BUILDING PIPELINES INSTEAD OF WALLS

THERE HAS BEEN A SIGNIFICANT RISE IN US NATURAL GAS EXPORTS TO MEXICO IN THE PAST FEW YEARS.

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The development and financing of pipelines transporting natural gas from within Texas into Mexico, with creditworthy Mexican offtakers such as Comisión Federal de Electricidad (CFE) and Petróleos Mexicanos (Pemex), has become a dominant feature of project finance in the oil and gas sector and has kept many project finance bankers and lawyers busy in recent years.

There has been a significant rise in US natural gas exports to Mexico in the past few years. US natural gas pipeline exports to Mexico had previously peaked in 2004 at a historical benchmark of approximately 400,000 MMcf. After slight declines in the years after 2004, pipeline exports in 2011 renewed growth at an even more rapid pace and have reached new historic benchmarks each year, with exports in 2015 of more than one million MMcf (see Figure 1)[1].

Although this increase seems counter-intuitive given the general slowdown in oil and gas development, US natural gas has found a market in Mexico due primarily to an increase in the development of gas-fired power generation in Mexico.

Natural gas as a percentage of all fuels used to generate electricity in Mexico has grown from 27% in 1999 to 47% in 2013 and imported natural gas has grown as a percentage of total natural gas consumption from approximately 2% to 30%[2]. This increase in demand and reliance on imports in Mexico has been driven by low natural gas prices in the U.S. These trends are projected to continue in the coming decade, with forecasts for U.S. exports to Mexico reaching 150 Bcf a month by 2020[3].

CFE recognised several years ago the opportunity presented by low natural gas prices and launched an ambitious campaign to expand Mexico's natural gas pipeline system. As such, although there have been pipeline deals with Pemex as the offtaker, the majority have been with CFE and are the focus here.

The intent of CFE's initiative was to expand the limited gas transport capacity (both in the US and in Mexico), increase redundancies and ensure that natural gas would be accessible in all Mexican states[4]. The limit and concentration of existing pipeline assets in Mexico driving the expansion can be seen on Figure 2[5].

CFE pipelines have typically been bid, constructed and financed as either Mexican-only or US-only projects, although recently some projects have entered the market as pipelines located in both countries and financed together.

CFE bid process

CFE generally follows a relatively standardised bid process for choosing sponsors to construct and operate proposed pipeline projects regardless of the project structure or applicable project jurisdiction. CFE tenders may be structured as i) open invitations with no minimum or maximum number of bidders, ii) direct contract awards or iii) restricted invitations with at least three participants invited to bid.

For the most part, pipeline tenders are open invitations and CFE publishes the bid guidelines, including project specifications and timeline i) a one-month review period between bid submission and awarding a contract and ii) a two-year period between the contract award and the proposed commercial operation date for the pipeline), on its website[6].

Bidders are required to provide i) an overview of their design and technical expertise, including development, construction and operation of natural gas transportation projects as well as their plan and schedule for construction, rights of way acquisition permitting, etc, ii) an economic offer (including submission of a financial model with sufficient data to analyse the calculations and assumptions reflected in the proposal and evidence of the bidder's financial capability to execute the project) and iii) comments to the legal and administrative documentation. CFE reviews the technical and economic proposals as a preliminary matter to determine bidders qualified for further consideration.

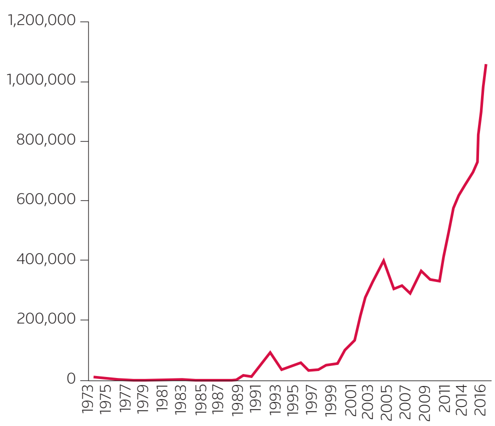
Parties involved

- *Sponsors* – The sponsors actively biding on and constructing CFE pipelines include a range of entities, including Mexican energy firms (including Fermaca, Grupo Carso and Grupo Clisa), North American midstream companies (including Energy Transfer Partners, Transcanada and Howard Energy Partners) and their Mexican subsidiaries (including ATCO Mexico, a subsidiary of ATCO Grupo, and IEnova, a subsidiary of Sempra), as well as engineering, procurement and construction contractors, including MasTec Inc.

In many instances, consortia of these parties have also been formed to bid on specific projects, and have provided an excellent opportunity for cooperation between US and Mexican sponsors, such as the Energy Transfer/Carso Energy/MasTec joint venture constructing the Waha pipelines as well as the Howard Energy Partners/Grupo Clisa partnership currently sponsoring the Neuva Era project.

FIGURE 1 - US GAS PIPELINE EXPORTS TO MEXICO

MILLION CUBIC FEET



● *Sources of financing* – For the most part, the pipeline transactions to-date, whether in the US, in Mexico or in both the US and Mexico, have been financed in the commercial bank market. The lenders providing financing to the projects have included both large international banks as well as Mexican lenders.

Projects being developed wholly in Mexico have, for obvious reasons, seen more focus by Mexican lenders. So far, the sector has not been attractive to export credit agencies or multilaterals. Although some have featured tenors of up to 20 years, others have had shorter mini-perm tenors that will make them clear candidates for project bond refinancings in the coming years, and it appears generally that tenors are tightening.

As most of the recent financings have been project financings, they have benefited from robust collateral packages, including direct agreements with material counterparties to commercial contracts, including CFE, secured accounts, independent engineer oversight of project expenditures and construction progress, and real property security.

Key transaction characteristics

As is the case for any project financing, the terms, conditions and pricing of the core revenue contracts, in this case the transportation services agreements (TSAs) entered into with CFE, are key to both sponsor returns and securing investor confidence in potential projects. The following are some key characteristics of recent transactions:

● *Term* – The initial terms of the TSAs are generally long, with 25-year periods common for pipelines on each side of the international border.

● *Capacity* – CFE is clearly the credit underpinning these transactions, contracting typically on a take-or-pay basis for the majority of the transportation capacity. Although the project companies are permitted, or obligated in certain cases, to make additional capacity available to third-parties, such additional revenue from excess capacity is generally not taken into consideration by lenders in sizing the project debt but is often permitted to be financed through incremental debt capacity.

● *Construction/completion obligation* – A key difference in recent CFE pipeline financings has been an absence of fully wrapped EPCs, with sponsors preferring to construct the projects under several EPC, supply and service agreements for each pipeline. Although atypical for traditional project financings, lenders have generally gotten comfortable with several construction and supply contracts due to the low technical complexity of the pipeline projects and associated completion risk.

● *Project rights* – In certain bid documentation, has CFE requested direct recourse to and rights in respect of pipeline projects, including step-in rights to cure project company defaults, eg, construction delays. Certain recent US deals have also granted CFE second lien security interests in the same collateral as the senior lenders, which has necessitated the negotiation of detailed intercreditor arrangements.

● *Force majeure* – Recent CFE TSAs have allocated the risk associated with events of force majeure between the parties depending on whether the pipeline is still under construction or if it has achieved commercial operations.

During construction, CFE's right to exercise termination or step-in rights are generally triggered after a shorter period than its similar rights during commercial operations. In addition, force majeure during construction typically delays the achievement of commercial operations and therefore the commencement of capacity payments by CFE.

In contrast, force majeure events during operations often allow for the continuation of capacity payments from CFE to the project company for some period of time prior to CFE's termination rights being triggered.

● *Termination payments* – CFE has required relatively broad discretion to terminate its TSAs, whether for cause or at its discretion. Lenders have focused on ensuring that any corresponding payments from CFE for terminations for convenience cover outstanding financing obligations including principal, interest, hedge breakage and any other fees.

● *Rights of way* – As is typical for any pipeline financing, lenders have paid particular attention the right of way acquisition strategy of the relevant sponsors as well as the legal regime governing rights of way. Generally speaking, lenders have expected that all obtained rights of way be mortgaged in favour of the lenders.

As a result of the more complicated regime for right of way acquisition in Mexico and the relatively untested provisions stemming from the 2014 Hydrocarbons Law, financings in Mexico have required that a higher portion of rights of way be acquired and secured prior to financial closing. The ranges vary depending upon deal-specific factors.

By comparison, pipeline transactions in Texas have featured more flexible rights of way provisions, and lenders have been willing to close after the acquisition of any "critical rights of way" but otherwise relying on the transparent, predictable and project-friendly eminent domain regime in Texas to ensure that the necessary rights of way will be secured post-closing.

- *Permits* – What are considered key regulatory approvals in CFE pipeline projects will also vary according to whether they are in the US, Mexico or both.

For pipelines transporting natural gas from the US into Mexico, lenders have typically expected that the project will have received a Federal Energy Regulatory Commision (FERC) Presidential Permit required for exports or imports of energy resources, including natural gas, and for border crossing facilities. And, for pipelines in Texas, a Texas Railroad Commission T-4 Permit is required through which the power of eminent domain is granted to natural gas pipelines in Texas that are gas utilities.

In recent years applications for FERC Presidential Permits, which are subject to a public comment period that is followed closely by both sponsors and lenders, have faced increasing opposition from environmental groups. So far such opposition has not resulted in significant delays for FERC review, although sponsors and lenders will likely continue to monitor the opposition and any changes in FERC's approach in dealing with such commentary.

For pipeline projects in Mexico, lenders will typically expect that the projects have received an environmental impact and risk authorisation from the Secretaría del Medio Ambiente y Recursos Naturales. Other permits are also required for project completion, including authorisation for natural gas transportation from the Comisión Reguladora De Energía, although some lenders have become comfortable enough with the application and approval process that issuances of such permits are not uniformly required as a condition to closing.

- *CFE credit support* – Successful bidders are generally required to provide performance security in the form of letters of credit to CFE in support of the project company's obligations under the TSA. Lenders have shown some flexibility on whether this performance security is to be provided directly by a sponsor (without recourse to the project company) or if the letter of credit capacity can be included in the senior debt.

Although there has certainly been some variability in the structure of CFE pipeline deals in recent years, it is clear that each transaction has built upon the one before, creating an ever-evolving set of key deal characteristics.

CFE's plans for future construction remain ambitious, with the infrastructure announced for near to medium-term development expected to provide an additional 2,385km of pipelines to Mexico's system[7]. This is projected to require an additional US$6.7bn in investment in CFE-awarded natural gas pipelines. As such, although the sector has been marked by numerous successful transactions, it is likely that many more are to come. ■

Footnotes

1 – https://www.eia.gov/dnav/ng/hist/n9132mx2A.htm

2 – Presentation by Enrique Ochoa Reza, Commission Federal de Electricidad, November 2014.

3 – PGJ Online, April 4, 2018, New Opportunities Arise with Demand in Mexico

4 – Presentation by Enrique Ochoa Reza, Comision Federal de Electricidad, November 2014

5 – http://www.gob.mx/sener/acciones-y-programas/plan-quinquenal-de-gas-natural-2015-2019

6 – For reference, the bid guidelines for a recent tender can be found online at: http://www.cfe.gob.mx/Proveedores/3_Licitacionesprincipales/Paginas/Gasoducto-Ojinaga-El-Encino.aspx.

7 – US Department of State, Bureau of Western Hemisphere Affairs, June 2015 Overseas Business Insights

FIGURE 2 - MEXICAN GAS NETWORK