

Private sector

Note No. 157

November 1998

World Bank Guarantees for Oil and Gas Projects

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Private investors are considering several large-scale oil and gas production, pipeline, and cross-border pipeline projects in developing countries, including in West Africa and in the Caspian Sea region. While the World Bank and the International Monetary Fund are well known for their work in helping to create enabling environments for foreign investment in large infrastructure projects, by supporting reform in such areas as taxation and energy legislation, this Note focuses on a different role for the World Bank—encouraging private sector involvement in large-scale oil and gas projects by providing guarantees in direct support of the government contractual undertakings that may be needed to induce foreign direct investment in these projects. World Bank guarantees offer a unique type of risk mitigation that may prove to be a catalyst in raising finance for these projects.

In developing countries hydrocarbon resources have traditionally been owned and developed by the state. But as recovering these resources has become increasingly difficult and costly, governments have begun inviting foreign investors to become involved in the sector. The role offered to private sector participants varies from country to country, but in all cases the government continues to play a significant role, sometimes as a regulator, sometimes as an investor, sometimes as an offtake purchaser, and sometimes as all three.

Because of the large capital requirements for many oil and gas projects, and the growing reluctance of many oil and gas companies to use their balance sheets to fund these projects, many private sector sponsors are pursuing project financing. A successful project financing depends in large part on the strength of the contractual commitments of the various project participants, which, taken together, ensure lenders that there will be a reliable source of cash flow for repayment of the debt. Among the most important commitments are the contractual undertakings of the host government or governments.

Government undertakings

The concession agreement between a government and the project entity is the document that defines the government's obligations to the project. This Note uses the term *concession agreement* broadly, to include production sharing agreements, transport and transit agreements, and government offtake agreements.

In a typical oil and gas concession agreement the government grants to the project entity the right to develop the project in exchange for a stream of payments or payments-in-kind. This government revenue stream may take several forms, but typically includes one or more of the following:

- Fixed rents.
- Royalties (based on sales).
- Profit overrides (effectively reducing the upside potential to sponsors).
- Taxes (income or otherwise).

In some concessions the government, or a state-owned enterprise such as the state gas company, will contract to purchase the oil or gas



produced by the project. If the state enterprise contracts for a significant share of the throughput, the creditworthiness of this offtake obligation becomes key to the project's financeability.

A comprehensive concession agreement for a large oil and gas project should address the government's obligations to establish a framework for dealing with a variety of risks that

might otherwise hinder a project financing. Such risks include political force majeure events (such as civil unrest and general strikes), currency availability and convertibility, and permitting (box 1).

What are the consequences if a government fails to meet its obligations under a concession agreement? Clearly, a simple right to terminate the concession agreement offers no real remedy to the project sponsors and no comfort to their lenders. Instead, a concession agreement needs to provide for financial compensation to the project sponsor, through a compensatory reduction of the government's revenue stream or through contingent payment obligations.

A government's willingness to bear such a contingent liability is in theory a function of its reward for doing it. The desirability of the project to the country will guide the government's propensity to take risk in general. In other words, if the government views the benefits as high, it will be willing to stand for a large contingent obligation to the project. But if the government views the benefits as modest, it will be willing to stand for only modest undertakings.

Whatever the scope of government undertakings, and regardless of the methodology used to calculate adjustments or compensation, the ability of a government to meet its obligations, financial and nonfinancial, may well be the factor that determines a project's financeability. Supplementing the government obligations with a World Bank guarantee covering part of the project debt may add the element that will make successful financing and implementation possible.

Cross-border complications

Cross-border projects pose additional structuring challenges. Because some level of agreement is needed between the two governments on the desirability of the project, cross-border projects should include an intergovernmental agreement. Such an agreement would constitute an international treaty. These are typically

BOX 1 POSSIBLE GOVERNMENT UNDERTAKINGS IN A CONCESSION AGREEMENT

- **Maintain the same scheme of rents, royalties, taxes, duties, and accounting procedures.**
- **Grant rights of way, easements, permits, and licenses without delay.**
- **Grant import and export rights and visas.**
- **Provide physical security of assets and personnel.**
- **Adjust rents and royalties or make financial compensation to sponsors to maintain economic equilibrium in the event of political force majeure such as:**
 - **Civil unrest, war, terrorism, blockade.**
 - **National or general strikes.**
 - **Expropriation and withdrawal of authorization.**
 - **Diversion or interruption of the commodity flow (including at the wellhead).**
 - **Change in relevant law.**
- **Permit foreign currency transactions, banking, and bank accounts.**
- **Guarantee cleanup of preexisting contamination.**
- **Use international dispute resolution procedures.**
- **Guarantee payments by government entities, such as**
 - **Demand charges (for example, from the state enterprise fuel purchaser).**
 - **Specified damages.**
 - **Economic equilibrium (a mechanism for making compensatory payments or adjustments when there is a divergence from the economic transaction negotiated between the contractual parties).**

less detailed than private sponsors might like. It is perhaps wishful thinking by project sponsors to expect that intergovernmental agreements would address with any detail financial compensation and risk allocation, although cross-border technical issues, such as facilitating continuous maintenance services on a transnational pipeline could be included. But the existence of an agreement should provide significant comfort to project sponsors and their lenders.

The structuring of financial compensation for which a government might become liable also gets complicated in cross-border projects. In addition to reparations for costs directly caused by a breach of undertaking or a political risk event, private sponsors might ask for financial compensation to cover consequential losses, such as:

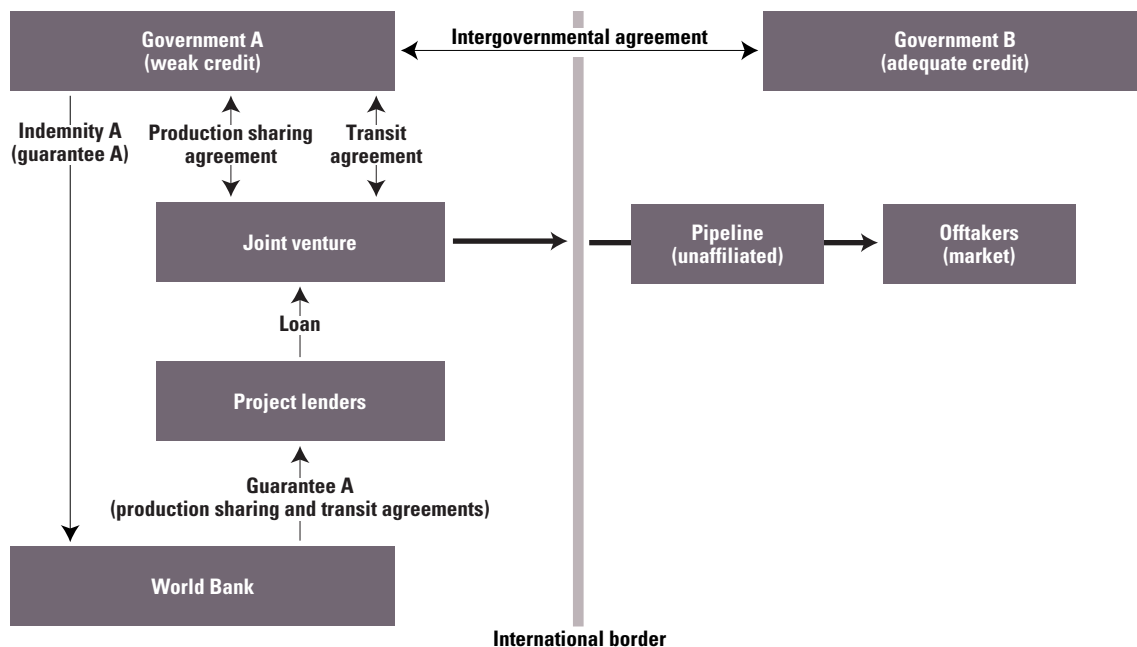
- Carrying costs of an entire chain of projects (for example, debt servicing and other fixed costs, or equity return in all countries).
- The inventory carrying cost of interrupted throughput throughout a pipeline.

In the complex negotiations for a cross-border project the principals will need to reach a mutually beneficial agreement on the appropriate compensation if a breach should occur. While a government might agree to a contingent liability exceeding the investment in its country, the World Bank’s Articles of Agreement limit its ability to guarantee loans to the investment project that is in the member country.

World Bank guarantees

A government’s financial obligations that flow to commercial lenders to a project (through, say, bank loans, Eurobonds, or 144A bonds), may be credit-enhanced by the World Bank using a partial risk guarantee. World Bank guarantees are “partial” in that they cover the minimum number of risks and the smallest amount of debt consistent with successful implementation of a project. In general, if project debt service is interrupted by failure of the government to make payment as required by the concession agreement, guaranteed lenders may call on the World Bank for payment (exceptions

FIGURE 1 CROSS-BORDER SALES TO MARKET



include payment failures resulting from events agreed to be commercial risks or events of natural force majeure, since the Bank does not underwrite such risks as a matter of policy). The World Bank would promptly pay undisputed amounts, a commitment that raises the credit rating of the government's payment obligation to AAA in the eyes of the project lenders. The World Bank would then demand reimbursement from the government under the terms of an indemnity agreement (World Bank guarantees are not insurance policies).

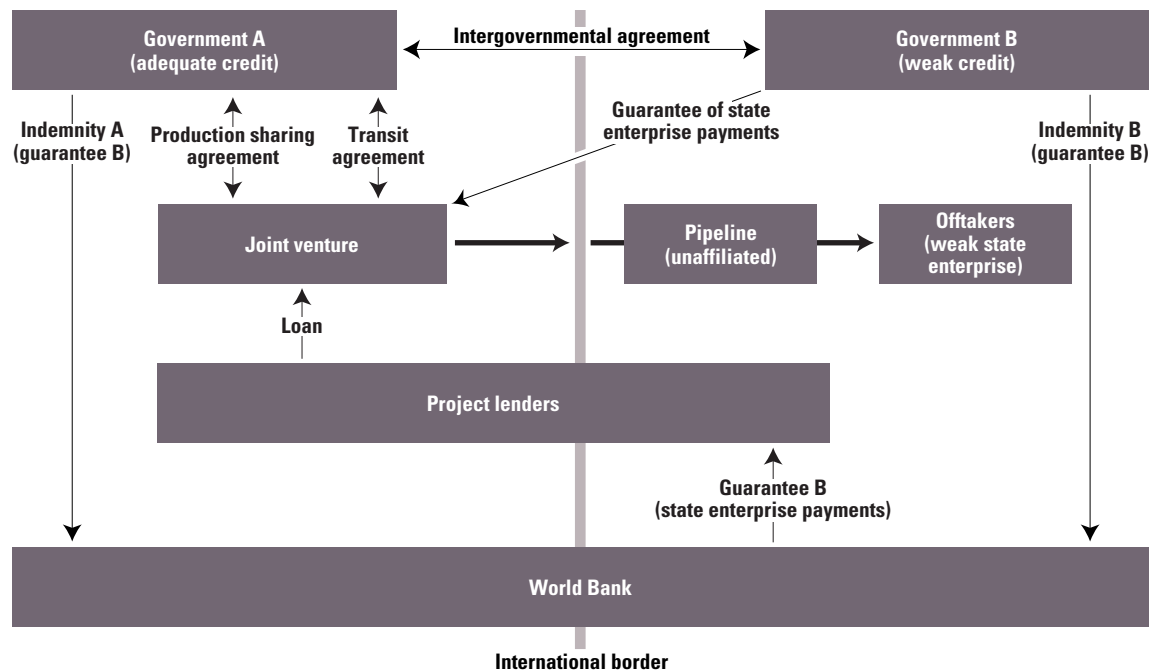
In most countries the World Bank considers its guarantees to be additional to its annual lending program. The provisions of the guarantees do not create new obligations but merely back-stop the obligations that a government has already made to a project in the concession agreement. Bank regulators in most major economies have exempted loans covered by Bank guarantees from certain provisioning requirements, lowering the cost of the loans and increasing the appetite of lenders to make them.

Structuring

To use World Bank guarantees, two requirements have to be met: the government in whose territory the project is located must indemnify the Bank, and the government whose obligations are being supported by the guarantee must indemnify the Bank. In most project structures, these two requirements would be met by the same government, but in cross-border projects the structures can be problematic. Some simple examples illustrate the issues.

Figure 1 shows a relatively simple structure in which a joint venture develops an oil or gas project in one country and delivers the product to the international border. Government A, which the project lenders perceive as a weak financial credit, enters into concession agreements with the joint venture. The project lenders agree to make a term loan to the joint venture on the condition that the World Bank guarantee that loan against the risk of government A breaching either of its concession agree-

FIGURE 2 CROSS-BORDER SALES TO A STATE ENTERPRISE



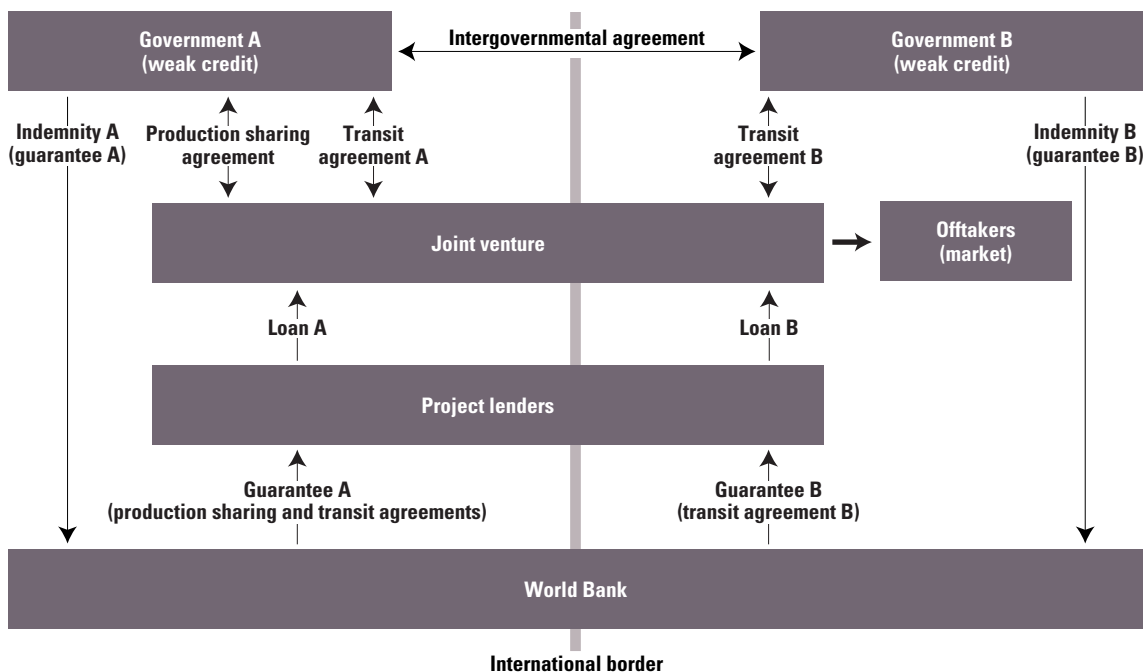
ments and causing an interruption in debt servicing. The downstream part of the project is creditworthy, so from the World Bank’s perspective the “project” is entirely within country A, the obligations being backed are those of government A, and thus the indemnity of government A covers the Bank’s requirements.

The example in figure 2 reverses the credit scenario. Government A has sufficient credit standing so that its concession agreements need no further support. But because the product is to be sold at the border to a state enterprise in country B that lacks independent creditworthiness, government B will have to guarantee the payment obligations of the state enterprise. The project lenders, perceiving government B as a weak financial credit, agree to make a term loan to the project on the condition that the World Bank back the guarantee obligations of government B. Again, in the World Bank’s view the “project” is entirely in country A. To meet the Bank’s requirements, both government A (in whose territory the project is lo-

cated) and government B (whose obligations are being backed) will have to indemnify the Bank for the amount of the loan. Depending on the economic benefits accruing to country A, the requirement for an indemnity from government A could prove to be difficult to arrange without some clever structuring.

Figure 3 shows a simple cross-border joint venture where a single joint venture holds the concessions for a production facility and pipeline in country A and for a pipeline in country B. Both governments are perceived as weak financial credits by the project lenders, which will lend to the joint venture only if the Bank guarantees the governments’ payment obligations. The World Bank views the initiative as two “projects” divided by the international border. To maintain transparency, the Bank prefers that the project lenders provide two separate loans, with the proceeds of each loan to be used exclusively for expenditures in one country. The Bank’s indemnity requirements can easily be met in this structure, with government A

FIGURE 3 SINGLE CROSS-BORDER PROJECT



indemnifying the Bank for claims under guarantee A (which covers loan A for the “project” in country A), and government B doing the same for the “project” in its country.

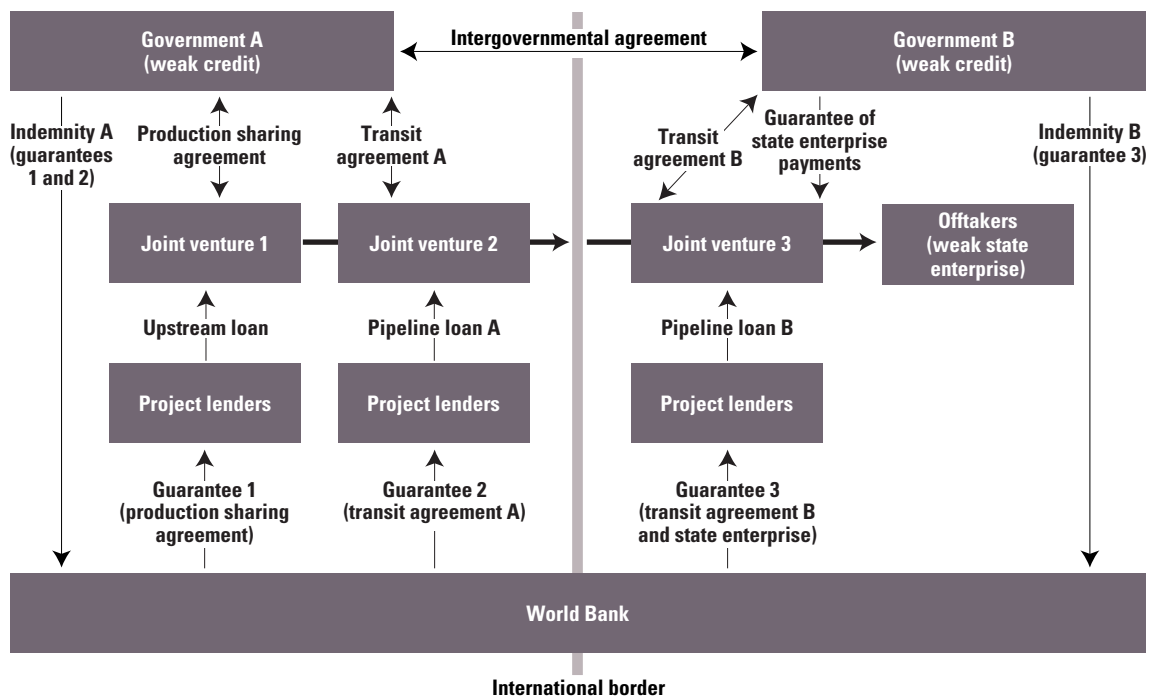
Figure 4 merely pulls the pieces together in what is perhaps a more likely scenario. In this example the functions are split among separate joint ventures, each constituting a “project” from the Bank’s perspective. (There are often business reasons for separate joint ventures, such as to accommodate local ownership and local financing.) The Bank considers joint operations agreements between these joint ventures (including cross-default provisions in loan agreements) as commercial risks outside the scope of its guarantees. If each guarantee backs a term loan for expenditures only in the country of the “project,” each government’s exposure under its indemnity to the World Bank is limited to the amount invested in its territory and the Bank’s indemnity requirements are clearly met.

The variations on the theme are endless. These four examples are meant only to illustrate the possibilities for using World Bank guarantees.

The process

For the World Bank the process of issuing a guarantee begins with requests to the Bank from a host government and the private sponsors to provide a partial risk guarantee to the project lenders. Bank procedures require approval of each guarantee by its board of executive directors. Each project must meet the Bank’s standard technical, environmental, economic, and financial criteria and be in a country that is reforming to the Bank’s satisfaction. The Bank must determine that the project is in the best interest of the country and that allocating guarantee coverage to the project is in the Bank’s and the country’s best interest. At its discretion, the Bank may incorporate in its own appraisal the results of technical, finan-

FIGURE 4 MULTIPLE PROJECTS, MULTIPLE GUARANTEES



cial, and other assessments undertaken by advisers to the project lenders.

For an oil or gas project World Bank policy generally requires public disclosure of an environmental assessment in final and agreed form at least sixty days before board approval of the project. Preparation of the environmental assessment is chiefly the responsibility of the sponsors.

The sponsors are also responsible for arranging their own financing. With the permission of the appropriate central bank, loans guaranteed by the World Bank can be in any freely convertible currency or the local currency of the country in which the project is located.¹

Conclusion

In the financial structuring of oil and gas projects World Bank guarantees can complement loans from the International Finance Corporation and the Bank and insurance from the Multilateral Investment Guarantee Agency. Guaranteed debt is often arranged at lower costs and longer maturities than would otherwise be possible; the pass-through of these savings to the government can be an important part of the Bank's value added in a project. But the World Bank's presence in a project reaches beyond the guaranteed debt, often bringing comfort to other parties not directly benefiting from the guarantee.

¹ For more information see *The World Bank Guarantee: Catalyst for Private Capital Flows* or the *Guarantees Handbook*, available from the Project Finance and Guarantees Department, (202) 473-1650.

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