

Storm clouds in the Middle East

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Political unrest has turned what looked like a promising year for project finance in the Middle East into another year of uncertainty, at least in the short term.

Some government tenders for projects may be delayed. However, other projects are moving forward with financing. The ultimate test in the next few months may be the financing for the Muharraq wastewater treatment plant in Bahrain.

The projects sector in the Middle East had looked certain to be on the rebound this year. Escalating oil prices have helped the region recover from the credit crisis of 2008. A handful of projects were successfully financed in 2009 and gradually the market began to pick up in 2010.

Late last year, two new independent power projects came to the market, and the release of more projects was expected in the first quarter of this year. Egypt, in particular, was leading the way in terms of diversity of projects in the public-private partnership sector with new tenders for road, hospital, wastewater and power projects expected this year.

Then came the wave of political unrest and upheaval in North Africa that soon spread in more limited form to Yemen, Bahrain, Oman and Iraq.

Panelists at the MEED annual project finance conference in Dubai the first week in March were keen to emphasize the resilient nature of the economies of not just the emirates along the Persian Gulf but also many of the other countries that make up the wider Middle East and North Africa region. The conference is normally held in Bahrain, but had to be moved due to a fear that the unrest in that country might disrupt the conference.

The most immediate economic effect of the recent events has been a significant rise in the price of oil. The price increases follow the same pattern as after other regional conflicts. The price of oil more than doubled immediately after Iraq invaded Kuwait in 1990. The US-led war in Iraq led to another price spike in 2003. Higher oil prices mean more revenue for the oil-producing countries, but create other issues.

Egypt

Egypt has put an impressive pipeline of public-private partnership projects out for tender. The projects at various stages in the tender process include two wastewater treatment plants, the Abu Rawash project and the 6 October plant. It also has tenders outstanding for the Rod El Farag Axis road project, two new university hospitals and the Dairut international power project.

One of the speakers at the MEED conference, Rania Zayed, head of the Public Private Partnership Central Unit in Cairo, said the new interim government is fully behind the continued procurement of these projects, but offered that the timing of bid submissions may be pushed back until after the general elections that are expected in Egypt in September. Ms. Zayed also emphasized that a new public-private partnership law that is key to these projects remains in force.

On the assumption that there is a relatively smooth transition from the current interim government to a stable longer term government after the elections, what is the prognosis for Egypt's project finance market?

It is impossible to predict. Before the political crisis, there was a significant pool of local bank liquidity, and it was anticipated that many of the smaller-scale PPPs in Egypt would be wholly financed by Egyptian banks. The US\$110 million debt facility for the New Cairo wastewater project, which is the PPP Central Unit's pilot project, was provided by a consortium of local banks.

The new projects being tendered are on a much larger scale and will require participation by the international lending community to be financed. For example, the Dairut independent power project is 1,500 megawatts. The release of the Dairut IPP tender was keenly anticipated by international developers and lenders before the government collapsed. Ten individual companies or consortia qualified to bid. Each of the bidders was expected to be supported by a consortium of international commercial banks and export credit agencies.

The role of export credit agencies and multilateral lending agencies like the International Finance Corporation will now be more important than ever to bridge any gap if the potentially more skittish private sector lenders wait to take the measure of the new government that emerges after the elections.

Another challenge that Egypt will face with development of large infrastructure projects will be from projects elsewhere in the region competing for funding that may be somewhat scarcer in the short term until the political situation settles.

Egypt's credit ratings have been downgraded by each of the international credit rating agencies in the wake of the recent events. Standard & Poor's cut the long-term foreign currency debt rating on Egypt to BB, two levels below investment grade.

The country has had a somewhat mixed track record when it comes to implementation of projects through public-private partnerships. Three independent power projects were successfully financed in Egypt in the last decade: Sidi Krir, Port Said and Suez. The electricity tariffs for each of the projects were US dollar denominated. The Egyptian government floated the Egyptian pound in January 2003, sending shock waves through the entire Egyptian economy. The Egyptian pound underwent a major devaluation, and the Egyptian Electricity Authority's tariff payments (in terms of the Egyptian pound equivalent) doubled in two years. The experience contributed to some skepticism within the Egyptian government as to the merits of private sector involvement in infrastructure projects.

However, the implementation of a new PPP law and framework over the last few years promised a new era in private participation in Egyptian infrastructure projects.

Other Countries

The country in the Persian Gulf most affected by the wave of unrest is Bahrain. Standard & Poor's lowered Bahrain's long and short-term sovereign rating from A- to A-2. Moody's downgraded the sovereign rating from A2 to A3. The Formula One World Championship that was scheduled to commence in Bahrain on March 13 has been cancelled. The country's tourism and hospitality sectors are reported to be significantly affected by a dramatic reduction in the number of foreign visitors the country would typically receive at this time of year.

There has been much speculation during the last few weeks that the contagion of the political unrest in North Africa would also spread to Jordan. So far, apart from some relatively minor and peaceful protests in Amman, this has not happened. On February 5, a gas pipeline that delivers natural gas to Jordan was seriously damaged by an explosion in the Egyptian Sinai town of Al Arish. It has been widely reported that Egyptian officials believe the explosion was caused by an act of sabotage. Jordan relies heavily on Egypt for the natural gas to fire its gas-fired power plants.

Two independent power projects have either been developed or are under development in Jordan. The Amman East project, developed by a consortium of AES and Mitsui, has been operating since July 2008. The Al Qatrana project is currently under construction by a consortium of the Korea Electric Power Company in partnership with the Saudi power company Xenel. The Amman East project operates on gas supplied via the Jordanian gas transmission pipeline that connects with the Egyptian pipeline damaged in the February 5 explosion. The Al Qatrana project will as well once it starts operating.

Repair of the damaged gas pipeline is reportedly going well, and gas supply from Egypt could resume soon, according to local press reports.

However, the longer-term impact of this disruption in gas supply on the Jordanian IPP market remains to be seen.

The Jordanian government has released tenders for two new independent power projects, known as IPP 3 and IPP 4. The Jordanian tendering authority, NEPCO, asked in a request for proposals in February for “base” bids for a 300 megawatt power plant to run on diesel fuel—this is IPP 3—together with an option for a 200 to 250 megawatt peaker plant using either diesel engine technology or combustion turbines operating in simple cycle, as IPP 4. Bids for both projects are due on March 24.

The level of interest shown by the shortlisted bidders in these projects will be a barometer of the current health of the project finance market in Jordan.

Bellwether Financings and Bids

Bankers speaking on panels at the MEED conference in Dubai all said that the successful financing of some of the projects scheduled to reach financial close in the next several months will be crucial in helping to restore confidence in the project finance sector in the region.

These projects include the 1,600 megawatt Shuweihat 3 independent power project and the Shams 1 solar power project in Abu Dhabi and the Muharraq wastewater project in Bahrain. Financing of the Shuweihat 3 project should not, despite recent events, pose too much of a challenge. The Abu Dhabi IPP model is probably the most bankable in the Middle East. A consortium of Sumitomo and the Korea Electric Power Company was appointed as preferred bidder for the project last year. Shuweihat 3 is the Abu Dhabi Water and Electricity Authority’s first power-only independent power project.

All other power projects procured under the Abu Dhabi project finance program have been combined with water desalination plants. The Abu Dhabi Water and Electric Authority has committed under the power contract for the project to purchase all of the output for 25 years. Of the total US\$1.5 billion project cost, US\$1.2 billion is to be financed by commercial banks and export credit agencies.

The United Arab Emirates have not experienced any demonstrations over the last few weeks and are unlikely to do so. The rulers of the Emirates enjoy high level of support among the local Emirati populations. Per capita incomes are high, even by the standards in Middle Eastern oil countries. Dubai has transformed itself into a hub for international air travel and has become an important international financial center. The public services and infrastructure in the Emirates, particularly in Dubai and Abu Dhabi, are the envy of the Middle East.

The financing of the Shams 1 project may present more of a challenge, but not due to the recent political instability as much as that it will be the first large-scale solar project to be financed on a project finance basis in the region. Shams 1 is a 100 megawatt concentrated solar project using parabolic trough technology spread over a site area of 2.5 square kilometers. The Abu Dhabi Water and Electricity Company will purchase output under a power purchase agreement with a term of 25 years. The debt facility is expected to be around

US\$600 million to be provided by a consortium of commercial banks. The preferred bidder is a joint venture of Abengoa Solar and Total.

Perhaps the real test of the confidence of the international banking sector in the region will be the financing of the Muharraq wastewater treatment plant project in Bahrain. This project will be the first wastewater treatment plant done through a public-private partnership . Bahrain asked for proposals in June 2009. A consortium of Samsung, United Utilities and Invest AD was chosen as preferred bidder in July 2010. The 27-year concession agreement involves the construction of a 100,000 cubic metre per day wastewater treatment plant on a build, own and operate basis together with a deep gravity sewer network on a build, own, operate and transfer basis. The project debt is expected to fund at around US\$300 million and to be provided by three commercial banks—Credit Agricole, Sumitomo and Natixis—together with the Export- Import Bank of Korea.

Given the recent events in Bahrain, if the sponsors are able successfully to finance the Muharraq project in the next few months, the financing may prove to be the real litmus test for the project finance market not just in Bahrain, but also for the entire region. A number of other power projects in the region are currently in the bidding stage. Bidders have lined up for the Sur IPP project in Oman and the Quarayyah IPP project in Saudi Arabia. The Quarayyah project is expected to be 1,800 to 2,100 megawatts and has attracted significant interest among local, regional and international power developers. Bids for the Quarayyah project are due by March 19. Bids were due for the Sur project in Oman on March 7.

Liquidity

The extent to which the recent events in the Middle East have affected bank margins, the tenor of loans and other financing terms for these bids remains to be seen. The support of export credit agencies is likely to be more important than ever in the wake of Middle East tensions. The project finance market in the Middle East has been in recovery mode since the credit crisis of 2008. Liquidity for projects has been affected by the contagion of the European sovereign debt problems and the forthcoming implementation of Basel III by international banks.

The fundamental drivers of growth in the region have not changed. Population growth in many of the Middle East and North African or “MENA” countries remains high, and some countries in the region still lack basic infrastructure. The political unrest has not altered demand. The current political climate may be symptomatic of a dramatic shift in the expectations of much of the population of the Middle East. The demonstrations that toppled governments in countries like Egypt and Tunisia are a cry for better economic services and faster economic growth. Unemployment among young college graduates is at levels that would not be tolerated in the West. A direct consequence of the recent political unrest for foreign sponsors of projects could be a hardening of local employment requirements in project documentation.

Project finance in the Middle East can be split into two groups in terms of countries: the oil- and gas-rich countries and Emirates such as Abu Dhabi, Qatar and the Saudi Arabia and other countries that have successfully implemented project finance initiatives but do not share the same depth of resources as their oil- and gas-rich neighbours. Countries that fall into this latter category are Bahrain, Jordan and Oman, although Oman as a significant exporter of oil sits somewhere in the middle of these two groups.

Countries in the second group in particular rely heavily on a reputation for stability to attract foreign capital. The ruling families and the governments of Bahrain, Oman and Jordan have enjoyed 20 to 30 years of relative peace and prosperity. The governments of these countries have implemented some very impressive public-private partnership programs, launched by the successful project financing of the first IPP in the Persian Gulf in the mid 1990s, the Al Manah IPP project in Oman and then followed by a series of other water and power projects. Even though their governments are not facing serious unrest at home, the broader regional instability has the potential to affect the economic prospects of these countries more than their oil-rich neighbors.

The oil-rich countries of the Gulf have the means of developing infrastructure with or without private investment. Their preference is clearly to involve the private sector to free up cash for other uses, but they can pay for it themselves if necessary.

Another factor in the project finance equation is the limits on the amount of exposure international banks and export credit agencies are prepared to take at any given time in the Middle East. These sources of funds are now in demand more than ever. The oil-rich countries have sometimes proven better at competing for scarce capacity.

Mega projects in the oil and gas, petrochemical and refining sectors, like the Emirates aluminium smelter project and the US\$14 billion Jubail refinery project in Saudi Arabia that closed on its financing late last year, have been able to attract very large commitments from the international banks and export credit agencies. Saudi Aramco is expected to launch the US\$10 billion Yanbu refinery project within the next 18 months on the back of the successful financing of the Jubail refinery project. Plans are also underway for the expansion of the Emirates aluminium smelter project, which is expected to feature a large component of export credit agency funding.

Another possible source of competition for scarce funds is the nuclear energy program in the United Arab Emirates, which is now well advanced. A Korean consortium led by KEPCO was awarded a US\$20 billion contract to design, build and operate four 1,400 megawatt nuclear power plants in Abu Dhabi in December 2009. The government-run Emirates Nuclear Energy Corporation is expected to establish a joint venture company with the KEPCO consortium using a structure similar to that used by Abu Dhabi Electricity and Water Authority for the Shuweihat 3 project. The Export-Import Bank of Korea is expected to lend around US\$10 billion to the KEPCO consortium for development of this project.

Saudi Arabia has also recently announced ambitious nuclear energy plans and, last month, Saudi Arabia and France signed a bilateral cooperation agreement on developing nuclear energy for peaceful purposes.

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