

<b>SAUDI ARABIAN OIL COMPANY (Saudi Aramco)</b> <b>GENERAL INSTRUCTION MANUAL</b> <b>ISSUING ORG. TREASURER'S</b> <b>SUBJECT: RENTALS/LEASES/CHARTERS</b>	<b>G.I. NUMBER</b> 20.161 <span style="color: blue;">Approved</span>	
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## CONTENT:

This instruction outlines the criteria, special review procedures, financial analysis and approval authority applicable to rentals, leases and charters.

1. Objective
2. Scope
3. Criteria
4. Financial Analysis
5. Capital -vs- Operating Leases
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7. Responsibilities and Procedures
8. Approval Authority

## SUPPLEMENTS

1. Rental, Lease, Charter or Purchase Financial Evaluation
2. Capital -vs- Operating Leases

## 1.0 OBJECTIVE:

To provide Management with a formal system for the analysis, review and approval of proposed rental, lease and charter agreements for use of equipment or installations which would otherwise require capital investment.

## 2.0 SCOPE:

All proposed rental, lease or charter contracts which obtain the use of capital type equipment and facilities by the Company will be processed following normal corporate review procedures.

- 2.1 Rental, lease and charter costs chargeable directly to Capital projects or to the Exploration or Development Program will be separately funded as part of the cost of projects which make up these programs. All leases classified as Capital Leases will also be included in this category, since they require capital funding.
- 2.2 \* All other proposed rental, lease or charter agreements which do not meet the criteria of 2.1 above will involve costs chargeable to Departmental Net Direct Expenditure Budgets. Where an item of equipment or an installation is leased or proposed to be leased, and is therefore included in the Departmental Net Direct Expenditures Budget, and subsequent events justify or require capital funding, the reduction of these leasing costs does not release these funds for expenditure elsewhere. Furthermore, in any operational variance analysis,

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any significant underrun resulting from a reduction or elimination of leasing or rental costs for this reason should be shown separately.

- 2.3 All of the above rental, lease or charter agreements in 2.1 and 2.2 should follow the procedures outlined in this instruction.

### 3.0 \*CRITERIA:

The Company will normally utilize rentals, leases and charters when one or more of the following criteria apply:

- 3.1 \* The terms of the contract are of equal or better economic attractiveness as compared to Saudi Aramco ownership, based on the current value of money rate established by Treasurer's.
- 3.2 The need to be served is fluctuating or temporary.
- 3.3 Testing and experience are required because the goods or services are unknown or unevaluated in the Saudi Aramco environment.
- 3.4 Obsolescence is a significant condition making purchase a high risk.
- 3.5 \* Required resources such as manpower, housing, management, technical skills and specialized maintenance not readily available on an ownership basis can be temporarily acquired with a lease.
- 3.6 \* Required resources can be obtained in a timely manner on a lease basis but are not otherwise available within an acceptable time frame.
- 3.7 \* Items not critical to Company operations, as determined by Management, could be obtained through rentals, leases and charters if the economics prove this method of acquisition to be financially attractive.
- 3.8 \* Items not meeting any of the foregoing criteria should be considered capital acquisitions and obtained through the normal purchasing procedures.

### 4.0 \*\* FINANCIAL ANALYSIS:

As commonly utilized within Saudi Aramco, a rental agreement will provide equipment with manning while a lease agreement usually provides equipment only. Charter agreements can also be classified as leases (for example, a bareboat charter) or rentals (for example, full service charter). The capital acquisition will not include any services (that is, manning or maintenance) in the capital purchase cost. Thus a comparative analysis of a rental, lease or charter contract

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which includes additional services versus a capital acquisition will require a deduction of the service amounts from the discounted cash flow of the rental, lease or charter price, or the addition of premium to the capital acquisition to cover the cost of Saudi Aramco providing these services. The procedures outlined herein are applicable to any of the foregoing types of agreements; however, the financial analysis must be based on a comparison of similar goods and services. If the ultimate intent is to capitalize the proposed equipment or facility, a Lease/Rental/Charter versus Purchase financial analysis will be required. In other cases where the intent is not to capitalize the equipment or facility, only the Lease/Rental/Charter financial analysis is required. (For the financial evaluation procedures and requirements see Supplement 20.161-1).

## 5.0 **\*\*CAPITAL -VS- OPERATING LEASES:**

Lease payments are either expenses or amortized depending upon whether the lease arrangement is classified as an operating lease or a capital lease. The capital lease is treated as collateralized borrowing and is initially recorded on Saudi Aramco's books as the addition of an asset and a debt with the asset value being depreciated in the normal manner. Since capital leases are classified as a form of borrowing, they should be reviewed with the Treasurer prior to finalization. Capital Leases also require normal capital funding authorization. The operating lease payments are expensed on a straight line basis over the lease period unless another systematic basis is more representative of the periodic benefit received. As a result, with operating leases, the cash flow and operating expenses are generally concurrent, but with capital leases depreciation lags behind cash outflow.

In order to qualify as an operating lease, the contract must meet the following criteria.

- \*\* (a) The lease agreement cannot automatically return ownership of the leased property to Saudi Aramco at the end of the contract or provide that Saudi Aramco may recover the leased property at what could be considered to be a bargain purchase price. (The lease can contain an option for Saudi Aramco to purchase the leased property at an agreed upon price as long as the price approximates the fair market value of the property at the date the option becomes exercisable).
- \*\* (b) The fixed noncancelable term of the lease must be less than 75 percent of the estimated economic useful life of the leased property.
- \*\* (c) The present value of the minimum lease payments must be less than 90 percent of the fair market value of the leased property. Supplement 20.161-2 provides a ready means for classifying leases and determining their financial impact.

In connection with options in an operating lease, any renewal or purchase option must be exercisable at the sole discretion of Saudi Aramco and in order to compensate for this higher risk, the lessor may incorporate a higher interest or discount rate into the operating lease payment schedule. The capital

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lease payment schedule will incorporate costs which are all known to the lessor as the lease agreement will normally specify terms of the lease period. Thus a lower interest rate reflecting the lower risk will normally be built into capital lease payments than into operating lease payments for the same asset.

Due to the Saudi Aramco practice of utilizing an asset until it becomes obsolete, the salvage value of an asset is deemed to be zero for analytical purposes.

## 6.0 \*\* NEGOTIATING FACTORS:

A rental, lease or charter agreement is a contract and as such its development must adhere to the procedures established in the Saudi Aramco Contracting Manual. The Contracting Department should be consulted as soon as the need for an outside service or facility is considered.

Negotiation of terms and critical evaluation of the financial aspects are the paramount considerations in developing lease and rental agreements. Additional factors that should be considered are renewals, purchase, options, cancellation privileges and purchase/sale/lease back arrangements.

- 6.1 \*\* Renewal clauses and purchase options give the lessee the right to continued use of the property beyond the basic term of the contract or the right to buy. Selection of the basic term is fundamental and affects cost and other aspects of the contract. This time period may not always be the entire "service life" of the equipment or facility but should normally correspond to the full period of time the asset is required, that is, its full "economic life".
- 6.2 \*\* Renewal clauses should specify a method of calculating payments for the additional period. The basic financial cost of the asset (that is, principal plus interest) is ordinarily established when the asset is first made available. Other associated costs such as corporate overheads and the cost of operation and maintenance of the asset (if such services are provided) would, of course, be variable. If there is an indefinite or continuing need for the property, it would be desirable to obtain a favorable purchase option or, at least, a right of "first refusal" to buy it at market price. However, consideration must be given to the impact of the renewal clause on the lease's classification as operating or capital.
- 6.3 \*\* A cancellation provision would be highly desirable when the property has a high rate of obsolescence, the continuing need for the asset is uncertain, or when for other reasons its use depends on changing workload requirements.

## 7.0 \* RESPONSIBILITIES AND PROCEDURES:

- 7.1 \* The Service Review Committee (SRC) is responsible for reviewing contracts or amendments to contracts for lease, rental or charter of facilities or equipment as determined in the Saudi Aramco Contracting Manual Chapter VII, Procedure 17.

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7.2 \* The SRC must review the Rental/Lease/Charter Contract twice, first as a Contract Plan and second as a Contract Award. For the first review, a brief should be prepared following the sample format shown in the Saudi Aramco Contracting Manual Chapter VII, Procedure 17. If the ultimate intent is to capitalize the proposed equipment or facility, the Plan must also state that along with the bid solicitation for a lease/rental/charter contract, a simultaneous solicitation to directly purchase the proposed capital type equipment or facility will be requested. Fifteen (15) copies together with Contract Request (Form A-3879) should be forwarded to the Manager, Contracting Department under confidential cover. The Contracting Department will include the item on the earliest SRC agenda as a Contracting Plan. The proponent manager must be available when the proposal is to be reviewed by SRC to provide further information in justification of his proposal if requested.

7.3 \* Subsequent to receiving and evaluating bids but prior to Contract execution, the Contracting Department will include the Contract as an Award recommendation on the SRC Agenda. The recommendation shall include the Lease/Rental/Charter financial evaluation (see Supplement 20.161-1). One (1) copy of the Award recommendation should be forwarded to the Treasurer's Organization under confidential cover for review. The Contract will only be endorsed for signature by the Contracting Department after the SRC approves the Award recommendation. The Contracting Department will note on the Corporate Review Form that the Contract has been approved by SRC and the Corporate Review Form, together with a copy of the SRC minutes approving the action, will be made a part of the permanent contract file.

## 8.0 APPROVAL AUTHORITY:

The Chief Executive Officer may authorize the Company to enter into rental, lease and charter agreements subject to the Approval Authority limits as stated in the Saudi Arabian Oil Company Management Guide. Rental, lease and charter agreement proposals not in conformance with the Management Guide, must be approved by the Board of Directors or the Executive Committee.

Recommended:  
Treasurer

Approved:  
Exec. Vice President - Finance

Approved:  
Chairman, Services Review Committee

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## A. Development of Financial Data

Financial data in the form of contractor bids and purchase orders are to be developed with the assistance of the Contracting or Purchasing Departments. The Treasurer's Staff Department will provide assistance and data regarding insurance aspects which need to be considered. Each Contract Award must be supported by a financial analysis of the alternate bids consistent with the procedures outlined below.

## B. Tax Considerations

The dual role of SAG, as both the equity owner of Saudi Aramco and the taxing authority, necessitates that the comparative evaluation of lease, rental and purchase alternatives be consistently based on a discounted pre SAG tax (that is, zero tax rate) cash flow analysis. Use of this method will yield the alternative with the lowest combined SAG/Saudi Aramco discounted cost.

## C. Economic Life

Financial Analysis of the rental/lease/charter alternative compared to the purchase option should be consistent in using the same economic life in rental/leases/charters as is used for the capital acquisition.

## D. Rental or Charter Analysis

The rental/charter analysis will require a present value evaluation of the contract price. The prevailing discount rate to be used in the analysis is obtained from the Treasurer's Staff Department and generally reflects Saudi Aramco's cost of money. A format for this evaluation is presented below:

<b>Year</b>	<b>Actual Rental/Charter</b>	<b>Present Value Rate</b>	<b>Present Value of Cash</b>
<b>(1)</b>	<b>Cash Flows/Year</b>	<b>(3)</b>	<b>Flows</b>
	<b>(2)</b>		<b>(4)</b>

## E. Lease with Purchase Options

As with the rental/charter analysis, a present value evaluation will be required. The format to be used is shown below, and is generally the same as that used in Section D. The difference occurs due to the

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optional purchase prices which must also be discounted to find their present worth:

Year (1)	Actual Lease Cash Flows/ Year (2)	Present Value Rate (3)	Present Value of Cash Flows (4)	Actual Purchase Option Price (5)	Present Value Rate (6)	Present Value of Purchase Option Price (7)	Total (4) + (7) (8)
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## F. Capital Purchase

The Capital Purchase cost used in the analysis should be developed according to the following guidelines:

Category of Estimate	-	ER Estimate
Facility to be installed	-	This should be direct purchase price quote from the Vendor
Engineering and	)	Costs associated with these
Inspection	)	line items should be fully
		documented and justified.
Price Trend	)	
Contingency	)	

Once the Capital Purchase cost has been developed according to the above stated guidelines, the payment provisions of the purchase contract should be analyzed to determine the method of payment. A present value evaluation of the purchase price will be required and should follow the format given below:

Number of Months from Contract Signing (1)	Actual Payment Cash Flows (2)	Present Value Rate (3)	Present Value of Cash Flows (4)
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## G. Financial Evaluation of the Alternatives

Use of a modified profitability index, hereafter referred to as a Lease/Rental Cost Index (LCI),

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provides a consistent evaluation of the magnitude of the discount received or premium paid for leasing or renting instead of purchasing. Also, the LCI can be used by management to compare lease/rental/purchase alternatives for various non-deferrable items when cash constraints exist. Asset acquisitions which have a lease alternative and relatively low LCI's could be leased, thereby lowering the impact on near term cash flow. The remaining non-deferrable items with relatively high LCI's should be purchased. By utilizing this index analysis, asset purchases with relatively low lease costs are avoided thus providing for optimal allocation of cash flow. The Lease/Rental Cost Index is derived in the following manner for each alternative.

Discounted Lease or Rental Cash Flow (Section D or E)

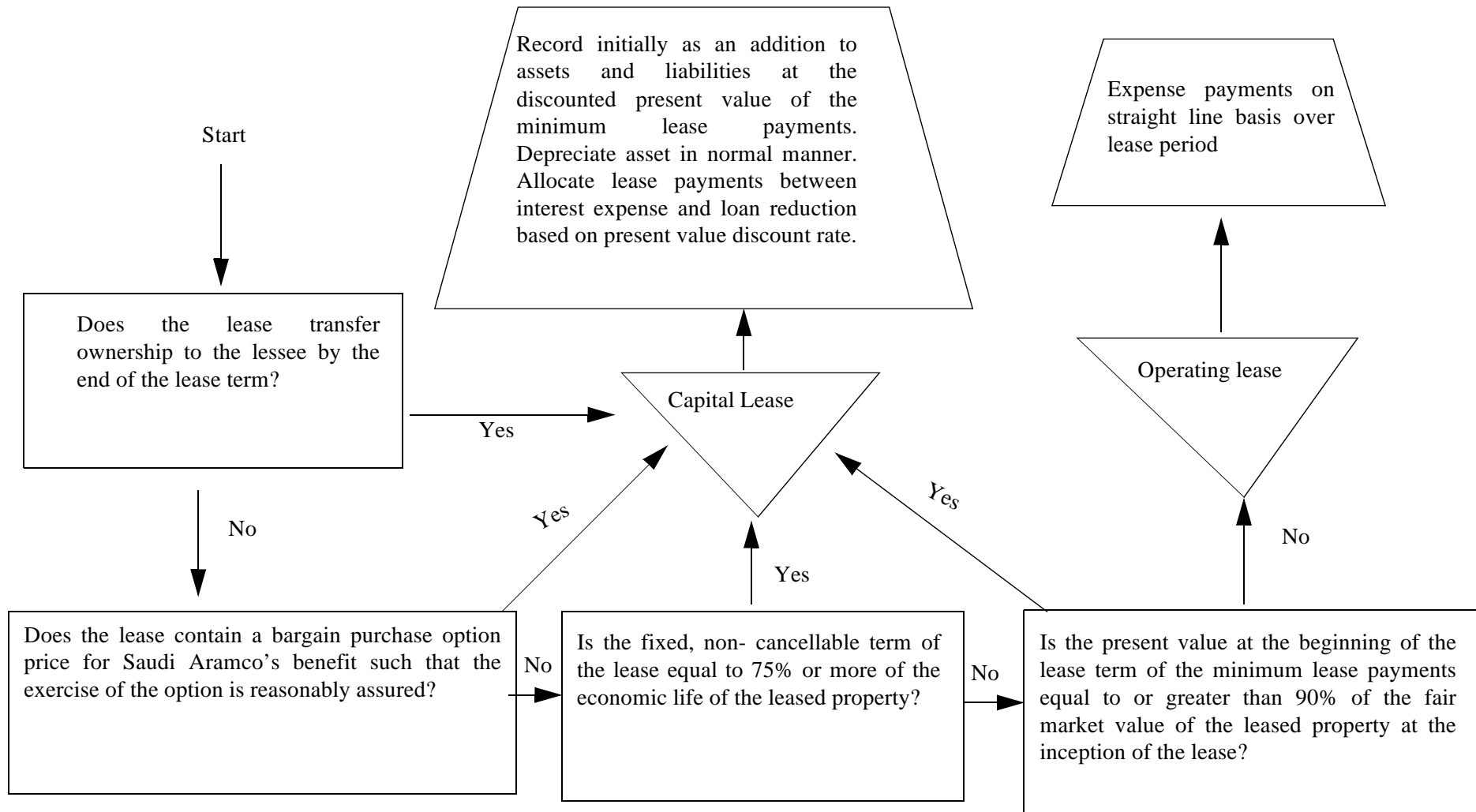
LCI =-----

Discounted Purchase Price Cash Flow (Section F)

Under normal circumstances, lease or rental options with LCI's of 1.00 or less would be exercised. For those over 1.00, the asset would become a capital purchase. However, during times of cash constraints, the decision to purchase may be undesirable. During such times, a subjective evaluation of the accepting of a lease or rental contract with an LCI greater than 1.00 will have to be made.



CAPITAL VS OPEARTING LEASES



\* Present value discount rate to be applied is the implicit rate that equates the value of the minimum lease payments to the fair market value at the inception of the lease if known.

Otherwise it is Saudi Aramco's incremental borrowing rate.

\*\* Minimum lease payments include:

- Minimum rental payments excluding executory costs such as insurance, maintenance, taxes to be paid by lessor;
- Guaranteed residual value at the end of the lease;
- Any penalty imposed on Saudi Aramco for non-renewal of lease.