KIRKLAND & ELLIS

Blog Post

Project Finance Opportunities in Oil Storage

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The world is quickly running out of oil storage infrastructure; can project finance help fund a new wave of storage projects?

State of the Market

As we've previously discussed in Kirkland & Ellis' Energy and Infrastructure Blog, the first three months of 2020 witnessed the single largest quarterly percentage drop in oil prices in history. At the same time, the global COVID-19 pandemic has crushed oil demand. The resulting oversupply has made oil storage the hottest commodity in the energy world today.

While the U.S. has significant capacity to store crude oil, existing U.S. oil storage infrastructure is not equipped to handle surging need for storage triggered by the recent 66% price drop along with the simultaneous collapse in oil demand. At current production levels, the U.S. could deplete its existing crude oil storage capacity by June or July, with some analysts predicting remaining capacity will only last a matter of weeks.

There does not appear to be any immediate end in sight to the conditions resulting in oversupply and collapsing demand. Despite the agreement signed on Sunday among 23 oil-producing countries and led by Saudi Arabia, the U.S. and Russia to reduce global production by 9.7 million barrels a day, oil oversupply is expected to continue to outpace available storage facilities.

For the oil industry, decreasing volume is not a matter of turning off a spigot; a forced reduction in output of this magnitude may have long-term disruptive effects. If producers are forced to shut-in production due to lack of storage options, some reservoirs and conventional producing wells could suffer permanent damage.

In his March 31, 2020, daily COVID-19 press brief, President Trump commented on the dramatic shortage of oil storage capacity and discussed a major infrastructure stimulus package. The U.S. federal government plans to support U.S. oil producers by making storage in the Strategic Petroleum Reserve available to U.S. producers. The total capacity on offer is 30 million barrels of oil for deliveries beginning in late April or early May, with another 47 million to follow. Some North American producers are turning to alternative storage such as caching crude oil in parked rail cars, but this solution lends itself to regulatory, transportation and security challenges. While these creative solutions will help, none are sufficient to alleviate the problem; producers continue to seek storage solutions for excess supply, leaving space for ambitious developers to fill the storage void.

Project Finance for Oil Storage

In recent years, traditional project finance structures have not been widely used for domestic oil storage projects. Given the relatively simple construction and minimal market risk for storage operators, cheaper and more flexible financing was often available in the corporate finance and term loan B markets. But since early March, the leveraged finance markets have been largely shuttered to new issuances, with widespread disruption limiting access to credit for all but the most creditworthy borrowers. Moreover, pricing has increased, with recent midstream deals launched prior to the COVID-19 crisis reporting flexed spreads and tightening covenants.

Notwithstanding disruption in the term loan B market, project finance lenders continue to fund deals, especially in the midstream sector. Moreover, since project bankability is viewed objectively based on the quality of the development asset and not on existing company cash flow, project finance structures present the opportunity for credit enhancement, which allows upstart players and ambitious developers to quickly raise financing for a newly hot asset class.

A traditional project finance deal structure relies on certain contractual features to ensure the bankability of the project, including a fully wrapped engineering and procurement and construction (“EPC”) contract, contracted cash flow covering all debt service for the term of the financing and creditworthy contract counterparties. These “gold standard” contractual arrangements may be hard to obtain in the oil storage context, where margins are thin and offtakers often prefer more flexible arrangements.

Nonetheless, we see a number of banks willing to fund oil storage assets with project finance structures absent certain of these features. Because of the limited technological risk and relative lack of complexity of oil storage project construction, lenders are more willing to fund oil storage project deals without wrapped EPC contracts. Wrapped EPCs typically provide certainty for banks by placing full responsibility (and liability) for all aspects of engineering, procurement and construction on one contractor that has a breadth of experience, resources and capabilities with respect to the particular project. By contrast, a sponsor may use so-called "multi-prime" strategies, in which the project owner itself takes on the bulk of responsibility of developing the project by entering into various engineering, equipment supply and construction contracts with multiple contractors and the risk of "finger-pointing" among contractors for delays and cost increases. For oil storage projects, many lenders are willing to accept the multi-prime approach, which can offer substantial savings to sponsors. These savings are a key piece of the equity thesis for lower margin storage projects.

Moreover, given the strong market demand for oil storage in the mid- to long-term, banks have shown a willingness to lend against contracted cash flows with less creditworthy counterparties and perhaps even with some merchant risk (often combined with a full cash sweep).

In addition, oil storage projects can often be developed in a modular fashion (i.e., a project can begin with a certain number of tanks and build additional tankage — using the existing infrastructure — when new offtake agreements are put in place). Lenders in storage projects have demonstrated willingness to provide flexible accordion/expansion credit facilities in order to support subsequent capital expenditures to support this modular approach.

Looking Ahead

The market is in desperate need of oil storage infrastructure. As super-majors and other established projects players are cutting capital expenditures, raising liquidity to defend existing assets and aiming to maintain dividends, a market opportunity — along with potential sources of financing — exists to develop critical domestic oil storage infrastructure.

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