





---

## Disclaimer

*This Memorandum was prepared by the specialists of AVK-Securities & Finance Ltd., hereinafter referred to as «AVK», on the basis of information provided by OJSC «North-West Telecom», hereinafter referred to «the Company», and of information obtained from the sources specified herein. AVK does not make any representation or warranty as to the accuracy and completeness of this information.*

*This Memorandum, hereinafter referred to as «the Memorandum», makes available information on the preliminary results of the Company's reorganisation, and on the Company's activities and financial standing. The Memorandum is not an official record of the Company, and is prepared for information purposes only.*

*All financial and operational results of the Company's activity contained in the Memorandum are presented as at 1 July 2003, unless stated otherwise. The valuations given herein of the Company's shares are given as at 1 July 2003.*

*All the information in this Memorandum is provided «as is». The Memorandum is not subject to any guarantee that it will remain accurate or complete, or that it will be current at any given date after publication.*

*This Memorandum is not to be construed as a recommendation or as an offer to buy or sell the Company's securities in any location or jurisdiction where such a recommendation is illegal. The fact that AVK or the Company has published this Memorandum does not constitute an offer or a solicitation of an offer to participate in any particular transaction in the Company's securities. The publication of this Memorandum is not to be viewed as an offer of financial services by the Company or by AVK in any country, state or jurisdiction where such services are illegal.*

*Investments in the Company's securities, including its ADRs, entail risk. The description of risks is given in the section «Risk Factors» in this Memorandum.*

*Neither the US Securities and Exchange Commission, nor any other country's or state's securities commission, nor any other regulatory authority, has expressed its approval or disapproval of the Company's ADR programme, nor expressed its opinion on the accuracy or completeness of the information provided herein. Any statement to the contrary shall be viewed as a criminal offence.*

*This Memorandum is not aimed at the specific investment purposes of any particular user of this Memorandum. Investors are urged to consult their own professional advisers before taking action on the basis of information on securities appearing herein. Should an investment be denominated in a currency other than the investor's domestic currency, fluctuations in the currency exchange rate may have a negative effect on the income from that investment.*

*AVK shall not be liable for any direct or indirect loss arising in any way from an investment decision based on the information provided herein or from any other use of this Memorandum.*

*It is prohibited to duplicate, distribute, forward, publish or use the contents of this Memorandum without the prior written consent of the Company, except in respect of information that can be obtained from public sources.*

# Contents

---

<b>SUMMARY</b>	<b>7</b>
<hr/>	
<b>RISKS</b>	<b>15</b>
<hr/>	
Country risks	16
Company-specific risks	17
Financial risks	18
Sector risks	19
Stock-market risks	21
Risks associated with the accuracy of information and forecasts	22
<b>THE TELECOMMUNICATIONS SECTOR</b>	<b>23</b>
<hr/>	
History of the sector	24
Sector results: 2002 and the first half of 2003	27
The market	33
<b>THE REORGANISATION OF THE SVYAZINVEST OPERATORS</b>	<b>37</b>
<hr/>	
Reorganisation of Svyazinvest	38
Consolidation of operators	40
<b>THE COMPANY'S FINANCIAL AND OPERATING RESULTS</b>	<b>45</b>
<hr/>	
History of the Company	46
Strategy	52
Competitive strengths and weaknesses	56
Services	58
Services and customers	61
Principal competitors	65
Personnel	68
Organisation	70
Subsidiaries	74
Telecommunications equipment	76
Operating performance	79
Financial results	83

---

<b>SHARE CAPITAL AND CORPORATE MANAGEMENT</b>	<b>95</b>
Capital structure	96
Shareholders' rights	98
Dividend policy	100
ADRs	102
Governing bodies	104
Decisions that affect the Company's financial position	107
The work of the board	109
Members of the board and board of management	111
<b>LEGAL AND TAX ISSUES</b>	<b>115</b>
Telecommunications regulation	116
Taxation of non-residents	119
Accounting rules and procedures	121
Legal issues	125
Litigation	126
<b>THE INVESTMENT CASE</b>	<b>127</b>
Company comparisons	128
Valuation	132
<b>ANNEX 1. IAS FINANCIAL REPORTS OF THE COMPANY</b>	<b>145</b>
Independent auditors' report	146
Consolidated balance sheet as at 31 December 2002	147
Consolidated statement of operations for the year ended 31 December 2002	148
Consolidated statement of cash flows for the year ended 31 December 2002	149
Consolidated statement of shareholders' equity for the year ended 31 December 2002	150
Notes to the consolidated financial statements	151
<b>ANNEX 2. CONTACTS</b>	<b>179</b>

---



# Summary

---

The open joint stock company North-West Telecom (N. W. Telecom) is universal service operator in the North-Western Federal District (NWFD). Until 2002, it was a provider of services in the St Petersburg area under the name Peterburgskaya Telephonnaya Set. In 2002, it was renamed North-West Telecom, and merged with a number of smaller telecommunications operators in the NWFD, which thereby became its regional branches. This made it one of the largest fixed-line communications operators in Russia.

Two other communications companies in the NWFD, Komi Republic Svyaz and Lensvyaz (in the Republic of Komi and the Leningrad region) are not part of N. W. Telecom, but will be incorporated into it in 2004.

The territory covered by North-West Telecom is a relatively small part of Russia, but it is located in the European part of the country. It borders the Baltic countries and Scandinavia, and contains many cities, including the second largest in Russia, St Petersburg. The primary features of the area are that it has the highest level of urbanisation of any of the federal districts, a very diversified economy, several seaports and a well developed road network.

More than 11% by volume of Russia's industrial output is produced in the NWFD. There is economic growth in all the regions of the north-west, with a number of industries developing faster than in other regions, such as shipbuilding, complex and precision engineering and instrument-making. The food, forestry, wood-processing, paper and pulp industries and ferrous metallurgy are also being developed.

Economic conditions in the district favour the development of the telecommunications business. Other telecommunications operators are also finding NWFD a very promising region for their business prospects, and are competing with North-West Telecom.

The Company provides a wide range of telecommunications services to residential and corporate customers. Its focus is on overall demand, while at the same time it is also developing 'VIP services'. In addition to traditional telephony, it also provides switched and dedicated internet access services, and enquiry services.

#### Structure of revenues from North-West Telecom's main communications services, 2002

%	2002
Local communications	48.0
Inter-urban and international communications	45.3
Telegraph services	1.8
Wireline broadcasting	1.4
New telecommunications services	2.5
Other	1.0
Total	100.0

Source: the Company

N. W. Telecom main services are local, inter-urban and international communications. It has 3.4 million subscribers, mostly living in cities and more than half of them in St Petersburg.



**Network statistics**

	2002
Line capacity (UTN and RTN <sup>1</sup> ) (000)	3,612.3
Operational capacity (UTN and RTN) (000)	3,399.0
Level of digitisation (UTN) (%)	39.0
Level of digitisation (RTN) (%)	8.5

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

Source: Svyazinvest

For its long-distance communications services, N. W. Telecom uses the telecommunications channels of Rostelecom.

**Growth of North-West Telecom's traffic**

	2002	1st half of 2003
Inter-urban communication (millions of minutes)	1,082.8	584.7
International communication (millions of minutes)	145.9	79.3
Growth in the number of new subscribers (%)	4.5	1.1

Source: Svyazinvest

North-West Telecom owns the switched capacity, network infrastructure and priority of access to the end-user in the North-Western Federal District. Under Russian legislation, as the 'natural monopolist' in the local telecommunications industry, the Company is subject to the control of the RF Ministry for Anti-Monopoly Policy and Support of Business.

**Development of North-West Telecom's network within its territory**

	2003 <sup>1</sup>
Growth in the length of inter-urban channels (000 kilometres)	
All channels	206.1
Channels using digital transmission systems	204.6

<sup>1</sup> Preliminary data.

Source: the Company

The telecommunications market of the North-Western Federal District is characterised by intense competition. However, the Company has a 40% share by volume of the services provided in the region. St Petersburg, on the other hand, has more 'alternative' telecommunications operators than any other city in the region, and, as a result, N. W. Telecom St Petersburg subsidiary controls only 20% of the city telecommunications market.

The Company's largest market share is in local and inter-urban fixed line communications. Its position in this market segment is fairly stable throughout its territory. There is still considerable unsatisfied demand for new telephone installations: stimulated in St Petersburg by the large volume of residential and industrial construction in the city, and in the rest of the district by relatively low levels of telephone penetration. As at 1 December 2003, there were around 250,000 outstanding requests for telephone installations, or 7% of the Company's subscriber base.

**Summary**

The Company's major competitors are mobile communications operators, because of the rapid development of the mobile communications networks and high demand for the services provided by these operators. However, North-West Telecom's tariffs are lower than those of the other mobile operators, resulting in high demand for the Company's services.

Internet access is the one of the main areas of competition in the telecommunications market. In 2002, management estimates, the Company's share in the provision of switched Internet access was 40%.

North-West Telecom's main competitive advantages compared with the alternative operators are its reasonable tariffs for traditional services, its well developed network infrastructure and an ability to provide additional services using existing equipment. The alternative operators are providing a better customer service, but the Company is taking active steps to improve its services in this respect.

## **Finance**

The Company was formed in 2002 as a result of the reorganisation of nine telecommunications operators of the North-Western Federal District, when North-West Telecom merged with nine other joint-stock companies (regional telecom operators). IAS financial statements are therefore available only for 2002. Financial statements for the first six months of 2003 have been drawn up by AVK under International Financial Reporting Standards (IAS), using estimates and forecasts based on data received from the Company.

## **Company strategy**

The Company's development strategy is to provide quality telecommunications services for domestic, government and commercial users in the North-Western Federal District by developing the telecommunications infrastructure, improving the quality of service and introducing modern technologies.

To achieve these strategic goals, management is working in several directions, which include the expansion and modernisation of the existing telephone network, construction of a multi-service network, and the development of IP telephony and internet access services.

The aim of the strategy is to expand the subscriber base by 13% between 2002 and 2008. In addition to its technological goals, management is aiming to improve its customer service. To this end, it is working on segmentation of its subscriber base and carrying out marketing research. The Company's subsidiaries will then be reorganised into a structure based on the subscriber groups and services identified by the research. The decision to concentrate the Company's efforts on this plan was made after the reorganisation of North-West Telecom in 2002. The Company's technological development plans and investment projects will also be guided by this market research.

In support of this strategy, the Company is optimising its organisational structure. This reorganisation is aimed at building a unified management structure, eliminating the duplication of functions and concentrating management in the Company's central administration. During 2003, special attention was also paid to the optimisation of business processes, which makes it the leading Svyazinvest operator in this respect.

The Company has set the following goals for 2004–2008:

- to maintain average annual growth in revenue of at least 14%;
- to ensure that its share of the NWFD telecommunications market does not fall below 30%;
- to ensure that long-distance communications contributes at least 37% of the revenue from fixed-line communications, and at least 34% of total revenue;
- to increase to 51% the proportion of revenue derived from services provided for the business sector;
- to complete its consolidation of Lensvyaz and Komi Republic Svyaz;
- to strengthen its position in the most attractive and lucrative parts of the NWFD: St Petersburg, the Murmansk, Archangel, Kaliningrad and Leningrad regions, and the Republic of Karelia.

**Condensed balance sheet, IAS**

<b>R million</b>	<b>2002</b>	<b>1st half of 2003*</b>
<b>Assets</b>		
<b>Non-current assets</b>		
Property, plant and equipment	16,332.7	15,374.5
Other	1,074.0	192.0
<b>Current assets</b>		
Inventories, net	225.9	589.4
Accounts receivable, net	999.9	1,664.8
Other current assets	681.3	898.0
Cash and cash equivalents	347.2	353.5
<b>Total assets</b>	<b>19,661.0</b>	<b>19,072.0</b>
<b>Equity and liabilities</b>		
<b>Shareholders' equity</b>		
Share capital	937.9	937.9
Retained earnings and other provisions	12,707.0	13,024.0
<b>Minority interest</b>	<b>6.7</b>	<b>0.0</b>
<b>Non-current liabilities</b>		
Borrowings	1,258.0	214.5
Other non-current liabilities	1,644.9	742.6
<b>Current liabilities</b>		
Payables and accrued liabilities	1,924	2,860.5
Borrowings	1,132.6	1,140.4
Other current liabilities	50.6	153.0
<b>Total equity and liabilities</b>	<b>19,661.0</b>	<b>19,072.0</b>

\* AVK estimates.

Source: the Company

**Condensed profit and loss statement, IAS**

<b>R million</b>	<b>2002</b>	<b>1st half of 2003*</b>
<b>Revenues</b>	<b>10,790.6</b>	<b>5,651.3</b>
<b>Operating income</b>	<b>1,188.4</b>	<b>851.7</b>
Depreciation expenses, net	1,737.0	1,006.0
Other expenses and income, net	(342.0)	(49.0)
<b>Profit before tax</b>	<b>846.2</b>	<b>802.6</b>
<b>Net profit</b>	<b>482.9</b>	<b>592.2</b>

\* AVK estimates.

Source: the Company

**Summary**

### Consolidation of companies

The NWFD's telecommunications reorganisation took place in 2000–2002, when the operators of the Archangel, Murmansk, Vologda, Novgorod, Pskov, Kaliningrad and Karelia regions and of the city of Cherepovets were merged with the Company.

The merged operators enjoy a number of advantages in the execution of their financial plans, investment, technical policy and creditworthiness, and they are more attractive to investors than smaller organisations. The merger reduced the risks associated with operating in certain districts of the RF, allowed for the consolidation of financial cash flows and permitted the implementation of projects which would have been too expensive for small operators to finance. Standard & Poor's has raised the Company's international credit rating from CCC/Stable to B-/Stable.

The merged operators have also been able to take advantage of each other's experience. The structure of the subsidiaries has been reorganised, the management system has been unified and a budget system has been introduced. All the subsidiaries' business processes have been analysed, helping management to decide how they can be improved.

North-West Telecom's market indicators have changed considerably since the merger. During the reorganisation process, between September 2000 and February 2003, the liquidity of the shares increased considerably. The spread between the bid and offer prices of the ordinary shares narrowed from 54% to 8%.

### Company securities

#### The share capital of North-West Telecom on 1 July 2003

	Number of shares issued	Nominal value per share R	Total nominal value R	%
Ordinary shares	735,917,222	1.00	735,917,222	78.46
Type A preference shares	202,022,788	1.00	202,022,788	21.54
Total	937,940,010		937,940,010	100.00

Source: the Company

The table above shows the number of shares issued by North-West Telecom. The Company's charter allows it to issue a further 36,517 ordinary shares and 64,605 type A preference shares, all at a nominal value of R 1.00.

The first issue of Company's securities was registered on 31 May 1993, during the reorganisation of the state enterprise Rossvyazinform into a joint-stock company.

The most recent issues were carried out as part of the reorganisation and merger of ten telecommunication operators of the North-Western Federal District.

**The largest shareholders in North-West Telecom on 31 December 2004**

Name	Status	Holding		%
		Ordinary shares	Type A preference shares	
OJSC Investment Company for Telecommunications (OJSC Svyazinvest)	Holder	374,172,243	0	39.893
Brunswick UBS Warburg Nominees	Nominee	139,809,692	35,490,242	18.690
Depository Clearing Company (Depozitarno-kliringovaya kompaniya)	Nominee	65,064,077	29,436,092	10.075
Lindsell Enterprises Limited	Holder	50,363,027	21,291,645	7.640

Source: the Company

Since September 1995, the Company's shares have been traded on RTS under the following ticker symbols:

SPTL – North-West Telecom ordinary shares  
SPTLP – North-West Telecom preference shares

The Company shares also trade on the St Petersburg Stock Exchange, in the corporate stock section of the St Petersburg Currency Exchange and on the Moscow Interbank Currency Exchange (MICEX).

In September 2001 the Company registered its Level 1 ADR programme. Each ADR represents 50 ordinary shares. The total number of ADR is 50,000,000. J P Morgan was chosen to be the depository bank for the programme, and Clifford Chance Punder as the legal consultant.

As well as its shares, two issues of the Company's bonds are traded on stock exchanges. The first issue was registered in March 2002, with a total nominal value of R 300 million and a maturity period of two years. This issue is traded in the Russian Trade System (RTS) and on MICEX, and on the over-the-counter market. The second issue was registered in July 2003 with a total nominal value of R 1.5 billion and a maturity period of four years. It is traded on MICEX and the over-the-counter market.



# Risks

---

# Country risks

---

## Socio-political 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.

**High levels of crime and corruption increase the risks of doing business in Russia.** The political and economic changes of recent years have led to a breakdown in the normal functioning of all branches of authority. Bribing officials is widespread, and criminality is high, especially in major cities.

**There is a danger of terrorist acts on Russian territory,** despite the acceptance in Chechnya of the proposed constitution and the steps towards a peaceful solution of the problems of the region. World events in the last few years have shown how destructive terrorist attacks can be.

## 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 unwilling to do so.

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

---

**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 North-West Federal District, was completed only in October 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 the AVK company 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

---

**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. In addition, the large number of categories of concessionary users could reduce the Company's profitability.

**Inflation could increase the Company's expenditure and lower its profitability.** For the last few years, the Russian economy has experienced high inflation — 18.6% in 2001, and falling to a still high 15.1% in 2002. According to figures available so far, the federal government is planning to hold inflation at 12% in 2003. Some of the Company's costs, such as the level of wages, depends on the growth in the general level of prices in Russia. The Company therefore cannot always raise tariffs in line with the increase in expenditure on certain items. High inflation could increase the Company's outlays and reduce its profitability.

**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. 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.

**Should the Company be unable to attract sufficient capital, it would be forced to reduce its investment projects and operational activity, and this could have a negative effect on the Company's operational performance and lead to losing a share of the market.** The Company must make considerable investment in modernising and reconstructing the network equipment. The realisation of the investment projects depends to a large extent on the Company's ability to attract additional capital. One means of financing investment projects is a bonded loan. Should rates on the Russian bonded loan market begin to rise sharply, the Company would not be able to complete its investment projects, thus lowering its competitiveness. In addition, as a result of these causes the Company could lower its profitability and raise significantly the costs of servicing the loan.

**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

---

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.

**Risk of sector legislation.** 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 telecommunication», 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.

**Licensing risks.** 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 RF 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 telecommunication» 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 telecommunication» 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

---

**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 Procedure for taking decisions having a major effect on 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

---

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

---

# 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 RF 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 RF 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 Rossvyazinform. 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;
- Elektrosvyaz of Rostov region, Rostov-on-Don Telegraph;
- Elektrosvyaz 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, Siberian 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 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
<b>Total</b>	<b>127,911.5</b>	<b>27.49</b>	<b>82,482.5</b>	<b>39.1</b>
<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 RF 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 communication 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 (56 kilometres), Tomsk-Molchanovo (664 kilometres), Ekaterinburg-Berezovskiy (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.** SIBERIAN  
Federal District

**7.** FAR-EASTERN  
Federal District

Branches of North-West Telecom (N. W. Telecom) are located in the following areas of the North-Western Federal District (NWFD): Republic of Karelia, the Archangel (including the Nenets Autonomous District), Vologda, Kaliningrad, Murmansk, Novgorod and Pskov regions, and St Petersburg. The communications companies of the Republic of Komi and Leningrad regions are at present not part of N. W. Telecom, but will be included in 2004.

The NWFD is the fourth largest federal district in Russia, with a surface area of 1.676 million sq. km. (9.8% of the territory of the RF). The population of the district at the start of 2002 was 14.29 million (9.9% of the population of Russia). Of this, 81.8% of the population of the NWFD live in towns: this is the highest level of urbanisation in the federal districts. The NWFD occupies fourth place among the federal districts for density of population (8.52 per sq. km.).

**General statistics of the North-West Telecom regions.**

	major towns	territory of the region in 1000 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
Republic of Karelia	Petrozavodsk (pop. 285,300)	172.4	0.76	4.4	74	16,225
Archangel region	Archangel (357,000) Severodvinsk (231,300)	587.4	1.43	2.4	75	20,606
Vologda region	Vologda (296,300) Cherepovets (322,700)	145.7	1.3	8.9	68	24,177
Kaliningrad region	Kaliningrad (418,200)	15.1	0.94	62.5	77	30,014
Murmansk region	Murmansk (366,200)	144.9	0.98	6.7	92	17,208
Novgorod region	Velikiy Novgorod (225,000)	55.3	0.71	12.9	71	12,881
Pskov region	Pskov (198,600) Velikiye Luki (114,100)	55.3	0.78	14.1	67	14,916
St Petersburg		n/av	4.59	n/av	100	247,372
<b>Total</b>		<b>1,176.1</b>	<b>11.45</b>	<b>9.7</b>	<b>85</b>	<b>383,399</b>

Source: RF state committee for Statistics

The economy of the north west specialises in:

- high-specification, complex and precision engineering and instrument making,
- shipbuilding
- ferrous and non-ferrous metallurgy (the metallurgy industry of the NWFD comprises 75% non-ferrous metallurgy companies and 25% ferrous metallurgy companies)
- forestry, wood-processing and paper and pulp industries
- chemical industry (the production of complex mineral fertilisers, plastics, household chemicals, etc.)
- energy supplies

Economic growth has been noted since 1999 in all the regions of the north west. The share of the NWFD's total gross regional product in Russia's GDP reaches 10%. More than 11% of the overall volume of Russia's industrial output is produced in this region.

**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
North-Western Federal District	123.0	103.0	116.4	11.7

Source: RF state committee for Statistics

- In the future the North-Western Federal District will retain its significance as the largest supplier in European Russia of energy and mineral resources, and products of the metallurgical, chemical, forestry, wood-processing and paper and pulp industries, and engineering products.

The standard of living of the population of the NWFD is equal to the average for Russia. According to the figures for 2002, the NWFD was in fourth place among the Russian federal districts for level of per capita income, and in second place for level of expenditure. A specific feature of the NWFD is the wide variation between the regions in the indicators for per capita income/expenditure and GRP:

- In 2002 the Murmansk region was in seventh place in Russia for level of per capita GRP; the Pskov region was in sixty-first place.
- Last year the average income of the population of the Murmansk region was R 5,410 per month, and for St Petersburg R 4,480, whereas the average income of the population of the Kaliningrad region was R 2,630 per month, and for the Pskov region R 2,350.

#### Standard of living of the population in the North-West Telecom regions.

	per capita volume of GRP, 1000 roubles	position of the region in the RF	average per capita income, 1000 roubles/month			average per capita expenditure, 1000 roubles/month		
			2000	2001	2002	2000	2001	2002
Russian Federation	43.3	—	2.28	3.06	3.89	2.22	3.00	2.83
North-Western Federal District	42.5	4 among FDs	2.24	3.02	3.85	2.09	2.84	2.72
Republic of Karelia	37.3	22	2.22	2.80	3.81	1.71	2.30	2.38
Archangel region (incl. Nenets AD)	40.3	18	2.03	2.88	3.63	1.58	2.37	2.19
Vologda region	51.9	11	1.98	2.64	3.37	1.62	2.23	1.92
Kaliningrad region	27.6	42	1.95	2.14	2.63	2.07	2.20	2.31
Murmansk region	59.7	7	3.39	4.38	5.41	2.65	3.52	3.36
Novgorod region	28.9	36	1.78	2.37	2.90	1.59	2.13	2.03
Pskov region	21.5	61	1.36	1.74	2.35	1.24	1.62	1.73
<b>St Petersburg</b>	<b>43.9</b>	<b>16</b>	<b>2.58</b>	<b>3.47</b>	<b>4.48</b>	<b>2.82</b>	<b>3.78</b>	<b>3.61</b>

Source: RF state committee for Statistics

In 2002 the NWFD was in fourth place among the federal districts for volume of investment into the fixed capital. Investments were spread unevenly: more than a third of the total inward investment fell to St Petersburg. A similar situation occurred with foreign currency investments in the NWFD: more than half of their total volume belongs to St Petersburg, and 17% to the Archangel region (in particular to the Nenets AD, where gas and oil fields are being exploited).

According to State committee for statistics data, there are 197 large and medium-sized communications companies operating in the area covered by North-West Telecom (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 them was R 31,788 million (11% of the figure for the RF), and this included R 29,688 million of telecommunications services. According to the figures for 2002, North-West Telecom's share is calculated at 34% of the overall market for telecommunications services in the North-Western Federal District. The Company's low share in the market is explained by the high level of competition among the communications operators in St Petersburg.

In comparison with 2001, in 2002 the volume of communications services in the territory of the federal district grew by 44.1%; however, the Company's share of the market dropped by 5% (from 39% in 2001 to 34% in 2002).

The main volume of telecommunications services in the North-Western Federal District occurs in St Petersburg (72.36% of the total communications services in the district). In 2002 the share of services provided in St Petersburg increased by only 4%.

# The reorganisation of the Svyazinvest operators

---

# Reorganisation of Svyazinvest

---

## **The aims of the reorganisation**

The plan for the reorganisation of the Russian telecommunications industry was first introduced in 2000, in a 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 of telecommunications and information technology, the Russian Privatisation Centre and the open joint-stock company 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 (%)	1,000.0	3.8
Number of operators whose shares have a bid-offer spread of less than 50%	33	26

<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: RTS (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 \$150–1570 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 European operators.

# Consolidation of operators

The reorganisation of all the telecommunications operators in the North-Western Federal District resulted in a merger centred on St Petersburg Telecommunications (telecommunications company of St Petersburg). The first stage of this process took place in 2002, when St Petersburg MMT and St Petersburg Telegraph were merged with St Petersburg Telecommunications. In the second stage, eight operators in the North-Western Federal District were merged with St Petersburg Telecommunications.

## Key statistics of telecommunications operators in the North-Western Federal District, on 1 January 2001

Operator	Telephone density**	Total capacity (000 lines)	Revenues* (R million)	Assets* (R million)	Market capitalisation (\$ million)
St Petersburg Telecommunications	38.20	1,907	1,581.2	7,685.3	130.5
Electrosvyaz of Pskov region	21.20	141	261.5	505.0	9.1
Novgorodtelecom	20.81	157	280.8	358.7	5.1
Cherepovetselectrosvyaz	29.25	96	191.3	265.5	4.5
Electrosvyaz of the Republic of Karelia	23.02	193	346.6	727.2	7.4
Electrosvyaz of Vologda region	17.04	186	320.4	499.1	2.7
Electrosvyaz of Kaliningrad Region	16.05	157	482.0	593.3	2.5
Artelecom of Archangel Region	18.54	303	558.2	1,155.0	16.4
Murmanelectrosvyaz	24.40	240	680.8	1,435.8	12.0

\* according to Russian accounting standards.

\*\* fixed lines number per 100 persons.

Source: Svyazinvest, Russian Trade System

The consolidation process started in October 2000, when the managements of the companies developed 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 selection criteria.

The institution chosen was Renaissance Capital<sup>1</sup>, which had earlier taken part in the reorganisation of St Petersburg Telecommunications with St Petersburg Telegraph and 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 the 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 included into the merger agreements.

The calculation to determine the share conversion factor, which was used to estimate the companies values, was based on an analysis of accounting ratios, their share prices, net assets values, and discounted cash-flow analysis.

<sup>1</sup> Renaissance Capital is the leading independent investment group operating in Russia. It provides services for Russian and foreign investors. Since it was founded in 1995, the group has attracted over \$8bn of investments to Russian enterprises and has carried out many large-scale projects.



**Calculation of share price estimates for the merger of telecommunications operators in the North-Western Federal District, 1 January 2001**

Operator	Type of share	Number of shares in issue, Sept 2001	Conversion factor*	Number of additional shares issued by St Petersburg Telephone Network	Share price as determined by the companies' boards of directors (R)
St Petersburg Telecommunications	Ordinary	473,056,966	n/av	n/av	10.21
	Preference	114,440,851	n/av	n/av	4.74
Electrosvyaz of Pskov Region	Ordinary	9,696,000	1.61	15,610,781	18.85
	Preference	3,232,000	1.61	5,203,638	6.48
Novgorodtelecom	Ordinary	102,211	229.75	23,455,458	2,025.57
	Preference	34,070	229.75	7,790,694	668.50
Cherepovetselectrosvyaz	Ordinary	289,490	53.53	15,495,009	344.57
	Preference	96,496	53.53	5,165,031	113.68
Electrosvyaz of the Republic of Karelia	Ordinary	246,748,493	0.15	35,779,115	0.88
	Preference	82,248,564	0.15	11,926,568	0.41
Electrosvyaz of Vologda Region	Ordinary	7,104,900	2.35	16,660,997	21.79
	Preference	2,368,300	2.35	5,553,754	7.07
Electrosvyaz of Kaliningrad Region	Ordinary	5,434,100	7.11	38,636,440	38.12
	Preference	1,811,366	7.11	12,878,823	14.32
Artelecom of Archangel Region	Ordinary	130,944,560	0.42	54,997,606	1.77
	Preference	43,648,186	0.42	18,333,163	0.59
Murmanelectrosvyaz	Ordinary	31,112,500	2.00	62,224,850	14.43
	Preference	10,370,833	2.00	20,730,266	4.71
Total	Ordinary			262,860,256	
	Preference			87,581,934	

\* The conversion factor is the number of additional shares of St Petersburg Telecommunications 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 process identified St Petersburg Telecommunications as the biggest company in North-West Region, representing 63% of the merged company. The next largest of the merging companies were Murmanelectrosvyaz and Artelecom.

**Comparison of indicators of the telecommunications operators in the North-Western Federal District**

Operator	Total capacity (000 lines)	Share in total capacity (%)	Revenues in 2000* (R million)	Share in total revenues (%)	Assets* (R million)	Share in total assets (%)	Market capitalisation (\$ million)	Share in total market capitalisation (%)
St Petersburg Telecommunications	1,907	56.42	1,581.2	33.62	7,685.3	58.11	130.5	68.61
Electrosvyaz of Pskov Region	141	4.17	261.5	5.56	505.0	3.82	9.1	4.78
Novgorodtelecom	157	4.64	280.8	5.97	358.7	2.71	5.1	2.68
Cherepovetselectrosvyaz	96	2.84	191.3	4.07	265.5	2.01	4.5	2.37
Electrosvyaz of the Republic of Karelia	193	5.71	346.6	7.37	727.2	5.50	7.4	3.89
Electrosvyaz of Vologda Region	186	5.50	320.4	6.81	499.1	3.77	2.7	1.42
Electrosvyaz of Kaliningrad Region	157	4.64	482.0	10.25	593.3	4.49	2.5	1.31
Artelecom of Archangel Region	303	8.96	558.2	11.87	1,155.0	8.73	16.4	8.62
Murmanelectrosvyaz	240	7.10	680.8	14.48	1,435.8	10.86	12.0	6.31
<b>Total</b>	<b>3,380</b>	<b>100.00</b>	<b>4,702.8</b>	<b>100.00</b>	<b>13,224.9</b>	<b>100.00</b>	<b>190.2</b>	<b>100.00</b>

\* according to Russian accounting standards.

Source: Svyazinvest, AVK calculations

**Relative Value of the Merged Companies, September 2001**

Operator	%
St Petersburg Telecommunications	63.0
Electrosvyaz of Pskov Region	2.0
Novgorodtelecom	3.0
Cherepovetselectrosvyaz	2.0
Electrosvyaz of the Republic of Karelia	5.0
Electrosvyaz of Vologda Region	2.0
Electrosvyaz of Kaliningrad Region	6.0
Artelecom of Archangel Region	8.0
Murmanelectrosvyaz	9.0

Source: AVK calculations

---

In November 2001, as specified in the reorganisation plan, the telecommunications operators of the North-Western Federal District held special shareholders' meeting at which the terms of 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 whom approved the transaction. A shareholders' meeting of St Petersburg Telecommunications decided to change the company's name to North-West Telecom.

The next stage of the reorganisation included the approval by the by RF Ministry for Anti-Monopoly Policy and Support of Business (MAP RF), to merge the operators in the district with St Petersburg Telecommunications.

The proposal to merge the North-Western District telecommunication operators was approved 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. Svyazinvest accepted the proposed requirement. In 2003, this requirement was removed by MAP RF. On 31 October 2002, the merging companies were removed from the official register of companies, and their shares were converted into newly issued shares of North-West Telecom.

The legal procedure was completed in February 2003 with the registration of a report on the issue of these shares by the RF Federal Commission for Securities, and with the holding of the inaugural general meeting of North-West Telecom. Shareholders appointed a new board of Directors and a new managing director. These changes were included into the Company Charter at the annual general meeting on 25 June 2003.

The most important effects of the reorganisation were as follows.

The goals set for the reorganisation of the telecommunications operators in the North-Western Federal District were achieved. The goals included merging small operators into a large company that could provide services in all regions of 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. During the reorganisation process, between September 2000 and February 2003, the liquidity of the shares increased considerably. The spread between the bid and offer prices of the ordinary shares narrowed from 54% to 8%.

The reorganisation turned the independent operators of the North-Western Federal District into a unified company providing all kinds of telecommunications services. After the merger, the capacity of North-West Telecom reached 3,612,000 lines, making it fourth largest of the seven operators created during the reorganisation of Svyazinvest.

The structure of the subsidiaries has been reorganised, the management system has been unified and a budget system has been introduced. An analysis of business processes has been conducted in all the subsidiaries, helping management to decide how they can be improved. Subsidiaries have also been given an opportunity to make use of St Petersburg Communications' experience in attracting investments and their strong corporate management.

Standard & Poor's has raised the Company's international credit rating from CCC/Stable to B-/Stable.



# The Company's financial and operating results

---

# History of the Company

---

The development of telecommunications services in the north-western area of Russia goes back to the second half of the 19th century. On 15 April 1855 the Main Telegraph Station was opened in St Petersburg, equipped with nine electromagnetic telegraph apparatuses. Its opening gave a start to the creation of one of the first Russian telecommunications enterprises. A few years after Alexander Bell received his patent in 1876 for the first telephone apparatus in the world that was convenient to use, the telephone network began to develop throughout the whole of Russia, and in particular in the north-western area.

In 1882 Bell's International Telephone Company won a concession to set up and run a city telephone network in St Petersburg, providing the beginnings of the St Petersburg telephone network. At that time the company served 259 subscribers and provided a local communications service. In the 1880s–90s telephone communications services also began to develop in a number of other towns in the north-western area.

At the beginning of the 20th century telegraph and telephone communications were operating in all the major towns in the north-west of Russia. The largest communications enterprise in the region and leader in the technical development of communications networks was the St Petersburg Telephone Network. In 1901 it was transferred from private ownership into the possession of the St Petersburg city administration, which provided for the reconstruction and enlargement of the telephone network, and lowered the excessively high subscriber charges.

In 1919, like the other communications companies throughout the RSFSR, the St Petersburg Telephone Network together with the other communications companies of the north-western area was nationalised and as a state enterprise remained the property of the state right up until 1994.

The RF's State programme for 1992 for the privatisation of state and municipal enterprises was accepted in 1992 and brought into effect by resolution No. 2980–1, dated 11 July 1992, of the Supreme Council of the RF and by presidential decree No. 721, dated 1 July 1992, On organisational measures to transform state enterprises and voluntary associations of state enterprises into joint-stock companies. This acceptance gave a start to the processes of transforming the state communications enterprises into joint-stock companies.

On 5 May 1993, as a result of privatisation, the Open-Type Joint-Stock Company (OTJSC) Peterburgskaya Telefonnaya Set (PTS) (St Petersburg Telephone Network) was established on the basis of the Leningrad City Telephone Network State Communications and Informatics Enterprise. At this point the first issue of PTS shares was floated: 371,727 ordinary shares, 140,310 type A preference shares and 265,421 type B preference shares with a par value of R 1 denominated. In accordance with the privatisation plan a controlling block of PTS voting shares 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 at an auction. On the results of the voucher auction a split occurred resulting in the number of shares increasing by a factor of 20 and comprising 12,742,960 ordinary shares and 2,806,200 preference shares with a par value of R 00.05.

In 1995 the block of PTS shares that had been assigned to state ownership was transferred into an account to form the authorised capital of the telecommunications holding Open Joint-Stock Company (OJSC) Svyazinvest, together with the state's blocks of shares in the other regional telecommunications operators. For this reason the company's initial privatisation plan, which envisaged the sale by tender of 10% of the block of PTS shares belonging to the state, was re-examined. In November 1995 a presidential decree was issued cancelling the sale by tender and transferring to Svyazinvest a part of the block consisting of about 9% of the company's authorised capital (if the block was sold PTS would be one of the regional telecommunications companies in which Svyazinvest did not have a controlling interest). The remaining part of the block of PTS shares was sold at a cash auction.

One peculiarity of the PTS set up in 1993 was that its sphere of activity was quite narrow: it only provided local telephone communications in St Petersburg. The provision of intercity and international communications and telegraph communications in St Petersburg was done by OJSC Sankt-Petersburgskiy mezhdugorodny i mezhdunarodny telefon (SPb MMT) and OJSC Sankt-Peterburgskiy telegraf (SPT) respectively, which had also been set up as a result of privatisation in 1993.

However, from the moment of its incorporation PTS participated actively in enlarging its business by setting up joint enterprises in the most promising sections of the telecommunications market: cellular and pager communications, payphones, cable networks, etc. In all about 20 commercial enterprises were set up with the participation of PTS, including the Closed Joint-Stock Company (CJSC) Delta Telecom, CJSC Severo-zapadny GSM, CJSC PeterStar, CJSC Sankt-Peterburgskiy Taksofony, CJSC Neda, CJSC Neva Kabel and CJSC NEK Neva Kommunikatsionnye Sistemy.

In 1994, for the efficient and co-ordinated running of their subsidiaries, PTS jointly with SPb MMT founded the holding company OJSC Telecominvest. PTS's blocks of shares in the subsidiary and dependent enterprises were transferred either partially or in full to the authorised capital of the newly-formed telecommunications holding. PTS's share in Telecominvest's authorised capital at the latter's founding was 95%. Later the number of Telecominvest's shareholders increased, and in December 1995 PTS's share in the authorised capital had dropped to 25%.

In 1997 PTS, which from the moment of its founding had been exclusively an urban communications operator, began providing a service for subscribers in the Leningrad region, after receiving the relevant licence. The number of subscribers served in the territory of the Leningrad region is extremely small, and because of this the company's work in the Leningrad region does not have any real influence on the results of its activities. However, this was the first occasion in the Russian telecommunications market when a local operator began providing its services in the territory of another member of the RF.

In 2000, as part of the overall reorganisation of the regional telecommunications operators who were part of the OJSC Svyazinvest holding, the three main telephone and telegraph communications monopolies of St Petersburg – PTS, SPb MMT and SPT – were merged. SPb MMT and SPT were added to PTS and entered the PTS structure as subsidiaries. This allowed PTS to widen significantly the range of services provided, which now included intercity and international communications and telegraph communications.

Since the programme for the reorganisation of the regional telecommunications operators foresaw the merging of the telecommunications operators of the NWFD into one company on the basis of PTS, at a general meeting of the regional companies's shareholders in autumn 2001 the decision was taken to reorganise the companies by merging with PTS. At the same time, shareholders of PTS took the decision to merge with the regional operators and to rename the company OJSC North-West Telecom (N. W. Telecom). The company was to become the largest communications operator in the whole of the north-western area.

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 North-Western Federal District (NWFD) were merged with N. W. Telecom in 2002:

- OJSC Artelecom, Arkhangel region
- OJSC Murmancelectrosvyaz
- OJSC Novgorodtelecom
- OJSC Electrosvyaz, Pskov region
- OJSC Cherepovtselectrosvyaz
- OJSC Electrosvyaz, Vologda region
- OJSC Electrosvyaz, Kaliningrad region
- OJSC Electrosvyaz, Karelian Republic



**Main parameters of the companies whose merging formed the present structure of North-West Telecom (December 2001).**

<b>Title of the company</b>	<b>Line capacity</b>	<b>Telephone penetration, phone line per 100 persons</b>	<b>Proportion of digitisation, %*</b>
Peterburgskaya Telefonnaya Set	1 922 901	39.53	34.52
Artecom, Arkhangel region	296 336	19.62	35.45
Murmanelectrosvyaz	273 471	28.41	42.97
Electrosvyaz, Vologda region	195 334	18.71	34.37
Electrosvyaz, Karelian Republic	189 597	24.17	30.11
Novgorodtelecom	167 139	21.99	22.19
Electrosvyaz, Kaliningrad region	163 519	17.00	23.56
Electrosvyaz, Pskov region	145 217	22.99	40.55
Cherepovetsselectrosvyaz	106 553	30.39	62.32

\*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 north-western area, N. W. Telecom became the largest company in the north-western area to provide telecommunications services in the territories of all the members of the RF within the NWFD, with the exception of the Leningrad region and the Komi republic. At present there are three traditional telecommunications operators remaining in the north-western area who have not merged with N. W. Telecom and in whose capital N. W. Telecom does not have a controlling interest or has an insignificant interest: OJSC Lensvyaz, OJSC Svyaz of the Komi republic, and OJSC Pskovskaya GTS.

### **Significant events of recent years**

<b>September 1995</b>	Trading began of OTJSC PTS ordinary shares on the Russian Trading System (RTS).
<b>August 1996</b>	OTJSC PTS received a licence for the right to provide services in the Leningrad region.
<b>September 1996</b>	In connection with their conversion to shares for a new floatation, the RF Federal Commission for the Securities Market cancelled the issues of the first floatation of N. W. Telecom shares; consequently the shares' par value rose to R 1, and their quantity to 382,288,800 ordinary and 84,186,000 preference shares.
<b>May 1996</b>	In accordance with the federal law On joint-stock companies, the company's name was changed from OTJSC Petersburgskaya Telefonnaya Set to OJSC Petersburgskaya Telefonnaya Set.
<b>August 1996</b>	PTS received a licence for the right to provide services in the Leningrad region.
<b>January 1997</b>	First dealings in SPT preference shares on the RTS.

### **History of the Company**

<b>August 1997</b>	A digital transport network covering the whole territory of St Petersburg, built on the basis of fibre-optic rings, was brought into commercial operation; this allowed a major improvement in the communication quality and the reliability of the urban network.
<b>December 1997</b>	Registration of the Oblastnoy transportny uzel (Regional Transport Centre). SPT began providing communications services on the territory of the Leningrad region.
<b>1997-1998</b>	Initial attempt to start a 1 Level ADR programme: a depositary service agreement was concluded with the Bank of New York, and Brunswick Warburg were chosen as financial consultants. The issuing of the ADR was postponed because of the financial crisis in Russia.
<b>May 1998</b>	Elektronny uzel spetsialnykh sluzhb (Special Services Electronic Centre) brought into operation, covering all two- and three-digit numbers.
<b>April 1999</b>	With the transfer of the right to regulate tariffs from the local authorities to the RF Ministry for Anti-Monopoly Policy and Support of Business, PTS received the capability of raising tariffs for local communications services, unchanged since 1996.
<b>September 1999</b>	An agreement was concluded with the National Association of Stock Market Participants on disseminating corporate information about PTS.
<b>November 1999</b>	PTS shares were included in the second-tier quotation list of the RTS.
<b>December 1999</b>	The Programme for raising the liquidity and market value of PTS securities was approved.
<b>1999–2000</b>	Agreement was reached on restructuring until 2005 the PTS debt to foreign equipment suppliers; part of the debts and the relevant equipment was transferred to Telecominvest.
<b>March 2000</b>	SPT ordinary and preference shares were permitted to be traded on the Moscow Inter-bank Currency Exchange.
<b>April 2000</b>	An extraordinary meeting of the SPT shareholders took the decision to reorganise the company by merging SPb MMT and SPT with it.
<b>June 2000</b>	The international investigative corporation Dun & Bradstreet awarded PTS a credit rating of 5A2, the highest evaluation in the rating of the top 50 businesses in St Petersburg.
<b>September 2000</b>	SPT began to advance the provision of a new communications service via the Iskra-2 digital network business service, covering the whole of the RF and the CIS.
<b>December 2000</b>	Completion of the process of merging SPb MMT, SPT and PTS.
<b>January 2001</b>	PTS took fifth place in the corporate management rating prepared by the Russian Institute for Corporate Law and Management.
<b>March 2001</b>	As part of the programme to change over to a system of time-based charging, an agreement was concluded with the Lithuanian Elsis firm to supply time-based charging equipment.

---

<b>April 2001</b>	PTS signed a contract with Alcatel on the supplying of Alcatel-produced equipment for data transference systems, for the construction in St Petersburg of a multi-service ATM (Asynchronous Transfer Mode)/Frame Relay/IP (Internet Protocol)/TDM (Time-Division Multiplexing) network.
<b>July 2001</b>	An agreement was concluded with J.P. Morgan bank for a depositary service for starting the Level 1 ADR programme.
<b>August 2001</b>	PTS received authorisation from the RF Federal Commission for Securities (RF FCS) to issue ADRs. The US SEC registered a Level 1 ADR programme for PTS shares.
<b>October 2001</b>	Standard & Poor's international rating agency awarded a corporate management rating of 5.6
<b>November 2001</b>	An extraordinary general meeting of the Company's shareholders took the decision to reorganise PTS by merging with it the eight telecommunications operators of the north-western area of Russia, and to rename the company OJSC North-West Telecom.
<b>December 2001</b>	PTS was renamed North-West Telecom (N. W. Telecom). The alterations to the company's charter in connection with its renaming as N. W. Telecom were registered by the registration office of the St Petersburg administration.
<b>December 2001</b>	Long-term credit ratings in local and foreign currency were awarded by Standard & Poor's, at a level of CCC and a forecast of Stable.
<b>March 2002</b>	Standard & Poor's awarded the Company and its planned issue of rouble bonds a long-term credit rating of ruBB on the Russian scale.
<b>April 2002</b>	RF MAMPSB approved the application for the merging with N. W. Telecom of the eight telecommunications operators of the north-western area of Russia.
<b>May 2002</b>	Standard & Poor's lowered the Company's corporate management rating from 5.6 to 5.0 due to the lack of transparency in the sale of shares of the Delta-Telecom company.
<b>October 2002</b>	The merging of the eight telecommunications operators of the north-western area of Russia with N. W. Telecom took place by converting the shares of the additional companies into N. W. Telecom shares.
<b>November 2002</b>	Standard & Poor's raised the Company's corporate management rating from 5.0 to 5.6, as changes in N. W. Telecom board of directors made it possible to rely upon the appearance of more effective systems of management and control.
<b>December 2002</b>	The RF FCS formally registered the issue of N. W. Telecom shares which were floated by converting the additional eight telecommunications operators in the north-western area into securities.
<b>March 2003</b>	N. W. Telecom first published financial reports to international standards for 2001.
<b>April 2003</b>	On the results of the evaluation of the consequences of the merging of the eight telecommunications operators of the north-western area with N. W. Telecom, Standard & Poor's raised the long-term credit rating in local and foreign currency from CCC to B-, and the credit rating on the Russian scale from ruBB to ruBBB. The forecast for all ratings was 'Stable'.
<b>September 2003</b>	Standard & Poor's raised the Company's corporate management rating to 5.9 after the financial statements for 2002 were published.

# Strategy

The Company's mission — the provision of all forms of telecommunications services to domestic users and organisations in the North-Western Federal District (NWFD) of the RF, using modern technologies and highly qualified staff, with the aim of maintaining its leading position among communications operators.

The Company's development strategy — to provide quality telecommunications services to domestic users and state and commercial organisations in the territory of the North-Western Federal District, by developing the telecommunications infrastructure, improving the quality of service and introducing modern technical solutions.

The strategic aims of North-West Telecom are divided into:

- 1. Technological:** a phased modernisation and reconstruction of the telecommunications networks; participation in the formation of a telecommunications infrastructure for the NWFD that is sufficient for the growth rates of the communications industry; construction of a multiservice network.
- 2. Financial:** growth in the Company's revenues and income; increase in its capitalisation; creation of favourable circumstances to attract investment and the realisation of planned investment projects.
- 3. Market:** to overcome the negative tendencies caused by the Company's loss of the most attractive segments of the NWFD communications market; reinforcing the Company's positive image.
- 4. Corporate:** creating the conditions for each employee to develop his abilities in accordance with the Company's corporate culture.
- 5. Social:** to increase the scientific, industrial and economic potential of Russia, and to co-operate with her integration into the world information community.

## Characteristics of the priority fields of development for North-West Telecom

Field of development	Real growth of the indicator					
	2003	2004	2005	2006	2007	2008
1. Transport networks, FOCL*, 1000 km.	224	950	580	450	430	440
DRRCL*, 1000 km.	117	120	110	100	50	70
2. Automatic inter-urban telephone exchanges (AIUTE), channels	53,300	45,500	46,000	47,500	50,200	56,000
3. Local telephone networks (line capacity), 1000 numbers	85	150	80	110	40	50
4. Internet, million users/million minutes	0.3/7.5	0.5/9.5	0.8/12.5	1.2/17	1.8/22	2.6/28

\* FOCL — fibre-optic communications line; DRRCL — digital radio-relay communications line.

Source: the Company

**Characteristics of the expansion of the North-West Telecom networks**

Indicator	2004		2005		2006		2007		2008	
	Abs. val.*	%	Abs. val.*	%	Abs. val.*	%	Abs. val.*	%	Abs. val.*	%
International traffic, 1000 mins./annual growth rate	171,310	116.0	198,720	116.0	230,514	116.0	267,400	116.0	310,180	116.0
Inter-urban traffic, 1000 mins./a. g. r.	1,649,538	116.0	1,913,464	116.0	2,219,600	116.0	2,574,700	116.0	2,986,700	116.0
Local traffic (line capacity), 1000 subscribers/a. g. r.	3,847	104.1	3,927	102.1	4,037	102.8	4,077	101.0	4,127	101.2
Local traffic (used capacity), 1000 subscribers/a. g. r.	3,622	104.4	3,703	102.2	3,813	103.0	3,857	101.2	3,911	101.4

\* Abs. val. — absolute value.

Source: the Company

The planned growth in operational capacity will ensure an average annual increase of 2.2% in the indicator for telephone penetration, from 30.6 telephones per 100 people in 2003 to 34.9 per 100 people in 2008.

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

**1.** Intelligent communications network services (ICN). As a first stage in the development of the sales of packages of services, the introduction of universal telephone cards (UTC) is being examined. These are credit, payment and pre-payment cards which will allow the use of the whole range of services offered by the Company.

As a special group of ICN services, consideration is being given to Call Centre Services, where it will be most logical to implement initially services with a mass demand: telephone marketing, help desks, card platform support, hot line services and information services using IVR technology. There is a demand for these services among corporate clients who might be interested in outsourcing the processes of interacting with their customer base. In addition the Company is proposing to develop an information and enquiry service for its own purposes.

**2.** IP-telephony services (Voice IP, IP-number).

**3.** Broadband Internet access.

**4.** Packaging of services.

The following can be included among the packages that would have the greatest mass demand in the medium term:

- For large and medium size businesses – quality digital telephony; IP-telephony, high-speed Internet access (256 kbyte/sec. and above); virtual corporate networks with voice and data integration; video conferencing; call centre; individual IN services; video services in individual cases (issuing of video advertising, etc.).
- For small businesses – quality digital telephony; IP-telephony (less individually tailored than for big businesses); Internet access with speeds up to 128 kbyte/sec., and higher in individual circumstances; virtual corporate networks with integration of voice and data (in individual cases); call centre; intelligent networks; voice mail, faxing and universal mail services; video services in individual cases (issuing of video advertising, etc.).
- For domestic users (users with increased demand for telecommunications services) – quality digital telephony; IP-telephony; Internet access with speeds from 64 or 128 kbyte/sec., and in individual cases up to 2 mbyte/sec.; individual IN services; voice mail, faxing and universal mail services; video services in individual cases (VOD, etc.).

**5.** Creation of virtual corporate networks. Provision of remote access to corporate networks (IP VPN) via secure connections (Managed IP VPN).

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

- to use new telecommunications technologies (ADSL, SHDSL, ISDN);
- to digitise the primary network and switched networks
- to develop unified corporate standards and to introduce them in the regional branches;
- to develop a system of quality control and to initiate ISO 9000 certification.

From the point of view of subscriber structure, a priority for the Company is activity in the most lucrative segments of the business sector and high-income domestic users.

In its human resources policy the Company is paying great attention to raising the qualifications of its personnel. A systematic approach to the management of training is being implemented: the requirements for personnel training are drawn up, training is planned and carried out, and the results are analysed and evaluated. One source that the Company uses to replenish itself with qualified specialists is specialist training establishments. Evening or correspondence classes are other ways used to improve the qualifications of personnel without interrupting work.

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. Overall, the tariff reform is being carried out to reduce cross subsidising between the types of service and categories of user, and to change over to a system of limit pricing for inter-urban communications services (the cost of the service depends on the volume of traffic); it will also bring the Company's pricing policies closer to general European tendencies.

As a result of implementing this strategy, by 2006 the Company should achieve the following results:

- guarantee an average annual growth in revenue (in dollar equivalent) of at least 14%;
- maintain its share of the NWFD telecommunications market at not less than 30%;
- maintain the share of revenue from long-distance communications at not less than 34% of the Company's overall revenue;
- increase to 51% the proportion of revenue from services provided for the business sector;
- strengthen its position in the areas of the NWFD that are the most attractive and lucrative from the point of view of providing telecommunications: St Petersburg, the Murmansk, Archangel, Kaliningrad and Leningrad regions, and the Karelian republic.

The North-West Telecom 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.

The process to optimise the organisation of North-West Telecom includes the separation of its non-specialist sections (cafes, dining halls, holiday centres, medical establishments) into independent companies. Additionally, in accordance with the unified policy being carried out by Svyazinvest in relation to its subsidiaries, the Company will sell its cellular assets that use NMT-450 standard networks. The Company's internal reorganisation is aimed at:

- redistributing the functions of the marketing departments into specialised fields; improving the status of the marketing services and giving them the capability of drawing up their own budgets;
- perfecting the systems of staff motivation in the Company;
- laying down new business processes for the Company linked with marketing; improving the efficiency of the existing business processes.

# Competitive strengths and weaknesses

A SWOT table has been compiled to show North-West Telecom'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 almost all the regions of the North-Western Federal District of the RF, and consequently the possibility of realising inter-regional projects.</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>• Obsolete network infrastructure requiring modernisation.</li> <li>• Predominance in the customer base of the domestic segment, which is far less profitable than commercial organisations.</li> <li>• Lack of effectiveness in the sales (passive sales methods) and after-sales services.</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 information technologies programmes (Electronic Russia).</li> </ul>	<ul style="list-style-type: none"> <li>• In accordance with the new edition of the RF Law «On Telecommunications», there is a possibility that from 2005 the Company will be appointed a universal services operator in the territory of the North-Western Federal District. As a result, the Company's financial state might be impaired because of the provision of unprofitable universal services (see Section Risks).</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>• The appearance of new competitors both in the areas of fixed communications and in new communications services, resulting from the liberalisation of the Russian communications market (entry into the WTO).</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>• The appearance of new sectors where the Company has no historical advantage.</li> </ul>

## The main services provided by North-West Telecom on 1 July 2003

Title of service	Nature of service	Registration number of licence	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. 3075 — St Petersburg	1 Jan. 2004
		No. 3166 (with addenda Nos.1–5) — Leningrad region	1 July 2006
		No. 23225 — Karelian and Komi republics, Archangel, Vologda, Kaliningrad, Leningrad, Murmansk, Novgorod and Pskov regions, Nenets AD, St Petersburg	1 Aug. 2007
2. Local telephone communications.		No. 3166 — Leningrad region	1 July 2006
3. Local and intrazonal telephone communications.		No. 23227 — Karelian and Komi republics, Archangel, Vologda, Kaliningrad, Leningrad, Murmansk, Novgorod and Pskov regions, Nenets AD, St Petersburg	4 Oct. 2012
4. Channel rental.	Provision of communications channels for rental.	No. 23224 — Karelian and Komi republics, Archangel, Vologda, Kaliningrad, Leningrad, Murmansk, Novgorod and Pskov regions, Nenets AD, St Petersburg	1 Aug. 2007
5. Telematic services.	The transmission of information via the telecommunications network, with the exception of telephone, telegraph and data transference services.	No. 22791 — Karelian and Komi republics, Archangel, Vologda, Kaliningrad, Leningrad, Murmansk and Novgorod regions	11 July 2007
6. Data transference.	The exchange of any form of data between subscriber apparatuses equipped for data transference via the telephone network.	No. 22792 — Karelian and Komi republics, Archangel, Vologda, Kaliningrad, Leningrad, Murmansk, Novgorod and Pskov regions, Nenets AD, St Petersburg	11 July 2007
7. Telegraph communications.	Telegram service, including via the AT-telex service.	No. 23226 — Karelian and Komi republics, Archangel, Vologda, Kaliningrad, Leningrad, Murmansk, Novgorod and Pskov regions, Nenets AD, St Petersburg	14 Nov. 2007
8. GSM-450 standard.	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. 24074 — Archangel region	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. 17591 — St Petersburg	3 Apr. 2006
10. 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. 24658 — Archangel, Vologda, Kaliningrad, Murmansk, Novgorod and Pskov regions, Karelian republic and Nenets AD	30 Dec. 2007
11. 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. 12972 (with addenda Nos.1 — 5) — Archangel region	8 Oct. 2004
		No. 14838 (with addenda Nos.1-4) — Murmansk region	21 Apr. 2005
12. Terrestrial transmission of television programmes.		No. 15664 (with addenda Nos.1-2) — Pskov region	21 Apr. 2005

**The main services provided by North-West Telecom on 1 July 2003 (Continued)**

Title of service	Nature of service	Registration number of licence	Date of expiry of licence
13. Video conferencing.		No. 19132 (with addendum No.1) — Karelian rep., Archangel, Vologda, Kaliningrad, Leningrad, Murmansk, Novgorod and Pskov regions, St Petersburg	27 Aug. 2006
14. Transmission of television programmes via the cable television network.	The transmission of television and sound broadcasts to a wide circle of territorially dispersed listeners using the cable television network.	No. 12842 (with addenda Nos.1-3) — city of Vologda	9 Sep. 2004
		No. 14799 (with addenda Nos.1-3) — Murmansk region, Lovozero	21 Apr. 2005

Source: the Company

**Tariffs for North-West Telecom 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 <sup>2</sup> , roubles/unit
			Standing charge, roubles/mth.	Calls, roubles/min.			Standing charge, roubles/mth.	Calls, roubles/min.		
Peterburgskaya telefonnaya set										
Domestic	100	3,000	25.2	0.17	—	—	—	—	2.43	27.54
State org.	170	6,000	58.6	0.17	—	—	—	—		
Commercial org.	170	6,000	58.6	0.17	—	—	—	—		
ArTelecom										
Domestic	110	6,000	—	—	110	3,000	—	—	3.03	26.74
State org.	130	7,000	—	—	130	7,000	—	—		
Commercial org.	170	7,000	—	—	170	7,000	—	—		
Electrosvyaz, Vologda region										
Domestic	95	4,000—analogue, 6,000—digital	—	—	80	3,000	—	—	2.37	20.06
State org.	120	3,000	—	—	120	3,000	—	—		
Commercial org.	120	6,000	—	—	120	6,000	—	—		
Electrosvyaz, Kaliningrad region										
Domestic	90	5,500	—	—	90	2,250	—	—	2.71	17.26
State org.	155	7,000	—	—	155	3,500	—	—		
Commercial org.	155	8,700	—	—	155	4,350	—	—		

**Services**

## Tariffs for North-West Telecom 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 <sup>2</sup> , roubles/unit
			Standing charge, roubles/mth.	Calls, roubles/min.			Standing charge, roubles/mth.	Calls, roubles/min.		
Electrosvyaz, Karelian republic										
Domestic	100	5,000	60	0.12	90	3,000	50	0.12	3.03	30.87
State org.	120	6,000	96	0.15	120	6,000	96	0.15		
Commercial org.	120	6,000	96	0.15	120	6,000	96	0.15		
Murmanelectrosvyaz										
Domestic	120	7,000	39.21	0.20	100	3,500			3.18	27.59
State org.	170	7,000	119	0.16	170	3,500				
Commercial org.	170	7,000	159	0.11	170	3,500				
NovgorodTelecom										
Domestic	95	4,762	—	—	95	1,905	—	—	3.07	26.34
State org.	130	5,000	—	—	130	5,000	—	—		
Commercial org.	130	5,000	—	—	130	5,000	—	—		
Electrosvyaz, Pskov region										
Domestic	90	4,000 (6,000 <sup>3</sup> )	—	—	90	4,000	—	—	2.65	21.29
State org.	140	5,000 (8,000 <sup>3</sup> )	—	—	140	5,000 (8,000 <sup>3</sup> )	—	—		
Commercial org.	140	5,000 (8,000 <sup>3</sup> )	—	—	140	5,000 (8,000 <sup>3</sup> )	—	—		
Cherepovetselectrosvyaz										
Domestic	95	6,500 — digital, 4,000 — analogue,	—	—	80	3,000	—	—	3.42	21.81
State org.	120	3,000	—	—	120	3,000	—	—		
Commercial org.	120	6,000	—	—	120	6,000	—	—		

<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).

<sup>3</sup> For cities of Pskov and Velikiye Luki, and Pskov and Velikiye Luki districts.

Source: the Company

# Services and customers

The main fields of activity of North-West Telecom, making up more than 93% of the revenue from communications services, are the organisation and provision of local (48.0%) and long-distance (45.3%) telephone communications for subscribers in the territory of the North-Western Federal District (NWFD) (with the exception of the Leningrad region and Komi republic).

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 areas with the highest levels of telephonisation according to relative indicators are St Petersburg and the Pskov and Murmansk regions, where the telephone penetration rates of the urban (UTN) networks are respectively 40, 33 and 31 telephones per 100 people, and 0, 14 and 13 per 100 people for the rural network (RTN). According to absolute figures, the greatest line capacity is in the Peterburgskaya telefondnaya set, with 54.28% of the overall total of lines. The data provided on the distribution of North-West Telecom's line capacity and working capacity between UTNs and RTNs indicate that the level of 'urbanisation' of the Company's traditional telephony is above the average across the inter-regional communications companies that are part of the Svyazinvest group. Thus the UTN share of the line capacity of the Company's network is 93.08% (average: 84.48%). This is explained by the significant predominance of the proportion of the urban population in the population structure of the NWFD when compared to the average for Russia.

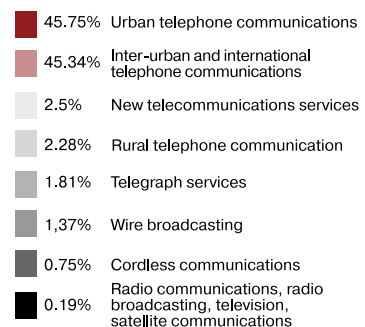
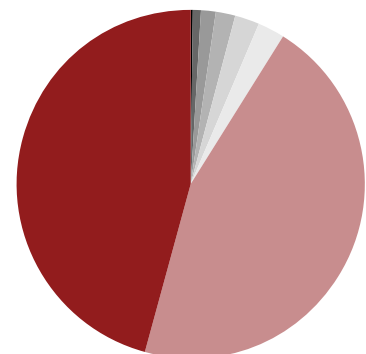
Local communications are the largest source of income for the Company, making up 48% of the revenue from the communications services. A future drop in the growth rate of telephone penetration is forecast, due to the replacement of traditional communications by IP-telephony and mobile communications.

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 North-West Telecom it is the smallest among the seven inter-regional communications operators.

Long-distance communications make up 45.3% of the Company's revenue from communications services. The intrazonal communications, communications between the districts making up a region, form part of inter-urban communications.

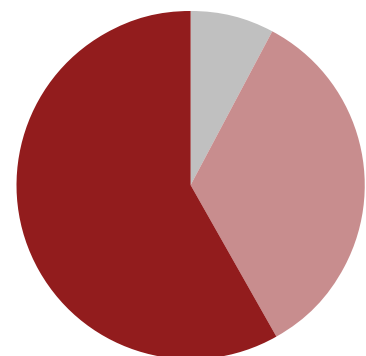
The service is provided on the basis of an agreement with Rostelecom. Pricing per minute has been introduced so that revenue from inter-urban and international communications can be calculated. A new accounting system has been in operation since 1 August 2003 between Rostelecom and the inter-regional 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.

At the present moment North-West Telecom is undertaking a restructuring of the customer base with the aim of identifying the most suitable structure from the point of view of the profitability of the Company's activity. From this point of view the most attractive segment is corporate customers, and it is consequently characterised by the fiercest competition.



Structure of revenues from North-West Telecom communications services in 2002 according to type of activity.

Source: the Company



Structure of revenues from North-West Telecom communications services in 2002 according to category of user.

Source: the Company

**North-West Telecom subscriber structure on 1 January 2003**

Title of branch	Domestic		State organisation		Commercial organisations		Total, units	Telephone penetration*	
	units	%	units	%	units	%		UTN**	RTN**
Peterburgskaya telefonnaya set	1,562,633	86.47	62,206	3.44	182,370	10.09	1,807,209	40	—
Artecom, Archangel region	289,824	47.99	289,824	47.99	24,312	4.02	603,960	28	15
Electrosvyaz, Vologda region	148,573	80.70	10,662	5.79	24,877	13.51	184,112	26	11
Cherepovetsselectrosvyaz	92,392	88.55	3,437	3.29	8,513	8.16	104,342	30	—
Murmanelectrosvyaz	233,794	87.04	15,881	5.91	18,922	7.05	268,597	31	13
Electrosvyaz, Karelian republic	163,865	86.20	9,096	4.78	17,147	9.02	190,108	29	16
Novgorodtelecom	133,905	84.86	8,807	5.58	15,086	9.56	157,798	28	13
Electrosvyaz, Pskov region	115,086	85.45	7,603	5.65	11,996	8.91	134,685	33	14
Electrosvyaz, Kaliningrad region	130,212	81.50	11,267	7.05	18,298	11.45	159,777	21	8
North-West Telecom	2,870,284	79.50	418,783	11.60	321,521	8.90	3,610,588	28.73	12.84
Average for Svyazinvest	n/av	85.15	n/av	5.8	n/av	9.1	n/av	23.4	11.17

\* Telephone penetration — number of telephones per 100 people.

\*\* UTN — urban telephone network, RTN — rural telephone network.

Source: the Company

**Distribution of line capacity and used capacity in the UTNs and RTN of North-West Telecom on 1 January 2003**

Title of the branch	Total		UTN		RTN	
	Line capacity, lines	Coefficient of use, %*	Line capacity, lines	Coefficient of use, %*	Line capacity, lines	Coefficient of use, %*
Peterburgskaya telefonnaya set	1,960,755	94.11	1,960,755	94.11	0	0
Artecom, Archangel region	363,735	93.70	303,971	94.93	59,764	87.43
Electrosvyaz, Vologda region	204,032	91.13	153,906	92.82	50,126	85.95
Cherepovetsselectrosvyaz	108,745	96.61	100,265	97.23	8,480	89.23
Murmanelectrosvyaz	280,223	97.04	269,147	97.17	11,076	93.90
Electrosvyaz, Karelian republic	202,716	94.45	171,970	95.39	30,746	89.19
Novgorodtelecom	172,605	92.44	141,378	94.88	31,227	81.39
Electrosvyaz, Pskov region	148,057	91.99	109,111	95.69	38,946	81.63
Electrosvyaz, Kaliningrad region	171,433	94.96	151,821	96.09	19,612	86.18
North-West Telecom	3,612,301	94.10	3,362,324	94.70	249,977	85.94
Average for Svyazinvest	n/av	92.03	n/av	92.82	n/av	87.72

\* Coefficient of use is the percentage of working capacity in the total line capacity.

Source: the Company

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

Title of the branch	UTN	RTN	Total
Peterburgskaya telefonnaya set	57,209	0	57,209
Artelecom, Archangel region	24,160	9,639	33,799
Electrosvyaz, Vologda region	34,743	8,389	43,132
Cherepovetselectrosvyaz	8,984	2,073	11,057
Murmanelectrosvyaz	3,608	70	3,678
Electrosvyaz, Karelian republic	15,591	9,657	25,248
Novgorodtelecom	17,067	8,843	25,910
Electrosvyaz, Pskov region	4,619	3,582	8,201
Electrosvyaz, Kaliningrad region	36,747	5,294	42,041
North-West Telecom	202,728	47,547	250,275

Source: the Company

The classification of the business sector developed by the Company is:

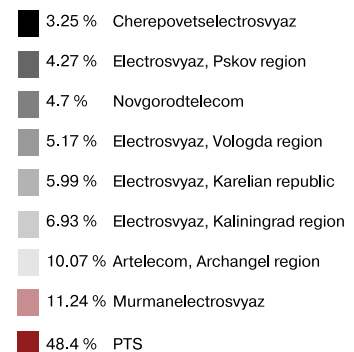
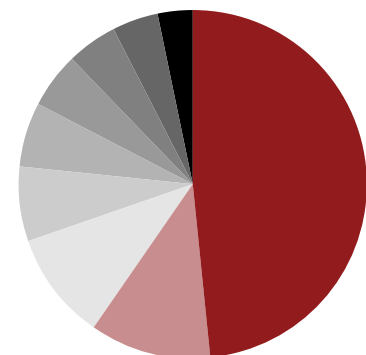
1. VIP customers, which include large industrial concerns, companies with a large network of branches, major financial and trading concerns, business centres and development companies. Special sections are being set up to work with this category of customer. For each customer there will be a personal manager who will take care of the customer both before and after an agreement has been concluded. An efficient form of sales is direct sales, with an individual approach.
2. Medium-size active companies, including hotels, financial organisations, advertising and marketing companies, trading companies and companies with a high demand for communications services per employee. The modus operandi is the same as for VIP customers.
3. Small-size active companies, which include law firms, tourism companies, companies with a low demand for communications services per employee and state organisations.

For this segment the contact person could be the personal manager of a group of customers, or a call-centre operator (an answering machine outside working hours).

Among the Company's customers there is no category of 'very large organisation' that could provide more than 10% of North-West Telecom's revenues.

In accordance with development strategy, the most promising areas are St Petersburg, the Murmansk, Archangel and Kaliningrad regions, the Karelian republic, and the Leningrad region (if Lensvyaz is amalgamated with the Company). It is the weight of these branches in the Company's revenue structure that will increase in the medium term.

North-West Telecom'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 communications», and rules and decisions of the government of the RF.



Regional structure of North-West Telecom revenues according to figures for 2002

Source: the Company

**Dynamics of the revenue from communications services in the branches of North-West Telecom**

Title of branch	Growth rate of the indicator, %.																	
	Long-distance		Faxing		UTN		RTN		RCBT*		WB*		WRC*		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	Other	Internet		
Peterburgskaya telefonnaya set	8.6	11.3	n/av	98,2	20.5	34.4	n/av	n/av	n/av	n/av	n/av	n/av	n/av	n/av	43.7	2.6	n/av	(100)
Artecom, Arch-angel region	22.3	20.6	10.4	5.3	102.9	41.1	63.7	40.8	30.3	1.6	15.3	57.0	19.0	50.5	6.6	n/av	162.8	
Electrosvyaz, Vologda region	27.5	21.3	5.3	18.5	59.1	28.3	28.3	16.2	30.0	271.4	16.7	32.3	11.7	10.3	32.6	n/av	165.9	
Cherepovetse-lectrosvyaz	20.0	11.4	24.0	10.5	89.5	23.6	60.9	27.7	34.1	n/av	n/av	21.5	(22.6)	n/av	n/av	n/av	20.9	
Murmanelectros- vyaz	26.1	18.0	14.3	(5.5)	39.0	27.8	43.4	21.2	29.9	(19.6)	23.5	15.2	27.0	70.1	(14.9)	n/av	184.3	
Electrosvyaz, Karelian republic	28.0	19.9	20.7	7.0	60.6	35.8	33.7	36.0	42.3	n/av	n/av	30.0	6.0	n/av	n/av	n/av	88.5	
Novgorodtele- com	22.0	15.5	11.3	15.8	51.7	21.7	69.1	23.2	34.7	n/av	n/av	9.3	(1.6)	64.0	29.4	n/av	51.3	
Electrosvyaz, Pskov region	20.4	19.7	15.5	16.3	0	35.3	39.2	40.2	42.6	80.8	35.6	(12.5)	19.7	n/av	n/av	n/av	62.1	
Electrosvyaz, Ka- liningrad region	9.5	17.5	0	35.7	64.6	88.9	26.4	38.4	35.4	n/av	n/av	11.7	42.6	(5.2)	12.8	n/av	n/av	

\*RCBT – radio communications, radio broadcasting and television, WB – wire broadcasting, WRC – wireless radio communications.

Source: Svyazinvest



# Principal competitors

The north-western area of Russia is characterised by a relatively high level of competition. One of the overall indicators of the competition in the region is the number of licences for communications services. There are 24 licences to provide communications services per 100,000 inhabitants in the North-Western Federal District. Growth can be seen in the licences registered for the main segments of high-income services, such as local, inter-urban and international communications, telematic services, data transference and channel rental.

In the structure of the combined revenue from communications services received by all the communications operators in the North-Western Federal District (NWFD), 69.52% goes to alternative communications operators.

The table contains information about alternative communications operators who are competitors of North-West Telecom.

## Major alternative communications operators in the territory of the NWFD on 1 January 2003

Title of branch	Territory	Range of services	Customer base	Company's plans
Baltic Communications Ltd (BCL)	Karelian and Komi republics, Archangel, Vologda, Leningrad Murmansk, Novgorod, Pskov and Tver regions, cities of Moscow and St Petersburg	Local, inter-urban and international telephone communications, switched and dedicated Internet access; access via dedicated channels in Moscow and more than 30 countries to One Stop Shopping, data transference services, installation of digital exchanges.	Number of customers — more than 600 corporate customers. As well as working with corporate customers, BCL also provides telecommunications solutions for telephone operators and Internet providers.	Using new ECI Telecom equipment, BCL plans to install 12 high-productivity SDH nodes (level STM-4) capable of increasing the throughput capacity and functionality.
Equant (office in St Petersburg)	Russian Federation	Local, inter-urban and international telephone communications, switched and dedicated Internet access; data and message transference, corporate networks, multiple solutions, video conferencing, unification of local networks, IP-telephony solutions for operators, has representatives in the 14 largest regions of Russia, distribution arranged by more than 100 partner organisation throughout Russia; modern communications network with access from 220 countries including from 300 towns in Russia, the CIS and Baltic states.	100 companies and customers who are present in more than one location in the region or country; more than 30,000 business customers.	The company plans to provide shortly a range of new services, incl. a service to monitor the networks by the end of the year. The company intends in the future to increase significantly the range of services provided and to improve the quality of service.
Komin	North-Western Federal District	Provides inter-urban and international satellite communications channels for rental; telematic services; connection to the Internet; supply and installation of equipment and stations for satellite and radio-relay communications.	The company works primarily only with communications operators, providing communications channels for rental; the exception is telematic services, where there is a share of about 1% of domestic users.	The company's plans for 2002 were to enlarge the Kaliningrad node to several tens of lines, and also to move into the markets in cities like Dushanbe, Sakhalin and Volgograd. The operator plans to open access nodes in two more regions of Russia. Introduction of a new 'remote Internet' service and development of IP-telephony.

**Major alternative communications operators in the territory of the NWFD on 1 January 2003 (Continued)**

Title of branch	Territory	Range of services	Customer base	Company's plans
Oktyabrskaya zheleznaya doroga	North-western Russia, city of Murmansk	Local telephone communications.	The main part of the company's customer base is legal entities. The company's services are oriented towards the business sector, with about 1000 organisations as subscribers.	Enlarging the customer base.
PeterStar	Leningrad region, St Petersburg	Local, inter-urban and international telephone communications (incl. using telephone cards), organisation of high-speed digital switched and dedicated data transference channels, cordless access to the telephone network, data transference using ATM, ISDN and Frame Relay technologies, and also broadband access, Long Reach Ethernet, DSL, switched and dedicated Internet access, construction of corporate networks, video conferencing, secure office exchanges with full technical backup, connection to external trading and information services, 777 operator enquiry service for customers.	More than 90,000 customers, mainly people living on Vasilyevskiy Island and corporate customers. The company has a 27.4% share of the business market, 7% of the mass market for Internet access, and 39.4% of the market for data transference services.	The company intends to develop data transference and Internet access services using DSL technology; it also plans to provide services using MPLS technology; a plan to construct a new data transference network using IP technology is being implemented.
Peterburg Tranzit Telecom	Moscow, St Petersburg	The company works in the wholesale market, selling telecommunications resources (number and channel capacity) to major communications operators.	Communications operators (wholesale purchasers of communications channels).	To enlarge the network.
Rascom	Karelian republic, Vologda, Leningrad, Moscow, Murmansk, Novgorod, Pskov and Tver regions, cities of Moscow and St Petersburg	Provision of communications channels for rental; telephony services (connects offices or buildings to its ISDN digital telephone network using its own RASCOM fibre-optic network); connection to Internet; video conferencing, data transference; IP-telephony.	Mainly communications operators and Internet providers.	Development of its infrastructure throughout Russia.
Golden Telecom (Sovintel, Teleross)	Russian Federation	Telephony services; corporate data transference networks (using Frame Relay, TCP/IP, X.25 or clear channels); Internet access (incl. using ADSL technology with speeds up to 2 Mbyte/sec., and switched corporate access services; connection with speeds of up to 100 Mbyte/sec. for major customers and Internet providers); integrated solutions; web design and solutions for e-businesses; virtual and dedicated hosting; co-location of server equipment.	More than 10,000 customers (25% — corporate). Only Internet access and IP-telephony services provided for domestic users.	Development of its network of branches in the north-western areas of Russia.

Source: the Company

Because of the rapid development of the mobile communications market and fierce competition between the operators, accompanied by a fall in the cost of services, a potential threat to the competitive position of traditional communications operators comes from mobile communications (especially in inter-urban communications). This table gives information about North-West Telecom's major competitors in the mobile communications market.

#### Major cellular communications operators in the NWFD on 1 January 2003

Title of company	Territory	Range of services	Share of market	Customer base	Company's plans
MTS (Telecom XXI)	Leningrad, Archangel, Vologda, Murmansk, Novgorod, Pskov and Kaliningrad regions; St Petersburg; Karelian republic	Local, inter-urban and international cellular communications using GSM digital standard, frequency bands 900 and 1800 Mhz.	Share of the market in St Petersburg and its region, app. 20%.	More than 500,000 customers.	To improve the existing services and raise their quality. Introduction of new advanced technologies. Enlarge the network in the Leningrad region.
Severo-Zapadny GSM (Megafon)	Leningrad, Archangel, Vologda, Murmansk, Novgorod, Kaliningrad and Pskov regions, St Petersburg and Karelian republic	The company provides local, inter-urban and international cellular communications using GSM digital standard, operating in 900 and 1800 Mhz wavebands.	More than 60% share of the market in St Petersburg and its region.	1,330,000 customers.	Introduction of new services using the SIM menu technology; news, repertoires, entertainment, sales and rental services.

Source: the Company

# Personnel

On 1 Jan 2003 the number of employees was 30,568, consisting of:

Managers:	2,319 (7.59%)
Specialists:	9,883 (32.33%)
Workers:	18,366 (60.08%)

Of the Company's total of employees, 54.67% work in its three biggest subsidiaries, St Petersburg Telephone Networks, Artelecom of Archangel region and Murmancelectrosvyaz. More than a quarter of employees (28.28%) work in the biggest subsidiary, St Petersburg Telephone Networks.

## Distribution of employees in subsidiaries on 1 January 2003

Name of subsidiary	Number of employees			
	Total	Including		
		managers	specialists	workers
St Petersburg Telephone Networks	8,645	485	3,270	4,890
Artelecom, Archangel Region	4,715	396	1,560	2,759
Murmancelectrosvyaz	3,350	254	1,036	2,060
Electrosvyaz, Republic of Karelia	2,991	282	904	1,805
Electrosvyaz, Vologda Region	2,652	253	751	1,648
Electrosvyaz, Kaliningrad Region	2,544	147	811	1,586
Electrosvyaz, Pskov Region	2,326	195	604	1,527
Novgorodtelecom	2,233	184	599	1,450
Cherepovets Electrosvyaz	993	68	284	641
Directorate (on 1 April 2003)	119	55	64	n/av

Source: the Company

Personnel policy is directed towards providing the Company with qualified employees, improving their skills and qualifications, the professional development of staff and dealing with the employees' social problems.

To improve the efficiency of management, the systems for personnel organisation and management are being renewed, the number of loss-making subsidiaries is being reduced and the size of the staff is being optimised.

A time-plus-bonus wage system is mainly used. This allows the differentiation of wage rates according to the complexity, intensity, conditions of work, and the employee's qualification. To increase salaries and provide competitive labour rates, wages are systematically increased.

In 2002 the average wage increased by 29.2% (4,641 roubles) compared to 2001 and reached 5,997 roubles. According to the regulations for the wage plus bonus system, the formation of bonus funds depends on fulfilling the main production indexes. The Company also pays bonuses for professional skills, high achievements in work and the execution of special tasks.

There are special incentives for workers who do extra work in addition to their duties. They are given additional payments for combining duties, increasing their volume of work and standing in for people who are temporarily absent.

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 Jan 2003 21.64% of employees had a higher education and 27.57% had a specialised intermediate education.

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

Education	Number	
	Total	% of employees
Higher	6,615	21.64
Specialised intermediate	8,427	27.57
Other	15,526	50.79

Source: the Company

A priority in the Company's policy is raising the employees' qualifications. Employees are trained in training centres in the subsidiaries, and institutes of higher education and correspondence courses are used to train specialists.

The age structure of the Company's employees is notable for the predominance of middle-aged people: 41.66% of employees are under 40.

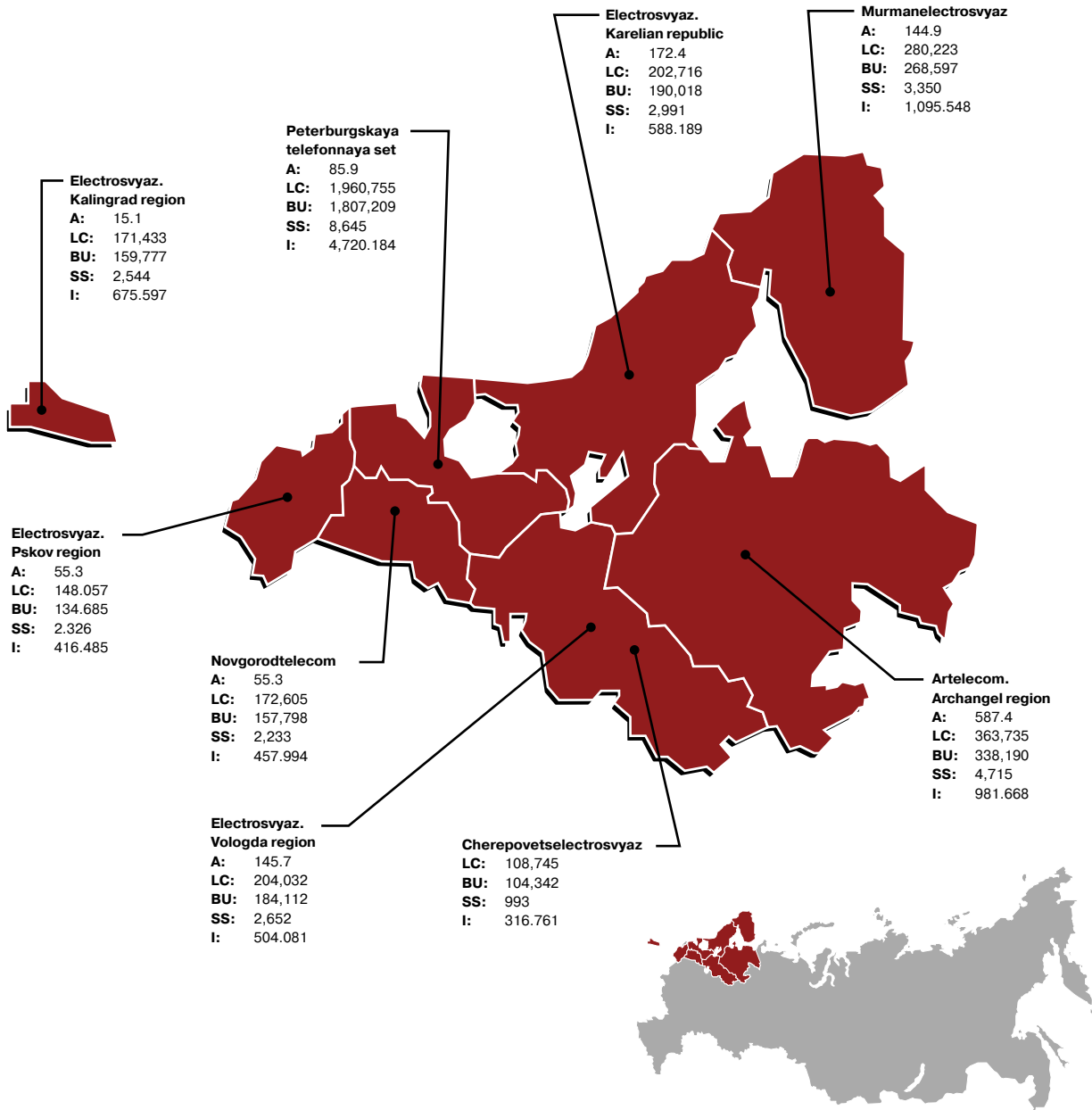
#### Distribution of employees in the Company by age on 1 January 2003

Age	Number	
	Total	% of employees
Under 40	12,735	41.66
40 to 50	11,325	37.05
50 and above	6,508	21.29

Source: the Company

# Organisation

The organisational structure of North-West Telecom comprises a General Management and nine 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  
**I** Income from telecommunications services in 2002, R million

The **Peterburgskaya telefonnaya set branch** serves subscribers in the largest city of the North-Western Federal District (NWFD), St Petersburg, which is located in the east of the district on the Gulf of Finland in the Baltic. St Petersburg is the largest cultural, industrial and financial centre of the north-west, where more than 30% of the population of the NWFD lives. St Petersburg has the highest telephone penetration among the members of the federation served by North-West Telecom in the north-western area. The Peterburgskaya telefonnaya set branch is the company's outright leader for line capacity (more than half of the company's total line capacity), and for volume of income from communications services (almost 50% of the company's total income from communications services).

The **Artelecom, Archangel region, branch** serves subscribers in the territory of the Archangel region, located in the north of the NWFD. In surface area the Archangel region is one of the largest members of the federation in the north-western district, and is in second place for size of population. The density of population in the Archangel region is the lowest among the members of the federation served by North-West Telecom. The branch's high line capacity is the reason why it is one of the leaders among the North-West Telecom branches for volume of income from communications services.

The **Murmanelectrosvyaz branch** serves subscribers in the territory of the Murmansk region, located in the north-west of the NWFD. The low density of population and high levels of income of the population guarantee a high demand for communications services, and Murmanelectrosvyaz is in second place among the North-West Telecom branches for volume of income from communications services, preceded only by St Petersburg. The level of digitisation of the communications services in the Murmansk region exceeds 40%, which is the second highest figure among the company's branches.

The **Electrosvyaz, Vologda region, branch** serves subscribers in the territory of the Vologda region (apart from the town of Cherepovets), located in the south-east of the NWFD, and is characterised by a low density of population and one of the lowest telephone penetration rates in the north-western area. The level of digitisation of the communications networks is close to the average for North-West Telecom.

The **Electrosvyaz, Karelian republic, branch** serves subscribers in the territory of the Karelian republic, which is located in the north-west of the NWFD, north of the Leningrad region and south of the Murmansk region. The republic has a relatively large surface area and is characterised by a low density of population. However, the telephone penetration and level of digitisation of the communications networks are close to the average for the north-western area.

The **Novgorodtelecom branch** serves subscribers in the territory of the Novgorod region, which is located in the south of the NWFD, south of the Leningrad region and west of the Vologda region. The Novgorod region is characterised by a relatively small surface area and a low density of population; telephone penetration in the region is slightly below the average for the north-western area, and the communications networks have the lowest level of digitisation.

The **Electrosvyaz, Kaliningrad region, branch** serves subscribers in the territory of the Kaliningrad region, which is the westernmost member of the Russian Federation and is located on the Baltic coast. A particular feature of the geographical location of the Kaliningrad region is that it does not have borders with any other members of the Russian Federation, but borders on Poland and Lithuania. The Kaliningrad region has the smallest surface area in the NWFD and the highest density of population. However, the telephone penetration rate in the Kaliningrad region is the lowest in the NWFD and the communications networks have one of the lowest levels of digitisation.

The **Electrosvyaz, Pskov region, branch** serves subscribers in the territory of the Pskov region, which is located in the south-west of the NWFED, south of the Leningrad region and west of the Novgorod region. The Pskov region is characterised by a relatively small surface area and low density of population; telephone penetration in the region is slightly below the average for the north-western area, but the communications networks have a relatively high level of digitisation.

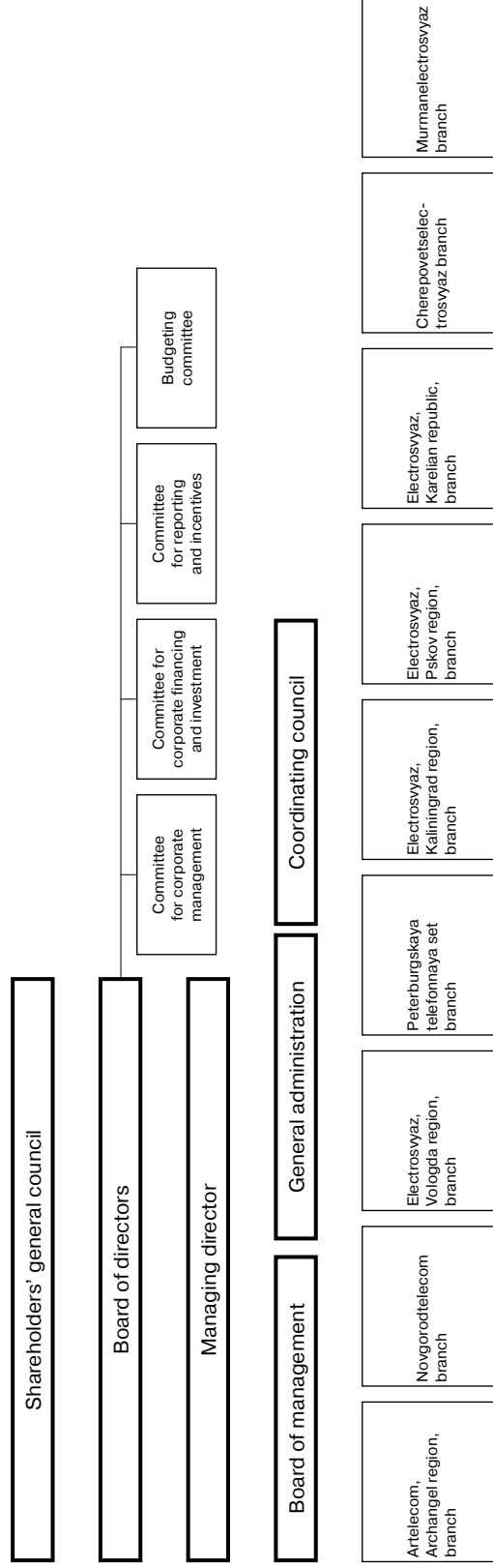
The **Cherepovetselectrosvyaz branch** serves subscribers in the territory of the town of Cherepovets, located in the south-west of the Vologda region. It is the smallest North-West Telecom branch for line capacity and volume of income from communications services. However, its telephone penetration rate is one of the highest in the north-western area, and the branch's communications networks have the highest level of digitisation. On 1 January 2004 Cherepovetselectrosvyaz branch was liquidated.

The management of North-West Telecom 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 North-West Telecom 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.



# North-West Telecom Organisational scheme



# Subsidiaries

As at 1 July 2003, the Company had shareholdings in more than 30 companies. It had holdings of more than 50% in nine companies, and 25–50% in another nine.

## Companies of which North-West Telecom owns more than 50%

	Holding 1 July 2003, %
AMT	100.0
Centrum	100.0
Pagetelecom	100.0
Polykomp	90.0
Arkhangelsk City Telephone Network	77.0
Vologda Cellular Communications	60.0
St Petersburg Centre of Electrosvyaz (St Petersburg Telecommunications Centre)	54.38
Novgorod Datecom	52.0
Bona	51.0

## Companies of which North-West Telecom owns between 25% and 50%

	Holding 1 July 2003, %
Kolatelecom	50.0
Neva Kabel	49.0
Delta Telecom	43.0
Commercial Radio and TV	40.0
Medexpress	35.0
Kaliningradskiye Cellular Networks	33.5
VestBaltTelecom	28.0
Okhtaton Technologies	26.0
Tele-Nord	25.0

Of these companies, the most significant for the Company in terms of their earnings contribution are Neva Kabel, Medexpress, Arkhangelsk Telephone Network and VestBaltTelecom.

The other subsidiaries are too small to affect the Company's financial position.

Company	Territory	Main activities	Earnings, 2002 R 000	Net profit, 2002 R 000
Delta Telecom	St Petersburg, Leningrad region	Cellular telephony, NMT-450	478,275	n/av
Neva Kabel	n/av	Production and sale of telephone cables, using Nokia technology and equipment	238,843	n/av
Medexpress	n/av	Insurance	231,530	n/av
Arkhangelsk Telephone Network	Arkhangelsk	Local telephone services	75,940	16,123
VestBaltTelecom	Kaliningrad	Local telephone services	129,430	n/av

Arkhangelsk Telephone Network has the right of ownership of the telecommunications equipment to provide local telephone services. In September 2002, all the equipment was given to the ArtTelecom, the North-West Telecom's subsidiary, under the lease contract.

North-West Telecom intends to continue developing Arkhangel Telephone Network as a part of the program of separation of the Company's non-specialist sections into its subsidiaries.

During the time of the preparation of this Memorandum, the Company has sold its holding of Delta Telecom's stock, which conforms to the general policy adopted by the Company to cease providing NMT-450 standard services.

# Telecommunications

## equipment

The Company is the owner of a developed telecommunications infrastructure in the region with the highest proportion of urban population. This helps the formation of a solvent demand for telephony services, and also for new types of service requiring a major modernisation of equipment. According to the preliminary results from the end of 2003 the line capacity of the Company was 3.69 million numbers, the digitalisation was 42%.

### Telephone exchanges

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

	Line capacity, 1000 numbers	Used capacity, 1000 numbers	Rate of use of line capacity	Proportion of electronic switches in the overall line capacity
On 1 Jan. 2001	3,379.7	3,142.7	92.99%	29.09%
On 1 Jan. 2002	3,460.0	3,257.7	94.15%	33.90%
On 1 Jan. 2003	3,612.3	3,399.0	94.10%	36.91%
Preliminary results for the end of 2003	3,691.6	3,463.5	93,82%	42.05%

Source: the Company

All the newly operational automatic exchanges are electronic, and therefore the level of digitisation is continually rising. The main suppliers of switching equipment are NEC, Alcatel, Siemens and Lucent Technologies.

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

	Line capacity, 1000 nos.			Proportion of overall line capacity		
	2001	2002	2003*	2001	2002	2003*
Electronic switches	1,173.1	1,333.2	1,552.4	33.90%	36.91%	42.05%
Semi-electronic switches	78.2	89.4	87.3	2.26%	2.47%	2.37%
Cross-bar switches	1,888.8	1,906.3	1,874.9	54.59%	52.77%	50.05%
Step-by-step switches	319.9	283.4	203.9	9.24%	7.84%	5.52%
Manual switches	0.04	0.04	0.03	0%	0%	0%

\* preliminary results for 1 October 2003.

Source: Svyazinvest, 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 2,808 automatic exchanges in operation in the Company, including 358 electronic, 60 step-by-step and 2,273 cross-bar exchanges.

The branches that are best equipped with electronic exchanges are Cherepovet-selectrosvyaz (65% of the overall line capacity is via electronic exchanges), Murmancelectrosvyaz (51%) and Electrosvyaz, Pskov region (49%). At the same time 49% of the total line capacity of electronic exchanges is taken by Peterburgskaya telefonnaya set (PTS), where about 54% of the overall line capacity is concentrated. Manual exchanges are used only in the Murmansk branch.

Retaining the structure of the line capacity according to type of area shows the uniform introduction of new capacity in urban and rural locations.

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

	Line capacity, 1000 numbers			Proportions in the overall line capacity			Proportion of line capacity of electronic exchanges		
	2001	2002	2003*	2001	2002	2003*	2001	2002	2003*
UTN	3,211	3,362.3	3,386	93%	93%	93%	35.9%	39.0%	48%
RTN	249	250	251.6	7%	7%	7%	7.8%	8.5%	11%

\* preliminary results for the end of 2003.  
Source: Svyazinvest, the Company, calculation by AVK

Scheduled work to re-equip analogue exchanges allowed an increase in the line capacity fitted with a system of time-based charging. Equipment from the Elsis and Contech company fitted with a system for time-based calculation of connections has been installed in all branches apart from the Pskov branche. Investments in the system of time-based charging installation will allow the Company to optimise traffic load and improve quality of the services.

**Local carrier networks and subscriber access technologies**

The inter-exchange junctions in the primary urban networks of the North-Western Federal District are 90% digitised. The subscriber lines are mainly analogue. Rural transmission lines are organised using metallic cable, overhead and radio-relay lines. Analogue systems make up 50% of the overall number of transmission systems.

When moving from analogue to digital networks in the local urban networks, it is intended to use the strategies of replacement and overlaying. Replacement means using digital transmission and switching systems to replace obsolete equipment and to increase the capacity of the existing networks. Overlaying involves creating a new digital network parallel to the existing network; the new network can be optimised and enlarged according to the growth in the number of subscribers and the demand for services.

As part of the Company's development plan it is also intended to digitise the rural telephone networks.

The continuing growth in the level of digitisation of the networks allows the provision of switched and dedicated Internet access services to be widened (this is particularly highly developed in the Vologda branch); this includes using ATM/Frame Relay channels, and ISDN, ADSL and SDH technologies for data transference. Many branches provide a video-telephone service using ISDN technology.

The development of broadband multiservice networks is planned.

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

At present the intrazonal primary networks of the North-Western Federal District are based on the use of cable, radio-relay and overhead transmission lines. In the cable transmission lines both analogue and digital transmission systems are used. The radio-relay lines use mainly analogue transmission systems.

AS at 1 January 2003, the length of the telephone channels in the intra-zonal network was 2,049 channel km., 66.3% of this being the length of the telephone channels using digital transmission systems. During 2002 a total of 950 inter-urban telephone channels were brought into operation in the branches of the Company.

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

	2001	2002	2003*
Growth in the length of inter-urban telephone channels, total (1000 ch. km.)	110.4	103.07	109.33
— using digital transmission systems (1000 ch. km.)**	148.0	107.25	111.2
Growth in the length of transmission lines (shows only construction of new Cable, Radio-Relay and Fibre-Optic CLs, total (km.))	114.5	276.13	230.1
— FOCL	114.5	115.33	156.1
— digital RRCL	0	161.2	74

\* preliminary results for 1 October 2003.

\*\* 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

Lines belonging to OJSC Rostelecom are used as inter-zonal lines. Analogue and digital equipment, including SDH technology, is used as the transmission system in trunk routes.

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

On 1 January 2003 the line capacity of the AIUTES was 53,306 zonal communication channels and lines. The greatest amount of work in enlarging the AIUTES was carried out in the PTS and Artelecom branches.

#### Dynamics of the growth of outbound automatic channels

	Growth of outbound automatic channels (channel)			Level of activation of digital AIUTES, %	
	2001	2002	2003*	2002	2003*
AIUTE, total	2,163	1,537	1,195	82.66	82.96
incl. via zonal communication	1,661	760	1,018	77.56	77.04

\* preliminary results for 1 October 2003.

Source: the Company, Svyazinvest

#### Other forms of equipment

In some branches, in particular PTS, Novgorodtelecom and Artelecom, equipment has been installed to provide the 'Altay' system of mobile radio communications. Equipment installed in the Murmansk and Novgorod branches allows paging services to be provided.

Billing equipment was purchased and put into operation in the Company networks during 2002. This allows IP-telephony to be developed, and also multiple-service telephone card services to be provided (using the relevant intelligent platform), in particular in the PTS and Novgorodtelecom branches.

In almost all branches networks of all-purpose payphones have been developed and control centres established, and work is underway to widen the data transference networks.

The Company is also developing the provision of cable television services. Broadband multiservice networks are also being installed using cable television networks.

# 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 operational indicators have a performance considerably below that of the other branches of the Company.

This unevenness in the development of services by the branches 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 North-West Telecom

	2000	2001	2002	1st half of 2003
No. of basic subscriber apparatuses, 1000 units	3,086	3,202	3,345	3,382
incl. Urban telephone network (UTN)	2,875	2,985	3,123	3,158
Rural telephone network (RTN)	210	217	222	224
No. of domestic basic subscriber apparatuses, 1000 units	2,650	2,749	2,870	2,902
incl. Urban telephone network (UTN)	2,477	2,568	2,684	2,713
Rural telephone network (RTN)	173	181	186	189

Source: Svyazinvest

The average growth rate for basic subscriber apparatuses in the Company is 3.5% per year. According to figures for the first half of 2003, the number of basic telephone apparatuses installed rose by 1.1% in comparison with 1 January 2003, to 3,382,000.

The dynamics of the growth in the Company's subscriber base show that the number of subscribers connected via an urban telephone network (UTN) is growing at a faster rate than the number of subscribers connected via a rural telephone network (RTN). During 2002 the number of UTN subscribers increased by 4.6%, whereas the number of RTN subscribers increased by 2.3%. The unevenness in the connection of UTN and RTN subscribers is explained firstly by the fact that the Company's Peterburgskaya telefonnaya set branch (PTS), which operates only in the city of St Petersburg, serves 54% of all the Company's subscribers, according to data for 1 July 2003. Secondly, the costs of connection via an RTN are higher than for connection via a UTN. In addition, these facts are also the reason why the proportion of subscribers connected via a UTN was 93% during the period under review; this was the highest figure among all the inter-regional telecommunications operators.

The majority of the Company's subscribers are domestic subscribers, which is typical for all the telecommunications companies. The proportion of this particular sector in the overall total of the Company's subscribers has remained unchanged at 86% during the whole of the period under review.

Among all the Company's branches each one has a share of less than 10% of the Company's subscriber base, apart from the Peterburgskaya telefonnaya set branch and the Archangel branch whose share is exactly 10.1% according to figures for 1 July 2003.

**Dynamics of the number of payphones served by North-West Telecom**

	2000	2001	2002	1st half of 2003
No. of payphones, units, incl.	13,001	9,077	8,576	8,390
Inter-urban	1,256	1,000	337	194
Share of the overall total of payphones	9.7%	11.0%	3.9%	2.3%
Urban and rural	7,228	5,617	4,806	4,605
Share of the overall total of payphones	55.6%	61.9%	56.0%	54.9%
All-purpose	4,517	2,460	3,433	3,591
Share of the overall total of payphones	34.7%	27.1%	40.0%	42.8%

Source: Svyazinvest

All the inter-regional telecommunications companies are gradually giving up the installation and maintenance of payphones that offer specialised services (inter-urban or urban communications) because of their low profitability. The installation of all-purpose payphones brings the Company more revenue and allows additional communications services to be offered to the customers. The overall total of payphones served by the Company dropped between 2000 and 1 July 2003 by 4,611 to 8,390, due to the removal and modernisation of international, urban and rural payphones. The number of payphones providing inter-urban communications fell from 1,256 in 2000 to 194 on 1 July 2003. During the same period urban and rural payphones fell by 36.3%, and on 1 July 2003 there were 4,605.

According to figures for 2000, the number of all-purpose payphones served by the Company totalled 4,517, but in 2001 this was reduced to 2,460 through the sale of the Company's affiliate Sankt-Peterburgskiy taksofony. According to figures for the first half of 2003, the number of all-purpose payphones has grown from 3,433 at the start of 2003 to 3,591, an increase of 4.6%.

**Dynamics of inter-urban and international traffic in North-West Telecom**

	2000	2001	2002	1st half of 2002	1st half of 2003
Total, m mins., incl.	844.4	1,041.4	1,228.7	574.4	664.0
Inter-urban	735.7	914.1	1,082.8	505.9	584.7
International	108.7	127.3	145.9	68.5	79.3

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. In comparison with the figures for 2001, overall traffic (international and inter-urban) grew by 18% during 2002, to 1,228.7 million minutes. In the first half of 2003 the Company's international and inter-urban traffic was 664 million minutes, which is 89.6 million minutes more than during the first half of 2002.

In comparison with international traffic, inter-urban traffic is growing at a faster rate. According to figures for 2002, inter-urban traffic grew by 18.5% to 1,082.8 million minutes, while international traffic grew by 14.6% in comparison with the figure of 127.3 million minutes in 2001. The proportion of international calls in the Company's overall traffic has remained unchanged at 88.1% during the period under review. The growth in international and inter-urban traffic has been caused by the enlarging of the Company's subscriber base, the increase in capacity of the automatic inter-urban telephone exchanges and the increase in business activity in the region.



The Company's Peterburgskaya telefonnaya set branches operates in St Petersburg where the indicator for number of inhabitants is the second highest in Russia after Moscow. Because of this the branch's share in the overall traffic of the Company is 44%, and the proportion of the international traffic is 69%, according to data for the first half of 2003.

#### Dynamics of the number of radio relay stations in North-West Telecom

	2000	2001	2002	1st half of 2003
No. of basic radio relay stations, 1000	1,162.0	1,075.6	976.6	935.1
incl. multi-programme	1,006.4	942.0	862.7	833.1
No. of UHF-FM radio relay stations, 1000	53.2	55.3	61.5	65.6

Source: Svyazinvest

The overall number of basic radio relay stations served by the Company dropped between 2000 and 1 July 2003 to 935,100, or by 19.5%. The main reason for the reduction in the number of basic radio relay stations lies in the low profitability of the service and high costs of installation.

A more profitable form of business is the installation of radio relay stations using UHF-FM. During the first six months of 2003 the number of UHF radio relay stations increased by 4,100 or by 6.7% in comparison with the figures for 1 January 2003.

#### Dynamics of the development of Internet access services provided by North-West Telecom

	2000	2001	2002	1st half of 2003
Volume of information transmitted through the Internet, Gb	n/av	n/av	44,709	38,295
Connection to the Internet via PSTN, 1000 mins.	n/av	n/av	516,430	519,650
E-mail messages, Gb	815.20	1244.7	n/av	n/av

Source: Svyazinvest

During the first half of 2003 the volume of information transmitted through the Internet and connections to the Internet via the PSTN were effectively almost the same as for the whole of 2002. The volume of information transmitted through the Internet during the first half of 2003 was 38,295 Gb, which is 14.3% less than the total for 2002. Connections to the Internet were 516,430,000 minutes in 2002, and during the first half of 2003 they were already at 519,650,000 minutes.

The bulk of the Internet traffic occurs in the St Petersburg, Archangel, Murmansk and Kaliningrad branches, and their share in the overall amount of Internet information transmitted in the Company is 71%, according to figures for the first six months of 2003. At the same time the St Petersburg branch's share is only 13%, which is less than the share of each of the other branches; this is due to the high level of competition in St Petersburg in providing Internet access services.

**Efficiency of the operational performance of North-West Telecom**

	2000	2001	2002	1st half of 2002	1st half of 2003
Average no. of lines, 1000	3,046	3,150	3,279	3,236	3,380
Revenue/no. of lines, R 1000	1.54	2.20	2.97	1.41	1.62
Revenue /no. of employees, R 1000	158.3	147.1	325.3	150.4	185.7
Average no. of lines /no. of employees, unit	102.5	65.6	109.4	106.7	114.4

Source: Svyazinvest

The indicators for the Company's operational efficiency are improving each year. During the first half of 2003 the average number of lines increased to 3,380,000, from 3,236,000 in the first half of 2002. In 2002 the average number of lines was 3,279,000, which was 4.1% higher than the figure for 2001.

The increase in the number of lines in use, an increase in tariffs and the growth in international and inter-urban traffic all had a strong effect on the indicator for revenue/no. of lines. In 2002 revenue/no. of lines was R 2,970, or 135.2% of the figure for 2001. During the first six months of 2003 revenue/no. of lines rose in comparison to the same period of 2002 by 15.2%, reaching R 1,620.

Revenue/no. of employees in the first six months of 2003 was R 185,700, an increase of 23.4% on the figure for the first half of 2002. In 2002 revenue/no. of employees was R 325,300 against R 147,100 in 2001, a growth of 121.1%. The reasons for the significant growth in this indicator were an increase in tariffs and also a reduction in the Company's staff. The average no. of lines/no. of employees was 114.4 according to the figures for the first half of 2003, against 106.7 during the same period of 2002. According to the figures for 2002, the average number of lines per employee was 109.4, which was 66.7% more than the figure for 2001.

There are no obvious leaders among the Company's branches for the efficiency indicators. In the revenue/no. of lines indicator the Murmansk and Kaliningrad branches are in the lead. During the first half of 2003 this indicator in the Murmansk and Kaliningrad branches exceeded the Company's average by 37% and 38% respectively. However, among the branches it is the St Petersburg branch that has the highest indicators for revenue/no. of employees and average no. of lines/no. of employees, R 315,000 and 216 lines; this is caused by the branch's large number of subscribers and consequently, in comparison with the other branches, the largest revenue from providing services.

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

However, 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 density of population, and high standards of living, favourable geographic location (flat ground area), close proximity of population aggregates, and strong competition in the market for new services.

# Financial results

---

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 the notes and independent auditors' report by Ernst & Young, the unaudited financial statements for the first six months of 2003 and the information on the Company's operations. The Company's financial statements are prepared in accordance with International Financial Reporting Standards (IAS).

The Company was formed in 2002 as a result of the reorganisation of nine telecommunications operators of the North-Western Federal District, when North-West Telecom – then called St. Petersburg Telecommunications – merged with eight other joint-stock companies (regional telecom operators). IAS financial statements are therefore available only for 2002 and for the first six months of 2003. The restructuring of the Company was completed by 31 October 2002.

## **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 Financial Reporting Standards (IAS).

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). Because of the reorganisation, the Company's management believes that it is not practicable to present comparative financial information for 2001, or to determine retained earnings and other reserves as at 1 January 2002.

The profit and loss statement given here for the first half of 2003 is unaudited. The financial statements for that period were drawn up by AVK, using estimates and projections based on data 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, audited financial statements were not available for the first six months of 2003.

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 Ministry for finance'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	1st half of 2003 <sup>1</sup>
<b>Assets</b>		
<b>Non-current assets</b>		
Property, plant and equipment, including advances to suppliers	16,332.7	15,374.5
Intangible assets, net	101.9	0.1
Investments in associates and other financial investments, net	944.7	156.5
Other	27.5	35.6
<b>Total non-current assets</b>	<b>17,406.8</b>	<b>15,566.7</b>
<b>Current assets</b>		
Inventories, net	225.9	589.4
Accounts receivable, net	999.9	1,664.8
Other current assets	681.3	898.0
Cash and cash equivalents	347.2	353.5
<b>Total current assets</b>	<b>2,254.4</b>	<b>3,505.7</b>
<b>Total assets</b>	<b>19,661.2</b>	<b>19,072.4</b>
<b>Equity and liabilities</b>		
<b>Shareholders' equity</b>		
Share capital <sup>2</sup>	937.9	937.9
Additional paid-in capital and retained earnings, including the effect of inflation on share capital	12,706.4	13,023.8
Current profit	482.9	592.2
<b>Total shareholders' funds</b>	<b>13,644.4</b>	<b>13,961.8</b>
<b>Minority interest</b>	<b>6.7</b>	<b>0.0</b>
<b>Non-current liabilities</b>		
Borrowings	1,258.4	214.5
Other non-current liabilities <sup>3</sup>	1,644.9	742.6
<b>Total non-current liabilities</b>	<b>2,902.9</b>	<b>957.1</b>
<b>Current liabilities</b>		
Payables and accrued liabilities, taxes payable and social security	1,924.0	2,860.5
Dividends payable	50.6	109.4
Other current liabilities	0.0	43.2
Borrowings <sup>4</sup>	1,132.6	1,140.4
<b>Total current liabilities</b>	<b>3,107.2</b>	<b>4,153.5</b>
<b>Total equity and liabilities</b>	<b>19,661.2</b>	<b>19,072.4</b>

<sup>1</sup> AVK estimates.

<sup>2</sup> Ordinary and preference shares.

<sup>3</sup> Deferred income taxes, equipment contributions, and other non-current liabilities.

<sup>4</sup> Current portion of long-term debt, current portion of obligations under finance leases.

Source: the Company

## Financial results

**Profit and loss summary**

R million	2002	1st half of 2003 <sup>1</sup>
<b>Revenues</b>	<b>10,790.6</b>	<b>5,651.3</b>
Operating expenses	(9,602.2)	(4,799.6)
<b>Operating income</b>	<b>1,188.4</b>	<b>851.7</b>
Interest expenses, net	(260.1)	(85.8)
Other expenses and income, net <sup>2</sup>	(82.1)	36.7
<b>Income before provision for income taxes and minority interest</b>	<b>846.2</b>	<b>802.6</b>
Income-tax expenses	(362.1)	(209.9)
<b>Income before provision for minority interest</b>	<b>484.1</b>	<b>592.7</b>
Minority interest	(1.3)	0.0
<b>Extraordinary income and expenses</b>	<b>0</b>	<b>(0.5)</b>
<b>Net income</b>	<b>482.9</b>	<b>592.2</b>

<sup>1</sup> AVK estimates.

<sup>2</sup> Foreign exchange losses, monetary gains, and other expenses.

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

**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 North-West Telecom's local services**

	Connection fee (R 000)	Subscription (R)	Rate per minute for local calls (R)
Minimum charge	3.0	105.0	0.05
Maximum charge	8.7	195.0	0.16

Source: the Company

The current tariffs were introduced on 1 August 2003. Time-based billing is used only in the Company's Novgorod, St Petersburg and Karelia 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 0.67; the highest rate is R 8.50.

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.

**Expenses**

The Company considers the following expenses significant:

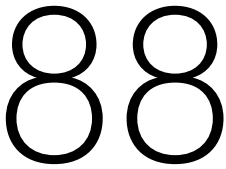
- Operating expenses, which include wages and salaries, cost of materials, equipment repairs and maintenance, and advertising costs;
- Taxes other than income tax;
- Depreciation and amortisation;
- Provisions for bad debts;
- Traffic costs.

**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.

**Financial results**



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 of and asset sales**

In 2002 and the first six months of 2003, the Company conducted no corporate transactions (sales, purchases, mergers or takeovers) that significantly affected the results of its financial and commercial activities. On 15 May 2003, the board of directors approved the proposed merger of the Company with Lensvyaz and Svyaz of the Komi Republic. However, the terms and financial consequences of this merger cannot at present be forecast. Its completion as scheduled depends on many factors, including the regulatory authorities and the approval of the shareholders.

#### **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.



**North-West Telecom's income and expense structure  
(breakdown of income and expenses as a proportion of total revenues)**

%	2002	1st half of 2003 <sup>1</sup>
<b>Revenues<sup>2</sup></b>		
Revenues from local and long-distance communications services	81.2	82.2
Revenues from other communications services	16.7	14.9
Revenues from other services	2.1	2.9
<b>Total revenues</b>	<b>100.0</b>	<b>100.0</b>
<b>Expenses</b>		
Wages, salaries, other benefits and payroll taxes	(30.1)	(28.6)
Materials, repairs, maintenance and utilities	(10.8)	(5.2)
Depreciation and amortisation	(16.1)	(17.8)
Traffic costs	(17.4)	(17.8)
Taxes other than income tax	(3.2)	(1.9)
Other operating expenses <sup>3</sup>	(11.4)	(13.6)
<b>Total expenses</b>	<b>(89.0)</b>	<b>(84.9)</b>
<b>Operating profit</b>	<b>11.0</b>	<b>15.1</b>
Income from associates	0.0	0.1
Interest expenses, net	(2.4)	(1.5)
Other expenses and income, net <sup>4</sup>	(0.8)	0.5
<b>Income before tax</b>	<b>7.9</b>	<b>14.2</b>
Income tax	3.4	(3.7)
<b>Income after tax</b>	<b>4.5</b>	<b>10.5</b>
Minority interest	0.01	n/ av
Extraordinary income and expenses	n/ av	0.0
<b>Net income</b>	<b>4.5</b>	<b>10.5</b>

<sup>1</sup> AVK estimates.

<sup>2</sup> 2002, R 10,790.6 million; first half of 2003, R 5,651.3 million.

<sup>3</sup> Interconnection charges, losses on disposal of property and equipment, bad debts written off, other operating expenses.

<sup>4</sup> Foreign exchange losses, monetary gains, other expenses.

Source: the Company

**Revenues broken down by category of subscriber**

%	2002	1st half of 2003 <sup>1</sup>
Residential customer	59.0	56.3
Corporate customer	37.1	35.9
State organisation	3.9	7.9
Total <sup>2</sup>	100.0	100.0

<sup>1</sup> AVK estimates.

<sup>2</sup> 2002, R 10,790.6 million; first half of 2003, R 5,651.3 million.

Source: the Company

**Financial results**

The relatively insignificant share of state organisations in this breakdown is explained by the lower number of discounts provided by the Company, and by the expansion of its services to other customers.

### Profitability indices

%	2002	1st half of 2003 <sup>1</sup>
Net operating margin <sup>2</sup>	11.0	15.1
Profit margin on core operations <sup>3</sup>	12.4	17.7
Net profit margin <sup>4</sup>	4.5	10.5

<sup>1</sup> AVK estimates.

<sup>2</sup> Ratio of operating profit to revenues.

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

<sup>4</sup> Ratio of net profit to revenues.

Source: the Company

The profitability indices were higher in the first half of 2003 than in 2002. The increase in the net operating margin was mainly because of a reduction in costs of materials, equipment servicing and staff bonuses. The increase in the net profit margin reflects lower income-tax expense.

### 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.

### Selected data from the cash-flow statement

R million	2002
Net cash from operating activities	2,429.5
Net cash used in investing activities	(2,115.6)
Net cash used in financing activities	(137.9)

Source: the Company

In 2002, the Company's cash flow from its investing and financing activities was negative. As in 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). As at 31 December 2002, the Company's current liabilities were R 852.9 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	1st half of 2003 <sup>1</sup>
<b>Current assets</b>		
Inventories, net	225.9	589.5
Accounts receivable, net	999.9	1664.8
Other current assets	681.3	898
Cash and cash equivalents	347.2	353.5
<b>Total current assets</b>	<b>2,254.3</b>	<b>3,505.8</b>
<b>Current liabilities</b>		
Accounts payable and accrued liabilities <sup>2</sup>	1,924.0	2,860.5
Dividends payable	50.6	109.4
Other liabilities	0.0	43.2
Borrowings <sup>3</sup>	1,132.6	1,140.4
<b>Total current liabilities</b>	<b>3,107.2</b>	<b>4,153.5</b>
<b>Total working capital/ (deficit)</b>	<b>(852.9)</b>	<b>(647.7)</b>

<sup>1</sup> AVK estimates.

<sup>2</sup> Taxes payable and social security.

<sup>3</sup> Current portion of long-term debt and current portion of obligations under finance leases.

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 twice as much as accounts receivable, which amounted to R 999.9 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 was reduced by R 205.2 million, thanks to a 66.5% increase in receivables and a 161% growth in inventories.

## Investments

The Company's investments are broadly focused on the development of the local telephone network, which usually absorbs 70% of the Company's total investments. In 2002, 75% of its 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. It plans to direct up to 80% of total investment to that purposes in 2003, and hopes to use borrowed funds for around 57% of total development spending.

### Sources of investment finance

R million	2002	2003 <sup>1</sup>
<b>Sources of funds</b>		
Internally generated funds	1,309.0	1,474.7
Borrowings	432.1	1,512.5
<b>Total investment volume</b>	<b>1,741.1</b>	<b>2,987.2</b>

<sup>1</sup> Preliminary results.

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 1,771.9 million, 10.7% higher than in 2002. This growth was due to a decline in total fees received from government customers, whose contribution to total receivables grew by 4.8% to 22% in the period. The following table breaks down receivables by type of subscriber. Please note that the data for 2002 are taken from the notes to the audited IAS financial statements, while those for the first half of 2003 are AVK's estimates and projections, based on data provided by the Company; there could therefore be discrepancies in the breakdown.

### The structure of North-West Telecom's receivables

%	2002	1 st half of 2003 <sup>1</sup>
Corporate customers	17.2	22.0
Residential customers	31.6	29.3
Government customers, government tariff reimbursements	51.2	48.7
<b>Total<sup>2</sup></b>	<b>100.0</b>	<b>100.0</b>

<sup>1</sup> AVK estimates.

<sup>2</sup> 2002, R 1,600.9 million; first half of 2003, R 1,771.9 million.

Source: the Company

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 18% to 23%. During the first half of 2003, short-term borrowings grew by 0.7% to R 1,140.4 million

**The structure of North-West Telecom's borrowings**

R million	2002	1st half of 2003 <sup>1</sup>
Long-term borrowings, obligation under finance leases <sup>2</sup>	1,258.4	214.5
Short-term borrowings and accrued liabilities <sup>3</sup>	1,132.6	1,140.4
Accounts payable	1,924.0	2,860.5

<sup>1</sup> AVK estimates.

<sup>2</sup> Current portion of long-term debt and current portion of obligation under finance leases.

<sup>3</sup> Taxes payable and social security.

Source: the Company

The Company's non-current liabilities consist of long-term bank credits, credits on equipment supply and long-term obligations under leases. Interest rates on its long-term dollar and euro credits vary from 4.5% to 8.5%. These credits are mostly secured by telecommunication equipment. As at 30 June 2003, the Company's long-term borrowings were 82.9% lower than at the beginning of 2003, thanks to redemptions of debt.

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 48.7% higher than at the end of 2002, mainly because of growth 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 projections and evaluations, the balance-sheet valuation of the Company's fixed assets as at 30 June 2003 was 94.1% of the figure for the end of 2002. This decline in value was due to retirement of assets and accumulated depreciation.

**Valuation of the Company's fixed assets**

<b>R million</b>	<b>2002</b>	<b>1st half of 2003*</b>
Cost	45,543.1	44,025.4
Accumulated depreciation	(29,325.7)	(29,421.0)
Construction in progress	0.0	770.1
Advances paid to suppliers	115.2	0.0
Residual value	16,332.7	15,374.5

\* AVK estimates.

Source: the Company

**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.

# Share capital and corporate management

---

# Capital structure

## The share capital of North-West Telecom on 1 July 2003

	Number of shares issued	Nominal value per share (R)	Total nominal value (R)	%
Ordinary shares	735,917,222	1.00	735,917,222	78.46
Type A preference shares	202,022,788	1.00	202,022,788	21.54
Total	937,940,010	—	937,940,010	100.00

Source: the Company

North-West Telecom's charter allows the Company to place a further 36,517 ordinary shares and 64,605 type A preference shares at their par value of R 1.

The first issue of North-West Telecom securities was registered on 31 May 1993, during the conversion of the state-owned telecoms enterprise Rossvyazinform into a joint-stock company Peterburgskaya telephonnaya set. The Company issued 371,727 ordinary shares, 140,310 type A preference shares and 265,421 type B preference shares, all with a nominal value of R 1. The total value of the issue was R 777,458. A further six issues of ordinary and type A preference shares were prompted by the revaluation of the fixed assets and by the merger of the Company with St Petersburg Telegraph and St Petersburg Intercity and International Telephone in 2000.

Issues 8 to 15 were registered on 9 October 2002, during the reorganisation of nine telecommunication operators of the North-Western Federal District, when North-West Telecom merged with eight joint-stock companies: Artelecom of Archangel region, Murmanelectrosvyaz, Novgorodtelecom, Cherepovtselectrosvyaz, Electrosvyaz of Vologodskaya region, Electrosvyaz of Kaliningrad region, Electrosvyaz of the Republic of Karelia, Electrosvyaz of Pskov region. In total, these issues amounted 262,860,256 ordinary and 87,581,937 type A preference shares type A at a nominal value of R 1.



On 31 December 2003, the Company's largest shareholder was Svyazinvest.

#### Major shareholders of North-West Telecom

Name	Status	Number of shares		%
		Ordinary	Preference	
Svyazinvest	Holder	374,172,243	0	39.893
Brunswick UBS Warburg Nominees	Nominee	139,809,692	35,490,242	18.690
Depository Clearing Company (Depozitarno-klirirovaya kompaniya)	Nominee	65,064,077	29,436,092	10.075
Lindsell Enterprises Limited	Holder	50,363,027	21,291,645	7.640

Source: the Company

#### The structure of North-West Telecom's share capital

	%
Russian organisations (owners and nominees)	74.440
Foreign organisations	11.641
Individual holders of more than 0.1% of the shares	0.173
Individual holders of less than 0.1% of the shares	13.746

Source: the Company

Since 18 July 2002, the register of the Company's shares has been maintained by the telecoms registrar (Registrator-Svyaz), holder of the federal authorities' open-ended licence No. 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 number: (095) 933-42-21. E-mail: regsw@asvt.ru.

# Shareholders' rights

---

## General rights

The shareholders' rights are defined in the Company's charter and the relevant laws. All shareholders who are on the register on the date that the register is closed are entitled to attend shareholders' meetings. Holders of ordinary and type A preference shares all have the right:

- in the event of the Company's liquidation, to receive a share of its assets in proportion to their shareholdings;
- to dispose of the shares that they own without the consent of other shareholders or of the Company;
- to sell their shares to the Company if the Company wishes to acquire them;
- to gain access to certain Company documents as specified in the federal law «On joint-stock companies»;
- in certain cases, as specified in 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 type A preference shareholders 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 that decision or did not vote on it;

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

If (individually or together 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 registrar of any changes in his or her data, and to maintain the confidentiality of information about the Company's activity.

## The rights of ordinary shareholders

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

- to take part and vote in annual general meetings;
- to receive dividends;
- if (individually or together 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.

---

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

All type A preference shares carry the same rights. In addition to the rights listed in the «General rights» section above, every 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 restrict the shareholder's rights;
- to take part in other 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 dividend on the type A preference shares. This right applies only if the next shareholders' meeting after the annual general meeting has also not decided to pay a dividend, and the right is terminated at the first full dividend pay-out.

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

### **Shareholders' preferential rights, and protection from mergers and takeovers**

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

---

The charter gives the Company the right to decide on the dividend pay-out once a year. The board of directors recommends the size of the annual dividend on the ordinary and type A preference shares. This is ratified at the annual general meeting, which also decides, by a simple majority of votes, on the size of the dividend, the pay-out date and the form in which it is paid.

Dividends are paid out to those shareholders who are listed in the register on the date of compilation of 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 dividends are paid out of the Company's net profit as stated in the annual profit and loss statement under Russian accounting standards. Dividends on type A preference shares can alternatively be paid out of funds set aside for this purpose. In the event of the Company undergoing a reorganisation by way of a merger, the net profit is defined as the aggregate net profit (or loss) of the Company and 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 a dividend, 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 date that is determined by the annual general meeting. If the annual general meeting fails to set a pay-out date, the dividend must be paid no later than 60 days from the day when the decision was made to pay out the annual dividends.

## **Dividends on preference shares**

Under the Company's charter, the total dividend per preference share is equal to 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%. However, if that calculation results in a lower amount than the dividend per ordinary share, the dividend per type A preference share must be increased to match that on the ordinary shares.

Under the Company Charter, dividends are paid on the type A preference shares on a date determined by the annual general meeting. If that meeting fails to fix a date, the dividend must be paid no later than 60 days from the day when the decision was made to pay out the annual dividend.

## Dividend dynamics

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

### Dividends, 2000–02

	Dividends on ordinary shares (R)		Dividends on type A preference shares (R)		Total dividend payout (R)	
	Per share	Total sum	Per share	Total	Excluding the merged companies	Including the merged companies
2000	0.119	56,293,780	0.257	29,441,300	85,735,080	143,809,800
2001	0.077	36,425,386	0.248	28,381,331	64,806,717	133,774,600
2002	0.064	47,098,702	0.14	28,283,190	75,381,892	75,381,892

Source: the Company, Svyazinvest

In the year 2000 22.71% of the net profit of North-West Telecom and other companies was paid out to the shareholders (payout ratio by North-West Telecom in this year was 22.72%). In the year 2001 the payout ratios were 19% and 17.8% respectively and after the merger in the year 2002 the payout ratio of North-West Telecom was 23%. 14.92%, 10% and 14.39% of the net profit of North-West Telecom was paid out to the ordinary shareholders in 2000–02. After the merger the payout ratio may be raised as the result of higher efficiency of the Company.

Name of Issuer	Open Joint-Stock Company Petersburg Telephone Network (PTN)*
Date Registration Statement on Form F-6 («Form F-6») Filed with U. S. Securities and Exchange Commission («SEC»)	July 26, 2001
Number of American Depositary Shares («ADSs») Registered	50,000,000
Ratio of ADSs to Shares of Issuer	Each ADS represents 50 common shares
Name of Depositary Bank	Morgan Guaranty Trust Company of New York**
Name of Custodian	Closed Joint-Stock Company ING Bank (Eurasia) (Moscow office)
Name of Russian Share Registrar	Closed Joint-Stock Company Registrar-Svyaz

\* As predecessor to Open Joint-Stock Company North-West Telecom, this issuer's current name.

\*\* As predecessor to JPMorgan Chase Bank.

Source: the Company

The Depositary Bank has issued the ADSs of Open Joint-Stock Company North-West Telecom («the Company»). 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

---

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 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 shares (except in certain cases when the board of directors 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 of directors can make the decision on their own).

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

- the election of members of the board of directors and the audit committee, or the withdrawal of their authority;
- changes in the share capital (except in certain cases when the board of directors 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 involving a conflict of 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 the 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 another 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 of directors, 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 holders of more than half the voting shares in issue. If there is not a quorum at the annual 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 the medium-term 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, budgeting for 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;
- deciding on the quantity and composition of branch management, appointing management personnel, 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 terminating their authority when necessary.

The board of 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 Company's day-to-day operations, and makes decisions on matters that are not the responsibility of shareholders' meetings, the board of directors and the board of management. In addition, the managing director acts as chairman of the 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, responsibilities and remuneration of the managing director are stipulated in 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 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. The company secretary ensures that the Company's governing bodies and officials observe the procedures required to protect the rights and interests of shareholders.

The entitlements, obligations, duties, term of office and remuneration 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 established to assist the company secretary; its composition, staffing, structure and responsibilities are determined by an internal document that is approved by the board of directors.

As at 1 January 2004 the company secretary was not appointed yet.

# Decisions that affect the Company's financial position

---

## **Increasing or reducing the share capital**

The Company may increase its share capital in two ways:

- by placing additional 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 requires a majority of votes cast at a shareholders' meeting. A decision to increase the share capital by placing additional 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 the votes cast at a shareholders' meeting. In other cases, an increase in the share capital by a placement of shares can be sanctioned by a unanimous decision of the board of directors. If they are not in agreement, they can decide to put the matter to a shareholders' meeting, to be decided by a simple majority of votes cast at the meeting.

The Company may reduce its share capital in the following ways:

- 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 open or closed subscription, where the conversion would be 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 shareholders' meeting;
- 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 Company's net assets, and which is not concluded in the course of the Company's ordinary economic activity.

Under the charter, a large transaction involving the acquisition or disposal of assets valued at between 25% and 50% of the balance-sheet value of the Company's net assets requires unanimous approval by the board of directors, or, if the board cannot agree, a simple majority of votes cast at a shareholders' meeting. If the value of such a transaction is between 0.75% 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 a transaction involving more than 50% of the value of the net assets requires a three-quarters majority of votes cast at a shareholders' meeting.

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 20% or more of the voting shares of an organisation which 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 managerial post in such an organisation's managing organisation (that is, an organisation acting as its managing director).

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

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 of the board of directors have an interest in the transaction; and/or
- the value of the transaction equals 2% or more of the balance-sheet value of the Company's assets; and/or
- the transaction is a placement of shares and/or of other 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

---

The board of directors has 11 members, who are elected each year at the annual general meeting by the voting method described above. The charter also authorises the annual general meeting to dismiss the entire board, by a majority of votes cast.

The working principles of the board of directors are set out in the Company's board procedures, as approved by a shareholders' meeting. Board meetings may be convened by the chairman of the board of directors, 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.

The following issues 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 shareholders' meetings;
- the use of reserves and certain other funds;
- the approval of transactions involving the acquisition or disposal of assets whose value is between 0.75% and 50% of the balance-sheet value of the Company's net assets, and the approval of transactions involving a conflict of interest;
- any increase in the share capital by placing additional shares; (see «Decisions that affect the Company's financial position»);
- placements of bonds and other securities;
- buying placed shares, bonds and other securities;
- the definition of the Company's priorities, including approval of the annual, medium-term and long-term budgets, and approval of strategies and programmes of development;
- the approval of the shares registrar and of the terms of his contract, as well as 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 amount of remuneration and compensation paid to the members of the audit committee, and decisions on the auditors' fees;
- management of internal control procedures;
- approval of the Company's structure, and of the opening of branch offices and representative offices;
- defining priorities in the activity of the branches;
- the creation of permanent or temporary board subcommittees;
- 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, establishment of the board of management and the appointment of the company secretary;
- other matters laid out in the Company Charter.

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

Each member of the board of directors has one vote at board meetings, and if there is a deadlock the chairman of the board has the deciding vote.

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

The board of directors may appoint subcommittees in order to improve the efficiency and quality of its work. The members of the subcommittees are not necessarily the members of the board of directors.

There are four subcommittees of the board of directors: corporate governance subcommittee, investment subcommittee, financial reporting and remuneration subcommittee and budgeting subcommittee.

# 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 affiliated companies, as at 1 January 2004.

## The board of directors of North-West Telecom

Name	Year born	Position	Shareholding in North-West Telecom %	Shareholdings in affiliated companies %
Vadim Yevgenyevich Belov	1958	Deputy managing director, Svyazinvest	0.00003	0.0
Yury Alexandrovich Bilibin	1971	Assistant to the managing director, Svyazinvest	0.0	0.0
Alexander Alexandrovich Gogol	1946	Rector of St Petersburg State University of Telecommunication	0.0	0.0
Alexander Vyacheslavovich Ikonnikov	1971	Director of the Association for the Protection of Investors' Rights, chairman of the board of management of Association of Independent Directors	0.0	0.0
Oleg Anatolyevich Lebedinets	1977	Director of the analytical department of Brunswick Asset Management	0.0	0.0
Dmitry Vladimirovich Levkovsky	1965	Vice-president of NCH Advisors, Inc.	0.0	0.0
Irina Mikhailovna Ragozina	1950	Director of corporate governance, Svyazinvest	0.0	0.0
Ivan Ivanovich Rodionov	1953	Managing director of AIG-Brunswick Capital Management	0.0	0.0
Sergei Vladimirovich Soldatenkov	1963	Managing director of Megafon	0.0024	0.0
Alexander Abramovich Sysoyev	1949	Deputy managing director, Telecominvest	0.0376	0.0
Valery Nikolayevich Yashin	1941	Managing director, Svyazinvest; chairman of the board of directors of North-West Telecom	0.172	0.0

Source: the Company

Vadim Belov was managing director of the Moscow office of SPK Capital from 1998 to 1999, and since then has been a deputy managing director of Svyazinvest.

Yury Bilibin was deputy commercial director, and head of investment and international connection management at St Petersburg Telephone Network from 1998 to 1999. Since 1999 he has been the Assistant to the managing director of Svyazinvest.

Alexander Alexandrovich Gogol has been the rector of St Petersburg State University of Telecommunications since 1998.

Alexander Ikonnikov worked in the ministry of fuel and energy of the Russian Federation from 1997 to 1999, then from 1999 to 2000 was employed by the National Association of Stock Market Participants. At present he is the executive director of the Association for the Protection of Investors' Rights and chairman of the board of management of the Association of Independent Directors.

Oleg Anatolyevich Lebedinets was a financial analyst in the investment company Wood & Company from 1999 to 2000, became deputy director of research in the investment bank Alfa-Capital in 2000 and since 2002 has been director of the analytical department of the investment fund Brunswick Asset Management.

Dmitry Vladimirovich Levkovsky has been vice-president of NCH Advisors, Inc. since 1995.

Irina Mikhailovna Ragozina was the chief of the management of the blocks of shares of Svyazinvest from 1997 to 1999, when she became the director of corporate governance.

Ivan Ivanovich Rodionov has been managing director of AIG-Brunswick Capital Management since 1997.

Sergey Vladimirovich Soldatenkov was first deputy managing director and commercial director of St Petersburg Telephone Network from 1999 to 2000, the managing director of North-West Telecom from 2000 to 2002 and has been the managing director of Megafon since 2003.

Alexander Abramovich Sysoyev was managing director of St Petersburg Telegraph from 1995 to 1998, managing director of Lensvyaz from 1998 to 2002, the managing director of North-West Telecom from 2002 to 2003, and has been the deputy managing director of Telecominvest since October 2003.

Valery Yashin was the managing director of St Petersburg Telephone Network from 1993 to 1999, and since then has been the managing director of Svyazinvest.

## The board of management of North-West Telecom

Name	Year born	Position	Shareholding in North-West Telecom %	Shareholdings in affiliated companies %
Nikolai Gennadyevich Bredkov	1953	Deputy managing director and director of corporate governance	0.00633	0.0
Sergei Mihailovich Gavryushev	1951	Chairman of the Coordination board	0.01	0
Ilya Vladimirovich Kravchuk	1975	Deputy managing director and director of operational management and business development	0	0
Sergei Ivanovich Kuznetsov	1953	Managing director and Chairman of the board of directors	0	0
Igor Nikolayevich Samylin	1957	Regional director of St Petersburg Telephone Network	0	0
Oleg Anatolievich Semanov	1967	Deputy managing director and Director of strategic planning and technical policy	0.002	0
Maya Mikhailovna Semchenko	1967	Chief accountant	0	0
Evegeny Borisovich Stepanov	1978	Director of personnel management	0	0
Grigory Borisovich Chernyak	1949	Deputy managing director and Director of assets management	0.04	0
Elena Vladimirovna Umnova	1954	Director of the Finance Department, Svyazinvest	0	0

Source: the Company



**Members of the corporate governance subcommittee on 17 July 2003**

Position in the subcommittee	Name	Position
Head of the subcommittee	Ragozina I. M.	Member of the board of directors of the Company; Director of corporate governance of Svyazinvest
Members	Ikonnikov A. V.	Member of the board of directors of the Company; Director of the Association for the Protection of Investors' Rights; chairman of the board of management of Association of Independent Directors
	Bredkov N. G.	Deputy managing director and director of corporate governance of the Company
	Petrova O. V.	Deputy head of the corporate governance department of Svyazinvest

Source: the Company

**Members of the investment subcommittee on 17 July 2003**

Position in the subcommittee	Name	Position
Head of the subcommittee	Bilibin Y. A.	Member of the board of directors of the Company; Assistant managing director of Svyazinvest
Members	Soldatenkov S. V.	Member of the board of directors of the Company; Managing director of Megafon
	Gogol A. A.	Member of the board of directors of the Company; Rector of St Petersburg State University of Telecommunication
	Levkovsky D. E.	Member of the board of directors of the Company; Vice-president of NCH Advisors, Inc.

Source: the Company

**Members of the financial reporting and remuneration subcommittee on 28 November 2003**

Position in the subcommittee	Name	Position
Head of the subcommittee	Rodionov I. I.	Member of the board of directors of the Company; Managing director of AIG-Brunswick Capital Management
Members	Lebedinets O. A.	Member of the board of directors of the Company; Director of the analytical department of Brunswick Asset Management
	Ikonnikov A. V.	Member of the board of directors of the Company; Director of the Association for the Protection of Investors' Rights; chairman of the board of management of Association of Independent Directors
Associates (with voting rights)	Stepanov E. B.	Director of personnel management
	Filippova N. V.	Head of the HR department of Svyazinvest

Source: the Company

**Members of the budgeting subcommittee on 28 November 2003**

Position in the subcommittee	Name	Position
Head of the subcommittee	Belov V. Y.	Member of the board of directors of the Company; Deputy managing director of Svyazinvest
Members	Zabuzova E. V.	Head of the economic planning and budgeting department of Svyazinvest
	Shalagin A. V.	Deputy managing director and director of economics and finance of the Company
	Lebedinets O. A.	Member of the board of directors of the Company; Director of the analytical department of Brunswick Asset Management

Source: the Company

**Members of the board and board of management**

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

Under the board procedures, members of the board of directors receive remuneration and refunds of their relevant expenses for the period that they work for the Company. They receive both quarterly and yearly remuneration. The basis on which their remuneration is calculated 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 sales in the previous accounting quarter. The most recent shareholders' meeting has set that percentage at 0.0062%. The remuneration of the chairman of the board 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 remuneration may be proportionately reduced, in accordance with board procedures.

The annual remuneration of the directors is calculated as a percentage of the Company's net profit in the previous financial year, according to the Company accounting data. At the most recent shareholders' meeting, this rate was set at 0.4%.

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.

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

As on 1 January 2004, there was no options based incentive scheme for the management of the Company.

Legal and tax issues

# Telecommunications regulation

---

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's (RF's) 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 Communications», 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	130.7	123.3	137.6
Organisations	106.8	115.0	109.0
Government organisations	114.4	137.7	125.9
Commercial enterprises	105.7	111.4	106.9

Source: the State Statistical Committee (Goskomstat)

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 Goskomstat RF, tariffs continued to rise, with the residential rate 20.6% higher than in the first half of 2002.

# Taxation of non-residents

---

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.

When a non-resident institution sells shares in a Russian company, the proceeds are not liable to tax, whether the buyer is a resident or a non-resident. It is much the same when a non-resident sells ADRs to another non-resident, but when ADRs are sold to a Russian resident, any capital gain is subject to income tax at 20%. However, this can be avoided where there is a conventional double taxation arrangement between Russia and the country of the investor.

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.

## **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 American 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.

**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

---

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.

## Major differences between RAR and IAS

**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.

The 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**

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.

**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.

**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.

**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.

**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.

**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.

**Financial leases.** In Russian law, the risks attached to an asset acquired under a lease contract are attributed to the lessor unless otherwise specified in the contract.

For accounting purposes, if an asset acquired under a financial lease and its depreciation are accounted for in the balance sheet of the lessor, the lessee keeps such leases off the balance sheet; and vice versa.

**Business expenses.** For accounting purposes, all regular business expenses (travel, advertising and insurance expenses, for example) are charged to the profit and loss statement in the current year.

For tax purposes, certain adjustments are made to some categories of expense, such as discretionary insurance (including employees' and professional liability insurance), contributions to private pension funds, advertising costs and, to a limited extent, selling expenses.

**Borrowing costs.** Interest on loans can be either treated as an expense or capitalised. Russian accounting rules provide that interest expenses must be capitalised during the period when a non-current asset is being built or created.

**The cash-flow statement.** The presentation of information in the cash-flow statement is in many respects different under RAR and under IAS. For example, the RAR classification of cash flows by type of activity (operational, financial, investments) is different from internationally accepted practice. Also, RAR do not define the term «cash equivalents», so the cash-flow statement is confined to cash balances, and ignores what in international practice would be described as cash equivalents.

**Explanatory notes.** Explanatory notes to financial statements must contain material information on the company and its financial condition, comparative analysis of the reported year and previous years, the company's accounting policy (and any changes made to that policy in the reported year), and any other information that would be material for any potential user.

The rules for the disclosure of information are prescribed by law, and in many respects they are similar to those stated by IAS, concerning subjects such as the disclosure of events occurring in the reporting year, information on affiliates, earnings per share, the breaking down of information by company segment, and government support.

**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

---

## **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

---

The Company is currently defendant in a number of lawsuits which are connected with its business. The majority of them are being brought against the company by customers demanding compensation for psychological and material losses because of poor telecommunications service. There are also complaints about the calculation of telecommunications bills. The total amounts being claimed are not large.

There are also non-regulated hearings brought by corporate bodies, but the Company's management does not expect any of these cases to cause the Company any serious damage.

The Company is also defending suits brought by minority shareholders attempting to reverse decisions made by the board of directors and shareholders' meetings in connection with the reorganisation of the company. These suits are likely to fail: there have been several judgements confirming the legality of the reorganisation.

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

# The investment case

---

# Company comparisons

---

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 <sup>1</sup> , (\$ 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
Center Telecom	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

<sup>1</sup> Earnings before interest, taxes, depreciation and amortisation.

Source: company 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	—	22.0
Internet and data transmission	5.8	8.0	10.7	—
Network interconnection	—	7.8	15.0	—
Other	24.7	4.2	6.3	7.0

Source: company 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, 31/12/02**

(% of authorised capital)	Matav (Hungary)	Telekomunikacja 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: company data

**Company comparisons**

## Comparing North-West Telecom with similar companies

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

	Market Cap' (\$m)	EBITDA/ assets	EBITDA/ sales	Sales/ fixed lines <sup>2</sup> (\$000)	EBITDA/ equity	Liabilities/ assets	Price/ sales	Price/ earnings	Price/ EBITDA	Market Cap/ fixed lines <sup>2</sup> (\$000)
North-West Telecom	303	0.15	0.27	0.09	0.22	0.31	0.87	22.46	3.23	0.08
Center Telecom	511	0.20	0.29	0.09	0.36	0.43	0.91	n/av	3.19	0.08
Uralsvyazinform	654	0.16	0.30	0.17	0.30	0.45	1.15	18.43	3.84	0.20
VolgaTelecom	480	0.21	0.32	0.10	0.32	0.35	1.13	17.71	3.55	0.11
Sibirtelecom	394	0.18	0.27	0.12	0.29	0.39	0.88	18.81	3.22	0.10
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> Companies' IAS financial statements, 31 December 2002; stock exchange data, May 2003.

<sup>2</sup> 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.

North-West Telecom's (N. W. Telecom) ratio of EBITDA to assets, as reported in its 2002 IAS financial statements, is in line with the Svyazinvest Group average and with Cesky Telecom, showing that they have comparable levels of return on assets (ROA). If income grows in the next few years, so will the Company's ROA.

Since North-West Telecom has redeemed most of its debt, its debt ratio is now lower than those of most of the eastern European telecom operators. The company is therefore in a position to increase its long-term debt. Its low EBITDA/equity ratio is accounted for by the relatively low ratio of debt to total liabilities – that is, the company’s return on equity is no lower than that of similar companies, but most of them have a higher proportion of debt.

N. W. Telecom sales per fixed line are lower than those of foreign telecoms. This is because Svyazinvest companies receive most of their income from traditional communication services with fixed tariffs (equal to the prime cost of the service). However, the Svyazinvest telecoms operators’ tariff income per line is expected to grow from 2004 onwards, for four reasons:

- the re-balancing of tariffs, which should increase income from local communications;
- the reduction of long-distance tariffs, which is likely to increase traffic;
- changes in regulation, and the introduction of an investment component into the regulated tariff.
- the spread of de-regulation to other services (internet access, data transmission), demand for which is growing in the Russian regions.

N. W. Telecom EBITDA/sales is relatively low, because its regulated tariff income is a larger proportion of its revenues than that of similar companies with comparable expenditures. However, the Company’s recent merger with other operators in the region is likely to bring down its operating expenses.

The Company’s low price/sales ratio suggests that its income is underrated by the market compared with similar companies abroad, and with some of the other Svyazinvest Group telecoms operators. This reflects the low market liquidity of its shares, and expectations that the Company will merge with telecom operators in Leningrad region and the Republic of Komi. We expect the Company’s income to grow steadily in the next few years, followed by an increase in its market capitalisation.

N. W. Telecom low market capitalisation per line is striking, but is typical of the Svyazinvest companies. The digitisation of the network is one of the main factors in valuing their securities, and North-West Telecom’s income per line is well behind that of similar eastern European companies, because of the low level of network digitisation. However, the investment projects that North-West Telecom is planning should bring it up to the technical level of the Eastern European operators within the next five to seven years, and this should benefit its market cap per line.

At present, we think, investors should view the shares of the Svyazinvest Group companies (and in particular those of North-West Telecom) 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

---

## Valuation methods

To calculate the market value<sup>1</sup> of North-West Telecom's shareholders' equity, the following methods were used:

- valuation of net assets;
- 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 net asset valuation model**

In this model, the value of shareholders' equity is calculated as the difference between the market value of the company's assets and the present value of its liabilities.

The method takes into account the company's actual assets and liabilities, and is particularly suitable for the valuation of a company such as North-West Telecom, which is a heavy consumer of funds and materials. However, this method does not account either for trends in the industry as a whole, or for forecasts of income and expenses, which may significantly distort the calculation of the Company's value.

The calculation was based on the accounts as at 1 July 2003, as prepared under Russian accounting standards (RAR).

<sup>1</sup> For the purposes of the present Section, and in accordance with Russian standards of valuation, the term 'market value' is understood to be the most probable price at which the asset being valued could be sold in a competitive open market, when the parties to such a transaction are acting reasonably and possess all the necessary information, and when the price or the transaction is not affected by extraordinary factors.

**Calculation of the market value of the Company's assets**  
**Calculation of the market value of the assets of the Company on 1 July 2003**

R million	Book value	Market value	Adjustment
<b>Current assets</b>			
Cash and cash equivalents	341	341	0
Short-term investments	12	13	0
Accounts receivable	1,869	1,787	(82)
Inventories	589	589	0
VAT	381	372	(9)
Other current assets	0	0	0
<b>Total current assets</b>	<b>3,192</b>	<b>3,102</b>	<b>(91)</b>
<b>Non-current assets</b>			
Long-term investments	156	511	355
Property, plant and equipment	11,517	20,869	9,352
Construction in progress	770	894	124
Intangible assets	0	0	0
Other non-current assets	36	36	0
<b>Total non-current assets</b>	<b>12,479</b>	<b>22,310</b>	<b>9,830</b>
<b>Total assets</b>	<b>15,671</b>	<b>25,411</b>	<b>9,740</b>

Source: the Company, AVK

**Property, plant and equipment.** On 1 July 2003, the residual value of the Company's property, plant and equipment was R 11,517 million. The Company's property, plant and equipment comprises plots of land, buildings and other structures, machinery and equipment, vehicles and other fixed assets.

The Company owns plots of land with a total area of 253,276 square metres, and with a book value of R 4 million. The market value of the land owned by the Company was assumed to be equal to its cost. The market value of the leasing rights on the plots of land leased by the Company is assumed to be zero, since on average the leasing terms are the same as those in the market as a whole.

Buildings and other structures, machinery and equipment, and vehicles were valued by the indexation method: adjustments for inflation use indices for the prices of construction materials and in the engineering industry, published by the State Statistics Committee of the Russian Federation.

In valuing the market value of the Company's property, plant and equipment, adjustments were made for depreciation not only for physical wear and tear but also for obsolescence.

The value of other components of property, plant and equipment (computers, office equipment, production and household equipment) was calculated without adjustment, as their book value is assumed to be equal to their market value.

On this basis, the market value of the Company's property, plant and equipment was R 20,869 million as at 1 July 2003.

#### Market value of property, plant and equipment on 1 July 2003

R million	Residual value	Market value	Adjustment
Land	4	127	123
Buildings and other structures	5,577	13,248	7,671
Machinery and equipment	5,452	6,889	1,437
Vehicles	81	121	40
Other property, plant and equipment	483	483	0
<b>Total</b>	<b>11,598</b>	<b>20,869</b>	<b>9,271</b>

Source: the Company, AVK

**Accounts receivable.** As at 1 July 2003, accounts receivable totalled R 1,869 million, of which R 21 million were long-term and R 1,848 million were short-term.

To calculate the market value of accounts receivable, they were discounted to their due dates. The discount rate was assumed to be 17%, which is based on rates of 19% (the average bank-loan rate in mid-2003) for individual debtors and 16% (the refinancing rate) for institutional debtors, and on the breakdown of the receivables between types of debtor (individual and institutional). After these adjustments, the market value of accounts receivable was R 1,787 million.

**Construction in progress.** As at 1 July 2003, the book value of construction in progress was R 770 million. It was calculated from the sum of real costs incurred by the Company from the start of construction up to the reporting date, adjusted for inflation during the period. On this basis, the market value of construction in progress was R 894 million.

**Long-term investments.** As at 1 July 2003, long-term investments totalled R 156 million, and consisted mainly of shareholdings in subsidiaries, associates and other companies.

#### Long-term investments

R million	Book value	Market value	Adjustment
Investments in subsidiaries	76	63	(13)
Investments in associates	33	192	159
Investments in other companies	30	239	209
Other long-term investments	17	17	0
<b>Total long-term investments</b>	<b>156</b>	<b>511</b>	<b>355</b>

Source: the Company, AVK

Shareholdings in subsidiaries and associates in which North-West Telecom holds at least 20% of the share capital were valued by net assets and capitalisation of profit (after interest and tax), the calculations being based on their accounts for 2002 and the first half of 2003.

Other long-term investments were valued at book value.

On this basis, the market value of the Company's long-term investments was R 511 million.

**Inventories.** As at 1 July 2003, inventories were valued at R 589 million, and consisted mainly of materials and spare parts for telecommunications equipment. Adjusted for their average shelf life, and given the relatively stable economic situation in Russia, the inventories' book value is close to their market value.

**VAT.** As at 1 July 2003, the book value of VAT was R 381 million. This was discounted, in line with the payment schedule of accounts payable to suppliers and subcontractors, at the rate used for accounts payable, and amounted to R 374 million.

**Cash assets.** These are absolutely liquid, so their book value is equal to their market value.

**Other assets.** This item consists of short-term investments, intangible assets and other non-current assets, and was not adjusted, as these assets are insignificant, amounting in total to only 0.3% of the total book value of the assets.

Thus, on 1 July 2003, the market value of North-West Telecom's assets was R 25,411 million.

#### Calculation of the present value of the Company's liabilities on 1 July 2003

R million	Book value	Market value	Adjustment
<b>Short-term liabilities</b>			
Short-term borrowings and credits	1,140	1,116	(24)
Accounts payable	2,096	1,936	(160)
Other short-term liabilities	153	149	(4)
<b>Total short-term liabilities</b>	<b>3,389</b>	<b>3,201</b>	<b>(188)</b>
<b>Long-term liabilities</b>			
Long-term borrowings and credits	99	91	(8)
Other long-term liabilities	743	507	(235)
<b>Total long-term liabilities</b>	<b>841</b>	<b>598</b>	<b>(243)</b>
<b>Total liabilities</b>	<b>4,230</b>	<b>3,799</b>	<b>(431)</b>

Source: the Company, AVK calculations

**Borrowings and credits.** As at 1 July 2003, short-term borrowings and credits amounted to R 1,140 million, and long-term items to R 99 million. Their present values were calculated from their repayment schedules, the sums to be repaid and the applicable rates of interest, using a discount rate of 19% (see the section below, «Calculation of the discount rate»), and amounted to R 1,116 million and R 91 million respectively.

**Accounts payable.** As at 1 July 2003, accounts payable amounted to R 2,096 million. Their present value was calculated from their repayment schedules, the sums to be repaid and a discount rate of 19% (see «Calculation of the discount rate»), and amounted to R 1,936 million.

**Other long-term liabilities.** As at 1 July 2003, this item amounted to R 743 million. It comprises debts to suppliers and contractors (mainly suppliers of equipment) and debt on lease payments. Its present value was calculated from the Company's redemption schedule and a discount rate of 19% (see «Calculation of the discount rate»), and amounted to R 507 million.

**Other short-term liabilities.** This item, totalling R 153 million, consists of dividends payable to partners (the founders of the Company) and deferred income. In accordance with the terms of redemption of arrears of dividends, dividends payable for 2002 were normalised to their present value. Deferred income and dividends payable for past years were recognised at book value. After adjustments this item amounted to R 149 million.

On this basis, as at 1 July 2003 the present value of North-West Telecom's liabilities was R 3,799 million.

**Calculation of the market value of the Company's net worth.** The value of the Company's net worth (shareholders' funds) was calculated as the difference between the market value of its assets and the present value of its liabilities. On this basis, as at 1 July 2003 the Company's net worth was R 21,612 million.

#### Calculation of the market value of North-West Telecom by the net asset method

R million	31 July 2003
Market value of assets	25,411
Present value of liabilities	3,799
Total market value of 100% holding of North-West Telecom	21,612

Source: AVK calculations

#### 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 net cash flow.** The cash-flow model used to estimate the Company's net worth was generated by AVK on the basis of data provided by North-West Telecom and Svyazinvest. It also takes into account the provisions of the Russian Federation plan «The Concept of Development of the Telecommunications Services Market» and development trends in the industry. The following concepts describe the various elements of the cash-flow forecasts

1. The development of North-West Telecom is forecast up to 2011. It is assumed that during this period the Company will implement its investment plans and pay off all the funds borrowed for such projects.
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.  
It is assumed that income from international, inter-city and local calls contributes over 80% of total revenues.  
Revenue from each type of service was forecast for the main groups of customers (residential, government and business). In calculating operating revenue, allowances were made for organic growth of service volumes and increases in tariffs.
3. It is assumed that 'other revenues' include income from subsidiaries and non-core activities.
4. Operating expenses consist of salaries, cost of materials, fees paid to Rostelecom for outgoing traffic, taxes and duties written off to expenses, research and development costs, interest on borrowings, maintenance of fixed assets, software, utilities and other items written to expenses.  
'Other expenses' include interest payable that is not included in the cost price, selling costs and retirement of fixed assets, provisions for doubtful debts, taxes and dues not written off to expenses, fines, penalty fees, exchange-rate differences and write-offs of accounts receivable.  
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.
5. The value of capital investments was estimated on the basis of the need to develop the intelligent network service, the extension of the inter-city telephone channels, the modernisation of automatic telephone exchanges and the installation of new capacity.  
It is assumed that implementation of the investment programme will increase the Company's revenues by about three times between 2002 and 2011.
6. No adjustment is made for VAT on either revenues or expenses.
7. The income tax rate is assumed to be 24%.

**Forecast of the Company's net cash flow in 2003–2011**

R million	Second half of 2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>Inflow</b>									
Operating revenue	6,380	13,778	15,875	18,842	22,132	25,249	27,269	28,905	30,639
Revenues from non-core activities	161	675	832	967	1,100	1,211	1,308	1,387	1,470
Borrowings	2,838	1,800	600	300	3,050	200	200	0	0
<b>Total inflow</b>	<b>9,379</b>	<b>16,253</b>	<b>17,307</b>	<b>20,109</b>	<b>26,282</b>	<b>26,660</b>	<b>28,777</b>	<b>30,292</b>	<b>32,109</b>
<b>Outflow</b>									
Operating expenses	3,515	8,353	9,764	11,436	12,808	14,384	15,747	16,850	18,020
Other expenses	976	2,080	2,428	2,567	2,650	2,637	2,526	2,423	2,436
Income tax and similar deductions	329	621	660	880	1,274	1,567	1,770	1,937	2,085
Capital investment	1,574	3,730	3,540	3,973	4,193	4,661	2,371	2,371	2,371
Repayment of borrowings	2,059	1,078	460	470	3,727	1,133	1,525	670	0
<b>Total outflow</b>	<b>8,452</b>	<b>15,862</b>	<b>16,852</b>	<b>19,326</b>	<b>24,653</b>	<b>24,382</b>	<b>23,938</b>	<b>24,250</b>	<b>24,911</b>
<b>Net cash flow</b>	<b>927</b>	<b>391</b>	<b>455</b>	<b>783</b>	<b>1,629</b>	<b>2,278</b>	<b>4,839</b>	<b>6,041</b>	<b>7,198</b>
<b>For reference</b>									
EBITDA	2,303	4,609	5,182	6,433	8,328	9,857	10,531	11,076	11,654
EBIT	1,623	3,176	3,416	4,293	5,866	6,948	7,600	8,128	8,688
Net profit	1,042	1,966	2,090	2,786	4,036	4,962	5,604	6,134	6,603

Source: the Company, Svyazinvest, 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 net cash flow estimate and the calculated discount rate, a computation has been made of the present value of net cash flow between 2003 and 2011.

The calculations assume 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 2003–2011 was calculated at R 9,050 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 after the end of the projected period (that is, after 2011). 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 federal ministry for economic development and trade. The present residual value of the Company's net worth was calculated at R 13,379 million.

Using the discounted cash-flow valuation method, therefore, it was calculated that, as at 1 July 2003, the market value of 100% of North-West Telecom was R 22,429 million.

**Calculation of the market value of North-West Telecom by the discounted cash-flow method**

R million	1 July 2003
Total discounted net cash flow for the forecast period	9,050
Present residual value of the business	13,379
Total market value of North-West Telecom	22,429

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 services 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), Greece and Israel. These companies are comparable with North-West Telecom in their size, the structure of their revenues from different activities and their business efficiency. The basic indicators of these companies are shown in the following table.

#### Basic indicators of North-West Telecom and 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
OTE	5,101	5,085	6,068	2,030
Bezeq	2,898	1,739	3,006	763
North-West Telecom <sup>1</sup>	—	345	3,399	91

<sup>1</sup> The values of EBITDA and sales were calculated on the basis of the consolidated financial statements as adjusted to conform with international standards.

Source: the Company, Reuters

Evaluation of the degree of comparability of the benchmark companies was based on computing financial and other indicators and ratios which indicate the profitability and size of the companies, and comparing them with similar indicators and ratios of North-West Telecom. These are listed in the following table:

#### Comparison of indicators and ratios of the benchmark companies and North-West Telecom

	North-West Telecom	Matav	Cesky Tel	OTE	Bezeq
EBITDA/ total assets	0.14	0.20	0.15	0.19	0.22
EBITDA/ sales	0.26	0.41	0.49	0.40	0.44
EBITDA/ equity	0.21	0.41	0.22	0.49	0.54
Revenue per line (\$000)	0.10	0.79	0.44	0.84	0.58
Debt/ equity	0.44	0.97	0.40	1.48	1.46
Telephone density in the region (%)	25.6	38.0	36.0	57.0	47.0

Source: AVK calculations

As the above table shows, the selected benchmark companies resemble North-West Telecom to different degrees. A weighting was therefore assigned to each company to reflect the degree to which its indicators differed from those of North-West Telecom, and was then used to calculate the multiples used for the comparison.

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 the multiples used for the valuation**

	Matav	Cesky Telecom	OTE	Bezeq	Weighted multiple
Weighting (%)	19.0	53.0	17.0	11.0	
Market cap/ EBITDA <sup>1</sup>	4.17	4.29	2.51	3.80	3.92
Market cap/ sales	1.73	2.12	1.00	1.67	1.81

<sup>1</sup> EBITDA — earnings before interest, taxes, depreciation and amortization.

Source: AVK calculations

In the following table we show how these multiples were applied to North-West Telecom 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 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 North-West Telecom has been discounted by 40% (based on the price of the Company's shares in the Russian Trading System). Consequently, a 'bonus' of 66.7% has been added to the valuation of the majority interest.

**Computation of the market value of the net worth of North-West Telecom**

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 <sup>1</sup>	3.92	2,839	11,123	66.7	18,537
Market cap/ sales	1.81	10,790	19,527	66.7	32,544

<sup>1</sup> EBITDA — earnings before interest, taxes, depreciation and amortization.

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. Thus, as at 1 July 2003, the market value of 100% of North-West Telecom, as calculated by the relative valuation method, was R 25,541 million.

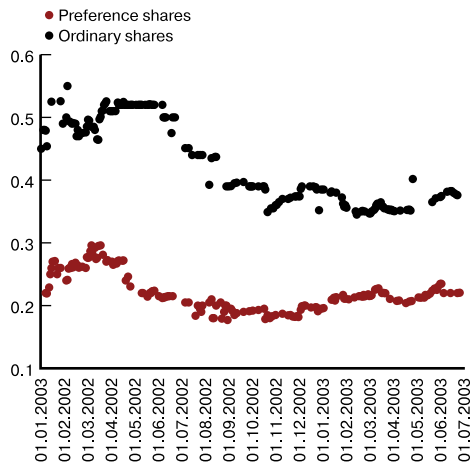
**Calculation of the market value of a 100% holding of North-West Telecom by the relative valuation method**

	Market value (R million)	Weighting (%)
Value of net worth, calculated using market cap/ EBITDA <sup>1</sup>	18,537	50.0
Value of net worth, calculated using market cap/ sales	32,544	50.0
Calculated market value of 100% holding of North-West Telecom	25,541	

<sup>1</sup> EBITDA — earnings before interest, taxes, depreciation and amortization.

Source: AVK calculations

**Valuation**



Movements in the average weighted price of the Company's shares in the RTS (\$)

Source: Russian Trading System (RTS)

## 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 North-West Telecom 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 Trading System (RTS). The following figure shows the changes in the average weighted price of the shares since 2002.

This calculation used the average weighted prices of one ordinary share (\$0.351, or R 11.423 at the Central Bank of the Russian Federation's rate of exchange) and one preference share (\$0.223 or R 6.714).

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:

$$(R\ 11.423 \times 735,917,222) + (R\ 6.714 \times 202,022,788) = R\ 9,763\ \text{million}$$

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 100% of North-West Telecom, as calculated by the comparative transaction method, was R 16,272 million as at 1 July 2003.

## Calculation of the market value of 100% of North-West Telecom by the comparative transaction method

	Average weighted price per share (R)	Number of shares in issue	Total value (R million)
Ordinary shares	11.423	735,917,222	—
Preference shares	6.714	202,022,788	—
All shares	—	—	9,763
Bonus for the majority holding (%)	—	—	66.7
Total market value of a 100% holding of North-West Telecom	—	—	16,272

Source: the Company, RTS, AVK

## 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:

#### Weights of the methods based on different criteria

%	K1	K2	K3	K4
Criteria weightings	20.0	25.0	40.0	15.0
Net asset valuation method	45.0	50.0	10.0	10.0
Discounted cash flow valuation method	40.0	35.0	65.0	25.0
Relative valuation method	10.0	10.0	25.0	30.0
Comparative transaction method	5.0	5.0	0.0	35.0

Source: AVK calculations

The result of this calculation was the following weightings:

	(%)
Net asset valuation method	27.0
Discounted cash flow valuation method	46.5
Relative valuation method	19.0
Comparative transaction method	7.5

#### Calculation of the market value of North-West Telecom's net worth

To derive a single market value from the four methods of valuation, the results that they produced were assigned the weightings calculated above.

#### Calculation of the market value of North-West Telecom's net worth

	Value of shareholders' funds (R million)	Weighting (%)
Net asset valuation method	21,612	27.0
Discounted cash flow valuation method	22,429	46.5
Relative valuation method	25,541	19.0
Comparative transaction method	16,272	7.5
<b>Total</b>	<b>22,338</b>	

Source: AVK calculations

Thus, as at 1 July 2003, the estimated market value North-West Telecom's net worth was R 22,338 million.

## Calculation of the market value of North-West Telecom's shares

The calculated value of the Company is the value of 100% possession of its shares. Of North-West Telecom's share capital, some 78.5% consists of ordinary shares and 21.5% of preference shares.

Analysis of the quoted market prices of the Company's shares in the Russian Trading System shows that the price of the preference shares around the valuation date was approximately 60% 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,  $(P_{ord} \times 735,917,222) + (P_{pref} \times 202,022,788) = R\ 22,338$  million: meaning that the value of all the ordinary shares is R 19,179 million, and the value of all the preference shares is R 3,159 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 North-West Telecom's shares<sup>1</sup>

		All shares	Ordinary shares	Preference shares
Value of shareholders' funds (R million)		22,338		
Apportioned between types of share (R million)			19,179	3,159
Adjustment for minority interest (%)	40.0			
Calculated market value per share (R)			15.6367	9.3820

<sup>1</sup> The CBR rate of exchange as at 1 July 2003 was R 30,3809.

Source: AVK calculations

Thus, as at 1 July 2003, the market value of the net worth of one ordinary share was R 15.64, and for one preference share it was R 9.38.



# IAS financial reports of the Company

---

**Annex 1.**

# Independent auditors' report

---

## To the shareholders and board of directors of North-West Telecom

**1.** We have audited the accompanying consolidated balance sheet of North-West Telecom, a Russian open joint-stock company («the Company» or «N. W. Telecom»), 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 on the basis of 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 presentation of the financial statement. We believe that our audit provides a reasonable basis for our opinion.

**3.** As described in Notes 2 and 20, the Company has not determined and presented its assets and liabilities under defined benefits plans in accordance with International Accounting Standard (IAS) 19, *Employee Benefits*. We were not able to quantify the adjustments, if any, to the financial statements.

**4.** As described in Notes 2 and 8, the Company's accounting records relating to property and equipment 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*. Certain estimates were made by management to present property and equipment in the accompanying 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.

**5.** As a result of the matters described in paragraphs 3 and 4 above, such adjustments, if any, could materially affect (a) property and equipment, equipment contributions, assets and liabilities under defined benefits plans, deferred income tax liability and retained earnings as at 31 December 2002, (b) depreciation expense, other benefits expense, income tax expense and net income for the year ended 31 December 2002, and © related disclosures.

**6.** In our opinion, except for the effects on the 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 North-West Telecom as at 31 December 2002, and the results of their operations and their cash flows for the year then ended in conformity with International Financial Reporting Standards.

**7.** As described in Note 1, the Company was the subject of a reorganisation that was approved by the shareholders on 28 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 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 as at 31 December 2002

(in thousands of roubles in terms of purchasing power of the rouble at 31 December 2002)

R 000	NOTES	31 DECEMBER 2002
<b>Assets</b>		
<b>Non-current assets</b>		
Property, plant and equipment, net	8	16,217,463
Intangible assets, net	9	101,860
Investments in associates, net	11	246,160
Other financial investments, net	11	698,638
Advances to suppliers of equipment		115,210
Other non-current assets		27,509
Total non-current assets		17,406,840
<b>Current assets</b>		
Inventories, net	12	225,931
Accounts receivable, net	13	999,942
Other current assets	14	681,281
Cash and cash equivalents	15	347,176
Total current assets		2,254,330
<b>Total assets</b>		<b>19,661,170</b>
<b>Shareholders' equity and liabilities</b>		
<b>Shareholders' equity</b>		
Preference shares	16	202,023
Ordinary shares	16	735,917
The effect of inflation on share capital		1,724,089
Additional paid-in capital and retained earnings		10,982,343
Total shareholders' equity		13,644,372
<b>Commitments and contingencies</b>	<b>21</b>	<b>-</b>
<b>Minority interest</b>		<b>6,716</b>
<b>Non-current liabilities</b>		
Deferred income taxes	5	1,399,183
Long-term borrowings, net of current portion	17	1,125,727
Obligations under finance leases, net of current portion	18	132,316
Equipment contributions		221,994
Other non-current liabilities		23,692
Total non-current liabilities		2,902,912
<b>Current liabilities</b>		
Current portion of long-term debt	17	793,162
Current portion of obligations under finance leases	18	131,509
Short-term borrowings	17	207,901
Accounts payable and accrued expenses	19, 22	1,331,962
Taxes payable and social security	19	592,042
Dividends payable		50,594
Total current liabilities		3,107,170
<b>Total shareholders' equity and liabilities</b>		<b>19,661,170</b>

# Consolidated statement of operations for the year ended 31 December 2002

(in thousands of roubles in terms of purchasing power of the rouble at 31 December 2002)

R 000	NOTES	2002
<b>Revenues</b>	<b>4</b>	<b>10,790,609</b>
<b>Operating expenses</b>		
Wages, salaries, other benefits, expenses and payroll taxes		3,252,647
Interconnection charges		1,875,615
Depreciation and amortisation		1,733,986
Materials, repairs and maintenance, utilities		1,167,841
Taxes other than on income		346,560
Losses on disposal of property and equipment		162,969
Bad debt expenses		108,440
Other operating expenses	4	954,104
<b>Total operating expenses</b>		<b>9,602,162</b>
<b>Operating income</b>		<b>1,188,447</b>
Foreign exchange losses, net		(189,497)
Interest expenses, net		(260,077)
Monetary gains, net		129,348
Other expenses, net	4	(21,976)
<b>Income before provision for income taxes and minority interest</b>		<b>846,245</b>
Income tax expenses	5	362,113
<b>Income before provision for minority interest</b>		<b>484,132</b>
Minority interest		(1,260)
<b>Net income</b>		<b>482,872</b>
<b>Dividends on preference shares</b>	<b>7</b>	<b>(62,610)</b>
<b>Net income available to ordinary shareholders</b>		<b>420,262</b>
Basic and diluted earnings per ordinary share (R)	6	0.57

# Consolidated statement of cash flows for the year ended 31 December 2002

(in thousands of roubles in terms of purchasing power of the rouble at 31 December 2002)

R 000	2002
<b>Cash flows from operating activities</b>	
Income before provision for income taxes and minority interest	846,245
Adjustments to reconcile net income to net cash from operating activities:	
Depreciation and amortisation	1,733,986
Net cost of finance	260,077
Foreign exchange losses	189,497
Losses on disposal of property and equipment	162,969
Provision for doubtful accounts	108,440
Income from associates	2,885
Gains on disposal of investments	(26,719)
Monetary gains	(129,348)
Changes in operating assets and liabilities:	
Inventories	(13,841)
Accounts receivable	(317,095)
Other current assets	(278,646)
Accounts payable and accrued expenses	896,602
Taxes and social security expenses payable	(424,963)
<b>Cash generated from operations</b>	<b>3,010,089</b>
Interest paid	(214,688)
Income tax paid	(365,888)
<b>Net cash from operating activities</b>	<b>2,429,513</b>
Cash flows from investing activities	
Capital expenditure	(2,206,218)
Proceeds of sales of property and equipment	70,535
Other	20,060
<b>Cash flows from investing activities</b>	<b>(2,115,623)</b>
<b>Cash flows from financing activities</b>	
Proceeds of long-term borrowings	811,677
Repayments of long-term borrowings	(693,340)
Proceeds of short-term borrowings	1,125,682
Repayments of short-term borrowings	(1,157,008)
Payment of finance lease liability	(118,963)
Dividends paid	(105,988)
<b>Net cash used in financing activities</b>	<b>(137,940)</b>
<b>Effect of hyperinflation on cash and cash equivalents</b>	<b>(42,407)</b>
<b>Net increase in cash and cash equivalents</b>	<b>133,543</b>
<b>Cash and cash equivalents as at 31 December 2001</b>	<b>213,633</b>
<b>Cash and cash equivalents as at 31 December 2002</b>	<b>347,176</b>
<b>Supplementary information</b>	
<b>Non-cash transactions</b>	
Equipment acquired on finance lease terms	223,764
Offsets of receivables and payables and barter transactions	35,020
<b>Equipment received free of charge</b>	<b>7,970</b>

# Consolidated statement of shareholders' equity for the year ended 31 December 2002

(in thousands of roubles in terms of purchasing power of the rouble at 31 December 2002)

	Ordinary shares, par value R 1		Preference shares, par value R 1		Effect of inflation on share capital	Additional paid-in capital and retained earnings	R 000
	Shares	R 000	Shares	R 000			
Balance as at 31 December 2001	735,917,222	735,917	202,022,788	202,023	1,724,089	10,633,240	13,295,269
Net income	—	—	—	—	—	482,872	482,872
Dividends declared	—	—	—	—	—	(133,769)	(133,769)
<b>Balance as at 31 December 2002</b>	<b>735,917,222</b>	<b>735,917</b>	<b>202,022,788</b>	<b>202,023</b>	<b>1,724,089</b>	<b>10,982,343</b>	<b>13,644,372</b>

# Notes

## to the consolidated financial statements

---

### 1. Corporate information

**Authorisation of accounts.** The consolidated financial statements of North-West Telecom, its subsidiaries and associated companies for the year ended 31 December 2002 were authorised for issue by the Company's managing director on 31 July 2003.

**The Company's business.** N. W. Telecom is the largest wireline services provider in the North-West Federal District of Russia. The Company's main activities are conducted on the territory of St Petersburg, and generate approximately 50% of its revenues. The Company is an open joint stock company incorporated in the Russian Federation.

The principal business of N. W. Telecom is providing fixed-line local and long-distance telecommunication services to individuals, companies and government organisations. N. W. Telecom also provides other kinds of telecommunication and telematic services. The Company leases communications and Internet channels to other providers. N. W. Telecom has all the licences required to provide these services, and management has reasonable expectations that the licences will be renewed.

The Company's management considers that the Company operates in one geographical and one business segment, and it evaluates performance and makes investment and strategic decisions based upon a review of profitability for the Company as a whole.

The Company's head office is at 26 Bolshaya Morskaya Street, St Petersburg, Russia. The average number of employees of the Company during 2002 was 30,455.

N. W. Telecom is the principal successor to the state-owned enterprise originally known as the Leningrad City Telephone Network. The Company was privatised on 6 May 1993, when it assumed the assets and liabilities of the former state-owned enterprise.

The open joint-stock company Svyazinvest, the national telecommunications holding company controlled by the government of the Russian Federation, owns 51% of the Company's common stock. Svyazinvest controls the majority of wire-line service providers in Russia, as well as other telecommunication and related assets.

**Merger with other operators controlled by Svyazinvest.** On 28 November 2001, the shareholders of the Company approved the merger of N. W. Telecom with eight telecommunication operators in the North-West Federal District of Russia that were also controlled by Svyazinvest. The aim of this merger was to establish a single fixed-line telecommunication provider in the North-West Federal District.

Additional ordinary and preference shares of the Company were issued, and exchanged for 100% of the outstanding shares of the regional enterprises as follows:

Regional Enterprise	Shares issued by the Company		Exchange ratio
	Ordinary	Preference	
Artecom, Arkhangelsk	54,997,606	18,333,163	0.420
Electrosvyaz, Pskov	15,610,781	5,203,638	1.610
Electrosvyaz, Kaliningrad	38,636,440	12,878,823	7.110
Electrosvyaz, Karelia	35,779,115	11,926,568	0.145
Electrosvyaz, Vologda	16,660,997	5,553,754	2.345
Novgorodtelecom, Velikiy Novgorod	23,455,458	7,790,694	229.750
Cherepovetselectrosvyaz, Cherepovets	15,495,009	5,165,031	53.525
Murmanelectrosvyaz, Murmansk	62,224,850	20,730,266	2.000
<b>Total</b>	<b>262,860,256</b>	<b>87,581,937</b>	

The merger was completed on 31 October 2002, after receipt of the necessary approvals from the RF Federal Commission for Securities. The Company completed the conversion of shares in the above operators, and they were folded into one legal entity. These entities were merged into the Company and have become its regional branches.

Transaction costs related to the merger, amounting to R 137,425,000, were charged to expenses (R 11,545,000 in 2002 and R 125,880,000 roubles in previous years).

While International Financial Reporting Standards (IAS) do not specify the accounting principles to be applied to transactions among entities under common control, the Company has accounted for the merger based on the principles of uniting of interests as described in IAS 22, *Business Combinations*. In applying this method, the Company has reflected all amounts in the financial statements at their historical carrying amounts as if the entities had been combined from 1 January 2002, the beginning of the period presented. Unless otherwise described, all the information in these financial statements is presented in this way.



Based on the requirements of IAS 22, the following table summarises the total assets, liabilities, revenue and pre-tax income or loss of each of the regional operators for the year ended 31 December 2002 (the year in which the reorganisation was completed):

R 000	Total assets	Total liabilities	Revenues	Pre-tax income (loss)
North-West Telecom	9,183,836	2,710,825	5,204,925	549,646
Artelecom, Arkhangelsk	2,235,890	905,868	1,179,608	101,415
Electrosvyaz, Pskov	640,875	71,491	448,956	20,599
Electrosvyaz, Kaliningrad	1,044,759	284,129	721,406	(4,464)
Electrosvyaz, Karelia	1,540,551	499,071	704,800	(43,066)
Electrosvyaz, Vologda	1,042,921	243,625	559,079	37,563
Novgorodtelecom	709,404	151,121	496,567	111,760
Cherepovetsselectrosvyaz	562,315	120,138	360,691	50,341
Murmanelectrosvyaz	2,735,614	913,029	1,214,239	(105,031)
	19,696,165	5,899,297	10,890,271	718,762
Eliminations and other adjustments	(34,995)	110,785	(99,662)	127,483
<b>Total</b>	<b>19,661,170</b>	<b>6,010,082</b>	<b>10,790,609</b>	<b>846,245</b>

Before the restructuring on 31 October 2002, the businesses operated as separate subsidiaries of Svyazinvest. Accordingly, the Company has a limited operating history as a combined business.

**The Russian business environment.** The Russian economy, while officially deemed to be of market status from 2002, continues to display certain traits consistent with that of a market in transition. These characteristics have in the past included higher inflation than normal, lack of liquidity in the capital markets and the existence of currency controls, which cause the national currency to be illiquid outside Russia. The continued success and stability of the Russian economy will be significantly affected by the government's continued actions with regard to supervisory, legal and economic reforms.

Management cannot predict what effect changes in fiscal, political or tariff policies may have on the Company's financial position or its ability to make investments in property and equipment. The financial statements in this document do not include any adjustments that might result from these uncertainties. Related effects will be reported in the financial statements as they become known and it becomes possible to quantify them.

**Liquidity and financial resources.** As at 31 December 2002, the Company's current liabilities exceeded its current assets by approximately R 852,840,000 Roubles. As a result, there are uncertainties as to the Company's liquidity and future capital resources.

Since its privatisation the Company has invested in expansion and modernisation of its network. To a significant extent, the Company has financed its investment activities through current liabilities and vendor debt. The Company also requires access to debt and other long-term financing.

Management is addressing the Company's liquidity needs by implementing the following measures:

- The development of a system of billing by the minute (from 31 July 2003 by the regional branch in Karelia, and it is pending in St Petersburg and in other regions, as it requires specific permissions from the RF Ministry for Anti-Monopoly Policy and Support of Business, which management expects to obtain by 31 December 2003);
- The replacement of hard-currency debts by rouble-denominated bonds. The first placement, of R 300 million of bonds, took place in February 2002 (see Note 17 «Loans and borrowings»), and, at the date of this report, a second placement of R 1,500 million was planned for September 2003 (see Note 24, «Subsequent events»);
- Management has delayed payment for certain operating costs, to enable it to manage its working capital requirements, and expects to continue to be able to do so;
- If needed, certain projects may be deferred or curtailed to fund the Company's current operating needs.

Management believes that there will be sufficient funding in 2003 from (a) existing cash balances, (b) cash generated from operations, (c) placement of rouble bonds in the Russian market, and (d) other financing from domestic lending institutions.

## 2. Summary of significant accounting policies

**Basis of preparation.** The Company maintains its accounting records and prepares its statutory accounting reports in Russian roubles and in accordance with the Regulations on Accounting and Reporting in the Russian Federation under the historical cost convention. The accompanying financial statements are based upon the statutory accounting records, which have been adjusted to present the accompanying financial statements in accordance with International Financial Reporting Standards (IAS). IAS include standards and interpretations approved by the International Accounting Standards board (IASB), the International Accounting Standards and Standing Interpretation Committee and the International Accounting standards Committee Foundation (IASCF). There are significant differences between Russian Accounting Regulations and IAS.

The consolidated financial statements have been prepared on an historical cost basis (adjusted for the effects of inflation in accordance with IAS 29).

Before 2002, the Company presented its financial statements in accordance with accounting principles generally accepted in the United States, and denominated in US dollars.

Because of the 2002 reorganisation, the Company changed the reporting of its financial information to conform with IAS. These accounts therefore reflect the first year that the Company has applied IAS. As a result of the reorganisation and the change in accounting, it was not practical for the Company to present comparative financial information for 2001, including the determination of retained earnings as at 1 January 2002.

**Management estimates.** The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities as at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The actual results could differ from those estimates.

**Basis of consolidation.** The consolidated financial statements comprise the financial statements of the Company and its subsidiaries drawn up to 31 December 2002. As described above, the Company

has accounted for the reorganisation on the principles of uniting of interests as described in IAS 22, *Business Combinations*.

Subsidiaries are consolidated from the date on which control is transferred to the Company, and cease to be consolidated from the date on which control is transferred from the Company. Significant inter-company balances and transactions have been eliminated. Minority interests reflect the interests in the consolidated subsidiaries not held by the Company (See Note 10, «Subsidiaries»).

**Investments in associates.** The Company's investments in its associates are accounted for under the equity method of accounting. An associated company is defined as an entity on which the Company has significant influence and which is neither a subsidiary nor a joint venture of the Company. Investments in associates are carried in the balance sheet at cost plus post-acquisition changes in the Company's share of net assets of the associates, less any impairment in value. The statement of operations reflects the Company's share of the results of operations of the associates.

**Accounting for the effects of inflation.** The accompanying consolidated financial statements are prepared in accordance with IAS and under the historical cost convention, and adjusted in accordance with IAS 29, *Financial Reporting in Hyperinflationary Economies*.

The adjustments and reclassifications made to the statutory records for the purpose of IAS reporting include a re-statement for changes in the general purchasing power of the rouble in accordance with IAS 29. IAS 29 requires that financial information prepared in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the balance-sheet date. These adjustments were calculated using conversion factors derived from the Russian Federation Consumer Price Index published by the Russian State Committee on Statistics.

The following table lists the indices used to adjust amounts in these consolidated financial statements relative to 2002 prices (2002 = 1.0) for the years ended 31 December and the corresponding conversion factors:

Year	Index	Conversion factor
1992	7,541	362.4
1993	67,846	40.3
1994	211,612	12.9
1995	487,575	5.6
1996	594,110	4.6
1997	659,403	4.1
1998	1,216,401	2.2
1999	1,663,091	1.6
2000	1,997,843	1.4
2001	2,374,037	1.2
<b>2002</b>	<b>2,733,087</b>	<b>1.0</b>

The main guidelines followed in adjusting the consolidated financial statements to current purchasing power are:

- all amounts are stated in terms of the measuring unit current as at 31 December 2002;
- monetary assets and liabilities as at 31 December 2002 are not re-stated, as they are already expressed in terms of the monetary unit current as at 31 December 2002;
- non-monetary assets and liabilities which are not carried at amounts current as at 31 December 2002 are re-stated by applying the relevant conversion factors;
- shareholders' equity is re-stated by applying the relevant conversion factors;
- Indexation adjustments to property and equipment applicable to prior periods are credited to retained earnings in the accompanying balance sheet;
- All items in the consolidated statements of operations and of cash flows, except for depreciation, amortisation and losses from disposal of fixed assets and other assets, are adjusted by applying appropriate conversion factors;
- The effect of inflation on the Company's net monetary position is included in the consolidated statement of operations as a gain or loss on the net monetary position.

International accounting and financial reporting bodies believe that, with effect from 1 January 2003, Russia should no longer be considered hyperinflationary. As a result, management has determined that it will cease to re-state for changes in the general purchasing power of the rouble after 31 December 2002. The annual rate of inflation during 2002 was 15.1%.

**Translation of foreign currencies.** Assets and liabilities denominated in foreign currencies are translated into roubles at the official exchange rates of the Central Bank of the Russian Federation (CBR) at the year-end. Transactions denominated in foreign currencies are reported at the CBR's rates of exchange at the date of the transaction. Any gains or losses on assets and liabilities denominated in foreign currencies that arise from a change in official exchange rates after the dates of the transactions are recognised as currency translation gains or losses.

Transactions that are conducted in roubles when the related assets and liabilities are denominated in foreign currencies (or conventional units) are recorded in the Company's financial statements on the same principles as transactions denominated in foreign currencies.

**Property and equipment.** The Company's accounting records relating to property and equipment 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*. Certain estimates were therefore made by management to present property and equipment in the accompanying financial statements.

The Company expects to hire an independent appraiser in 2003 to assist in the reconstruction of the historical cost of property and equipment, to make any adjustments that are necessary for the Company's books and records to comply with IAS.

Property and equipment are depreciated on a straight-line basis over the estimated economic useful life of each class of assets, as follows:

Assets	Estimated economic useful life
Buildings and constructions	20–50 years
Switches and transmission devices:	
Analogue switches	10–20 years
Digital switches	10–15 years
Cable and transmission devices:	10–20 years
Other fixed assets:	
Vehicles	5 years
Computers and office and other equipment	3–5 years

Construction in progress is recorded as the total of actual expenses incurred by the Company from the beginning of construction to the reporting date, adjusted for the effect of inflation between the date when such expenses occur and the reporting date, in accordance with IAS 29.

Borrowing costs that are directly attributable to the acquisition or construction of fixed assets are capitalised as part of the cost of the related asset when it is probable that they will result in future economic benefits to the Company and the costs can be measured reliably. Capitalisation of borrowing costs commences when the activities to prepare the asset for intended use start, and lasts until the assets are ready for their intended use. Other interest expenses and borrowing costs are recognised as expenses in the period in which they are incurred.

Construction in progress is depreciated once the property and equipment are put into operation.

The carrying values of property and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. If any such indication exists, and where the carrying values exceed the estimated recoverable amount, the assets are written down to their recoverable amount. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs. The recoverable amount of property and equipment is the greater of the net selling price or value in use. In assessing value in use, the estimated future cash flows are discounted to their present value, using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses are recognised in the statement of operations.

The cost of maintenance, repairs and replacement of minor items of property is charged to maintenance expense. Renewals and betterments are capitalised. Upon the sale or retirement of property and equipment, the cost and related accumulated depreciation are eliminated from the accounts. Any resulting gains or losses are included in the operating results.

The period of validity of the Company's operating licences is significantly shorter than the useful lives used for depreciation of the cost of property and equipment. Management believes that the operating licences will be renewed without significant cost, which would allow the Company to realise the cost of its property and equipment through normal operations.

**Property and equipment contributions.** Property and equipment transferred to the Company free of charge by its customers and other entities outside the privatisation process is capitalised at market value at the date of transfer, and corresponding deferred income is recognised as a liability in the balance sheet and credited to the statement of operations on the same basis as the equipment is depreciated.

If contributions of property and equipment do not generate revenues, such contributions are not recorded.

Grants received from municipal authorities for the purchase of property and equipment are reflected in the balance sheet as deferred income, and recognised as income during the useful life of the asset in accordance with IAS 20, *Accounting for Government Grants and Disclosure of Government Aid Information*.

**Intangible assets.** Intangible assets acquired separately from a business are capitalised at the cost of acquisition. If the market value can be reliably determined, intangible assets acquired as part of an acquisition of a business are capitalised separately from goodwill. If the asset does not have a readily ascertainable market value, the fair value is limited to an amount that does not create or increase any negative goodwill arising on the acquisition. Intangible assets, excluding development costs, that are created within the business are not capitalised. Expenditure on those assets are charged against profits in the year in which they are incurred.

Intangible assets are amortised on a straight-line basis over the estimated economic useful life of each class of assets, as follows:

Licences	3–5 years
Software	7–10 years
Goodwill	5 years

The carrying values of intangible assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

**Research and development costs.** Research and development costs are charged to expenses as they are incurred.

**Investments.** All investments are initially recognised at cost. After initial recognition, investments classified as available for sale are measured at fair value. Gains or losses on investments that are available for sale are recognised as a separate component of equity until the investment is sold, collected or otherwise disposed of, or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported in equity is included in income.

Long-term investments that are intended to be held to maturity, such as bonds, are subsequently valued at their amortised cost using the effective interest rate method.

**Inventories.** Inventories are priced at the lower of cost or net realisable value. Cost is determined primarily using the specific identification method.

**Accounts receivable.** Accounts receivable are stated at face value, less an allowance for doubtful accounts. An estimate of doubtful debts is made when collection of the full amount is no longer probable.

**Cash and cash equivalents.** Cash and cash equivalents represent cash on hand and in the Company's bank accounts, as well as cash deposits and short-term investments with original maturity dates of three months or less as at 31 December 2002.

**Interest-bearing loans and borrowings.** All loans and borrowings are initially recognised at cost. Thereafter, initial recognition, interest-bearing loans and borrowings, are measured at amortised cost, using the effective interest rate method.

**Provisions.** Provisions are recognised (a) when the Company has a present obligation (legal or constructive) as a result of a past event, (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and (c) a reliable estimate can be made of the amount of the obligation. Where the group expects a provision to be reimbursed, the reimbursement is recognised as a separate asset, but only when the reimbursement is virtually certain. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as an interest expense.

**Pensions and other post-employment benefits.** Social contributions (including contributions to the state pension fund) are made through a unified social tax (UST), and calculated by the Company by the application of a regressive rate ranging from 35.6% to approximately 18% of the annual gross remuneration of each employee. The Company allocates the UST to three social funds (the state pension fund and social and medical insurance funds), where the rate of contributions to the pension fund varies from 14% to 28%, depending on the annual gross salary of each employee. The Company's contributions relating to the UST are charged to expenses in the year to which they relate.

In addition to statutory pension benefits, the Company also contributes to defined benefit plans. The majority of the Company's employees are eligible to participate on the basis of a number of factors, including years of service, age and compensation. These plans are maintained by the non-government pension fund Telecom-Soyuz, which is not related to the Company. The plans provide for payments of retirement benefits from the statutory retirement age, which is currently 55 for women and 60 for men. The benefits are based on a formula incorporating the minimum statutory pension level, length of service in both the Company and the telecommunications industry, final average earnings and position in the Company. The benefits do not vest, and are subject to the employee retiring from the Company on or after the statutory retirement ages. Under the Company's agreements with the pension funds, it contributes either a fixed percentage of the participating employee's salary or amounts fixed in the agreements.

The Company has not complied with IAS 19, *Employee Benefits*. Specifically, the Company has not made an actuarial determination of the present value of its benefit obligation under these arrangements to allow it to record its obligation and make the disclosures required under IAS 19 as at 31 December 2002.

In order to fund a portion of the Company's obligation, the Company has committed to contribute agreed amounts (negotiated annually) to certain non-government pension plans. Contributions made by the Company to these plans are charged to expenses when they are incurred.

The Company is reviewing its employees' benefit plans, and intends to harmonise them upon completion of this review, obtain an actuarial analysis and record and adequately disclose its obligations under the defined benefit plans, in order to comply with the requirements of IAS 19. Without an actuarial valuation, management is not able to quantify the impact, but believes the liability is material.

**Leases.** Finance leases of equipment that transfer all the risks and rewards incident to ownership of the leased item to the Company are capitalised at the inception of the lease, at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability in such a way as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged to interest expense.

Capitalised leased assets are depreciated over the shorter of their estimated useful life of the asset or the term of the lease.

Leases where the lessor retains all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the statement of operations on a straight-line basis over the term of the lease.

**Revenues.** The Company categorises sources of revenue as follows:

1. Monthly subscription fees;
2. Long-distance services – domestic and international;
3. Rent of channels;
4. Installation fees;
5. Internet services;
6. Radio broadcasting;
7. Rent of premises;
8. Telegraph services;
9. Wireless services;
10. Other telecommunication services;
11. Other revenues.

**Monthly subscription fees.** The Company recognises revenues related to monthly network fees for local services in the month that the service is provided to the subscriber.

**Long-distance services.** Revenues from long-distance services are based on the time used by the caller, the destination of the call and the services used. The Company charges long-distance fees by the minute. The Company recognises revenues related to the long-distance services in the period when the services are rendered.

**Rent of channels.** The Company provides other telecommunication operators with access to its network. The Company recognises revenues related to the rent of channels in the period when the services were rendered.

**Installation fees.** The Company recognises installation fees for open-ended contracts with its subscribers as revenues when the installation is complete.

**Internet services.** The Company recognises revenues related to internet services in the period when the services are rendered.

**Radio broadcasting.** The Company operates a wireline radio broadcasting network. The revenues are primarily the monthly fees from subscribers. The Company recognises the revenues related to radio broadcasting in the period when the services were rendered.

**Rent of premises.** The Company leases its premises to other businesses under annual contracts. Renewal options are available on the majority of leases. These contracts are accounted for as operating leases, and related rental revenues are recognised over the lease term.

**Telegraph services.** Revenues from telegraph services consist of fees for cable transmissions and other wireline data transmission services. The Company recognises revenues related to telegraph services in the period when the services are rendered.



**Wireless services.** The wireless services provided by the Company include paging and GSM services. The Company recognises the revenues related to wireless services in the period when the services were rendered.

**Other telecommunication services.** Other telecommunication services mainly consist of revenues from the Company's network of payphones and from the rent of channels.

**Other revenues.** Revenues other than telecommunication revenues derive primarily from the production and technical support of telecommunication equipment, sales of handsets and accessories, transport services, maintenance of recreational facilities and other social infrastructure, and sales of goods and services by non-core units.

**Income tax.** Deferred tax assets and liabilities are calculated in respect of temporary differences in accordance with IAS 12, *Income Taxes*.

IAS 12 requires the use of a balance-sheet liability method for financial reporting of and accounting for deferred income taxes. Deferred income taxes are provided for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. The Company's principal temporary differences arise in respect of property and equipment. A deferred tax asset is recorded only to the extent that it is probable that a taxable profit will be available against which the deductible temporary differences can be used.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date, and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be used.

Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the period when the asset is realised or the liability settled, on the basis of tax rates that have been enacted or substantively enacted at the balance-sheet date.

Deferred tax liabilities relating to undistributed earnings of associated companies are recognised when it is probable that such earnings will be remitted to the Company in the foreseeable future.

**Value-added tax.** Value-added tax (VAT) on sales is payable to the tax authorities on an accrual basis, based on invoices issued to the subscriber. VAT incurred for purchases and paid to suppliers may be reclaimed, subject to certain restrictions, against VAT on sales. VAT related to purchase transactions that are not reclaimable as at the balance sheet dates are recognised in the balance sheets on a gross basis.

### 3. Segment information

N. W. Telecom operates in one industry, the provision of wireline telecommunication services, in one territory, the North-West Federal District. The Company's structure is based on territorial units which service the corresponding parts of the Company's network. The Company's management considers that the Company operates in one geographical and one business segment, and its evaluations of performance and its investment and strategic decisions are based on a review of profitability for the Company as a whole.

#### 4. Revenues and expenses

##### Revenues

R 000	2002
Monthly subscription fees	3,669,323
Domestic long-distance services	3,055,484
International long-distance services	1,459,670
Rent of channels	624,570
Installation fees	574,771
Internet services	215,770
Radio broadcasting	158,282
Rent of premises	140,842
Telegraph services	127,859
Wireless services	94,177
Other telecommunication services	446,442
Other revenues	223,419
	10,790,609

For the year ended 31 December 2002, the Company identified revenue from major customer groups as follows:

R 000	2002
Residential (individual) customers	6,371,150
Corporate customers	3,998,980
Government customers	420,479
<b>Total</b>	<b>10,790,609</b>

##### Other operating expenses

R 000	2002
Consultancy and other professional fees	110,610
Rent (excluding channel rent)	107,111
Business travel	68,206
Transport expenses	65,534
Fire protection and security	61,918
Fines and penalties	60,934
Payments to Gossvyaznadzor	48,018
Advertising	35,722
Cost of goods sold	34,815
Training	29,486
Postage	22,170
Consultancy fees in respect of the merger described in Note 1 above	11,545
Other	298,035
<b>Total</b>	<b>954,104</b>

\* the State Inspectorate controlling telecommunications

**Other income and expenses, net**

R 000	2002
Contributions to the research and development fund	38,221
Other income	(37,593)
Loss from write-off of social assets	16,395
Gains from disposal of investments	(26,719)
Other expenses	31,672
	<b>21,976</b>

**5. Income tax****Income tax expense**

R 000	2002
Current tax	348,194
Deferred tax	13,919
	<b>362,113</b>

A reconciliation of the theoretical and the actual income tax charge is as follows:

R 000	2002
Income before provisions for income taxes and minority interest	846,245
Theoretical tax charge at the statutory income tax rate of 24%	203,099
Effect of:	
Expenses not deductible for tax purposes	170,837
Loss on disposal of property and equipment, not deductible for tax purposes	38,826
Permanent elements of monetary gain	115,889
Inflation effect on deferred tax balance at the beginning of the year	(185,475)
Other reconciling items	18,937
<b>Income tax expense as reported in the accompanying financial statements</b>	<b>362,113</b>

Deferred tax assets and liabilities comprised of the following as at 31 December 2002:

R 000	2002
<b>Deferred income tax liabilities</b>	
Property and equipment	1,386,665
Investment valuation	212,047
Other	262,284
Gross deferred income tax liabilities	1,860,996
<b>Deferred income tax assets</b>	
Accounts payable	287,450
Accounts receivable	43,831
Other	130,532
Gross deferred income tax assets	461,813
<b>Net deferred income tax liability</b>	<b>1,399,183</b>

## 6. Earnings per share

Basic and diluted earnings per share are calculated by dividing the net profit for the year attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year. Ordinary shares issued as part of the reorganisation – accounted for a method similar to the uniting of interests method – are included in the calculation of the weighted average number of shares from 1 January 2002, as the financial statements of the Company are prepared as if the combined entity had existed at that date. The number of ordinary shares is therefore the aggregate of the weighted average number of shares of the combined entities, expressed as an equivalent number of shares of the Company outstanding after the reorganisation.

	2002
Net income (R 000)	482,872
Preferred dividends (R 000)	(62,610)
Net income attributable to ordinary shareholders (R 000)	420,262
Weighted average number of ordinary shares for basic and diluted earnings per share	735,917,222
<b>Earnings per ordinary share, basic and diluted (R)</b>	<b>0.57</b>

The Company has no potentially dilutive shares outstanding.

There have been no other transactions involving ordinary shares or potential ordinary shares since the reporting date and before the completion of these financial statements.

## 7. Dividends

### Declared in 2002 (for the year 2001)

R 000	2001
Dividends on ordinary shares	71,159
Dividends on preference shares	62,610
<b>Total</b>	<b>133,769</b>

Approved at the annual shareholders' meeting for 2002 (see Note 24, «Subsequent Events»)

R 000	2002
Dividends on ordinary shares	47,099
Dividends on preference shares	28,283
<b>Total</b>	<b>75,382</b>

Dividends paid to shareholders are determined by the directors and legally declared and approved at the annual shareholders' meeting. Earnings available for dividends are limited to profits determined in accordance with Russian statutory accounting regulations.

## 8. Property and equipment

R 000	Buildings and constructions	Switches and transmission devices	Machines and other equipment	Assets under construction and equipment awaiting installation	Total
<b>Cost</b>					
As at 1 January 2002	21,990,547	17,934,953	4,003,165	814,224	44,742,889
Additions	—	—	—	2,127,606	2,127,606
Disposals	(472,482)	(621,267)	(167,541)	(66,090)	(1,327,380)
Transfers into operation	348,842	979,345	385,640	(1,713,827)	—
<b>As at 31 December 2002</b>	<b>21,866,907</b>	<b>18,293,031</b>	<b>4,221,264</b>	<b>1,161,913</b>	<b>45,543,115</b>
<b>Accumulated depreciation</b>					
As at 1 January 2002	13,590,844	11,797,228	3,067,546	—	28,455,618
Charge for the year	527,235	831,916	328,790	—	1,687,941
Depreciation on disposals	(247,595)	(413,932)	(156,380)	—	(817,907)
<b>As at 31 December 2002</b>	<b>13,870,484</b>	<b>12,215,212</b>	<b>3,239,956</b>	<b>—</b>	<b>29,325,652</b>
<b>Net book value as at 31 December 2002</b>	<b>7,996,423</b>	<b>6,077,819</b>	<b>981,308</b>	<b>1,161,913</b>	<b>16,217,463</b>

The net book value of plant and equipment held under finance leases at 31 December 2002 is R 86,772,000. Leased assets are pledged as security for the related finance lease liabilities.

Total interest costs capitalised during 2002 amounted to R 9,835,000.

Fixed assets with a net book value of R 623,009,000 as at 31 December 2002 were pledged as security for bank loans.

The accounting for property and equipment does not comply with IAS 16, 29 and 36 – see Note 2, «Summary of Significant Accounting Policies».

## 9. Intangible assets

R 000	
<b>Cost</b>	
At 1 January 2002	203,102
Additions	50,494
Disposals	(13,564)
<b>At 31 December 2002</b>	<b>240,032</b>
<b>Accumulated amortisation</b>	
At 1 January 2002	96,617
Charge for the year	45,540
Disposals	(3,985)
<b>At 31 December 2002</b>	<b>138,172</b>
<b>Net book value at 31 December 2002</b>	<b>101,860</b>

## 10. Subsidiaries

As at 31 December 2002, the consolidated financial statements of N. W. Telecom included the significant subsidiaries listed below:

Name	Nature of business	Holding, (%)
Arkhangelsk City Telephone Network	Provision of network services	77.0
Vologda Cellular Network	Cellular transmission services	60.0

All consolidated entities are incorporated under the laws of the Russian Federation. Certain other subsidiaries have not been consolidated and were accounted for using the cost method, because their costs and revenues would not materially affect N. W. Telecom results. These investments were included in other financial investments. See Note 11, «Investments in Associates and Other Financial Investments».

## 11. Investments in associates and other financial investments

### Investments in associates on 31 December 2002

Name	Nature of business	Holding (%)	Carrying value (R 000)
<b>Accounted for by the equity method</b>			
Delta-Telecom, St Petersburg	Cellular network (NMT-450 MHz)	43.0	176,636
WestBaltTelecom, Kaliningrad	Provision of network services	28.0	38,053
Medexpress, St Petersburg	Medical insurance services	35.0	16,692
Severnaya Clearing Chamber, Vologda	Payment and settlement systems	20.0	12,100
Tele-Nord, Murmansk	Cellular network (NMT-450 MHz)	25.0	2,679
			246,160
<b>Carried at cost</b>			
Neva Cable, St Petersburg	Manufacture and sale of cables	49.0	394
KMS, Kaliningrad	Cellular network (NMT-450 MHz)	34.0	300
Other associates			23
			717
Less allowance for impairment			(717)
<b>Total</b>			<b>246,160</b>

Associates accounted for by the equity method were initially recorded at cost, and the carrying amount was increased or decreased to reflect the N. W. Telecom share of the associates' profits or losses after the date of acquisition. All associates are incorporated under the laws of the Russian Federation.

The following other financial investments in subsidiaries and in financial assets available for sale were accounted for at cost as at 31 December 2002.

Name	Nature of business	Holding (%)	Carrying value (R 000)
Telecominvest	Communication companies holding	15.0	615,336
St Petersburg Bank of Reconstruction and Development	Banking services	18.0	21,495
St Petersburg Centre of Electrosvyaz	Communication training services	54.0	15,359
Svyazbank	Banking services	0.4	14,597
AMT	Information and financial services	100.0	12,677
RusLeasingSvyaz	Leasing services	4.0	6,143
Other			35,312
			720,919
Less allowance for impairment			(22,281)
<b>Total</b>			<b>698,638</b>

All the above companies are incorporated under the laws of the Russian Federation.

As discussed in Note 10, «Subsidiaries», certain other subsidiaries have not been consolidated, and were accounted for using the cost method, because their profit or loss did not materially affect N. W. Telecom results. They are included in 'Other financial investments' above.

Because the financial assets available for sale are not quoted in an active market, management has reflected such assets at cost less a reserve for impairment.

## 12. Inventories

R 000	31 December 2002
Cable, materials and spare parts for telecommunication equipment	214,239
Finished goods and goods for sale	13,864
Other inventories	936
	229,039
Less: allowance for unused and obsolete inventory	(3,108)
<b>Total</b>	<b>225,931</b>

## 13. Accounts receivable

R 000	See notes	31 December 2002
Residential customers	a	506,193
Corporate customers	a	274,817
Government customers	a	115,892
Government tariff reimbursements	b	704,022
Other receivables	c	137,277
		1,738,201
Less provision for doubtful accounts		(738,259)
<b>Total</b>		<b>999,942</b>

- a. The Company invoices its government and corporate customers monthly. The Company sends residential customers monthly requests for payment, and substantially relies upon these customers to remit payment. All customers' payments are based on tariffs, denominated in roubles, in effect at the time of calls made.
- b. In accordance with Russian legislation, invalids, veterans and certain other categories of the population pay only 50% of published tariffs for services provided by the Company. The local or federal government should reimburse the remaining 50%, but they do not always make such reimbursements in full. Most of the allowance for doubtful accounts shown above relates to such receivables.
- c. Other receivables include pre-paid taxes and settlements related to the Company's non-core activities.



**14. Other current assets**

R 000	31 December 2002
Input VAT	376,237
Pre-payments and advances	211,734
Taxes pre-paid	64,900
Other assets	138,780
	791,651
Less provision for doubtful accounts	(110,370)
<b>Total</b>	<b>681,281</b>

**15. Cash and cash equivalents**

Cash and cash equivalents as at 31 December 2002 comprised the following:

R 000	31 December 2002
Cash at bank and on hand	327,925
Short-term bank deposits	19,251
<b>Total</b>	<b>347,176</b>

**16. Share Capital**

The Company's Share Capital comprised of the following as at 31 December 2002:

Share capital:	2002	
	Shares	Share capital (R 000)
Preference shares, R 1 par value		
Shares issued and outstanding as at 31 December 2002	202,022,788	202,023
Shares authorised, not issued	64,605	
Ordinary shares, R 1 par value		
Shares issued and outstanding as at 31 December 2002	735,917,222	735,917
Shares authorised, not issued	36,517	
<b>Total share capital</b>		<b>937,940</b>

The share capital account represents the authorised capital of the Company as stated in the charter documents. Of the capital stock issued as at 31 December 2002, 78% was attributable to common shares and 22% to type A preferred shares. Ordinary shares carry one vote. Type A preferred shares, are non-voting. All ordinary shares and type A preferred shares are eligible for distribution of earnings available in accordance with Russian statutory accounting regulations. Type A preference shares are entitled to a minimum annual dividend equal to 10% of the statutory net income available for dividends. Dividends on type A preference shares may not be less than the dividends on ordinary shares. Holders of type A preference shares have a preferential right to recover the par value of preference shares in the event of liquidation.

Breakdown of the Company's shareholders as at 31 December 2002:

	Ordinary shares		Preference shares		Total
		(%)		(%)	
Svyazinvest	374,172,243	51.0	—	—	374,172,243
Brunswick UBS Warburg Nominees	102,844,749	14.0	20,325,485	10.0	123,170,234
Other legal entities	215,789,975	29.0	86,720,674	43.0	302,510,649
Individuals	43,110,255	6.0	94,976,629	47.0	138,086,884
	<b>735,917,222</b>	<b>100.0</b>	<b>202,022,788</b>	<b>100.0</b>	<b>937,940,010</b>

In August 2001, the US Securities and Exchange Commission registered the Company's Level 1 American depositary receipts (ADRs) programme for ordinary shares. In September 2001, the Company concluded a depositary agreement with JP Morgan Chase Bank. Each ADR represents 50 ordinary shares. As at 31 December 2002, no ADRs had been issued under this programme (see also Note 24, » Subsequent events«).

## 17. Loans and borrowings

### Short-term borrowings

R 000	Interest rate (%)	31 December 2002
Sberbank	18.0–19.0	88,900
Petrovskiy Bank	20.0	64,000
Svyazbank	21.0–23.0	20,000
Promenergobank	18.0–22.0	14,000
Other	18.0–23.0	21,001
		207,901

**Sberbank.** The Company has borrowed several loans from Sberbank, totalling R 88,900,000 and maturing between January and October 2003. The Company has pledged property and equipment valued at R 168,789,000 for these loans.

**Petrovskiy Bank.** There are two loans from Petrovskiy Bank, totalling R 64,000,000 and maturing in March and June 2003. The Company has pledged property and equipment valued at R 120,351,000 as collateral.

**Svyazbank.** There are several loans totalling R 20,000,000. Two loans totalling R 15,000,000 are payable on demand. The remaining R 5,000,000 mature in March and April 2003. The Company has pledged property, plant and equipment valued at R 31,288,000 as collateral.

**Promenergobank.** There are several loans totalling R 14,000,000 and maturing in July and December 2003. The Company has pledged property, plant and equipment valued at R 21,387,000 as collateral.

**Long-term borrowings**

R 000	Interest rate (%)	Maturity	31 December 2002
<b>Loans</b>			
Vnesheconombank	6.0–8.5	2006	544,634
Svyazinvest	Interest-free	2004	63,169
RTK–Leasing	19.0	2006	29,716
Other			17,998
<b>Total loans</b>			<b>655,517</b>
<b>Vendor debt</b>			
Consortium of Mitsui, Sumitomo and NEC Corporation	LIBOR plus 2.2–2.5	2004	594,807
Siemens	6.0–8.0	2007	280,329
Other			88,236
<b>Total vendor debt</b>			<b>963,372</b>
<b>Bonds</b>			
N. W. Telecom bonds	16.0–20.0		300,000
<b>Total long-term borrowings</b>			<b>1,918,889</b>
Less current portion of long-term debt			(793,162)
<b>Total long-term borrowings, net of current portion</b>			<b>1,125,727</b>

**Vnesheconombank.** This indebtedness represents the Company's liability to the Federal government for amounts paid by the government under equipment delivery contracts concluded between the Company and foreign suppliers in 1995–97. Vnesheconombank acted as the agent of the government to effect the payments and collect the funds from N. W. Telecom.

The balance outstanding consists of several debts totalling R 544,634,000, including interest and penalties. These debts were originally denominated in deutschmarks and, following the introduction of the European currency, re-denominated in euros. These debts are unsecured.

These debts mature in 2006, but, due to the financial crisis in 1998, management is attempting to restructure them. On 27 July 2002, the government issued resolution # 574, which is designed to restructure these debts for repayment by 2012. The restructuring agreements are expected to have been concluded by the end of 2003.

**Svyazinvest.** In April 2000, the Company received a US dollar-denominated interest-free loan from Svyazinvest of \$2 million (R 63,169,000 at the exchange rate on 31 December 2002). Repayment of \$1 million is due in December 2003, and the remainder in December 2004. This loan is not secured. As described in Notes 1 and 16, Svyazinvest is a majority shareholder of N. W. Telecom.

**RTK–Leasing.** In June 2002, the Company entered into a loan agreement with RTK–Leasing for R 29,716,000. This loan is repayable in monthly payments by January 2006, and is not secured.

**Mitsui, Sumitomo and NEC.** In March 2000, N. W. Telecom entered into a debt restructuring agreements with several vendors: Mitsui, Sumitomo and NEC Corporation. The loans are for approximately €18 million (R 594,807,000 at the 31 December 2002 exchange rate). Under these agreements, the repayment terms, including interest, were amended, and N. W. Telecom had to provide additional security in the form of guarantees by Svyazinvest. The interest rates range from 2.2% to 2.5% over the London inter-bank rate (LIBOR). Interest and principal payments are made monthly. The maturity date is in December 2004.

**Siemens.** These loans consist of several euro-denominated vendor agreements with Siemens for the delivery and installation of telecommunications equipment. The total amount is €8,467,000 (R 280,329,000 at the 31 December 2002 exchange rate). Some of the repayments of the principal are due monthly and some quarterly. The maturity date is June 2008. The loans are secured by telecommunications equipment.

**Bonds.** On 6 March 2002, N. W. Telecom issued 300,000 non-convertible bonds with a face value of R 1,000 each, for a total of R 300 million. The bonds were sold at a discount of 3.5%. The maturity date is 10 April 2004. Interest is payable in July 2002 at 20% per annum, in October 2002 at 19% per annum, in April 2003 at 18% per annum and in October 2003 and April 2004 at 16% per annum.

## 18. Obligations under finance leases

The Company has finance lease contracts for telecommunication equipment. Future minimum lease payments under these contracts, together with the present value of the net minimum lease payments as at 31 December 2002, were as follows.

R 000	Minimum payments	Present value of payments
Within one year	139,702	131,509
More than one year but not more than five years	238,837	132,316
<b>Total minimum lease payments</b>	<b>378,539</b>	<b>263,825</b>
Less amounts representing finance charges	(114,714)	—
<b>Present value of minimum lease payments</b>	<b>263,825</b>	<b>263,825</b>

## 19. Accounts payable and other current liabilities

R 000	31 December 2002
Accounts payable related to capital construction and other investing activities	388,446
Customer advances	359,399
Payable to employees	163,585
Trade payables to Rostelecom	115,892
Contributions to the Research and development fund	85,528
Other payables	219,112
<b>Total</b>	<b>1,331,962</b>

**Other current liabilities.** This primarily consists of amounts payable relating to salary and social insurance.

R 000	2002
VAT	370,866
Unified social tax	67,155
Sales tax	44,079
Property tax	41,343
Income taxes	28,277
Other taxes	40,322
<b>Total</b>	<b>592,042</b>

## 20. Pension plans and employee benefits

In 2002, the Company made various payments to employees in addition to salary. These payments generally represent financial aid to the Company's employees officially classified as disabled and bonuses to employees who had not breached Company policies during the last fiscal year. Such benefits were included in the item 'Wages, salaries, other benefits, expenses and payroll taxes' in the accompanying statement of operations, and amounted to approximately R 857,476,000.

As described in Note 2, «Summary of significant accounting policies (Pensions and other post-employment benefits), in addition to statutory pension benefits the Company also contributes to defined benefit plans. The Company has not yet made an actuarial determination of the present value of its benefit obligation under these arrangements, to allow it to record its obligation and make the required disclosures under IAS 19, *Employee Benefits*, as at 31 December 2002. Up to and in 2002, the record of pension expenses was based on the amount of contributions paid to Telecom-Soyuz. Pension fund contributions charged to expenses in 2002 were R 61,094,000.

## 21. Commitments and contingencies

**Capital expenditure commitments.** The Company has purchase commitments for property and equipment incidental to the ordinary course of business. Such commitments amounted to R 64,155,000 as at 31 December 2002. In aggregate these commitments are at prices that are not above current market prices.

**Insurance cover.** The Russian insurance industry is still developing, and many forms of insurance protection common in other parts of the world are not yet generally available. During 2002, the Company did not maintain insurance cover on a significant part of its property and equipment, nor for business interruption, nor for third party liability in respect of property or environmental damage arising from accidents on the Company's property or relating to the Company's operations. Until the Company obtains adequate insurance cover, there is a risk that the losses caused by the destruction of certain assets could have a material adverse effect on the Company's operations and financial position.

**Litigation, claims and assessments.** The Russian legal system is characterised by (1) inconsistencies between and among laws, presidential decrees and Russian government, ministerial and local orders, decisions and resolutions and other acts; (2) conflicting local, regional and federal rules and regulations; (3) a lack of judicial and administrative guidance on interpreting legislation; (4) relative inexperience of judges and courts in interpreting legislation; and (5) a high degree of discretion on the part of governmental authorities.

Management is unable to estimate what developments may occur in the Russian legal system, or the effect of any such developments on the Company's financial condition or future results of its operations. The financial statements do not include any adjustment that may result from these uncertainties.

## 22. Related-party transactions

**The government of the Russian Federation and state-owned telecommunications companies.** As discussed in Note 16, «Share capital», the government of the Russian Federation, through its 75%-owned holding company Svyazinvest, has effective voting control over N. W. Telecom. The Company regards Svyazinvest as its parent entity (as disclosed in Note 16, Svyazinvest owns 51% of the Company's ordinary stock). Svyazinvest was wholly owned by the Russian government until July 1997, when the government sold 25% plus one share of the charter capital of Svyazinvest to the private sector.

An effectively operating telecommunications and data transmission facility is of great importance to Russia for various reasons, including economic, strategic and national security considerations. Consequently, the government has and may be expected to continue to exercise significant influence over the operations of Svyazinvest and its subsidiary companies.

In addition, Svyazinvest effectively controls other recently privatised telecommunications companies, which have business relationships with the Company.

During 2002, the Company entered into transactions with such state-controlled and regulated companies, involving among other things the provision of long-distance interconnection and the establishment of joint telecommunications projects. N. W. Telecom has a loan of \$2 million outstanding to Svyazinvest as at December 2002 (see Note 17). Other transactions with state-controlled and regulated telecommunications companies were not material in 2002, except in the case of Rostelecom.

**Rostelecom.** Rostelecom, a majority-owned subsidiary of Svyazinvest, is the primary provider of domestic long-distance and international telecommunications services in the Russian Federation. The Company has negotiated interconnection agreements with Rostelecom. The annual expense associated with traffic carried by Rostelecom and terminated outside the Company's network is reported as interconnection charges. In 2002, interconnection charges related to Rostelecom amounted to R 1,256,572,000, while other expenses amounted to R 216,596,000. The amount payable as at 31 December 2002 was R 115,892,000.

**Transactions with state organisations.** State organisations are a significant part of the Company's customer base, purchasing services both directly through numerous authorities and indirectly through their affiliates. Certain entities financed by the government budget, including the ministry of defence, are users of the Company's network. These entities are generally charged lower tariffs, as approved by the RF Ministry for Anti-Monopoly Policy and Support of Business, than those charged to other customers. In addition, the government may by law require the Company to provide it with certain services in connection with national security and the detection of crime.

Government subscribers accounted for approximately 47% of gross trade accounts receivable as at 31 December 2002 (R 819,914,000), including R 704,022,000 of compensation for discounting of tariffs for certain sections of the population (see Note 13, «Accounts receivable»).

**Associates.** During 2002 the Company entered into various transactions with its investees, including the provision of interconnection to the public network, and rent of premises for technological and office use.

Delta-Telecom, an investee of the Company, provides mobile connections and rent of channels. Income received from Delta-Telecom in 2002 amounted to R 24,683,000, and the associated expenses were R 12,338,000 Roubles.

Medexpress provides insurance services for employees and property. Income received from Medexpress in 2002 amounted to R 397,000, while associated expenses were R 24,266,000.

Other transactions with associated companies had no material overall effect on the financial condition of the Company.

The Company's consolidated balance sheet included the following balances of settlements with associates as at 31 December 2002:

R 000	2002
Accounts receivable from associates	7,888
Accounts payable to associates	66,014

The consolidated statement of operations for 2002 included the following transactions:

R 000	2002
Sales to associates	39,794
Purchases from associates	61,114

## 23. Financial instruments

**Interest-rate risk.** The following table sets out the carrying amount, by maturity, of those of the Company's financial instruments that are exposed to interest-rate risk as at 31 December 2002.

R 000	<1 year	1–5 years	Total
<b>Fixed rate</b>			
Long-term borrowings	567,927	756,155	1,324,082
Short-term borrowings	207,901	—	207,901
Obligations under finance leases	131,509	132,316	263,825
<b>Total at fixed rate</b>	<b>907,337</b>	<b>888,471</b>	<b>1,795,808</b>
<b>Floating rate</b>			
Long-term borrowings	225,235	369,572	594,807

Fixed-rate long-term borrowings include the R 63,169,000 interest-free loan from Svyazinvest, repayable in December 2003 and 2004. Had this been subject to the average interest rate of 14.6% effective at the end of December 2002 for rouble bank loans to enterprises, the fair value of the loan would have been R 51,160,000.

## 24. Subsequent events

**Dividends.** The Company's board of directors has proposed dividends for the year ended 31 December 2002 totalling approximately R 75,382,000 (of which R 28,283,000 Roubles would be paid on the preference shares and R 47,099,000 on the ordinary shares). The proposed dividends were approved at the annual shareholders' meeting on 23 June 2003.

**Tariffs for telecom services.** With effect from July 2003, tariffs for certain type of local and long-distance calls and installation fees were increased by approximately 25% for individuals and 14% for legal entities. Tariffs for other services were increased by an average of 15%.

**Planned issue of bonds.** In June 2003 the Company filed a prospectus for a proposed issue of bonds for R 1,500 million. The bond placement is planned for September 2003. The interest rate will be set on the date of issue.

The repayment schedule is as follows:

1. After three years from the day of placement R 450 million
2. After 3.5 years from the day of placement R 450 million
3. After four years from the day of placement R 600 million

However, the bond-holders will have a right to claim early repayment at the end of two years after the date of issue.

**Merger of Lensvyaz and Svyaz of Republic Komi.** On 15 May 2003, the board of directors approved plans for the Company to merge with Lensvyaz and Svyaz of Republic Komi. The timing and financial effect of this event cannot yet be estimated. The completion of mergers is subject to regulatory and shareholder approval.



**Telecommunications reforms.** A new law «On Telecommunications» will come into effect on 1 January 2004. After 31 December 2002, Rostelecom began to reform the system of settlements with regional operators for domestic long-distance traffic. Under the existing method, these settlements are based on a rate for one minute of domestic transit traffic sent through 50 kilometres of Rostelecom's networks. This method, known as the integral settlement rate (ISR), contains two components – a linear component, and a termination charge, which is calculated from the weighted average of incoming and outgoing traffic. The ISR was set once a year, and based on the traffic data for the preceding year, which distorted the economic benefits and costs of providing and terminating transit traffic in the year to which it was applied.

Under the planned changes, full consideration is expected to be given to the cost of Rostelecom carrying and the benefits to the Company of terminating domestic long-distance traffic. Such a system will allow the Company to receive revenues for terminating domestic long-distance traffic on the basis of actual volumes of traffic in the current period, which will increase the transparency and timeliness of settlements.

As at 31 July 2003 the Company had not signed the new interconnection agreements with Rostelecom.

Management cannot currently predict the effect of these changes on the Company's operations.

**Implementation of Oracle.** On 3 June 2003, the board of directors approved an agreement with Otkritiye Technologii 98 to purchase Oracle E-Business Suite for \$15,460,000 (approximately R 470,000,000).

**Issue of ADRs.** In July 2003 the Company started to issue ADRs under the programme described in Note 16, Share capital». As at 31 July 2003, 15,780 ADRs had been issued, representing 789,000 ordinary shares, or 0.1% of total ordinary shares issued and outstanding.



# Contacts

---

**Annex 2.**

## **OJSC NORTH-WEST TELECOM**

Postal address: 14/26 Gorokhovaya street (26 Bolshaya Morskaya street), Saint-Petersburg, 191186 Russia  
Phone: +7 (812) 595 45 66, fax: +7 (812) 110 62 77

### **General Director**

Sergey Ivanovich Kusnetsov  
Phone: +7 (812) 110 61 90, fax: +7 (812) 110 62 77  
office@nwtelecom.ru

### **Head of Shareholder and Securities Department**

Vladislav Yurievich Smyslov  
Phone: +7 (812) 312 03 81, fax: +7 (812) 325 83 23  
vsmyslov@ptn.ru

### **Head of Public Relations Department**

Tatiana Nikolaevna Borisenko  
Phone: +7 (812) 595 45 64, fax: +7 (812) 595 45 42  
tborisenko@ptn.ru

## **AVK-Securities & Finance Ltd.**

Postal address: 197101 Russia, Saint-Petersburg, pr. Kamennooostrovsky 10  
Phone: +7 (812) 230 77 33, 326 82 04, fax: +7 (812) 237 06 50

General Director, large foreign investor relations  
Dmitri Evgenievich Ivanter  
Phone: +7 (812) 230 77 33, fax: +7 (812) 237 06 50  
ivanter@mail.avk.ru

Head of Research Department, project manager  
Svetlana Yurievna Palyanova  
Phone: +7 (812) 327 33 99, fax: +7 (812) 279 66 05  
research@mail.avk.ru

Lead Telecommunications Analyst  
Irina Sergeevna Semenova  
Phone: +7 (812) 327 33 99, fax: +7 (812) 279 66 05  
isemenova@mail.avk.ru