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## Challenges Facing the Power and Oil & Gas Sectors in the Middle East

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The Middle East is not insulated from the impact of the squeeze in global financial markets. While the impact of the sub-prime crisis within the Middle East may not be as profound as it is elsewhere, lenders are adopting a cautious approach to consumer lending, as well as to financing infrastructure projects. Noticeably, the credit crunch has resulted in a slow-down of the real estate sector, but the overall demand for energy remains unabated.

### Liquidity Meets Project Finance

The oil and gas sector has not escaped from the credit crisis. Regional governments have had to revisit their development projects both in the upstream and downstream sectors. Of the two, it is the downstream sector that has seen more of an impact. The downstream sector is affected by a decline in demand, a drop in margins and a threat of over-supply of products like petrochemicals.

As a result, governments have taken steps to rein in some of their downstream projects. The Government of Saudi Arabia, for example, has announced a delay in the development of the Yanbu refinery. Similarly, the Government of Oman has already stated that the Duqm refinery and petrochemical complex project is one of the developments that is most likely to face a delay as a result of the global financial crisis.

Although the risk of delay in the development of upstream projects cannot be ruled out completely, the upstream sector generally continues to benefit from the existence of a basic demand for oil and gas, driven also by developments in China and India. Key upstream projects continue to remain a priority, therefore. For example, the Government of Saudi Arabia has launched a tender for the Manifa oil project and has taken measures to increase the output of the Damman oil field; and the Qatari Government has entered into an exploration and production (E&P) deal with a German developer.

While the appetite of many commercial lenders may continue to be affected by liquidity constraints, caused principally by conservative or non-existent inter-bank lending, the same is also beginning to hold true in respect of the Islamic banks in the region. Until now, many Islamic lenders in the GCC have readily lent to government-backed (or quasi-government owned or backed) entities and projects. The readiness of such lenders to continue to make Islamic capital available to such entities and such projects has now slowed down. Inter-bank lending is suffering within the GCC. A number of real estate-backed bonds are due for refinancing during the first quarter of

2009 and regional banks have, in the short term, adopted a “wait and see” stance amid rumours that regional governments may be willing to let go of some of their less profitable ventures.

All these clearly indicate that lenders are reverting back to their true nature – they are risk-averse and cautious. The constraints on banks need to be balanced with the demand for infrastructure in the region, however. Accordingly, there is no better time for the public sector to co-operate with the private sector and to work together in coming up with solutions that are designed to facilitate the continuity of key projects. In this regard, most GCC governments are benefitting from the petro-dollars attributable to recent high oil prices. In such cases, initial capital injections remain a possibility, with a view to funding some of the up-front construction costs and refinancing the project at a later date.

Furthermore, the role of multi-lateral agencies and export credit agencies ought not to be understated, especially where governments do not have the benefit of petro-dollars and innovative solutions are needed to finance projects. In addition, the role of regional funds, whether governmental or quasi-governmental (eg pension funds), cannot be ignored.

### Availability of Fuel

Apart from availability of financing, a key challenge facing the region is the availability of fuel to sustain the electricity and related water sector. While it is easy to believe that oil and gas is readily available, it is important to note that the availability of fuel remains a challenge, so much so that regional governments are now beginning to explore other sources of feedstock for power generation.

Coal is now in vogue. The Emirate of Ras Al Khaimah is soon to embark upon a coal-fired project to be undertaken on an independent power producer (IPP) basis and the Emirate of Ajman is also giving consideration to a coal-fired IPP project. Oman is in the process of appointing consultants to advise on the possible development of a coal-fired power project at Duqm. Abu Dhabi is considering the development of a nuclear power programme and, although this may still be a few years away from fruition, it remains a real possibility in meeting power demands in the region.

Renewable energy is also being seriously considered: there are the Masdar initiatives in Abu Dhabi, such as the Shams 1 project; Jordan has recently tendered the Al-Kamsha wind project and, further afield, ONE in Morocco is looking at the development of a 300 MW wind project at Tarfaya in the Sahara.



A coal-fired power plant

### Insurance

All stakeholders, particularly the lenders, recognise the significance of identifying and allocating a project's risk profile. Increasingly sophisticated tools are being used to measure and address a range of technical, environmental, economic and political risks, particularly in developing countries and emerging markets.

Complex project finance schemes require complex insurance arrangements, as part of the strategy of mitigating risk. Insurers, brokers and other insurance advisers have become far more proactive, and at an earlier stage, in assessing the risks involved with particular projects. The insurance of large-scale projects – both at the construction and operating stages – is a long-term commitment (although lenders often complain that the periods of cover provided by the commercial insurance market are not long enough).

Changing global financial conditions and insecurities surrounding the future of projects at a regional level will inevitably have an impact, in particular on the negotiation of new insurance covers for ongoing projects. Whereas in the past, lenders exerted significant commercial pressure on insurers, for instance to waive their right to avoid (rescind) the relevant insurance policy on the grounds of “minor” non-disclosures or misrepresentations made at the time of the presentation of the risk, more recently the position of the insurance industry has hardened. As a result, lenders have, for instance, sought to follow a co-insurance route (insuring in the names of both the project company and the lenders, which is allowable under English law at least). More risk-averse lenders have taken out additional cover

to protect themselves against the risk of the policy being declared invalid on the grounds of non-disclosure or misrepresentation (the so-called “non-vitiating” cover), although this carries a huge additional premium cost.

In view of the scale of project insurances in the Middle East, reinsurance can often play a significant role, particularly in those jurisdictions where it is a legal requirement that all or a part of the cover is placed with domestic insurers – who have no appetite for retaining any or the greater part of the risk. While this adds financial stability to the overall arrangements, reinsurance with “offshore” reinsurers carries risks for the ultimate insureds. If the insurer becomes insolvent, any proceeds payable under the contract would normally be paid to the estate of the insurer and distributed to its creditors according to the bankruptcy laws of its jurisdiction of incorporation. It is unlikely that the project company or lender will have any priority interest in such monies.

Subject to the relevant local law, one solution would be to require the insurer to execute an assignment of the reinsurance proceeds in favour of the project company (taking it out of the insurer's insolvency estate). A notice of assignment would be served on the reinsurer in the normal way and the reinsurance proceed would be paid direct to the project company (or more likely the security trustee). The alternative is to adopt a “cut through” route, requiring the reinsurer to undertake, in the event of the insurer's insolvency, to pay proceeds directly to insureds. This is not enforceable under English law, however, since the liquidator of the insurer could argue that the undertaking does not represent a security interest, merely an unsecured payment direction.

In view of these legal uncertainties, lenders need, more than ever given the current climate, proactive assistance from their insurance advisers to ensure that the insurance or reinsurance arrangements as far as possible match their expectations.

It is too early to identify definite trends in relation to Middle Eastern project insurances as a result of the global crisis. Nonetheless, the Gulf market is starting to move from a “monopoly” of single-site power and infrastructure developments to other forms of infrastructure such as roads, rail and waste-water. This has had an impact, for instance, on the appetite for and structure of sabotage and terrorism (S&T) cover, since these newer asset classes are seen as less of a risk as terrorist targets (certainly as compared to gas/oil-fired power plants, petrochemical complexes sites or oil/ gas pipelines). It remains to be seen, however, whether in practice the risk assessment should alter. A terrorist attack on just part of a railway line may still have devastating consequences for revenue flows.

### Conclusion

The Middle East continues to face challenges in financing its energy and infrastructure requirements. Now, more than ever, however, a greater role for public/ private sector co-operation is needed to ensure that the economies here continue to benefit from fundamental economic building blocks to sustain medium- to long-term growth. ■

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