Sohar Refinery Project

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Sohar Refinery Company (SRC) has become the first refinery to be successfully financed in the bank market in more than 10 years. Financial closure was reached in 2003. With a total figure in excess of US$1.2bn, 90 per cent of it being financed with 14-year debt, it is the largest project financing in Oman since Oman LNG and one of the largest in the oil and gas sector in the Middle East region for some years.

The Project

SRC is building a new plant designed to process a blend of 76,400 barrels per day of atmospheric residue (AR) and 40,000 per day of Oman export blend (OEB). The technology is a combination of licence and open art technologies at the heart of which is a 75,250 barrels per day residue fluid catalytic cracking unit (RFCC).

The result is a relatively complex refinery with high conversion capability able to add significant value in its product slate. The project is key to Oman Refinery Company as it is able to process and upgrade the AR produced by the existing government owned Mina Al Fahal (MAF) refinery.

It will sell 10 per cent of its production in Oman (mostly gasoline) with 90 per cent exported via ORC, though this balance may change over time. The project is being fed by a new 250km dedicated pipeline bringing blended AR and OEB from MAF. In addition, there is port access where the project has proprietary storage and loading facilities.

Although a natural extension of the existing MAF refinery in Muscat a decision was taken early in the development plan to locate the project at Sohar. Space constraints in the Muscat area together with environmental considerations prevented expansion there whereas the Sohar Industrial Area already has port and other infrastructure services required by SRC.

Sponsors

The Government and Oman Oil Company are the project sponsors. While the government was keen to support the project it was not willing to compromise on the need for SRC to be able to stand on its own two feet.

SRC’s executive management team was given the task of (i) proving the commercial viability of its project, (ii) negotiating an attractive EPC contract and (iii) creating the right contractual structure to optimise the amount of financing.

Financing

The financing attracted Japanese export support in the form of a JBIC Direct Loan of US$262m and NEXI insured co-financing of US$262m. Ten international and regional banks underwrote US$908m (including the NEXI facility) and have since been joined by twenty seven participants.

It is NEXI’s first venture in Oman, following JBIC’s previous experience first in the agriculture sector in 1989, then in the Sohar port financing in 1999 and more recently in a LNG carrier financing. For JBIC this is the first project loan to a refinery plant.

The underwriting bank group was selected in mid June 2003 when a commitment letter and term sheet were agreed quickly followed by JBIC and NEXI joining the group. The documentation banks, BNP leading commercial lenders and BTM leading JBIC and NEXI interests started work in mid June.

Legal Issues

JBIC and NEXI, as well as the commercial lenders, were represented by Linklaters, which established two separate legal teams, each headed by a partner. This was particularly important in areas where JBIC and NEXI's interests diverged from those of the commercial lenders or there were differences in focus between the two.

Much of the time, the interests of JBIC and NEXI and those of the commercial banks were aligned, but not always. As would be expected, there were differing views on intercreditor issues which had to be worked through. In addition, JBIC and NEXI were particularly keen throughout the process to ensure that the documentation provided, to the maximum extent possible, for a refinery which could be operated on a merchant basis if the need ever arose.

The project produced an several interesting legal issues. As Clive Ransome of Linklaters explained, being the first of the Sohar Industrial Area projects to reach financial close, SRC and the banks negotiated a sub-usufruct agreement (which gives SRC its land rights) with Sohar Industrial Port Company, an agreement which will now serve as the model sub-usufruct agreement for all the future Sohar financings The parties also had to negotiate the underlying support agreement for the sub-usufruct with the Omani Ministry Of Transport and Communications.

Other interesting legal issues included interfacing the responsibilities of the construction contractor with those of the six licensors (whose technology has not been fully wrapped by the construction contractor), working through some last minute complex changes to the proposed jetty arrangements at the port, agreeing the timetable for claims on termination of the Toll Processing Agreement payments and negotiating a completion test which was acceptable to all parties.

Time pressure was also a challenge. As a trade-off for the attractive EPC price offered by JGC (25 per cent below the next best offer), SRC had to launch construction in early July 2003, well ahead of the financing being in place. By the end of November the shareholders had spent more than US$200 million and were keen to refinance 90 per cent of this advance through the credit facilities. Furthermore, payments to the contractor due to step up in early 2004 added pressure on the MLAs from the Ministry of Finance.

Risks and how they were mitigated

Laurent Devin of BNP Paribas explained that the parties involved got comfort from (i) first and foremost, the underlying economics of the project for the Sultanate of Oman are sound and (ii) the contractual structure with strong completion and market risk mitigation resulted in a broad bank market appeal.

The Nexant Chem Systems market report commissioned by the banks indicates that there is a buoyant demand in the Asian markets for the products and that SRC's cash cost margin, should it operate in a merchant environment, would be slightly in excess of US$6 per barrel, large enough to support project financing even with a high leverage.

Second, notwithstanding the apparent economic benefit of the project for Oman, the contractual structure finally agreed by all parties has gone to great lengths to insulate SRC from all major risks, including all market risk. This has been achieved by structuring the project around a tolling agreement; making it the first oil refinery project to be financed around a tolling arrangement.

The core project document is therefore the Toll Processing Agreement. Under this agreement, Oman Refinery Company tolls crude oil and residue feedstock through the refinery and takes exclusive delivery of the output which it then on-supply to BP and Oman Polypropylene LLC. SRC is at all times paid an availability charge and a performance charge which cover all its costs (including debt service and an agreed level of equity return) and, although liable for liquidated damages for poor performance, all damages incurred by SRC are subordinated to debt service and only become payable when SRC has adequate funds to make the payments.

This mechanism serves to shield SRC and its banks from possible negative cash flow effects of poor operation of the refinery. Last, as all of Oman Refinery Company's payment obligations are fully backed by the Omani Ministry of Finance, banks are not really exposed to Oman Refinery Company credit risk.

On the construction side as well, banks are well protected against construction delay. This protection comes from a Debt Service Undertaking provided by the Sponsors directly to the banks. Under the terms of this undertaking, the Government has undertaken to fund all of SRC's financing obligations in the event of a delay in completion and has further undertaken to repay the banks in full if completion has not been reached by an agreed longstop date.

Recent Omani transactions have been well received by the market but there were questions as to whether the pricing (reflective of the strong Government support) for the financing of a greenfield oil refinery, with 10 banks already in the MLA group, would attract sufficient long term regional and international liquidity. As it turned out the general syndication of the US$645m uncovered commercial loan was an unqualified success. The three bookrunners (BNP Paribas as coordinator, GIB and HSBC) raised more than US$600m in a month.

Conclusion

According to Devin, this transaction will perhaps be remembered 'as a milestone for the revival of the general syndication market after the sluggishness of recent GCC project finance syndications'. Only the future will tell.

The enhancement of the structure through the 360 degree government support is probably one of the reasons for the success. The history of successful projects in Oman is no doubt another one. More importantly perhaps is that, behind the contractual structure, however solid it is, banks realised that there was an export driven project which made sense for the country. As a result of successful syndication, the 37 banks committed to this project were scaled down significantly leaving each of them with some substantial lending capacity for other deals in Oman.

This certainly bodes well for future syndications. The level of strong support can only send a welcome message to other countries in the region which are relatively free of political risk and which also have a long list of projects which they want to bring to the market as well as providing a useful boost to the global project finance market in general.