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# Summary

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The open joint-stock company Svyazinform of the Nizhny Novgorod region was set up on 15 December 1993 as a result of the privatisation of the local telecommunications operators. At the 2002 annual general meeting, the Company's shareholders agreed to change its name to VolgaTelecom. The reorganisation was completed by the end of 2002, and resulted in the merger of VolgaTelecom with ten other telecommunications operators of the Volga Federal District.

VolgaTelecom is the biggest fixed-line operator in the Volga Federal District (VFD), and is a part of Svyazinvest holding, which still holds 38% of the Company's authorised capital. VolgaTelecom has branches in all parts of the VFD except the Bashkortostan, Tatarstan, Perm regions, and Komi-Perm Autonomous District. The Company's share in the VFD telecommunications market is over 60%.

The industry of the district is a very large contributor to the development of Russia's economy. In 2002, the VFD's share of Russian industrial output was 22.8%. Engineering (car manufacture) and the fuel and energy industries are pre-eminent in the industrial structure of the VFD. It is also notable for its favourable location between the eastern and western parts of Russia. Despite these advantages, the main potential of the district is concentrated in five regions, which provide around 70% of the district's output. In 2000, GRP per head in the VFD was 19% below the Russian average.

This economic potential provides the Company with great opportunities for development. The favourable geographical location, the size of the population (22% of the population of Russia) and high levels of urbanisation should help the Company to develop its services in the VFD.

VolgaTelecom is the main telecommunications operator in the district, and provides access to public network for all the other local operators. The Company provides the following services:

- local communications
- inter-urban and international communications
- mobile communications
- telecommunications
- telegraph communications
- radio and wireline broadcasting
- trunking for mobile radio telephone communications
- rental of channels
- data transfer
- paging

Local, inter-urban and international communication services contribute 84% of the Company's revenues.

In 2002, the Company's market shares were 79% of services to residential customers, 60% for corporate customers and 81% for state organisations. The Company is actively developing new services, including a switched internet access service, in which the Company had a 52% market share in 2002. Tariffs for basic services such as local, inter-urban and international communications are subject to state control, which severely restricts the Company's revenue, and increases the chances of it losing customers if competition in the market toughens. It is therefore possible that the Company's tariffs for inter-urban and international services will have to be reduced to prevent customers switching to alternative operators.

VolgaTelecom has around 3.9 million subscribers, of which 3.3 million live in cities. At the end of the first six months of 2003, 85.8% of the Company's subscribers were residential customers.



**Structure of revenues from VolgaTelecom's main communications services**

%	2002	1st half of 2003
Local communications	44.3	43.8
Inter-urban and international communications	46.8	41.3
Telegraph services	1.8	4.4
Wireline broadcasting	2.8	2.6
Payphones	n/av	1.9
Other	4.3	6.0
Total	100	100

Source: the Company, AVK estimates and calculations

**Growth of VolgaTelecom's traffic**

	2002	1st half of 2003
Inter-urban communication (millions of minutes)	1,569.3	896.9
International communication (millions of minutes)	67.6	36.0
Growth in the number of new subscribers (%)	5.6	2.8

Source: Svyazinvest

Every year the Company introduces new line capacity, installs new fixed-line telephones and expands its subscriber base. At the same time, the demand for installations of fixed-line telephones in the VFD still exceeds the growth of line capacity, which implies good development prospects for the Company. Management is working to increase the level of digitisation of its networks, construct multi-service networks and implement cable television projects and intelligent network service.

**Network statistics**

Telecommunication network	2002	2003 <sup>2</sup>
Line capacity (UTN and RTN <sup>1</sup> ) (000)	4,238.0	4,451.0
Operational capacity (UTN and RTN) (000)	3,885.0	4,126.2
Level of digitisation (UTN) (%)	46.9	54.9
Level of digitisation (RTN) (%)	10.0	14.1

<sup>1</sup> UTN — urban telephone exchanges, RTN — rural telephone exchanges.

<sup>2</sup> Preliminary data.

Source: the Company

**Intra-zonal network development**

	2002	1st half of 2003 <sup>1</sup>
Growth in the length of interurban channels all channels (%)	26.3	34.3
Channels using digital transmission systems (%)	39.6	38.0

<sup>1</sup> Preliminary data.

Source: the Company, Svyazinvest

**Summary**

## **The Company's strategy**

The Company's development strategy is to provide quality telecommunications services to domestic users and state and commercial organisations in the territory of the Volga Federal District, by developing the telecommunications infrastructure, improving the quality of service and introducing modern technical solutions. The Company's strategy is also directed towards maintaining and strengthening its leading position in the VFD.

This strategy is designed to maintain the Company's share in overall revenues from communications services in the VFD at not less than 51.2% until 2008, and to strengthen its position in the most competitive markets (Nizhny Novgorod, Samara and Saratov regions).

As part of the Company's plan to develop and improve standards of living in the VFD, it is planned to increase telephone penetration. VolgaTelecom's plans provide for an annual increase in telephone penetration of approximately 4.3%. On 1 January 2003, penetration was 19.5 telephone apparatuses per 100 people, and the growth rates given above assume an increase in telephone penetration to 25.1 per 100 people by 2008. At the same time, a priority for the Company is to develop its most lucrative segments, the business sector and high-income domestic users. In accordance with this strategy, management intends to maintain its share of the VFD commercial communications market at not less than 14% until 2008.

To satisfy the demand for communication services and to improve the quality of its services, the Company is expanding the digitisation of the network and replacing equipment. Management plans to reduce the depreciation of switching equipment from 42.3% of its initial value in 2003 to 32.3% in 2008, and depreciation of network equipment from 52.1% to 48.1% over the same period.

Special attention is being paid to the development of new services (intelligent communications network services, IP telephony and internet access services). The new services use new technologies (ADSL, SHDSL, ISDN). In addition, the Company is developing the provision of access to the public telephone network via the data transfer network, with the 'last mile' by xDSL broadband. This is the first stage in a changeover to NGN (Next Generation Network) packet switching.

The main fields of activity of VolgaTelecom's human resources department are in the selection, training and rotation of staff, improving their qualifications, training specialists at all levels, developing compensation packages and corporate culture, and motivating staff to perform efficiently and productively. A number of structural changes are taking place in the Company, with the aim of vertically integrating divisions to eliminate inefficient subdivisions and duplication of functions.

Staff training is undertaken in the Company both off-site (in training centres and institutes of higher education in the VFD and Moscow) and by short, targeted courses aimed at raising qualifications (training days, seminars, conferences and master classes). As an additional pension support for employees, the Company has concluded an agreement with the non-state pension funds TelecomSoyuz and Doveriye.

To increase the Company's efficiency and reduce its overheads, an ERP (enterprise resources planning) system was obtained in May 2003. This is part of Svyazinvest's project to standardise and accelerate the processing of managerial information not within the telecommunications operator, but across the whole of Svyazinvest holding.

VolgaTelecom's management is working towards a staged optimisation and harmonisation of tariffs throughout the merged Company. Work will continue on raising tariffs for regulated services to an economic level. The main elements of the Company's policy on regulated tariffs are to increase prices for local telephone connections, gradually to reduce the tariffs for inter-urban telephone communications and for access to the telephone network, and a phased reduction in cross-subsidy between local and long-distance communications services.

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## Consolidation of companies

The integration of regional telecommunications operators within federal districts was carried out in 2002 as a part of Svyazinvest holding's strategy of creating telecommunications companies which would be attractive to investors. Seven regional telecommunications companies were formed, of which VolgaTelecom was one. The reorganisation of the eleven telecommunications operators in the Volga Federal District resulted in a merger centred on Svyazinform of Nizhny Novgorod region. This resulted in the formation of VolgaTelecom as a large telecommunications operator, providing services to subscribers throughout the district.

The legal procedure was completed with the registration of a report by the RF Federal Commission for Securities, and with the inaugural annual general meeting of the merged company VolgaTelecom in March 2003, at which the Company's charter was approved, a new managing Director and a new board of Directors were appointed.

The initial goals of the telecommunications reorganisation in the Volga Federal District have now been achieved. These goals included the merger of small operators into a large company that could provide services throughout the district. Single operators have a number of advantages when carrying out financing, investment and technical policy, are more creditworthy than small companies and are more attractive to investors. The merger also enabled the smaller operators to share their corporate management experience. Moreover, the Company now has a single financing system and a single investment programme for the development of telecommunications services in the district, and a single management structure, which has allowed for the optimisation of management costs. After the merger, the total capacity of the Company was 4.2 million lines, making it the second largest of the seven operators founded during the reorganisation of Svyazinvest.

As intended, the Company became more attractive to investors, as indicated by the following:

- the liquidity of the shares has increased significantly — between September 2000 and March 2003, the spread between the bid and offer prices of the ordinary shares narrowed from 26% to 1.5%;
- between September 2000 and March 2003, according to RTS data, the merging companies' aggregate market capitalisation more than doubled, from \$140 million to \$300 million;
- Standard & Poor's has raised the Company's international credit rating from B-/Stable to B/Stable.

Having completed the reorganisation process, the Company is already implementing a number of investment projects to create an integrated information network in the VFD and further to increase the Company's attractiveness to investors. A large market share in the traditional and new services sectors, widening range of provided services, communications network development and construction should help the Company to achieve its goals.

## Finance

The Company's financial statements drawn up under International Accounting Standards (IAS) are presented here with the balance-sheet and profit and loss statement for 2002 and the first six months of 2003. The unaudited non-consolidated financial statements for 2002 have been drawn up by AVK for the analysis of the Company's financial indices. The unaudited non-consolidated financial statements for the first six months of 2003 been drawn up by AVK according to the data provided by the Company. The audited consolidated financial statements for 2002 including balance-sheet and profit and loss statement are given here for general consideration.

## VolgaTelecom's balance sheet, IAS

R million	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment, including advances to suppliers	17,443.2	16,076.8	17,244.0
Intangible assets, net	37.2	16.0	0.0
Investments in associates and other financial investments, net	178.1	226.9	700.9
Other	0.0	0.0	11.5
<b>Total non-current assets</b>	<b>17,658.5</b>	<b>16,319.7</b>	<b>17,956.4</b>
<b>Current assets</b>			
Inventories, net	467.6	413.2	599.5
Accounts receivable, net	744.3	697.6	1,174.4
Other current assets	1,065.9	925.3	1,000.9
Cash and cash equivalents	214.9	158.8	242.7
<b>Total current assets</b>	<b>2,492.6</b>	<b>2,194.9</b>	<b>3,017.5</b>
<b>Total assets</b>	<b>20,151.1</b>	<b>18,514.6</b>	<b>20,973.8</b>
<b>Equity and liabilities</b>			
<b>Shareholders' equity</b>			
Share capital	1,639.8	1,639.8	1,639.8
Retained earnings and other provisions, the effect of inflation on share capital, incl.:	11,455.5	10,910.6	13,277.9
Current profit	915.0	673.6	140.1
<b>Total shareholders' equity</b>	<b>13,095.3</b>	<b>12,550.4</b>	<b>14,917.7</b>
<b>Minority interest</b>	<b>342.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Non-current liabilities</b>			
Borrowings, non-current portion of obligations under finance leases	974.7	763.3	1,442.8
Deferred income taxes and equipment contributions	1,674.1	1,591.3	864.9
<b>Total non-current liabilities</b>	<b>2,648.8</b>	<b>2,354.6</b>	<b>2,307.7</b>
<b>Current liabilities</b>			
Payables and accrued liabilities, taxes payable and social security, accounts payable to Rostelecom	2,430.5	2,119.7	2,104.0
Dividends payable	58.9	56.7	344.1
Other current liabilities	0.0	625.5	217.4
Borrowings, current portion of long-term debt, current portion of obligations under finance leases	1,575.5	807.7	1,082.9
<b>Total current liabilities</b>	<b>4,064.9</b>	<b>3,609.6</b>	<b>3,748.4</b>
<b>Total equity and liabilities</b>	<b>20,151.1</b>	<b>18,514.6</b>	<b>20,973.8</b>

<sup>1</sup> Non-consolidated balance sheet.

<sup>2</sup> AVK estimates.

Source: the Company

**Profit and loss summary, IAS**

R million	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
<b>Revenues</b>	<b>13,202.4</b>	<b>11,512.7</b>	<b>6,356.6</b>
Operating expenses	(10,898.9)	(9,684.5)	(5,647.4)
<b>Operating income</b>	<b>2,303.5</b>	<b>1,828.2</b>	<b>709.3</b>
Interest expenses and similar items, net	(186.9)	(155.9)	(98.2)
Foreign exchange losses, monetary gains, income from sale of investments, income from associates and other expenses and income, net	151.5	74.9	(143.1)
<b>Income before taxation and minority interest</b>	<b>2,268.1</b>	<b>1,747.3</b>	<b>468.0</b>
Income-tax expenses	(1,184.3)	(1,073.6)	(328.7)
<b>Net income before minority interest</b>	<b>1,083.8</b>	<b>673.7</b>	<b>139.3</b>
Minority interest	(168.8)	0.0	0.0
Extraordinary income and expenses	0.0	0.0	0.8
<b>Net income</b>	<b>915.0</b>	<b>673.7</b>	<b>140.1</b>

<sup>1</sup> Non-consolidated P&L.

<sup>2</sup> AVK estimates.

Source: the Company

The profitability indices were lower in the first half of 2003 than in 2002. The expected economies of scale have not yet been fully realised, because the Company's efforts are still being concentrated on reforming the corporate and management structures. In addition, the profitability indices were largely affected in the first six months of 2003 by the increases in depreciation costs and staff bonuses.

**The Company's securities****The share capital of VolgaTelecom on 1 January 2004**

	Number of shares issued	Nominal value per share R	Total nominal value R	%
Ordinary shares	245,969,590	5.00	1,229,847,950	75.00
Type A preference shares	81,983,404	5.00	409,917,020	25.00
Total	327,952,994		1,639,764,970	100.00

Source: the Company

The table above shows the number of shares issued by VolgaTelecom. The Company's charter allows it to place a further 1,299,093 ordinary shares and 531,496 type A preference shares with a nominal value of R 5.00.

The first issue of VolgaTelecom's securities was registered on 28 December 1993, during the reorganisation of the state enterprise Rossvyazinform into a joint-stock company Nizhegorodsvyazinform. The most recent issues were registered on 25 October 2002, as part of the reorganisation and merger of eleven telecommunication operators of the Volga Federal District.

In November 2003 the Company combined additional issues of securities. Registration numbers of the ordinary shares issues from 3 to 12 were annulled, and both emissions have been assigned the new registration number 1-01-00137-A. Registration numbers of the preference shares issues from 3 to 12 were annulled, and both emissions have been assigned the new registration number 2-01-00137-A.

**Summary**

On 1 January 2004, the Company's main shareholder was Svyazinvest, with 38.004% of its share capital.

#### The main shareholders of VolgaTelecom

Name	Status	Number of shares		%
		Ordinary	Type A preference	
Svyazinvest	Holder	124,633,745	0	38.004
ING Bank (Eurasia)	Nominee	44,034,981	8,489,778	16.02
Depository Clearing Company (Depozitarno-kliringovaya kompaniya)	Nominee	13,913,380	13,886,962	8.48
Brunswick UBS Warburg Nominees	Nominee	10,755,305	9,144,366	6.07

Source: the Company

The Company's shares have been traded on RTS since 18 December 1996, under the following ticker symbols:

NNSI – ordinary shares  
NNSIP – preference shares

Since August 1998 the Company's ordinary and preference shares have also been traded on the stock section of MICEX, the Moscow Interbank Currency Exchange.

To expand the market for its shares and to attract foreign investors, the Company has issued and registered Level 1 ADRs. Each ADR represents two ordinary shares. The total amount of ADRs issued is 30,000,000. At present, the Company's ADRs are traded on over-the-counter markets in the US and Europe: the Berlin and Frankfurt stock exchanges. The necessary depository services are provided by J. P. Morgan Chase Bank. The agreement with J. P. Morgan Chase Bank was signed in spring 2002. Management is also considering initiating a listing procedure with one of the international stock exchanges.

Since 21 February 2003, the first issue of the Company's bonds has been trading on MICEX alongside its shares. The total volume of the bond issue is R 1 billion.

The Company's principal financial contractors are as follows.

Name	Status
J. P. Morgan Chase Bank	Depository for the Level 1 ADR programme
Ernst & Young	Auditors
Registrar-Svyaz	Share registrar

# Risks

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# Country risks

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## **Sociopolitical and economic risks**

### **High economic risks are inherent in Russia, a country with a transitional economy.**

Favourable circumstances in world markets have allowed Russia in recent years to improve its trading balance, significantly to increase its gold and foreign exchange reserves and sharply to reduce its external debt. Thanks to the increase in the real earnings of the population, this growth can be seen not just in export-orientated production but in other branches of industry as well. At the same time, Russia is a transitional economy, which means the risks of doing business there are higher than in Europe and the USA. These risks are connected both to external conditions, such as for example a potential drop in oil prices, and to internal factors, above all the progress of structural reforms in the electricity supply system, housing and communal services and in the telecommunications sector.

### **Wide income differentials in Russia's population creates conditions for social conflict.**

The pay of a quarter of the country's population is below the subsistence level. A possible deterioration could not only lead to a radicalisation of political attitudes but could also strengthen the opposition to the transformation of Russia into a market economy.

## **Risks connected with legislation and the legal system**

### **The underdevelopment of the legal and judicial system in Russia increases the risks of investing and doing business.**

The Russian authorities are trying gradually to eliminate the deficiencies in the law at all levels, but reforms are hindered by corruption and the inefficiency of the bureaucratic apparatus. Investors can be faced with an arbitrary interpretation of laws that are already imperfect. This problem is especially real in the provinces, where the local authorities are frequently not answerable to anyone.

Much is said about the dependence of Russian courts on the economic and political influence of the authorities. Judges are often too inexperienced in applying the new laws that regulate the relationships between companies. In Russia, court decisions sometimes have no influence at all on subsequent decisions in similar cases. Cases can drag on for a very long time. Lawsuits can be used for political purposes. These factors indicate the imperfection of the Russian judicial system and the difficulty of forecasting the outcome of legal proceedings.

### **The rights of minority shareholders in Russian companies are poorly defended.**

As a result, such shareholders can be confronted by late or unreliable information about the company's activity, the use of confidential or insider information on the market, the derogation of rights during the reorganisation of the company or the absence of a transparent and understandable mechanism for determining dividend payments. Legislatively such situations are not regulated in Russia, which directly affects a company's style of corporate management.



# Company-specific risks

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## Company-specific risks

**The Company's partners are often also its competitors.** Under Russian legislation, the Company, as the operator of a common-user network, must offer alternative operators access to its lines, allow them to install their equipment on its premises and provide other services necessary for their activity. These conditions could lead to conflicts of interest between the Company and these alternative operators. Should the Company prove unable to cooperate efficiently with other operators, that could lead to a loss of customers and affect the Company's performance in the future.

**Growth in the demand for the services offered by the Company could cause a shortage of the qualified personnel and equipment needed for carrying on operations.** The reforming of the Company was completed at the end of 2002. At the present moment a real improvement can be seen in the Company's performance indicators for traditional communications services and in the range of new services being offered. However, neither the processes linked to the introduction of a new system of financial accounting, nor many operational processes linked to charging for the communications services provided (for example, a billing system) have yet been completed in the Company. Lack of the necessary quantity of high-qualified personnel, and also a shortage of the network equipment needed to satisfy demand could lead to a drop in the quality of the services offered by the Company, and also to a reduction in the number of the Company's customers, which would have an effect on the operational and financial indicators.

**The Company's short operational and financial history makes it difficult to judge either the quality of the Company's management or its financial performance.** The Company's formation, as a result of the reorganisation of the joint-stock communications companies in the Volga Federal District, was completed only in November 2002. Presentation of the Company's operational and financial indicators comes up against a number of problems. The Company's operational indicators up to 2002 are therefore an aggregate of the indicators of the separate communication companies from which it was formed. In addition, until 2002 only four of these joint-stock companies did not present consolidated financial statements compiled to international accounting standards. Investors should not rely on companies' accounts compiled under Russian accounting standards (RAR). The financial information about the Company in this memorandum consists only of financial reports for 2002, compiled under RAR and audited by the independent company Ernst & Young, and for the half-year to 30 June 2003, compiled to international standards by AVK from data provided by the Company. Since these reports cover such a short period, it is difficult to evaluate the trends in and prospects for the Company's development.

**The Company is at risk of a loss of income from the provision of long-distance communications services.** Inter-urban and international communications traffic is at present strongly dependent on Rostelecom. Should Rostelecom's tariffs for access to these channels be altered to the Company's detriment, a fall in the Company's operational performance would be possible. However, if competition became fiercer in the long-distance communications market, Rostelecom could be forced to lower its tariffs, and this would have a positive effect on the Company's revenues. On the other hand, customers could switch to alternative providers long-distance communications services.

In addition, the Company could lose revenue from long-distance communications if alternative operators develop IP telephony, which can also be used for international and inter-urban communications and is cheaper for the subscriber than traditional means. Because of this, tariffs for long-distance communications services could tend to fall.

# Financial risks

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**Tariffs for communications services are controlled by the RF Ministry for Anti-Monopoly Policy and Support of Business (MAP RF). The Company therefore cannot forecast how tariffs might change, or, as a result, its own profitability.** At present tariffs for main communications services are calculated on the 'cost plus' method – that is, the Company's reasonable costs plus an agreed rate of profit. Thus the Company has no incentive to reduce its costs, since the higher the expenditure it can justify, the higher MAP RF will set the tariffs. Because of this, the Company's profitability could remain unchanged in the event that the tariffs for communications services are raised.

**Alterations in currency exchange rates could increase the Company's outlays and heighten the risks of non-payment of debts.** For the last few years, the rouble has fluctuated against the dollar and the euro, usually tending to fall against them. The Central Bank of the Russian Federation (CBR) has undertaken various measures to support the rouble, but the ability of the federal government and the CBR to keep the rates stable depends upon many political and economic factors. Possible measures aimed at rouble support include financing budget deficiency without additional monetary issue, controlling the inflation level, and keeping currency reserves at a relatively high level. Various possible measures to support the rouble include financing the budget deficit without issuing more money, controlling the rate of inflation and maintaining sufficient foreign-currency reserves.

A significant proportion of the Company's leasing contracts and credits are denominated in US dollars or euros. A fall in the rouble against other currencies could increase the Company's expenditure on debt servicing and payments on leasing agreements. One way of reducing this risk could be to link tariffs to the rate of the dollar or the euro, but tariffs are regulated by the MAP RF and set in roubles, so the Company's profitability could be reduced if there was a major fall in the rate of the rouble against other currencies.

Since the reorganisation, the company conducts all payments in Russian roubles, in order to hedge the liabilities and avoid currency risks. Contracts using foreign currency may only be signed with companies which are not based in Russia, or with Russian companies who supply equipment with a significant share of imported components.

**In unfavourable economic circumstances, the Company could be at risk of being unable to repay its debts.** It has many leasing contracts on which it makes payments, and it uses bonded loans and long- and short-term bank credits to finance its operations and investment projects. Unfavourable external circumstances that could affect the Company's ability to repay its debts could include a slow-down in the economic growth rate, a rise in the rates paid on credits, an increase in the rates on the loans market. Unfavourable internal conditions could be as a lengthening of the payback period for investment projects, a drop in demand for the Company's services, an increase in debts receivable, and force majeure circumstances.

To reduce this risk, the Company examines its investment projects very carefully, and keeps track of the relationship between its own and borrowed finances; it also sets limits on the receipt of short-term credits.

# Sector risks

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The main risks for the telecommunication sector of the Russian Federation are connected with the system of state regulation, technological developments, the equipment of communication networks, the growth of competition and potential changes in demand for communications services.

An adverse development of any of these factors could damage telecommunication operators' their business and financial status, and reduce the prices of their shares. For investors in the sector there is therefore a risk of a depreciation of their investments in the shares of telecommunications companies.

## Regulatory risk

The telecommunications sector is strictly regulated by the state, most importantly in:

- the licensing and supervision of telecommunication services;
- the state ownership of sector resources (telephone lines and wireless spectrum);
- the regulation of tariffs on the services of the incorporated communication operators.

**Russian telecommunications legislation is in the process of being reformed, with the aim of bringing it into line with international standards.** In 2003 the federal government passed a new law, «On Telecommunications», to establish regulatory procedures for the sector. However, this law still leaves opportunities for the state to take protectionist actions against individual communication operators. This creates a particular risk for the investor, because the telecommunications sector has no effective regulatory mechanism.

**The terms on which new licences are issued to telecommunication operators and existing licences extended are determined by a federal body with executive powers.** At present its functions are carried out by the RF Ministry for telecommunications and information technology. This role includes the right to determine how the different kinds of services in the various parts of the Russian Federation are licensed, whether by competition or direct appointment. However, the law «On Telecommunications» does not say how such competitions should be held; this will require an additional by-law, which has not yet been drafted. As a result, operators cannot be sure that their licences will be extended, or that the ministry will not change the terms or territory of the licence, or their responsibilities as licence-holders.

In the past, the risk of not receiving a licence was especially high for mobile (cellular) operators. Until recently, the ministry limited the number of licences issued, and consequently restricted the number of operators in any one territory or providing a particular mobile standard. This proved an insuperable barrier to entry, and artificially maintained a series of monopolies.

**The Russian state is the sole regulator of the use and distribution of telephone lines and wireless frequency spectrum.** This is written into the Russian Federation's international telecommunications treaties. Although the state is trying to bring the distribution of wireless frequencies and their conditions of use into line with international standards, disparities remain.

A risk for communications operators that use a wireless frequency is that the government — including the security services, armed forces and presidential communications — first call on wireless frequencies. There is also a risk that the state commission on radio frequencies will decide to transfer a radio frequency band from one user to another.

The Ministry for telecommunications and information technology is also responsible for ensuring the availability of telephone lines. However, there is a risk that the state will be unable to make the necessary investment in good time, and that at some point there will be a shortage of lines. Indeed, this is already the case in Moscow, but a new system of telephone numbering is to be introduced, and at that point the financing of new lines should become the responsibility of the local telecommunication operators.

**The new law «On Telecommunications» introduces a guarantee that universal communication services will be made available in the Russian Federation.** Operators of universal services are to be selected by competition, and if there are no candidates the responsibility can be imposed on the largest operator in the territory, with no right of refusal. At present, the interregional

telecommunications company (MRT) is the only telecommunications operator in most of the Russian Federation, and so will be appointed the universal service operator in those areas. The universal service mechanism is to be introduced throughout the Russian Federation in 2005.

A provider of universal services has to offer a certain minimum range of telecommunication services wherever there is a population, which will require the operator to make significant investments. Tariffs for universal services will be set at a minimal level, to ensure their general availability. Thus it will be unprofitable for an operator to be the universal service provider.

Admittedly, the law «On Telecommunications» specifies a mechanism to ensure that the operator of universal service is compensated for this loss, but this mechanism has not yet been created. Universal service operators therefore face the risk of that compensation will be delayed and/or incomplete, increasing their receivables and reducing their profitability.

The compensation is to be paid out of a fund, the universal services reserve. When universal communication services are introduced, all of the Russian Federation's telecommunication operators will be expected to make periodic contributions to the fund. Not only will the introduction of this system of contributions erode the profitability of the operators, but the legislation does not actually say how the contributions are to be calculated, increasing the risks still further.

**Current anti-monopoly legislation (the law «On natural monopolies») states that, when a service operator is recognised as a 'natural monopolist', its tariffs are subject to regulation by the MAP RF.** A telecommunications provider that is the only operator in a given market runs the risk of being included in the register of natural monopolists, and finding itself subject to such regulation. Under this law, MRT is considered to be a natural monopoly, and is indeed subject to regulation by anti-monopoly bodies.

Any change in tariffs charged for the services of operators that are natural monopolists has to be coordinated with the MAP RF; this can lag behind changes in the real economic situation which affect the operator's costs. A delay in changing a tariff could reduce the operator's competitiveness and profitability.

### **Equipment-related risks**

The performance of the telecommunication service operators is dependent on the state of their network equipment. There is always a risk that failures in the network will result in failures in software and to some extent in equipment.

Telecommunications equipment is evolving vigorously at present. Developing the technically advanced networks that this makes possible requires significant investment. However, the prospects of such investments being recovered are threatened by the speed with which new technologies may emerge, enabling other operators to construct even more competitive networks.

The growth of competition in the sector is also creating risks. There is considerable demand for telecommunication services in the Russian Federation. This is producing rapid growth in revenues, resulting in an expansion of the services being supplied by the operators, and also in the number of operators. This in turn is boosting competition in the sector, so that the next few years could see pressure to reduce operators' costs. This would be likely to reduce either their profitability or their market share.

This competition is intensified by the appearance of new technologies. Mobile operators are competing for subscribers with the local and international wireline communications (the traditional operators) operators by offering comparable prices and that are greater convenience. The traditional communication operators are also being undercut by operators using IP telephony, reducing the traditional operators' volumes and thereby weakening their incomes.

# Stock-market risks

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**The Company's ADR programme is linked to risks arising out of weaknesses in Russian legislation on ADRs.** The taxation of non-residents whose income comes from sources inside the Russian Federation is controlled by Russian legislation, the laws of the investor's country of origin and double taxation agreements with other governments. However, to obtain partial or total exemption from Russian taxes under these agreements is complicated and underdeveloped. This creates the risk that a holder of ADRs will be unable to make use of the regulations and end up paying more tax than expected.

In addition, a holder of ADRs could be unable to receive payments due on the underlying deposited shares, for instance in the event of the Russian authorities toughening the exchange control regime. In such a case, the depositary bank would not immediately be able to convert the funds received from the Company into US dollars, nor transfer them to the USA. Should the exchange rate move in the meantime, the ADR holder could lose part or all of the value of the funds being distributed.

Holders of ADRs could be unable to exercise their right to a vote at shareholders' meetings, or other rights exercised by the Company's shareholders. For example, they might not receive voting papers in time, and be unable to send voting instructions to the depositary bank (which does not take responsibility for the non-fulfilment of voting instructions caused by circumstances outside its control). This would mean that holders of the Company's ADRs could be deprived of the ability to act when they disagree with a vote cast by the depositary bank on behalf of the shares underlying the ADRs.

**The market value of the Company's shares and ADRs is exposed to negative effects from many factors that are not directly connected to its financial and economic position.** Such factors include the overall economic situation in Russia, the liquidity of the Russian stock market and the condition of the financial markets. The events of 1998 showed that a crisis in the Russian financial markets or in the markets of other developing countries can degrade the value of the Company's shares even if its financial and economic situation remains stable.

**The prices of the Company's shares and ADRs can fluctuate very widely.** The market in the shares is illiquid. As a rule, the lower the liquidity of a market, the greater the potential fluctuations in the value of the instruments being traded, and the greater the potential spread between buying and selling prices. Any detrimental information or event can lead to a significant fall in the market value of the Company's shares or ADRs.

At present the Company's management is considering the benefits of being listed on international stock exchanges (London, New York).

A further issue of ordinary shares could erode current shareholders' interest in the Company's authorised capital. The Company's charter allows a decision to increase the authorised capital by a further issue of ordinary shares can be taken either by a shareholders' meeting or by the board of directors (see «Decisions that affect the Company's financial position»). Major shareholders of the Company could make a decision to issue more shares, which could shrink the proportion of total equity held by small holders of shares and ADRs, and reduce their influence on the decisions made by the Company.

# Risks associated with the accuracy of information and forecasts

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**In writing this memorandum, AVK has not submitted the information about the Company's competitors to independent scrutiny.** All the information about the Company's competitors contained in the memorandum is taken from publicly available sources. In using this information, AVK has relied on its accuracy without carrying out an independent scrutiny. Because of this there may be inaccuracies in the presentation of information about the Company's competitors.

**The forecasts of the Company's performance contained in the memorandum may not be achieved.** The memorandum contains forecasts made by AVK on the basis of data provided by the Company and made by the Company itself, which are exposed to risks and uncertainty. The Company's actual results could be significantly different from the forecasts, due to the effects of the risks and uncertainties described in the sections on risks and in other sections of the memorandum.

# The telecommunications sector

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# History of the sector

The public telephone network in the USSR was operated by state companies, which were subject to the centralised planning system's control. The market-oriented non-governmental operators did not appear until 1990s.

## Main development indicators of the telecommunications industry in Russia

'Subscriber devices' (handsets, faxes, modems, answering machines etc.) connected to city and rural telephone networks, millions (1 April 2003)	31.6
Fixed-line telephone lines per 100 residents (1 April 2003)	25.6
Cellular telephone subscribers, millions (1 January 2003)	17.6
Cellular telephone accounts per 100 residents (1 January 2003)	12.5

Source: RF Ministry for telecommunications and information technology

Russia's first telephone networks were built in the two largest cities, Moscow and St Petersburg, in the 1880s. The first long-distance line, between Moscow and St Petersburg, was in operation by the end of the 19th century. The telecommunication networks were privately owned by companies or operated by them under long-term concessions. After the establishment of the USSR, the networks were nationalised and developed as a single national enterprise under the control of the country's centralised planning system until 1994.

In the 1950s the penetration of telephone communications was still low, with no more than 1.5 million telephone lines in the public network. However, by the 1970s the main telecommunications infrastructure had been formed, including local, regional and long-distance networks.

At that time the public telephone networks were managed by the Ministry for telecommunications and information technology, and their management structure was broadly in line with the territorial division of the country. Being unconnected with the defence infrastructure, the Ministry for telecommunications and information technology was given a relatively low priority in the allocation of funds. During the years of Soviet rule, investment in the public telephone networks was no more than 1% of the country's annual investment spending, which was clearly not sufficient for the rapid development of the industry. This federal policy resulted in:

- a lack of telephone communication with small and remote settlements;
- long waiting-lists for private telephone lines in large cities;
- insufficient international telecommunication capacity;
- poorly developed inter-city communications.

In the beginning of the 1990s, when the USSR was strengthening its economic ties with other countries, the newly founded businesses started to demand a higher quality of telecommunication services than the existing public telephone networks could provide. As a result, the Russian federal communication agencies (initially those in Moscow and St Petersburg) created joint ventures with foreign partners. These new operators rapidly built up modern digital networks. They provided high-quality services, but prices were high.

In 1991, the structure of the industry was drastically changed. The regional telecommunication agencies were restructured into a single system under the control of a group of federal enterprises, collectively named Rossvyazin-



form. The RF Ministry for telecommunications and information technology gave up the economic management of the industry.

Under this reorganisation, a number of separate but still federally owned enterprises were created out of the regional communication agencies, independent city telephone networks (in Moscow, St Petersburg, Novosibirsk, Yekaterinburg, Kostroma, Pskov and Arkhangelsk) and special telegraph agencies (the Central Telegraph Agency in Moscow and agencies in St Petersburg, Rostov-on-Don and Yekaterinburg). The territorial segmentation of the long-distance and international telecommunication pools was abolished, and they were united under another federal enterprise, Rostelecom (except for international telecommunication stations in Moscow, St Petersburg and Yekaterinburg, which became independent long-distance telecommunication agencies).

In 1992, RF government regulation No. 1003, «On privatisation of telecommunication agencies» authorised the privatisation of the Russian federal telecommunication agencies in accordance with the federal scheme for the privatisation of federal and municipal enterprises. The conditions of the privatisation were as follows.

- The federation was to retain controlling interests in newly incorporated telecommunication joint-stock companies for the first three years of their existence.
- The radio and television broadcasting agencies were detached from the telecommunications industry, and remained in federal ownership.

Altogether, 127 joint-stock telecommunication companies were incorporated.

Thus, by 1993 these federal telecommunication enterprises had been reorganised into joint-stock companies, with the state retaining controlling interests in most of them. Shareholders' equity was mostly distributed as follows:

- 38%, in the form of ordinary shares, were assigned to the federation;
- 25%, in the form of preference shares, were given to the employees;
- 22%, in the form of ordinary shares, were transferred to the regional property funds, to be sold on by commercial tender and by auction (and paid for in cash or by the vouchers handed out to each citizen at the time of the privatisation).

RF presidential decree No. 1989 of 10 October 1994, created a new joint-stock company, Svyazinvest, by combining the state-owned shareholdings in 85 of the joint-stock telecommunication companies.

The details of the incorporation of the company were spelled out in RF government regulation No. 1297 of 25 November 1994, «On incorporation of the joint-stock company Svyazinvest», and modified in No. 742 of 24 July 1995. The most significant provisions were that:

- Svyazinvest was incorporated with the aim of raising investments for the development of regional public telecommunication networks in the Russian Federation;
- of Svyazinvest's shareholders' equity (ordinary shares), 51% were to remain federal property for three years;
- the remainder of the shares (49% of shareholders' equity) was to be prepared for sale by commercial tender.

It was the creation of Svyazinvest that gave the structure of the Russian telecommunication industry its present form.

The RF Ministry for telecommunications and information technology no longer deals with the business activities of the telecommunication companies. Instead it functions as the state regulator of the industry (except in the matter of pricing), plans its overall development and drafts new telecommunications legislation. It also issues licences to operators, certifies the telecommunication equipment installed in the federal telecommunication network and controls the dealings between the operators working in the telecommunication market.

Svyazinvest controls the financial and economic aspects of its telecommunication operators' activities via its representatives on their boards of directors. It also defines their policy, and is involved in the design of long-term development strategies and unified management standards.

Prices in the industry are regulated by the RF Ministry for Anti-Monopoly Policy and Support of Business.

Initially, Svyazinvest did not include Rostelecom, Giprosvyaz (Moscow), Yekaterinburg City Telephone Network and Central Telegraph. The federal shareholdings of these companies were folded into Svyazinvest in May 1997 as the result of a special RF government resolution.

In 1997 it was decided to privatise 49% of Svyazinvest; 25% plus one share was to be sold by auction to Russian and foreign investors and the rest was to be sold by tender exclusively to domestic investors.

The auction took place on 25 July 1997, and was won by a Cypriot company, Mustcom Ltd, representing a consortium consisting of UNEXIM-BANK Group, Renaissance-Capital (an investment company), Deutsche Morgan Grenfell, Morgan Stanley Asset Management and the Quantum Fund, owned by George Soros. The price was \$1.875 billion.

Svyazinvest currently has only three shareholders: the Ministry of state property of the Russian Federation, with 50% plus one share, the Russian Fund for Federal Property with 25% minus two shares and Mustcom Ltd with 25% plus one share.

During 1998–2000, Svyazinvest underwent the first of two stages of restructuring. Telecommunication operators were consolidated in five regions – Moscow, St Petersburg, Rostov, Sverdlovsk and Novosibirsk – by means of the following mergers:

- Rostelecom, Moscow International and Long-Distance Telegraph;
- Petersburg Telephone Network, St Petersburg International and Long-Distance Telegraph, St Petersburg Telegraph;
- Uraltelecom (the telecommunication operator of the Sverdlovsk region), Yekaterinburg Mobile Telephone Network, Yekaterinburg City Telephone Network, Yekaterinburg Telegraph, Urals Telecommunication Design Office;
- Electrosvyaz of Rostov region, Rostov-on-Don Telegraph;
- Electrosvyaz of Novosibirsk region, Novosibirsk City Telephone Network;

In September 2000, Svyazinvest's board of directors approved the strategy of a second stage of restructuring. This involved the integration of most of the regional telecommunication companies into seven companies, one for each of Russia's North-Western, Central, Southern, Volga, Urals, Sibir and Far-Eastern federal districts.

This consolidation process took around two years, and was complete by the end of 2002. The number of telecommunication operators affiliated to Svyazinvest was reduced to 14. In each of the seven federal districts of the Russian Federation there is now an inter-regional telecommunication operator which owns the main telecommunication network in that territory. Rostelecom, Central Telegraph and the regional companies Lensvyaz (the telecommunication operator of the Leningrad region), Svyaz of the Republic of Komi, Dagsvyazinform, MGTS and Kostroma City Telephone Network remain independent companies.

The foundation of the industry now consists of the so-called 'traditional operators' – Svyazinvest operators which own the main infrastructure of the telecommunication networks.

As well as the traditional operators, the Russian telecommunication market includes corporate networks and the so-called 'alternative' operators. Corporate networks belong to large institutions and industrial companies, and are mostly maintained by them (they also can sell or lease any excess capacity to other companies). The alternative operators appeared in the 1990s, as independent commercial companies sought to enter profitable parts of the telecommunication market, such as cellular telephony.

The Russian telecommunication industry now has a clear holding structure and is highly concentrated. The majority of the market is shared between operators belonging to the following institutions: Svyazinvest (including the seven traditional operators that it controls), Joint-stock Financial Corporation Systema, Alpha-group and Telecominvest.

# Sector results:

## 2002 and the first half of 2003

According to the RF Ministry for telecommunications and information technology, revenues from public telecommunication services (including postal services) in Russia were R 273.2 billion roubles in 2002, 41% more than in 2001. The industry's revenues from the provision of services are increasing, because of growth in such physical indicators as the number of subscribers and traffic volumes, and in tariffs. At constant prices, sales volumes in the telecommunication market grew by 16.2% in 2002.

Revenues from public telecommunication services in the first half of 2003 were R 175.2 billion, or 49.3%, higher than in the same period of the previous year.

The RF Ministry for telecommunications and information technology issued 3,931 licences for communication services in 2002. Most of these licences (82%) were for electronic communication services. At 1 January 2003 there were 14,602 valid licences in force, including 11,894 for electronic communication services, 2,515 for television and radio broadcasting, 187 for postal services and six for international data exchange.

### The breakdown of industry revenues between the Russian regions

In 2002, Moscow remained the largest consumer of telecommunications of any Russian region, producing 41% of the industry's revenues. The Central federal district (which includes Moscow) accounted for around one half of the telecommunications services provided.

### Regional breakdown of telecommunication services revenues

	Revenue 2001 (R billion)	Revenue 2002 (R billion)	Growth (% year on year)
Central Federal District	100.6	140.3	39
North-Western region	15.8	24.0	52
Urals Federal District	11.8	17.7	50
West Siberian region	11.9	17.1	44
Volga region	10.6	15.6	47
North Caucasian region	9.6	14.4	50
Far-Eastern region	7.3	10.4	42
East Siberian region	5.3	7.4	40
Volga and Vyatka region	4.1	5.6	37
Central Chernozem region	3.5	4.8	37
<b>Total Russian Federation</b>	<b>185.6</b>	<b>263.8</b>	<b>42</b>

Source: RF Ministry for telecommunications and information technology

### The revenues of the 'alternative' and 'traditional' telecommunications companies

In 2002, for the first time since the so-called 'alternative' telecommunications operators appeared in Russia, their telecommunication services earned more than those of the 'traditional' companies, with 53.18% of the industry's income. This outperformance continued in the first half of 2003.

#### Revenues from public telecommunication services

	Revenue 2002 (R million)	Growth (% year on year)	Revenue 1st half of 2003 (R million)	Growth (% year on year)
'Traditional' operators	127,912	27.5	82,483	39.1
'Alternative' operators	145,313	55.7	92,752	60.0
<b>Total</b>	<b>273,225</b>	<b>41.1</b>	<b>175,235</b>	<b>49.0</b>

Source: RF Ministry for telecommunications and information technology

The revenues of the alternative telecommunication companies were 55.7% higher in 2002 than in 2001, growing twice as fast as the 27.5% of the traditional companies. In the first half of 2003, growth was faster in both groups, but the traditional companies still lagged the alternative operators.

#### Breakdown of industry revenues by type of subscriber

In 2002, households accounted for 43.3% of the industry's income. There is a clear trend of households increasing their share of revenues, due to higher tariffs and traffic volumes. The industry's overall revenue from households rose by 66.7% in 2002, due to increased mobile communication volumes and higher local tariffs.

#### Industry revenue growth, broken down by type of subscriber

	Revenue 2002 (R million)	Growth, year on year (%)	Revenue 1st half of 2003 (R million)	Growth, year on year (%)
<b>Traditional companies</b>				
Residential subscribers	64,764.0	31.64	37,677.3	26.5
Government subscribers	18,000.2	28.23	10,183.4	18.9
Corporate subscribers	45,147.2	21.69	34,621.8	65.1
Total	127,911.5	27.49	82,482.5	39.1
<b>Alternative companies</b>				
Residential subscribers	53,558.8	146.07	31,895.4	58.3
Government subscribers	4,886.6	129.17	1,781.5	26.6
Corporate subscribers	86,868.0	25.15	59,075.5	61.7
<b>Total</b>	<b>145,313.2</b>	<b>55.73</b>	<b>92,752.4</b>	<b>59.7</b>

Source: RF Ministry for telecommunications and information technology

Businesses accounted for 48.3% of total industry revenues in 2002, and state-financed institutions for 8.3%, in line with the previous year's figure. During the first six months of 2003, the contribution of corporate and government subscribers to industry revenues rose to 60.3%.

There are considerable differences in the make-up of the revenues of the alternative and traditional telecommunication companies. Businesses are

the main source of the alternative companies' revenues, accounting for 60% of their income in 2002, but the proportion of revenues from households is clearly growing, due to rapid penetration of mobile telephony and the relative saturation of corporate demand. In 2002, businesses were the most important source of revenues for the 'alternative' operators. Their revenues from households grew by 146% in 2002, and provide the main reason for these companies' increased share of industry revenues. Their revenues from business subscribers increased by only 25%.

The alternative telecom companies do little business with state-financed institutions, which accounted for only 1.5–3% of their revenues in 2001 and 2002.

The traditional telecommunication companies receive most of their income from households and state-financed institutions (respectively 50.6% and 14% in 2002). They are the main supplier of telecommunication services to the public sector. However, in the first six months of 2003, the contribution of state-financed institutions to the revenues of the traditional telecommunication companies fell to 12.4%, due to a relatively small increase in tariffs (household tariffs grew by 42%). This was in line with the policy of the Ministry for Anti-Monopoly Policy and Support of Business, to reduce payment disparities between household and business sectors.

### Breakdown of revenues by type of service

Mobile telecommunications is the leading contributor to revenues, accounting in 2002 for 33.9% of total industry sales (compared with 29.3% in 2001). Mobile communications was also the largest contributor to revenue growth in 2002, producing absolute growth of R 35.7 billion out of a total of R 79.6 billion, and a growth rate of 63%. This trend continued in the first half of 2003.

The alternative operators are the main suppliers of mobile communication services, having specialised in these services from the very beginning, and 62% of their revenues came from that source in 2002. They account for 98% of total mobile revenues.

### Breakdown of industry revenues by type of service

	Revenue 2002 (R million)	Growth (% year on year)	Revenue 1st half of 2003 (R million)	Growth (% year on year)
Postal services	19,965.1	32.4	12,634.0	36.7
Special communications	1,000.8	17.7	517.0	17.5
Long-distance and international telephone communications	68,564.2	21.5	34,003.9	7.7
Urban telephone communications	53,572.8	40.3	30,496.4	29.5
Rural telephone communications	4,107.5	36.8	2,363.7	25.9
Radio communication, TV and radio broadcasting, television, satellite communication	9,625.4	29.4	6,161.8	43.0
Wireline broadcasting	2,246.7	20.2	1,240.6	15.2
Mobile communications	92,477.3	62.9	60,377.1	66.4
Other	21,664.8	n/av	27,440.5	n/av
<b>Total</b>	<b>273,224.7</b>	<b>41.1</b>	<b>175,235.0</b>	<b>49.3</b>

Source: RF Ministry for telecommunications and information technology

Revenues from long-distance communications accounted for 25.1% of total income, down from 29.2% in 2001 and falling further to 19.4% in the first half of 2003. Despite significant growth in international traffic, long-distance communication revenues grew by only 7.7% in the first half of 2003. The traditional telecommunication companies had a 73% share of industry revenues from international communication services in 2002. Households and businesses showed fairly similar demand for these services, at 50.8% and 41.3% respectively. In the first half of 2003, the balance shifted towards households, which accounted for 52.7% of revenues from international telecommunication.

Income from local telephone communications (urban and rural) was 21.1% of the total, with rural communication accounting for only 1.5%. However, urban and rural telephone communications expanded by 40% in 2002, mainly due to higher subscriptions and installation fees and an increase in the number of fixed lines.

Local telephone communication services are provided mostly by the traditional telecommunication companies, with a 76% market share. In terms of the type of subscriber, local telecommunications are similar to long-distance, with households accounting for 48% and state-financed institutions for 7.7%.

The alternative operators mostly work with corporate clients, in the local communications sector of the market which provide 80% of their revenues from local telephone communication.

### **Investments in the telecommunications industry**

According to the RF Ministry for telecommunications and information technology, R 65.4 billion were invested in the industry in 2002, 10.8% more than in 2001.

Domestic fixed capital investments increased to 62% of total industry investments.

Foreign investments amounted to \$436 million, 13% less than in 2001 (in constant US dollars).

Approximately the same amount of investments came from Finland (\$109 million) and the USA (\$105 million). Germany accounted for 14% of the total. The most popular type of foreign investment is by the provision of credit. Direct foreign investments are in decline, amounting to 22% of total foreign investments in 2002 compared with 27.5% the year before.

Capital investments in the telecommunications industry amounted to R 51.8 billion in 2002. Most of them were made by the traditional telecommunication companies, which own the main technical assets of the industry. Moreover, during the last two years the traditional telecoms have been working more actively to upgrade and expand their networks. The traditional telecommunication companies' capital investments increased by 48% in 2002.

The installation of new lines was considerably accelerated in 2002 in all the main segments of the Russian telecommunications industry. During the year, urban automatic telephone exchanges switched on 2.8 million new fixed lines, 50% more than the previous year. Alternative telecommunication companies accounted for 20% of the new lines, and 26% of the subscribers of these lines were households. Alternative operators are offering their services to households more actively than before, and taking the more solvent customers from the traditional companies.

In 2002, Svyazinvest's holding companies put 1.37 million fixed lines into operation, 85% of them in households.

As a result, the Russian Federation's telephone density rose from 24.1 lines per 100 subscribers at the end of 2001 to 25.4 at the end of 2002. Telephone penetration in urban areas is still three times that of rural areas, at densities of 30.7 and 11.1 respectively.

The introduction of international radio relay lines also accelerated significantly in 2002. According to the RF Ministry for telecommunications and information technology, 27,200 kilometres of digital radio relay lines came on stream in Russia in 2002, 375% more than in the previous year. There was a decline, however, in the amount of cable coming on stream, from 32,600 kilometres in 2001 to 23,700 in 2002. The largest projects implemented in 2002 were fibre-optic lines: Russia-Kazakhstan

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(56 kilometres), Tomsk-Molchanovo (664 kilometres), Ekaterinburg-Bereзовskiy (183.6 kilometres) and Ulyanovsk-Dmitrovgrad (144 kilometres). Moreover, 7,300 kilometres of fibre-optic transmission lines were put into operation alongside the tracks of the state-owned railway.

High demand for mobile telecommunication services contributed to the expansion of the mobile network infrastructure. This segment was the leader both in absolute growth and in speed of expansion. In 2002, the number of mobile telephone numbers increased by 12.2 million (compared with 4.25 million in 2001). Residential mobile penetration was 12.54 telephones per 100 subscribers (compared with residential fixed-line density of 19.2 at the end of 2002). By the end of 2002, there were 18 million mobile telephones in use in Russia.

In summing up the performance of the Russian telecommunications industry in 2002 and the first six months of 2003, we would mention the following.

- Revenues from telecommunication services in Russia continued to grow unabated.
- There is increasingly fierce competition between the traditional and the alternative telecommunication companies, but the traditional companies are standing their ground and their revenue growth is accelerating.
- The contribution of households to industry revenues is growing, due to the increased range of services and higher fixed-line tariffs
- Mobile communications remains the industry leader in absolute revenues and revenue growth.
- Telecommunication companies are continuing to increase their investments in the development of networks in the Russian Federation. Most capital investments are still made by the traditional companies, and this should allow them to strengthen their market presence.

# The market



**1.** CENTRAL  
Federal District

**2.** NORTH-WESTERN  
Federal District

**3.** SOUTHERN  
Federal District

**4.** VOLGA  
Federal District

**5.** URAL  
Federal District

**6.** SIBIR  
Federal District

**7.** FAR-EASTERN  
Federal District

Branches of VolgaTelecom are located in eleven of the regions of the Volga Federal District (VFD): the Mariy-El, Mordvin, Udmurt and Chuvash republics, and also in the Kirov, Nizhniy Novgorod, Orenburg, Penza, Saratov, Samara and Ulyanovsk regions. VolgaTelecom does not serve Bashkortostan, Tatarstan and the Perm region (including the Komi-Permyatskiy Autonomous District), which are also part of the VFD.

The area of the VFD is 1.038 million sq. km., or 6.1% of the territory of the RF. The VFD occupies second place after the Central Federal District for the size of its population; 22% of the population of Russia live in the Volga Federal District. The urban population makes up more than 70% of the total population of the district.



### General statistics of the VolgaTelecom regions

	major towns	territory of the region in 000 sq. km.	population at the beginning of 2002, million people	density of population at the beginning of 2002, persons per sq. km.	proportion of urban population as % of total population	number of enterprises in the region at the beginning of 2002
Mariy-El	Yoshkar-Ola (pop. 247,600)	23.2	0.75	32.3	62	12,280
Mordovia	Saransk (310,800)	26.2	0.91	34.7	60	13,953
Udmurtia	Izhevsk (648,000)	42.1	1.62	38.4	70	29,591
Chuvashia	Cheboksary (462,200)	18.3	1.35	73.6	61	16,282
Kirov Region	Kirov (465,900)	120.8	1.56	12.9	71	28,788
Nizhniy Novgorod region	Nizhniy Novgorod (1,332,700)	76.9	3.60	46.8	78	63,429
Orenburg region	Orenburg (514,600)	124.0	2.20	17.7	57	36,073
Penza region	Penza (522,500)	43.2	1.50	34.8	65	20,443
Samara region	Samara (1,134,400), Tolyatti (726,100)	53.6	3.26	60.8	80	82,103
Saratov region	Saratov (856,600)	100.2	2.68	26.7	73	49,873
Ulyanovsk region	Ulyanovsk (656,700)	37.3	1.44	38.6	73	21,284
<b>Total</b>		<b>665.8</b>	<b>20.86</b>	<b>31.3</b>	<b>71</b>	<b>374,099</b>

Source: RF State Committee for Statistics

In 2002 the VFD's share of the industrial output of Russia's economy was 22.8%, the highest figure among the federal districts. Engineering (car manufacture) and the fuel and energy industries are pre-eminent in the industrial structure of the VFD. Major chemical industry companies are located in the district (Khimvolokno and the Kirovo-Chepetskiy Chemical Works).

The main potential of the VFD is concentrated in Tatarstan, Bashkortostan, and the Samara, Perm and Nizhniy Novgorod regions. Their share amounts to more than 70% of the industrial output of the region.

The dynamics of the VFD's industrial output index correspond to the average for Russia. As in the whole of the RF, the district is maintaining a favourable rate of industrial growth. According to the figures for 2002, among the regions of the VFD only the Samara region showed a negative rate of industrial growth. This can be explained initially by a drop in production in the principal branch of the economy, engineering (car manufacture). Production ceased in the region's main company, the Volga Automobile Factory in 2002, due to difficulties in selling the product.

### Dynamics of the industrial output index, % of the previous period

	2000	2001	2002	proportion of the overall industrial output of the RF in 2002 (%)
Russian Federation	112.0	105.0	103.7	100.0
Volga Federal District	111.0	105.0	102.2	22.8

Source: RF State Committee for Statistics

Thanks to its favourable geographical and transport location and to its powerful economic potential, the VFD plays important strategic roles in the socio-economic development of Russia. In the future the district will be one of the leaders in the rate of economic growth.

### The market

In 2002 the VFD was in sixth place among the seven federal districts for the levels of income and expenditure of its population. In almost all the VolgaTelecom territories the average income and expenditure of the population are below the average for Russia. The only exception is the Samara region, which is in the first twenty regions of Russia for per capita level of GRP.

#### Standard of living of the population in the Volga Federal District

	per capita volume of GRP, R 000	position of the region in the RF	average per capita income, R 000/month			average per capita expenditure, R 000/month		
	2000		2000	2001	2002	2000	2001	2002
<b>Russian Federation</b>	<b>43.3</b>	—	<b>2.28</b>	<b>3.06</b>	<b>3.89</b>	<b>2.22</b>	<b>3.00</b>	<b>2.83</b>
<b>Volga Federal District</b>	<b>35.1</b>	<b>5 among FDs</b>	<b>1.70</b>	<b>2.29</b>	<b>2.94</b>	<b>1.58</b>	<b>2.14</b>	<b>2.08</b>
Mariy-El	15.7	73	1.05	1.36	1.73	0.89	1.21	1.15
Mordovia	26.0	45	1.11	1.54	2.10	0.88	1.18	1.15
Udmurtia	34.2	27	1.48	1.97	2.42	1.28	1.72	1.63
Chuvashia	18.6	67	1.12	1.53	1.99	1.07	1.46	1.38
Kirov region	24.1	53	1.33	1.79	2.38	1.30	1.74	1.59
Nizhniy Novgorod region	28.6	37	1.70	2.38	3.17	1.70	2.34	2.14
Orenburg region	37.2	23	1.44	1.92	2.44	1.12	1.49	1.38
Penza region	18.0	71	1.23	1.67	2.11	1.18	1.64	1.46
Samara region	47.3	13	2.60	3.26	4.13	3.01	3.84	3.90
Saratov region	25.1	48	1.44	1.93	2.41	1.21	1.62	1.58
Ulyanovsk region	22.5	56	1.24	1.66	2.24	1.17	1.55	1.72

Source: RF State Committee for Statistics

In the regions in question both investment into the fixed capital and foreign investment into the economy are extremely uneven. The Samara region is the leader in attracting rouble and foreign currency investment.

For the last ten years the Samara region has been a donor region: a member of the RF which does not receive subsidies from the federal budget in order to balance its budget. As well as the Samara region, during the last three years the Nizhniy Novgorod region has also been a donor-region (2000 and 2001) as has the Orenburg region (2001 and 2002).

According to RF State Committee for Statistics, there are 426 large and medium-sized communications companies operating in the territory of the Volga Federal District (out of 2,112 large and medium-sized communications companies operating in the territory of the RF). In 2002 the overall volume of services provided by the communications companies in VolgaTelecom's area of operation was R 19,425 million (6.7% of the figure for the RF), and this included R 17,220 million of telecommunications services. According to the figures for 2002, VolgaTelecom's share is calculated at 63.7% of the overall market for telecommunications services in the Volga Federal District (not including the Tatarstan, Bashkortostan and the Perm region).

In comparison with 2001, in 2002 the volume of communications services in the territory of the federal district grew by 40%; however, the Company's share of the market dropped by 5.5% (from 69.2% in 2001 to 63.7% in 2002).

The main volume of telecommunications services in the Volga Federal District occurs in the Samara and Nizhniy Novgorod regions (28.8% and 17.7% respectively of the total communications services in the district).

# The reorganisation of the Svyazinvest operators

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# Reorganisation of Svyazinvest

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## The aims of the reorganisation

The plan for the reorganisation of the Russian telecommunications industry was first introduced in 2000, in the document entitled «Consultation project: valuation, and restructuring and privatisation options». This was prepared by a consortium of consultants from Arthur Andersen, Allen & Overy, Commerzbank and GIST (the Russian state telecommunications institute). It was prepared, in anticipation of the sale of the state's shareholding in Svyazinvest, under the orders of the Ministry of state property of the Russian Federation, the Ministry for telecommunications and information technology, the Russian Privatisation Centre and the Svyazinvest itself.

The reorganisation was prompted by the realisation among Svyazinvest's shareholders that the country's telecommunications infrastructure was inadequate to support the stable economic development of the regional telecommunications operators. In particular:

1. The operators' assets and the state of their equipment would not allow the necessary investment in modernisation.
2. The small regional telecommunications operators were financially too weak to develop and to compete with the alternative operators then coming into the markets.
3. The markets in the shares of the regional telecommunications operators were too illiquid, and the industry was poorly capitalised.

The reorganisation plan proposed the amalgamation of the regional telecommunications operators within each of the Russian federal districts. The intention was that such an amalgamation would create economies of scale, increase the companies' attractiveness to investors and, as a result, increase their market capitalisation.

The amalgamation took the form of merging the small telecommunications operators with the largest regional telecommunications operator (the 'base company') in each federal district.

This gave the telecommunications companies the opportunity to:

- cut their expenses;
- improve their management and expand the range of services provided;
- undertake investment projects that would have been too large for the smaller companies;
- increase the liquidity of their shares and increase their capitalisation.

The reorganisation of the telecommunications industry has improved the operational and financial indices of the amalgamated companies, and has increased the capitalisation and investment attractiveness of the Svyazinvest holding company, in anticipation of further privatisation.

The amalgamation of the regional telecommunications operators into regional companies took place between October 2000 and March 2003, and in full accordance with Russian law.

**The results of the reorganisation of Svyazinvest**

	Before the reorganisation (October 2000)	After the reorganisation (April 2003)
Number of regional telecommunications operators (not including MGTS, the Moscow telecoms network) <sup>1</sup>	77	12
Average installed capacity (000)	309	3,305 <sup>2</sup>
Number of operators with below-average installed capacity	53	3 <sup>2</sup>
Russian Trade System traded shares of regional operators <sup>3</sup>	136	26
Average capitalisation of Svyazinvest operators, not including MGTS (\$ million)	21	380
Number of regional operators with below-average capitalisation <sup>3</sup>	51	3
Average bid-offer spread of Svyazinvest operators' ordinary shares (%)	1,000	3.8
Number of ordinary and preference shares that have a bid-offer spread of less than	33	22

<sup>1</sup> Including subsidiaries of Svyazinvest that were not involved in the reorganisation.

<sup>2</sup> Average of the seven regional telecommunications operators.

<sup>3</sup> Operators involved in the reorganisation; issues of ordinary and preference shares.

Source: Russian Trade System, Svyazinvest

The reorganisation reduced the number of operators in the Russian Federation from 77 to 12. A considerable number of networks were amalgamated, and the average size of company (in installed capacity) grew by almost ten times. The operators became more similar in size: before the reorganisation the smallest operator serviced a network of 25,000 telephone numbers, and the biggest 1.8 million, while the range is now from 1 million to 5.5 million.

The number of listed Svyazinvest group stocks traded in the Russian Trade System was reduced from 136 to 26 (including both ordinary and preference shares). This helped to overcome the poor liquidity of most of the trading stocks.

At the beginning of the reorganisation, about ten of the companies' stocks did not have both a bid and an offer price in the trading system, and more than ten shares were trading with a spread of more than 1,000%. Generally, the range of spreads was from 4.5% to 6,000%. After the reorganisation, the liquidity of the newly amalgamated operators' shares was much better than that of their predecessor companies, with spreads falling to a normal range of 0.6–14%.

After the amalgamation, the regional operators' capitalisation rose to an average of \$380 million, which increased the attractiveness of their shares for institutional investors. In addition, the differences between their levels of market capitalisation decreased from a range of \$0.058–262 million to \$80–640 million. As in January 2004, the capitalisation range was \$150–1,570 million.

In summary, the reorganisation turned a large number of companies with illiquid shares and poor market capitalisation into seven operators whose operational and market characteristics are comparable with those of eastern European operators.

# Consolidation of operators

The reorganisation of all the Telecommunications operators in the Volga Federal District resulted in a merger centred on Nizhegorodsvyazinform.

## Key statistics of telecommunications operators in the Volga Federal District on 1 January 2001

Operator	Telephone density <sup>1</sup>	Total capacity (000 lines)	Revenue <sup>2</sup> for 2002 (R million)	Assets <sup>2</sup> (R million)	Market capitalisation (\$ million)
Nizhegorodsvyazinform	20.72	828	1,401	2,852.1	70.0
Kirovselectrosvyaz	17.71	292	439	909.7	7.9
Martelecom	21.19	176	290	502.9	1.9
Saratovselectrosvyaz	13.76	406	739	986.2	9.9
Svyazinform of Penza region	14.13	235	346	660.6	3.3
Svyazinform of Mordovia	18.79	183	297	908.2	3.2
Svyazinform of Samara region	17.20	587	1,194	1,518.2	47.4
Svyazinform of the Republic of Chuvashia	14.92	221	340	522.5	3.5
Udmurt Telecom	18.47	331	542	911.8	9.1
Ulyanovskselectrosvyaz	14.45	222	366	862.0	3.0
Electrosvyaz of Orenburg region	15.38	375	743	1,124.6	12.9

<sup>1</sup> Fixed lines number per 100 persons.

<sup>2</sup> According to Russian accounting standards.

Source: the Company, Svyazinvest, Russian Trade System

The consolidation process started in October 2000, when the managements of the companies elaborated on their schemes of reorganisation and announced that they were selecting a financial institution to advise them. Knowledge of telecommunications industry specifics and previous reorganisation experience were the criteria in selecting a consultant.

The institution chosen was Gamma-Group<sup>1</sup>, which had previously taken part in the reorganisation of other Russian telecommunications companies.

The formation of the new company was divided into several stages. These included the valuation of the companies and the calculation of share conversion factors. The valuation was carried out by the financial advisor. Based on this evaluation, the prices of the shares were determined to repurchase shares from those shareholders who voted against or did not participate in voting. The results of these efforts were approved by the boards of directors in September 2001, and were indicated in the merger agreements.

The valuations of these companies' shares was based on comparisons of accounting ratios, analysis of net asset value, historical quotations of shares and discounted cash flow. These calculations provided the share conversion factors.

The valuation of the shares was determined by an independent certified appraiser, the Nizhegorodskoye Legal Partnership, and was approved by the Company board of Directors.

<sup>1</sup> Gamma-Group was founded in 1994. Originally it provided brokerage services. Gamma-Capital, IB division of Gamma-Group, was set up in 1998.

**Calculation of share price estimates for the merger of telecommunications operators in the Volga Federal District**

Operator	Type of share	Number of shares in issue, October 2001	Conversion factor <sup>1</sup>	Number of additional shares issued by Nizhegorod-svyazinform	Share price as determined by the companies' boards of directors (R)
Nizhegorodsvyazinform	Ordinary	87,508,200	n/av	n/av	21.92
	Preference	29,169,300	n/av	n/av	6.90
Kirovelectrosvyaz	Ordinary	1,228,095	10.1	12,399,351	137.38
	Preference	409,365	10.1	4,132,855	48.00
Martelecom	Ordinary	13,068,825	0.36	4,732,377	7.29
	Preference	4,356,198	0.36	1,578,028	1.80
Saratovelectrosvyaz	Ordinary	127,966,080	0.201	25,767,099	2.16
	Preference	42,655,360	0.201	8,589,006	0.84
Svyazinform of Penza region	Ordinary	152,625	38.69	5,903,505	513.19
	Preference	50,875	38.69	1,968,213	241.33
Svyazinform of Mordovia	Ordinary	31,956,189	0.14	4,599,590	3.38
	Preference	10,652,064	0.14	1,533,404	1.09
Svyazinform of Samara region	Ordinary	1,981,005	24.84	49,211,737	518.52
	Preference	660,335	24.84	16,403,965	143.89
Svyazinform of the Republic of Chuvashia	Ordinary	227,588	26.89	6,120,471	361.28
	Preference	75,862	26.89	2,040,099	179.96
Udmurt Telecom	Ordinary	10,808,805	2.01	21,693,209	19.98
	Preference	3,602,935	2.01	7,231,086	6.90
Ulyanovskelectrosvyaz	Ordinary	2,241,580	3.22	7,207,080	45.16
	Preference	747,193	3.22	2,402,300	19.97
Electrosvyaz of Orenburg region	Ordinary	289,064,000	0.072	20,832,688	1.04
	Preference	96,354,000	0.072	6,944,148	0.35
<b>Total</b>	<b>Ordinary</b>			<b>158,467,107</b>	<b>n/av</b>
	<b>Preference</b>			<b>52,823,104</b>	

<sup>1</sup> The conversion factor is the number of additional shares of Nizhegorodsvyazinform, into which one share of the company was converted. Ordinary and preference shares were converted at the same rate.

Source: Svyazinvest, the Company

This valuation exercise identified Nizhegorodsvyazinform and Svyazinform of Samara region as having the largest market capitalisation and total capacity among the merging operators, and they therefore represent the biggest proportion of the share capital of the merged company.

**Consolidation of operators**

**Comparison of telecommunications operators in the Volga Federal District on 1 January 2001**

Operator	Total capacity (000 lines)	Share in total capacity (%)	Core operating incomes in 2000 <sup>1</sup> (R million)	Share in core operating incomes (%)	Assets <sup>1</sup> (R million)	Share in total assets (%)	Market capitalisation (\$ million)	Share in total market capitalisation (%)
Nizhegorodsvyazinform	828	21.47	1,319.3	20.92	2,852.1	24.26	70.0	40.67
Kirovelectrosvyaz	292	7.57	403.2	6.56	909.7	7.74	7.9	4.59
Martelecom	176	4.56	206.2	4.33	502.9	4.28	1.9	1.10
Saratovelectrosvyaz	406	10.53	693.0	11.03	986.2	8.39	9.9	5.75
Svyazinform of Penza region	235	6.09	312.7	5.17	660.6	5.62	3.3	1.92
Svyazinform of Mordovia	183	4.75	265.9	4.43	908.2	7.72	3.2	1.86
Svyazinform of Samara region	587	15.22	1,133.5	17.83	1,518.2	12.91	47.4	27.54
Svyazinform of the Republic of Chuvashia	221	5.73	323.4	5.08	522.5	4.44	3.5	2.03
Udmurt Telecom	331	8.58	525.4	8.09	911.8	7.75	9.1	5.29
Ulyanovskeletrosvyaz	222	5.76	327.1	5.47	862	7.33	3.0	1.74
Electrosvyaz of Orenburg region	375	9.73	670.1	11.09	1,124.6	9.56	12.9	7.50
Total	3,856	100.00	6,180.0	100.00	11,759.0	100.00	172.1	100.00

<sup>1</sup> According to Russian accounting standards.

Source: Svyazinvest, AVK calculations

**Relative Value of the Merged Companies (October 2001)**

Operator	%
Nizhegorodsvyazinform	35.6
Kirovelectrosvyaz	5.0
Martelecom	1.9
Saratovelectrosvyaz	10.5
Svyazinform of Penza region	2.4
Svyazinform of the Republic of Mordovia	1.9
Svyazinform of Samara region	20.0
Svyazinform of the Republic of Chuvashia	2.5
Udmurt Telecom	8.8
Ulyanovskeletrosvyaz	2.9
Electrosvyaz of Orenburg region	8.5

Source: AVK calculations

In October and November 2001, as specified in the reorganisation plan, the telecommunications operators of the Volga Federal District held special shareholders' meetings at which the terms of participation of each company, reorganisation, and the merger were submitted for discussion. The preparation of detailed information and the holding of presentations and meetings between managers and investors provided transparency for the minority shareholders, most of them approved the deal. At the inaugural general meeting of the Company it was decided to change its name from Nizhegorodsvyazinform to VolgaTelecom.



The proposal to merge the other telecommunications operators of the region with Nizhegorodsvyazin-form was approved by RF Ministry for Anti-Monopoly Policy and Support of Business (MAP RF) in April 2002. Originally, MAP RF proposed a set of requirements for the merger which would provide competition. This proposal included provisions for another reorganisation within 6 months of the merger with the intent of segregating the legal entities which provide non-regulated by the government services only. The requirements were satisfied by Svyazinvest; however, in 2003 MAP RF relinquished its requirements.

On 30 November 2002, the merging companies were removed from the official register of companies, and their shares were converted into newly issued shares of VolgaTelecom. Additional shares were distributed among the shareholders of the merging companies.

The legal procedure was completed in March 2003 with the registration of a report on the issue of shares by the RF Federal Commission for Securities, and with the holding of the inaugural annual general meeting of the merged company VolgaTelecom. Shareholders approved the changes made to the Company charter, acknowledged legal succession of the merged company, and appointed a new board of directors and a new managing director.

The most important effects of the reorganisation were as follows:

1. The goals set for the reorganisation of the telecommunications operators in the Volga Federal District were achieved. The goals included merging small operators into a large company that could provide services the district. Single operators have a number of advantages for carrying out financing, investment, and technical policy, have a higher creditworthiness, and are more attractive to investors.
2. Between September 2000 and March 2003, while the merger was taking place, the merging companies' aggregate market capitalisation more than doubled, from \$140 million to \$300 million. The spread between the bid and offer prices of the ordinary shares narrowed from 26% to 1.5%. Therefore, share liquidity has significantly increased and now provides existing shareholders with additional income in the form of increased stock price.

After the merger, the total capacity of the Company was 4.2 million lines, making it the second largest of the seven operators founded during the reorganisation of Svyazinvest. VolgaTelecom has the highest ratio of operating profit to earnings of the Svyazinvest operators

3. Standard & Poor's has raised the Company's international credit rating from B-/Stable to B/Stable, which means a higher creditworthiness for VolgaTelecom



# The Company's financial and operating results

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# History of the Company

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The Open Joint-Stock Company (OJSC) Svyazinform, Nizhniy Novgorod region Nizhegorodsvyazinform, was set up on 15 December 1993 as a result of the privatisation of the Rossvyazinform, Nizhniy Novgorod region, State Communications and Informatics Enterprise. At this point the first issue of the company's shares was floated: 567,830 ordinary shares, 194,462 type A preference shares, and 15,558 type B preference shares with a par value of 00.50 denominated rubles (here and later in current values).

In accordance with the privatisation plan a controlling block of the company's voting shares, making up 38% of the authorised capital, remained in the state's hands, the type A preference shares were issued free to the members of the workforce and the remaining shares were sold as a restricted subscription to the company's workforce and were realised by open sale. On the results of the 1995 voucher auction a share split occurred resulting in the number of shares increasing by a factor of 50 and comprising 29,169,400 ordinary shares and 9,723,100 preference shares with a par value of R 00.01.

In 1995 the controlling block of the company's voting shares, making up 38% of the authorised capital, which in accordance with the privatisation plan had been assigned to state ownership, was transferred into an account to form the authorised capital of the telecommunications holding Svyazinvest, along with the state's blocks of shares in the remaining regional telecommunications operators.

On 30 September 1996, in connection with a revaluation of the company's property and equipment, a conversion of the company's shares with a par value of R 00.01 to shares with a par value of R 15 was carried out. Immediately after the registration a split occurred in the share value, with a ratio of 1:3. Consequently the company's authorised capital was divided into 87,508,200 ordinary and 29,169,300 preference shares with a par value of R 5.

In 2000 the RF Ministry for telecommunications and information technology prepared a Concept for the development of the market for telecommunication services in the Russian Federation which contained the intended reorganisation of the structure of the Svyazinvest holding by merging the inter-regional communication companies and improving the system of corporate management. It was decided that as part of the overall reorganisation of the telecommunications operators who were part of the Svyazinvest holding, the merging of the communications operators of the Volga Federal District (VFD) into one inter-regional communications company should be done on the basis of the Nizhegorodsvyazinform. Only the telecommunications operator of the Perm region would be part of another inter-regional communications company: Uralsvyazinform would become the centre of the formation of a unified communications operator for the Urals area.

Since the programme for the reorganisation of the regional telecommunications operators foresaw the merging of the telecommunications operators of the VFD into one company on the basis of Nizhegorodsvyazinform, at the general meetings of the shareholders of the 11 telecommunications operators in 2001 the decision was taken to reorganise the company by merging with Nizhegorodsvyazinform the ten telecommunications operators of the VFD.

At the annual meeting of the Nizhegorodsvyazinform shareholders in June 2002 the decision was taken to rename the company VolgaTelecom. The new name reflected the fact that the company was to become the largest communications operator in the whole of the VFD.

As part of the further implementation of the programme to reorganise Russia's regional telecommunications operators, the following companies that provided telecommunications services in the territory of the VFD were merged with VolgaTelecom in 2002:

- Kirovelectrosvyaz
- Martelecom
- Svyazinform, Penza region
- Svyazinform, Mordvin Republic
- Svyazinform, Samara region
- Svyazinform, Chuvash Republic
- Saratovelectrosvyaz
- Udmurt Telecom
- Ulyanovskelectrosvyaz
- Electrosvyaz, Orenburg region

**Main parameters of the companies whose merging formed the present structure of VolgaTelecom (December 2001)**

Title of the company	Line capacity	Telephone penetration, phone lines per 100 persons	Proportion of digitisation, % <sup>1</sup>
Nizhegorodsvyazinform	843,992	21.87	36.00
Svyazinform, Samara region	601,135	17.50	25.49
Saratovelectrosvyaz	437,149	15.17	28.45
Electrosvyaz, Orenburg region	392,791	16.28	39.51
Udmurt Telecom	341,456	19.12	45.69
Kirovelectrosvyaz	303,288	18.64	21.53
Svyazinform, Penza region	253,032	15.43	32.65
Ulyanovskelectrosvyaz	232,138	15.25	14.41
Svyazinform, Chuvash Republic	228,858	15.90	26.72
Svyazinform, Mordvin Republic	188,169	19.85	51.15
Martelecom	176,539	21.79	68.26

<sup>1</sup> Proportion of digitisation is calculated as the share of line capacity of digital switching in the company's overall line capacity.

Source: Svyazinvest

After the merging of the regional telecommunications operators in the VFD, VolgaTelecom became the largest company in the district to provide telecommunications services in the territories of all the members of the RF within the VFD, with the exception of the Bashkortostan and Tatarstan Republics, the Perm region and the Komi-Permyatskiy Autonomous District.

**Significant events of recent years:**

<b>October 1997</b>	The US Securities and Exchange Commission (SEC) gave permission for the issuing of a first-tier ADR for Nizhegorodsvyazinform shares.
<b>November 1997</b>	First-tier ADR for Nizhegorodsvyazinform shares included in the listings of the Berlin and Frankfurt stock exchanges.
<b>July 2001</b>	The Nizhegorodsvyazinform board of directors confirmed the Action programme for communication with the public and disclosing information about the Company.
<b>November 2001</b>	An extraordinary general meeting of the Company's shareholders decided on the reorganisation of Nizhegorodsvyazinform by merging with it the ten telecommunications operators of the VFD.
<b>March 2002</b>	Long-term credit ratings in local and foreign currency were awarded by Standard&Poor's international rating agency, at a level of B- and a forecast of Stable.
<b>April 2002</b>	The RF Ministry for Anti-Monopoly Policy and the Support of Business approved the application for the merging with Nizhegorodsvyazinform of the ten telecommunications operators of the VFD.
<b>June 2002</b>	Nizhegorodsvyazinform was renamed VolgaTelecom.
<b>November 2002</b>	The merging of the ten telecommunications operators of the VFD with VolgaTelecom took place by converting the shares of the additional companies into VolgaTelecom shares.
<b>January 2003</b>	The RF Federal Commission for Securities (RF FCS) formally registered the issue of VolgaTelecom shares which were floated by converting the additional ten telecommunications operators of the VFD into securities.
<b>February 2003</b>	Standard & Poor's raised VolgaTelecom's long-term credit rating to B, forecast Stable.
<b>March 2003</b>	Standard & Poor's awarded VolgaTelecom and the Company's rouble bonds issue a long-term credit rating of ruA- on the Russian scale.
<b>August 2003</b>	Standard & Poor's awarded VolgaTelecom a corporate management rating of 5.8.
<b>November 2003</b>	The Company combined all issues of its shares. Registration numbers of the ordinary shares issues from 3 to 12 were annulled, and the shares have been assigned the new registration number 1-01-00137-A. Registration numbers of the preference shares issues from 3 to 12 were annulled, and the shares have been assigned the new registration number 2-01-00137-A.

# Strategy

The Company's mission – provision, on the basis of innovative and technological breakthrough, of all spectrum of telecommunications services in Volga Federal District (VFD) within the framework of the general conception of the development of Russian telecommunications industry.

The Company's development strategy – to provide quality telecommunications services to domestic users and state and commercial organisations in the territory of the Volga Federal District, by developing the telecommunications infrastructure, improving the quality of service and introducing modern technical solutions. The Company's strategy is directed towards maintaining and strengthening its leading position in the VFD.

The strategic aims of VolgaTelecom are divided into:

1. *Social*: co-operating in the economic development of the RF; increasing the well-being and level of intellectual development of the population by providing high-quality communications services and access to information resources.
2. *Technological*: a phased modernisation and reconstruction of the telecommunications network; by 2010 to achieve 100% digitisation of the base stations and area centres, and 100% provision of digital channels for the area centres; participation in the formation of a telecommunications infrastructure for the VFD that is sufficient for the growth rates of the communications industry.
3. *Financial*: growth in the Company's revenues and income; increase in its capitalisation; realisation of planned investment projects.
4. *Market*: maintaining the Company's share in the overall revenue from communications services in the VFD at not less than 51% until 2008; development of new forms of communications service; realisation of the potential of the most lucrative customer segments (commercial organisations); strengthening its position in the most competitive markets (Nizhniy Novgorod, Samara and Saratov regions); creating an image of the Company as a successful, informationally transparent company, the main provider of communications services in the Volga Federal District; ensuring that the Company has a high degree of influence on the development of the telecommunications market in the VFD.
5. *Corporate*: creation of a flexible corporate structure which will respond to the requirements of the times and will help each employee develop his creative potential to the full.

## Characteristics of the priority fields of development for VolgaTelecom

Field of development	Real growth of the indicator					
	2003	2004	2005	2006	2007	2008
1. Transport networks, FOCL <sup>1</sup> , km.	1,880.0	1,520.0	2,380.0	2,050.0	1,480.0	1,260.0
DRRCL <sup>1</sup> , km.	270.0	240.0	370.0	190.0	130.0	160.0
2. Mobile communications networks, GSM-900, 000 numbers	600.0	1,000.0	1,245.0	1,400.0	1,620.0	1,700.0
NMT-450, 000 numbers	38.0	33.0	25.0	17.0	9.0	3.0
DAMPS, 000 numbers	145.0	105.0	80.0	52.0	40.0	25.0
CDMA, 000 numbers	1.5	20.0	35.0	55.0	78.0	95.0
3. Local telephone networks (line capacity), 000 numbers	237.0	280.0	250.0	240.0	190.0	195.0

<sup>1</sup> FOCL — fibre-optic communications line; DRRCL — digital radio-relay communications line.  
Source: the Company

The forecast figures for the capacity of the Company's local network assume an annual increase in telephone penetration of approximately 4.3%. On 1 January 2003 telephone penetration was 19.5 telephone apparatuses per 100 people, and the growth rates given above assume an increase in telephone penetration to 25.1 per 100 people by 2008.

From the point of view of consumer structure, a priority for the Company is activity in the most lucrative segments of the business sector and high-income domestic users. In accordance with the strategy developed, the Company intends to maintain until 2008 its share of the overall revenues received from commercial organisations by communications operators in the VFD at not less than 14%. To attract customers in the target segments, VolgaTelecom has set a course on improving its service organisation and setting up an effective sales system. With this aim the Company is undertaking these measures:

- direct sales with 'image' advertising;
- using combinations of different methods of promoting the Company's services to medium and small businesses;
- developing service centres which will be designed to serve medium and small businesses;
- personally addressed mail and promotion of products via 'image' advertising;
- creation of call centres, which are an effective sales channel for the mass market (including small businesses);
- developing the dealer network for services that have to be processed quickly.

The strategy adopted by the Company allows for the intensive development of the following new services:

1. Intelligent communications network services (ICN).  
In 2002 a contract was signed with Huawei Technologies for a Tellin® intelligent platform. Five intelligent services will be provided using this platform: freephone (FPH), televoting (VOT), premium rate (PRM), prepayment cards (PCC) and universal access number (UAN).
2. IP-telephony (VoiceIP, IP-number).  
The IP-telephony service will be developed in two directions:
  - Installation of IP-telephony nodes for inter-urban and international communications. The service will be provided on the basis of prepayment cards;
  - Provision of access to the common-user telephone network via the data transference network. The 'last mile' will be xDSL broadband access. This is the first stage in a changeover to networks with NGN packet switching.
3. Broadband Internet access.
4. Internet and data transference.
5. Cable television.
6. Mobile communications.
7. Paging.

To improve the quality of the services provided, it is intended:

- to use new telecommunications technologies (ADSL, SHDSL, ISDN); to raise the level of digitisation of the network and to replace equipment (the Company plans to reduce the depreciation of switching equipment from 42.3% of its initial value in 2003 to 32.3% of the initial value in 2008; for network equipment depreciation would be reduced from 52.1% to 48.1% for the same period).
- to develop unified corporate standards and to introduce them in regional branches;
- to develop a system of quality control and to carry out certification of the services to ISO 9000.

One of the chief tasks in the Company's human resources policy is ensuring a supply of highly qualified personnel. The main fields of activity of VolgaTelecom's human resources department are in the quality selection, training and rotation of staff, raising qualifications, training specialists of all levels, as well as developing compensation packages.



Staff training is undertaken in the Company both in the form of training away from work (in training centres and institutes of higher education in the VFD and Moscow) and in short targeted courses to raise qualifications: training days, seminars, conferences and master classes. As an additional pension support for employees, the Company has concluded an agreement with the non-state pension funds TelecomSoyuz and Doveriye. On reaching pensionable age, staff will be able to obtain the right to an additional non-state pension via these bodies; the size of the pension will depend upon the length of the person's continuous service with the Company.

Two of the main tasks of the Human Resources Department are improving the Company's structure and optimising the size of the staff. A number of structural changes are taking place in the Company with the aim of eliminating inefficient subdivisions and duplication of functions. To increase the efficiency of the Company's activity and to reduce its overheads, an ERP system was obtained in May 2003 which will allow the procedures for processing managerial information to be standardised and accelerated.

Co-operation with the RF Ministry for Anti-Monopoly Policy and Support of Business (MAP RF) in the area of tariff regulation will be directed towards carrying out a staged optimisation of tariffs and towards harmonising their levels across the branches of the unified Company. Work will continue to bring tariffs for regulated services up to an economic level. The main directions of the Company's tariff policy in the area on regulated tariffs are: to increase the prices for local telephone connections and gradually to reduce the tariffs for inter-urban telephone communications and for providing access to the telephone network; a phased reduction in cross subsidy between the local and long-distance communications services, while retaining a partial cross subsidising of the rural telephone network service; a changeover in the near future to a system of limit pricing for tariffs.

#### Growth in tariffs for the urban telephone network across the VolgaTelecom branches, 2004–2008, %

branch	2004			2005			2006			2007			2008		
	Dom. <sup>1</sup>	S. o.	C. o.	Dom.	S. o.	C. o.	Dom.	S. o.	C. o.	Dom.	S. o.	C. o.	Dom.	S. o.	C. o.
1. Kirov branch	27.27	15.38	15.38	21.43	20.00	20.00	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
2. Nizhniy-Novgorod branch	15.38	6.67	6.67	13.33	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
3. Orenburg branch	21.74	6.67	6.67	21.43	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
4. Penza branch	27.27	15.38	15.38	21.43	20.00	20.00	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
5. Samara branch	25.00	6.67	6.67	13.33	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
6. Saratov branch	15.38	6.67	6.67	13.33	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
7. Ulyanovsk branch	25.00	6.67	6.67	13.33	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
8. Mariy-El republic branch	21.74	14.29	14.29	21.43	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
9. Mordvin republic branch	25.00	6.67	6.67	13.33	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
10. Udmurt republic branch	25.00	6.67	6.67	13.33	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32
11. Chuvash republic branch	27.27	14.29	14.29	21.43	12.50	12.50	11.76	5.56	5.56	7.89	7.89	7.89	7.32	7.32	7.32

<sup>1</sup> Dom. — domestic, S. o. — state organisations, C. o. — commercial organisations.

Source: the Company

As a result of implementing this strategy, by 2008 the Company should achieve the following results:

- maintain its share of the VFD telecommunications market at not less than 51.2%;
- create a new organisational structure for sales and marketing and raise their status;
- optimise the process for making decisions connected to customer service and sales;
- strengthen its position in the most attractive areas of the VFD, the Nizhniy Novgorod, Samara and Saratov regions.

The VolgaTelecom trademark is not yet sufficiently well known to people living in the regions and because of this the Company will shortly be carrying out a large-scale branding campaign in all the branches.

### Forecast of VolgaTelecom's position in the communications market of the VFD

Indicator	2003	2004	2005	2006	2007	2008
Revenue from VFD telecommunications services, R 000	26,095,000	33,000,000	40,000,000	46,900,000	53,500,000	61,000,000
Rev. from communications services,%	52.9	50.7	50.8	50.5	51.0	51.2
Rev. from providing com. services to domestic users,%	30.4	28.1	28.4	28.7	29.4	29.3
Rev. from services to commercial organisations,%	16.9	15.8	13.9	12.2	12.8	14.0
Rev. from services to state organisations,%	5.6	6.8	8.5	9.6	8.8	8.0
Rev. from local communications services,%	23.6	21.8	22.9	22.7	22.9	23.1
Rev. from inter-urban and international communications,%	21.2	19.7	18.2	17.5	17.3	16.8
Cordless and cellular communications,%	0.6	0.6	0.6	0.7	0.7	0.8

Source: the Company

As a result of the reorganisation of the communications operators in the Volga region and the consolidation of the assets of the amalgamated companies, VolgaTelecom became a participant in 83 companies. To simplify the ownership structure and to improve the supervision over the activities of the organisations, the Company needs to restructure its whole subsidiary business. At the present moment information is being collected from all the companies, and the effectiveness of their operations is being analysed; this will be used to draw up a plan to restructure the whole subsidiary and dependent business.

The restructuring is intended to cover these points:

- the sale of shares, and financial shares of companies, initially for unprofitable forms of activity;
- consolidating the assets of cellular companies into one separate business unit with the working name of Volga-Mobile;
- increasing the financial shares and the number of shares of companies that are working efficiently and have good prospects for development;
- reorganising enterprises that have the same functions by integrating/merging;
- initiating bankruptcy procedures to carry out the liquidation of unprofitable and inoperative organisations.

The sale of shares and financial shares belonging to VolgaTelecom will be carried out firstly when the Company has a share of less than 20% of the organisation, when the organisation carries out non-specialist activity, and when it provides communications services that have few prospects and low incomes (telegraphy and radio broadcasting).

# Competitive strengths and weaknesses

A SWOT table has been compiled to show VolgaTelecom's competitive strengths and weaknesses.

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Ownership of the region's main telecommunications infrastructure (switched capacity and communications channels), large area of network coverage in the territory of operations.</li> <li>• Provision of a range of communications services and because of this the possibility of flexible pricing for non-regulated communications services.</li> <li>• Company's priority access to the end-user (right of ownership of the 'last mile'), and consequently the presence of a large subscriber base.</li> <li>• Long experience in providing telecommunications services and constructing communications networks.</li> <li>• Knowledge of the geographic, economic and social features of the regional communications market.</li> <li>• Presence in most regions of the Volga Federal District of the RF, and consequently the possibility of realising inter-regional projects.</li> <li>• Highly professional staff.</li> <li>• The Company is part of the Svyazinvest group of companies, the largest company in the Russian communications market (40% of the market), which guarantees it a major significance in the industry.</li> </ul>	<ul style="list-style-type: none"> <li>• Absence of a unified marketing policy.</li> <li>• Predominance in the customer base of the domestic segment, which is far less profitable than commercial organisations.</li> <li>• Underdeveloped sales (passive sales methods) and after-sales services.</li> <li>• Absence of customer support services and of a stated customer relations policy.</li> <li>• A poor system of documentation, and fragmentation between the Company's branches.</li> <li>• As a natural monopolist in the industry, the Company is the object of state control, which severely restricts its revenue base: revenue from tariffs makes up more than 90% of the total volume of sales.</li> <li>• A social responsibility, historically laid on the Company by the state and forcing it to deal with social problems such as the priority reduced-rate telephonisation of veterans, participants of WWII, etc.</li> </ul>

Opportunities	Threats
<ul style="list-style-type: none"> <li>• Priority development of new high-profitability communications services for which there is an increasing demand (IP-telephony, VPN, ISDN, Internet, cordless access to the common-user network, DECT and WLL technologies).</li> <li>• Widening the package of services and seizing additional niches in the market.</li> <li>• Further widening of the subscriber base. Perfection of a system to motivate the most attractive users of the Company's services, commercial organisations. Organisation of commercial services oriented towards an aggressive business style. Changeover to a system of customer relationship management (CRM).</li> <li>• Growth of revenue from renting out equipment, caused by the appearance of new communications operators as the market is liberalised.</li> <li>• Increase the efficiency of capital investment by integrating the use of equipment (offering new communications services alongside traditional ones).</li> <li>• Reduction of the Company's overheads through the optimisation of the organisational and management structure.</li> <li>• Participating in the realisation of federal informatisation programmes (Electronic Russia).</li> </ul>	<ul style="list-style-type: none"> <li>• According to the new wording of the law On Telecommunications, from 2005 the Company may be appointed an «universal service operator» in the Volga Federal District. Provision of unprofitable universal services may cause worsening of the Company's financial condition (see «Risks»)</li> <li>• The appearance of new competitors in the areas of fixed communications and new communications services, resulting from the liberalisation of the Russian communications market (entry into the WTO).</li> <li>• Toughening of the tariff regulation principles by the RF Ministry for Anti-Monopoly Policy and Support of Business.</li> <li>• Changes in the conditions of licensing.</li> <li>• Reduction of revenue from inter-urban and international traffic due to the development of IP networks by alternative communications operators.</li> <li>• Development of cordless means of communication which reduce capital expenditure on the construction of communications networks and lower the barriers against entry into the market; this would help the development of competitors' communications networks.</li> <li>• Other operators may construct more competitive networks.</li> <li>• The appearance of new sectors where the Company has no historical advantage.</li> </ul>

# Services

## The main services provided by VolgaTelecom on 1 July 2003

	Nature of service	Registration no.	Date of expiry of licence
1. Local, inter-urban and international communications	Local communications: telephone connections between users located within the boundaries of one built-up area or administrative district. Inter-urban and international communications: telephone connections between users located in the territories of different members of the RF or in different administrative districts of the same member of the RF (apart from districts that are parts of towns); communications to the territory of a foreign state	No.24345	28 Nov. 2007
2. Local and intrazonal telephone communications		No.23245	4 Oct. 2012
3. Channel rental	Provision of communications channels for rental	No.23246	12 Sept. 2007
4. Telematic services	The transmission of information via the telecommunications network, with the exception of telephone, telegraph and data transference services	No.23240	1 Aug. 2007
5. Data transference	The exchange of any form of data between subscriber apparatuses equipped for data transference via the telephone network	No.23241	1 Aug. 2007
6. Telegraph communications	Telegram service, including via the AT-telex network	No.23243	4 Nov. 2007
7. Standard GSM-900	Provision of mobile radio communications to a large number of mobile customers with an outlet into the common-user telephone network, based on the cellular principle of allocating frequencies according to the area served	No.23 244	17 Mar. 2010
8. Standard GSM-450		No.23242	1 Feb. 2006
9. Trunking: mobile radiotelephone communications	The provision of mobile radio communications to mobile subscribers or groups of subscribers, using dynamic channel allocation among the users, allowing group connection, conferencing and other functions	No.24343	28 Nov. 2005
10. Paging with multiplexing of UHF FM channels	The provision of the one-way transmission of information to subscribers within the limits of the area served, using a specialised subscriber terminal	No.11917	8 Apr. 2004
11. Paging		No.24344	28 Nov. 2005
12. Transmission of sound broadcasts over the wire broadcasting network	The transmission of sound broadcasts to a wide circle of territorially dispersed listeners using wires	No.23 721	12 Sep. 2007
13. Terrestrial transmission of television and sound programmes, and transmission of additional information	The transmission of television, sound and other information using frequency means of communication	No.12282	24 July 2004
14. Terrestrial broadcasting of television programmes		No.16383	17 Oct. 2005
15. Terrestrial broadcasting of audio programmes		No.17571.	19 May 2005
		No.15426	15 Mar. 2006
16. Terrestrial broadcasting of television and audio programmes		No.19983	8 Nov. 2008
17. Terrestrial broadcasting of television programmes		No.23257	1 Aug. 2005
18. Terrestrial broadcasting of television programmes		No.25357	14 Mar. 2006
19. Transmission of television programmes via the cable television network		No.23264	20 May 2007
		No.14461	9 Mar. 2006
		No.17234	25 Jan. 2006
	No.20830	18 Jan. 2007	
	No.14602	9 Mar. 2005	
20. Transmission of television and audio programmes via the cable television network	No.25379	14 Mar. 2006	
	No.26974	25 May 2006	

## The main services provided by VolgaTelecom on 1 July 2003 (continued)

	Nature of service	Registration no.	Date of expiry of licence
21. Activity linked to state secrets	Work involving the use of information which is a state secret	B325542 No.523	9 Dec. 2007
	Undertaking measures and/or providing services to protect state secrets	B325543 No.524	9 Dec. 2007

Source: the Company

## Tariffs for VolgaTelecom services on 31 December 2002

	Title of service									
	Urban, flat rate, roubles/month	Access to UTN, roubles	Urban, time-based		Rural, flat rate, roubles/month	Access to RTN, roubles	Rural, time-based		Inter-urban com. <sup>1</sup> , roubles/min.	Internal telegraph, roubles/word
			Standing charge, roubles/mth.	Calls, roubles/min.			Standing charge, roubles/mth.	Calls, roubles/min.		
Kirov branch										
Domestic	85	5,000	—	—	85	5,000	—	—	2.31	16.18 <sup>2</sup>
State org.	110	5,000	—	—	110	5,000	—	—		
Commercial org.	110	5,000	—	—	110	5,000	—	—		
Mariy-El republic branch										
Domestic	71	3,833	—	—	71	2,667	—	—	3.3	0.7
State org.	115	6,000	—	—	115	6,000	—	—		
Commercial org.	115	6,000	—	—	115	6,000	—	—		
Mordvin republic branch										
Domestic	90	3,500 <sup>3</sup>	44	0.08 <sup>4</sup>	90	3,500	44	0.10	3.1	0.8
State org.	120	7,500	77	0.10 <sup>4</sup>	120	7,500	77	0.12		
Commercial org.	120	7,500	84	0.10 <sup>4</sup>	120	7,500	84	0.12		
Nizhniy Novgorod branch										
Domestic	100	6,000	80	0.15	90	6,000	72	0.15	2.39	0.8
State org.	130	9,000	104	0.15	130	9,000	104	0.15		
Commercial org.	130	9,000	104	0.15	130	9,000	104	0.15		
Orenburg branch										
Domestic	85	6,000	50	0.8	85	4,000 <sup>5</sup>	—	—	2.72	0.8
						3,000 <sup>6</sup>				
State org.	130	9,000	80	0.8	130	9,000	—	—		
Commercial org.	130	9,000	80	0.8	130	9,000	—	—		
Penza branch										
Domestic	85	5,000	51	0.14	85	5,000	51	0.14	2.24	15.01 <sup>2</sup>
State org.	110	7,000	64	0.14	110	7,000	64	0.14		
Commercial org.	110	7,000	64	0.14	110	7,000	64	0.14		

## Tariffs for VolgaTelecom services on 31 December 2002 (continued)

	Title of service									
	Urban, flat rate, roubles/month	Access to UTN, roubles	Urban, time-based		Rural, flat rate, roubles/month	Access to RTN, roubles	Rural, time-based		Inter-urban com. <sup>1</sup> , roubles/min.	Internal telegraph, roubles/word
			Standing charge, roubles/mth.	Calls, roubles/min.			Standing charge, roubles/mth.	Calls, roubles/min.		
Samara branch										
Domestic	100	7,000	—	—	100	2,700	—	—	2.92	0.8
State org.	120	7,000	—	—	120	7,000	—	—		
Commercial org.	120	7,000	—	—	120	7,000	—	—		
Saratov branch										
Domestic	100	5,000	—	—	90	1,000	—	—	2.51	19.23 <sup>2</sup>
State org.	120	6,000	—	—	120	2,500	—	—		
Commercial org.	120	6,000	—	—	120	2,500	—	—		
Udmurt republic branch										
Domestic	90	4,500	—	—	90	4,500	—	—	3.1	0.8
State org.	130	7,000	—	—	130	7,000	—	—		
Commercial org.	130	7,000	—	—	130	7,000	—	—		
Ulyanovsk branch										
Domestic	80	6,000	48	0.12	80	6,000	48	0.12	2.47	0.8
State org.	120	7,000	62	0.12	120	7,000	62	0.12		
Commercial org.	120	7,000	62	0.12	120	7,000	62	0.12		
Chuvash republic branch										
Domestic	80	5,500	—	—	80	3,500	—	—	2.44	0.8
State org.	120	7,000	—	—	120	7,000	—	—		
Commercial org.	120	7,000	—	—	120	7,000	—	—		

<sup>1</sup> To represent inter-urban communications services, an average profit-making rate is used as indicator; it is calculated as the ratio of the revenue from the service in question and the communications traffic. The indicator is adequate for analytical purposes provided that the subscriber structure of inter-urban communications is constant.

<sup>2</sup> Revenue per telegram (average profit-making rate), roubles per unit.

<sup>3</sup> For cities of Saransk — 7,000 roubles and Ruzayevka — 4,500 roubles.

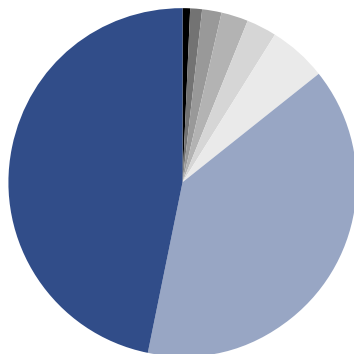
<sup>4</sup> Cost of one-minute call in cities of Saransk, Ruzayevka and Lyambir — 0.10 roubles/min., for state and commercial organisation in these towns — 0.12 roubles/min.

<sup>5</sup> Domestic users living in the district centres.

<sup>6</sup> Domestic users living in outlying areas.

Source: the Company

# Services and customers



- 46.8 Inter-urban and international telephone communications
- 38.9 Urban telephone communications
- 5.4 Rural telephone communications
- 2.8 Wire broadcasting
- 2.5 New telecommunications services
- 1.8 Faxing
- 1.1 Cordless communications
- 0.7 Radio communications, radio broadcasting, television, satellite communications

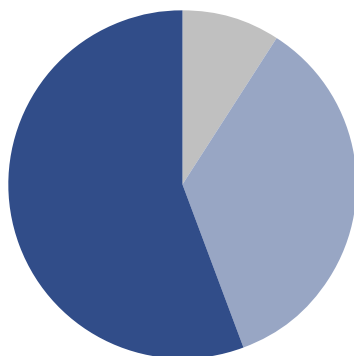
Structure of revenues from VolgaTelecom communications services in 2002 according to type of activity, %.

Source: the Company

The main fields of activity of VolgaTelecom, making up more than 90% of the revenue from communications services, are the organisation and provision of local (44.2%) and long-distance (46.8%) telephone communications for subscribers in the territory of the Volga Federal District (VFD) (with the exception of the Perm region).

Overall, the structure of the Company's revenue according to type of service and category of user is comparable to the average for these indicators across the seven inter-regional communications companies. The most profitable customer segment is commercial organisations; their weight in the subscriber structure for fixed communications, based on the number of telephones, is 9.27%, and they bring in 23.5% of the revenue from local communications. The least profitable segment is domestic users, with a weight of 85.61% in the subscriber structure and a 66.8% share of the revenue from local communications.

The areas with the highest levels of telephonisation according to relative indicators are the Mariy-El and Mordvin republics, with telephone penetration rates of 32.1 and 26.8 telephones per 100 people respectively in the urban network, and 9.5 and 12.5 per 100 respectively in the rural network. However, this lead over the remaining branches according to relative figures is due to the fact that the areas in question have the lowest densities of population in the federal district. According to absolute figures the largest line capacity (20.7% of the Company's total line capacity) is in the Nizhniy Novgorod branch.



- 55.7 Domestic
- 35.2 Commercial organisations
- 9.1 State organisations

Structure of revenues from VolgaTelecom communications services in 2002 according to category of user, %

Source: the Company



**VolgaTelecom subscriber structure (number of telephones per 100 people) on 1 January 2003**

branch	Domestic		State organisations		Commercial organisations		Telephone penetration <sup>1</sup>	
	units	%	units	%	units	%	UTN <sup>2</sup>	RTN
Kirov branch	241	82.20	19	6.48	33	11.26	25.5	9.8
Mariy-El republic branch	139	85.20	9	5.52	15	9.20	32.1	9.5
Mordvin republic branch	160	87.90	9	4.95	13	7.14	26.8	12.5
Orenburg branch	320	86.72	20	5.42	29	7.85	22.1	11.5
Penza branch	205	86.49	12	5.06	20	8.44	21.0	8.1
Samara branch	495	84.61	30	5.13	60	10.26	20.6	13.9
Saratov branch	370	85.86	22	5.10	39	9.05	19.1	10.9
Udmurt republic branch	268	85.08	15	4.76	32	10.16	24.5	10.2
Ulyanovsk branch	195	84.05	13	5.60	24	10.35	19.7	9.5
Chuvash republic branch	189	85.13	12	5.41	21	9.46	23.2	8.0
Nizhniy Novgorod branch	707	86.96	36	4.43	70	8.61	27.8	10.2
<b>VolgaTelecom</b>	<b>3,289</b>	<b>85.61</b>	<b>197</b>	<b>5.12</b>	<b>356</b>	<b>9.27</b>	<b>23.3</b>	<b>10.5</b>
<b>Average for Svyazinvest<sup>3</sup></b>	<b>n/m</b>	<b>85.15</b>	<b>n/m</b>	<b>5.75</b>	<b>n/m</b>	<b>9.11</b>	<b>23.4</b>	<b>11.17</b>

<sup>1</sup> The coefficient represents the share of equipped capacity in the installed one.

<sup>2</sup> UTN — urban telephone network; RTN — rural telephone network.

<sup>3</sup> Weighted average based on the numbers of the population living in the area served by Svyazinvest.

Source: the Company

**Distribution of line capacity and working capacity in the VolgaTelecom UTNs and RTNs on 1 January 2003**

branch	Total		UTN		RTN	
	Line capacity, lines	Coefficient of use,% <sup>1</sup>	Line capacity, lines	Coefficient of use,% <sup>1</sup>	Line capacity, lines	Coefficient of use,% <sup>1</sup>
Kirov branch	324,394	92.6	274,350	94.9	50,044	78.1
Mariy-El republic branch	178,359	91.4	153,203	94.0	25,156	81.5
Mordvin republic branch	198,833	91.4	147,142	91.2	51,691	84.3
Orenburg branch	411,304	90.2	294,742	88.6	116,562	87.2
Penza branch	276,003	87.3	226,963	93.7	49,040	86.9
Samara branch	639,691	92.5	542,843	87.3	96,848	85.6
Saratov branch	488,121	88.8	404,601	91.3	83,520	89.6
Udmurt republic branch	351,735	90.1	293,549	93.9	58,186	84.9
Ulyanovsk branch	253,190	94.1	215,070	93.0	38,120	94.5
Chuvash republic branch	239,628	94.1	195,618	95.2	44,010	90.4
Nizhniy Novgorod branch	876,616	93.8	784,538	95.0	92,078	83.7
<b>VolgaTelecom</b>	<b>4,237,874</b>	<b>91.7</b>	<b>3,532,619</b>	<b>92.8</b>	<b>705,255</b>	<b>86.1</b>
<b>Average for Svyazinvest<sup>2</sup></b>	<b>n/m</b>	<b>92.03</b>	<b>n/m</b>	<b>92.82</b>	<b>n/m</b>	<b>87.72</b>

<sup>1</sup> Coefficient of use is the percentage of working capacity in the total line capacity.

<sup>2</sup> Weighted average based on the numbers of the population living in the area served by Svyazinvest.

Source: the Company

**Services and customers**

Long-distance communications make up 46.8% of the Company's revenue from communications services. Intrazonal communications, communications between the districts that make up a region, are also a part of inter-urban communications. The digitisation of VolgaTelecom's intrazonal networks, at 41%, is on the average for the inter-regional communications companies. The installation of high-speed transmission lines using SDH equipment, broadband access lines (T-3 service) and cordless communications lines using DECT and WLL technologies are bringing about a reduction in the shortage of channels in the Company's zonal network, a decrease in the number of failures and an increase in the volume of inter-urban and international traffic.

The service is provided on the basis of an agreement with Rostelecom. Pricing per minute has been introduced so that revenue from inter-urban and international communications can be calculated. A new accounting system has been in operation since 1 August 2003 between Rostelecom and the inter-regional communications operators, which involves the calculation of both outgoing and incoming traffic, as well as the allocation by Rostelecom of revenues from long-distance communications services. To improve the accuracy and transparency of calculations, pricing per second is being introduced for accounting between operators.

Local communications are the second most important source of income for the Company, providing more than 44% of the revenue from communications services.

One of the features to be examined in considering the demand for traditional communications is the indicator for the waiting list; in the case of VolgaTelecom it is second largest among the seven inter-regional communications operators.

**Unsatisfied demand for access to the common-user telephone network in the branches of the Company on 1 January 2003, number of requests**

branch	UTN	RTN	Total
Kirov branch	48,970	4,115	53,085
Mariy-El republic branch	10,014	2,542	12,556
Mordvin republic branch	14,166	3,990	18,156
Orenburg branch	52,620	21,813	74,433
Penza branch	33,626	7,558	41,184
Samara branch	171,800	22,665	194,465
Saratov branch	80,548	11,453	92,001
Udmurt republic branch	52,107	11,898	64,005
Ulyanovsk branch	59,994	7,434	67,428
Chuvash republic branch	39,812	4,648	44,460
Nizhniy Novgorod branch	92,400	10,568	102,968
<b>VolgaTelecom</b>	<b>656,057</b>	<b>108,684</b>	<b>764,741</b>

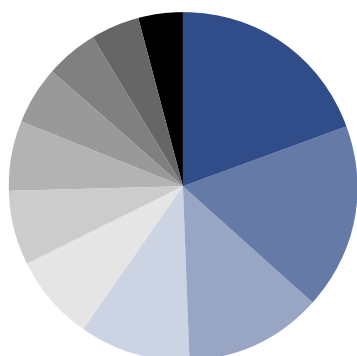
Source: the Company

### Dynamics of the revenue from communications services in the branches of VolgaTelecom

Title of branch	Growth rate of the indicator, %																	
	Long-distance		Faxing		UTN		RTN		RCBT <sup>1</sup>		WB <sup>1</sup>		WRC <sup>1</sup>		Internet		New services	
	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001	2001/2000	2002/2001
Kirov branch	28	26	33	38	37	43	22	41	59	56	30	11	10	5	67	84	100	211
Mariy-El republic branch	25	17	362	7	28	55	34	55	0	102	30	26	685	459	104	90	100	92
Mordvin republic branch	27	27	14	3	44	36	55	56	250	28	31	4	99	39	75	18	100	1,906
Orenburg branch	30	17	16	10	36	35	19	28	7	27	9	12	67	662	126	67	100	75
Penza branch	31	20	14	14	43	20	37	25	0	0	16	3	6	19	102	83	100	46
Samara branch	19	20	53	13	14	68	16	42	0	5	11	1	24	24	143	124	100	2,040
Saratov branch	39	22	5	7	49	64	31	41	0	0	45	10	26	3	136	81	100	260
Udmurt republic branch	26	18	7	5	20	42	21	29	0	0	12	20	0	1 751	0	0	100	42
Ulyanovsk branch	26	31	28	22	92	48	79	36	0	0	67	34	277	212	50	73	100	84
Chuwash republic branch	25	23	6	12	34	50	30	41	19	55	13	27	0	0	28	52	10	85,805
Nizhny Novgorod branch	24	11	6	21	27	34	17	31	0	0	9	2	14	0	137	151	100	301
<b>Total</b>	<b>27</b>	<b>19</b>	<b>22</b>	<b>2</b>	<b>33</b>	<b>46</b>	<b>26</b>	<b>36</b>	<b>13</b>	<b>34</b>	<b>21</b>	<b>12</b>	<b>51</b>	<b>89</b>	<b>92</b>	<b>88</b>	<b>100</b>	<b>53</b>

<sup>1</sup> RCBT — radio communications, radio broadcasting and television, WB — wire broadcasting, WRC — wireless radio communications.

Source: the Company



■	4.13	Mariy-El republic branch
■	4.53	Mordvin republic branch
■	4.88	Penza branch
■	5.4	Chuvash republic branch
■	6.48	Ulyanovsk branch
■	6.93	Kirov branch
■	7.95	Udmurt republic branch
■	10.3	Orenburg branch
■	12.77	Saratov branch
■	17.22	Samara branch
■	19.41	Nizhny Novgorod branch

Regional structure of VolgaTelecom revenues in 2002, %.

Source: the Company

One of the Company's main priorities is a major change in its relationships with its customers, first of all with corporate and VIP customers, but also with high-income domestic users. Special programmes are being developed for these segments, involving the most profitable and promising services, such as mobile communications, broadband Internet access, corporate data transference networks, intelligent services and cable television. The construction of an inter-regional multiservice network will allow virtual networks to be created for major corporate customers in the Volga Federal District.

One part of VolgaTelecom's strategy to improve its competitiveness and strengthen its position in the corporate segment of the telecommunications market is to conclude exclusive contracts with major enterprises on multifaceted mutually beneficial co-operation. Detailed service and a personal approach will become the main directions for the further improvement in the quality of work with the Company's corporate customers. At the present moment there is no category of 'very large organisation' among the Company's customers that could provide more than 10% of VolgaTelecom's revenues.

One of the most important directions in VolgaTelecom's work with customers is ensuring that the latter fulfil their contractual obligations towards the Company. The credit policy of VolgaTelecom includes the following methods of reducing debts owed to the Company:

1. Automated phone calls to the subscribers using an established text containing a reminder of the necessity of paying for the telecommunications services provided and the amount of the debt.
2. Temporary interruption of access to the telephone network.
3. Discussions over the phone with the debtor.
4. Discussions with a representative of the debtor with the aim of receiving the outstanding amounts due to the contract, without having recourse to the courts.
5. Signing of a repayment schedule.
6. If the debtor does not fulfil his obligations:
  - for commercial organisations: unilateral cancellation of the contract with subsequent claims through arbitration;
  - for individuals: application to the courts for cancellation of the contract and recovery of debts;
  - for state organisations: interruption of access to the communications services, with the exception of duty and emergency communications, and also recovery of the debt via arbitration.
7. With commercial organisations that regularly do not pay punctually for the communications services used: the conclusion of additional agreements on paying for telecommunications services by prepayment, and the direct debiting of the amounts owed from the user's settlement account.

VolgaTelecom's policy of co-operation with integrated operators in the areas where the Company is present is laid down in accordance with the recently adopted new edition of the federal law «On Telecommunications», and rules and decisions of the government of the RF, and is directed towards combined action in the telephonisation and development of the socio-economic sphere of the VFD. The relationships between the Company and the integrated operators who together make up the common-user telephone network must be built on establishing fair offset rates which compensate for the justified expenses and produce a standard rate of income.

# Principal competitors

The Company meets fierce competition in three key regions, the Nizhniy Novgorod, Samara and Saratov regions. As well as a large number of regional alternative operators, such major companies as Golden Telecom Inc. (including the Kombella and Komincom companies that are part of it), TransTeleCom and Global One (Global Odin) are present in the markets in these areas. It is aggressive marketing policies of these well-known companies, their development of the latest telecommunications technologies, their flexible pricing policy using an individual approach to each customer, their large number of sales personnel and their clear progressive system of staff motivation that provide the main threat to the competitiveness of VolgaTelecom.

## Major alternative communications operators in the Volga Federal District on 1 January 2003

Title of company	Territory	Range of services	Share of market <sup>1</sup>	Customer base	Company's plans
Golden Telecom (Rossiya-On-Layn, TeleRoss)	Russian Federation	Telephone communications, data transference, telematics, Internet access, organisation of VPNs.	n/av	Services are only provided to the business sector.	New «Dialogue» cards, ISDN, video conferencing.
Ekvant (Global Odin Ltd.)	Russian Federation	Local, inter-urban and international communications, data transference and telematics, provision of communications channels for rental, Internet access via a dedicated network, assistance in organising networks, esp. VPN.	Share of the market is estimated at 20–25% of all business customers. Increase in demand for data transference and Internet services is expected. The company is considering withdrawing completely from the telephone business. The number of customers for switched Internet access is continuing to grow but the service is not very profitable for the company.	Only serves the business sector, and only the largest customers. Annual increase in traffic is app. 50%.	Installation of IP VPN, organisation of cordless access, enlarging its own fibre-optic loop.

<sup>1</sup> Share of the market in the territories of licensing given in the column «Territory».

Source: the Company

In the communications market of the Nizhniy Novgorod region fixed telephone communications services are provided by 16 alternative operators connected at a local level. The largest are Agentstvo delovoy svyazi Ltd., Svyazist Ltd., NN Rossvyazinformat Ltd., TK Korona, Transsvyaz, Povolzhye Servis-Tsentr, Volgarechsvyaz, Telcom Ltd and Rossiyskiye Zhelezniye Dorogi.

Inter-urban and international communications in the Nizhniy Novgorod region are provided by Agentstvo delovoy svyazi, using its own switching channels.

In the IP-telephony segment Energoinform, Fonecom, New telecom, Stelt telecom and Volgarechsvyaz are the competitors to the Company's Nizhniy Novgorod branch.

VolgaTelecom's main competitors in the Internet access market are Agentstvo delovoy svyazi, Nizhegorodskiye informatsionnye seti, Nizhegorodteleservis, SENDI-SERVIS and Nizhegorodskiy teleservis.

In the communications market of the Samara region there are more than 120 operators providing wired telephone communications, 15 operators providing inter-urban and international telephone communications, 5 operators providing cellular communications and 20 operators providing Internet services.

In the Saratov region 116 operators are registered, with 165 licences to provide communications services. Of the total of operators, 69 have licences to provide local (urban and rural) telephone communications, 39 have licences for data transference and telematic services, 6 for radiotelephone (cellular) communications, 3 for mobile radiotelephone communications (trunking), 7 for paging services, 7 for providing communications channels for rental and 8 for cable television.

The main competitive advantages of the alternative operators lie in:

- the absence of social obligations;
- flexible tariff policies;
- possession of their own network using digital exchanges;
- marketing is better developed (individual approach to each customer); use of the CRM concept;
- better customer service, both technical and marketing (after-sales service);
- efficient sales and after-sales equipment services and business planning; this allows a quick reaction to changes in the market.

Regional alternative operators are not a serious threat to the Company since most of them are very small and have little interest in developing their operational activity (e. g. communications operators that are part of state bodies); they therefore do not claim the role of strategic competitors.

One more representative of the 'big three' cellular communications operators, Mobilnye TeleSistemy (MTS), stands by itself in the VFD cellular market. At the end of the first quarter of 2003 MTS did not have a single licence in the combined Volga licensing territory, and therefore unlike other federal operators its Volga network is being built up piecemeal. The company is beginning to move into the Volga regions.

MTS has a single system of tariff schedules for the whole of Russia, with a few exceptions (Tatarstan is one of these). However, prices for services in one and the same schedule can vary in the different regions. In addition prices for the operator's services are shown in nominal units, but the cost of a nominal unit in roubles varies in the sections of the company, and therefore the real cost of subscribers' phone calls in different regional networks can vary significantly.

By the summer of 2003 the company had not yet put its own networks into commercial operation in the VFD. As it does not have any licences for the VFD, the company is actively buying up the largest operators (from the number of subscribers) working in the GSM 900/1800 standards. At the end of June 2003 the operator's overall subscriber base in the Volga area had reached 700,000. This is about 17% of the cellular communications market in the VFD (including GSM, AMPS/DAMPS, NMT and CDMA standards). The company is in fourth place in the region for the number of subscribers.

## Major cellular operators in the Volga Federal District on 1 January 2003

Title of company	Territory of licensing	Range of services	Share of market <sup>1</sup>	Customer base	Competitive strengths	Competitive weaknesses	Description of company
SMARTS	The holding contains 16 companies, 12 of them operating in the regions of the VFD	All GSM 900/1800, GSM 1800 standard mobile communications services, incl. WAP.	App. 25% (incl. other cellular communications standards). In 4th place in RF for number of subscribers, and 1st in VFD. 1 m subscribers at end of October 2003.	Number of subscribers is increasing rapidly, mainly in the domestic sector; this limits the revenue base as services for domestic users are less profitable than for the business sector.	— Single set of tariffs for intranet roaming in use throughout territory of licensing. — Tariff schedule is in roubles. — wide choice of additional services.	— In a number of regions the area of operation is limited to the administrative centre. — The Company has a license for 900/1800 standard mobile communications services in 6 out of 12 regions of VFK — Small area of coverage	Controlled by the company's management
Vympelcom-R (Bi-Layn)	Has licences to provide services in all regions of the VFD, but networks are in operation only in the Astrakhan, Volgograd, Samara, Saratov and Ulyanovsk regions, and Bashkortostan, Tatarstan and the Chuvash republic.	GSM standard 900/1800 cellular communications. Roaming services, SMS messaging, voice mail. Has its own IP gateway to Moscow.	The operator's overall subscriber base in the VFD at the end of September 2003 (incl. BiLayn-Samara subscribers in the DAMPS network) was app. 800,000. This is app. 22% of the cellular communications market in the region (incl. GSM, AMPS/DAMPS, NMT and CDMA standards). the Company is 3rd in the region for number of subscribers.	Domestic users make up 85% of the subscriber base and the business sector accounts for the remaining 15%.	Reduced rates for intranet roaming within the BiLayn-Volga territory: Nizhniy Novgorod, Saratov, Samara, Volgograd, Astrakhan, Ulyanovsk and Penza regions, Bashkortostan, Tatarstan, and the Mordvin, Chuvash, Mariy-El and Kalmyk republics.	— Per-second pricing from the first second of the conversation. — Urban numbers are not available to the company's subscribers in all regions.	Vympelcom owns 55% of shares.
MSS-Povolzhye (Megafon)	Has licences to provide services in all regions of the VFD, but networks are in operation only in the Astrakhan, Volgograd, Samara, Saratov and Ulyanovsk regions, and Bashkortostan, Tatarstan and the Kalmyk and Mordvin republics.	GSM standard 900/1800 cellular communications. Roaming services, SMS messaging.	App. 25% (incl. other cellular communications standards). The company is in 2nd place in the VFD for number of subscribers. At the end of October 2003 there were slightly less than 1 million subscribers.	Domestic users and business sector.	— Single set of tariffs for intranet roaming in use throughout territory of licensing. — Growing area of coverage. — Reduced rates — Tariff schedule is in roubles — Wide range of services not requiring additional payment.	—	The cellular operator Megafon owns 100% of shares. The company intends to expand in the markets of Volgograd, Ulyanovsk and Rostov-on-Don.

<sup>1</sup> Share of the market in the territories of licensing given in the column «Territory».

Source: the Company

## Principal competitors

# Personnel

On 1 January 2003 the number of employees was 52,320, consisting of:

Managers:	2,724 (5.21%)
Specialists:	15,629 (29.87%)
Workers:	33,967 (64.92%)

Of the Company's total of employees, 56.4% work in its four biggest subsidiaries in Nizhniy Novgorod, Samara, Saratov and Orenburg.

## Distribution of employees in branches on 1 January 2003

Subsidiary	Number of employees			
	Total	Including		
		managers	specialists	workers
Nizhniy Novgorod branch	8,953	402	2,789	5,762
Samara branch	7,503	366	2,701	4,436
Saratov branch	6,800	347	1,835	4,618
Orenburg branch	6,248	326	1,636	4,286
Kirov branch	4,643	332	1,195	3,116
Branch in the Republic of Udmurtia	3,531	266	951	2,314
Ulyanovsk branch	3,391	154	1,068	2,169
Branch in the Chuvash Republic	3,239	159	870	2,210
Penza branch	3,069	50	998	2,021
Branch in the Republic of Mordovia	2,709	140	861	1,708
Branch in the Mariy-El Republic	2,234	182	725	1,327
<b>Total</b>	<b>52,320</b>	<b>2,724</b>	<b>15,629</b>	<b>33,967</b>

Source: the Company

The Company's personnel policy is directed towards the efficient use of the potential of the staff, improving and developing their skills and dealing with employees' social problems.

With the object of attracting top-quality specialists and preventing losses, the Company regularly increases salaries. In 2002 the average wage increased by 35.8% compared to 2001 (3,194 roubles) and reached 4,337 roubles. A special piecework rate is used in some branches to pay employees engaged in construction and repair work.

The Company pays great attention to the social protection of its staff. Conditions of work are constantly being improved and social benefits are provided for employees.

The measures undertaken make it possible to attract qualified specialists. On 1 January 2003 more than 20% of employees had a higher education and 29.73% had a specialised intermediate education. Of the Company's specialists, 75.1% have a higher education and 80.7% have a specialised intermediate education.



**Distribution of employees in the Company by level of education on 1 January 2003**

Education	Number	
	Total	% of employees
Higher	10,549	20.16
Specialised intermediate	15,554	29.73
Other	26,217	50.11

Source: the Company

Improving the employees' skills is undertaken by VolgaTelecom teaching centres in Nizhny Novgorod, Yoshkar-Ola, Kirov, Ulyanovsk, Samara, Orenburg, Saransk, Saratov and Izhevsk. In 2002 more than 15,209 people improved their skills in teaching centres and various seminars. Links with institutes of higher and intermediate education are also being developed, and agreements are being concluded for special courses at day or evening classes and by accelerated forms of training.

The age structure of the Company's employees is notable for the predominance of middle-aged people: 45.01% of employees are under 40.

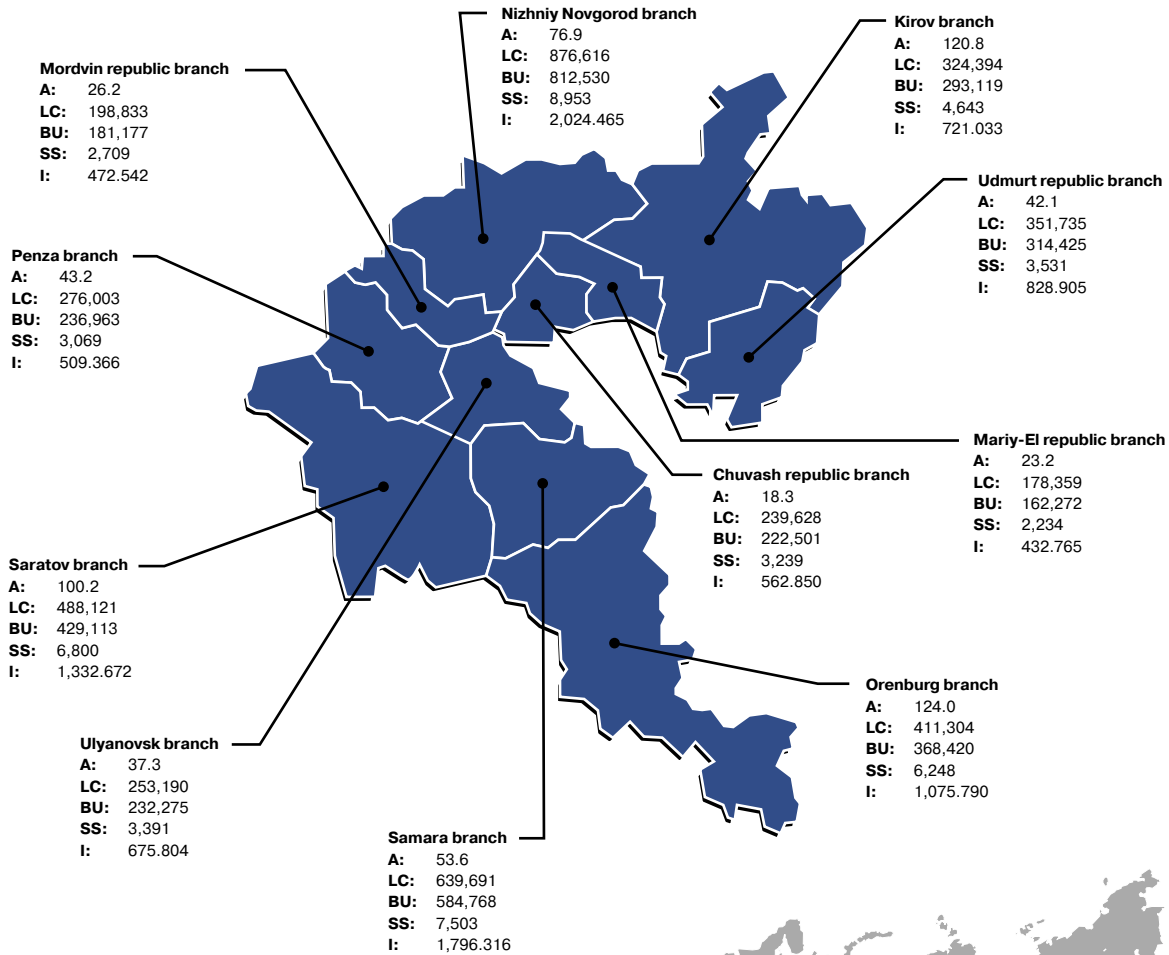
**Distribution of employees in the Company by age on 1 January 2003**

Age	Number	
	Total	% of employees
Under 40	23,547	45.01
40 to 50	19,168	36.64
50 and above	9,605	18.36

Source: the Company

# Organisation

The organisational structure of VolgaTelecom comprises the General Management and 11 branches:



**A** Area of the region served, (000) sq. km.  
**LC** Line capacity on 1 January 2003, lines  
**BU** Number of base units on 1 January 2003  
**SS** Strength of staff on 1 January 2003, persons  
**I** Income from telecommunications services in 2002, R million

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The **Nizhniy Novgorod branch** serves subscribers in the territory of the Nizhniy Novgorod region, located in the north-western part of the Volga Federal District (VFD). The region has the largest population among the members of the federation in the area served by VolgaTelecom, and a relatively high density of population. The communications networks in the Nizhniy Novgorod region are characterised by a level of digitisation that is close to the average for VolgaTelecom, and the branch is the company's largest for line capacity and volume of income from communications services.

The **Samara branch** serves subscribers in the territory of the Samara region, which is located in the southern part of the VFD, east of the Saratov region and west of the Orenburg region. The Samara region is an industrially developed area with relatively high levels of income of the population; it has a high density of population and is characterised by a telephone penetration rate that is close to the average for the members of the federation served by VolgaTelecom. The communications networks of the Samara region have a comparatively low level of digitisation, only slightly exceeding 25%. The Samara region is consistently in second place among the VolgaTelecom branches for line capacity and volume of income from communications services.

The **Saratov branch** serves subscribers in the territory of the Saratov region, which is located in the south-west of the VFD, bordering on Kazakhstan. The Saratov region has a large surface area in comparison with the majority of the other members of the VFD served by VolgaTelecom, and is characterised by a relatively low density of population. The level of digitisation of the communications networks is below the average for the company. Even so, the Saratov branch consistently occupies third place among the VolgaTelecom branches for line capacity and volume of income from communications services.

The **Orenburg branch** serves subscribers in the territory of the Orenburg region, which is located in the southern part of the VFD and shares a border with Kazakhstan. In surface area it is the largest member of the federation served by VolgaTelecom, and despite the large size of the population it is characterised by one of the lowest densities of population in the VFD. The level of digitisation of the communications networks is above the average for VolgaTelecom, and is close to 40%.

The **Udmurt republic branch** serves subscribers in the territory of the Udmurt republic, located in the central part of the VFD. The values for population density and line capacity in the Udmurt republic are close to the average values for these indicators for all the members of the federation served by VolgaTelecom. The communications networks of the Udmurt republic branch are characterised by one of the highest levels of digitisation among the VolgaTelecom branches.

The **Kirov branch** serves subscribers in the territory of the Kirov region, located in the northern part of the VFD. In surface area the Kirov region is only slightly smaller than the Orenburg region, and has the lowest density of population in the VFD. The levels of income of the population are close to the average for all the members of the federation served by VolgaTelecom. The communications networks of the Kirov region are characterised by one of the lowest levels of digitisation among the VolgaTelecom branches.

The **Penza branch** serves subscribers in the territory of the Penza region, which is located in the western part of the VFD, north of the Samara region. In surface area it is one of the smallest members of the VFD. The density of population in the Penza region is close to the average for all the members of the federation served by VolgaTelecom, but the telephone penetration rate is comparatively low. The level of digitisation is also close to the average for VolgaTelecom.

The **Ulyanovsk branch** serves subscribers in the territory of the Ulyanovsk region, which is located in the central part of the VFD. In surface area the Ulyanovsk region is one of the smallest members of the VFD, with a density of population that is close to the average for the members of the federation served by VolgaTelecom. The communications networks of the Ulyanovsk branch are served primarily by cross-bar switches, and are characterised by the lowest level of digitisation in the company.

The **Chuvash republic branch** serves subscribers in the territory of the Chuvash republic, located in the central part of the VFD. In surface area the Chuvash republic is the smallest member of the VFD, but is characterised by the highest density of population. The telephone penetration and level of digitisation of the communications networks in the republic are below the average for the members of the federation served by VolgaTelecom.

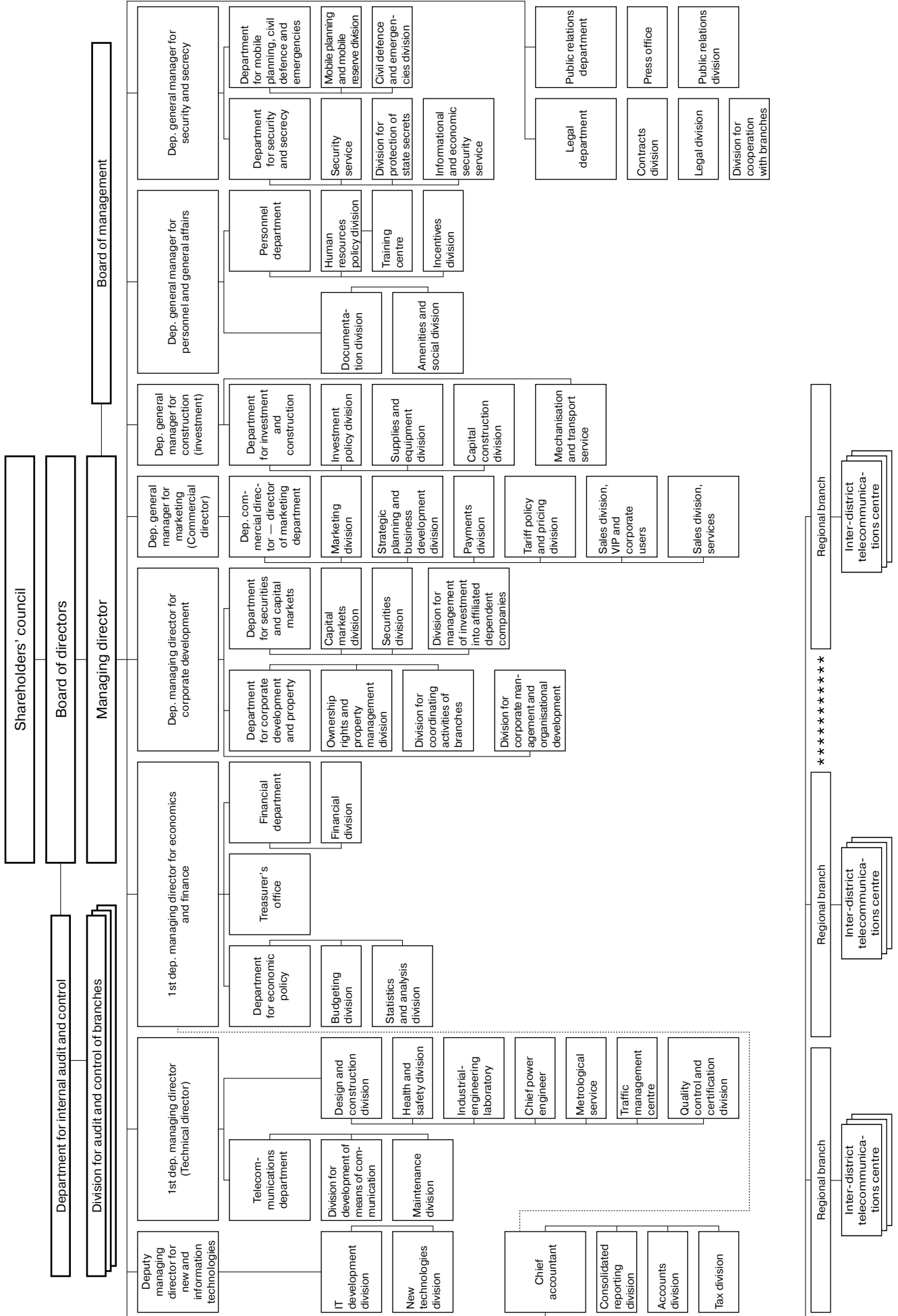
The **Mordvin republic branch** serves subscribers in the territory of the Mordvin republic, which is located in the west of the VFD, north of the Penza region and south of the Nizhniy Novgorod region. In surface area and size of population it is one of the smallest members of the VFD, with a density of population close to the average for all the members of the federation served by VolgaTelecom. The level of digitisation in the Mordvin republic is one of the highest in the VFD.

The **Mariy-El republic branch** serves subscribers in the territory of the Mariy-El republic, located in the central part of the VFD. In surface area and size of population it is one of the smallest members of the VFD, with a density of population that is slightly lower than the average for all the members of the federation served by VolgaTelecom. The level of digitisation in the Mariy-El republic is the highest in the VFD, at nearly 70%.

The management of VolgaTelecom is characterised by a high degree of centralisation. The General Management implements the overall management of the company's activity, strategic and budgetary planning, and the shaping of technical, human resources and social policies.

The branches of VolgaTelecom are formed on a territorial principle: each branch carries out the functions of telecommunications operator in the member of the federation in which it is located, and in whose territory it serves subscribers. All the specialist subdivisions of the branches are accountable to the relevant specialist subdivision of the General Management.

INTER-REGIONAL COMPANY



# Subsidiaries

As at 1 January 2004, the Company had shareholdings in 69 companies. It owned more than 50% of 18 companies, and between 25% and 50% of another 10.

## Companies of which VolgaTelecom owns more than 50%

	Holding, 1 January 2004 (%)
TelesvyazInform	100.0
Udmurtskiye sotovye seti-450 (Udmurtia Cellular Communications-450)	100.0
Nizhegorodskaya sotovaya svyaz (Nizhny Novgorod Cellular Communications)	100.0
Tsifrovye telekommunikatsii (Digital Networks)	100.0
Vyatka page	91.0
Pulse Radio Yoshkar-Ola	61.0
Sotovaya Svyaz Mordovii (Mordovia Cellular Communication)	60.0
Guard enterprise ROS	51.0
Orenburg-GSM	51.0
Izhcom	51.0
Radio-Resonanse	51.0
Vyatskaya Sotovaya Svyaz (Vyatsk Cellular Communications)	51.0
Narodny Telephone Saratov	50.0 + 1 share
Tatincom-T	50.0 + 1 share
Chery-Page	50.0
Saratov-Mobile	50.0
Ulyanovsk-GSM	50.0
Nizhegorodsky radiotelephone	50.0

## Companies of which VolgaTelecom owns between 25% and 50%

	Holding, 1 January 2004 (%)
Tsifrovye seti Udmurtii-900 (Udmurtiya Digital Networks-900)	49.0
Commercial Information Networks OMRIS	42.4
Commercial Bank C-Bank	41.7
Pulse Radio	40.0
Transsvyaz	40.0
Penza-Mobile	40.0
Nizhegorodteleservice	40.0
Telesot	32.4
Chuvashiya Mobile	30.0
Samara-Telecom	27.8

The most significant of these subsidiaries for the Company's future activities are Nizhegorodskaya sotovaya svyaz, Udmurtskiye sotovye seti-450, Ulyanovsk-GSM, Narodny Telephone Saratov and Tsifrovye seti Udmurtii-900, Tatincom-T.

These companies are VolgaTelecom's largest subsidiaries, and they provide the most promising high-technology communications services. The holding of Tsifrovye seti Udmurtii-900 is to be increased in the future.

Nizhegorodskaya sotovaya svyaz is the biggest company in the territory serviced by VolgaTelecom. The Company increased its holding to 100% in March 2003, and is planning to create a single company, Mobile Telecom, by combining Nizhegorodskaya sotovaya svyaz with other subsidiaries, such as Sotovaya Svyaz Mordovii, Vyatskaya sotovaya svyaz, Orenburg-GSM and Saratov-Mobile.

Company	Territory	Main activities	Earnings 2003 <sup>1</sup> (R 000)	Net profit, 2003 <sup>1</sup> (R 000)
Nizhegorodskaya sotovaya svyaz	Nizhny Novgorod and its region	mobile telephony GSM-900/1800	760,089	241,290
Ulyanovsk-GSM	Ulyanovsk and its region	mobile telephony GSM-900/1800	227,258	49,116
Udmurtskiye sotovye seti-450	Udmurtiya	mobile telephony NMT-450	87,641	13,956
Narodny Telephone Saratov	—	mobile telephony CDMA	161,550	43,694
Tsifrovye seti Udmurtii-900	Udmurtiya	mobile telephony GSM-900/1800	323,719	112,046
Tatincom-T	Tatarstan	mobile telephony GSM-900/1800	322,057	61,954

<sup>1</sup> For 9 months of 2003.

Source: the Company

# Telecommunications equipment

On 1 January 2003 the overall line capacity of the Company's local telephone network was 4,237,900 numbers; of these, 3,532,600 were in urban telephone networks (UTN) and 705,300 in rural telephone networks (RTN). The Company is the second largest in Svyazinvest group after CenterTelecom for the size of its line capacity. In addition to traditional types of communications, VolgaTelecom is actively developing new services which the Company is providing using digital technology: Internet, data transference, ISDN, services of an intelligent communications network, and others.

## Dynamics of line capacity and used capacity of the Company's network

	Line capacity, (000 numbers)	Used capacity, (000 numbers)	Rate of use of line capacity (%)	Proportion of electronic switches in the overall line capacity (%)
On 1 Jan. 2001	3,853.6	3,518.0	91.29	30.33
On 1 Jan. 2002	3,998.5	3,687.8	92.23	33.81
On 1 Jan. 2003	4,237.9	3,884.7	91.67	40.75

Source: the Company

The increase in the proportion of electronic switches in the overall line capacity indicates the growth in capacity brought about by the installation of modern electronic equipment. Digital switching equipment from leading manufacturers (Alcatel, NEC, Siemens and IskraTel) is being installed.

## Dynamics of the change in line capacity according to type of switch

	Line capacity (000 numbers)			Proportion of overall line capacity		
	2000	2001	2002	2000	2001	2002
Electronic switches	1,168.6	1,51.9	1,726.8	30.33%	33.81%	40.75%
Semi-electronic switches	257.0	253.5	259.2	6.67%	6.34%	6.12%
Cross-bar switches	1,919.3	1,903.4	1,860.7	49.81%	47.60%	43.91%
Step-by-step switches	507.3	488.8	390.6	13.16%	12.22%	9.22%
Manual switches	1.30	0.94	0.54	0.03%	0.02%	0.01%

Source: the Company, calculation by AVK

Each year the proportion of cross-bar and step-by-step automatic exchanges decreases as electronic exchanges are introduced. On 1 January 2003 there were 5,931 automatic exchanges in operation in the Company, including 468 electronic, 67 step-by-step and 5,262 cross-bar exchanges.

The branches that are most fully equipped with electronic exchanges are the Mariy-El republic (80% level of digitisation), Mordvin (80%) and Orenburg (68%) branches. Manual exchanges are still in operation in the Kirov branch. Line capacity is spread relatively evenly: about 58% of the overall line capacity is concentrated in the Nizhniy Novgorod, Saratov, Samara and Orenburg branches, and 56% of the line capacity of electronic exchanges is concentrated in the same branches.

Due to their low profitability, investment in the development of rural telephone communications is at a lower level than for urban networks, and this explains the delay in the digitisation of rural communications. The proportion of electronic switches in the overall line capacity is far higher in towns; however, the increase in the line capacity of electronic exchanges in rural areas from 42,000 numbers in 2000 to 71,000 in 2002 has raised the level of digitisation of rural exchanges from 6.2% to 10%



**Structure of the line capacity according to urban (UTN) or rural telephone exchange (RTN)**

	Line capacity, 000 numbers			Proportions in the overall line capacity			Proportion of line capacity of electronic exchanges		
	2000	2001	2002	2000	2001	2002	2000	2001	2002
UTN	3,177.9	3,312.4	3,532.6	82.0%	83.0%	83.0%	35.5%	39.6%	46.9%
RTN	675.7	686.1	705.3	18.0%	17.0%	17.0%	6.2%	7.1%	10.0%

Source: the Company, AVK calculations

On 1 January 2003 the overall line capacity of the exchanges capable of carrying out time-based charging was 64% of VolgaTelecom's total line capacity. The line capacity of the time-based charging system in commercial use on 1 January 2003 was 19.4%. At the present moment time-based charging has already been introduced in the Nizhniy Novgorod, Orenburg, Penza, Samara and Saratov branches, as well as in the branches in the Mordvin and Udmurt republics. Investment in the completion of the time-based charging system will allow the evening-out of the load on the telephone network and improvement in the quality of communications.

**Local carrier networks and subscriber access technologies**

The main directions in the development of the carrier network are in the use of fibre-optic communications lines (FOCL) and SDH transmission systems. Digitisation of the local network allows an increase in the throughput of the communications channels and improvements in the quality of the service provided, and gives subscribers access to modern telecommunications services. Equipment from Cisco Systems, Lucent Technologies and Nortel Networks is used for packet switching.

Broadband digital access services are being actively introduced. The xDSL broadband access is being used at the 'last mile' stage when providing IP-telephony, which will allow the network to change over in the future to a network with NGN packet switching. On 1 January 2003 the number of connection endpoints using xDSL technology in the Company stood at 583, with 279 of them (48%) were connected in the Nizhniy Novgorod branch.

Subscriber access is also provided by ISDN fixed-access technology. The ISDN line capacity of the Company at the end of 2002 was 4,604 ports, 42% being operational.

One of the most important projects is VolgaTelecom's inter-regional multi-service network. This project is being developed to create virtual networks of major corporate clients, above all state structures, who are participating in the realisation of the Federal Special-Purpose Programme 'Electronic Russia' in the Volga region; it is also intended for solving corporate problems of data transference between the Company's branches.

**The development of zonal communications and trunk routes**

The construction of a trunk network is taking place on the basis of FOCLs using loop structures; this considerably increases their throughput capability and reliability.

The length of the telephone channels in the intrazonal network on 1 January 2003 was 11,606,100 channel km., 78.3% of which were telephone channels using digital transmission systems. The largest increase in the intrazonal network occurred in the Samara branch (333 km.)

**Dynamics of the growth in the length of inter-urban telephone channels and transmission lines**

	2002	2003 <sup>1</sup>
Growth in the length of inter-urban telephone channels, total (000 ch. km.)	2,431.6	3,984.0
— using digital transmission systems (000 ch. km.)	2,578.3 <sup>2</sup>	3,451.7
Growth in the length of transmission lines (shows only construction of new Cable, Radio-Relay and Fibre-Optic CLs, total (km.)	1,918	2,156.0
- FOCL	1,885	1,881.0
- digital RRCL	33	275

<sup>1</sup> Preliminary results.

<sup>2</sup> The increase in inter-urban channels using digital transmission systems is greater than the overall increase in channels, due to the decommissioning of virtual local networks and analogue transmission systems.

Source: the Company, Svyazinvest

**Automatic Inter-Urban Telephone Exchanges (AIUTE)**

At present there are 13 AIUTES operating in the Company, mainly of S-12 and EWSD type. The level of digitisation of the AIUTES is 84.6%. On 1 January 2003 the line capacity of the AIUTES was 47,939 zonal communication channels and lines, with 38,072 operational (79%). During 2002 a total of 20,670 channels were modernised in AIUTES in five branches, including 10,890 in the Nizhniy Novgorod branch.

**Dynamics of the growth of outbound automatic channels**

	Growth of outbound automatic channels (channels)		
	2001	2002	2003 <sup>1</sup>
AIUTE, total	804	1,413	2,340
incl. via zonal communication	611	597	1,923

<sup>1</sup> Preliminary results.

Source: the Company, Svyazinvest

**Other forms of equipment**

One of the largest projects being undertaken is the construction of an intelligent data network (IDN) in the Company's Nizhniy Novgorod branch. This is the first stage of a pilot design for the construction of a federal IDN, organised by Svyazinvest with the support of the RF Ministry for telecommunications and information technology. During the trialling period, which will last three months, it is planned to approve an INAP-R protocol interface with the Siemens and Alcatel intelligent platforms in the cities of Moscow and Perm. Apart from the development of the network from the point of view of territorial growth, work is underway to create a unified network management system and a unified accounting system for the services provided. Billing equipment is used for this purpose. In particular, this equipment allows multiple-service telephone cards to be used when paying for communications services.

Mention can also be made of the equipment installed in the Kirov, Orenburg and Ulyanovsk branches for providing paging services.

Cable television networks belonging to the Company exist in the Company's branches operating in the territories of the Orenburg, Samara and Saratov regions, and in the Mariy-El and Chuvash republics. At present a broadband cable television network is being set up in the Nizhniy Novgorod branch.

Equipment of the 'Altay' type for providing mobile radio communications has been installed in the Kirov, Penza, Samara and Ulyanovsk branches. The 'Volemot' system is also in use in the Samara branch. The REX-400 e-mailing system, based on the X.400 protocol, has been installed in the Orenburg and Udmurt branches.

Equipment for a trunking network has been installed in the Kirov branch and Mariy-El republic.

# Operating performance

The reorganisation of the communications operators led to the creation of seven inter-regional communications companies (MRT), but the quantity and quality of the services offered by the companies making up the MRTs vary greatly; this is due to the uneven nature of the economic development in the regions. Therefore in each MRT there are branches that in some indicators have a performance considerably below that of the other branches of the Company.

This unevenness in the development of services by the branches of VolgaTelecom can lead to a false impression of the Company's performance indicators and dynamics of development. Consequently the remainder of this section will provide specific operational indicators for the Company's branches, which have the highest or the lowest indicators among all the Company's branches.

The data for 2000 and 2001 were calculated by adding up indicators of all of the communications operators, which were subsequently included in the merged company.

## Dynamics of the number of subscriber apparatuses in VolgaTelecom

	2000	2001	2002	1st half of 2003
No. of basic subscriber apparatuses, 000 units	3,471	3,634	3,837	3,945
incl. Urban telephone network (UTN)	2,900	3,039	3,218	3,316
Rural telephone network (RTN)	571	595	619	629
No. of domestic basic subscriber apparatuses, 000 units	2,949	3,100	3,286	3,385
incl. Urban telephone network (UTN)	2,480	2,605	2,766	2,854
Rural telephone network (RTN)	469	495	520	531
No. of cellular communications subscribers, 000 subscribers	n/a	8	22	31

Source: Svyazinvest, the Company

During the first six months of 2003 the number of basic subscriber apparatuses rose by 108,000, and comprised 3,945,000 units. Overall in 2002 the number of subscriber apparatuses rose by 5.6%, and in 2001 the increase was 163,000 or 4.7% if compared to 2000. During the period under review the proportion of telephone apparatuses served by an urban telephone network (UTN) has remained at 84%, which is typical for all the inter-regional communications companies. The rate of connecting subscribers via a UTN also exceeds the equivalent growth rate for telephone apparatuses served by a rural telephone network (RTN). For example, if during the first half of 2003 the number of basic subscriber apparatuses served by UTNs increased by 3%, the number of telephone apparatuses served by RTNs increased by 1.5%. The greater installation and maintenance costs of RTNs in comparison with UTNs dictate the higher growth rates of the latter.

The proportion of domestic telephone apparatuses has grown since 2000 from 85% to 85.8%; this was a result of the increase in the rate of satisfying requests for connection among the population, and also of the appearance of commercial communications operators in the area that the Company served, and whose services some of the Company's customers began to use.

The number of cellular communications subscribers was 22,000 according to data for 1 January 2003. The continued growth in demand for cellular communications services is the reason for the increase in the number of subscribers. In comparison with 2002 the number of subscribers using cellular communications had increased by 41% on 30 June 2003. For the first half of 2003 growth rates for residential customers were 88.5%. At the same time the share of residential customers among all of the subscribers of cellular services grew from 58.5% at the end of 2002 to 79% at the end of the first half of 2003.

#### Dynamics of the number of payphones served by VolgaTelecom

	2000	2001	2002	1st half of 2003
No. of payphones, units, incl.	24,445	20,833	20,211	19,743
Inter-urban	1,565	864	414	397
Share of the overall total of payphones	6.40%	4.15%	2.05%	2.01%
Urban and rural	17,440	12,285	11,473	10,680
Share of the overall total of payphones	71.34%	58.97%	56.77%	54.10%
All-purpose	5,440	7,684	8,324	8,666
Share of the overall total of payphones	22.25%	36.88%	41.18%	43.89%

Source: Svyazinvest

During the three and a half years from 2000, the number of payphones of all types served by the Company has dropped by 4,702,000, and on the 1 July 2003 was 19,743. The reduction in the number of payphones is due to the replacement of payphones that provide only inter-urban communications and payphones providing communications inside towns with all-purpose payphones. Since 2000 the number of inter-urban payphones has fallen by 74.6% and on 30 June 2003 was 397. According to figures for the first six months of 2003, the number of urban and rural payphones was 10,680, 6.9% less than at the start of 2003.

The Company is actively installing all-purpose payphones, which can provide communications inter-urban and international. In comparison with 2000 the proportion of all-purpose payphones in the overall total of payphones installed has doubled, and according to figures for the first six months of 2003 is 43.9%, which is the second highest figure among all the inter-regional communications companies (MRTs)

The Company's branch in Udmurt republic and the Penza branch are the leaders for the number of all-purpose payphones installed. They share 38.5% of all the all-purpose payphones installed by the Company.

#### Dynamics of inter-urban and international traffic in VolgaTelecom

	2000	2001	2002	1st half of 2002	1st half of 2003
Total, million mins., incl.	1,066.4	1,350.1	1,636.9	767.6	932.9
Inter-urban	1,015.0	1,288.7	1,569.3	735.3	896.9
International	51.5	61.4	67.6	32.2	36.0

Source: Svyazinvest

Since not all the Company's branches conduct a time-based calculation of local telephone calls, data for the Company's local traffic are not available. The Company's overall traffic has a tendency towards continual growth. In comparison with 2000, the Company's traffic increased by 26.5% in 2001, and the growth in 2002 was 21.2%. During the first six months of 2003 the

Company's overall traffic grew by 21.5% in comparison with the same period of 2002. At the same time inter-urban traffic is increasing at a faster rate than international traffic. In 2002 inter-urban traffic grew by 21.8%, while international traffic increased by 10%.

The reasons for the increase in overall traffic and for the faster growth rates for inter-urban traffic were the growth in the demand for services and the enlarging of the Company's customer base.

The greatest amount of international and inter-urban traffic is shared by two of the Company's branches, the Nizhniy Novgorod and Samara branches. Each of these branches has a 19% share of the Company's overall inter-urban traffic. The two branches share 44% of the Company's overall international traffic, the Samara branch's share being 27%. The large size of the resident populations and the high levels of business activity in these regions are the causes behind the highest indicators for international and inter-urban traffic of all the Company's branches.

#### Dynamics of the number of radio relay stations in VolgaTelecom

	2000	2001	2002	1st half of 2003
No. of basic radio relay stations, (000)	3,706.3	3,472.1	3,138.8	2,913.0
incl. multi-programme	3,263.6	3,048.7	2,787.8	2,594.2
No. of UHF-FM radio relay stations, (000)	419.9	457.7	537.1	963.6

Source: Svyazinvest

The number of basic radio relay stations is tending to drop since the whole industry is becoming uneconomic. During the first six months of 2003 the overall number of radio relay stations fell by 7.2% to 2,913,000. At the same time, the Company is trying to replace wired radio with radio relay stations operating in the UHF range. The number of radio relay stations broadcasting in UHF-FM increased during the first six months of 2003 by 79.4%, to a total of 963,600.

#### Dynamics of the development of Internet access services provided by VolgaTelecom

	2000	2001	2002	1st half of 2003
Volume of information transmitted through the Internet, Gb	n/av	n/av	80,856	64,055
Connection to the Internet via PSTN, 000 mins.	n/av	n/av	516,430	448,440
E-mail messages, Gb	31.28	48.97	n/av	n/av

Source: Svyazinvest

Every year the Company augments the volume of information transmitted by offering a wide range of services in this field and by providing a high quality of information transference. According to figures for the first six months of 2003, the volume of information transmitted reached 64,055 Gb, whereas for the whole of 2002 this indicator was 80,856 Gb. Connections to the Internet using the PSTN were 448,440,000 minutes during the first half of 2003, which is 13% less than for the whole of 2002.

The Nizhniy Novgorod, Orenburg and Samara branches were historically the first of the Company's branches to start developing data transference services. Therefore their proportion in the overall volume of information transmitted was 64%, according to data for the first half of 2003.

#### Operating performance

**Efficiency of the operational performance of VolgaTelecom**

	2000	2001	2002	1st half of 2002	1st half of 2003
Average no. of lines, (000)	3,406	3,571	3,771	3,714	3,941
Revenue /no. of lines, (R 000)	1.8	2.2	2.8	1.3	1.6
Revenue /no. of individual employees, (R 000)	110.3	147.1	203.9	93.4	124.5
Average no. of lines /no. of employees, unit	83.3	65.6	73.7	71.4	79.6

Source: Svyazinvest

The indicators for the Company's operational efficiency during the period under review have improved steadily. The commissioning of new lines, the increase in the capacity of automatic telephone exchanges and the increase in tariffs for communications services have had a positive influence on the efficiency indicators. On 30 June 2003 the indicator for average number of lines was 3,941,000, which is 6.1% better than the figure from 2002. According to figures for 2002, the average number of lines in operation was 3,714,000, or 105.6% of the total for 2001. Revenue/no. of lines in 2002 was R 2,770, which was R 570 higher than in 2001. During the first half of 2003 revenue/no. of lines grew by 19.1% to R 1,560 in comparison with the same period of 2002.

Reduction in staffing was another reason for the improvement in the efficiency indicators. During the first half of 2003 revenue/no. of employees grew by 33.3% to R 124,530, in comparison with the same period of 2002. According to the figures for 2002, revenue/no. of employees was R 203,900 or 138.6% of the figure for 2001. In addition, during the first half of 2003 the average number of lines/no. of employees rose to 79.6, which is 11.5% higher than for the first half of 2002.

The main role in the efficiency indicators is played by the tariffs for communications services, and since they do not differ greatly between the branches, there are no obvious leaders among the Company's branches. In addition, one should be cautious when comparing the Company's and similar foreign companies' efficiency indicators because of the specifics of the Company's activity. In general, the primary features of the Company are high population density, strong competition in the field for new services, relative proximity of cities and villages, and favourable geographic location (flat ground area).

It is worth noting, that reorganisation played a significant part for the Company's operational performance, which caused such changes as optimisation of the number of personnel, sale of non-specialist forms of activity, reduction of transaction costs, and other changes.

# Financial results

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This section examines the most important elements of the Company's financial results for the year ended 31 December 2002 and the first half of 2003 (the six months to 30 June). The information given here should be read in conjunction with the sections containing the Company's financial statements for 2002, including independent auditors' report by Ernst & Young.

The Company was formed in 2002 as a result of the reorganisation of eleven telecommunications operators of the Volga Federal District, when VolgaTelecom merged with ten other joint-stock companies (regional telecom operators). IAS financial statements are therefore available only for 2002. On 30 November 2002 the merging companies were removed from the official register of companies.

## **Basis of preparation**

The Company maintains its accounting records and prepares its statutory accounting reports in roubles and in accordance with the Regulations on Accounting and Reporting in the Russian Federation (RAR). The accompanying financial statements are based on those accounting records, adjusted to conform with International Accounting Standards (IAS).

The non-consolidated financial statement profit and loss statement given here for 2002 and the first half of 2003 is unaudited. The financial statements for that period were drawn up by AVK, using estimates and projections based on financial statements prepared under RAR received from the Company. The financial statements do not completely satisfy the requirements of IAS, as accounting reports can only be completely reliable if there is an uninterrupted record of day-to-day operations. Consequently, the Company's balance sheet and profit and loss statement for this period have had to be adjusted to conform with international standards (IAS). In this connection, it would be wise to exercise caution when examining and comparing the Company's financial indicators for 2002 and for the first six months of 2003. At the time of preparation of this memorandum, nonconsolidated financial statements were not available for the first six months of 2003. The audited financial statements of the Company given here are confined to the balance sheet as at 31 December 2002 and the related statements of profit and loss, cash flow and shareholders' equity for the year to 31 December 2002. They do not include a comparative balance sheet as at 31 December 2001, comparative statements of profit and loss, cash flow and shareholders' equity for the year ended 31 December 2001, or the related disclosures as required by International Accounting Standards (IAS).

Russian financial reporting standards and principles differ significantly from international standards. It is therefore impractical to compare financial statements prepared under RAR with those complying with IAS, and the RAR financial statements are not presented in this section. Major differences between RAR and IAS may be viewed in the subsection on accounting procedures and regulations, within the section on legislation and taxation in Russia.

AVK has adjusted the Company's RAR financial statements for the first six months of 2003 to conform with IAS. The following adjustments have produced significant differences in the financial results.

- Although all Svyazinvest companies comply with IAS 29, *Financial Reporting in Hyperinflationary Economies*, adjustments for inflation have not been made, as economic conditions in Russia do not currently satisfy the criteria listed in that standard.
- The valuation of fixed assets (property, plant and equipment) reported for 2002 does not reflect reliable information, as, despite the requirements of IAS 16 (*Property, Plant and Equipment*) and IAS 36 (*Impairment of Assets*), the assets were not formally valued, according to the 2002 auditors' report and the opinion of the auditors on fixed assets. When the 2002 accounts were prepared, management's estimated values were used for the fixed assets. This improved the reliability of the valuations of property, plant and equipment as at 30 June 2003.
- IAS 16 defines fixed assets as those that are used for more than one accounting period. However, under RAR Accounting Decree No. 6, fixed assets that are used in the production cycle and are valued at less than R 10,000 (implying a short useful life and rapid depreciation) are allowed to be treated as costs. Accordingly, AVK has adjusted the total value of fixed assets and depreciation to allow for items of that kind. This has affected the IAS-adjusted financial results of previous periods and the net profit figure for the first six months of 2003.
- Leases are treated differently in IAS 17, *Leases*, than in the federal finance ministry's ordinance No. 15 of 17 February 1997. The Company has therefore applied a higher amortisation rate to leases than is allowed for in IAS 17. The reported amount of inflated accrued depreciation has been adjusted accordingly. Leases and commitments under lease contracts were accounted for in the off-balance-sheet accounts in accordance with IAS 17, which affected the IAS financial results for previous periods and the net profit figure at 30 June 2003.
- The line 'Other receivables and payables' in the Company's accounts, as recorded under RAR, consist of taxes, tax refunds and other charges. As allowed by IAS 1, *Presentations of Financial Statements*, such reciprocal receivables and payables have been netted off in the IAS financial statements for the first six months of 2003. In addition, there were amounts payable that were not reflected in the RAR accounts for that period, but were included in the IAS balance sheet, with appropriate adjustments made to the expenses part of the profit and loss statement.
- The Company's provisions for bad debt are different under IAS and RAR. The provisions reported in the balance sheet and the corresponding costs in the IAS profit and loss statement for the first six months of 2003 have been adjusted for this difference.



## Selected financial data

### Balance-sheet summary

R million	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment, including advances to suppliers	17,443.2	16,076.8	17,244.0
Intangible assets, net	37.2	16.0	0.0
Investments in associates and other financial investments, net	178.1	226.9	700.9
Other	0.0	0.0	11.5
<b>Total non-current assets</b>	<b>17,658.5</b>	<b>16,319.7</b>	<b>17,956.4</b>
<b>Current assets</b>			
Inventories, net	467.6	413.2	599.5
Accounts receivable, net	744.3	697.6	1,174.4
Other current assets	1,065.9	925.3	1,000.9
Cash and cash equivalents	214.9	158.8	242.7
<b>Total current assets</b>	<b>2,492.6</b>	<b>2,194.9</b>	<b>3,017.5</b>
<b>Total assets</b>	<b>20,151.1</b>	<b>18,514.6</b>	<b>20,973.8</b>
<b>Equity and liabilities</b>			
<b>Shareholders' equity</b>			
Share capital	1,639.8	1,639.8	1,639.8
Retained earnings and other provisions, the effect of inflation on share capital, incl.:	11,455.5	10,910.6	13,277.9
Current profit	915.0	673.6	140.1
<b>Total shareholders' equity</b>	<b>13,095.3</b>	<b>12,550.4</b>	<b>14,917.7</b>
<b>Minority interest</b>	<b>342.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Non-current liabilities</b>			
Borrowings, non-current portion of obligations under finance leases	974.7	763.3	1,442.8
Deferred income taxes and equipment contributions	1,674.1	1,591.3	864.9
<b>Total non-current liabilities</b>	<b>2,648.8</b>	<b>2,354.6</b>	<b>2,307.7</b>
<b>Current liabilities</b>			
Payables and accrued liabilities, taxes payable and social security, accounts payable to Rostelecom	2,430.5	2,119.7	2,104.0
Dividends payable	58.9	56.7	344.1
Other current liabilities	0.0	625.5	217.4
Borrowings, current portion of long-term debt, current portion of obligations under finance leases	1,575.5	807.7	1,082.9
<b>Total current liabilities</b>	<b>4,064.9</b>	<b>3,609.6</b>	<b>3,748.4</b>
<b>Total equity and liabilities</b>	<b>20,151.1</b>	<b>18,514.6</b>	<b>20,973.8</b>

<sup>1</sup> Non-consolidated balance sheet.

<sup>2</sup> AVK estimates.

Source: the Company

## Financial results

**Profit and loss summary**

R million	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
<b>Revenues</b>	<b>13,202.4</b>	<b>11,512.7</b>	<b>6,356.6</b>
Operating expenses	(10,898.9)	(9,684.5)	(5,647.4)
<b>Operating income</b>	<b>2,303.5</b>	<b>1,828.2</b>	<b>709.3</b>
Interest expenses and similar items, net	(186.9)	(155.9)	(98.2)
Foreign exchange losses, monetary gains, income from sale of investments, income from associates and other expenses and income, net	151.5	74.9	(143.1)
<b>Income before taxation and minority interest</b>	<b>2,268.1</b>	<b>1,747.3</b>	<b>468.0</b>
Income-tax expenses	(1,184.3)	(1,073.6)	(328.7)
<b>Net income before minority interest</b>	<b>1,083.8</b>	<b>673.7</b>	<b>139.3</b>
Minority interest	(168.8)	0.0	0.0
Extraordinary income and expenses	0.0	0.0	0.8
<b>Net income</b>	<b>915.0</b>	<b>673.7</b>	<b>140.1</b>

<sup>1</sup> Non-consolidated P&L.

<sup>2</sup> AVK estimates.

Source: the Company

**Revenue**

The Company distinguishes the following sources of revenue:

- Long-distance services — domestic and international;
- Rent of channels;
- Installation fees;
- Wireless services;
- Rent of premises;
- Internet services;
- Radio and TV broadcasting;
- Telegraph services;
- Other telecommunication revenues;
- Other revenues.

More than 10% of the Company's revenue is derived from the following sources:

- Monthly subscription fees for local services;
- Long-distance services
- Wireless services.

**Monthly subscriptions**

The Company provides connections to the local telephone network and receives monthly subscriptions and the proceeds of connection charges and of time-based billing, all of which are recognised as revenues. The system of time-based billing provides for a monthly subscription and payment per minute for traffic above a set monthly limit. All tariffs on local services are regulated by the RF Ministry for Anti-Monopoly Policy and Support of Business.

Monthly subscriptions vary, depending on the type of connection to the network (individual or shared), and the type of subscriber (private individuals or institutions). The rates also depend on the region, and whether the connection is to an urban or a rural telephone exchange. The lowest subscriptions are for telephones connected to shared lines, the highest for telephones connected to individual lines.

#### Current rates for VolgaTelecom's local service

	Connection fee (R 000)	Subscription (R)	Rate per minute for local calls (R)
Minimum charge	5.0	110.0	0.10
Maximum charge	9.0	150.0	0.18

Source: the Company

The current tariffs were introduced on 1 July 2003. Time-based billing is used only in seven of the Company's subsidiaries.

#### Long-distance services — domestic and international

Long-distance services are charged by the minute, the tariffs being regulated by the RF Ministry for Anti-Monopoly Policy and Support of Business. The Company's subsidiaries do not all charge the same rates.

The rates for long-distance services are based on:

- the type of subscriber (residential, state organisation, corporate);
- the time of day and day of the week;
- distance.

The rate also depends on whether the connection is automatic or via the operator. All calls via the operator are charged at the basic rates, adjusted for inflation index No. 2, except where automatic connection is not available.

The current minimum rate per minute for an inter-city call is R 1.20; the highest rate is R 10.50.

Rates for international calls are fixed by Rostelecom. In this case, too, the rate per minute depends on distance, whether the connection is automatic or via the operator, the time of day and the day of the week.

#### Wireless services

The Company's subsidiaries that provide wireless services are Nizhny Novgorod Sotovaya Svyaz, Ulianovsk GSM, Orenburg GSM, Vyatka Sotovaya Svyaz, and Udmurtiya Sotoviye Seti — 450. The main standards that the operators provide are GSM 900/1800 and NMT-450. The Company distinguishes the following sources of revenue from wireless services:

- subscriptions;
- service fees;
- additional service fees (including internet access, voice mail).

## Expenses

The Company considers the following expenses significant:

- Operating expenses, which include wages and salaries, cost of materials, equipment repairs and maintenance, and advertising costs;
- Taxes other than income tax;
- Depreciation and amortisation;
- Provisions for bad debts;
- Traffic costs.

## Operating expenses

The Company's operating expenses consist of:

- Wages, salaries and other benefits;
- Materials, repairs and maintenance;
- General and administrative expenses;
- Lease expenses;
- Advertising costs;
- Audit and consultancy expenses.

Management forecasts that operating expenses will grow as the Company itself develops and grows, with the increase in the number of subscribers and the introduction of new services and technology.

Management expects spending on wages and salaries to grow as national pay rates rise, notwithstanding a small planned reduction of staffing. It expects wages and salaries to fall to a lower percentage of total revenues (see the profit and loss statement below).

Management expects advertising costs to grow, in line with the Company's plans to market its brand, penetrate new markets and provide new services.

## Taxes other than income tax

These expenses include tax items that are related to sales volumes and to assets. Management expects that, assuming unchanged tax rates, tax expenses will increase with the growth of sales and the commissioning of new construction and equipment.

## Depreciation and amortisation

Management expects these expenses to grow with the commissioning of new equipment and networks under the Company's development programme.

## Provisions for bad debts

The Company provides for doubtful and bad debts during the period that such indebtedness arises, and classifies them by type of debtor. The ages of receivables are calculated from the moment that the debts become overdue.

## Traffic costs

This item consists of payments for services provided by Rostelecom and other telecom operators. The Company expects these expenses to increase with the growth of international and inter-city traffic, as payments to Rostelecom are based on traffic volumes. Payments to other operators include roaming costs and payments for access to the Internet and for the rent of channels.

## Acquisitions, mergers, takeovers, divisional reorganisations and asset sales

Management considers the development of mobile (cellular) services its main priority and, in this connection, is consolidating its mobile assets. In March 2003, the Company completed the acquisition of 50% of Nizhny Novgorod Sotovaya Svyaz for R 20 million. As at 30 June 2003, the Company owned 100% of Nizhny Novgorod Sotovaya Svyaz.

## Financial performance

The following table presents the Company's revenues and expenditure for 2002 and the first half of 2003 as a percentage of total revenues in the period. This permits analysis of the structure of the profit and loss statement and of those items that significantly affect the Company's financial performance.

### VolgaTelecom's income and expense structure (breakdown of income and expenses as a proportion of total revenues)

%	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
<b>Revenues<sup>3</sup></b>			
Revenues from local and long-distance communications services	73.4	82.5	82.0
Revenues from other communications services	24.1	14.7	14.9
Revenues from other services	2.5	4.0	3.1
<b>Total revenues</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Expenses</b>			
Wages, salaries, other benefits and payroll taxes	(31.3)	(34.7)	(34.1)
Materials, repairs, maintenance and utilities	(10.7)	(11.9)	(7.2)
Depreciation and amortisation	(14.5)	(13.9)	(24.4)
Traffic costs	(11.3)	(11.0)	(10.1)
Taxes other than income tax	(3.1)	(3.1)	(1.8)
Other operating expenses	(11.7)	(9.5)	(11.2)
<b>Total expenses</b>	<b>(82.6)</b>	<b>(84.1)</b>	<b>(88.8)</b>
<b>Operating profit</b>	<b>17.4</b>	<b>15.9</b>	<b>11.2</b>
Interest expenses and similar items, net	(1.3)	(1.4)	(1.5)
Other expenses and income, net <sup>4</sup>	1.1	0.7	2.3
<b>Income before tax</b>	<b>17.2</b>	<b>15.2</b>	<b>7.4</b>
Income tax	(9.0)	(9.3)	(5.2)
<b>Income after tax</b>	<b>8.2</b>	<b>5.9</b>	<b>2.2</b>
Minority interest	(1.3)	0.0	0.0
Extraordinary income and expenses	0.0	0.0	0.01
<b>Net income</b>	<b>6.9</b>	<b>5.9</b>	<b>2.2</b>

<sup>1</sup> Non-consolidated.

<sup>2</sup> AVK estimates.

<sup>3</sup> 2002, R 13,202.4 million; first half of 2003, R 6,356.6 million; 2002 (unconsolidated), R 11,512.7 million.

<sup>4</sup> Foreign exchange losses, monetary gains, income from associates and other expenses and income, net.

Source: the Company

## Financial results

The majority of the Company's revenues comes from residential customers; in 2002 they contributed 53.1% of total revenues, compared with 37% from corporate customers and 9.9% from state organisations. In the first six months of 2003, the contribution from residential customers was 55.3%; the contribution from corporate customers increased by 1.7% and from state organisations decreased by 1.2%.

### Profitability indices

%	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
Operating profitability <sup>3</sup>	17.4	15.9	11.2
Core operating profitability <sup>4</sup>	21.1	18.9	12.6
Net profit profitability <sup>5</sup>	6.9	5.9	2.2
Equity capital profitability <sup>6</sup>	7.0	5.4	0.9

<sup>1</sup> Non-consolidated.

<sup>2</sup> AVK estimates.

<sup>3</sup> Ratio of operating profit to revenues.

<sup>4</sup> Ratio of operating profit to operating expenses.

<sup>5</sup> Ratio of net profit to revenues.

<sup>6</sup> Ratio of net profit to shareholders' equity.

Source: the Company

The decrease in the net operating margin was mainly because of an increase in depreciation costs and staff bonuses. The return on net profit margin fell for the same reasons.

### Liquidity and financial resources

The Company uses different sources of financing in the process of its economic activities: cash from core operations, long-term and short-term credits and borrowings, and bonded loans. During the period under review, financial resources were mainly spent on the development and introduction of new networks and equipment, and to support day-to-day operations.

In 2002 and previous periods the Company used long-term and short-term borrowings to finance the development of its networks. This financing mainly took the form of credits from banks and suppliers of equipment. Since management plans to develop the Company's networks further, and will need further credits from banks and suppliers, cash flows from investing and financing activities may continue to be negative for several more years.

Management plans to use the cash flow from operating activities to increase and support its liquidity and to replenish current assets, as the Company has a deficit of working capital (defined as current assets minus current liabilities).

### Liquidity of the Company

	2002	2002 <sup>1</sup>	1st half of 2003 <sup>1</sup>
Current liquidity coefficient <sup>3</sup>	0.6	0.6	0.8
Absolute liquidity coefficient <sup>4</sup>	0.05	0.04	0.06

<sup>1</sup> Non-consolidated.

<sup>2</sup> AVK estimates.

<sup>3</sup> Ratio of current assets to short-term liabilities.

<sup>4</sup> Ratio of cash and cash equivalents to short-term liabilities.

Source: the Company

As at 31 December 2002, the Company's current liabilities were R 1,414.7 million higher than its current assets. However, management believes that it would be able to reschedule the terms of payments on day-to-day operations in the event that the Company's current assets prove insufficient.

**Working-capital calculation**

R million	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
<b>Current assets</b>			
Inventories, net	467.6	413.2	599.5
Accounts receivable, net	744.3	697.6	1,174.4
Other current assets	1,065.9	925.3	1,000.9
Cash and cash equivalents	214.9	158.8	242.7
<b>Total current assets</b>	<b>2,492.6</b>	<b>2,194.9</b>	<b>3,017.5</b>
<b>Current liabilities</b>			
Accounts payable and accrued liabilities	2,430.5	2,119.7	2,104.0
Dividends payable	58.9	56.7	344.1
Other liabilities	0.0	625.5	217.4
Borrowings	1,575.5	807.7	1,082.9
<b>Total current liabilities</b>	<b>4,064.9</b>	<b>3,609.6</b>	<b>3,748.4</b>
<b>Total working capital/(deficit)</b>	<b>1,572.3</b>	<b>1,414.7</b>	<b>730.9</b>

<sup>1</sup> Non-consolidated.

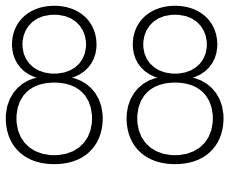
<sup>2</sup> AVK estimates.

Source: the Company

The substantial size of this deficit is due mainly to the high level of short-term borrowings, accounts payable and accrued liabilities. At 31 December 2002, accounts payable were approximately 3 times as much as accounts receivable, which amounted to R 697.6 million. More detailed information on payables is given in «Accounts receivable and payable», below. During the first half of 2003, the net deficit in working capital, according to AVK estimates, was reduced by R 638.8 million, due to increase of 45% in resources and 68% in receivables as well as reduction of 65% in other liabilities.

**Investments**

The Company's investments are broadly focused on the development of the local telephone network, which usually absorbs around 66.6% of the Company's total investments; in 2002 45% of its total investments were funded from the Company's own resources. Management plans to direct a significant part of the Company's funds to the development of the local telephone network and of long-distance communications. For 2003, it plans to direct up to 10% of total investment to the modernisation of long-distance communications equipment, and to reduce borrowed funds from around 55% to 46% of total development spending.



### Sources and applications of investment finance

R million	2002 actual	2003 estimates
<b>Sources of funds</b>		
Internally generated funds	1,561.9	2,432.7
Borrowings	1,907.0	2,042.9
<b>Total investment volume</b>	<b>3,468.8</b>	<b>4,475.6</b>
<b>Applications of investments</b>		
Local telephone network	2,288.7	3,056.3
Long-distance telephone network	550.8	444.0
New services	398.1	398.4
Other	231.2	576.9

Source: the Company

Interest rates on credits received for investment in equipment, and the associated currency risks, are described in the following section.

### Accounts receivable and payable

At the end of the first half of 2003, accounts receivable for network services were R 1,174.4 million, 68.3% higher than in 2002. According to AVK estimates, This growth was due to a decline in total fees received from government customers and an increase in sales. 35% of the Company's payables are residential customers, 35% are government tariff reimbursements, 30% are corporate customers.

### Turnover of the Company

	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
Resources turnover <sup>3</sup> , days	15.4	15.4	38.2
Receivables turnover <sup>4</sup> , days	20.3	21.8	66.5
Payables turnover <sup>5</sup> , days	80.3	78.8	134.1

<sup>1</sup> Non-consolidated.

<sup>2</sup> AVK estimates.

<sup>3</sup> 360 days divided by ratio of expenses for the period to inventory resources at the end of the period.

<sup>4</sup> 360 days divided by ratio of revenue for the period to receivables at the end of the period.

<sup>5</sup> 360 days divided by ratio of expenses for the period to payables at the end of the period.

Source: the Company

According to AVK estimates, the quicker growth of payables and receivables in relation to revenue and operational expenses has brought about significant increase of turnover, which may further result in more intensive use of credit resources for supporting current operation.

The Company's current liabilities consist mainly of debt on lease payments and bank credits obtained to finance current assets. The credits are mostly secured by telecommunication equipment. Interest rates on the Company's rouble credits vary from 12% to 25%. During the first half of 2003, short-term borrowings increased by 34.1% and amounted to R 1,082.9 million.



**The structure of VolgaTelecom's borrowings**

R million	2002	2002 <sup>1</sup>	1st half of 2003 <sup>2</sup>
Long-term credits and loans, long-term finance lease liability	974.7	763.3	1,442.8
Short-term credits and loans, short-term part of the long-term credits and loans, short-term part of the long-term finance lease liability	1,575.5	807.7	1,082.9
Payables and accrued liability, tax and social maintenance debts, debts to Rostelecom	2,430.5	2,119.7	2,104.0

<sup>1</sup> Non-consolidated.

<sup>2</sup> AVK estimates.

Source: the Company

The Company's non-current liabilities consist of long-term bank credits, bonded loans, credits on equipment supply and long-term obligations under leases. Interest rates on its long-term dollar and euro credits vary from 6.5% to 9%, and on rouble credits from 19% to 21%. These credits are mostly secured by telecommunication equipment. As at 30 June 2003, the Company's long-term borrowings were 89% higher than at the beginning of 2003, thanks to a bonded loan, issued on 21 February 2003 for a total of R 1 billion.

The Company is subject to currency credit risk, as the Russian economy is characterised by high inflation and an unstable currency. Possible depreciation of the rouble could result in the Company incurring losses, by putting up the costs of imports and of foreign-currency denominated debts, and may significantly affect the Company's financial performance.

The Company's accounts payable consist mainly of liabilities related to operating activities, advances, debts on capital construction and arrears of wages. As at 30 June 2003, accounts payable were 0.7% lower than at the end of 2002, mainly because of a decrease in debts to suppliers and contractors.

**Property, plant and equipment**

Property, plant and equipment (fixed assets) consist of telecommunication equipment constructed with the Company's own funds, equipment obtained under finance leases, construction in progress and equipment waiting to be installed. The Company's accounting records relating to fixed assets are not designed to support their presentation in accordance with IAS 16 (*Property, Plant and Equipment*), IAS 29 (*Financial Reporting in Hyperinflationary Economies*) and IAS 36 (*Impairment of Assets*). As a result, the presentation of fixed assets in the consolidated financial statements for 2002 is based partly on management's estimates, and the corresponding figures for the first half of 2003 are based on AVK's estimates, using data provided by the Company.

According to AVK's forecasts and calculations, the balance-sheet valuation of the Company's fixed assets as at 30 June 2003 was 107.2% of the figure for the end of 2002. This decline in value was due to retirement of assets and accumulated depreciation.

**Management incentive schemes**

The Company has developed an incentive programme for the managing director, which provides for bonuses to be paid when certain financial and productivity levels are attained. The Company also pays bonuses to members of the board of directors. At the time of preparing this memorandum, there was no options-based incentive scheme for the management of the Company, nor had any final decision been made on such a programme.

**Financial results**



# Share capital and corporate management

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# Capital structure

## The share capital of VolgaTelecom on 1 January 2004

	Number of shares issued	Nominal value per share (R)	Total nominal value (R)	%
Ordinary shares	245,969,590	5.00	1,229,847,950	75.00
Type A preference shares	81,983,404	5.00	409,917,020	25.00
<b>Total</b>	<b>327,952,994</b>	—	<b>1,639,764,970</b>	<b>100.00</b>

Source: the Company

VolgaTelecom's charter allows the Company to place an additional 1,299,093 ordinary shares and 531,496 type A preference shares at their par value of R 5.

The first issue of VolgaTelecom's securities was registered on 28 December 1993, when the state telecoms enterprise Rossvyazinform was transformed into a joint-stock company, and consisted of 567,830 ordinary shares, 194,462 type A preference shares and 15,558 type B preference shares, all with a nominal value of R 0.5 (denominated). The total value of the issue was R 388,925. A second issue of type A preference shares was prompted by the revaluation of the fixed assets and of the nominal value of the shares from R 500 to R 5.

Further issues were registered on the 25 October 2002, during the reorganisation of 11 telecommunication operators of the Volga Federal District, when VolgaTelecom was merged with the joint-stock companies Kirovelectrosvyaz, Martelcom, Svyazinform of Mordovia, Electrosvyaz of Orenburg region, Svyazinform of Penza region, Svyazinform of Samara region, Saratovelectrosvyaz, Ulyanovskelectrosvyaz, Udmurt Telecom and Svyazinform of the Republic of Chuvashia. A total of 158,467,107 ordinary shares and 52,823,104 type A preference shares, at a nominal value of R 5, were issued for exchange with the shares of the other merging companies.

In November 2003 the Company combined all issues of its shares. Registration numbers of the ordinary shares issues from 3 to 12 were annulled, and the shares have been assigned the new registration number 1-01-00137-A. Registration numbers of the preference shares issues from 3 to 12 were annulled, and the shares have been assigned the new registration number 2-01-00137-A.

On 1 January 2004, Svyazinvest was the largest shareholder of the Company, with 38.004% of the share capital.

## Major shareholders of VolgaTelecom on 1 January 2004

Name	Status	Number of shares		%
		Ordinary	Type A preference	
Svyazinvest	Holder	124,633,745	0	38.004
ING Bank (Eurasia)	Nominee	44,034,981	8,489,778	16.02
Depository Clearing Company (Depozitarno-klirirovaya kompaniya)	Nominee	13,913,380	13,886,962	8.48
Brunswick UBS Warburg Nominees	Nominee	10,755,305	9,144,366	6.07

Source: the Company

**The structure of VolgaTelecom's share capital on 1 January 2004**

	%
Russian organisations (owners and nominees)	79.057
Foreign organisations <sup>1</sup>	8.636
Individual holders of more than 0.1% of the shares	0.476
Individual holders of less than 0.1% of the shares	11.832

<sup>1</sup> Includes only those foreign organizations, which are referred to as «holders» in the Company's register for shareholders; a significant share of foreign organizations is included into the Company's register for nominees, which will be disclosed at the general shareholders' meeting.

Source: the Company

Since 18 February 2002, the Company's share register has been maintained by the telecoms registrar (Registrar-Svyaz), holder of federal open-ended licence 10-000-1-00258, dated 1 October 2002. The registrar's address is P O Box 45, 15A Kalanchevskaya Street, Moscow 107078. Telephone and fax: (095) 933-42-21. E-mail: regsw@asvt.ru.

# Shareholders' rights

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## General rights

The shareholders' rights are defined in the Company's charter and the relevant law. All shareholders listed in the register on the date that the register is closed are entitled to attend all shareholders' meetings. Even at times when owners of the type A preference shares are not entitled to vote, both they and the ordinary shareholders have the following rights:

- in the event of the Company's liquidation, to receive a share of its assets in proportion to their shareholding;
- to dispose of their shares without the consent of other shareholders or of the Company;
- to gain access to certain Company documents, as indicated in the Federal law «On joint-stock companies»;
- in certain cases, as specified by the Federal law «On joint-stock companies», to defend their civil rights in court, and to claim damages from the Company.

On occasions when the owners type A preference shares are entitled to vote, they and the ordinary shareholders have the right to demand redemption of any part of their shareholding in the event of:

- the Company reorganising or concluding a major transaction, if the shareholder voted against such an event or did not vote on it;
- the amendment of the Company's charter to limit the shareholder's rights, if the shareholder voted against such an event or did not vote on it.

In addition, if (individually or with other shareholders) they hold at least 2% of the voting shares, they are entitled to have items added to the agenda of the annual general meeting and to propose candidates for managerial positions and directorships, for election by the meeting.

If (individually or with other shareholders) they hold at least 10% of the voting shares, they can require the board of directors to call an extraordinary general meeting and to audit the Company's financial and commercial activities.

If (individually or together with other shareholders) they hold at least 25% of the voting shares, they can demand access to and copies of the Company's accounts and the minutes of the board of management's meetings.

Every shareholder is obliged to inform the register keeper of any change in his or her data, and not to divulge confidential information about the Company's activities.

## The rights of ordinary shareholders

All ordinary shares carry the same rights. In addition to those listed under «General rights» above, each ordinary shareholder has the right:

- take part and vote in annual general meetings;
- to receive dividends;
- if (individually or with other shareholders) they hold at least 1% of the ordinary shares in issue, to sue any member of the board of directors, the managing director and/or the management, or a managing organisation or a manager acting as the managing director, for reimbursement of losses inflicted on the Company as a result of their actions or omissions.

Ordinary shareholders also have other rights under Russian federal law and the Company's charter.

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### **The rights of preference shareholders**

All type A preference shares carry the same rights. In addition to those mentioned in «General rights» above, each type A preference shareholder has the right:

- to receive an annual fixed dividend, except as provided by the charter and the relevant law;
- to take part in annual general meetings and vote on questions concerning the Company's reorganisation or liquidation and on proposals to amend the Company's charter where this would limit the shareholder's rights;
- to take part in shareholders' meetings, and to vote on the agenda when the annual general meeting, for whatever reason, has not decided to pay a dividend or has decided to pay out only part of the preference dividend. This right applies from the next meeting after the annual shareholders' meeting where the decision to pay out the dividends was not made, and the right is terminated from the moment of the first full pay-out.

Type A preference shareholders also have other rights under Russian federal law and the Company's charter.

### **Shareholders' preferential rights**

The Company's charter gives shareholders the preferential right to buy extra shares and convertibles placed by open subscription, in proportion to the size of their existing shareholdings. In addition, the federal law «On joint-stock companies» gives shareholders the preferential right to buy extra shares and/or convertibles placed by closed subscription, in proportion to the shareholding of that type that they already own; this right being available when the shareholder voted against or did not vote on this placement of shares and/or convertibles by closed subscription.

If an ordinary shareholder (individually or with other shareholders) intends to buy at least 30% of a placing of ordinary shares, they are obliged to give the Company between 30 and 90 days' notice in writing. Within 30 days after completing this transaction, the purchaser is obliged to offer to buy from other shareholders their ordinary shares and convertibles at the market price, or at the weighted average price during the six months to the date of their acquisition of the placing, whichever is the higher.

# Dividend policy

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The charter gives the Company the right to decide to pay out dividends once a year. The board of directors recommends the size of the annual dividends on the ordinary and type A preference shares. This is ratified by the annual general meeting, which also decides, by a majority of votes, on the size of the dividends, their pay-out dates and the form in which they are to be paid.

Dividends are paid to shareholders listed in the share register on the date of drawing up the list of those entitled to participate in the annual general meeting.

The Federal law «On joint-stock companies» and the Company's charter provide that the dividends are paid out of net profit, as stated in the annual profit and loss statement under Russian accounting standards. Dividends on type A preference shares may alternatively be paid out of special funds of the Company set aside for this purpose. In the event of the Company undergoing a reorganisation in the form of a merger, the net profit is defined as the aggregate of the net profit (or loss) of the Company and of the companies with which it is merging, as reported under Russian accounting standards in their profit and loss statements as at the date of the reorganisation.

When deciding to pay out dividends, the Company must take into account the limits set by federal law.

## **Dividends on ordinary shares**

Dividends on ordinary shares are paid out at a time determined by the annual general meeting. If that meeting fails to fix a date, the dividends must be paid out not more than 60 days after the day when it was decided to pay out the annual dividend.

## **Dividends on preference shares**

The Company's charter states that the total dividend per type A preference share shall equal 10% of the Company's net profit in the previous financial year, divided by the number of preference shares in issue. The proportion of the Company's net profit paid out to the preference shareholders is lower if the preference/total shares ratio is less than 25%. If the sum so calculated is less than the dividend per ordinary share in that year, the preference dividend must be increased to match that on the ordinary shares.

Under the Company's charter, dividends on preference shares are to be paid on a date determined by the annual general meeting. Should that meeting fail to fix a date, the preference dividend must be paid out not more than 60 days from the day when the decision was taken to pay the dividend.

## **Dividend payments**

The Company pays dividends at the same times each year. In the following table, the dividend data for VolgaTelecom and for the companies with which it was merged are shown separately for 2000 and 2001, and combined for 2002.



**Dividend dynamics, 2000–2002**

	Dividends on ordinary shares (R)		Dividends on type A preference shares (R)		Total dividend payout (R)	
	Per share	Total	Per share	Total	Excluding the merged companies	Including the merged companies
2000	0.27	23,627,214	1.04	30,336,072	53,963,286	128,293,300
2001	0.32	28,002,624	0.96	28,002,528	56,005,152	132,969,200
2002	0.7066	173,802,112	1.7954	147,193,003	320,995,115	320,995,115

Source: the Company

In the year 2000 20.69% of the net profit of VolgaTelecom and other companies was paid out to the shareholders (payout ratio by VolgaTelecom in this year was 17.85%). In the year 2001 the payout ratios were 20.1% and 19.95% respectively and after the merger in the year 2002 the payout ratio of VolgaTelecom was 21.81%. 7.8%, 9.98% and 11.81% of the net profit of VolgaTelecom was paid out to the ordinary shareholders in 2000–2002. After the merger the payout ratio on ordinary shares was raised as the result of higher efficiency of the Company.

## ADR Program

Name of Issuer	Open Joint-Stock Company Nizhegorodsvyazinform <sup>1</sup>
Date Registration Statement on Form F-6 («Form F-6») Filed with U. S. Securities and Exchange Commission («SEC»)	September 17, 1997
Date Form F-6 Most Recently Amended with SEC	April 19, 2002
Number of American Depositary Shares («ADSs») Registered	30,000,000
Ratio of ADSs to Shares of Issuer	Each ADS represents 2 ordinary shares
Name of Depositary Bank	J.P. Morgan Chase Bank <sup>2</sup>
Name of Custodian	Closed Joint-Stock Company ING Bank (Eurasia) (Moscow office)
Name of Russian Share Registrar	Closed Joint-Stock Company Registrar-Svyaz

<sup>1</sup> As predecessor to Open Joint-Stock Company VolgaTelecom, which was organized on June 28, 2002.

<sup>2</sup> As successor to the Bank of New York.

Source: the Company

The Depositary Bank has issued the ADSs of Open Joint-Stock Company VolgaTelecom. Each ADS of the Company represents an ownership interest in the number of shares which the Company has deposited with the custodian under the applicable deposit agreement among the Company, the Depositary and the holders of ADRs. Each ADS also represents any securities, cash or other property deposited with the Applicable Depositary but which it has not distributed directly to the ADR Holders. The ADSs of the Company are evidenced by what are known as American depositary receipts, or ADRs, in the same way a share is evidenced by a share certificate.

Because the Applicable Depositary's nominee is the registered owner of the applicable shares underlying the ADSs of the Company, each ADR Holder must rely on the Depositary to exercise the rights of a shareholder on its behalf. The obligations of the Depositary are set out in the Deposit Agreement. The Deposit Agreement and the ADSs of the Company are governed by New York law.

The following is a summary of the material terms of the Deposit Agreement relating to the ADSs of the Company. Because it is a summary, it does not contain all the information that may be important to an ADR Holder. For more complete information, readers of this summary should read the Deposit Agreement and the applicable form of ADR, which contains the terms of ADR Holder's ADSs. A copy of the Deposit Agreement was filed as an exhibit to the relevant Registration Statement on Form F-6.

**Share Dividends.** The Depositary has agreed to pay to the applicable ADR Holders the cash dividends or other distributions it or the Custodian receives on shares or other deposited securities, after deducting its fees and expenses. An ADR Holder will receive these distributions in proportion to the number of underlying shares that its ADSs represent. ADR Holders must hold the ADRs on the date established by the Depositary in order to be eligible for dividends and other distributions. In general, the Depositary will set a record date for the ADRs that is the same record date used by the Company for dividends and other distributions on the shares. It is possible that the record dates that the Company uses for dividends and other distributions on the shares and the record date used by the Depositary for the ADRs may not be the same.

**Deposit of Underlying Shares.** The Depositary will issue ADSs if an ADR Holder or its broker deposits a share extract evidencing such ADR Holder's ownership of shares with the Custodian. Shares deposited with the Custodian must be accompanied by documents, including instruments showing that those shares have been properly transferred or endorsed to the person on whose behalf the deposit is being made.

The Custodian holds all deposited shares for the account of the Depositary. ADR Holders thus have no direct ownership interest in the shares and only have the rights as are set out in the Deposit Agreement. The Custodian also holds any additional securities, property and cash received on or in substitution for the deposited shares.

Upon each deposit of shares, receipt of related delivery documentation and compliance with the other provisions of the Deposit Agreement, including the payment of the fees and expenses of the Depositary and of any taxes or charges, the Depositary will issue an ADR or ADRs in the name of the person entitled thereto evidencing the number of ADSs to which that person is entitled.

**Withdrawal.** When an ADR Holder turns in its ADS at the Depositary's office, upon payment of applicable fees, expenses and taxes, a share extract evidencing such ADR Holder's ownership of the underlying shares will be delivered to it at the Custodian's office.

**Transmission of Notices to Shareholders.** The Company promptly transmits to the Depositary those communications that it makes generally available to its shareholders. If those communications were not originally in English, the Company translates them. Upon the request of the Company, the Depositary arranges for the timely mailing of copies of such communications to all ADR holders and makes a copy of such communications available for inspection at the Depositary's Corporate Trust Office.

**Voting Rights.** ADR Holder does not have the right to attend the Company's shareholder meetings; rather, it may instruct the Depositary to vote the shares underlying its ADRs. An ADR Holder could exercise its right to vote directly if it withdraws the ordinary shares. However, an ADR Holder may not know about the meeting sufficiently in advance to withdraw ordinary shares.

**Fees and Expenses.** Persons depositing shares will be charged a fee for each issuance of ADSs, including issuances resulting from distributions of shares, rights and other property, and for each surrender of ADSs in exchange for deposited securities. The Depositary may also charge a per-ADS fee for any cash distribution to ADR holders, a per-ADR fee for ADR transfers, and an annual per-ADS fee to cover Depositary's expenses to inspect the records of the Russian share registrar. ADR Holders or persons depositing shares also may be charged for certain other expenses specified in the Deposit Agreement.

**Payment of Taxes.** Each ADR Holder will be responsible for any taxes or other governmental charges payable on its ADRs or on the deposited securities underlying such ADRs. The Depositary may refuse to transfer ADRs or to allow an ADR Holder to withdraw the deposited securities underlying such ADRs until such payment is made, or it may deduct the amounts of taxes owed from any payments to such ADR Holder. It may also sell deposited securities by public or private sale, to pay any taxes owed.

**Arbitration.** Courts in the Russian Federation will not recognize or enforce judgments of the federal courts of the United States of America or the courts of the State of New York. Any dispute, controversy or cause of action brought against the Company under the Deposit Agreement will be settled by arbitration. The arbitrators will have no authority to award punitive or other than actual damages and only may make findings according to the Deposit Agreement. If the dispute, controversy or cause of action arising out of the Deposit Agreement is not subject to arbitration, it will be litigated in the federal or state courts in the Borough of Manhattan.

# Governing bodies

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Under the Company's charter, its governing bodies are the shareholders' meetings, the board of management, the managing director and the company secretary.

## Shareholders' meetings

A shareholders' meeting is the highest governing body. The annual general meeting must be held not less than four months and not more than six months after the end of the financial year. Its agenda must include the following questions.

- The election of members of the board of directors and the audit committee;
- approval of the appointment of the auditors;
- approval of the annual report and financial statements, the allocation of profits and the distribution of the dividend.

Any shareholder or group of shareholders with at least 2% of the voting shares is entitled to table questions at the annual general meeting and to propose candidates for the board of directors and audit committee. Such proposals must be sent to the Company not more than 60 days after the end of the financial year.

Questions within the competence of shareholders' meetings are described in the federal law «On joint-stock companies» and the Company's charter. Certain matters are required to be put to the shareholders' meeting, and require the approval of at least three quarters of the votes cast by qualified shareholders. They include the following:

- any change in the Company's charter;
- the reorganisation or liquidation of the Company;
- approval of the amount, nominal price and type of new issues of shares;
- any increase in the share capital by the placing of extra shares, except in certain cases when the board can make the decision on their own;
- the approval of major transactions, and the placing of convertible bonds and other securities, except in certain cases when the board can make the decision on their own.

A shareholders' meeting may decide on the following questions by a simple majority of votes cast:

- the election of members of the board of directors and the audit committee, and the withdrawal of their authority;
- alterations in the share capital, except in certain cases when the board can make the decision on their own;
- splitting and consolidation of shares;
- participation in holding companies, financial and industrial groups, associations and joint ventures;
- the approval of the annual report and the distribution of profits for the financial year;
- the approval of internal documents regulating the activities of the Company's governing bodies';
- the approval of transactions in which members of the board or of management have a financial interest (see «Decisions that affect the Company's financial position»);
- the release of a person, who (individually or with others) has bought at least 30% of a placing of ordinary shares, from the obligation to offer to buy shares from other shareholders;
- the transfer of authority from the managing director to a managing organisation or a manager;
- other matters laid down in the Company's charter.

Voting at shareholders' meetings is on the principle of one vote per ordinary share and, in certain cases, per preference share. When electing the board of directors, each share carries as many votes as there are places on the board, and can be distributed between the candidates at the shareholder's discretion.

An extraordinary general meeting may be called by the board, the audit committee, the auditors or a holder or holders of at least 10% of the voting shares.

A shareholders' meeting is considered to have a quorum if it is attended by shareholders with more than half the voting shares in issue. If there is no quorum at the annual shareholders' meeting, a new shareholders' meeting must be held with the same agenda. This new meeting has authority if it is attended by holders of at least 30% of the voting shares in issue.

### **The board of management**

The board of management is a collective body that organises the execution of decisions taken by shareholders' meetings and the board of directors. The composition of the board of management, the number of its members and the withdrawal of their authority are proposed by the managing director and other members of the board of directors, and decided upon by the board of directors as a whole. The entitlements, obligations and responsibilities of the board of management are defined by the contracts that its members sign with the Company. The annual general meeting approves the procedures which determine how the board of management's meetings are called and held, how it takes its decisions, and the amount and method of the remuneration paid to its members.

The board of management is responsible for the general operations of the Company, including the following.

- Deciding on the main direction of the Company's activities, including setting the annual budget, drafting medium and long-term budgets, formulating strategies and development programmes for the Company, its divisions and branches, and analysing their performance;
- preparing materials for shareholders' meetings, proposing the subjects to be discussed and decisions to be made by the directors and the shareholders' meetings, and presenting those materials to the subcommittees of the board of directors;
- providing technical and administrative support for the Company's governing bodies;
- defining the Company's policies on technical, financial and economic, tariff, staff, social and security matters, as well as the methods of planning for, budgeting and controlling the Company's activities;
- defining the Company's accounting policy, and controlling the introduction of international accounting standards;
- deciding on the allocation of capital investment and capital equipment to the Company's branches;
- defining the quantity and composition of branch management, appointing its members, terminating their authority when necessary and approving their management procedures;
- preliminary selection of candidates for leading posts in branches and divisions, approval of their contracts and when necessary undertaking their dismissal.

The management also has the right to decide on other aspects of the Company's day-to-day operations, on the instructions of the board of directors or in response to proposals by the managing director.

### **The managing director**

In the charter, the managing director is termed a 'sole executive body' and is appointed by the board of directors. The managing director manages the day-to-day operations of the Company, and makes decisions on matters that, under the charter, are not the responsibility of shareholders' meetings, the board of directors or the board of management. The managing director also functions as the chairman of the Company's board of management. He or she represents the Company's interests, concludes transactions on its behalf, approves the appointment of staff, and issues instructions to be followed by all employees.

The entitlements, obligations, remuneration and responsibilities of the managing director are defined by his or her contract with the Company. The board of directors can withdraw the authority of the managing director at any time.

In the following cases, the board of directors must be given advance notification of the intention to undertake such a transaction:

- the value of the transaction exceeds by at least 15% the market prices of similar goods or services in the area where the Company operates, if the Company the Company is the purchaser in this transaction;
- the value of the transaction is less, by at least 15%, than the market prices of similar goods or services in the area where the Company operates, if the Company is the vendor in this transactions;
- the value of the transaction is less, by at least 15%, than the average quarterly sale price (or tariff) of the similar goods or services produced by the Company;
- the transaction is a consultancy agreement whose value exceeds by at least 1% the Company's revenues from the sale of goods and services in the previous quarter;
- the Company becomes a lender under a credit or loan contract, the effect of which is to increase the value of all the Company's credit contracts by more than 2% of the Company's revenues from the sale of goods or services for the previous quarter;
- the transaction is an issue of warrants (guarantees) on third parties' commitments, with the result that the total of warrants (guarantees) issued by the Company exceeds 2% of the Company's revenues from the sale of goods and services for the previous quarter;
- decisions are made on transactions relating to the disposal of property or the mortgaging of property (other property charges) with regard to the restrictions imposed by the Company.

## **The company secretary**

The charter authorises the board of directors to appoint a company secretary, with the task of ensuring that the Company's governing bodies and officials observe the procedures required to protect the rights and interests of shareholders.

The entitlements, obligations, term of office, remuneration and duties of the company secretary are defined by internal documents and by his or her contract with the Company. To ensure the effective performance of those duties, a department may be created to assist the company secretary; its composition, regular staffing, structure and responsibilities are defined by internal documents and approved by the board.

As at 1 January 2004 the secretary of the board of Directors acts as a company secretary. The Corporate Conduct Code will be adopted in the near future.

# Decisions that affect the Company's financial position

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## **Increasing and reducing the share capital**

The Company may increase its share capital in two ways:

- by placing extra shares up to the authorised maximum;
- by increasing the nominal value of the shares.

A decision to increase the share capital by increasing the nominal value of the shares is made by a majority of votes cast at a shareholders' meeting. A decision to increase the share capital by placing extra shares by closed subscription, or by open subscription if the number of extra shares being placed is more than 25% of the ordinary shares already in issue, requires at least three quarters of votes cast at a shareholders' meeting. In other cases, an increase in the share capital by placing authorised shares can be sanctioned by a unanimous decision of the board of directors. If the board is not in agreement, it may decide to put the matter to a shareholders' meeting, to be decided by a majority of votes cast at the meeting.

The Company may reduce its share capital by:

- reducing the nominal value of the shares;
- by re-purchasing and redeeming shares to reduce their total number.

A decision to reduce the share capital requires a simple majority of votes cast at a shareholders' meeting.

Under federal law, the Company must not reduce its share capital to an amount less than 1,000 times the official monthly minimum wage. If, at the end of the next and each successive financial year after being reduced, the share capital exceeds the balance-sheet value of the net assets, the Company is obliged to reduce its share capital to no more than the value of the net assets (but not below 1,000 times the official monthly minimum wage which is currently equal to R 600).

## **Issues of bonds and other securities**

Decisions on the issue of non-convertible bonds and other securities are made by a majority vote of the board of directors. The placing of convertible bonds and other securities by closed or open subscription, when the securities would be converted into ordinary shares, is decided as follows:

- if the proposed issue is larger than 25% of the ordinary shares already in issue, the decision requires a three quarters majority of the votes cast at a general meeting of shareholders;
- otherwise, the decision is made by a majority vote of the board of directors.

## **Large transactions and transactions where there is a conflict of interest**

According to the federal law «On joint-stock companies», a 'large transaction' is a transaction or several interconnected transactions involving the acquisition or disposal of assets whose value is 25% or more of the balance-sheet value of the net assets, and that is not concluded in the course of the Company's ordinary economic activity.

Under the charter, a large transaction that involves the acquisition or disposal of assets valued at between 25% and 50% of the balance-sheet value of the net assets requires unanimous approval by the board of directors, or, in the absence of unanimity, a simple majority of the votes cast at a general meeting of shareholders. If the value of such a transaction is between 0.5% and 25% of the balance-sheet value of the Company's net assets, it must be approved by a majority of votes at a meeting of the board of directors. The approval of large transactions involving more than 50% of the value of the net assets on the balance sheet requires a three-quarters majority of votes at a general meeting of shareholders.

A transaction is considered to involve a conflict of interest when a member of the board of directors, a person functioning as an executive body of the Company, or a shareholder of the Company who (alone or with others) owns 20% or more of the voting shares, or a person who is entitled to give instructions to the Company, or their spouse, parent, child, sibling, half-sibling, adoptive parent, adopted child, and/or associates:

- is a party to, a beneficiary of or an agent or representative involved in the transaction;
- individually or with others, owns at least 20% of the shares of an organisation that is a party to, a beneficiary of or an agent or representative involved in the transaction;
- has a post in the management of an organisation that is a party to, a beneficiary of or an agent or representative involved in the transaction, or a post in the management of such an organisation.

In a company where more than 1,000 shareholders have voting shares, a transaction involving a conflict of interest can be approved by a majority vote of directors who have no interest in the completion of the transaction.

However, the decision must be taken instead at a shareholders' meeting, by a majority of votes of the shareholders who own voting shares and have no interest in the outcome, if:

- all the members of the board have an interest in the transaction;
- the value of the transaction equals 2% or more of the balance-sheet value of the Company's assets;
- the transaction is a placing of securities convertible into ordinary shares, where the total value is more than 2% of the ordinary shares already in issue plus the ordinary shares resulting from the conversion of previously issued convertibles.



# The work of the board

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## **The authority and work of the board of directors and its subcommittees**

The board of directors has 11 members, who are elected each year by the annual general meeting by the voting method described above. The charter also authorises the annual general meeting, in exceptional circumstances, to dismiss the entire board of directors by a majority of votes cast. The working principles of the board of directors are defined by the Company's board procedures, as approved by a general meeting of shareholders. Board meetings may be called by the chairman of the board of directors, a member of the board, the audit committee, the auditors, executive bodies of the Company or by a shareholder or group of shareholders with at least 5% of the voting shares.

Four subcommittees report to the board, three of which include independent directors or their representatives, and augment the managerial functions of the board.

The following matters are for the board of directors to decide, and may not be delegated to any other collective body or individual executive:

- the valuation of the Company's assets;
- preparation for and holding of general meetings of shareholders;
- the use of reserves and certain other funds;
- the approval of transactions involving the acquisition or disposal of assets whose value is between 0.5% and 50% of the balance-sheet value of the Company's net assets, and the approval of any transaction involving a conflict of interest;
- an increase of the share capital by placing extra shares (see «Decisions that affect the Company's financial position»);
- placements of bonds and other securities;
- buying back shares, bonds and other securities;
- definition of the Company's priorities in certain matters, including strategies for and programmes of development, and the approval of the annual, medium-term and long-term budgets;
- the approval of the share registrar, the conditions of his contract and the termination of his contract;
- recommendations on the amount of dividend to be paid, the form it takes and the pay-out date;
- recommendations on the remuneration and compensation paid to the members of the audit committee, and decisions on the auditors' fees;
- management of internal control procedures;
- managing the structure of the Company, and of the opening of subsidiaries and representative offices;
- defining priorities in the activities of branches and subsidiaries;
- creating permanent or temporary board subcommittees;
- taking decisions as to the Company's participation in other organisations and its relationships with them;
- the election (or re-election) of the chairman and deputy chairman of the board of directors, the appointment of the managing director, the organisation of the board of management and the appointment of the company secretary;
- other matters laid out in the Company's charter.

A majority vote of the board members attending a meeting is essential for decisions on matters within the board's remit, except that increases and reductions in the share capital and the approval of large transactions require the consent of the whole of the board of directors (see «Decisions that affect the Company's financial position»).

Each member of the board of directors has one vote at board meetings, and the chairman of the board has a deciding vote in case of a deadlock.

Under the Company's charter, the quorum for board meetings is more than half of the board members. Board meetings may be held in person (which includes the use of telephone conference calls) or directors' opinions and votes may be sent in by post.

As at 1 December 2003 there were no subcommittees of the board of directors.

# Members of the board and board of management

The tables below list the members of the Company's board of directors and board of management, with their positions and their shareholdings in the Company and its subsidiaries on 1 October 2003.

## The board of directors of VolgaTelecom

Name	Year born	Position	Shareholding in VolgaTelecom (%)	Shareholding in subsidiaries (%)
Maxim Victorovich Bobin	1975	Head of legal department, Moscow office, NCH Advisors, Inc	0.0	0.0
Alla Borisovna Grigorieva	1967	Deputy managing director and head of corporate governance, Svyazinvest	0.00061	0.0
Vladimir Vladimirovich Dudchenko	1973	Head of analysis, Moscow office, NCH Advisors, Inc	0.0	0.0
Elena Victorovna Zabuzova	1950	Director of economic planning and budgeting, Svyazinvest	0.0	0.0
Alexander Vladimirovich Lopatin	1964	Chairman of the board of directors of Tsentralny Telegraf	0.0	0.0
Vladimir Fedorovich Lyulin	1938	Managing director, VolgaTelecom	0.18588	0.0
Georgy Alexeyevich Romsky	1956	Deputy managing director, Svyazinvest	0.0	0.0
Victor Dmitrievich Savchenko	1960	Director of the legal department, Svyazinvest	0.0	0.0
Oleg Romanovich Fedorov	1968	Executive director of United Financial Group	0.0	0.0
Sergey Valerievich Chernogorodsky	1977	Director of department of share capital, Svyazinvest	0.0	0.0
Yevgeny Valerievich Yurchenko	1968	Deputy managing director, Svyazinvest, chairman of the board of directors of VolgaTelecom	0.0	0.0

Source: the Company

Maxim Bobin has been working for the Moscow representative office of NCH Advisors, Inc since 1998. A lawyer, he has been the head of the legal department since 2000.

Alla Grigorieva was deputy head of the shareholding department of Svyazinvest from 1998 to 1999, and since then has been the deputy managing director and head of corporate governance.

Vladimir Dudchenko was a consultant in the Moscow representative office of NCH Advisors, Inc from 1996 to 2001, and since then has been head of its analysis department.

Elena Zabuzova was deputy director and head of financial market operations in RAO UES from 1998 to 2001. Since then she has been deputy director and head of economic planning at Svyazinvest.

Alexander Lopatin from 1997 to 1998 was the Director of Treasury of RAO UES. From 1999 to 2000 was the first deputy managing director of Svyazinvest; and from April 2000 to September 2003 was deputy managing director. Since September 2003 he has been the chairman of the board of directors of Tsentralny Telegraf (Central Telegraph).

Vladimir Lyulin has been the managing director of VolgaTelecom since 1997.

Georgy Romsky was technical director of St Petersburg International and Intercity Telephone from 1995 to 2000, when he became a deputy managing director of Svyazinvest.

Victor Savchenko was a lawyer in the Ministry of justice (the presidium of the inter-republican bar) from 1998 to 2001. Since 2002 he has been director of the legal department of Svyazinvest.

Oleg Fedorov was from 1998 to 1999 the managing director of Moscow Company of Investments and Innovations. From 1999 to 2000 he was the head of the department of protection of investors' rights at NAUFOR, and started working as team manager of independent directors at the Association for the protection of investors' rights. From 2000 to 2002 he was director of Consulting Centre NAUFOR, and from 2002 to 2003 he was the deputy executive director of the Association for the Protection of Investors' Rights. Since 2003 he has been executive director of United Financial Group.

Sergey Chernogorodsky has been working for Svyazinvest since 1999: until 2002 he was the head of investor relations, from 2002 to 2003 the deputy director of the securities department and since 2003 he has been the director of the department of share capital department.

Yevgeny Yurchenko was a manager of the St Petersburg branch of Bank MENATEP, and since 2002 he has been a deputy managing director of Svyazinvest.

#### The board of management of VolgaTelecom

Name	Year born	Position	Shareholding in VolgaTelecom (%)	Shareholding in subsidiaries (%)
Alexander Vasilievich Arakcheev	1938	First deputy managing director and technical director	0.06122	0.0
Vasily Petrovich Vystorop	1949	Deputy managing director	0.0	0.0
Lyubov Ivanovna Grigorieva	1953	Deputy managing director head of corporate development	0.01192	0.0
Mikhail Vasilievich Diakonov	1954	Deputy managing director for innovations	0.0	0.0
Oleg Lvovich Yevdokimov	1963	Deputy managing director head of new and information technologies	0.00016	0.0
Sergey Leonidovich Yelkin	1949	Deputy managing director, director of the Samara branch	0.04756	0.0
Alexander Ivanovich Kirillov	1956	Deputy managing director, director of the Republic of Mariy-El branch	0.06681	0.0
Ludmila Alexeyevna Kormilitsyna	1955	Deputy director of telecommunications, Svyazinvest	0.0	0.0
Oleg Animpadistovich Korolkov	1941	Deputy managing director and director of the Saratov branch	0.10259	0.0
Vladimir Fedorovich Lyulin	1938	Managing director of VolgaTelecom, chairman of the board of management	0.18588	0.0
Nikolai Ivanovich Popkov	1973	Chief accountant	0.0	0.0
Taissiya Mikhailovna Sipatova	1954	First deputy director of economics and finance	0.0	0.0
Ivan Petrovich Sklyarov	1948	Deputy managing director head of marketing (commercial director)	0.00103	0.0
Elvira Konstantinovna Schukina	1954	Director of the legal department	0.0	0.0

Source: the Company

#### Members of the board and board of management

## **Remuneration of and bonus programmes for directors and managers**

Under board procedures, members of the board of directors receive remuneration and refunds of their relevant expenses during the period that they work for the Company. They receive both quarterly and yearly remuneration. The basis of calculation of remuneration is decided at the annual general meeting at which they are elected.

Board members' quarterly remuneration is calculated as a percentage of the Company's reported sales in the previous accounting quarter. The most recent annual general meeting has set that percentage at 0.0062%. The remuneration of the chairman is 1.3 times that of the other board members.

If a member of the board of directors is absent from more than half of its meetings, his or her remuneration may be proportionately reduced.

Directors' annual remuneration is 0.4% of the Company's reported net profit in the previous financial year.

Extra remuneration, to be paid to board directors via the Company's share option plan, is calculated on the basis of their individual performances.

Under board of management procedures members of the board of management also receive remuneration and refunds of their relevant expenses for the period that they work for the Company.

The remuneration to the members of the board of management is paid out quarterly as a part of net profit of the Company. The size of the remuneration is proposed by the chairman of the board of management and set by the board of directors. According to the decision of the board of directors on 15 July 2003, the size of the remuneration to the members of the board of management is equal to 0.43% of the net profit of the Company according to the financial statements.

The members of the board of management may get extra remuneration via the Company's share option plan.

# Legal and tax issues

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# Telecommunications

## regulation

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The government regulates the main aspects of telecommunications activity and cooperation between operators. At present, the government considers that state regulation is sufficient to allow operators to build their markets and conduct their activity on a competitive basis. The regulatory mechanism is being improved constantly, in line with international and European standards.

Under Russian legislation, the following telecommunications activities are regulated by the state:

- the provision of inter-city telephone services for fixed-line subscribers;
- the provision of local telephone services for fixed-line subscribers;
- the provision of telephone access, whether fixed-line or mobile (cellular).

The production products, services and economic activities of Russian telecommunication operators are regulated by article No. 8 of the Russian constitution, which guarantees freedom of competition and of economic activity.

State telecommunications policy is planned and implemented by the RF Ministry for telecommunications and information technology, which coordinates the creation and development of telecommunications networks, devises and approves the details of the state's regulation of the industry, and regulates cooperation between telecommunications operators.

The laws that regulate the activity of the Russian telecommunications operators are designed to maintain the integrity, stability and safety of operation of the Russian Federation telecommunications network. The most important are the federal law «On Telecommunications» and various decrees issued by the President and government of the RF, the RF Ministry for telecommunications and information technology and the RF Ministry for Anti-Monopoly Policy and Support of Business.

**The federal law «On Telecommunications».** The most recent version of this law was approved by the President of the RF in July 2003, and came into effect on 1 January 2004.

It determines the authority that various branches of the government exercise over the regulation of the telecommunications sector, and the rights and obligations of telecommunications operators and users. The current version includes' new regulations, based on international experience, which have not previously existed in the RF:

- it establishes a guaranteed universal communications service, and describes how it is to be financed;
- it establishes an improved method of financing subsidies to certain categories of users;
- it makes it possible for licences and resources to be allocated on a competitive basis.

**The universal telecommunications service** is guaranteed by the federal law «On Telecommunications», and includes the provision of payphones, data transmission services and internet access, including internet clubs. The rules that govern the provision of service and the terms and procedures of tariff regulation are fixed by the federal government.

In general, as set out in the federal law «On Telecommunications», the government's involvement with the telecommunications sector takes the following forms, which are handled by the RF Ministry for telecommunications and information technology and other state organs:

- regulation of radio-frequency spectrum and of the distribution of line capacity;
- licensing of telecommunications operators' activities;
- certification of telecommunications equipment;
- regulation of telecommunications tariffs.

**The regulation of radio-frequency spectrum** is a state monopoly. It is provided according to international agreements and RF legislation, as well as the needs of the government and considerations of national security. Regulation is in the hands of the State Radio-frequency Committee.

The basic considerations given to the use of radio-frequency spectrum are:

- deciding the order of access (with priority being given to government interests);
- payment for access;
- time-limited allotments of radio-frequency (terms of service are ten years or less, depending on the licence application); and
- transparency of the procedure for distribution of frequencies.

**Regulation of the distribution of line capacity.** The state is the exclusive allocator of line capacity. Its decisions on the distribution and use of this resource take into consideration the recommendations of international organisations. Telecommunications operators are charged a one-off fee for their allocation of capacity. Standard requirements for the availability of lines for telecommunications networks are established by the RF Ministry for telecommunications and information technology. As required by the federal law «On Telecommunications», the ministry also ensures the availability of lines for allocation.

**The licensing of telecommunications operators** is, again, subject to the law «On Telecommunications» and to government regulations. Telecommunications providers are obliged to be licensed. The drafting of licence terms, the mechanism for allocating licences (including auction and competition terms) and the monitoring of licensing conditions are all implemented by the RF Ministry for telecommunications and information technology.

The law specifies a considerable number of documents which are to be submitted by applicants when applying for licences. It also determines the procedures and conditions governing the examination of applications, and the rules governing the extension of licence periods.

Where service requires the use of radio-frequency spectrum or the communications network, and there is limited availability in the area in question, the licence is allocated by auction or competitive tender. Auction procedures are fixed by the RF Ministry for telecommunications and information technology.

**Certification of telecommunications equipment.** All equipment used in telecommunication networks must be certified before they are connected with the public telecommunication system. The certification system is operated by the RF Ministry for telecommunications and information technology.

**The regulation of tariffs** is governed by the federal law «On Telecommunications», the law «On Natural Monopolies» and other federal statutes. Under current Russian legislation, public electronic telecommunications services are subject to price regulation. Tariffs on fixed-line telecommunications operators, which are considered to be natural monopolists, are regulated by the RF Ministry for Anti-Monopoly Policy and Support of Business. Operators that are deemed to have a natural monopoly have their tariffs set by the ministry.

The main signs that a fixed-line telecommunications service operator has a natural monopoly are:

- the inability of other telecommunications operators to provide a similar service;
- the conclusion from an analysis by the ministry that an operator's activity contains elements of natural monopoly.

If telecommunications operators are not natural monopolists, they are free to fix their own tariffs.

Tariffs are regulated on the basis of price limits, using the following principles:

- a determination of compensation of operators for their reasonable costs;
- calculation of a reasonable return on capital for telecommunications operators;
- the need to satisfy demand for telecommunications services;
- the protection of telecommunications consumers from unjustified increases in tariffs;
- the inclusion, within the structure of regulated tariffs on telecommunications services, of taxes and other compulsory payments required by Russian law.

Until the restructuring of Svyazinvest's holding in and organisation of joint-stock operators, tariffs on telecommunications services could be different in economically similar regions. Since 2001, the tariff policies of the RF Ministry for Anti-Monopoly Policy and Support of Business and of the regional telecommunications companies have been designed to balance prices within each company. Territories are exempted from this regime if they are subject to specific economic or environmental conditions that increase the economic cost of telecommunications services.

At present two tariff systems are in use – fixed monthly subscriptions, and time-based call charges. The former method is predominant, but time-based payment was introduced in some towns and regions in 2002, and Svyazinvest is planning to apply it to the majority of customers by 2005 (as soon as the network is ready).



**Average growth of tariffs for state-regulated telecommunications services, 1999–2002**

% year on year	2000 to 1999	2001 to 2000	2002 to 2001
Residential subscribers	30.7	23.3	37.6
Organisations	6.8	15.0	9.0
Government organisations	14.4	37.7	25.9
Commercial enterprises	5.7	11.4	6.9

Source: RF State Committee for Statistics

It is worth mentioning that during 2002, tariffs for state-regulated telecommunications services grew several times faster than inflation. Within that, they increased faster for residential subscribers than for organisations, because of a tariff re-balancing policy implemented by the RF Ministry for Anti-Monopoly Policy and Support of Business.

Overall, subscriptions increased by 31%, within which residential tariffs increased by 43.7%, and tariffs for organisations by 18.4%. Tariffs for telegraph services grew by 15.5% in 2002. In the first half of 2003, according to RF State Committee for Statistics, tariffs continued to rise, with the residential rate 20.6% higher than in the first half of 2002.

# Taxation of non-residents

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This section outlines tax issues that affect non-resident individual and institutional investors in the shares of Russian companies and in American depositary receipts (ADRs) representing such shares. All the Russian and overseas legislation mentioned here is in force as at the date of the writing of this memorandum, October 2003, and of course is subject to change. This document is concerned only with general regulations, and the taxation of investors depends on their specific circumstances. We urge readers to consult their tax advisors for a full assessment of the tax implications of investing in the shares of Russian issuers or in the corresponding ADRs.

## **Taxation in Russia**

Until recently, the Russian state has simply levied no taxes at all on income received by non-residents from the Russian shares and ADRs that they own. There has been a risk that a Russian custodian will be treated as the actual holder of such shares, and therefore be liable to tax on the dividends. However, under the tax and duties ministry's order No. BG-3-23/150 of 28 March 2003, an ADR holder is treated for tax purposes as the recipient of the dividends.

**The taxation of companies.** This legislation applies only to non-resident institutional investors, and not to those whose activities in Russia are carried out by permanent representatives.

Income received by non-residents from within the Russian Federation is liable to Russian income tax, and is required to be paid net of tax.

Should at least 50% of the Company's assets be real estate, situated in the RF territory, according to the Russian legislation a non-resident buyer of the Company's shares must withhold taxes, payable by a seller.

Dividends on shares owned by non-residents are liable to tax at 15%, but again this may be avoided under double taxation arrangements. The maximum rate of tax on dividends paid to a US investor is 10%, but this can be reduced to 5% if the investor owns more than 10% of the share capital of the company paying the dividends. The same principle applies to investors from Germany, except that the rates are 15% and 5%. The tax rate on dividends for British investors is 10% independent from an equity stake of the investor.

For a more detailed account of how double taxation agreements may be used to reduce the tax burden, see the section below, «The rules of double taxation agreements».

**The taxation of individuals.** The following section applies only to non-resident individual investors. To be considered non-resident for Russian tax purposes it is necessary to spend less than 183 days in Russia during the fiscal year (which is also the calendar year).

Non-resident individual investors in the shares or ADRs of Russian entities are liable to income tax at 30%, both on dividends and on capital gains, when ADRs are sold to a Russian resident.

However, under double taxation agreements, individual investors may be able to avoid paying income tax on their capital gains from the sale of securities, and to reduce the tax that they pay on dividends to the same rate as applies to institutional investors. The procedure for applying for tax exemption under double taxation agreements is outlined in the following section, «The rules of double taxation agreements».

**The rules of double taxation agreements.** If a non-resident individual investor is entitled to avoid tax under a double tax agreement, he should provide documentary evidence in advance to any company from which he receives dividends. If a non-resident individual investor sells Russian securities to a Russian resident, he should provide the purchaser, too, with the documentary evidence; if he does not, the purchaser is obliged to deduct the tax from the payment.

Before 1 January 2002, non-resident individual and institutional investors had to apply to the Russian tax authorities for exemption under double taxation agreements. At the time of writing, however, non-resident companies are no longer required to claim exemption in advance. It is enough for a non-resident company to confirm to any individual or company from which it is receiving money that it is a tax resident of a state with which the Russian Federation has a double taxation agreement. This confirmation must be certified by the tax authority of that state and translated into Russian.

Individuals, in order to obtain tax exemption, must submit the following forms and documents to the RF Ministry of taxation and duties:

- an official form, verifying that they are residents of the country, which Russia has signed a double taxation agreement with, which must be valid within the current tax period;
- a documentary evidence for the income received;
- a documentary evidence for the taxes paid outside RF, which must be certified by the tax authority of that state.

As a rule, the depositary and the issuers will help investors to deal with the necessary documentation.

### **Taxation in the investor's country**

There follow summaries of the current tax rules in the United States of America, Great Britain and Germany, as they affect income from Russian securities investments owned by residents of those countries. This section is not comprehensive, and certain groups of investors may have a special tax status. Readers are recommended to consult their tax advisors for a full explanation of the tax implications of investing in Russian shares and ADRs.

#### **The USA**

In this section we touch only on the federal taxation of individual and institutional investors. American tax rules on income from investments from investments in Russia are the same for shares and for ADRs. Special regulations may apply to certain categories of investor, notably banks, finance companies, organisations with tax privileges and owners of 10% or more of a Russian company's ordinary shares.

**Taxation of dividends.** Under USA tax law, the total amount of dividends paid to a company (that is, including any tax paid in the Russian Federation) is considered as income from foreign sources and subject to tax. However, tax paid in Russia up to a rate of 10% is covered by a double taxation agreement, and treated as if it had been paid in the USA.

**Taxation of income from sales of shares or ADRs.** A profit realised on the sale of shares or ADRs is considered as short-term if they have been held for less than a year and long-term if they have been held longer. All capital gains and losses are subject to income tax and tax allowances in the usual way.

#### **Great Britain**

This section deals with income tax, capital gains tax and corporation tax.

**Taxation of dividends.** Dividends paid by Russian companies to residents of Britain, including any tax deducted at source, are subject either to income tax or to corporation tax. Under the two countries' double taxation agreement, tax paid in Russia up to a rate of 10% is treated as if it had been paid in Britain. Tax payments treated in this way may include tax on the Russian company's profits, if the recipient is a British company that controls more than 10% of its shares.

**Taxation of income from sales of shares or ADRs.** In British law, a profit realised on the sale of shares or ADRs is subject either to capital gains tax or to corporation tax. If the seller of the securities is a company, any resultant profit or loss is included in the calculation of its annual profits and subject to normal corporation tax.

## **Germany**

This section deals with income tax and corporate income tax.

**Taxation of dividends.** Individual investors resident in Germany pay income tax on only half of any distribution of company profits.

Dividends paid to a company that is resident in Germany are not subject to income tax. Special conditions may apply to certain groups of investors, such as banks and other financial institutions.

There is also a double tax treaty between the Russian Federation and Germany regarding property tax and income tax.

**Taxation of income from sales of shares or ADRs.** In 2002 there was a major change in the income-tax treatment of securities sales. For individual investors resident in Germany, income tax is now levied on half the profit from the sale of shares or ADRs if they have been held for less than a year. If they have been held for longer, the profit is tax free, so long as the investor has less than 1% of the ordinary shares of the company.

Companies resident in Germany are generally not liable to tax on the sale of shares. However, if the sale results in a loss, it cannot be used to reduce the company's taxable profits. Again, special conditions may apply to certain groups of investors, such as financial institutions.

# Accounting rules and procedures

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Russian accounting legislation has significantly increased the alignment of Russian accounting practices with international accounting standards. As a result, Russian accounting has become less focused on the requirements of tax legislation. However, although most of the Russian accounting regulations (RAR) are now based on International Accounting Standards (IAS), there are certain differences to be found when compiling financial statements.

**Fixed assets accounting.** According to RAR, fixed assets accounting bases on the revalued costs and not on the original costs including inflation index, as it is in IAS. RAR does not require the analysis of fixed assets depreciation.

**Accounting for fixed assets.** Under RAR, fixed-asset accounting is based on revalued costs, whereas in IAS it is based on indexation of the original costs for inflation. RAR does not require the depreciation of fixed assets to be analysed.

**Accounting for leased equipment.** In IAS, the value of leased equipment is treated as being the lower of the fair value and the present value of the minimum lease payments; RAR uses the undiscounted value.

In IAS the balance sheet shows the principal of the debt separately from finance charges, whereas in RAR these liabilities include finance charges. Under RAR, leasing liabilities are often presented in off-balance-sheet accounts.

**Deferred tax liabilities.** The new accounting standard introduced in Russian Federation in 2003 stipulates a complex method of accounting for deferred tax which does not fully correspond with IAS. In addition, under IAS the balance-sheet value of fixed assets provides different figures for deferred tax liabilities than those produced under RAR.

**Pension plans.** In RAR there is no requirement to account for defined-contribution pension-plan liabilities.

**Financial instruments.** The new accounting standard introduced in the Russian Federation in 2003 stipulates that financial investments should be recorded at market value if their price is quoted in a market. IAS require financial investments to be represented at fair value or amortised cost.

**Subsidiaries.** Under IAS, subsidiaries are included in the consolidated financial statements at cost, at revalued amounts or using the equity method, whereas in RAR they are included either at cost or at market value.

## Major differences between RAR and IAS for VolgaTelecom

**Rules for preparing a consolidated financial statement.** Although RAR require that companies prepare consolidated financial statements, these statements are considered subordinate to the unconsolidated statements of a company's divisions, and consolidated statements are often not prepared. They can be prepared in accordance either with IAS or with RAR.

Companies are allowed to prepare consolidated financial statements if the following requirements are satisfied:

- the company can prove that, in consolidated financial statements prepared in accordance with IAS, the figures are accurate;
- in the consolidated financial statements, the notes (in accordance with IAS), describe accounting practices which are different from those required by the Ministry for finance;
- the decision to prepare the company's consolidated statement in accordance with IAS instead of RAR has been voted on by the board of directors, the owners or the shareholders.

**The tax base.** The tax base for companies is usually income from the sale of goods and services, less deductible expenses. Historically, the primary purpose of Russian accounting has been to ensure fiscal accountability; thus, despite all the changes taking place in this sphere, the profit figure reported for accounting purposes is often the same as the profit produced for purposes of taxation.

Russian law requires most companies to calculate their gross revenue for tax purposes on an accrual basis, although those with relatively small sales are allowed to report on a cash basis. Current expenses are also recognised on an accrual basis. If income is recognised on a cash basis only, actual outgoings are recognised as expenses. Before the first section of the current federal tax code became law, subsidiaries with their own bank accounts and whose accounts were maintained off the balance sheet of their parent company were viewed as separate taxpayers, and not allowed to consolidate their financial statements with those of the parent company for tax purposes. Now, however, subsidiaries are no longer viewed as separate, and are obliged to transfer some of their tax liability to the parent company; this is calculated in accordance with legally defined norms.

**Deductible expenses.** The law allows certain current expenses to be deducted for tax purposes, subject to certain restrictions.

- Overheads and similar expenses, some advertising costs and training costs are deductible up to a certain percentage of turnover or of wages and salaries;
- Accrued interest on loans is deductible, but only up to a certain interest rate;
- Travel expenses are deductible only within legally defined limits.

**Depreciation for tax purposes.** For accounting purposes, the depreciation of fixed assets is calculated using a method introduced on 1 January 1998. It allows companies to decide on the useful life of an asset, and to use either the straight-line or the declining-balance method of depreciation. Depreciation for tax purposes has to be calculated by either the straight-line or the accelerated method, and the regulations specify how the useful life of an asset is to be determined; this sometimes differs from the actual useful life. For tax purposes, intangible assets are amortised for the estimated life of the company or of the asset, whichever is the shorter. When no useful life can be determined for an intangible asset, it is assumed to be ten years.

**Corporate profit tax rate.** At present, the corporate profit tax rate for most companies is 24%. It is divided into three parts: federal (6%), regional (16%) and local (2%). Regional governments are allowed to reduce their portion to 4%.

**Deferral of losses.** Companies are allowed to defer losses for ten years, but they cannot be used to reduce the company's taxable profit by more than 30%.

### **The accounting rules accepted in the Russian Federation and VolgaTelecom's accounting policies**

The method of preparation, structure and form of a company's financial statements are defined by Accounting Decree No. 4/1999, «Companies' financial statements».

Financial statements must be calculated in roubles and published in the Russian language. The company must present its financial statements to the shareholders' representative body, as specified by the company's charter, to the federal government's statistical bodies and to the tax authorities.

The company's annual financial report includes the balance sheet, profit and loss statement, statement of cash flows and notes to the balance sheet. Small businesses are allowed to use a simplified format. The financial year is the same as the calendar year. Federal accounting laws and regulations require certain companies, including public companies, to publish their annual financial reports not later than 1 June of the following year, and must offer interested parties free access to their reports. Public companies must publish their balance sheets, profit and loss statements and auditors' reports. Financial statements must be audited, and must be approved by the company's shareholders at their annual general meeting.

**The balance sheet.** Assets are grouped in the balance sheet according to the principle of increasing

liquidity. They are divided into current and non-current assets, depending on the length of their estimated useful life. Assets (except for receivables) that are used for more than 12 months are considered non-current. Liabilities are divided into various categories, including equity, provisions, non-current liabilities (those due more than 12 months after the reporting date) and current liabilities.

**Receivables.** In accordance with RAR, overdue non-collateralised receivables are considered bad debts, and must be written off the balance sheet three years after their due date. Provisions for bad debts are usually not made, or are calculated in accordance with the requirements of the legislation.

The Company makes provisions for bad debts on a quarterly basis.

**Inventories.** Inventories of goods that are used in production are recognised at cost, using the average cost, FIFO, LIFO or cost-per-item method of calculation. Finished goods are accounted for at their actual cost of production, a standardised production cost or their balance-sheet valuation. Work in progress is accounted for at standardised cost, direct costs, the cost of materials and sub-assemblies, or (for unique products) the sum of expenses incurred.

The Company recognises finished goods at their actual cost of production. The cost of materials used is calculated using the average cost method. However, precious metals used in production are valued by the cost-per-item method.

**Investments.** Investments are initially recognised at their actual cost, which can include contractors' costs, intermediaries' charges and other similar costs. Investments that have a market value are re-valued at the end of each quarter or month; other investments may have to be depreciated.

The Company classifies investments according to their type and maturity. On disposal, bonds and shares are valued using the FIFO method, while other securities are valued at their actual cost.

**Property, plant and equipment.** Plant and equipment are accounted for at historical cost. Companies are allowed to revise these costs at the beginning of each year, to counter the effect of inflation.

Depreciation of fixed assets can be accounted for by the straight-line, declining balance, useful life or item-of-production methods. The straight-line method requires the use of depreciation rates that are prescribed by law, and is the most common.

In 2003 the Company did not re value its fixed assets. They are depreciated by the straight-line method.

**Intangible assets.** Accounting Decree No. 14/2000 determines what assets can be treated as intangible. Depreciation is calculated over the asset's estimated useful life, using either the straight-line, item-of-production or declining-balance method. If the useful life cannot be determined, the period of depreciation is set at 20 years (ten years for tax purposes). Intangible asset can be depreciated for more than 20 years. Administrative costs treated as contributions to the stock of capital and goodwill are considered intangible assets, and must be depreciated over less than 20 years.

Intangible assets are depreciated by the straight-line method on a monthly basis. The useful life of intangible assets is estimated by a special committee and confirmed by the managing director.

**Provisions.** Companies are able to decide what provisions should be made, and whether they should be made in any given year. Provisions are usually made for employees' holiday pay and repairs.

The Company makes provisions for decrease in value of owned securities and fixed assets, for bad debts and for conditional liabilities.

**The rules for currency exchange transactions.** As a result of the financial crisis of 1998, Russia tightened its currency regulations. Successive laws and rules have covered various aspects of currency regulation, and impose large fines on transgressors. There is a limited list of operations which do not require permission from the Central Bank of the Russian Federation (CBR). These include loans with

a term of no more than 180 days, payments under import-export contracts in which payments are deferred by no more than 90 days, and non-commercial transfers. The rules for contributions to the authorised capital of a foreign company remain rather complicated. Loans with a term of more than 180 days, and issued at market rates, can usually be carried out under a new and less complicated licensing procedure, but other operations involving foreign currencies can only be conducted with the permission of the CBR.

To prevent capital from leaving Russia, CBR states that foreign currency required for advance payments for imported goods can be purchased only if the equivalent rouble amount is deposited in a corresponding bank in Russia. This depositing procedure can be eliminated only if it is guaranteed by a foreign bank that is classified as highly reliable, or in certain other cases.

Foreign currency can be bought in Russia through an authorised currency exchange on condition that it is used as a payment abroad for a legal operation. If it is not used for such an operation, it must be sold through an authorised currency exchange within seven days. Special attention is paid to the documents which prove that the payment conforms with the currency regulations. This conformity must be monitored by banks. Banks can be made to pay fines if transactions are improperly conducted.

If a Russian company, including a joint venture involving foreign capital, receives export revenues denominated in a foreign currency, it must sell 25% of the receipts through an authorised currency exchange within seven days of receiving payment. This must be handled by a bank that is authorised to conduct such operations. There are strict rules governing the places where such foreign-currency revenues can be sold.

There are strict controls over the process of receiving and making payments in export and import operations.

Almost all payments made within the territory of the Russian Federation must be denominated in roubles.

Foreign companies are allowed to maintain foreign currency accounts and certain types of rouble accounts. Each type of account must be used for certain specified purposes. These companies' earnings from sales denominated in roubles can usually be either converted to another currency and repatriated, or used to finance local expenses. In Russia it is also possible to receive rouble earnings without opening an account at a Russian bank, by using a corresponding rouble account which allows the earnings to be converted into another currency and sent abroad.

From 1 January 1999, rouble payments between residents and non-residents have been regarded as currency exchange operations, and are subject to regulation by the CBR.

Any operation being planned that involves a foreign currency should be analysed from the regulatory point of view, as there is a risk of fines for breaking currency exchange laws (usually 100% of the value of the transaction), or of a bank refusing to conduct the transaction.



# Legal issues

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## **The registration and transfer of share ownership**

In Russian law, every holder of ordinary or preference shares in the Company has the right to sell his or her shares without the permission of other shareholders, and without any limitation or additional conditions.

All of the Company's shares are issued and registered according to Russian law. Registrator-svyaz is the Company's independent registrar.

The Company's registrar keeps and maintains the register of shareholders, which documents rights of ownership in the Company and any transfers of those rights. The registrar must record all instances or transfers of these property rights in either written or electronic form. These records may only be changed in response to written instructions from the shareholders. Russian law says that the registrar may not unreasonably refuse to register share ownership rights in favour of a new holder or his or her nominee.

The shares that underlie the Company's ADRs in issue are held by a nominee, acting on behalf of the depository bank. The depository bank exercises the same rights as shareholders in the Company, on behalf of the holders of the ADRs.

## **The responsibilities of shareholders**

Under the general provisions of Russian law, shareholders are not responsible for the obligations of the joint-stock companies whose shares they hold. However, where shareholders have authority over the Company, the law imposes a secondary liability on them if the Company is forced into bankruptcy as a result of their actions or omissions.

# Litigation

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At present the company is a defendant in a number of lawsuits in connection with its business. The majority of the lawsuits have been brought by individual telecommunications customers. Most of them are demanding preferential tariffs, as provided for by the current legislation. Others are demanding compensation for psychological damage and material losses because of the Company's refusal to re-register contracts for telecommunications services, or because of delays in providing the access to telephone network that was promised in their contracts. None of these cases involve large claims.

The Company is also involved in some outstanding cases brought by organisations. Management does not believe that any of these cases could seriously damage the Company.

No actions are being brought against the Company in connection with its reorganisation.

None of the cases brought against the Company has affected or will affect its activities or financial position. However, by virtue of the character and scope of its activities, the Company is not insured against lawsuits that might affect its business.

# The investment case

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# Company comparisons

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When we compare Russian telecommunications companies with those in other countries, Russia seems to exhibit a number of characteristics that seriously affect the development of the telecommunications sector and that are not shared by other countries. Russia's vast territory, the remnants of Soviet-era financing principles and a lack of investment in the 1990s have left the fixed-line networks technically and physically underdeveloped. Russian telecommunication operators are still at a stage in their evolution that most European operators have already passed. Now, in response to the growing demand for telecommunications, the Svyazinvest companies are planning to expand their networks, increase their capacity and widen the range of their services.

Operators in the majority of eastern European countries have also passed this stage, and have exhausted the opportunities to grow by increasing their fixed-line client base. However, these operators' networks are technically far more advanced than those of the Russian companies, and their markets are fully de-regulated. Moreover, telephone penetration is much higher in the eastern European countries than in Russia.

The de-regulation and widespread privatisation that have taken place in eastern Europe have contributed to the creation of an effective tariff system, a process which in Russia is still incomplete. This is why Svyazinvest operators are less profitable than similar companies in other countries.

At present, the markets' view of the Svyazinvest operators is affected by trends that are typical of emerging markets (including Russia) and by the particular character of the Russian telecoms sector (including the reforms currently under way). To judge the validity of the market's view, we can compare a company's multipliers with those of similar companies.

The best comparison is with the successors to the state telecoms companies in emerging markets. They are operating in similar macro-economic conditions, their networks are similar in scale and they are the leading 'traditional' telecommunication service providers in their countries. The telecoms markets in these countries are showing considerable growth, led by mobile communications and data transmission services. Also, although most of these companies went through the first stage of their privatisation in the early 1990s, their governments have retained an interest in their share capital.

The telephone line capacity of the Russian regional operators is now comparable with that of operators in the European emerging markets, but is producing considerably lower income.

### Operating and financial indicators of telecommunication operators in European emerging markets, 2002

	Revenue (\$ million)	EBITDA (\$ million)	Number of fixed lines (000)
<b>Svyazinvest regional operators</b>			
Uralsvyazinform	562	168	3,324
VolgaTelecom	419	134	4,238
North-West Telecom	342	93	3,612
Sibirtelecom	444	121	3,781
CenterTelecom	555	158	6,109
Dalsvyaz	180	33	1,191
Southern Telecommunications Company	377	106	3,545
<b>Eastern European operators</b>			
Matav (Hungary)	2,289	950	2,882
Telekomunikacja Polska	4,598	1,765	10,792
Cesky Telecom	1,618	801	3,661
Lietuvos Telekomas	264	137	936
OTE (Greece)	5,085	2,030	6,068

Source: companies' data

The eastern European operators derive less of their income than the Svyazinvest companies from fixed-line services, but most of them get 13–30% of their income from mobile communication services.

### Sources of income of telecom operators in European emerging markets, 2002

% of revenues	Matav (Hungary)	Telekomunikacja Polska	Lietuvos Telekomas	OTE (Greece)
Fixed-line communications	39.3	66.8	68.0	71.0
Mobile (cellular) communications	30.2	13.2	n/av	22.0
Internet and data transmission	5.8	8.0	10.7	n/av
Network interconnection	n/av	7.8	15.0	n/av
Other	24.7	4.2	6.3	7.0

Source: companies' data

Although part of the authorised capital of all European emerging markets' operators remains in government ownership, a considerable proportion is traded on the open market. The high proportion of the shares owned by private investors allows them to participate in strategic decision-making.

### Ownership of the share capital of telecom operators in European emerging markets on 1 January 2003

% of authorised capital	Matav (Hungary)	Telekomu- nikacja Polska	Cesky Telecom	Lietuvos Telekomas	OTE (Greece)
State	'Golden share'	17.9	51.1	9.0	33.8
Strategic investors	59.2	47.5	27.0	60.0	13.7
Remaining shares outstanding (including ADRs and GDRs)	40.8	34.6	21.9	26.3	52.5

Source: companies' data

### Comparison of the Company with similar companies in emerging markets

### Comparing VolgaTelecom with similar companies

#### The companies' main market indicators<sup>1</sup>

	Market Cap (\$ million)	EBITDA/ assets	EBITDA/ sales	Sales/ fixed lines (\$000)	EBITDA/ equity	Liabilities/ assets	Price/ sales	Price/ earnings	Price/ EBITDA	Market Cap/ fixed lines (\$000)
VolgaTelecom	480	0.21	0.32	0.10	0.32	0.35	1.13	17.71	3.55	0.11
Uralsvyazinform	654	0.16	0.30	0.17	0.30	0.45	1.15	18.43	3.84	0.20
North-West Telecom	303	0.15	0.27	0.09	0.22	0.31	0.87	22.46	3.23	0.08
Sibirtelecom	394	0.18	0.27	0.12	0.29	0.39	0.88	18.81	3.22	0.10
CenterTelecom	511	0.20	0.29	0.09	0.36	0.43	0.91	n/av	3.19	0.08
Dalsvyaz	79	0.12	0.19	0.15	0.18	0.30	0.43	50.98	2.34	0.07
Southern Telecommunications Company	295	0.17	0.28	0.11	0.27	0.37	0.77	10.20	2.74	0.08
Matav	3,964	0.20	0.41	0.79	0.41	0.49	1.73	15.01	4.17	1.38
Telekomunikacja Polska	4,354	0.19	0.38	0.43	0.52	0.63	0.95	19.30	2.47	0.40
Cesky Telecom	3,436	0.15	0.49	0.44	0.22	0.29	2.12	26.24	4.29	0.94
Lietuvos Telekomas	275	0.24	0.52	0.28	0.37	0.35	1.04	15.01	2.00	0.29
OTE	5,101	0.19	0.40	0.84	0.49	0.60	1.00	12.50	2.51	0.84
Bezeq	2,898	0.22	0.44	0.58	0.54	0.59	1.67	n/av	3.80	0.96

<sup>1</sup> Stock exchange data, May 2003; operating indicators for the end of 2002.  
Source: AVK calculations

Although the capitalisation of the Svyazinvest operators grew after their mergers, the market still rates them below comparable foreign companies. However, Svyazinvest considers that the Russian regional companies still have considerable growth potential, given the prospects of the Russian telecom market as a whole. The managements of the Svyazinvest companies plan to make huge capital investments during the next few years, which should allow them to bring their network technologies up to European standards. Their plans to install more lines will allow them to increase the number of subscribers, whereas in Europe there is less pressure of demand for fixed telephone lines, and, accordingly, a smaller prospect of growth in the client base.

Overall, the Svyazinvest operators are comparable with similar companies in terms of return, and they have less debt. At the same time, they have low ratios of sales to fixed lines, due to lower tariffs for local communication and a lower volume of de-regulated services. However, we believe the merged companies have a good chance of increasing their yield per line in the next two to three years, whereas the eastern European operators have completely exhausted the potential for income growth by raising tariffs.

VolgaTelecom's ratio of EBITDA to assets, as reported in its 2002 IAS financial statements, is the highest in the Svyazinvest Group, and in line with the figures of similar foreign companies. This shows that it has a comparable level of return on assets (ROA). If the company's income grows in the next few years, so will its ROA.

VolgaTelecom now has less debt than most of the eastern European telecom operators. The company is therefore in a position to increase its long-term debt. Its low ratio of EBITDA to equity is accounted for by the relatively low leverage. However, the Company intends to rise its debt, which should increase ROE.

The Company's sales per fixed line is lower than those of foreign telecoms operators. This reflects the fact that the Svyazinvest companies receive most of their income from traditional communication services with fixed tariffs (equal to the prime cost of the service). However, their tariff income per line is likely to grow from 2004 onwards, for the following reasons:

- the re-balancing of tariffs, which should increase income from local communications;
- the reduction of long-distance communication tariffs, which is likely to increase traffic;
- changes in regulation, and the introduction of an investment component into the regulated tariff.

The Company's sales per fixed line are also likely to be helped by the spread of de-regulation to other services (internet access, data transmission), demand for which is growing in the Russian regions, and by rising revenues from the mobile (cellular) communication services of VolgaTelecom's affiliated company Nizhny Novgorod Cellular Communication.

VolgaTelecom has a relatively low ratio of EBITDA to sales, because its regulated tariff income is a larger proportion of its revenues than that of similar companies with comparable expenditures. However, its recent merger with other operators in the region is likely to lower the Company's operating expenses.

VolgaTelecom's ratio of price to sales is the second highest among the Svyazinform companies, after that of Uralsvyazinform, and in line with the indicators of similar eastern European companies. However, we expect the company's income to grow steadily over the next few years, followed by an increase in its market capitalisation.

The present ratio of market capitalisation to the number of lines is strikingly low, but this is typical for all the companies of Svyazinvest Group. Network digitisation is one of the significant factors influencing the market value of the Company's shares. VolgaTelecom is well behind similar companies in terms of market capitalisation per fixed line because of the low digitisation of its network. However, the investment projects that management has planned should enable it to reach the technical level of the eastern European operators within the next five to seven years, and this should lift the market value of its lines.

At present, investors should view the shares of the Svyazinvest Group companies (and in particular those of VolgaTelecom) as long-term investments, which could produce substantial profits once the companies complete their investment projects and introduce more telecommunication services based on new technologies.

## Valuation methods

To calculate the market value of VolgaTelecom Company's shareholders' equity, the following methods were used:

- discounted cash flow;
- the relative valuation (guideline company) method; and
- the comparative transaction method.

These valuations were based on documents and other information received from the Company and Svyazinvest, and on general information on the economy from specialist reviews and periodicals.

The market value of the Company's shareholders' funds was calculated in roubles as at 1 July 2003.

### **The market value of the company's net worth: the discounted cash flow valuation method**

The discounted cash flow valuation method is based on the forecasting of income and discounting it back to its present value. The major advantage of this method is that it permits allowances to be made for the expected future income of the business. However, the accuracy of the results is highly dependent on the accuracy of the cash-flow forecasts.

To discount the forecasts back to their present value, the discount rate was calculated in accordance with the capital asset pricing model (CAPM).

### **Generation of a net cash flow**

The cash flow model used to estimate the Company's net worth was generated on the basis of data presented by the Company. The following concepts describe the various elements of the cash-flow forecasts.

1. Development of VolgaTelecom is forecast out to 2013. This period is divided into several stages. Between 2003 and 2010, the Company intends to implement various planned investment projects. In order to do so, significant funds will be borrowed between 2003 and 2009. Profits are likely to grow significantly after that period as a result of those implemented investments. That in turn should allow the Company to make capital investments in 2010 from its own resources, and to complete the repayment of any credits and borrowings in 2012. In 2013 the Company is likely to enter the 'stable operating stage', and growth in net cash flow beyond that date is assumed to be 6% p. a. (which is the inflation rate forecast by the RF Ministry for economic development and trade).
2. The Company's operating revenue consists of income from international, inter-city and local calls, wireless and radio communication, telegraph and internet services, radio and TV broadcasting, satellite communication, wireline broadcasting, ATE and ISDN services, wireless radio-communication, cellular (mobile) telephony and certain other sources of revenue.
3. Total expenses consist of operating expenses and non-selling expenses.

Operating expenses consist of salaries before deductions, cost of materials, fees paid to Rostelecom for outgoing traffic and other items written to expenses. Forecasts of expenses were based on the assumption that they increase in line with revenue, and on expected increases in the prices of the individual items of expense.

Operating and non-selling expenses also include interest payable, provisions for doubtful debts, taxes and duties not charged to expenses, the cost of retirement of fixed assets, fines and penalties and exchange-rate difference.



4. The value of capital investment was estimated on the basis of the need both to replace existing equipment and to buy new equipment. It is assumed that implementation of the investment programme will increase the Company's revenues by about 5.8 times between 2002 and 2013.
5. In 2003, the Company placed a bonded loan for a total sum of R 1,000 million; redemption is planned for 2006. It is assumed that the Company will extend the duration of its bank credits from 12 months to 36 months.
6. Income Tax makes up 24%.

#### Forecast of the Company's cash flow, 2003–2013

R million	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Inflow</b>											
Operating revenue	17,352	21,047	25,438	30,556	35,292	40,586	46,580	53,406	56,610	60,007	63,607
Credits and borrowings	3,688	4,885	2,716	3,700	3,350	1,745	570	0	0	0	0
<b>Total inflow</b>	<b>21,040</b>	<b>25,932</b>	<b>28,153</b>	<b>34,256</b>	<b>38,642</b>	<b>42,331</b>	<b>47,150</b>	<b>53,406</b>	<b>56,610</b>	<b>60,007</b>	<b>63,607</b>
<b>Outflow</b>											
Expenses	12,057	13,873	15,478	18,880	21,875	24,682	27,999	31,190	33,067	35,270	37,606
Capital investments	4,402	3,984	3,420	5,434	5,622	6,069	7,211	7,966	3,664	3,664	3,664
Repayment of credits and borrowings	2,202	3,649	3,348	4,146	3,908	3,148	2,085	1,863	772	190	0
Income Tax	687	772	924	1,206	1,486	1,798	2,204	2,689	4,771	5,057	5,361
<b>Total outflow</b>	<b>19,349</b>	<b>22,279</b>	<b>23,171</b>	<b>29,667</b>	<b>32,891</b>	<b>35,697</b>	<b>39,499</b>	<b>43,709</b>	<b>42,273</b>	<b>44,182</b>	<b>46,631</b>
<b>Net cash flow</b>	<b>1,690</b>	<b>3,653</b>	<b>4,983</b>	<b>4,589</b>	<b>5,750</b>	<b>6,633</b>	<b>7,651</b>	<b>9,697</b>	<b>14,337</b>	<b>15,825</b>	<b>16,976</b>

Source: the Company, AVK calculations

#### Calculation of the discount rate

The discount rate used here was calculated in accordance with the capital asset pricing model (CAPM). This model allows the required yield of a stock instrument to be calculated on the basis of its riskiness and of the yield of a selected market portfolio. CAPM calculations are based on historical stock-market statistics, which makes it possible to avoid the subjectivity inherent in most other valuation models and methods.

These calculations used indices published by the leading independent information agency AK&M. These indices are based on information about transactions in several trading systems, and thus cover a larger volume of trades than other indices maintained in the Russian Federation.

The market portfolio used in this calculation is the one that is used in the calculation of AK&M's composite index. This portfolio comprises shares in various basic industrial enterprises and telecommunications companies, plus Sberbank and Aeroflot.

Transactions in these shares provide most of the trading volume in the market: transactions in shares not included in this market portfolio are relatively infrequent, and their prices are not regularly quoted.

The yield of the telecommunications industry, which is used to calculate the beta for the discount calculation, was estimated on the basis of the portfolio used for calculation of AK&M's index for this industry. This consists of the shares of VolgaTelecom, Dalsvyaz, Rostelecom, North-West Telecom, Sibirtelecom, Uralsvyazinform, CenterTelecom and Southern Telecommunications Company.

For the purpose of the discount rate calculation, the annual yield of the market portfolio was analysed for the period from 1 January 2000 to 1 July 2003 (871 records). The Russian economy is insufficiently stable for a longer period to be used.

Because the stock market is influenced by so many different factors, when calculating the yield of the market portfolio a still shorter period was used, from 1 January 2001 to 1 July 2003 (621 records). These calculations produced a projected total yield for the overall market of 51%.

The projected industry yield, calculated using the CAPM, was 19%.

#### **Calculation of the market value of the Company's net worth**

On the basis of the estimated net cash flow and the calculated discount rate, a computation has been made of the present value of net cash flow in 2003–2013.

The calculation assumes that the Company receives its income and makes payments in the middle of each year. As at 1 July 2003, the discounted present value of net cash flow in 2003–2013 was calculated at R 28,204 million.

The calculation of the present residual value of the Company's net worth (shareholders' funds) is based on the assumption that the business will continue to produce income even after the end of the projected period (that is, after 2013). Calculation of the residual value is based on Gordon's Model of the permanent growth rate of net cash flow. In this model, the growth rate is assumed to be equal to the inflation rate. For this purpose, the calculation uses the forecasts of the RF Ministry for economic development and trade. The present residual value of the Company's net worth was calculated at R 25,015 million.

Using the discounted cash-flow valuation method, therefore, it was calculated that, as at 1 July 2003, the market value of a 100% holding of VolgaTelecom was R 53,219 million.

#### **Calculation of the market value of a 100% holding of VolgaTelecom by the discounted cash flow method on 1 July 2003**

	R million
Total discounted net cash flow for the forecast period	28,204
Present residual value of the business	25,015
Total shareholders' funds	53,219

Source: AVK calculations

### Market value of the company's net worth: The relative valuation method

The relative valuation method (guideline company method) analyses other companies in the industry that are similar to the Company, and then values the Company's shares by reference to those companies' share prices and financial ratios.

This method implies, first, the selection of comparable companies in the telecom industry to serve as a benchmark. The following criteria were used:

- the types of service provided and the earnings structure;
- the structure of the company's capital (total debt/equity);
- the liquidity of the company's shares, and a history of stock-market transactions in those shares;
- the size of the company (earnings, capacity and the like).

Next, financial multiples are selected for the purposes of comparison.

The benchmark companies selected for the comparison were telecom operators in eastern Europe (the Czech Republic, Hungary, Lithuania), Greece and Israel. These companies are comparable with VolgaTelecom on the basis of size, the structure of their revenues from different activities and their business efficiency.

#### Basic Indicators of VolgaTelecom and of the benchmark companies

	Market capitalisation, May 2003 (\$ million)	Sales, 2002 (\$ million)	Fixed telephone lines, May 2003 (000)	EBITDA, 2002 (\$ million)
Matav	3,964	2,289	2,882	950
Cesky Telecom	3,436	1,618	3,661	801
Lietuvos Telekom	275	264	936	137
Bezeq	2,898	1,739	3,006	763
VolgaTelecom	n/av	422	3,885	139

Source: Companies' annual reports, Reuters

Evaluating the degree of comparability of the benchmark companies for further comparison with VolgaTelecom was based on a computation of financial and other indicators and ratios which indicate the profitability and size of the companies, and comparing them with the Company's similar indicators and ratios. These are listed in the following table:

#### Comparison of indicators and ratios of the benchmark companies and VolgaTelecom

	VolgaTelecom	Matav	Cesky Tel	Lietuvos Telekom	Bezeq
EBITDA/total assets	0.22	0.20	0.15	0.24	0.22
EBITDA/sales	0.33	0.41	0.49	0.52	0.44
EBITDA/equity	0.33	0.41	0.22	0.37	0.54
Revenue per line (\$000)	0.11	0.79	0.44	0.28	0.58
Debt/equity	0.51	0.97	0.40	0.54	1.46
Telephone density in the region (%)	19.5	38.4	36.0	27.0	47.0

Source: AVK calculations

## Valuation

As the above table shows, the selected benchmark companies resemble VolgaTelecom to different degrees. A weighting was therefore assigned to each company to reflect the degree to which its indicators differed from those of VolgaTelecom, and was then applied in the calculation of the multiples used for the comparison. These weightings are shown in the first line of the following table.

The computation of value was based on two ratios: market capitalisation/EBITDA and market capitalisation/sales. The following table shows how the final multiples were derived from the weighted averages of those ratios.

### Computation of multiples for VolgaTelecom

	MataV	Cesky Telecom	Lietuvos Telekom	Bezeq	Weighted multiples
<b>Weighting (%)</b>	<b>25.0</b>	<b>24.0</b>	<b>30.0</b>	<b>21.0</b>	—
Market cap/EBITDA	4.17	4.29	2.00	3.80	3.47
Market cap/sales	1.73	2.12	1.04	1.67	1.6

Source: AVK calculations

In the following table we show how these multiples were applied to VolgaTelecom to derive a market value. In addition, an adjustment was made to reflect the relatively insignificant influence of small shareholders on the strategic and day-to-day management of a joint-stock company, as compared with that of a 100% owner. It is possible also to value objectively the amount of control conferred by different types of securities. Analysis of the Russian stock market shows that preference shares are valued 30-50% lower than the same company's ordinary shares. For the purposes of the present document, therefore, the valuation of a minority interest of one share of the Company has been discounted by 40% (based on the price of the Company's shares in the Russian Trade System). Consequently, a 'bonus' of 66.7% has been added to the valuation of the majority interest.

### Computation of market value of the net worth of VolgaTelecom

Ratio	Calculated multiple	Indicator to be multiplied (R million)	Capitalisation (indicator x multiple) (R million)	Bonus for the controlling (majority) interest (%)	Market value of net worth (R million)
Market cap/EBITDA	3.47	4,363	15,132	66.7	25,219
Market cap/sales	1.6	13,202	21,159	66.7	35,265

Source: AVK calculations

Finally, the values derived by the use of these different multiples were combined to give a valuation of shareholders' funds, as shown in the following table. The market cap/EBITDA ratio was given a weighting of 60%, and the market cap/sales ratio a weighting of 40%.

Thus, as at 1 July 2003 the market value of 100% holding of VolgaTelecom as calculated by the relative valuation method, was R 29,238 million.

## Calculation of market value of 100% holding of VolgaTelecom by the relative valuation method

	Market value (R million)	Weighting (%)
Value of net worth, calculated using market cap/EBITDA	25,219	60.0
Value of net worth, calculated using market cap/sales	35,265	40.0
Calculated market value of 100% holding of VolgaTelecom	29,238	—

Source: AVK calculations

## The market value of the company's net worth: The comparative transaction method

The comparative transaction method is used for companies whose shares are traded on a stock exchange.

The shares of VolgaTelecom are traded in the Russian stock market. The use of the comparative transaction method was based on the quoted prices of the Company's shares in the Russian Trade System (RTS). The following figure shows changes in the average weighted prices in trades since 2002.

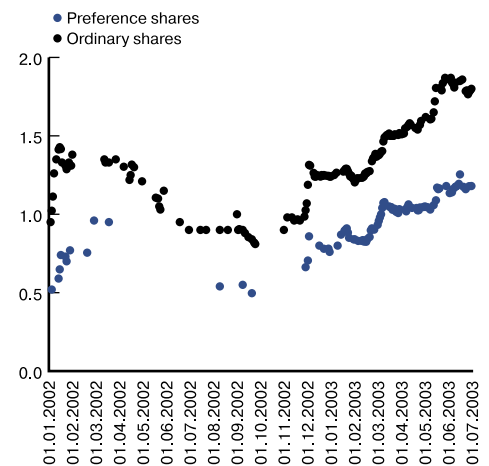
This calculation used the average weighted prices of one ordinary share (\$1.80, or R 54.69 at the Russian Central Bank's rate of exchange as at 1 July 2003), and one preference share (\$1.18 or R 35.85).

To value the Company's net worth, the price of one ordinary share, multiplied by the total number of ordinary shares in issue, was added to the price of one preference share, multiplied by the total number of preference shares in issue. That gave the calculation:

$$(R\ 54.69 \times 245,969,590) + (R\ 35.85 \times 81,983,404) = R\ 16,390\ \text{million.}$$

The resultant sum was adjusted for the 66.7% 'bonus' described above, to reflect the value of a controlling (majority) interest in the 100% holding as compared to a holding of one share.

After that adjustment, the market value of a 100% holding of VolgaTelecom, as calculated by the comparative transaction method, was R 27,317 million as at 1 July 2003.



Movements in the average weighted prices of VolgaTelecom's shares in the RTS (\$)

Source: Russian Trade System

## Calculation of the market value of 100% Holding of VolgaTelecom by the comparative transaction method on 1 July 2003

	Average weighted price per share (R)	Number of shares in issue	Total value (R million)
Ordinary shares	54.69	245,969,590	—
Preference shares	35.85	81,983,404	—
Total shares	—	—	16,390
Bonus for the majority holding (%)	—	—	66.7
Total market value of a 100% holding of VolgaTelecom	—	—	27,317

Source: the Company, AVK calculations

## Weighted reconciliation of the different methods of valuation

To summarise the results of these different methods of valuation, they were weighted by means of the hierarchy analysis method, the technique devised by the American scientist Thomas L. Saaty for giving numerical values to subjective assessments. In this case, the results of different valuation methods were compared using the following criteria: the comprehensiveness and reliability of the Company's accounts and internal reports (K1), the records of the Company's current financial position and start-up expenses (K2), the process of accounting for the Company's deferred income (K3), and (K4) specific influences over its valuation, such as market prices, legal restrictions, investment activity in the region, the competitive environment, the state of the industry and the prospects of development.

The selected criteria were assigned weights (see the first line of the following table) designed to reflect the degree of influence that they have on the accuracy of the final computation of the Company's market value.

Each of the methods of valuation was then assessed as to the degree to which it meets each of these criteria, and weighted as follows:

### Weightings of the methods based on different criteria

%	K1	K2	K3	K4
Criteria weightings	15.0	20.0	50.0	15.0
Discounted cash flow valuation method	46.0	46.0	59.0	58.0
Guideline company method	23.0	23.0	17.0	16.0
Comparative transaction method	31.0	31.0	24.0	26.0

Source: AVK calculations

The result of this calculation was the following weightings:

	%
Discounted cash flow valuation method	55.0
Relative valuation method	19.0
Comparative transaction method	26.0

### Calculation of the market value of VolgaTelecom's net worth

To derive a single market value from the three methods of valuation, the results that they produced were assigned the weightings calculated above.

#### Calculation of the market value of VolgaTelecom's net worth on 1 July 2003

	Value of shareholders' funds (R million)	Weighting (%)
Discounted cash flow valuation method	53,219	55.0
Relative valuation method	29,238	19.0
Comparative transaction method	27,317	26.0
Total	41,848	—

Source: AVK calculations

Thus, as at 1 July 2003, the estimated market value of VolgaTelecom's net worth was R 41,848 million.

### Calculation of the market value of the Company's shares

The received value of the Company is the value of 100% possession of the Company.

Of VolgaTelecom's share capital, some 75% consists of ordinary shares and 25% of preference shares.

Analysis of the quoted market prices of the Company's shares in the Russian Trade System shows that the price of the preference shares around the valuation date was approximately 67% of the price of the ordinary shares.

The market value of the Company's shareholders' funds is equal to the sum of the values of all the ordinary and preference shares. Thus,  $P_{ord} \times 245,969,590 + P_{pref} \times 81,983,404 = R\ 41,848$  million, meaning that the value of all ordinary shares is R 34,176 million, and the value of all preference shares is R 7,673 million.

The values of the shares are adjusted to reflect the insignificant amount of control exercised by individual shareholders as compared with a 100% shareholder. As above, this adjustment was set at 40%.

#### Calculation of the market value of VolgaTelecom's shares on 1 July 2003

		All shares	Ordinary shares	Preference shares
Value of shareholders' funds (R million)	—	41,848	34,175	7,673
Adjustment for minority interest (%)	40	—	—	—
Calculated market value per share (R)	—	—	83.365	56.154
CBR rate of exchange on 1 July 2003 (R/\$)	30.3809	—	—	—
Market value per share (\$)	—	—	2.7440	1.8483

Source: AVK calculations

By this calculation, as at 1 July 2003 the market value of the net worth of one ordinary share was R 83.365 (\$2.7440 at the CBR rate of exchange), and of one preference share it was R 56.154 (\$1.8483).

### Valuation





# IAS financial reports of the Company

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**Annex 1.**

# Independent auditors' report

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## To the shareholders and board of directors of VolgaTelecom:

**1.** We have audited the accompanying consolidated balance sheet of VolgaTelecom (a Russian open joint-stock company – hereinafter «the Company»), as at 31 December 2002, and the related statements of operations, cash flows and shareholders' equity for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

**2.** Except as discussed in paragraph 4, we conducted our audit in accordance with International Standards on Auditing issued by the International Federation of Accountants. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

**3.** The Company has not presented comparative amounts for the year ended 31 December 2001 as required by International Accounting Standard (IAS) 1, *Presentation of Financial Statements*.

**4.** The Company has not determined and presented its assets and obligations existing under defined benefits plans in accordance with IAS) 19, *Employee Benefits*. We were not able to quantify the adjustments, if any, to the financial statements.

**5.** The Company's accounting records relating to fixed assets are not designed to support their presentation in accordance with IAS 16, *Property, Plant and Equipment*, IAS 29, *Financial Reporting in Hyperinflationary Economies* and IAS 36, *Impairment of Assets*. As such, certain estimates were made by management to present fixed assets in the accompanying consolidated financial statements. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to the adjustments, if any, which might have been determined to be necessary had additional evidence been available to permit a better analysis of the assumptions and estimates made by management.

**6.** As a result of the matters described in paragraphs 3 and 4 above, adjustments, if any, could materially affect (i) property, plant and equipment, equipment contributions, assets and liabilities existing under benefits plans, deferred income tax liabilities and retained earnings as at 31 December 2002 (ii) depreciation expense, other benefits expense, income tax expense and net income for the year ended 31 December 2002 and (iii) related disclosures.

**7.** In our opinion, except for the effects on the consolidated financial statements of such adjustments, if any, resulting from the matters referred to in paragraphs 3 and 4 above, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of VolgaTelecom as at 31 December 2002, and the results of its operations and its cash flows for the year then ended in conformity with International Financial Reporting Standards.

**8.** The Company was the subject of a reorganisation that was approved by the shareholders on 9 November 2001. The Company has accounted for the merger on the principles of uniting of interests as described in IAS 22, *Business Combinations*. In applying this method, the Company has reflected amounts in the consolidated financial statements as if the entities had been combined from 1 January 2002, the beginning of the period presented.

31 July 2003

# Consolidated balance sheet

## statement for the year ended 31 December 2002

(in thousands of roubles expressed in the purchasing power of the rouble at 31 December 2002)

R 000	31 December 2002
<b>Assets</b>	
<b>Non-current assets</b>	
Property, plant and equipment, net	17,325,235
Intangible assets, net	37,209
Investments in associates	104,837
Other investments	73,218
Advances to suppliers of equipment	117,948
Total non-current assets	17,658,447
<b>Current assets</b>	
Inventories, net	467,619
Trade accounts receivable, net	744,250
Other current assets	1,065,877
Cash and cash equivalents	214,863
Total current assets	2,492,609
<b>Total assets</b>	<b>20,151,056</b>
<b>Shareholders' equity and liabilities</b>	
<b>Shareholders' equity</b>	
Share capital, preference shares	409,917
Share capital, ordinary shares	1,229,848
The effect of inflation on share capital	2,213,925
Retained earnings and other reserves	9,241,606
Total shareholders' equity	13,095,296
Minority interest	342,039
<b>Non-current liabilities</b>	
Long-term borrowings	751,887
Deferred tax liability	1,544,322
Finance lease obligations	222,846
Equipment contributions	129,781
Total non-current liabilities	2,648,836
<b>Current liabilities</b>	
Accounts payable and accrued liabilities	1,637,339
Taxes and payroll-related obligations	697,765
Accounts payable to Rostelecom	95,398
Dividends payable	58,857
Current portion of long-term debt	489,100
Short-term borrowings	893,372
Current portion of finance lease obligations	193,054
Total current liabilities	4,064,885
<b>Total liabilities and shareholders' equity</b>	<b>20,151,056</b>

# Consolidated profit and loss

## statement for the year ended 31 December 2002

(in thousands of roubles expressed in the purchasing power of the rouble at 31 December 2002)

R 000	2002
<b>Revenues</b>	<b>13,202,423</b>
<b>Operating expenses</b>	
Wages, salaries, other benefits, expenses and payroll taxes	(4,137,379)
Interconnection charges	(1,497,269)
Materials, repairs and maintenance, utilities	(1,414,897)
Taxes other than on income	(394,353)
Depreciation and amortisation	(1,907,645)
Losses on disposal of property, plant and equipment	(119,633)
Bad debt expenses	(194,984)
Other operating expenses	(1,232,768)
<b>Total operating expenses</b>	<b>(10,898,928)</b>
<b>Income from operations</b>	<b>2,303,495</b>
Income from associates, net	35,487
Interest expenses and similar items, net	(186,915)
Losses from other investments, net	(12,937)
Other income, net	121,446
Foreign exchange losses, net	(237,454)
Net monetary gains	244,959
<b>Income before taxation and minority interest</b>	<b>2,268,081</b>
<b>Income tax expenses</b>	<b>(1,184,279)</b>
<b>Net income before minority interest</b>	<b>1,083,802</b>
<b>Minority interest</b>	<b>(168,754)</b>
<b>Net income</b>	<b>915,048</b>
<b>Dividends on preference shares</b>	<b>(71,633)</b>
<b>Net income available to ordinary shareholders</b>	<b>843,415</b>
<b>Basic and diluted earnings per share (R)</b>	<b>3.43</b>

# Consolidated statement of cash flows for the year ended 31 December 2002

(in thousands of roubles expressed in the purchasing power of the rouble at 31 December 2002)

R 000	2002
<b>Cash flows from operating activities</b>	
Income before taxation and minority interest	2,268,081
Adjustments for:	
Foreign exchange losses, net	237,454
Net monetary gains	(244,959)
Depreciation and amortisation	1,907,645
Losses on disposal of property, plant and equipment	119,633
Income from associates	(35,487)
Losses from other investments, net	12,937
Interest expenses and similar items, net	186,915
Bad debt expenses	194,984
<b>Operating profits before changes in working capital</b>	<b>4,647,203</b>
Decrease in accounts receivable	102,047
Increase in inventory	(83,282)
Increase in other current assets	(644,902)
Increase in accounts payable and accrued liabilities	781,802
<b>Net cash generated from operations</b>	<b>4,802,868</b>
Interest paid	(231,347)
Income tax paid	(620,901)
<b>Net cash provided by operating activities</b>	<b>3,950,620</b>
<b>Cash flows from investing activities</b>	
Purchases of property, plant and equipment	(4,008,029)
Purchases of investments and other non-current assets	(15,034)
Proceeds of disposal of property, plant and equipment	561,236
Interest received	3,564
<b>Net cash used in investing activities</b>	<b>(3,458,263)</b>
<b>Cash flows from financing activities</b>	
Proceeds of loans and borrowings	2,141,372
Repayments of loans and borrowings	(2,303,342)
Dividends paid	(117,345)
<b>Net cash used in financing activities</b>	<b>(279,315)</b>
<b>Monetary effects on cash and cash equivalents</b>	<b>(63,077)</b>
<b>Effects of changes in exchange rates on cash and cash equivalents</b>	<b>(147,566)</b>
<b>Decrease in cash and cash equivalents</b>	<b>2,399</b>
<b>Cash and cash equivalents at the start of the year</b>	<b>212,464</b>
<b>Cash and cash equivalents at the year-end</b>	<b>214,863</b>
<b>Non-monetary transactions</b>	
Equipment contributions	34,682

# Consolidated statement of shareholders' equity for the year ended 31 December 2002

(in thousands of roubles expressed in the purchasing power of the rouble at 31 December 2002)

	Share capital (nominal)				Effect of inflation on share capital R 000	Retained earnings and other reserves R 000	Total R 000
	Preference shares par value R 5		Ordinary shares par value R 5				
	Shares	R 000	Shares	R 000			
Balance as at 31 December 2001	81,983,404	409,917	245,969,590	1,229,848	2,213,925	8,484,671	12,338,361
<b>Net income</b>	—	—	—	—	—	<b>915,048</b>	<b>915,048</b>
<b>Dividends</b>	—	—	—	—	—	<b>(158,113)</b>	<b>(158,113)</b>
<b>Balance as at 31 December 2002</b>	<b>81,983,404</b>	<b>409,917</b>	<b>245,969,590</b>	<b>1,229,848</b>	<b>2,213,925</b>	<b>9,241,606</b>	<b>13,095,296</b>

# Contacts

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**Annex 2.**

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