

When banks open their safes

Let's remember a riddle for children: "A and B were sitting on a chimney. A fell, B was lost... Who stayed on a chimney?" A child who doesn't go to school would say: "Nobody". A schoolchild would for no doubts say: "And"... And if instead of a common chimney there is an oil or gas pipeline, the situation is as follows. "A" at one side of the pipeline is a supplier; "B" at another side is a purchaser. They are tied with long-term contracts. And who stands for "And"? Can you guess? Of course, that's an investor!

Vladimir Matias, Managing Partner of Asset Capital Partners GmbH and the Head of Moscow office explains the terms on which an investor is ready to finance a pipeline project.

Not long ago even big companies faced difficulties when attracting both debt and equity capital for oil&gas projects. In 1998-1999 even such a solid company as OAO "AK "Transneft" couldn't raise quite a small in modern terms amount of money – USD 200-300m – for the Baltic Pipeline System project. The reasons were high country risks, low oil prices and because the company was unknown to Western creditors. Several years have passed, and according to a company's representative, "nowadays it is a privilege for banks to credit Transneft". The main reason for that is that the company has almost no competitors. Transneft is the biggest monopoly operator with diversified oil pipeline transportation network and lower costs of services compared to the rail transportation costs. From the banks' point of view, the company is financially stable and has strong demand for funds for reconstruction, expansion and improvement of capacities. That is why there's a queue of banks eager to provide debt of billions USD, and even such ambitious plans as raising more than USD 11b for the "Eastern Siberia – Pacific Ocean" project are on the verge of embodiment.

Classical traditions and Russian peculiarities

The banks open their safes only when they see that the risk of money loss is minimum. This is a financial axiom. The bankers say that they finance "the pipeline" which connects the miners and suppliers of hydrocarbon raw materials with sale and export markets or purchasers, but only when they all are tied with long-term contracts; they cannot finance just a piece of iron in the ground.

In general, the bankers consider "the pipe" as long-term liabilities or firm agreements between suppliers, purchasers of hydrocarbon raw materials and pipeline operating company. The terms and conditions of granting a credit should be in strict conformity to the terms of contracts concerning volumes, terms and transportation tariffs. Moreover, the contract should provide for the security of all project assets, including the pipeline itself, compressor stations and infrastructure. So, there is the main idea of classical project financing in pipeline sector.

One or two years ago the bankers didn't want to think of financing pipeline projects and companies, if there were no long-term contracts for pumping according to "ship-or-pay" scheme. For instance, if one has pumped only 80% of stipulated amount of raw materials during 10 years of contract, he still should pay for the whole amount, in accordance with Western traditions.

But the time goes by, and the rules have changed. Nowadays, when the situation in Russia has changed for the better, viz.: oil prices are high for a long-term period and macroeconomic climate is favorable, there's no lack of finance of pipeline projects. Another reason for that is that such assets have become more attractive for both Russian and foreign banks. Now potential lenders act according to the conditions of Russian borrowers: for instance, foreign banks allow credits to "Transneft" for all-time low interest rates, though the company doesn't have long-term contracts for oil pumping (usually the contracts are concluded for a year).

There are the other examples of raising large amounts for strategically important projects in pipeline sector of Russia. Western and Russian banks have financed on rather favorable terms even such borrowers, who were unknown in banking area two years ago.

Russian banks are beyond competition?

In accordance with the world default statistics, the pipeline projects are among the most stable ones. Such projects are mostly the big ones, thus appear to be potentially attractive for bankers, who usually struggle for them.

Only two or three years ago even a consortium of Russian banks couldn't grant credits in amount of 300-500 mln USD. Nowadays Russian banks are much stronger; they work more actively and become serious competitors to foreign financial institutions. Here is a last-year example. The Western banks were about to finance "Transneft", but in the end of the game Sberbank intercepted the initiative on almost the same terms. This fact proves that Russian banks have become more active and aggressive in good meaning of the word. Due to their presence at the market, Russian banks quickly analyze the nature of borrowers, local peculiarities of their activity and project risks. Notwithstanding their financial power, foreign banks often cannot withstand the rate of project evaluation and all credit-approving procedures. Furthermore, there are typical Russian peculiarities of established client relationships between Russian banks and lending companies. All the above mentioned often makes Russian banks more competitive and compensate their higher interest rate (a premium to "Western" rate is about 1,5-2% per annum).

Peculiarities of project financing

A possibility of project financing is always considered before the realization of a big project. The reasons to that are in its structural peculiarities. First, in project financing takes part a special company, i.e. an individual legal entity. Second, off-balance financing is possible. The project risks are distributed among all parties to the project (investors, general construction contractors, suppliers and purchasers of raw materials, finance banks, export-credit agencies, etc.). In project financing there is a possibility to get a limited regress right (a right to raise a claim) on sponsors or investors, which is very attractive for many companies (especially for developing ones), because it allows to separate project risks and risks of investor itself.

Project financing is usually a long-term financing with higher costs of capital comparing to corporate loans. Its main peculiarity is a possibility to pay off the credit from future cash flows, which are accumulated by the project company, since the basic provision for attracted capital is the project itself and its expected cash flows. That is why a banker and a consultant should have a perfect knowledge of a particular sector (in this case a pipeline one) and schemes of diminishing and distributing of risks among all project members when using such way of financing.

Project financing structure has a range of main characteristics. First of all, it's a creation of a SPV – special purpose vehicle. The project investors should be financially and technically strong and capable to guarantee the successful completion of the project. Debt to equity ratio

can differ from 70/30 to 50/50 depending on the risk profile. A first-class company with many years of experience and irreproachable reputation is a general construction contractor. The contractor under the construction-engineering contract undertakes to deliver the work turnkey with the fixed cost of work. The usage of checked technologies and multiparty examination is obligatory upon the completion of a project. The banks' role in project financing is much greater, than in traditional corporate one. The banks have rights to control all projects assets, contracts and other agreements of the project company with the third parties.

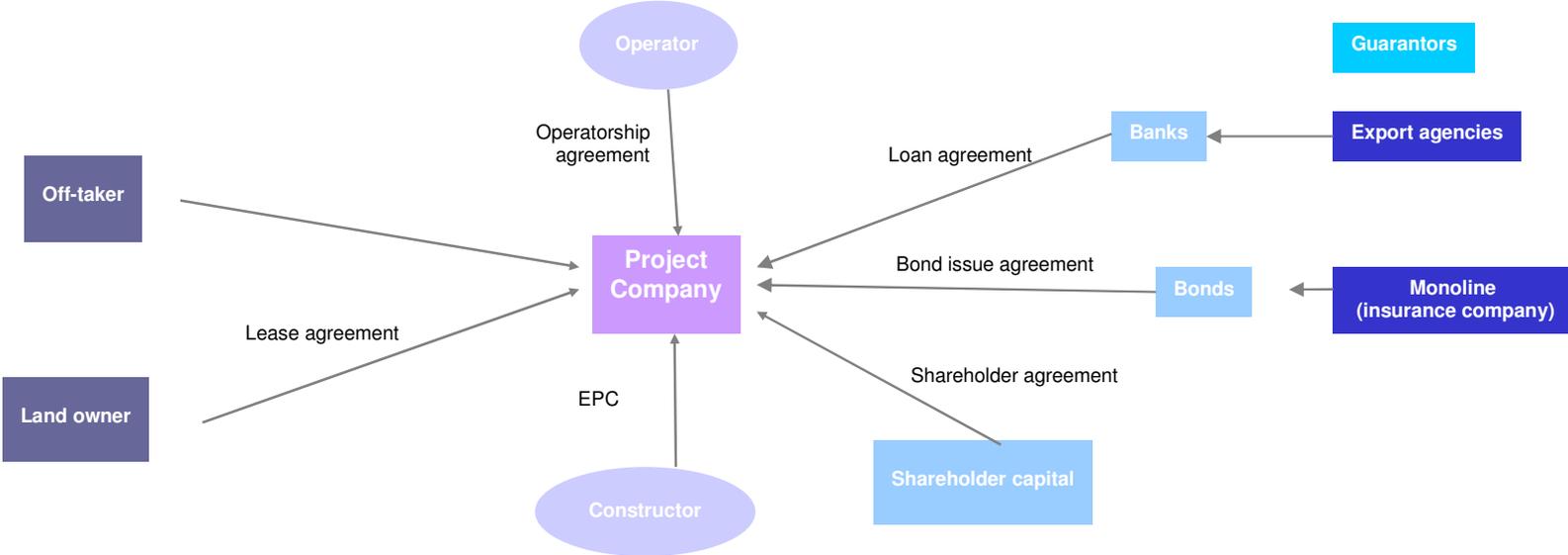
In credit risk evaluation the project financing is based on the whole range of principles. Everything is evaluated, and in the first place the credibility of the project investors (their opportunity to provide the necessary payments to the owners' equity and their guarantees to settle the accounts) and of the suppliers, with whom the contracts for the transportation of fuel are concluded.

There are a lot of factors that influence the decision to finance the pipeline, viz.: whether there's a high-qualified project operator with stable reputation and experience; low risk of supply problems; independence of one supplier; strong competitive position (limited risk of appearance of cheaper alternative ways of transportation); and, of course, acceptable contractual structure (distribution and decreasing of risks).

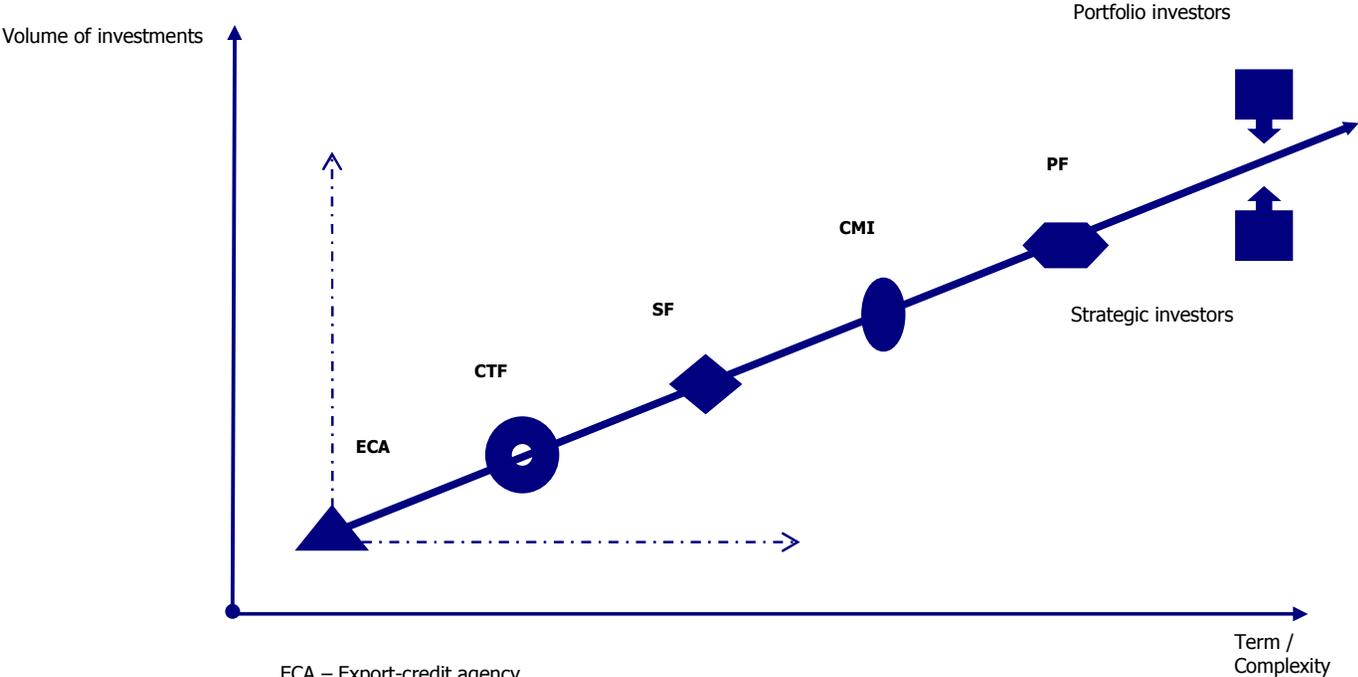
Particular attention is paid lately to the conformity of an investment project to national and international requirements of ecological safety. This is particularly important if the pipeline transportation of hydrocarbon raw materials is used. At present no one big Western bank will take part in projects, which do not correspond to "Equator Principles". The world leading finance organizations, which signed this document, outlawed the companies that pollute the environment, and they no more grant credits to the borrowers, who cannot provide the conformity to the stipulated ecological and social policies and processes. Financial consultants of fuel and energy complex' projects always turn investors' attention to the fulfillment of ecological demands, and hold necessary consultations with the participation of independent ecology auditors.

No doubt that the evaluation of all the above mentioned factors before making a decision to take part in project financing has the sense only if the investing climate in the country (including its tax regime) is stable.

Classical structure of Project Financing



Evolution of debt financial instruments in Russia



ECA – Export-credit agency
CTF – Commodity trade financing
SF – Structured financing
CMI – Capital market instruments (bonds, promissory notes)
PF – Project financing