March 2013

Energy briefing

Synthetic ownership structures in the energy sector

In the upstream energy space, production-sharing agreements, concessions or licences (referred to generically in this briefing as the "Contract") will typically require prior government approval for the assignment/transfer of all or part of a party's interest in the Contract by an existing participant to a third party. Similarly, for a person to take on ownership or an operatorship stake in a petrochemical or refining asset, governmental and regulatory approvals are often required.

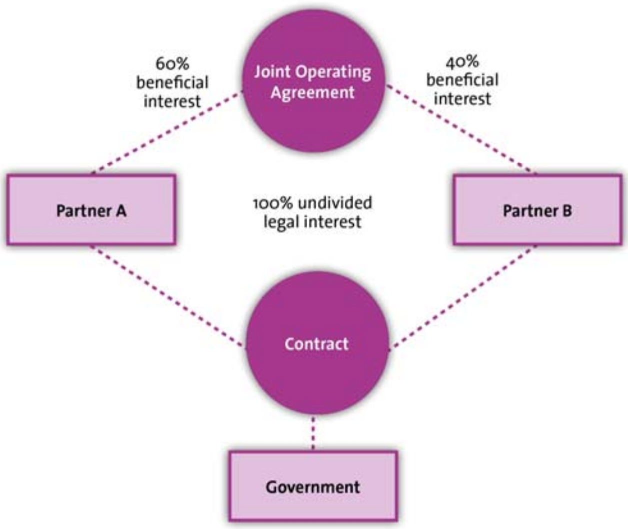
In a number of jurisdictions, receiving the requisite governmental and regulatory approvals may involve a lengthy and uncertain process. Farm-ins in the upstream energy sector and acquisitions in the petrochemical and refining energy sectors, are therefore usually conditional on receiving such governmental and regulatory approvals.

The relevant contractual constraints or underlying rules of law requiring governmental and regulatory approvals may be circumvented by employing, until the relevant governmental and regulatory approvals are received, what are known in the energy sector as "synthetic" or "virtual" ownership structures. Such structures do not usually require governmental or regulatory approvals, but can still achieve the same or similar economic outcome as that achieved by conventional interest transfer structures.

The conventional structure for holding upstream oil and gas assets is direct ownership[1] by participants or joint venture parties by being a party to the relevant Contract. Where multiple party interests apply, the participants under the Contract are often party to an unincorporated joint venture with respect to the assets (see Figure 1). Similarly, interests in refining or petrochemical projects are usually held:

- directly, particularly if there is only a single participant by virtue of the participant being a party to all the relevant agreements; or
- indirectly, particularly if there is more than one participant, by holding the shares in a special purpose vehicle/joint venture company which has been created to hold the assets, and which is itself a party to the relevant underlying agreements.

Figure 1: Typical position in upstream oil and gas after, e.g. A farms out 40 per cent. of its interest to B and obtains Government consent.



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The "synthetic" or "virtual" structures examined in this briefing that are employed by participants in an upstream farm-in scenario or a petrochemical or refining asset acquisition scenario, are:

- in the case of upstream oil and gas assets, where the participant takes equity in a company which itself has the "direct" rights to the asset (or at least an option to acquire such equity). We will refer to this structure as "Synthetic Farm-In"; and
- in the case of refining or petrochemical assets, where a participant has neither direct rights to the asset or shares in a company which holds such rights, but rather derives rights equivalent to those which an "equity" owner in the project would expect to have, pursuant to an offtake agreement. We will refer to this structure as "Synthetic Offtake Ownership".

Why use a synthetic structure?

In an upstream farm-in scenario, the farmee may require or desire to be the de facto owner of its proportionate share of the asset as soon as it signs the conventional farm-in agreement and, crucially, before receipt of the required government approval. The motivation for doing this may stem from the asset's profitability or the farmee's desire to influence the management of the operations until receipt of government approval.

Similarly, the farmor may want the farmee to be treated as its de facto partner upon signing the farm-in agreement because it needs the farmee to share the funding burden with the farmor as soon as the farm-in agreement is signed.

In such circumstances, the farmor and the farmee can employ a Synthetic Farm-In structure that allows them to treat the farmee as a de facto interest holder before receiving government approval, albeit without breaching local law or the Contract.

In a refining or petrochemical asset acquisition scenario, the same above rationale for employing Synthetic Farm-In arrangements usually applies.

Synthetic Farm-In and Synthetic Offtake Ownership structures can also be driven by tax reasons or by an existing partner's desire to capitalise its assets without diluting its direct ownership rights, in which case the relevant structure can be a more permanent rather than an interim solution.

Overview of Synthetic Farm-Ins

Synthetic Farm-Ins usually apply during the interim period between signing a farm-in agreement and the receipt of any required governmental or regulatory approval for the assignment/transfer of the Contract. They aim to mimic, during the interim period and to the extent permissible under local law and the Contract, the position that the farmor and farmee would be in once the government approval is received.

The two key differences between a conventional farm-in and a Synthetic Farm-In are:

- **management of the asset -** in a number of Synthetic Farm-Ins, the farmee is involved in the day-to-day decision-making and management of the upstream asset during the interim period. In a conventional farm-in, the farmor would usually have an obligation to consult with the farmee in relation to key decisions and to manage the asset in the ordinary course of business, but the farmee is unlikely to be heavily involved in the day-to-day management of the asset during the interim period; and
- **funding -** in a Synthetic Farm-In, the farmee will have the same funding obligations during the interim period that it would have after receipt of government approval. In contrast, in a conventional farm-in (i) where the parties agreed that the risk in the asset will pass at the signing date but the title under the Contract will be transferred on the completion date, the farmee will usually only be obliged to pay its proportionate share of the operational and capital costs relating to the interim period after receipt of government approval and becoming an interest holder in accordance with the Contract; or (ii) where the parties agreed that risk and title will pass to the farmee on the completion date, the farmee will only be liable for its proportionate share of the costs from the completion date onwards, i.e. not at all during the interim period.

Structuring Synthetic Farm-ins

There are a number of ways in which the parties can employ a Synthetic Farm-In structure during the interim period. However, the most commonly used structures are:

- **Option 1:** the farmee acquiring shares in the company that is party to the Contract (see Figure 2); or
- **Option 2:** the farmee entering into an interim financing agreement and having an option to acquire shares in the company that is a party to the Contract (see Figure 3).

Figure 2: Synthetic Farm-in Option 1.
B acquires equity interest in party to Contract. Can be collapsed to typical position on obtaining Government consent.

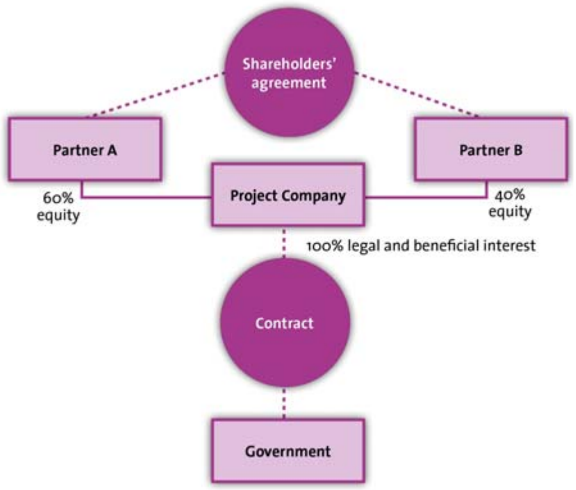
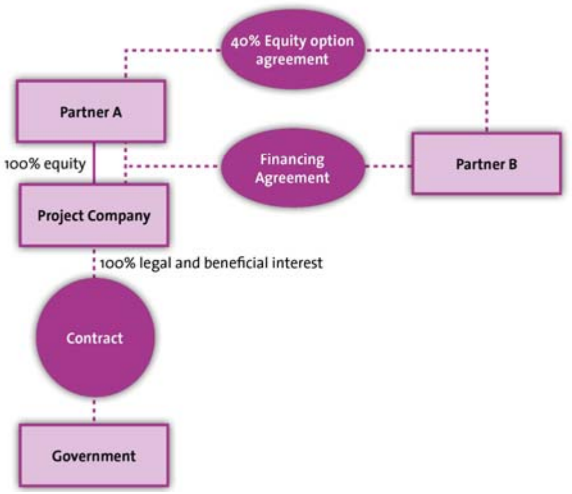


Figure 3: Synthetic Farm–in Option 2.
B loans money to A/party to Contract and takes option to acquire equity in party to Contract. Can be collapsed to typical position on obtaining Government consent or Option 1 if consent not obtained.



The parties' choice of the Synthetic Farm-In structure will largely depend on their commercial circumstances, the farmor's willingness and/or ability to sell part of its equity in the company that holds the Contract, the farmee's appetite to have equity in the company that holds the Contract, the agreed funding obligations during the interim period and the local law and Contract requirements.

For example, if the Contract and/or local law does not permit a change of control without obtaining prior government approval, the farmee will not be able to acquire a controlling interest in the farmor-owned company that holds the relevant Contract without obtaining such prior government approval. The process of obtaining government approval for the change of control can be as lengthy as the government approval process in respect of the assignment/transfer of the Contract, which makes the relevant Synthetic Farm-In structure an impractical interim period solution.

Therefore, the parties will have to consider the relevant Contract, the local law and their commercial circumstances before deciding which synthetic structure they should implement and whether a Synthetic Farm-In arrangement is a practical solution to the often lengthy government approval process.

Option 1: equity interest in the Contract holding company

This structure enables the farmee to acquire an interest in the company that is a party to the Contract to enable the parties during the interim period to have the same or similar economic benefits and obligations and decision-making rights that they would be entitled to once the farm-in agreement is effective after receipt of government approval.

The documentation of this structure will include, in addition to the farm-in agreement and the joint operating agreement:

- a share purchase agreement relating to the equity that the farmee is taking in the company that is party to the Contract. The equity interest that the farmee acquires in the company that is a party to the Contract will usually mirror the farmee's interest under the farm-in agreement; and
- a shareholders' agreement that is structured to achieve a comparable position in the interim period to the regime of the joint operating agreement that will apply after receipt of the government approval. The shareholders' agreement should address the parties' funding obligations, cash calls and distribution of profits, transfer of shares, change of

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control, withdrawal rights, sole risk operations, operator's liability and decommissioning obligations.

Option 2: financing agreement and an equity option

Where acquiring equity in the company that holds the Contract (i.e. Option 1) is not a solution that the parties are willing to consider (e.g. because the farmee prefers not to hold equity in the company that holds the Contract), the parties can enter into an interim financing arrangement where the farmee finances that part of the operations proportional to the farmee's conditional interest under the farm-in agreement. Under this arrangement, the farmee will have no interest under the Contract and will effectively act as a lender to the farmor, pending government approval.

The financing agreement will, among other things, regulate the decision-making process and management rights in respect of the Contract and any restrictions on disposals by the farmor during the interim period.

In addition to the usual securities that would apply while the loan is outstanding (e.g. share pledges and guarantees), the farmee may also consider having an equity option exercisable during the interim period to acquire a percentage of the shares in the company that holds the Contract. The number of the shares that are subject to the equity option will usually reflect the farmee's interest under the farm-in agreement.

The farmee may decide to exercise the equity option if:

- the approval of the government is delayed and certain key decisions (e.g. renewal of exploration period, final investment decision or extension of the Contract's term) are due to be made;
- the farmee's circumstances change and it is no longer opposed to acquiring an interest in the Contract holding company;
- default has occurred under one of the other loan securities put in place; and/or
- the farmee has a concern about the farmor's ability to comply with the loan securities in place under the financing agreement.

If the parties agree to enter into an equity option during the interim period, it would be advisable to have an agreed form of shareholders' agreement which will come into effect upon the exercise of the equity option and which covers the same issues discussed in "Option 1: equity interest in the contract holding company" above in relation to the shareholders' agreement.

Accordingly, the Option 2 Synthetic Farm-In structure is usually documented by entering into, in addition to the farm-in agreement and joint operating agreement:

- a financing agreement and the related security documents; and
- an equity option agreement (if relevant) with an agreed form shareholders' agreement as a schedule which becomes affective upon the exercise of the equity option.

Overview of Synthetic Offtake Ownership

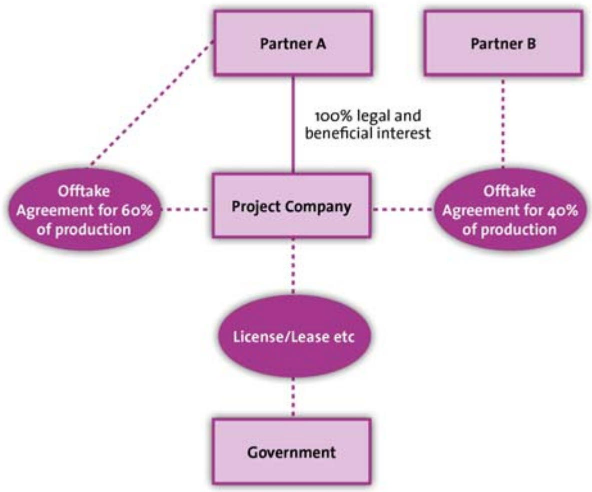
Synthetic Offtake Ownership occurs when two or more parties desire to have an interest in an asset or business, but such that not all of the parties have a legal interest. Those parties are instead given such rights in an offtake contract as are necessary to, so far as is practicable, make their economic position the same as if they had a legal ownership interest in that asset. This is achieved by giving such parties management rights consistent with what a "real" owner of their "virtual" interest would have, and rights to a certain proportion/percentage of the offtake from the plant, rather than, as would be the case typically under an offtake agreement, a fixed amount (see Figure 4).

The virtual owner will typically bear its proportion of all of the risks, liabilities and obligations attributable to the refinery/petrochemical project facilities and in return receive the same proportion of any offtake, rights or benefits arising from its virtual ownership or use of such facilities.

In many ways there are parallels in this structure to unincorporated joint ownership in upstream oil and gas arrangements, where the operator will run a particular project on behalf of the other participants, is able to cash-call the other participants in accordance with agreed budgets and work programmes in proportion to each party's beneficial interest, and is generally only liable to participants to the extent it is guilty of gross negligence or wilful misconduct. Typically, the offtake contract becomes a quasi equity document too, because it will provide for each party's contribution, rights and vetoes in relation to the running of the project facilities. These provisions would typically be contained in a separate shareholders' or partnership agreement if all parties had a legal ownership stake in the asset or business.

The Synthetic Offtake Ownership arrangement is typically documented through a supply/offtake agreement with the proposed virtual owner as the offtaker and the existing legal owner/operator as the supplier.

Figure 4: Synthetic Offtake Ownership.
Rather than taking equity in Project Company, B obtains similar economic rights under an offtake agreement.



Key considerations for a Synthetic Farm-In or a Synthetic Offtake Ownership

Set out below are a few of the key specific issues which might arise in a synthetic ownership arrangement. Some are, of course, important considerations in any ownership arrangement but take on a different flavour in the Synthetic Farm-In and Synthetic Offtake Ownership context.

Term and termination

Synthetic Farm-In and Synthetic Offtake Ownership arrangements may well have a defined term or be linked to receipt of governmental and regulatory approvals. Where they are linked to the receipt of governmental and regulatory approvals, the structure is usually collapsed upon receipt of the requisite governmental and regulatory approval. If the relevant authorities do not approve the applicable transaction, the parties can either terminate the synthetic arrangements put in place or agree to apply them permanently.

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In the context of a Synthetic Farm-In, if the parties agreed to collapse the synthetic structure upon receipt of government approval, the mechanics of collapsing such structure will depend on the relevant Synthetic Farm-In arrangement employed:

- **Option 1 (equity interest in the Contract-holding company):** the shareholders' agreement would usually provide that the equity held by the farmee will be sold to the farmor for a nominal value (because the farmee now owns its interest separately); and
- **Option 2 (financing agreement and an equity option):** the financing agreement would be typically terminated and the loan would be forgiven (subject to any relevant tax considerations). If the equity option was exercised during the interim period, the sale of equity outlined in the paragraph above will usually apply.

Once the relevant Synthetic Farm-In is collapsed, the conventional farm-in agreement and the joint operating agreement would regulate the parties' relationships.

In the case of a temporary Synthetic Offtake Ownership, upon receipt of government approval the offtake agreement would terminate and instead the virtual owner would have equity in the project company (and rights under a shareholders' agreement). In the case of a permanent Synthetic Offtake Ownership arrangement, the logic and solidity of the structure becomes more unstable and the fiction more apparent as the term of the arrangement nears its end. For example, any rights which have been negotiated vis à vis shutdowns of the plant or requirements to contribute to capital costs for improvements or other de-bottlenecking projects, unless carefully drafted, cease to provide appropriate incentives to the parties. The virtual owner will be less comfortable taking on these sorts of costs as it gradually receives less and less of the projected benefits. It is difficult to negotiate these rights at the outset when a certain position might be reasonable for, say, the first 20 years of a 30-year term, but increasingly inappropriate for the remainder of the term.

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On the other hand, a liability to pay shutdown costs is more acceptable to the virtual owner towards the end of the term when it is more likely it will have received its share of the benefit of the facility to be shut down during its working lifetime.

Operator and operator liability

The operator of the upstream asset or the refining or petrochemical facility will typically not accept any liability towards the virtual owner, except perhaps in the case of its gross negligence or wilful misconduct. The overall position has some logic, in that if the virtual owner: (i) in the context of Synthetic Farm-In had direct rights under the Contract, the same position would apply under the joint operating agreement; and (ii) in the context of Synthetic Offtake Ownership, had a legal ownership stake, it would likely not have a separate liability regime applicable if the project facilities were managed badly other than through its rights as a shareholder.

Compensation on termination

If the Synthetic Farm-In is terminated because no government approval is received, the farmee would expect to recoup any funds committed by it during the interim period. The recovery of interim period funds can be in the form of a cash payment by the farmor (if the farmor's financial circumstances permit this) or royalty from production (if the asset is producing or has a high chance of producing in the future). In some circumstances, the farmee may be prepared to forgo any funds committed by it during the interim period if it considers such funds an opportunity cost.

Similarly, if the owner in the context of a Synthetic Offtake Ownership has contributed large sums during the interim period or paid a substantial upfront sum for its economic rights, for example, in order to obtain a proportion of offtake at production cost rather than market cost throughout the term, there is a strong argument that it should be entitled to a return of a proportion of that sum (calculated on a net present value basis) in the event of regulatory and government approvals not being received or early termination of the offtake arrangement, even if due to its own default. The upfront consideration may be part of a larger consideration for a bigger deal such as the establishment of a joint venture to hold existing assets, where the virtual ownership arrangements are likewise part of a larger structure involving a joint venture agreement and other equity documents. This may complicate matters but does not detract from the basic argument. If the virtual owner were a legal owner, it would typically expect to receive some compensation for its shares if it defaulted as a shareholder and was bought out.

Audit rights and finances

The virtual owner will want to ensure that it has adequate protection as to expenditure relating to the asset and ensuring that it is paying its fair share, and receiving its fair share of the benefits of the asset. Key components of this will include detailed requirements in the documents in respect of invoicing and robust auditing rights and control over how the legal owner/operator accounts for its dealings at the asset and facilities and any changes over time to its accounting practices.

Management rights

The virtual owner will want management rights commensurate with the percentage interest its virtual ownership equates to. If low (say, less than 25 per cent) this might equate to information and review rights, but few decision/veto rights. However, this picture would change as the virtual ownership interest equates upwards to, say, a 50 per cent interest in the asset or business. Above this, of course, the virtual owner would expect decision/veto rights over all or most material decisions. Key areas for consideration for a synthetic arrangement will include asset strategy, sale and purchase strategy, feedstock acquisition strategy (in the case of Synthetic Offtake Ownership), approval/participation in capital costs, approval of discretionary shutdowns and changes to costs charged to the asset.

Pre-emption rights/restrictions on disposals

The virtual owner may require pre-emption rights in the event the legal owner/operator proposes to dispose of the asset or a prohibition or standstill period in relation to disposals. Consideration could be given as to whether a purchaser would take on the asset subject to the Synthetic Farm-In or Synthetic Offtake Ownership arrangement or whether there should be some sort of option or requirement for a purchaser to buy out the virtual owner's rights.

Other Synthetic Offtake Ownership issues

The following considerations apply in the context of Synthetic Offtake Ownerships:

- **motive in running the facilities:** tensions may exist between the virtual owner and the legal owner/operator over how best to manage the project facilities; one may define its motive in participating in the relevant asset or business as being the maximisation of profit derived from selling its proportion of the offtake to third parties while the other desires only that its proportion of offtake be produced as economically as possible to increase its profits from transactions at derivative plants;
- **treatment of virtual owner vis à vis other customers:** the virtual owner will be keen to ensure that it is treated no less favourably than any other customers or co-venturers of the legal owner/operator in respect of its offtake rights; and
- **derivative rights:** the virtual owner will want to ensure that it has adequate rights to related and necessary facilities such as pipelines or storage facilities for feedstock or offtake, again commensurate with what its ownership interest would be if it were a legal interest.

Conclusion

This briefing has shown that there are a number of synthetic structures that can be considered to give potential investors more flexibility when considering acquiring an upstream or petrochemicals/refining asset, in particular where the process of obtaining governmental and regulatory approvals is lengthy and uncertain. A synthetic structure might be long-term or even permanent in nature or perhaps merely implemented during an interim period pending receipt of relevant third party approvals for a more conventional arrangement. The structure chosen will, of course, depend on the commercial interests of the parties and their given circumstances in any given example.

This article was first published in the International Energy Law Review.

Notes:

1 Ownership at least in the rights granted under the Contract. In most jurisdictions this will not actually convey ownership rights in any oil and gas in the ground.

Further information

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