THE FINANCING ASPECTS OF THE ACQUISITION OF FPSOs – a legal perspective.

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INTRODUCTION

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 dating back to 1977 used by Shell on its “Castellion field” in Spain Mediterranean. FPSOs are now being used in a number of deepwater fields all over the world and they are becoming increasingly popular as they form an economic and convenient means of developing offshore fields and also sometimes marginal fields, located far away from any existing infrastructure. Currently there are about 85 FPSOs operating in different parts of the world

The deepwater areas of Africa (principally Nigeria, Angola, Congo, Equatorial Guinea and Gabon) and its potential to attract the use of FPSOs are enormous. A look at the map of the oil producing countries in the African continent, reveal that there are many deepwater oil blocs that have been awarded but are yet to come on stream examples include ExxonMobil’s “Erha”, ChevronTexaco’s “Agbami”, Total’s “Dalia” and Esso’s Kizomba. Apart from the allocated fields, there are still a lot of deepwater fields available for allocation in Africa. Examples are OPLS 251 – 255, 257 – 264, 313 – 315, 317, 319, 321., 323, 325, 327 – 331 in Nigeria and the nine oil blocs recently put on offer in the Joint Development Zone administered by Nigeria and Sao Tome and Principe, also series of blocs in Angola and Equatorial Guinea to mention a few. It is interesting to note that out of the 15 deepest FPSOs installed or sanctioned for use all over the world, 10 units are for Africa. These are FPSOs Hungo, Kissanje, Plutonio, Dalia, Atlantic FPSO, Girassol and Baobab for use in Angola, Erha and Agbami for Nigeria and Nemed for Egypt.

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 game…The 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.” I believe that this will indeed be the trend of future African oil and gas deepwater development.

Classification of FPSOs

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

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1 Sources – Technip-Coflexip offshore Magazine August 2002 titled 2002 worldwide survey of FPSO units
   Quests offshore resources inc’s website
   Internet independent research
2 Extracts from a Nigerian newspaper – This Day Newspaper of 22nd April 2003 at pages 26 – 27.
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 in use by Petroleo Nautipa on the Etame field in Gabon is an example 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 is an example of FPSOs within this category;

c. Large FPSOs with a production capacity of between 180,000 and 200,000 bopd – FPSOs “Girassol” owned by Total and “Bonga” owned by SNEPCO 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 who would grant a lease or license to persons wishing to prospect for and extract petroleum won in the host country. 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/parties/grantee of the concession to whom the concession was granted to develop either under a joint venture with the host government or by means of a production sharing contract.
- The lenders/financiers who will finance a substantial portion of the project.
- The construction contractor who will be awarded the contract for the construction of the FPSO or the oil service contractor who invests in the construction/conversion of FPSOs for the purpose of leasing them to oil companies.

Consideration for acquisition/financing of FPSOs

- Financial considerations;
- Type of oil company involved i.e. whether multi-national or independent
- Tax considerations;
- Nature of the concession obtained from the host government i.e whether joint venture or production sharing contract and the terms and conditions of the grant;
- Type of field and duration of field life;
- Risk exposure of the oil company

Methods of 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

Acquisition of FPSOs normally involves awarding a contract for the construction of a new FPSO or conversion of an existing VLCC into an FPSO.

Award of construction contract

The construction/conversion contract can be awarded in any of the following ways:

- Award of 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 VLCC (Very Large Crude Carrier) into an FPSO. The contractor will in turn engage several subcontractors for the different phases of the project including the hull, topsides, integrated deck amongst others.
- Award of 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 in the event of a problem.
- Award of the contract to a construction consortium made up of separate contracting companies with joint and several liability of its members.

Ownership structure

Ownership of the FPSO can be effected between the joint venture partners in several ways.

- 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;
- joint ownership by the joint venture partners in a proportion equivalent to their equity holdings in the concession;
- 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 most common law jurisdictions, a FPSO is regarded as a ship and ownership of every merchant ship including FPSOs is divided in 64, the partners can therefore own directly the relevant number of shares in the FPSO proportionate to their equity in the concession.

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

A construction contract will be entered into between the oil company and the construction contractor for the construction of the FPSO. The key issues relating to a construction contract include:

- Structuring of the construction arrangement - whether to have a turnkey contract with one contractor or separate individual contractors subject to one overall project manager or a construction consortium. As stated earlier banks usually feel more comfortable with a turnkey contract;
- Pricing and payment - stage payments are common;
- Title and risk – 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;
- Completion date – Completion date would be determinable from the provisions of the contract signed between the parties. Liquidated damages will be payable if the completion date is delayed due to the fault of the contractor.
- Alterations and delays resulting from such changes – Two types of changes contemplated: 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;
- Consents – usually the duty of the oil company to obtain all necessary approvals and consent relating to the development of the field;
- Warranty – the warranty period should be long enough and only begin to run from the passing of a well-defined completion test.

**Lease/ Charter of an FPSO**

This would involve the oil company leasing or chartering the FPSO for a fixed period of time in consideration for payment of hire. There are two main types of leases: an operating and finance lease.

**Operating/Finance lease**

A finance lease 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 is more akin to a form of structured outright ownership and it is therefore not applicable to my discussion here, which contemplates
only true leases. 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.

Under an operating lease, the oil company/lessee takes the unit on lease direct from an oil service contractor/lessor, who specialises in the lease and operation of 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 lease of the FPSO and a separate operating and maintenance contract. The agreement would usually not provide for a purchase option and if it does, it may not be conclusive in the sense that the price and the terms and conditions of sale may not have been fixed.

**Time/bareboat charterparty**

The provisions of an operating and finance leases in a shipping context, appears to be more akin to a time and bareboat charter party with the exception that a time charter party usually gives the oil company an option to purchase the FPSO after a stated period, usually after the costs have been amortised in the charterer’s books. The charter becomes the lease, the charter party the leasing agreement and the charter hire becomes the lease rental payments.

The main advantage in opting for a lease is that the acquisition does not involve the huge capital outlay required for an outright purchase/ownership and the purchase option gives the oil company the flexibility of purchasing the unit at the expiration of the charter period. 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.

**ILLUSTRATION OF AN OPERATING 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.
4. The Lessor operates and maintains FPSO for lessee during lease term.
5. The Lessee return the FPSO to the lessor at the end of the lease term.
Financing of FPSOs

In discussing financing, I shall only be talking on acquisition through ownership and finance leases, which I had already said is a form of structured ownership.

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: loan financing and lease financing. Please note that this list is by no means exhaustive.

Self – Financing

This option is available to an oil company that decides to finance the acquisition of its FPSO itself. 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.

This mode of financing will be realisable only 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, it may be difficult for the parties to proceed on this basis unless one of the partners usually the oil company is magnanimous enough to undertake the sole financing 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 such a situation, is: would such funds be made freely available to the joint venture without an interest element and if interest is charged, this would appear to remove a FPSO financed under such circumstances from the ambit of self-financing. There was a case of one of the multinational oil company’s 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 borrowed money from its parent company and made it available to the JV at a minimum interest.

Alternative Financing – Lending and Leasing

Lending
The joint venture partners may opt for loan financing from banks/financial institutions to finance the acquisition of their FPSOs. One of the parties, the operator, may be mandated to source for the loan, the terms of which must be acceptable to the partners before the transaction can be closed. There are several issues financiers would consider in their decision to finance a FPSO project.

**Project Bankability**

Before the lenders agree to finance the acquisition of an FPSO project, they must ensure that the entire project, 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 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.
- 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.

**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 an FPSO project, 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 20 years 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. Although a residual value insurance can be insisted upon in this regard, if obtainable. 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, which would make the FPSO 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. If the reserves contained in a field are not large enough to keep the FPSO operational throughout its lifetime, then the technology to be employed must be such as would permit the unit to be re-usable on multiple field projects 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, expropriations 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 unit is being built, designed and commissioned. The draw down of debt will be tied to payment events or milestone 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:

<table>
<thead>
<tr>
<th>Event</th>
<th>Payment (percent of contract price)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Signing of contract</td>
<td>5</td>
</tr>
<tr>
<td>1,000 tons steel delivered to shipyard</td>
<td>5</td>
</tr>
<tr>
<td>Commencement of steel fabrication</td>
<td>15</td>
</tr>
<tr>
<td>Completion of the hull</td>
<td>20</td>
</tr>
<tr>
<td>Completion of the integrated deck</td>
<td>20</td>
</tr>
<tr>
<td>with the topsides</td>
<td></td>
</tr>
<tr>
<td>Skidding the deck on the hull</td>
<td>15</td>
</tr>
<tr>
<td>Launch</td>
<td>5</td>
</tr>
<tr>
<td>Delivery</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

After construction, lenders should verify completion before the final draw down is made. Lenders should ensure that final draw down is of sufficient size to provide an incentive for the 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.

**Financing Agreement.**

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

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 in order to achieve their objective.

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3 Financing ships and Mobile offshore installations – J.E Slogett.
Security Issues

The type of security obtained and the remedies available will largely depend on the laws of the jurisdiction involved. In a normal asset purchase transaction, security is usually taken for an offensive purpose, to enable the lender to sell the asset in the event of a default. However, this is different with project finance. In obtaining security for financing an FPSO, the primary objective of the lenders should be more defensive to ensure that the security taken would protect them from actions by unsecured or junior creditors of the company, rather than to sell off the unit because it may not be easily marketable.

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 more usual kind of security that will be taken to secure the loan will include

- a mortgage on the FPSO;
- 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 lender/oil company; and
- 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 future assets i.e. assets to be acquired by the borrower after the creation of the charge;
- 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 should know are:

- Security can be taken over all types of assets both present and future assets.
- Security can be taken relatively simply by means of a floating charge over all of a company’s asset and at the same time the company is allowed to continue to deal with those assets in the ordinary course of business.
- Security can 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 the field development programme - any programme for the development of a petroleum discovery i.e. field development programme (FDP) must be approved by the relevant petroleum authorities prior to the award of the contract for the construction of the FPSO upon approval, the operator will be required to apply to the petroleum authorities for all permits and approvals necessary for the different phases of the project. These approvals include a conceptual design approval, detailed engineering approval for the engineering works, facility – operating permit e.t.c. Where the oil company concludes the contract for the FPSO before applying for some of these licences and a modification is required by the authorities, will such modifications be treated as alterations or change orders and will this lead to additional finance being required.
- Revocation of licence - 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 – Finance Leases**

As stated earlier, finance leases are contracts for lease of property possessing the characteristic of a purchase. A finance lease can be defined as a lease that covers substantially the useful life of an asset or the net present value (NPV), using minimum lease payments 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 because generally speaking, the lessor has entered into the leasing transaction to obtain a return on an investment, which can only be earned over time with the realisation of tax benefits. If the lease is terminated early such benefits are lost and the lessee may wish to be compensated by receiving a lump sum on the termination date equivalent to the NPV of the benefits, which would have been earned if the lease had run its full course.

The lease usually contains a purchase option for the equipment to be sold to the lessee at the expiration of the lease term at a nominal price, which is likely to be exercised. 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 some countries, the lessee claims capital allowance in a finance lease while the lessor claims in an operating lease. 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 nominal price. In a finance lease, the lessor provides only the FPSO while the oil company operates and maintains the unit by itself or through third parties on its behalf.

Under this form of financing, the oil company/lessee could either take a lease of an existing FPSO or approach a lessor to finance the construction or conversion of the FPSO and subsequently lease it to the oil company/lessee. In the latter case, the lease would be
structured as a leveraged lease and would be 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 and very appropriate for financing large FPSOs.

**Leveraged lease – Construction Financing**

The oil company/lessee approaches a lessor for the lease/financing of a FPSO to be newly constructed and leased to the oil company. Upon successful negotiations with the lessor, the oil company will award an EPCI contract for the construction of the FPSO. The title to the unit will be transferred to the lessor during the early stages of construction, 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 may wish to supervise the performance of the construction contract. 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 parties to a leveraged lease would include: -

a. The lessee/oil company who approaches the lessor for financing, determines the FPSO to be constructed and leased, negotiates the price and warranties, awards the contract and subsequently hires the use of the FPSO by entering into a lease agreement with the lessor.

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, 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 of the lease rental payments.

d. The owner trustee represents the equity participant/lessor and acts as the lessor by executing the lease agreement 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.
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.

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. 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 contract price at a period stated in the contract and delivers the FPSO to the lessee at the beginning of the lease term. Completion period and warranties given by the contractor as to the qualities, capabilities and efficiency of the FPSO are important to the lessor and the lenders and in some cases the contractor may be required to enter into a direct agreement with the lenders.
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.
Purchase versus Lease

The oil company requires huge capital outlay for the purchase whereas in a lease, there is no initial capital outlay as the FPSO belongs to the oil service contractor and is being hired for a fixed duration of time.

Although ownership involves huge capital outlay at inception, the oil company/owner retains the risks/rewards of ownership of asset e.g appreciation and residual value of the FPSO which will not be available to a lessee under an operating lease.

Operation and maintenance of the FPSO will be borne by the oil company while in a lease, the maintenance and operation is the responsibility of the oil service contractor lessor.

Construction/completion risk is borne solely by the oil company in a purchase while it is borne by the lessor/oil service contractor in a lease.

The transaction will be noted on the company’s balance sheet in a purchase while a lease can be done off balance sheet.

If a purchase is financed through loan financing, lenders’ security will be limited to a mortgage on the FPSO while in a lease, title is vested in the lessor. However, if the lessor is a bank/financial institution, the value the lenders will place on it for valuation purposes will be similar to the valuation for a mortgage as the bank would not be interested in operating the FPSO and would therefore need to be satisfied that the lessee would be able to make the hire payments as and when due.

Conclusion

FPSOs are going to get more popular in the field development programs of oil producing countries all over the world as oil companies continue to prospect for crude oil in deep and ultra deep waters offshore. The method of acquisition suitable to each company would be determined to a very large extent by the company’s corporate structure, needs and or preferences. For instance a multinational oil company with a large field with huge reserves may require a huge FPSO for the production of the field, this may not necessarily be adaptable to the needs of a small oil company and failure to realise this could of course lead to disastrous consequences. The various modes of acquisition and financing have been discussed and each has its peculiar features, which would be relevant depending on the preferences and needs of the company involved. It is therefore important for the various participants embarking on an FPSO project to be acquainted with the options available to them whether for purposes of acquisition, financing, construction or leases in order to be in a position to make informed decisions which would ultimately result in the success of the project.
YINKA AGIDEE
PARTNER
THE ROCK AND PARTNERS
GLOBE MOTORS BUILDING,
25, ADEYEMO ALAKIJA STREET,
VICTORIA ISLAND,
LAGOS.

Tel: 002341 3204531, 4808436
Fax: 002341 3204584
E-mail: therockandpartners@hotmail.com;
trp@trp-ng.com.