Article

Islamic Project Financing: The Shuaibah and Marafiq Models

By John Dewar and Alison Smith

If the market required any convincing as to the growing strength and prominence of Islamic financing in the Middle East financing market, then the closing of the Shuaibah power project in 2005 (then the largest single financing for an individual power sector project) — followed by the Marafiq project financing in June 2007, the largest individual power and water project in the world — should serve as compelling evidence. These deals in aggregate encompassed US$5.5 billion in senior financing facilities, including Islamic facilities totaling US$210 million and US$600 million respectively. In addition, the Shuaibah Expansion Project, which closed in October 2007, included an Islamic facility of US$85 million (comprising 50% of the project's senior financing facilities). Assisted undoubtedly by the high hydrocarbon prices of recent years, Islamic financing is experiencing a boom, growing at an estimated rate of 15% in each of the last three years.

Both the Shuaibah and Marafiq financings combined funding from Islamic finance institutions, international and local commercial banks and export credit agencies. These deals represent recent examples of how Islamic finance techniques have been successfully utilised in the context of multi-sourced financings, while remaining consistent with the principles of the Islamic Shariah.

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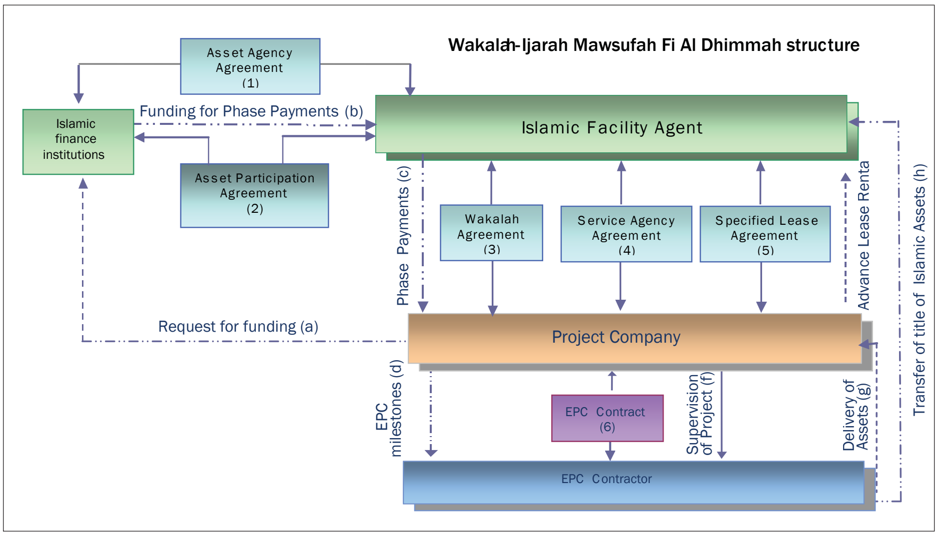

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This article explores the main structural aspects of these transactions in the context of Islamic financing and the future challenges that Islamic finance institutions and project companies may face in the Middle East's project finance sector.

Unusually, in the context of complex cross-border project financings, the Islamic tranches are governed by the law of the Kingdom of Saudi Arabia and the provisions of Shariah law. Customarily, finance documentation in Middle East project financings is governed by English law (except in New York-preferring Qatar). The Islamic facilities in Shuaibah and Marafiq are based on a Wakalah-Ijarah Mawsufah Fi Al Dhimmah structure, a hybrid based on the existing and recognizable Ijarah Islamic finance technique, under which a financial institution leases an asset to the customer. In the context of a project financing, however, the asset needs to be built. This is where the structure must be redefined so that it remains fit for purpose while conforming to the Shariah.

Hybrid bespoke structure

Under this structure, the project company is employed as the Islamic finance institution's agent or "wakil" under an agency agreement, entitled the Wakalah Agreement, to procure the construction and delivery of certain assets required by the project and identified in the Wakalah Agreement (the Assets).

The provision of the Assets is facilitated by the project company's entry into the engineering, procurement and construction (EPC) contract with the EPC contractor. A key Shariah principle is that the financial institution must share the commercial risks with the project company, and thus it is expressed to be responsible for effecting the insurance and major maintenance of the asset. In order to offset the financial institution's risks in this regard, the project company agrees separately in the Service Agency Agreement to insure and maintain the Assets on behalf of the Islamic facility agent. This structure can be characterized by the ongoing risk over the asset that the Islamic finance institution is agreeing to take.

"Finance documentation in Middle East project financings is governed by English law"

Title to the Assets passes directly from the EPC contractor to the Islamic facility agent

Under the Agency Agreement, the Islamic finance institutions appoint the Islamic facility agent as their agent in respect of the financing and, under the Asset Participation Agreement, agree to participate in financing the construction and ownership of the Assets procured from the EPC contractor by the project company. Title to the Assets passes directly from the EPC contractor to the Islamic facility agent and the Islamic facility agent undertakes (on behalf of the Islamic finance institutions) to lease the Assets (to be constructed). The lease will

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be effective from a specified date as set out in the Specified Lease Agreement. In certain jurisdictions, this may lead to concerns over the relevant tax treatment and thus appropriate structuring should be considered.

Contracts with an uncertain price may be treated as void under Shariah principles

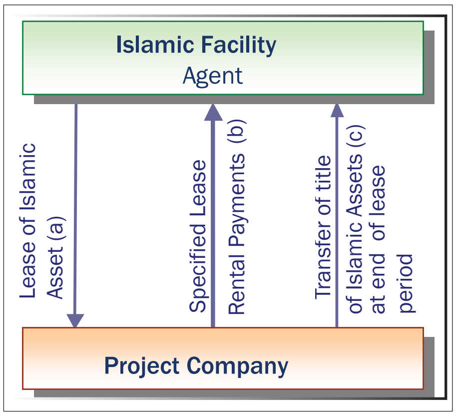
During the construction period, upon receipt of funds from the Islamic finance institutions, the Islamic facility agent will make phase payments to the project company in accordance with an agreed payment schedule for on-payment to the EPC contractor under the EPC contract. All responsibilities relating to the procurement of the Project's execution, completion and supervision rest with the project company. During this period, the project company is required to pay to the Islamic facility agent advance lease rentals set out in a pre-determined advance lease rental schedule.

The specified lease rental comprises two elements:

(a) a fixed element for each payment date which represents the capital repayment; and

(b) a variable amount representing the Islamic finance institutions' profit.

While the Shariah prohibits the payment of interest (on the basis that money may not be used to make money as this would represent an unfair exploitation), Islamic principles do not prohibit the making of profit, provided that there is a level of risk sharing between the parties. The specified lease rental represents the financial institutions' return based on the profits generated on the sale of the asset to the project company. Project finance by its very nature means that the financial institutions are assuming certain risks in the project and this is consistent with Shariah principles. At the end of the lease period, provided that all lease rentals have been paid, legal title to the leased assets will be transferred to the project company.



The Islamic finance institutions are bound by the intercreditor arrangements

In order to ensure that all of the finance parties (conventional and Islamic) are bound by the intercreditor arrangements, under which the finance parties agree among other things not to take independent action against the project company, they enter into an intercreditor agreement.

Challenges going forward

The demand for Islamic finance at present is

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relatively high and, coupled with increasing market liquidity, has led active participants in the sector to conclude that the growth in demand will continue. However, there remain some challenges for participants in Islamically funded project financing which should not be underestimated.

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Islamic funding must be structured so that it meets the requirements of each Islamic financial institution's Shariah committee (responsible for providing guidance on Shariah requirements and determining (on behalf of its institution) whether the proposed financing and related documentation is Shariah compliant). The views of the Shariah committee at a certain institution or in a different jurisdiction may be different from another's, which may be more or less conservative. Amendments to the structure may be required to balance the changing requirements of the respective Shariah committees within the context of a parallel conventional financing.

Islamic finance institutions may not be as flexible in their approach as conventional lenders in similar circumstances as a result of the constraints imposed on Islamically financed products. The strict views of certain Shariah committees may not be immediately compatible with the project company's structuring requirements, with the result that project companies need to be willing to be flexible in their approach. The long-term nature of project finance brings its own challenges in this regard since project companies may be unable to obtain from certain Islamic institutions the flexibility to change the transaction or refinance during its tenor.

While maintaining adherence to Shariah principles, Islamic finance institutions will need to keep these matters under review and be creative in their approach if they are to remain competitive in the international capital markets.

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