WORLD BANK GROUP
THE WORLD BANK IBRD • IDA | IFC International Finance Corporation | MIGA Multilateral Investment Guarantee Agency

FINANCIAL SOLUTIONS BRIEF

UKRAINE
Gas Supply Security Facility

PROJECT HIGHLIGHTS

- A first-of-kind IBRD trade finance guarantee helps Naftogaz import gas to support Ukraine's energy security. The World Bank, along with the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD), collaborated with Ukraine to help Naftogaz achieve its aim.
- An innovative financing structure provides payment security to gas suppliers. It also provides liquidity to Naftogaz when most necessary.
- The facility was fully deployed within three months of becoming effective. During that time, it served over 33 gas contracts with seven different suppliers.

Naftogaz, Ukraine's national oil and gas company, plays a key role in the economy and is the company that the population relies upon for heating to get through the country's harsh winters. However, Naftogaz's ability to deliver to its customers came under threat in 2013. Ukraine faced unprecedented politico-economic challenges during this time and the company's creditworthiness deteriorated. This led to Naftogaz having unfavorable access to finance and gas supply terms.

The Ukraine Gas Supply Security Facility was designed to address these constraints. The facility has a revolving structure and incorporated innovative features for the World Bank's International Bank for Reconstruction and Development (IBRD) and participating commercial banks. It was the first time that an IBRD guarantee was used for commodity finance. For participating commercial banks, it was the first large, syndicated, trade finance letter of credit (LC) not fronted by a single bank.

PROJECT DESCRIPTION

The financing involves a €478 million revolving loan facility provided in equal shares by Citi and Deutsche Bank. Naftogaz can apply for LCs or loans (direct loans are available in special circumstances for contracts settled on a prepayment basis) to be issued under the facility for the benefit of eligible gas suppliers in support of eligible gas contracts. The pool of potential gas suppliers includes companies using any of the existing gas delivery points on Ukraine's borders, including Belarus, Hungary, Poland, Russia, and Slovakia. Eligible individual gas contracts are generally for "month ahead" or "balance of month periods" during the winter season on a fixed price, post-payment basis. The usual value of individual contracts is €10–15 million. All contracts follow the European Federation of Energy Traders (EFET) contractual standard. Once a gas supplier ships the contracted amount of gas, it can call the LC for payment. The facility is expected to revolve three times, allowing Naftogaz to procure eight billion cubic meters of gas during the two-year availability period.

CONTEXT

Ukraine has gone through considerable upheaval in recent times. Following the Crimea crisis in 2014, the country's economy collapsed, with GDP falling seven percent in 2014. GDP then fell 10 percent in 2015, resulting in the need for much international support. Notably, the International Monetary Fund (IMF) approved an international financial rescue package of $17.5 billion in March 2015. Ukraine also agreed to a $15 billion sovereign debt restructuring in November of the same year.

Ukraine's gas supply was severely affected by the economic and geopolitical turmoil. Gas is an essential fuel source for both heating and power generation in the country, representing one-third of its primary energy supply. Traditionally, Ukraine had imported most of its gas from Gazprom of Russia. Given these events, Naftogaz and Ukraine started pursuing a diversification strategy with an aim to import gas steadily throughout the year from several suppliers across a number of countries.

Hampering Naftogaz's gas sourcing strategy was the market's high-risk perception of Ukraine. This was an obstacle to purchasing more gas through western border points. Ukraine's access to international financial markets was also very limited. As a state-owned company, Naftogaz was also considered a high credit risk by Western European gas suppliers. This meant it had to prepay for gas, instead of receiving the 50-day payment terms typical of European EFET standard contracts. The need to prepay in turn created a liquidity problem for Naftogaz, which usually collected on its invoices after 60 days. With limited access to cost-effective working capital finance, especially in the summer months, Naftogaz looked to international financial institutions for support.

FINANCING

The facility consists of a €455 million credit and a €23 million accrued interest tranche. It is expected to "revolve" over three times during the two-year availability period, amounting to €1.7 billion worth of gas purchases. IBRD provided a full payment guarantee for principal and interest to the participating lenders. The transaction was enabled by additional exposure made available to IBRD by EIB through a $500 million guarantee of IBRD's then-existing exposure to Ukraine, representing an innovative form of cooperation between the two institutions.

Facility disbursement happens through the issuance of LCs for the benefit of gas suppliers, callable following the delivery of contracted gas. An LC that is called becomes a loan to be repaid in seven equal installments in the subsequent year. Repaid amounts may be reissued as new LCs during the availability period, allowing the facility to revolve. Should a scheduled repayment be missed, the lenders would ultimately have the right to call on the Bank's guarantee.

To prevent a call on its guarantee, the World Bank paid special attention to ensuring timely repayments under the working capital facility. A key aspect of the risk management arrangements was to create an onshore IBRD Revenue Account (modeled after EBRD) similar arrangement for its €300 million gas purchase credit line for Naftogaz), through which a minimum of $1.5 billion of Naftogaz revenue needs to flow on a rolling 12-month basis. If the amount flowing through the account fails to meet the minimum requirement, a "Warning Event" occurs. This leads to funds being swept to an offshore reserve account. If Naftogaz misses a scheduled repayment, an "Acceleration Event" can be declared, requiring immediate repayment of the outstanding facility balance.

BOX 1. STRUCTURE HIGHLIGHTS

- The first-ever use of a World Bank Guarantee for trade finance mobilizing commercial trade LC for Ukraine's gas supply.
- Short-term World Bank exposure requirement: no more than four years (which exposure is then returned to Ukraine for other uses).
- Exposure headroom created from EIB Guarantee.
- Reserve accounts created in Ukraine and offshore, activated for loan repayment following trigger events.

INNOVATION IN USING THE GUARANTEE INSTRUMENT

Lenders financing the gas supply contracts required payment security, but Naftogaz also needed the liquidity for its gas purchases. To accommodate Naftogaz, the World Bank agreed to stand behind a revolving facility where the LC instrument would be used to make regular payments under multiple eligible gas trade contracts.

The mitigation of payment risk required the focus to shift from preventing a call on an LC to ensuring that the LC, once called, was going to be repaid. This introduced several "layers of defense" to ensure repayments are made on time. These layers also provide corrective measures to be deployed quickly if lower cash flows threaten the payment schedule or a payment is missed. The Government of Ukraine also agreed to provide a final backstop to Naftogaz's repayment obligations, before the World Bank's guarantee can be called.

In addition, the repayment schedule was carefully designed to coincide with the company's revenue-earning months during the winter season. This gives Naftogaz relief in the summer when much of its liquidity is required for filling up gas storage for the next heating season.

BENEFITS OF WORLD BANK GROUP SUPPORT

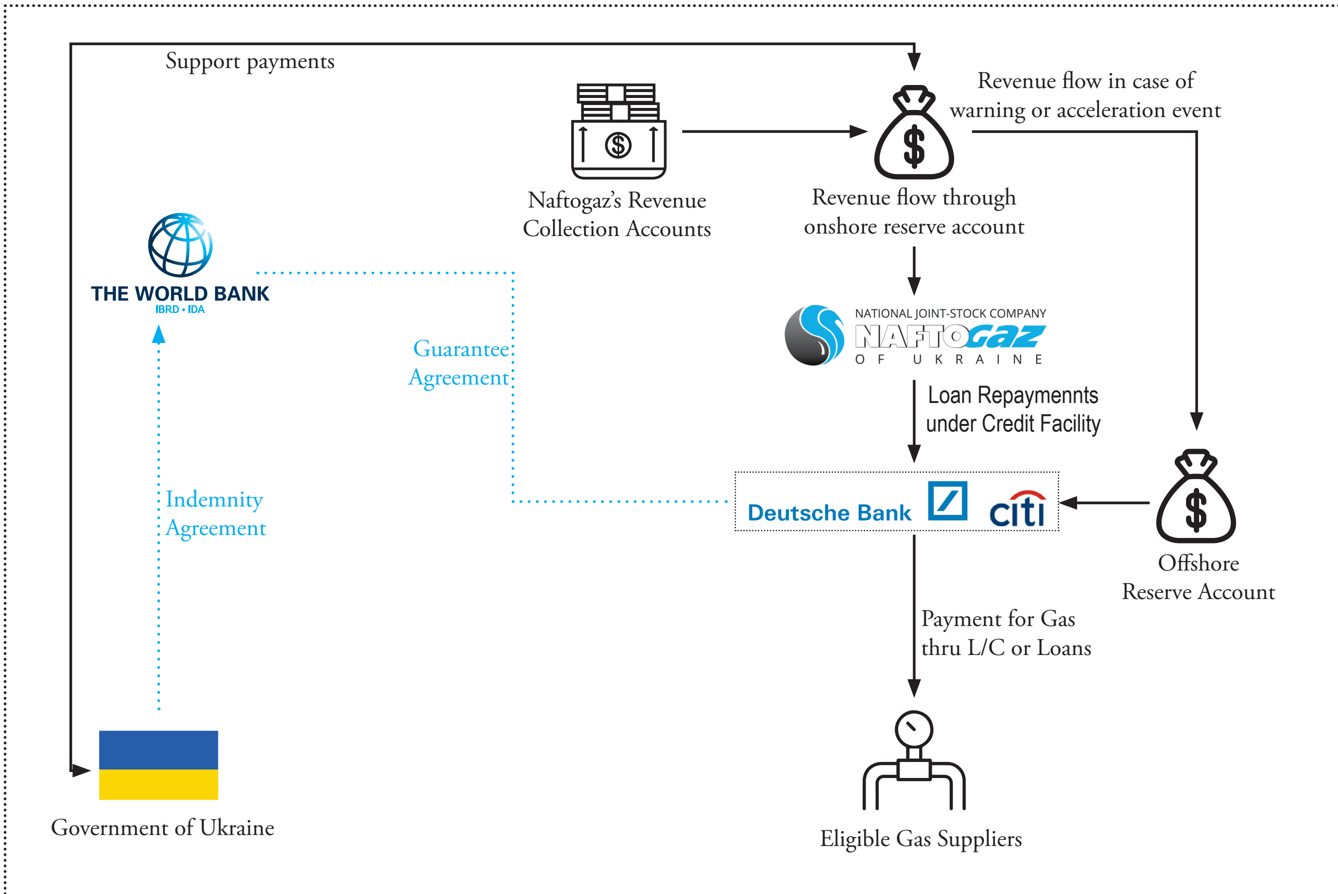
The World Bank, along with EIB and the EBRD, collaborated with Ukraine to help Naftogaz achieve its objectives. The World Bank-supported facility contributes to Ukraine's gas supply security by expanding its gas supply sources and helping Naftogaz build gas storage reserves during summer months. This helps Naftogaz serve its customers better during winter months. About 12.5 million Ukrainian households that consume gas and district heating are expected to benefit indirectly from the facility, mostly by reducing the risk of curtailment (as was experienced during the 2014–2015 winter). Households are also less likely to suffer from the negative health and other economic and social impacts resulting from reduced gas availability.

For Naftogaz, the World Bank's guarantee improves its liquidity situation considerably because of the large volume and low cost of financing obtained. Naftogaz derives additional financial benefits from being able to move from pre-payment to standard European post-payment terms. In addition, the transaction brings greater commercial discipline into Naftogaz's gas procurement practices and paves the way to building the company's credit and relationships with international commercial banks.

The transaction also provided international recognition of the success of Ukraine's ongoing energy reform program. This introduces measures crucial to improving Naftogaz's financial situation without unduly affecting consumers. These measures include tariff increases and support payments for the most vulnerable household customers.

The gas purchase facility got off to a flying start by deploying the whole facility over 33 gas contracts with seven different suppliers within three months of being effective. The financial covenants for the IBRD revenue account were met well on the first quarterly test date, reflecting the company's improving profitability and signaling the start of a financial turnaround after several challenging years.

GUARANTEE STRUCTURE



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