From Joint Ventures to Incorporated Joint Ventures
by
Dr. Tim Okon

April 28, 2009
**Definitions:**

<table>
<thead>
<tr>
<th>Joint Venture (JV)</th>
<th>Incorporated Joint Venture (IJV)</th>
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<tbody>
<tr>
<td>• A business undertaken by two or more legally separate parties in an effort to share risk and use differences in expertise</td>
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<tr>
<td>• In a joint venture, two or more &quot;parent&quot; companies agree to share capital, technology, human resources, risks and rewards in a formation of a new entity under shared control</td>
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<td>• 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)</td>
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<td>• A venture can be for one specific project only, or a continuing business relationship</td>
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<td>• 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</td>
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Typical JV Structure

Bi-lateral, Multi-lateral & Export Credit Agencies
Bank Syndicates

Non-recourse Debt
Inter-creditor Agreement

Sponsor A
Sponsor B
Sponsor C

Equity Shareholder Agreement
Board of Directors

Labour
Technology License
OML
Capex
JV Company
OPCOM
Operating Expense

REVENUES ROYALTY TAXES DIVIDENDS
Understanding Incorporation

**JV Today**

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

<table>
<thead>
<tr>
<th>Income statement</th>
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<tbody>
<tr>
<td>FGN</td>
</tr>
<tr>
<td><strong>Income</strong></td>
</tr>
<tr>
<td>60</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
</tr>
<tr>
<td>40</td>
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<table>
<thead>
<tr>
<th>Balance sheet</th>
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<tbody>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Liabilities</td>
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<tr>
<td>X</td>
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**Incorporation**

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

<table>
<thead>
<tr>
<th>Income statement</th>
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</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
</tr>
<tr>
<td>Oil revenues</td>
</tr>
<tr>
<td>Gas revenues</td>
</tr>
<tr>
<td>JV OPEX/CAPEX</td>
</tr>
<tr>
<td>Taxes &amp; Royalties</td>
</tr>
<tr>
<td>Dividends</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asset Utilization Drives Income</th>
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<tbody>
<tr>
<td><strong>Expenses</strong></td>
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<tr>
<td>JV assets</td>
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<tr>
<td>- PPE</td>
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<tr>
<td>- Cash</td>
</tr>
<tr>
<td>- Capital</td>
</tr>
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<table>
<thead>
<tr>
<th>Interest Charge</th>
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<tr>
<td><strong>Debt</strong></td>
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**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

**Investment**
- NNPC funds share of investments
  - FGNI cash call
  - Third Party financing
- NNPC receives share of sales proceeds which is passed directly to FGNI
- FGNI receives taxes and royalties from JV partners only
- There are no retained funds for future, FGNI takes all its proceeds out of organization
- There is no balance sheet, organization has no assets or liabilities
- NNPC control is limited to level of investment that is put in.
- Lack of transparency constrains level of decision making
- Can change operators as per agreement

**Revenue**
- Removes the need for cash call & annual funding strategy
  - One off equity injection
  - JV Inc raises debt financing
- NNPC receives share of revenues after expenses & taxes via “Dividend”
- FGNI receives taxes and royalties from entire JV Inc (JV Partner + NNPC)
- JV Inc will retain some portion of earnings to fund future investment
  - Dependent on dividend policy
- JV Inc will have balance sheet with own assets & liabilities
  - Balance sheet used to raise finance
- NNPC will exercise greater direct control via board & management
- Develops NNPC’s expertise in Operations
- Makes operations and financial data transparent
- No Change: Can change operators as per Shareholders Agreement

**Taxes**

**Retained Earnings**

**Balance Sheet**

**Control/Transparency**

**Operators**
## Incorporation: Can Take Different Forms

<table>
<thead>
<tr>
<th>Description</th>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>NNPC E &amp; P</td>
<td></td>
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</tr>
<tr>
<td>INC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>JV INC</td>
<td></td>
<td></td>
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<tr>
<td>All NNPC</td>
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- Each individual JV is incorporated as a separate entity. Ownership 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.
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

<table>
<thead>
<tr>
<th>Strategic Alignment</th>
<th>NNPC E&amp; P</th>
<th>JV Inc</th>
<th>NNPC Inc</th>
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<tbody>
<tr>
<td></td>
<td>• supports strategic objectives of enabling economic growth, growing domestic gas</td>
<td>• supports strategic objectives of enabling economic growth, growing domestic gas</td>
<td>• supports strategic objectives of enabling economic growth, growing domestic gas</td>
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<td></td>
<td>• Delivers agreed upon net proceeds for FGN</td>
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<tr>
<td>Financial Value</td>
<td>• Deal is equitable, NNPC finances itself through equity &amp; debt</td>
<td>• Deal is equitable, each party retains same level of ownership.</td>
<td>• Deal is equitable, each party retains same level of ownership.</td>
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<tr>
<td></td>
<td>• No reduction of FGN Net proceeds</td>
<td>• NNPC finances share through equity &amp; debt</td>
<td>• NNPC finances share through equity &amp; debt</td>
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<td></td>
<td>• Provides flexibility for NNPC to quickly respond to changing market dynamics or strategic objectives</td>
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</tr>
<tr>
<td></td>
<td>• Removes FGN bureaucracy</td>
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<td>• Removes FGN bureaucracy</td>
</tr>
<tr>
<td>Responsiveness</td>
<td>• Does not enable an effective structure to improve performance</td>
<td>• NNPC will be strongly positioned to drive and implement changes directly</td>
<td>• Does not enable an effective structure to improve performance</td>
</tr>
<tr>
<td></td>
<td>• Develops NNPC expertise in operations</td>
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<tr>
<td>Performance Enablers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk Exposure</td>
<td>• Does not negatively impact risk NNPC/ FGN risk levels</td>
<td>• Does not negatively impact risk NNPC/ FGN risk levels</td>
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</tr>
<tr>
<td>Do-ability</td>
<td>• Will take some time to implement</td>
<td>• Will take some time to implement</td>
<td>• Will take some time to implement</td>
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<tr>
<td></td>
<td>• Earliest “go-live” 2008</td>
<td>• Earliest “go-live” 2008</td>
<td>• Earliest “go-live” 2008</td>
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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 JV profits**
  - Retention of capital allowances is an essential part of the JV 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 JV 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 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**
- Parent A
- Parent B
- **Operating Committee**
  - 8 members – business unit VPs
  - Meet monthly
  - Set operating targets and approve operating decisions; provide functional expertise to JV
- **CEO**
- Joint venture

**U.S.-Japan Electronics JV**
- Parent A
- Parent B
- **Board**
  - 12 members
  - Meet quarterly
  - Approve strategy and budgets; protect shareholder interests
- **CEO**
- Joint venture

**Board**
- **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

**Energy JV**
- Parent A
- Parent B
- **CEO Discussion**
  - Meet once per year, or as required
  - Confirm long-term direction, resolve deadlocks, set partnership tone
- **Board**
  - 8 members
  - Meet quarterly
  - Approve strategy and budgets; protect shareholder interests
- **Board “reps”**
- **CEO**
- Joint venture
# Board Roles and Responsibilities

**Board Objectives**

<table>
<thead>
<tr>
<th>Protect Shareholders’ Interests</th>
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<tbody>
<tr>
<td><strong>What it means</strong></td>
</tr>
<tr>
<td>- Board approves major strategic and operating decisions</td>
</tr>
<tr>
<td>- Board involved in strategy formulation process</td>
</tr>
<tr>
<td>- Monitors key long term strategic indicators (e.g., NPV, reserves replacement, . . .)</td>
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<tr>
<td><strong>Why it is important</strong></td>
</tr>
<tr>
<td>- Board responsible for ensuring strategy maximizes shareholder value</td>
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<table>
<thead>
<tr>
<th>Roles to Achieve Objective</th>
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<tbody>
<tr>
<td><strong>1. Shape and Approve Strategic Direction</strong></td>
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<tr>
<td><strong>2. Monitor Performance</strong></td>
</tr>
<tr>
<td><strong>3. Ensure Superior Management</strong></td>
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<tr>
<td><strong>4. Govern Board Effectively</strong></td>
</tr>
<tr>
<td><strong>5. Establish/Maintain Values, Ethics and Financial Integrity</strong></td>
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</table>

<table>
<thead>
<tr>
<th>What it means</th>
<th>Why it is important</th>
</tr>
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<tbody>
<tr>
<td>- Board monitors key financial performance indicators (e.g., ROE, quarterly earnings)</td>
<td>- Board responsible for overseeing corporate performance</td>
</tr>
<tr>
<td>- Board ensures plan is in place to develop and retain future leaders and to compensate appropriately</td>
<td>- Board responsible for ensuring future leadership can advance shareholder interests</td>
</tr>
<tr>
<td>- Board nominates new directors</td>
<td>- Board must run itself well to achieve objectives</td>
</tr>
<tr>
<td>- Runs meetings effectively</td>
<td>- Board responsible for protecting against misconduct and potential liabilities</td>
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<tr>
<td>- Board evaluates its own performance</td>
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<tr>
<td>- Board ensures adequate legal and transparency controls are in place</td>
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A Robust Dividend Policy Must be Defined to Manage Government Take and Ensure Retained Earnings are Sufficient to Fund Future Investment

**Key dividend principles**

- **Ensure future cash outlays are met**
  - Future investments
  - Debt service
  - Cash reserves, e.g. in case of oil price downturn

- **Optimise debt leverage**
  - Use debt to finance investments
  - Distribute more cash to shareholders

- **Manage investor expectations**
  - Dividend policy often seen as an indicator of management’s optimism/pessimism on business outlook
  - Minimize changes to dividend policy may

**Applicability to JV Inc**

- **High**
  - JV inc’s should generate significant cash
  - Excessive dividends would compromise ability to sustain/grow production
  - Necessity to build cash reserves

- **High**
  - Having a strong cash position will make JV Inc’s attractive to investors

- **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