

## OAO AK Transneft Outlook Revised To Negative On Similar Sovereign Action; Ratings Affirmed

### *Rationale*

On Oct. 24, 2008, Standard & Poor's Ratings Services revised its outlook on Russian pipeline operator OAO AK Transneft to negative from stable following a similar action on the sovereign. At the same time, the 'BBB+' long-term corporate credit rating was affirmed.

The outlook revision reflects the Russian government's diminishing ability to provide extraordinary support to Transneft. At the same time the possibility of the Russian government intervening negatively in Transneft's activities and forcing it to bail out or provide support to other entities is increasing.

The rating is supported by the company's unique market position as the key transporter of Russia's crude oil production to domestic and export destinations. Consequently, the company benefits from positive government support, including supportive tariff regulation. Transneft also benefits from a strong operating profile, historically cautious financial management, and highly competitive costs compared with those of shipping alternatives.

Constraining factors include risks associated with the company's major multibillion dollar capital projects, primarily the Eastern-Siberia-to-Pacific-Ocean (ESPO) pipeline. While debt-financed investments for the ESPO pipeline construction have already led to an anticipated increase in leverage, the tariff for the new route has not yet been determined. In addition, several other major projects including second stages of the Baltic Pipeline System and ESPO are currently under discussion in the Russian government, which could potentially further increase Transneft's investment program and consequently weaken credit metrics.

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### *Publication Date*

Oct. 24, 2008

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In first-quarter 2008, the company showed healthy operating results, with revenues increasing 17% year on year on the back of 19% tariff increase, while the operating margin remained a high 60%. Moreover, the 10% extraordinary tariff increase approved by the Federal Tariff Service starting from Aug. 5, 2008, should help offset interest rate increases on a credit line from state-owned Sberbank (not rated) and hefty Russian cost inflation. We expect the government to adjust the tariffs in line with Transneft's new investment mandates.

We believe the Russian government has the ability to enhance Transneft's stand-alone credit quality and we anticipate extraordinary state support for the company in a distress situation. The ongoing positive influence comes from the largely favorable, albeit opaque, regulation and tariff setting. This support is incorporated into Transneft's stand-alone credit quality, which we assess at 'BBB-'.

The rating currently factors in a further two-notch uplift for likely extraordinary state support, due to Transneft's strategic position as the delivery network for most of Russia's oil output and the resulting value to the government as a tool of its energy policy. Although still substantial, the government's ability to provide support is weakening, as highlighted by the negative outlook on the sovereign. We continue to use a bottom-up approach when analyzing the rating on Transneft. We differentiate the rating on Transneft from those on the Russian Federation (foreign currency BBB+/Negative/A-2; local currency A-/Negative/A-2; Russia national scale 'ruAAA') to reflect Transneft's position as a separate commercial entity facing both burdens and benefits from its relationship with the state. We acknowledge that future administrations might treat the company differently, should the country's political environment or energy policy change significantly. The company also faces the risks inherent in Russia's evolving regulatory and political environment.

### ***Liquidity***

Transneft's liquidity is adequate, taking into account strong state support. The company has a committed revolving credit line of Russian ruble (RUR) 145 billion (\$5.4 billion) from Sberbank, which matures in October 2014. Under this facility, the company can attract short- and long-term loans to finance its operations and investment projects, notably for the ESPO pipeline construction. Most of the short-term maturities of RUR56.5 billion as of Sept. 30, 2008, represent Sberbank loans under this line. This is offset by RUR33.5 billion in cash, stable monthly revenues of about RUR20 billion, and availability under the same line of approximately RUR75 billion.

As a weakness, we note that about 30% of Transneft's cash reserves are deposited in second- and third-tier Russian banks, which may be susceptible to the current financial market stress. We expect Transneft to be able to attract additional liquidity resources from state-owned financial institutions should the government require it to start other investment projects. In the longer term, the company may attract financing in the Eurobond market as it did in July 2008 when it floated its \$1.65 billion Eurobond despite already deteriorating financial market conditions. We expect the company's free operating cash flow to be heavily negative in 2009, due to ongoing investment activity.

### ***Outlook***

The negative outlook reflects our likely downgrade of Transneft if we also downgrade the sovereign, because the ability of the government and state-owned banks to provide extraordinary support to the company will diminish in such a scenario.

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The evolution of Transneft's stand-alone credit quality will depend on how ongoing investment projects (including the ESPO pipeline) proceed with regard to tariff levels and their structure, as well as crude volumes. We expect that the company will retain its position as Russia's sole oil pipeline network operator and thus its strategic importance to the government.

Unexpected variations in the company's investment policy could pressure the rating if not offset by increasing tariffs or other forms of government support, including potential acquisitions of troubled entities that the government wants to support, which could result in excessive debt increases.

***Ratings List***

Outlook Action/Ratings Affirmed

	To	From
OAo AK Transneft		
Corporate Credit Rating		BBB+/-Negative/— BBB+/-Stable/—
Ratings Affirmed		
OAo AK Transneft		
Senior Unsecured (4 issues)		BBB+
TransCapitalInvest Ltd.		
Senior Unsecured (4 issues*)		BBB+
*Borrower OAo AK Transneft.		

NB: This list does not include all ratings affected.

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