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# Russia: Sakhalin II project financing

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Project financing for the US$20 billion Sakhalin II project - the world's largest limited-recourse oil and gas financing and Russia's largest foreign investment and project financing - has finally been secured.

Japan Bank for International Cooperation (JBIC) and a consortium of international commercial banks signed the US$5.3 billion project finance contract in June 2008. By this date the development was already more than 90 per cent complete.

Since its inception in the 90s, Sakhalin Energy Investment Company's (SEIC) project has been hounded by delays, cost over-runs and objections from the Russian government and environmental campaigners.

Amid this controversy development costs for Sakhalin II soared from less than US$10 billion to more than US$20 billion. The sponsors met this funding gap with equity resulting in the project's unusual 27:73 debt:equity ratio.

The phase two integrated oil and gas production project [Projects Database] involves the construction of:

- three offshore platforms
- onshore processing facilities
- two 800km pipelines
- an oil export terminal
- a two-train LNG production facility on Sakhalin island

First year-round oil production and export should start in H2 of 2008 and SEIC is also aiming for the LNG plant start-up before the end of this year. LNG export to markets in Japan, Korea and the North American West Coast should start shortly thereafter.

**Financing**

JBIC provided US$3.7 billion towards the US$20 billion project financing while a consortium of commercial banks participated in a US$1.6 billion uncovered loan tranche.

The MLAs include:

- Bank of Tokyo Mitsubishi
- BNP Paribas
- Credit Suisse
- Mizuho
- Sumitomo Mitsui Banking Corporation (SMBC)

The deal should reach financial close in July when the banks - led by Bank of Tokyo Mitsubishi, Mizuho and SMBC - will move to syndication.

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Linklaters advised SEIC on the financing while White & Case advised JBIC and the commercial lenders. Credit Suisse acted as financial advisor to the sponsor.

Notwithstanding its political elements, the deal has a solid traditional oil and gas project finance contract structure; it is a limited recourse deal and has offshore and onshore security, direct agreements and offshore accounts for collection of most of the revenue.

Furthermore, the hefty equity stake - even though not intentionally structured into the deal - makes it an attractive deal for the lenders.

Not all institutions in the debt market however were seduced by this low debt ratio and strong structuring; SEIC failed to secure financing from either the UK or US export credit agencies or EBRD.

The US Export Import Bank received a letter of interest from the Shell-led project company in 2001 and this was converted into a final application in March 2002. The sponsors also approached the UK Export Credits Guarantee Department (ECGD) in October 2002.

However, the banks did not reach a conclusive decision as to whether Sakhalin II met their project acceptability criteria and were hounded by NGOs - such as World Wildlife Fund (WWF), Friends of the Earth (FoE), BankWatch and Sakhalin Environment Watch - for the next six years over the project's environmental and social concerns.

SEIC withdrew its application for financing in March 2008, as SEIC's Ivan Chernyakhovskiy explains: "With the progress of Sakhalin II Phase 2 construction we needed to secure project financing in good time before completion in the H1 of 2008.

"From our view point, ECGD's and US ExIm 's involvement in the financing risked additional delays, and these were not compatible with the company's wishes and timing for expediting financing. In SEIC's view, both credit agencies had significant uncertainties on the time line for their final decision making."

**Project off-take agreements**

SEIC has signed binding heads of agreement or SPAs for more than 98 per cent of the plant's 9.6 mtpa of LNG. Around two-thirds of the LNG capacity will be supplied to Japan - to nine buyers - while the remaining LNG will be supplied to Korea and Sempra Energy's Energía Costa Azul terminal in Baja California, Mexico.

The buyers include:

- Tokyo Gas - 1.1 mtpa for 24 years
- Tokyo Electric - 1.5 mtpa for 22 years
- Kyushu Electric - 0.5 mtpa for 22 years
- Toho Gas - 0.5 mtpa for 24 years
- Shell Eastern Trading - 1.6 mtpa for 20 years
- Tohoku Electric - 0.42 mtpa for 20 years
- Hiroshima Gas - 0.21 mtpa for 20 years
- KOGAS - 1.5mtpa for 20 years
- Osaka Gas - 0.2mtpa for more than 20 years

However, as one source close to the deal says: "It was an interesting project from a structuring point of view in that when it was originally developed for project financing it was at a very early stage in the marketing of the sales arrangements with off-takers and had very few off-take agreements in place - at the time this was a very unusual structure for an LNG project financing transaction."

But given the project's proximity to Japan and the government's desire to secure energy supplies from overseas there was little doubt that Sakhalin would secure off-takers.

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**The involvement of Gazprom**

The Sakhalin II production sharing agreement was Russia's first PSA. When the deal was signed in 1994 between the government and SEIC, the sponsor company comprised:

- Marathon Oil - 30 per cent
- McDermott - 20 per cent
- Mitsui - 20 per cent
- Royal Dutch Shell - 20 per cent
- Mitsubishi Corporation - 10 per cent

The agreement - shaped during a time when a weak Russian economy hankered after any form of foreign investment - was criticised for being too heavily skewed in favour of SEIC.

As a report to the EGCD published in April 2006 by The Corner House, FoE and WWF UK, explains: "Under the terms of the PSA...all cost over-runs are effectively deducted from the state's revenue, not the consortium's profits. During the planning and early construction of the project, costs rose dramatically. In February 2005, the Audit Chamber of the Russian Federation found that, as a result of the terms of the PSA, cost over-runs had already cost the Russian state US$2.5 billion. This situation worsened further when, in the spring of 2005, SEIC announced that project costs had mushroomed from US$10 billion to US$20 billion."

Resentment over the project's spiraling costs and the unsympathetic terms of the agreement led to an increasingly fractious relationship between the state and SEIC.

Discontent was expressed chiefly through concerns that Sakhalin II violated Russian environmental laws. The state claimed that pipeline laying had caused hundreds of millions of dollars of damage to Sakhalin's sensitive habitat and the project's environmental permit would have to be revoked.

In November 2006 Oleg Mitvol, deputy head of the Russian environmental supervisory agency Rosprirodnadzor, announced that the government was preparing a US$15 billion complaint against SEIC for illegal logging and the damaging rivers in the course of its pipeline construction.

SEIC ostensibly revised its environmental action plan while new terms for the PSA were negotiated.

In April 2007 Gazprom completed its US$7.5 billion acquisition of just over half of the Sakhalin II development and the project's modified environmental policy was approved by Russian authorities.

Following Gazprom's entry, interest in SEIC was divided:

- Gazprom - 50 per cent plus one share
- Shell - 27.5 per cent
- Mitsui - 12.5 per cent
- Mitsubishi - 10 per cent

The shift in ownership of the project company was met with mixed responses from the debt market.

EBRD issued a statement saying it would no longer consider the financing package of the Sakhalin II project as there had been a significant material change to the project that it had been discussing for the past five years.

However the bank said: "If the new group of shareholders were to request it and make a case that the project could be eligible for EBRD investment, the bank could consider financing in the future. The closer the project comes to completion, however, the less value EBRD financing could add."

However, Gazprom's position in the Russian gas market will have given commericial lenders comfort in terms of the overall political and economic stability of the project.

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**Environmental Challenges**

Sakhalin II has been plagued by environmental and social opposition since its inception. Key concerns include:

- **impact on whales** - Sakhalin Island's off-shore waters are home to the critically endangered Western Gray whales, of which there are only around 100 remaining. The large-scale oil developments could threaten future survival of the population
- **impact on salmon and fisheries** - the two 800km pipelines will cross over 1,100 watercourses, many of which provide spawning and rearing habitat for wild salmon, including the endangered Sakhalin taimen. The salmon fisheries are the traditional backbone of the local economy and an important part of the culture of the indigenous peoples
- **pollution risks** - no oil spill response plan is in place that is proven to work in the sea-ice conditions off Sakhalin Island
- **dumping of waste in Aniva Bay** - during construction of the LNG terminal at least 1.5 million cubic metres of construction dredging waste was dumped into Aniva Bay and more than 500,000 cubic metres of wastewater will annually enter the fisheries-rich bay
- **impact on indigenous peoples** and concerns that the livelihood of tens of thousands of fishermen and other would be threatened

James Leaton, senior policy advisor for WWF, explains: "The fundamental flaws are already built into the project in terms of its location next to the gray whale feeding area.

"Obviously there has been a lot of trouble in terms of the construction of the onshore pipelines and there are ongoing concerns as to whether SEIC has built them in the correct way to withstand the seismic disturbance that occurs in the region and the extreme weather conditions there.

"It's too late to influence the construction but that is a key phase, which was part of our argument with the banks: SEIC has already made its decisions and it has already built an increasing proportion of the project as time goes on, so what are you influencing at this point?

"I think going forward the main outstanding issue for us is oil spill response. The Piltun area is covered in ice for half the year and there is still no recognised way of cleaning up an oil spill in ice. If there was a spill it would be very damaging for the gray whale habitat.

"The companies are obviously looking at what the spill response should be and I think we would hold the banks who are financing the project responsible to ensure that the plan is as robust as it can be."

AEA Technology - employed as an independent consultant on the Phase 2 Project - produced a report on SEIC's commitments as laid out in its Health, Safety, Environmental and Social Action Plan (HSESAP).

SEIC was keen to highlight that: "The report observes that the HSESAP incorporates commitments to a number of important environmental, social development and research plans and programmes."

But the report stressed that two "non-compliances" in execution had occurred; namely in aspects of onshore pipeline construction and issues relating to the protection of Western Gray Whales.

Leaton announced in 2007: "The AEA Technology report is nearly 300 pages of reasons not to fund the Sakhalin II project. It's time ECGD broke new ground and actually turned down a project on environmental grounds, rather than ignoring the evidence staring it in the face."

The AEA report did however praise Shell's decision to commission an independent whale advisory panel in 2004 to advise measures to limit impact on the rare whale population.

But as Leaton points out this had little real impact on project decision making: "The way companies are set up, they struggle to incorporate science into their decision making. The timing of the panels was not conducive to the operator

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actually changing the project. The sponsors had already commissioned contractors and produced the designs and set the budget according to that."

He adds: "That was the problem; SEIC didn't have a mechanism for incorporating the best scientific advice into the way they developed the project."

Leaton is adamant that the key environmental concerns have still not been addressed: "I would argue that if SEIC had put it right they would have got financing from a broader range of institutions. We were successful in highlighting cases where they weren't meeting the standards that should be required of a project like this that is located in a very sensitive habitat. That is why they didn't get finance from EBRD or ECGD."

Aside from BNP Paribas, the banks involved in the project are all Equator Principle signatories and as such should ensure the projects they finance are developed according to sound environmental management practices.

Leaton says: "We had a discussion with Credit Suisse as to why the project breached Equator Principles and at the time they said they were acting in a purely advisory role and so the principles didn't apply."

Despite these assurances Credit Suisse did later sign agreements to finance the project.

However banks, such as JBIC, emphasise that their role in the project is partly to ensure adverse effects to the environment are minimised.

For example, JBIC held a consultation forum 13 times in Tokyo and Hokkaido to give stakeholders in the fishery industries the opportunity to voice their doubts over the development and to ensure these were communicated to SEIC.

A JBIC spokesman says: "As a result of those communications, SEIC decided to develop the Oil Spill Response Plan (OSRP) especially for Hokkaido, even though it is not required legally."

**Conclusion**

Despite the controversy over whether Sakhalin II is EP-compliant, the project is more than 90 per cent complete and did secure more than US$1.6 billion of bank debt in tight market conditions.

As White & Case partner Jason Kerr, who co-led the finance documentation with Peter Finlay, says: "This deal reflects the continued confidence and appetite of the international debt community for well structured energy deals in the Russian market."

An industry expert adds: "This will be a very interesting template for the development of future project financings in Russia and the energy sector. A considerable amount of work went into the development of a bankable onshore and offshore security structure and an extensive environmental monitoring and compliance regime. These structures will be reviewed and used as a benchmark going forward.

"The structure had the input of significant international sponsors and Gazprom - together with considerable input during the course of the transaction from ECAs, multilateral and commercial lenders."

**The project at a glance**

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| Project Name | Sakhalin II |
| Location | Russia |
| Description | The second phase of Sakhalin II involves construction of two production and drilling platforms offshore, and pipelines that would run underwater to the northern tip of Sakhalin Island, and then overland to the southern end of the island to oil and gas export terminals and a Liquefied Natural Gas plant. |

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|---|---|
| Sponsors | Sakhalin Energy Investment Company (SEIC):<br>• Gazprom: 50%<br>• Shell: 27.5%<br>• Mitsui: 12.5%<br>• Mitsubishi: 10% |
| EPC Contractor | • Toyo Engineering<br>• Choyidoya Corporation<br>• Khimenergo<br>• Nipigas |
| Construction Stage | Over 90% complete |
| Total Project Value | US$20 billion |
| Total equity | US$14.7 billion |
| Total senior debt | US$5.3 billion |
| Senior debt breakdown | JBIC: US$3.7 billion project finance loan<br>US$1.6 billion uncovered loan:<br>• Bank of Tokyo Mitsubishi<br>• BNP Paribas<br>• Credit Suisse<br>• Mizuho<br>• SMBC |
| Debt:equity ratio | 27:73 |
| Export credit agency support | JBIC: US$3.7 billion project finance loan |
| Mandated lead arrangers | • Bank of Tokyo Mitsubishi<br>• BNP Paribas<br>• Credit Suisse<br>• Mizuho<br>• SMBC |
| Legal Adviser to sponsor | Linklaters |
| Financial Adviser to sponsor | Credit Suisse |
| Legal adviser to banks | White & Case |
| Date of financial close | July 2008 |

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