LECTURE 4

CONTRACTUAL ARRANGMENTS

4.1. INTRODUCTION

The purpose of contractual arrangements may be to mitigate the impact of risks, and to isolate lenders from a market price risk attached to a project. The uncertainty and high degree risks involved in the exploitation of oil necessitates some contractual dimensions that will determine the allocation of risks between various parties. Although there are various contractual arrangements, it is useful to be concise and evaluate the following arrangements:

4.2. CONCESSION AGREEMENTS, LICENSES, OR LEASES, ETC

Concession is the license or permit to drill for oil or gas on a block obtained under the license from the State. Concession agreement is valid provided the issuing State has claimed ownership rights of the oil and gas within its borders or located within its continental shelf. The concession holder may farm-out part of the allocated block if the concession holder does not have the ability to source for the financing of the project. Upon granting of the concession, the established concession agreement may play many roles as the contract, as well as a sales agreement for the project through which the sponsor will source its funding. From the perspective of a project company, a concession agreement may serve as a security instrument in project finance. However, the exercising of power of the host government may affect the use of concession agreement as security. For example, most recently the Argentine Judge ordered seizure of assets of oil drillers worth US$156,432,000.00, in the Falkland Islands. Such seizure may affect the way to take security in project finance regarding the exploitation of oil.

4.3. CONSTRUCTION AGREEMENT

Construction agreement relates to a supply contract where the contractor agreed to build the project upon assumption of the relative risks. In other words, the contractor assumed the task and risk of building the project. The contractor bears the legal obligation by means of indemnities, which it can grant to the project company for delay, or failure to meet with the required standard. From a lender's perspective, where there is a variation of the project and construction, it may be subject to the approval of the lenders. Because of the huge resources invested in a typical exploitation of oil projects, the reputation and creditworthiness of the contracting company has to be unquestionable. That will enhance the ability of the contractor to cater for possible payment of indemnities that may arise for any breaches. The position of English law, with regards the passing of risks in materials is that risks pass when title passes. However, varying the construction agreement in this regard means that risk can remain with the contractor until takeover of the project.

The lender can mitigate the issue of risk associated with construction of the project by ensuring that it has access to insurance money where there is all risk insurance for the project.

4.4. OPERATING AND MAINTENANCE (O&M) AGREEMENTS.

The operation and maintenance agreement will cover how the project should be operated and maintained through-out its life-span. That means, the effect of O&M is upon completion of the project and the commencement of the commercial operation of the project. The problem with Operation and Maintenance agreement arises where a certain operation or maintenance aspect of the project is committed into the hands of a third party, thereby shifting the allocation of risks. The importance to involve third parties include, inter alia, the fact that the costs of O&M can be predetermined, and the ability to replace the third party for failure to perform satisfactorily. On a legal point of view, the third-party contractor in charge of O&M may indemnify the operator of the project for unsatisfactory performance. From the lender's perspective, the risk relating to the borrower's ability to service debts, is transformed into a pre-established indemnity to the benefit of the lender.

4.5. OFF-TAKE AGREEMENT

In the context of exploitation of oil, the purpose of off-take agreement is to assure the lenders that the project is unaffected by “market price risk” because price is agreed in the off-take agreement. However, since crude oil is sold in the market on a shorter term because of fluctuating market price, it may not require an off-take agreement during the negotiation of financing of the project since it will be beneficial for the sponsors to enter into contract on short term basis, instead of long term contract.

Therefore, instead of an off-take contract, the joint venture party may find it more expedient to enter a contract to sell a specific amount of production at a fixed price. Thus, while the aim of the contract will be to hedge (i.e to enter in a contract to protect against possible financial loss) the risk, the problem with this type of contract is that it will disadvantage the project company if the price rises for a long period.

Moreover, entering into an off-take agreement may disadvantage the project company since it means entering into a settlement obligation whereby if the project company lacks commodities, it will be obliged to source from another source, possibly at a higher price to fulfill the off-take contract.

The possible way to mitigate such a situation from affecting both parties may be to have a very low percentage for the hedged contract. However, by retaining a high percentage in the off-take agreement, the lenders will not be exposed to the adverse effect of the off-take agreement on the project company towards repayment of the debt even if the price falls.

4.6. RISK MANAGEMENT: RETAIN, TRANSFER OR INSURE RISK

Risk identification is important in project finance, especially in lenders' perspective to mitigate the consequences of the risks. As per S.Gatti, the three basic strategies the SPV can put in place to mitigate the impact of a risk are: retaining of the risk; transfer the risk by allocating it to one of the key counterparties; and transfer the risk to professional agents whose core business is risk management - insurers.

These are relevant especially where part of the project like construction phase, or operation and maintenance of the project is committed into the hand of a third party thereby shifting the allocated risks.

A question that may arise is what the legal position of the lender will be where a third party investor has provided equity to the contractor to get the financing. Supposing that legal liabilities have passed through the project company to the sub-contractor, thereby reducing the project risk of the project company to a residual one; It may be of great concern to the lender. To mitigate the uncertainty, the lender may insist on getting a warranty by the project company, which will spell out the liquidated damage the sub-contractor will pay if things go wrong.

However, if the lender exercised too much control over the construction, and/or operation and maintenance of the project, the lender may subject itself to equitable subordination claims if things go wrong and possibly breach of contract liability.

It is worth noting that the fundamental principle under English law for example is the notion of privity, which reflects that contracts create rights and duties only for parties who are privy with each other, and that a promise is unenforceable unless consideration moves from the promisee to promisor. Therefore, lenders who are in contract privity only with the project company may not see themselves as contractually bound with sub-contractors. However, the question of when title and risk pass may demand judicial consideration.

Lenders may minimize risks by having direct loan agreement for payment directly to the contractor and subcontractor instead of the project company. Similarly, loan agreement might make the sub-contractor a third-party beneficiary with power to enforce lender's commitments. The lender might also become a guarantor of the project company's obligation to pay the contractor, and that will create a right of the contractor to recover based on the doctrine of promissory estoppels.

As stated above, there could be a transfer of risk to insurers, whose core business is risk management. The reason for using insurance to mitigate risk is that the absence of insurance can hinder the bankability and credibility of the project. Since the lenders assume risk by financing a project, the coordination of the insurance with the project financed, minimises the risks of the lenders, especially where the project is located in political and legal jurisdictions that is uncertain to the lenders. These uncertainties may persuade lenders to participate during the drafting of the contractual arrangement to mitigate any foreseeable future risks.