SeverTEK

01/02/2003

The SeverTEK oil project - a 50-50 joint venture between Russia's largest oil producer, Lukoil, and Fortum of Finland, to finance drilling, and construction of a pipeline to the South Shapkino field north of the Arctic circle - is a benchmark deal by any standards. No offtake agreement, no production sharing agreement (PSA), a western oil major and international banks willing to take on unwrapped Russian operating risk, and a Russian oil major's local knowledge being leveraged as part of the credit.

But of all those firsts, the most remarkable of all is that this deal is a project financing for an oil extraction venture in Russia without a PSA - and it sold. PSAs have long been the only method under which foreign oil majors would invest in Russia, and as a consequence only three deals have been done: Sakhalin I and II and the Kharagaya project. PSAs are fiscal and legal exemptions that overcome foreign investor discomfort with a number of aspects of the Russian oil sector: paying royalties on production prior to payback of capital costs; repatriation of export earnings and conversion of 50% of those earnings into roubles. The problem is that to date the three PSAs granted have been done as acts of parliament and Russia is not going to do any more until it has legislation in place. Concurrently, there is scepticism that Russia is serious about PSA legislation. Certainly the Russian oil majors are not pro, claiming such legislation is unnecessary and eschewed in favour of foreign competition.Consequently, if any foreign investment in Russian oil and gas is going to happen in the future, it is likely to follow the SeverTEK template. Key to the deal is EBRD backing. As Vladimir Matias, head of HypoVereinsbank project and asset finance division in Moscow, says: "The EBRD umbrella was crucial. Without a multilateral level of comfort for commercial banks such deals would not get done. The multilateral umbrella role is of a great importance, especially in the project pre-completion phase where banks are dealing with uncovered Russian risk. In the pre-completion phase, the projects are not in production with exports generating offshore receivables to mitigate the associated country and country risks. Consequently, you need financial structures that provide enough comfort during project construction."

But more than that, SeverTEK is an example of the EBRD doing what it should be doing in Russia - flexible long term lending that creates a template for the private sector to follow. As Kevin Bortz, director of the EBRD's natural resources team, says: "The political and commercial success of this deal shows there is a real alternative to PSAs, and the EBRD hopes it will help increase the level of foreign lending and co-operation in Russian oil and gas." It is a direction the EBRD is committed to for the foreseeable future.Total project cost is $355 million-$155 million in equity equally split between the sponsors and $200 million divided into $100 million six-year A and B loans from the EBRD. The multilateral took the A loan on its own account in February 2002 and HypoVereinsbank came in as lead arranger on the B loan in mid-year, fully underwriting it at the same time and taking $30 million itself. Appetite among the limited club of 10 banks invited to join far outstripped the $70 million available in syndication which closed in August with Credit Lyonnais, Dexia and ING as arrangers; LB Kiel, Natexis and RZB joining as co-arrangers and IFTT as lead manager. Lawyers for the lenders were White & Case, London and Moscow, and for the borrowers, Vinson & Elkins, London and Moscow.Pricing on the B loan is 300bp over libor during the two-year construction period, which also carries a completion guarantee from the sponsors. Once the guarantee falls away the project is fully non-recourse and pricing steps up to 475bp for the remaining four years.In addition to the EBRD and Hypo pushing the lending boundaries, the sponsors have also pushed forward the fontier of co-operation. Lukoil's role in this deal is far weightier than in past deals involving Russian majors. SeverTEK is the first time that project support has come 50% from a foreign partner and 50% from a Russian company. Usually, support is from the western side with only pledges from the Russian side. Similarly, Fortum was willing to accept the increased risk of no offtake agreement. That made the deal unique as far as Lukoil is concerned. As Sergei Popov, managing director Lukoil Financial Services in London, says: ? For the first time there was no long-term offtake which from Lukoil's perspective makes sense ? it allows us to maximize our netback on domestic sales.? The increased market risk on the oil is mitigated by a marketing support agreement between the two sponsors and although Fortum is not obliged to it has indicated it will take 100% offtake if need be.Fortum has also demonstrated that at least one western major will invest under the normal Russian legal regime. With no PSA, Fortum must repatriate and convert back into roubles 50% of its offshore earnings into onshore Russian accounts. And the project facility reflects that ? the first call on offshore oil receivables being the repatriation. However, it is a convertibility risk shared between both sponsors and if domestic sales are high, it could be onshore accounts that are called upon, on occasion, to service debt.SeverTEK production is scheduled to start this year and is forecast to reach a maximum volume of 2.6 million tonnes per year. The South Shapkino field has 23 million tonnes of proven and probable reserves, and the whole territory covered by Severtek's licences has a total of 41 million tonnes. Green technologies in which Fortum has built up a body of expertise will be used to meet standards on permafrost protection and emission levels.Oil will be transported from South Shapkino to KomiTek's Kharyaga-Usinsk pipeline through Severtek's new pipeline; south to Usinsk via KomiTek's pipeline; and thence to Ukhta by Transneft, the Russian pipeline monopoly. From there it can continue to the Baltic port of Primorsk by the recently-upgraded trunk pipeline, or be transported, probably to Finland, by train ? with the added advantage that it would not be included in Transneft's export quota system. The deal pushes the boundaries of foreign lending into Russian oil further than they have ever been before. Will it be repeated? HypoVereinsbank claims to be tendering for a deal with a similar proposal already and expects an announcement by mid-year at the latest.

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Status: Syndicated August 2002

Sponsors: Lukoil; Fortum

Location: Russia

Description: First Russian oil and gas deal without a PSA. Development of South Shapkino field

Total project cost: $ 355 million

Equity: $155 million in equity equally split between the sponsors

Debt: $100 million six-year A and B loans from the EBRD.

Lead arranger: HypoVereinsbank

Arrangers: Credit Lyonnais, Dexia and ING

Co-arrangers: LB Kiel, Natexis and RZB

Lead manager: IFTT

Tenor: 6 years

Pricing: B loan is 300bp over libor during two-year construction period stepping up to 475bp

Lawyers for the lenders: White & Case, London and Moscow

Lawyers for the borrowers: Vinson & Elkins, London and Moscow.