

THE FINANCING ASPECTS OF THE ACQUISITION OF FPSOs – A consideration of the options available to prospective owners and their financiers – outright ownership versus lease – a legal perspective.

INTRODUCTION

Overview of Floating Production Systems

Floating Production Systems consist of Floating, Production, Storage and Offloading (FPSO) vessels, SWOPS (Single Well Oil Production Systems) Production SPARS and Semi-Submersible Production Platforms amongst others. The need to acquire floating production systems arose as a result of the increasing need by oil companies to prospect for crude oil in the offshore areas of oil producing countries due to the depletion of their oil reserves located onshore and the consequent limitation faced by them with using fixed production platforms in the exploration and production process of offshore fields.

Brief Outline of Floating Production Storage and Offloading Vessels

FPSOs are specialised vessels used in the production and storage of crude oil located in shallow and deepwater fields offshore. They are a relatively new concept in the maritime and offshore oil and gas industries with the construction of the first FPSO dating back to about twenty years and there are currently about 85 FPSOs operating in different parts of the world. Although they are regarded as ships, they differ significantly from conventional ships because they are stationery, i.e designed to be in one location for the useful life of the field and are built bearing in mind the peculiar characteristics of the reservoir, sea depth and the wind and wave conditions existing in the field where they are to be used. Their main features usually consist of topside facilities comprising crude oil separation unit, water injection plant, gas compression modules and various other facilities used to process the fluids produced, mooring systems, either spread mooring system or turrets to keep the FPSO permanently moored at the site and a loading buoy to offload oil from the FPSO into export tankers.

FPSOs are highly capital-intensive and the cost of acquiring an FPSO could run into several millions of dollars, depending on the size and of course the preferences of the oil company concerned. For instance, Total's FPSO "Girassol" in use at block 17 offshore Angola is estimated to have cost about \$700million, FPSOs for Exxon Mobil's Nigerian "Erha" and "Yoho" fields in Nigeria were awarded at a cost of about \$600million dollars and \$400million dollars respectively, Agip's FPSO "Grey Warrior" for its Nigerian "Abo" field, which recently came on stream was also acquired at a cost of about \$700million dollars.

FPSOs are in use in practically all-deepwater locations all over the world and they are gaining increasing popularity as they form an economic and convenient means of developing offshore, deep and ultra deepwater fields and also sometimes marginal fields, located far away from any existing infrastructure.

The deepwater of Africa and its potential to attract the use of FPSOs is enormous. A look at the map of the oil producing countries in the African continent, reveal that

there are many deepwater oil blocks yet to be awarded in Africa. In Nigeria, for instance, apart from all the deepwater fields that have been awarded, most of which have not yet come on stream, there are presently still so many deepwater fields still available for allocation. OPLS 248 – 264, 313 – 315, 317 – 331 are examples of some of the blocks presently still available. Also the recent offer for the award of nine oil blocs in the Joint Development Zone administered by Nigeria and Sao Tome and Principe is another example.

A report produced by Global Pacific and Partners on estimates of oil and gas reserves for Sub-Saharan Africa states: “Over 2003 – 2025, Africa will witness new basin openings, new discovery zones, basin maturations, a more extensive deepwater gameThe period 2004 – 2010 will be a major development phase in the key producer countries, especially in offshore and deepwater zones, and interest will be high in the ultra-deep, with EEZ openings. Large discoveries will encourage this pattern.”¹ I believe that indeed will be the trend of African oil and gas deepwater. This may be why it is believed in some quarters that FPSOs are indeed the future of the deepwater development in Africa. I recall hearing a manager in an oil service company say ‘replace every offshore field where a platform is being used with an FPSO and you will indeed see the future of FPSOs in Africa. If this were indeed correct, it would be necessary to consider the various methods of acquisition and the financing options available to an oil company in its decision to acquire an FPSO. Prior to these, I would discuss briefly the various categories of FPSOs and the parties likely to be involved in an FPSO project.

¹ Extracts from a Nigerian newspaper – This Day Newspaper of 22nd April 2003 at pages 26 – 27.

Classification of FPSOs

For purposes of this presentation, I would classify FPSOs into three main categories:

- a. Small FPSOs with a production capacity of about 60,000 bopd - FPSOs “Sendje Berge” and “Berge Helene” owned by Bergesen DY AS of Norway are examples of FPSOs within this category;
- b. Generic/medium sized FPSOs with a production capacity of about 160,000 bopd - FPSO “Sendje Ceiba” in use by Amerada Hess on the Ceiba field in Equitorial Guinea falls is an example of FPSOs within this category;
- c. Large FPSOs with a production capacity of between 180,000 and 200,000bopd – FPSOs “Girassol” owned by Total and “Grey Warrior” owned by Agip are examples of FPSOs within this category.

Parties to an FPSO project

The relevant parties to an FPSO project would be:

- * The host government/grantor/concessionaire of the field where the FPSO will be used. The laws of the host country will usually vest ownership of all petroleum acreages in the host government and persons wishing to prospect for and extract petroleum won, would only be able to do so on the basis of a lease or license granted by the host government. This usually takes the form of a joint venture between the host government and the oil company involved or a production-sharing contract.
- * The sponsors/oil companies/grantee of the concession. The sponsors could consist of two or more companies seeking to carry out exploration and production activities on the field and having different equity interest. One of them will be the operator of the concession and would have a higher equity interest than the other participants. The parties would operate through an unincorporated joint venture with a joint operating agreement (JOA) to govern their relationship.
- * The lenders/financiers who will finance a substantial portion of the project. Financier/Lenders are typically commercial banks, credit/financing institutions, leasing institutions, bilateral and multilateral export credit agencies and the sponsors themselves.
- * The construction contractor who will be awarded the contract for the construction of the FPSO or the conversion of a VLCC into a FPSO or the oil service contractor who invests in the construction/conversion of FPSOs for the purpose of leasing and operating them for oil companies.

Acquisition of FPSOs

During this presentation, two main methods of acquisition will be considered: outright ownership/purchase of the FPSO and charter/lease of the FPSO. There are of course several hybrids between these two forms.

Outright Ownership/Purchase of an FPSO

FPSOs cannot be purchased like conventional trading tankers because of their highly specialised nature. Their acquisition normally involves awarding an EPCI (Engineering, Procurement, Construction and Installation) turnkey contract to a construction contractor for the construction of a new building or conversion of an existing or new build VLCC (Very Large Crude Carrier) into a FPSO. The contractor will in turn engage several subcontractors for the different phases of the project including building or conversion of the hull, topsides, mooring systems, integrated deck etc and would have overall responsibility of the project.

In the alternative, the oil company could award separate contracts to several independent contractors for different phases of the project. The contractors will be subject to the control of one overall project manager who will enter into a project management agreement with the oil company. The main disadvantage of this method is that the oil company will usually not have a single entity from whom to claim

damages (unlike in the case of the construction contractor above) in the event of a problem. Also this method of acquisition is usually not favoured by lenders, who normally prefer a turnkey contract, which give them the option of entering into a direct agreement with the construction company and also hold the company liable if things go wrong.

A third option is for the oil company to award the contract for the FPSO to a construction consortium made up of separate contracting companies with joint and several liability of its members.

Lease/ Charter of an FPSO

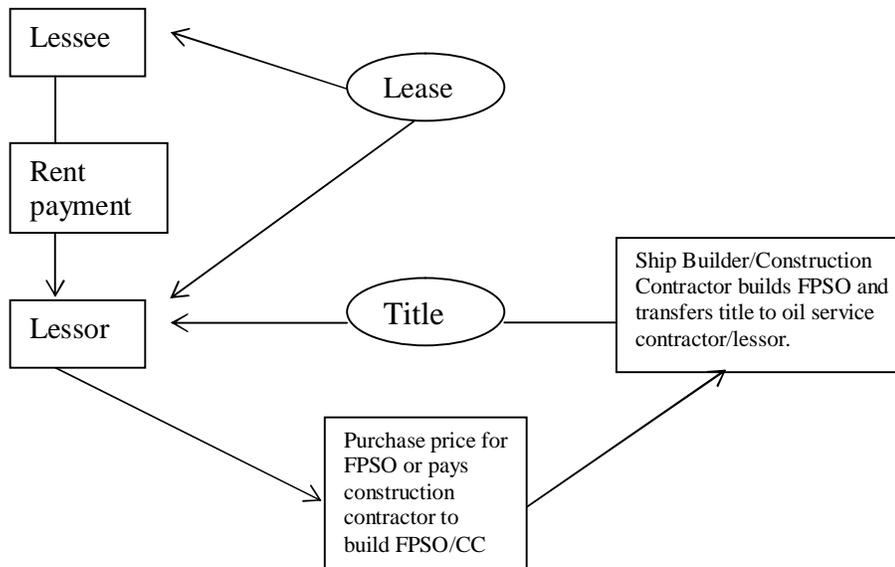
This would involve the oil company leasing or chartering the FPSO for a fixed period of time, usually the useful life of the field in consideration for payment of hire. The lease could either be an operating or finance lease. The provisions of an operating and finance leases in a shipping context, appears to be more akin to a time and bareboat charter party. The charter becomes the lease, the charter party the leasing agreement and the charter hire becomes the lease rental payments.

An operating or direct lease is one, which provides the lessee with the use of an asset for a period of time considerably shorter than the useful life of the asset. The lease agreement is usually cancellable and the lessee in most cases does not assume the economic risks and rewards of ownership like early obsolescence and appreciation. A finance lease on the other hand, is a contract that transfers ownership of the property to the lessee at the end of the lease term i.e. it is a contract for the lease of property that possesses the characteristics of a purchase. A finance lease in its true sense can be likened to a form of structured outright ownership, as it is usually the intention of the parties at the inception of the lease that the leased equipment would ultimately belong to the lessee. It is therefore not applicable to our discussion here, which contemplates true leases for successful hirings of the FPSO. More will be said on finance leases on the issue of financing.

Under an operating lease, the oil company/lessee takes the unit on lease direct from an oil service contractor/lessor who specialised in the lease and operation of the FPSOs for a fixed period of time, possibly the useful life of the field. The lease period would however be considerably shorter than the useful life of the FPSO. This is because the operating lessor looks to different lessees to recoup its investment by successive re-hiring of the unit. The operating lessor supplies the FPSO to the oil company on a lease and operate basis by providing the FPSO, the offshore crew to operate the FPSO, insurance, and general maintenance of the FPSO during the lease term. The parties would usually enter into two separate agreements: the agreement for the hire/lease of the FPSO and a separate operating and maintenance contract. The agreement would be cancellable and would usually not provide for a purchase option.

FPSOs offered on a lease and operate basis would appear to be more adaptable for smaller to medium sized fields whose proven reserves are sometimes too small to justify an investment in full field development production facilities. Such FPSOs are less likely to be field specific and re-usable on multiple field projects without incurring huge conversion costs.

Operating/Direct Lease (Time Charterparty)



Summary

1. A Lessor enters into a lease agreement with a lessee.
2. The lessor pays for the purchase price/construction price of the FPSO and takes title to the unit.
3. The lease begins and the lessee commences rental payment to the lessor.

Financing of FPSOs

There are several ways an oil company can finance the acquisition of its FPSO.

1. Self-financing; and
2. Alternative Financing – this includes any other form of financing other than self-financing. We shall be considering the two main forms of alternative financing: lending and leasing. Please note that the list is by no means exhaustive.

Self – Financing/Equity Contributions

This option is available to an oil company that decides to fund the acquisition of its FPSO. This would in its simplest form entail the joint venture partners i.e. both the host government and the oil company or companies, financing the acquisition from their own resources in ratios proportionate to their equity holdings in the concession. These funds will possibly consist of equity contributions made up of the share capital and shareholders' funds of the joint venture partners.

Ownership of the FPSO can be effected between the joint venture partners in several ways. Three principal options would be considered:

1. incorporation of a new company to own the FPSO with a 50/50 shareholding by the joint venture partners or in ratios proportionate to their equity interest in

the concession; for instance in Nigeria, Saipem and SBM offshore formed a company FPSO Mistrust Nigeria Limited. FPSO Mistrust owns FPSOs and leases them out to oil companies. Although these are oil service companies, the same principle will apply to oil producing companies.

2. joint ownership by the joint venture partners in a proportion equivalent to their equity holdings in the concession;
3. direct ownership by each party of a one half share of the FPSO i.e. 32/32 shares or whichever percentage ratio is acceptable to the parties. In Nigeria and other common law jurisdictions, a FPSO is regarded as a ship and ownership of every merchant ship including FPSOs is divided in 64 and the direct ownership of a FPSO by two or more parties is thereby facilitated.

Tax and other relevant considerations would usually determine which of the options the parties would choose.

The above three methods of ownership itemised above are the ideal and should work out perfectly if both joint venture partners contribute cash in proportion to their equity holdings for the financing. However, this may not always work out in practice due to possible cash constraints on the part of one or more of the parties particularly the host government.

Faced with these possible constraints, particularly the issue of cash calls, it may be difficult for the parties to proceed on this basis of financing. However, depending on how enthusiastic the operator of the field, it may choose to solely finance the acquisition of the FPSO from sources available to it or through contributions from its parent company. The question that would arise in my own opinion in a situation where an oil company chooses to finance the acquisition of its FPSO whether through its own funds or contributions from its parent company, is: would such funds be made freely available to the joint venture without an interest element. My opinion and what I believe is the industry practice is that the financing may be made available to the joint venture at a minimum interest rate as opposed to the prevailing bank rate. This in itself would appear to remove a FPSO financed under such circumstances from the ambit of self-financing. I am aware of a multinational oil company in Nigeria which financed the acquisition of its FPSO and development of the field, which in total came to about \$2 billion in this manner. At the onset, both partners decided to develop the field through alternative financing by applying for a loan and the operator was given the mandate to source for the loan. The transaction suffered many setbacks because the parties could not agree on the interest rate also there was a lot of suspicion between the oil company and the government on the exact terms of the negotiation between the operator and the foreign banks etc. In the end in order to move the project forward, the operator opted to solely provide the funding from its parent company at a minimum interest to the JV.

Alternative Financing – Lending and Leasing

Lending

The joint venture partners may opt for alternative financing from banks/financial institutions. One of the parties, the operator, may be mandated to source for the loan, the terms of which must be acceptable to both partners. There are two main categories

of financial institutions that undertake this type of financing. The commercial banks/lenders who undertake such financing to maximise profits; and the bilateral or multilateral credit agencies like the IFC (International Finance Corporation) World Bank, Export Credit Agencies and such like, whose main objective may be to undertake the development of specific projects, in developing countries.

Project Bankability

Before the lenders agree to finance the acquisition of an FPSO they must ensure that the entire project relating to the FPSO, which is the development of the field where the FPSO would be used, is bankable. Bankability is simply the acceptability or otherwise of a project's structure as the basis of the financing. In its simplest form, this would mean that the reserves contained in the field where the FPSO is to be used are proven and sufficient to justify the financing required for its acquisition. In assessing whether a project is bankable the lenders will carry out a detailed review of the entire project to ensure its viability, consider the project risks and contractual structure issues.

Project Review – This will involve a financial, legal, economic and technical review of the project.

- * A financial review will be based on the financial health and solidity of the project to ensure that the revenue received will exceed the cost and be sufficient for the various needs of the project.
- * A legal review will consider the legal and tax system in the site country and the effect of the system on the project. Lenders should not take the risk of a change in law and the project should not be exposed to the possibility of discriminatory taxation.
- * Economic review will analyse whether the local economy/host country can support the project i.e. availability of requisite infrastructure and a competent labour force; and
- * A technical review will be based on the design and equipment to be used and the reliability and performance of such equipment.

Project Risks

The potential risks that will be associated with the project are the completion, resource, operating, market, currency and political risks.

- * Completion risks relate to the period that the project can be completed and brought into operation. This is usually the period of highest risk for lenders because of possible cost overruns, delays in completing the infrastructure, labour difficulties, technical setbacks etc. During this time, the project is absorbing money not generating it. It is therefore imperative that the lenders ensure that the necessary capital for the project is committed before disbursements are made.
- * Resource risks relate to whether the geological reserves contained in the field will be sufficient, of good quality and be economically recoverable.
- * Operating risks deal with the issue of availability of raw materials for the project, a competent labour force, vulnerability of the project to breakdown,

- expertise of the operator and the exposure of the project to a hostile environment.
- * Political risks are risks of civil disorders and revolutions, community disturbances and unrests, outright expropriation without compensation or creeping expropriation such as the imposition of tax or royalties, removal of construction licences or licences for the import of project equipment and such like.
 - * Currency risks often overlap with political risks and deals with the stability of the currency of the host country. The currency used may experience some change in availability, convertibility or transferability. The lenders will need to ensure that these risks are mitigated through means like hedging. However, currency risks will not be material where the end product of the project would be sold in an international currency which is substantially stable.

Contractual Structure Issues

This will entail a review of all the documentation relating to the project including the concession agreement, construction contract and crude oil sales agreement to ensure that the risks of the project are properly allocated between the parties.

Bankability – Summary

In considering the bankability of financing an FPSO project, all the points mentioned above are equally important, however, lenders should pay particular attention to the following:

- * The estimated geological reserves of the field and its life span i.e. whether the expected life of the field is longer than the loan repayment period. Large FPSOs are estimated to have a life span of 20years without dry-docking. Bearing in mind that the loan granted by the lenders for the acquisition of the FPSO will have to be re-paid from the operational use of the FPSO, if the estimated reserves contained in the field is not adequate to keep the FPSO in use for a substantial part of the useful life of the FPSO, banks could have a situation where the income to be generated by the FPSO on the field will not be sufficient to clear the cost of purchasing it in the first place. A residual value insurance can be insisted upon in this regard. **However this problem may not be yet be relevant in most of the deepwater fields in Africa, which are new discoveries and largely untapped.**
- * Whether the technology to be used will involve cutting edge or untested technology i.e. whether the FPSO will be re-usable on multiple field projects without having to incur huge financial outlay as conversion cost. This would tie in with the first point on geological reserves. The reserves contained in a field would indirectly determine how long a FPSO can be used on a field. FPSOs are by their very nature highly specialised vessels and they are designed (particularly the large ones) to remain at one location throughout the life of the field if the reserves are of sufficient quantity. However, this should not preclude re-usability and the FPSOs can be ordered with this mind.

- * The country/political risk is also a factor lenders must consider carefully particularly in Africa where most of the democracies are nascent with risks of civil disorder, revolution and military coup-de-tat and also sometimes incessant communal clashes because of what the regions perceive to be an uneven distribution of wealth and the insensitivity of the host government and the oil companies to the plight of the people. Examples are communal clashes in the Niger Delta region in Nigeria.

Once the lenders are satisfied of the viability of the project, they would commit themselves to finance the acquisition of the FPSO. This would involve two stages.

- The first stage is the construction stage where the lenders provide financing progressively as the FPSO is built, designed and commissioned. The draw down of debt will be tied to payment events or mile stone which will be divided into identifiable stages in order to provide incentives for the construction work to be carried out in a timely fashion and also, so that the lenders will be able to verify the completion of each stage before releasing more funds. A typical payment pattern could be:

Event	Payment (percent of contact price)
Signing of contract	5
1,000 tons steel delivered to shipyard	5
Commencement of steel fabrication	15
25% steel erected	20
75% steel erected	20
Steel erection completed	15
Launch	5
Delivery	15
	100¹

After construction, completion should be verified by the lenders before the final draw down is made and lenders should ensure that final draw down is of sufficient size to provide an incentive for the construction contractor to ensure proper completion of the project. In addition part of the contract price may be withheld until the expiration of the defect liability period and the carrying out of extensive performance test. In some cases, a final draw down may be allowed before completion against a completion guarantee.

- The second stage is the operation stage during which the FPSO becomes operational and the entire project comes on-stream. It is during this phase that the lenders are re-paid from the project revenue. It is therefore imperative and in the lenders best interest to ensure that the project is completed and brought into operation within the shortest possible time.

¹ Financing ships and Mobile offshore installations – J.E Slogett.

Financing Agreement.

The financing agreement will contain the terms and conditions on which the lenders agree to lend funds to the oil company for the acquisition of FPSO.

Some of the usual clauses which should be contained in the agreement will include, the general conditions precedent to show that the borrower is properly constituted and authorised, condition precedent to each draw down mainly that no event of default had occurred and was continuing and no representation or warranty made or deemed to be made is incorrect, draw down mechanics, interest clause (this will usually be the LIBOR rate), repayment clause, illegality clause, representations and warranties, undertakings and events of default.

Under a loan financing arrangement, both partners i.e. the host government and the sponsors of the project/oil company must be completely committed to finance the acquisition through lending. This again could be an ideal situation and in practice, the partners may be unable to agree on the modalities, which could lead to a breakdown of negotiations and result in one of the parties, the oil company applying for the financing on behalf of both partners. The oil company would have to guarantee the host government's obligations under the loan. This in itself would be fraught with all kinds of difficulties as lenders may be unwilling to lend under such arrangement because of country, political and currency risks among others.

Security Issues

It is in the lenders' interest to ensure that they obtain as much security for the financing as possible. In the usual asset purchase financing, security is normally used as an offensive to enable the lenders dispose of the security and use the proceeds to repay the debt in the event that the project fails. This is because the asset being financed would be readily marketable and can be easily disposed of.

However, in project finance, security is used both for offensive and defensive purposes because project assets are not easily marketable and cannot be easily disposed of in the event of a default. Assuming for instance that the construction contractor goes bankrupt, you will agree that it will be incredibly difficult to find a buyer for a partially constructed FPSO, which was being constructed based on the design considerations of a particular field. (Although the oil company would usually obtain a bank guarantee from the construction contractor to cover payment of instalments in the event of a bankruptcy). Also the host government's consent may be required to an enforcement action because the FPSO is being used for the production of the concession granted.

Therefore in obtaining security, the primary objective of the lenders should be more defensive to ensure that the security taken will protect them from actions by unsecured or junior creditors of the company. The idea behind the defensive purpose is to discourage or prevent unsecured creditor from pursuing a potentially disruptive action against the debtor/oil company because the lenders/secured creditors would to a large extent be insulated from the effects of such an action.

Secondly security can be obtained to enable the lenders to take over the operation of the FPSO for the realisation of the project, rather than just selling of the FPSO and using the proceeds to repay the loan. The type of security obtained and the remedies available under the law largely depend on the jurisdiction involved. The Nigerian legal system, which is based on the English legal system, allows secured creditor/lenders to appoint a receiver/manager over a company's business and assets who will run the business with a view to repaying any amount due to the lenders. In jurisdictions where this is not allowed (civil jurisdictions) it may be possible for lenders to obtain control by taking security over the shares of the sponsors/oil company which would in theory entitle them to assume the right of the shareholders on a default and to replace the company's management. In some jurisdictions the only remedy that will be available to a pledgee of shares will be a judicial sale.

The more usual kind of security that will be taken to secure the loan will include a mortgage on the FPSO and prior to the completion of the construction, lenders can obtain bank guarantees from the oil company or direct from the construction contractor to cover repayment of instalments in the event of a bankruptcy, assignment of the concession (this will of course require the consent of the host government), assignment of the proceeds of the crude oil, fixed and floating charge on the assets of the sponsor/oil company, establishment of a trust account for the receipt of the proceeds of sale of the crude oil amongst others.

Taking Security – Checklist

The lenders lawyers should establish the following:

- * Which asset the borrower owns and which it merely has a right to use under a lease/licence;
- * Over what asset of the borrower can a fixed charge/security be created;
- * Whether floating charges can be created over the borrower's asset;
- * Whether security can be created over an asset not in existence at the time of the creation of the charge i.e. whether a charge can be created over assets to be acquired by the borrower in future;
- * Whether security can be created over movable assets without the physical transfer of those assets to the mortgagee or pledgee;
- * What degree of control the chargee must exercise over the asset to constitute a fixed as opposed to a floating charge;
- * Whether there are restrictions on foreigners taking security over land;
- * What creditors, will by law, be preferred over secured creditors;
- * Whether third parties or liquidator can interfere with the grant of security or with its enforcement;
- * Whether, on a default, the lenders will be able to appoint a receiver over the assets;
- * Whether the bank/lenders will be responsible for the receiver's action or whether a receiver can be appointed an agent for the borrower.

Brief overview of Security Under Nigerian Law

Some of the more important features of the Nigerian security law, which a project financier intending to finance the acquisition of an FPSO should know, are:

- * allows security to be taken over all types of assets both present and future assets.
- * allows security to be taken relatively simply by means of a floating charge over all of a company's asset and at the same time allow the company to continue to deal with those assets in the ordinary course of business.
- * allow security to be taken over all classes of assets without taking possessions i.e. non-possessory security interest.
- * Enforcement including by way of sale can be effected without involving the court, a secured creditor can also operate an asset by taking possession by appointing a receiver.
- * Certain types of security (fixed charge/security) will rank ahead of preferential creditors.
- * Only minimal fees and duties are payable on a creation of security and only the normal transfer taxes (stamp duty) are payable on its enforcement.
- * The trust concept allows interest in security to be transferred relatively simply and in a secured syndicated loan; the security is usually vested in the name of an agent bank as agent and trustee for itself and other banks.
- * There is a central registration system for most categories of security interest, which enables creditors and prospective lenders to check what security a company has already created in favour of other creditors.

Peculiar Security Issues affecting the financing of FPSOs – ownership in petroleum in situ in most countries is vested in the host government. Typical requirements of the petroleum authorities in most countries are:

- * Approval of any programme for the development of a petroleum discovery i.e. field development programme (FDP). The FDP must be approved prior to the award of the contract for the construction of the FPSO.
- * A licence can be revoked on various grounds including the appointment of a receiver over the licensee, a breach or non-observance by the licensee of any of the terms and conditions of the licence and a change in the control of the licensee. A change in control will include lenders with security over the shares in the licensee exercising their enforcement remedies under that security.
- * Prohibition on assignment. A licensee wishing to give security over his interest will require the consent of the Minister of Petroleum. The consent if given will state that a further consent will be required for any enforcement of the security interest. However questions arise as to the kind of security that can be given over a company's interest in an oil or gas field. The security is over the company's interest in a bundle of contractual rights, the most important being the company's rights under the concession/production licence and the JOA as opposed to security over the minerals in the ground. As with any other security over contractual rights as opposed to tangible assets, the value of the security is heavily dependent on the nature of the contractual rights i.e. can the rights be terminated if the security is enforced? Theoretically, lenders may be faced with the fact that the government may revoke the licence if they appoint a receiver.

Leasing

This is the other alternative financing method being considered in this presentation and would involve a consideration of finance leases, which as stated earlier are contracts for leases of property possessing the characteristic of a purchase.

An oil company can choose to finance the acquisition of its FPSO by means of a finance lease. A finance lease can be defined as a lease that covers the substantially (or more) the useful life of an asset or the net present value, using minimum lease payment and the interest rate at the inception of the lease, is equal to or greater than the fair value of the leased asset. The lease is usually non-cancellable and contains a purchase option, which is likely to be exercised for the equipment to be sold to the lessee at the expiration of the lease term. In a finance lease, the lessor provides only the FPSO while the oil company operates and maintains the unit and purchases it at the expiry of the lease term.

Under this form of financing, the oil company/lessee could either take a lease of an already constructed FPSO from a lessor for a stated period, which would cover the useful life of the FPSO in consideration for payment of hire or approach a lessor, who would possibly be a bank/financial institution to finance the construction of a new building and lease it to the oil company/lessee at the completion of construction. In the latter case, the lease would be structured as a leveraged lease and is referred to as construction financing. A leveraged lease is a variant of a finance lease and is usually used for financing the acquisition of large capital equipment project with an economic life of about 25 years or more. It is very appropriate for financing large FPSOs and will be discussed in detail shortly.

As stated above, it is usually the intention of the parties for the lessee to own the FPSO unit at the expiration of the lease term on payment of a nominal fee. However, depending on the jurisdiction concerned, the lease agreement may have to be silent on the purchase option, in order to enable the lessor to claim capital allowances. In Nigeria for instance, the lessee claims capital allowance in a finance lease while the lessor claims in an operating. Therefore, in order to prevent the lease from being categorised as a finance lease and allow the lessor to claim capital allowances, the lease agreement would be silent on the purchase option. The purchase agreement would be contained in a side agreement and at the expiry of the lease the unit would be disposed of to the lessor at a very nominal price.

Leveraged lease

The oil company/lessee approaches a lessor for the lease/financing of a FPSO to be newly constructed and leased to the oil company. The oil company will subsequently thereafter award an EPCI turnkey contract to a construction contractor for the construction of the FPSO. The title to the FPSO to be leased will be transferred to the lessor while the FPSO is still in the early stages of construction. Also, the construction contract will be assigned by the oil company/lessee to the lessor and construction financing will be arranged.

Although the construction contract is strictly between the oil company/lessee and the construction contractor, the lessor who would end up being the ultimate owner in name of the FPSO after construction may wish to supervise the performance of the construction contract with the construction contractor. In order to facilitate this, a construction supervision agreement will be entered into between the oil company/lessee and the lessor to enable the lessor in the capacity of construction supervisor to oversee the testing, delivery and acceptance of the FPSO. The period during which the FPSO is being constructed would be the interim lease term and could involve a separate interim loan (construction loan) agreement to be entered into by the lessee and the lessor, as the lessor could decide to treat the financing for that period as separate from the base lease term, i.e. the period after the FPSO has been constructed. In the alternative the construction loan may be capitalised and included in the total construction cost of the FPSO, which is to be financed by the lease.

The parties to a leveraged lease agreement would include: -

- a. The lessee/oil company who selects the FPSO to be constructed and leased, negotiates the price and warranties, awards the construction contract or enters into a construction contract with a contractor and subsequently hires the use of the FPSO by entering into a lease agreement. The lessee operates the FPSO either by itself or through a third party on its behalf, receives all revenues from the FPSO and makes rental payment.
- b. The lessor/equity participant who becomes the owner of the FPSO by providing only a percentage (typically about 20%) of the capital necessary to purchase the FPSO. The lessor receives the rental payment remaining after the payment of debt service and any trustee's fees and claims the tax benefits incidental to the ownership of the leased FPSO.
- c. The lenders/loan participants, they provide the remainder of the capital (typically about 80%) required to purchase the FPSO on a non-recourse basis to the lessor/equity participants. The loan is secured by a first lien on the FPSO, an assignment of the lease, and an assignment of the lease rental payment. The loan participants or lenders are typically banks, insurance companies, trust and other institutional investors.
- d. The owner trustee represents the equity participant/lessor and acts as the lessor by executing the lease and all other documents the lessor would normally sign in a lease. The owner trustee holds title to the FPSO for the benefit of the equity participant/lessor subject to a mortgage in favour of the loan participants/lenders. The owner trustee's appointment is usually contained in a trust deed and he has no affirmative duties and has little discretionary power beyond that specifically granted in the trust agreement. The equity participants indemnify the owner trustee against cost and liabilities arising out of the transaction except for wilful misconduct or negligence on the part of the owner trustee.
- e. Indenture trustee is appointed by and represents the lenders/loan participants. The indenture trustee and the owner trustee enter into a trust agreement where

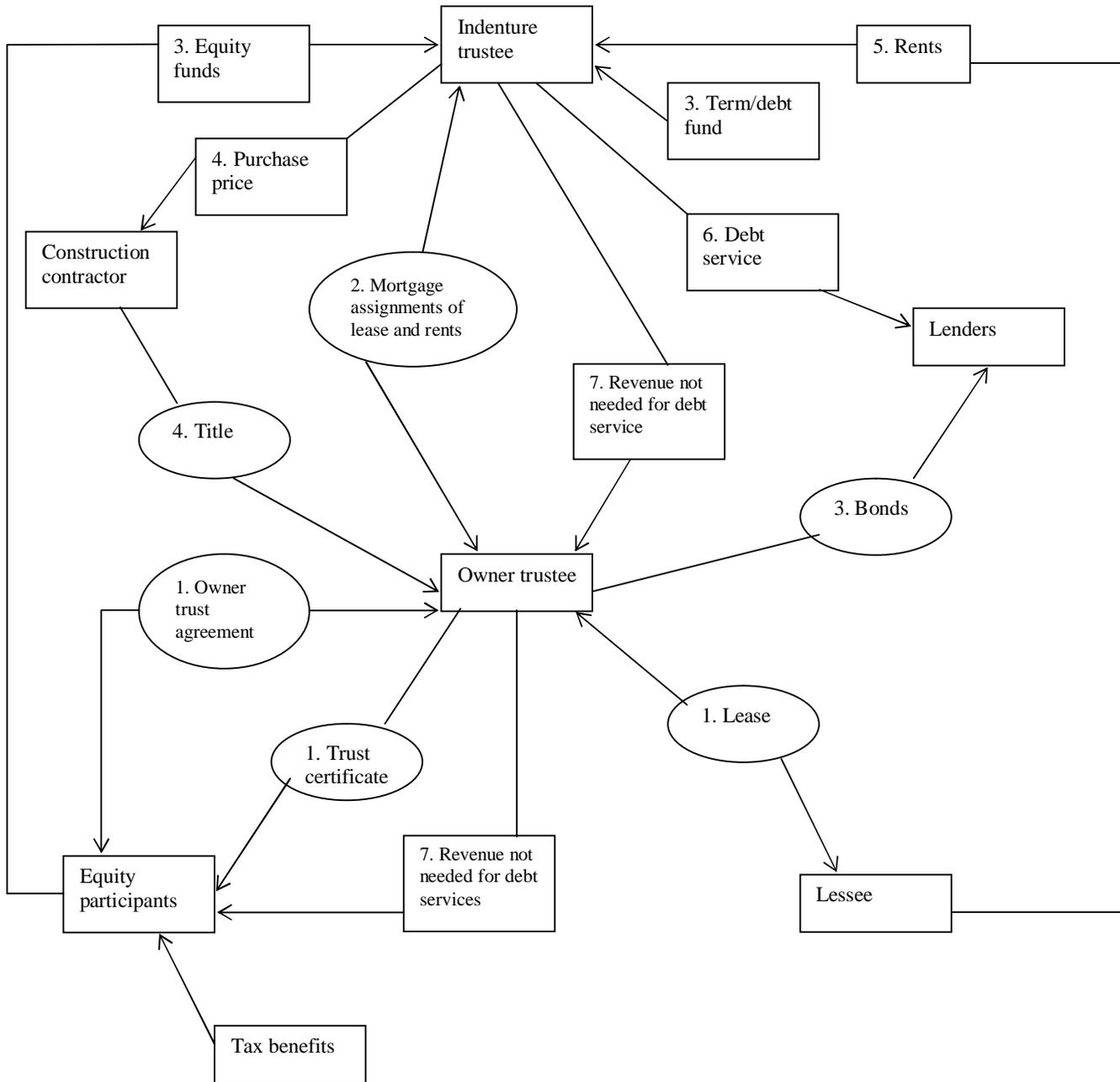
the owner trustee assigns to the indenture trustee, for the benefit of the lenders/loan participants and as security for the leveraged debt and any other obligations, all of owner trustee's interest as lessor in the FPSO, the lease agreement, the right to receive rents and any payment under any other agreement. The trust agreement sets out the form of the facility of the financing provided, the event of default and the instruction and priorities for distribution of funds to the lenders/loan participants and other parties.

The indenture trustee receives the funds for the loan participants/lenders and the equity participants/lessor when the transaction is about to close, pays the contractor, holds the security and collects rents and other payments due under the lease from the lessee. Upon receipt of rental payments the indenture trustee pays debt payments to the lenders/loan participant and distributes the remaining revenue to the owner trustee for the equity participants/lessor. In the event of default, the indenture trustee can foreclose on the FPSO and take other appropriate action to protect the security interest of the lenders/participants.

A single trustee may be appointed to act as both owner trustee and indenture trustee. This will usually be the case in a simple leveraged lease transaction possibly with possibly one equity participant and loan participant. The advantage of using a single trustee is that the arrangement will be simpler and the cost will be greatly reduced. However, the disadvantage is that there could be serious conflicts of interest between the equity participant and the loan participant particularly in the event of a default by the lessee.

- f. The construction contractor constructs the FPSO to be leased. The contractor receives the construction contract price at a period stated in the construction contract and delivers the FPSO to the lessee at the beginning of the lease. The completion period and warranties of the contractor as to the qualities, capabilities and efficiency of the FPSO are important to the equity participant/lessor and the loan participants and in some cases the construction contractor may be required to enter into a direct agreement with the lenders/loan participants.

Illustration of a leveraged lease



Summary

1. The equity participants establish an owner trust; trust certificates are issued, and the owner trustee as lessor and the lessee signs a lease agreement.
2. The owner trustee and the indenture trustee sign a security agreement; a mortgage is granted on the leased asset, and the lease and rentals are assigned as security to the indenture trustee.
3. The owner trustee issues notes or bonds to the lenders; the lenders pay term debt funds to the indenture trustee; equity funds are paid by the equity participants to the indenture trustee.
4. The purchase price is paid and title is assigned to the owner trustee, subject to the mortgage.
5. The lease commences; the lessee pays rents to the indenture trustee.
6. Debt service is paid by the indenture trustee to the lenders.
7. Revenue not required for debt service or trustees' fees is paid to the owner trustee and, in turn, to the equity participants.

Other agreements

Construction Contract

A construction contract will be entered into between the oil company and the construction contractor. The contract could be for a new building, conversion of an old VLCC or one under construction. Sometimes banks/lenders may seek to enter into direct agreements with the construction contractor to enable them step into the shoes of the oil company in the event of a default. The key issues relating to a construction contract include:

- The structuring of the construction arrangement i.e. whether to have a turnkey contract with one contractor or separate individual contractors subject to one overall project manager. As stated earlier banks usually feel more comfortable with a turnkey contract;
- The pricing of the contract and how it is to be paid - stage payments are common and a typical payment structure is contained in Table 1 on page 8 of this paper;
- When do title and risk pass – title to the materials passes to the oil company upon delivery to the site or upon payment for those materials being made pursuant to a payment certificate. This is basically to protect the oil company and ensure that if the construction contractor becomes insolvent, creditors cannot seize any material on site. Nevertheless, the oil company still bears a considerable risk since a half completed FPSO will still cost a considerable amount to complete. In order to guard against this risk, the oil company can demand for a bank guarantee to cover repayment of instalments in the event of bankruptcy, during construction, but full cover is hardly obtainable;
- Is there a fixed date for completion and how is it determined – liquidated damages will be payable if the completion date is delayed due to the fault of the contractor;
- Are alterations permissible and who is responsible for delays resulting from such changes. Two types of changes – compulsory changes occurring as a result of alterations in the rules of classification societies or statutory authorities and changes required by the owner as the detailed design is developed. A Provisional Cost is usually included in the contract to take care of these situations;
- Who is responsible for obtaining consents – usually the duty of the oil company to obtain all necessary approvals and consent;
- What warranty does the construction contractor give – the period should be long enough and only begin to run from the passing of a well-defined completion test.

Crude Oil Sales Agreement

This is the agreement for the sale of the crude oil produced by the FPSO hereunder, will be very interested in the contents because it is from the proceeds of the crude oil sold that the loan will be repaid.

Purchase versus Lease

In an outright purchase/ownership operation and maintenance of the FPSO will the responsibility of the oil company and borne out by it or contracted to a third on its behalf.

In a true lease i.e operating lease, the maintenance and operation is the responsibility of the lessor.

In an outright purchase, the construction/completion risk is borne solely by the oil company while in a lease it is borne by the lessor.

Main distinction in outright purchase/ownership, the oil company either by itself or through its financiers advances capital for the construction of the FPSO. In a lease, there is no capital outlay as the FPSO belongs to the oil service contractor and is being hired for a fixed duration of time.

In a purchase the transaction whether self or through other sources will be noted on the company's status while an operating lease, can be done off balance sheet.

Summary/Conclusion

The fact that the use of FPSOs is going to get more popular in the field development programs all over the world is not in doubt. It is therefore important for parties to be acquainted with the various options available for the acquisition and financing of FPSOs in order to be able to make informed decisions based on their preferences and peculiar needs. The method of acquaintance suitable to a multinational oil company with a large field with huge reserves may not necessarily be adaptable to the needs of a small company, it is therefore important for parties to be acquainted with the various options available to them in their decision to acquire FPSOs for the development of their fields.

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