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Research Update: Gazprom 'BB-' CCR on Watch Developing Following Bid for Yukos Production Subsidiary

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Rationale

On Nov. 30, 2004, Standard & Poor's Ratings Services placed its 'BB-' long-term corporate credit rating and senior unsecured debt ratings on Russian gas company OAO Gazprom and related entities on CreditWatch with developing implications, following the group's announcement that it is to bid for Yuganskneftegas, a production subsidiary of Russian oil company OAO NK Yukos (CC/Watch Neg/--).

The sale is scheduled to take place by the Russian government on Dec. 19, 2004, and is to partly cover tax claims faced by Yukos. The starting price for the controlling 76.8% stake in Yuganskneftegas (which produces about one million barrels per day) has been set at \$8.6 billion by the Russian government. The actual price will depend on competition and should be paid in full 14 days after the tender. The CreditWatch placement will be resolved when there is some clarity about the outcome of the Yuganskneftegas tender and the final price and financing of Gazprom's bid (including cooperation with any partners and any additional debt to be assumed by Gazprom).

The CreditWatch placement reflects the uncertainties about the future strategy of Gazprom and the policy of its main shareholder, the Russian government, regarding this and other large-scale acquisitions; Gazprom's debt appetite; and the group's ability to rely on the Russian government's financial support in the future.

The ratings on Gazprom could be raised if there is strong evidence of government support, particularly when the government implements its plan to increase its shareholding in the group from 38% to 51% by exchanging the assets of state-owned OJSC Oil Company Rosneft (B/Developing/--) for Gazprom's treasury stock. Gazprom would benefit from a larger and more diversified asset base and better resilience to low hydrocarbon prices because the newly acquired oil assets--like other Russian oil companies--have better resilience to low prices compared with gas companies (because domestic gas prices are set at a very low level by the regulator). The starting price of \$8.6 billion is several billion U.S. dollars below a recent third-party valuation for Yuganskneftegas, which is one of the most efficient assets in the Russian oil industry. The benefits of a successful bid would depend on the extent of any "bargain" price Gazprom might pay, counterbalanced against its use of debt to finance the purchase and risk of future liabilities for past taxes or to parties, such as Yukos shareholders, who might challenge the fairness of the transaction.

The ratings on Gazprom could be lowered, however, if Gazprom were pressured by the government to implement large-scale, politically

motivated risky and uneconomical investments that would further increase its already significant leverage, in the absence of clear evidence of government support to offset the company's increased risk and liabilities. On June 30, 2004, Gazprom had total debt of \$18.3 billion on the balance sheet (including significant short-term debt of \$5.9 billion) and \$2.8 billion of guarantees. Standard & Poor's notes that in spite of favorable hydrocarbon prices and a gradual increase in domestic gas prices that now cover operating expenditures, Gazprom did not generate any positive free cash flow in the first half of 2004 due to ongoing cost inflation and rising capital expenditures.

Liquidity.

Gazprom's liquidity is currently not sufficient to finance the bid for Yuganskneftegas. In addition, although the company has benefited from several successful Eurobond placements, its short-term debt is still significant, with \$5.9 billion maturing in less than one year at June 30, 2004, compared with cash reserves of \$3.6 billion and broadly neutral free operating cash flow. This exposes Gazprom to refinancing risk.

Although the share of secured debt reduced following Eurobond placements in 2004, Gazprom still uses a significant proportion of its export contract revenues as collateral to back its bank debt. In the longer term, Gazprom's liquidity is exposed to the risks of volatile demand for emerging market debt and a weak financial system in Russia, where Gazprom has limited flexibility as the largest corporate borrower.

Recovery analysis.

Gazprom has senior unsecured notes issues outstanding under its \$5 billion medium term note program: €1 billion and \$1.2 billion due in 2010 and 2034 (with a put option in 2014), respectively. The senior unsecured notes were issued by Gazprom's financial subsidiary, Gaz Capital S.A., and guaranteed by the parent company.

In addition, Gazprom's public debt includes \$500 million and \$700 million of loan participation notes issued by Salomon Brothers AG due in 2007 and 2009, respectively, and a \$1,750 million loan participation note issued by Morgan Stanley due in 2013. The rating on the senior unsecured notes, as well as the rating on the loan participation notes, mirrors the corporate credit rating on the company because the noteholders face solely the credit risk of Gazprom. Both structures have been widely used by various Russian companies.

Gazprom also has \$1,250 million of senior export notes outstanding, secured by exports of gas to Western Europe. The 'BBB-' rating on these notes is higher than the corporate credit rating and is based on the company's ability to perform under its export contracts. Overall, Gazprom's secured debt is substantial, but well below 20% of its total assets. Standard & Poor's usually does not differentiate between the ratings of secured and unsecured debt for Russian companies because of uncertainty about relative standing of various creditor groups in case of bankruptcy under Russian legislation. In Gazprom's case, however, Standard & Poor's believes that performance and bankruptcy proceeding risks are lower than the default risk. The bid for Yuganskneftegas is not expected to affect Gazprom's performance risk under the transaction.

Ratings List

	To	From
OA0 Gazprom		
Corporate credit rating	BB-/Watch Dev/--	BB-/Developing/--

NB: This list does not include all ratings affected.

Ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. It

can also be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: London Ratings Desk (44) 20-7176-7400; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5916; or Moscow (7) 095-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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