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Research Update: Russian Gas Producer Novatek Assigned 'BB-' And 'ruAA-' Ratings; Outlook Stable

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Table Of Contents

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Credit Rating: BB-/Stable/--

Rationale

On March 17, 2006, Standard & Poor's Ratings Services assigned its 'BB-' long-term corporate credit rating to OAO NOVATEK (Novatek), Russia's largest independent gas producer. The outlook is stable. At the same time, a 'ruAA-' Russia national scale rating was assigned to the company.

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

Novatek has demonstrated over the past decade 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 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 the first nine months of 2005, Novatek produced 513 thousands of barrels of oil equivalent per day (mostly gas). The company's reserve life is comfortable at about 27 years. Novatek plans to increase production to 45 billion cubic meters (bcm) by 2010, up from 25 bcm in 2005, but this will depend on continued access to the Gazprom-owned transportation system. Novatek's realized weighted average prices are well below international levels, because only Gazprom is permitted to export Russian gas. Novatek's prices are not regulated directly. Instead, they indirectly depend on how Gazprom is regulated, as Gazprom is responsible for about 87% of the country's gas production.

In 2005, the improvement in Novatek's credit ratios partly reflected the company's corporate restructuring, as non-core assets were sold, majority 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 the first nine months of 2005 Novatek's production increased by 63% compared with the corresponding period in 2004, mostly due to the consolidation of production assets, and funds from operations reached almost $300 million. EBITDA covered net debt and gross interest expense by a high 190% and 16x, respectively. At Sept. 30, 2005, Novatek had reported total debt of $405 million.

Liquidity

Novatek's liquidity is moderate for the rating as $350 million of total debt is due within one year. This exposure is to some extent mitigated by cash in hand of $200 million and by the company's positive free operating cash flow generation ($100 million in the first nine months of 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 be able to maintain at least its current production level and will successfully refinance 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. At Sept. 30, 2005, Novatek reported net debt to EBITDA of 0.3x on a last-quarter-annualized basis.

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.

Ratings List

OAO NOVATEK	
Corporate credit rating	BB-/Stable/--
Russia national scale rating	ruAA-

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