SG Resources: Salt future

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SG Resources has closed financing on the Southern Pines gas storage project. The deal is the first ever gas storage project financing to close in the US. Such assets remain rare opportunities with unique challenges – securing financing is a difficult process.

Southern Pines is a multi-cavern, high-deliverability natural gas storage project, located in Greene County, Mississippi. It consists of five caverns, each with a capacity of roughly 6 billion cubic feet. The project's phase 1 consists of the conversion of two of these salt caverns into gas storage facilities, and would provide the operator with 8 billion cubic feet of capacity.

The developer, SGR Holdings, is an experienced developer of gas storage infrastructure. Its founders have a long track record of project development, construction, asset management, and financial structuring for such assets. During a four-year period in the nineties SGR built up an independent high deliverability storage company – Market Hub Partners – and in 1998 refinanced several operating facilities in the high-yield debt market, a first for the storage business. Market Hub's owners numbered PacifiCorp and Nisource, among others, but it is now a Duke Energy subsidiary.

The storage business is an essential part of the US gas infrastructure. It helps shippers optimize their networks, assists in ensuring system reliability, and can make up for service interruptions. The disruption that Hurricane Katrina caused to gas production offshore has helped the business case for storage owners immensely.

In the late 1990s, several developers believed that gas storage facilities could become useful speculative assets, and that they could make impressive returns selling gas on spot markets, much as a merchant peaking project would with power.

Aquila, then the merchant energy arm of Utilicorp, proposed financing such a project at Lodi, in California. CIT had provided Western Hub Properties, owned by JP Morgan and Haddington, a $50 million construction loan, and DZ and Union Bank of California were preparing in 2001 to launch an acquisition loan of about $60 million. ArcLight Capital was originally a partner in the project, but eventually gained full control of the asset.

In fact, at this stage SGR was also well advanced with a financing for the Southern Pines asset. It got so far as to complete much of the design work and gained the necessary approvals from the Federal Energy Regulatory Commission (FERC) by October 2002. By this time, however, Enron had hit the US energy markets.

The collapse in the merchant energy market did three things that directly affected gas storage facility owners. It frightened away project finance banks from financing anything but the strongest and most straightforward credits, it slashed the credit quality of the universe of customers for such an asset, and it put paid to the idea that a storage facility could be run as a speculative venture.

SRG's management spent much of the intervening period working on other projects, but by September was ready to approach the market once more, with many of their permits still in place. It had already made CIT familiar with the asset, and despite what SRG's president, Tony Clark, calls strong interest from a number of private equity funds, decided to pair up with ArcLight, which he says "has an in-depth knowledge of the natural gas storage business."

SGR's customers are a mixture of utilities, pipeline operators and energy merchants. Lenders are looking for 50% of the capacity of the facility to be contracted with creditworthy customers. SGR signs a variety of contracts – long and short, for firm and for interruptible capacity.

The plant has a good location, and can connect to four pipeline systems nearby – the Destin Pipeline, the Florida Gas Transmission pipeline at Citronnelle, Alabama, the Transco Mobile Bay lateral, also at Citronelle, and the Gulfstream Natural Gas System at Coden-Station, Alabama. The project concluded the bulk of these agreements in the second half of 2003, and so far has FERC approval for the Destin agreement, with the remaining three likely to receive approvals by the end of 2006.

The location of Southern Pines, towards the east and slightly inland of Mississippi, is also advantageous. Much of the new gas infrastructure in the US is focused on the southeast, including a number of LNG facilities to be located along the Gulf Coast. Both Gulf LNG Energy and ChevronTexaco are proposing terminals at Pascagoula, 40 miles to the south.

While storage facilities such as that of SGR are not essential to LNG's importation, they make it much easier for importers and shippers to manage the flow of gas to customers. While most LNG terminals normally include some form of storage capacity, this is not on the scale of the Southern Pines project, which in phase one has a deliverability of 0.6 billion cubic feet per day (cfpd), and 0.4 billion cfpd of injection.

Phase two of the project will increase these figures to 1.2 billion cfpd of deliverability, and 0.6 billion cfpd of injection. While the first phase will go into service in the middle of 2007, this second phase would come online a year later. Building the project involves a signing contracts for pipeline and meter station equipment, gas handling and compressor equipment, and the work on preparing the salt caverns where the gas will be stored. The first two can be procured conventionally, while the second involves drilling activity similar to what an oil producer would undertake.

Lenders must take comfort in the ability of the developer to manage the construction process, and by staggering the drawdown in funds so that they are only used when the requisite contracts are in place. The banks came on board to an aggressive schedule – the sponsor did not make the end of 2005 as planned, but still signed loan agreements 120 days after engaging CIT, and after syndicating the debt.

The deal has a maturity of eight years following the completion of construction and has a average debt service coverage ratio of roughly 1.4x. Clark did not comment on the pricing, but market rumour has suggested that that it is at around the 250bp mark. At close, ArcLight came in to take a 40% stake in the venture, equivalent to a roughly $12 million equity contribution.

Gas storage assets, while rare, are attracting serious private equity attention. But SGR has signalled its intention to be an owner-operator, rather than, as previously, a turnkey developer.

SG Resources Mississippi
Status: Closed 27 January 2006
Size: $144 million
Location: Greene County, Mississippi
Description: 8 billion cubic feet gas storage facility
Sponsors: SGR Holdings, ArcLight Capital
Debt: $115 million
Arranger: CIT
Maturity: Construction plus eight years
Independent engineer: E3 Consulting
Sponsor legal: Dewey Ballantine
Lender legal: LeBoeuf, Lamb, Greene & MacRae