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Ukraine-Russia gas deal

Discount of USD 121/tcm is realistic for 50% stake in GTS

- We estimate the ongoing Ukraine-Russian gas talks could result in a USD 121/tcm gas discount for Ukraine in 2012 from Russia in exchange for a 50% stake in its gas transportation system (GTS). The average 2012 price for imported gas, therefore, will be USD 295/tcm
- Our key assumption is a value of USD 11.0 bln for 50% of Ukraine's GTS, implied by benchmarking to Gazprom's 2007 acquisition of 50% of Belarus' Beltransgaz and Russia's alternative costs implied by the Nord Stream project. We expect the deal to be structured in two parts – a cash consideration (USD ~7.0 bln paid over a couple years) and the price discount
- Two key factors support our scenario: (1) Ukrainian politicians' need for the wider benefits of a discount ahead of next October's election such as less pressure on hryvnya and a less significant household gas tariff hike, and (2) Gazprom's acquisition of 100% in Beltransgaz indicates its strategic interest in control over transit systems in neighboring countries
- We note that our scenario is based on a significant number of unknowns, contradictory news flow and historically difficult and opaque arrangements
- Some of the potential prices given by Ukrainian politicians (including a discount of USD 192/tcm to USD 224/tcm in 2012) are blue-sky scenarios, in our view. Russia's leaders, on the eve of their March presidential election, are not ready to give any free handouts to Ukraine
- On the company level, the discount is positive for industrial users with gas-intensive businesses like chemical fertilizers (STIR UK), steel (AZST UK, ENMZ UK, ALMK UK) and sugar (AST PW), but negative for independent gas producers (JKX LN, CAD LN, RPT LN, KOV PW) whose sales price is capped by domestic market rates
- We also see benefits for the overall Ukrainian economy and fiscal sphere that might create downward pressure on the sovereign yield curve: (1) potential FDI from Gazprom and decrease in Ukraine's current account deficit, (2) cheaper gas for local industrial producers; and (3) no need for a substantial increase in household gas tariffs (~15% instead of 50%) to restart Ukraine's USD 15.5 bln IMF loan program

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We value 50% of Ukraine's GTS at USD 11 bln

We think the most likely outcome of ongoing talks between Ukraine & Russia on gas is a 50/50 JV to manage Ukraine's gas transit system (GTS) in exchange for a cash contribution from Gazprom and a discount on imported gas. We use Gazprom's acquisition of its first 50% stake in Belarus' Beltransgaz in 2007 as a benchmark scenario for Ukraine's GTS/gas deal.

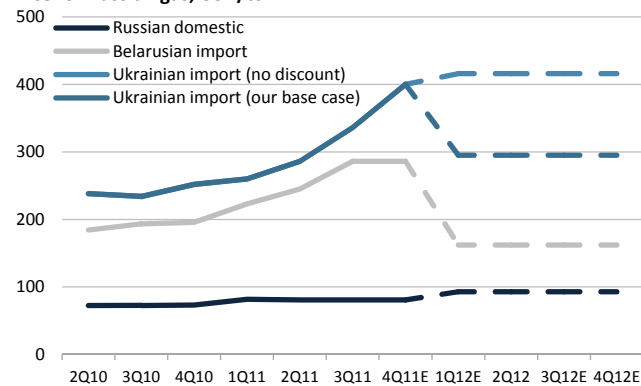
We present two valuation cases to estimate the possible value of 50% of Ukraine's GTS to Gazprom and Russia; the implied valuation range is narrow at USD 10.5 bln – USD 11.3 bln. We take USD 11.0 bln as our base-case assumption for 50% of Ukraine's GTS.

CASE 1: Benchmarking to Beltransgaz (2007): implied value of USD 10.5 bln

Belarus sold its first 50% stake in Beltransgaz, its gas transportation monopoly, to Gazprom in 2007 for **USD 7.5 bln**, according to our estimates, which consisted of:

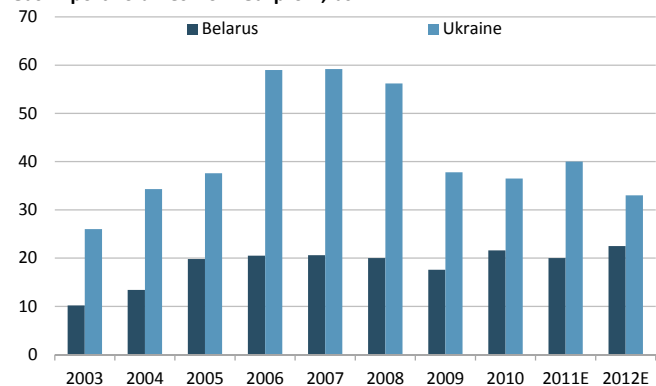
- USD 2.5 bln in cash, paid by agreement between Belarus and Gazprom based on the total valuation of the pipeline of USD 5.0 bln (reportedly valued by ABN Amro in 2006)
- USD 5.0 bln (estimated) in gas discounts for Belarus over 2008-2011. This is considered Gazprom's premium for access to the pipeline and perhaps a premium from Russia for geopolitical concessions

Price for Russian gas, USD/tcm



Note: Dashed line represents our forecasted price. Source: Gazprom, Bloomberg, Ukraine's Energy Ministry, Concorde Capital estimates

Gas import volumes from Gazprom, bcm



Source: Gazprom, Concorde Capital estimates

Ukraine's GTS is **2.8x** larger than Belarus', accounting for length and 2011 throughput. We acknowledge Belarus' case also partially reflects a political reward for integration into the Russian-led Customs Union and apply a **50%** discount to Belarus' deal. This implies total consideration of **USD 10.5 bln** for 50% of Ukraine's GTS: **USD 7.5 bln * 2.8x * (1 - 50%)**.

CASE 2: Nord Stream alternative costs: implied value of USD 11.3 bln

Ukraine's GTS also could be valued by the Russians based on alternative costs. In this case, benchmarking to Nord Stream project could be indicative. Total CapEx (net of capitalized interest) on Nord Stream, according to the project's website, is USD 10.0 bln (EUR 7.4 bln), or USD 181/tcm of capacity. Applying this multiple to Ukraine's GTS and adjusting the result by its modernization needs (USD 3.2 bln, based on Mott MacDonald estimates made in September 2011), we get an implied price of USD 11.3 bln for 50% of Ukraine's GTS.

Valuation summary

We take USD 11.0 bln, which is between the values implied by our two cases, as our base-case assumption for 50% of Ukraine's GTS.

Beltransgaz acquisition case (2007)

Estimated value of 50% in Beltransgaz, USD bln	7.5
Cash consideration, USD bln	2.5
Price discount, USD bln (est.)	5.0

Ukrainian GTS valuation by Beltransgaz

Ukrainian GTS size vs. Beltransgaz	2.8x
Assumed discount for Ukrainian GTS	50%
Implied value of 50% in Ukrainian GTS	10.5

Source: Company data, Concorde Capital estimates

Nord Stream case

Nord Stream parameters

Estimated CapEx, USD bln	10.0
Throughput capacity, bcm	55
Implied value per tcm, USD	181

Ukrainian GTS valuation by Nord Stream

Export capacity, EU, bcm	142
Assumed value per tcm, USD	181
Assumed replacement value, USD bln	25.8
Net modernization needs, USD bln	3.2
Assumed value of Ukrainian GTS, USD bln	22.6
Implied value of 50% in Ukrainian GTS	11.3

Source: Company data, Concorde Capital estimates

Price discount implied by Beltransgaz deal for Ukraine is USD 121/tcm in 2012

We expect the parties to structure the USD 11.0 bln for 50% of Ukraine's GTS in two parts – a cash consideration and gas price break – as Gazprom did to facilitate the Beltransgaz deal in 2007.

1. Cash contribution to JV: USD 7.0 bln

We assume Gazprom pays effectively for 50% stake in Ukrainian GTS in the form of cash. We expect the size of the cash consideration to be USD 7.0 bln, again benchmarking to the Beltransgaz case and adjusting for the size of Ukraine's GTS (USD 2.5 mln * 2.8x = USD 7.0 bln). Most likely, the payment will be split into a couple of annual tranches, like in Belarus' case.

2. Price discount: USD 121/tcm in 2012

The rest of USD 11.0 bln, or USD 4.0 bln will be paid in gas price discount, under our scenario. If the discount is paid over one year, and assuming 33 bcm in gas imports for Ukraine in 2012, we estimate Ukraine might get a discount of USD 121/tcm on gas next year. This would imply an average import price of USD 295/tcm next year.

Gas discount: good for hryvnya, sovereign yield curve and gas-intensive businesses; bad for independent gas producers

Positive for economy, short-term sovereign debt

A discount of USD 121/tcm on imported gas would have a hugely positive effect on Ukraine's trade balance and current account (about USD 4.0 bln) and financial account (USD 7.0 bln, to be spread over a couple of years). This will substantially ease depreciation pressure on the hryvnya and create downside pressure on the sovereign yield curve, with short-term papers affected the most.

Equity winners & losers

On the company level, the discount is positive for industrial users but negative for independent gas producers.

Winners

- + Chemical fertilizers producers (gas consists of 70-80% of costs). We estimate Stiroi's (STIR UK) EBITDA margin could increase by 22 pp compared to the no-discount scenario
- + Astarta (AST PW), which uses gas for sugar production. We think its EBITDA margin could improve 2.8 pp
- + Steel makers, Azovstal (AZST UK), Yenakieve Steel (ENMZ UK) and Alchevsk Steel (ALMK UK), each could add 2.0 pp to their EBITDA margins
- + In the fixed income universe, beneficiaries include Naftogaz (NAFTO) and basic materials names Metinvest (NETINV) and Ferrexpo (FXPOLN) and to a lesser extent all other Eurobond issues due to a potential shift in the sovereign yield curve

Losers

- Independent gas producers, whose gas sales price is capped by domestic market rates and is linked to the price of gas imported from Russia. We estimate the discount could decrease revenue by 18-22% for JXX Oil & Gas (JKX LN), Cadogan Petroleum (CAD LN), Regal Petroleum (RPT LN) and Kulczyk Oil Ventures (KOV PW).

Key limitations to our scenario

- Gazprom could value Ukraine's GTS higher than we did as costs of new alternative routes for gas transportation could be more than for Nord Stream. In addition, Ukraine's GTS has huge gas storage capacity (31 bcm vs. benchmark's Beltransgaz 0.7 bcm in 2006 and 1.8 bcm now). Both of these factors were ignored in our approach.
- The size of Gazprom's cash contribution and price discount could vary considerably from our scenario, especially in light of Ukraine's requests for a high discount. Still, we believe it is politically important for Russia, which has more bargaining power in negotiations, to give Ukraine a smaller discount than is being thrown around in public by Ukrainian officials (i.e. prices of USD 224/tcm – USD 250/tcm and discounts of USD 192/tcm – USD 166/tcm). This is important due to the upcoming presidential elections in Russia - a tough position toward Ukraine earns candidate Vladimir Putin more political points.
- The timeline for a potential deal is unpredictable, and there is a risk negotiations and the process of valuation of Ukraine's GTS could drag on for the foreseeable future. The experience of gas deals with Russia suggests that even though a decision could be made next year, the new price could be applied to all gas supplies in 2012.

Key risks to our estimates

- Divestment of any part of Ukraine's GTS requires changes to legislation that currently prohibits the transfer of Naftogaz of Ukraine's assets. Technically, the ruling Party of Regions could push necessary legislative amendments through parliament within a couple weeks time, but the deal would be politically unpopular as the GTS is regarded to be a strategic state asset.
- Establishment of a 50/50 JV to manage Ukraine's GTS with Gazprom is a major legal issue and its lawfulness would be carefully analyzed by critics and future governments. The trial and seven-year sentence handed down to former Prime Minister Yulia Tymoshenko for exceeding authority for her role in a 2009 gas deal with Russia set a precedent and might discourage current officials from assuming responsibility for controversial actions.
- Transfer of a stake in Ukraine's GTS to Russians would inevitably hurt the Party of Regions' approval, especially in the central and western parts of Ukraine.
- Ukraine would likely violate Europe's Energy Charter, of which it is a signatory, in transferring 50% of its GTS to Gazprom.
- Our scenario assumes the new deal will only amend existing gas contracts, while theoretically Ukraine and Russia could scrap all existing deals and prepare a new one completely from scratch.

Appendix: News flow on the gas deal

<i>Date</i>	<i>News</i>
Nov. 15	Ukraine may receive USD 220-230/tcm gas import price in 2012 <i>Undisclosed source (Ekonomicheskoye Izvestiya)</i> "In case of successful negotiations, [...] Ukraine could save up to USD 6.0 bln with gas price discounts in 2012" <i>Ukrainian Prime Minister Mykola Azarov (Ukraine's 1st TV channel)</i>
Dec. 10	Russia is preparing international agreement with Ukraine to: - create a 50/50 JV to manage Ukraine's GTS - possibly later some EU companies would join the JV with EU/Russia/Ukraine stakes to be 33/33/34 - another 50/50 JV will be made to operate Ukraine's gas distribution networks - no price discount is discussed in preliminary documents <i>Undisclosed source (Zerkalo Nedeli)</i>
Dec. 12	"There will be no New Year Gift [to Naftogaz]" <i>Gazprom CEO Alexei Miller (Interfax)</i>
Dec. 13	"If we will have to pay USD 400/tcm for [Russian] gas, we will pay." <i>Ukrainian Prime Minister Mykola Azarov (Interfax)</i>
Dec. 14	"In case of success, Ukraine will pay USD 224/tcm to Gazprom in 2012." <i>Ukrainian Deputy Energy Minister Volodymyr Makukha (RIA Novosti)</i>
Dec. 15	USD 416/tcm for Russian gas in 2012 is assumed in the draft of Ukraine's state budget <i>Ukrainian Prime Minister Mykola Azarov (Interfax)</i>
Dec. 21	"We believe Ukraine's [gas] price should not be higher than USD 250/tcm." <i>Ukrainian President Viktor Yanukovich (Interfax)</i>

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