
Summary of the Operation Performance Evaluation Review
Review evaluation of an oil field development
January 2007

THE PROJECT

In 2002, the Board approved an A/B project finance loan with the purpose of developing oilfield reserves.

PROJECT RATIONALE

The project was fully consistent with the sector and country strategies. The joint venture (JV) gave equal weight to each partner. One company (company A) was expected to provide advanced technology and management and therefore training skills, and an environmentally friendly approach to an oil project development, including significant levels of associated gas. The other (company B), through its existing ownership of a similar company would bring the knowledge of the local environment and through its position as one of the largest domestic integrated oil companies, the ability to handle issues related to pipeline capacity allocation and domestic marketing of crude oil. The financing structure as a true project financing post completion was to be a breakthrough for the financing markets with high demonstration effect potential for a non- Project Sharing Agreement (PSA) oil project.

ACHIEVEMENT OF OBJECTIVES

Three main objectives were set at approval, namely: demonstration effect derived from supporting a successful non-PSA-related joint venture with a reputable foreign strategic investor; the setting of high standards for business conduct and compliance with sound environmental policies in a sensitive ecological context. The project was implemented to a large extent on time. There were bottlenecks with regard to transportation that prevented shipments and delays in drilling activity. These resulted in large overruns compensated by a lower cost for the Central Processing Facility (CPF) and higher revenues from lower level of production due to a significantly higher price of oil. In spite of these shortcomings, EvD regards the successful implementation of the project as being *Achieved*.

Company A imposed on the JV its high standards of corporate governance. This was evidenced by the production of IAS financial accounting and timely reporting in respect of financial operating and environmental matters. Considering that some grey areas remained in respect of pricing transparency and that high corporate standards imposed under the control of this company may no longer be followed with as strict a discipline, corporate governance is rated by EvD as *Partly Achieved*.

The Environmental Impact Assessment was completed independently on behalf of the JV in 1998. An Environmental Action Plan was developed by the bank and an independent environmental audit was undertaken in 2005. In the absence of an environmentally conscious partner there will be little incentive for Company B, which has now prepaid the loans, to abide by the project undertakings with respect to gas flaring. With little prospect for an improvement of this situation, EvD's rating of the achievement of this objective is therefore *Partly Achieved*. The rating of overall fulfilment of objectives gives due consideration to the fact that the first one, considered as having been achieved, is in fact a collection of a number of sub-objectives and should therefore be assigned a greater weight than the two others which have been only partly achieved or not achieved. Achievement of Objectives is therefore assigned a *Satisfactory* rating.

OVERALL ASSESSMENT

The Bank's project financing of the oilfield development carried a strong potential to be a highly successful investment: a creative way of raising funds for a joint venture between a large domestic oil company and a strategic foreign co-sponsor, in an untested legal framework and with sound environmental objectives. The economic success of the project leading to the prepayment of the loan and an easier early retirement of the foreign sponsor is partly responsible for some of its shortcomings.

Fulfilment of Objectives was rated *Satisfactory* only because achievements under the joint venture are unlikely to be pursued under the new management and unfulfilled environmental undertakings may never materialise. Transition impact was similarly affected by the lack of continuity and replicability of some of the short-lived realised features. With due consideration for actual achievements in this respect, overall transition impact was nevertheless rated *Good*. In spite of the ongoing high level gas flaring, which lowered the extent of environmental change to *Some*, the environmental performance of the project was attributed a *Good* rating. The project's financial performance is *Excellent*, this is indeed fortuitous as the project started off with significant cost overruns but the unexpected surge in the price of oil more than compensated for such initial setbacks.

The Bank's additionality at appraisal was *Verified in All Respects* as there is no doubt that the Bank was instrumental in the success of the project financing, which would not have attracted any commercial lender had it not been put together under the leadership of EBRD. Through its selection of the project, the structuring and syndicating of the financing, the monitoring of the project company and assistance in smoothing out partners' relationships at management level, the banking team displayed outstanding skills and Bank Handling was consequently rated *Excellent*. EvD therefore assigned a *Successful* rating to the project Overall Performance.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The joint venture delivered most of the anticipated transition impact as could be predicted at appraisal. Most achievements in terms of transition impact being mitigated by the strong uncertainties looking forward, EvD's rating of overall transition impact cannot be better than *Good*. The Bank was clearly additional on all counts in this transaction. The strong appreciation of the price of oil made both company B and the project cash rich and the financing somewhat redundant. The Bank's financial additionality had also been negatively affected by company A's withdrawal from the joint venture. At the time of approval, however, the Bank's additionality was *Verified in All Respects*.

BANK HANDLING

Project selection was excellent, helped by the long gestation period during which the Bank became thoroughly familiar with the corporate environment as well as physical constraints of this environment. The banking team had already established a relationship with company B and was aware of the inherent challenges. It developed a very good relationship with company A who valued highly the Bank's involvement as a project lender.

The prepayment of the facility could have hardly been predictable or avoidable. It is reasonable to suspect that, once on its own, company B was eager to do away with the reporting and environmental constraints attached to the project financing. However, the project's and the parent company's cash build up due to the rise in crude oil price are bound to have been the main reason for the prepayment. This resulted in the Bank being deprived of high revenues for the last two years and the profitability of the operation was further reduced. The project nevertheless generated enough revenues to comfortably cover the Bank's cost and its profitability was rated *Satisfactory* according to EvD's own standards.

EvD regards the prepayment of the loan and the less-than-cooperative attitude of the remaining shareholder as external elements to the project itself which the banking team had to cope with as with other uncertainties that could not have been foreseen. In the event, monitoring by the Bank was of very high quality and its involvement to broker a new shareholder agreement was commendable. The structuring of the loan documents did not allow for the gas flaring issue to be tackled as early as would have been desirable, however, the Bank's professional handling of the general structuring, documentation and syndication of the project financing deserved and obtained highest recognition. Bank Handling is therefore assigned by EvD an *Excellent* rating.

LESSONS LEARNED

Lesson: Political risk may be better mitigated by the choice of the local partner than by the legal framework that governs the project. Governments have levers available outside the operating framework to try and renegotiate a contract that may have been regarded as offering the best protection against an attempt by the local Government to alter the pre-agreed economics of a project in the extractive industry. This is being experienced in this country as well as in other countries of operations of the Bank. In this case, however the presence of a strong local partner as 50 per cent shareholder may well have been the best avenue to mitigate political risk.

Lesson: A 50/50 joint venture increases the risk of management deadlock detrimental to a project. In this case, the bank acted with tact and diplomacy which may have been helped by the increasingly favourable economics of the project which created a strong incentive to find a solution. This was obtained by elevating controversial issues to shareholder level, thereby bypassing local susceptibilities. It also required sweeping management changes to give the new agreement a chance to work satisfactorily.

Lesson: Important environmental undertakings should be covenanted in the loan documentation. It is not sufficient to rely on the knowledge that the technical development plan calls for environmental remediation if the project has been approved by the Board on the basis that such key investments would make it environmentally sound. Non-compliance with such undertakings should translate into a breach of covenant requiring a formal waiver by the Bank. In accordance with Bank's procedures regarding waivers, amendments and consents, this would thus lead to informing the Board on non-compliance with material environmental/safety issues as would be the case for other material conditions.

Lesson: The negative impact of prepayment of a project loan may be alleviated through proper pricing. The profitability of an investment is analysed on the basis of its IRR through discounting net cash flows. In addition to the collection of a prepayment penalty fee, the loss of higher margins on reducing principal amounts at the tail end of the facility's life are easily compensated by fees received up front and calculated on the full amount of the facility. The Bank should always seek to maximise up-front fee collection particularly in situations where fluctuating commodity prices are an unpredictable possible cause for prepayment.