Privatisation and PPP in the Middle East

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The Middle Eastern region is undergoing an era of unprecedented growth. Rapidly growing economies, coupled with significant liberalisation of trade and financial regulations, has established a framework to facilitate sustainable growth in foreign investment into privatisations and public private partnerships. While the MENA region has historically lagged behind other regions for foreign investment, changes in trade policies, the growth of its capital markets and improved liquidity among the regions banking sector has resulted in an unprecedented amount of private investment activity. The need for significant infrastructure enhancements has become clearly apparent. Water is a prime example of the need. With 5% of the world's population and only 1% of the world's freshwater resources, significant opportunities exist. During Taylor-DeJongh's 20-years of experience in the region, we are witnessing for the first time the confluence of trade liberalisation, privatisation activities and the need for infrastructure requirements combined with liquidity of local capital markets to represent a significant market opportunity.

Privatisations and public private partnerships provide the means to modernise and grow the respective economies in an efficient manner. State-owned enterprises, formerly operated by central government appointees and agencies, are continuing to be divested; and new commercial infrastructure projects are undergoing international tenders, resulting in a private entities building, owning and operating these facilities. Several factors are contributing to the acceleration of these initiatives:

- realisation that many SOEs require modernisation and must utilise best practices applied most effectively by the private sector-in order to compete in the global economy;
- growing populations put pressure on social, health and education budgets of governments; and
- realisation that private capital can be attracted to other physical infrastructure development, thereby allowing government budgets to reallocate to the "soft requirements".

Economic drivers

MENA economies are realising substantial growth. Net oil exports for the region are projected at US$180bn, a jump of US$35bn from 2003. Consequently, oil producing countries experienced rapid growth in 2004; Oman's economy grew at 12.5%; UAE grew by 8% in 2004 while Saudi Arabia grew at 5.3%. Surprisingly, the outlook for non-oil producing countries was almost as robust, with Jordan growing 6% in 2004, due in a large part to the resurgence in trade with Iraq. And Egypt and Lebanon are on track for their best economic performance in five years. Oil-rich nations are investing inter-regionally. For instance, Lebanon received the highest flow of funds from Arab investors in 2004, totalling US$850m. A surge in inter-regional tourism has promoted significant growth of Lebanese real estate. Similarly, Arab investments in Morocco topped US$672m in 2003.

Opportunities for private sector investment exist throughout the infrastructure sector including water, power, roads, rail, mining, ports and airports. Population growth and youth are pressing the needs for additional capacity and modernisation. For example, power demand in UAE is growing at a 6% annual rate and is expected to require US$8bn of new investment over the next decade. Additionally, water resources require substantial expansion and modernisation. Ports and airports are also areas that require substantial near-term investments.

Attributes of privatisation and public private partnerships

Privatisation holds the promise of monetising former state-owned assets, delivering immediate capital flows to the host government and alleviating or minimising future commitments of capital. By minimising future capital flows to these commercial interests, the government is free to focus its resources on social demands such as education, healthcare and basic infrastructure. A model success story has been Jordan which has divested 44 companies over the past decade, reaping US$900m. Oman and Dubai have utilised PPPs as a means of bringing private investment along with private operating efficiencies into projects such as power, water and steel.

Privatisations have been effected through the sale of SOE shares on the local bourses or offshore stock exchanges or through international auctions. Examples of privatised SOEs include Jordan Aircraft Maintenance (80% interest sold to Abu Dhabi firm Abraaj Capital), Dubai's initial public offering of Emeer Properties and Egypt's international tender for sale of a controlling share in Suez Cement. Public private partnerships (PPP), through concession agreements, are favoured for use in commercially supportable infrastructure projects such as water, power, shipping and ports and the energy sector (although the states typically hold majority interest directly in the energy projects). PPP programmes have been extraordinarily successful, including international tenders for US$1.5bn Taweelah A1 Water and Independent Power Project (IWPP), the US$417m Barka 1 IWPP and the US$140m Ajman water concession.

The ability to hold a successful competitive bid process for SOE privatisation and PPPs is a testament to the legal reforms enacted in support of such a venture. A good example is the United Arab Emirates, which enacted (i) political and economic liberalisation; (ii) supportive infrastructure investment; and (iii) liberal trade, business and labour laws. UAE's recognition and willingness to invest significantly in its infrastructure have resulted in the diversification of the economy and highly competitive international tenders. Dubai expanded its establishment of free zones bringing over 100 of the world's top airlines through its airport contributing to the success of ancillary businesses. UAE's financial reform and market liberalisation have led to Dubai becoming the centre of activities for the establishment of international banks and financial services companies serving the region. Trade expansion has expanded UAE's diversification, with oil accounting for 30% of GDP and 70% of its total exports.

Jordan, a non-oil producing MENA country, has taken a different approach to a programme of successful privatisations. Jordan's privatisation initiative is one of the region's most successful programmes. To date, Jordan has (i) divested a 33% stake in Jordan Cement Factories; (ii) granted four bus concessions in the Greater Amman area to Public Transport Corporation; and (iii) sold a 49% stake of Jordan Telecommunications Corporation. In total, government divestitures in approximately 44 companies have resulted in proceeds of US$900m. The basis for success of Jordan's initiative was (i) securing support from the highest level of government, to manage some of the more difficult social and valuation issues; (ii) securing a first major transaction; and (iii) managing the private sector's requirement of transparency.

To facilitate the implementation and execution of its privatisation initiative, Jordan established the Jordan Privatisation Commission (JPC), with the appropriate leadership required to ensure execution of the programme. The JPC's initiatives forced changes to the regulatory framework. As privatisation initiatives arose, changes required for the effective execution of the transaction were championed by the JPC, resulting in modification of legislation and/or regulation to provide transparency to the investor and ensuring adequate oversight by the government. Effectively the JPC forced legislators to act in a timely manner due to pending transactions, rather than waiting for legislative actions prior to structuring and proceeding with privatisation initiatives.

Availability of capital markets for privatisations

Increased liquidity and resurgent capital market activities in Kuwait, Bahrain and UAE have helped foster growth of financial intermediaries and UAE has quickly become a new hub of financial intermediaries for the MENA region. Oil-driven financial surpluses have been reinvested into local companies through over-the-counter share purchases, or through a growing cadre of regional private equity firms, that participate in privatisations and capital markets equity and debt offerings. Enhancing liquidity of the capital markets is the growth of medium and long-term Islamic bonds.

The three top performing major stock markets in 2004 were Saudi Arabia, Egypt and Qatar, all posting 40% gains. The average Arab Index, which encompasses market data from each of the region's capital markets, has risen 181% from 1999 to 2004. The region's capital markets have different types of restrictions of foreign ownership, ranging from Jordan which allows 100% foreign ownership to Qatar which limits foreign ownership of bourse-listed companies to 25%. Many of the large Saudi SOEs are going directly to capital markets to monetise assets, but have restrictions on foreign ownership.

The banking sector is increasingly stable and profitable, and capital markets issuers are enjoying longer tenors and often oversubscribed issues. Former SOEs that have strong creditworthiness are finding an option to list shares on major stock exchanges such as London and New York through the issuances of Depository Receipts (DR). The DR

Table 1: Recent privatisation transactions in the Middle East

Egypt:	Pending privatisation of the SOE portion of Suez Cement, promoting a bid of US$550m from French concern, Cimentis Francais.
Jordan:	In an effort to further promote commercial interest, the government concessioned the management of the Aqaba Port Authority, in order to implement best practises and promote mixed use property applications including commercial port expansion and tourism.
UAE, Oman:	Promoted and successfully implemented public private partnerships in water and power, beginning with the Taweelah A2 and A1, and Oman's Barka 1 and Barka 2 (bid process announced). UAE has become the home to numerous international financial intermediaries as a result of its accessibility and business climate. Abu Dhabi-based Al Gaith Holding has won a US$750m deal to build a steel plant at Oman's Sohar Industrial Port.
Saudi Arabia:	Reforms were approved in 2004; the ceiling on taxes on foreign commercial activities was reduced to 20% from 45%; talks of Saudi's accession to WTO are expected to be complete in the near term. Saudi Cabinet approved a new law for investment in its mining sector to best exploit Saudi's mineral wealth. The new law offers investors, both local and foreign, a number of incentives including tax-free importation of equipment and spare parts, the right to obtain multiple licences, and ability to explore for various minerals in the licensed area. The Saudi IPO of Ettihad Etisalat (Saudi mobile network) was a US$13.6bn offering that was 51 times oversubscribed. NCCI, the largest insurance company in Saudi Arabia, was privatised with 70% of its shares being floated on the Saudi market. Other privatisations anticipated for 2005 include Power & Water Utilities Company, Saudi Arabian Mining Company, and Saudi Dairy & Foodstuffs Company.
Qatar:	Norsk Hydro has reached an agreement with Qatar Petroleum to invest US$1.5bn of a total project cost of US$3bn, in a new 570,000 ton aluminum smelter in Qatar. Completed financing and construction has begun of US$9bn financing for Qatargas II liquefaction facility.

market is an attractive alternative as it allows capital that would not typically invest directly in a country to invest in these companies.

Debt and equity issues over the past two years include:

- Issues of longer term Islamic Sukuk offerings are being widely snapped up and the market for Islamic bonds is growing, with the most recent offering of a US$1bn issue proposed by the Islamic Development Bank with sales anticipated in Europe, Asia and Islamic Development Bank member countries.
- AES Barka's US$29m IPO in Oman was 17 times oversubscribed.
- Qatar Gas Transport Company which is expected to raise US$3.2bn-US$3.8bn, has received significant pre-market attention with 50,000 subscription forms being distributed in less than two hours at Doha banks.
- Qatar is setting up to open its stock market to foreign investors, with foreign investors able to own up to 25% of shares of companies listed on the US$40bn bourse.
- In Jordan there has been a US$40m bond offer for the Middle East Complex for Engineering Electronics and Heavy Industries; offered at a fixed rate five-year period.

Challenges

An effective PPP or an SOE divestiture is a significant undertaking, requiring changes to the economy's legal, regulatory and financial framework. Consideration must be given to public sentiment in and for the policy changes to be culturally accepted prior to the SOE divestiture or PPP tender. Among the most challenging aspects of privatisation are the socio-economic and cultural ramifications. Socio-economically, a privatisation of an SOE will often result in the new management instituting best practices and efficiencies that often translate into employee redundancies. Cultural changes result from the privatisation of a state asset that has historically been viewed as a natural government service or a government subsidy that would be placed in the hands of a commercially driven foreign investor. These concerns can be managed as in Jordan.

Jordan enacted an innovative programme to manage dislocations and redundancies by following underlying principals of equity, establishing general rules to preserve rights of employees in all privatised enterprises, and provided transition packages that included share ownership and placement assistance.

A subsidised public service may cause severe dislocations to consumers if the subsidised industry is immediately switched to market-based pricing. An example of this subsidy exists in Saudi Arabia, where official water rates are estimated to be 50% below the actual cost of delivering the service. An innovative approach was formulated in Morocco with the signing of a 30-year concession agreement with Veolia Environmental. Water supply was divided into six tranches determined by district. Poorer neighbourhoods paid US$0.20 per cubic metre while higher income neighbourhoods paid US$0.60 per cubic metre. The government set the tariff price, resulting in the lowest tranche being subsidised by the government, and the highest tranche recapturing the subsidy. Morocco implements a similar system of supplying electricity.

Success stories

Critical to the successes has been the liberalisation of the business environment alongside government investment that encourages private sector development.

Many of the large-scale revenue-producing infrastructure projects have been auctioned under PPP concessions, with SOE participation as a minority shareholder (or majority shareholder depending upon the strategic industries). This structure has been employed in the petroleum and petrochem sectors and more recently in water and power projects.

The region's energy and energy-related independent water and power projects (IWPP) have been a significant success. Governments have offered concessions to private investors with a certain percentage of ownership continuing to be held by the state utility. For instance, Abu Dhabi moved to rapid privatisation of water and power projects beginning in 1998, in part due to looming water shortfalls of 100 million gallons per day (MGD). Abu Dhabi was faced with a projected doubling of water requirements (from 313 MGD to 600 MGD) and a doubling of power requirements to 14,600 MW from the current 7,600 MW. The largest undertaking is the Al Shuweihat power and desalination plant 240km west of Abu Dhabi. Al Shuweihat will be built in three phases, each phase consisting of 1,500 MW and a 300 MGD desalination facility. Other recent transactions can be seen in Table 1.

Conclusion

The successes of the MENA privatisation and PPP programmes stem from a willingness by host countries to utilise private capital, in increasing abundance, of the need to improve infrastructure and services previously in the domain of the state. Even prior to the current oil boom, privatisation and public private partnerships were being implemented and beginning to take hold. Significant opportunities remain across the spectrum of infrastructure projects including water, power, transportation and multiple industrial sectors.

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