

Refining attitudes towards oil and gas financing

Launched in the midst of credit turmoil, the recent US\$3bn Sonangol transaction has tested the market's appetite for unsecured low priced deals in the oil and gas sector. Meeting with a mixed reaction, the deal illustrates a shift in attitudes towards the financing of oil and gas corporates across the globe. Rebecca Spang reviews the sector.

Launched back in August, Angola's state oil company Sonangol approached the market once more with a US\$3bn eight-year syndicated facility. Despite Angola's high level of country risk, Sonangol's previous deals have never failed to attract a large syndicate of banks, all of which have taken fairly large ticket sizes. Margins have of course been falling over recent years, but participants have still generally expected to get a fairly large outright return on their money, often up to US\$500mn.

Last year's US\$1.4bn syndicated term loan for joint venture Sonangol Sinopec International was significantly oversubscribed.

In 2005, Sonangol secured a US\$3bn syndicated pre-export finance, marking the first Sonangol deal to extend to seven years. Funds in this instance refinanced a previous facility signed in 2004, when a US\$2.35bn crude oil prepayment financing was raised for the oil company.

With every passing year Sonangol manages to break records in terms of size, tenor and usually pricing, and every year the market clamours to take part in the deal. Yet this time, the reaction to the US\$3bn has been slightly more mixed. It is no longer a structured trade transaction, and has far more in common with the corporate loans extended to oil and gas conglomerates in Russia or even Latin America.

In addition to the loosening structure of the deal, the timing came just as the credit crunch in the capital markets hit, liquidity tightened and credit committees became even more wary.

Yet to decline an invitation to participate in this year's deal was still a difficult choice. If a bank has previously made a return of US\$400mn on taking part in a previous

syndication, with relatively little effort, they would have to do a fair amount of trade finance business to make up what they would normally have expected to make on Sonangol in 2007.

"And of course no-one's budget ever gets reduced just because their favourite client no longer wants the product made on the deal," remarks John Macnamara, managing director, structured commodity trade finance, Deutsche Bank.

He is familiar with the Sonangol transaction,



**Fraisse at Natixis:
Pre-export resurgence**

with Deutsche having been one of the mandated lead arrangers on the 2005 prepayment financing facility.

Yet, for some in the market, the decision to participate ultimately came down to price. As one source from a London-based commodity bank explains: "We thought carefully about participating in the transaction. We felt comfortable with the country risk, the structure of the deal and even the tenor of eight years.

"Ultimately, it came down to the fact that pricing was on the low side and didn't meet our internal hurdle rate for return on equity. We considered to sell down part of our participation into the insurance markets but that appeared to be more difficult than it looks due to the lack of capacity for this type of risk. It is a pity but in this particular case, it is sometimes more prudent to decline a participation and to look for alternatives and/or wait for better times."

A call for more structure?

The overriding story over the last few years in the oil and gas sector is that of ever rising oil prices and growing power of national oil companies with the ability to demand lower priced funds. For top tier borrowers, most loans are loosely structured and feature low pricing. Yet, there have been signs the market is turning.

"Finding it more difficult to obtain their financing requirements in the capital markets, certain large commodity groups are now returning to their relationship banks at higher margin levels and with more conservative structures. Consequently, we are seeing a reappearance of the use of pre-export finance," comments Dominique Fraisse, deputy global head of natural resources at Natixis.

At the end of September, Gazprom Neft, the oil arm of the Russian state-owned company Gazprom, launched a US\$2.2bn syndicated loan facility to raise funds for up and downstream business expansion.

The three-year facility pays 75 basis points, a rise of 15bp compared to the borrower's previous transaction raised last year which included a tranche paying 60bp. The pricing is said by those close to the deal to better reflect the current market climate.

The enduring appeal and resilience of the pre-export finance structure was demonstrated by the Russian oil company Rosneft. In August it decided to pull its bond after a lack of take-up due to adverse bond market conditions. However, the company's concurrent US\$2bn pre-export facility, despite featuring low margins under

60bp, managed to attract a huge take up from the market and was significantly oversubscribed.

Calyon was the mandated lead arranger on this transaction. Reflecting on the success of this deal, Alain Fanaie, global head of structured commodity finance at the bank, is optimistic about the future of structured commodity finance (SCF): "On the positive side, I would say that although the credit crunch is hitting areas such as corporate finance and leveraged buy-out – as far as our business is concerned it brings stronger structures and better pricing, both in terms of margins and fees."

He adds: "The big oil producers had pulled out of the SCF market so they could get unsecured funding and very thin margins. But there are now some discussions that even the large oil players will come back again, but at the moment they are waiting to see how things evolve."

Rosneft could be back in the market in the coming year, after Peter O'Brien, vice-president for finance and investments at Rosneft, told conference delegates in September that it had already paid off half of the US\$22bn loan it acquired to finance the acquisitions of assets from the now bankrupt Yukos oil firm, and was now looking to refinance a significant proportion of the remaining loan by September 2008. He also added that the post-poned Eurobond might be relaunched before the end of the year.

But Rosneft's use of pre-export remains the exception among all the top tier oil and gas borrowers, with the potential for doing SCF in the oil and gas sector lying with the single B to BB rated oil corporates, and according to Deutsche's MacNamara, the best place to find these is in Russia.

"There are quite a number of new mid-caps emerging that look broadly very similar to how the now-top tier corporates were looking immediately post-crisis back in 1999-2000." It was in this post-Russian crisis era where the strength of pre-export financings was first successfully tested.

RBL trends

Another financing tool increasingly used in the sector is reserve-based lending (RBL), a technique that was developed, mainly by the French banks, to finance oil producers at the 'first oil' stage, and it was initially confined to the North Sea. It is now often

used in the emerging markets to finance producers such as Afren, an independent oil and gas firm in Nigeria.

At the end of June, Afren closed syndication on a US\$200mn debt facility via mandated lead arranger BNP Paribas to finance its



**Fanaie at Calyon:
Big players may return**

Okoro Setu project.

Despite the current climate in the credit markets, Natixis' Fraise predicts that RBL will remain a popular technique: "As lenders have become more comfortable with emerging market risk, and commodity prices have continued to rise, the increasing use of RBL was further supported by

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increased liquidity conditions, and the relaxing of debt structures before the summer. It is likely, though, that the trend will be robust enough to continue, despite the recent credit market problems."

Fellow Natixis colleague, Michel Jay, natural resources - energy, global head of upstream and structured finance adds: "The key is to have both strong emerging country risk appetite and strong technical expertise, with a good knowledge of the

industry, of the producers and an extensive understanding of the underlying reservoirs. "Typical RBL structures are very tight, allowing banks to maintain close control over the borrower's activities – and these transactions are usually well-priced. As such, most of these deals will be club-deals, or syndicated to a limited number of familiar banks, for example the four banks who led on Afren."

RBL deals have proven popular particularly for those borrowers who could not get pre-export financing due to a lack of track records of production. Completion risk is also reduced by the fact that unlike a project financing, a lot of money has already been invested in the company's development and they are already in production mode, with the funds being used to finance the company's growth curve.

However, besides from the impact of the credit crunch, RBL's future could also be challenged by the "resurgence in project finance". As Deutsche's MacNamara remarks: "With project finance being re-born and now being accepted under the specialised lending protocol of Basel II rulings, the resurgence in project finance would potentially threaten this new strand of reserve-based lending as it overlaps so much with project finance."

He adds: "In terms of risk, RBL sits between project finance and pre-export finance, but so far all the key RBL banks have been pretty careful with their lending and very methodical in assessing the risks, and so far there haven't been any deals that have failed."

Energy infrastructure investment

According to the International Energy Agency's (IEA) World Energy Outlook published in December 2006, investment needed to improve energy infrastructure stands at over US\$20tn by 2030, with the most going to emerging markets.

This opens up huge potential for project financing and hybrid financings incorporating export credit tranches in the oil and gas sector.

However, there are still significant challenges. According to project finance advisory firm Taylor-DeJongh, on the short-term side banks will face capacity constraints generated from outside the oil and gas sector.

Loans to the home and retail sector will be sufficiently problematic that credit committees are likely to impose more stringent lending policies. With lending capacity reduced, it predicts that ECAs will become increasingly important in deals to firstly increase capacity, and secondly provide political risk cover.

On the long-term side, Taylor-DeJongh advises that it will become necessary to match more closely forward price assumptions ie, those made by the banks, with reality. It suggests that typical base assumptions for both oil and gas have generally been very conservative when compared to actual historical prices over the past three or four years. "Without realistic base assumptions, some worthwhile projects may be overlooked, especially given today's escalating capital costs," it states.

Risk and opportunity in Central Asia

Increasing political risks are another long-term challenge for the oil and gas market, as companies pursue energy sources in increasingly risky environments.

Disputes have broken out in Kazakhstan between an international consortium of investors led by Italy's Eni and the Kazakh government over the development of Kashagan, an oilfield in the Caspian Sea region. The government wants to renegotiate a contract with the consortium, having been angered that production would be delayed by a further two years and that the first phase costs have doubled. There have also been complaints about the environmental impact of the project. According to Michael Denison, central Asia and Caucasus analyst working for risk consultancy Control Risks, the roots of this problem lie in the 1990s when the Kazakh government was relatively inexperienced following the fall of the Soviet Union and in retrospect it probably gave international companies too good a deal. Coupled with the increasing production costs, it now wants to restore the balance of power with its international investors.

It has done this through passing an amendment to the natural resources bill that allows the government to cancel or introduce retrospective changes to contracts if it is felt they harm the economic interests of the country. The Kazakh

government has said it wouldn't implement this law in the Eni case, but the European Union has already aired its concern about the amendment.

Denison refers to the Kazakh government's actions as "unsettling", adding: "This retrospective amendment legislation is not inspiring a lot of confidence. Banks may not lend money to oil companies running large companies running large projects if they are still at the mercy of legal changes that can be applied retrospectively."

However, he adds: "Whether the government will apply it randomly or not is another question entirely, I suspect that it won't, but it always has it up its sleeve."

As yet, the uncertainty surrounding Kazakhstan has not entirely dampened

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appetite for Kazakh risk in the oil and gas sector. In the last few months there have been two large-scale oil and gas-related financings. The first is a US\$1.05bn bridge facility raised for KMG Kashagan, a special purpose vehicle set up by KazMunaiGaz, the state-owned oil and gas corporate. It was signed at the end of September by mandated lead arrangers Société Générale, BNP Paribas and Citi.

At the beginning of October, KazMunaiGaz mandated ABN Amro, Calyon and Credit Suisse to arrange a US\$3bn financing to support its acquisition of a controlling share in Rompetrol Group. This acquisition will help the company increase its oil processing capabilities by providing it access to two refineries in Romania. Kazmunai has also acquired stakes in the Turkey oil company Petkim.

Neighbour to watch

In Central Asia, Kazakhstan is the biggest

potential market with oil coming on stream shortly. However, watching its development closely is nearby Turkmenistan.

Until the death last year of the president Saparmurat Niyazov, Turkmenistan was one of the most closed states in the world and relatively untouched by foreign investment. There have been a few landmark deals, most notably Natixis arranging the first RBL facility in the Caspian Sea for Burren Energy in 2003. However, Niyazov's successor Kurbanguly Berdymuhamedov is showing signs of being more open to outside influence, and changes may already be occurring. "Although the oil and gas sector is quite fragmented between different countries, there are signs they may come together in some form of national state-owned oil and gas company similar to Azerbaijan's Socar or Kazakhstan's Kazmunai," observes Denison.

Latin American resilience

Latin America seems to have been relatively immune to turmoil in the credit market problems. Across all sectors, there has been a number of high profile transactions that have managed to close fully subscribed with aggressive pricing. "Companies such as Petrobras are coming to refinance their exposure at very aggressive pricing. You are seeing refinancings with tenors of three to seven years, carrying margins of just 40-50bp," remarks Thomas Friebe, managing director, head of loan syndications - Latin America, WestLB.

"They are doing that because they are so liquid right now. They are approaching banks and saying either give me a very good price and I'll let you keep that exposure on the books – or I just refinance and repay you," he adds.

Besides Brazil, Peru's oil and gas sector is under development, and there may be some pre-export and SCF deals raised in this market. There is a lot of exploration going on in that market and Perupetro has just signed an exploration and production (E&P) contract with India's Reliance next year to operate a block in the Maranon basin.

As GTR went to press, commitments on the US\$3bn Sonangol deal were being finalised, and the signing was scheduled for the first half of November.