Outsourcing projects: Lessons from Venezuela

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Nineteen ninety-eight was a tumultuous year for Venezuela, both in political and economic terms. Democratic elections put the presidency in the hands of Hugo Chavez, a former military officer, whose political platform and campaign rhetoric raised concerns in the foreign investment community about his commitment to free markets and foreign investment. A worldwide collapse in oil prices exacerbated Venezuela's economic and financial situation and has called into question the country's ability to service its US$22bn of foreign debt.

Despite these events and the virtual collapse of the Latin American capital and debt markets, Petróleos de Venezuela, S.A. ("PDVSA"), the Venezuelan state-owned oil and gas company, successfully outsourced three large oil and gas projects[1] to three different consortia in 1998[2]. These three projects (the "PDVSA projects"), which involved over US$1.5bn of investment, were part of a broader effort undertaken by PDVSA several years ago to increase the production and distribution of the country's oil and gas resources. The idea behind this effort, also known as the *Apertura* or the "Opening", is for PDVSA to use private sector participation as a means to access foreign capital and technology, while building relationships with local and foreign partners. This goal has been accomplished through oil field operating service agreements, profit sharing agreements, strategic associations, and outsourcing.

This article focuses on the major issues and considerations relevant to the successful outsourcing of a large industrial project drawing on the authors' experience with the three PDVSA projects to highlight significant issues and concerns.

What is outsourcing and why do it?

Outsourcing refers to an arrangement whereby a contractor or a consortium of contractors (the "contractor") obtains the right, generally from the government or a state-owned entity (the "sponsor"), to provide a particular service to the sponsor and, in certain cases, to other industry participants.

Outsourcing is different from other forms of government contracts or concessions, including technical assistance contracts, management or leasing contracts, licences or sales of existing business, because of the greater level of risk involved for the contractor. In the typical outsourcing project (the "project"), the contractor commits to design, engineer, construct, operate and, in some cases, own the project's assets. In comparison with the situation where a contractor is asked to either manage a project, lease a project for a fixed term or purchase an existing business enterprise, in which cases the contractor assumes only the operational and management risks of the enterprise, the contractor in an outsourcing project assumes, in addition to such risks, the risk associated with the design and construction of the project. Payment for the contractor's services is usually based on a monthly or quarterly tariff (the "tariff") payable over the term of the contract, which tariff reflects the expected costs (including financing costs) to be incurred by the contractor in connection with the project and a rate of return on the contractor's investment.

The question of whether or not to outsource a project will generally only arise if the project in question involves activities that are not part of the sponsor's core business operations. Understandably, sponsors are reticent to cede control over activities that are part of their core business activities whether or not there are economic or technical benefits that might be gained. Sometimes the line is difficult to draw. For example, although none of the PDVSA projects involved operations that were part of PDVSA's core activities (e.g., exploration or production), both the PIGAP II project (a gas reinjection facility) and the Jose Terminal project (a crude oil marine terminal) are critical to PDVSA's core activities.

If the project is suitable for outsourcing, the decision to outsource may be motivated by a number of factors. Frequently, a particular project will require significant new capital investment by the sponsor and the sponsor's capital resources may be limited. Even if the sponsor has sufficient capital resources or access to such resources, it may prefer to deploy (or conserve) such capital for its core business activities, where its return on capital is likely to be greater. This factor was certainly present in the PDVSA projects.

A second factor that sometimes motivates sponsors to outsource a project is the ability to benefit from, and possibly acquire, specific technical and engineering know-how or expertise. Bidders for outsourcing projects frequently organise themselves into consortia composed of companies that have specialised expertise in various aspects of the project (e.g., construction, equipment procurement, operation, etc.). By forming such consortia, bidders are able to leverage their technical and operational expertise and relationships to design, construct and operate the project less expensively and more efficiently than the sponsor, producing savings for the sponsor in the form of a lower tariff. In addition, as part of the terms and conditions of the project, sponsors will require that they obtain the right to use the know-how developed by or used in the project at the end of the term of the project.

A third reason a sponsor may prefer to outsource a project is to avoid or minimise its exposure to the completion risk associated with the design and construction phase of a particular project, a risk that the contractor (or, to some extent, its lenders or its EPC contractor) generally assumes in an outsourcing project. Avoiding this risk is particularly important in projects where the technology being utilised is untested or the design or location of the facility involves special site or other risks.

Finally, a sponsor may choose to outsource a project to achieve favourable accounting and/or budgetary treatment of such project. Depending upon the terms and structure utilised, the sponsor may be able to achieve off-balance sheet treatment of its payment obligations in respect of the project. Similarly, a project that is outsourced may be subject to varying characterisations (e.g., capital project or operating expense) for internal budgeting purposes, which may be desirable from the sponsor's perspective. Such considerations are sometimes particularly important to state-owned enterprises.

STRUCTURES FOR OUTSOURCING

There are three structures typically used in connection with the outsourcing of a project. The "build, own and operate" or "BOO" structure involves the construction, ownership and operation of the project by the contractor. The "build, own and transfer" or "BOT" structure is similar to the BOO structure except that at the end of an agreed-upon term (the "term"), the contractor transfers the project and its assets to the sponsor. The "build, lease, transfer" or "BLT" structure differs from the BOT in that the contractor does not own and operate the project during the term but rather leases the project to the sponsor before the project is transferred to the sponsor. While these three structures are similar in many respects, the choice of a particular structure will depend on a variety of factors, including whether the sponsor desires to have the facility transferred back to it at the end of the term, the extent of control that the sponsor wishes to exercise over the design, development and operation of the facility, the accounting objectives of the sponsor, and the level of project risk that the sponsor is willing to assume.

Treatment of the project at the end of the term and sponsor control over the project. The most obvious difference among the possible structures is whether the project is transferred back to the sponsor at the end of the term. In certain cases, sponsors are reluctant to permit the contractor to maintain indefinite ownership of the project for various reasons. First, a sponsor may wish to acquire the know-how and technology to operate and maintain the facilities during the term and take it over at the end of the term, particularly if the project is one of a series of similar such projects or is important to other activities in which the sponsor is involved. Second, sponsors, particularly state-owned sponsors, may wish to avoid the perception that they are selling off or losing control of state assets, particularly when foreign contractors are involved. Finally, and most importantly, the contractual right to acquire the project at the end of the term provides the sponsor with powerful leverage in negotiating an extension of the term on terms and conditions favourable to the sponsor.[3]

Closely related to the treatment of the project at the end of the term is the degree of control that the sponsor will want to exercise over the project. In those cases where the project ultimately will be owned by the sponsor, the sponsor may seek to impose more specific technical requirements on the design, construction and maintenance of the project. These technical requirements will ensure both minimum quality standards and the ability of the sponsor to operate and maintain the project when it is transferred back to the sponsor. Additionally, the sponsor may wish to ensure that the project's equipment and systems are compatible with its own. However, the more control the sponsor seeks to exert over the design, maintenance and operation of the facilities, the more it will limit the ability of the contractor to take advantage of its technical, engineering and operating expertise, thereby reducing the potential for cost saving and efficiency, one of the main reasons for outsourcing the project in the first instance.

Throughout the formulation and implementation of the PDVSA projects, PDVSA was careful to try to balance the need to have strict performance standards in the project documentation (the "project documents") while granting the contractor flexibility to achieve those standards in a manner that was compatible with its mode of operations.

Accounting treatment of the project. One reason sponsors often do not structure outsourcing projects to revert to the sponsor at the end of the term relates to their accounting objectives for the project. Such accounting treatment, which determines whether the project will be on or off the sponsor's balance sheet, depends in large part on the treatment of the project at the end of the term. Although it is not the only consideration that is relevant, generally speaking, the transfer of the project to the sponsor at the end of the term for little or no consideration will usually result in on balance sheet treatment of the project. In determining the proposed accounting treatment of a project, sponsors and their advisors will review the project documents in light of FASB 13, which deals specifically with the accounting treatment of leases.

The basic issue in the determination of the accounting treatment of a project is whether the project document that the contractor and the sponsor are entering into is an operating lease, which generally receives off balance sheet treatment, or a capitalisable lease conveying the right to use property, plant or equipment for a certain time period, which is generally on balance sheet. To distinguish leases from other arrangements, various aspects of the project are considered including, most importantly, the following: (i) whether the project assets revert to the sponsor at the end of the term or the sponsor has the right to acquire such assets for a nominal price, (ii) whether the term of the contact represents 75% or more of the estimated economic life of the project; and (iii) whether the present value of the fixed capacity payments (excluding certain costs) approximates or exceeds 90% of the fair market value of the project as of the date the parties entered into the project document. To the extent that the answers to the foregoing are in the affirmative, the project document will probably be treated as a capitalisable lease and the project will most likely be considered on balance sheet.

CONTRACTUAL ISSUES TO CONSIDER

No matter which structure the sponsor elects for the outsourcing of the project, the process will not be successful unless the project documents provide adequate legal protections and remedies for the contractor and the project lenders (the "lenders") and a fair allocation between the contractor and the sponsor of the risks associated with the project.

Financeability on a limited recourse basis. One of the principal concerns of a prospective contractor in assessing whether to participate in a project is the extent to which the project is financeable on a non-recourse or a limited-recourse basis. Accordingly, the ability of the sponsor to structure the project so that it is financeable on a limited recourse basis is absolutely essential. In the PDVSA projects, this was particularly important given the economic and political situation in Venezuela and the turmoil that was occurring in the international capital and debt markets at the time the projects were put to bid.

Perhaps the most critical element of structuring a financeable project is to ensure that the project documents permit the contractor to service its debt in almost all circumstances. From the contractor's perspective, this requires that the project documents contain "take or pay" tariff provisions, which provide that the contractor gets paid its monthly or quarterly tariff whether or not the sponsor actually "takes" the services provided by the contractor. In the PDVSA projects, PDVSA included modified take or pay provisions, which required PDVSA to pay for services if the services were capable of being provided whether or not they were being used by PDVSA.

With the exception of the Jose Terminal project, however, the take or pay provisions in the PDVSA projects did not require PDVSA to pay any tariff if the services were not capable of being performed, even if the non-performance was caused by a *force majeure* event.[4] In such circumstances, the contractor would have to rely on business interruption insurance or other means (e.g., debt service reserve accounts) to ensure that it could continue to service its project debt. Although structuring take or pay provisions in this manner may limit the sponsor's exposure in the event of *force majeure* type of events, it will also have the effect of increasing the tariff that it will pay, as contractors will reflect the cost of such insurance or other mechanisms in their tariff to cover such situations. For the sponsor, the decision to include broad take or pay provisions (at least with respect to *force majeure* events caused by governmental acts or omissions) and accept the risk of the occurrence of unforeseen developments or include narrow take or pay provisions and pay a higher tariff is typical of the conflicting interests a sponsor has to balance in structuring an outsourcing project.

A second set of contractual issues that will influence the financeability of the project will be the terms and conditions relating to the termination of the project documents. The contractor will wish to define as narrowly as possible the circumstances under which the project may be terminated by the sponsor, and it will require ample cure periods and broad step-in rights for the benefit of its lenders. At termination, the contractor will seek to ensure that the sponsor will purchase the project from the contractor at a price that, at a minimum, will cover the contractor's then outstanding project debt. In the PDVSA projects, the project documents were structured to provide for such minimum payment even in circumstances where termination was caused by a breach by the contractor or a prolonged *force majeure* event.

Additional provisions which the contractor will seek to obtain for the benefit of its lenders include the ability to pledge the assets of the project and the right to assign the contractor's rights and responsibilities under the project documents to the lenders, in each case without having to obtain the prior consent of the sponsor. In addition, the contractor will want the lenders to have the right to appoint a replacement contractor, in the event that the contractor is not fulfilling its obligations under the project documents.

The PDVSA projects included many of these and other provisions in an effort to facilitate the contractor's ability to finance the project on a limited recourse basis, including permitting the tariff to be payable in US dollars into offshore bank accounts, protecting against certain legal risks (see discussion below) and, in the case of the Jose Terminal project which was a multi-user project, requiring that users of the facility meet certain minimum credit quality criteria.

Changes in project conditions. In addition to ensuring that the project is financeable on a limited recourse basis, the contractor will want to protect its equity investment in the project against changes in project conditions. For such purpose, protection will be sought against unforeseen changes in the economics of the project and in the applicable legal and regulatory environment. These include changes in law, particularly environmental and tax laws, for which the contractor will argue that the sponsor is better positioned to take the risk (at least in the case of a state-owned sponsor). The contractor will request that the tariff be adjusted to reflect the impact of such changes above agreed-upon levels. The contractor will also seek tariff adjustments for changes based on inflation rates (at least with respect to fixed and variable operating costs), changes in funding costs between bid submission and financial closure, labour costs, exchange rates and other matters. Sponsors rarely agree to assume all of these risks and sometimes, recognising this, contractors request instead a general "stabilisation clause", which would permit them to renegotiate the terms and conditions of the project documents (including the tariff) if there is any change in law or certain other specific conditions that adversely affect their expected return.

In the PDVSA projects, PDVSA provided protections for changes in environmental law with provisions for the adjustment to the tariff if any such changes resulted in an increase in the contractor's operating costs over a certain percentage. PDVSA provided similar such protection for increases in labour costs and value added tax rates during the construction period of the ACCRO III and IV and the PIGAP II projects. Increases in municipal taxes were also addressed in the PDVSA projects, but the mechanism for the protection was slightly different from a straight adjustment to the tariff. In the event of an increase in municipal taxes, the contractor had the option of absorbing such increases or requesting an adjustment to the tariff. If the contractor requested an increase in the tariff, but PDVSA and the contractor were unable to mutually agree on such adjustment, then PDVSA had the option of either indemnifying the contractor for the additional amount of municipal taxes paid by the contractor or purchasing the project for the net present value of the remaining tariff stream using the same discount rate as is applied to termination of the project in the case of a prolonged *force majeure* event.

Providing upside for the contractor. A project will be more attractive to a prospective contractor if the project provides the contractor with the potential to increase its returns by generating additional revenue from the project other than by collecting the tariffs paid by the sponsor. Such potential upside might include the ability of the contractor to offer the services it is providing to the sponsor to third parties. In the Jose Terminal project, for example, the contractor can offer shiploading and storage services to third party users of the terminal and generate additional revenues. Similarly, in the PIGAP II project, the project documents permitted the contractor to use the heat generated by the gas injection facility to co-generate electricity for its own use and for sale to third parties.

Projects which allow for the possibility of additional revenue or growth are attractive to contractors not only because they may be able to realise greater returns on their investment, but also because they permit the contractor to respond to changes in economic circumstances. The contractor is able, for example, to charge a new, presumably higher, tariff to new users to reflect changes in economic conditions. This last point is usually not lost on project sponsors. Projects which contain mechanisms to permit the contractor to capture additional upside usually contain less protection against the type of risks that tend to reduce the contractor's return.

THE PROCESS: HOW THE PROJECT IS AWARDED

The contractor for all three of the PDVSA projects was chosen following the completion of a competitive bidding process which was designed to enable PDVSA to create an environment in which it would receive the lowest tariff. Such a bidding process also ensures a sponsor the greatest amount of control over the negotiation of the transaction, the structure of the process and the drafting of the project documents. It is also an effective way of assuring the transparency of the process, a critical factor for state-owned sponsors.

Companies were invited to participate in each of the PDVSA projects based on minimum financial criteria and, in the case of the prospective operators of the project, minimum technical qualifications. Companies that elected to participate in each process received initial drafts of the project documents (which included both the legal documentation and the technical specifications) and were given the opportunity to comment on such materials in writing and during question and answer sessions with PDVSA and its financial and legal advisors. Prospective contractors were allowed to perform due diligence on the project through visits to a data room and tours of the site for the new PDVSA projects and existing PDVSA facilities. Final project documents were distributed to bidders prior to the date on which the bids were due. The final project documents were non-negotiable and bidders were asked to base their bids on the terms and conditions of such definitive project documents.

In the ACCRO III & IV and PIGAP II projects, the bid consisted of a technical bid, which detailed the specifications in accordance with which the bidder proposed to design and construct the project, and an economic bid, which set forth the proposed tariff structure. Technical bids, were opened first and were evaluated to determine whether the technical specifications met the minimum requirements set by PDVSA. Once the bids were determined to be technically acceptable, the economic bids were opened and the contractor with the lowest net present value tariff was awarded the bid, provided that such bid was below an established benchmark. The benchmark, which was determined by PDVSA after the submission of the bids, but prior to the opening of the economic bids, was based on PDVSA's best estimate of what it would cost PDVSA to do the project itself.

Conclusion

While BOO, BOT and BLT structures are not new concepts to project financing, the use of such structures by governments or state-owned entities for the development of their own commercial activities is a recent phenomenon in Venezuela. Given the continued increase in the number of project financings worldwide[5] and the fierce competition for access to the large capital resources that such projects require, the outsourcing of projects provides an attractive alternative to traditional methods of financing. The successful bidding of the PDVSA projects will provide a model for future outsourcing projects, whether in Venezuela or in other emerging markets.

Notes:

[1] *ACCRO III & IV is a US$640m project consisting of (i) natural gas liquids extraction facilities in Santa Barbara and San Joaquin, Venezuela, (ii) a natural gas liquids fractionation facility in Jose, Venezuela and (iii) natural gas liquids storage and refrigeration facilities in Jose, Venezuela. PIGAP II is a US$570m gas injection facility in North Monagas, Venezuela. The Jose Terminal is a US$400m crude oil storage and ship loading terminal project in Jose, Venezuela. The successful bidders for these projects included companies such as Enron International, TransCanada International, Williams International · Company, Enbridge International, Schlumberger's Production Operators and Northville Industries.*

[2] *The legal documentation for the ACCRO III & IV project was executed in August 1998, for the Jose Terminal project in December 1998 and for the PIGAP II project in February 1999.*

[3] *If the project is structured to revert to the sponsor at the end of the term, the project documents will need to contain provisions regarding, among other things, payment to the contractor upon the expiration of the term, maintenance of the assets prior to the expiration of the term, the manner in which insurance proceeds for full or total casualty losses are dealt with given the sponsor's reversionary interest in the project, and the contractor's decommissioning and/or remediation obligations.*

[4] *In the Jose project, PDVSA agreed to pay a portion of the tariff for up to 60 days despite the occurrence of a force majeure event. In addition, in the ACCRO III & IV and the PIGAP II projects, in certain limited circumstances, if the services could not be provided during a force majeure event, PDVSA was required to make the tariff payments.*

[5] *In 1997 and 1998 alone, over 900 project financing transactions were signed.*

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