MOODY'S INVESTORS SERVICE

Credit Opinion: OAO AK Transneft

Global Credit Research - 24 Mar 2015

Moscow, Russia

Ratings

Category	Moody's Rating
Outlook	Negative
Corporate Family Rating -Dom Curr	Ba1
NSR LT Issuer Rating -Dom Curr	Aa1.ru
TransCapitalInvest Limited	
Outlook	Negative
Senior Unsecured	Ba1/LGD4

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Key Indicators

[1]**OAO AK Transneft**

	9/30/2014(L)	12/31/2013	12/31/2012	12/31/2011	12/31/2010
FFO Interest Coverage	8.6x	9.5x	8.2x	7.2x	6.1x
Net Debt / Fixed Assets	32.5%	32.8%	35.4%	36.3%	26.7%
FFO / Net Debt	50.4%	59.2%	48.6%	45.4%	57.1%
RCF / Net Debt	49.1%	58.4%	48.2%	45.2%	56.7%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- BCA and rating are capped by Russian foreign currency debt ceiling of Ba1 and aligned with sovereign rating

- Weakening of macroeconomic environment in Russia and developing tariff regulation

- Risk of government-encouraged upward revisions of a large investment programme

- Monopoly oil pipeline business in Russia

- Track record of managing investments and dividends in light of tariff dynamics

- Strong financial profile and liquidity position

Corporate Profile

Fully controlled by the Russian government (the latter owns 100% of its voting shares), OAO AK Transneft (Transneft) is the largest crude oil transportation company in the world, with a 53,606 km pipeline system servicing both Russia's domestic crude oil needs and export operations. In 2013, the company transported 481.1 million ton of crude oil, around 96% of which was Russian oil and 4% transit oil. Thus, Transneft transports around 88% of Russia's oil production volume. Transneft's natural monopoly business is fully regulated by the government. 2013 reported sales reached around RUB596.8 billion, or $18.7 billion (net of revenues from crude oil supplies to China, which are mirrored by the oil purchase costs, under 2009-dated $10 billion, 20-year loan-for-oil deal). Around 92.0% of the sales came from regulated oil transportation services, including 84.9% and 7.1% from oil and oil product transportation, respectively. Oil product transportation services are provided by OAO AK Transnefteproduct (Transnefteproduct) and its subsidiaries, which are part of the Transneft group and own a 19,146 km oil product pipeline network in Russia.

SUMMARY RATING RATIONALE

As Transneft is owned by the Russian government, we apply our government related issuer (GRI) rating methodology in determining the company's issuer rating. According to this methodology, the rating is driven by a combination of (1) Transneft's standalone baseline credit assessment (BCA) of ba1; (2) the Russian government's Ba1 bond rating with negative outlook; (3) high default dependence between the company and the government; and (4) the high probability of the provision of state support to the company in the event of financial distress.

On February 25 2015, we downgraded Transneft's issuer rating and senior unsecured rating of the outstanding $1.05 billion loan participation notes issued by TransCapitalInvest Limited, Transneft's special purpose vehicle (SPV), to Ba1 from Baa3 and converted into a corporate family rating (CFR). These actions were prompted by the downgrade of Russia's government bond rating to Ba1/NP from Baa3/Prime 3 (P-3) on Friday 20 February. Transneft's ratings were downgraded because of (1) the downgrade of the sovereign debt rating of Russia; and (2) severe deterioration in the operating environment for Russian corporates.

Transneft's BCA has been lowered to ba1 being capped by the Russian foreign currency debt ceiling of Ba1. The BCA assessment for Transneft factors in (1) the sustainability of its monopoly oil pipeline business in Russia; (2) a historically maintained linkage between investments and tariff decision, which, however, may be challenged by tariff-growth-capped regulation and indirectly affected by global oil market and weak domestic economic conditions; and (3) a likelihood of resuming pressures on the company's financial profile as a result of its large investment programme, which is associated with various risks, ranging from execution risk to those arising from additions to the company's list of investment projects, upward revision of programme costs and longer-than-expected payback periods.

DETAILED RATING CONSIDERATIONS

WEAKENING OF RUSSIA'S CREDIT PROFILE PROMTED DOWNGRADE OF TRANSNEFT'S RATING

The weakening of Russia's credit profile, as captured by the downgrade of the sovereign to Ba1 from Baa3, has prompted the rating action on Transneft as it faces an increasingly challenging operating environment in Russia.

The key drivers behind the downgrade of Russia's sovereign rating were (1) expectations that Russia's economic strength and medium-term growth prospects will weaken in spite of planned fiscal and monetary policy responses; and (2) the deterioration of the government's financial strength as a result of fiscal pressures and the continued erosion of Russia's foreign exchange (FX) reserves. Both these factors are also leading to heightened systemic risks for Russia's infrastructure and utility companies.

According to Moody's, the severe -- and likely to be sustained -- oil price shock, coupled with Russian borrowers' highly restricted access to the international market due to ongoing sanctions, is undermining economic fundamentals and increasing financial stresses on both the public and private sectors, contributing to the challenges for Russian infrastructure and utility companies. Moody's expects real GDP contractions of around 5.5% in 2015 and 3% in 2016, bringing real growth over the 10 years through 2018 to virtually zero.

STRONG BUSINESS FUNDAMENTALS DO NOT FULLY OFFSET REGULATORY RISK AND ECONOMIC WEAKNESSES

Transneft's monopoly oil pipeline system services Russia's oil industry, a world largest one and strongest in Russia, a major source of the national wealth. Transneft transports around 90% of Russia's oil production volume, with around 48% of the transported volume going for export. Transneft's consolidated revenue predominantly consists of that from oil and oil product transportation services, which is regulated, contributing to the company's cash flow generation sustainability.

However, we view Transneft's business risk as high compared with the relatively low risk of national regulated network operators in mature markets. The reason is that compared with developed regulatory regimes in mature markets, the regime in which Transneft operates is still developing and may be subject to political interference in the future.

We noted that tariffs for Transneft were historically supportive, despite the shortcomings of the regulatory environment as a whole such as unpredictability and lack of history of sustainable application. Historically, tariffs for Transneft were set to ensure that the company was able to cover its key operating costs, maintenance costs, taxes and interest costs on debts associated with new investment projects, whilst ensuring profitability. Nevertheless, we note that the linkage among tariffs and company's investment programs and profitability will get weaker if the economy deteriorated further and the government were to respond to increasing claims of the oil industry and seek to encourage oil production and economic growth.

INVESTMENT PROGRAMME MAY INCREASE TO SUPPORT GOVERNMENT'S POLICY

The key challenge for Transneft remains its investment programme of around RUB1,991.8 billion (around $33.2 billion at $/RUB exchange rate of 60) for 2014-20, with new pipeline projects accounting for around 31.8% of the total amount; modernization and reconstruction contribute approximately 68.2%. The programme reflects the government's ambitious objectives to speed up the development of the oil industry and strengthen the latter's international presence. Though we positively note that Transneft has completed a number of large projects and/or main stages of some of them (in particular the second phase of its key $23 billion Eastern Siberia Pacific Ocean - ESPO pipeline project), we understand that the company continues to implement several smaller projects and may consider a number of new ones. The composition of the company's portfolio of investment projects, including time schedule and amounts, is largely influenced by the state and may be adjusted to meet the state's interests. In particular, the programme has been recently supplemented by a RUB172 billion project to expand the capacity of the ESPO-1 pipeline to 80 million tonnes. At the same time, we understand that the payback of the ongoing projects remains dependent on domestic tariff regulation and oil market developments.

Given its continuing large investments, Transneft could see its commitment to a reasonably conservative financial profile challenged going forward, if the company were not additionally supported by the government in terms of the regulated tariffs and/or equity injections.

CLOSE ALIGNMENT OF CREDIT WORTHINESS WITH THE SOVEREIGN

Our assumption of a high level of default dependence between Transneft and the government incorporates their close economic and political relationship, with the government and Transneft sharing an exposure to the domestic oil business. The government's essential role in the markets for credit and foreign exchange also adds to this high level of dependence.

The high probability of state support factored in the rating reflects Transneft's significant importance to the development of the Russian economy, with the company being vital for the Russian trade balance. We understand that, currently, the Russian government does not plan to materially reduce its stake in Transneft over the next few years.

STRONG FINANCIAL PROFILE

Transneft's nine months 2014 last twelve months financial metrics are strong: funds from operations (FFO) interest cover was at 8.6x (FY2013:9.4x) , FFO/net debt of 50.4% (FY2013: 59.2%). The leverage measured by debt/EBITDA was 1.8x (FY2013:1.7x); all the mentioned metrics incorporate our standard adjustments. We expect that Transneft's credit metrics will remain solid in 2015 and stronger than required for BCA of ba1 however, company BCA is capped by the Russian foreign currency debt ceiling of Ba1.

Transneft is exposed to foreign currency risk as its debt is largely denominated in foreign currency, which may negatively affect its financial metrics in the current environment of devaluation of Russian rouble. Transneft has currently some flexibility to manage this risk given its relatively low cost of the debt, long-term debt maturity profile and sizable dollar-denominated cash reserves and liquid instruments, which, as of end-2014, more than covered foreign-currency debt maturities in 2014-15. Additionally, we understand that Transneft's needs in servicing US dollars denominated debt are currently more than covered by US dollar-nominated cash flow stream from oil sales to the People's Republic of China under a 20-year contract with CNPC until 2030.

Liquidity Profile

As of end-September 2014, Transneft had cash and cash equivalents of around RUB91.4 billion (around $2.3 billion). In addition, Transneft had a RUB313.8 billion (around $8.0 billion) liquid portfolio of notes and deposits mainly issued by Russian largest state-controlled banks This amount more than covers the company's short-term debt obligations as of the same date of around RUB167.3 billion (around 28% of total reported debt). Going forward, pressure could be exerted on Transneft's liquidity if the company were to become involved in an increasing number of investment projects and these were not supported by long-term credit facility agreements and/or financing schemes agreed with the state.

Rating Outlook

The negative outlook is in line with the negative outlook for the sovereign rating and reflects the fact that Transneft's ratings are capped at the Russian foreign currency bond ceiling, and any downgrade of the foreign currency bond ceiling would result in a downgrade of the company's ratings.

What Could Change the Rating - Up

There is low likelihood for any upward pressure on Transneft's ratings at present, given the negative outlook on economic conditions in Russia. Moody's could change the outlook on the ratings to stable if it were to change the outlook on Russia's government bond rating to stable, provided there was no material deterioration in company-specific factors, including operating and financial performance and liquidity.

What Could Change the Rating - Down

Negative pressure on Transneft's rating will develop in the event that Moody's downgrades the sovereign rating. The rating agency could also downgrade Transneft's ratings if the deterioration in the operating environment in Russia were to lead to a significantly weaker financial profile and increasing constraints on liquidity.

Rating Factors

OAO AK Transneft

Regulated Electric and Gas Networks Industry Grid [1][2]	**Current LTM 9/30/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 3/24/2015**	
Factor 1 : Regulatory Environment and Asset Ownership Model (40%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Regime	Ba	Ba	Ba	Ba
b) Asset Ownership Model	A	A	A	A
c) Cost and Investment Recovery (Ability and Timeliness)	Baa	Baa	Baa	Baa
d) Revenue Risk	Baa	Baa	Baa	Baa
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program	Ba	Ba	Ba	Ba
Factor 3 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	9.9x	Aaa	9x - 10x	Aaa
b) Net Debt / Fixed Assets (3 Year Avg)	32.8%	Aa	30% - 35%	Aa
c) FFO / Net Debt (3 Year Avg)	56.0%	Aaa	50% - 60%	Aaa
d) RCF / Net Debt (3 Year Avg)	55.1%	Aaa	50% - 60%	Aaa
Rating:				
Indicated Rating from Grid Factors 1-4		Baa1		Baa1

Rating Lift				
a) Indicated Rating from Grid		Baa1		Baa1
b) Actual Rating Assigned				Ba1

Government-Related Issuer	Factor
a) Baseline Credit Assessment	ba1
b) Government Local Currency Rating	Ba1
c) Default Dependence	High
d) Support	High
e) Final Rating Outcome	Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 9/30/2014(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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