Potential unlimited

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Gazprom hopes to step up its project finance lending programme ? but management fears that European gas liberalisation could undermine the long-term export contracts that are essential as collateral.

According to Sergei Dubinin, deputy chairman of Gazprom, the company intends to raise investment capital for ?a number of principal projects? in the form of off-balance-sheet project finance. (see interview).

Dubinin says that having succesfully closed the $2 billion loan for the Gazprom-ENI Blue Stream pipeline ? by far the largest deal for a Russian borrower since the 1998 financial crisis ? the company's priority is to secure financing for two Arctic offshore upstream projects: Shtokman (gas) and Prirazlomnoye (oil).

But Dubinin also warns that European gas market liberalisation could make collateralising such finance ?impossible?, and calls on European political and financial institutions to help ensure the projects' future. He indicates that Gazprom ? which is opposed to the full market liberalisation envisaged by the European Energy Charter ? wants its foreign partners in projects to work with unified sales contracts under which they would bear some of the burden of low Russian and CIS gas prices.

Impact of market liberalisation
Minds at Gazprom may have been concentrated on the possible impact of European gas market liberalisation by a European Commission legal challenge to supply contracts between Gazprom and three Italian utilities.

The Commission believes that exclusivity clauses in the contracts, that bar the buyers from selling the gas on and prevent Gazprom from selling to other companies in Italy, are contrary to EU law.

Gazprom's fear is that full implementation of the 1998 EU gas directives will make it vulnerable to challenges on a wider scale ? which could affect contracts used as collateral for deals such as Blue Stream.

Ruslan Vazetdinov of RPFB Project Finance, a financial advisor to Gazprom on its project finance portfolio, warns that attention has to be paid to the impact of liberalisation on long-term contracts in order to safeguard long-term development of gas reserves.

?The problem is that the EU directives will put an end to loan structures that we have been working with over a period of time,? he says. ?If we are not going to use such structures, we need to make sure there is something in their place, and nothing very clear has been proposed. If a spot market really develops, hedging instruments will have to be found.?

Speakers at a recent conference on Russian gas in London said that market liberalisation is inevitable, and the question is how it is managed. Bert van der Toorn, deputy director of natural resources of the European Bank of Reconstruction and Development, said the EU should ?take a very cautious approach?. ?The transition period is crucial, because if the policy is not clear, you will be saying [to Gazprom], ?for project finance, you just have to wait'.? Michael Levitsky, senior investments officer at the International Finance Corporation, said: ?The question is not, ?can you do large gas projects in a liberalised market?', but ?will it be a real market?'?

Apart from the issue of collateralising long-term contracts, Gazprom is also wary of the full opening of the Russian market to western companies envisaged by the East-West Energy Charter. Largely because of energetic lobbying by Gazprom, Russia signed the Treaty in 1994 but has refused to ratify it.

Gazprom fears that under the treaty it would be compelled to give third-party access to its pipeline system to central Asian producers of cheap gas, and be forced to charge the same rate as it does for internal deliveries ? thus effectively helping its competitors to export gas to western Europe. The treaty's supporters say this is a misreading of its provisions.

But the treaty's potential impact on Gazprom's market dominance, and therefore the structure of its investment programme, can scarcely be denied. And minds will not change overnight.

The EU is therefore continuing to push at the political level, and the issue will next be discussed at a meeting in May of the EU-Russian energy working group headed by Francois Lamoureux, head of the European Commission transport and energy directorate, and Russian deputy prime minister Viktor Khristenko.

Speakers at the London conference emphasised that Gazprom stands to gain both from the treaty and from other aspects of liberalisation. Nathalie van der Velde of the European Commission gas unit said the Russian company would have ?great new oppportunities? to sell directly to western European end-users as a result of the EU directives' stance on regulated or negotiated third-party access to distribution networks in EU states ? the enforcement of which has led to infringement proceedings against France, Germany, Luxemburg and Portugal.

Vazetdinov of RPFB Project Finance told the conference that liberalisation would compel European gas companies to ?look for more possibilities upstream?, and partnerships with Gazprom could satisfy this need. He added that the European companies that have gas supply contracts with Gazprom are better positioned to become partners in its investment projects, since they could use a set-off to mitigate risk, which is stronger security than gas receivables.

Regardless of the treaty, the Russian government itself plans a degree of market liberalisation, of which Gazprom's domestic competitors are the likely beneficiaries. Over the next year, the government will work to perfect rules governing the wholesale gas market, including export, and access to Gazprom pipelines for independent producers.

Valery Otcherov, chairman of gas trader Itera ? which has taken over large parts of Gazprom's distribution business and is now rapidly expanding in production ? told the London conference that by 2006-07, 25% of export capacity would probably be supplied by Gazprom's competitors.

While Gazprom sees Itera as an ally ? and according to critics has lavished favourable treatment on it ? it has a more adversarial relationship with the Russian oil companies, who currently burn 20-30bcm per year of gas that they can not sell without pipeline access.

Liberalisation will change all that, and already the most aggressively expansionist oil producer, Tyumen Oil Company (TNK), has acquired an interest in Rusia Petroleum, licence-holder for the gigantic Kovykta gas field, in Irkutsk, eastern Siberia, which has 1.4 trillion cubic metres of reserves. TNK is thus the third largest Rusia shareholder after operator BP and Gazprom; it is also pursuing a complex legal battle with the Interros financial-industrial group over another shareholding. Iosif Bakaleynik, TNK chief financial officer, said in a recent interview that ?as the [gas] market opens up, TNK will go into it in a big way?.

Development imperatives

Over the last decade of economic transition in Russia, Gazprom has been an oasis of stability. Although domestic consumption of gas has fallen (from 405bcm in 1991 to 339bcm in 1999, according to recent JP Morgan research) its share of Russia's primary energy balance has risen, to 50% ? and the government energy strategy, drafted earlier this year, will aim to reduce that share and restore a balance with oil and other fuels. While Gazprom has on the one hand been virtually compelled to subsidise the Russian economy, and that of other former Soviet states (principally Ukraine, Byelarus and Moldova) via low prices and non-payment, on the other it has relentlessly increased its sales to hard-currency export markets. It has raised finance for the Yamal-Europe and Blue Stream pipelines.

But production is now falling, some of Gazprom's older fields are in decline, and development of its reserves base in the Arctic and elsewhere is urgent. Its lack of the financial resources needed to fund this development, and Russian country risk perception that constrains its access to international capital markets, has fuelled its enthusiasm for joint venture partnerships and off-balance-sheet project companies on the Blue Stream model.

Gazprom's overall output has declined for two years running, from 554 bcm in 1998 to 546 bcm in 1999 and 520bcm in 2000, and company chairman Rem Vyakhirev said in a recent interview that the company's main task was to ensure that the problem does not endanger its export business. The main reason for the fall was the decline of some of Gazprom's core production subsidiaries ? including Urengoygazprom, the largest subsidiary in its west Siberian heartland, and Orenburggazprom, the largest in European Russia. By 2020, JP Morgan estimates, three-quarters of output will need to come from new fields, as existing fields will be producing only 170bcm per year.

In short, upstream development has to start now, and transport systems refurbished and expanded accordingly.

Borrowing history and prospects

Gazprom took out its first structured project finance loan in 1994 ? $1.6 billion for the Tragaz project, guaranteed by the Italian export credit agency SACE and collateralised by receivables pledged to the lender and paid into an offshore escrow account. This structure was replicated in a 1996 bilateral loan from Wintershall bank.

In 1997, at the height of the enthusiasm for Russian risk prior to the August 1998 financial meltdown, Dresdner Bank arranged a $2.5 billion syndicated facility for Gazprom.

Its innovative structure contained a mechanism that allows several groups of lenders to share security on one gas contract, whereas previously the contracts had been pledged as a single asset for only one syndicate of lenders.

The Blue Stream loan used a similar structure to allow one set of receivables to be used as collateral by several groups of lenders.

Receivables are assigned 100 per cent to a single trustee, who acts as the beneficiary for all lenders, sharing security between a number of escrow accounts on the basis of a predetermined formula. Inter-creditor issues were resolved in negotiations on the loan deal, and a structure put in place that provides puts different groups of lenders in pari-passu positions, and not subordinated to each other.

Gazprom's repayment burden will rise from slightly under $2.5 billion this year to $2.6 billion in 2002, back to $2.5 billion in 2003 and $2 billion in 2004, and then waver between $1 billion and $1.3 billion in 2004-08 until dropping substantially ? although Dubinin of Gazprom disputes this, stating that by 2003 the burden will already be much lighter than it is now (see interview).

Analysis of Gazprom's debt service profile shows that it would be advisable for the company to shift debt service of new borrowings to the years after 2004, Vazetdinov of RPFB told the London conference. He said that this could be achieved either with 10-year bonds amortising after six or seven years, or long-term project finance facilities. At present the latter looks more likely.

?Gazprom's ability to raise on-balance-sheet finance is restricted by limited availability of unencumbered gas receivables, although more efficient use of gas contracts would allow some movement in this direction,? he said. ?As for unsecured bond issues, Gazprom is working with investment banks to test investors' appetites, but this depends on market perception of Russian risks.

?Limited recourse financing is more promising, and the company's capacity for it unlimited, subject to investment opportunities, appropriate structure and government support.?

Industry partners could contribute by enhancing the bankability of structures, Vazetdinov said. ?Gazprom is prepared to share its market and resources. In return it requires risk sharing and collaboration in raising funds for projects.?

Barriers to the capital markets

Gazprom, more than any other Russian company, has the potential to raise investment capital directly on the international markets ? but not yet, for three main reasons: first, perceptions of Russian country risk; second, the ring-fence around its Russian shares; and third, its corporate governance problems.

The country risk issue impacted on Gazprom's intended $500 million eurobond this year, for which it mandated CSFB and SSSB group. First the Russian government's failure to reach agreement on sovereign debt with the IMF and the Paris club put the brakes on ratings upgrades; then the Argentina crisis threw a long shadow over all emerging markets. The issue is on hold.

The ring-fence around Gazprom's Russian shares, put in place in the early days of privatisation to limit shareholdings by foreigners, mean that its ADRs trade at about three times the Russian shares in dollar terms. Institutional investors are not keen on the ADRs, although holding Russian shares through ?grey? schemes is popular. But large-scale investment will not begin until the ring-fence comes down, and although the Russian government indicated last year that it was considering the issue, it will not happen quickly.

The third problem that constrains capital investment is corporate governance, concerns over which are centred on Gazprom management's relationship with gas trader Itera. Boris Fyodorov, former deputy prime minister and representative of independent shareholders' on the Gazprom board, has accused management of failing to answer questions about Itera ? which has built a multi-million dollar business in the last five years on the basis of production licences sold to it at favourable prices by Gazprom and access to Gazprom pipelines that is denied to others.

Gazprom managers have repeatedly denied that they, or relatives or associates, are beneficiaries of Itera's business. Last month the principal Itera holding company, Itera Group NV of the Netherlands Antilles, made public its shareholders ? but critics were unsatisfied, as three-quarters of the shares are held by trust funds that blur the identity of final beneficiaries. At the same time Itera has declined to list all its subsidiaries (there are more than 130) or their precise relationship with the Itera holding company.

Consequently suspicions of a Gazprom-Itera link have not been dispelled. An inquiry by the Russian parliamentary audit chamber failed to clarify the issue; another, by Gazprom's auditors, PriceWaterhouseCoopers, is underway.

That, too, became mired in controversy ? PwC was criticised from within the accounting profession for taking on work that involved checking its own audit, while Gazprom management rejected the independent shareholders' demand that a separate check be made by Deloitte & Touche.

The issues have stalled a $250 million technical assistance loan to Gazprom, approved by the EBRD in September last year subject to certain corporate governance conditions being met, but not yet disbursed. At an investment forum in London last month, EBRD deputy vice president David Hexter said the bank's doubts concerned ?reputational risk?, and not Gazprom's ability to pay. ?There are certain questions we asked Gazprom to which they have not given answers, and until we get answers we will not be lending the money,? he said.

Some market sources hope that after company chairman Rem Vyakhirev retires in June, a management reshuffle will pave the way for resolving some of these issues.

The projects

The Shtokman field, Gazprom's current development priority, contains one of the five largest gas deposits in the world, with reserves estimated (to Russian standards) at 3.2 trillion cubic metres of gas and 60 million tonnes of condensate ? and an investment requirement estimated between $15 and $25 billion. Gazprom subsidiary Rosshelf, the licence holder, will hold 50% of the project, with the rest being divided between TotalFinaElf, Conoco, Fortum and Norsk Hydro.

A proposal for TotalFinaElf to take a larger share and become the operator is under discussion between the partners; so are prospects of raising finance from European institutions, such as the European Investment Bank ? if not for the field, then for a northern gas pipeline to supply Shtokman gas to Europe via the Karelian peninsula and the Baltic Sea. A production sharing agreement (PSA) is being approved by the Russian government.

The Prirazlomnoye oil field, 60-70km offshore in the Pechora Sea, contains an estimated 83 million tonnes of recoverable oil reserves, and is also expected to get PSA status.

Prirazlomnoye is being developed jointly by Gazprom and Wintershall, a wholly-owned subsidiary of BASF of Germany, who joined the project in March 1999 after BHP of Australia withdrew from it. Russian oil companies have also shown interest. Initial investment of $1-$1.3 billion is to be undertaken by Gazprom and Wintershall jointly, of which $800 million is required to complete construction by Sevmash of Arkhangelsk of an ice-resistant platform for the field.

By contrast, the $1 billion project at the Zapolyarnoe gas field in western Siberia has been put on hold, and in December last year Royal Dutch Shell and Gazprom announced they were delaying the establishment of a joint venture company for it. A Gazprom source said: ?We are having difficulty reaching agreement with Shell on finance and corporate structure.? Maksim Shub, director of corporate affairs at Shell's Moscow office, said that one contributory factor in the delay was the shelving, after the Russian 1998 financial meltdown, of a $1 billion convertible bond by Gazprom that was envisaged when the two companies formed their strategic alliance in 1997.

After the big Arctic projects, the most important upstream development is the North Astrakhan PSA, with recoverable reserves of 465 million tonnes of oil and 144 bcm of gas, for which ENI-Agip, Gazprom subsidiary Stroitransgaz and Astrakhannefteprom (a Stroitransgaz-regional government joint venture) have signed a letter of intent for joint development. Further out, the Russian section of the Caspian sea is notable for sheer scale (reserves estimated at 2-4 billion tonnes of oil equivalent), and the Kovykta field in eastern Siberia is strategically important, as it would open up the Chinese export market.

As for transport, the priority after Blue Stream is a second string of the Yamal-Europe pipeline. The crucial question is whether Poland will agree to Gazprom's proposal to build an intersystem link to join the southern European pipeline in Slovakia ? thus bypassing Ukraine and strengthening Russia's hand in its dispute with Ukraine over unpaid gas bills and illegal siphoning. Poland has not committed itself to the scheme for fear of offending Ukraine, but signs that its attitude is changing were reported after talks between Polish deputy prime minister and Russian deputy prime minister Viktor Khristenko in Moscow in March. Now Russian prime minister Mikhail Kasyanov is due to visit Warsaw in May to push Poland further. Friction remains at corporate level, though: talks between Gazprom and the Polish gas company Polskie Gornictwo Naftowe i Gazownictwo about the construction of three compressor stations on the existing pipeline broke down without agreement in March.

A card in Russia's hand when negotiating with Poland is a proposed 1500km 20-35 bcm per year northern gas pipeline, bringing Shtokman gas to Germany via the Karelian peninsula and the Baltic Sea, which would be an alternative to the

Yamal-Europe line add-ons. Enthusiasm at a political level was expressed during a visit by Finnish prime minister Paavo Lipponen to Moscow in December last year, and NordTransGaz, a joint venture of Gazprom and Fortum, has completed a feasability study.

A $1 billion reconstruction project on the Trans-Balkan pipeline aims at doubling Gazprom's capacity to export to Greece and Turkey. It comprises reconstruction work at Turzhok in Russia, Dolina in Ukraine and the gas main sections in the Balkan countries.

Further out is the prospect of a pipeline to take Kovykta gas to China.

Any one of these ventures is big enough to make bankers' mouths water, and Gazprom's travails are therefore likely to be followed with ever growing interest.

Taking Shtokman

In a PF exclusive, Sergei Dubinin, deputy chairman of Gazprom's management committee, talks future deal flow with Simon Pirani

Project Finance: What are Gazprom's plans with regard to financing project development?

Sergei Dubinin: Gazprom intends to raise investment capital for a number of principal projects ? both upstream development and transportation ? in the form of project finance. The largest on which we are working is the development of the Shtokman gas deposit. We have been in discussions with potential partners at Shtokman, including Conoco, Fortum, Norsk Hydro, TotalFinaElf, Rosshelf, and some domestic equipment manufacturers, for several years. We are in talks with the government about conducting the project under a production sharing agreement.

Neither the corporate nor financial structure has been finalised, but we are working on these as a priority and we believe they will be soon.

PF: What is your attitude to TotalFinaElf's hopes of becoming the project operator?

SD: This issue will be decided on a consensus basis by all those who sign the memorandum of agreement on the project, but this has yet to be signed.

PF: What about other projects?

SD: Through Rosshelf we are involved in the Prirazlomnoye oil field, also an offshore project, in which we are partnered with Wintershall of Germany. As with Shtokman, talks are in progress about corporate and financial structures, and conditions of investment.

Shtokman is much the bigger project and will need $20-25 billion. Our intention is that each project must as far as possible finance itself from its own resources, on off-balance-sheet project finance principles.

PF: Do you expect to continue with structures similar to that used for Blue Stream?

SD: From our point of view the Blue Stream project financing made rather excessive use, as security, of gas sales contracts not directly related to the project itself. It could be described as oversecuritised, and this was due to some exaggerated evaluations of Russian risk factors.

PF: The Shtokman project has been discussed both at a political level, between prime minister Kasyanov and prime minister Jospin, and within European institutions. Are the project participants hopeful of raising finance from

European institutions, and specifically the European Investment Bank?
SD: We have a positive view of the perspectives for cooperation with European institutions. We have examined all the possibilities for financing, including European structures. The EIB, in particular, may be extremely useful.

We also want to achieve a mutual understanding with our European industry partners that we are not going to undertake projects with the exclusive aim of serving the European market's needs.

Everyone knows that European gas prices are substantially higher than prices on the Russian market. We believe the Russian prices have to rise, and this is envisaged in the country's energy strategy. But as long as a differential remains, a definite part of the burden of subsidising the Russian market rests, inevitably, on all Gazprom's projects.

The economics of these projects ? including the participants' revenues, proportional to their share of investment and level of participation ? will have to reflect gas prices both on the European market and the domestic Russian market. We are not going to have a situation where our international partners are able to take advantage of the higher gas prices in Europe while Gazprom is selling primarily into the domestic market, and subsidising that market.

This problem has to be discussed, and an understanding reached, not only with our commercial partners but also with European institutions. It's obvious that they could take steps to help reduce the burden of financial risk on our European corporate partners. It's my personal opinion that, in particular, European financial institutions such as the EIB or EBRD could extend certain types of guarantees or risk-sharing to European companies to cover their investments in the Russian energy sector.

PF: How will the proposed liberalisation of the European gas market impact on Gazprom's plans?
SD: Security for any project must be provided by sales of gas from that particular project. It would be impossible to finance a $20 billion project without using long-term contracts for sale of gas from that deposit.

If the European institutions think it important to guarantee energy supplies from Russia, a part of their strategy should be to create the conditions in which long-term gas contracts can be continued. Only then will it be possible to organise financing for projects on the scale of Shtokman.

PF: Are you saying that it will be difficult to raise finance for the projects until the consequences of European gas market liberalisation become clearer?
SD: More than that. Gazprom is firmly convinced that even if implementation of EU gas directives leads to market liberalisation, that liberalisation can not be undertaken with disregard for the issue of guaranteeing a steady level of revenues for suppliers. These revenues are essential for the raising of loan finance. Credits for projects on the scale of Shtokman will not be available unless those revenues are assured. Clearly, loan capital on that scale can only be available directly to a first-class borrower, such as Conoco or Total, or on the basis of security provided by long-term contracts. Further, we consider that the financing for each project must be collateralised from the proceeds of the project itself, and that there must for each project be a single contract for sales from that project in European countries, to which all participants will be party. Liberalisation must not work in such a way as to prevent investment capital being raised for long-term projects.

PF: Advocates of liberalisation say that similar arguments to yours were advanced in the 1970s in relation to oil, but that the market was liberalised just the same.
SD: There are more sources of oil, more suppliers. There are other differences. The gas industry has an integrated pipeline system covering the whole of Europe.

When all is said and done, if liberalisation as a goal is more important than ensuring guaranteeing gas deliveries, then all we can say is that Gazprom will certainly deliver in full on current contracts ? but as for future deliveries from new deposits, we will only be able to sign contracts to supply gas to the extent that we can raise the investment resources to exploit those deposits.

PF: How is Gazprom's repayment burden on current loans impacting on the company? How do you hope to get through the period 2003-04, when the repayment burden will be at its highest?
SD: Repayment levels in 2001 and 2002 are higher than those for 2003 and 2004. By 2004 our debt repayment situation will have eased considerably: it will go down in 2003 and by 2004 nearly everything will be repaid. The years 2001 and 2002 will be the hardest; last year the debt burden was also very high. For these three years [2000-02] it will be running at around $1.5 billion. By 2004 it will be far less than that. We are planning our work on the basis of prompt payment of all outstanding commitments.

PF: As you have pointed out previously, corporate governance is an issue that concerns western investors and lenders who deal with Gazprom, and the company is now drawing up a corporate governance. But Gazprom continues to face criticism on specific corporate governance issues, in particular on its relation to Itera.
SD: Directors representing both independent shareholders and the government raised this question on the board of directors. They wanted to know more about Gazprom's relations with Itera, and information was provided about all aspects of it, i.e. sales, transport and transit operations. All the documents we have confirm that Itera enjoys no particular advantages in its dealings with Gazprom. Gazprom is not an shareholder, and as far as I know ? and this is an official declaration by myself and my colleagues in Gazprom management ? none of them are individual shareholders. Of course I haven't checked up on my colleagues and in that sense can only speak about my own position, but they have all made official declarations. These declarations did not satisfy everyone, and so it was decided that Gazprom's relations with Itera would be checked by the company's auditors, PriceWaterhouseCoopers. This investigation will soon be completed and the results made public, and I am convinced that nothing untoward will be found.

PF: Was it wise for the Board of Directors to ask PWC to make this investigation ? which meant them checking aspects of an audit they themselves had carried out ? while simultaneously rejecting the minority shareholders' representatives' proposal for an independent investigation by Deloitte & Touche?
SD: It was exactly because PWC is our official auditor, and has a legal basis for carrying out this investigation, that it was commissioned. The auditors are commissioned by shareholders at the AGM. They are responsible to the annual general meeting of shareholders and to that meeting alone. This strictly accords with the Russian law, under which the auditor can only be confirmed by the AGM, no other way. Furthermore, no entity apart from the auditor can have access to the relevant documents. If every 10 per cent of shareholders separately wanted to arrange investigations we would start a never-ending process.

PF: Given the scale of Gazprom's business dealings with Itera, does Itera's opaque structure, of 120 or 130 companies in a range of locations, cause concern?
SD: As far as I know the principal Itera holding company is constituted in the US. I have not heard that any complaints have been raised about it, or claims made against it, regarding payment of taxes or anything else.

Despite some funny things that have happened recently in the political sphere, our high regard for the authority of the US government and institutions has not diminished, and we take it as an example of an open economy, transparent economy, a law-governed state. If there were concerns, surely they would have been expressed there.

Sergei Dubinin, 50, joined Gazprom's management committee in 1995. He became its deputy chairman in 1998 after leaving the Central Bank of Russia, where he served as chairman (1996-98). He also had spells as first deputy finance minister (1993-94) and minister of finance (1994).