Stress Testing Russian Oil and Gas

Taxation, Rouble Flexibility Mitigates Falling Crude Prices

Special Report

New Price Deck: Fitch Ratings has revised its base-case price deck per barrel of Brent to USD55 in 2015, USD65 in 2016, and USD80 in the long term. We believe that the oil price will adjust to the marginal cost of supply during the course of the next one to two years, but an alternative scenario is that prices will not recover in the medium term. Taking into account the overall uncertainty in the market we now put more emphasis on stress testing to see how oil and gas (O&G) companies will fare under USD55 in the medium term.

Less Earnings Volatility: The earnings of Russian O&G companies are less volatile than those of most of their international peers, primarily due to the progressive tax regime in the upstream sector, the relative flexibility of the rouble exchange rate, and – in the case of gas producers – regulation of domestic natural gas prices. All these factors smoothed the Russian majors' EBITDA drop in 2009, when oil prices collapsed, and we expect the same factors to help out Russian O&G companies in 2015-2017, should oil prices remain depressed.

A possible revision of the tax regime aimed at increasing the government's stake in O&G revenues presents a risk, though we view this scenario as unlikely at this stage.

Capex Flexibility: We expect that O&G companies' capex will go down at least in dollar terms as a result of the fall in the rouble, as up to 75% of it is rouble-pegged. In addition, we expect Russian companies to reduce their capex budgets in response to weaker prices and fewer financing options through stricter capital discipline, negotiations with contractors and possibly putting some new projects on hold.

Adequate Liquidity for Now: Lower oil prices coincided with the Ukrainian crisis and most Russian corporates lost access to the international capital markets, their primary source of funding. The current liquidity of all Fitch-rated players in the sector, though, remains adequate due to generally favourable debt maturity profiles, accumulated cash, credit lines with Russian state banks, naturally hedged positions and potential help from the state. However, companies will need to reconsider their financing if the situation does not change throughout 2015-2016.

Sovereign Cap: Even under the stress-case scenario the fundamentals of Russian O&G names will remain strong, and lower oil prices in themselves should trigger no downgrades. However, their ratings are increasingly dependent on the direction of the sovereign rating. Fitch downgraded Russia to 'BBB-'/Negative in January 2015, and as we cap the ratings of Russian O&G players at the sovereign rating, this was replicated for higher-rated industry players.

Figure 1

Oil at USD80/55 – Summary

Issuer	Rating	Mid-cycle Leverage[a] at USD80	Mid-cycle Leverage[a] at USD55	Negative Rating Action Leverage[a] Sensitivity	Mid-cycle Coverage[b] at USD80	Mid-cycle Coverage[b] at USD55	Negative Rating Action Coverage[b] Sensitivity
Gazprom	BBB-/Negative	1.2●	1.7●	2.5	11.0●	7.5●	10
LUKOIL	BBB-/Negative	1.1●	1.4●	2.5	15.8●	12.8●	8
Gazprom Neft	BBB-/Negative	2.1●	2.4●	2.5	9.8●	7.7●	10
Novatek	BBB-/Negative	1.4●	1.7●	2.5	10.3●	8.4●	8
Tatneft	BBB-/Negative	0.0●	0.1●	1.5	>50●	>50●	10
Bashneft	BB/RWN	1.0●	1.2●	2.5	11.9●	9.0●	8

[a] FFO Adjusted Net Leverage
[b] FFO Interest Coverage
Source: Fitch

● some headroom available under the negative rating action sensitivity guidance
● close to the sensitivity guidance
● negative rating action guidance reached

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Stress Testing Russian Oil and Gas at USD55

New Stress Case: USD55, No Recovery

- We put more emphasis on stress testing as it is unclear when oil prices achieve equilibrium.

We believe that USD80 for Brent and USD75 for WTI are long-term equilibrium levels based on full-cycle costs. However, it may take some time for suppliers to react and for oil prices to reach a sustainable level.

As a base-case scenario we now assume that Brent will average USD55 in 2015, before recovering to USD65 in 2016 and USD80 in 2017. The stress-case scenario is that there will be no recovery in the medium term – and Brent will be around USD55 for a longer period of time. This report aims at demonstrating how Russian O&G companies will cope under USD55/bbl, and looks at how their metrics would change compared to our previous base-case assumption (USD80 flat in 2015-2017).

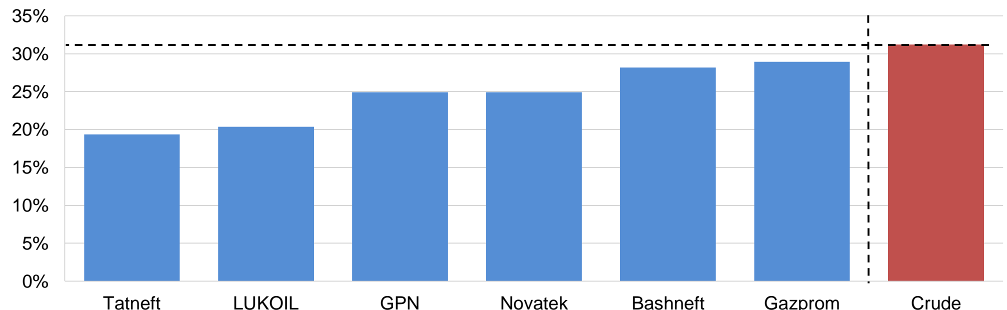
Falling Crude Mitigated by Weaker Rouble, Taxation

The lower earnings volatility of Russian O&G companies compared to most international peers is credit positive, and we take it into account in our forecasts. Three major factors contribute to it. First, a progressive tax regime, which means that the effective tax rate paid by Russian oil producers increases as oil prices rise, and vice versa. Second, a relatively flexible exchange-rate regime, which means the rouble will depreciate in response to oil price falls, cushioning the impact of lower export revenues. Third, the regulation of domestic gas prices, which are set in roubles, but which fall in dollar terms more slowly than oil prices do as long as the rouble depreciation does not exceed the fall in crude prices. The importance of these factors was demonstrated in 2009, when the EBITDA of the Russian O&G companies declined more slowly than that of most international peers.

- Russian O&G companies are insulated from falling oil prices through progressive taxation, a flexible rouble and regulated gas prices.

Figure 2

EBITDA Decline – From USD80 to USD55/bbl (2015)



Source: Fitch

According to our sensitivity analysis, Brent falling from USD80 to USD55, or by 31%, will result in the companies' EBITDA declining by a median of only 23% (in dollar terms). This also takes into account the rouble depreciation effect: we assume USD/RUB50 at USD80/bbl, and USD/RUB60 at USD55/bbl. In addition, a weaker rouble should help companies to control their capex as a significant part of it – up to 75%, according to some of Fitch-rated O&G companies – is normally rouble-denominated. This will allow many Russian companies to be free cash-flow neutral even under low oil prices.

An important caveat here is that an exchange rate is affected not only by crude prices, and so a stronger rouble without an oil recovery could result in worse results, and vice versa. However, we do not think such recovery is a significant risk at USD55/bbl.

Leverage Broadly Moderate; Coverage More of a Concern

Prior to the 2014-2015 price drop all Fitch-rated O&G companies had pursued rather conservative credit policies – which should help them to survive the period of low oil prices. Their funds from operations (FFO) adjusted net leverages will increase, mainly on the back of

Related Research

Fitch Revises Base Case Crude Price Deck to Match Stress Case for 2015 (January 2015)

Fitch Downgrades Russia to 'BBB-'; Outlook Negative (January 2015)

Russian Oil & Gas Dashboard 2H14 (August 2014)

contracted operating cash flows, but should remain below our negative rating guidelines even under the stress-case scenario. FFO interest coverage ratios, though, will worsen more quickly. This is mostly a result of the companies' blocked access to international capital debt markets as we believe that cheaper dollar-denominated loans will be gradually substituted by rouble loans with significantly higher interest rates.

Higher interest rates mean that some Russian O&G companies may see their interest coverage ratios falling below Fitch's negative rating guidelines. However, this factor alone should not result in a downgrade, as long as an issuer's leverage and other metrics are commensurate with the current rating level.

The Russian central bank raised its key interest rate by 6.5pp to 17% in December 2014 to defend the rouble. We believe that interest rates are likely to edge down through 2015, but we assume they will remain high, at least for the next one to two years.

Some Projects May Be Put on Hold

Russian O&G companies' cash-flow generation will remain solid even under the USD55 scenario. However, some new large-scale projects may need to be put on hold. The main reason for this is the lack of external finance rather than the companies' stretched credit metrics.

- Some projects may need to be put on hold due to slower progress on the finance side.

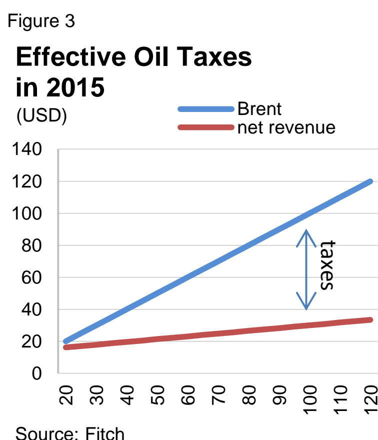
We believe that Fitch-rated O&G issuers will survive 2015-2016 rather comfortably and should be able to repay their upcoming debt maturities. However, as a result of the Western sanctions and investors' overall perception of Russia-related risks, they are now effectively cut off from international financial markets, their previously preferred source of finance. This could mean that Russian O&G companies may need to freeze some of their most ambitious projects, unless state support or other sources of finance are available, such as loans and prepayments from Chinese banks and customers.

In particular, it may take more time to build the liquefied natural gas (LNG) terminals contemplated by Novatek, Rosneft and Gazprom, predominantly due to slower progress on the finance side. Gazprom may also be forced to postpone or cut down its USD55bn capex programme associated with the "eastern route" gas deliveries to China, unless it agrees a sizeable prepayment from its perspective customer, Chinese National Petroleum Company (CNPC; A+/Stable). Furthermore, sanctions imposed on the sector by the US and the EU make tight oil and Arctic shelf projects more remote prospects.

The state has announced that it will support Rosneft and Novatek, as well as possibly other O&G companies, by allocating money from the country's USD80bn welfare fund. However, the exact timing and amount of such support – which would not suffice to finance all large-scale projects in Russia anyway – is as yet unclear. There is some more clarity only with regard to Novatek. In December the state officials announced that it may receive a RUB150bn (USD3bn) loan to finance its Yamal LNG project. However, the final decision does not seem to have been taken yet.

We are planning to publish a more detailed report on the effect of EU/US sanctions on the Russian O&G sector in early February 2015.

Figure 3



Source: Fitch

Tax Regime Revision, More Regulation Risks Remain

The Russian oil industry is characterised by a relatively high level of taxation, which on the one hand limits earnings per barrel of oil produced, and on the other hand makes cash flows more smooth and predictable. This is because both major industry-specific taxes – the export duty and the mineral extraction tax (MET) – are progressive in nature. They are revenue based and increase as a share of revenue as the crude price rises, and vice versa.

For example, we estimate that at USD100 an oil exporter would pay 70% of revenues in taxes, while at USD55 this proportion would decrease to 60%, making net revenue decline by only 23%, compared to the 45% decline in crude prices. The so-called “tax manoeuvre” undertaken by the government and aimed at gradually reducing export duty and increasing MET is still in line with this progressive taxation principle.

- More regulation and state control in the sector are key risks.

The main risk here is that the government may want to increase its stake in O&G revenues and raise taxes if oil prices remain depressed for a long period. Depending on its scale, this could result in a dramatic deterioration in companies’ credit metrics. However, this scenario is not probable, in our view. The government seems to realise that this step would result in a significant fall in investment – potentially leading a significant output drop.

Another risk is that the state may indirectly press oil companies to keep prices for gasoline and other domestically sold oil products below the export netback, to avoid public discontent and curb inflation. As a result, there may be a temporary disparity between oil product prices and netback changes. We assume that domestic rouble-denominated oil product prices will grow two times slower than the netback parity prices. However, a more interventionist government stance may result in even more disparity – leading to worse results, especially for companies with a higher exposure to the domestic market, such as Gazprom Neft and Bashneft. Gazprom and Novatek would in their turn be hit if the government decides to freeze domestic gas tariffs.

Individual Profiles

OAO Gazprom (BBB-/Negative)

Figure 4

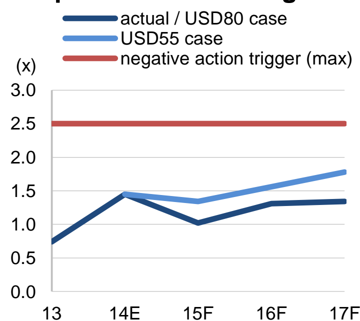
Gazprom

	2015 @ USD80	2015 @ USD55	Diff.
Brent	80	55	-31%
EBITDA (USDm)	43,700	29,502	-32%
FCF (USDm)	2,386	938	-61%
FFO adjusted net leverage (x)	1.0	1.3	0.3
FFO interest cover (x)	12.6	8.0	-4.6
Capex decline			10%

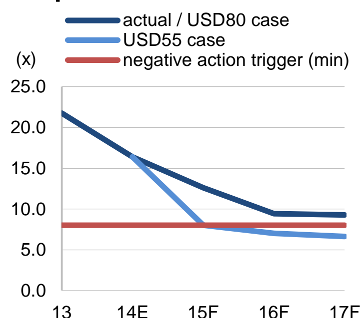
Source: Fitch

Figure 5

Gazprom – Net Leverage



Gazprom – Interest Cover



Gazprom exports natural gas to Europe under long-term contracts with prices mainly linked to those of oil products with a six- to nine-month lag. This means that the company’s EBITDA will continue to decrease in 2016, even if oil prices stabilise at USD55 in 2015-2016.

We expect Gazprom’s leverage would hover around 1.5x, which is still below our negative rating guideline. Its coverage should be healthy at around 10x at USD80, but may fall below 8x under the USD55 scenario. However, this alone would not trigger a negative rating action.

Gazprom’s upstream capex is quite flexible. Its developed fields have 600bcm of production capacity, compared with around 460bcm of output in 2014. This means that Gazprom is able to cut its upstream capex by at least 20%-30% with no short-term production effect. Together with the fall in the rouble, this should help the company to finance its priority projects despite lower operating cash flows.

Nevertheless, if oil prices remain depressed and no large external funding is available, Gazprom will start phasing out some of its largest gas projects, including new or expanding LNG plants, such as the third train of Sakhalin 2 and the Baltic LNG, as well as the USD55bn “eastern route” pipeline to China. Gazprom stated in 2014 that it is negotiating with China a USD25bn prepayment to finance construction of the gas pipeline to China and the development of Chayanda and Kovykta fields. It is as yet unclear whether it will be received.

OAO LUKOIL (BBB-/Negative)

Figure 6

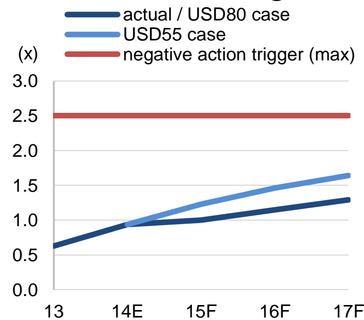
LUKOIL

	2015 @ USD80	2015 @ USD55	Diff.
Brent	80	55	-31%
EBITDA (USDm)	15,244	12,139	-20%
FCF (USDm) (before WQ2)	-1,871	-2,399	28%
FFO adjusted net leverage (x)	1.0	1.2	0.2
FFO interest cover (x)	17.9	14.6	-3.3
Capex decline			11%

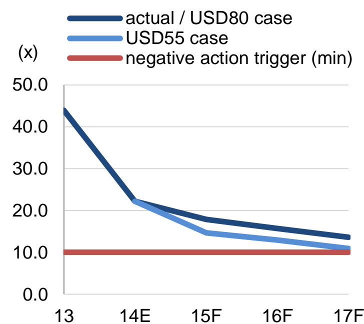
Source: Fitch

Figure 7

LUKOIL – Net Leverage



LUKOIL – Interest Cover



We expect LUKOIL's leverage to remain below 2x in 2015-2017 under either scenario, while its interest cover will be at least 11x, making it one of the strongest Fitch-rated O&G names in Russia in terms of credit metrics.

LUKOIL should be able to finance all its largest upstream projects even under our stress-case scenario, including the Caspian Sea Filanovsky field and the enormous Imilorskoye field in Western Siberia. Tight oil projects, including those operated by its subsidiary Ritek, are likely to be put on hold, both due to sanctions and poor profitability under current oil prices. However, this should not significantly affect the company's production profile in the medium term as it has mostly concentrated on conventional onshore and shallow-water projects. LUKOIL has announced that it will reduce its 2015 capex by around 10%-15%, mainly at the expense of downstream and midstream projects.

The company's Iraqi West Qurna II field is on its way toward the self-financing stage. LUKOIL expects to recover USD5bn of previously incurred costs in 2015, though we conservatively assume it will be lower at USD2bn.

JSC Gazprom Neft (BBB-/Negative)

Figure 8

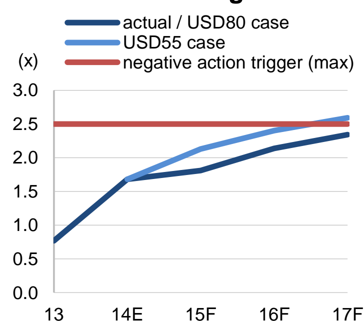
GPN

	2015 @ USD80	2015 @ USD55	Diff.
Brent	80	55	-31%
EBITDA (USDm)	7,486	5,619	-25%
FCF (USDm)	-1,825	-1,629	-11%
FFO adjusted net leverage (x)	1.8	2.1	0.3
FFO interest cover (x)	12.9	10.3	-2.6
Capex decline			21%

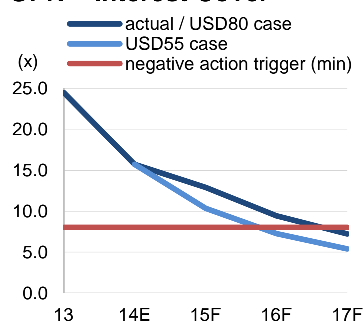
Source: Fitch

Figure 9

GPN – Net Leverage



GPN – Interest Cover



We had expected GPN's healthy financial metrics to get a bit stretched in 2015-2016 even before oil prices started to decline on the back of the company's ambitious upstream and downstream capex programme. We now believe that the company's leverage will worsen more quickly to around 2.5x by 2017 if oil prices remain depressed at USD55. Its coverage may also over time go below 8x, which is our negative rating action guideline. This may exert some pressure on GPN's ratings. However, other factors, such as potential support available from its parent Gazprom and possibly more significant reduction of capex than now assumed should support ratings under the stress-case scenario.

GPN's ambitious target to increase its total production to 2 million barrels per day by 2020, or by 60% may be difficult to achieve under current prices. Some projects, including the Novoport field, may need to be scaled back. Tight oil and offshore projects, such as the Dolginskoye field, may also be delayed, due to the sanctions which prohibit transfer of technologies, and lack of external finance. Even taking into account possible delays we assume GPN's production will be relatively stable in the next two to three years.

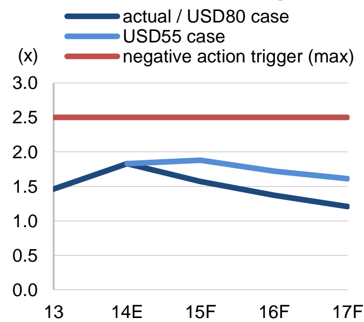
OAO Novatek (BBB-/Negative)

Figure 10
Novatek

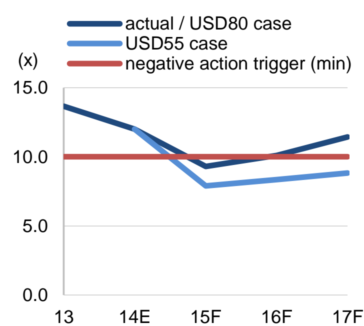
	2015 @ USD80	2015 @ USD55	Diff.
Brent	80	55	-31%
EBITDA (USDm)	3,062	2,299	-25%
FCF (USDm)	402	272	-32%
FFO adjusted net leverage (x)	1.6	1.9	0.3
FFO interest cover (x)	9.3	7.9	-1.4
Capex decline			19%

Source: Fitch

Figure 11
Novatek – Net Leverage



Novatek – Interest Cover



Novatek is a domestic gas producer. It is exposed to international oil prices through sales of gas condensate, liquefied petroleum gas (LPG) and other products. Its revenues from domestic gas sales should remain intact in roubles, but will fall in dollar terms because of the depreciation.

The company's leverage will remain below 2x under either scenario. However, its coverage may marginally fall below the negative rating action trigger of 10x. This alone is unlikely to provoke a negative rating action.

In our modelling we assume that Novatek's Yamal LNG project, where the company has a 60% stake, will be predominantly project financed with no recourse to Novatek. Novatek should receive around USD3bn from the National Welfare Fund in early 2015, and the rest (around USD18, according to our estimates) should be provided by Russian and Chinese banks. If there is a delay on the finance side, Novatek could potentially increase its exposure to the project through equity injections or loans. This could result in a significant deterioration in its credit metrics – and possibly a downgrade.

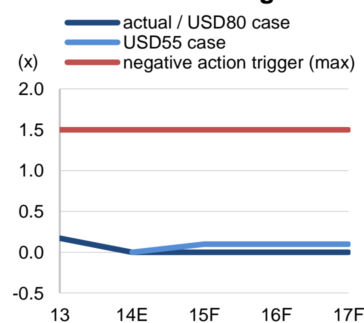
OAO Tatneft (BBB-/Negative)

Figure 12
Tatneft

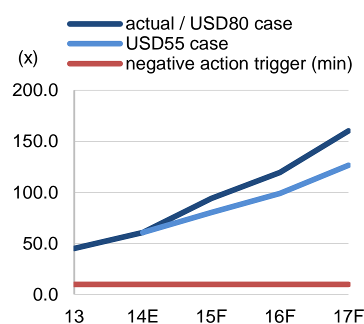
	2015 @ USD80	2015 @ USD55	Diff.
Brent	80	55	-31%
EBITDA (USDm)	3,341	2,694	-19%
FCF (USDm)	449	390	-13%
FFO adjusted net leverage (x)	below 0	below 0	-
FFO interest cover (x)	94.0	80.4	-13.6
Capex decline			17%

Source: Fitch

Figure 13
Tatneft – Net Leverage



Tatneft – Interest Cover



Tatneft remains the least leveraged company in our O&G portfolio. Under either scenario its net leverage will hover around zero, and its interest cover will exceed 50x, reflecting its insignificant debt.

Tatneft's credit metrics may worsen slightly if the company decides to proceed with Taneco's second stage. The Taneco refinery was commissioned in December 2011, and the company has long debated whether to expand it. Our current forecasts assume there will be no expansion. However, even if Tatneft does decide to go ahead with the project its credit metrics should remain sound and Fitch does not expect them to trigger a downgrade.

Joint Stock Oil Company Bashneft (BB/Rating Watch Negative)

Figure 14

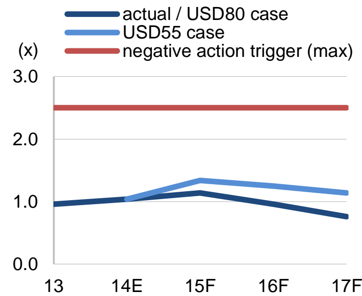
Bashneft

	2015 @ USD80	2015 @ USD55	Diff.
Brent	80	55	-31%
EBITDA (USDm)	2,133	1,532	-28%
FCF (USDm)	-144	-135	-6%
FFO adjusted net leverage (x)	1.2	1.3	0.2
FFO interest cover (x)	10.8	10.2	-0.6
Capex decline			23%

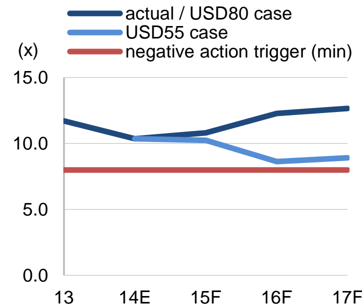
Source: Fitch

Figure 15

Bashneft – Net Leverage



Bashneft – Interest Cover



Bashneft was effectively nationalised in late 2014 and its capex, dividend and financing policies may significantly change. This uncertainty is reflected in the Rating Watch Negative. We expect more clarity after Bashneft's new board is elected in March 2015.

Currently, we expect that Bashneft's leverage will remain relatively stable under either scenario, mostly because its debt is predominantly denominated in roubles and will hence fall in dollar terms. Its coverage may reduce over time as Bashneft may need to refinance part of its debt in mid-2016 but should remain above our negative rating action guidance even under the USD55 scenario. Overall, Bashneft's debt maturity profile remains rather favourable.

We assume Bashneft's capex will remain high in 2015-2017 as it will continue to develop the Trebs and Titov project, and the Burneftegas asset acquired in early 2014. We also assume dividends to be moderate at 25% of net profits, which is standard for most state-owned companies in Russia and significantly less than the company paid when being a part of Sistema Joint Stock Financial Corporation.

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