

Cash or credit?

With oil prices at record highs, what role is there for project finance in the cash rich oil and gas sectors? By Terry A. Newendorp, Chairman and CEO, and Shilpa Shah, Associate, Taylor-DeJongh.

The rise in oil prices that began in 2003 has continued this year, providing the oil industry with a steady stream of surplus revenues. Since the end of 2003, the weekly price for Brent crude has risen from \$30/barrel to \$50/barrel in the last week of May 2005. In addition, the forward price curve shows little decline in oil prices through 2010, indicating an expectation that high prices are to be a reality for at least a few more years.

Over the longer-term, a return to the historic average of around \$26/barrel is a reasonable assumption.¹ However, the price assumptions used by oil companies for the evaluation of potential long-term investments have only recently moved closer to this historic average as they have been revised upward and fears of a recurrence of the supply glut of the late 1990's begin to dissipate.

Nonetheless, the significance of this change is that it increases the pool of projects that may be considered financially acceptable for investment (even more so, when the parallel rise in natural gas prices is taken into account).

A flurry of new investment this year could provide a much needed boost to the project finance market, which began to revive itself in 2004 following the retreat of several commercial banks from the market a few years earlier. The question remains, though, as to whether project finance can be seen as an attractive option in an industry that now has the ability to self-finance investments. In other words, will higher oil prices help or hinder project finance?

The odds against project finance

There is an obvious reason why project finance may lose out in the current price environment. The windfall of oil revenues means that oil companies have less need for the additional capacity offered by project finance. To date several companies have used their extra earnings to pay down existing debt so that current gearing ratios among companies in the industry are at their lowest levels in years. Some have also been handing money back to shareholders through share buybacks. The improved financial health naturally increases oil companies' ability to finance projects on balance sheet with the added benefit of being able to avoid the lengthy and burdensome processes normally involved in a project financing.

In addition, it is likely that with greater financing flexibility, companies will choose to pursue some projects that would otherwise have difficulty meeting the contractual requirements for a successful project financing. This is true for some of the LNG receiving terminals that have been proposed in the US and elsewhere. Several of these terminals are being built to provide access to the US gas market, with the aim of sourcing supply from several different liquefaction sites and providing flexibility in the form of cargo destination options, in order to optimize the timing of LNG deliveries in various markets. For those without a long-term sale and purchase agreement (SPA), the outstanding volume and price risk makes them unsuitable candidates for project finance.

High commodity prices frequently provide the impetus for investment in new infrastructure, as in the recent rise in natural gas prices, which has increased the competitiveness of LNG. It is estimated that \$150 billion

worth of new investments will be made in the upstream LNG industry between now and 2010, and as much as \$220 billion by 2015.² In the absence of project finance this would require investors in upstream LNG projects to have the capacity and willingness to absorb the magnitude of this capital requirement, a prospect that is unlikely. In particular, it is important to note the increase in scale of some recently proposed LNG liquefaction projects.

Scale of investment need

With total costs running over \$3 billion for many of these projects, few if any sponsors would be willing to bear this degree of credit risk entirely on their balance sheets. Instead, sponsors are likely to look to project finance to provide the necessary additional capacity and to take advantage of limited-recourse options.

For example, in December 2004, the \$9.3 billion Qatargas II LNG project reached financial close with a project financing package that included a \$3.6 billion facility from commercial banks, \$0.8 billion from two export credit agencies (ECA), and \$0.5 billion from Islamic banks. It is probable that this type of multi-source financing will appear again as other large LNG projects undergo the financing process, e.g., Qatargas III and Sakhalin II.

Like the LNG industry, the global petrochemical industry will also experience a tremendous increase in supply capacity over the next decade. In particular, developers of new capacity will be seeking to fulfill the rapidly rising demand for petrochemical products in China and India.

However, in a high commodity price environment, being close to reasonably-priced natural gas supply is instrumental to maintaining world-class competitiveness. For this reason, a majority of new petrochemical capacity will be located in the Middle East, where the value of 43 currently proposed projects is estimated at nearly \$40 billion.³ This includes six mega-projects with total estimated project costs of US\$2 billion or higher.

While all of these projects may not be built, the volume of investment is again large enough to warrant a meaningful role for project finance. In addition, consider the fact that many projects in both the LNG and petrochemical sectors are undertaken as joint ventures, frequently involving an IOC or major international chemicals company partnering with a local company. Where joint-ventures include a partner of modest investment capability, project finance can provide a structure that doesn't require the wealthier partner to cover more than its proportionate share of the financing.

With so much investment opportunity in the LNG and petrochemical sectors, the need for project financing may also arise from the fact oil companies still have fundamental investment obligations to their core activities of exploration and production (E&P). At a time when many companies are facing a real threat of dwindling reserves, a rise in E&P spending, especially for riskier ventures, can be expected. Companies will prefer to reserve their balance sheets for these and other upstream projects that cannot be project financed.

NOCs and Independents

Still, better balance sheets and investments in LNG terminals and other gas infrastructure represent only a portion of the industry impacted by high oil prices. The benefits of high oil prices are not felt uniformly across oil companies. The mega-projects also primarily illustrate the experience of the big international oil companies (IOCs), a picture that does not capture impacts on many of the mid-sized (Independents) or national oil companies (NOCs). When this is taken into account, as well as the tremendous volume of investment proposed in the LNG and petrochemical industries over the coming years, the outlook for project finance begins to look more promising.

Unlike the IOCs, NOCs incur greater obligations to their governments, which can only be expected to rise with higher prices. With many governments facing budgetary crises and growing social sector demands at home, few will pass up the opportunity to increase their "tax" take from their NOCs.

As an example, in 2004, Mexico's Petróleos Mexicanos (Pemex) paid \$42 billion dollars in government taxes, accounting for one-third of the country's annual tax revenues. This compares to the approximately \$10 billion of investment made by Pemex in the same year, most of which was financed by debt.

Venezuela's Petróleos de Venezuela (PdV) also struggled last year to pursue investments because it was required to spend \$3.7 billion, in addition to its normal tax payments, for new government social programs and an infrastructure development fund. This is indicative of how the NOCs are – with few exceptions – unable to necessarily turn their greatly-increased revenues into a larger capital expenditure budget for new investments.

At the same time, in recent years, as concerns about energy self-sufficiency and security of supply escalate, several NOCs have sought to acquire stakes in foreign ventures in order to increase and diversify their assets. For example, Brazil's Petróleos Brasileiros (Petrobras) has expanded its activities in other South American countries and is utilizing its expertise in deepwater technology to pursue opportunities in the Gulf of Mexico and West Africa. Similarly, major LNG exporters Petronas (Malaysia) and Sonatrach (Algeria) have taken interests in foreign liquefaction projects including, respectively, Egypt's ELNG II and Peru's Camisea LNG projects. If surplus oil revenues are squeezed by governments, NOCs may seek to carry out some of their foreign investment objectives through project financing.

Somewhat more like the IOCs, but smaller in size, are the Independents. Their time horizon for investments tends to be shorter than IOCs, enough that they may rely on currently-aggressive forward price curves for their price assumptions and have no experience with project finance.

However, with unprecedented cash resources at their disposal in the current environment, there is a likelihood that they will seek to take shares in longer-term investments. With many Independents' activities limited to exploration and production up to now, downstream assets may seem like especially good candidates for financial commitment, thereby increasing their involvement along the value chain.

Anadarko set a precedent in August 2004 when it became the first Independent to enter the LNG terminal business through its acquisition of Access Northeast Energy, sponsor of the Bear Head LNG terminal in Nova Scotia. As their investments venture into new territories, Independents can find that project financing gives them leverage to take on significantly larger projects while safely limiting their own balance sheet exposure.

As more projects are undertaken in emerging markets where banks may have lending limits, project financing can also improve a project's financeability by drawing from multiple sources of financing. This often includes a loan tranche from one or more export credit agencies (ECA) and, in fewer cases, a bond placement in the capital markets. In addition to the added debt capacity, a project's support from an ECA can increase the comfort level of commercial banks lending to the project, possibly drawing greater interest in the project from entities with previous reservations.

Finally, as forward prices curves remain bullish and the competition to bring online new LNG and petrochemical capacity heats up, some sponsors are aiming for alternatives to the normally lengthy period (around 15 months) required to close project finance deals. In order to maximize their benefits from high commodity prices, some projects may seek to expedite the financing process, as in the case of the Qatargas III LNG project, which currently has a timeline of about 8 months from application to financial close. Other LNG projects, aiming to be operational in time to secure access to the US natural gas market, may follow the strategy of Marathon's Equatorial Guinea LNG project, in which the project's sponsors made a final investment decision in July 2004 to proceed without a financing commitment. This shortened the scheduled timeline of the project with a project financing now set to proceed.

Project finance trends

In the Middle East, where many of the LNG projects and most of the new petrochemical mega-projects are being developed, the local bank markets (and Islamic financing institutions) are extremely liquid and in

search of capital-intensive projects in which to lend to or invest. As is often the case, where capital availability exceeds asset availability, the urge to make loans or investments can drive a couple of trends, namely, an increase in the amount of capital that is lent or invested per transaction and a decrease in the rigor of the credit approval process.

Banks may begin to assume what would be, in less-frothy times, market risks that are more typically borne by equity participants. This is particularly true of local banks or regionally-oriented banks that...

- (a) get more comfortable with the local market conditions, or possibly even with international markets that are served from the local market; and
- (b) have fewer options in terms of spreading their asset portfolio over many countries, as do major European banks.

In this environment, the project finance market can become overheated, as lenders compete to participate in fewer, but much more capital-intensive, projects. It can also create substantial discrepancies in views of market and credit risks among local and international banks and ECAs.

It is not only in the Middle East where this phenomenon can occur, as we have seen in China, where Chinese banks act to entirely squeeze out foreign bank participation in major project financings. They provide debt on terms that can be seen as substantially more favorable than the terms that would be expected from a broader selection of international lenders.

In these situations, sponsors can rightfully be expected to seize the moment of opportunity to place their project finance debt on terms that can represent substantial improvements over deals completed just a few years ago.

However, it may not be the case, as mega-projects absorb much of the bank liquidity in certain markets, that such terms and conditions will persist. Consequently, costs of capital on the debt side may be about as favorable – and terms as flexible – as borrowers can reasonably expect. This would then represent an extraordinary time to borrow on a project finance basis.

Further, the trend in mega-projects has not failed to catch the eye of the investment bankers who are always interested in attempting a capital markets offering, especially when capital amounts can be measured in billions, not just tens-of-millions of dollars. So, there is once again the lure amongst investment banks to possibly return to the arena of project finance that most of them abandoned five years ago. In particular, capital markets can be an effective capital tool for project financings in Qatar, Trinidad, Australia, Malaysia, Oman, and possibly even other countries that enjoy investment grade ratings.

Conclusion

So, even with the oil and gas sector awash in cash, the potential for project financing remains robust, and perhaps even healthier than in recent memory. The sheer size of transactions in the oil sector, the LNG industry and the petrochemicals industry; the continued need by most NOCs for resorting to debt leverage to achieve their capex goals; and the readiness of banks to make loans on terms perhaps unheard of in recent years, makes the oil and gas sector a fruitful proposition for project finance.

Footnotes:

1 Based on weekly data for the last two decades. "Back to the Old Paradigm," Petroleum Economist, February 2005.

2 "LNG – The Growth Industry," Citigroup Global Markets Report, December 2004.

3 "Major Middle East Petrochemical Projects," Middle East Economic Digest, April 29, 2005.

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