

Energy (Oil & Gas)/  
Electric-Corporate  
Special Report

## Central European Oil and Gas and Electricity Sectors – Outlook for 2007

### Analysts

Arkadiusz Wicik, CFA  
+48 22 338 6286  
arkadiusz.wicik@fitchratings.com

Andrew Steel  
+44 20 7862 4086  
andrew.steel@fitchratings.com

### Contents

Summary.....	1
CE Oil Sector.....	2
Focus on E&P.....	2
Expected Solid Profitability in 2007.....	2
At What Stage is the Refining Cycle? Sector Consolidation Pursued by Main Players.....	2
Capex Expected to Grow.....	3
Privatisation Plans.....	4
CE Gas Sector.....	4
Security of Oil & Gas Supply.....	4
Outlook.....	4
CE Electricity Sector.....	4
Consolidation and Privatisations.....	4
PPAs in Poland.....	5
Increasing Power Prices and Cross-Border Trade.....	5
Significant Investment Needs.....	5

### ■ Summary

In this special report, Fitch Ratings examines some of the key factors and drivers likely to affect the credit outlook for the Central European (“CE”) oil, gas and electricity sectors in 2007.

Fitch believes that in 2007 the focus will be on sector consolidation, either by cross-border acquisitions or creation of vertically integrated state-owned power groups; continued privatisation in some CE countries; expected cash flow generation; leverage trends among the largest players; as well as sizeable investment needs in the electricity sector and, to a lesser extent, in the refining sector.

Fitch views M&A activity as a major credit driver for the region in 2007. The agency notes that the largest players in the region, including Austria’s OMV AG, MOL Hungarian Oil and Gas Plc (“MOL”) and the Czech Republic’s CEZ, a.s. (rated ‘A-’), have low leverage and some flexibility to conduct debt-funded acquisitions without the risk of credit deterioration. The exception is Poland’s PKN Orlen S.A. (“PKN”, rated ‘BBB’) which is on Rating Watch Negative due to the acquisition of Lithuania’s Mazeikiu Nafta AB (“MN”, rated ‘B+’) refinery, the largest transaction in the CE oil and gas industry in the past few years.

Overall, Fitch sees CE as a region of high GDP growth potential – it is expanding twice as fast as much of Western Europe. This will have a direct impact on growing demand for power and refined products. When coupled with improvements in the legal framework, business climate and economic stability, mostly due to the EU accession– and with Romania and Bulgaria set to join the EU in 2007 – this makes the region attractive for foreign investors, including western Europe-based utility companies.

Fitch expects that the major CE players will become more debt-hungry in the coming three to five years, given their ambitious capex plans and expansion strategies. The strongest credits in the region are likely to obtain external funding with tight credit spreads, given strong investor appetite for quality CE issuers.

Consolidation of the CE oil and gas sector is also expected to continue in 2007-2008, mostly as a result of further acquisitions conducted by the regional leaders including OMV and MOL. The Polish refiner PKN, though, will shift its strategic focus to balance sheet de-leveraging and the integration of MN. In addition, Russian OAO LUKoil (rated ‘BBB-’), which already owns two refineries in Bulgaria and Romania, and a petrol station network in CE, plans to expand further in the region.

Fitch currently rates eight companies operating in the CE oil and gas and electricity sectors – see the table in Annexe 1 at the end of this report.

■ CE Oil Sector

Focus on E&P

For most large CE oil companies, the refining and marketing segment (“R&M”, including petrochemicals) is the main profit contributor. For companies like PKN, MN or the Rompetrol Group N.V. (“Rompetrol”, rated ‘B-’), this generated virtually 100% of EBITDA in Q106-Q306. For MOL, R&M accounted for 50% of EBITDA in the same period.

The exception is OMV, whose refining segment generated 17% of EBITDA in Q106-Q306, while its E&P segment generated 81% – mostly due to the contribution from its Romanian subsidiary Petrom.

Fitch expects that some CE companies will seek opportunities to shift their business profile from pure R&M into a combination of R&M and exploration and production (“E&P”) businesses. For example, PKN, which is to date the only large company without E&P operations, announced in early 2006 a strategic plan to enter E&P and to gradually increase its contribution to group cash flow (with a target 21% integration ratio by 2015).

Fitch views investments in E&P as high risk, as it is a difficult segment where risks should be shared with capital partners, especially when companies do not have a strong track record.

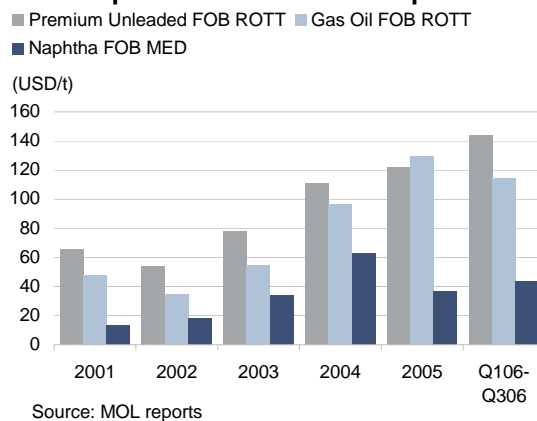
In addition, in the current environment of high crude oil prices, the risk of overpaying for upstream assets is considerable. MOL, which already operates in the E&P business (which contributed 29% of EBITDA in Q106-Q306) plans to grow this segment. MOL’s strategy assumes a tripling of hydrocarbon production by 2010 and to increase contribution from this segment to above 40% of EBITDA.

Expected Solid Profitability in 2007

Fitch expects CE oil companies to report solid cash flow generation in 2007. Refining margins, which are the main profit driver for most companies in the region, are expected to stay considerably above the long-term average, although lower than in the record year of 2005 and strong 2006 period.

Additionally, most refineries in the region will continue to capitalise on their ability to refine heavier and cheaper Russian crude oil and produce good quality products. This should result in further margin enhancement on the back of the high discount of Russian REBCO (Ural Blend) to Brent

**Crack Spreads on Fuels and Naphtha**



crude. This discount averaged USD4/bbl in Q106-Q306 compared with the five-year average of USD2.4/bbl.

Crude oil prices are projected to remain high in 2007 and Fitch expects companies operating in the E&P segment to report strong profitability. Fitch’s 2007 price deck<sup>2</sup> for crude oil is USD50/bbl (NYMEX-WTI), which is considerably above the breakeven price at CE companies’ upstream businesses.

Fitch believes the CE refining sector has favourable fundamentals for existing refining companies. This is largely due to lower levels of competition than in Western Europe – in part because of the landlocked position of some refiners – and to the growing demand for refining products on the back of strong GDP growth and increasing car usage across the region. The petrochemicals business, though highly cyclical, is expected to see a marked growth in demand for polyolefins over the next five years.

At What Stage is the Refining Cycle?

Refining is a highly cyclical industry, and it should be noted that the current upturn in margins has been of a fairly long duration. This upturn began in 2003 and is unlikely to be reversed in the short term as the rate of refinery capacity expansion is unlikely to outpace the growth in demand.

Though refining supply and demand in CE is fairly balanced, global lack of refining capacity is expected to be sustained until new refineries come on stream closer to 2008 and 2009.

Refining margins have already started to ease moderately in 2006 and are expected to decline more significantly around 2008-2009. It is also likely that

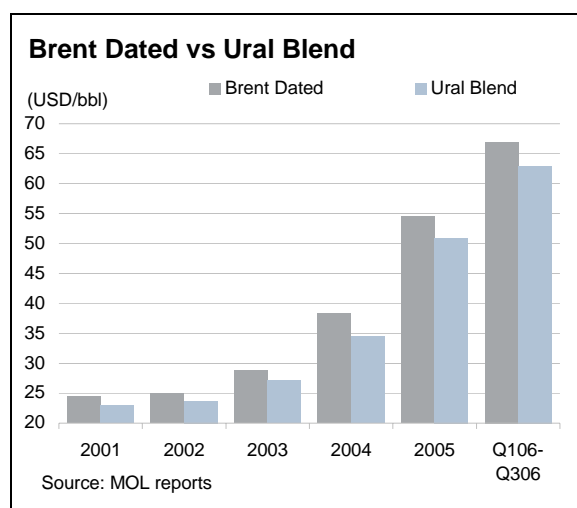
<sup>1</sup> The integration ratio is defined as the relation of E&P production to refining throughput.

<sup>2</sup> Fitch’s price deck is used primarily for modeling and rating purposes (and is intended to represent a conservative scenario).

global refining margins may be hit substantially around 2010-2012 when new refining capacity in the Middle East comes on stream.

The Russian oil discount is also expected to narrow over time from the current USD4/bbl to USD2.5/bbl-USD3/bbl by 2008 given the planned increase in refining throughput in Russia and higher demand for Russian crude from China. Therefore it is important for CE refiners to invest cash surplus<sup>3</sup> generated in 2006 into refinery upgrades or other projects that will enhance their business profile, such as successful investments in the oil upstream business or development/ refurbishment of retail networks.

Fitch's approach to refining companies is based on the principle of rating through the cycle, which assumes analysis of mid-cycle financial profiles, for example five-year average cash flows and leverage. Therefore the agency does not expect rating downgrades to occur due to the upcoming period of lower refining margins in 2008-2009, unless margins drop dramatically to the levels seen in 2002. The key rating driver is expected to be M&A activity.



#### Sector Consolidation Pursued by Main Players

Fitch expects consolidation in the CE oil industry to continue, driven mainly by the three largest players in the region, OMV, PKN and MOL, which have expanded their footprint significantly in the past five years due to regional acquisitions. Given limited growth opportunities in their home countries, the largest three players are expected to continue making cross-border acquisitions. They are well positioned to take part in regional consolidation given their experience, regional presence, scale and financial profiles. In addition, the main players may expand outside CE given limited acquisition targets in the region. This may include E&P investments in Russia, Kazakhstan and the Middle East. OMV's acquisition

of a 34% stake in the largest Turkish fuel distributor Petrol Ofisi A.S. (rated 'BB-') in H106 is an example of expansion beyond CE.

Worth noting is that OMV, PKN and MOL are committed to maintaining solid financial profiles. In fact, PKN and MOL see the maintenance of an investment-grade credit rating as part of their strategy. If sizeable debt-funded acquisitions are pursued, these companies aim to deleverage to their gearing targets, which is the case with PKN after the MN acquisition. Fitch notes that OMV and MOL have considerable headroom for acquisitions given their low leverage (at end-Q306, MOL had net cash surplus of USD553m, while OMV had a gearing ratio of 5%<sup>3</sup> versus a 30% target gearing).

OMV and PKN are expected to devote considerable time in 2007 to restructuring and integrating their recently acquired assets – Romania's Petrom in the case of OMV and the Czech Republic's Unipetrol and Lithuania's MN in the case of PKN. MOL is likely to invest the proceeds from planned disposals of its mid-stream gas assets to E.ON Ruhrgas into upstream business and R&M.

#### Major Recent Acquisitions in CE

Date	Company	Target	Amount
Dec 2006*	PKN	84.4% of MN	USD2.3bn
Mar 2006	E.ON Ruhrgas	MOL's gas midstream business	EUR1bn**
Apr 2006	Enel	66% of SE	EUR840m
Mar 2006	OMV	34% of Petrol Ofisi	USD1.054bn

\* Expected closing of the transaction, \*\* initial purchase price including assumed debt  
Source: Fitch, based on company press releases

#### Capex Expected to Grow

Capital expenditure is expected to rise in the CE refining segment as companies aim to change refined product yield due to increasing demand for middle distillates at the expense of petrol. They are also continuing to upgrade their refineries to produce cleaner fuels according to stringent EU 2009 standards. In addition, some refineries, including PKN, MN and Rompetrol, have earmarked considerable capex to be spent in the petrochemicals segment over the next three to four years.

Fitch believes that increased capex spending should not affect the credit standing of major CE players, provided that it is funded mostly from cash flow from operations and that it enhances the business profile.

<sup>3</sup> At end-Q306 OMV's leverage, excluding cash held at its Romanian subsidiary Petrom, was 24%.

### Privatisation Plans

The privatisation drive in 2007 is expected to switch to the Balkans. The Serbian government plans to sell oil company NIS, while the Croatian government may sell a further stake in Croatian oil and gas company INA after its recent IPO (MOL already owns a 25% plus one share stake in the company).

### ■ CE Gas Sector

#### Security of Oil and Gas Supply

Fitch views the CE region as highly reliant on supplies of oil and gas from Russia. Pipeline deliveries from Russia meet almost the entire gas demand in some countries and 100% of crude oil demand in some regional refineries.

The agency expects discussions related to CE's diversification away from Russian crude oil and gas to continue in 2007, fuelled by interruptions in gas supplies in early 2006 and stopped pipeline deliveries to MN in July 2006. The Russian approach to the delivery of natural resources to CE may suggest that political considerations outweigh economic needs in some cases.

Some projects, for example the Nabucco pipeline, may gain momentum. The EUR4.6bn project, transporting Caspian and Middle East gas through Turkey, Bulgaria, Romania and Hungary to Austria – and with a capacity of 30bcm – is planned to be completed in 2011. In addition, liquefied natural gas (“LNG”) terminals are on the discussion table, including one in Croatia and one in Poland.

Nevertheless, given significant gas reserves in Russia and relatively low transportation costs through existing gas pipelines, OAO Gazprom (rated ‘BBB-’) is expected to continue to be the major gas supplier to CE in the foreseeable future. In the case of crude oil, as previously mentioned, CE refiners will continue to benefit from price differentials, albeit narrowing, between Brent crude and Ural Blend.

#### Outlook

The credit outlook for CE gas companies is stable, but it varies according to a company's ability to pass on rising imported gas prices to final customers. There has been increased government pressure in some countries, for example Slovakia, to extend the state's influence over energy price-setting in order to reduce prices – or at least to reduce increases in the gas prices paid by end-users, given significant growth in gas costs over the past few years.

In some cases, the risk of gas cost pass-through to end-users is mitigated by a company's profitability

from other segments, for example revenues from pipeline transit business from Russia to western Europe in the case of Slovakia's Slovensky plynarensky priemysel, a.s. (“SPP”) (rated ‘A’) or indigenous oil and gas production in the case of Poland's PGNiG.

Fitch expects competition to gradually increase once the markets are fully liberalised, starting from July 2007. This is when households will have the right to choose their gas supplier. Nevertheless, Fitch does not expect material losses in gas incumbents' market share – at least in the first few years after liberalisation.

### ■ CE Electricity Sector

#### Consolidation and Privatisations

The power sector in CE, which remains far more fragmented than in Western Europe, is expected to see some consolidation. CEZ, the largest power group in the region, plans to continue its cross-border expansion.

Having completed the acquisition in 2006 of Bulgaria's 1,260 GW Varna power plant and two Polish power plants, CEZ recently announced a EUR1.5bn investment in a new coal-fired power plant in Bosnia and Herzegovina.

CEZ has sizeable headroom to increase leverage and maintain its ‘A-’ rating. Its net debt/EBITDA ratio stood at 0.8x at end-Q306, which is far below average among leading western European utilities (around 2.5x). CEZ states it has additional borrowing capacity of EUR4bn through to the end of 2009.

Furthermore, a number of established western European players have expressed an interest in entering or expanding in the CE market through privatisations and/or acquisitions. This includes Enel SpA (rated ‘A+’), which completed the acquisition of a 66% stake in Slovak power generator Slovenske Elektrarne, a.s. (“SE”, rated ‘BB+’) in 2006. Germany's E.ON AG (rated ‘AA-’), which owns stakes in a number of power distributors in the region, has recently announced plans to build a 400 MW combined-cycle gas turbine (CCGT) plant in Hungary.

The power sector in most of the CE countries remains largely state-owned (Poland, Hungary) or controlled by the state (Czech Republic, despite partial privatisation of CEZ). Slovakia is the first country that allowed a sale of a controlling stake in a key power group (in this case, SE) to a foreign investor. The privatisation of electricity sectors in

2007 is expected to take place mostly in south-eastern Europe, especially in Romania and Bulgaria.

In 2007, the fragmented electricity sector in Poland is expected to see consolidation into four large integrated power groups. According to the government plan, two of these will remain state-controlled as strategic assets, while two smaller ones may be privatised in the coming years. Two larger groups will be formed by creating a holding structure comprising PSE (without its unbundled transmission company), BOT and eight local power distributors, and another will be created to include PKE and two groups of distributors.

Fitch takes a positive view of the plan to create large vertically integrated groups in Poland. This will improve the business profile of the Polish energy sector and should decrease the cost of capital of the new groups, which is important in view of their sizeable capex needs. However, it remains to be seen if the government-led sector consolidation will result in repeating the success of CEZ (which is apparently the Polish government's goal), given that the companies are more likely to be consolidated under the holding structure rather than merged.

Additionally, the Polish power sector is burdened with over-employment and rigid agreements with trade unions, which may make workforce reduction a difficult task.

#### PPAs in Poland

2007 is also expected to see the outcome of the long-awaited decisions concerning Power Purchase Agreements ("PPAs") in Poland. The PPAs, which now account for roughly 50% of power sold in the country, have been challenged by the European Commission as state aid. They also make liberalisation of the power sector difficult, given that most power generators sell power to PSE under PPAs at a different price, reflecting each generator's cost base rather than a market-based approach.

The government plans that the power generators, which will be consolidated into integrated groups, will see their PPAs terminated without cash compensation, while independent generators may choose to voluntarily terminate a PPA with cash compensation for stranded costs.

#### Increasing Power Prices and Cross-Border Trade

Fitch expects that energy prices in CE will continue to converge towards those of Western Europe. This is driven by growing demand for energy in the

region and an expected generation capacity shortfall if ageing units are not replaced with new ones.

In Poland, the largest CE country, demand for electricity is expected to increase by 3% per year in the coming five years. The Czech Republic is a good example of energy prices converging to Western Europe – wholesale base-load prices increased by 16% in 2006 and will rise by a further 15% to EUR44/MWh in 2007, which is still around 20% lower than in Germany.

Slovakia will, in 2007, become a net importer of power after the planned shutdown of one old nuclear unit in late 2006. The deficit is expected to be met with imports mostly from CEZ in the Czech Republic.

It is worth noting that CE countries are relatively well interconnected compared to Western Europe and regional deficits of power generation may be met from imports from the neighbouring countries. In early December 2006, Poland's PSE and Lithuania's Lietuvos Energija AB signed an agreement to construct an interconnector between both countries. This may allow exporting power from Poland to the Baltic state to meet the power deficit once Lithuania's Ignalina nuclear power plant is decommissioned in 2009.

In Poland, where power prices are relatively low even when compared with other CE countries, increased capex needs in coming years should result in higher power prices as generators will have to service additional debt.

It remains to be seen what the price impact will be regarding liberalisation of the energy market from July 2007, when households will be able to choose an energy supplier.

#### Significant Investment Needs

Fitch expects capex in the power sector to increase significantly in the next five years, given that new generation capacity is needed due to stringent emission standards or end of useful plant life. For example, Poland requires investments in the generation segment of around EUR1.5bn per year.

All large regional players – CEZ, Poland's BOT and PKE, and Slovak SE – have plans to build new capacity in the coming five years. In the case of BOT and PKE, the projects (833MW and 460 MW capacity respectively) have already started, and are planned to be funded by a combination of debt and internal cash flow.

■ Annex 1

CE Oil & Gas and Electricity Companies Rated by Fitch

Issuer	Sector	Issuer Default Rating	Senior Unsecured Rating	Outlook/Watch
<b>Bulgaria</b>				
Petrol AD	Fuel Distribution	B-	B-	Stable
<b>Czech Republic</b>				
CEZ, a.s.	Integrated Utility	A-	A	Stable
<b>Lithuania</b>				
Mazeikiu Nafta AB	Refining and Marketing	B+	NR	RW Positive
<b>Poland</b>				
BOT Elektrownia Turow SA	Electricity Generation	B-	NR	RW Evolving
PKN Orlen SA	Refining and Marketing	BBB	NR	RW Negative
<b>Romania</b>				
The Rompetrol Group NV	Refining and Marketing	B-	NR	Stable
<b>Slovakia</b>				
Slovenske Elektrarne, a.s.	Electricity	BB+	BBB-	RW Positive
Slovensky plynarensky priemysel, a.s. (SPP)	Gas Transportation and Supply	A	NR	Stable

Source: Fitch

Copyright © 2006 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.