

4TH ANNUAL ASIA PACIFIC 2012
19 JUNE 2012, SINGAPORE

FPSO LEASE CONTRACTS

PRE- & Post Contractual Risk Management

*“ It is never the risk that causes
damage or creates opportunity
it is the response ”*

Ernst & Young

Joseph & Partners

ADVOCATES SOLICITORS

BW PIONEER FPSO

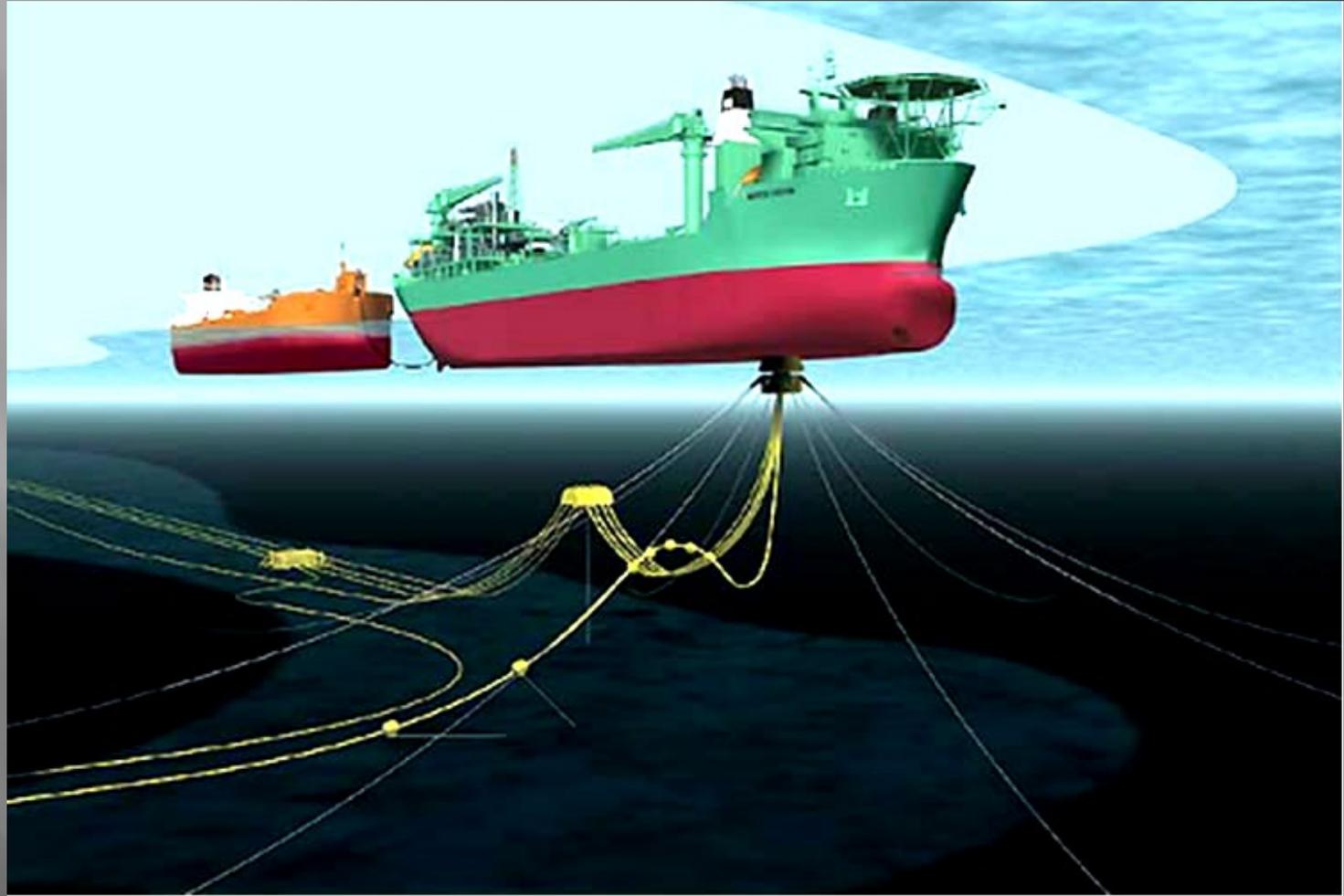


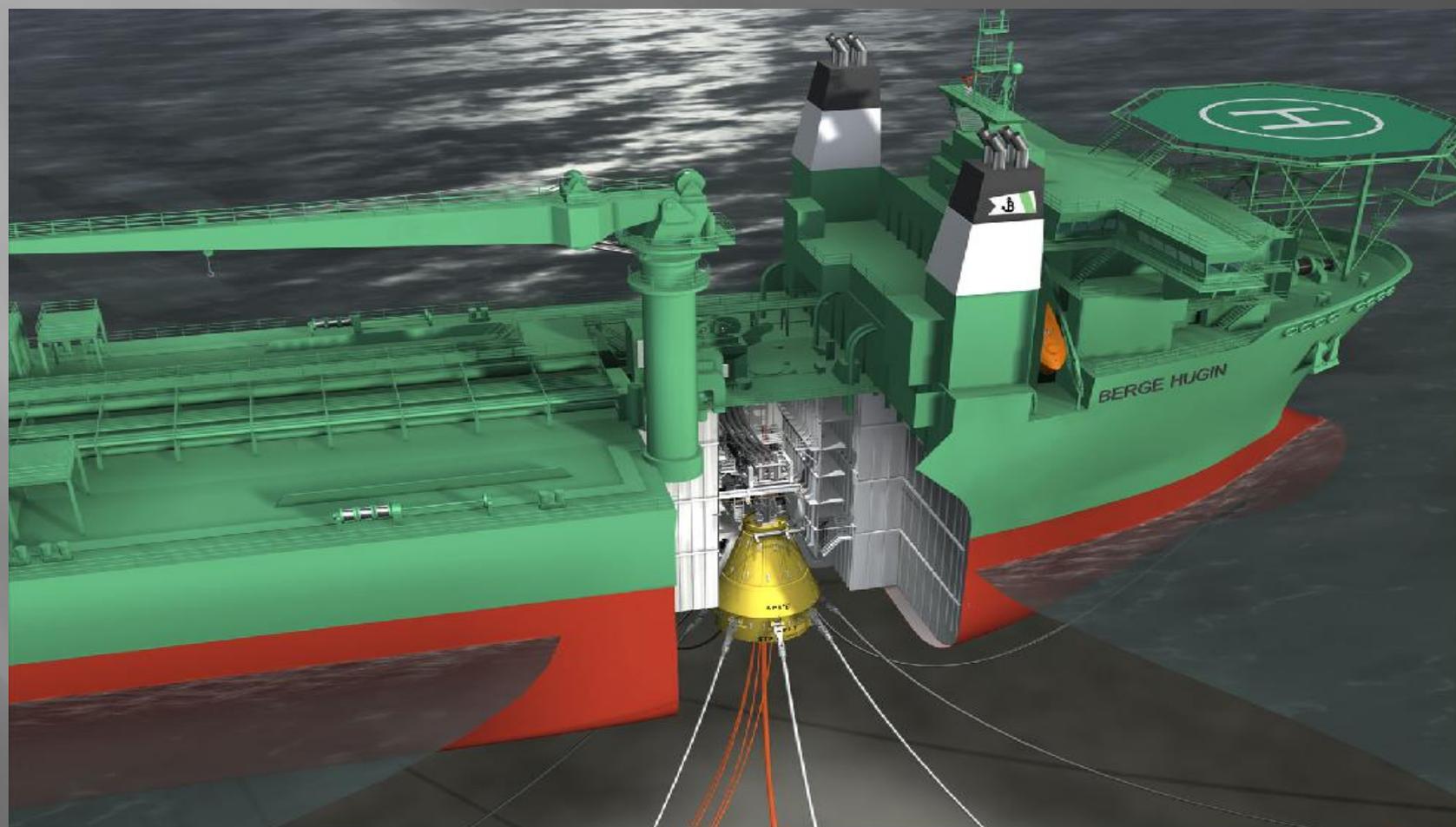
FPSO QUEENSWAY











Pierce STP



ASIA PACIFIC FPSO MARKET

- Asia Pacific Countries expected to lead charge for oil and gas exploration with Malaysia expected to be for runner.
- Large number of these oil fields will utilize FPSO both newbuilds and conversions as opposed to fixed production platforms

Drewry Report.

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FPSO OVERVIEW

The FPSO in context of the wider offshore industry
FPSO market Capex expected to increase relative to other platform markets driven by:

Maturing of shallow water regions

promotes deepwater growth

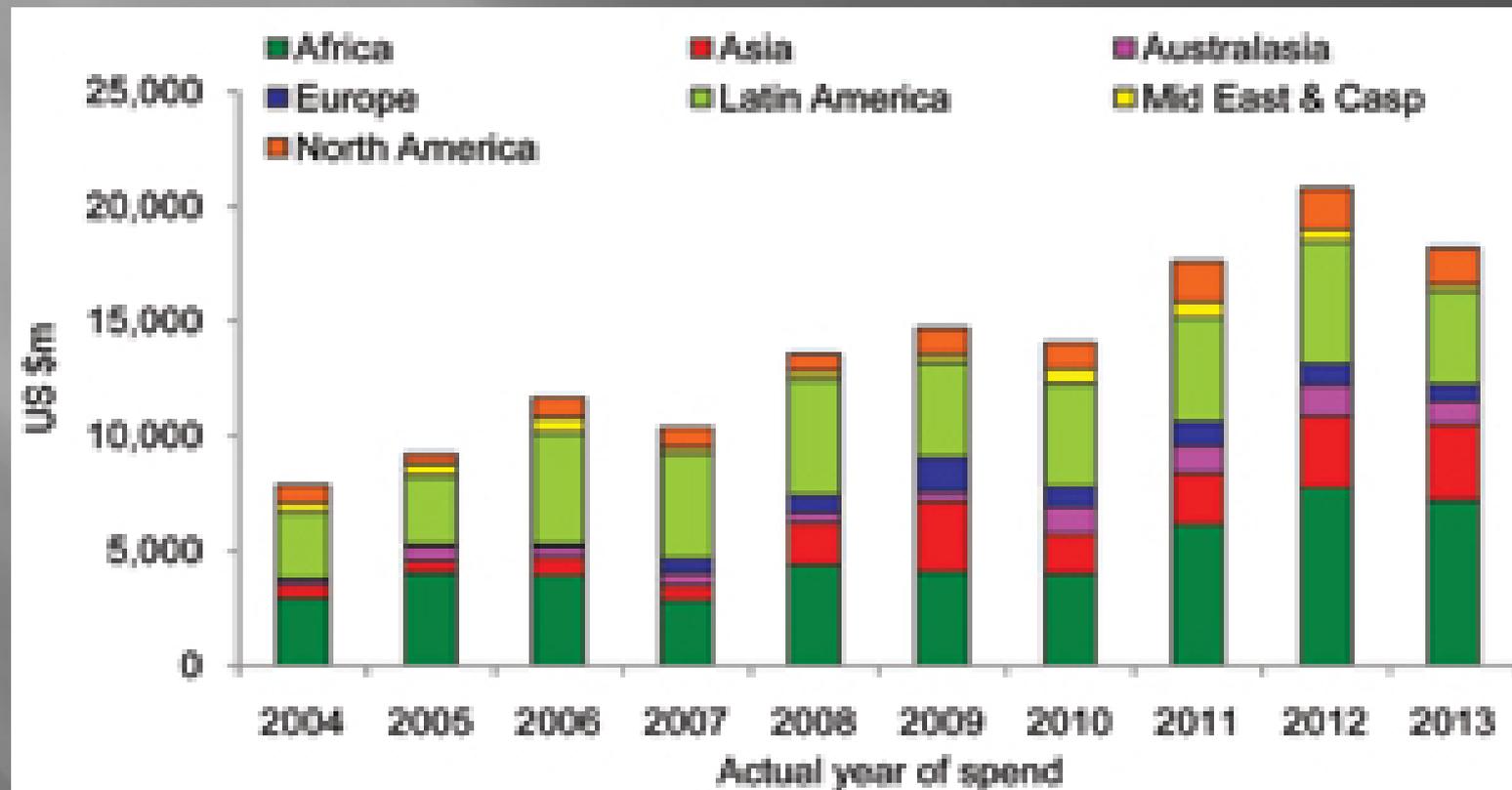
Encourages leased assets

Nationalisation of shallow water reserves –

Majors & large Independent Oil Cos have valuable deepwater experience far away from exportation infrastructure

Global floating production capex (US) spend by region 2004-2013

Floating production capex to exceed \$85 billion 2009-2013



. (Source: "Global Perspectives Floating Production Market Update 2009/13")

IMPACT OF CREDIT CRUNCH ON FPSO MARKET

The lack of credit and falling oil prices, which are considered short term, causing

- project delays and cancellations
- concerns about many operators' financial and operational stability.

Even with project delays and deferrals, the total FPSO market over the period 2009 through to 2013 is set to exceed \$85 billion of capital spending, an increase of \$32 billion over the previous five years.

FUTURE OF FPSO

The future for the FPSO is bullish because of advantages of an FPSO is that it is Floating production, storage, and offloading (FPSO) vessels will command the majority of the expenditure within this sector, with expenditure likely to reach \$48.6 billion, of which 45% will be new-builds and 55% conversions.

This reflects the advantages they offer over other development solutions.

FUTURE OIL AND GAS DEVELOPMENT

During the forecast period 2009 to 2013, further growth and capital intensive developments associated with deep and ultra-deepwater projects, which are crucial drivers for floating production market growth.

The whole industry is moving toward deepwater and ultra-deepwater developments, in more severe environmental conditions and more remote locations.

EFFECT OF FINANCIAL CRISIS ON FPSO MARKET

There are currently three main interrelated areas of concern affecting the contemporary global oil and gas market:

potential future under-investment,
declining revenues of oil and gas companies, and
the financial crisis leading to recall or repayment of loans ahead of time as well as the lack of re-financing.

PROJECT CANCELLATIONS

The credit crunch has caused a number of **project cancellations and deferrals**. Especially units built on speculation.

Among those cancelled :

East Venture and East Challenge FPSOs.

FPSOcean, which recently entered into liquidation proceedings, having failed to secure financing or win a contract for its spec built Deep Producer 1 FPSO.

FPSOcean sold an Aframax tanker to Greek buyers for \$22 million, which they were holding tankers as possible conversion candidates.

Deep Producer 1 remains unfinished at Dubai Drydocks.

PROJECTS ON HOLD

Nexus Floating Production experiencing difficulties in finding a solid contract for the Nexus 1 FPSO.

In 2008, Nexus signed a letter of intention with Burgundy Gobal Exploration Corp. for the seven-year lease of the unit for an estimated \$800 million for use in the Camago-Malampaya oil rim project.

As of mid-April, BW Offshore, which has a marketing agreement with Nexus, had signed a letter of understanding with Premier Oil for the potential charter of Nexus 1 for use offshore Vietnam.

Samsung Heavy Industries expects to deliver Nexus 1 in June. The Nexus 2, also under construction at Samsung, has been deferred due to the lack of leasing opportunities.

The new delivery date is November 2012.

PRE- CONTRACTUAL STAGE

Long and often complicated process of preparation and negotiation.

Decisions made and positions taken in this pre-contractual phase may have a significant impact on the final risk allocation and thereby, directly and indirectly, the net income of the project.

The contractor should keep this in mind, as early gains could lead to later damage to success and profitability.

PRE-CONTRACTUAL STAGE

An FPSO project, from contractual commitment to first oil, will take from 15 to 30 months.

The contractor will normally finance the assets and the conversion work, and receive payment at a day rate starting at the commencement of field operations.

The contractor consequently makes substantial investments according to field-specific requirements before the commencement of revenues.

The contractor's financial exposure and risk profile means that it is vulnerable at the beginning of the project.

Pre-qualifications

The field operator might begin the FPSO project with official pre-qualifications, whereby they consider potential contractors and various technological solutions in order to determine the optimal development of the field

PRE – CONTRACTUAL STAGE

The main focus will normally be on technical solutions. the contractor may have to prepare a commercial indication together with corporate and contractual structures.

Can impact on the later tender preparations or contract negotiations, as the proposed legal structure may create an 'anchor' effect, effectively binding the contractor in later negotiations.

Furthermore, the tax perspective should be a part of the contractor's evaluations, starting at this early stage.

Proposed confidentiality agreements should also be reviewed.

Parties should be aware that such agreements sometimes contain obligations and liabilities that go beyond confidentiality-related issues.

The pre-qualifications might also contain formally binding qualifications that should be reviewed and analyzed.

TENDER STAGE

After completion of the pre-qualifications, the company will single out potential contractors and decide on a path forward. The most common method of determining the final FPSO contractor for the project will be through an invitation to tender.

INVITATION TO TENDER

Invitation to tender

(ITB)

Package of technical, commercial and legal requirements issued by the company together with an invitation to the potential contractors to show how they meet them. The contractor will need to put together a package of technological solution, delivery schedule and price which constitutes a favourable offer to the field operator.

Vital legal issues that must be considered at this stage, for example:

ITB asking for a binding bid and, if so, will it permit legal qualifications?

Any structural requirements included, such as requirements for a potential contracting party?

Should contractor decide on its own legal structure at this time?

Should a consortium model be considered?

Is there a reference to a certain jurisdiction?

Does the invitation to tender include standard contractual documents?

What are the important tax and import issues in the relevant country?

Does the relevant country require a certain local presence?

Should the contractor initiate negotiations with potential local partners?

PRICING AT TENDER STAGE AND RISK ALLOCATION

The price (normally a day rate) which the contractor is offering is implicitly based on a certain contractual risk allocation.

price is coherent with the proposed risk allocation.

costs of finance which are based on revenues (commencement of day rate)

Effect of delays in the money stream

Bid make the necessary qualifications so that the pricing is coherent with the final risk allocation in the contract.

NEGOTIATION STAGE

Negotiations

Following one of the above stages, the field operator will normally single out one or two contractors as potential partners for the project.

At this stage the field operator will have two main focuses: (i) to ensure fast-track schedule/commencement of the project; and (ii) the coordination and interface between the completion of the drilling phase, subsea hardware delivery and installation, and hook-up of the FPSO. The field operator will not wish to commit itself to the purchase or charter an FPSO with defined delivery dates without ensuring that other necessary deliverables for field development are available at the relevant time. It is therefore unrealistic to rely on a fully negotiated FPSO contract before commencement of the work in order to secure schedule, and the parties typically negotiate a letter of intent or heads of agreement as a confirmation of the tender award. This phase involves substantial challenges for both parties.

ALTERNATIVE TO TENDER

Single source negotiations

Field operators may approach only one lease contractor in order to start negotiations directly, without a tender phase. For these projects, the points below concerning negotiations will apply.

FEED STAGE

Front-end Engineering and Design studies from potential contractors

Front-end Engineering and Design (FEED) studies may be ordered before and after a pre-qualification or independently. The FEED contractor is more of a subcontractor to the field operator and will be paid for the specific service. However, if this delivery results in the later award of the lease contract, the issues under discussion could become a source of contention. The FEED contract should therefore be reviewed with this in mind. In any event, regulation in respect of design protection and general IP protection must be addressed.

LETTER OF INTENT

Commitment from operator so contractor needs to start placing orders with subcontractors in order to meet the time schedule.

Cancellation fees should be covered. Contractor should avoid any kind of reservoir risk.

The contractor should also consider whether bank guarantees and/or corporate guarantees should be required accordingly.

Projects where several partners are developing the field, but only the minor partner will be the formal contract party.

cancellation fees can end up worthless if backed by a single purpose company.

This illustrates how the contractor should already at this stage be focusing on avoiding any kind of reservoir risk.

Finally, the letter of intent/heads of agreement should include regulation covering the possibility that this part of the pre-contractual phase is extended for any reason.

FPSO LEGAL ISSUES

FPSO contract is complex – requires careful navigation

FPSO CONTRACT STRATEGY

- Turnkey Strategy

Operator employs single contractor (as Head Contractor) to manage and integrate project with sub-contractors.

- Modular Strategy

Operator contracts separately for component parts of the project like design, procurement, construction and installation. Operator manages marine and offshore operation of the FPSO itself.

FPSO CONTRACT PYRAMID

Operator (Production License or PSA)
Acquisition of vessel
Conversion of vessel or new build
Conversion/Shipbuilding contract with shipyard
Procurement of Contractor – Equipment
Design Engineering
Consultancy for Delivery and Managing
Towing, Installation and Hook Up
Commissioning of FPSO
FPSO ACCEPTED BY OPERATOR
Operation and Maintenance Contract

FPSO KEY CONTRACT ISSUES

- Contract Work Scope
 - Design Responsibility
 - Technical Specs
 - Functional and Descriptive
 - FPSO on board processing system

FPSO KEY CONTRACT ISSUES

FPSO CONVERSION

- Head contractor and sub-contractors, the shipyard, and materials required to incorporate the new design with existing structure for new and old to operate together. Interface level.

FPSO KEY CONTRACT ISSUES

- Indemnities

Knock for knock – operator and contractor indemnify each other against property damage, personal injury, death sustained by member of own group & employees in performance of project “Irrespective of Cause “ and regardless of whether the damage has been inflicted negligently or in breach of duty.

Limit indemnity to damage or injury, definition of operator, broadly or narrowly , does it include personnel in the field

Narrow indemnify not to extend to property and personnel of its own contractor .

Alternative ; “stand alone “ field mutual hold harmless agreement
Each contractor assumes risk for his own property and personnel indemnifies n etc.

FPSO KEY CONTRACT ISSUES

- Post Delivery Defects – harmonise various project contracts

defects affects production
affect day rates

Down Time who is willing take responsibility for this

Loss of Hire Insurance This is one of the largest exposure faced by head contractor.

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FPSO CONTRACT RISKS

Back to Back Terms

Force majeure

Liquidated damages for late delivery

Technical & Functional requirements under FPSO contract similar to those included in contract between owner and supplier and

guarantee periods must be for similar duration

RISK MANAGEMENT

The following risks must be considered when negotiating FPSO contracts:

The credit risk for FPSO clients and the need for parent bank guarantees are often underestimated; the contract must clarify whether the oil company is acting on its own account or on behalf of a licensed group with *pro rata* liability between the participants (if so, the contract must identify the participants);

Liquidated damages and the penalty structure for late delivery must be specified; the procedure for acceptance of the FPSO vessel under the FPSO contract often involves integration risks that should be placed with the FPSO client;

The owner should not suffer financially if undersea installation is delayed or the FPSO client is not ready;

A performance-based hire structure may be complicated and may depend on integration and interfacing with other parties or on reservoir management that is out of the control of the owner;

Subjective termination rights should be avoided;

The early termination fee should cover the net present value of the contract;

RISKS MANAGEMENT

- ▣ The owner should never accept reservoir-related risks;
- ▣ Exceptions from the 'knock-for-knock' principle in liability provisions must be identified and preferably clarified with the insurers;
- ▣ Net earnings after deduction of local and central taxes (including withholding taxes) must be stated; it may be an advantage (and often a requirement) to operate through a company located in the jurisdiction of operation;
- ▣ Local content requirements may be difficult to satisfy due to the unavailability of competitive and qualified local resources; and
- ▣ Risks of political or legal changes should be borne by the FPSO clients.

- ▣ Traditionally, banks financed a FPSO conversion project only when the owner had secured a long-term FPSO contract. Banks must assess in priority the risk of cost overrun during the conversion period, as well as the risk of off-hire and termination during the operation period.

- ▣ The aim of the security structure is normally to enable the banks to complete the conversion project and perform the FPSO contract (through a nominated company or by selling the project). This is an ambitious aim; there would be many pitfalls if security interest in the FPSO project had to be enforced.

- ▣ In order to complete a conversion project, banks must have taken assignment of the ship conversion contract and all other relevant procurement contracts (in addition to a mortgage against the vessel). This may be possible from a legal point of view, but completing the FPSO project on time and within budget will be a challenge.

- During the operation period, the position of the banks is more traditional and is similar to other financing methods based on hire payments under a long-term charter contract. Banks must consider certain issues, including whether the mortgage against the vessel also covers the various modules installed. Some of the modules may be leased or installed in such a way that the laws of the flag of the vessel do not consider the modules as part of the vessel (but as equipment that may be removed).

- If banks want to enforce the mortgage against the vessel, a potential problem is that the vessel may be located outside the jurisdiction of any competent court. Moreover, enforcement may occur through the courts of a jurisdiction that lacks a sophisticated enforcement legislation.
- Banks may wish to enforce a defaulted loan by invoking their step-in rights based on an assignment of rights under the FPSO agreement. However, banks will be reluctant to perform FPSO contracts in light of the risks and benefits for the remaining contract period, and FPSO clients may not have agreed that banks will be entitled to nominate a third party to step in and perform the contract for the remaining contract period.

- FPSO clients often demand a 'quiet enjoyment' letter providing that the banks shall not be entitled to enforce a mortgage against the vessel (if it jeopardizes operations) as long as hire payment is made under the FPSO contract. There is no standard quiet enjoyment letter; therefore, banks can strengthen their position towards the FPSO client in a default situation by negotiating the terms of the letter. The terms of the letter may be linked to the assignment of the FPSO contract to the banks. Quiet enjoyment letters may include:
 - an acknowledgement of the assignment;
 - the duty of the FPSO client to notify the bank of any default under the FPSO contract;
 - the right of the bank to remedy such default; and
 - the right of the bank to sell the vessel and the FPSO contract (in which case the FPSO client must cooperate).

- ▣ Lease/ Charter of an FPSO
- ▣ This would involve the oil company leasing or chartering the FPSO for a fixed period of
- ▣ time in consideration for payment of hire. There are two main types of leases: an
- ▣ operating and finance lease.

- ▣ **Operating/Finance lease**
- ▣ A finance lease is a contract that transfers ownership of the property to the lessee at the end of the lease term i.e. it is a contract for the lease of property that possesses the characteristics of a purchase.
- ▣ A finance lease is more akin to a form of structured outright ownership and it is therefore not applicable to my discussion here, which contemplates only true leases. An operating or direct lease is one, which provides the lessee with the use of an asset for a period of time considerably shorter than the useful life of the asset.
- ▣ The lease agreement is usually cancellable and the lessee in most cases does not assume the economic risks and rewards of ownership like early obsolescence and appreciation.

- Under an operating lease, the oil company/lessee takes the unit on lease direct from an oil service contractor/lessor, who specialises in the lease and operation of FPSOs, for a fixed period of time, possibly the useful life of the field. The lease period would however be considerably shorter than the useful life of the FPSO. This is because the operating lessor
- looks to different lessees to recoup its investment by successive re-hiring of the unit.
- The operating lessor supplies the FPSO to the oil company on a lease and operate basis
- by providing the FPSO, the offshore crew to operate the FPSO, insurance, and general
- maintenance of the FPSO during the lease term. The parties would usually enter into two
- separate agreements: the agreement for the lease of the FPSO and a separate operating
- and maintenance contract. The agreement would usually not provide for a purchase
- option and if it does, it may not be conclusive in the sense that the price and the terms and
- conditions of sale may not have been fixed.

- **Time/bareboat charterparty**
- The provisions of an operating and finance leases in a shipping context, appears to be
- more akin to a time and bareboat charter party with the exception that a time charter party usually gives the oil company an option to purchase the FPSO after a stated period, usually after the costs have been amortised in the charterer's books. The charter becomes the lease, the charter party the leasing agreement and the charter hire becomes the lease rental payments.
- The main advantage in opting for a lease is that the acquisition does not involve the huge capital outlay required for an outright purchase/ownership and the purchase option gives the oil company the flexibility of purchasing the unit at the expiration of the charter period. FPSOs offered on a lease and operate basis would appear to be more adaptable for smaller to medium sized fields whose proven reserves are sometimes too small to justify an investment in full field development production facilities. Such FPSOs are less likely to be field specific and re-usable on multiple field projects without incurring huge conversion costs.

LEASING – FINANCE LEASES

- contracts for lease of property possessing the
- characteristic of a purchase. A finance lease can be defined as a lease that covers
- substantially the useful life of an asset or the net present value (NPV), using minimum
- lease payments and the interest rate at the inception of the lease, is equal to or greater than the fair value of the leased asset.
- The lease is usually non-cancellable because generally speaking, the lessor has entered into the leasing transaction to obtain a return on an investment, which can only be earned over time with the realisation of tax benefits. If the lease is terminated early such benefits are lost and the lessee may wish to be compensated by receiving a lump sum on the termination date equivalent to the NPV of the benefits, which would have been earned if the lease had run its full course.
- The lease usually contains a purchase option for the equipment to be sold to the lessee at the expiration of the lease term at a nominal price, which is likely to be exercised.
- However, depending on the jurisdiction concerned, the lease agreement may have to be silent on the purchase option, in order to enable the lessor to claim capital allowances. In some countries, the lessee claims capital allowance in a finance lease while the lessor claims in an operating lease. Therefore, in order to prevent the lease from being categorised as a finance lease and allow the lessor to claim capital allowances, the lease agreement would be silent on the purchase option. The purchase agreement would be contained in a side agreement and at the expiry of the lease the unit would be disposed of to the lessor at a nominal price. In a finance lease, the lessor provides only the FPSO while the oil company operates and maintains the unit by itself or through third parties on its behalf.

- Under this form of financing, the oil company/lessee could either take a lease of an
- existing FPSO or approach a lessor to finance the construction or conversion of the FPSO
- and subsequently lease it to the oil company/lessee. In the latter case, the lease would be
- structured as a leveraged lease and would be referred to as construction financing. A
- leveraged lease is a variant of a finance lease and is usually used for financing the
- acquisition of large capital equipment project with an economic life of about 25years or
- more and very appropriate for financing large FPSOs.

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FPSO LEASING OPTION

Within the FPSO market, the **leasing option** is a developing area that gives operators certain advantages.

Allows the operator the opportunity to avoid putting this asset onto its own balance sheet and also to pass on the risks associated with construction (in particular, delay) to an FPSO owner, with extreme penalties incurred if deadlines are missed.

The FPSO leasing market has recently seen the addition of several new small entrants to the large companies such as SBM and Modec, long established as major leased FPSO suppliers

- **Leveraged lease – Construction Financing**
- The oil company/lessee approaches a lessor for the lease/financing of a FPSO to be newly constructed and leased to the oil company. Upon successful negotiations with the lessor, the oil company will award an EPCI contract for the construction of the FPSO.
- The title to the unit will be transferred to the lessor during the early stages of construction, the construction contract will be assigned by the oil company/lessee to the lessor and construction financing will be arranged.
- Although the construction contract is strictly between the oil company/lessee and the construction contractor, the lessor who would end up being the ultimate owner in name of the FPSO may wish to supervise the performance of the construction contract. In order to facilitate this, a construction supervision agreement will be entered into between the oil
- company/lessee and the lessor to enable the lessor in the capacity of construction supervisor to oversee the testing, delivery and acceptance of the FPSO.

- The parties to a leveraged lease would include: –
- a. The lessee/oil company who approaches the lessor for financing, determines the FPSO to be constructed and leased, negotiates the price and warranties, awards the contract and subsequently hires the use of the FPSO by entering into a lease agreement with the lessor.
- b. The lessor/equity participant who becomes the owner of the FPSO by providing only a percentage (typically about 20%) of the capital necessary to purchase the FPSO. The lessor receives the rental payment remaining after the payment of debt service and any trustee's fees and claims the tax benefits incidental to the ownership of the leased FPSO.
- c. The lenders/loan participants, provide the remainder of the capital (typically about 80%) required to purchase the FPSO on a non-recourse basis to the lessor/equity participants. The loan is secured by a first lien on the FPSO, an assignment of the lease and of the lease rental payments.
- d. The owner trustee represents the equity participant/lessor and acts as the lessor by executing the lease agreement and all other documents the lessor would normally sign in a lease. The owner trustee holds title to the FPSO for the benefit of the equity participant/lessor subject to a mortgage in favour of the loan participants/lenders.
- e. Indenture trustee is appointed by and represents the lenders/loan participants. The indenture trustee and the owner trustee enter into a trust agreement where the owner trustee assigns to the indenture trustee, for the benefit of the lenders/loan participants and as security for the leveraged debt and any other obligations, all of owner trustee's interest as lessor in the FPSO, the lease agreement, the right to receive rents and any payment under any other agreement.

- A single trustee may be appointed to act as both owner trustee and indenture trustee. This will usually be the case in a simple leveraged lease transaction
- possibly with possibly one equity participant and loan participant. However, the disadvantage is that there could be serious conflicts of interest between the equity participant and the loan participant particularly in the event of a default by the lessee.
- f. The construction contractor constructs the FPSO to be leased. The contractor receives the contract price at a period stated in the contract and delivers the FPSO to the lessee at the beginning of the lease term. Completion period and warranties given by the contractor as to the qualities, capabilities and efficiency of the FPSO are important to the lessor and the lenders and in some cases the contractor may be required to enter into a direct agreement with the lenders.

□ Purchase versus Lease

- The oil company requires huge capital outlay for the purchase whereas in a lease, there is no initial capital outlay as the FPSO belongs to the oil service contractor and is being hired for a fixed duration of time.
- Although ownership involves huge capital outlay at inception, the oil company/owner retains the risks/rewards of ownership of asset e.g appreciation and residual value of the FPSO which will not be available to a lessee under an operating lease.
- Operation and maintenance of the FPSO will be borne by the oil company while in a lease, the maintenance and operation is the responsibility of the oil service contractor
- Lessor.Construction/completion risk is borne solely by the oil company in a purchase while it is borne by the lessor/oil service contractor in a lease.
- The transaction will be noted on the company's balance sheet in a purchase while a lease can be done off balance sheet.
- If a purchase is financed through loan financing, lenders' security will be limited to a mortgage on the FPSO while in a lease, title is vested in the lessor. However, if the lessor is a bank/financial institution, the value the lenders will place on it for valuation purposes will be similar to the valuation for a mortgage as the bank would not be interested in operating the FPSO and would therefore need to be satisfied that the lessee would be able to make the hire payments as and when due.

- **Conclusion**
- FPSOs are going to get more popular in the field development programs of oil producing countries all over the world as oil companies continue to prospect for crude oil in deep and ultra deep waters offshore. The method of acquisition suitable to each company would be determined to a very large extent by the company's corporate structure, needs
- and or preferences. For instance a multinational oil company with a large field with huge reserves may require a huge FPSO for the production of the field, this may not necessarily be adaptable to the needs of a small oil company and failure to realise this could of course lead to disastrous consequences.
- The various modes of acquisition and financing have been discussed and each has its peculiar features, which would be relevant depending on the preferences and needs of the company involved. It is therefore important for the various participants embarking on an FPSO project to be acquainted
- with the options available to them whether for purposes of acquisition, financing, construction or leases in order to be in a position to make informed decisions which
- would ultimately result in the success of the project.

Thank you

Contact Details

Primila Edward

Straits Consulting Group

Tel : +603 2300 0414 | Fax : +603 2300 0414

Mobile : +6016 6723 576

Email : primilaedward@yahoo.com

Jeremy M Joseph

Joseph & Partners

Tel : +603 62037877 | Fax : +603 62037876

Mobile : +6012 3955 594

Email : jeremy@jnplaw.my

Website : www.jnplaw.my

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SOLICITORS