

The arbitrage of a pipeline

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A recent trend in hydrocarbon funding is for public bond investors to provide leverage – through bonds– in transactions where Oil and Gas (O&G) companies' assets have been taken "private".

The following note analyses two such transactions – Greensaif and EIG Pearl - in which private capital managers bought O&G pipeline cash-flows/leases and obtained leverage for the transactions through large benchmark bond issuances. Some ESG investors have invested in these package deals even though it seems unlikely that they would have bought the O&G companies' bonds on a stand-alone basis.[1]

Considering the size and prominence of the transactions[2] and a pipeline of similar deals from other producers[3], a closer look seems warranted.:

- The public bonds appear to have been included in some ESG indexes because of data gaps. Index construction rules have seemingly defaulted the bonds to a higher ESG score than the pipeline-owning company as a stand-alone ESG rating on these bonds is lacking. If Greensaif had been given the same ESG rating as its parent company Aramco, it would likely have been excluded. Without a rating, the index has given a default region/sector value, allowing it into the index.
- Managers and investors in these transactions, and banks providing bridge financing, should solicit for ESG ratings of the public bonds to facilitate accurate risk analysis and disclosure.
- European regulators should evaluate the developing trend of these funding vehicles being established in Luxembourg, despite having minimal economic association with or benefit to European stakeholders.
- It would be desirable to have the private managers' Special Purpose Vehicles (SPVs) disclose sustainability metrics under the EU's Corporate Sustainability Reporting Directive (CSRD) in the same manner as other companies, for example Scope 3 emissions and double materiality considerations.[4] Such disclosures from midstream activities of the biggest O&G companies in the world would help create much-needed transparency across the whole sector.

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[1] AFII has analyzed specific deal details in two fairly sizable transactions pertaining to Saudi Aramco's oil and gas pipeline network: "GREENSAIF: A not-so-green double-edged sword", 6 Feb 2023; "New EIG/Aramco bonds in ESG indices", 16 Feb 2022 and "Oil, gas and bond pipelines: the case of Aramco/EIG/BLK", 5 Feb 2022. Sample bonds are EIGPRL $4.387 46s (XS2400630187) and GASBCM [sic!] $6.129 38s (XS2542166231).

[2] As an indicator of this, we note the implicit commenting on the Greensaif transaction in Larry Fink's latest CEO letter, "*For example, in the Middle East, we invested in one of the largest pipelines for natural gas, which will help the region utilize less oil for power production*." This is unlikely to cannibalize on the EIG Pearl oil pipeline transaction: the intent appears to be to re-route oil that is not used for power production to exports, see "Saudi Gas, Renewables Will Help Boost Oil Exports"; Energy Intelligence Group, 21 Jul 2022.

[3] E.g. see "BlackRock, KKR Eye New Backers for Adnoc Oil Pipeline Investment", Bloomberg, 23 Mar 2023.

[4] We would expect such disclosures to be required from 1 Jan 2025.

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Deal structures

A blueprint of how a pipeline private-to-public structure works is provided in Figure 1.

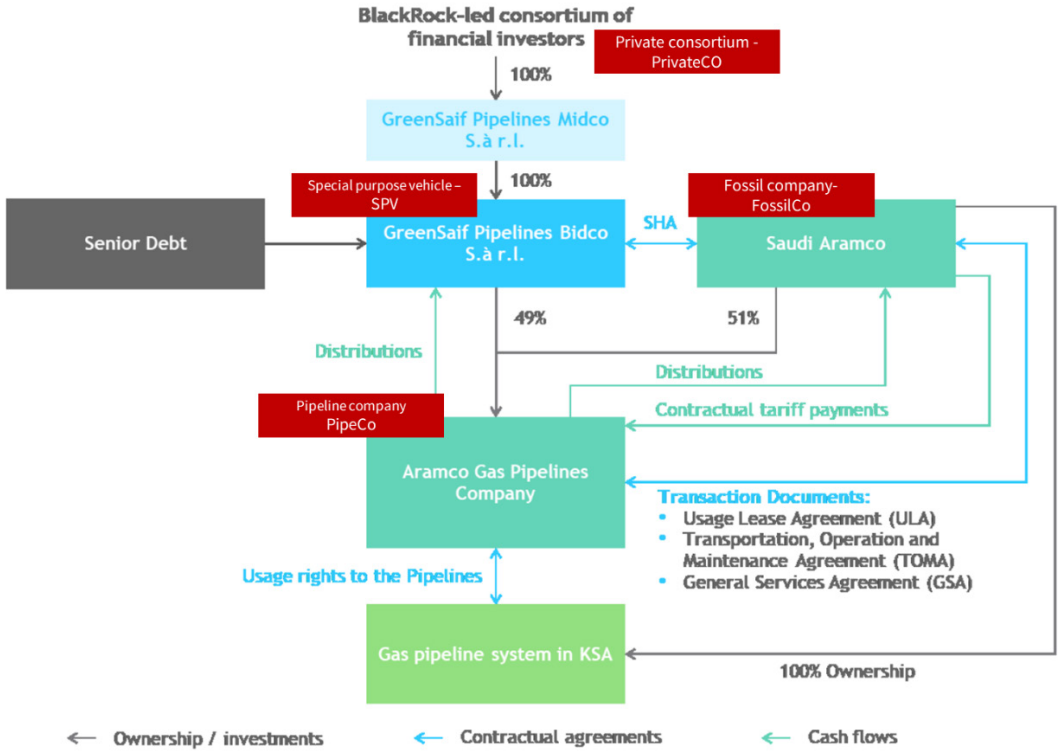
An O&G company (FossilCo) seeks upfront cash for a project but, for some reason, does not want to raise it through direct issuance of bonds. Instead, FossilCo engages with a Private Consortium (PrivateCo) and enters into a lease-lease-back of FossilCo's integrated pipeline network.

The lease-lease-back vehicle is structured as a jointly owned (51% FossilCo, 49% PrivateCo) pipeline company (PipeCo). PipeCo owns the lease, and leases back the pipeline to FossilCo, who retains operational control. As the majority owner and operator, FossilCo retains full financial and operational control over the pipelines. This is important, as one could argue that **both control and economic benefit remain with FossilCo and that the underlying cash-flow-generating assets have very limited value for anyone but FossilCo**.[5]

Over the duration of the trade (up to 25 years), FossilCo pays lease fees to PipeCo, which in turn pays these amounts as dividends ("distributions") to the owners, PrivateCo. FossilCo obtains upfront cash and, in exchange, PrivateCo benefits from the lease payments or "interest" over a number of years.

In essence this is a maturity transformation trade, as in any loan or bond the issuer gets an upfront amount of money and pays out interest to the buyer/lender.

Figure 1. Financing structure of the lease-lease-back transaction in the Greensaif case. Excerpt from bond prospectus, limited print resolution as per the original. Annotations in red as per AFII. Source: Greensaif webpage, AFII.



[5] An implication of this is that in case of default by the PipeCo on the SPC and PrivateCo, there would likely be very limited value in terms of attempting to recover value through some claims on the pipeline assets, especially as recourse would likely to have to be executed in domestic jurisdictions. In such case, the differential in potential recovery between "senior debt" and equity would also likely be small.

Funding mechanics: The pipeline fulcrum

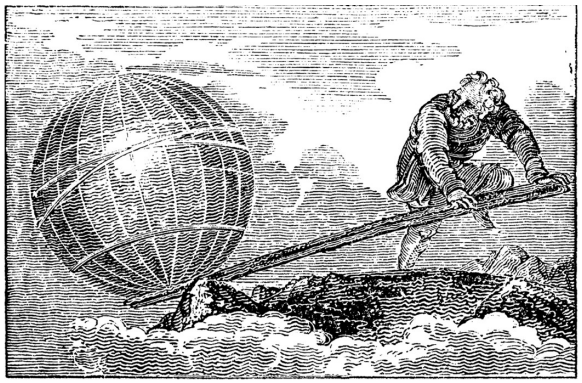
PrivateCo sets up a special purpose vehicle (SPV) to take the minority (49%) stake in PipeCo. The SPV pays an upfront amount to the PipeCo, which in turn pays this to FossilCo as payment for the lease.

Assume that the value of the lease is USD30bn.[6] This means that PrivateCo should be paying just shy of USD15bn to PipeCo, which in turns paying this to FossilCo.[7] A non-leveraged PrivateCo would collect a number of investors, led by a General Partner/asset manager, and raise the USD15bn capital from those investors directly. However, the norm would be a leveraged solution, where the capital provided by the PrivateCo would be in the region of 2bn, and the remaining 13bn is raised through bridge loans from banks.[8]

In the final stage of the funding of a deal, the USD13bn of bridge loans are refinanced by public bond markets, potentially lowering funding costs on the loan portion of the SPV substantially.

What is the economic benefit for the PrivateCo of crowding in public funding through bridge loans and public bond refinancing? Assume the transaction is valued at 30bn and that lease fees are set at USD1.8bn per annum, such that the return (pro-rated) for the SPV investment is (1.8 * 50%)/15=6% (USD900mn). This is the sum that will be paid out in distribution from the SPV to PrivateCo if there were no leverage in the transaction.

Figure 2. "Give me a lever long enough and a fulcrum on which to place it, and I shall move the world." - Archimedes



If we include leverage/borrowed money, the return on capital to PrivateCo can be substantially increased. Assume that the bridge loan or bond funding of the USD13bn comes at 5% cost, or in absolute USD650mn per annum. This means that the remaining 900mn-650mn = 250mn can be divided between the owners of PrivateCo. Given they have invested USD2bn, they then get a yield of 250mn/2bn = 13%.

The risk to the equity holders of PrivateCo is of course if the funding costs come in above the 6%; in the example above, losses would be incurred when funding costs go to 7%. Hence, it is crucial for GPs/LPs[9] in PrivateCo to avoid situations where the public funding becomes more costly as the cost of leverage is a key determinant of economic gain. Clearly, if the leverage becomes more costly due to being associated with a particular ESG factor (negative) premium, that is not financially optimal for PrivateCo.

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[6] The numbers in the following section are hypothetical and should not be claimed to be indicative for any of the mentioned transactions.

[7] FossilCo will also pay 15bn to PipeCo which then immediately pays it back to FossilCo, such that it nets out.

[8] For an example of this, see "Aramco pipeline receives $13.4bn loan from a multi-bank consortium", Arab News, 6 Mar 2022. We discuss the carbon-footprinting of bridge loans in this context in "Operation Private Markets: A Bridge CO2 Far", AFII, 16 Dec 2021.

[9] General Partners (GPs) and Limited Partners (LPs). In this context, the GP would be understood to be the asset manager that has taken a lead in the consortium, structuring the deal and with operational responsibility of the SPV (although not necessarily own invested capital), and LPs as co-investment partners. For example, in the EIG Pearl transaction, we would consider EIG Energy Partners the likely GP.

Key questions and recommendations

ESG ratings

Data indicates that both EIG Pearl as well as Greensaif bonds are included in the JPMorgan ESG CEMBI index whereas Saudi Aramco is not.[10] The index rules dictate that credits in the bottom 20% of ESG scoring are excluded. If a credit does not have a rating, it will be assigned a score based on the region where it resides. Given that the parent company is excluded but the SPV is not,, arguably the default rule has resulted in a stronger SPV ESG rating than would be achieved with a stand-alone analysis.[11] As an interesting footnote, the UK's Financial Conduct Authority (FCA) has recently published its concerns regarding a lack of stringency in application of ESG rules when constructing indices.[12] In an ESG investment strategy, information gaps should not generate exposures that would otherwise be excluded if the data had been present.

Thus, a small effort should be required, on behalf of the private consortium GP, the bridge loan providers, the index provider or the final bond investors, to solicit for a "stand-alone" ESG rating of the pipeline funding SPVs, in order to correctly assess the public bonds eligibility for ESG index inclusion. One could even foresee unsolicited ESG ratings in this context, as the cost of providing such an opinion is likely to be low five-figures. As a proportion of the size of these transactions, the costs would be minimal. Without such efforts being made , regulators may start questioning why such multi-billion dollar "arbitrage" transactions , are not being monitored for ESG impact.

SPV jurisdiction, regulatory arbitrage, and CSRD scope

The SPV mailbox structures that provide funding for FossilCo above are set up in Luxembourg, despite – to our knowledge – very limited end-investor exposure in the European Union (the asset manager being US-based, bonds being denominated in USD and no real economic activities based in Europe). It is likely that the choice of jurisdiction is due to tax- or regulatory optimisation and seems to divert from European regulators' pursuit of increased transparency around "green" financial transactions, as well as Luxembourg's efforts to position itself in terms of "green finance." Indeed, one could consider this to be a case of jurisdictional greenwashing.

Given the choice of jurisdiction and the significance of the transactions, the very minimum we could expect is that the SPV comes under the scope of the Corporate Sustainability Reporting Directive.[13] The advantage of this would be to let investors better understand the underlying assets' Scope 3 emissions as well double materiality considerations.

[10] Access to the index data is restricted, however, we proxy this statement by looking at holdings of the LGIM ESG EM Corporate Bond ETF (EMAB GY) which has positions across the curves of EIGPRL and Greensaif, but not in ARAMCO bonds. According to Bloomberg, the fund is classified as Article 8 under SFDR. According to our calculations, EIGPRL and GASBCM bonds constitute around 2%/4% of the market value of the ETF on market value/duration basis (AFII calculations).

[11] Sustainalytics analysis of Aramco here: rank of 14,705 out of 15,361 in a global universe.

[12] "FCA outlines where improvements are needed in ESG benchmarks", FCA, 20 Mar 2023.

[13] One of the in-scoping conditionalities is at least €20mn of assets, which, arguably, the SPVs would have.

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