URALSIB FINANCIAL CORPORATION

# BIG PICTURE: GAZPROM

## THE STRATEGIC CASE

**A consistent outperformer.** Although the new government has declared that it will focus on boosting growth outside the extractive industries, particularly amongst the country's small and medium-sized enterprises, we believe Gazprom should continue to be one of the main proxies for the Russia story. In the past this Russia proxy status has meant periods during which Gazprom's share price has suffered due to "energy politics," but nevertheless over the past eight years it has been a consistent outperformer. We expect this outperformance to continue as we believe the inauguration of Dmitry Medvedev as Russia's new president will mark the start of a greater effort by the government to re-brand Russia's investment credentials more positively.

*The strategy of the new government will help Gazprom increase its value*

**Problems, but worth more.** Of course, just as the positives for Gazprom have become clearer, so too have the problems. These include a host of technical and administrative issues as well as major question marks over costs and funding. These uncertainties will limit the valuation upside for Gazprom shares until progress is made or the solutions are better understood. But a shift from a period of relative inactivity in developing new projects and poor pricing of gas to a more proactive phase with better pricing will help the share price move up to a new trading range, in our view.

*Major question marks, but positive news will allow the stock to rise to new range*

**Safer exposure to oil tax cut story.** With so much uncertainty surrounding the issue of tax cuts for the oil sector (how much? when?), we believe Gazprom represents a relatively safer route to gain exposure. If the tax cuts are less than the market expects, then stocks such as LUKOIL and Rosneft will fall, whereas Gazprom has not risen so much on this story and has other potential price drivers in place. If the tax cuts match or exceed expectations, then Gazprom will also benefit via its oil subsidiaries.

*Gazprom has not risen so much on the tax cut story but will benefit via its oil businesses*

**Not rated as yet; we provide strategic case and op-eds.** *This note lists the main strategic reasons for buying Gazprom shares. Our oil team is currently reviewing its financial model and will issue revised forecasts and a stock recommendation in due course. In the appendix of this note are two op-ed articles that we recently wrote for the media: one on the improving perception of Gazprom and the other on EU-Russia energy cooperation.*

### THE STRATEGIC CASE

- **New projects.** Gazprom's gas production has been more or less flat for many years, and as output at several of its giant fields is declining, the widespread fear has been that production volumes will not be sufficient to match rising domestic and export demand. But following years of delays to major new projects due to indecision or politics, Gazprom is now pushing ahead with several major new projects. The company plans to raise production from 570 bcm in 2007 to 660 bcm within three or four years and substantially more through the next decade. The projects earmarked for development have the capacity to deliver such levels of output if technical, cost and administrative issues can be overcome. The structure of some of these new projects, with Gazprom allowing international energy majors to take an equity share and operational roles but retaining control, could provide an effective way for Gazprom to overcome such problems, in our view.

*Annual production should rise from 570 bcm in 2007 to 660 bcm within 3-4 years*



Chris Weafer, cweafer@uralsib.ru

21 May 2008

- **Export market share secure.** Russia has effectively won its "pipeline war" with the EU. Despite attempts by Brussels to secure a route and gas for its proposed pipeline, the Kremlin has successfully formed consortia to build the Nord Stream and South Stream pipelines (combined capacity of 85 bcm) by the middle of the next decade. Meanwhile, exports to China and Korea are planned at similar volumes, meaning that Moscow has effectively tied up all new gas output from central Asia for the next decade.

*Nord Stream and South Stream will add 85 bcm to European export volumes*

- **Export price rising in light of higher oil prices.** The price at which Gazprom is selling its gas to Europe (and the price of gas to come via the new pipes) has already moved up from an average of $264 per 1,000 cubic meters in 9M07 to $370 as of March this year in response to the record oil prices. The combination of higher production, expanding export volumes and higher prices will drive Gazprom's revenues sharply higher over the next 10 years, in our view.

*Price of export sales has risen to $370 per 1,000 cubic meters from $264 in 9M07*

- **Domestic price must rise faster.** We believe the domestic gas price must rise at a much faster rate than currently planned. The target of $106 per 1,000 cubic meters for domestic customers by 2011 (vs. the current price of approximately $55) is no longer enough to bring that price up to the equivalent export price on a netback basis. At the current European export price the domestic price would have to rise to around $200 per 1,000 cubic meters. In our view the government is highly unlikely to sanction such an increase (albeit its commitment to the WTO requires it to) because of the negative impact this would have on inflation, but quite obviously the domestic price has to rise faster than now assumed in analysts' models.

*Domestic gas prices would have to quadruple to reach export price today*

- **Higher tax regime probably postponed.** Fears of the government applying a higher tax burden on domestic gas sales, to capture some of the higher revenue from rising tariffs, are receding. Recent indications from government officials suggest a delay in raising taxes to at least 2011 as Gazprom needs the money to fund its huge capex plans.

*Fears of a windfall tax have eased a lot*

- **LNG business to grow.** The company now has a much better business model to help it diversify both geographically upstream and, especially, downstream in Europe. LNG is going to play a much larger role on the global energy market and, via structures like a gas OPEC, Gazprom will have a leading and influential role. Gazprom's oil business is also set to become much more important, especially if market expectations over an imminent deal with BP-TNK prove correct.

*Russia wants to be dominant in the growing LNG segment*

## BUT SEVERAL MAJOR WORRIES

**Serious issues.** In our view the four main problems facing Gazprom are:

- technical difficulties at new offshore and onshore projects;
- the capital cost of developing several major projects concurrently;
- political problems with the new export pipelines;
- whether Gazprom's bureaucratic nature will allow its international partners enough freedom to work effectively.
- There are persistent market rumors that Gazprom is facing a major loss of middle management personnel. Moreover a shake-up at a senior management level is widely anticipated after a new chairman is appointed. Should this happen, this could also delay projects.

*Technical problems, Gazprom bureaucracy, and how much and from where?*

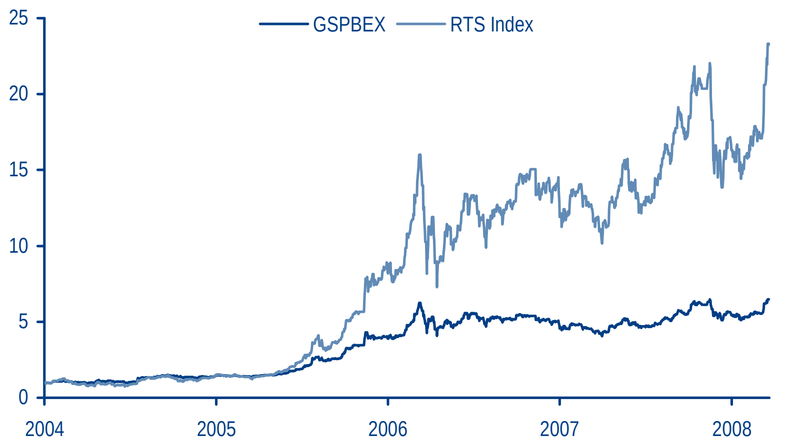
**Sakhalin-2 structure replicated.** We believe Gazprom will partly address these issues by replicating the structure it has adopted at Sakhalin-2 for all new projects. This structure involves Gazprom retaining a 50%+1 share and selling or bartering (for an equity position in a project outside Russia) a 25%+1 stake to a major international energy company and the remaining 25%-2 shares to one or more other international energy companies. In this way Gazprom shares both the technical problems and the cost.

*Bringing in international partners will help*

**Major technical issues.** Huge uncertainty still surrounds the technical problems faced at projects such as Shtokman and the eventual development costs. The technical and environmental problems experienced by operators such as Shell in Sakhalin, plus huge cost overruns, are quite likely to replicated in other major energy projects, in our view. Gazprom Deputy CEO Alexander Medvedev said last year that the company expects to spend about $420 bln on new projects through 2030, but that is of course just a preliminary estimate.

*$420 bln in capex earmarked over the next 20 years*

**Gazprom and the RTS During Putin's 2nd Term**




*Source: Bloomberg*

*(March 2004=1)*

## SHARES HAVE BEEN A CONSISTENT OUTPERFORMER

**Stock has outperformed every year bar one.** Gazprom's share price has outperformed the RTS Index every year since 2000, apart from in 2006, when it merely matched the index. Since early 2001, when the shares first traded on the RTS, the price has appreciated by 5,794%, while the RTS has risen by 1,494%. Gazprom ADRs rose by 14.7% during the week in which the company's chairman was sworn in as Russia's third president and his prime minister promised to cut oil taxes. Gazprom and Sberbank, more than any other Russian stocks, have traded as proxies for the Russia story. But while Sberbank is viewed as the proxy for the expanding economy, Gazprom's shares have traded more often with political and strategic events, particularly as a reaction to progress, or lack thereof, on energy negotiations. During the period when Moscow's relationship with EU states was fraught with problems (May 2006 to May 2007) Gazprom's share price fell by 12% while the RTS rose 17%. But as the table below shows, the stock has been a consistent outperformer and a strategic analysis of the company suggests this outperformance will continue.

*Gazprom's share price has risen almost 5,800% since January 2001, when it started trading on the RTS*

**Gazprom Consistently Outperforming the RTS Index**

| Period | Gazprom % | RTS Index % |
|---|---|---|
| 2001 | 108 | 82 |
| 2002 | 47 | 38 |
| 2003 | 73 | 58 |
| 2004 | 110 | 8 |
| 2005 | 145 | 83 |
| 2006 | 70 | 71 |
| 2007 | 23 | 19 |
| YtD 2008* | 10 | 8 |
| 01/01/01-present | 6,095 | 1,630 |
| Putin's second term | 579 | 248 |
| 1/5/06 to 1/5/07 | (12) | 17 |

** as of close May 16*

*Source: RTS, Datastream*

## PRODUCTION

**Maturing fields face output decline.** One reason why Gazprom's shares struggled between mid-2006 and mid-2007 (see the table above) was the well-aired concern that Gazprom had not made any significant progress in developing new fields and would therefore encounter declining output at existing fields before any new production could be brought on line. Such a situation could lead to a shortage of gas for the domestic market and for export markets. This remains a major issue for the EU as its gas usage is set to increase steadily. Industry observers have been particularly concerned about the risk of a significant drop in production from Gazprom's giant Urengoy, Yamburg, Komsomolskoye and Medvezhye fields.

*Several giant fields are thought to be near to a declining output profile*

**Fears over delays are being addressed.** Over recent months Gazprom has made a lot more progress in the preparatory work for several projects that are capable of covering the looming output decline at existing fields and covering new demand from Europe. In February Gazprom announced that it had asked the government to award it the development rights for six gas fields and it has subsequently been reported that the application has been successful. Recently Gazprom was also awarded the license for the Chayanda deposit, which contains 1.2 tln cubic meters of gas reserves.

*The worry was that delays would lead to a shortage of gas*

**Russian Gas Production Trends**

| Year | Production, bcm | YoY Growth, % | Exports*, bcm | YoY Growth, % |
|---|---|---|---|---|
| 1998 | 551 | 3.4 | 125 | 4.2 |
| 1999 | 551 | 0.0 | 132 | 5.6 |
| 2000 | 545 | (1.1) | 129 | (2.3) |
| 2001 | 542 | (0.6) | 127 | (1.6) |
| 2002 | 555 | 2.4 | 129 | 1.6 |
| 2003 | 579 | 4.3 | 139 | 7.8 |
| 2004 | 579 | 0.0 | 149 | 7.2 |
| 2005 | 598 | 3.3 | 155 | 4.0 |
| 2006 | 612 | 2.3 | 161 | 3.9 |
| 2007 | 570 | (6.9) | 151 | (6.5) |
| 2008E | | | 158 | 4.8 |

** to Europe, excluding Ukraine and Belarus*

*Source: Company data, BP Statistical Review (2007)*

*The production trend has been flat for a long time*

### Yamal Peninsula

**The country's major new gas-producing region.** The Yamal Peninsula is expected to produce the bulk of Russia's new gas over the next two decades. Estimated gas reserves at the peninsula stand at 10.4 tln cubic meters and production is expected to start in late 2011 or early 2012. Production is initially planned at 5 bcm (in 2012), and by 2018 it will rise to 140 bcm – just slightly below the annual gas volumes that Russia currently exports to Europe. By 2025 production is planned to be at a sustainable 250 bcm per year.

*Yamal will be developed as several separate projects*

**Total cost could rise to $200 bln.** The cost of developing Yamal from now until 2015 is estimated at between $40 bln and $50 bln, while late last year Shell said it believes the total capex for the entire project will run to some $200 bln. Yamal consists of several gas fields, with the three largest – Bovanenko, Kharasaveyskoye and Novoportovskoye – holding about 5.9 tln cubic meters of gas, 100 mln tons of gas condensate and 227 mln tons of crude. We believe Gazprom is likely to create separate projects at each field and replicate the share structure at Sakhalin.

*Development cost estimates vary widely*

### Shtokman

**Long delayed for political reasons.** Shtokman was used as a political football by Moscow and the EU during Vladimir Putin's second presidential term. The project was about to get the green light in 2005 but was stalled by the Kremlin looking to win a new trade deal with Brussels and more favorable investment access for Russian companies in Europe. During the fallout from VTB's purchase of a 5% stake in EADS in 3Q06, the Kremlin cancelled the Shtokman project as it was then structured. This move was one of the reasons for Gazprom's poor stock performance in the period. But relations have subsequently improved, and the deal has been restructured, with Total owning a 25% blocking stake and StatoilHydro the remainder. There have been some reports of problems affecting the start of the project, but all the parties claim it is on track and will proceed according to plan.

*Reports of rows with partners but still appears to be on track*

**Gas for Europe and LNG.** Shtokman's total reserves are estimated at 3.8 tln cubic meters (C1 and C2). The project is expected to cost between $15 bln and $20 bln and will be financed using a debt to equity ratio of 60:40. Given the huge technical difficulties of building seabed facilities in the Arctic and the project's location 650 km from the Russian coast, we believe the final cost is likely to be a lot higher. The current plan is that production will start in 2013. Annual production is forecast at 23.5 bcm. Phase 1 of the project is to provide gas for the Nord Stream pipe and phase 2 is to provide gas for a planned LNG plant.

*To be developed as a gas pipe source plus to feed LNG plant*

### Yuzhno-Russkoye

**Work has already begun.** Work on the Yuzhno-Russkoye project started in December 2007. Gazprom has "bartered" a 25% stake in the project with BASF of Germany in exchange for a significant minority stake in Wingas, a company set up to ultimately sell Russian gas to German consumers. E.ON is also trying to acquire an equity position in the Yuzhno-Russkoye field, and negotiations are apparently taking place over what assets Gazprom may receive in Germany in return.

*JV in place with BASF and maybe later E.ON*

### Far East projects

**Several projects on a significant scale.** Gazprom has several major projects in Russia's Far East at various stages of planning and development. Most of the gas from these projects will be exported to China and Korea or used in LNG plants. In 2007, Gazprom gave a detailed analysis of the prospects for the region's gas assets and highlighted the following:

*China has been pressing for gas pipelines as a trade-off for investment and arms purchases*

- Gas production in the Far East currently stands at 8 bcm, while reserves are an estimated 7 tln cubic meters.
- Gazprom plans to raise regional output to 27 bcm by 2010, 85 bcm by 2015 and 150 bcm by 2020, leveling off at 162 bcm by 2030.
- Of the 85 bcm to be produced by 2015, 50 bcm will be exported to China and Korea, 21 bcm will be processed at LNG plants and the remainder will be sold on the regional gas market.
- The total cost of these projects, as estimated by Gazprom last September, is around $94 bln.
- Sakhalin-2, in which Gazprom now has a controlling stake, is scheduled to produce 9.6 mln tons of LNG this year, but this timetable is slipping.
- The three main new projects in the region are:
    i. Sakhalin-3 (no specific time scale)
    ii. Chayanda, due on line by 2016
    iii. Kovykta, due on line by 2017 but currently stalled as a result of a dispute with BP. This deposit holds about 1.9 tln cubic meters of gas.

*Negotiations with BP over Kovykta have been long drawn out*

## EXPORT VOLUME GROWTH

**Exports to Europe were down last year.** Gazprom exported 150 bcm of gas to Europe in 2007, down 6.5% from the 161.1 bcm shipped in 2006. The company plans to export 157.7 bcm in 2008 and 210-250 bcm per year by 2020. In addition, Gazprom sells 55 bcm to Ukraine (although this gas is merely a wash-through of Turkmenistan gas) and 21.6 bcm to Belarus. By 2020, Gazprom expects to export 50-80 bcm to China and Korea by direct pipeline and to export considerable volumes of LNG.

*The plan is to raise exports to Europe from 151 bcm to 210-250 bcm*

**New pipelines will help.** South Stream superseding the Nabucco pipeline and Russia's recent deals to take delivery of Central Asian gas provided a substantial boost to confidence that Gazprom's export volumes will start to rise over the next 10-15 years.

*New pipeline routes now agreed*

**South Stream involves less politics.** The agreement to build the Nord Stream and, particularly, the South Stream pipeline ahead of the alternative EU-proposed Nabucco pipeline means that Gazprom has a significant lead over any alternative gas supplier as the two Russian pipelines are now likely to be operational before Nabucco. The latter will eventually be built, but not before either Turkmenistan produces substantially more gas (if indeed it finds it) and/or trade relations between the West and Iran have been normalized. The prospects for South Stream look better than those for Nord Stream as the route for the northern pipe faces a myriad of political and environmental challenges. South Stream will have a capacity of 30 bcm annually, while Nord Stream will be built in two phases, the first of which will carry 27.5 bcm by 2011 (under the optimistic scenario) and the second of which will raise this to 55 bcm by 2015, as Gazprom looks to eventually supply the UK market. The cost of the pipelines has been initially estimated at $10 bln each. The Nabucco pipe has a planned capacity of 21 bcm.

*South Stream is also technically difficult but involves fewer political issues than Nord Stream*

**EU faces gas deficit.** Gazprom deputy CEO Alexander Medvedev said last year that by his calculations Europe will face a gas deficit of 85 bcm by 2015. This shortage could be covered by supplies from the two pipelines, which we believe essentially places the onus on Brussels to sort out the wrangling around the Nord Stream route in particular.

**Private producers.** NOVATEK CFO Mark Gyetvay recently said that he believes the country's independent gas companies will raise production from the current 98.5 bcm to 248 bcm per year by 2015. We do not expect Gazprom to lose its monopoly on gas exports.

*Russian gas production excluding Gazprom is set to more than double over the next 10 years*

**Deal with Turkmenistan.** The two deals struck between Russia and Central Asian governments last year also help secure Gazprom's dominance in the European market. The first deal, agreed with Turkmenistan, calls for capacity upgrades for the existing Pricaspiysky Pipeline (aka the Caspian Littoral Pipeline) to 20 bcm by 2010 (vs. 10 bcm today) and to 50 bcm by 2017. An initial MOU was signed this time last year and confirmed last December, but doubts remains as to whether it is yet legally binding.

*Russia has secured an important deal with Turkmenistan*

**Deal with Central Asian trio.** The second deal was agreed between Russia and Turkmenistan, Uzbekistan and Kazakhstan and stipulates the construction of a new Central Asian Central Pipeline. This will eventually take 20 bcm of Central Asian gas to Russia on the Siberian side of the Urals. The upshot of these two deals is that none of the Central Asian states – especially Turkmenistan – will have any spare gas to supply the Nabucco pipeline for a very long time. The deal between Russia and Turkmenistan, for example, is set to run until 2028.

*New deal with other Central Asian states also helps Gazprom*

**Russia's Major European Gas Customers**

| | 2006 bcm | 2007 bcm | % of total in 2007 |
|---|---|---|---|
| Germany | 34.4 | 39 | 25.9 |
| Turkey | 19.9 | 23.4 | 15.6 |
| Italy | 22.1 | 21 | 14 |
| France | 10 | 9.8 | 6.5 |
| Austria | 6.6 | 5.4 | 3.6 |
| Finland | 4.9 | 4.7 | 3.1 |
| Netherlands | 4.7 | 4.4 | 2.9 |
| Greece | 2.7 | 3.1 | 2.1 |
| UK | 8.7 | 1.2 | 0.8 |
| Other | 3.6 | 0.4 | 0.3 |
| **Total Western Europe** | **117.6** | **112.5** | **74.7** |
| Poland | 7.7 | 7 | 4.6 |
| Czech Republic | 7.7 | 7 | 4.6 |
| Hungary | 8.8 | 6.4 | 4.2 |
| Slovakia | 7 | 6.2 | 4.1 |
| Romania | 5.5 | 3.9 | 2.6 |
| Bulgaria | 2.7 | 3.4 | 2.3 |
| Serbia | 2.1 | 2.2 | 1.5 |
| Croatia | 1.1 | 1 | 0.7 |
| Other | 1.2 | 1 | 0.6 |
| **Total Eastern Europe** | **43.8** | **38.1** | **25.3** |
| **Total exports*** | **161.4** | **150.6** | **100** |

Source: Gazprom

*Germany, Italy, France and, soon, UK, all need more gas*

## HIGHER EXPORT PRICES

**Price is already up more than $100 YtD.** The price at which Gazprom sells gas to Europe is rising with the strength in the price of crude oil, albeit with a lag. The Federal Tariff Service produced a report on the outlook for the domestic gas price (see next paragraph) last September in which it said that the average price for export gas year to date was $264 per 1,000 cubic meters. Gazprom officials said the average for 4Q07 was $300 per 1,000 cubic meters. Gazprom CEO Alexei Miller confirmed to President Putin in March this year that the export price was already at $370 per 1,000 cubic meters and that the outlook was for an average price of $400 for 2008. Since then the price of crude has risen by almost 20%, meaning that the gas price is likely to rise even further.

*Price of gas lags that of crude oil but is following it higher*

**Rising prices to CIS countries.** Gazprom is also in the process of eliminating subsidized gas sales to former Soviet countries and has agreed new price regimes with all. Of course, at the back end, it has also had to agree a higher price for the gas it buys from Central Asia. This was necessary to secure the contracts to acquire increased volumes from the Central Asian producers and in may cases, e.g. Ukraine, it will be passed through to the end user as prices to them are raised. In 2006 Gazprom paid only $50 per 1,000 cubic meters for Turkmenistan gas, but in 2007 this price rose to $100. For 1H08 the price was raised to $130 and for 2H08 it will be $150 per 1,000 cubic meters. From 2009 the price agreed for all Central Asian gas will be $270 per 1,000 cubic meters.

*Gazprom is shedding its previous role as part of Russia's foreign aid program*

## DOMESTIC TARIFFS MUST RISE FASTER

**Domestic price considerably lagging export price.** The current plans for domestic gas tariff increases will see the price double in stages from around $50 to $106 per 1,000 cubic meters by 2011 This schedule was agreed when the netback price, i.e. the equivalent price Gazprom gets for its exports ex transport and other costs associated with exports, was around $100 per 1,000 cubic meters. Last September, when the average European export price was $264 per 1,000 cubic meters, the Federal Tariff Service said that this schedule would have to change to allow the domestic price to rise to $160 per 1,000 cubic meters, which would have equated to the netback European price at the time. The export price as of March, according to Gazprom's CEO, was $370 per 1,000 cubic meters.

*Because export price has risen so much the plan to raise domestic tariffs is too small and too slow*

**But slowed by inflation fears.** Two things are clear. One is that the price of gas sold to Russian consumers, especially business users which account for 80% of consumption, will have to rise faster than is currently scheduled. The second is that the schedule to achieve this will be extended as there is no way that the government will allow this to happen too soon given the detrimental effect this would have on inflation. The bottom line, however, is that Gazprom will sell the bulk of its gas to the domestic market at an faster rising price.

*But government is concerned over inflation impact*

**But tax rise put off.** The fear was that this rise would be matched with a hike in the tax take by the state, for example, if it wanted to give back some of the rise to residential consumers as a subsidy. Government officials talked about a windfall of $25 bln among the gas industry even at the lower 2011 price target. However, recent sound bites from the government suggest that any higher tax regime would be delayed for four or five years because Gazprom needs the cash flow to fund its huge capex program.

*Previous plan for windfall tax probably now put-off*

## DIVERSIFICATION

**More businesses.** Gazprom is also moving towards greater diversification in its gas business, both upstream geographically and downstream. Again, this is one strategy made clear over five years ago but not materially followed through due to a lack of clearance from the Kremlin or political wrangling. Now we see some greater progress in several areas:

*Growth seen in other business and product areas*

**LNG:** Gazprom will soon be in the LNG business as a result of its controlling stake in Sakhalin-2. Phase 2 of the Shtokman project is to supply gas to an LNG plant located either on the Baltic Sea coast or at Murmansk. The Baltic Sea plant is one of the companies "on-off" projects but the anecdotal evidence is that Gazprom is talking to potential partners. Previously the company said that it will build a plant there with an initial capacity of 7 mln tons. The company plans to spend $45 bln on LNG facilities up to 2030.

*Planning to spend $45 bln on LNG projects*

**International** As the Kremlin concludes trade deals with countries such as Libya and Algeria, reciprocal deals usually involve energy, with Gazprom as the contracted party. A recent deal with Libya is evidence of this trend, and we expect more of the same in deals with countries in the Persian Gulf and eventually with Nigeria.

*Expanding into countries such as Libya*

**Oil** See the "Oil Business" section below

**Downstream** Gazprom was aggressively rebuffed by Europe's legislators when it expressed an interest in acquiring downstream assets in the continent's largest gas-consuming countries. Suggestions that Gazprom was planning a bid in the UK provoked a wave of protests. But now we see a more effective model that could allow Gazprom to gain exposure to downstream in the UK, France and Italy. It already has a JV with BASF in Germany, and that model is likely to be replicated in the other countries, in our view. In exchange for accommodating a major energy partner from each country into an upstream project in Russia, Gazprom benefits by entering into a JV with the partner in their home country. Hence BASF, which owns a 25% stake in the Yuzhno-Russkoye project, has accommodated Gazprom with a significant minority stake in Wingas, a gas distribution company in Germany. Wingas will buy the Russian gas that arrives via the Nord Stream pipe and will sell it directly to consumers. We expect similar structures to be set up in Italy (with ENI), in France (with Total) and in the UK (with BP).

*Likely to barter an % position in downstream for % position in upstream in Russia*

**Other** Gazprom's other expansion projects, for example in the electricity and coal sectors, are outside the scope of this note.

*Electricity, coal, etc*

## GAS OPEC

**Taking a more active part.** The concept of an OPEC-style structure for the world's main gas producers has generated a great deal of debate since Putin described it as an "interesting idea." However, Putin has been very clear that he would not see this as a price cartel but rather as a group that could coordinate efforts to develop a more orderly export market for gas. This is particularly pertinent as the outlook is for a greater share of LNG in the global energy mix.

*Putin described it as an "interesting idea"*

**Informal structure in place.** A "gas OPEC" already exists in the form of the Gas Forum, set up by Qatar in 2001. It has no formal charter or structure but 14 gas-producing countries are members, and Norway has observer status. Russia would like this forum to be upgraded into a formal structure with a charter, etc. The idea is that countries capable of being big players in the LNG market should cooperate on technology and market development, with Russia, by virtue of his substantial market share, taking a leading role comparable to Saudi Arabia's influential role within OPEC.

*Gas Forum exists under guidance from Qatar*

**Develop an orderly market.** Working within a gas OPEC structure would allow Gazprom to develop its LNG business via cooperation deals with national energy companies from the other 14 member countries. This would mean sharing the burden of technology development, sharing costs and Gazprom extending its geographical reach by bartering equity positions in projects in Russia for equity positions elsewhere. It would also mean that, just as we see in the oil industry now, the drivers behind the development of LNG would be the producer countries rather than the international oil and gas companies.

*Plan is to share technology and develop orderly market rather than price fixing*

World Gas Reserves

| | tln cubic meters | % of total |
|---|---|---|
| **Russia** | **47.65** | **26.3** |
| Kazakhstan | 3.00 | 1.7 |
| Turkmenistan | 2.86 | 1.6 |
| Uzbekistan | 1.87 | 1 |
| Azerbaijan | 1.35 | 0.7 |
| **Total Central Asia** | **9.08** | **5** |
| Iran | 28.13 | 15.5 |
| Qatar | 25.36 | 14 |
| Saudi Arabia | 7.07 | 3.9 |
| U.A.E. | 6.06 | 3.3 |
| Nigeria | 5.21 | 2.9 |
| Other OPEC | 18.75 | 10.3 |
| **Total OPEC** | **90.58** | **49.9** |
| US | 5.93 | 3.3 |
| Norway | 2.89 | 1.6 |
| Australia | 2.61 | 1.4 |
| Malaysia | 2.45 | 1.4 |
| China | 2.45 | 1.4 |
| Others | 17.82 | 9.8 |
| **Total world** | **181.46** | **100** |

*Source: BP Statistical Review (2007)*

*Russia's position is totally dominant and more gas is likely to be found in Arctic region*

## OIL BUSINESS

**Expect developments with Gazprom Neft.** Gazprom is already a major crude oil producer by virtue of its ownership of Gazprom Neft and the 50% of Slavneft that it owns (with TNK-BP owning the other 50%). The company has ambitions to be a bigger player in oil and rumors have persisted for some time of a possible deal with TNK-BP. It is also not beyond the realms of possibility that the persistent rumor of a formal merger between Gazprom and Gazprom Neft may take place to create Russia's biggest oil producer. Certainly, escalating activity surrounding TNK-BP suggests that we are close to some resolution in what has been a long outstanding uncertainty. Resolving this difficult issue early in Medvedev's presidency must also be something that the government would welcome to head off any potential problems later.

*Long term market rumors of a possible tie-up with TNK-BP*

**State's share of oil output would rise:** A merged Gazprom Neft and TNK-BP would have average daily production of 2.7 mln bbl (as of the start of this year) vs. Rosneft's 2.3 mln bbl. Such a move would also mean that the state's share in oil production would rise from 44% to 60% (or from 47% to 63% if Russneft's production is eventually acquired by either of the state companies)

*Would make it Russia's largest*

**Serbian acquisition.** Gazprom is also acquiring oil assets in Europe and recently bought a 51% stake in Serbia's Nafta Industrija Serbije for EUR400 mln. We expect further foreign acquisitions.

*Recent deal for control of Serbia's national oil company*

**Russian Oil Production by Company**

| | | | Average daily vol., mln bpd | % of total |
|---|---|---|---|---|
| Rosneft | | | 2.3 | 23.3 |
| Gazprom | direct | 0.3 | | |
| | Gazprom Neft | 0.7 | | |
| | Slavneft (50% equity stake) | 0.2 | 1.2 | 11.3 |
| Tatneft | | | 0.5 | 5.1 |
| Bashneft | | | 0.2 | 2.3 |
| **Total "state" sector*** | | | **4.1** | **42.1** |
| LUKOIL | | | 1.8 | 18.3 |
| Surgutneftegaz | | | 1.3 | 12.8 |
| TNK-BP | direct | 1.4 | | |
| | Slavneft (50% equity stake) | 0.2 | 1.6 | 16.1 |
| Russneft** | | | 0.3 | 3 |
| PSA | | | 0.3 | 2.5 |
| Other | | | 0.5 | 5.2 |
| **Total "non-state" production** | | | **5.7** | **57.9** |
| **Total production** | | | **9.8** | **100** |

*Source: Russian Energy Ministry, CDU*

** "State" sector includes oil produced by companies controlled by regional administrations*

*** Russneft's oil production is expected to be sold by the courts and may be acquired by either Rosneft or Gazprom Neft*

*State's share now at 42%*

## RE-BRANDING

**A big part of the story.** Re-branding is the subject of the two op-ed pieces that follow in Appendix 1 and 2 in this note.

*See op-ed articles that follow in Appendix 1 and 2*

## APPENDIX 1: GAZPROM: RE-BRANDING A GIANT

Note: *Note: This op-ed article appeared in The Moscow Times on May 6*

The inauguration of Dmitry Medvedev will likely mark a turning point in how the world views Gazprom. For much of the past four years that view has been one of suspicion mixed with frustration as approval for projects that would increase the country's energy exports was often delayed while some political theater played out in the backdrop. More often than not, delays were also caused as the Kremlin "bartered" participation in Russia's upstream for a reciprocal position elsewhere in Europe's energy sector. The net result is that Gazprom, more than any other listed company, has become synonymous with the Kremlin and the country.

For investors this has meant prolonged periods during which Gazprom's share price has performed poorly. Today the world's biggest energy producer – on an oil equivalent basis it produces more energy every day than Saudi Arabia – is also one of the cheapest. That is the legacy of four years of project delays and the headlines generated by the Kremlin's often fractious relationship with Brussels. But today the message is much more positive. Real progress has been made towards starting work on major new production projects and the first battles in the "pipeline wars" have seen Gazprom score a decisive victory. The Kremlin's relationship with Europe, especially as the French are about to assume the presidency of the EU and Silvio Berlusconi is back at the helm in Italy, is considerably improved over the position this time last year. As much as anything else, President Medvedev is expected to preside over the "re-branding" of Russia on the global stage and in particular in the energy sector. That also means a major re-branding of Gazprom. This is how the value of the world's biggest energy company will rise towards the $1 tln mark targeted by the Kremlin; not by hoping for some valuation expansion with a secondary Asian listing, but by making progress on major energy projects, by expanding into higher margin businesses in Europe, by being at the forefront of the development of LNG. As we enter this new period in the development of the country, Gazprom will remain a clear proxy. For this reason it is one stock that is more than capable of at least doubling in price during the next presidency, in our view.

We can best describe the past eight years in Russia as the preparatory phase of the 20-year Putin Plan. At the beginning of Putin's first presidency the government's main priority was to stabilize the country and the economy after the chaos of the 1990s. It also recreated a very strong role for itself and its agencies in the economy and especially in the so-called strategic industries. The oil and gas sectors rank at the top of that list and are dominated by the two state-controlled energy companies, Gazprom and Rosneft. In practical terms this meant that while the Kremlin was busy renegotiating deals it viewed as disadvantageous, having been agreed under the weak government of the 1990s, it did not give its support for the development of any major new energy projects. This was despite that fact that quite a few major oil and gas deposits have been identified for more than a decade. Against that backdrop, and in light of steadily rising hydrocarbon prices, the energy fear-factor has been rising in the EU as in other major energy importers. The threat to Europe's gas supplies caused by Gazprom's efforts to reduce the gas volumes it sold at a substantial discount – a legacy of Russia's foreign-aid program and inconsistent with its obligation to shareholders – only served to heighten those fears. The share price suffered.

But today Gazprom has signed off on new pipeline routes that will reduce the EU's current vulnerability to the existing two gas export pipelines and eventually allow valuable gas exports to Europe – now accounting for the bulk of Gazprom's profits – to rise by 60% over the next seven years. It has secured contracts and pipeline routes in and out of Central Asia and is carving a leading role in the group of gas producing countries that wants to better coordinate the development of the gas industry, especially in LNG. As the spending/investment phase of the 20-year plan aims to wean the country from the commodity dependency that Putin inherited in favor of a more diversified economy, the country needs improved trade relationships and greater two-way investment flows. That is as much a guarantee of increased energy cooperation and progress in building new projects as any signed contract.

Gazprom's Yamal Peninsula project has been earmarked to replace the bulk of the expected decline from existing gas fields. Yamal's reserve base is 10.4 tln cubic meters and the field is projected to produce 150 bcm of gas (equal to Russia's total current export volume to the EU) by 2012, rising to around 250 bcm annually after 2020. The projected cost of developing this project is between $40 bln and $50 bln, and there are plenty of engineering challenges to overcome. We also expect this project to eventually be structured on the basis of a 50%+1 share for Gazprom and the remainder spread among several other (mainly European) companies. The involvement of Europe's big energy companies, often with an operational role, should raise the comfort level that we are now firmly into the new development phase.

## APPENDIX 2: RUSSIA'S ENERGY – LEVERAGE, NOT THREAT

*Note: This op-ed article appeared in the New Europe newspaper on May 3*

Russia has never used its energy resources as any part of either an economic or political threat. It did not do so during the Soviet era or during the eight years of Vladimir Putin's presidency and we do not expect it to during the presidency of Dmitry Medvedev. But the Kremlin has been using energy as the cornerstone of its plan to restructure the country away from commodity dependency and as leverage in its efforts to "internationalize" the economy. But as the new presidential term starts it also heralds a new phase in Russia's energy strategy. For the Kremlin, the hope is that by leveraging off its competitive advantage in oil and gas, the country will eventually gain much greater economic diversity and, hence, security. For Russia's neighbors, especially in Europe, this offers the probability of a higher level of energy security. The message remains clear: Both Russia and Europe have a lot to gain by "bartering" a new energy-for-trade/investment deal. Equally, both sides have a lot to lose by retaining existing barriers – including a suspicion about motives – or by building new ones.

Over the eight years of Putin's presidency, Russia considerably strengthened its position. It started preparatory work on several major new energy projects that have the potential to supply a sizeable part of Europe's future energy needs. It signed off on new pipeline routes that will reduce the current vulnerability to the existing two gas export pipelines. It secured contracts and pipeline routes in and out of Central Asia and is carving a leading role in the group of gas-producing countries that wants to better coordinate the development of the gas industry, especially in LNG. But Europe's bartering position is also stronger. It has what Russia now needs. As the spending/investment phase of the 20-year plan that is hoped will change the country from the commodity dependency that Putin inherited to one with a more diversified economy, the country needs an improved trade relationship and greater two-way investment flows.

We can best describe the past eight years in Russia as the preparatory phase of the 20-year Putin Plan. At the beginning of Putin's first presidency the government's main priority was to stabilize the country and the economy after the chaos of the 1990s. It also recreated a very strong role for itself and its agencies in the economy and especially in the so-called strategic industries. The oil and gas sectors rank at the top of that list and are dominated by the two state-controlled energy companies, Gazprom and Rosneft. In practical terms this meant that while the Kremlin was busy renegotiating deals it viewed as disadvantageous, having been agreed under the weak government of the 1990s, it did not give its support for the development of any major new energy projects. This was despite that fact that quite a few major oil and gas deposits have been identified for more than a decade. Against that backdrop, and in light of steadily rising hydrocarbon prices, the energy fear-factor has been rising in the EU as in other major energy importers. The threat to Europe's gas supplies caused by Gazprom's efforts to reduce the gas volumes it sold at a substantial discount – a legacy of Russia's foreign-aid program and inconsistent with its obligation to shareholders – only served to heighten those fears.

While few actually doubt Russia's willingness to maintain existing contracted export volumes, the increasing level of energy insecurity in Europe has grown partly because of the lack of major new investment in energy projects and the fact that the gas which Europe will need in the future remains snuggly under the ground. Without new investment Russia may soon not have enough gas to honor both existing export contracts and domestic demand. Without progress on new projects, there will not be enough new gas to meet Europe's likely future needs. But today the situation is actually much different. The long drawn out process to legislate the new "rules of the game" for foreign participation in Russia's energy sector has come to an end. Those rules are that either of the two state-controlled companies takes a 50%+1 share stake in all major projects and foreign companies take up to a 50%-1 share with others possibly taking a 25% stake and an operational role. This was the end result of the Sakhalin-2 restructuring and it is the structure of the Shtokman offshore project, which is expected to eventually supply 30 bcm of gas to Europe via the Nord Stream pipe and feed an LNG plant. Total, ENI, BASF, Shell, BP, StatoilHydro and other major European energy companies are all now working on projects structured in this way.

The major project to replace the expected decline from existing gas fields is Gazprom's Yamal project. Yamal's reserve base is 10.4 tln cubic meters and the field is projected to produce 150 bcm of gas (equal to Russia's total current export volume to the EU) by 2012, rising to around 250 bcm annually after 2020. The projected cost of developing this project is between $40 bln and $50 bln, and there are plenty of engineering challenges to overcome. We also expect this project to eventually be structured on the basis of a 50%+1 share for Gazprom and the remainder spread among several other (mainly European) companies.

Finally starting the development phase in these and other big projects addresses a big part of Europe's concern over the long-term reliability of Russia as an energy partner. The involvement of Europe's big energy companies, often with an operational role, should raise the comfort level even more. Signing off on the South Stream pipeline, albeit viewed with suspicion by officials in Brussels, is also part of the process of creating a better platform upon which to leverage future trade and investment deals in Europe. But of course the 30 bcm of gas that will eventually come through that pipeline network to distribution hubs in Austria, Serbia and Italy will also address the fears of future energy security. And yes, the Kremlin has leveraged off its historic ties in Central Asia to retain its key exporter role for gas from the region. It would have been foolish not to have done so. But none of this means that energy dependent countries in Europe have greater reason to worry about energy security. As Russia uses its energy platform as the basis for pushing more diversification and greater internationalization of its economy, a more balanced trade relationship will develop. The sooner that happens the less likelihood of a repeat of the situation this past winter when, as a result of supply cuts across the southern Caspian region, gas consumers in Greece were left holding, not so much the can, but a candle.

URALSIB Securities Ltd
Tower 42, 25 Old Broad St., London EC2N 1HQ, UK
Telephone: +44 (0) 20 7562 8000
Fax +44 (0) 20 7562 8099
Authorized and Regulated by FSA
Member Firm London Stock Exchange

URALSIB Capital LLC
8 Efremova Street, Moscow, Russia 119048
Telephone: + 7 (495) 788 0888
Fax: + 7 (495) 705 7010

Auerbach Grayson & Co.
25 West 45th Street, 16th Fl., New York,
New York 10036
Tel: +1 (212) 557-4444, Fax: +1 (212) 557-9066

## Disclaimer

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s) about the subject. The lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Opinions, estimates and projections in this report constitute the present judgment of the undersigned lead analyst(s) as at the date of the report. They do not necessarily reflect the opinions of URALSIB and are subject to change without notice. Name of lead analyst: Chris Weafer (Strategy).

This report is provided for informational purposes only. Under no circumstances is it to be used or considered as an offer or a solicitation of an offer to buy or sell securities.

Information and opinions contained in this report have been compiled by URALSIB from sources believed to be reliable and while all reasonable care has been taken in the preparation of this report, URALSIB makes no representation or warranty, express or implied, to its accuracy or completeness. Neither URALSIB nor its principals, employees, agents or affiliates accept any liability for any direct or consequential loss arising from any use of this report or its contents. Investors should make their own investment decisions using their own independent advisors, as they believe necessary and based upon their specific financial situations and investment objectives when investing. The information is the exclusive property of "URALSIB Capital LLC" and may not be reproduced or distributed without prior written permission.

URALSIB, their principals, employees, agents or affiliates may have positions or effect transactions in the securities referred to in this report and may engage in securities transactions with respect to securities covered by this report. They may also sell to or buy from customers on a principal basis and may serve as a director of issuers of such securities. Disclosures of conflicts of interest, if any, are listed below.

Investing in Russia and Russian securities may not be suitable for all investors and involves a high degree of risk. Investors should perform their own due diligence before investing, having due regard to their investment objectives and financial situation. Exchange rate fluctuations may affect the value of, and/or income from, securities denominated in currencies other than an investor's currency. Past performance is not an indication of future results necessarily. Prices of securities, income from an investment, liquidity and availability of securities are subject to change without notice. URALSIB has no obligation to modify, amend or update this report, nor to otherwise notify a reader of this report should any opinion, projection, forecast, estimate or other matter change or subsequently becomes inaccurate or if research coverage of the company by URALSIB ceases.

This report is not intended for the use of Private Customers as that term is defined under the Financial Services and Markets Act 2000. This report has been approved for publication in the United Kingdom by URALSIB Securities Limited, authorised and regulated by the Financial Services Authority and a member firm of the London Stock Exchange.

Additional information available upon request.



This report has been prepared by the correspondent of Auerbach Grayson & Company Incorporated named above on the date listed above. We are distributing the report in the U.S. and accept responsibility for its content subject to the terms as set within the report. Any U.S. person receiving this report and wishing to effect transactions in any security discussed herein should do so only with a representative of Auerbach Grayson & Company Incorporated. Additional information on recommended securities is available on request.

# Research
**+7 (495) 723-7020**

**Head of Research**
Konstantin Chernyshev, che_kb@uralsib.ru

**Strategy & Politics**
Chris Weafer, cweafer@uralsib.ru
**Economics**
Vladimir Tikhomirov, PhD, tih_vi@uralsib.ru
**Oil & Gas**
Victor Mishnyakov, mishnyakovvv@uralsib.ru
**Utilities**
Matvey Taits, tai_ma@uralsib.ru
Pavel Popikov, popikovpn@uralsib.ru
**Metals & Mining**
Michael Kavanagh, kavanaghms@uralsib.ru
Kirill Chuiko, chu_ks@uralsib.ru
Dmitry Smolin, smolindv@uralsib.ru
**Fixed Income**
Nadezhda Myrsikova, myr_nv@uralsib.ru

**Telecommunications, IT & Media**
Konstantin Chernyshev, PhD, che_kb@uralsib.ru
Konstantin Belov, belovka@uralsib.ru
Olesya Vlasova, vlasovaoa@uralsib.ru
**Consumer Goods & Retail**
Maria Startseva, startsevamv@uralsib.ru
**Banking**
Leonid Slipchenko, slipchenkola@uralsib.ru
**Real Estate**
Barry Schumaker, BSchumaker@uralsib.ru
Anatoly Vysotsky, vysotskyav@uralsib.ru
Oleg Plaksin, plaksinoo@uralsib.ru
**Equity Market, Indexes**
Vasiliy Degtyarev, Degtyarev@uralsib.ru

**Editorial & Production**

**English Language Editions**
John Walsh, walshj@uralsib.ru
Nathan Gardener, gardenern@uralsib.ru
**Internet / Design / Data**
Andrei Bogdanovich, bogdanovicas@uralsib.ru
Andrey Goncharov, goncharovai@uralsib.ru
Vladimir Kosyakov, kosyakovvs@uralsib.ru

**Russian Language Editions**
Julia Prokopenko, pro_ja@uralsib.ru
Andrei Pyatigorsky, pya_ae@uralsib.ru
Julia Kryuchkova, kru_jo@uralsib.ru
Olga Simkina, sim_oa@uralsib.ru
Yevgeny Grinkrug, grinkruges@uralsib.ru

# Equity Brokerage
**+7 (495) 788-0888**

**Head:** Mark Temkin, tem_ma@uralsib.ru

**Moscow**
Michelle Kelner
+7 (495) 723 7026
E-Mail: kelnerM@uralsib.ru

**London**
Ken Williams
+44 (0)20 7562 8012
E-Mail: kwilliams@uralsib.com

**New York**
Harold Warren
Direct: +1 (212) 453-3529
Trading: +1 (212) 557-4444
E-Mail: hwarren@uralsib.com

**URALSIB on Bloomberg: type USIB <Go> on your Bloomberg terminal**