

Russian gas tax policy

■ Industry Overview

Alert: Gas, condensate tax formula – Initial impression positive

New formula largely as expected: MinFin has posted on its website its long-awaited proposal for a formula-based mineral extraction tax (MET) for gas. Although detailed analysis is still needed, per Interfax, and confirmed with conversations with representatives of Gazprom (GAZP.MM; US\$4.07; 1) and Novatek (NVTQ.L; US\$106.30; 1), the formula appears to be largely as we had expected:

- It will go into effect from January 2014, replacing the existing explicit RUB/mcm levels approved last year (RUB700/mcm and RUB788/mcm for Gazprom, RUB471/mcm and RUB552/mcm for independents vs. 2013 levels of RUB566/mcm and RUB251/mcm, respectively);
- It will incorporate various drivers of field profitability, importantly including a direct link to realized prices, but also field complexity and other such issues; and
- It also applies a formulaic approach to the MET for gas condensate, and likewise generally confirms already approved levels for the next 2 years.

This is likely very close to the final version: Because this has been posted by MinFin, which is the hawk in the government on tax-related issues, and based on past experience, we think that the final, approved version of the formula will likely be very close to this proposal and that any modifications from here are unlikely to be worse for gas producers. A comment period for gas company and other expert feedback runs through June 5th.

Our take – Positive for both gas producers: Although it has been generally expected, we see the introduction of this formula as positive for the two major gas producers for the following reasons:

- **First: De-risks gas margins after 2015:** The currently approved tax levels only run through 2015. Gas price policy after 2015 remains something of a mystery, but by explicitly linking gas taxes to realized prices, we think the corresponding tax to go with any given price level is now largely de-risked. Additionally, this should give Gazprom more flexibility on taxation should oil prices and/or European realized gas prices go into decline.
- **Second: Condensate taxation also de-risked:** As the condensate MET is only c12% of the MET for oil, some investors were concerned a sharp tax increase could be forthcoming, which would have been particularly damaging for Novatek. For example, in the past* we have calculated that an equalization of condensate and oil MET would have cost Novatek c\$530mn in 2012 vs. EBITDA of c\$3.0bn. We did not expect a tax increase on condensate to happen for various reasons, but getting tax levels confirmed via an explicit formula should largely remove that concern from the market.

Ronald Paul Smith
+7-495-643-1581
ronald.p.smith@citi.com

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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*For more details on our expectations on the condensate MET, please see the following note, published March 19th: [Novatek OAO \(NVTkq.L\) - Growth to Return in 2013E; LNG, Tax Concerns Overdone](#).

Gazprom

Valuation

We derive our Gazprom target price of \$7.2 based on: 1) a DCF valuation of \$6.6, using a WACC of 10.3% and terminal growth of 3.0% (50% weight); 2) 2012E EV/EBITDA target price of \$7.0 based on a target multiple of 3.6x (25%); and 3) 2012E P/E valuation of \$8.3 based on a target multiple of 5.3x (25%).

Risks

Among the downside risks which could impede the shares from achieving our target price, we highlight the potentially higher taxes as the government searches for more revenue sources with which to plug a budget shortfall, lower European gas export price on the back of a weak crude price, faster-than-expected market share losses domestically as independent producers gain traction; a potential for significant increases in the company's cost structure; and, given the significant levels of capex for bringing new fields on stream to replace declining production at core West Siberian fields, and execution risk.

Novatek OAO

Valuation

We derive our Novatek target price of \$151/ADR based on: 1) a 50% weighting to a DCF value of \$161/ADR (3% terminal growth rate, WACC of 8.4%); 2) 25% weighting to 2013 target P/E multiple of 15.0x (\$140/ADR); and 3) 25% weighting to a 11.5x target EV/EBITDA multiples (\$142/ADR).

Risks

Among the key risks that could cause the stock to deviate from our target price, we highlight the following: 1) slower pace of gas market liberalisation and tariff hikes as approved by FTS; 2) Potential reversal of fortune on the policy management front, an area of remarkable strength of the past few years; 3) Standard oil & gas company risks relating to oil price and exchange rate volatility.

Appendix A-1

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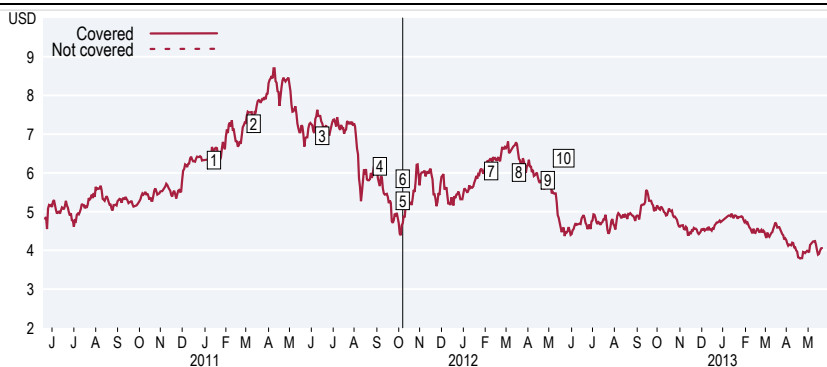
Gazprom (GAZP.MM)

Ratings and Target Price History

Fundamental Research

Analyst: Ronald Paul Smith

Covered since June 16 2011



	Date	Rating	Target Price	Closing Price
1	14-Jan-11	1M	*9.50	6.53
2	11-Mar-11	1M	*10.30	7.29
3	16-Jun-11	1M	*11.00	7.28
4	6-Sep-11	1M	*10.30	5.66

* Indicates change

	Date	Rating	Target Price	Closing Price
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	10.30	4.70
7	9-Feb-12	1	*8.00	6.36
8	20-Mar-12	*2	*6.50	6.36

	Date	Rating	Target Price	Closing Price
9	30-Apr-12	*1	*7.50	5.76
10	22-May-12	1	*7.20	4.59

Rating/target price changes above reflect Eastern Standard Time

Gazprom (GAZP.MM)

Ratings and Target Price History

Best Ideas Research Relative Call (3 Month)

Analyst: Ronald Paul Smith

Covered since June 16 2011



	Date	Rating	Target Price	Closing Price
1	13-Jul-11	*ADD MP	-	7.24

* Indicates change

	Date	Rating	Target Price	Closing Price
2	17-Oct-11	*REM MP	-	5.18

Rating/target price changes above reflect Eastern Standard Time

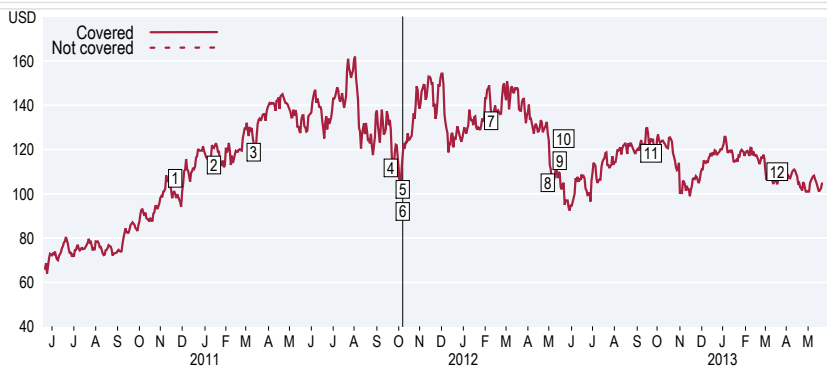
Novatek OAO (NVTQ.L)

Ratings and Target Price History

Fundamental Research

Analyst: Ronald Paul Smith

Covered since September 13 2011



	Date	Rating	Target Price	Closing Price
1	22-Nov-10	*2M	*107.00	99.90
2	14-Jan-11	2M	*125.00	120.70
3	11-Mar-11	2M	*130.00	122.70
4	21-Sep-11	*1M	*170.00	129.00

* Indicates change

	Date	Rating	Target Price	Closing Price
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	170.00	118.00
7	9-Feb-12	*2	*153.00	135.50
8	30-Apr-12	2	*149.00	127.10

	Date	Rating	Target Price	Closing Price
9	16-May-12	*1	149.00	109.30
10	22-May-12	1	*139.00	105.00
11	21-Sep-12	1	*153.00	125.00
12	19-Mar-13	1	*151.00	104.30

Rating/target price changes above reflect Eastern Standard Time

Novatek OAO (NVTQ.L)

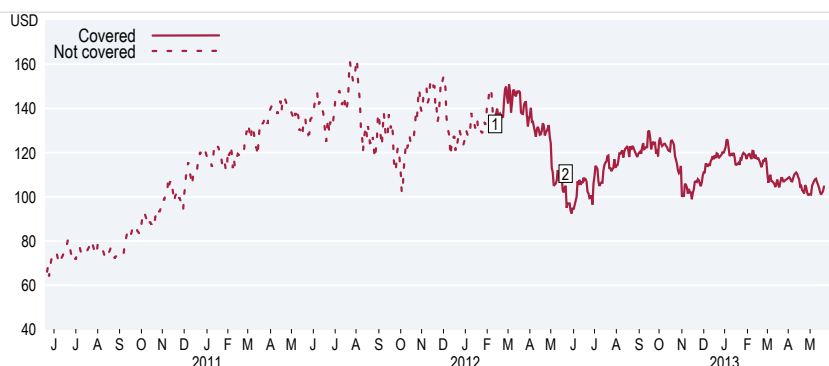
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Ronald Paul Smith

Covered since September 13 2011



Date	Rating	Target Price	Closing Price
1 13-Feb-12	*ADD LP	-	136.50

* Indicates change

Date	Rating	Target Price	Closing Price
2 22-May-12	*REM LP	-	105.00

Rating/target price changes above reflect Eastern Standard Time

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12 Month Rating			Relative Rating		
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48%	39%	12%	7%	87%	7%
53%	49%	43%	65%	49%	51%

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