8.7 PRINCIPAL RISKS AND UNCERTAINTIES

78%
sales volumes of our tubular products used in oil and gas industry in 2014

INDUSTRY RISKS

DEPENDENCE ON THE OIL AND GAS INDUSTRY

The oil and gas industry is the principal consumer of steel pipe products worldwide and accounts for most of our sales, in particular sales of OCTG, line pipe and large-diameter pipe. In 2014, sales volumes of pipes used in oil and gas industry accounted for approximately 78% of our tubular products.

The oil and gas industry has historically been volatile and downturns in the oil and gas markets can adversely affect demand for our products, which largely depends on the number of oil and gas wells being drilled, completed and reworked, the depth and drilling conditions of wells and the construction of oil and gas pipelines. The level of such industry specific activities in turn depends on the level of capital spending by major oil and gas companies. The level of investment activities of oil and gas companies, which is largely driven by prevailing prices for oil and natural gas and their stability, significantly affects the level of consumption of our products.

In case of significant and/or sustained decline in oil and natural gas prices energy companies could reduce their levels of expenditures. As a result, the demand for oil and gas pipes can substantially decrease, leading to the tightening of competition and a possible decrease of market prices for tubular products.

Thus, the decline in oil and gas exploration, drilling and production activities and prices for energy commodities could have a negative impact on our results of operations and financial position.

INCREASES IN THE COST OF RAW MATERIALS

We require substantial quantities of raw materials to produce steel pipes. The principal raw materials used in production processes include scrap and ferroalloys for use in steelmaking operations, steel billets used for the production of seamless pipes and steel coils and plates for the production of welded pipes. The demand for the principal raw materials we utilize is generally correlated with macroeconomic fluctuations, which are in turn affected by global economic conditions.

Prices for raw materials and supplies have a key influence on our production costs and are one of the main factors affecting our results of operations. They are influenced by many factors, including oil and gas prices, worldwide production capacity, capacity utilization rates, inflation, exchange rates, trade barriers and improvements in steelmaking processes. Costs of the principal types of raw materials that we require increased in 2014 as compared to 2013 in all TMK's divisions. The share of raw materials' and consumables' costs in the total cost of production in 2014 was 64%.. The increase in prices for scrap, coils and other raw materials, if not passed on to customers in a timely fashion, can adversely affect our profit margins and results of operations.

our large-diameter pipe sales to Gazprom amounted **to 55%**

Our plants also consume significant quantities of energy, particularly electricity and gas. In 2014, the prices (in Roubles) for electricity and natural gas for the plants of the Russian division increased on average by 4% and 7%, respectively, compared to 2013. In 2014, the share of energy costs and utilities remained almost flat and amounted to 8% of the total cost of production. Nevertheless, price increases for energy resources will increase our costs of production and could have an adverse effect on results of operations and financial results.

DEPENDENCE ON A SMALL GROUP OF CUSTOMERS

As we focus on supplying primarily the oil and gas industry, our largest customers are oil and gas companies. In 2014, our five largest customers were Rosneft, Gazprom (excluding Gazprom Neft), Surgutneftegas, Lukoil and Bourland and Leverich which together accounted for 32% of our total sales volumes. The increased dependence of pipe sales on a single large customer bears the risk of an adverse effect on results of operations in the event that our relationship with any of these major customers deteriorated.

Our large-diameter pipe business is largely dependent on one of our largest customers, Gazprom, and is subject to increasing competitive pressure. In 2014, 55% of our large-diameter pipes were sold for Gazprom projects. Gazprom is one of our largest customers for 1,420 mm diameter welded pipes used for construction of gas trunk pipelines. Increased competition in the supply of large-diameter pipes or a change in relationships with Gazprom could negatively affect our competitive position in the 1,420 mm diameter pipe market, resulting in decreased revenues from sales of these products and adversely affecting our business, financial position and results of operations. Additionally, large-diameter pipe business depends significantly upon the level of construction of new oil and gas pipelines in Russia and the CIS. The delay, cancellation or other changes in the scale or scope of significant pipeline projects, or the selection by the sponsors of such projects of other suppliers could have an adverse effect on our sales of large-diameter pipes, and thus on the results of operations and financial position. We mitigate this risk by developing cooperation with new customers from CIS countries.

COMPETITION

The global market for steel pipe products, particularly in the oil and gas sector, is highly competitive and primarily based on compliance with technical requirements, price, quality and related services. In the Russian and CIS markets, we face competition primarily from ChTPZ, which produces both welded and seamless pipes, OMK, which produces welded pipes, and the Ukrainian and Chinese pipe producers.

Accession of Russia to the WTO and subsequent reduction of import duties on steel pipes to the level of 5%–13.8%, as well as usage of unfair methods of competition by some importers, in the first place, contribute to the growth of steel pipes import to Russia and to the Customs Union from China and Ukraine. Nevertheless, implemented in 2013, antidumping duties in the amount of 18.9%–19.9% on imports of Interpipe's (Ukraine) pipe production, antidumping duties equal to 19.15% on imports of cold-drawn stainless pipes originated from China, the safeguard measure in the form of import quota in respect of certain corrosion-resistant steel pipelines, which ceased to have effect in November 2014, ensured the alignment of conditions of competition in the market of pipe products in Russia in 2014. Antidumping duties, the reduction of deliveries of certain types of pipes by Ukrainian producers caused by, among other things, the critical state of the Ukrainian economy, and decline in imports from China by 31% due to the antidumping investigation initiated in respect of OCTG, led to a reduction in imports of pipes in 2014 by 24%. Also, devaluation of the Rouble and sanctions imposed by USA and EU in respect of supply of products for exploration and extraction of tight oil are exerting negative influence on the dynamic of import of goods from other counties. At the same time it should be noted that the Eurasian Economic Union (EAEC), the former Customs Union, began to operate from January 1, 2015. Member States of the EAEC are the Republic of Armenia, Belarus, Kazakhstan and the Russian Federation, as well as the expected accession of the Kyrgyz Republic.

In February 2015 the Eurasian Economic Commission upon the application of Russian manufacturers, including TMK, initiated the anti-dumping investigation against imports into the territory of the EAEC seamless stainless steel pipes originating from Ukraine. Calculated by the applicants preliminary dumping margin for the deliveries from Ukraine into the customs territory of the EAEC amounted to an average of 11.3%. In the first half of 2015 the decision of Eurasian Economic Commission upon the results of the antidumping investigation against the imports of seamless OCTG from China is expected to be made which will also help to reduce the volume of dumped imports. Nevertheless, if the measures taken by the EAEC have appeared to be insufficient for the protection from the unfair import in the future, this could have an adverse impact on TMK market position.

Outside Russia and the CIS, we compete against a limited number of premium-quality pipe products producers, including Tenaris, Vallourec, Sumitomo, Voestalpine and a limited number of Chinese producers, including Baosteel and TPCO.

In the United States, TMK IPSCO faces competition primarily from Boomerang, Tenaris, U.S. Steel and VallourecStar, a subsidiary of Vallourec, as well as from imported OCTG and line pipe products, principally from Asia.

In 2013, the majority of the U. S. steel pipe producers, including TMK IPSCO, submitted a request to the U.S. Department of Commerce to initiate anti-dumping and countervailing duty investigations of certain oil country tubular goods from India, South Korea, the Philippines, Saudi Arabia, Taiwan, Thailand, Turkey, Ukraine and Vietnam.

In August 2014, the following duties were imposed as the result of antidumping investigations: India — 2.05% — 9.91%; Turkey — 35.86%; South Korea — 9.89% — 15.75%, Taiwan — 2.34%, Vietnam — 25.18% — 111.47%.

According to the results of the countervailing duty investigation the countervailing duties 5.67% — 19.57% for India and 2.53% — 15.89% for Turkey were imposed.

Decisions and determinations subsequent to results of the investigations mentioned above are expected to contribute to the improvement of competitive conditions on the market, price increase and improvement of market positions of American plants.

In October 2014, TMK IPSCO and other seven producers requested United States International Trade Commission to conduct an investigation regarding the imposition of countervailing and antidumping duties on welded API line pipe from South Korea and Turkey. Preliminary determination should be announced in March, 2015. We are expecting that preliminary determination in the investigation will be affirmative in relation to imports of welded line pipe. However, any unfavorable decision could have negative effect on the price environment in the segment.

FINANCIAL RISKS

LIQUIDITY RISK

As of December 31, 2014, our total debt amounted to $3,223 million as compared to $3,694 million at the end of 2013 influenced by the depreciation of the Rouble against the U. S. dollar. As of December 31, 2014, our Net-Debt-to-EBITDA ratio was 3.7.

In 2014, we duly satisfied and discharged obligations under loan agreements and refinanced a certain part of our loan portfolio.

In February, 2015 we redeemed our 5.25% Convertible Bonds due 2015 convertible into GDRs each representing four ordinary shares of TMK. To redeem the bonds TMK used cash accumulated from operating and financial activities, including four-year USD denominated credit facility from one of the leading Russian commercial banks.

Improving liquidity profile remains one of our priorities, and we continue to carry out measures to maintain sufficient liquidity and improve loan portfolio structure. During 2014, to assure effective access to financial resources, we concluded short-term and medium-term credit line agreements with Sberbank, Gazprombank, VTB, AlfaBank, RaifizenBank and Absolut Bank for the total amount of $500 million and 27.5 billion Roubles. As of 31 December 2014 we committed credit lines in Russian, European and American banks with the available limit of $879.7 million.

Nevertheless, there can be no assurance that our efforts to improve liquidity profile and reduce leverage will prove successful. The negative market reaction on deteriorating global financial situation, US and EU sanctions, increase of Bank of Russia key rate may have an adverse impact on our ability to borrow in banks or capital markets, and may put pressure on our liquidity, significantly increase borrowing costs, temporary reduce the availability of credit lines or lead to and possibility to incur financing on acceptable terms.

COMPLIANCE WITH COVENANTS

Certain of our loan agreements and public debt securities currently include financial covenants. Some covenants impose financial ratios that must be maintained, other impose restrictions in respect of certain transactions, including restrictions in respect of indebtedness. A breach of financial or other covenants in existing debt facilities, if not resolved by means such as obtaining a waiver from the relevant lender and/or making amendments to debt facilities, could trigger a default under our obligations.

We comply with the covenants under our public debt securities and covenants under loan agreements. As of 31 December 2014, we were in compliance with lenders' requirements under covenants.

Nevertheless, in case financial markets or economic environment on the markets, where we operate, deteriorate in the future, we may not comply with relevant covenants. In case of possible breach we will obtain all necessary waivers or standstill letters. We do not expect the occurrence of such events in the near future.

INTEREST RATE RISK

Interest expenses are the prevailing part of our finance costs. In 2014, our finance costs decreased as compared to the level of 2013 influenced by the depreciation of the Rouble against U. S. dollar. Our weighted average nominal interest rate as of December 31, 2014 increased by 54 basis points as compared to December 31, 2013.

Substantial part of our loan portfolio is represented by loans with fixed interest rate. However, some loan agreements contain a right of creditors to change interest rates in case of change of credit indicators by the Central Bank of Russia and in other cases. After significant growth of the key rate in the end of 2014, interest rates for some of our borrowings were increased. At the time being, negative impact is inconsiderable; nevertheless, if current policy of the Central Bank of Russia continues, interest rates could be changed for the most of our borrowings.

Additionally, certain part of our loan portfolio is represented by loans taken out at floating interest rates. As of December 31, 2014, loans with floating interest rates represented $461 million. The underlying rates in current loans with floating interest rates are LIBOR and EURIBOR. In 2012, taking into account low levels of interest rates which were close to its historical levels, we hedged a part of interest rate risks. Considering hedging, at the end of 2014 the share of variable-rate debt amounted to 8% of our total credit portfolio.

Nevertheless, several loans with floating interest rates in our credit portfolio are not hedged, and, should floating interest rates increase in the future, interest expenses on relevant loans will increase.

CURRENCY RISK

Our products' prices as well as our costs are nominated both in Roubles and in other currencies (generally, in U. S. dollars and EUR). We hedge our net investment in operations located in the United States and Oman against foreign currency risks using U. S. dollar denominated liabilities. Gains or losses on the hedging instruments relating to the effective portion of the hedge are recognised as other comprehensive income while any gains or losses relating to the ineffective portion are recognised in the income statement. In 2014, we incurred foreign exchange losses from spot rate changes in the total amount of $903 million, including $301 million recognised in the income statement and $602 million (before income tax) recognised in the statement of comprehensive income.

As of December 31, 2014, 67% of our loans were denominated in U. S. dollar. In this regards, as well as taking into consideration continuing volatility of the Rouble against U. S. dollar, the risk of losses owing to the Rouble devaluation remains sufficiently high. Since revenue of the Group is nominated in Euros, the U. S. dollar and Roubles due to the geographic diversification of sales, this provides a natural hedge for our foreign exchange position. Nevertheless, depreciation of the Rouble against the U. S. dollar could adversely affect our net profit as coherent losses will be reflected in our consolidated income statements.

INFLATION RISK

A significant amount of our production activities are located in Russia, and a majority of direct costs are incurred in Roubles. We tend to experience inflation-driven increases in certain costs, such as raw material costs, transportation costs, energy costs and salaries that are linked to the general price level in Russia. In 2014, inflation in Russia reached 11.4% as compared to 6.5% in 2013. In spite of the measures of the Russian government to contain inflation, growth of inflation rates may be significant in the short-term outlook. We may not be able to increase the prices sufficiently at an opportune time in order to preserve existing operating margins.

Inflation rates in the United States, with respect to TMK IPSCO operations, are historically much lower than in Russia. In 2014, inflation in the United States decreased to 0.76% in comparison to 1.5% in 2013.

High rates of inflation, especially in Russia, could increase our costs, decrease our operating margins and adversely affect our business and financial position.

LEGAL RISKS

CHANGES IN TAX LEGISLATION AND TAX SYSTEM

Our subsidiaries make significant tax and non-budgetary funds payments, in particular, profit tax, VAT, property tax and payments to social security funds. Changes in tax legislation could lead to an increase in tax payments and, consequently, to a lowering of financial results. As significant part of the operations is located in Russia, the main risks relate to changes in the legislation of the Russian tax system. The Russian Government continually reviews the Russian tax legislation. The new laws generally reduce the number of taxes and the overall tax burden on business while simplifying tax legislation. Nevertheless, should the Russian taxation system suffer any changes related to increasing of tax rates, this could adversely affect our business.

Moreover, the Russian oil industry is subject to substantial taxes, including significant resources production taxes and significant export customs duties. Changes to the tax regime and customs duties rates may adversely affect the level of oil and gas exploration and development in Russia, which can adversely affect the demand for our products in Russia.

CHANGES IN ENVIRONMENTAL LAW

We meet the requirements of national environmental laws at our industrial capacities location areas: the directives and regulations of Russian, the United States, the European Union, Romanian, Kazakhstan and Omani legislation.

The main ecological-and-economical risks of our Russian plants are related to changes and tightening of Russian environmental protection laws. Environmental legislation in Russia is currently undergoing serious reformation. The imposition of a new law and regulation system may require further expenditures to install new technological and waste disposal equipment, pollution and wastewater control equipment, as well as will lead to growth of the rate of payments for negative impact on the environment. It is expected that compliance with the regulations will be accompanied by stricter control by state monitoring authorities. If existing legislation is changed, that may lead to additional costs or unforeseen expenses, which, however, could not have a material adverse effect on our financial position and results of operations.

We estimate that the environmental legislation of the European Union and the United States, Romania, Kazakhstan and Oman will not undergo any material changes in the near future. Nevertheless, if such changes arise, the cost of compliance with new requirements could have a material adverse effect on our business.

OTHER RISKS

EQUIPMENT FAILURES OR PRODUCTION CURTAILMENTS OR SHUTDOWNS

Our production capacities are subject to the risk of equipment failures due to unanticipated events, such as fires, explosions and adverse weather conditions. Manufacturing processes depend on critical pieces of steelmaking and pipe-making equipment. Such equipment may, on occasion, be out of service as a result of unanticipated failures could require us to close part of the relevant production facility or cause to reduce production on one or more of production lines. Any interruption in production capability may require us to make significant and unanticipated capital expenditures to affect relevant repairs, which could have a negative effect on our profitability and cash flows. We currently maintain insurance against losses that may arise in case of property damage, accidents and transportation of goods. We also maintain corporate product liability and directors' and officers' liability insurance policies. Nevertheless, any recoveries under insurance coverage that may be obtained in the future may not offset lost revenues or increased costs resulting from a disruption of operations.

INSURANCE AGAINST ALL POTENTIAL RISKS AND LOSSES

We do not carry insurance against all potential risks and losses that may arise in connection with the quality of our products, property damage, work-related accidents and occupational illnesses, natural disasters and environmental contamination. We currently maintain no business interruption insurance. Losses or liabilities arising from these or other events could increase our costs and could adversely affect our business, financial position and operating results.

ABILITY TO EFFECT STAFF ALTERATIONS AND SHORTAGES OF SKILLED LABOR

Our Russian subsidiaries are in many regions the largest employers in the cities in which they operate, such as Volzhsky, Taganrog, Kamensk-Uralsky and Polevskoy. While we do not have any specific legal social obligations or responsibilities with respect to these regions, the ability to effect alterations in the number our employees may nevertheless be subject to political and social considerations. Any inability to make planned reductions in the number of employees or other changes to operations in such regions could have an adverse effect on the results of operations and prospects.

Competition for skilled labor in the steel pipe industry remains relatively intense, and labor costs continue to increase moderately, particularly in the CIS, Eastern Europe and the United States. We expect the demand and, hence, costs for skilled engineers and operators will continue to increase, reflecting the significant demand from other metallurgical companies and other industries. Continual high demand for skilled labor and continued increases in labor costs could have a material adverse effect on our business, financial position and results of operations.