# AB MAŽEIKIŲ NAFTA Annual Report ’98

# General Manager’s Review

On behalf of the Management of the MAŽEIKIŲ NAFTA Joint Stock Company, I must admit that 1998 was a difficult and strenuous year for our company both in economical, and in financial aspect. December 1997 brought a world-wide crisis in oil and oil product market. The glut of oil and products in the world market and the Asian crisis caused the sharp fall of the prices for oil and products. While purchasing the crude oil on fixed prices from Russia, but selling the oil products on market prices, we suffered a loss of over 50 million LTL in the first quarter of 1998. In summer, when the prices became a little more stable, we successfully adjusted the suffered loss and even earned profit. However, due to the financial crisis in Russia, which started in August, we had to turn away from the profitable Ukrainian market to Western European one, and to sell our surplus production there on significantly lower prices. The more so, during the last two months of 1998 the prices for oil and oil products have been falling considerably again, therefore we finished the year with a loss. The extent of the fall of prices as well added to the loss: if the prices for oil dropped by 30-40 USD per tonne, the prices for oil products slumped by 50-60 USD per tonne. The Russian financial crisis has caused our company problems in respect with the refinancing of company working capital. We have had to apply for financial assistance to the Lithuanian Government, which granted our company a short-term 63.1 million USD loan.

During 1998 we continued establishing our position in domestic market by attracting new customers. Our success was sealed by a more flexible price policy, various market studies, and the analysis of our customers’ needs. The local market share for the AB MAŽEIKIŲ NAFTA own light oil products reached 68 % in 1998,

# General Manager's Review

representing a 10 % increase over 1997 levels. The total percentage of market share of light oil products produced in our company reached 86.5 % in 1998.

As the prices in the oil product markets continue to fall, our Marketing Department is entrusted with special tasks: to establish a stable position in domestic market, to expand its share by another 10 %, to increase the sales volumes in the neighbouring markets and position ourselves there, to reach the balance in prices for crude oil purchased and oil products sold.

In 1998 our company carried out huge investment activities. At the Būtingė Terminal alone work has been carried out amounting to almost 400 million LTL. The Mažeikiai – Būtingė oil pipeline has been completed, auxiliary and crude oil storage tanks have been installed, the installation of off-shore pipeline and the single point mooring buoy has been finished. The construction and commissioning of two large technological objects – an Oligomerization Unit and a new Steam Boiler Plant – have been completed at the Mažeikiai refinery. The activities of Joint Venture Naftelf, which supplies high quality jet fuel JET A-1 to the Baltic airports, have been expanding. Aiming at the development of commercial activities in Poland, together with several other Lithuanian companies, a joint venture enterprise, Liteximp, has been founded.

1998 the company spent preparing for privatization. For this purpose, financial, technical and environmental audits have been performed. After Lithuanian Government selected the strategic investor, Williams International Company of the USA, and signed the Letter of Intent in July, it was decided to reorganize the Lithuanian oil industry by merging the three major oil companies, AB MAŽEIKIŲ NAFTA (refinery operations), AB BŪTINGĖS NAFTA (terminal operations) and AB NAFTOTIEKIS (pipeline operations), into one company. From December 1, 1998 this company has existed as a legal entity, functioning under the name of AB MAŽEIKIŲ NAFTA with divisions in Būtingė and Biržai.

The crisis in the oil market is not over yet. Market analysts are not forecasting any in rise prices in the nearest future; some of them state that the prices for oil and oil products will remain low during 1999 and 2000. The estimates and forecasts made by our company economists also show that it will be difficult to gain profit from crude oil processing and oil product sales in 1999. Under such conditions the main goal for our company in 1999 is to maintain our existing position in the markets at minimum cost. For this purpose the company's budget for 1999 has been reduced by 100 million LTL, planned investment funds have been revised and reduced, a Completion Schedule for Būtingė Terminal has been prepared and arrangements are being made to meet the requirements of the new European specifications for gasoline and diesel fuel. In addition, the company will feel the need both for Government support, backed by State guarantees for company borrowings, legislative and regulatory measures aimed at protecting the domestic market, and the backing of all its employees and shareholders.

General Manager Gediminas Kiesus

# AB MAŽEIKIŲ NAFTA–Refinery

# Crude Oil Supply

Crude oil supply to AB MAŽEIKIŲ NAFTA comes entirely from Russia through a branch of the Druzhba pipeline link with a maximum throughput of 16 million MT per year.

There was no disruption to crude oil supplies in 1998. As there are still no inter-governmental agreements with Russia, AB MAŽEIKIŲ NAFTA continued to work with suppliers on a contractual basis as in previous years. Crude oil was supplied by Russian oil companies or traders on an agreed price basis. Up until December the company had been purchasing crude oil on fixed prices, later – price formulas have been introduced to the contracts. The price for crude oil fluctuates according to its world market price.

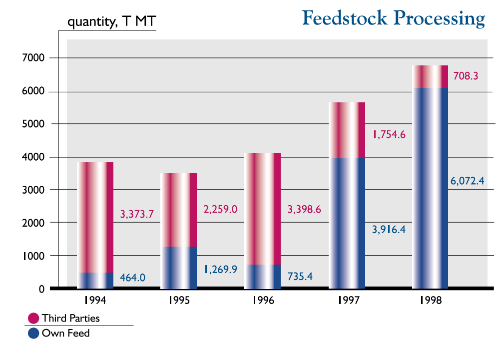
Major crude oil suppliers this year were the following companies: LUKoil, Andre & CIE SA, Rosby Oil Corporation, and Petronord.

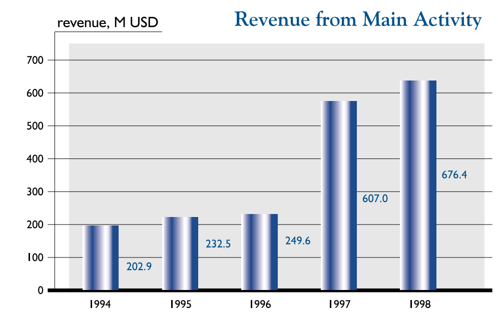
The refinery also purchased alternative feedstock types - gas condensate, atmospheric residue, and middle distillates - to produce refined products. This aided better utilization of the production capacities of FCC complex. Atmospheric residue was mainly supplied by Uni-Baltic Oy, Naftextra, Ipco Trading SA, and Berson Trading Ltd.. The major supplier of gas condensate and middle distillates was Tintrade. The refinery continued to provide toll processing services on a fee basis for other oil companies.

# Feedstock Processing

The refinery's capacity utilization rate increased from 34% to 45 % in 1998, when the refinery processed 6.8 million MT of feedstock. Almost 6.4 million MT of crude oil was processed (27 % more than in 1997), including 5.7 million MT of own crude oil (1.65 times more than in 1997).

In 1998 the refinery processed 6.1 million MT of its own feedstock. i.e. 90 % of the total quantity processed. The outstanding quantity of crude oil was supplied for processing by third party companies. During 1998, compared to the previous year, own feedstock processing volumes increased 1.55 times.

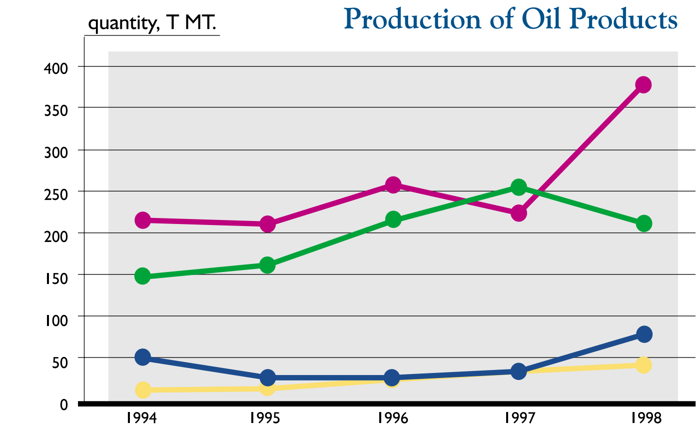


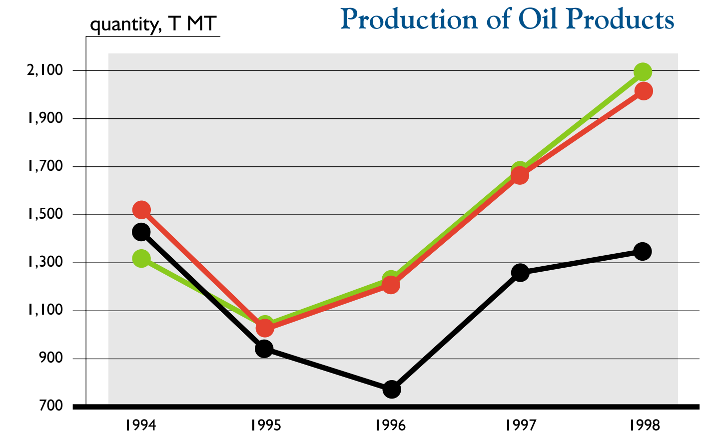

# Changes In Production

The MAŽEIKIŲ NAFTA Refinery produces and markets only environmentally safe grades of unleaded petrol. Year 1998 saw:

- increased production volumes of high octane number gasoline A-95 and A-98.
- cancellation of production of jet fuels of grade RT due to initiation and expansion of the production of jet fuel JET A-1.
- trial batch of modified diesel fuel containing cetane number increasing additive.
- cancellation of a whole range of bitumen grades (road bitumen: BK-200, BK-120, BK-8, BKK-200, BKK-120, BKK-80), after the alteration of road bitumen specifications in 1998.
- production of new bitumen grades, such as B 70/100, B 100/150, B 160/220, according to new Conformity certificates.
- initiation of production of liquefied petroleum gas (Auto-gas) of grades PBA and PA.




| | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|
| LPG | 148 | 161 | 217 | 254 | 211 |
| Jet Fuel | 215 | 210 | 259 | 225 | 377 |
| Bitumen | 52 | 27 | 25 | 35 | 81 |
| Sulphur | 10 | 14 | 23 | 34 | 41 |




| | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|
| Gasoline | 1,310 | 1,036 | 1,226 | 1,685 | 2,095 |
| Diesel Fuel | 1,521 | 1,024 | 1,205 | 1,661 | 2,018 |
| Fuel Oil | 1,428 | 938 | 766 | 1,257 | 1,343 |

## Transportation

In 1998 92 % of refined products were delivered to customers by railway, and 8 % of refined products were delivered to customers by tank trucks.

Aiming to solve the increasing demand for transportation, in 1998 AB MAŽEIKIŲ NAFTA purchased 233 railway tank-cars (with a capacity of 66 tonnes each), and additionally acquired on leasing from VB Lizingas 100 railway tank-cars (65 tonnes each) for transportation of light oil products. For bitumen transportation the company purchased another 20 railway tank-cars (62 tonnes each).

In 1998 the company purchased 17, and acquired by leasing 13 tank-trucks, purchased 4 tank trailers and 9 tanker semi-trailers, and respectively 2 and 11 of these were acquired on leasing for transportation of light oil products. This totals to additional transportation capacity of 1,544 $m^3$ for light oil products.

Once the Būtingė Terminal is completed, transportation problems will be solved completely. The new terminal facilities (product pipeline) will handle the export of the production to Western Europe.

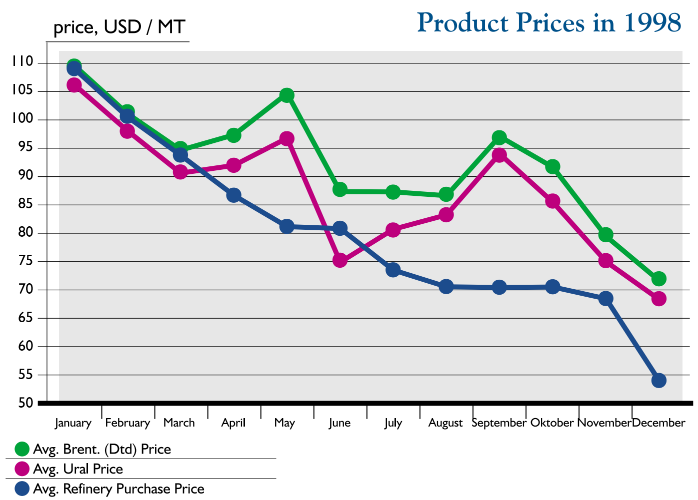
## Marketing

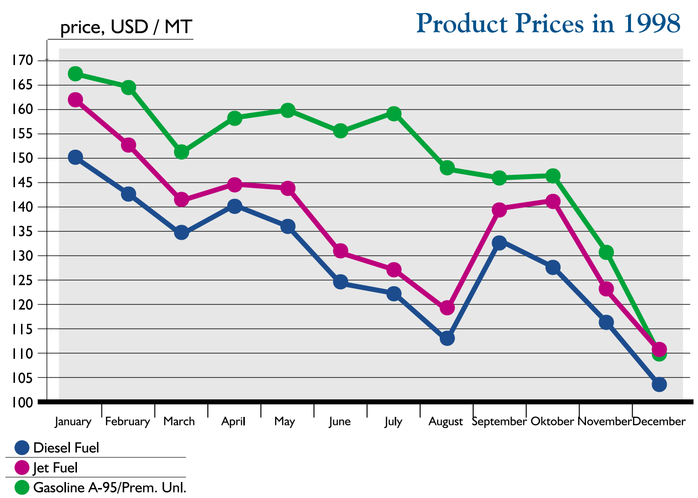
In 1998 the company had a sufficiency of working capital. This allowed for better utilization of production capacities and increase in production volumes of refined oil products. The refinery manufactured 5,587,030 tonnes of its own oil products, which is 1.6 times more than in 1997. The company managed to strengthen its position in the markets in which it already had a presence, and also began to investigate new markets. However, our company was greatly affected by the world crisis in oil and oil products market.

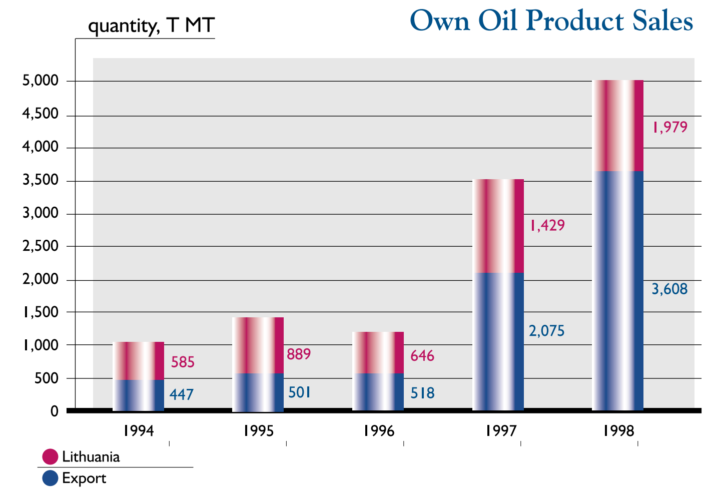
AB MAŽEIKIŲ NAFTA
Own Production Market Distribution, %

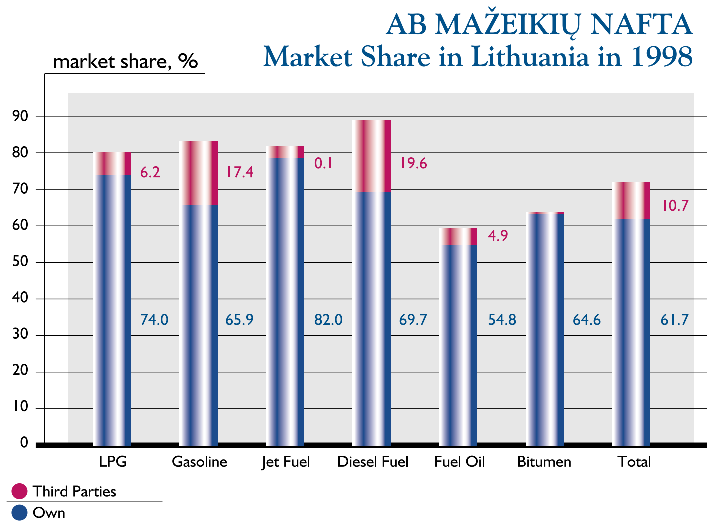
| | Lithuania | Export |
|---|---|---|
| LPG | 35.4 | 64.6 |
| Gasolines | 21.4 | 78.6 |
| Jet Fuel | 7.0 | 93. |
| Diesel | 28.8 | 71.2 |
| Fuel Oil | 69.7 | 30.3 |
| Bitumen | 76.9 | 23.1 |
| Sulphur | 79.4 | 20.6 |

# Marketing


Product Prices in 1998
price, USD / MT
110
105
100
95
90
85
80
75
70
65
60
55
50
January
February
March
April
May
June
July
August
September
Oktober
November
December
Avg. Brent. (Dtd) Price
Avg. Ural Price
Avg. Refinery Purchase Price


Product Prices in 1998
price, USD / MT
170
165
160
155
150
145
140
135
130
125
120
115
110
105
100
January
February
March
April
May
June
July
August
September
Oktober
November
December
Diesel Fuel
Jet Fuel
Gasoline A-95/Prem. Unl.


Own Oil Product Sales
quantity, T MT
5,000
4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
585
447
889
501
646
518
1,429
2,075
1,979
3,608
1994
1995
1996
1997
1998
Lithuania
Export


AB MAŽEIKIŲ NAFTA
Market Share in Lithuania in 1998
market share, %
90
80
70
60
50
40
30
20
10
0
6.2
74.0
17.4
65.9
0.1
82.0
19.6
69.7
4.9
54.8
64.6
10.7
61.7
LPG
Gasoline
Jet Fuel
Diesel Fuel
Fuel Oil
Bitumen
Total
Third Parties
Own

## Wholesale Marketing

The drop of oil prices resulted in increased production volumes and a glut of cheap products in the market. Owing to tremendous competition, the oil product prices went down considerably (while the price for crude oil dropped by 30 USD/t, the fall in price for oil products totalled 50-60 USD/t during 1998).

This year 1,979,265 tonnes of the company's own oil products, i.e. 35.4 % of total production, were sold in Lithuania (in 1997 - 1,429,354 tonnes respectively). The market share for the AB MAŽEIKIŲ NAFTA own light oil products increased from 58% (1997) up to 68% (1998), and the fuel oil share was up from 45% to 55%. Progress was predetermined by a more flexible price policy, the analysis of customer needs and state of the market. This is the most profitable market for our company, but too small for our production capacities.

The export of our products reached 3,607,765 tonnes in 1998 (1.74 times more than in 1997). Nevertheless, the Russian crisis had a marked impact on our sales strategy.

During 1997 and at the beginning of 1998 our main export directions were markets of Russia and Ukraine. With the onset of the economic crisis in Russia, export flows turned towards Western Europe, where they clashed with desperate competition in an over-saturated market. During the pre-crisis period we sold 29 % of all the gasoline produced by AB MAŽEIKIŲ NAFTA to the Ukrainian market. Approximately 20 % of gasoline and 45 % of diesel fuel from the total quantity sold were exported to Western Europe. We also increased the sales to the neighbouring states of Poland, Latvia and Estonia.

This market reorientation had a considerable influence on our company's financial results.

## Retail Trade

Profit per tonne of petroleum products is considerably higher in the retail trade than in the wholesale trade. For this reason the company tried to expand retail trade through its daughter companies UAB VENTUS-NAFTA and UAB GALNAFTA-VENTUS. However, because of the reorganization of the company these companies were transferred to the Lithuanian State Property Fund, and the expected profit was not received.

# Process Improvement

In order to reduce cost price and meet strict European oil product qualityrequirements at the refinery, the MAŽEIKIŲ NAFTA Management has implemented a number of improvements and modifications in major process units:

- Oligomerization Plant was brought into operation to initiate production of a high-octane component of gasoline derived from propylene-butylene fraction called oligomerizate. This improvement increased gasoline yield by 1.6%;
- FCC Complex: waste catalyst was replaced at MTBE Plant. MULTOR 620 analyzer was installed to measure the quantity of $CO$, $CO_2$ and $O_2$ in regeneration gas downstream reactor;
- LK 2: Spent catalyst of Russian origin was replaced by a new HALDOR TOPSE catalyst, at the Diesel Fuel Hydrotreating Unit. It enables the production of more purified diesel fuel;
- Bitumen Plant: mixers were installed in the finished bitumen tanks to reduce expenditure for the preparation of final products produced;
- Storage-Shipment Shop: mixers were introduced in gasoline storage tanks to reduce expenditure during the preparation of final products produced;
- Flaring Block: a new screw compressor was installed. As a result a larger part of low pressure hydrocarbon (flare) gases is returned back to gas fuel line;
- Heat Supply Section has been brought into operation. This unit helps to reduce the volume of steam purchased from the nearby power station, as well as to reduce steam prime costs;
- LK complex: electronic level metering and control systems of protective oil tank were installed in compressors IK-201 and IK-301. Such a system, when compared to a pneumatic one, has the following advantages: reliability, high control quality; impulse tubes are no more required. Model 5000 AMETEK analyzers were installed to determine humidity quantity and hydrogen concentration;
- Hydrogen Plant: magnetostrict sulphuric acid level metering instruments manufactured by K-TEK were introduced in Water Chemical Preparation Plant (Feed Water Plant). Such precise metering instruments permit the recording of sulphuric acids from acid storage as well as control its consumption in the course of process (for filter regeneration) i.e. to achieve a $H_2SO_4$ balance. $CO$, $CO_2$ and $CH_4$ gas concentration analyzers Model 880 A produced by ROSEMOUNT ANALYTICAL were introduced;

# Process Improvement

- Steam-Air Supply Shop: the technologically and economically obsolete relay control system on compressor IK-1,2 was changed for an automatic control system with the help of the company ELINTA. This makes operation more reliable and permits the gathering of detailed information on compressor operation;
- SAAB level metering instruments were installed on the LPG Block, Bitumen Plant and FCC storage facilities. This enables the keeping of computerized records and balance readings.
- METLER-TOLEDO instruments were introduced to measure pH and FISHER-ROSEMOUNT instruments to measure oxygen quantity in chemically treated water that is used to feed the heat recovery boilers. Keeping the pH quantity stable in the range 9.0 ± 0.1 makes possible an extension of the period between major overhauls.

In 1998, 108 million LTL were invested in the refinery process reconstruction and improvements. The total amount of funds invested equalled 146 million LTL.

# Other Activities

There are a number of subdivisions within the refinery that are not directly related to process and production of oil products.

- **Automation Shop:** Manages the introduction of new scientific and technical equipment in the process and refinery subdivisions (e.g. process computerization), organizes the work of programmers, participates in program management installations and computer technical servicing and maintenance;
- **Power Shop:** Supplies power to all process units and units under reconstruction, repairs and installs power equipment and ensures its safe and reliable operation;
- **Communication Shop:** Maintains a continuous operation of the company communications network, end devices, ATS operation, as well as dealing with any problem related to the exploitation and servicing of equipment;
- **Instrumentation and Automation Department:** Introduces the latest control systems and provides for reliable and uninterrupted operation of instrumentation, process automation control system, alarm and interlock system and the fire alarm system.
- **Maintenance-Mechanical Shop:** Arranges and implements current maintenance and refinery overhaul, manufactures non-standard parts and factory-made goods, introduces innovative technologies.
- **Transportation Shop:** Provides transport on request to various departments, delivers products to customers. It is also responsible for all vehicle repairs, the maintenance of all cars and trucks and for providing railway tank cars with diesel locomotives;
- **Refinery Household Shop:** Looks after the company's territory including redecoration and repair of buildings, maintenance of the heating system, etc.;
- **Occupational Medicine Service:** This analyzes the impact of the process environment on employee health and determines measures to prevent negative exposure. It also provides first aid in cases of serious injury or accident;
- **Municipal Department:** This provides communal and utility payment services;
- **The Plinkšės Hotel and Varduva Holiday Complex** provide hotel and recreation services for all company's guests and its employees;
- **Cultural Centre for Oil Industry Workers:** This is a centre in Mažeikiai town that displays the country's cultural developments and offers organization and planning for leisure and recreational pursuits;
- **Food Supply and Public Catering:** This department arranges public catering;

AB MAŽEIKIŲ NAFTA is involved in a wide range of activities, which can be a challenge to supervise. For this reason the Management has decided to restructure the company by taking the example of a similar foreign company, gradually spinning off existing company subdivisions that are not directly related to the production of oil products.

# Personnel

Every year attention is given to upgrading and improving production processes. Thus the work becomes more complicated which increases the requirements on employees' qualifications. Management attaches great importance to improving employee skill levels. In December 1998 the disparity between the number of employees, having 5th-8th work categories, and the number of job places, requiring this qualification, was equal to 377. Therefore, a considerable number of employees went to various training courses, seminars, conferences and exhibitions not only in Lithuania, but also abroad. In 1998 the company spent 1,724,000 LTL on employee training.

There are two active trade unions in the company. AB MAŽEIKIŲ NAFTA trade unions fight for the employee interests not only within the company, but also country-wide. The result of the cooperation between the company's senior management and the trade unions is a Collective Bargaining Agreement, which serves as the company's interior law, and is signed every two years. The major part of this agreement defines social guarantees for the employees.

In 1998 there were 3434 people employed at the refinery (251 employees less than in 1997):

Their breakdown by job description is as follows:

| | |
|---|---|
| Senior executives | 10 %; |
| Experts | 13 %; |
| Clerks | 1 %; |
| Workers | 76 %. |

The education of the employees:

| | |
|---|---|
| University education | 16 %; |
| Specialized secondary education | 25 %; |
| Secondary education | 52 %; |
| Incomplete secondary education | 7 %. |

94.7 % of employees were involved in production area, and

5.3 % – in non-production area.

60.4 % (2087) employees worked under harmful working conditions, including:

| | |
|---|---|
| 79.7 % | men (1664); |
| 20.3 % | women (423). |

Owing to specific working conditions, 71 % men (2454) and 29 % women (1000) were employed by the refinery on December 31, 1998. The average age of the refinery employees is 37.

Turnover of personnel in 1998 was 1.9 % (4.4 % in 1997).

The average employee salary per month was 2340 Litas in 1998:

| | |
|---|---|
| senior executives | 4577 LTL; |
| experts | 2834 LTL; |
| clerks | 1618 LTL; |
| workers | 1970 LTL. |

## Health And Safety At Work

In 1998, no serious accidents occurred to inhibit the refinery's smooth operation. Four fires and seven minor accidents were reported last year (in 1997- 11 and 17 respectively), with no loss suffered (5028 LTL in 1997). 3 industrial and 5 off-the-job injuries were recorded. To prevent further cases AB MAŽEIKIŲ NAFTA has toughened process and work discipline and put in place stricter penalties for any breach of safety routines.

The safety and hygiene conditions of employees are of great importance to the company. The Occupational Medicine Service periodically examines the employees' health, makes general clinical and biochemical analyses, which allow to evaluate the general state of health and help to diagnose illnesses. The results of these analyses contribute to preventing the cases of industrial diseases.

## Environmental Safety

All environmental issues at the refinery are resolved together with process problems. To reduce negative impact on the environment, in 1998 AB MAŽEIKIŲ NAFTA Refinery invested 1.2 million LTL and introduced the following major improvements:

- reconstruction of Condensate Treatment Unit at the FCC Complex KT-1/1;
- installation of equipment for $H_2S$ treatment from decomposition gases for column K-601 at the FCC Complex KT-1/1;
- purchase and installation of a pontoon for the tank RZ –14;
- estimation of the possibilities to increase the output of sulphur in the Sulphur Recovery Units up to minimum 95 %.

Though the volumes of crude oil refining in 1998, compared to 1997, increased more than 1.5 times, the quantity of industrial effluents to the Baltic Sea and the Venta basin dropped. Also, the quantity of emissions to the atmosphere decreased.

# Change In The Company's Share Capital

On the 29th of September 1998 the Seimas (Parliament) of the Republic of Lithuania passed a law on the reorganization of the companies AB Būtingės Nafta, AB Mažeikių Nafta and AB Naftotiekis, which made provision for:

- the reorganization of the BŪTINGĖS NAFTA, MAŽEIKIŲ NAFTA and NAFTOTIEKIS companies reorganized by way of a merger, AB BŪTINGĖS NAFTA and AB NAFTOTIEKIS ceasing their activities as legal entities and being amalgamated with AB MAŽEIKIŲ NAFTA which continues its activities;
- the shares in the companies, established on the basis of AB MAŽEIKIŲ NAFTA assets - the retail filling stations as well as those in the Plinkšės Hotel being transferred to the shareholders of AB MAŽEIKIŲ NAFTA in proportion to their shareholding in AB MAŽEIKIŲ NAFTA;
- the shares of the company established on the basis of AB NAFTOTIEKIS assets - the wood processing workshop, being transferred to the shareholders of AB NAFTOTIEKIS in proportion to their shareholding in AB NAFTOTIEKIS;
- the mistakes made during the formation and increase of the AB MAŽEIKIŲ NAFTA share capital shall be rectified during the reorganization.

The reorganization project of the companies Mažeikių Nafta, Būtingės Nafta and Naftotiekis stipulates the following:

- The authorized capital of AB MAŽEIKIŲ NAFTA will be reduced by 13,229,090 LTL, thereby correcting the mistakes made in the formation (7,201,000 LTL) and increase (6,028,090 LTL) of the share capital of AB MAŽEIKIŲ NAFTA and 1,322,909 ordinary registered shares with a nominal value of 10 LTL in AB MAŽEIKIŲ NAFTA, belonging to the Government of the Republic of Lithuania, will be annulled;
- The authorized capital of AB MAŽEIKIŲ NAFTA will be decreased by 69,120,000 LTL and 7,300,000 LTL respectively, transferring the shares of UAB VENTUS NAFTA and UAB PLINKŠIŲ VIEŠBUTIS to the AB MAŽEIKIŲ NAFTA shareholders in proportion to their holding of shares in AB MAŽEIKIŲ NAFTA;
- The share capital of AB NAFTOTIEKIS will be decreased by 10,800,000 LTL with the transfer of the shares of AB Tvoklė to the AB NAFTOTIEKIS shareholders in proportion to their shareholding in AB NAFTOTIEKIS.

Resolution No. 1228 of the Government of Lithuania "On the Valuation of Assets of the BŪTINGĖS NAFTA, MAŽEIKIŲ NAFTA and NAFTOTIEKIS Companies under Reorganization" dated 13th October 1998 stipulates that:

- the assets of the companies under reorganization are to be valued according to the valuation of Banque Paribas and accounted for according to their book value;
- the assets of AB BŪTINGĖS NAFTA and AB NAFTOTIEKIS are to be transferred to AB MAŽEIKIŲ NAFTA that will continue its activities.

According to the balance sheets of the companies under reorganization as at the 30th June 1998, the assets of AB MAŽEIKIŲ NAFTA after the reorganization will equal to 1,930,129,043 LTL.

The liabilities of AB MAŽEIKIŲ NAFTA after the reorganization will comprise of the liabilities of AB MAŽEIKIŲ NAFTA prior to the reorganization and the liabilities of AB NAFTOTIEKIS and AB BŪTINGĖS NAFTA, which will be merged with AB MAŽEIKIŲ NAFTA and will cease their existence. According to the balance sheet data of the 30th June 1998, the liabilities of AB MAŽEIKIŲ NAFTA after the reorganization will equal to 1,176,724,979 LTL.

# Change In The Company's Share Capital

Chapter 2, Section 8 of the law on the reorganization of the companies BŪTINGĖS NAFTA, MAŽEIKIŲ NAFTA and NAFTOTIEKIS stipulates that the guarantees of the Government of the Republic of Lithuania for the loans supplied to the companies BŪTINGĖS NAFTA, MAŽEIKIŲ NAFTA and NAFTOTIEKIS will remain valid for all of the guaranteed loans when they become taken over by the reorganized AB MAŽEIKIŲ NAFTA.

The share capital of AB MAŽEIKIŲ NAFTA after the reorganization will be equal to 693,443,200 LTL, split into 693,443,200 shares with the nominal value of 1 LTL.

The share capital will be comprised of the share capitals of the BŪTINGĖS NAFTA, MAŽEIKIŲ NAFTA and NAFTOTIEKIS companies, including the changes effected because of the reduction in the share capital of AB MAŽEIKIŲ NAFTA and AB NAFTOTIEKIS during the reorganization.

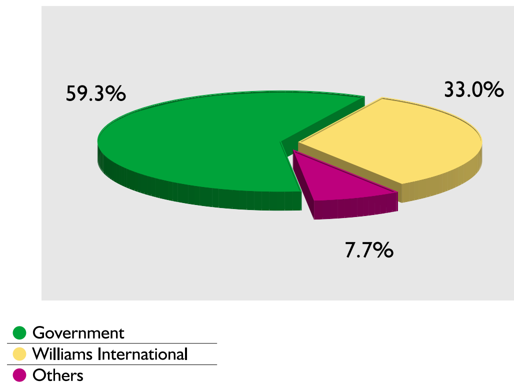
To determine the share conversion ratio, the Banque Paribas valuation of aforementioned companies under reorganization was used which was presented to the Government of Lithuania in the report dated 7th July 1998, with a reservation that the value of the above companies cannot be less than the nominal value of their share capitals (Resolution of the Government of the Republic of Lithuania No.1228, dated 13th October, 1998).

The official date of the reorganization of the companies was December 1, 1998 and now the Government of the Republic of Lithuania owns 613,703,642 shares in the reorganized AB MAŽEIKIŲ NAFTA with a nominal value of 613,703,642 LTL; in other words, it holds 88.5% of the share capital of the new company.

| | AB MAŽEIKIŲ NAFTA (prior to the merger) | AB NAFTOTIEKIS | AB BŪTINGĖS NAFTA | Total |
|---|---|---|---|---|
| Share capital | 494,985,300 | 69,200,000 | 129,257,900 | 693,443,200 |
| Value | 1,086,263,000 | 471,509,000 | 129,257,900 | 1,687,029,900 |
| Number of shares exchanged | 49,498,530 | 6,920,000 | 1,292,579 | |
| Value of one share | 21.95 | 68.14 | 100 | |
| Conversion ratio | 9.0205039 | 28.007349 | 41.104381 | |
| Number of shares after reorganization | 449,501,684 | 193,810,856 | 53,130,660 | 693,443,200 |

On 29 September 1998 the Seimas of the Republic of Lithuania adopted Resolution No. VIII-869 On the Recognition of a Strategic Investor, which stipulates that the US company, Williams International, is confirmed as strategic investor and is granted the right to acquire 33% of new AB MAŽEIKIŲ NAFTA shares.

Expected AB MAŽEIKIŲ NAFTA
share capital after a new share emission



# Branches Of The Company

# Būtingės Nafta

Seeking to guarantee oil supplies, Lithuania searched for alternatives to the most reliable existing supply route for Russian oil through the Belorussian oil pipeline. The Government of Lithuania decided to construct a new import/export terminal at Būtingė, which would be connected by a pipeline to the Mažeikiai refinery. AB BŪTINGĖS NAFTA was established in 1995 in order to ensure the implementation of the terminal and the related projects.

However, the project encountered considerable financial problems, which caused delays in the implementation of the project. The terminal under construction was criticised by the Republic of Latvia and its environmentalists. In the meantime, it seems that the project can be completed in two phases: Phase 1 - (oil import/export); Phase 2 - (export of oil products) is believed to be completed later on.

The oil terminal consists of a Single Point Mooring buoy located 7.5 km offshore, that is connected to the shore facilities by 40-inch submarine pipeline. It is intended that tankers of up to 80,000 DWT will be serviced. Currently there are three crude oil storage tanks of 50,000 $m^3$ each and three auxiliary tanks erected on site. For Phase 2 it is planned to construct three additional oil tanks, six diesel fuel tanks, two gasoline tanks and two jet fuel tanks. The terminal is connected to the AB MAŽEIKIŲ NAFTA Refinery by a 22" diameter onshore pipeline of 91.5 km in length. The throughput of the pipeline is 16.2 million tonnes (8 million tonnes in each direction).

At the beginning of 1999 it is intended to start the exports of Russian oil to Western Europe through this terminal. In the year 2000 it is expected that construction will commence of a product pipeline from Mažeikiai to Būtingė. With this, the cost of exporting production to Western Europe would be reduced.

On December 31, 1998, there were 49 employees working at the Būtingė Terminal: 12 senior executives, 17 experts, 3 clerks and 17 workers.

# Naftotiekis

The construction of the pipeline was begun in 1966. The operation of the Polock -Ventspils pipeline began in 1968. In 1970 the Biržai oil transportation pump station was constructed, where at that time only one emergency maintenance/repair service was in place. In 1980 the Polock – Mažeikiai pipeline was commissioned.

Up until 1992 the Biržai Oil Transportation Pump Station belonged to Novopolock Oil Transportation Board DRUZHBA. After the restoration of Lithuanian independence, the Biržai pump station became the Lithuanian State-owned oil shipping company NAFTOTIEKIS, which was reorganized as the NAFTOTIEKIS Special Purpose Joint Stock Company in 1995.

Currently there are 500km of the oil and oil product pipelines on the territory of Lithuania that are serviced by this company:

- part of the oil pipeline Polock - Ventspils in Lithuania 87.384km;
- part of the product pipeline Polock - Ventspils in Lithuania 87.384km
- part of the oil pipeline Polock - Mažeikiai in Lithuania 225.514km;
- oil pipeline Mažeikiai - Būtingė 91.5km;
- the future product pipeline Mažeikiai - Būtingė 91.5km.

In 1998 the company transported 14,585,716 tonnes of crude oil, 3,205,696 tonnes of diesel fuel to Ventspils; 6,295,299 tonnes of crude to Mažeikiai. This makes 106.65 % of the volume in 1997. The major client companies are: LUKoil, Ozhako Tupeks, Sidanko and Yukos.

To ensure the reliable operation of the oil and product pipelines, internal diagnostics of the Polock - Biržai - Ventspils oil pipeline was performed in 1998. During these activities bends, internal and external corrosion spots, mechanical damage to the pipeline, and the quality of longitudinal seams were identified.

The internal diagnostics cost 1.63 million LTL. The costs of the elimination of the defects detected during the examination reached 0.7 million LTL. The internal diagnostics revealed inadequacies with the standard requirements; therefore the Polock-Biržai-Ventspils oil pipeline is being reinsulated. In 1998 ten kilometres of this pipeline were reinsulated at a cost of 1.3 million LTL. Also, according to the contract with Swiss company ABB, the power supply substations are under reconstruction; it is expected that this will be completed in 2000.

On December 31, 1998, there were 220 employees working at AB NAFTOTIEKIS (21 senior executives, 34 experts, 20 clerks and 145 workers): 185 of them worked at Biržai oil shipping pump station, 27 worked at Joniškis oil shipping pump station, 8 worked at Mažeikiai final oil metering skid.

# AB MAŽEIKIŲ NAFTA Financial Statements

# Report Of Independent Public Accountants

(LTL '000)

ARTHUR ANDERSEN

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Report of Independent Public Accountants

To the shareholders of AB Mažeikių Nafta

1. We have audited the accompanying consolidated balance sheets of AB Mažeikių Nafta (a joint stock company registered in the Republic of Lithuania) and subsidiaries (the Company) as of 31 December 1998 and 1997, and the related consolidated statements of income, shareholders' equity and cash flows for the year-ended 31 December 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

2. Except as discussed in the following paragraphs 3 and 4, we conducted our audits in accordance with International Standards on Auditing as set forth by the International Federation of Accountants (IFAC). 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 the management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

3. We did not observe the physical inventory taking as of 31 December 1997 because that date was prior to our initial engagement as auditors of the Company. For the same reason we have not audited the statement of income for the year-ended 31 December 1997.

4. Tangible assets are properly presented in accordance with Lithuanian accounting principles, however, United States Generally Accepted Accounting Principles (US GAAP) require presentation of fixed assets on the basis of historical cost less accumulated depreciation. In accordance with resolutions of the Lithuanian Government, the Company has revalued tangible assets four times prior to 31 December 1998 resulting in a cumulative increase in the net book value of tangible assets of LTL 460,358 thousand. Due to the many movements and lack of separate registrations of the indexed amounts per asset, the Company is unable to quantify the effect of the indexations on the balance sheets as of 31 December 1998 and 1997, and, accordingly, we are unable to express an opinion on the historical cost and accumulated depreciation thereon in accordance with US GAAP.

5. In our opinion, except for the effect of the matters discussed in paragraph 3 above, the financial statements referred to above present fairly, in all material respects, the financial position of AB Mažeikių Nafta and subsidiaries as of 31 December 1998 and 1997, and the results of their operations and cash flows for the year-ended 31 December 1998 in conformity with Lithuanian accounting principles and, except for the matters additionally discussed in paragraph 4 above, also in conformity with US GAAP.

6. As further disclosed in Notes 18 and 20 to the consolidated financial statements, the Company requires additional funding to complete construction in progress in the amount of LTL 314,345 thousand and has LTL 615,751 thousand of short-term loans falling due in 1999. The satisfaction of these commitments and liabilities depends on the Company's ability to refinance short-term loans and to raise additional long term financing resources. The Company's management is currently

# Report Of Independent Public Accountants

(LTL '000)

negotiating with several financial institutions regarding such refinancing. The financial institutions have indicated that the attraction of a strategic investor and sovereign guarantees are required for them to provide the required financing to the Company. The management of the Company is currently negotiating with a strategic investor (Note 1) and has received indications by Government officials, that the Company will receive sovereign guarantees.

7. As further disclosed in Notes 23 and 14 to the consolidated financial statements, the Company has recorded LTL 117,496 thousand as accounts payable to the State Tax Authorities and a corresponding LTL 43,626 thousand of accounts receivable both regarding VAT and excise tax related to export for which payment has not been received by the Company. In accordance with the tax legislation, the Company should pay the mentioned taxes and then apply to the State Tax Authorities for compensation of taxes paid. The Company's ability to pay the outstanding accounts payable to the State Tax Authorities, should such request be received, depends on timely payment from the customers and the availability of external financing resources to finance the lack of working capital arising from this issue.

8. As further discussed in Note 26 to the consolidated financial statements, several claims in the total amount of LTL 167,240 thousand were submitted by the oil terminal project contractors against the Company, the outcome of which are uncertain at this time. Provisions in the amount of LTL 18,600 thousand have been made for claims in the amount of LTL 27,200 thousand, however, no provisions have been made in the consolidated financial statements for any additional liabilities that may result from these claims.

9. As more fully disclosed in Note 26 to the consolidated financial statements, several licenses are required to operate the Būtingė oil terminal. Furthermore, certain changes in legislation are required and additional land lease agreements must be obtained for the existing pipelines operated by the Company and for the planned pipeline from Mažeikiai to Būtingė. No provisions have been made in the consolidated financial statements for the uncertainty or the cost associated with obtaining these licenses and land lease agreements.

ARTHUR ANDERSEN
(Company audit license No. 117)

Per Moeller — Vytautas Bučas

Auditor's license
No. 000020

The audit was completed on 8 February 1999.

# Consolidated Statements Of Income For The Years Ended 31 December 1998 And 1997

(LTL '000)

| | 1998 | Unaudited 1997 |
|---|---|---|
| **Net sales** | 2,816,654 | 2,524,189 |
| Cost of sales | (2,406,696) | (2,108,611) |
| Selling and distribution expenses | (161,054) | (122,105) |
| General and administrative expenses | (185,127) | (134,221) |
| Depreciation and amortization | (96,049) | (93,886) |
| **Operating income (loss)** | (32,272) | 65,366 |
| Financial income (expenses), including exchange gain, net | (51,407) | (36,422) |
| **Income (loss) before equity in earnings (equity's losses) of associated companies and income tax** | (83,679) | 28,944 |
| Equity in earnings (equity's losses) of associated companies | (58) | 58 |
| **Income (loss) before income tax and minority interest** | (83,737) | 29,002 |
| Income tax | (13,561) | (10,987) |
| **Income (loss) before minority interest** | (97,298) | 18,015 |
| Minority interest | (400) | (93) |
| **Net income (loss) for the year** | **(97,698)** | **17,922** |

# Consolidated Balance Sheets As Of 31 December 1998 And 1997

(LTL '000)

| | 1998 | 1997 |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Cash and cash equivalents | 126,053 | 217,637 |
| Short-term investments | - | 70,745 |
| Trade accounts receivable, net | 191,278 | 141,940 |
| Prepayments and other current assets | 117,484 | 100,203 |
| Inventories, net | 149,118 | 250,839 |
| **Total current assets** | 583,933 | 781,364 |
| **Long-term investments** | 3,612 | 2,570 |
| **Tangible assets** | | |
| Machinery and equipment | 403,485 | 357,785 |
| Buildings | 150,217 | 129,272 |
| Construction in progress | 739,954 | 401,436 |
| Other tangible assets | 205,246 | 163,139 |
| Total tangible assets | 1,498,902 | 1,051,632 |
| **Intangible assets** | 46,876 | 7,444 |
| **Long-term accounts receivable** | 1,946 | 1,913 |
| **TOTAL ASSETS** | 2,135,269 | 1,844,923 |

# Consolidated Balance Sheets As Of 31 December 1998 And 1997

(LTL '000)

| | 1998 | 1997 |
|---|---|---|
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current liabilities** | | |
| Current portion of long-term loans | 59,444 | 21,101 |
| Current portion of long-term lease | 2,702 | 2,549 |
| Short-term loans | 615,751 | 276,517 |
| Trade accounts payable | 194,085 | 262,132 |
| Other accounts payable | 18,886 | 31,856 |
| Advances received | 58,772 | 30,789 |
| Accrued liabilities | 165,471 | 24,729 |
| Other current liabilities | 8,033 | 3,058 |
| **Total current liabilities** | 1,123,144 | 652,731 |
| **Long-term liabilities** | | |
| Long-term loans | 462,413 | 396,128 |
| Long-term lease | 12,704 | 5,507 |
| Subsidies | 19,851 | 19,851 |
| Deferred road tax | 1,225 | - |
| **Total long-term liabilities** | 496,193 | 421,486 |
| **Minority interest** | 1,617 | 1,217 |
| Commitments and contingencies | - | - |
| **Shareholders' equity** | | |
| Share capital (693,443,200 shares authorized, issued and outstanding as of 31 December 1998) | 693,443 | 811,470 |
| Legal reserve | 8,775 | 8,775 |
| Revaluation reserve | 437 | 15 |
| Accumulated deficit | (188,340) | (50,771) |
| **Total shareholders' equity** | 514,315 | 769,489 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | 2,135,269 | 1,844,923 |

# Consolidated Statement Of Shareholders' Equity For The Year-Ended 31 December 1998

(LTL '000)

| | Share capital | Legal reserve | Reva-luation reserve | Accu-mulated deficit | Total |
|---|---|---|---|---|---|
| Balance as of 31 December 1997 | 811,470 | 8,775 | 15 | (50,771) | 769,489 |
| **Decrease in share capital due to reorganization:** | | | | | |
| Separation of UAB Tvoklė from Pipeline operator | (10,800) | - | - | - | (10,800) |
| Elimination of Oil terminal shares held by Pipeline operator | (43,650) | - | - | - | (43,650) |
| Separation of UAB Ventus–Nafta from Oil refinery | (69,120) | - | - | - | (69,120) |
| Separation of UAB Plinkšių Viešbutis from Oil refinery | (7,300) | - | - | - | (7,300) |
| Correction of error of formation and increase of the authorized share capital of Oil refinery | (13,229) | - | - | - | (13,229) |
| Adjustment to correct Oil refinery share capital booked in 1997 | 7,201 | - | - | - | 7,201 |
| **Increase in share capital:** | | | | | |
| Increase in Pipeline operator's share capital | 18,871 | - | - | (18,871) | |
| **(Loss) for the year** | - | - | - | (97,698) | (97,698) |
| **Dividends paid by Pipeline operator for 1997** | - | - | - | (12,000) | (12,000) |
| **Dividends paid by Oil refinery for 1997** | - | - | - | (9,000) | (9,000) |
| **Increase in revaluation reserve** | - | - | 422 | - | 422 |
| Balance as of 31 December 1998 | 693,443 | 8,775 | 437 | (188,340) | 514,315 |

# Consolidated Statement of Cash Flows For The Year-Ended 31 December 1998

(LTL '000)

| | 1998 |
|---|---|
| **Cash flows from operating activities** | |
| Net (loss) for the year | (97,698) |
| Adjustments to reconcile net (loss) to net cash provided by operating activities: | |
| Depreciation | 92,387 |
| Amortization | 3,662 |
| Retirements of tangible assets, net | 2,607 |
| Retirements of intangible assets, net | 75 |
| Provision for accounts receivable | 23,706 |
| Provision for obsolete inventories | (818) |
| Equity in earnings (equity's losses) of associated companies | 58 |
| Minority interest | 400 |
| | 24,379 |
| Changes in operating assets and liabilities: | |
| Inventories | 102,539 |
| Trade accounts receivable | (73,343) |
| Prepayments and other current assets | (23,010) |
| Trade accounts payable | (68,047) |
| Other accounts payable | (12,970) |
| Advances received and other current liabilities | 32,958 |
| Accrued liabilities | 140,742 |
| Net cash provided by operating activities | 123,248 |
| **Cash flows from investing activities** | |
| Acquisition of intangible assets | (43,168) |
| Acquisition of tangible assets | (105,680) |
| Additions to construction in progress | (451,863) |
| Additions to long-term investments | (44,750) |
| Cash contributions to entities, excluded during reorganization | (2,400) |
| Proceeds from short-term investments | 1,625 |
| Net cash (used in) investing activities | (646,236) |

# Consolidated Statement of Cash Flows For The Year-Ended 31 December 1998

(LTL '000)

Continued

| | |
|---|---|
| **Cash flows from financing activities** | |
| Proceeds from short-term loans | 787,000 |
| Repayments of short-term loans | (447,766) |
| Proceeds from long-term loans | 137,840 |
| Repayments of long-term loans | (33,212) |
| Proceeds from long-term lease | 15,795 |
| Repayments of long-term lease | (8,445) |
| Deferred road tax | 1,225 |
| Increase in long-term accounts receivable | (33) |
| Payment of dividends | (21,000) |
| Net cash provided by financing activities | 431,404 |
| **Net (decrease) in cash and cash equivalents** | (91,584) |
| **Cash and cash equivalents at beginning of year** | 217,637 |
| **Cash and cash equivalents at end of year** | 126,053 |
| **Supplemental cash flow information** | |
| Cash paid for interest | 63,916 |
| Cash paid for income tax | 13,561 |

# Addresses

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