TEACHING AN OLD DOG NEW TRICKS –

CONVERTING THE NPDC AND NNPC UNINCORPORATED JOINT VENTURES TO LIMITED LIABILITY COMPANIES – ISSUES WORTH CONSIDERING

The Federal Government of Nigeria (the "FGN"), through the Nigerian National Petroleum Corporation (the "NNPC") and or the Nigerian Petroleum Development Company Limited ("NPDC"), holds majority of the participating interests in those arrangements referred to, as the traditional joint ventures. These traditional joint ventures are unincorporated (contractual) joint ventures. Specifically, under these unincorporated joint ventures ("UJVs"), the NNPC and NPDC enter into Joint Operating Agreements ("JOAs") with other oil and gas producing companies, which serve as the key governing documents for each JOAs (in practice, many of the terms of these JOAs mirror one another).

Under the UJV arrangements, interests in oil & gas assets are jointly owned by NNPC/ NPDC and its partners, in proportions represented by their respective participating interests. NNPC together with the NPDC and its joint venture partners, through the mechanism of cash calls, share the financing of the costs of working these assets. They also contribute to such other costs, including capital expenditure, in connection with these assets usually in accordance with their respective participating interests.

Funding of oil and gas operations under the UJV arrangements remains difficult, for various reasons, including the competing needs for the dwindling federal revenues. Thus, it has remained increasingly difficult for the NNPC and NPDC to fulfil their cash call obligations as and when due. Additionally, Paragraph 29 of the NPDC's Articles of Association provides that "in no circumstance shall the company undertake any external borrowing of money for whatever cause." Therefore, the NPDC is also precluded from obtaining loans externally notwithstanding the purpose of such loan. The NPDC resolves this by entering into Carry Arrangements ("CA") with its joint venture partners.

Typical security arrangements associated with CAs include transfer of Carry Project Assets to the Carrying UJV partners during the pendency of the CA and payment of proceeds from sale of NPDC's share of crude oil into escrow accounts for the account of the Carrying UJV partners.

Furthermore, there was the landmark decision of the Nigerian Supreme Court in April 2002. The effect of the judgement was that funds for the FGN's share of cash calls, which used to be first line charge from the budget could no longer be such and had to come from the FGN's share of the budget upon the apportionment of the FGN's share of the budgetary allocation. In very clear terms, the Supreme Court held that it was unconstitutional for the FGN, to finance certain expenditures, including its cash call obligations under its UJV arrangements from the budget (mostly consisting of oil revenue) before distribution to the three (3) tiers of government. Prior to this Supreme Court decision, the FGN funded cash call obligations as a first line budgetary item.

The foregoing being the case, the FGN can no longer shy away from the need to address the funding problems that plague the UJVs, since NNPC and the NPDC together with their joint venture partners carry out a substantial volume of the petroleum activities/operations, in Nigeria.

The foregoing challenges and limitations often result in the shortage of funds available to the NNPC and the NPDC to meet their participating interests share of operating costs and expenditure, through their cash call payments. This results in reduced exploration projects and negative impact on reserves replacement.

These challenges have also affected new production projects which have proceeded very slowly and have had to be financed, through alternative funding solutions proffered by NNPC and NPDC's partners. It has been reported that NNPC's indebtedness under the UJV arrangement is on a continuous rise.

As a step towards resolving the foregoing challenges and other issues, the FGN is considering the conversion of the UJV arrangements with its joint venture partners to limited liability companies which will have NNPC or NPDC and their relevant joint venture partners as shareholders (the "IJVs"). It has been predicted that the IJV model will aid the financing of joint venture projects. The benefits of incorporation of a company include, having a separate legal personality from its owners and the ability of the IJVs to independently raise finance for funding petroleum operations without reliance on, and/or recourse to, its shareholders.

The IJV as a company, is expected to run as a purely commercial enterprise. As a company incorporated under the Nigerian Companies and Allied Matters Act (CAMA), it can raise financing in the normal course of its business, thereby eliminating the challenges associated with cash call obligations. In addition to the taxes, levies, rents, royalties and bonuses that are usually imposed on companies operating in the oil and gas sector, the FGN stands to gain from dividends that will be distributed to shareholders by each IJV.

As suitable as the proposed IJV model is to the NNPC and the NPDC and their joint venture partners, the IJV also has its own potential challenges that need to be addressed, mitigated or guarded against. Some of the key potential challenges and hurdles which may affect proper implementation of the IJV model are discussed in the paragraphs below, as well as recommendations for overcoming same.

Since raising finance is crucial to the success of the IJV model, critical consideration must be given to the asset transfer issues, funding and future financial requirements of the incorporated companies, amongst others. Upon incorporation, the IJV will be responsible for its own financial obligations and for obtaining capital for its operations. As a limited liability company incorporated under the CAMA, the provisions of the CAMA will apply to the IJV upon incorporation. Ways by which the IJV may receive funding may be through equity or debt.

The IJV can raise finance through rights issue and private placement, private placement only where it is a private limited company and could have broader options, where it is a public company. Equity financing is usually expensive and because of this, most companies prefer debt financing. section 38 of the CAMA confers incorporated companies (to the extent permitted by their articles of association) with all the powers of a natural person of full legal capacity. Further, section 166 of the CAMA provides that:

> *"a company may borrow money for the purpose of its business or objects and may mortgage or charge its undertaking, property and uncalled capital, or any part thereof, and issue debentures, debenture stock and other securities whether outright or as security for any debt, liability or obligation of the company or of any third party"*.

A combined reading of sections 38 and 166 of the CAMA is to the effect that the IJV will, subject to the terms of (or restriction in) its memorandum and articles of association and shareholders or other internal agreements, be free to raise financing for its operational and investment activities and to assign revenues from the sale of production to lenders. Debt financing as well as retained earnings can also be used for specific items or for operations generally.

A large number of the subsisting UJVs have peculiar financing structures which may preclude the possibility of a simple transfer of UJV assets to the IJVs. UJV co-venturers typically consummate major transactions in the upstream sector through reserve based lending and other project finance structures which are collateralized by the cash flows from each co-venturer's participating interest share of petroleum.

A plausible concern for lenders may well be that security created over the participating interest and the borrower's (JV Partner) participating interest share of hydrocarbon proceeds will be affected because the participating interest will be transferred to the IJV company in exchange for shares in the IJV company. Furthermore, lenders are likely to be concerned that the offtake arrangements will subsequently be undertaken by the IJV company. The effect of the foregoing, therefore, is that it becomes pertinent to engage lenders relatively early in connection with the IJV structure to better understand the nature/extent of existing liabilities of the UJV partners and the terms upon which such lenders are amenable to providing consent for the transfer of loan liabilities and charged assets to the IJV company.

One option in connection with existing debts is for same to continue to remain on the books of the borrower JV Partner even after the transition to an IJV. In exchange, the lenders may consider swapping the security taken over the Party's participating interest with security over the shares of the borrower JV Partner. In negotiating this, it is pertinent to look at issues such as economic interest versus participating interest, existing carry arrangements, other corollary arrangements, benefits which other non-borrower JV Partners may have derived; amongst other issues which may not be necessarily straightforward but are germane to achieving a successful transaction.

Under an IJV regime, the shareholders will typically get returns on their investments by way of dividend, measured by each shareholder's equity interests. All companies incorporated under the CAMA are by section 379 authorized (but not compelled) to declare dividends upon the recommendation of the company's directors. Thus, it is recommended that a robust dividend policy consisting of a set of guidelines to be adopted in determining how much of the IJV's earnings will be paid out to shareholders be also prepared as part of the entire corporate governance rules/documentation. It is pertinent to have a robust and well considered dividend policy as a residual dividend policy whereby the IJV chooses to rely on retained earnings to finance projects and pay dividend from leftover earnings may be unacceptable to existing lenders and the UJV partners (now shareholders).

In addition, the CA method of financing is expected to cease upon commencement of the IJV regime. It is pertinent that the IJV Shareholders' Agreement makes provisions to the effect that during the subsistence of the carry, the co-venturers take more of dividend/equity lifting. The CAs can also be restructured as shareholder loans, by the co-venturers to the IJV, with specified terms for repayment. Such shareholder loans can then be subordinated to any new third-party loans procured by the IJV. There are several other issues worth considering and this paper cannot in one-part deal with all such issues.

The foregoing are some of the issues we consider germane as the NNPC and NPDC together with their joint venture partners, look to convert the existing tradition joint ventures, which are unincorporated, to incorporated joint venture companies. We do hope that the transition is seamless and the expected gains are indeed achieved. In circumstances where the foregoing are given due consideration, then the old dogs- the NPDC and NNPC can, indeed, be taught new tricks.

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