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Summary:
OAO NOVATEK

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Summary:

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Credit Rating:	BB-/Stable/--

Rationale

The rating on OAO NOVATEK, Russia's largest independent natural gas producer, reflects the company's operational dependence on the pipelines of Russian natural gas supply company OAO Gazprom (BBB/Stable/--) for the transportation of natural gas. The rating also reflects 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 not changed, two of Novatek's key assets were only partially owned and had been accounted for as equity investments before the consolidation of minority interests in 2005. The rating also reflects 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 has built 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 the first nine months of 2006, Novatek produced 21.5 billion cubic meters of gas, a 14% increase compared with the same period of 2005, driven mainly by organic growth at the company's core fields. This, coupled with better pricing conditions, resulted in a 32% revenue increase. Novatek maintained strong profitability of about 50%, while moderate capital expenditures allowed for healthy free operating cash flow (FOCF) generation of $375 million. This FOCF was partially used to repay the company's debt and strengthen its financial profile further. At Sept. 30, 2006, the company's total debt of about $160 million was covered by available cash of $190 million.

Liquidity

The company's liquidity position is strong. At Sept. 30, 2006, short-term debt was less than $120 million, which was comfortably covered by $190 million in cash and equivalents. The company's strong FOCF is another source of internal liquidity.

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.

Outlook

The stable outlook reflects Standard & Poor's Ratings Services' 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 FOCF and to maintain net debt at less than its annual EBITDA.

The rating 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 rating.

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