Ban Diego LNG

A Case Study in the Use of Project Financing in Partnerships

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Abstract

One of the least appreciated reasons for why firms employ project financing is its ability to help reconcile different financing capabilities among partners. Partnerships are very common in the energy industry. Firms use them to share many forms of risk: exploration, operating and political. Alongside this traditional use, partnerships have become the necessary means by which International Oil Companies (IOCs) access attractive resources owned or controlled by state governments or state companies.

When this latter case occurs, the disparity in partner financing capability may be great. Many state firms lack access to global capital markets and are capital constrained. Others see their cash flows diverted by their government owner to other uses. In such circumstances, the financially constrained state firm may seek to be "carried‟ by its stronger private partners. When a firm is "carried," its partners loan it the money to fund its share of project capital costs. Repayment often is provided for out of the „carried partner's‟ share of project cash flow.

This is an expensive and undesirable outcome for private energy firms. Carrying a partner involves assuming their equity investment risk. For this they typically earn return typical of a debt instrument. This economic debit can be large and can result in a negative expected NPV for the project. It also sets a bad precedent, misaligning investment stakes among the partners and telegraphing to potential partners in other ventures that "carries‟ may be available. For these reasons private firms forcefully resist "carry‟ requests.

Project financing can ameliorate these partner tensions and the risks posed to attractive ventures. By using the project's assets and cash flow to secure funding, the equity cash from each partner can be reduced to manageable levels.

This case involves a very attractive LNG project threatened by this type of partner funding dispute. A carry has been requested and is being resisted. Project financing has been broached but there are disagreements as to what should be attempted. For the private partner there are issues of how much project financing can realistically be achieved, whether a residual „carry‟ will be required and will the project still be worth pursuing.

The case is historically grounded in a major Middle East LNG partnership where a carry was requested by the state firm and acceded to by a small private partner. The major private partner/operator then had to decide how to salvage both the venture and its leadership position.