STANDARD & POOR'S

Global Credit Portal

RatingsDirect®

May 22, 2006

OAO NOVATEK

Primary Credit Analyst:
Per Karlsson, Stockholm (46) 8-440-5927; per_karlsson@standardandpoors.com

Secondary Credit Analyst:
Elena Anankina, Moscow (7) 495-783-4130; elena_anankina@standardandpoors.com

Table Of Contents

OAO NOVATEK

ISSUER CREDIT RATING	
OAO NOVATEK	
Corporate Credit Rating	BB-/Stable/--

Business risk profile:

Weak

Financial risk profile:

Aggressive

Debt maturities:

At Dec. 31, 2005
Within one year: RUR8.2 bil
2007: RUR375 mil
2008: RUR360 mil
2009: RUR141 mil
Thereafter: RUR16 mil

Collateralization:

Not meaningful

Total rated debt:

None

Corporate credit rating history:

Mar. 17, 2006	BB-

Major Rating Factors

Strengths:

- Low cost base;
- Large proved reserve life;
- Future growth expectations underpinned by firm projects;
- Gas condensate processing plant and crude oil exports that provide a degree of diversification and higher realized prices; and
- Prudent financial policies and high standards of disclosure and financial reporting.

Weaknesses:

- Dependence on the unified natural gas supply system (UGSS) of Gazprom, Novatek's market-dominant competitor;
- Short track record of consolidated financial reporting after the acquisition of the remaining shares of two core operating subsidiaries;
- Risks of operating in Russia, including regulatory risk and a changing tax environment;
- Low (albeit gradually improving) domestic natural gas prices, coupled with the inability to export natural gas;

and
- Concentrated reserve base.

Rationale

The ratings on OAO NOVATEK (Novatek), Russia's largest independent natural gas producer, reflect the company's operational dependence on the pipelines of Russian natural gas supply company OAO Gazprom (BB+/Positive/--) for the transportation of natural gas. The ratings also reflect the very low domestic natural gas prices compared with international benchmarks, Novatek's somewhat concentrated reserve base, and the company's short track record of consolidated financial reporting following the full consolidation of two core operating companies in December 2004. Although its operations have stayed unchanged, two of Novatek's key assets were only partially owned and had been accounted as equity investments before the consolidation of minority interests in 2005. The ratings also reflect the risks of operating in Russia, including tax and regulatory uncertainties.

Over the past decade Novatek has demonstrated its ability to manage these significant risks effectively and build a good working relationship with Gazprom. Potential risks associated with Gazprom's dominant and privileged position in the Russian natural gas market are further mitigated by Gazprom's fundamental interest in having independent producers like Novatek supplying the domestic market, where prices are low, thereby enabling Gazprom to boost its profitable exports. Novatek's credit quality benefits from the company's very low cost base, which results in high profitability and expected positive free cash flow generation over the medium term, despite low price realizations.

In 2005, Novatek produced 25.2 billion cubic meters (bcm) of natural gas. The company's reserve life is comfortable, at approximately 25 years. Novatek plans to increase production to 45 bcm by 2010, but this will depend on continued access to the Gazprom-owned transportation system. Novatek's realized weighted average prices are well below international levels, as only Gazprom is permitted to export Russian natural gas.

In 2005, the improvement in Novatek's credit ratios partly reflected the company's corporate restructuring, as non-core assets were sold, remaining stakes in core fields were acquired, and the owners' proceeds from an IPO were used to repay shareholder loans from Novatek as well as a portion of the company's own debt. In 2005, Novatek's natural gas sale volumes increased due mostly to the consolidation of production assets, and funds from operations reached about $422 million. FFO covered net debt by a high 195% and net debt to EBITDA were 0.3x. At Dec. 31, 2005, Novatek had reported total debt of about $322 million.

Liquidity

A high portion of Novatek's long-term debt matures in the short term. In total $290 million of total debt is due within one year. This exposure is to some extent mitigated by cash in hand of $105 million and by the company's positive free operating cash flow generation (about $173 million in 2005). Novatek also has access to about $300 million in uncommitted bank facilities. The uncommitted nature of bank lines granted to Novatek reflects market practice in Russia.

As is the case with other regional peers, Novatek's access to external financing is constrained by the weakness of the domestic financial system and by volatile demand of international investors for emerging-market debt. Novatek's management expects to refinance the company's short-term debt with longer dated debt. If refinancing were successful, the company's liquidity position would improve substantially.

Outlook

The stable outlook reflects our expectations that Novatek will maintain at least its current production level and will successfully refinance or repay its short-term debt. We also expect Novatek to continue to deliver positive free operating cash flow and to maintain net debt at less than its annual EBITDA. In 2005, Novatek reported net debt to EBITDA of 0.3x.

The ratings would likely benefit from a longer track record of successful financial performance. Adverse changes on the regulatory or competitive fronts, or evidence of heightened operational risk from Gazprom, could constrain or put downward pressure on the ratings.

Business Description

With production of 25.2 billion cubic meters of natural gas in 2005 (or 184 million barrels of oil equivalents {mmboe} in total hydrocarbon production), Novatek is the largest independent natural gas producer in Russia. Production takes place mainly at three, 100% controlled core fields (Yurkharovskoye, East-Tarkosalinskoye and Khancheyskoye) located in the natural gas-rich Yamal-Nenets Autonomous District (BB+/Stable/--).

Table 1

OAO NOVATEK Total Revenues

(RUR mil.)	2005	Percentage of oil & gas revenues	2004	Percentage of total oil & gas revenues
Natural gas	22,729	61.0	12,943	61.6
Stable gas condensate	6,349	17.0	0	N/A
Crude oil	3,899	10.5	6,025	28.7
Oil products	2,797	7.5	2,050	9.8
Liquefied petroleum gas	1,472	4.0	0	N/A

RUR--Russian ruble. N/A--Not applicable.

Business Risk Profile

The rating on Novatek is constrained by a fundamental concern regarding Novatek's operating dependence on state-owned Gazprom's UGSS for delivery of its natural gas. Like all Russian crude oil and natural gas producers, Novatek is also subject to a range of substantial country-specific risks that constrain the ratings. These include uncertainty about the sustainability of the current fiscal regime and the low protection of property rights.

The business profile, however, is supported by a strong proven reserve life; an established track record of cooperation over the past decade with Gazprom, a very competitive cost structure; large reserves that support management's ambitious growth plans; diversification provided by exported crude oil and stable gas condensate; and a transparent group structure.

Exploration and production

With proved developed reserves of about mmboe2,600 at year-end 2005, Novatek enjoys a solid reserve base. On a proved and probable basis, reserves are about mmboe7,400. The reserve life index of 14 years on a proved developed basis, or 25 years on a proved basis, is healthy compared with international peers. In 2005, Novatek's reserve replacement rate was a high 311%. The company's reserves in the three core fields have been appraised by petroleum consultants DeGolyer & MacNaugthon. The appraisals relied on Novatek's representations regarding the extension of the terms of the licenses to include certain producible volumes of reserves beyond the primary term of the licenses. Novatek's licenses for the Yurkharovskoye, Khancheyskoye, and East Tarkosalinskoye fields run until 2034, 2019, and 2018, respectively.

Approximately 52% of natural gas production in 2005 took place in the East Tarkosalinskoye field. Novatek's strategic production target is 45 bcm of natural gas in 2010 (production was 25.2 bcm, before own usage and technical losses, in 2005). We view this as a very ambitious goal, but manageable due to the large reserve base, although it is largely dependent on access to Gazprom's pipelines.

To sell its natural gas, Novatek is dependent on access to Gazprom's UGSS. We view this exposure as a fundamental risk for the ratings. The risk is higher than for Russian oil companies. Gazprom controls the majority of the natural gas production in Russia, with about 87% of production. As the sole owner, only Gazprom has full access to information about pipeline capacity.

The main factor mitigating this dependence on Gazprom is that Gazprom has a fundamental interest in having independent suppliers like Novatek selling natural gas on the domestic market, where prices are low but demand is growing. This enables Gazprom to free up volumes for cash-generative exports. Independent natural gas suppliers are therefore expected to be important players for the Russian natural gas industry in the medium to long term, and their share in total domestic supply is expected to increase substantially over the next 15 years.

Other factors that mitigate Novatek's dependence on Gazprom are as follows:

- Novatek has not experienced any distribution interruptions to date.
- Gazprom and Novatek recently signed a strategic framework agreement, stating their joint interest in transporting, processing, and distributing natural gas. No other independent producer has such an agreement with Gazprom. This agreement follows an established history of cooperation between the two companies.
- Novatek has a long-term contract in place with Gazprom for use of the pipelines for current production. Gazprom and Novatek are cooperating on some projects, including pipeline investment.
- Novatek's standing as Russia's second-largest natural gas producer (constituting about 20% of the total independent production).
- Novatek is also the main independent natural gas supplier to large industrial regions (such as Tyumen and Samara; the Sverdlovsk region is supplied by Itera group who purchases the gas from Novatek). Novatek's natural gas production is already factored into Russia's natural gas balance, and it is needed for Gazprom to meet its long-term commitment in more profitable exports markets.

Access to natural gas pipeline capacity is, however, critical for Novatek's ambitious growth plans, and Novatek needs to negotiate with Gazprom on any further capacity needs.

Although Novatek is not regulated, the prices it receives for natural gas depends indirectly on the prices that the regulator sets for Gazprom, its largest domestic competitor. Novatek's realized prices have been marginally above the regulated prices (see Table 2 below) and well below international norms. Standard & Poor's believes that future improvement in the domestic natural gas price level will be only gradual, as the country's economy is heavily dependent on cheap natural gas. Novatek sells its natural gas primarily to wholesalers (48% in the fourth quarter 2005), with some concentration of sales to the Itera group (26% of wholesale sales), and to end-consumers (52%).

Table 2

OAO NOVATEK'S Realized Gas Prices

($/boe)	2002	2003	2004	1H 2005
End customers				
Average prices	3.1	4.3	5.1	6.0
Transportation tariff	1.9	1.7	1.8	2.2
Netback	1.2	2.6	3.3	3.8
Sold ex-field (wholesalers)				
Average prices	1.4	2.3	2.8	3.4
Weighted average netback	1.4	2.4	3.1	3.6
Regulated prices & tariffs				
Average regulated wholesale prices	2.6	3.4	4.4	5.6
Transportation costs	1.2	1.5	1.8	2.1
Theoretical regulated netback	1.4	1.9	2.5	3.4
Novatek premium	0.05	0.43	0.55	0.20

Boe--Barrels of oil equivalent.

Crude oil and gas condensate

Crude oil and gas condensate, a by-product of natural gas production in the form of a type of light crude oil production, provides important diversification for Novatek, which is positive from a ratings perspective. Although only about 10% of Novatek's production is crude oil and gas condensate, it constituted about 27% of total revenue in 2005. Novatek can export these products, and is not dependent on its major competitor for transportation. In June 2005, Novatek completed an approximately $200 million investment in a gas condensate processing plant (the Purovsky processing plant), which allows Novatek to process 100% of its gas condensate production. The plant is located close to the East Tarkosalinskoye field. The stable gas condensate can be exported by rail (Novatek has a liquefied petroleum gas (LPG) railcar fleet and access to stable gas condensate export facilities at the Vitino port). This investment will substantially increase diversification and enhance margins. About 35% of total revenue is expected to be derived from crude oil, oil products, LPG, and stable gas condensate in the future.

Table 3

OAO NOVATEK Operating Statistics*

	Year ended Dec. 31		
	2005	2004	2003
Reserves*			
Proven developed reserves (mboe)	2,622	2,712	2,223
Proven reserves (thousands of barrels of oil equivalent; mboe)	4,573	4,178	4,149
Natural gas (%)	91.7	91.6	90.8
Developed (%)	57.3	64.9	53.6
Breakdown of proved developed reserves (Russia 100%)			
Yurkharovskoye field (%)	20.7	20.3	6.7
East Tarkosalinskoye field (%)	68.8	68.7	86.0
Khancheyskoye field (%)	10.4	10.0	6.0

Table 3

OAO NOVATEK Operating Statistics* (cont.)			
Production			
Core field production (mboepd)	500,837	411,584	348,249
Core field natural gas production (%)	90.0	88.9	91.5
Breakdown of core field Production			
Yurkharovskoye field (%)	35.6	33.2	18.1
East-Tarkosalinskoye field (%)	51.3	53.4	75.9
Khancheyskoye field (%)	13.1	13.5	6.0
Reserve replacement*			
Novatek reserve life (years)	24.8	27.3	32.1
Novatek developed reserve life (years)	14.3	17.9	17.3
Natural gas reserve life (years)	25.4	28.6	32.3

*Based on 100% of three core fields (at Dec. 31, 2004 and Dec. 31, 2003). Novetek directly controlled only 32.2% and 43.0% in East Tarkosalinskoye and Khancheyskoye, respectively, in 2003. The remaining stakes were acquired in both fields in December 2004, and include the reserves of associates. Mboepd--Thousands of barrels of oil equivalent per day.

Profitability

We view Novatek's profitability as adequate for the rating. Since the majority of sales stem from the domestic markets with substantially lower prices than international prices, the efficiency of Novatek's production is critical for profitability. So far Novatek has been successful in this regard, and the company's cost profile is competitive. Novatek's lifting costs and production cost are low (see table 4), and we expect Novatek to continue to be successful in this strategy. Novatek's profitability could come under pressure, however, if taxes or transportation costs were to increase further.

Table 4

OAO NOVATEK Exploration And Production Unit Measures	
($/boe)	**2005**
Production (mmboe)	184.0
Revenue/boe	7.17
Production costs/boe	0.45
Transportation expenses/boe¶	1.21
Taxes other than income/boe	0.83
Depreciations, depletions, and amortizations/boe	0.63
Results of operations costs all-in/boe	3.58

mmboe--Million barrels of oil equivalent.

Financial Risk Profile

Accounting

Novatek reports under IFRS on a quarterly basis (with detailed notes and management discussion and analysis), and is fully comparable to international peers regarding timing and details. The company provides supplementary data for its exploration and production division according to IAS on an annual basis. We view these factors as very positive credit features. The 2005 annual report was, however, the first annual account under the current group structure, following extensive restructuring of the group.

Corporate governance/Risk tolerance/Financial policies

Standard & Poor's expects Novatek's future growth to be primarily organic, with only smaller bolt-on acquisitions. We expect the company to maintain net debt at less than its annual EBITDA throughout the cycle (0.3x in 2005). As with the current prudent credit ratios, however, the track record of Novatek's current financial policies is short.

Cash flow adequacy

Following production increases, as a result of the acquired majority stakes in producing assets in December 2004, FFO for the full-year 2005 reached about $422 million ($170 million in 2004). FFO is expected to continue to increase in the short term owing to a greater focus on more profitable exports of stable natural gas condensate and continued production growth.

Credit ratios also improved substantially in 2005 thanks to debt repayments and FFO to net debt in 2005 reaching a high 195%.

The company's free operating cash flow was negative in 2003 and 2004, due to heavy capital expenditure of about $110 million and $200 million, respectively. In 2005, capital expenditure was $157 million, but free operating cash flow was strong, covering 54% of total debt. Capital expenditure is expected to remain high, at $175 million-$250 million per year in the medium term. Most capital expenditure is expected to target further development of proven reserves and processing capacity. The share of discretionary capital expenditure is high, however, and expenditure could therefore be substantially reduced if necessary. Standard & Poor's expects Novatek to continue to deliver positive free operating cash flow.

Capital structure/Asset protection

A weakness of Novatek's capital structure is its high level of short-term debt--$290 million, or 90% of total financial debt, at Dec. 31, 2005. The majority of this --$200 million of credit-linked notes--matures in June 2006. This short-term debt is, however, offset by cash balances of about $100 million, and expected strong cash flow generation. At Dec. 31, 2005, Novatek had no secured borrowings, and we expect the overall secured borrowing to stay below 15% in the future. The group's debt is expected to be centralized at OAO NOVATEK. About 80% of Novatek's borrowings are denominated in U.S. dollars.

Table 5

OAO NOVATEK Peer Comparison (2004)

($ mil.)	OAO NOVATEK	OAO Evraz	OAO Magnitogorsk Metallurgical Kombinat	OJSC Rosneft
Corporate credit rating*	BB-/Stable/--	BB-/Stable/--	BB-/Stable/--	B+/Positive/--
Main weaknesses	Operational dependence on dominant Gazprom for transportation; short financial track record with current group structure.	The ratings are constrained by exposure to the cyclical steel industry, as Evraz is a land-locked commodity player exposed to Russia's institutional risks and dependent on the export of semifinished products. The company also undertakes significant investments.	Lack of vertical integration in raw materials (unlike most local peers); position as a land-locked commodity producer in a cyclical industry; high planned capital expenditure and risks of operating in The Russian Federation.	Aggressive approach to debt; capital expenditure and corporate governance practices.

Table 5

OAO NOVATEK Peer Comparison (2004) (cont.)				
Main strengths	Excellent reporting transparency; less complex group structure; improving profitability and cash flow.	Largest steel producer in Russia; diversified end markets; vertical integration into raw materials; strong profitability and cash flow generation posted by the group in 2005.	Low cost position, resulting in high profitability and cash flow; diversified exports and generally positive conditions in the global steel industry.	High proportion of products exported; good access to export routes; vertical integration; diversified retail and marketing network.
Financial year 2004				
Revenues	855	5,925	4,829	4,515
EBITDA	264	1,994	1,712	1,547
Funds from operations (FFO)	168	1,499	1,401	1,113
Capital expenditure	188	524	407	855
Net debt adjusted	729	1,031	1,091	12,663
EBITDA margin (%)	30.9	33.7	35.5	34.3
FFO/net debt (%)	23.1	145.4	128.4	8.8
Net adjusted debt to EBITDA (x)	2.8	0.5	0.6	8.2

*Ratings at May 16, 2006.

Table 6

OAO Novatek Financial Statistics			
(RUR mil.)	**Year ended Dec. 31**		
	2005	**2004**	**2003**
Revenues	38,523	24,615	16,058
EBITDA	19,121	7,594	3,707
Net income	13,697	5,694	3,281
Funds from operations (FFO)	11,946	4,851	1,749
Capital expenditures	4,433	5,424	3,177
Net debt	6,138	20,997	6,203
Equity	57,268	44,487	11,545
Total assets	78,762	82,450	26,386
Operating income/sales (%)	49.6	30.9	23.1
FFO/net debt (%)	194.6	23.1	28.2
Net debt/capital (including short-term debt) (%)	9.6	31.8	34.1
Net debt/EBITDA (x)	0.3	2.8	1.7

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com