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Key Issues and Considerations in Developing Petrochemical Projects in Newly Emerging Markets

Introduction

This article provides a brief overview on some of the key issues and considerations that will need to be analysed by foreign sponsors (the "**Foreign Sponsors**") looking to develop petrochemical projects in newly emerging markets. Most petrochemical projects development in newly emerging markets, will involve the Foreign Sponsors working in collaboration with a state or a local entity (the "**Host Sponsor**") nominated by the government of the host country (together with the Foreign Sponsors, the "**Sponsors**").

In light of the significant costs associated with the development of a large-scale petrochemical project, the Foreign Sponsors will generally consider a variety of possible financing options including project financing, corporate financing or host government guaranteed financing. The availability of international project financing will depend on whether a range of legal/commercial/political issues can be addressed in a manner satisfactory to the lenders in order to satisfy lending requirements. This article assumes that the Foreign Sponsors will be considering and evaluating a variety of different financing options and does not include an exhaustive review of the issues that would need to be addressed in order to support a limited recourse project financing structure.

Legal Framework

As part of the initial due diligence process, the Foreign Sponsors will evaluate, amongst other things: (i) the host country's legal system; (ii) the system of legal entities in the host country; (iii) property protection under the host country's legislation and issues associated with land ownership; (iv) currency control and accounts; (v) investment protection; (vi) issues relating to taking security; (vii) choice of governing law and arbitration issues; and (viii) taxation.

In connection with this evaluation, the Foreign Sponsors will assess the extent to which the legal framework provides for: (i) equitable terms for foreign participation as for state/local participation; (ii) protection for foreign investment into the host country; and (iii) the protection of lenders' interests to the extent there is external financing. It may be that the host country's law does provide some protections for the Foreign Sponsors but that these protections may not be well defined or ever tested in practice. It is also quite possible, that in many situations, the existing laws of the host country are not sufficiently developed to provide desired levels of certainty to the Foreign Sponsors and any lenders. In some situations, the government of the host country may be amenable to amending existing

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legislation or enacting new legislation to address deficiencies or gaps in existing legislation. If this is not possible however, the Foreign Sponsors will need to consider alternative ways of addressing issues and concerns that arise from the deficiencies or gaps in existing legislation.

Feasibility Study

Undertaking the development of a petrochemical facility is a complex, lengthy and expensive process. Therefore, it is imperative from the outset for the Foreign Sponsor and the Host Sponsor to understand each other's goals and objectives. Although the Sponsors will share the overall objective of developing a successful and profitable project, the specific goals and motivations of the Foreign Sponsor and the Host Sponsor may vary with respect to specific issues and strategies. For example, the Host Sponsor's interests are likely to include a desire to: (i) leverage hydrocarbon resources by capturing downstream margins; (ii) support industrialisation of the host country's economy; (iii) grow the local petrochemical industry; (iv) create jobs; and (v) promote foreign investment. The Foreign Sponsors' interests are likely to include a desire: (i) to access a reliable supply of petrochemical and chemical products (using competitively priced feedstock); (ii) to build and develop marketing capability; (iii) to establish an early presence in, and access, the local and surrounding regional markets; and (iv) to leverage strategic and/or political alliances with the host government.

During the feasibility study, the Sponsors will want to develop the initial project scope and some of the key commercial principles. These are likely to include selecting the site and identifying potential synergies with existing facilities (e.g. utilities, infrastructure and domestic off-takers) and identifying anticipated feedstock sources to determine that the basic facility features are aligned with the project economics and assessment of technology options and product marketing options.

Front End Engineering and Design (FEED)

The purpose of the FEED is to conduct an engineering study of the technical aspects of the project and, to produce basic design and cost parameters. The scope of the FEED will typically include: (i) confirmation of the technical and economic feasibility of the proposed project scope; (ii) arrangements with licensors for the basic engineering packages for process units; (iii) determination of the engineering, procurement and construction (EPC) strategy; (iv) development of cost estimates for capital cost and operating cost; and (v) preliminary environmental impact assessments.

The Sponsors will manage the FEED process by establishing a steering committee or other oversight mechanism that includes representatives of both parties to supervise the FEED development, including the cost sharing agreement thereof. The cost sharing arrangements can be addressed either through a standalone cost sharing agreement or through the MOU.

Memorandum of Understanding (MOU)

In order to memorialize the initial commercial understanding of the parties and to establish the framework for the FEED, the Sponsors are likely to enter into an MOU. This agreement could be structured as follows: (i) legally binding in its entirety; (ii) non-legally binding in its entirety; or (iii) partially legally binding for certain provisions (e.g. the initial cost sharing arrangements and the exclusivity obligations on either or both parties). The answer may depend in part on how far progressed the parties are in their commercial discussions and whether it is intended that the parties will incur significant expenditure during the MOU phase.

The Foreign Sponsors often consider in detail the legally binding nature of the MOU. In order for an agreement to be considered and treated as legally binding, most systems of law require that the terms of any agreement are sufficiently clear and detailed so as to create enforceable and legally binding rights and obligations on the parties. If the terms of any MOU are not sufficiently clear and detailed, there is the risk that any relevant court or arbitral proceedings would find those provisions unenforceable. Consequently, the Sponsors may need to spend potentially significant time and costs in order to negotiate an MOU whose terms meet these requirements.

On the positive side, a legally binding MOU will motivate the parties to consider and address a number of key commercial issues. This process could identify any potential deal breakers at an early stage and save time when negotiating the fully termed agreements later. On the negative side, despite having spent a significant amount of time to negotiate a legally binding MOU, there is always the possibility that the parties will seek to renegotiate any purportedly agreed provisions in the MOU. Ultimately, the Foreign Sponsor will need to consider whether a binding arrangement is most appropriate at the initial stages of the project development. In any case, a legally binding MOU or an equivalent document will need to be agreed prior to any final investment decision. If the Sponsors decide to pursue a non-legally binding MOU, it is likely that cost sharing agreements, parallel to the MOU, will be required. It is also possible for the Sponsors to enter into a more detailed and legally binding MOU or Heads of Agreement following an agreement on the initial MOU, which may have been non-legally binding.

Furthermore, discussions with the Host Sponsor in the MOU stage of detailed term sheets for agreements will contribute to ensuring commercial alignment, as disagreements on key commercial issues can delay project implementation.

Another key consideration for a Foreign Sponsor is whether the MOU negotiations will be pursued on an exclusive basis. If the Foreign Sponsors seek exclusivity, the Host Sponsors may also request some form of commitment from the Foreign Sponsors not to pursue similar projects in the same country or region for a defined time period. Any exclusivity obligations that are agreed will need to be legally binding on the parties. However, the Foreign Sponsors will need to consider what remedies are available under the governing law of the MOU for breach of exclusivity obligation. In many situations these may be limited.

The Foreign Sponsor may also consider whether to include exit fees and termination liability for the parties in the MOU if the project does not proceed.

Regardless of the form, the MOU is an important document which should address high level commercial issues such as apportionment of initial costs, project implementation timetable, financing strategy, feedstock arrangements, marketing rights, land, infrastructure and utilities.

Shareholders Agreement (also known as Joint Venture Agreement)

In order to establish a project company ("**Project Company**") to undertake the development of a petrochemical project, the Foreign Sponsors will be required to enter into a form of shareholders agreement with the Host Sponsor and any other equity owners. In many circumstances, the law of the host country will require the Project Company to be incorporated in, and therefore be the subject to, the laws of the host country.

A Foreign Sponsor may request that the shareholders agreement be governed by a mutually acceptable governing law, subject to international arbitration rules with the seat of arbitration in an independent location. In some instances, this may be acceptable to the Host Sponsor. In other instances, the Host Sponsor may require that the shareholders agreement is governed by the laws of the host country. In such a case, and indeed in a number of examples, the compromise position is to agree to the governing law of the host country but to international arbitration with the seat of arbitration located in an independent location. If there is a dispute between the Sponsors and the Foreign Sponsor is successful in obtaining an award against the Host Sponsor, the Foreign Sponsor may still need to enforce the international arbitration award in the courts of the host country. Whether such enforcement is required depends on the location of the Host Sponsor's assets and this may be a challenging process. For instance, it may be difficult to enforce a foreign arbitral award in a host country that is not signatory to the New York Convention.

The Sponsors will need to consider and agree upon the proposed capital structure of the Project Company. If the project is going to be project financed, the parties will need to agree on the target debt to equity ratio. In some instances, the Host Sponsor will want to contribute in kind (i.e. non cash) equity; in such a case, the contributions in kind will need to be valued.

The issue of management and control of the Project Company will often be a difficult discussion between the Sponsors. In some situations, the Host Sponsor may require a 51% (or greater) shareholding in the Project Company. In this situation, the Foreign Sponsor will need to make sure that even though the Host Sponsor has the majority interest, the Shareholders Agreement is structured to provide that all or certain key decisions require the approval of both the Foreign Sponsor and the Host Sponsor. In circumstances where there are multiple domestic investors, minority shareholder rights will need to be considered.
The Sponsors will also need to consider what constitutes a deadlock and the consequences thereof.

There are a number of circumstances, for instance, upon the occurrence of certain defaults, where a shareholder may be required to sell its interest to the other shareholder, or purchase the interest of the other shareholder. In order to address this situation, the parties will need to agree on a mechanism to ensure that the price for the interest being sold is at a fair market value.

Feedstock Arrangements

Regardless of whether the Sponsors are looking to achieve project financing, from a commercial perspective a Foreign Sponsor will want the feedstock arrangements to provide: (i) certainty as to pricing and volume; (ii) minimum supply period; and (iii) some form of consequences for the feedstock supplier's failure to supply.

It is typical in many petrochemical projects in newly emerging markets for the feedstock arrangements to be governed by the laws of the host country. Although there are examples to the contrary, often the feedstock supplier is a national oil and gas company which is the sole source of supply in the host country without any alternative third party option. In circumstances where the feedstock supplier is the national oil and gas company, this may provide the Foreign Sponsor with comfort that the Project Company will receive the required quantities of feedstock on a continuous and reliable basis. However, this comfort should not detract from the Foreign Sponsor trying to negotiate the best possible terms for the feedstock agreement. Ideally, the feedstock agreement should be viewed as a standalone agreement with robust provisions and rights available to the Project Company rather than a feedstock agreement with less certain supply obligations which is justifiable only when viewed in light of the overall commitment of the government of the host country to implementing the petrochemical project.

Feedstock pricing is naturally one of the most important issues for any Foreign Sponsor. In order to support the overall economics of the project, the Foreign Sponsor will seek competitive feedstock pricing which remains stable throughout the term of the feedstock agreement. Given the importance of this issue, many Foreign Sponsors may pursue clarifications and assurances on feedstock pricing from the government of the host country or the Host Sponsor as part of the initial discussions held with those entities. In some instances, the Foreign Sponsors may seek to agree a high level commercial arrangement for feedstock (e.g. on matters such as pricing and volume) up front in the MOU.

Ideally, any remedy provisions under the feedstock agreements for the feedstock supplier's failure to supply should operate with a view to restore the Project Company to the position it would have been absent the breach. If an alternative feedstock supply is available a damages regime can be structured around compensating the Project Company for the price difference in securing the alternative feedstock. In the absence of an alternative feedstock, which is not unlikely to be the case, the Project Company could be looking to recover significant damages from the feedstock supplier for failure to supply. More often than not, the feedstock supplier in petrochemical projects in newly emerging markets is unlikely to agree to a damages regime (or anywhere close) that would restore the Project Company to where it would have been absent the supply failure. This leaves the Foreign Sponsors in a difficult position, which will be made even more challenging if third party lenders are involved. Where the government of the host country (whether fully or partially) owns the feedstock supplier and/or the Host Sponsor, the Foreign Sponsors may get some comfort from the alignment of interest.

Marketing or Offtake Arrangement

The ability to offtake or market all or a significant part of the products which are ultimately produced by the Project Company often serves as an incentive for the Foreign Sponsors to participate in a petrochemical project in a newly emerging market.

The key difference between the two potential roles is that a marketer is effectively paid by the Project Company to market the products and the Project Company receives the price paid for the products by the end consumer minus the marketing fee and direct costs of the marketer. In the offtaker model, the offtaker purchases the products at the delivery point for an agreed price (which is often established by reference to an agreed international pricing index) and the offtaker takes the profit (or potentially loss) of the price paid by the end consumer.

From a purely commercial perspective, there are a number of key issues from the Foreign Sponsor's perspective. These will depend in part on whether the Foreign Sponsor assumes the role of marketer or offtaker, which is a matter of negotiation with the Host Sponsor. If the Foreign Sponsor is to assume the role of marketer, it will be obliged to market and sell the products pursuant to an agreed marketing plan which will be approved by the shareholders in the shareholders agreement. The other shareholder(s) will want to monitor the performance of the marketer against the agreed terms of the marketing plan. The other shareholder(s) may also look to the marketer to achieve prices which are above the average price for similar products in the market during the corresponding period and expect consequences if the marketer fails to achieve these prices. The issues associated with the performance of a marketer can be some of the most highly negotiated provisions in any marketing agreement.

If it is decided that the Foreign Sponsor takes the products on an offtake basis rather than as a marketer, the issues about performance of the marketer and the end price of the products will be irrelevant, as the Project Company's interest in the products ends once the products are sold and transferred at the relevant delivery point to the offtaker.

Land

In many instances, the Host Sponsor will already have identified the land proposed to be used as the site for the project. It will be important for the Foreign Sponsors to understand whether the identified site takes into consideration potential expansion and utilities corridors. A well selected site in terms of its conditions, location and accessibility to infrastructure can reduce capital costs. To the extent land has not already been allocated to the project, negotiation with the land owner at an early stage is vital. Ideally this should be done during the feasibility study or the FEED stage to ensure that access to land is on schedule for site preparation and construction activities. It will also be necessary to assess environmental conditions at the proposed site. Frequently the parties will agree to conduct a baseline environmental survey to identify any pre-existing conditions at the proposed site that may require remediation, whose costs and risks should be allocated to the land owner.

Infrastructure and Utilities

It will be necessary for the Sponsors to identify at an early stage the infrastructure and utilities that will be required to build and operate the facilities. Among the key questions that will arise in this connection are: Is there any existing infrastructure that can be utilised? If so, on what terms? In the absence of any existing infrastructure, it may be necessary for the Sponsors to construct facilities such as marine terminals, pipelines, truck and rail transportation. As for utilities, what utilities are required for the project? From where will they be sourced? The Sponsors should ascertain the facilities to be built or acquired by the Sponsors, and services and utilities to be procured from third parties. Facilities to be built or acquired by the Sponsors will form part of the capital cost of the project, while services and utilities to be procured from third parties will be operating costs. It is quite common to have a mix of these two options.

One issue that the Foreign Sponsors regularly face is the question of reliability of any proposed third party service provider. Often, the provider of electricity and water to the project is the national electricity and water company of the host country. In such a case, the capital cost will be reduced as the project is leveraging on the existing infrastructure. However, reduced capital cost should not compromise the reliability of the utility supplier and the risk of supply interruptions. If the project is to be project financed, the Sponsors will also need to address any timing and interface issues that might be of lenders' concerns, especially where the proposed utility supplier is to construct new infrastructure to provide services to the Project Company.

Construction Strategy and Arrangements

Construction services for petrochemical projects are typically procured by way of: (i) lump sum "turn-key" EPC contracts (whether pursuant to a single or multiple contract structure); (ii) "EPCM" arrangements in which one or more contractors is engaged to undertake detailed design and, to manage and co-ordinate procurement and construction activities; or (iii) a hybrid of EPC/EPCM strategies.

The EPC strategy for a project will usually be considered, in the first instance, during the preparation of the feasibility study and then further developed during the early stages of the FEED. In developing the EPC strategy for a project, the Foreign Sponsors will principally be concerned with minimising capital cost and optimising the procurement schedule, but may also desire to promote or support contractors in their respective countries. In addition to price and schedule considerations, the Host Sponsor will regularly be keen to ensure that the selected EPC strategy maximises the participation of the host country's suppliers and labour and, develops the contracting market in the host country.

The EPC strategy will need to take into account any constraints resulting from the proposed financing structure for the project. For example, if project financing is contemplated, bankability concerns may, depending on the completion support package offered by the Sponsors, require the adoption of a single EPC contract pursuant to which there is, generally speaking, a transfer of completion risk to a credit worthy contractor (or consortium of contractors). Other relevant factors in deciding upon the EPC strategy will be: (i) the size and complexity of the project; (ii) the selected process technologies, including whether the Sponsors and/or lenders require process technology risk to be "wrapped" by the EPC contractors; (iii) the capacity of the Host Sponsor, in conjunction with the Foreign Sponsors, to manage a complex multi-package strategy (such strategies may deliver price benefits for the Sponsors but inevitably will mean that greater risk is passed to the Project Company/Sponsors); and (iv) the host country's contracting market, including the extent to which experienced international contractors are established in the host country or constrained from entering into the local market by, for example, ownership and/or licensing requirements.

The first contracts that will need to be put in place will ordinarily be process licence agreements. These will need to be negotiated and agreed with selected technology suppliers to enable the development of the basic engineering packages for the process units. Following completion of the FEED, and (typically) finalisation of shareholders agreement, the EPC contract(s) will be tendered and awarded. The number of contracts and the time and complexity of the tendering process for such contracts will be driven by the selected EPC strategy.

Bi-lateral Investment Treaties

As part of the legal due diligence exercise, the Foreign Sponsor should review the potential applicability of any international treaties that may provide legal, tax or other advantages. In particular, the Foreign Sponsor should ascertain: (i) whether there is any bilateral investment treaty (the "**BIT**") in force between the country of the Foreign Sponsor and the host country; and (ii) if it is in force, the terms of the BIT. A BIT is an agreement establishing the terms and conditions for private investment by nationals and companies of one state in another state. Most BITs provide that investments, made by an investor from one contracting state in the territory of the other contracting state, will receive certain guarantees such as fair and equitable treatment and protection from expropriation. A distinctive feature of many BITs is that an alternative dispute resolution mechanism outside of the host country and its own courts is allowed, whereby an investor, whose rights under the BIT have been violated, will have recourse to international arbitration, often through the International Centre for the Settlement of Investment Disputes.

The existence of a BIT will, of course, provide some degree of comfort, and depending on the nature and level of the proposed investment, protections provided thereunder may be sufficient to an investor. However, given the scale, commitment and level of investment required to develop a petrochemical project, it is unlikely that the mere existence of a BIT would provide sufficient comfort to Foreign Sponsors or their prospective lenders (if any). In certain circumstances, preferring specific and direct government support to the general protections offered under the BIT, the Foreign Sponsors (and their lenders, if any) may require the government of the host country to enter into an agreement with them and provide direct and specific contractual commitments for their benefit.

Government Support

A request for direct support by the government of the host country through an investment agreement or an implementation agreement may result in lengthy and difficult discussions. The government of the host country may be reluctant to provide direct support to the Foreign Sponsors, since the host country will have existing laws intended to regulate foreign investment generally and entering into a direct agreement risks creating a precedent for future foreign sponsors regardless of the sector of their investment.

There are a number of areas that the Foreign Sponsors may desire direct support or clarification from the government of the host country. For instance, the Foreign Sponsors may request assistance with respect to work permits/visa for their employees to work on the project in the host country. The Foreign Sponsors would also want seek confirmation from the government of the host country that the Project Company and any relevant projects will be treated equally with domestic projects and protected against any change in law, which would have an adverse effect on the Project Company or the investment of the Foreign Sponsors. Exemptions from currency controls, tax benefits, land rights, as well as availability and enforceability of lender security are also issues that the Foreign Sponsors would request support from the government of the host country.

Conclusion

The key issues and considerations highlighted above are an indication only and are not to be taken as an exhaustive list of concerns to be considered by a Foreign Sponsor. The nature and gravity of each matter will vary on a case-by-case basis.