Delek & Avner (Tamar Bond) Ltd. (Series 2020 Notes, Series 2023 Notes, Series 2025 Notes)

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Credit Rating(s)	
Senior Secured	
US$400 mil 4.435% Due 2020 nts due 12/30/2020	
Foreign Currency	BBB-/Stable
US$400 mil 5.082% Due 2023 nts due 12/30/2023	
Foreign Currency	BBB-/Stable
US$400 mil 5.412% Due 2025 nts due 12/30/2025	
Foreign Currency	BBB-/Stable
Senior Secured	BBB-/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country.

Project Description

In May 2014, Israel-based special-purpose entity (SPE) Delek & Avner (Tamar Bond) Ltd. (Delek, or the issuer) issued $2 billion of limited-recourse secured notes and lent the proceeds to Delek Drilling Limited Partnership and Avner Oil Exploration Limited Partnership (Delek Drilling and Avner). In May 2017, Avner merged with Delek Drilling, transferring all of its assets and liabilities to it (the partnership, or the sponsor). The partnership deals in the exploration and production of oil and gas and is indirectly controlled by the Delek Group. The partnership has used the loan proceeds to refinance previous facilities that partially funded its share of the development of the Tamar natural gas reservoir (Tamar or the project) located off the coast of Israel.

The issuer currently has three series of notes outstanding with a balance of $320 million each, maturing between December 2020 and December 2025. Each series ranks pari passu and has a bullet-type repayment profile, with interest paid on outstanding principal every six months. Delek Drilling services the loans advanced by the issuer via the proportionate share of revenues generated from the agreements for the sale of gas and condensate in the Tamar field. These, in turn, are the only source of payment for the notes.

Credit Highlights

Key strengths	Key risks
Strategically important asset	Exposure to volume risk, despite sales underpinned by take-or-pay contracts
Stable operational track record, supported by an experienced operator	Exposure to price risk, especially on the anchor contract signed with Israel Electric Corp. Ltd. (IEC)
Long asset life	Unusual and aggressive capital structure, could expose the project to refinancing risk

The project remains strategically important to the State of Israel. Currently, Tamar produces the vast majority of the natural gas consumed in Israel. Although the start of commercial operation of the Leviathan and the Karish gas reservoirs (expected for fourth-quarter 2019 and second-quarter 2021, respectively) will add new sources of supply, gas demand fundamentals in Israel and in nearby export countries are expected to mitigate the impact of the upcoming competition under our rating scenarios.

There is a track record of stable operation supported by an experienced operator. Noble Energy Mediterranean Ltd. (Noble), has successfully operated the project with approximately 99.7% availability since the start of commercial production of the gas. The reservoir produced gas steadily throughout 2018, supplying its customers' demand, including at peak hours, and totaling an annual supply of about 10.3 billion cubic meters (BCM) (2017: 9.7 BCM). The project's operating performance is reflected into about 8% revenue growth in 2018 (including contractual price indexation).

From December 2019 the project is exposed to growing volume risk. The project's exposure to volume risk is partially mitigated by existing gas sale and purchase agreements (GSPA) structured with minimum "take or pay" (TOP) sales volumes. Based on the contracts in place as of today, firm contracted off-take volumes are currently about 10.5 BCM per annum and may gradually decline as competition increases. Notably, from December 2018 the TOP volumes contracted with IEC were reduced to 3 BCM per annum, placing further reliance on the demand fundamentals for natural gas in the region in order for the gap to be filled.

The project is exposed to growing price risk. The existing GSPAs feature certain protections that mitigate the project's exposure to contracts' prices. These take the form of floor mechanisms and indexation that may be linked U.S. inflation, electricity tariffs as updated by the Electricity Authority (EA), and Brent crude oil prices or a combination. We note, however, that in the first quarter of 2019 the Tamar partners and IEC reached an agreement that froze the U.S. inflation linkage priced in the contract for 2019-2021. This agreement will therefore depress cash flows compared to our previous expectations. Additionally, the IEC contract grants both parties the option to request a price adjustment by up to 25% in either direction in July 2021 and by 10% in either direction in July 2024. There is, in our view, a high likelihood that the IEC price may suffer a substantial reduction in July 2021. We have therefore factored such risk in our analysis. For any capacity supply that needs to be re-contracted, we expect pricing to be broadly in line with the key commercial terms set by the regulatory framework and market competitive dynamics that will exist at the time. On the positive side we note that the price freeze agreed with IEC and still not executed and finally approved by the regulator, will allow Delek to move demand that has until now been defined interruptible (i.e. based on availability) to firm (i.e. committed), increasing the rigid client base.

The unusual and aggressive structure of the debt, could expose the project to refinancing risk. The project has a comparatively unusual and aggressive financial structure, incorporating only bullet maturity notes. To mitigate the associated refinancing risk, the project is required to trap cash ahead of the repayment date in order to defease the debt coming due. These features mitigate but do not remove the project's exposure to refinancing risk in our downside rating scenario. Additionally, unexpected shocks such as materially lower demand or prices, or a significant halt to operations, could affect the project's liquidity cushion and potentially increase its exposure to refinancing risk. However, at this point we do not factor such circumstances into our analysis, beyond our downside assessment, given the project's robust operational track record and the regulated nature of the gas contracts' key commercial terms.

The current level of reserves provides a sufficient tail for bonds to be refinanced. As of Dec. 31, 2018, Tamar had remaining 1P (proven) reserves of 8.1 trillion cubic feet (TCF), or 230 BCM. This equates to slightly above 20 years of remaining production under our base case or about 23 years under our downside scenario. This leaves a substantial tail for the Tamar bonds to be repaid and refinanced, if needed.

Outlook

The stable outlook reflects our view that, absent unexpected events, the Tamar reservoir will continue to build a track record of steady and reliable operating performance. It also reflects our expectation that the project will be able to mitigate volume and commodity price risk in the medium and long term.

Downside scenario

We could lower the rating if the Tamar reservoir operating or market conditions were to deteriorate.

Evidence of such deterioration could be a severe and prolonged decline in availability of the Tamar field, material reduction in flow rates, or any other indication that production levels and/or revenues are adversely and materially affected. Gas demand deviating from our forecasts, as well as adverse amendments to contracts with off-takers (such as price revisions), resulting from increased competition on the local market, for example, could trigger a downgrade, as well. We would also lower the rating as a result of a downgrade of IEC by more than two notches.

Upside scenario

In light of the lumpy capital structure, we do not anticipate an upgrade at this stage, since it would require a material and unanticipated improvement in metrics removing any residual refinancing risk.

Performance Update

The project may soon benefit from a new export route to Egypt. In February 2018 Delek Drilling and Noble signed two GSPAs with Dolphinus Holdings Ltd. (Dolphinus) for the export of natural gas to Egypt from the Tamar and Leviathan reservoirs. Under each of the GSPAs, each one of Tamar and Leviathan will supply 32BCM of gas over a 10-year period. In parallel, in September 2018 Delek Drilling and Noble entered into an agreement in order to secure the gas export route for the supply to Dolphinus through the acquisition, together with an Egyptian government related infrastructure company, of 39% of the shares in Eastern Mediterranean Gas Company S.A.E. (EMG). EMG is a private company registered in Egypt that was established for the purpose of importing gas to Israel from Egypt. EMG owns a 26 inch, 90 km offshore pipeline with a capacity of 7 BCM per annum connecting the Israeli transmission system in the Ashkelon area with the Egyptian transmission system in the El-Arish area, as well as related facilities. A condition of the acquisition of the shares in EMG is that Delek Drilling, Noble, and their Egyptian partner will become party to a Capacity, Lease and Operatorship Agreement (CLOA) with EMG, pursuant to which EMG will grant them the exclusive right to lease and operate the EMG pipeline for the entire term of the Dolphinus GSPAs. Finally, Delek Drilling, Noble, and the Tamar and Leviathan partners are negotiating an agreement for the allocation of the capacity of the EMG pipeline to accommodate the expected volumes under the Dolphinus GSPAs, between both partnerships, which will come into effect upon final execution of the EMG shares acquisition and the CLOA. While the terms of the GSPA may change, the execution of the underlying contractual arrangements--currently expected in the course of 2019--will allow Tamar, and in turn the project, to absorb any loss of volumes once Leviathan and the Karish gas reservoirs come on-stream. By exporting natural gas to a country with comparatively higher country risk compared to Israel, Tamar and the project will however weaken their counterparty risk exposure.

In the coming two years, IEC will off-take lower volumes than we previously expected. As a result, to avoid a drop in sales, the project is now more dependent on the gas demand fundamentals in the region. The TOP sales volumes under the off-take contract with the IEC contractually reduced from 5 BCM per year to 3 BCM per year by the end of 2018. Based on our expectation of IEC's supply needs, we previously anticipated sales to IEC in excess of the TOP in 2020 and 2021 respectively. During the course of 2019, IEC issued a tender for a supply contract of 2 BCM per year for the two years from December 2019. Both the Tamar and Leviathan partnerships competed for the tender, and IEC awarded the supply contract to Leviathan. We expect some of the existing clients that the project already provides gas to, albeit on an interruptible basis, may off-take additional volumes. Additionally, some of the volume lost to Leviathan may be offset by new sales to Egypt. In light of this, we currently maintain unchanged our expectation that Tamar will sustain volume sales. However, the shift in volumes away from a GSPA with an investment grade counterparty and favorable pricing may weaken the counterparty risk exposure of the project and the weighted average price at which the project is able to sell gas.

The competitive landscape creates opportunities for off-takers to renegotiate on pricing. As the start of the competing reservoirs' commercial operation get closer, we do not expect a further significant shift of off-takers away from Tamar.

Leviathan, the larger domestic competing natural gas field, will begin production in fourth-quarter 2019 and has a targeted supply of about 10-12 BCM per year for its phase I. However, Leviathan's partners have signed contracts for the sale of the majority of its target capacity with clients in nearby countries, supporting our view that the vast majority of Leviathan production will be likely exported. We do not anticipate significant competition with the project at this point as the project primarily targets on delivering gas to the Israeli domestic market whereas Leviathan seems more export-oriented.

Karish--the first of two smaller fields owned and developed by an independent Greek exploration and production company and expected to begin production in second-quarter 2021, as announced by the latter entity--will likely supply about 3 BCM-4 BCM per year exclusively to the Israeli market. We understand that Karish already allocated most of its production capacity to clients. As such, we do not expect to see additional competition with the Tamar operations that we do not already factor into our analysis.

That said, one way in which competition may materialize is through pressure on pricing. Under the terms of the Israeli government's natural gas framework (NGF) requirements, off-takers can reduce the contracted quantity with Tamar by up to 50%. There are signs that, owing to the additional supply, some off-takers may make use of this clause to enter into pricing negotiations with the partnership.

The recent capital expenditure (capex) reprofiling is credit neutral, in our view. The partnership recently revised its capex plan, bringing forward to 2019 and 2020 much of the spend previously anticipated for 2020 to 2022. Equally, during 2024-2026, the partnership now expects to incur substantially higher capex costs. We understand that the reprofile is associated with further drilling aimed at maintaining and increasing the current production level of the reservoir. The updated capex forecast changes the profile of the cash flow available for debt service and therefore the amount of cash trapped for debt repayment according to the terms of the bond. However, it does not substantially weaken the project's exposure to refinancing risk.

Downside Case

Assumptions	Key Metrics
• Annual sales of 9.5 BCM per year; as noted, our assumptions represent a downside case, such that actual performance may exceed the forecast, in the near term at least. • Prices to rise in line witha combination of U.S. consumer price index (CPI), the production component of the electricity tariffs set by the EA and Brent as per the terms of the GSPAs. However, we assume a 25% negative price adjustment under IEC's GSPA in third-quarter 2021 as allowed under the terms of the agreement. • Opex 10% higher than in the sponsors' base case. • Capex 10% higher than in the sponsors' base case. • U.S. CPI: 1.1% (2019), 1.3% (2020), 1.1% (2021), 1% (2022), 2% thereafter.	• Due to the unusual repayment profile and the reserve provisions in place to mitigate refinancing risk, our downside-case scenario continue to inform our 'bbb-' operations phase stand-alone credit profile (SACP). • The capital structure is unusual, in our view, in that it consists of several bullet maturities, partially synthesizing an amortizing repayment profile. • To ensure that sufficient funds are available to meet each bullet maturity, any release of funds from pledged accounts are halted 12-18 months (depending on the maturity) ahead of any amortization. The issuer thereafter accumulates cash in a fund in order to repay the maturing bond series along with cash flow from ongoing operations and the $100 million deposited in the debt payment fund. • Under our downside scenario, we forecast that cash flows available for debt service will be able to service interest on a timely basis and that structural features aimed at mitigating refinancing risk will support the repayment of all notes, albeit not in full. However the lease deed expiring in December 2038 (prior to the extension option, as per the Petroleum Law), coupled with the amount of proven reserves likely to remain available, provide sufficient grounds to assume that the issuer would be able to raise bridge financing for the shortfall and at the same time service the new debt on a timely basis. • Under such assumptions, we do not expect the exposure to refinancing risk in 2020, 2023, and 2025 to constrain the rating.

Rating Score Snapshot

Operations phase SACP (Senior Debt)

- Operations phase business assessment: 5 (1=best to 12= worst)
- Downside analysis overrides the preliminary SACP: Yes
- Performance expectation under the downside case: bbb-
- Liquidity: Neutral (no impact)

- Comparative analysis assessment: None (no impact)
- Operations counterparty ratings adjustment: bbb
- Financial counterparty ratings adjustment: None
- Operations phase SACP: bbb-

Modifiers (Senior Debt)

- Parent linkage: De-linked
- Structural protection: Neutral
- Extraordinary government support: No
- Sovereign rating limits: a+
- Full credit guarantees: No
- Senior debt issue rating: bbb-

Operations phase SACP

- We assign to the project an operations phase business assessment of 5 (on a scale of 1 [lowest risk] to 12 [highest risk]). This reflects our assessment of the project's moderate performance risk combined with a degree of market risk exposure.
- The capital structure of the project creates an annual debt service coverage ratio (ADSCR) profile that, if calculated excluding liquidity sources and taken at its minimum, in line with our project finance operations methodology, would not fully reflect the debt servicing ability of the project. Specifically, the project benefits from robust liquidity provisions that would persevere through a downside scenario.
- Our downside analysis provides a unique insight into the project's default risk, by simulating the project resilience to a shock in volumes and pricing with the support of the liquidity in place under the financing.
- As a result, the operations phase SACP is driven by our 'bbb-' downside assessment.

Revenue counterparty

- The project is reliant on IEC as the main off-taker over the course of the life of the notes. Tamar signed a GSPA with IEC in April 2013 for a duration of 15 years, two years after the maturity of the last note. Under the GSPA Tamar is contracted to deliver to IEC a minimum take or pay of 3 BCM, with a maximum off-take quantity of 6.68 BCM. We consider IEC as a material and irreplaceable counterparty and therefore assign to it a CDA of 'bbb'.

Operations counterparties

- Noble Energy Mediterranean Ltd., the project's operator and a 100% owned subsidiary of Noble Energy Inc. (BBB/Stable/--), was in charge of the construction and is now in charge of the operation of the Tamar field pursuant to the joint operating agreement. Noble has ample experience in this type of project, both locally and globally. Nevertheless, the project's operations are at this point straightforward in our view and we believe there are many potential alternative operators. Furthermore, we forecast the project's cash balances will be sufficient to cover at least one month's opex in the event that the operator were to be replaced. As a result, we do not apply a CDA to the project's operator.

Financial counterparty

- The account bank is the Tel Aviv branch of HSBC Bank PLC. The documented replacement language is not consistent with our financial counterparty criteria. However, our 'A+' rating on the counterparty assessed in line with our criteria applicable to bank branches does not currently pose a constraint to the rating on the notes.

Liquidity

- We assess the project's liquidity as neutral.
- The issuer does not benefit from a standard debt service reserve account. Instead, a $100 million debt payment fund was initially established to serve as a cushion for debt payments.
- Additionally, the issuer accumulates cash at least one year ahead of any scheduled principal repayment, which it will use along with the debt payment fund and the ongoing cash flows to repay the bullet notes as they become due.

Other modifiers

- Not applicable.

Related Criteria

- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria - Corporates - Project Finance: Key Credit Factors For Oil And Gas Project Financings, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Operations Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 2013
- Criteria | Financial Institutions | Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria - Corporates - Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

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