STANDARD & POOR'S

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OAO NOVATEK

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OAO NOVATEK

*(**Editor's Note:** In the original version of this report, published on July 12, 2007, the ratings on OAO Novatek and JSC Gazprom Neft were misstated. A corrected version follows.)*

Major Rating Factors

Corporate Credit Rating
BB-/Positive/--
Russia National Scale Rating ruAA-/--/--

Strengths:

- Low-cost position
- Large reserves
- Strong financial metrics
- Some diversification between gas and oil
- Improving fundamentals of the Russian gas industry

Weaknesses:

- Domestic gas prices remain very low (though growing)
- Dependence on pipeline infrastructure owned by OAO Gazprom
- Geographically concentrated operations
- Risks of operating in Russia, including uncertain enforcement of tax and regulatory rules

Rationale

The ratings on OAO NOVATEK (Novatek; BB-/Positive/--; all ratings herein are issuer credit ratings), Russia's largest independent natural gas producer, reflect the risk in the Russian gas industry, including very low domestic natural gas prices (compared with international benchmarks) and operational dependence on the pipelines of government-controlled OAO Gazprom (BBB/Stable/--). Although Novatek's prices are not regulated, they are indirectly affected by Gazprom's prices, which are subject to government regulation and set very low.

Nevertheless, Novatek has demonstrated its ability to effectively manage Russian gas-industry risks. Novatek's very low costs ($0.45/barrel of oil equivalent (boe) in 2006) and a degree of diversification in gas, condensate, and crude oil help the company to mitigate the effects of low gas prices and to generate solid EBITDA margins (47% in 2006 and 44% in first-quarter 2007) even when prices are low ($7.3/boe in 2007). Although Novatek cannot export gas, the semiregulated nature of domestic gas prices effectively limits Novatek's exposure to downside commodity price risk. Novatek is set to benefit from gradually increasing domestic gas prices, even if gas transportation tariffs and gas production taxes also increase.

Novatek has built a good working relationship with Gazprom, further supported by Gazprom's purchase of a 19% stake in Novatek in 2006. Potential risk associated with Gazprom's dominant and privileged position in the Russian natural gas market--with 85% of the country's gas production, ownership of the pipelines, and a monopoly on gas exports--is mitigated by Gazprom's economic interest in having independent producers like Novatek satisfy growing domestic demand at low prices, enabling Gazprom to boost its profitable exports.

Novatek's large reserve base (4.7 billion boe at year-end 2006) supports considerable opportunities for organic growth. In 2006, Novatek produced 28.7 billion cubic meters of gas, a 14% increase from 2005 (12.2% in total hydrocarbon terms). Growth in production, coupled with better pricing conditions, resulted in a 27% increase in revenue and a 21% increase in EBITDA (to Russian ruble (RUR) 48.8 billion and RUR23.6 billion, respectively). Strong cash flow generation moved Novatek to a net cash position. At March 31, 2007, the company's total debt of RUR3.7 billion was more than offset by available cash of RUR9.2 billion.

Liquidity

The company's liquidity position is strong. At March 31, 2007, short-term debt was RUR3.2 billion, covered comfortably by RUR9.2 billion in cash and equivalents and about RUR5.6 billion in unused bank facilities. The company's growing operating cash flow is another important source of internal liquidity--even if Novatek's access to external financing is, like that of its regional peers, susceptible to volatility because of fluctuating demand from international investors for emerging-market debt. The company's financial policy aims at maintaining an unrestricted balance sheet cash position of $100 million-$150 million and available bank lines of about $300 million-$500 million.

Outlook

The positive outlook reflects the potential for the ratings to be raised by one notch if Novatek continues to demonstrate a prudent financial policy in line with its target of keeping net debt below annual EBITDA. This is despite an expected increase in capital expenditures that will result in broadly neutral free cash flows in 2007-2008 (compared with strongly positive free cash flows in 2006). Progress in the company's capital expenditure program and the continuation of favorable relations with Gazprom would also be positive for Novatek's credit quality. In the coming years, the company is likely to benefit from improvements in Russian gas industry fundamentals; we expect that growing taxes and transportation costs will not fully offset the ongoing gradual increase in domestic gas prices.

Financial policy slippages, adverse regulatory changes, or evidence of heightened operational risk associated with Gazprom could put downward pressure on the outlook or ratings, although we don't consider this a base-case scenario. No substantial acquisitions are factored into the ratings, as we expect Novatek to focus on investing in its core business.

Business Description

With production of 28.6 billion cubic meters of natural gas in 2006 (or 208 million boe in total hydrocarbon production, including liquids), 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.

Table 1

OAO Novatek Revenue Structure

	2006		2005	
	Mil. RUR	% of revenues	Mil. RUR	% of revenues
Natural gas	28,048	57	22,729	59
Stable gas condensate	13,786	28	6,349	17
Liquified petroleum gas	3,270	7	1,472	4
Crude oil	1,928	4	3,899	10

Table 1

OAO Novatek Revenue Structure(cont.)				
Oil products	474	1	2,797	7
Other revenues	1,326	3	1,231	3

Business Risk Profile

Gas industry in Russia

Novatek is subject to the general risk of Russia's gas industry, including operational dependence on access to Gazprom's pipelines and very low domestic gas prices. Gazprom dominates the Russian gas industry, with 85.4% of domestic gas production and ownership of the country's gas pipeline system. Novatek's ambitious growth plans depend on access to natural-gas pipeline capacity. Although the law says that independent companies should have access to Gazprom's pipelines, in practice, many of them have had difficulty obtaining access.

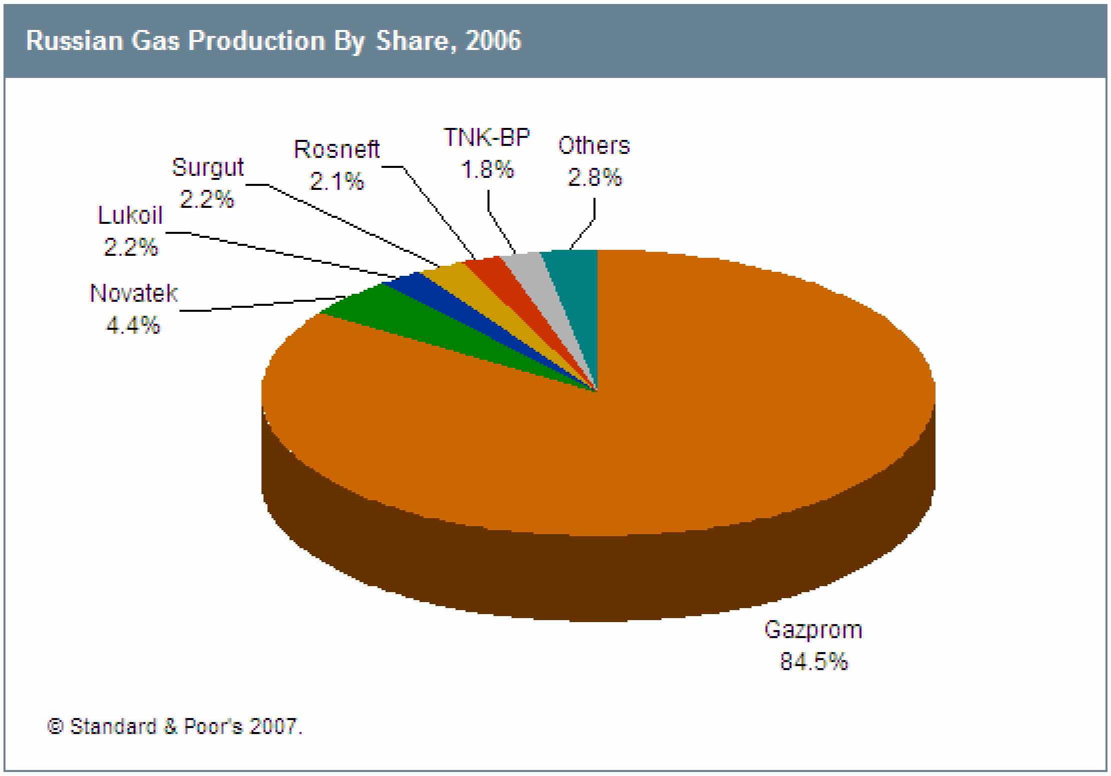
Novatek sells 100% of its gas on the domestic market, because Gazprom has a monopoly on exports. Although Novatek is not regulated, its gas prices depend indirectly on the very low prices set for Gazprom by the Russian government. Novatek's realized prices have been about 10%-15% above regulated prices and well below international benchmarks (see table 2). Novatek sells its natural gas primarily to wholesalers (56% in 2006), with some concentration of sales to the Itera group (not rated) and to energy companies (together, 29% in 2006). However, the company plans to gradually migrate away from wholesalers and increase direct sales to power generation and industrial customers as it builds its own sales network.

Table 2

Novatek's Realized Gas Prices				
	2006		2005	
	RUR/mcm	$/boe	RUR/mcm	$/boe
Average gas price to end-customers	1,253	7.3	1,121	6.8
Gas transportation cost	516	3	434	2.6
Average gas price on ex-field sales	737	4.3	687	4.2
Regulated price for end-customer sales	1,110	6.4	1,007	6.1
Novatek's average premium over regulated price	73	0.4	70	0.4

mcm--Thousand cubic meters.

Chart 1

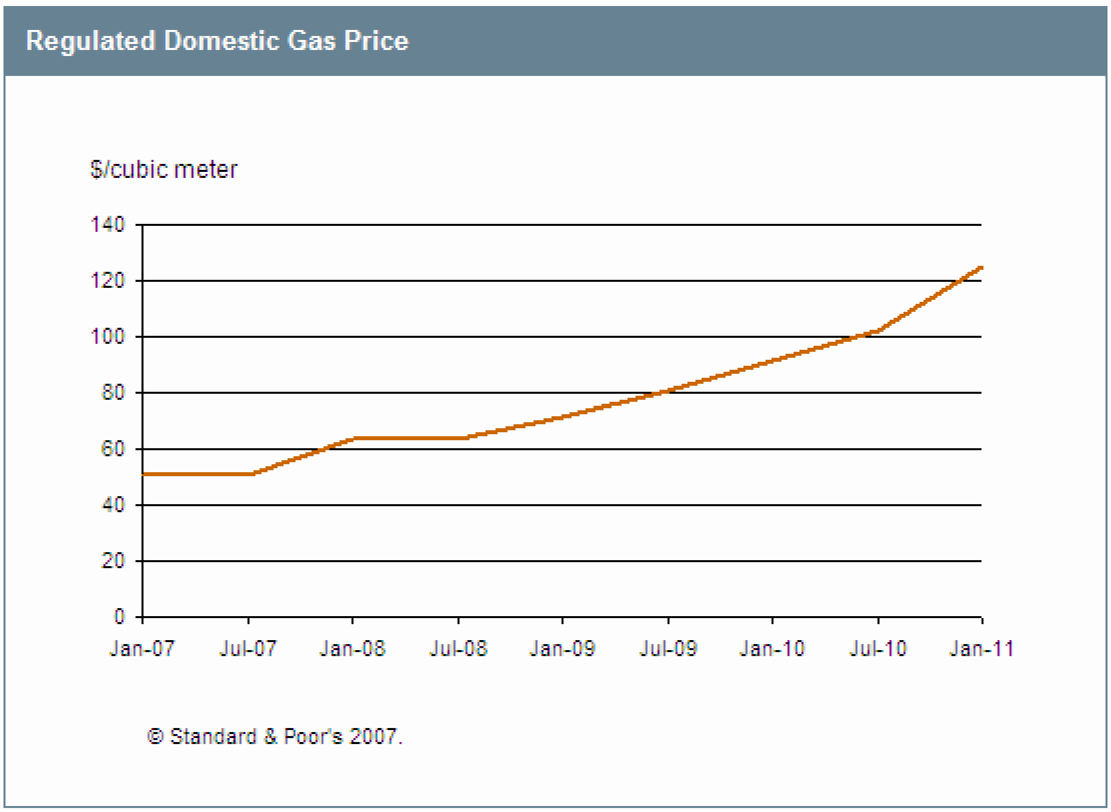


Novatek has a long track record of successfully mitigating these risks, and gas industry fundamentals in Russia are gradually improving:

- Gazprom has a strong interest in having independent suppliers like Novatek sell natural gas on the domestic market, where prices are low. Gazprom's production is broadly stable, while demand is growing. An increased share of domestic demand furnished by independent suppliers will enable Gazprom to free up volume for cash-generative exports. Accordingly, we expect Russian independent natural gas suppliers' share of total domestic supply to increase substantially during the next 15 years.
- Novatek's gas production is a significant factor in Russia's natural-gas balance. Gazprom relies on the company's contribution to domestic supply to meet its own long-term export commitments. Novatek's standing as Russia's second-largest gas producer (contributing about 28% of total independent production) and as the main gas supplier to large industrial regions such as Tyumen, Samara, and Sverdlovsk also helps mitigate industry risk.
- Novatek has a long, positive track record of cooperation with Gazprom. Unlike some other independent gas producers in Russia, the company never experienced distribution interruptions. Novatek has a strategic partnership agreement with Gazprom and cooperates on pipeline investments.
- Novatek's core fields are located near Gazprom's oilfields, where production is declining. This fosters physical availability of pipeline capacity. Even in first-quarter 2007, when unusually warm weather reduced demand for gas, Novatek had no difficulty accessing pipelines.
- Gazprom has been a 19.4% shareholder in Novatek since mid-2006, holding two of the eight seats on Novatek's board. Gazprom can thus exercise a degree of control over Novatek's investment and growth plans. This lessens the likelihood of a conflict scenario.

In 2006, the Russian government adopted a strategy of gradually increasing domestic gas prices to allow Gazprom's netbacks on domestic and export sales to converge by 2011. In addition, in early 2007, Gazprom was allowed to impose substantial surcharges on new customers and on higher volumes sold to existing customers. The country's economic growth makes higher gas prices more affordable, and the risk of a gas shortage helped to build broad political consensus that price increases are inevitable. Novatek will certainly benefit from these developments, which affect the reference point for its own prices (see chart 2).

Chart 2



Exploration and production

With proved reserves of 4.7 billion boe at year-end 2006 (651 billion cubic meters (bcm) of gas and 407 million barrels of oil and condensate), Novatek's SEC proved reserve life was a solid 23 years. In 2006, its reserve replacement rate was a healthy 144%, and the share of developed reserves in total proved reserves increased to 78% from 59% for gas and to 52% from 35% for liquids. Total production grew by 12.2% to 208 million boe (28.7 bcm of gas and 2.5 million metric tons of liquids). Novatek's strategic target is to achieve 45 bcm of gas production by 2010 and 65 bcm by 2015. We view this as an ambitious goal. This ambitious goal is feasible in light of the company's large reserve base. However, success is largely dependent on capital expenditures and pipeline availability.

Chart 3

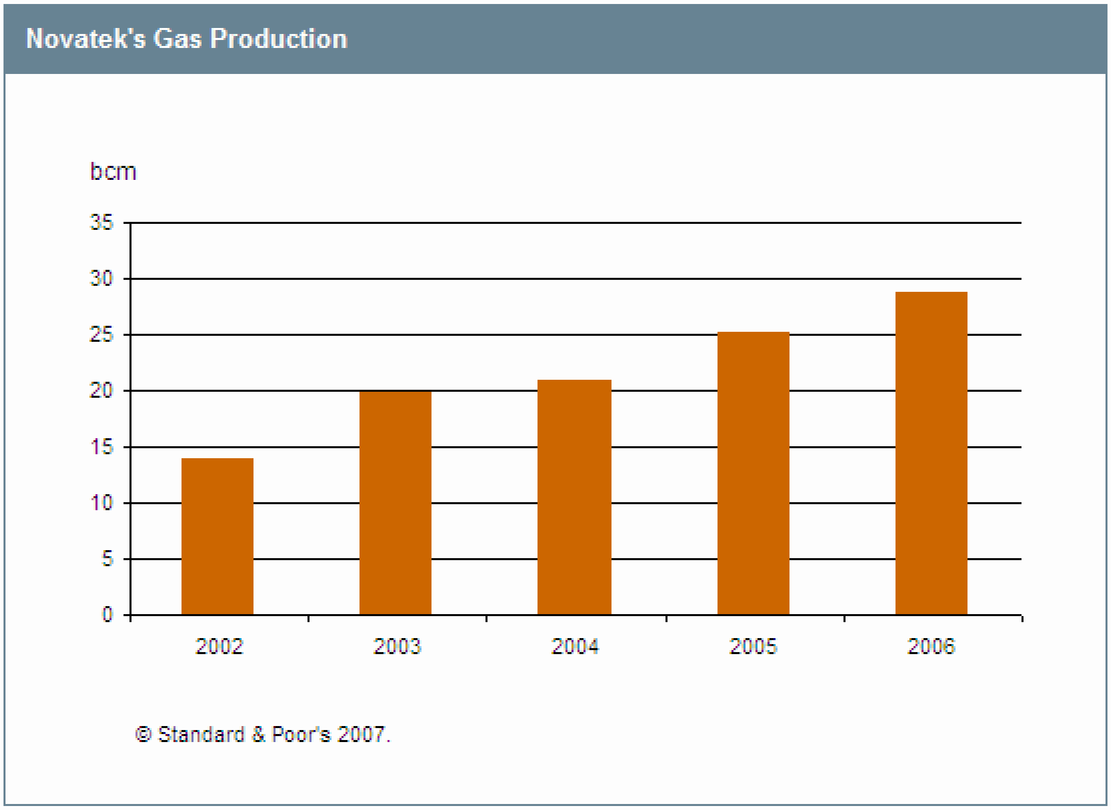
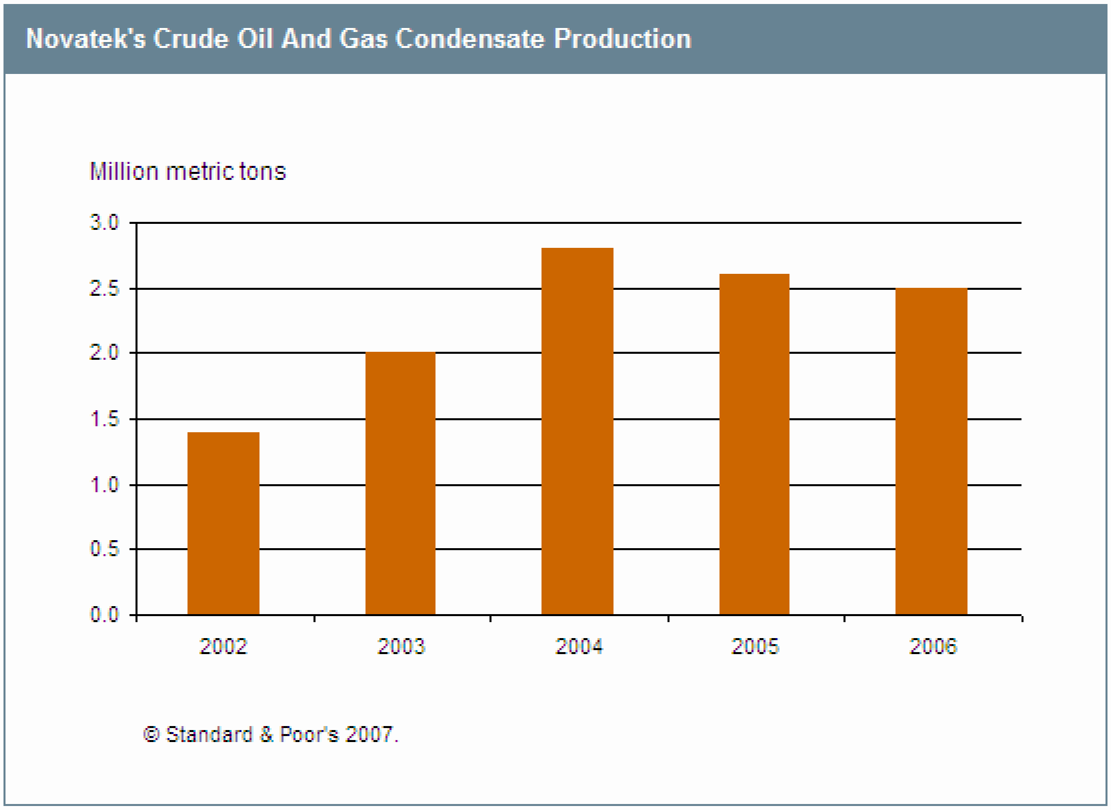

Novatek's Gas Production
bcm
35
30
25
20
15
10
5
0
2002
2003
2004
2005
2006
© Standard & Poor's 2007.

Chart 4

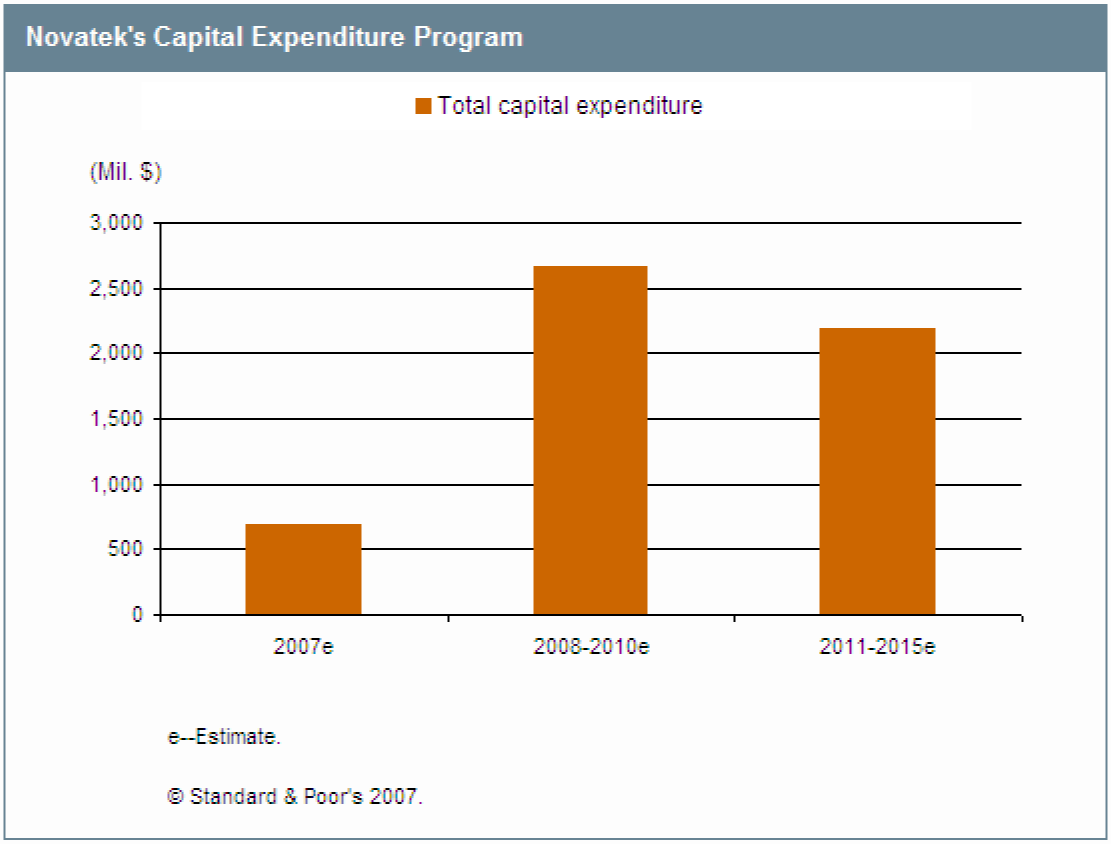


Novatek benefits from a degree of diversification provided by crude oil and gas condensate. Diversification strengthened after the Purovsky gas condensate processing plant was commissioned in mid-2005. Although independent Russian companies are restricted from exporting gas, Novatek is free to export crude oil and gas condensate, and transportation capacity via oil pipelines and railway is generally available. Therefore, prices and netbacks on Novatek's crude oil sales typically approximate those for Russian oil companies, and can be even higher for gas condensate. Accordingly, while crude oil and gas condensate were only 9% of Novatek's 2006 production, their share in revenue was 32%.

Novatek's production and reserves are quite concentrated. In 2006, 55% of production and 41% of proved reserves were concentrated at East Tarkosalinskoye, with another 33% of production and 50% of reserves at Yurkharovskoye. This concentration promotes economies of scale and reflects the geological features of Novatek's core operating region.

We expect Novatek's future growth to be primarily organic, with only smaller bolt-on acquisitions. Organic growth is more cost-efficient, as asset prices in Russia have gone up considerably, while Novatek's finding and development cost was only $0.57/boe in 2006. To implement its ambitious production growth strategy, Novatek is set to increase its capital expenditures dramatically. Investments are focused on achieving substantial production growth at the Yurkharovskoye field; producing crude oil and condensate from deeper horizons at the largely developed Tarkosalinskoye field; developing two smaller neighboring fields, Sterkhovoye and Termokarstovoye; and proceeding to stage 2 construction on its Purovsky new gas condensate processing plant. The company will likely focus on infrastructure spending in 2007-2008, and we don't expect major production growth until 2009.

Chart 5



Profitability

Novatek's profitability is high, with EBITDA margins of 47% in 2006 and 44% in first-quarter 2007 (compared with Gazprom's continuing losses on domestic sales). Very low production costs and diversification into liquids help to offset very low prices, and taxes on gas production in Russia are much lower than those on oil production. In 2006, Novatek's lifting costs were only $0.45/boe, and total production costs were $4.03/boe. Costs are gradually increasing, with the key drivers—including nonincome taxes and regulated transportation costs—beyond Novatek's control. Nevertheless, the company has a substantial margin of safety and is set to benefit on the revenue side from a planned increase in domestic gas prices.

Table 3

Novatek's Costs And Revenue Per Boe

($/boe)	2006	2005
Production (mmboe)	208	184
Revenue	8.46	7.23
Lifting costs	0.45	0.52
Transportation expenses	1.77	1.16
Taxes other than income	1.07	0.85
Depreciations, depletions, and amortizations	0.62	0.63
Other	0.12	0.17
Total production costs	4.03	3.33

Financial Risk Profile

Accounting

Novatek reports under IFRS on a quarterly basis and is comparable to international peers with respect to timing and details.

Following extensive restructuring in previous years, the company switched from equity accounting to full consolidation of its major operations in 2005.

Table 4

Reconciliation Of OAO NOVATEK Reported Amounts With Standard & Poor's Adjusted Amounts*

(Mil. RUR)

OAO NOVATEK reported amounts

	Shareholders' equity	Revenues	Operating income (before D&A)	Operating income (before D&A)	Operating income (after D&A)	Cash flow from operations	Cash flow from operations
Reported	68,320.0	48,675.0	22,881.0	22,881.0	19,153.0	16,607.0	16,607.0
Standard & Poor's adjustments							
Share-based compensation expense	--	--	--	176.0	--	--	--
Exploration costs	--	--	--	459.0	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	274.0	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	--	(323.0)	(323.0)
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	863.0
Minority interest	356.0	--	--	--	--	--	--
Other	--	139.0	139.0	139.0	--	--	--
Total adjustments	356.0	139.0	139.0	774.0	274.0	(323.0)	540.0

Standard & Poor's adjusted amounts

	Equity	Revenues	Operating income (before D&A)	EBITDA	EBIT	Cash flow from operations	Funds from operations
Adjusted	68,676.0	48,814.0	23,020.0	23,655.0	19,427.0	16,284.0	17,147.0

* Data for year ended Dec. 31, 2006. Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Corporate governance/risk tolerance/financial policies

Novatek's ambitious production growth plan would require substantial capital expenditure, which could reduce free cash flow generation in coming years.

Novatek has conservative financial targets of keeping net debt below EBITDA, covering capital expenditure from operating cash flows, and maintaining its EBITDA net interest coverage ratio at 10x-15x. Dividend payout on 2006 income was 36%, less than that of many industry peers. Payout targets are set, under Russian statutory accounting rules (which differ from IFRS), at more than 15% of net income for 2007 and more than 30% in 2008 and thereafter.

Cash flow adequacy

In 2006, Novatek generated a record RUR11.8 billion free operating cash flow (FOCF). FOCF in first-quarter 2007 alone was RUR3 billion. After acquiring majority stakes in its main operating assets in December 2004, Novatek increased its funds from operations (FFO) to RUR12.7 billion in 2005 and to RUR17.1 billion in 2006, while capital expenditure stabilized at RUR4.4 billion. Coverage was very strong, with the FFO-to-total-debt ratio at a high 5.5x and the FOCF-to-total-debt ratio at 24%. Stronger cash flow in 2005-2006 helped debt repayment. By year-end 2006, Novatek had a net cash position.

Although heavy capital expenditure may limit free cash flow generation in the coming years, the company has a very substantial safety cushion.

Capital structure/asset protection

Novatek's debt is currently limited, at only RUR3.2 billion versus RUR5.7 billion cash. The debt is mostly U.S. dollar-denominated, but the currency risk is offset by dollar-denominated gas condensate exports.

Table 5

OAO NOVATEK Peer Comparison*

(Mil. $)	OAO NOVATEK	OAO Gazprom¶§	TNK-BP International Ltd.§	LUKoil OAO¶§	JSC Gazprom Neft
Rating as of July 12, 2007	BB-/Positive/--	BBB/Stable/--	BB+/Stable/B	BBB-/Stable/--	BB+/Positive/--
Revenues	1,795	50,866	24,660	54,114	20,172
EBITDA	870	21,549	7,912	12,089	5,189
Net income from cont. oper.	518	11,438	6,629	7,484	3,661
Funds from operations (FFO)	630	13,351	5,326	9,305	4,287
Cash flow from operations	599	8,622	2,970	7,721	3,285
Capital expenditures	163	10,087	2,531	6,938	1,514
Free operating cash flow	435	(1,465)	439	784	1,771
Cash and investments	208	1,029	512	666	1,435
Debt	114	37,202	5,914	8,334	1,875
Common equity	2,512	89,842	9,996	32,900	9,930
Adjusted ratios					
Oper. income/sales (%)	47.2	42.4	31.6	22.4	25.7
EBIT interest coverage (x)	37.6	8.3	20.0	24.7	31.1
EBITDA interest coverage (x)	45.8	9.7	21.8	28.6	32.7
Return on capital (%)	25.0	14.9	45.7	26.2	46.0
FFO/debt (%)	551.7	35.9	90.1	111.7	227.7
Debt/EBITDA (x)	0.1	1.7	0.7	0.7	0.4

*Fully adjusted. ¶Fully adjusted (including postretirement obligations). §Excess cash and investments netted against debt.

Table 6

OAO NOVATEK/Financial Summary*

(Mil. RUR)	2006	2005	2004	2003	2002
Revenues	48,814	38,477	24,615	16,058	5,414
EBITDA	23,655	19,482	7,895	3,521	995

Table 6

OAO NOVATEK/Financial Summary*(cont.)					
Net income from continuing operations	14,079	13,697	5,694	3,281	644
Funds from operations (FFO)	17,147	12,682	4,866	1,820	577
Cash flow from operations	16,284	9,332	4,291	3,028	(764)
Capital expenditures	4,439	4,433	5,362	3,117	2,844
Free operating cash flow	11,845	4,899	(1,071)	(89)	(3,608)
Cash and investments	5,668	2,956	3,003	1,618	330
Debt	3,108	9,094	24,000	7,821	4,996
Common equity	68,320	57,268	44,623	11,545	5,444
Adjusted ratios					
Oper. income/sales (bef. D&A) (%)	47.2	49.4	31.3	21.2	18.4
EBIT interest coverage (x)	37.6	17.9	10.3	9.7	8.7
EBITDA interest coverage (x)	45.8	17.4	9.1	6.7	5.7
Return on capital (%)	25.0	26.2	17.9	29.9	12.2
FFO/debt (%)	551.7	139.5	20.3	23.3	11.6
Debt/EBITDA (x)	0.1	0.5	3.0	2.2	5.0

*Fully adjusted.

Ratings Detail (As Of January 25, 2008)*		
OAO NOVATEK		
Corporate Credit Rating		BB-/Positive/--
Russia National Scale Rating		ruAA-/--/--
Corporate Credit Ratings History		
28-Jun-2007		BB-/Positive/--
17-Mar-2006		BB-/Stable/--
17-Mar-2006	*Russia National Scale Rating*	ruAA-/--/--
Business Risk Profile		Weak
Financial Risk Profile		Intermediate
Debt Maturities		
At March 31, 2007 (mil. $) 2007: 3,201 2008: 240 2009: 2		

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.