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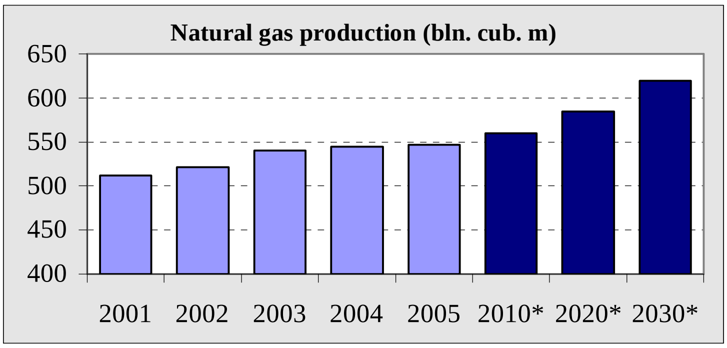
Gasprom: Liberalization is not far off, what after?

Gasprom is the greatest gas company in the world engaged in all activities from geological survey through gas delivery to end consumer.

The company takes the first place in the world on the natural gas production. In 2004 the company extracted 545.1 bln. cubic m of natural gas that is 16% of the world production and 86% of the Russian one. However after rocketing of the production in 2002-2003 when its volume increased from 512 to 540 bln. cubic , the rates fell almost to zero. It is tied up first of all to the exhaustion of fields and fall of their production. Thus in 2004 the decrease of gas production at three main fields that is Medvezhye, Urengoi, and Yamburg, made 26.1 bln. cubic m. However this decrease was fully compensated by the putting into operation the Zapolarnoe field where gas production rose to 27 bln. cubic m in 2004. Just this field is to become the basic center of production growth for the future five years. Gasprom plans to increase annual production by 0.5% in average thus planning to extract about 560 bln. cubic m of natural gas up to 2010, to make this figure equal to 580-590 bln. cubic m in 2020 and achieve 610-630 bln. cubic m level in 2030. It is planned to support this growth by new projects in East Siberia, the Far East, Yamal and the Arctic shelf. Note, that the realization of all these projects is rather expensive so Gasprom actively attracts Western companies for this work. At present there was formed a short-list for Stockman field development where gas deposits make about 3.2 trillion cubic m, and this Spring the company will select partners for its development. This action will allow both to share the burden of investments and to gain experience of Western companies in the development of complex fields. Besides creation of new projects Gasprom follows an active policy of assets exchange offering a share in yet unmined deposits against the participation in running projects. In particular, Gasprom is negotiating with Shell the exchange of 50% in Neokom resources at Zapolarnoe field for 25% at Sakhalin-2 project.

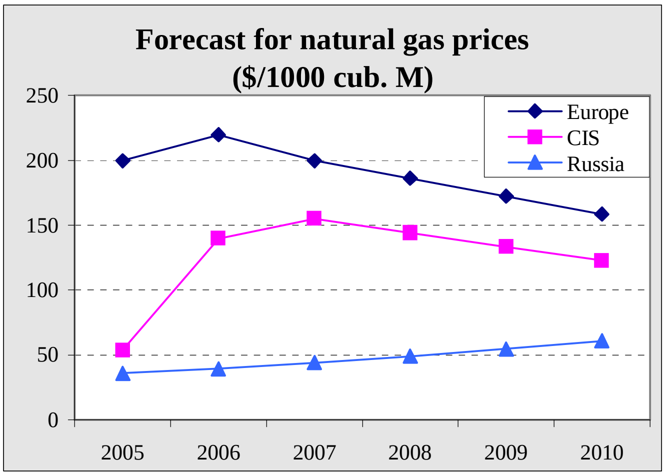


The situation with stocks addition is not bright as well. Proved stocks of natural gas at Gasprom make 28.9 trillion cubic m that is about 16% of the world stocks. Stocks of gas condensate make 1.24 bln. tons while oil stocks are 650 mln. tons. It makes Gasprom the largest gas company in the world not only by production but also by reserves. But if the majority of Russian fuel companies annually present at least reproduction of their resource basis, Gasprom for a long time suffered from decrease of its reserves. Thus in 2004 the stocks addition made only 378 bln. cubic m that is by 167 bln. cubic m less that annual level of production. However just in 2005 the company plans to get parity of production and reserves addition.

Another challenge for Gasprom lies in gas pipelines forming Russia's Unified Gas Transportation System (UGS). This system is the largest in the world, its overall length exceeds 153.3 thousand km. However, UGS is rather depreciated, only 11% gas pipe lines are younger than 10 years while 58% are in operation for more than 35 years. Besides, its capacity is nearing the limit. The input volume of gas constantly increases. While in 2004 the system received 687.4 bln. cubic m, the 2006 balance foresees the arrival of 723.8 bln. cubic m, though the capacity of gas pipe lines grew just for 16 bln. cubic m. In order to solve transportation problems in 2002 Gasprom initiated a large-scale program of UGS reconstruction and modernization. The development of gas pipe system is the top priority direction of Gasprom investments program. More than 60% of the total volume of investments is forwarded to these aims.

Considering growing consumption of natural gas and Gasprom plans to increase its export to Europe, there arrives a challenge of new transportation routing. Up to 2010 it is planned to build the first pipe run of the North European gas pipe lines with 27 bln. cubic m capacity. It will allow to increase the gas supply to Europe from present 147 bln. cubic m to 180 bln. cubic m in 2010. Gasprom has not got enough own gas production to provide for such volumes of supply, so it will apply its sole right for gas export and purchase blue fuel both at independent Russian producers and at Middle Asian ones. According to already signed agreements, in 2007 the volume of gas purchased in Middle Asian republics will make 70 bln. cubic m.

Note that the European market is the main source of Gasprom profit. Though gas supplies to Europe make less than 30% of the total volume of realized gas, its share in receipts makes as much as 47%. Here the home market which takes 58% of gas delivery gives just 27% of receipts. This difference is caused by the absence of free gas market inside the country. Gas prices are stated by the Federal Tariff Service (FST), so gas deliveries at home market are on the verge of efficiency. In fact, the company finances the economy of the country providing cheap gas for consumers. In 2003 the growth of wholesale prices was 20%, in 2004 the tariff increased by 20%, in 2005 by 22%. Meanwhile the growth of tariffs leads to the growth of consumer prices and inflation. That’s why FST in 2006 increased prices only by 11% to $39.5 for 1,000 cubic m though Russia’s Energy Strategy foresaw the rise of wholesale gas prices to $41 for 1,000 cubic m. We consider that the growth of tariffs for gas at the home market will continue to be limited and will be about 10% a year. So up to 2010 the prices will be $60.60 for 1,000 cubic m instead of $64 foreseen in the Energy Strategy.



For a long time gas deliveries to CIS countries could not be characterized by high profitability either, since the prices were significantly lower than the world ones. Besides, part of supplies was done on barter and reckoning schemes. However beginning from next year Gasprom will sharply increase gas tariffs for CIS countries. According to our estimations, they will make $140 for 1,000 cubic m in average.

Gasprom managing officials have got a strong desire to turn the company into not only gas, but oil company. The company followed the advice of investment consulters and started to buy oil assets. This on October 25 Gasprom concluded a deal on the purchase of 75.6% of Sibneft for more than $13 bln. This action will allow Gasprom to increase greatly the production of liquid hydrocarbon: if before the purchase the production made just 12 mln. tons with only I mln. tons of oil, in 2006 the production will be about 60 mln. tons. The company also studies other variants of oil assets purchase, in particular, the exchange of a part in Slavneft against TNK-BP assets which were earlier included in ONAKO. These acquisitions will allow Gasprom to take the fifth place among Russian oil companies and to diversify its business. Deutsche Bank which is Gasprom’s consulter also recommended to buy Surgutneftegas.

The first half of 2005 was very profitable for the company. According to international standards of accounting the receipts in this period have increased almost by 30% up to 611 bln. RU ($21.45 bln.). Operating expenses here increased by 15.3% to 402.18 bln. RU($14.11 bln.). Since the rate of receipts growth exceeded the rate of expenses, the pretax profit of the company has increased more – by 60.7% to 211.65 bln. RU ($7.43 bln.). Net revenues increased by 65.8% to 154 bln. RU ($5.4 bln.). So the net profitability has increased from 19.7% to 25.2%.

According to financial results of Gasprom in the first half of the year and taking into consideration announced plans of the company for the nearest future, we have revised our model of the company value estimation. In our calculations we used following assumptions:

1) Export gas prices in 2006 will be $220 for 1,000 cubic m and up to 2010 will decrease to $159 for 1,000 cubic m.

2) Tariffs for gas at the home market will increase by 10% a year and will achieve $60,60 for 1,000 cubic

m in 2010.

3) Prices for natural gas supplied to near-by countries in 2006 will be $140 for 1,000 cubic m in average, will make $155 for 1,000 cubic m in 2007 and then will start to decrease up to $123 for 1,000 cubic m in 2010.

4) Tariffs for gas transit along the territory of Ukraine will go up to $2 for 1,000 cubic m in 100 km.

5) Average price for Urals type oil in 2006 will make $45 for barrel and will start to decrease by $3 per barrel a year to $33 in 2010.

Forecast for oil and gas prices

	2005	2006	2007	2008	2009	2010
Natural gas price Europe ($/1000 cub. m)	200	220	200	186	172	159
Natural gas price Russia ($/1000 cub. m)	36.0	39.5	44.2	49.0	54.5	60.6
Natural gas price CIS ($/1000 cub. m)	53.5	140	155	144	134	123
Urals ($/bbl)	50	45	42	39	36	33

We have also compiled Sibneft financial results starting from the date of the transaction closeout – 25th of October. This was the cause of such a great growth of financial indices in 2006 as compared with 2005. We also took into account the $7.2 bln. which Gasprom will receive from the sale of its shares to Rosneftegas that resulted in a significant increase of revenues of the company in this year.

Forecast financial results ($ mln)

	2005	2006	2007	2008	2009	2010
Sales	42 817	61 237	64 388	64 500	64 893	65 830
Expenses	29 112	40 436	43 747	45 950	47 719	49 552
Profit before taxes	21 672	21 401	21 241	19 150	17 774	16 878
Minority interest	120	648	614	541	459	368
Net profit	16 351	15617	15 529	14 013	13 049	12 459
Capital expenditures	21 967	10 970	11 100	11 200	11 200	11 200

The sum of capital investments in 2005 included the expenditures for Sibneft purchase ($13.5 bln.). According to Gasprom investment program, in 2006 the volume of capital investments will make 278.4 bln. RU ($9.77 bln.). However it does not include investments of Sibneft estimated by us as $1.2 bln. Then, according to our estimations, the volume of Gasprom investments will growe to $10 bln. a year, while Sibneft investments will remain as $1.2 bln. a year. This year Gasprom borrowed more than $15 bln. including $13 bln. to buy Sibneft. In 2006 managing officials of the company plans to pay off about $4.3 bln. on this credit, and refinance the rest. On the whole the total demand in borrowed funds for the next year is estimated as 90 bln. RU ($3.16 bln.).

As a discount rate we took the weighted average cost of Gasprom capital estimated as 9.8% resulting in $155.8 bln. current price of cash flow of the company. With the account of 10.5% of RAO UES shares and 25% of Mosenergo shares which belong to Gasprom, as well as with the account of net debt of the company which was $15.6 bln. on June, 30, fair value of the company makes $143.6 bln. To determine the fair cost of a share it is necessary to consider that about 3.26% of Gasprom shares are treasury ones, so fair cost of a share is **$6.25**.

For a long time the main idea which moved up the quotations of Gasprom shares lay in the liberalization of the market of a gas monopolist's shares since there is an artificial division of markets. At Western markets circulate only 4.5% of shares. Besides, in the aggregate foreign investors may own not more than 20% of a gas monopolist's shares. Such a division led to a significant difference of cost achieving 300% or more. Recently thanks to the information of liberalization by the end of the year the quotations have greatly increased and at present exceed the estimated price by more than 7%. Here the difference of quotations between ADR and shares at the home market decreased to 14.4%. With the approach of liberalization this discount should lessen both thanks to the growth of internal prices and the decrease at world market places. We guess also that after this speculative idea is completed, the prices for shares will not only cease to grow but will go down a little. According to our estimations, the potential of decrease on local shares makes 7.4% and potential of ADR decrease makes 19.5%. So we recommend To Hold local shares of Gasprom and To Sell ADR of the company.

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