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Financing Gulf Cooperation Council Power Projects Post Credit-Crunch

John Sachs, Scott Flippen, and Nicole Weygandt

The rapid economic development of the Middle East has led to a dramatic rise in regional demand for power. The Gulf Cooperation Council (GCC)¹ region has seen economic growth rates of over 6 percent a year over the past five years, and even higher rates in some countries, such as Qatar, which experienced growth of over 15 percent in 2006–08. As a result, according to Moody’s Investors Service, by 2015 the region’s generating capacity needs to be expanded by 60,000 megawatts to meet demand and will require more than U.S. \$50 billion of investment.

Some countries, such as Qatar . . . experienced growth of over 15 percent in 2006–08.

Most GCC governments have a history of successfully tapping the private sector through independent power project (IPP) and independent water and power project (IWPP) structures to meet their infrastructure requirements and are continuing to do so. In recent years, however, this success has been underwritten in large part by international commercial banks eager to

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lend to the sector. The continuing credit crunch has changed this situation drastically, and the reduced availability of commercial debt is threatening the region's ambitious power expansion plans and the development of future projects. As a result of the reduced availability of commercial bank debt for power projects in the region, the overall cost of project debt has increased and tenors, i.e., the length of time over which the loans are repaid, have shortened, prompting sponsors to finance projects on less favorable terms and to seek supplemental sources of financing, such as export credit agencies (ECAs) and regional Islamic banks.

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RECENT RAPID GROWTH

Since 1995, 25 IPPs and IWPPs totaling over 27,000 megawatts of power capacity and representing U.S. \$36 billion of investment have been developed in the region.² Although

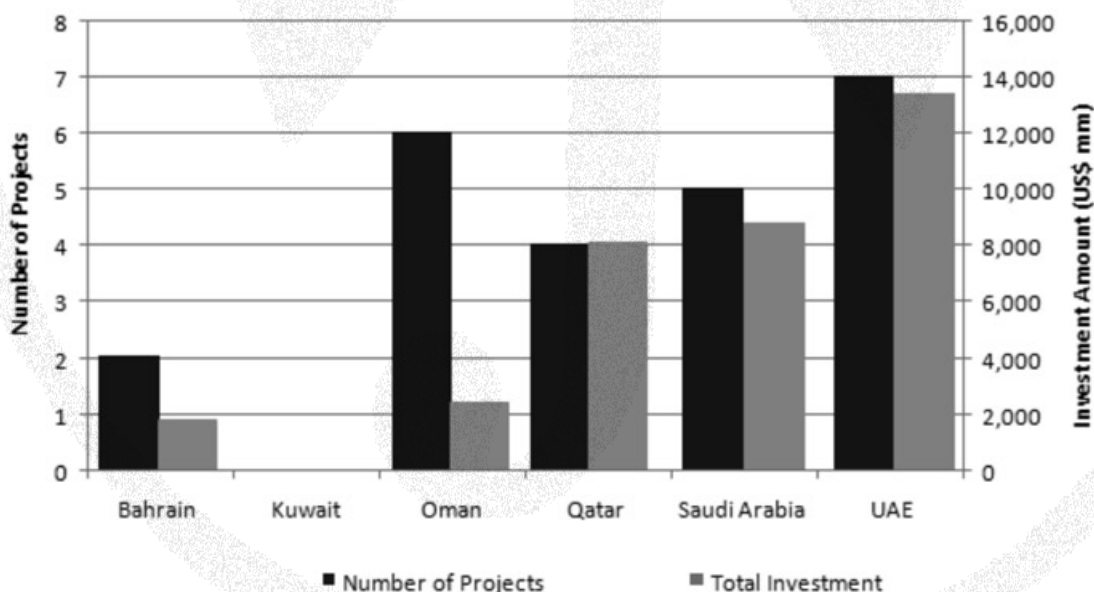
it started slowly, the pace of development has increased in recent years: in 2003–08 approximately two-thirds of IPPs and IWPPs by number and 85 percent by added power generation capacity reached financial close.

The most prominent programs to date have been in Abu Dhabi, Saudi Arabia, and Qatar (see **Exhibit 1**), all of which implement their programs via public-private partnerships, whereby government-owned entities are equity participants in the projects. Projects tend to be underpinned by long-term (15–20-year) off-take agreements with creditworthy state-owned utilities and/or sovereign government guarantees, allowing them to achieve favorable financing terms.

Recently, European and Japanese energy companies have dominated the market, although Asian companies have begun to aggressively expand.

The appeal of these project structures is evidenced by the number and variety of international sponsors that have bid for the right

Exhibit 1. GCC Projects and Investment by Country



Source: Dealogic.

to finance, build, own, and operate plants in the GCC. Recently, European and Japanese energy companies have dominated the market, although Asian companies have begun to aggressively expand their presence, frequently entering projects as minority partners. U.S. sponsors, led by CMS Energy, AES, and PSEG, have historically enjoyed great success in the market. However, interest from U.S. companies seems to have waned. In 2007, CMS Energy sold its GCC portfolio to Abu Dhabi National Energy Company (TAQA), and PSEG has also exited the region. AES is currently in the process of auctioning off several of its major regional assets.

Interest from U.S. companies seems to have waned.

As part of the evolving share ownership noted above, the GCC power market has also seen greater participation from local sponsors. While domestic companies have been active in certain countries from the earliest stages, the majority of local investors have focused exclusively on their home markets. Recently, a number of regional players have emerged and are pursuing projects throughout the region. According to data from Dealogic, the list of the top five largest investors in GCC IPPs and IWPPs now includes

two GCC-based companies (ACWA Power and Gulf Investment Corporation).

The GCC power market has also seen greater participation from local sponsors.

Before the start of the credit crisis, IPP and IWPP financings in the GCC took place in a relatively liquid financial market, driven in part by the ready availability of international commercial bank debt. Across the transactions that have closed via project financing, more than 60 percent of debt has come from commercial banks, with relatively limited local bank participation. ECAs and Islamic financiers have played a lesser role and have tended to complement commercial bank debt as the size of transactions has increased (**Exhibit 2**).

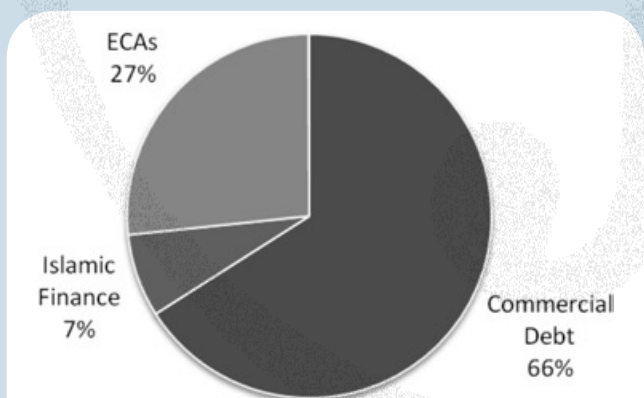
SURVIVING THE CREDIT CRUNCH

Prior to the credit crunch, commercial banks were providing very generous terms on the back of long-term, government-backed, off-take agreements. Tenors on project debt were typically 15–20 years and could go as long as 25 years. The Ras Laffan C IWPP, the only IPP or IWPP to reach financial close during 2008, was able to raise 25-year debt on the basis of a 25-year power purchase agreement (PPA) with Qatar's state-owned utility, backed by a guarantee from the Qatari Ministry of Finance. In contrast, the Al Dur IWPP in Bahrain, which reached financial close at the end of June and had originally been envisioned to have 20-year debt, was only able to structure an 8-year mini-term financing. In 2007, when five projects totaling over 8,000 megawatts and nearly U.S. \$11.3 billion of investment reached financial close, lending margins fell to historic lows of as little as LIBOR (London Interbank Offered Rate) plus 65 basis points (**Exhibit 3**).

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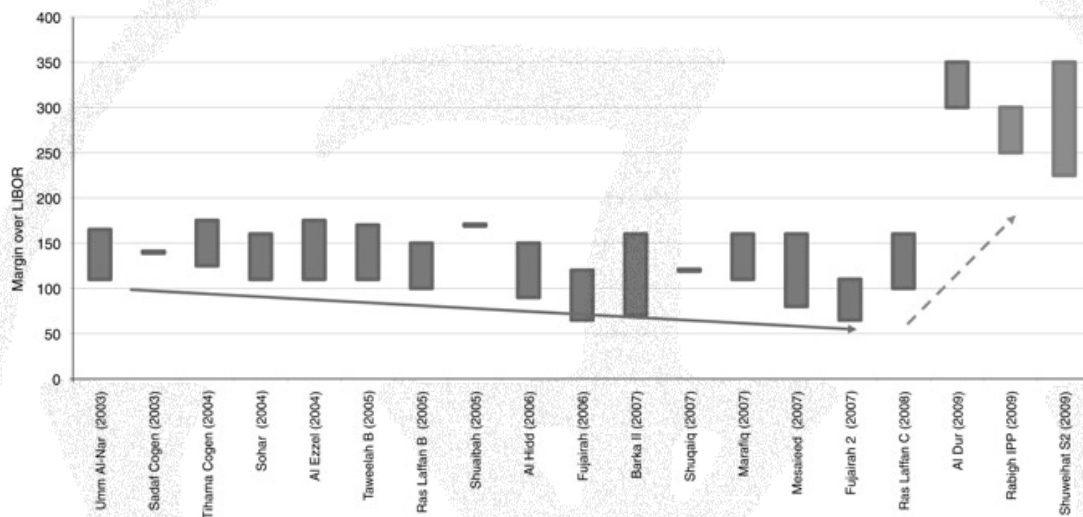
With the start of the credit crunch, however, markets tightened considerably. In September 2008, the *Middle East Economic Digest* reported that only 12 banks were actively seeking project

Exhibit 2. Breakdown of Debt Financing for GCC IPPs and IWPPs



Source: Dealogic.

Exhibit 3. GCC IPP/IWPP Cost of Commercial Debt, 2003–09



Note: Includes long-term debt only. Does not include stand-by facilities, letters of credit, bridge loans, and similar arrangements. Margins for the last three projects are estimates for projects that have not yet reached financial close.

Source: Dealogic, Project Finance International.

finance transactions as compared with 2 years before, when more than 45 banks were in the market. The credit markets have since recovered somewhat, and it would appear that more banks are seeking deals, but in general banks are seeking smaller exposures and are shying away from lengthy tenors. Given the massive project size, typically in the U.S. \$2.0–3.5 billion range, that has been the norm in recent IWPP projects, the reduced availability of commercial bank debt has left a major hole in several projects' financing plans. Sponsors have therefore begun to adapt their financing strategies to the changing market.

With the start of the credit crunch, however, markets tightened considerably.

The three major projects in the market today—Shuweihat S2 (Abu Dhabi), Al Dur (Bahrain), and Rabigh (Saudi Arabia)—this year have encountered a more difficult credit environment than has been found in the GCC for some time. The main problems that are created by the reduction in commercial bank debt capacity are higher margins (partly because banks' cost of

capital has risen and partly because there is less competition in the market) and shorter tenors, reflective of lenders' increasingly risk-averse attitudes. Project sponsors have responded by tapping additional sources of finance, making concessions in the terms of their financings, and seeking greater support from governments.

Shuweihat S2 (Abu Dhabi)

In Abu Dhabi, the U.S. \$3.2 billion Shuweihat S2 IWPP, initially a partnership between Suez Energy and the Abu Dhabi Water & Electricity Authority (ADWEA), has been forced to explore a full range of options to complete the financing. After proving unable to raise long-term debt financing at the end of December 2008, the project was forced to obtain a U.S. \$900 million, nine-month bridge loan to cover initial construction. The bridge facility must be replaced by long-term project financing by September 2009; otherwise, the sponsors risk nationalization by the government of Abu Dhabi.

Suez and ADWEA have sought to improve the attractiveness of the project by extending the 20-year power and water purchase agreement by 5 years. Suez also sold half of its 40 percent stake

in the project to Marubeni, potentially allowing the Japan Bank for International Cooperation (JBIC) to provide a U.S. \$1.1 billion direct loan. A loan of this size would reduce the commercial bank tranche to a more manageable size, while also improving overall market sentiment toward the project.

Al Dur (Bahrain)

Similarly, the U.S. \$2.1 billion Al Dur IWPP in Bahrain, which had originally targeted the end of 2008 for its financial close, has altered its financing structure by incorporating a “hard mini-perm” structure, an 8-year loan with the majority of the principal due in the final year. By effectively forcing a refinancing within 8 years, the structure is able to attract lenders currently unwilling to agree to longer tenors, while allowing the sponsors—and the Bahraini government, which needs the power—to bridge a difficult credit market without further project delays.

As with the Shuweihat S2 IWPP, Al Dur, which has only just reached financial close, sought support from ECAs. In particular the U.S. \$1.7 billion commercial debt tranche is supplemented by a U.S. \$200 million loan from the U.S. Export-Import Bank and a \$300 million Islamic finance tranche, as well as political risk insurance from the Korean Export Insurance Corporation (KEIC). The pricing on the commercial tranche is reported to be well above the highest historical margins in the region, at LIBOR plus 300–350 basis points post-construction.

Saudi Projects

Two Saudi projects that had expected to complete financing in 2009 highlight an additional set of challenges in obtaining financing in the current credit environment. The Ras al-Zour IWPP, while seemingly able to raise sufficient debt commitments—including U.S. \$1.2 billion in debt from local banks, U.S. \$2.5 billion in JBIC direct loans, and U.S. \$500 million in international bank debt—was recently converted from a private-sector concession to a government-owned engineering, procurement, and construction (EPC) deal, after the project found itself facing trouble with equity funding. Local press reports indicate that the Malaysian partner to the project, Malakoff, was forced to exit the transaction after reducing its

initial stake from 20 percent to 8 percent, as it struggled to provide its portion of the equity funding. The remaining sponsors were unable to find a replacement before the government approved a proposal in April 2009 to cancel the private concession.

At the time of this writing, the Rabigh IPP in Saudi Arabia has been thought to have assembled the entire necessary project financing. The financing is expected to close in July, and its U.S. \$1.9 billion debt financing is expected to consist of U.S. \$900 million from Saudi Islamic banks and U.S. \$800 million from Saudi commercial banks, while international commercial banks are expected to provide around U.S. \$200 million under a KEIC-covered tranche and no uncovered lending. (There is a chance that China Ex-Im may participate in this deal as well, in which case the two Saudi tranches would likely be decreased in size.) Compare this deal with the last major project in Saudi Arabia, the U.S. \$3.5 billion Marafiq IWPP, which included over \$1.0 billion in uncovered lending from international commercial banks, and it becomes clear that the financing landscape in the GCC has changed.

AN OPPORTUNITY FOR THE CAPITAL MARKETS?

As the financial crisis has forced commercial lenders to reduce their exposure to the GCC power market, sponsors have pursued a number of alternatives to fill the void. However, one alternative that seems to be missing, in the power sector at least, is greater participation from capital markets.

The regional capital markets currently do not offer tenors long enough to support a power project financing. For that, sponsors would need to look to the international bond market.

There are signs that the regional bond market, which was growing rapidly prior to the onset of the financial crisis, is beginning to recover from the effects of the crisis. NCB Capital, a Saudi investment banking firm, estimated that the 2009 sukuk³ pipeline in the GCC was close to U.S. \$24.6 billion, nearly two-thirds of the global sukuk pipeline. Although this amount remains well below the highs of 2007, when sukuk issuance reached U.S. \$37.6 billion, it represents

a significant increase from 2008. The increase in sukuk issuance is a positive sign, but realistically, the regional capital markets currently do not offer tenors long enough to support a power project financing. For that, sponsors would need to look to the international bond market.

On the face of it, GCC IPPs and IWPPs, which offer predictable and steady cash flows over long-life concessions and are typically backed by creditworthy government guarantees, should be considered good candidates for bond financings. While international capital markets have the potential to become an important source of additional liquidity for the region, international bond investors have never truly embraced the region, and bond financings have only been used in a handful of projects. According to data from Dealogic, only seven GCC project financings (out of more than 200) have involved bond issues over the last 14 years, and only one, the Alba aluminum smelter expansion in Bahrain, was outside of Qatar.

One difficulty has been the lack of regional benchmark issuances. That issue is now being addressed, as several Gulf sovereigns have recently issued bonds in an attempt to establish a benchmark for local pricing. Earlier in 2009, Abu Dhabi launched a U.S. \$3 billion tranche of a U.S. \$10 billion bond program, with a rating of AA or Aa2 from S&P, Fitch, and Moody's. The initial tranche closed in March 2009 and came in under the guidance price.

One difficulty has been the lack of regional benchmark issuances.

The Abu Dhabi issuance was followed shortly thereafter by a U.S. \$3 billion sovereign Qatari bond, and Bahrain is reportedly planning a U.S. \$750 million sovereign sukuk. Both Oman and Kuwait have also given indications that they are considering bond issuances. The positive reception enjoyed by these sovereign bond issues has already given rise to a flurry of conventional and sukuk corporate bond issuances and mandates across the Gulf from major corporate players, including Mubadala, RasGas, Saudi Electricity Company, Qtel, ADWEA, IPIC, and Aldar.

Also of note is the Dolphin Energy natural gas pipeline project refinancing, which is cur-

rently in the market. The project sponsors are reportedly planning to reduce the commercial bank debt component of the financing in favor of an increased capital markets offering, as appetite for the project's bonds appears to be growing. It would seem that as the bond market returns and investors seek real assets as opposed to "structured" products, there should be an opportunity for capital markets to play a role in future GCC power financings.

As the bond market returns and investors seek real assets as opposed to "structured" products, there should be an opportunity for capital markets.

CONCLUSION

Most GCC states have adopted aggressive power expansion plans on the basis of IPP and IWPP concessions. This model, which is heavily reliant on debt financing, has come under intense pressure as a result of the continuing credit crisis. In light of the recent difficulties faced by private concessionaires, many sponsors are seeking increasing support from noncommercial-bank funding, including ECAs and Islamic finance institutions.

The next few months should see a number of private projects come to market, the success of which (or lack thereof) will greatly influence the future direction of the financing of power projects in the region.

GCC governments are also exploring a greater role for themselves—both in terms of providing increased support or assuming control over the development and operation of projects—or are reevaluating the pace and scale of their power-sector expansions. The next few months should see a number of private projects come to market, the success of which (or lack thereof) will greatly influence the future direction of the financing of power projects in the region. ☪

NOTES

1. The GCC comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
2. This article deals with greenfield and brownfield financings of IPPs and IWPPs; it does not address refinancing or acquisitions.
3. A sukuk is an Islamic financial instrument similar in nature to a conventional bond.