

From Joint Ventures to Incorporated Joint Ventures

by

Dr. Tim Okon

April 28, 2009

Definitions:

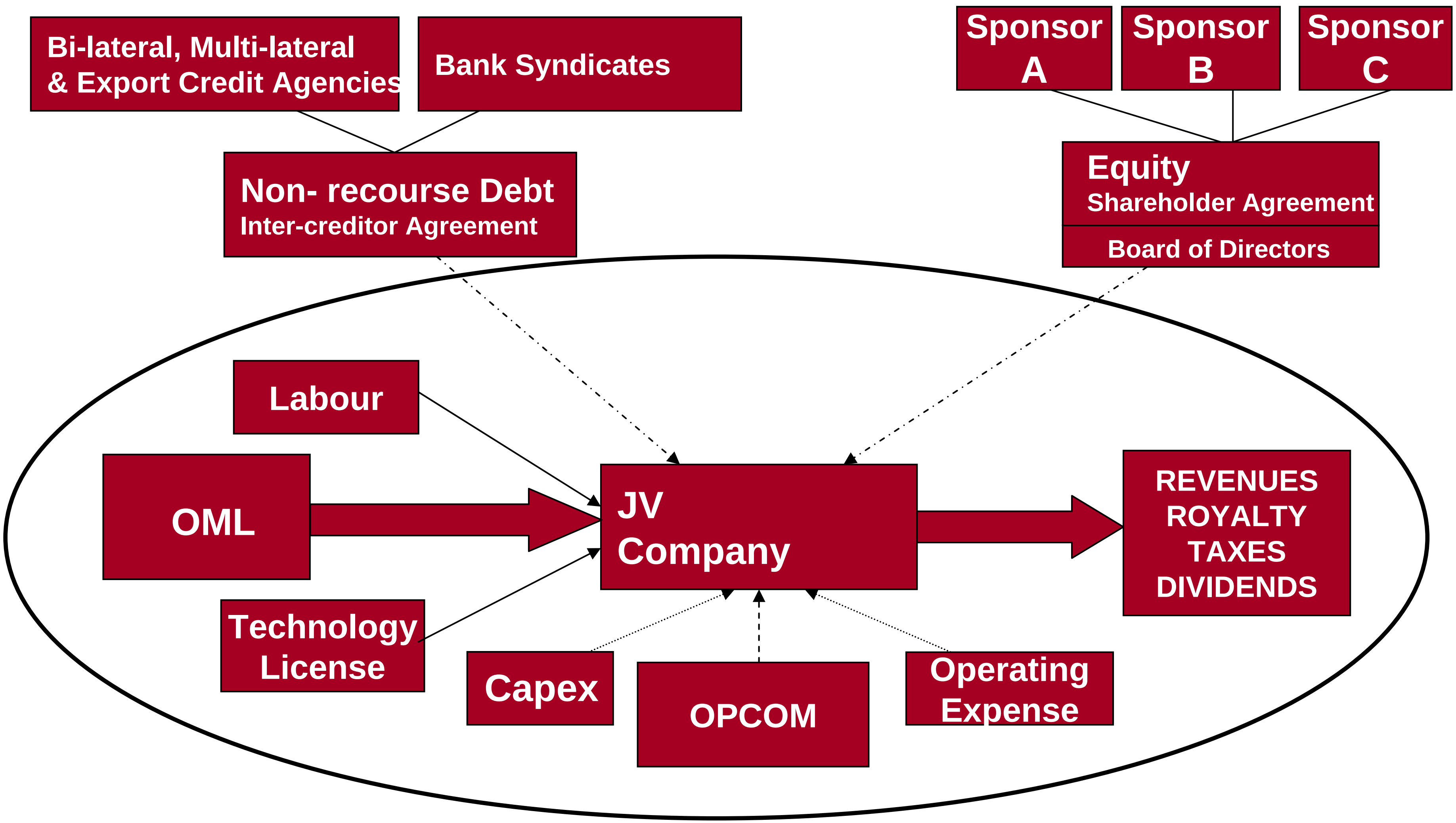
Joint Venture (JV)

- A business undertaken by two or more legally separate parties in an effort to share risk and use differences in expertise
- In a joint venture, two or more "parent" companies agree to share capital, technology, human resources, risks and rewards in a formation of a new entity under shared control
- Joint ventures are not uncommon in the oil and gas industry, and are often cooperations between a local and foreign company (about 3/4 are international)
- A venture can be for one specific project only, or a continuing business relationship

Incorporated Joint Venture (IJV)

- A Joint Venture which requires creation of a new legal entity in a specific country and allows two or more companies to collaborate and carry out a common activity requiring legal instruments such as by-laws, articles of incorporation, and shareholder's agreement

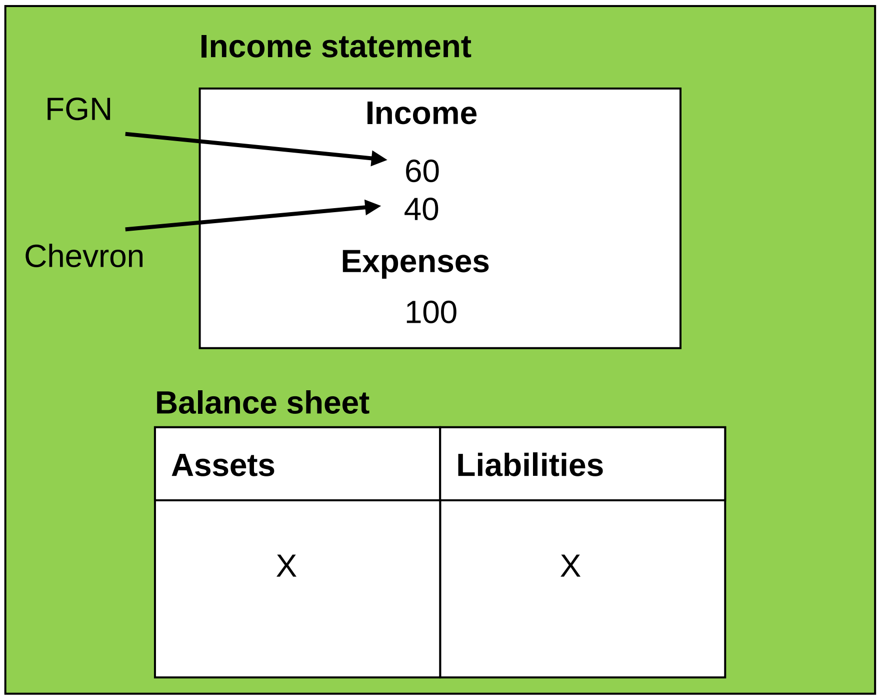
Typical JV Structure



Understanding Incorporation

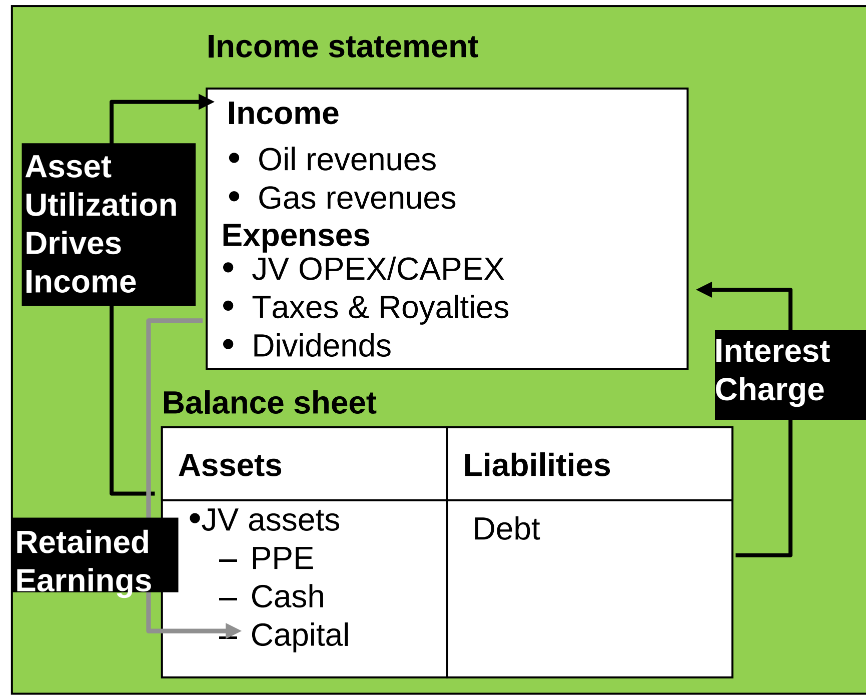
JV Today

NNPC's only means of financing share of investment is from FGN cash calls….



Incorporation

Incorporation allows NNPC to finance its share of JV operations through a balance sheet…..



Key Messages

- Incorporation enables NNPC to leverage asset base of JV to finance operations
- Key difference between incorporation and status-quo is NNPC's ability to raise debt, while the government can still maintain same share of ownership in JV via NNPC share.

Joint Venture vs. Incorporated Joint Venture

	Joint Venture	Incorporated Joint Venture

Investment	• NNPC funds share of investments
	  • FGN cash call
	  • Third Party financing
		• Removes the need for cash call & annual funding strategy
		  • One off equity injection
		  • JV Inc raises debt financing

Revenue	• NNPC receives share of sales proceeds which is passed directly to FGN	• NNPC receives share of revenues after expenses & taxes via “Dividend”
Taxes	• FGN receives taxes and royalties from JV partners only	• FGN receives taxes and royalties from entire JV Inc (JV Partner + NNPC)
Retained Earnings	• There are no retained funds for future, FGN takes all its proceeds out of organization	• JV Inc will retain some portion of earnings to fund future investment. • Dependent on dividend policy
Balance Sheet	• There is no balance sheet, organization has no assets or liabilities	• JV Inc will have balance sheet with own assets & liabilities • Balance sheet used to raise finance
Control/ Transparency	• NNPC control is limited to level of investment that is put in. • Lack of transparency constrains level of decision making	• NNPC will exercise greater direct control via board & management. • Develops NNPC’s expertise in Operations • Makes operations and financial data transparent
Operators	• Can change operators as per agreement	• No Change: Can change operators as per Shareholders Agreement

Incorporation: Can Take Different Forms

INC	Description	Pros	Cons
NNPC E & P			
JV INC	•Each individual JV is incorporated as a separate entity. Owner ship by existing equity owners in proportion to their current equity	• Solves funding problem and creates self sufficient entity. • Creates transparency across all JV partners • Drives performance improvements, increasing profits and revenues to FGN • Reduces level of FGN bureaucracy	• Will be met with resistance by JV partners. • Level of mistrust amongst parties could prevent optimum level of operations
All NNPC			

Vesting of Assets in the New NNPC Ltd.: The Concept of Incorporated JVs

- **NNPC currently holds FGN equity interest under the concessionary fiscal system in the unincorporated JVs. By vesting all these assets in the new NNPC Ltd., NNPC achieves equal status with the IOCs, pays only royalty and taxes to the federation account and sources its funding outside the government budget.**

Merits

- Creates a self funding entity that is outside cumbersome government budget processes
- Improves accountability within the governing structure of the iJVs.
- Offers greater opportunities for technology acquisition
- Lesser political interference given that operational control rests with iJV.
- Minimizes rent seeking activities related to crude liftings

Challenges

- The role of the portfolio manager (NAPIMS) is weakened since iJV essentially finances its projects. (arguably this role has not been effectively done in the past).
- Transition from JOA to SHA may require tough negotiations especially with regards to setting a date for take over of Operatorship.

All Forms of Incorporation Provide a Structure Solution, but JV Incorporation Ensures Environment for Performance Environment

	NNPC E& P	JV Inc	NNPC Inc
Strategic Alignment	• supports strategic objectives of enabling economic growth, growing domestic gas • Delivers agreed upon net proceeds for FGN	• supports strategic objectives of enabling economic growth, growing domestic gas • Delivers agreed upon net proceeds for FGN	• supports strategic objectives of enabling economic growth, growing domestic gas • Delivers agreed upon net proceeds for FGN
Financial Value	• Deal is equitable, NNPC finances itself through equity &debt • No reduction of FGN Net proceeds	• Deal is equitable, each party retains same level of ownership. • NNPC finances share through equity & debt • No reduction of FGN Net proceeds	• Deal is equitable, each party retains same level of ownership. • NNPC finances share through equity & debt • No reduction of FGN Net proceeds
Responsiveness	•Provides flexibility for NNPC to quickly respond to changing market dynamics or strategic objectives •Removes FGN bureaucracy	•Provides flexibility for NNPC to quickly respond to changing market dynamics or strategic objectives •Removes FGN bureaucracy	•Will still have some element of FGN bureaucracy
Performance Enablers	• Does not enable an effective structure to improve performance	• NNPC will be strongly positioned to drive and implement changes directly • Develops NNPC expertise in operations	• Does not enable an effective structure to improve performance
Risk Exposure	• Does not negatively impact risk NNPC/ FGN risk levels	• Does not negatively impact risk NNPC/ FGN risk levels	• Does not negatively impact risk NNPC/ FGN risk levels
Do-ability	• Will take some time to implement • Earliest “go-live” 2008	• Will take some time to implement • Earliest “go-live” 2008	• Will take some time to implement • Earliest “go-live” 2008

Implications of Incorporation on Funding

Implications

- Solves funding problem and creates self sufficient entity by removing the need for cash call & annual funding strategy through a one-off equity injection
- JV Inc raises debt financing by providing a solid balance sheet to be used to raise funds

Funding Sources

- **Recognition and retention of capital allowance and iJV profits**
  - Retention of capital allowances is an essential part of the iJV funding structure
  - Government receives royalties and taxes on a monthly basis as is the current practice with the IOCs
  - Preliminary evaluation complete
- **Retention of profit oil as concessionaire to currently producing PSCs**
  - Profit oil in these entities would enable NNPC invest in other areas such as projects in which it is a concessionaire and future PSCs as a contractor
  - Preliminary evaluation completed by Corporate Strategy group
- **Raising debt from capital markets**
  - A capitalised NNPC with assets in the iJV vested in NNPC should be able to raise money from the capital market subject to an optimum capital structure
  - Preliminary evaluation complete

Implications of Incorporation on NNPC Operatorship

- NNPC staff in JV will be exposed to world class operator expertise and over time NNPC will develop skills and could become operator in long term
- NNPC develops skills to be an operator in future or at least benchmark future operator performance
- NNPC can expand internationally via JV Inc's, thus sharing international risk with IOCs

JV Incorporation Provides an Industry wide solution with substantial additional benefits to NNPC & Nigeria

JV Inc is a robust industry solution …

- Removes the need for cash call and piecemeal financing
- Provides a viable and sustainable method for industry to self-finance
- Can be applied across the whole sector in a uniform manner.
- Globally tried & tested
  - Incorporation is the dominate model across NOC's around the world
- Aligns industry & FGN aspirations

… It also increases net proceeds to FGN

- Increased transparency & accountability will drive down industry costs and increase efficiencies
- Increased transparency will ensure less opex, capex are claimed against revenues thus increasing tax revenues.
- In the long-term JV Inc's will be able to raise increased amounts of debt financing, boosting investment levels and related revenue

… and sets NNPC on the road to of being "world class"

- NNPC gets direct access to expertise and operational excellence of the worlds top oil companies
- NNPC develops skills to be an operator in future or at least benchmark future operator performance
- NNPC can expand internationally via JV Inc's, thus sharing international risk with IOC's

Government Revenues under IJVs

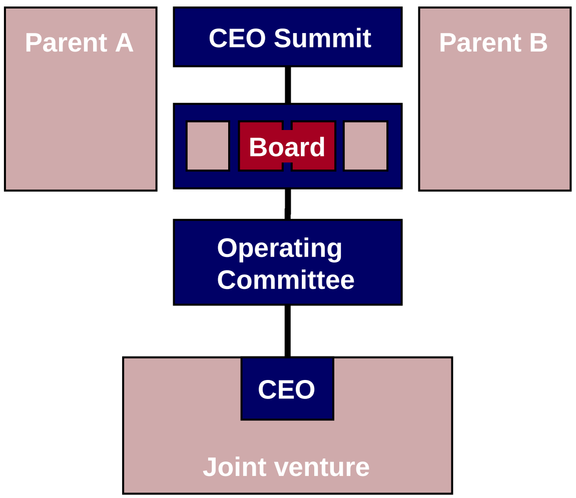
- FGN/NNPC will have to put in an initial cash injection to fund the balance sheet
  - This would be for one year only after which the IJVs would be self-funding
- Cash injection will negatively impact FGN cash flow in the short term since incorporation may not generate sufficient cash in first five years to fully reverse the deficit
- FGN will receive taxes and royalties from whole sector including NNPC share
- Increased transparency and accountability will drive down industry costs ensuring less opex and capex are claimed against revenues thus increasing taxable income
- In the long-term JV Inc’s will be able to raise increased amounts of debt financing, boosting investment levels and related revenue

Issues Concerning IJVs

- Board representation
- Dividend policy
- Staff secondment policies and the culture of the new organisation
- Financing costs for the new entity may be higher than typical IOC financing cost due to lower debt rating

Board Representation Will be the Best Way to Exercise Control in JV Inc

Industrial products sales JV

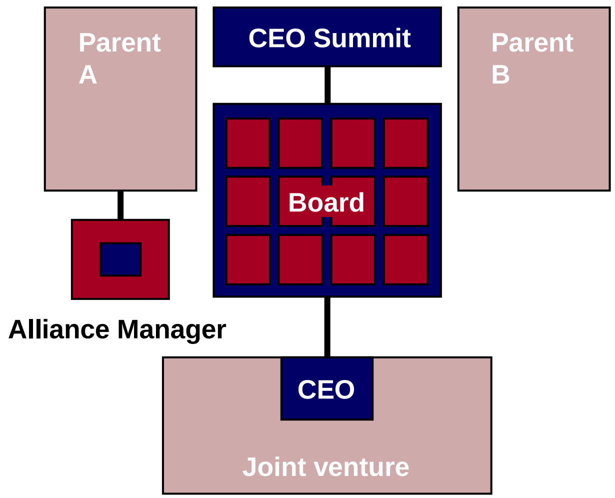


Operating committee
- 8 members – business unit VPs
- Meet monthly
- Set operating targets and approve operating decisions; provide functional expertise to JV

Board
- 4 members – group/business unit presidents
- Meet quarterly
- Set JV strategy; monitor performance; shape evolution; champion JV in parents

CEO summit
- Meet once per year or as required
- Confirm long-term direction, resolve deadlocks, set partnership tone

U.S.-Japan Electronics JV

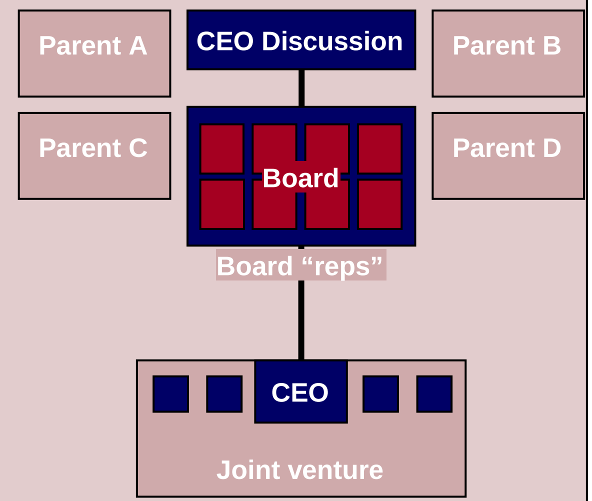


Alliance manager
- One VP from transnational parent
- Full-time position
- First point of contact between JV and parent

Board
- 12 members
- Meet quarterly
- Approve strategy and budgets; protect shareholder interests

CEO summit
- Meet once per year, or as required
- Confirm long-term direction, resolve deadlocks, set partnership tone

Energy JV



Board representatives
- Managers from parents, staffed full-time at JV
- Monitor JV operations and report to parents; no explicit operating roles

CEO discussion
- Hold informal discussions as required
- Confirm direction, resolve deadlocks, set partnership tone

Board Roles and Responsibilities

		What it means	Why it is important
Board objectives	**Protect shareholders' interests**		
Roles to achieve objective	**1. Shape and approve strategic direction**	• Board approves major strategic and operating decisions • Board involved in strategy formulation process • Monitors key long term strategic indicators (e.g., NPV, reserves replacement, . . .)	• Board responsible for ensuring strategy maximizes shareholder value
	2. Monitor performance	• Board monitors key financial performance indicators (e.g., ROE, quarterly earnings)	• Board responsible for overseeing corporate performance
	3. Ensure superior management	• Board ensures plan is in place to develop and retain future leaders and to compensate appropriately	• Board responsible for ensuring future leadership can advance shareholder interests
	4. Govern board effectively	• Board nominates new directors • Runs meetings effectively • Board evaluates its own performance	• Board must run itself well to achieve objectives
	5. Establish/Maintain Values, Ethics and Financial Integrity	• Board ensures adequate legal and transparency controls are in place	• Board responsible for protecting against misconduct and potential liabilities

A Robust Dividend Policy Must be Defined to Manage Government Take and Ensure Retained Earnings are Sufficient to Fund Future Investment

Key dividend principles	Applicability to JV Inc
Ensure future cash outlays are met – Future investments – Debt service – Cash reserves, e.g. in case of oil price downturn	**High** – JV inc's should generate significant cash – Excessive dividends would compromise ability to sustain/grow production – Necessity to build cash reserves
Optimise debt leverage – Use debt to finance investments – Distribute more cash to shareholders	**High** – Having a strong cash position will make JV Inc's attractive to investors
Manage investor expectations – Dividend policy often seen as an indicator of management's optimism/pessimism on business outlook – Minimize changes to dividend policy may	**High** – Government is in need of cash and could be tempted to maximise its take – Government will also be sensitive to predictability of cash inflows

'Ground rules' on dividend policy must be agreed upon ahead of time

A Sound Basis for Financial Reporting Needs to be Established

Issues to address

- **Establish the start-up balance sheet**
  - Determine which assets remain on commercialised NNPC (e.g., NLNG, NGC?)
  - Inventorize the assets and value them for book accounting purposes
  - Determine debts to be transferred to NNPC
  - Establish the liabilities and their book value (e.g., environmental)
- **Establish the start-up working capital, e.g.**
  - One-off allocation from government
  - Revolving credit line
  - One-off reimbursable loan

Objectives

- Establish basis for proper financial management
- Establish sound book keeping to facilitate debt management
- Provide necessary financial resources for NNPC to function and grow

Challenges

- Complete list of assets may be unknown
- Some recorded assets may be missing
- Difficult to establish valuation methodology
  - Is a high asset value better than a low one?
- Acquisition price may be unknown
- Need to ensure sustainability of NNPC
  - Debt rating of NNPC likely to be poorer than Government's
- Difficult to establish complete list of liabilities
- Difficult to value the liabilities

Conclusions

- IJVs are not necessarily easy to operate - the higher the number of participants, the greater the potential for misalignment
- The advantages in an IJV can be harnessed if there is clear definition of the roles of the participants
  - A preference for a joint operating body (JOB) rather than a designated operator or a technical service agreement with an individual party
  - A strong, independent and qualified decision making board focused on the interests of its shareholders
  - The balance between majority shareholder interests and minority shareholder interests
- NNPC as a shareholder in the IJVs would negotiate annual dividend policy with the Ministry of Finance