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Analysis

RUSSIA
Europe/M.East/Africa

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OAO Novatek

Corporate Profile

Second largest Russian gas company, whose high capital and cost efficiency position it well to exploit the growing attractiveness of the domestic market

OAO Novatek (rated Ba2/stable) is the largest independent gas company in Russia, and the second largest gas company by reserves after state-controlled OJSC Gazprom (rated Baa1/Baa2, stable outlook). Further significant competitors in the domestic Russian gas market include LUKOIL (rated Ba1/Ba2, positive outlook), Rospan (owned by Ba1/Ba2 rated TNK-BP) and Rosneft (rated Baa2), as well as Itera and Nortgas, two significantly smaller and unrated local players. Although seemingly dwarfed by Gazprom, Novatek ranks as the largest global gas-focused exploration & production (E&P) company by reserves with 505 billion cubic metres (bcm) of proved natural gas reserves (585bcm on a life-of-field basis) at year-end 2004, compared with reserves of 296 bcm and 257 bcm of its next largest global peers, EnCana Corp. (rated Baa2) and BG Group Plc (rated A2), respectively. In 2004, Novatek produced 17.3 bcm of natural gas (on a sales volume basis, gross production on a fully consolidated basis including 100% of core subsidiaries Tarkosaleneftegas and Khancheyneftegas was 20.87 bcm), all of which was sold domestically, and 2.1 million tonnes (mmt) of liquids (on a sales volume basis, gross production on a fully consolidated basis was 2.2 mmt), of which around 25% were exported and the remainder was sold domestically. Since December 2004, Novatek produces substantially all of its gas from three wholly-owned fields located in the Yamal-Nenets Autonomous district, in close proximity to Gazprom's "mega-fields" and its Unified Gas Supply System (UGSS), on which Novatek fully depends for transportation of its gas. In June 2005, Novatek also commissioned its Purovsky gas condensate processing plant, which today processes close to all of its unstable gas condensate.

Figure 1: Overview

Division	FYE 2004	FYE 2004	9months 2005	Moody's Outlook
Natural Gas				
Revenues (Rub. m)	7,612	12,943	16,873	Target to achieve 45bcm by 2010. Output growth driven by Yurkharovskoye field and widening domestic gas supply gap. Rising domestic gas prices.
% of total	47.4%	52.6%	58.9%	
Volumes (bcm)	13.2	17.3	20.6	
Crude Oil & Gas Condensates				
Revenues (Rub. M)	2,268	6,387	7,847	Moderate output growth. Improved profitability from Purovsky processing plant and greater export potential.
% of total	14.1%	25.9%	27.4%	
Volumes ('000 tonnes)	734	1,589	1,306	
Oil Products				
Revenues (Rub. M)	2,144	2,159	2,918	Moderate output growth. Mainly domestic sales likely to mean revenues will grow less than gas and condensates.
% of total	13.4%	8.8%	10.2%	
Volumes ('000 tonnes)	501	523	560	
Total Revenues (incl. other)	**16,058**	**24,615**	**28,634**	

Moody's Investors Service
Global Credit Research

In 2004, Novatek successfully bought out the Itera Group's minority stakes in two key operating assets, and today has full control of its three core fields. In 2005, Novatek shareholders used some of the proceeds from Novatek's initial public offering (IPO) of just over 19% of its shares to repay a loan provided by Novatek which had been applied to buy out Itera. In addition to this free float, Novatek' shareholders include its management and affiliated parties (69%), state-owned bank Vnesheconombank (5.6%) and the World Bank's International Finance Corporation (IFC), which holds approximately 1%.

Management Strategy & Group Structure

Novatek's strategy is based on the development of its vast undeveloped gas reserves to maintain its position as the leading independent domestic gas company

Over the past two years, Novatek's strategy has been to focus on its core oil and, predominantly, gas activities. Accordingly, most of management's efforts have been targeted at streamlining the organisation in order to obtain full control over core assets and dispose of selected activities which no longer suit the company's strategy. In 2004, Novatek acquired the 67.7% in Tarkosaleneftegas and the 57% in Khancheyneftegas it did not already own, thereby gaining full control over its three core operating subsidiaries. Given the close proximity of both fields and the synergies from operating both assets as one entity, Khancheyneftegas has since been merged into Tarkosaleneftegas (see group structure below). While there are still some minority investors in some of Novatek's remaining subsidiaries, these are significantly smaller and Novatek intends to gradually buy these out over time. Novatek has also completed the disposal of non-core operations, mainly related to construction services, banking and telecommunications.

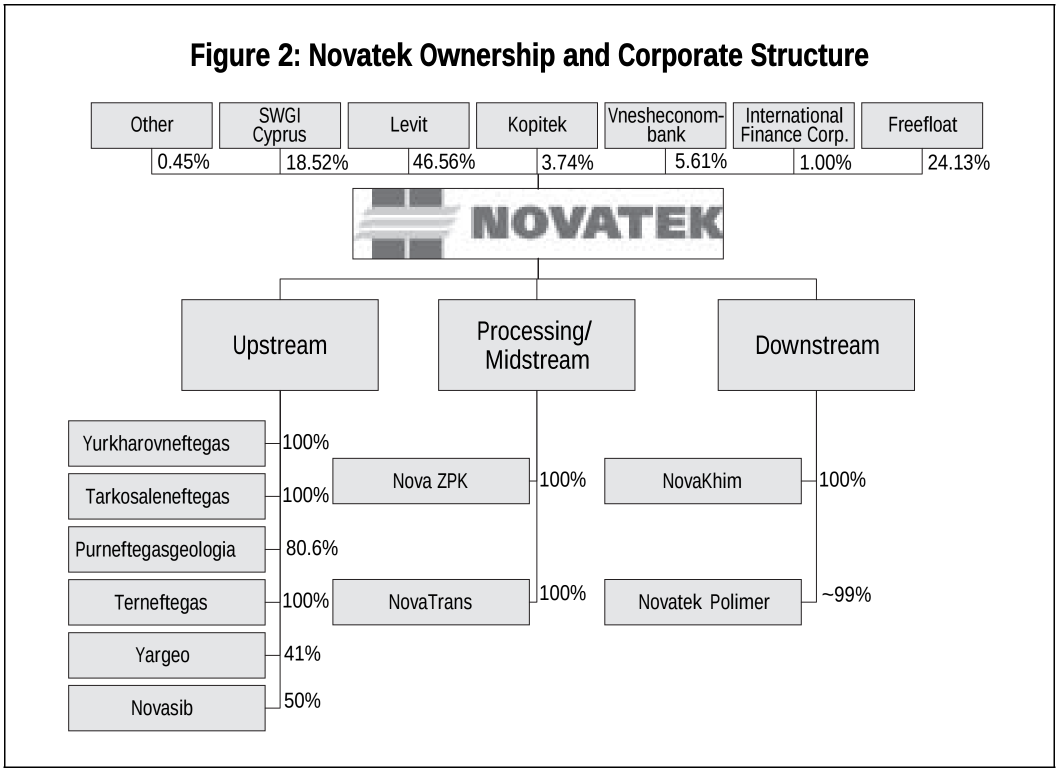
Going forward, management intend to focus on the following key strategic principles:

- **Increase Production:** Much of Novatek's strategy is based on converting its vast undeveloped reserves (particularly in the core Yurkharovskoye field) into producing reserves to meet the growing demand for domestic gas, which Gazprom is unable to satisfy. This is both due to the fact that Gazprom's priority lies with higher value exports (indeed we believe that Gazprom is not profitable in its domestic gas business under current artificially low pricing conditions) and its own requirements to develop new reserves.
- **Maintain low cost structure:** Novatek is one of the most efficient operators in Russia and globally, which enables it to produce impressive margins in Russia's subdued domestic gas market. One of the key priorities for the company is to maintain this advantage.
- **Maximise sales netbacks on natural gas and liquids:** Novatek aims to find the most profitable sales channels to market its gas and liquids products. While natural gas sales are restricted to the domestic market, liquids are finding customers outside of Russia. Novatek's new Purovsky processing plant and port facility in Vitino have significantly enhanced the company's flexibility and control over the distribution channels.
- **Simplify corporate structure and improve transparency:** Novatek will continue to streamline its portfolio, despite the large bulk of disposals having been achieved. Management also continue to focus on improving transparency, including efficient and timely production of quarterly and annual results.

Novatek has one of the cleanest corporate structures in Russia, with no evident group complexity or obscurity

Unlike many of Novatek's domestic peers, which are struggling to streamline their group structure and bring under their control core operating subsidiaries, Novatek's corporate structure is relatively simple and the fact that its core subsidiaries, Yurkharovneftegas and Tarkosaleneftegas, are 100% owned weighs positively on Novatek's ratings. Both Tarkosaleneftegas and Khancheyneftegas were recently bought out from Itera and other minority investors, financed in part with a USD 290 million loan from Novatek to shareholders. Novatek made the loan to shareholders who then bought out the Itera stakes and subsequently exchanged these shareholding interests for Novatek shares. These shares were then used as part of the IPO and the loan has since been fully repaid. Moody's notes that it does not expect Novatek to engage in any material financing transactions with shareholders going forward, and recognises that this was a one-off measure to consolidate the business.

Novatek's shareholder structure is also reasonably transparent, despite some lack of disclosure on the full ownership structure of its core owners, notably SWGI Growth Fund (Cyprus) Ltd., ZAO Levit and OOO Kopitek. However, Moody's understands that these entities are ultimately controlled by Novatek's management and employees, and in turn hold the majority of shares in Novatek, thereby mitigating some of the uncertainty related to the exact nature of their own shareholdings. Moody's also takes comfort from the fact that the International Finance Corporation (IFC), which is part of the World Bank, holds a symbolic 1% share in the company and that state-owned Vnesheconombank holds a 5.6% stake.



Key Rating Considerations

KEY FACTORS SUPPORTING NOVATEK'S RATINGS:

- **Substantial reserves:** Novatek's ratings benefit from the significant scale associated with its reserve and production base. Although a direct comparison with Gazprom's 100 billion boe in proved SPE reserves makes Novatek's 3.5 billion boe (4.1 billion boe on a life-of-field basis)[1] in proved SEC reserves seem minor, Novatek is about 1.5 times the size of BG Group (2.1 billion total proved reserves), one of the world's largest gas-focused E&P companies, although its pro forma 2004 production of 146 million boe is somewhat below BG's 167 million boe given its high level of undeveloped reserves.
- **High operating and capital efficiency:** Ratings also benefit from Novatek's high efficiency, which enables it to produce solid margins, despite low prices. Novatek's full-cycle costs are amongst the lowest in the industry, both in Russia and internationally.
- **Limited exposure to commodity price risk:** At the same time, Russia's artificially low domestic gas prices shield Novatek from commodity risk, as prices are set for moderate increases going forward.
- **Growing demand for domestic gas:** Ratings benefit from the growing domestic demand for gas, which cannot be met by Gazprom and therefore requires domestic competition to be satisfied. This gap is expected to reach up to 256 bcm per annum by 2020 and could be larger, if Central Asian supplies (which are expected to represent around 10% of domestic supplies by 2020) prove less reliable.
- **Transparent group structure and low "privatisation risk":** Ratings are also supported by a generally transparent corporate structure and limited "privatisation" risk, given that Novatek is essentially a green-field operation with no significant privatisation exposure.
- **Robust financial profile:** Ratings assume that Novatek in 2005 will produce and be able to maintain positive free cash flow throughout its plan period, despite greater investments.

1. *Moody's converts bcm into mboe using a 6.29x multiple, as is common in the industry. Minor differences to reported figures may be the result of different multiples.*

KEY FACTORS CONSTRAINING NOVATEK'S RATINGS:

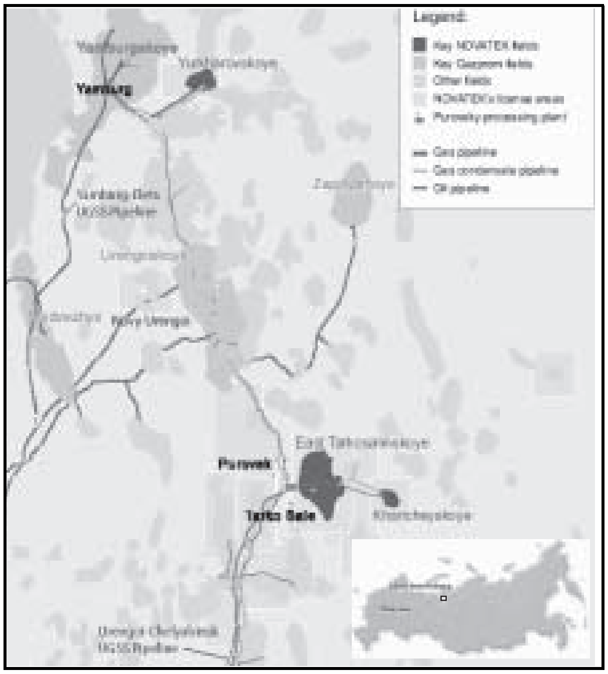
- **Dependence on Gazprom for pipeline access:** Gazprom holds the monopoly for gas transportation, thereby making Novatek dependent on access to the UGSS for the transportation of its gas. While Gazprom needs to ensure third-party access to its pipelines, this is subject to the availability of capacity and there have been occasions where access has been denied to other Russian independent gas producers.
- **Effective control of the Russian gas sector by Gazprom:** Gazprom effectively controls the Russian gas sector, both through its monopoly on the UGSS (see above), and its control of exports, transport tariffs (though these are set by the Federal Tariff Service, a government body), available capacity (which determines the capacity able to be produced by the independents) and policies. This necessitates a "Gazprom strategy" which ensures a framework of symbiotic co-operation rather than competition with Gazprom.
- **Project and execution risk related to high level of proved undeveloped and probable reserves:** With approximately 40% of Novatek's total proved reserves recoverable up to the license expiry date, undeveloped and an additional 2.6 billion boe of probable reserves, the company's challenge is to convert probable into proved reserves, particularly given that only 15% of 2P reserves in Yurkharovskoye, which will constitute around 60% of production by 2010, are currently developed.
- **Some customer concentration risks:** Currently, Novatek sells approximately 60% of natural gas to five customers, including 33% to Itera through a 5-year supply agreement.
- **Potential political interventionism:** Although there are no material events of license disputes between Novatek and state authorities, Moody's notes that the hydrocarbon sector has been declared a strategic activity by the Russian state and therefore is likely to be under greater state scrutiny and possibly intervention than other sectors. In 2005, Total S.A. (rated Aa1) failed to obtain regulatory approval to acquire a 25% plus one share stake in Novatek, which Moody's believes was widely politically motivated.
- **Geopolitical risks:** In addition to the above, we believe that Novatek, as a company active in the Russian oil & gas sector, is subject to greater geopolitical volatility than some other companies operating under more developed frameworks. Thus, factors such as non-transparent tariff setting, artificially low pricing, the threat for license disputes or the potential for private and/or non-Russian companies to be excluded from particular license auctions act as constraints to Novatek's ratings.

Model Rating Factors

In the following section, we map Novatek against some international E&P peers and one integrated Russian peer using the mapping criteria of Moody's global Rating Methodology for integrated E&P companies (see Related Research).

1.) RESERVES & PRODUCTION CHARACTERISTICS – Baa

Novatek has appraised proved reserves of 3.5 billion boe based on SEC reserves measurements on 2004 production levels of 68.7 million boe. However, given that reported 2004 production does not reflect the full consolidation of the group's assets, pro forma production of 145.7 million boe is a more realistic measure. When reserves are included that are likely to be recoverable past the license expiry dates, total proved reserves increase to 4.1 billion boe. Given that Novatek recently had its application approved to extend its license for the Yurkharovskoye field to 2034 (from 2017) and plans to do the same for both East Tarkosalinskoye (from 2018) and Khancheyskoye (from 2019) licenses, we assume that the full reserves will be able to be exploited, but use the pre-license expiry date figures for international comparability.



All three core fields are located in the Yamal-Nenets Autonomous District in very close proximity to Gazprom's so-called "mega-fields", notably Yamburgskoye and Novy Urengoi. Accordingly, Novatek's fields are also closely located to Gazprom's trunk pipelines, whose spare capacity has been growing, given that the mega-fields are in gradual decline. This is a vital factor in Novatek's ability to access Gazprom's pipeline for the transportation of its own gas, given that third-party access is only assured on available capacity. Production from the "mega-fields" has dropped by around 60 bcm over the last four years and as Gazprom shifts it focus for future long-term growth to the Yamal Peninsula, Barents Sea and Eastern Siberia, Novatek believes that pipeline capacity will increase over the next five years. Overall pipeline capacity in Novatek's operating area is in the region of 640 bcm, of which around 590 bcm was used in 2004. This leaves spare capacity of approximately 50 bcm, which – depending on the rate of depletion in Gazprom's fields and partially offset by the expected output growth from its Zapolyarnoye field – could grow to around 100 bcm by 2010.

Due to Novatek's vast reserve base, Novatek compares very favourably to peers on reserve and production characteristics, although its geographic concentration in Russia acts as a constraint. At the same time, Novatek's high level of undeveloped reserves adds some project risk, while at the same time offering good prospects for output growth. Novatek also holds exploration licenses for substantial areas in the vicinity of its present production areas.

Figure 3: Peer Reserve & Production Characteristics

Company	Rating	Proven developed reserves (mboe)	Total proved reserves (mboe)	Total production	Diversification
Novatek*	**Ba2**	**2,113**	**3,524**	**145.7***	**Low**
Category Mapping		A	A	Baa	Caa
BG Group	A2	1,319	2,147	166.8	Medium/High
Category Mapping		Baa	A	Baa	A
Apache	A3	1,303	1,937	169.5	Medium/High
Category Mapping		Baa	Baa	A	A
Occidental	A3	1,969	2,532	204.3	Medium/High
Category Mapping		A	A	Baa	A
Woodside	Baa1	261	951	56.0	Low
Category Mapping		Ba	Baa	Baa	B
Anardarko	Baa1	1,517	2,365	184.7	Medium
Category Mapping		Baa	A	A	Baa
EnCana	Baa2	1,515	2,245	281.8	Medium/High
Category Mapping		Baa	Baa	A	A
LUKOIL	Ba1	11,407	20,094	666	Low
Category Mapping		N.A.	Aaa	Aa	B

**20.4bcm (= 128.3 mboe) of natural gas and 2.0 million tonnes (=17.4 m barrels) of liquids, pro forma for full consolidation of core subsidiaries*

Novatek is targeting natural gas production of 45 bcm (~283 million boe) from currently 20 bcm (~126 million boe) by 2010, which will be predominantly delivered by the Yurkharovskoye field. In so doing, Novatek aims to be able to benefit from the growing supply gap in the domestic market, which is estimated to reach 256 bcm by 2020 from currently 73 bcm. Given Gazprom's focus on exports, where it is very profitable, we believe that independent suppliers are well positioned to meet this demand from smaller, streamlined and thus more profitable operations

.

Figure 4: Russian Domestic Gas Predictions and evolving "supply gap"

	2004	2020E
Total Domestic Russian Demand	~ 440 bcm	~ 510 bcm
Gazprom Supply	~ 340 bcm	~ 190 bcm
Central Asian Supply	~ 30 bcm	~ 60 bcm
"Gap" to be filled by Independents	~ 70 bcm	~ 256 bcm

Source: Based on Wood MacKenzie "Time to Step on the Gas", December 2004

2.) REINVESTMENT RISK - Aaa

Given the recent full consolidation of Novatek's core operating subsidiaries, historic data as regards reserve replacement and finding & development (F&D) costs does not accurately reflect the company's current F&D cost position. Nonetheless, it is fair to say that reserve replacement (even excluding the effects of acquisitions of full ownership of the fields) has historically been well above 100% and, in Moody's view, will remain solid for the foreseeable time. On a pro forma basis, proved developed reserves have grown 22% from 2003 to 2004 and – in Novatek's case – two-year finding & development costs have been extremely low. While Moody's expects these to rise in line with the industry (Novatek's 2004 drillbit F&D costs were $1.11), the significant gap with international peers is likely to be maintained, given the close proximity of its three core fields, the advantageous geology of the fields and the cost conscious management philosophy practiced throughout the organisation

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Figure 5: Reinvestment Risk Characteristics

Company	Rating	3-year all sources F&D (USD/boe)	3-year drillbit F&D costs (USD/boe)
Novatek*	**Ba2**	**$0.85**	**$0.79**
Category Mapping		*Aaa*	*Aaa*
BG Group	A2	$4.77	$4.80
Category Mapping		*Aaa*	*Aa*
Apache	A3	$6.59	$6.74
Category Mapping		A	A
Occidental	A3	$5.00	$6.74
Category Mapping		*Aa*	*Aa*
Woodside	Baa1	$6.70	$6.70
Category Mapping		*A*	*A*
Anadarko	Baa1	$7.65	$8.31
Category Mapping		*A*	*Baa*
EnCana	Baa2	$8.68	$15.95
Category Mapping		*Baa*	*Ba*
LUKOIL	Ba1	$1.33	N.A.
Category Mapping		*Aaa*	

** 2-year data in the case of Novatek*

3.) OPERATING AND CAPITAL EFFICIENCY – Aaa / Aa

Novatek's young and streamlined operations give it one of the most efficient cost structures in the industry. Full-cycle costs (i.e. the cash costs plus 3-year finding & development costs per barrel) are the lowest in the industry and Novatek's leveraged full-cycle ratio (which represents its cash margin on each barrel produced divided by its 3-year finding & development costs) of 479% is solid. More importantly, Novatek has been achieving these levels of efficiency in a pricing environment which is very different to the global environment faced by its non-Russian peers

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Figure 6: Operating and Capital Efficiency Characteristics

Company	Rating	Full-cycle cost (USD/boe)	Leveraged full-cycle ratio
Novatek	**Ba2**	**$8.41**	**479%**
Category Mapping		*Aaa*	*Aa*
BG Group	A2	$12.01	345%
Category Mapping		*A*	*A*
Apache	A3	$15.70	353%
Category Mapping		*A*	*A*
Occidental	A3	$16.37	498%
Category Mapping		*Baa*	*Aa*
Woodside	Baa1	$12.20	580%
Category Mapping		*Aa*	*Aa*
Anadarko	Baa1	$19.60	251%
Category Mapping		*Baa*	*Baa*
EnCana	Baa2	$18.28	216%
Category Mapping		*Baa*	*Baa*
LUKOIL	Ba1	N.A.	527%
Category Mapping			*Aaa*

Novatek sells its natural gas at prices well below levels achieved by Gazprom for exports. This is due to the fact that domestic gas prices in Russia are regulated and although Novatek technically is not bound by the regulated price, most of its customers (principally electric utilities, heavy industries or local regions) could alternatively buy their gas at regulated prices from Gazprom if the latter has available gas. Therefore, Novatek achieves price realisations closely linked to the regulated price. Domestic gas prices are expected to reach 36 USD/mcm in 2005, up from 1999 lows of 10.10 USD/mcm, but still well below the average realisations Gazprom achieves on European exports of nearly 140 USD/mcm in 2004. According to the Russian state's Energy Strategy to 2020, domestic prices are scheduled to reach 59-64 USD/mcm by 2010, offering significant upside to Novatek. At the same time, however, Moody's cautions that the pace of future price increases could be slowed down for political reasons, as domestic prices remain an effective tool to control inflation. Given that Novatek is profitable under today's pricing levels, this rather limits upside than poses a serious threat, with most of the domestic burden currently absorbed by Gazprom, provided that Novatek can maintain its tight control on costs.

4.) LEVERAGE AND CASH FLOW COVERAGE – A / Aa GOING FORWARD

Novatek is expected to have no meaningful debt by next year…

Novatek's historic financial profile paints a very different picture from its future financial profile. First and foremost, the fact that Novatek's core operating subsidiaries were not under its full control before 31 December 2004 distorts much of the meaningfulness of cash flow and earnings data, as these still reflect partial consolidation. Secondly, Novatek had the equivalent of USD800 million (Rub. 24 billion) in debt at year-end 2004. Most of this has since been repaid, both from internal cash flow and the proceeds of Novatek's recent IPO. Accordingly, total debt at 30th September 2005 stood at Rub. 11.5 billion (USD383 million) and is expected to be reduced further to around USD 240 million by the end of the year. On retained cash flow (RCF) of more than USD 400 million, Moody's expects Novatek's RCF-to-debt ratio (after sustaining capex) to be around 100% in 2005. The ratings also incorporate Moody's expectation that Novatek will remain strongly free cash flow positive from 2005 onwards.

Figure 7: Leverage and Cash Flow Coverage Characteristics

Company	Rating	Debt / Proved developed reserves	(Debt + Future Dev. Capex) / Tot. Reserves	(Retained Cash Flow - Sustaining Capex) / Debt
Novatek	**Ba2**	**$0.41**	**N.A.**	**4%**
Category Mapping		*Aaa*		*B*
BG Group	A2	$3.24	$4.77	28%
Category Mapping		*Baa*	*Baa*	*Ba*
Apache	A3	$2.45	$3.62	68%
Category Mapping		*A*	*A*	*A*
Occidental	A3	$2.29	$3.32	67%
Category Mapping		*A*	*A*	*A*
Woodside	Baa1	$4.40	$5.90	22%
Category Mapping		*Baa*	*Baa*	*Ba*
Anadarko	Baa1	$2.80	$4.05	38%
Category Mapping		*A*	*A*	*Baa*
EnCana	Baa1	$5.57	$7.56	25%
Category Mapping		*Ba*	*Ba*	*Ba*
LUKOIL	Ba1	$0.28*	N.A.	65%*
Category Mapping		Aaa		Aaa

** On total proved reserves and RCF/Debt excluding sustaining capex*
Sustaining capex is defined as all-sources F&D costs per boe multiplied by annual production

…and produces resilient free cash flows from its core assets, despite growing investment requirements

Novatek's ratings are underpinned by the strong cash flow generation derived from the group's three core production subsidiaries. While ratings anticipate that capital investments will rise to an average of approximately USD 250-300 million per annum to achieve the desired 45 bcm production level by 2010, particularly in relation to the group's Yurkharovskoye field, which will be contributing most of the output growth, ratings also assume that Novatek will be able to fund all essential investments from internal sources. This view is enforced by the relatively moderate risk from lower gas prices, given the already low level of domestic prices and the public commitment by the government to gradually increase prices (indeed this is one of the key pre-requisites for Russia's entry to the World Trade Organisation). Nonetheless, Moody's believes that Novatek would likely be able to develop its fields (and consequently grow production) under the assumption of flat domestic gas prices and still produce positive free cash flow.

Some financial flexibility is factored into the ratings

Novatek's ratings incorporate some financial flexibility for additional growth prospects beyond those related to its present assets, particularly given that non-financial factors (see Other Rating Considerations) currently outweigh its financial metrics in determining the credit rating. This includes further investments into the group's downstream integration. At this point, Moody's would expect RCF (after sustaining capex)-to-debt of at least 40% and positive free cash flow generation to comfortably support Novatek's rating. Moody's also notes that it assumes that Novatek will limit secured debt as a proportion of total debt to no more than 15% (currently, Novatek has no secured debt) and will raise debt centrally at the holding company, under which circumstances any senior unsecured debt to be rated would not be subject to notching and would consequently be rated at the level of the Corporate Family Rating.

Other Rating Factors

In addition to the above quantitative factors, there are a number of additional rating factors which play a significant role in shaping Novatek's credit rating. While Novatek's credit profile fundamentally resembles that of an investment grade company (similar to most of it Russian peers in the sector), there are a number of specific risks that currently constrain the rating at its present level.

THE GAZPROM FACTOR: CO-OPERATION, NOT COMPETITION

The dominant presence of Gazprom in the Russian gas sector, and in particular Novatek's direct dependence on Gazprom's pipeline network, constitute key risks for smaller independent gas companies in general, and Novatek in particular. Given the present structure of the market, we understand that Gazprom has adopted a strategy of tolerance towards the "independents", as they play an increasingly important role in the supply of domestic gas, allowing Gazprom to focus its strategic attention on exports, which provides the bulk of Gazprom's profitability. Indeed, Gazprom's domestic gas operations today are effectively subsidising the economy, as the gas giant will hardly be profitable at current prices. While this status quo may hold true today, we recognise a degree of uncertainty going forward, particularly as the domestic market becomes more attractive.

We currently see two key mitigating factors to this risk going into the future. Firstly, Novatek and Gazprom's relationship has been solid throughout, and there are no recent events of frictions or conflict, as indeed there have been with some other independent gas companies. Novatek and Gazprom in 2005 signed a co-operation agreement, which defines the general framework of their relationship, and – again unlike some of Novatek's independent competitors – Novatek tightly co-ordinates its strategy, production targets and exploration activities with Gazprom in advance of their initiation. Novatek has successfully adopted a strategy of co-operation, not competition, which ensures that Novatek ultimately supports the Russian gas sector by acting as a reliable domestic partner for Gazprom. It also goes without saying that exports remain Gazprom's domain and Novatek has no plans for independent projects associated with the export of gas, unless they are undertaken in co-operation with Gazprom. Novatek is free to export gas condensate and crude oil by rail although restrictions exist on Transneft's crude oil pipeline capacity. It recently commissioned a gas condensate processing plant in Purovsky to take greater control of sales channels, after historically having processed all of its unstable gas condensate products at Gazprom's Surgutsky plant. Gazprom may possibly use Novatek's modern plant to process its own gas condensate products going forward, underlining the non-competitive nature of both processing facilities.

Secondly, Novatek already plays a vital role in the provision of regulated domestic gas to key industrial heartland regions of Russia, principally on behalf of Gazprom. Replacing Novatek in the context of these supplies is difficult, particularly given that they are unprofitable for Gazprom. Novatek's gas reserves and production are factored into Russia's strategic gas balance, implying an expectation from the government that Novatek will continue to supply gas in the domestic market.

Going forward, Moody's will continue to examine the evolving relationship between both parties. In particular, we will monitor any potential changes to the present status quo under more supportive domestic operating conditions.

OWNERSHIP RISK IS PARTIALLY MITIGATED FROM NOVATEK'S LARGELY "GREENFIELD" CHARACTERISTICS, BUT A LONGER TRACK RECORD WILL HELP FURTHER REDUCE THIS RISK

Most of Novatek's assets, and in particular its core operating subsidiaries, were not brought into the company's control through privatisations, but indeed have been developed from greenfield stages, thereby mitigating some of the risks associated with Russia's history of murky privatisations. Also, none of the group's core assets ever belonged to Gazprom. Furthermore, Novatek has no history of tax avoidance schemes and has not faced any back tax claims for previous fiscal years. Nonetheless, Novatek has only recently begun to operate in the form of its present structure (and notably as the full owner of its core assets) and we would therefore expect to see a longer track record of operating as the number two Russian gas player.

SOME CUSTOMER CONCENTRATION RISK, BUT THIS SHOULD REDUCE OVER TIME AS DOMESTIC DEMAND INCREASES

Moody's notes that Novatek faces some customer concentration risk, given that close to 60% of its sales are made to five customers and a large long-term contract representing around 30% of volumes exists with Itera. While this poses a short to medium term risk, Moody's believes that growing domestic demand and a targeted strategy to diversify its customer base will result in greater diversification over the medium term. Moody's also assumes that Novatek will be able to extend the length of its contracts, which today – with the exception of the five year Itera contract – are mainly of 1 year duration. Moody's notes that Novatek's collection record is good, given that the bulk of payments are made in advance of delivery, thereby limiting counterparty risk.

RATINGS BENEFIT FROM A CLEARLY ARTICULATED FINANCIAL POLICY

Finally, Novatek's ratings benefit from sound and clearly communicated financial policies, including a firm commitment to maintaining adequate levels of liquidity, both on balance sheet and through banking relationships (although committed facilities remain unconventional in Russia). Novatek's dividend policy is conscious of the group's growing investment needs, although Moody's could see greater shareholder returns as the company builds up cash positions. These are factored into the rating, provided that any change in dividend policy is commensurate with the aforementioned financial parameters underpinning the rating.

Comparison With Russian Natural Resource Peers

COMPARED WITH RUSSIAN INDUSTRY PEERS, NOVATEK'S RATINGS ARE CONSTRAINED BY SIZE, DIVERSIFICATION AND GAZPROM DEPENDENCE, BUT ARE SUPPORTED BY A TRANSPARENT GROUP STRUCTURE, STRONG GOVERNANCE AND STABILITY OF CASH FLOWS

In addition to global E&P peers, Moody's also benchmarks Novatek against the wider peer group of rated Russian companies, particularly those that are privately owned. In this context, Novatek's ratings are supported by a simple and transparent ownership and group structure, strong corporate governance and a relatively stress-resilient "low price, low cost" business model, which shields it from the potential downside associated with its more oil price dependent peers. We also believe that Novatek's relative privatisation risk is low compared to some of the larger integrated oil companies, particularly those whose ownership is concentrated amongst one or few key figures.

At the same time, although oil companies ultimately also depend on state pipeline operator Transneft (rated A2 local currency, Baa2 foreign currency rating) for transportation of crude oil, we view the overall operational dependence on Gazprom as greater, given that (1) Gazprom – in addition to transportation – also dominates the Russian gas supply market, and (2) oil companies will tend to have alternative transportation routes (notably railway and barges) at their disposal. The relative size and diversification across the up- and downstream chain also adds an additional element of support to Novatek's integrated peers. Overall, we believe that Novatek's current Ba2 rating adequately reflects the group's strengths, while at the same time positioning it in the geopolitical context of the Russian market.

Figure 8: Positioning against Russian companies

Company	Rating	Comments
LUKOIL	Ba1 / Ba2, positive	Benefits from scale, integration and growing diversification in oil & gas. Higher commodity price exposure than Novatek. Improved governance and transparency, but complex group structure.
TNK-BP	Ba1 / Ba2, positive	Benefits from scale and integration. Higher commodity price exposure than Novatek. Good governance and transparency but uncertainty as regards ability to participate in strategic activities.
Sibneft	Ba1 / Ba2, positive	Pre-Gazprom: Weak governance and erratic dividends. Benefits from scale and efficiency. Higher privatisation and back tax risks.

Factors That Could Move Ratings Going Forward

AS NOVATEK DELIVERS ON ITS PRODUCTION GROWTH PLAN AND WITH RISING DOMESTIC GAS PRICES, THERE IS UPSIDE POTENTIAL TO THE RATINGS OVER THE MEDIUM-TERM…

Novatek's ratings could be upgraded over the medium term, if there is further clear evidence that it can deliver on its strategy of growth unimpeded from interference, even under more attractive domestic market conditions. Over time, as Novatek cements its position as a leading independent gas producer, both against competition from smaller independent gas companies and the larger integrated oil & gas peers (notably Rosneft and LUKOIL, which both have large domestic gas operations), diversifies its customer base, locks its suppliers into longer term contracts and monetises its presently undeveloped reserves, Novatek's ratings could rise.

…WHILE SIGNIFICANT FRICTIONS TO THE CO-OPERATIVE NATURE OF NOVATEK'S RELATIONSHIP WITH GAZPROM, OR ANY OTHER INTERFERENCE WITH NOVATEK'S ABILITY TO EXECUTE ITS STRATEGY, COULD PLACE PRESSURE ON THE RATINGS

Novatek's ratings are strongly positioned and would require a significant, unexpected shock to find themselves under pressure. Such a shock could constitute evidence of serious interference into Novatek's ability to operate profitably, produce natural gas and gas condensates from its existing licenses or fail to generate free cash flows. The key to any future rating movements lies in (1) Novatek's ability to monetise its undeveloped reserve base while continuing to keep a tight control on costs relative to the price at which it is able to sell it gas, and (2) the sustainability of its relationship with Gazprom under more favourable pricing conditions. Evidence of both factors either way going forward will determine scope for rating up- or downgrades.

Related Research

Rating Methodology:

Global Independent Exploration and Production (E&P Industry, October 2005 (94692)

Industry Outlook:

Russian Oil & Gas Companies (96366)

Analyses:

Total S.A., September 2005 (94324)

OJSC Gazprom, July 2005 (93608)

OAO LUKOIL, May 2005 (92660)

TNK-BP International Ltd., January 2005 (90877)

BG Energy Holdings Ltd, November 2004 (89593)

OJSC MMC Norilsk Nickel, October 2004 (89480)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Related Website

OAO Novatek Corporate

http://www.novatek.ru/eng/

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