Chapter

4

Formation of Joint Ventures

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4.1 Introduction

Globally Joint Ventures are formed with the core intention of risk and experience sharing with joint ventures (JV) partners and the mode of formation varies strategically from country to country depending on the law of the land. Internationally, Incorporated/ Unincorporated Joint Ventures/Subsidiaries are created based on host country's statutory requirements; their petroleum laws; Production Sharing Contracts. Additionally, the structure for holding a participation interest in a particular asset is also a function of tax laws wherein the companies strive to determine the best structure for avoidance of double taxation considering Bilateral Investment Protection Agreements, Double Taxation Avoidance Agreements.

As exploration and production (E&P) business is high risk and capital intensive, so the Company also managed it either through incorporated or unincorporated JV to mitigate the risk, leverage the combined financial strength and share experience of the JV partner. JVs are also entered into for getting access to the resources of the JV partners which could be rigs, logistics, existing contracts, etc.

Every joint venture operation is always governed through a joint operating agreement (JOA) and a unanimous decision by the JV partners, but in E&P business the operator has ultimate control on each activity of the operation and other partners act as only non-operators and participate only in the Technical, Operational, Administrative and Financial meetings for decision making. Operator also has the authority to take the decisions on day-to-day activities and take assistance from its affiliated companies. E&P JVs are a jointly controlled operation but the role of other partners being passive is fraught with the risk of unilateral decisions being made for operating activities without the unanimous consent of the JV partners. Also other risks are violation of mandatory regulations of the regulator by the JV partner entailing unreasonable financial burden on the JV partners, non-compliance of the terms and conditions of JOA, etc.

The Company formed incorporated or unincorporated Joint Ventures in 29 E&P assets while the remaining assets remained wholly owned by the Company. Review also revealed that the Company had no specific policy detailing the considerations for extent of acquisition of participation interest in offered E&P assets. For farming-in and faming-out of participation interest, the Company was solely dependent on either participation interest offered to it or its own perception of risk and reward.

Out of 45 E&P assets, Audit reviewed 15 joint ventures and five owned E&P assets involving an investment of ₹ 46,417.75 crore. Inadequacies noticed in three are discussed below.

4.2 Un-realistic estimation of reserves/production

The Company acquired (January 2009) Imperial Energy Corporation Plc, (IEC) an Exploration and Production Company, which was operating in Tomskh region of Russian Federation through its subsidiary Jarpeno Limited, Cyprus, at a cost of USD 2.12 billion (Rs 10,320 crore) with CCEA approval (August 2008) subject to stipulation that the IRR should be more than 10 per cent and an option to farm out a part of its stake to a Russian firm.

Before acquisition, the technical consultant and the Company had estimated the 2P reserves of IEL at 790 MMBOE and 826 MMBOE respectively. With these estimates of reserves and long term crude price at USD 85/bbl, the Company assessed the project as viable with the average daily rate of production of 35,000 barrel oil per day (bopd) for 2009 and thereafter , to enhance the production upto 80,000 bopd by 2011 .

During review, it was observed that at the time of reassessment of the viability of the project due to fall in crude price, the actual daily rate of production for 2008 as on 20th October 2008 was only about 5,634 bopd as against the projected production of 11,000 bopd (which was what the Board was informed in April 2008 at the time of appraisal). Further , the actual average production during 2009 and 2010 (till August) was 9067 bopd and 14,724 bopd respectively against the projected production of 35,000 bopd, due to tight reserve position and delay in drilling the wells as envisaged even after 18 months of its acquisition. The Company also did not exercise the option of farming out a part of its stake to a local partner to leverage their combined financial strength and shared experience of the JV partner. This resulted in financial loss to the Company as discussed below.

Consequent to low production, the Company could not achieve IRR of 10 per cent and incurred losses of USD 37.892 million (Rs.174.15 crore @ Rs 45.983/USD) & USD 212.464 million (Rs 1007.99 crore @ Rs 47.443/USD) for the years 2008-09 & 2009-10 respectively. Besides, due to non-achievement of targeted production, the Company also suffered a production loss of about 10.8 million barrel. Moreover, the Company had to reduce the proven reserve size of the asset during 2009-10 by 1.527 Million Metric Tonne (MMT) indicating the inflated size of reserves as estimated by the Company at the time of its acquisition. The Company did not address the reservations expressed in 2007 by Russian Resources Ministry regarding inflated reserve position declared by IEC, at the time of evaluation of investment opportunity in 2008.

Thus, un-realistic estimation of reserves/production rate resulted in a huge loss of ₹ 1182.14 crore during the period 2008-09 (January to March' 09) to 2009-10 which could have been mitigated if the Company had farmed out a part of its stake to a local firm.

Management replied (Dec. 2010) that due to discouraging and very different drilling results of 28 wells in three fields in 2008 & 2009; production could not be achieved as envisaged at the time of acquisition. As a result of poor production, project cash flows were impacted and losses were incurred. Therefore, the Company is carrying out various studies to identify the problem which resulted in poor performance of the 28 drilled wells and to find solution. Unless these studies give some conclusive results, a realistic production profile can not be generated and hence an economic analysis can not be carried out to comment on a likely IRR. Further, management replied that there was no reason to doubt the correctness of reserves data used by OVL and reported to the Government as the reserves were calculated by companies of international repute.

Management's reply is not tenable as the subsequent drilling results and reduction of proved reserve size by 1.527 MMT during 2009-10 raises doubt about the reserve size of the IEC and economic viability of the take over. The fact that the Company even now is not in a position to generate a realistic production profile and bring out an economic analysis confirms that all the problems associated with these fields were not properly assessed at the time of evaluation of opportunity which led to poor production performance and consequent losses. Investment risk in the final analysis could have been mitigated in the initial stage itself by farming out a part of its stake and in view of discouraging results now, it will be difficult for the Company to farm out a part of its stake to a local firm. Thus, not creating a joint venture by farming out a part of its stake has worked to the detriment of the Company's interests here and left it to bear a loss of ₹ 1182.14 crore during 2008-09 to 2009-10 and; also the poor performance of the wells drilled during 2008-09 has left the Company in a position of unlikely generation of a realistic production profile and IRR.

The technical consultant while confirming the audit observation opined that it is a known fact that tight reservoir had poor productivity and also poorer recovery in comparison to a normal one. The prediction for production levels was highly optimistic rather than realistic. Therefore, the Company should have been more cautious when the seller had indicated a very rosy picture especially when Russian Ministry had expressed doubts about the reserves quoted by the seller.

4.3 Formation of JV without prior approval resulted in cost rejection

ONGC Mittal Energy Limited, Cyprus (OMEL) signed an MOU (November 2005) with Nigerian Government with an investment commitment of US$ 6.0 billion in the downstream project and other strategic sectors like railways, power, road, etc. in Nigeria for participating in the forthcoming exploration licensing in April 2006. In terms of MOU, OMEL was awarded (June 2006) two blocks viz. OPL 212 (now OPL 285) and OPL 209 (now OPL-279).

Block-279 with 40 per cent participation interest was awarded to OMEL along with 60 per cent carry finance condition of participation interest held by Exploration and Production Limited (EMO) at overall financial commitment of US$ 140 Million from OMEL. The Board of the Company approved (June 2006) its share of investment of US$ 44.63 million as signature bonus and Minimum Work Commitment (MWC) in the First Exploration Phase with an understanding of likely distribution of 37.5 per cent stake in favour of Shell and TOTAL (a French Oil Company).

OMEL signed an agreement with EMO for acquisition of additional 20 per cent participation interest (24 February 2007) for consideration of US$ 50 million within seven days from the date of PSC and the Board of the Company had to approve (26 February 2007) the same to avoid commitment failure on the part of OMEL. However, the additional stake increased the financial commitment of the Company to US$ 96.90 million, which was beyond the financial powers of the Company i.e ₹ 300 crore or US$ 75 million, whichever was less.

OMEL transferred (23 May 2007) 14.5 per cent participation interest along with proportionate carry finance share to TOTAL for US$ 29.07 million worked out at weighted average cost of its earlier 40 per cent participation interest and additional 20 per cent participation interest including carry finance participation interest of EMO without approval of CCEA/GOI. Transfer of 14.5 per cent participation interest at weighted average cost instead of higher cost of additional 20 per cent participation interest resulted in loss of US$ 7.18 million (₹ 32.31 crore). Audit noticed that transfer of stake to TOTAL by OMEL and formation of an unincorporated JV with TOTAL was done without mandatory prior approval of the Nigerian National Petroleum Company (Regulator).

TOTAL was authorized to carry out Geological & Geographical (G&G) activities as it had Nigeria Deep water terrain expertise. TOTAL carried out G&G activities in France which resulted in violation of Nigerian Law and led to disallowance of an expenditure of US$ 9.87 million for cost recovery purposes. Similar disallowance of equivalent amount was noticed in another Block OPL 212 (now OPL 285) which led to overall disallowance of US$ 19.74 million of which the Company's share was US$ 10.07 million equivalent to ₹ 45.32 crore @ ₹ 45/US$. Ultimately OMEL had to establish its own G&G centre at Lagos, Nigeria.

The Management stated (January 2010) that the Board approved participation in OPL-279 considering that the amount involved is within the approved limit as the JVC was in discussion with

TOTAL for farm-in of the block. The Management further stated that pro-rata share including carry finance was charged from TOTAL to utilize their over 40 years E&P experience in the Nigerian basins.

The Ministry endorsed (October 2010) the reply of the Management.

We do not agree with the Ministry/Management's viewpoint as the formation of JV with TOTAL by transfer of part stake at lower price by ₹ 32.31 crore with an aim to exploit TOTAL's 40 years of experience in Nigerian Basin also did not fructify because TOTAL carried out G&G activities outside Nigeria in contravention of Nigerian Law leading to cost rejection of ₹ 45.32 crore by the host Government. Also, ultimately to avoid further cost rejection; the Company had to set up a G&G centre in Nigeria. The Ministry/Management's reply that the Company approved the investment while probable transfer of participation interest to TOTAL was in the process of discussion indicates that investment beyond its financial powers was approved by the Management on the ground that total investment net of probable transfer of part participation interest would be within its financial competence.

Our technical consultant also opined that investment profile was known to the Company and approval of CCEA should have been obtained prior to signing of contract. Further, execution of G&G activities outside Nigeria in spite of TOTAL's long work experience in Nigeria brought out weak planning, project Management and lack of study/adherence to guidelines. Goodwill of TOTAL could not be equated with financial loss to the Company.

4.4 Avoidable exposure to risk due to non-forming of JV

The Company acquired 100 per cent participation interest in Najwat Najem Block, (NN) Qatar and estimated volume of Original Oil in Place (OOIP) at 187.72 million metric barrel of oil equivalent (MMBO) (Proved Oil-98.159 MMBO + Possible Oil-89.561 MMBO) and also noticed a risk of pre-existing poor event continuity attached with its reserves estimations.

Further, it was also noticed that the Company decided to appraise the block by itself despite knowing the fact that about 12-16 leading E&P international oil companies were interested in the Block as they had purchased bid documents in view of the potential of the field with huge reserves. Thus, the Company had a fair chance to mitigate the possible risk of poor event continuity attached with its own estimation of oil reserves through formation of a JV by transferring its part participation interest at a good price along with carry finance of its own share which was a prevalent practice in the international exploration business.

Hence, decision of the Company to appraise the block by itself despite knowing the risk and interest shown by other E&P international oil companies, was not prudent. This not only deprived the Company of mitigating the impact of risk known to it, leveraging the combined financial strength and sharing experience of the JV partners but also resulted in financial loss as discussed in para 3.6 (Supra).

The Management stated (January 2010) that the decision to share the risk or reward in respect of any project is always based on Geo-scientific studies and was project specific. Najwat Najem, Qatar Project was a discovered field, the Company decided to appraise the project itself and if found commercial to develop the same.

The Ministry endorsed (October 2010) the reply of the Management.

We do not agree with the Ministry/Management's viewpoint as risk sharing and experience sharing was more a matter of prudent financial management, particularly in projects involving high exploration risk and huge capital investment. The Company being aware of pre-existing poor event continuity should have sold out a part of its risk at a good price along with carry finance as it was a discovered field and could have minimized its losses.

Our technical expert opined that the estimate of 187.72 MMBO of OIIP with proved OIIP component of 98.159 MMBO does not conform to standards of petroleum resources management system. The investment risk in final analysis, could have been mitigated in the initial stage itself if standard definitions and guidelines of Petroleum Resource Management System had been practiced by the Company for reserve estimation and prospect evaluation.

In essence, in the absence of structured documented policy for exercise of due diligence process for formation of joint ventures, the Company was not able to mitigate the risk and leverage the benefits from the combined financial strength and expertise of the JV partners.

Recommendation # 2

The Company should prepare guidelines for formation of Joint Ventures so as to mitigate the risk, leverage the combined financial strength and share experience of the Joint Venture partner.