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Davy Research

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Flash Note: Company update

Petroneft

Price: **31p**

Surprise pipeline arrangement with Bashneft dramatically improves project economics

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Share Price Performance

Company data	
Reuters/Bloomberg/Xetra	PTR.L/PTR LN/P8ET
Sector	Resource
Shares (m)	192.0
Daily No. Shares Traded (m)	0.448
Free Float (%)	53.4
52 Week High/Low	63.75/28
Capital Structure	
Mkt. Cap (£m)	59.0
Net Debt/(Cash)	6
Deferred consideration	N/A
Pref Shares/Non Eq Min	N/A
Minority interests	N/A
E.V. (£m)	50.1

Recent research and research resources

Recent research and financial data on *Petroneft*
Sector research and data on *Resource*

Agreement reduces capital requirement significantly

- Petroneft will build a 60km pipeline north from its 100%-owned Lineynoye oil fields in the Tomsk Oblast region of Russia to the Lukpaiskaya pumping station owned by Bashneft, a state organisation. Bashneft will then transport Petroneft's oil to the main Transneft pipeline system.
- We estimate a capital cost of approximately $25m for the pipeline and associated infrastructure.
- Prior to this, we estimate that Petroneft was planning to spend approximately $75m on a 156km pipeline to the south, which included an Ob river crossing and a complex custody transfer station.

Tariff structure very favourable

- Bashneft will charge Petroneft a tariff based on actual costs in proportion to transferred amounts but will not exceed the tariff for a similar Transneft segment.
- This allows some room for inflation but caps the tariff at the Transneft rate, which is very favourable.

Deal greatly increases likelihood of full production in 2009

- Petroneft can now develop its licence in phases from the north, starting with its Lineynoye and West Lineynoye fields. Existing fields to the south (Tungolskoye) or potential new fields (Korchegskaya and West Korchegskaya prospects) can then be developed incrementally.
- A pipeline to the north simplifies the project's commercial and technical aspects. There is less funding required, and the terrain to the north is more favourable for pipeline construction than that to the south.
- This is expected to facilitate timely ordering and construction of the pipeline to ensure that the target of full-scale production in 2009 is met.

Reduced capital and operating costs

Until now, Petroneft had been considering either building its own pipeline to the south, across the river Ob, to the Roskino pumping station (156km in total) or entering into a tariff agreement for capacity in pipelines to the south owned by other local operators.

Both of these options had drawbacks:

- The capital cost of building the pipeline was high (these costs had increased dramatically over the past year, and we estimate that they were likely to have been in the region of $75m), necessitating a higher degree of certainty in the licence's oil reserves to justify the expenditure.
- Entering into a tariff agreement would have exposed Petroneft to potentially unfavourable terms in the future with no alternative routes to market.

However, the protocol of intent signed by Petroneft and Bashneft, which defines the details of the infrastructure sharing agreement, counters both of these concerns:

- Building a shorter pipeline (and using a simplified custody transfer scheme) reduces Petroneft's capital commitment by approximately $50m. Petroneft reports that the pipeline economics are positive based solely on the known reserves in the Lineynoye and West Lineynoye oil fields in the north of the licence.
- Oil fields further south of the licence (Tungolskoye and potentially Korchegskaya among others) can be developed incrementally over time to optimise the overall economics for the company (Petroneft may alter its proposed work programme in light of this; Tungolskoye #4 testing has been delayed until February 2008).
- Bashneft is a government-controlled oil and gas producing company whose production in the region is declining. It needs Petroneft's oil to keep its pipelines full (and to contribute to its fixed costs) and has agreed to a long-term tariff agreement that is very favourable for both Bashneft and Petroneft.

Tariff terms very favourable

The tariff for this operation will be calculated based on actual costs in proportion to the amount transferred but will not exceed the Transneft tariff for a similar pipeline segment.

- We had previously estimated public domestic transport costs (within the Transneft system) to be approximately 60c per barrel.
- We expect the cost of this private transport (to get to the Transneft system) to be relatively small compared with this figure.
- We believe that Petroneft has secured better terms by dealing with a government-owned company than would have been possible in a private deal.

Supports full production in 2009

The lower capital cost of the pipeline reduces the reserve threshold required to begin the development phase and should facilitate the timely ordering of the pipeline. Combined with the relatively straightforward pipeline route (compared with the previously proposed pipeline to the south), this deal is expected to facilitate the start of full-scale production from Licence 61 in 2009.

Valuation – reserves now worth more

- Petroneft is currently trading on an EV per 2P barrel basis of approximately $3.50/bbl (based on 2P reserves of 33mmbbls of oil).
- An updated reserve report by Ryder Scott is expected in early January 2008. We expect a significant upgrade of 2P reserves in this report after 2007 drilling success. However, we suspect that the market is already partly discounting this success in the current share price (so the EV/2P figure will fall when the new reserves are confirmed).
- Today's pipeline agreement increases the likelihood of Petroneft's reserves being extracted in 2009 and also improves the economics of that extraction. The market should therefore pay more for these reserves, and this should be reflected in a higher share price.

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