

Convergence & Differentiation

What is
success in
a connected
world?*

Interview transcripts of Leonid Fedun,
Vice-President, JCS LUKOIL,
Russia



Leonid Fedun is Vice-President of JSC LUKOIL

PwC: How confident do you feel about future growth?

Leonid Fedun: The situation that has now developed in the Western markets is fairly evidently dependent on such negative aspects as the financial crisis. There, 70%–80% of gross domestic product is in the consumer services sector and a large part of this is accounted for by financial services. For this reason, such fluctuations as are now occurring on the market naturally have a negative effect on both the rate of development and all financial indicators, and the economy itself is extraordinarily dependent on the progress of the crisis. For developing markets, the situation is somewhat different, since the share of services is 50% at best, and the main industrial sector creates more value anyway, so there's no direct dependence.

Secondly, developing markets themselves, which for a long time were looked at as appendages of the overall global economy, are now to a significant degree beginning to work for themselves. This can be seen in China, in India, and to a significant degree in Russia.

The growth in domestic consumer demand creates a base that depends very little on the situation in America. ... There might be a certain contraction of consumer demand, but it will be extremely minor, unless of course oil prices tumble. But oil prices are set by OPEC. . On the whole, I think that there will be a further shakeout of players. In other words, countries with traditional old economies will lag behind in development compared to countries with a new economy, which is now called a developing economy, although in my view this term is also not entirely correct. The potential of these countries will continue to grow in the future, for a minimum of three years. I am confident about that.

As for Russia, there are fundamentally no grounds to think that oil prices will change substantially in the near future – say over the next three years. This means that there will be a constant financial replenishment, large injections, reserves are going to pass the \$500bn mark in the next few months, and given these prices and these oil duties, will continue to grow at a furious pace. In other words, the state has a very strong financial lever to resolve social problems, to continue to pump money into the economy. On the one hand, this will stimulate inflation, but inflation, like any two-edged sword, will stimulate consumer demand. If consumer demand is stimulated, then the other sectors of the economy will develop. That is to say, rates of 6%–7% are quite realistic given an oil price of \$80 and above. At the same time, the weakening of the dollar – \$1.80 per euro, or say 20 roubles to the dollar, by the end of the year – will not have a substantial effect on the situation, for the simple reason that the engine that's driving the Russian ship is not the global market, but the domestic market.

The problem of refinancing may affect banks. They took out big loans, as I understand it, but since the main borrowers are still state structures, I think that there will be a direct or latent transfer from state resources to the problem sectors. That is to say, the main trend that will remain strong for three years is a high oil price. This will ensure social and economic stability. Are there fundamental reasons for the oil price to drop? No, because 60% of oil production is controlled by countries that are interested in high prices. These are OPEC plus Russia, plus a few other countries that are able to regulate the price. A change in the situation is possible only if some other major deposits appear. Over the past 30 years three deposits have been found in the Mediterranean. One is high-sulfur – the Kazakhskoe deposit. Two others are deep-water deposits that lie at 3,000m, and thus there will be no effect on prices, as occurred when deposits in the North Sea and the Gulf of Mexico were discovered. At the time this helped to break the price trends that had been established in the 1970s and 1980s.

That's why there is a certain optimism.

Emerging Markets Perspectives – CEO Insights

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If we turn to negative aspects, then of course there is the ultra-high level of taxation on Russian oil companies. They have already exceeded 70% , so we're approaching Venezuelan conditions. But at the same time, I think that the company has adapted to this, since if the current trend continues, profits this year will reach more than \$20bn. So taxation is not a serious burden, because we have internal reserves that allow us to develop fairly successfully, and even to expand beyond the bounds of developing markets. But let's put it this way, today approximately one-third of Lukoil's value lies outside the Russian Federation. This is a fairly important basic factor, and on the whole we need to expect that the state will stimulate the progress of Russian companies, above all into developed and developing markets. Thus here too a certain optimism remains.

PwC: To talk about Lukoil's global ambitions, so to speak, what are your competitive advantages besides access to natural resources?

Leonid Fedun: That is our main, fundamental advantage. But the main problem that exists today for all of the world's leading companies is the short period of life given to them. In other words, given current rates of production, and given the restrictions on access to new resources, companies can in fact only count on 7–8 years. We're talking about proven resources here. For this reason, they are already moving to new indicators such as the "best-estimate resources". That is, you have an estimate appearing beyond the so-called 3P. We have a significant volume of resources that allow us to generate a high cashflow given the high oil price, and for this reason we are an attractive merger target. In addition, right now the refining margin and the credit margin have fallen sharply, both in Europe and worldwide. For this reason, in the near future we will make an effort to buy major players in order to diversify production, since our main aim is to balance the hundred million tons of oil that we produce with the same volume of refining, which will at least double our profits.

PwC: A question from a somewhat different area. Many companies in Russia, including even resource companies, say that one of their competitive advantages could be human resources. And naturally everyone complains, saying that now the situation with human resources in Russia is catastrophic. There are not enough people for managerial positions. I would like to know what you think of this in general, what you're doing to smooth the transition to the next generation of managers. And in general, if you could compare, let's say, what you demand from leaders who are coming up behind you and how comparable these requirements are with those demanded from managers in Western countries, in mature economies. Is there any difference?

Leonid Fedun: Well, you know, I don't see this problem in my company. Over the past two years, 60% of our senior executives have been replaced. These were people from the older generation, mostly 60 years old. In their place came people in their 30s and 40s. In my view, they're working fairly successfully.

On the whole, then, the HR problem doesn't hurt us strongly, since we are, after all, an old company. For 15 years now, we have had agreements with the leading Russian institutes on training specialists, and we have a special system to select stipend recipients. Also, more and more foreigners are working for us. For example, the whole downstream sector, refining, is headed by Miller, an American. In other words, we're drawing from the global market of specialists, and have a system of exchange of specialists with the western companies, including CONOCO.

But, of course, it would be incorrect to say that we have no problem with human resources at all. It has always existed, and we'd like to have the best specialists. But to say that it's holding back our growth would be absolutely not true.

Moreover, we have a different problem facing us. Since the cost of resources is going up, we are forced to do what other oil companies were forced to do in the 1970s and 1980s. I currently have 140,000 workers, and I need only 60,000. That is, I need to take a whole series of steps associated with outsourcing, with recapitalisation, in order to shrink the number of workers by approximately 50%, and then again by 50%.

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PwC: I see. And how does this mesh with the company's position as a socially responsible company? Do you have specific plans for reorienting?

Leonid Fedun: Our social responsibility, first and foremost, is to pay taxes. We pay half as much tax again as Gazprom, but don't tell anyone. This is our main social responsibility, like all other oil companies. Plus we also have internal social programmes: medical insurance; we have the oldest pension fund, etc. But when today in terms of salary we're already at about the level as the leading global companies, but at the same time we have a greater number of employees, then naturally we should begin to seriously optimise our structure. To be honest, it's one of the challenges facing the company.

This, by the way, is a problem for all companies of countries with a new economy. And for this reason all companies in the developing world are overstaffed.

PwC: A question from a different area. The role of the government: it's clear that in countries with fast-growing economies it's different on the whole. That is, the government plays a fairly active role in setting the rules, sometimes in order to boost the economy. What do you expect from the state, how is it helping now? What else could it do in order to help?

Leonid Fedun: How could it help? It could do nothing, because everything bad that it could do, it's already done: there is no access to deposits; there are ultra-high taxes.

PwC: Infrastructure?

Leonid Fedun: All of the projects we do ourselves; we haven't received a kopeck in government money. For example, we will soon be launching production at a deposit in Timano-Pechora, an all-greenfield project beyond the Arctic Circle. Next year we will be launching a deposit in the Caspian, the first sea deposit, which no one but us has; we've launched similar deposits in the Baltics. The state has given us no help at all. For this reason, we're not expecting anything good, but at the same time the company has been set up in such a way that it should be able to quietly grow and live under these conditions. The main thing is for nothing to get worse.

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