Nord Stream Pipeline - Phase 1

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The first phase of financing for the Nord Stream gas pipeline was brought to close in a market gripped by the global financial crisis, achieving an impressive over-subscription on a landmark transaction that is of strategic importance to both Russia and the EU.

This deal was driven to financial close by massive political will from the Russian side to secure offtake for its gas and from the European nations seeking greater security of supply to their gas networks.

It was one of the most eagerly anticipated project financings of 2010 and - together with PNG LNG and Saudi's Jubail Refinery - make for a vibrant Oil & Gas sector in the first half.

Financial close on the deal, postponed from its original target of December 2009, was pushed through to the signing ceremony at the London Stock Exchange on 16 March by the sponsor's dogged determination, pushed on by political will.

Nord Stream Phase 1 financing was provided by a club of 26 banks and three ECAs, with an array of advisers in tow. The 60 per cent over-subscription on commercial debt reflects the importance of the project to secure energy supplies and a well-structured transaction.

Nord Stream's chief financial officer Paul Corcoran says: "If there was a deal that was going to be done it was going to be ours no matter what the market conditions."

This driving ambition was essential to get the project to financial close given the financial crisis. White & Case partner Jason Kerr adds: "If this deal had financed just 18 months ago it would have sold very well with just a handful of MLAs. But the crisis intervened and had a major impact on the project finance market."

Nord Stream achieved two market firsts with Gazprom embarking on its maiden project financing deal from the outset [it had been involved in the PF of Sakhalin II, but came to the deal late], and it was the first multi-jurisdictional pipeline to be financed since the infamous Russia/Ukraine gas switch-offs in 2006 and 2008.

These inevitably gave the pipeline a politically controversial dimension as Nord Stream's lead sponsor and its supply came under greater scrutiny.

With these factors in mind, Nord Stream has become a trailblazer for the European pipeline market having completed the first large financing of the pack with both South Stream [Projects Database] and Nabucco [Projects Database] nearing their approach to the market.

The project

At a total length of 1,222km the pipeline will stretch from Vyborg in the Leningrad Oblast of Russia underneath the Baltic Sea to Lubmin in Germany passing through the jurisdiction of five European states.

It will supply an initial 27.5 billion cubic metres (bcm) of Russian natural gas to the European market with that total to double to 55 bcm following completion of the second phase.

With GDF Suez's addition set to be legally formalised over the coming weeks, ownership of the Nord Stream special purpose vehicle (SPV) will be split as follows:

- Gazprom - 51 per cent
- BASF Wintershall - 15.5 per cent
- E.ON Ruhrgas - 15.5 per cent
- Nederlandse Gasunie - 9 per cent
- GDF Suez - 9 per cent

Originally mooted by Gazprom in 1998, it was not until 2005 that the project got underway with the completion of feasibility studies and the creation of the SPV, the North European Gas Pipeline Company.

The following year the project was rebranded as Nord Stream with Société Générale hired as financial adviser and White & Case brought on board for legal support.

Over the course of the project Clifford Chance also supplied legal advice to the banks and ECAs, while Linklaters was with Gazprom. Both RBS and Commerzbank acted as financial adviser to the sponsor, with UniCredit advising it on the tranche guaranteed by Germany's Untied Loan Guarantee Programme (UFK).

Split across a dual pipeline, the project is being financed in parallel to the technical arrangement with a predictable income stream guaranteed through the 22-year transport agreement.

White & Case's Jason Kerr sees the gas transport arrangement (GTA) as being a vital component of the deal allowing it to simplify and nullify many of the risks associated with such a project: "The gas transportation contract was the key anchor for the deal because it supplies the revenue for Nord Stream to pay off the debt. Nord Stream doesn't take the risk of gas going through the pipeline and instead it simply makes the pipe available. A pretty neatly structured arrangement.

"The construction risks were clearly offset by the fact that Nord Stream is a very simple pipeline. So, provided it is kept open for Gazprom export then a fee will be taken [and all parties will be paid]."

In addition to securing supply and financing, the sponsors also had to gain approval for a series of permits and environmental permissions further complicating the financing.

Paul Corcoran: "The project needed permits from five countries through whose territory, or exclusive economic zone (EEZ), it passes through. Environmentally, we involved all nine Baltic countries since 2006 in the largest Espoo process which has ever been carried out.

"It was very important that all countries affected, especially environmentally, were consulted. Of course the project also had strong EU and Russian support [which helped]".

With the last of the permits awarded by the Finnish government in February 2010, the project route was reviewed by individual governments for final kinks or amendments.

The Swedish, German and Polish government each had the pipeline route amended at certain junctures to ease geopolitical or logistical issues. Many analysts saw these factors as being potentially fatal to the progression of the project due to Russia's continuing diplomatic isolation from the rest of Europe however these issues were handled quickly and effectively.

Germany, as the primary offtake country, played a pivotal role in softening any negative impact the pipeline had geopolitically and in securing backing from the EU. Indeed, former German chancellor Gerhard Schroeder was appointed chairman of the project.

Chief executive of Nord Stream's German joint sponsor BASF Wintershall, Rainer Seele, told IJ that Nord Stream is a vital "anti freeze tonic for Europe" as opposed to being a factor that will chill relations.

The financing

Spread across four tranches, the €5.5 billion financing is split at a debt equity ratio of 70:30. With ECA support from Italian SACE and Hermes the deal also included a US$1 billion tranche covered by the German Federal Government through UFK.

Each of the ECA covered debt tranches are over a tenor of 16.5 years and weigh in at a total €3.1 billion. In addition there is an €800 million uncovered commercial debt tranche spread over a tenor of 10 years.

In total 26 banks contributed across four tranches, 15 acting as MLAs. These banks, with MLAs denoted in brackets, are:

- BBVA
- Bank of Tokyo-Mitsubishi UFJ
- BayernLB (MLA)
- BNP Paribas (MLA)
- Caja Madrid (MLA)
- Commerzbank (MLA)
- Crédit Agricole CIB (MLA)
- Credit Suisse
- Deutsche Bank (MLA)
- Dexia Credit Local
- DZ BANK
- Espirito Santo Investment
- Fortis Bank Nederland
- ING (MLA)
- Intesa SanPaolo (MLA)
- KfW IPEX-Bank (MLA)
- Mediobanca (MLA)
- Natixis
- Nordea Bank
- Raiffeisen Zentralbank Oesterreich
- RBS (MLA)
- Société Générale (MLA)
- Standard Bank (MLA)
- SMBC Europe (MLA)
- UniCredit (MLA)
- WestLB

The majority of banks lent on a pro-rata basis across all four tranches. Ticket sizes came in four tiers, with several of the MLAs taking the top tier commitments in the order of €300 million, equating to roughly €60 million on the uncovered commercial tranche and €80 million on each of the ECA tranches. The bottom tier of ticket sizes covers commitments totalling around €100 million across the four tranches.

Most of the banks took the top ticket, including all 15 of the MLAs, with the sponsors successful in persuading many of the banks to take up the maximum contribution option.

The uncovered commercial debt tranche of €800 million is spread over an amortizing tenor of 10 years with pricing set at Euribor +275bp pre-completion; +430bp post completion until year seven; and +450bp thereafter.

Pricing was then set at a favourable rate for the sponsors with the Italian SACE €500 million chunk of debt set with a Euribor +165bp price. The Hermes covered €1.6 billion tranche is set at a price of Euribor +160bp.

Finally, the German Government provided untied cover for a loan tranche of €1 billion through UFK is prices at Euribor +180bp. With some banks having their repayment profiles tailored only slightly the pricing reflects an advantageous financing structure for the sponsors helped by the level of cover assured.

The ECA support was seen as the vital factor in securing such considerable interest from the bank market. The need to supply guarantees as a carrot for lenders was vital in persuading banks to invest during such uncertain financial times.

The use of SACE, UFK and Hermes also neutralized fears over perceived risk. Société Générale managing director of project finance Stephen Craen says: "I wouldn't say it was so much political risk, more the problem was banks' limits for Russia and Gazprom. [Gazprom] had been actively borrowing in the few years run up to that time and banks were reluctant, with the credit crunch having just occurred, to increase their limits."

In securing guarantees for 80 per cent of the debt Nord Stream ensured that lenders would view the project as being as risk free as possible. From the ECA point of view the sponsors focused the project away from the pipeline itself and on to contractual obligations and sponsor commitment.

"The ECA's were very pragmatic and understood that you couldn't take concrete fiscal security over a pipeline in international waters," says Kerr.

"So they tended to focus on the share pledge and contracts instead of the physical pipeline."

Corcoran adds: "The fact that we've got Hermes in, SACE in and UFK in shows that there is a degree of political risk cover implicitly in that. But equally the fact that we don't have IFC, EBRD and EIB in also says that we have a limited need for political risk support."

The ECA coverage is notable for the absence of the big European players such as the EIB and EBRD, but the presence of large scale German support meant that Nord Stream did not need to approach these or the IFC for funding, subsequently avoiding the complicated shareholding structure of these organisations.

Although Craen describes the project financing as following a certain conservative blueprint in its structure, he points out that it was important not "to ask banks to go to the edge in project financing terms".

This was vital in reassuring the lending community and the strategy appeared to work with Corcoran seeing the deal as a massive success. "We received bids from 29 banks, 60 per cent oversubscribed and were able to reach clearing prices below our indicative pricing in our model," he says.

The nature of the market and the viability of the project all meant that the deal did not have to push the agenda in terms of debt structure to garner interest. Overcoming the credit crisis was the key challenge Nord Stream had to hurdle and through keeping the structure simple it minimised the risk.

"We couldn't have launched at a worse time or at least we couldn't have been starting our market sounding at a worse time simply because of the credit crunch," says Craen.

"We spoke to banks some way ahead of time, it was quite a difficult time in the market not long after the Lehman Brothers crisis and at a time when gas prices were low, reducing Gazprom and Russia's revenues. There were also a number of major corporate problems in Russia. All those factors were curtailing banks market appetite for lending at all and also in terms of their appetite for Russian transactions.

"How it was overcome was getting as much cover as we could from SACE and Hermes and then introducing UFK. We reduced the tenor we were looking for from commercial banks and also brought in UFK. If there is any innovation in the financing then bringing in UFK was it" said Craen on the moves made to optimize investment."

The future

The close of phase one ushers in phase two which will commence financing almost immediately, according to Corcoran.

"We'd hope to be coming to the market in the summer of this year with a view to a signing by the year's end," he says.

"Having this large a number of banks who have all become familiar, obviously seen the project as attractive and been through all their internal reviews, investigation and approval I would hope that a large proportion of those would then have further appetite. Especially after the oversubscription for phase one considering that all the banks have been scaled back from their bids."

With such a successful phase one financing it is difficult to forsee any major storm clouds on the horizon. Craen attributes this to forward planning. "Nord Stream is a single project being developed in two phases; the financing approach reflects the underlying technical and commercial framework," he says.

"The financing structure for phase one specifically carefully contemplates how phase two will be financed. In this respect phase one has left a great platform for phase two."

With GDF Suez set to legally join the project over the coming months Wintershall chief executive Rainer Seele made it clear that he expects no more shareholders to join the project following the completion of phase one financing due to the complex contractual obligations each stakeholder holds.

Significantly, Nord Stream has been the first of the big pan-continental pipeline projects to clear the hurdle of financing with both Nabucco and South Stream two of the biggest projects set to approach the market over the coming years.

Both will aim to emulate the success of Nord Stream phase one and in doing so further relieve some of the added political tension associated with such projects and the European gas market generally.

"This deal show that these kinds of international transboundary pipelines can be effectively and successfully project financed," says Kerr.

With analysts and developers alike predicting a gas supply deficit of 120bcm per annum over the coming years it is no surprise that sponsors see cross territory pipelines as attractive propositions to try and plug this gap in addition to liquefied natural gas supply.

With Nord Stream Phase One concluded in tight fiscal conditions it constitutes a landmark transaction that paves the way for a series of other multi-jurisdictional pipelines to hit the market.

The combination of political will and sponors perseverance were pivotal in successfully bringing Nord Stream phase one to close.

Project at a glance

Project Name	Nord Stream natural gas pipeline phase one
Location	From Vyborg, Leningrad Oblast under the Baltic Sea to Lubmin, Germany
Description	Dual pipeline to be built both onshore and offshore transporting 27.5 billion cubic metres per annum of natural gas from Siberia to the European market.
Sponsors	Gazprom - 51 per cent BASF Wintershall - 15.5 per cent EON Ruhrgas - 15.5 per cent Nederlandse Gasunie - 9 per cent GDF Suez - 9 per cent
Operator	Nord Stream AG
Project Duration (Including construction)	2 years
Construction Stage	Construction began April 2010
Offtake Agreements	Dong Energy E.On Ruhrgas Wingas GdF Suez GazProm Marketing & Trading UK
Total Project Value	€5.5 billion (US$7.45 billion)
Total equity	€1.6 billion (US$2.16 billion)
Equity Breakdown	€1.6 billion in sponsor loans

Senior debt pricing	Uncovered debt tranche: Pre-completion Euribor +275bps, years 0-7 Euribor +430bps, post-completion onwards Euribor +450bps SACE covered tranche: Euribor +165bps Hermes covered tranche: Euribor +160bps UFK covered tranche: Euribor +180bps
Debt:equity ratio	70:30
Export credit agency support	€3.1 billion (US$4.2 billion) 80 per cent of total debt
Mandated lead arrangers	BayernLB BNP Paribas Caja Madrid Commerzbank Crédit Agricole CIB Deutsche Bank ING Bank NV Intesa SanPaolo KfW IPEX-Bank Mediobanca The Royal Bank of Scotland Société Générale Standard Bank SMBC UniCreditGroup
Participant banks	BBVA Bank of Tokyo-Mitsubishi UFJ Credit Suisse Dexia Credit Local DZ BANK Espirito Santo Investment Fortis Bank Nederland Natixis Nordea Bank Raiffeisen Zentralbank Oesterreich WestLB
Legal Adviser to sponsor	White & Case Linklaters
Financial Adviser to sponsor	Société Générale Commerzbank Royal Bank of Scotland
Legal adviser to banks	Clifford Chance
Date of financial close	March 16, 2010