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PROJECT FINANCING STRUCTURES FOR THE RUSSIAN NATURAL RESOURCES SECTOR

The research studies how lack of investment in natural resources sector can be overcome through application of project financing structures, which are still not used in Russia. The main characteristics of project finance are considered and its opportunities in comparison to traditional corporate finance are emphasized, the most common obstacles that prevent implementation of financing schemes are focused on as well necessary steps to improve this situation are outlined in the paper.

Показано, как недостаток инвестиций в минерально-сырьевом секторе может быть преодолен посредством использования проектного финансирования, которое до сих пор не получило распространения в России. Рассматриваются основные характеристики проектного финансирования, подчеркиваются его возможности по сравнению с традиционным коммерческим финансированием, описываются основные препятствия, мешающие внедрению данных схем финансирования, а также предлагаются шаги для улучшения сложившейся ситуации.

Introduction

The natural resources sector[1] is traditionally the main pillar of the Russian economy. For instance, the oil and gas production accounts for roughly 20 % of GDP and generates half of all foreign exchange revenues. This dependency is also mirrored in the federal budget of Russia, to which tax and royalty revenues from this sector contribute more than 30 %.[2]

In contrast to this enormous importance stands a long time of neglect of necessary investments to replace outdated machinery and to develop new resources. This shortfall has many of its roots in the former centrally-planned economy. However, even the roughly 15 years of market economy have not changed the situation substantially. There are estimations, that alone in the oil and gas sector a sum of more than 200 billion US-Dollars is needed for investments to enhance productivity, increase pipeline capacity and develop new fields. Otherwise current production levels cannot be retained and the still growing demand of the world market can not be satisfied.[3] Especially the potential for resource development is considerable: Russia possesses roughly 30 % of the world reserves of natural gas and 5 % of oil. In addition, there are still significant resources, that remain unexplored in the northern and eastern Siberian territories.[4]

The mentioned facts raise the question how this lack of investment can be overcome. In western countries, large investment projects are increasingly realised with the application of project financing structures. This kind of financing has also found its way to many transition countries of the former soviet block, where it is mainly applied in public-private partnerships for the modernization of existing and provision of new public infrastructure. This refers especially to those countries that have become new members of the European Union. However, in Russia – the largest transition country – project financing remains an exception.

This article looks for the reasons behind this low level of application in Russia. It starts in part 2 with a consideration of the main characteristics of project finance. Part 3 than em-

[1] The natural resources sector comprises upstream and downstream oil and gas production, petrochemicals, mining, smelting and refining of precious and non-precious base metals, coal and other minerals, processing, and the transportation of natural resources. See EBRD (2001a), p. 5.

[2] See EBRD (2001b), p. 79.

[3] See ibid, p. 81.

[4] See ibid, p. 76 and EBRD (2001a), p. 5.

phasizes its opportunities in comparison to traditional corporate finance. After that follows in part 4 a view on the current state of project financing in the Russian natural resources sector. The most important obstacles that prevent a stronger application of this financing scheme are in the focus of part 5. The article concludes with remarks concerning necessary steps to improve the conditions for a more intensified use of the tool 'project finance' in the future.

Project Finance – Main Characteristics

Project financing has its roots in the natural resources sector. First forms were developed in the oil fields of Texas in the 1930s. Later it was used for the financing of power generation plants in the US and for the financing of public infrastructure in the UK as an element of public-private partnerships ('PPPs'). It was also applied to pay for the setting up of mobile telephone networks in the end of the 1990s.[5]

According to Nevitt/Fabozi the term 'project financing' can be defined as follows:

"A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan."[6]

In detail, project financing structures are characterised by the following elements:[7]

(1) 'New Project' – mainly financing of a new project, although refinancing of maturing loans within existing project finance schemes is also possible.

(2) 'Ring-Fenced Project' – financing of a legally and economically confined project via a special purpose vehicle (SPV). The only business of this legal entity is the project (project company).

(3) 'Substantial Investment Needs' – enterprises to be realised via project finance schemes require investments that range from double-digit million sums to several billions of US-Dollars. The main part – 70 to 80 % – has to be financed by lenders. These are in the most of the cases banks. However, in the last time there is also an increasing use of bonds.[8] The remaining part – 20 to 30 % – is financed by the project sponsors.[9]

(4) 'Syndicated Lending' – Due to the often tremendous financial investment needs a single bank is in most of the cases unable to provide the whole financing.[10] Specialised banks (lead arranger) organise the financing by distributing the credit (syndicating) over a number of banks (participants).

(5) 'Non- or Limited Recourse Finance' – there are no or only limited guarantees from the sponsors for the project finance debt.

(6) 'Cash Flow – Reliance' – the lenders have to rely on the future cash flow for interest and debt repayments. The only real security for their invested capital consists of the project company's contracts, licenses or ownership of natural resources, since the physical assets of the project company are often of little worth and do not yield a 100 % compensation in the case of a borrowers default.

(7) 'Finite Life' – Each project has a certain 'life expectancy' determined by such factors like the duration of licenses or the availability of natural resources. Therefore, the project finance debt must be fully repaid by the end of a project's life.

The following figure shows a simplified project financing structure in the natural resources sectors: The project company stands in the core and has contractual relationships with constructors, sponsors, lenders and offtakers. A concession or license granted to the project company by the government or a public authority forms the legal foundation for the intended exploitation of natural resources. Naturally, the constructors are mainly involved in the construction phase of the project, but could remain partners by signing maintenance contracts for installed equipment.[11]

[5] See Yescombe (2002), p. 6.

[6] Nevitt / Fabozzi (2000), p. 1.

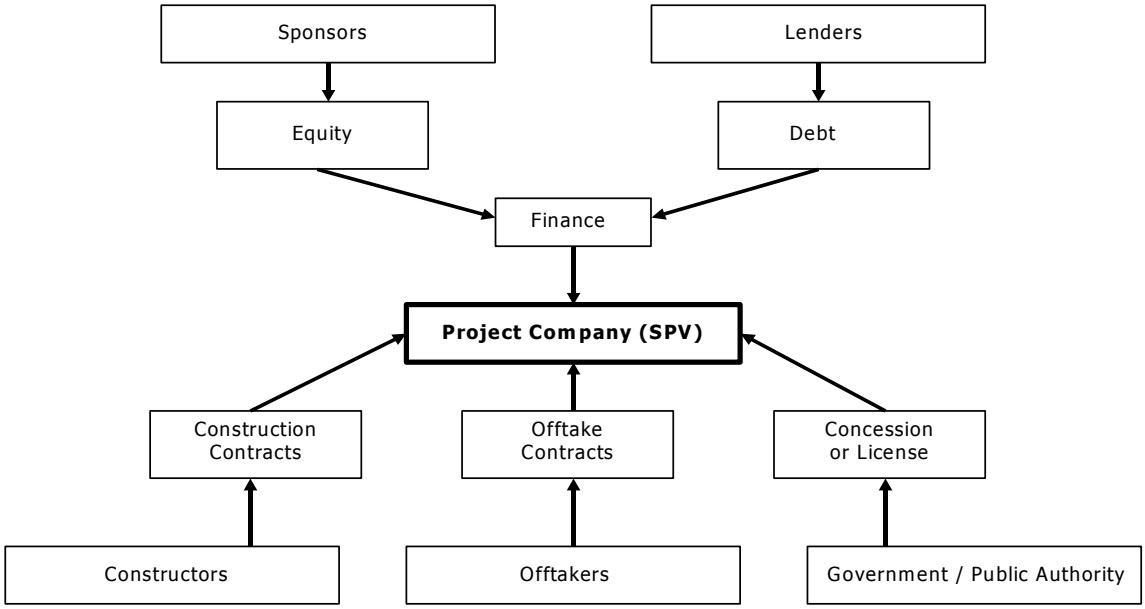
[7] See Yescombe (2002), p. 7f.

[8] A further development in this regard is the securitization of project finance loans.

[9] This amount of money can be considered as a signal, that the project sponsors are interested in the success of the enterprise.

[10] This is normally caused by insufficient financial resources and the necessity to prevent a too high risk exposure.

[11] The role of constructors can further increase, if they offer sales financing for their delivered equipment. It is even possible, that they become responsible for the whole construction and running of e.g. surface mines in so called



Source: According to Yescombe (2002), p. 8.

The Opportunities of Project Finance

Traditionally, new investment projects are financed with a corporate loan. In this case, the company uses its cash and existing or newly raised credit lines to pay for the project. For the company (sponsor), project finance structures with a large amount of external financing offer the opportunity to prevent a long capital lockup, to relieve the balance sheet and to increase the return on the equity, that is dedicated to the project ('leverage effect').[12] This also enables the sponsoring company to faster expand its business by realising more investment projects at the same time.

For the lenders, the project company's separate running guarantees a high level of transparency of the business processes and financial flows. They can be assured, that the project company is isolated from possible economic problems of the sponsor and will remain a going concern even when the sponsor is bankrupt. The separation also allows an easy selling of the project company to other parties.

From this point of view, project financing can be an adequate structure especially for transition countries like Russia where the organisation of enterprises is often still opaque and accounting does not comply with international standards. However, as described above, project financing structures are a network of contracts. Their enforceability has to be guaranteed by the legal systems, which are not yet as efficient as in developed countries of the western hemisphere.[13] Although experience from developing countries shows, that a lack of legal security can be outweighed by contractors with economic and political influence.[14]

The State of Project Finance in the Russian Natural Resources Sector

To this day, there has been only a very small number of project finance arrangements in Russia. However, all of them were realized in the natural resources sector.[15] The following table yields a survey of the most important projects in the mining sector. Here, only the first mentioned project – the Julietta Mine – in the Magadan region is effectively running. The credit contract for the Middle-Timan Bauxit Mining and Processing project is signed, but the disbursement of the loans is delayed due to the recent entry of RUSAL (Russian Aluminium) in the project.[16]

Build-Own-Transfer (BOT) or Build-Own-Operate (BOO) schemes. Although, this would not fit in the project finance structure shown here. See Linden (2002), p. 232.

[12] See Yescombe (2002), p. 14f..

[13] See EBRD (2005b), p. 69f..

[14] See Claudy (2002), chapter II, part A, and chapter IV.

[15] See The Banker (2004), p. 114.

[16] See EBRD (2006a).

Metal Project Financing					
Year	**Name / SPV / Purpose**	**Sponsors**	**Location**	**Total Project Cost**	**Lenders**
2000	Bema Gold's Julietta mine OMGC (Omsukchansk Mining Geological Company) Construction of the gold mine	– Bema Gold Corporation (Canada) (79 %) – Locals (21 %)	Magadan Region	40 Mio. USD	– HypoVereinsbank, Standard Bank and IFC (35 Mio. USD)
Planned	Middle-Timan Bauxit Mining & Processing Project – Phase 1 OAO Bauxite Timana / ZAO Komi Aluminium – Expansion of the mine, – Appraisal studies for an alumina refinery and an aluminium smelter complex	– SUAL Group (The Siberian-Urals Aluminium Company) (50 %) – RUSAL (Russian Aluminium) (50 %)	Komi Republic	150 Mio. USD	– EBRD (European Bank for Reconstruction and Development) (45 Mio. USD) – IFC (International Finance Corporation) (45 Mio. USD) – International bank syndicate (60 Mio. USD)
Planned	Asacha Gold Mine ZAO Trevozhnoye Zarevo Construction of the gold mine	– TSG (Trans-Siberian Gold)	Kamchatka Region	90 Mio. USD	– EBRD – Standard Bank

Source: Bema Gold Corporation (2000), EBRD (2004), EBRD (2005c), EBRD (2006a), Trans-Siberian Gold (2006).

A third project – the Asacha Gold Mine – is also 'in the pipeline', but the signing of the credit contract is postponed because of the lack of certain technical conditions and still missing documents in regard to the production license.[17]

The amounts of investment in the mining sector are lower than in the area of oil and gas (see table below). The first realised project financing scheme in this regard had an amount of nearly 800 million USD and is situated at the coast of Sakhalin Island. It mainly consisted of the construction of an offshore oil platform.

This so called Sakhalin II – Phase 1 project forms the base for Phase 2, which is currently the largest development and exploitation project with an estimated financial need of up to 10 billion USD. This project would also be the largest foreign direct investment in Russia since 1990. Currently, the project is under bank review, whereas open questions concerning the environmental impact are the most critical points that hinder a loan decision. This is especially due to the intended construction of undersea and offshore pipelines. On the one hand, the undersea constructions and the running of the oil platforms would effect the life habit of Gray Wales. On the other hand, the offshore pipeline would cross hundreds of wild salmon-bearing streams.[18] The table contains also the so called SeverTEK project, which is like the first phase of Sakahlin II already running. It was the first project finance scheme in the oil and gas sector that was realised after the financial crises of 1998. It comprises mainly oil production and pipeline construction in the Nenets Autonomous Area. The implementation of the project took only short time and prompted the hope for a large number of successors. However, till today, no further project finance loans were disbursed. The reason for the fast progress of the SeverTEK project was obviously related to the character of the involved participants. Two of them, namely the EBRD as one of the main lenders and Lukoil as the Russian partner possessed obviously enough political weight to accelerate bureaucratic processes. The following part will show that the latter are currently one of the largest 'hurdles' for an increasing project finance activity in Russia.

[17] See Trans-Siberian Gold (2006).

[18] See WWF (2004), p. 1.

Oil & Gas Project Financing					
Year	**Name / SPV / Purpose**	**Sponsors**	**Location**	**Total Project Cost**	**Lenders**
1997	Sakhalin II – Phase 1 SEIC (Sakhalin Energy Investment Company Ltd.) Construction of one offshore production and drilling platform	– Royal Dutch/Shell (55 %) – Mitsui and Co Ltd. (25 %) – Mitsubishi Corporation (20 %)	Sakhalin Island	780 Mio. USD	– EBRD (116 Mio. USD) – OPIC (Overseas Investment Corporation) (116 Mio. USD) – JBIC (Japanese Bank for International Cooperation) (116 Mio. USD)
2002	SeverTEK JSC SeverTEK Construction of: – wells – a central processing facility – a connection to the regional pipeline	– Fortum (50 %) – Lukoil (50 %)	Nenets Autonomous Area	355 Mio. USD	– EBRD (100 Mio. USD) – International bank syndicate (7 banks) arranged by the HypoVereinsbank (100 Mio. USD)
Planned	Sakhalin II – Phase 2 SEIC (Sakhalin Energy Investment Company Ltd.) Construction of: – two offshore production and drilling platforms – pipelines – oil and gas export terminals – Liquefied Natural Gas (LNG) plant	– Royal Dutch/Shell (55 %) – Mitsui and Co Ltd. (25 %) – Mitsubishi Corporation (20 %)	Sakhalin Island	10 Billion USD	– EBRD – JBIC – ECGD (the UK Government's Export Credit Guarantee Department) – EXIM (US Export-Import Bank) – Others

Source: EBRD (1997), EBRD (2002), EBRD (2005a), EBRD (2006b).

Obstacles to Project Finance in the Russian Natural Resources Sector

The most important obstacle to a larger use of project finance structures is the currently low demand for external financing in this sector. The few investments that are made by national producers are financed with high revenues from a drum-tight world market for resources and energy. Therefore, these companies do not look for financing structures with a long-term orientation. However, there are also a lot of problems that would make it difficult to organise project finance structures in practical terms – especially for foreign investors:

(1) Unclear political agenda in regard to natural resources and FDI

The years between 1990 and 2000 have been a period of political and economic instability with changing governments and a serious financial crisis in 1998. With the first tenure of president Vladimir Putin, that started in 2000, began an economic recovery and a process of political stabilisation. However, it is still not clear towards which kind of economic organisation Russia is developing and what role especially the natural resource sector and foreign direct investments (FDI) will play in this evolution. Because of these political risks, each larger project finance has to involve participants with political influence in Russia. This can be international development banks or important national enterprises with a close relation to the

Russian government. Especially the EBRD has in regard to Russia a substantial political weight. This is due to the fact that Russia itself is a member of this bank and that some of the other members are important trade partners of Russia like e.g. Germany.[19]

(2) High transaction costs due to long lead times and high complexity of the deals

High transaction costs are a typical problem of the organisation of project finance structures. This refers not only to Russia. However, numerous bureaucratic problems and the lack of experience increase them substantially.[20] The following points illustrate this more in detail.

(3) Too many necessary permits to set up SPVs

As described above, the core of each project financing scheme is the special purpose vehicle or easier: the project company. There is still a too long bureaucratic procedure to register such a legal entity. This refers especially to 'catch-22' situations, where it is e.g. impossible to get a permission without having a second one, but to get the second one, the first is needed. A further problem relates to the fact that the SPV has to have a license to expropriate natural resources like oil, gas and metal. This license can be transferred from the sponsor company. In the case of Russia there has to be a tender to move the license to the SPV which includes the risk to loose the production permission to third parties.[21]

(4) Lack of legal security for investors and lenders in the case of project failure

Not each project finance scheme reaches its financial goals. This can be due to an incorrect financial forecast, mismanagement or unforeseen events. In all cases it is necessary to find a solution, that satisfies primarily the interests of the lenders. The current legal situation in Russia impedes a quick distribution of assets in the case of project failures, since every transfer of ownership has do be done with an auction. Currently, investors evade this problem by an offshore registering of the project company like e.g. in the case of Sakhalin II.[22]

(5) Lack of project finance experience in the Russian banking market

The Russian banks are still in a process of transformation to become real financial intermediaries. There are some banks with sufficient capital resources, but they still have not enough project finance related experience.

(6) International commercial banks have the experience, but show little commitment

There is a large and developed international market for project finance. More than 100 banks act as lead arranger. Roughly 20 of them organise worldwide project finance syndicates.[23] However their interest for the Russian market remains low. The reason for this lies obviously in the still unclear direction of the Russian market development especially in the field of the natural resources industry. Another problem is the prohibition for foreign banks to open up branches in the Russian Federation, which could be the 'bridge heads' for an increasing commitment.

Conclusion

An increased application of project finance structures could help to overcome the lack of investment in the Russian natural resources sector. As shown, there remain a lot of bureaucratic problems to set up the necessary legal entities. But even more problematic are the open questions concerning the future path of the Russian economic policy, especially towards foreign investment. This leads to the following steps to be undertaken in order to increase investment in the natural resources sector: (1) Presentation of a political road map for the economic development in Russia – This guideline should include a clear decision for free competition and equal opportunities for foreign investments in the natural resources sector; (2) Simplifying of bureaucratic procedures – One element of this could be the organisation of 'one-stop-shops' for the registration of project companies; (3) Permission for foreign banks to open up branches.

The last point is of special importance, since the Russian banking sector is only poorly equipped with capital and, above all, already strongly involved in the business with the natu-

[19] For the special position of the EBRD see Claudy (2002), p. 133.

[20] See The Banker (2004), p. 114.

[21] See ibid, p. 109.

[22] See ibid.

[23] See Yescombe (2002), p. 24f.

ral resources sector. An increased investment of its scarce capital in this sector would further deteriorate the access to finance for other sectors of the Russian economy. Especially small and medium-sized enterprises would have increasing problems to find loans to pay for their expansion, what would hinder an overcoming of the monotone economic structure of Russia. This structural change is at least necessary in the long run, since even the largest proven or undiscovered reserves will be exhausted one day. But also in the short run a diversification is needed to relax the relationship between the development of world market prices for natural resources and the revenues of the Russian federal budget.

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