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FOCUS Hedge funds upbeat on Russian gas sector in anticipation of restructuring

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LONDON (Thomson IM) - The Russian government is under increasing pressure to restructure the country's gas sector to allow independent firms access to the domestic pipeline network as well as move to charge world market prices, thereby creating attractive investment opportunities, according to hedge fund managers based there.

At present, state-owned gas company Gazprom has complete control of the domestic gas pipeline. But with Europe now dependant on Russia for 25 pct of its gas, a figure that will rise to 40 pct within the next 10 years, Russia could struggle to meet future demand if it does not restructure the industry.

The government has already made clear its intention to move to world market prices, with domestic prices slated to rise to net export prices by 2011, but it will also need to allow independent access to the pipeline to meet future demand.

Peter Halloran, CEO of Pharos Financial Group, said Russia is under political pressure to meet demand from Europe and, at current production levels, runs the risk of falling short.

'Russia must develop gas reserves more quickly,' said Halloran, whose firm runs a 33 mln usd fund specialising in the gas sector. 'Gazprom's balance sheet is used up and production is flat, so they have to allow more independent producers, such as Novatek, Lukoil and Rosneft, access to the pipeline.'

Halloran said there will not be enough cash to invest in developing reserves to meet production requirements while the domestic gas price in Russia is kept artificially low.

The European gas price is currently 275 usd per cubic metre (mcm), which nets about 170 usd per mcm for Gazprom, while government-controlled Russian prices stand at 50-55 usd per mcm.

With the current net export price at 170 usd, Russian gas producers could expect to receive an export price of 110 usd assuming an oil price of 50 usd per barrel.

'The government can either force Gazprom to open up or it can take the pipeline and divide it up amongst different producers,' said Halloran.

Jochen Wermuth, managing director of Wermuth Asset Management, said Russia's move to charge world market prices to its neighbours and domestic customers over the coming years could mean a tripling or quadrupling of revenue for domestic gas sales and a quintupling of earnings for gas producers.

'The Russian government will move more and more towards a market-based approach, allowing free competition on the domestic supply side, while the export monopoly for Gazprom is likely to remain in place,' said Wermuth.

'The ideal solution for the sector will be to have Gazprom split up into competing production units, competing distribution units and a pipeline company which as a national monopoly should be state-regulated but grant equal access to all producers and consumers,' he said.

Pharos' Halloran said: 'The government could easily spin out certain aspects of Gazprom, and other assets, to realise value and concentrate more strictly on developing gas reserves.'

'Once Russia gets through the election I think we'll start to see some radical announcements on this,' he added. 'The first step will probably be to force selective access to the gas pipeline for oil producers who have a lot of gas reserves.'

Halloran anticipates opportunities opening up along the gas supply chain as well as in companies based in countries around the Caspian basin, an area rich in natural gas.

Oil companies are sitting on huge amounts of gas but they have no access to the pipeline, said Halloran.

'It's hard to value companies on the basis of reserves but, with Russian oil majors, the gas reserves are not priced into their valuations so that will be a driver going forward,' he said.

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