stable) and Chevron Texaco ('AA' / Outlook Stable) losing the opportunity to continue development, potentially under a lucrative PSA and tax regime and having to participate in a new tender. Costs of construction at the Sakhalin 2 development (Royal Dutch Shell 'AA+' / Outlook Stable - 55%, Mitsui 25%, Mitsubishi 20%) are set to increase by at least 20% to USD 12 billion as a result of tighter environmental regulations, while at the same time state-controlled OAO Gazprom ('BB' / Outlook Stable) negotiates to join the consortium. The recent Sakhalin 5 joint venture agreement between BP (49%, 'AA+' / Outlook Stable) and state-owned Rosneft (51%) provides that BP funds a disproportionate share of field development costs. In addition, the threat of licence revocation remains a threat for international oil companies in the absence of "acceptable" development plans. Such pressure has resulted in a recent agreement by Shell for incremental investment under amendments to the original Salym licence. Other upstream players are expected to follow with similar amendments over the coming months. Operations in major oil-producing countries have recently been adversely affected by industrial action driven by pay demands and apparent employer profitability. This year Norway (worlds 3rd largest national exporter in 2002) oil field workers staged an eight-day strike which reduced production by 10%, while last year Venezuela's PDVSA (7th largest, 'B-' / Outlook Stable) suffered a 2 month strike which reduced 2003 production by c.8%. Most recently strikes in Nigeria (6th largest) over the last two days have already resulted in a 10% drop in output. A two-week strike last year did not affect production. High prices have also contributed to increased conflict and oil theft in the onshore Niger delta. Last year violence escalated over a two-week period, resulting in a reduction to national production of 35%. In Kazakhstan, an intention in March last year by BG Group ('A-' / Outlook Positive) to sell its 16.67% stake (price USD 1.2 bn) in the exploration phase North Caspian PSA to CNOOC ('BBB' / Stable Outlook) and Sinopec resulted in 5 of the 6 remaining partners exercising pre-emption rights. The sale, originally set to complete by end 2003 is now threatened with the state, not a PSA partner, recently claiming an exclusive pre-emption right and as a result are set to become a significant partner in the field at the original price. Taxation rates around the world have notably increased in response to the rise in oil

prices over the last 18 months. In most cases these are not significant from a credit perspective, as the overall take at lower price levels remains flat. Perhaps, most surprising is the fact that tax increases have been seen in comparatively mature economies. For example, the UK upstream operators suffered an increase to petroleum revenue tax in 2002/03. There remains, in extremis, the possibility of wholesale expropriation in exporting nations with low production upside, lifting costs and technology requirements where increased state take outweigh the need for foreign capital. The 1970's witnessed extensive expropriation, most notable occurring in Iran where from 1973 through the 1979 revolution, sectoral ownership and operatorship were transferred to the state through the National Iranian Oil Company ('B+'/Outlook Positive). Fitch continues to monitor for the above risks for rated issuers. Contact: Isaac Xenitides, London Tel: +44 (0) 207 417 4300 Media Relations: Alex Clelland, London, Tel: +44 20 7862 4084.