

OJSC Svyazinvest

55, bld.2 Plyuschikha str.,
Moscow 119121 Russia
www.svyazinvest.ru

General Director

Valery N. Yashin
tel. +7 095 727 0402

Deputy General Director

Vadim E. Belov
tel. +7 095 727 0412

**Information Department
Director**

Oleg M. Mikhaylov
tel. +7 095 727 0418
fax. +7 095 727 0475
omikhayl@svyazinvest.ru

**Investor Relations Department
Head of Department**

Juliana U. Sokolenko
tel. +7 095 727 0472
fax. +7 095 727 0475
jsokolenko@svyazinvest.ru

Senior Expert

Ilia N. Kokovin
tel. +7 095 727 0471
fax. +7 095 727 0475
ikokovin@svyazinvest.ru

Securities Division**Deputy Director of Department**

Sergey V. Chernogorodsky
tel. +7 095 727 0485
fax. +7 095 248 0641
schernog@svyazinvest.ru

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SVYAZ  INVEST

I N V E S T O R R E P O R T

SVYAZINVEST

Valery Yashin: We're on the threshold of a new era in Russian telecommunications

Overview of Svyazinvest's financial performance in 2002

Merger of Businesses - a Key Restructuring Step



Ladies and Gentlemen,

Last year the process of merging 72 regional operators into seven powerful super-regional companies was completed. This is a huge breakthrough not just for Svyazinvest but for the entire Russian telecom sector. Analysts have been unanimous about the success of this structural reorganization and predicted excellent prospects for the consolidated companies.

This success is ever more striking against the backdrop of stagnation on the global telecoms scene, as foreign telecoms continued to lose value last year as fast as they did in 2000 and 2001. They have seen lower revenues and a number of companies have either gone bankrupt or undertaken

massive lay offs; meanwhile, telecom investment has effectively ceased.

Russia offers a completely different perspective. The collapse of U.S. and European telecom companies has had almost no effect on the domestic stock market, with the prices of most domestic companies posting significant gains last year. Russian operators have continued on the path of successful development and managed to post higher earnings thanks to growing demand.

This situation has begun to attract the attention of many international financial institutions, who have started to view the Russian telecom market as a unique growth story. Therefore, our goal today is to ensure the consolidation of the companies' businesses in order to take advantage of the current favorable environment and to boost the revenues of the super-companies.

This year we will present the new companies to the international community. This will be our main theme during the third international conference, "Russian telecommunications and investment", to be held in Moscow in March. This will also be the main topic of our discussions with investment funds and companies during our roadshow in New York and London in early April. Our roadshow last year sparked a lot of interest and we believe this year's set of meetings with foreign investors, analysts and colleagues will be even more interesting and fruitful.

My colleagues and I will be happy to meet with you during the roadshow and I hope we will have a chance to respond to all queries. After all, it is only through face-to-face communication that we can gather the necessary feedback that is so difficult to achieve through print media.

Valery N. Yashin
Svyazinvest CEO

Uralsvyazinform

Uralsviazinform has signed a cooperation agreement with the Yamal-Nenets Autonomous District administration outlining the parties' intentions to promote modern telecommunication services, increase budget revenue and enhance the public-private partnership. The parties specifically highlighted the need to make telephony services available in the region's rural areas (as part of the federal program for rural development through 2010) and to develop data transmission networks (as part of the federal program Electronic Russia 2002-2010). They also intend to work towards implementing several regional telecom programs. Governor Yu.V. Neyelov and Uralsviazinform general director V.I. Rybakin agreed to develop a unified information space to enable further economic development in the region and improve residents living standards.

Uralsvyazinform

The Khanty-Mansiisk branch of Uralsviazinform has signed a contract with a foreign supplier to buy 37 base stations for a GSM operator, ZAO Yermak RMS. Eleven stations will shortly be installed in Surgut, Bely Yar, Ult-Yagun, the Nefteyugansk highway and at TsDNG-6. One station will be added in Pyt-Yakh and the Megion station will have its capacity expanded. Eleven base stations will be installed in Nizhnevartovsk, six in Khanty-Mansiisk, six in Nefteyugansk, as well as several stations in Salym, Poikovsky and Karkateevy. Some of the new stations support the GSM-1800 standard and will increase the number of radio channels in Surgut, Khanty-Mansiisk and Nizhnevartovsk. The remaining ones will expand cellular coverage in all the aforementioned cities and towns, as well as along the Khanty-Mansiisk - Surgut - Nizhnevartovsk highway, connecting the autonomous with the southern parts of the region. Yermak's subscriber base in the 14 cities and towns of Yugra alone exceeds 38,000.

South Telecom

The Stavropol branch of South Telecom has launched a full-range data service center. The center is based on the electronic post-office REX400 and the SKAT-100 system and offers various electronic services such as telegraph, e-mail and fax messages. It also enables delivery of e-mail messages to a regular postal address via telegraph. Similar services within an integrated network are operating in 50 post offices across Russia and the CIS.

Government

In line with the Russian Labor Code, the telecom sector wages commission has extended the 2001-2002 agreement between the Communications Workers Union and the Communications Ministry for 2003. The Ministry of Labor has been notified of the agreement's extension.

South Telecom

Kuban Electrosvyaz, a subsidiary of South Telecom, has completed the expansion of its Krasnodar long-distance switch AXE-10, adding 5,100 ports. The equipment was supplied and installed by Ericsson-Nikola Tesla.

North-West Telecom

International credit rating agency Standard&Poor's has upgraded North West Telecom's corporate governance rating from 5.0 to 5.6.

Rostelecom

The Southern branch of Rostelecom has begun construction of a fiber-optic line from Russia to Azerbaijan. The length of the Russian section (to the Azeri border) is about 200 km. The new line will significantly improve Rostelecom's competitive position in ILD services.

Svyazinvest

Hong Kong hosted an international exhibition "Telecom Asia 2002" in December, with Russia represented by the Communications Ministry, Svyazinvest, Megafon, Crosna, Kosmicheskaya Svyaz, Giprosvyaz, and Radio Research Institution.

Uralsvyazinform

Uralsviazinform's AGM re-elected Vladimir Rybakin as general director for two more years.

Dalsvyaz

The Dalsvyaz EGM ousted Gennady Melnikov as general director and elected Igor Zabolotny to the post on a two-year contract.

South Telecom

Stavropol Region Electrosvyaz, a subsidiary of South Telecom, is negotiating with the Svetets company to expand its intellectual platform and supply a multiservice call center. The call center will be used to offer automatic information services.

Svyazinvest

Igor Pozhidayev has been appointed head of the holding's IT department. He was born in 1963 in Leningrad and educated at the Leningrad Mechanical Engineering Institute.

Center Telecom

Center Telecom has launched an automatic switch with capacity of 16,500 in Smolensk. The switch uses Alcatel digital equipment. In addition to the new lines, people in Smolensk are now able to use a wide array of value added services such as data transfer, Internet access, IP-telephony, virtual private networks, multimedia services, telemedicine, tele-education and conference calls.

SVYAZINVEST DOMINATES THE RUSSIAN FIXED-LINE TELECOMMUNICATIONS MARKET

Svyazinvest was incorporated in 1995 through the consolidation of controlling stakes in regional wireline telecoms.

Svyazinvest's charter capital is R19.5bn (\$617mn) and the company's shareholders are the Russian Property Ministry (50% plus one share), the Russian Federal Property Fund (25% minus one share) and a Cyprus-based consortium, Mustcom Ltd (25% plus one share).

The holding is made up of seven consolidated regional telecom companies. It also includes operators such as Central Telegraph, Lensvyaz, Dagsvyazinform, Komi Svyaz, MGTS, Kostromskaya GTS, the telecom research institute, Giprosviaz, and national DLD and ILD operator, Rostelecom.

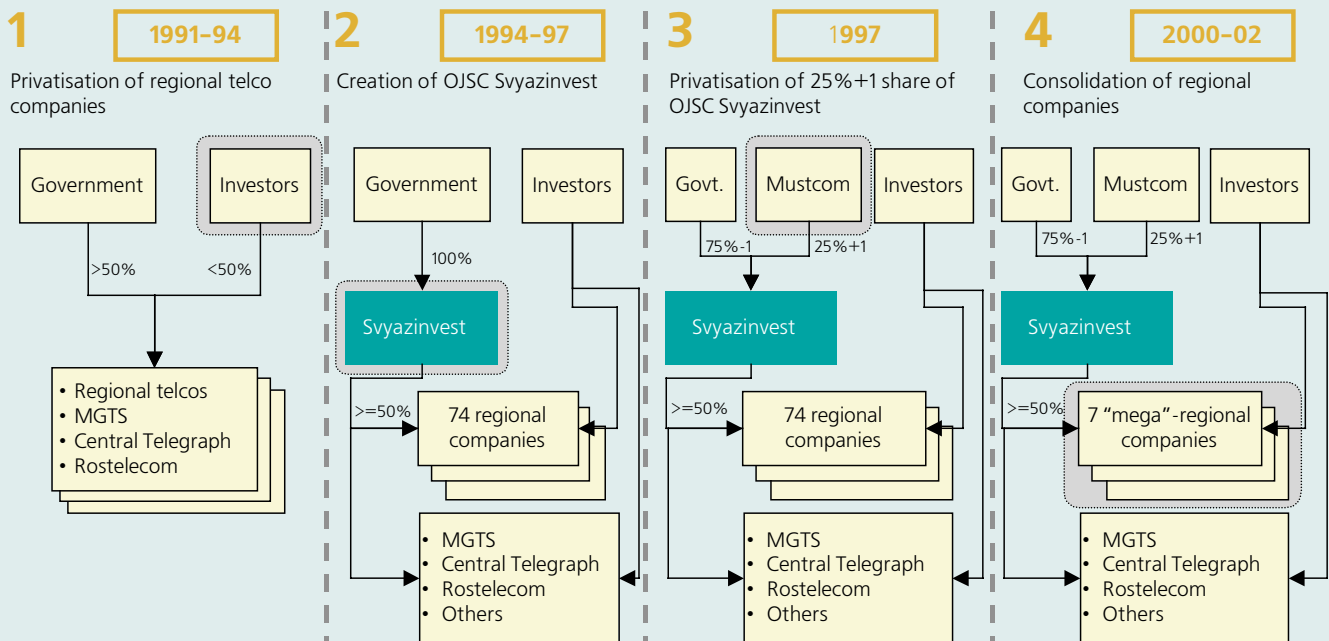
The holding's operators own licenses and provide local, DLD and ILD services, data transfer, Internet, ISDN, wireless access and mobile telephony in GSM, NMT-450, AMPS and DAMPS standards. Svyazinvest owns more than 80% of the country's telecom infrastructure and more than 90% of telephone subscribers use its services. The installed capacity of the company's telephone switches is 31.5 mn numbers and the level of digitalization 38%. Svyazinvest companies employ 367,000 people.

The holding's subsidiary Rostelecom is the only Russian national ILD and DLD operator whose monopoly position is guaranteed by the government for the next few years. Today, Rostelecom has a reliable digital international network with a primary ILD and TV Center at its core, as well as seven international switches. Rostelecom provides international communication services to every corner of Russia. The company has direct access to 74 countries and participates in 25 international cable systems.

Svyazinvest has demonstrated steady revenue growth over the last few years and 2002 was no exception, with the operating companies showing strong financial and operating performances.

The holding has been carrying out a major reorganization of its subsidiaries since 2000. At the end of 2002, 72 small regional telecoms were merged into seven super companies: Center Telecom, North-West Telecom, Uralsvyazinform, Volga Telecom, Sibir Telecom, South Telecom and Dalsvyaz. The new operators are comparable with the largest European wireline operators in terms of operating scale and subscriber base.

Privatisation and restructuring process resulted in Svyazinvest keeping control over seven regional companies



Svyazinvest holding was created to control the government stakes in the regional telecommunications operators, being attractive investment vehicle for a strategic investor

OVERVIEW OF RUSSIAN TELECOMMUNICATIONS MARKET IN 2002

In 2002 the telecom market remained among the most dynamic sectors of the Russian economy. According to the State Statistics Committee, the aggregate volume of telecom services in Russia grew by 15.6% y-o-y in real ruble terms to R285.5bn (\$9.1bn), well above the 4.3% expansion of the country's GDP. The share of telecom services in GDP rose from 2.2% in 2001 to 2.6% in 2003 (however, this is still below the 5% average for developing countries).

The telecom industry was also the first major sector in Russia where sweeping structural reforms were implemented. Compared to the oil & gas and utilities sectors, where reforms are still at the incipient stage, the fixed-line segment of the telecom sector has seen significant progress on both the structural and regulatory sides. The most important milestones in 2002 were:

- consolidation of Svyazinvest companies
- passage the first reading of a new telecommunications law by the Duma
- sharp (over 40%) hike in local tariff for households.

Importantly, sector reform is being carried out in a very favorable macroeconomic environment-strong demand for telecom services in Russia has been stimulated by increases in the population's real disposable income (last year it went up 9% y-o-y) on the back of overall economic growth (4.3% y-o-y) and the ruble's appreciation against the U.S. dollar (6.6% y-o-y).

Traditional operators in 2002 saw their revenues increase by 27% y-o-y in nominal ruble terms, whereas the revenues of mobile and alternative operators in 2002 grew at a considerably faster pace, 56% y-o-y, mostly on the back of booming demand for cellular services. As a result, incumbents continued to cede market share, which shrank from 50% in 2001 to 45% in 2002.

The rates of growth in the cellular segment last year exceeded even the most optimistic forecasts. In 2002, the number of mobile subscribers in Russia soared by 130% to 18mn, implying penetration of 12.3%, compared with 5.4% at the end of the previous year. The continued strong growth of the cellular subscriber base is largely due to the accelerating regional rollout of the major national cellular operators - MTS, Vimpelcom, and Megafon. Notably, in 2002, the number of mobile subscribers outside Moscow grew by 179%, compared with 81% growth in the Moscow License Area (MLA). In 2002, for the first time ever, the number of cellular users in the regions exceeded that in the MLA (10.9mn and 7.1mn as of the end of 2002, respectively). Nevertheless, cellular penetration outside the MLA still remained low at just 8.4% at the end of 2002, meaning that regions still retain significant growth potential.

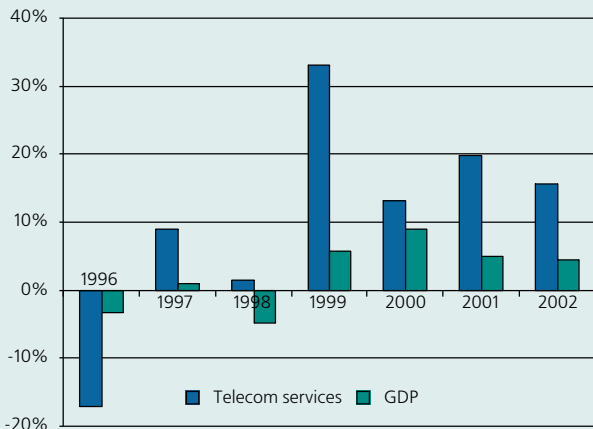
In 2002 the number of active Internet users increased by 39% to 6mn (based on Communications Ministry data), which implies 4.1% penetration. The share of Internet revenues in the traditional operators' top line, however, remained minuscule - less than 3%.

Investments in the telecom sector in 2002 grew by 10,8% y-o-y to R65.4bn, reflecting the improving financial position of domestic operators.

Overall, the results of 2002 show that the telecom sector is set to remain one of the leaders in terms of growth this year due to the following factors:

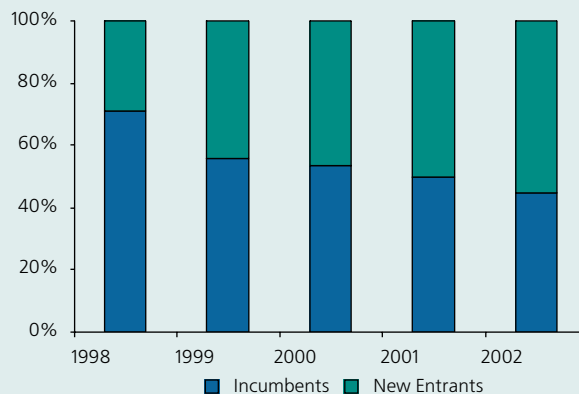
- benign macroeconomic environment;
- continuing sector reform, particularly tariff rebalancing;
- sustained growth in demand for telecom services both from corporate and individual clients.

Telecom market vs GDP growth, real terms



Source: State Statistics Committee

Telecom market breakdown by player



Source: State Statistics Committee

VALERY YASHIN: 'WE'RE ON THE THRESHOLD OF A NEW ERA IN RUSSIAN TELECOMMUNICATIONS'.

Svyazinvest has been on the Russian telecom scene for seven years now, but 2002 saw more events, important decisions and dramatic changes than all the previous years combined. A lot of work has been done over the last 12 months on the establishment of consolidated telecommunications companies in the seven federal districts. This achievement is all the more impressive given that only recently the legal incorporation of the consolidated companies alone was believed to require much more time.

The reorganization of the 72 incumbents into seven consolidated telecoms announced two years ago has now entered its final stage, which envisages the merger of the regional operators' businesses. The revival of the domestic telecom markets is explained not only by the sweeping changes to Russia's largest holding - Svyazinvest - but also by its increased transparency and improved disclosure. Below is an interview with Svyazinvest general director Valery Yashin.



Mr. Yashin, what in your opinion was the key event for the holding last year?

Last year's main achievement was certainly the establishment of the seven consolidated companies. It took us more than two years to accomplish it. I personally had no doubts that we would be able to achieve the consolidation process, though with hindsight the amount of work performed does look incredible. I think in Russia, and probably the world, there are no other examples of such sweeping transformations to a monopoly. We have achieved the goal we set out to achieve, and this confirms once again how uniquely qualified the

people employed in our companies are.

Now we can focus on speeding up corporate reform. The telecom market is very dynamic, and therefore even the slightest hesitation could considerably affect the business prospects of its players. We need to merge the businesses of the consolidated companies as soon as possible and reform their operations to ensure the efficiency and competitiveness of regional incumbents.

The holding company has demonstrated steady revenue growth over the past few years. However competition in the telecom market is intensifying, with alternative operators expanding into the regions. What is your view of the Svyazinvest companies' prospects in 2003?

Revenue growth in the wireline business depends on four factors: local tariff hikes, growth in DLD and ILD traffic, network expansion (increasing the subscriber base) and growth in revenues from value-added services (VAS).

Last year the Antimonopoly Ministry (MAP) granted two tariff increases to our companies. And although the hikes were not as great as we

wished, the trend in our opinion is positive. This year we expect local tariffs to be raised by 30%, most likely in May or June. We expect ILD and DLD traffic growth to come in at 18% on average, while our subscriber base is expected to expand by 5% - 6%. VAS revenues still account for only a minor portion of our operators' total sales, but we hope they will significantly increase this year due to the digitalization of existing networks and the construction of new multiservice networks.

Are there any companies that have already built multiservice networks?

In October last year Center Telecom launched a multiservice network based on Lucent Technologies equipment. The company invested \$10mn to build a network covering 25 cities in the Moscow region. In the future, Center Telecom plans to extend this multiservice network to other regions it services in European Russia. In addition to traditional telephony services, the network supports broadband data transmission, cable TV and other facilities.

Similar networks are being created by all Svyazinvest

operators, which aim to become leading providers not only of traditional, but also of value-added services. In future a federal intelligent network will be created to unify the regional operators' networks into a single efficient nationwide system.

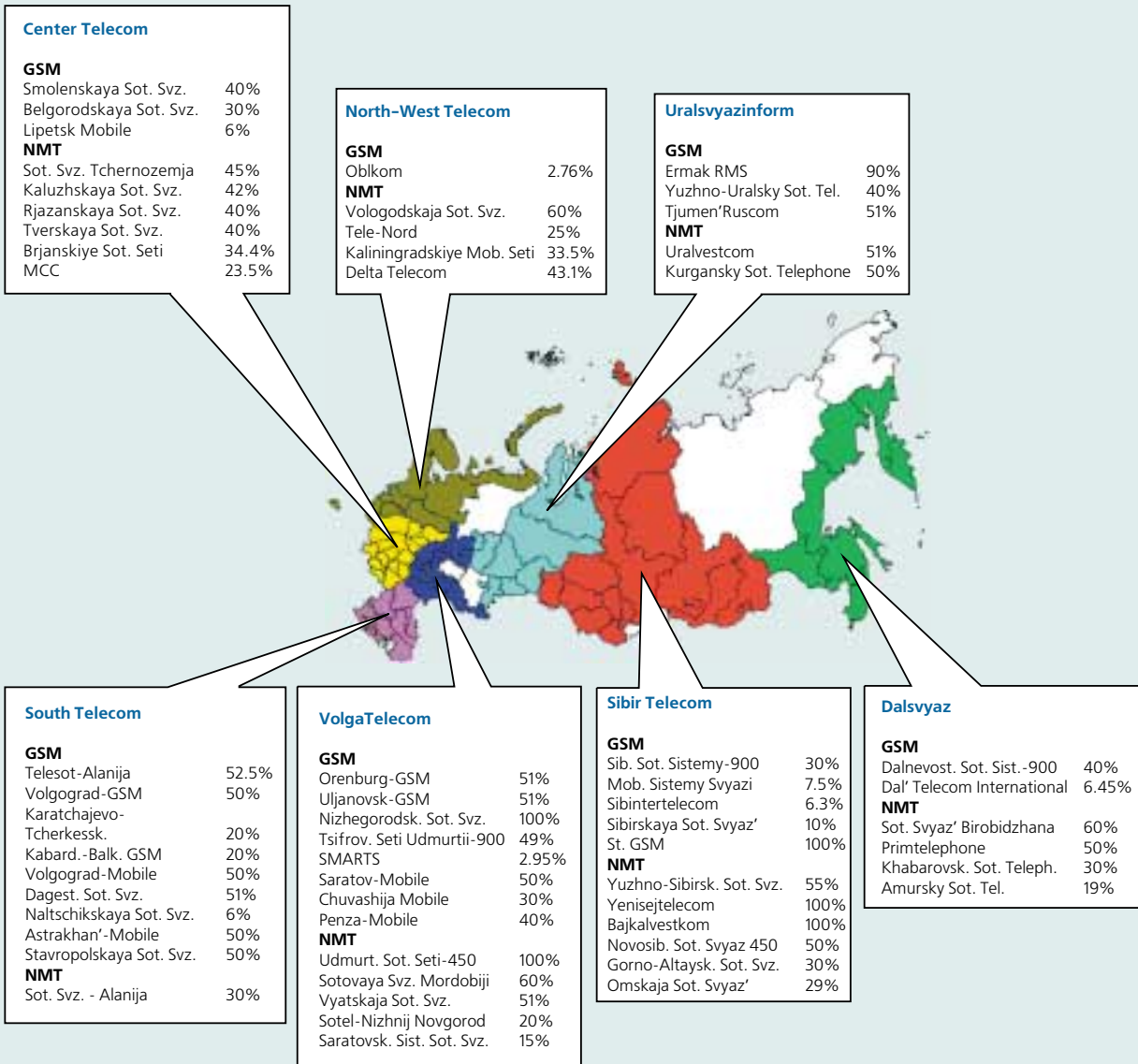
How do you plan to deal with the issue of ensuring the newly

constructed networks' compatibility?

Before the reorganization, each company purchased equipment on its own. As a result, the networks of even adjacent operators were sometimes incompatible. However, in April last year Svyazinvest held a telecom equipment tender, ushering in a new era in the

holding's technical policy whereby all purchases will be performed on a centralized basis. In addition to guaranteeing compatibility, this allowed our companies to obtain better maintenance terms and discounts. So we are able to buy more equipment with the same amount of money. As a result of the tender, the average price of

Svyazinvest mobile assets overview



purchased equipment dropped almost 20%, while the amount of equipment purchased increased by 25%.

It looks like traditional operators have recovered from the aftershock of the 1998 crisis. The main problem they faced then was how to repay the foreign currency loans they had taken to buy equipment. Because of the ruble devaluation, telecom operators lost their ability to service such loans overnight. What lessons have you learned from that experience?

Last year we began to implement a new borrowing policy within Svyazinvest to switch to ruble-denominated loans in order to eliminate FX risks.

In May Svyazinvest concluded a general cooperation agreement with Sberbank setting out the main principles of our long-term cooperation and stipulating better rates for the holding's operators.

Sberbank has adopted an aggregate loan limit for Svyazinvest of more than R7bn. The bulk of the money will be provided for five years and is earmarked for centralized equipment purchases. Because of the availability of long-term funding, the holding plans to significantly expand its network development capex. This year Svyazinvest plans to invest more than R32.5bn (\$1.02bn) and install a record number of new lines - over 3mn.

Several of your operators are providing mobile services. What do you think of this business' prospects?

Our subsidiaries' mobile businesses have good prospects.

Their subscriber base currently stands at over 1.5mn in NMT, AMPS/D-AMPS and GSM standards combined. The areas with the greatest development potential are the Urals, Siberia and Volga districts.

We are looking to develop not only GSM standard, but also some of the other standards in which our companies are currently operating, in particular NMT-450. The holding's operators own stakes in 28 mobile operators offering NMT-450 services in 38 regions. We understand that without technical modernization the value of our investments in the NMT-450 operators will be eroded. At the same time, NMT-450 operators have well-developed infrastructure and many years of experience. Therefore, we are currently looking to convert them from NMT to IMT-MC-450 standard, which would enable the companies to offer popular services. It is clear that the conversion of this standard to a digital format is promising and we are keen to pursue it.

Leading Russian companies are paying more attention to building better investor relations. What specific steps has Svyazinvest undertaken in this direction?

Last year we took a leap forward in terms of greater information transparency and better contacts, both among the holding's parties and the wider investment community. We used every opportunity to raise our profile and took part in prestigious forums, symposiums and conferences.

This year our goal is to introduce the new Russian telecom players

to the international investment community - these are the consolidated companies Center Telecom, North-West Telecom, Uralsviazinform, Sibir Telecom, South Telecom, Volga Telecom and Dalsvyaz. This is the theme of the third international conference: "Russian Telecommunications and Investment", to be held on March 28. It is also the main topic to be discussed during the road-show of Svyazinvest and its consolidated companies' management in New York from March 31-April 2 and London from April 3-4. This is not the first time we have organizing such events. Last year's interest in the conference and the road-show exceeded our expectations. My colleagues and I were happy to see the level of foreign awareness of the Russian market greatly improved. It was perhaps the first time ever that their questions demonstrated good knowledge of the Russian telecom scene.

In conclusion I would like to highlight the benefits of the consolidation yet again:

- improved management quality;
- higher liquidity and market capitalization;
- greater competitive advantages;
- reduced operating costs and tax optimization;
- stronger platform for raising external funding; and
- the ability to accumulate funding for priority areas of telecom development.

In my opinion, these factors make the telecom companies the best instrument for investors.

OVERVIEW OF SVYAZINVEST'S FINANCIAL PERFORMANCE IN 2002

The year 2002 - a pivotal one in Svyazinvest's restructuring - was very successful for the holding and its subsidiaries in terms of financial and operating performance. According to preliminary data, Svyazinvest's total revenues increased by 31% y-o-y to R113.7bn (\$3.6bn). Svyazinvest's top line performance looks particularly impressive in light of global telecoms' stagnating or even declining revenues. Two major factors concurred to enable Svyazinvest's impressive performance - strong local tariff hikes as part of tariff reform and growth in long-distance volumes on the back of an expanding domestic economy.

Importantly, last year Svyazinvest's revenue growth outpaced operating costs by 2 percentage points (operating expenses were up 29.3% y-o-y), whereas in 2001 costs were increasing faster than revenues - 30.8% vs. 29.1%. The improvement in cost performance was in part due to staff reductions - in 2002, Svyazinvest's total staff decreased by 5% to 364,410. As a result of better cost control, the holding company's operating margin expanded from 22% in 2001 to 29% in 2002. The holding company's net income was up 21% y-o-y to R10.8bn (\$344mn).

The total revenues of Svyazinvest's seven consolidated regional telecoms increased 30% y-o-y to R75.4bn (\$2.4bn), driven by the two abovementioned factors - local tariff hikes and strong LD volumes growth. Local tariff for households increased more than 40% across Svyazinvest operators in 2002, reflecting the government's commitment to tariff rebalancing and the elimination of cross-subsidizing both by type of service and customer group. In contrast, tariffs for state-funded and commercial customers went up only 23% and 14%, respectively.

Long-distance revenues, which accounted for nearly half of regional operators' revenue (49%), grew by 20% y-o-y to R36.9bn (\$1.2bn). In the domestic long distance (DLD) segment, strong traffic per line growth (16% y-o-y) was driven by ongoing economic expansion. As DLD tariffs remained flat, traffic growth translated almost fully into nominal growth in revenue from DLD services. In ILD, traffic per line growth (6% y-o-y) remained under pressure due to strong competition from altnets and VoIP service providers. The highest ILD traffic per line growth (10%) was observed in the North-West and Urals, while the

Central and Southern regions experienced the weakest ILD volume growth (only 3% y-o-y).

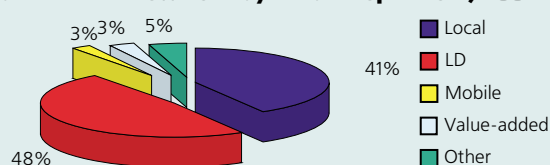
Mobile and value-added services combined contributed on average just over 5% to regional incumbents' top line last year. Mobile services, which on average accounted for 2.6% of the consolidated companies' revenue, displayed strong growth of 57% y-o-y in ruble terms. It is important to bear in mind that under Russian Accounting Standards (RAS) incumbents do not consolidate their cellular subsidiaries, even the fully owned ones, so these figures show only the companies' own cellular businesses. Value-added services accounted for a total 2.9% of regional operators' top line. As can be seen from the graph below, they are still overwhelmingly represented by Internet access, more than 90% of which is dial-up. However, services such as intelligent networks are increasingly gaining popularity with both individual and corporate customers and should expand rapidly going forward.

Costs were kept under control, which resulted in a 3 percentage point improvement in the operating margin of consolidated companies to 25%. Svyazinvest's total operating income rose 38% y-o-y to R33.0bn (\$1.05bn), while the operating income of consolidated regional operators increased by 41% to R19.0bn (\$604mn). Of the regional telecoms, Volga Telecom posted the biggest improvement in operating profitability: 29%, up from 22% in 2001

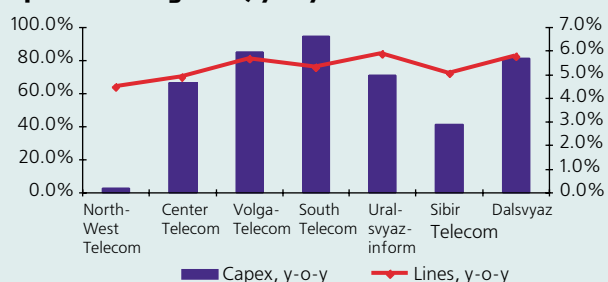
Consolidated companies' net income was flat y-o-y at R5.7bn (\$182mn) due to the introduction of bad debt provisions and a write-off of overdue accounts receivable that the Svyazinvest companies undertook in 2002.

Sound financial performance of regional telecoms has given them a strong incentive to boost capex in a bid to profit from strong revenue growth through increased network modernization efforts and new installations. The total capital expenditures of Svyazinvest operators increased by 44% y-o-y to R26.7bn. The number of lines installed increased by 6.4% y-o-y to 31.6mn, a remarkable result in comparison with the stagnating or even declining lines of many international operators. Network digitalization rate went up from 35% to 38%.

Revenue breakdown of Svyazinvest operators, 2002



Capex and lines growth, y-o-y



SEPARATE COST ACCOUNTING: GREAT EXPECTATIONS

To implement the government's ruling on the need to cover local costs and ensure a certain return on the local loop, incumbents have to substantiate the claim that their economic costs are not covered by the local tariff. For this purpose, Svyazinvest and McKinsey & Co have developed a methodology of separate cost accounting, which should provide grounds for local tariff hikes. The new methodology, which is expected to be approved by the regulator this year, factors in the cost of capital and provides for higher depreciation rates.

The cornerstone of tariff reform is the establishment of a new methodology for calculating companies' costs, which should be used as a basis for tariff rebalancing. The methodology itself - separate cost accounting (SCA) - has been worked out by Svyazinvest in cooperation with McKinsey and is based on EU experience. The key objectives of separate cost accounting are as follows:

- provide the basis for the establishment of economically justified tariffs and the elimination of cross-subsidies;
- determine fair interconnect charges to ensure non-discriminatory network access for all operators; and
- determine the level of compensatory payment for the provision of unprofitable services, such as rural fixed lines, payphones, etc.

The three key features of SCA differentiating it from the methodology currently in use, developed by the Antimonopoly Ministry (MAP) in the late 1990s, are as follows:

- Separate accounting of costs for each business process required to provide each type of service;
- Inclusion of the cost of capital (WACC) in expenses;
- Asset valuation at replacement cost instead of book value.

Activity-based cost accounting

Under the current methodology all costs incurred by telecom operators are lumped together and allocated in proportion to direct expenses and equipment type. As a result, at this point an operator is not able to properly allocate costs for different types of services, which precludes the regulator from setting reasonable prices.

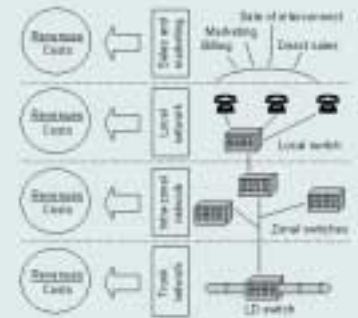
SCA allocates costs according to the business processes involved in the provision of each type of service. Costs are allocated on the assumption that each service is provided by an independent operator.

All activity of telecom operators is broken into the following business processes:

- Transmission and switching of telecom traffic, which is based on the following infrastructure
 - access network (last mile access);
 - core network (transport and zonal); and
 - trunk lines.
- retail sales (customer support, billing, etc).
- other activities - not related to the provision of telecommunication services, such as radio/TV broadcasting, equipment sales, etc.

Under the activity-based costing method, each business process required for the provision of a

Infrastructure breakdown for purposes of separate cost accounting



Source: McKinsey

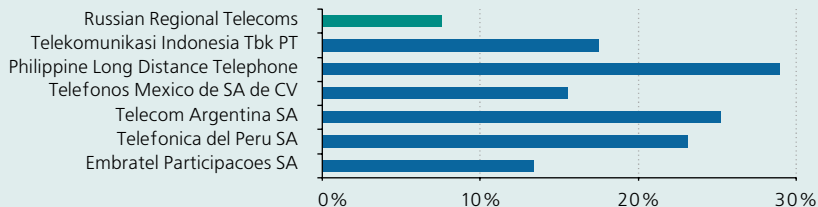
long-distance call is assigned a certain code, and every financial document is labeled with that code in order to place each expense under one of the above headings.

Each of the infrastructure segments in the picture above - local network, intrazonal network, etc. - would calculate its costs based on the total amount of traffic that passes through its part of the infrastructure, regardless of whether it is local, DLD or ILD. By the same token, the costs of the city transportation network will depend on traffic volume, regardless of the traffic's nature.

Cost of capital

SCA differs from the current approach in that it is based on the economic cost rather than the accounting cost. First and foremost, this approach implies the inclusion of the cost of capital in expenses, instead of using the so-called «standard rate of return» that MAP currently applies in its tariff setting methodology.

The cost of capital is the rate of return required by the suppliers of a firm's capital. For a business

Depreciation as % of sales

Source: Bloomberg

that finances its operations or investment through both debt and equity, the cost of capital includes the explicit interest on the debt and the implicit minimum return the owners require. This minimum return to owners is necessary to ensure that owners do not withdraw the funds invested in the firm. Economic profit, calculated as revenues minus economic costs, represents a better gauge of a company's performance compared to accounting profit, and hence is preferred by investors.

SCA implies a different approach to asset value

Apparently, material costs under McKinsey's methodology do not differ greatly from those currently used in financial reporting, and therefore do not warrant a dramatic tariff increase. The key difference is the approach to asset value and hence the calculation of depreciation charges.

At the moment, Svyazinvest operators record their depreciation charges based on the book value of their assets. Not surprisingly, the outdated nature of telecommunications equipment and the effect of the 1998 devaluation have dragged depreciation charges down to very low levels. Low depreciation expenses deprive Svyazinvest

operators of the funds necessary to upgrade their outdated network. For example, on average, the depreciation expense of Russian regional operators constitute 8% of revenues, compared to the EMEA average of 20%.

Under the new methodology, depreciation would be considered an economic expense, as it shows what proportion of an asset's value has been used up over a period and what amount of spending is required to maintain operations at their existing level. Therefore Svyazinvest, together with McKinsey, has proposed using the replacement cost of equipment and not the book value of assets as the basis for calculating depreciation charges.

Execution timeframe: government continues to drag its feet

Svyazinvest expects the implementation of SCA to start in 2003, which in turn should allow it to complete tariff rebalancing by 2006. After tariffs are brought to economically reasonable levels, they will be automatically hiked by the CPI-X% rate, where X represents the required efficiency factor. This method (known as price cap) keeps the regulator's interference in the tariff setting process to a minimum.

SCA is already operating in pilot form at all regional operators. However, to be used as the basis for tariff calculation, it has to be approved by the relevant ministries: MAP and Telecommunications, and we understand that SCA is facing serious opposition from MAP.

Given that Russia does not have much time for tariff reform (it is already significantly lagging Eastern Europe in telecom market liberalization), implementing SCA would imply a 29% four-year CAGR of local tariffs in real terms. This represents a real challenge in light of State Duma and presidential elections in 2003-2004. This is probably one of the reasons why the new tariff calculation methodology has been sitting in the MAP since early last year, with several deadlines for its approval having passed and still no sign of a conclusion to discussion between MAP, the Telecommunications Ministry and Svyazinvest.

The SCA methodology has good chances to be officially approved in 2003, but most probably with a much less aggressive approach to tariff increases than is called for under the actual methodology. At present, the methodology of separate cost accounting is being discussed by the relevant ministries and government agencies, whose agreement is essential to its final adoption. The new methodology is supposed to come into effect this year, though additional discussions may be necessary, meaning its final adoption may only take place next year.

MERGER OF BUSINESSES — A KEY RESTRUCTURING STEP

Corporate restructuring is Svyazinvest's most important task at this stage. The consolidated companies are about to begin merging their businesses, streamlining their operational structure and undertaking technology upgrades.

Svyazinvest, consulting firm Accenture, and the companies involved in pilot projects (Uralsviazinform and Volga Telecom), have already come up with proposals regarding the consolidated companies' future structure and the plan for achieving it.

Commercial Issues

One of the main goals of restructuring is greater focus on commercial issues and improving customer relations. This is to be accomplished by creating new marketing, sales and customer service departments (the sales and customer service departments are to be separated). Commercial departments will be formed on the basis of a «parent company-regional branch» vertical structure in order to achieve better centralization.

The marketing department is expected to set up a strategic marketing section and a new products and services section. The strategic marketing section will provide a full-scale assessment of customer needs, sector trends, the competitive environment, etc. The new products and services section will control and coordinate the development of new services. This approach will enable better focus on customer needs and greater price flexibility.

Much attention will be paid to high-income clients. The sales department will form task groups or sections focusing on corporate and VIP-customers. New efficient service standards will be put in place, such as an individual approach to customer service, with personal managers to be assigned to clients, etc.

Another important task is to reengineer the most important customer relations processes. In marketing, this entails undertaking market research, developing and implementing marketing strategies, new products, services and tariffs. In sales and support, this involves better contacts with corporate, VIP and other customer groups and dealers, improved cooperation between the sales and customer service departments of the consolidated companies and regional branches, as well as between their commercial and technical departments.

Customer service work will be improved on the basis of new technologies, such as CRM, offering efficient information support for service functions and providing relevant tools. Furthermore, customer interaction centers are to be considered, which will not only lower customer service costs, but also increase

corporate earnings through the commercial use of such centers (by servicing third parties).

Personnel Management

A unified personnel management strategy will be developed and tied up with the consolidated company's corporate strategy. It will describe personnel management methodology and approaches, unified corporate culture and the steps towards its implementation. The new corporate strategy will boost departmental cooperation, increase labor efficiency and staff loyalty, offer incentives for personnel initiatives and development, and achieve stronger corporate spirit in order to accomplish the consolidated companies' common strategic goals.

Another important aspect deals with implementing a new personnel incentives system based on fair results-oriented rewards. In addition to financial incentives, it will include non-financial rewards (individual career path, expertise development, rewarding initiative, etc.). The new incentives will help retain the most valuable staff and increase labor productivity.

Current personnel management efforts focus mainly on staff selection and record-keeping. Therefore, it is extremely important to implement the new functions and improve the expertise of the people assigned to carry out these tasks.

The Svyazinvest human resource department is currently undertaking an evaluation of regional operators' staff in key business areas. The results of this evaluation will give a better idea of current staff qualifications and enable the company to forecast future personnel requirements.

The third aspect deals with creating (at the consolidated company level) staff training programs based on staff qualifications, personnel requirement forecasts and personal qualification improvement plans.

A unified personnel management information system is also planned, in order to raise labor efficiency, improve data quality and streamline information research and processing.

One important change envisages structural development to become the responsibility of the human resources department within the consolidated company HQ. The work plan also envisages optimizing social assets (kindergartens, sanitariums, hotels, etc.) with plans for loss-making ones to be spun off.

Network

It is not envisaged to make fast and radical technology changes. Improvements will focus on network digitization and capacity expansion. The most important proposals include:

- integrating the «plan – design – construction – operation» process, and incorporating construction projects with the technology section in order to maintain unified management responsibility for the entire network management chain.
- to improve the responsiveness and customer orientation of network development with a focus on marketing and medium and short term planning (part of the investment budget to be allocated to high-return projects, i.e. VIP-projects evolving during the implementation phase).
- to install a centralized network development plan, taking into account the regional projects stream, based on knowledge of the local market.
- to gradually automate major technological functions in order to improve efficiency and quality, including: network management centers, technical accounting and activation systems, project management, workflow and problem solving, labor resources and record-keeping, inter-operator settlements and, potentially, SAPR.
- to outsource certain routine functions (construction, and, partly, operations). Because of the low technical level and automation, this area has the greatest potential for cost and personnel reductions.

Purchasing and Logistics

As regards purchasing and logistics, it is planned to create a unified product register with a breakdown into three categories, depending on the level at which decisions are being made – Svyazinvest (strategic equipment and materials), the consolidated company (major equipment and materials not covered by Svyazinvest), branch (auxiliary equipment and materials).

The second area of change is the reengineering of business processes. Work is currently being undertaken to systematize information on equipment and materials suppliers (a unified supplier register has been created and current contract terms analyzed) in order to select several key suppliers to draw-up contracts on better terms at the consolidated company level. This work will serve as the basis for developing a unified supplier policy (tender procedures, contract follow-up, accounts receivable management, risk management, standard contract templates, etc.), in order to lower operating costs. New processes governing purchase planning, execution, monitoring and logistics are expected to be developed and implemented shortly.

The third change deals with the gradual centralization within a consolidated company's purchasing and logistics department of functions. This includes purchasing planning and control, maintaining contacts

with major equipment and materials suppliers, developing a general purchasing and logistics methodology and policy, setting limits, etc. The regional branches' responsibilities will include accepting and storing equipment, delivering it for repairs and to construction projects, and purchasing (within the budget specified) auxiliary equipment (tools, small office equipment and supplies, working clothes, etc.). The work plan envisages optimizing logistics and construction assets (warehouses, building machinery, transport, etc.), in order to improve both the financial stability of the consolidated company through higher working capital and to lower the maintenance cost of inefficient assets.

In future a computer based warehousing systems is planned in order to raise the efficiency of warehouse space and the quality of record-keeping to optimize warehouse stocks.

Information Technology

Another important task is to develop and implement IT processes in the consolidated company. It is important to have clear vertical integration between the consolidated company headquarters and regional branches, and to centralize the main functions of IT departments. Furthermore, it is planned to use advanced development methods in the process of planning, designing, implementing and supporting the company's IT systems. It is especially important to identify and formalize interaction between the company's departments that will act as customers, ordering automation tasks, while the IT departments will take care of their implementation (for example, commercial services are responsible for formulating tasks related to CRM or billing systems, while the IT departments are responsible for their implementation, etc.).

An important step in the IT area is to come up with the consolidated company IT strategy setting out the principles of IT infrastructure, data architecture, applications, etc. IT strategy tied up with the company's corporate strategy will enable the efficient use of IT technologies within the consolidated company.

The level of information technology within a consolidate company directly affects the validity of data, relevance and timeliness of management decisions and, therefore, the efficiency of many corporate processes. The main task in this area is to enhance the status of IT through the creation of an IT department (at the consolidated company and subsidiary levels), and create an IT director's position (who will be deputy CEO of the consolidated company).

CALENDAR OF EVENTS¹

DATE	SVYAZINVEST	ROSTELECOM	CENTER TELECOM	NORTH-WEST TELECOM	VOLGA TELECOM
April 2003	Conference 'Tele-communications and Investment in Russia' Road Show New York & London Russian Economic Forum (London)		Road Show New York & London	Road Show New York & London	Road Show New York & London April 30 - Volga Telecom 1Q03 results
May 2003		Rostelecom 1Q03 results	Center Telecom 1Q03 results	North-West Telecom 1Q03 results	May 15 - Volga Telecom auditor's conclusion 2002 results
June 2003	Svyazinvest AGM	Rostelecom AGM	Center Telecom AGM	North-West Telecom AGM	Volga Telecom AGM
July 2003			Center Telecom 2002 results (IAS)	North-West Telecom 2002 results (IAS)	Volga Telecom auditor's conclusion 2002 results (IAS) Volga Telecom 1H03 results
August 2003	Svyazinvest 1H03 results	Rostelecom 1H03 results	Center Telecom 1H03 results	North-West Telecom 1H03 results	
September 2003				Corporate Governance Rating revision	
October 2003					October 30 - Volga Telecom 3Q03 results
November 2003	Svyazinvest 3Q03 results	Rostelecom 3Q03 results	Center Telecom 3Q03 results	North-West Telecom 3Q03 results	Dividend's payments
December 2003		2004 business plan	2004 business plan	2004 business plan	2004 business plan

DATE	SOUTH TELECOM	URALSVYAZINFORM	SIBIR TELECOM	DALSVYAZ
April 2003	Road Show New York & London Russian Economic Forum (London)	Road Show New York & London	Road Show New York & London April 30 - Sibir Telecom 1Q03 results	Road Show New York & London
May 2003	South Telecom 1Q03 results	May 5 - Uralsvyazinform 1Q03 results Uralsvyazinform AGM	May 15 - Sibir Telecom auditor's conclusion 2002 results	Dalsvyaz 1Q03 results
June 2003	June 5 - South Telecom AGM	Uralsvyazinform auditor's conclusion 2002 results (IAS)	Sibir Telecom AGM	Dalsvyaz 2002 results (IAS) June 25 - Dalsvyaz AGM
July 2003	South Telecom 2002 results (IAS)		Sibir Telecom auditor's conclusion 2002 results (IAS) Sibir Telecom 1H03 results	Dalsvyaz 2002 results (IAS)
August 2003	South Telecom 1H03 results	August 4 - Uralsvyazinform 1H03 results Dividend's payments		Dalsvyaz 1H03 results Dividend's payments
September 2003	Road-Show (Europe)			
October 2003			Sibir Telecom 3Q03 results	
November 2003	South Telecom 3Q03 results	November 5 - Uralsvyazinform 3Q03 results EGM Uralsvyazinform mega-region		Corporate Governance Ratings receiving Dalsvyaz 3Q03 results 2004 business plan
December 2003	South Telecom provisional 2003 results 2004 business plan	December 20 - Uralsvyazinform provisional 2003 results 2004 business plan	2004 business plan	

* All dates are the subject to further confirmation

HIGHLIGHTS OF SVYAZINVEST 2002 OPERATING AND FINANCIAL RESULTS

	North- West Telecom	Center Telecom	Volga Telecom	South Telecom	Ural- svyaz- inform	Sibir Telecom	Dalsvyaz	Consolidated companies, total	Ros- telecom	Svyaz- invest, total
Revenues, R mn	10,092	16,389	10,969	10,481	9,897	12,211	5,332	75,371	25,409	113,684
Ch. y-o-y	25%	28%	43%	38%	25%	27%	29%	30%	32%	31%
Operating costs, R mn	7,443	12,132	7,794	7,787	7,504	9,418	4,316	56,394	15,684	80,690
Ch. y-o-y	25%	22%	31%	41%	24%	24%	27%	27%	32%	29%
Operating profit, R mn	2,648	4,257	3,175	2,693	2,394	2,793	1,015	18,977	9,725	32,994
Ch. y-o-y	27%	48%	80%	32%	27%	37%	36%	41%	33%	38%
Operating margin	26%	26%	29%	26%	24%	23%	19%	25%	38%	29%
Net profit, R mn	463	982	1,561	1,450	655	447	156	5,714	3,603	10,800
Ch. y-o-y	-34%	-9%	40%	60%	-14%	-51%	-37%	0%	61%	21%
Average lines (000)	3,273	5,443	3,736	3,189	2,870	3,331	1,046	22,889	23	28,228
Ch. y-o-y	4%	5%	6%	5%	6%	5%	6%	5%	2%	5%
Capex, R mn	1,670	4,814	3,468	3,429	4,406	2,453	762	21,003	2,576	26,728
Ch. y-o-y	3%	67%	85%	95%	71%	41%	81%	63%	6%	44%
Capex per line, R	510	884	928	1,075	1,535	736	728	918	—	947
Revenue per line, R	3,083	3,011	2,936	3,287	3,448	3,666	5,099	3,293	—	4,027
Lines per employee	109	76	73	75	81	67	54	76	—	77
DLD traffic per line, min	331	441	420	464	533	426	411	433	—	408
Ch. y-o-y	14%	14%	16%	20%	19%	13%	14%	16%	—	13%
ILD traffic per line, min	45	30	18	30	37	24	26	30	—	38
Ch. y-o-y	10%	3%	5%	3%	9%	8%	6%	6%	—	-3%
Internet revenues, R mn	228	336	226	244	227	320	208	1,789	7	1,905
Ch. y-o-y	22%	65%	88%	67%	32%	47%	63%	53%	-98%	16%
Cellular revenues, R mn	58	323	88	—	932	192	131	1,725	—	1,725
Ch. y-o-y	7%	33%	121%	—	80%	30%	39%	57%	—	57%
Average employees	29,984	72,085	51,160	42,542	35,620	49,632	19,249	300,272	31,220	364,410
Ch. y-o-y	-4%	-4%	-6%	-7%	-4%	-4%	-5%	-5%	-11%	-5%