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MEG Christina Lake Oil Sands Project

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Even in the increasingly dynamic oil sands market, MEG Energy's in-situ oil sands project boasts some eye-catching features write **Simon Ellis** and **Vander Caceres**

Firstly, the project's Phase I and II financing in April featured the first Term B loan in the Canadian oil sands market which has previously been dominated by revolving debt facilities.

Secondly, the transaction demonstrated that oil sands are coming to the attention of Wall Street with major institution Warburg Pincus taking 30 per cent of project equity.

Perhaps most significantly, Christina Lake is the first oil sands project signed with the equity participation of a Chinese oil major - CNOOC - which acquired a Can$150m (US$135m) equity stake in April 2005.

The combined in-situ and piepline project - which will eventually generate 140,000 barrels per day - could now become the oil sands' latest benchmark.

The project

MEG was founded, and acquired its first oil sands lease, in March 1999 when WTI oil prices were approximately US$10 per barrel.

Over the following four years MEG assembled a 52 square mile oil sands lease in Christina Lake in the Athabasca region of north east Alberta.

In parallel to the project, MEG - lead by chief executive William Macaffrey, formerly of Amoco - put together a team boasting involvement in every oil sands project of its type to date as well as the high-powered political presence of E. Peter Lougheed - the premier of Alberta between 1971 and 1985 - as counsel.

Like most start-up projects in the region, Christina Lake will extract oil using the in-situ or Steam Assisted Gravity Drainage (SAGD) process.

The SAGD process relies on a dual-pipe mechanism, where super-heated steam is injected via a shaft into a bitumen deposit to produce thick crude oil. The crude flows into a second well from where it is pumped to the surface by a parallel pipe.

The process allows projects to be developed quickly and economically at around US$85m for every 10,000 barrels per day of bitumen production, after the initial lease purchase.

The project is being developed in a series of gradually increasing phases:

- Phase I - the pilot phase - will generate 3,000 barrels per day scheduled to commence production in the first quarter of 2007. This phase is 50 per cent complete.

- Phase II will generate an incremental 22,000 barrels per day and is in progress with long lead-time equipment is being ordered. Phase II is scheduled to commence production in the first quarter of 2009.
- Phases III and IV will increase production levels to 140,000 barrels per day.

Tackling oil sands risks

To encourage investors to invest in the project in a crowded market, and amid fears of inflation and market overheating, MEG Energy had to assuage some major project risks.

The major risks to oil sands developments in Alberta, aside from oil price fluctuation, have been seen as ensuring a stable labour supply and securing the links in the chain to get the crude to market - including pipelines, refining and upgrading capacity.

MEG claims it has offset labour risks in two ways:

- uilding its project in bite-sized increments over several years the avoid large peaks and valleys in workforce requirements.
- Building its equipment modules in urban areas, where the workforce is more stable, to be sent by truck to Christina Lake for assembly.

MEG estimates that by using these strategies it will keep the peak labour force for construction Phases I & II of at approximately 500 people.

Chief financial officer of MEG Energy Dale Hohm estimates, 'the peak labour force for facilities construction for Phases I & II of its Christina Lake Regional Project will approximate 500 people.

'This is less than one-tenth the number of people required during peak construction periods for the large mining and upgrading projects north of Fort McMurray.'

The venture has also secured a crucial pipeline from Christian Lake to the Edmonton hub, which will allow the project to .

Hohm states, 'The 320km ACCESS dual-pipeline - which is under construction in a 50/50 JV between MEG and Devon ARL - will transport diluent from the Edmonton refining and marketing hub to the Christina Lake region, and transport blended bitumen from Christina Lake back to the Edmonton hub.'

However the project has not secured firm agreements with refiners or upgraders and is expected to carry out these arrangements on a merchant basis.

Equity and debt financing

MEG Energy is a small company compared to the majors operating in Christina Lake such as Encana, BP or Devon but it is attracting a lot of investments.

Early in 2005, a group of institutional investors including Caisse de depot and managed by a Boston-based firm invested Can$26 million for a 30 percent stake in MEG.

In March 2005, in its second round of equity financing New York-based private equity house Warburg Pincus increased its stake in MEG to 30 per cent with an offer worth US$44.3 million.

A month later, China's CNOOC made its first investment in Alberta's oil sands by acquiring a 16.7 per cent stake in MEG.

The remainder 23.3 per cent stake is in the hands of the company's management and private individuals.

For the latest round of financing, MEG closed a Can$350 million private common equity financing with 14 institutional investors mainly from the US (including Warburg Pincus) and a US$750 million debt package.

The debt portion is split between a US$700 million seven-year term loan B and a US$50 million three-year revolving credit facility.

'The B loan was the first in the oil sands. MEG opted for that the term B market as it is deep and provides more flexibility than the traditional bank project financing market' says Hohm.

Credit Suisse and Lehman Brothers lead arranged the B loan, while Scotia Capital lead arranged the revolver.

Half of the B loan was drawdown on financial close and given that the facilities were oversubscribed more than two times, the arrangers were able to reduce pricing by 25bp to LIBOR + 200bp.

The remainder US$350 million tranche will be drawn over the next 24 months and carries a step up pricing with 100bp for the first year; 125bp for the following six months and 150bp for final six months.

The revolver is priced at LIBOR + 225bp.

S&P rated the debt package at BB with a recovery rating of 1 and Moody's assigned its Ba3 rating.

Bennett Jones and Latham & Watkins advised the sponsors, while Blakes Cassels & Graydon and Simpson Thacher advised the lenders.

Conclusion

The financing of MEG Energy through a Term B loan facility lays down the gauntlet to traditional suppliers of bank debt - including project financiers - to find more innovative and flexible models to fund the incremental SAGD projects.

Realistically, conventional project finance might have to content itself with the larger oil sands mining projects which require less flexibility.

As there are five new build mines as well expansions planned at the AOSP, Syncrude and Suncor plants with a net value of more than US$50bn that could be prize enough (see IJ Oil Sands review, 11 January 2006).

In the long term, there has been speculation that CNOOC's involvement will give the project privileged access to the Chinese market through a pipeline to the west coast. More tangibly it has provided the project with an investment-grade party capable of securing Wall Street finance.

The project at a glance

Project Name	MEG Lake Christina Oil Sands Project
Location	Christina Lake within the Athabasca Oil Sands of Alberta, Canada.
Description	Completion of Phase I & II, which involves new facilities, cogeneration and drilling. Phase I & II also include MEG's 50 per cent share in the construction of the 216 mile 25,000 barrel a day ACCESS Pipeline.
Sponsors	Warburg Pincus (30 per cent), Caisse de depot and other institutional investors (30 per cent), CNOOC (17 per cent) and MEG management and other individuals (23 per cent).
Start of production	Phase I & II: 2009 Phase III & IV: 2010-2013
Construction Stage	Over 50 per cent complete
Total Project Value	US$1.05 billion
Total equity	US$300 million
Total debt	US$750 million
Tranche 1	US$350 million term loan B
Tranche 1 maturity	7 years
Tranche 1 pricing	Libor + 200bp
Tranche 2	US$350 million term loan B - undrawn

Tranche 2 maturity	7 years
Tranche 2 pricing	LIBOR + 100bp for the first 12 months LIBOR + 125bp for the following 6 months LIBOR + 150bp for the last six months
Tranche 3	US$50 million revolving credit facility
Tranche 3 maturity	3 years
Debt:equity ratio	71:29
Lead arrangers tranche 1 & 2	Credit Suisse Lehman Brothers
Lead arranger tranche 3	Scotia Capital
Legal Adviser to sponsor	Bennett Jones Latham & Watkins
Legal adviser to banks	Blakes Cassels & Graydon Simpson Thacher
Date of financial close	3 April 2006