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## The Mirage Becomes Reality: Privatization and Project Finance Developments in the Middle East Power Market

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# The Mirage Becomes Reality: Privatization and Project Finance Developments in the Middle East Power Market

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## Abstract

This Essay discusses privatization and financing developments in the Middle East power market. In the coming years, the power sector will experience unprecedented growth and investment due to the increasing demand for electricity throughout the region and the desire of governments to diversify their economies away from oil. This need for electricity has fueled the drive towards privatization and the growth of independent power projects (or “IPPs”).

## ESSAYS

# THE MIRAGE BECOMES REALITY: PRIVATIZATION AND PROJECT FINANCE DEVELOPMENTS IN THE MIDDLE EAST POWER MARKET

*Loren Page Ambinder, Nimali de Silva & John Dewar\**

### INTRODUCTION

Over the past five years, the Middle East region<sup>1</sup> has become an oasis of project finance<sup>2</sup> opportunity. Lenders have closed almost US\$27 billion in project loans, with another US\$54 billion of loans in various stages of development or financing.<sup>3</sup> Expanding regional populations, macroeconomic growth, and a rising demand for services are driving the market.<sup>4</sup> As the legal, business, and regulatory environments in the region continue to develop and improve, the world financial community is becoming more interested in financing projects in the Middle East.<sup>5</sup> These demographic, regulatory, and economic changes, coupled with the desire of governments to keep these projects off their balance sheets, have made the Middle East the region du jour of international project financiers.

While traditional project financing techniques are enjoying

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1. For the purposes of this Essay, the "Middle East region" includes the area from North Africa to the Gulf region (i.e., Morocco, Algeria, Libya, Egypt, Lebanon, Syria, Jordan, Israel, the Gaza Strip, Saudi Arabia, Iran, Iraq, Kuwait, Qatar, Bahrain, Yemen, Oman, and the United Arab Emirates).

2. Project finance is, generally speaking, the financing of a project in which the lenders rely principally on the revenue stream generated by the operation of the project for the repayment of their loans. In essence, investors look to the creditworthiness and merits of the project rather than to the project sponsors. MILBANK, TWEED, HADLEY & MCCLOY, *PROJECT FINANCE: THE GUIDE TO FINANCING INTERNATIONAL OIL AND GAS PROJECTS* 3 (1996).

3. Standard & Poor's, *Project Finance in the Middle East: Emerging Opportunities*, 1999 *INFRASTRUCTURE FINANCE: PROJECT FINANCE, UTILITIES AND CONCESSIONS, CRITERIA AND COMMENTARY*, Oct. 1999, at 126.

4. See Baker IV & R. Thomas Amis, *The Middle East Power Sector: Poised for Growth*, *POWER ECON.*, Jan. 30, 2001; Frederik Sladden, *US-ARAB TRADELINE*, Feb. 18, 2000.

5. Standard & Poor's, *supra* note 3, at 126.

less popularity now in certain parts of the globe,<sup>6</sup> project finance remains a viable and effective means of financing infrastructure in the Middle East, particularly in the power, oil, and gas sectors.<sup>7</sup> First, governments are more reluctant to spend public money on large, capital-intensive projects due to the volatility of oil prices and accordingly, oil revenues. Instead, they have started to explore private means of financing these projects.<sup>8</sup> Second, there is a trend towards engaging in joint ventures for large infrastructure projects, especially in emerging market countries, and project finance is well-suited for financing joint ventures.<sup>9</sup> Third, project finance enables sponsors to allocate and transfer various project risks to other parties, thus decreasing the sponsors' overall risk exposure. Fourth, such limited recourse financing allows cash-strapped sponsors to take advantage of off-balance-sheet financing and tax incentives.<sup>10</sup> Thus, project finance remains a sought-after financing tool for governments that are seeking private finance and for project sponsors who wish to minimize their potential liabilities in emerging market regions.

This Essay discusses privatization and financing developments in the Middle East power market. In the coming years, the power sector will experience unprecedented growth and investment due to the increasing demand for electricity throughout the region and the desire of governments to diversify their economies away from oil.<sup>11</sup> This need for electricity has fueled the drive towards privatization and the growth of independent power projects (or "IPPs").

The privatization programs that are being developed and implemented in the Middle East generally possess similar strategies. These policies are characterized by a gradual, regulated

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6. See PROJECT FIN. MAG., Feb. 9, 2001 (stating that Brazilian state oil company Petrobras announced that it is ending the use of project finance vehicles for new offshore projects citing high costs, bureaucracy, and slowness); see also *Sponsor Profile—Calpine*, PROJECT FIN. MAG., Nov. 2000, at 29 (describing the explanation of Calpine Senior Vice-President for Finance, Robert D. Kelly, as to why Calpine Corporation moved away from using the traditional project finance model in U.S. power projects).

7. Standard & Poor's, *supra* note 3, at 126.

8. See Baker & Amis, *supra* note 4, at 18.

9. *Id.*

10. See Lucy Baker, *Listening to a Pioneer, George Wadia, Interview*, PROJECT FIN. MAG., Dec. 1, 1998; see also Standard & Poor's, *supra* note 3, at 126.

11. Baker & Amis, *supra* note 4, at 18; see Taimur Ahmad, *What Gulf?*, PROJECT FIN. MAG., Dec. 1, 2000.

transition of state-owned generation and distribution activities to private ownership. In order to illustrate the path that privatization is taking in the Middle East, the efforts of Abu Dhabi, Jordan, and Saudi Arabia will be discussed.

The development of new, "greenfield" independent power projects is usually the first step in the privatization of the power sector. Often, governments faced with serious capacity and power shortages turn to IPPs first because they are the simplest and most efficient method for creating new electricity supply. IPPs are flourishing in the Middle East as a result of electricity sector restructuring efforts, improvements in foreign investment laws, and the development of investor-friendly legal and regulatory regimes.

As the IPP market continues to grow and develop, financing structures for these projects are also evolving. In the past year, elegant and aggressive structures more typical of Western European financings were used in Abu Dhabi and Oman. These sophisticated financing structures are likely to spread to other countries in the region as investors gain more comfort and exposure to the region as a whole. To illustrate the evolution in IPP financing, the following projects will be discussed: the Al Manah IPP in Oman (1994),<sup>12</sup> the Taweelah A-1 Independent Water and Power Project ("IWPP") in Abu Dhabi (2000), and the Barka IWPP and Al Kamil IPP in Oman (2001).

### I. THE GROWING DEMAND FOR POWER—GOVERNMENTS COURT THE PRIVATE SECTOR

The compelling need for power has heralded the privatization of power and the development of IPPs in the Middle East.<sup>13</sup> In fact, the demand for power in some Middle Eastern countries is growing at 10% a year.<sup>14</sup> An estimated 100,000 MW of capacity will be required in the Middle East/North African area over the next ten years.<sup>15</sup> Governments cannot afford to foot the bill alone for such large-scale investments in infrastructure—a recent study by the Gulf Organization for Industrial Consultancy

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12. This was the first IPP in the region.

13. See *On the Move*, MEED, Jan. 5, 2001, at 21 ("If there is a common thread running through the region, it is the pressing need for new power capacity.").

14. *Id.*

15. *The Power Game*, MEED, Jan. 26, 2001, at 23.

determined that electricity sector investment in the Gulf region is likely to exceed US\$100 billion over the next decade.<sup>16</sup> Thus, many governments are turning to private foreign investment as the answer.<sup>17</sup>

In order to attract private developers, many of the region's governments, including Saudi Arabia,<sup>18</sup> Oman,<sup>19</sup> Jordan,<sup>20</sup> Egypt,<sup>21</sup> Israel,<sup>22</sup> and the United Arab Emirates ("UAE"),<sup>23</sup> have

16. See Baker & Amis, *supra* note 4, at 18; see also *The Power Game*, *supra* note 15, at 23.

17. See Philip Carter, *Generating Excitement*, PROJECT AND TRADE FIN., Mar. 1997, at 39-42 ("[T]he only route open to governments in the Middle East if they are to meet both the demand for power and their desire to keep it off their own balance sheets is to look for private finance.").

18. For instance, Saudi Arabia has recently introduced the following changes: the merger of the Saudi regional electricity companies into one entity, the formation of the Saudi Arabian General Investment Authority to streamline investment and reduce bureaucratic red tape, the adoption in April 2000 of a new Foreign Investment Law, and the consideration of a new tax code governing foreign investment. The Foreign Investment Law provides equal tax treatment to foreign and local investors, permits 100% foreign ownership of projects, and gives foreign investors access to attractive finance from the Saudi Industrial Development Fund. In addition, the government is considering the adoption of a new electricity law and regulations to push the privatization process along. *Ushering in the New Generation*, MEED, Mar. 16, 2001, at 24; Jason T. Burdette, *Saudi Law Launches New Investment*, US-ARAB TRADELINE, Apr. 21, 2000; Baker & Amis, *supra* note 4, at 18.

19. In Oman, the government has increased the permitted level of foreign ownership in local companies from 49% to 65%, with possible further increases in the near future. The tax laws also have been amended to encourage foreign investment as well. See Taimur Ahmad, *Oman Unveils*, PROJECT FIN. MAG., Feb. 1, 2000.

In addition, Oman has introduced an ambitious privatization program that was inaugurated with the promulgation of its 1996 Privatization Law by Royal Decree 42/96. See *Privatisation and Regulation in Oman: Action Plan*, EIU BUSINESS MIDDLE EAST, Nov. 1, 1996. It involves unbundling and corporatizing the ministry's existing activities into a number of separate generation, transmission, and distribution businesses, which will be initially owned by the government and then privatized. The initial phase focuses on new generating capacity and the completion of the national electric grid. The remainder of the agenda includes the privatization of existing generators and the creation of three transmission companies and regional distribution entities. See Sladden, *supra* note 4. The government is in the process of drafting a new law that will establish a specialized regulatory body to monitor the privatized power companies. See PROJECT FIN. MAG., Feb. 9, 2001.

20. Jordan passed an investment law in 1995 to ease restrictions on foreign investments. This law permits foreign direct investment in all projects and sectors, removes foreign shareholder limits, and reduces minimum capital requirements. Investors have the right to repatriate capital, profits, and dividends in any convertible currency. Baker & Amis, *supra* note 4, at 18. In 1999, Jordan repealed the Electricity Law of 1996 and replaced it with a new General Electricity Law No. (13), which will be discussed in greater detail in this Essay. *Id.*

21. Egypt implemented an aggressive privatization and economic reform program starting in 1991, which encourages foreign investment, places no transferability restric-

begun to implement a mix of foreign investment laws, transparent regulatory institutions, and privatization programs. Many other states in the Middle East are in the process of developing these types of reform as well.<sup>24</sup> This Essay focuses on the privatization efforts taking place in the region.

## II. PRIVATIZATION OF POWER IN THE MIDDLE EAST

Privatization is defined as the act of transferring assets, or responsibility for a service, from government control or ownership to private enterprise. It has been said that "[t]he essence of privatization is the transfer of commercial risk to the private sector . . . the necessary corollary of [that] transfer of risk is the corresponding transfer of control and decision-making to those managing that risk."<sup>25</sup> Political perceptions,<sup>26</sup> as well as realities,<sup>27</sup> however, make governments cautious about relinquishing outright control of the power sector to private investors. In fact,

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tions on money, and protects owners from nationalization, certain forms of expropriation, asset and license seizures, and regulation of prices or profits. *Id.* In July 1999, the government opened the door to privatizing seven regional generation and distribution companies by permitting initial offerings in three of the companies. *See* Sladden, *supra* note 4.

22. Israel's Law for the Encouragement of Capital Investments offers various incentives, such as government grants and tax benefits, to investors investing in approved enterprises. *See* ISRAEL MINISTRY OF FINANCE, ISRAEL'S INVESTMENT POLICY. In addition, Israel passed a new electricity law in 1996 that allows the energy minister to grant permits to IPPs. Israel has also adopted new regulations to allow private power producers to sell directly to end-users rather than to the state-owned Israeli Electric Corporation. *See* Sladden, *supra* note 4.

23. In 1998, the government of the United Arab Emirates adopted a new program encouraging direct foreign investment in the power sector. *Id.* A detailed discussion of Abu Dhabi's privatization program is discussed later in this Essay.

24. Morocco, Lebanon, Iran, and Qatar are in various stages of planning and instituting economic and regulatory reforms of their respective power industries. *Id.* *See generally* *The Power Game*, *supra* note 15, at 23.

25. Martin Amison, *Privatization and Project Finance in the Middle East*, INT'L FIN. L. REV., Nov. 1995, at 14.

26. Water and electricity are perceived by the public as fundamental utilities that should be owned and/or controlled by the government. *See Tentative Projects Market Develops in the Gulf*, PRIVATISATION INT'L, July 1, 1999; *Privatisation Issues in the GCC States*, PROJECT FIN. INT'L, Dec.12, 1997. In the UK, former Prime Minister Harold MacMillan, an opponent of utility privatization, described the privatization of utilities as "selling off the family silver" in a speech made in the House of Lords. *Id.*

27. Privatization will create the following results: privatized businesses will employ fewer people than public authorities, unsubsidized consumer tariffs based on real costs will cause public consternation, and a greater degree of control must pass to those who are assuming the risks of the project.

the policies being implemented in the Middle East call for privatization to be done in stages, with the governments maintaining, at least initially, a large degree of control over the decision-making.

The Middle East privatization programs share common themes. The objectives are three-fold. First, the state's generation, transmission, and distribution activities are unbundled. Second, one or more of these separated businesses are then transferred to independently managed, government-owned companies.<sup>28</sup> Third, these new corporatized entities are then gradually sold off to private investors. In most cases, the generation business is being privatized first, through the creation of IPPs and the privatization of existing power plants. Furthermore, the states are following the single "government buyer" model (i.e., private independent power producers sell their electricity to a state-owned entity who maintains control and ownership of the transmission sector).<sup>29</sup> These common attributes are illustrated by the privatization efforts of Abu Dhabi, Jordan, and Saudi Arabia.

### III. ABU DHABI: A REGIONAL LEADER IN POWER PRIVATIZATION

Abu Dhabi, one of the seven emirates comprising the UAE,<sup>30</sup> has been, and continues to be, a regional leader in re-

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28. See generally Baker & Amis, *supra* note 4, at 18. Most of these companies are initially majority-owned and controlled by the government. But in Qatar, assets owned by the Qatari Ministry of Electricity and Water were transferred in May 2000 to the Qatar General Electricity and Water Corporation ("QEWC"), a closed joint stock company that is 57% controlled by local investors and 43% controlled by the government. UNITED STATES ENERGY INFORMATION ADMINISTRATION, ENERGY REPORT ON QATAR (July 2000).

29. See generally Baker & Amis, *supra* note 4, at 18. But in Israel, new regulations have been adopted that allow private power producers to sell their electricity directly to end-users rather than to the state-owned Israel Electric Corporation ("IEC"). Israel is also studying the possible privatization of the IEC. *Id.* In addition, Oman is in the process of developing and financing the privatization of the Salalah IPP, which is discussed later in this Essay. The Salalah IPP will, for the first time, involve a private company selling power to end-users.

30. The UAE is a federation made up of the following emirates: Abu Dhabi, Dubai, Sharjah, Ajman, Fujairah, Ras al-Khaimah, and Umm al-Qaiwain. In June 1996, the UAE's Federal National Council approved a permanent constitution for the country. Political power is concentrated in the capital, Abu Dhabi. See *Report on United Arab Emirates*, ENERGY INFORMATION ADMINISTRATION, Oct. 2000.



structuring and privatizing the power sector.<sup>31</sup> Abu Dhabi commenced its program in 1996 with the issuance of Decision No. 1, which established the Privatization Committee for the Water and Electricity Sector. After the Committee's completion of an elaborate study, the Deputy Ruler of Abu Dhabi issued Amiri Decree No. 7 of 1997, which set forth the government's three-pronged approach for restructuring and privatizing the water and electricity sector. This approach involves (1) separating the assets of the state-run Water and Electricity Department ("WED") into separate entities and transferring interests in certain of those entities to private ownership, (2) developing and implementing a new legal and regulatory framework,<sup>32</sup> and (3) meeting future electricity and water demand through IWPP projects.<sup>33</sup>

In February 1998, the Abu Dhabi Water and Electricity Authority ("ADWEA") succeeded WED. ADWEA has overall responsibility for the water and electricity sector. The Abu Dhabi Water and Electricity Company ("ADWEC"), a company organized by ADWEA, serves as the exclusive wholesale purchaser and seller of power and water for the industry and is responsible for capacity planning and the tendering process for IWPPs. ADWEC is also the central purchaser of feedstock gas for the generation and desalination companies.<sup>34</sup>

ADWEC's role will be to purchase water and power from various independent generation and desalination companies (including IWPPs) via long-term power and water purchase agreements. ADWEC will then sell the water and power to the two distribution companies, via the state-owned transmission company ("Transco"), at a bulk supply tariff.<sup>35</sup> This tariff will

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31. See *Tentative Projects Market Develops in the Gulf*, PRIVATISATION INTERNATIONAL, July 1, 1999.

32. Law No. 2 of 1998, Concerning the Regulation of the Water and the Electricity Sector in the Emirate of Abu Dhabi, established the Regulation and Supervision Bureau, the first independent regulator in the Middle East. The Bureau, among other duties, monitors and ensures against monopolistic tendencies. See Ahmad, *supra* note 11.

33. Phillip Fletcher & Simon Davies, *Financing Success for Taweelah A1*, PROJECT FIN. INT'L Y.B., at 128 (2001); Alexander S. Kritzalis & Omar H. Al-Farisi, *Taweelah A-2: A Template for Future IWPP Projects in the Middle East*, PROJECT FIN. INT'L Y.B., 1999, at 134; see also *Special Report: Abu Dhabi*, MEED, Feb. 20, 1998, at 8.

34. *Id.*

35. Law No. 2 of 1998, Concerning the Regulation of the Water and Electricity Sector in the Emirate of Abu Dhabi, created the Abu Dhabi Transmission and Dispatch Company ("Transco"), various generation and desalination companies, and two distri-

include the cost of generation, ADWEC's operating costs, and the cost of dispatch. The distribution companies will then have to establish a non-subsidized customer tariff based on economic cost, which will include the cost of bulk supply, the transmission cost, and the distribution cost. Government subsidies will only be provided through a direct payment at the customer level for certain customer groups.<sup>36</sup> An independent regulatory agency will oversee the new companies and institutions, as well as regulate tariffs.

Pursuant to this privatization program, competition has recently been introduced into generation/desalination activities. Two IWPPs reached financial close thus far: the Taweelah A-2 project in 1999, and Taweelah A-1 project in 2000.<sup>37</sup> In both projects, the government retains sixty percent majority ownership and intends to gradually privatize its shares through initial public offerings to UAE nationals.<sup>38</sup> Currently, Abu Dhabi is in the bidding process for its third and most ambitious IWPP to date, the 1500 MW, 100 million gallon per day Shuweihat project.<sup>39</sup>

The privatization of the distribution and transmission sectors, however, is far less developed. Only limited competition is permitted between the regional distribution companies and, so far, no private investor has been brought on board. The transmission business is to remain, at least for the time being, a natural state monopoly.<sup>40</sup> This monopoly positions the government as the intermediary between the generation and distribution companies and allows the state to keep close control over the

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bution companies, one for Abu Dhabi and one for Al-Ain. See Kritzalis, *supra* note 33, at 135. The distribution companies are responsible for any additions to the distribution network. See *Special Report: Abu Dhabi*, *supra* note 33.

36. Kritzalis & Al-Farisi, *supra* note 33, at 134. Currently, however, the cost of power to consumers is being subsidized by the government. Ahmad, *supra* note 11.

37. The Taweelah A-2 project is a 710 MW, 50 million imperial gallon per day plant. The Taweelah A-1 project involves expanding the A-1 plant from 225 MW to 1350 MW. See Fletcher, *supra* note 33, at 129; see also Kritzalis & Al-Farisi, *supra* note 33, at 135.

38. *Id.* See *Special Report: Abu Dhabi*, *supra* note 33. In response to questions about the government's continuing dominant role in the sector, Abdullah Al Neaimi, director of IWPPs at ADWEA, countered, "[I]t takes time to privatize effectively. Right now we're not working with fully real market models, but we're working towards them." Ahmad, *supra* note 11.

39. See Ahmad, *supra* note 11.

40. *Id.*

level of any subsidy.<sup>41</sup> Jordan's privatization program, although not as mature as Abu Dhabi's, follows a similar template.

#### IV. JORDAN—LAYING THE FOUNDATIONS FOR STRUCTURAL REFORM

It is estimated that Jordan will need over 10,000 GWh of electricity production to meet its requirements in 2005 and 12,500 GWh by 2010, a thirty-four percent and sixty-five percent increase, respectively, over the current 2000 levels.<sup>42</sup> Like Abu Dhabi, Jordan's privatization program centers on a single government buyer approach. Transmission activities are to remain state-owned, while the generation and distribution businesses are to be gradually privatized.

In 1999, in an effort to pave the way for privatization, the Jordanian government replaced the Electricity Law of 1996 with a new General Electricity Law No. (13). In the same year, the National Electric Power Company ("NEPCO"), the state-owned utility company responsible for electricity production, was unbundled into three companies: NEPCO, the Central Electric Generating Company ("CEGCO"), and the Electric Distribution Company ("EDCO").

NEPCO, which is to remain fully owned by the government, is responsible for the management, operation, and development of the high voltage transmission network, load dispatching, and the regional electric grid network. For the time being, NEPCO will be the sole buyer of the electricity generated by CEGCO and any private power plants.

CEGCO is the main power generating company in Jordan and is slated for privatization in the next few years. Currently, CEGCO is a public shareholding company, seventy-five percent owned by the government and twenty-five percent owned by NEPCO. EDCO, also listed for privatization, is a public shareholding company that is fully owned by the government. EDCO is responsible for electricity distribution outside the concession areas awarded to the Jordan Electric Power Company ("JEPSCO")<sup>43</sup> and Irbid Distribution Electricity Company

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41. See *Special Report: Abu Dhabi*, *supra* note 33.

42. GOUSSOUS, EXPORT AND FINANCE BANK, JORDAN ELECTRICITY SECTOR REPORT, Jan. 23, 2001.

43. JEPSCO, a public shareholding company, has a concession to distribute electric-

("IDECO").<sup>44</sup> The government is in the final stages of selecting an advisory group to assist it in devising a strategy for the partial privatization of CEGCO and EDCO.<sup>45</sup> The privatization process is expected to commence around March 2002. In the meantime, the government is pushing ahead with its plans for a partial divestiture of fifty-five to seventy percent of its ownership in IDECO.<sup>46</sup>

Electricity tariffs were set by the Jordanian government in May 1996. Due to the increase in oil prices in the past year, the government is believed to be undertaking a review of the tariffs within the next six months.<sup>47</sup> The tariff rate on the electricity sold to utilities will probably increase, and this increase will trickle down to the end users, but not at the same rate.<sup>48</sup>

In May 2000, the government declared Belgium developer Tractebel as preferred bidder for the construction, operation, and ownership of the country's first IPP. The IPP, which will have a capacity of 450 MW, will be located at Kherbet-Al-Samra. The government and Tractebel are currently negotiating certain aspects of the project, including the terms for financing the project, with the hopes of achieving financial close within the next year.

## V. SAUDI ARABIA—ONE STEP FORWARD, TWO STEPS BACK?

Power project developers are closely watching Saudi Arabia's efforts to restructure its electricity sector. Saudi Arabia possesses a great deal of IPP potential—it needs to invest an estimated US\$117 billion over the next twenty-two years to keep up with its projected electricity demand, which calls for expanding generating capacity by an estimated 50,000 MW.<sup>49</sup> Saudi Arabia's policy, although not as clearly developed as Abu Dhabi's or Jordan's, appears to propose a similar strategy: unbundle state

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ity from Wadi Al-Deleil in the north to Theiban in the south, and from Mogawar in the east to the Jordan Valley in the west.

44. IDECO is a public shareholding company responsible for transmitting and distributing electricity in the governorates of Irbid, Jerash, Mafraq, and Ajloun.

45. Goussous, *supra* note 42. Progress in privatizing these companies is a condition for Jordan's extended fund facility agreement with the International Monetary Fund. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. Baker & Amis, *supra* note 4.

assets into generation, transmission, and distribution companies and adhere to the single government buyer approach.<sup>50</sup> Recent events at the end of last year, however, have called into question the government's commitment to privatization and reform.

Saudi Arabia's restructuring program received a kick-start in February 2000 when the Saudi Industry and Electricity Minister signed a merger agreement among Saudi Arabia's ten existing power companies. On April 5, 2000, the newly formed entity, the Saudi Electricity Company ("SEC"), was established as a joint-stock company, with the government holding a fifty percent ownership interest. According to the 1998 Decree (No. 169) on the Reorganization and Restructuring of the Electricity Sector, the government must establish a regulatory body during the first year after the incorporation of the SEC. Thus, the deadline for the formation of the regulatory agency is fast approaching. Government officials, however, remain adamant that they will meet this deadline.<sup>51</sup>

According to Industry and Electricity Minister Hashim Yamani, the government will privatize the generation sector first.<sup>52</sup> The government plans to use the single buyer approach initially, with the intention of moving to a power pool model within ten years.<sup>53</sup> Although foreign investor participation is welcomed in the generation sector, foreign investors are currently barred from involvement in transmission and distribution activities.<sup>54</sup>

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50. See *Saudi Arabia: Avoiding the California Nightmare*, MEED, Feb. 2, 2001, at 4.

51. *Id.* In a move that may signal the imminent establishment of a regulatory body, the government recently announced the appointments of its legal advisor and management consultant, both of whom will assist the financial consultant with the restructuring. *Id.*

52. *Id.* In October 2000, Saudi Arabia established a new utility company called Marafiq (the Power and Water Utility Company for Jubail and Yanbu). Marafiq, founded by the Royal Commission, the Public Investments Fund, Saudi ARAMCO, and Saudi Basic Industries Corporation, is to meet the future utility requirements of the two industrial cities of Jubail and Yanbu. *Id.* See ENERGY INFORMATION ADMINISTRATION, REPORT ON SAUDI ARABIA, Nov. 2000.

53. *Id.*

54. In February 2001, the Saudi Arabian General Investment Authority ("SAGIA") clarified government policy and published the "Negative List," which specifies those activities that are excluded from foreign investment. Power transmission and distribution were included on the list. This does not mean, however, that transmission and distribution activities will forever be excluded, since the list will be periodically reviewed. SAGIA has said that the first review will be completed next year. See *Ushering in the New Generation*, MEED, Mar. 16, 2001, at 24.

On October 9, 2000, the government appeared to falter in its commitment to restructuring when it succumbed to public pressure and rescinded the tariff increases established by the SEC in April 2000. Decree 169 established a new tariff structure that would enable IPPs to operate with a reasonable rate of return without the need for a government-guaranteed dividend. The SEC applied these tariffs in April 2000, but was forced to reduce them six months later (effective October 28, 2000) following public outcry from consumers who, accustomed to receiving government-subsidized electricity, were shocked at the increases in their electricity bills. Economists say that the new reduced tariffs, which, pursuant to Decree 169 cannot be raised for two years, are twenty-five percent below the minimum level that would provide an acceptable rate of return for investors.<sup>55</sup>

In addition to the uncertainty surrounding the tariff structure, Saudi Arabia's under-developed legal and operating environment, as well as the government's reluctance to provide guarantees, present further challenges to the restructuring and privatizing of its power sector.<sup>56</sup> In spite of these obstacles, however, Saudi Arabia continues to press ahead with new financing schemes for its power projects. For instance, the 1200 MW PP9 power station north of Riyadh was funded using extra revenues that were generated by a special tariff imposed on heavy consumers since 1995 (the Halala Fund).<sup>57</sup> In addition, the expansion of the 2400 MW Ghazlan II power plant was financed by an internationally syndicated US\$500 million loan that has, as part of its security, the right to call on receivables from prestigious customers like Saudi Aramco.<sup>58</sup>

The next test of Saudi commitment to the privatization process will be the development of the 320 MW "captive" IPP that Saudi Petrochemical Company ("Sadaf") plans for meeting its

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55. *Id.* However, bankers say that the tariffs are at least double the pre-2000 level and are sufficient to enable the SEC to cover its costs. *Id.*

56. *Id.* The US\$2.2 billion Shuaiba plant was initially set to become the first IPP, but plans for private investment did not materialize as a result of investor doubts about the tariff and the regulatory and legal regime. The project is now being funded through an Islamic financing by the Al-Rajhi Banking and Investment Corporation. See *Tentative Projects*, *supra* note 24; Sladden, *supra* note 4; see also *Challenging Future for Saudi Power*, PRIVATIZATION INTERNATIONAL, at 47.

57. *Special Report: Power*, MEED, Aug. 8, 1997.

58. *Id.*

own power requirements.<sup>59</sup> It remains to be seen whether the Saudi government has the political will necessary to implement subsidy-free tariffs and a transparent legal and operating framework. Until such a foundation is laid, private investors will continue to monitor progress from the sidelines.

## VI. THE RISE OF INDEPENDENT POWER PROJECTS IN THE MIDDLE EAST

Independent power projects are a vital component in the Middle East strategy for liberating the power sector. IPPs are typically investor-owned, special purpose vehicles that generate electricity either for bulk sale to an electric utility or for retail sale to industrial or other customers. They are the quickest and least intrusive method for injecting foreign investment into the power sector and placing generation into private hands. In fact, in many cases, IPPs precede the formal implementation of a privatization program.<sup>60</sup> This is because the privatization of new power sources, as opposed to the privatization of existing government-owned utilities, can be carried out despite the absence of a fully developed regulatory framework by providing for such regulation in the project documentation.<sup>61</sup> Thus, IPPs are important to Middle East privatization efforts not only because they quickly create an expanded supply of electricity, but because they are an easy and efficient way of transferring new generation activities to the private sector.

As of January 2001, seven IPPs and a further three independent water and power projects ("IWPPs") were either in, or were about to enter, the construction phase.<sup>62</sup> Many other projects are under consideration throughout the region, including in Algeria, Egypt, Israel, the Gaza Strip, Iran, Jordan, Oman, Qatar, Saudi Arabia, Tunisia, the UAE, and Yemen.<sup>63</sup> The growth of IPPs in the region has brought along with it financing features that are more typical of Western European projects, such as

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59. See *Saudi Arabia*, *supra* note 50. Sadaf has short-listed bidders Enron Corporation and CMS Energy as the foreign partner on the project.

60. The Al Manah IPP in Oman preceded the implementation of Oman's privatization program.

61. Manesh Hoskote, *Independent Power Projects (IPPs): An Overview*, The World Bank Group, FPD Energy Note No.2, May 1995.

62. *The Power Game*, MEED, Jan. 26, 2001, at 23.

63. *Id.*

longer loan tenors, less export credit agency involvement, and attractive low pricing. To demonstrate this evolving trend, the Al Manah IPP, the Taweelah Al IWPP, the Barka IWPP, and the Al Kamil IPP financings will be examined.

#### VII. *AL MANAH IPP (1994): THE POWER PIONEER*

The Al Manah project involved constructing a 90 MW power station and 186 km of transmission lines to link the power station to the Oman power grid. The IPP operates within the single government buyer context and has long-term power purchase agreements with the Ministry of Electricity and Water. For its first IPP, the Omani government opted for a build-own-operate-transfer ("BOOT") structure. Under a BOOT structure, the developers finance, build, own, and operate the project for a limited period of time and then transfer the project back to the state after project costs and project debt have been recovered. Oman chose this structure because not only did it afford the government access to private investment with little completion risk to itself, but it enabled the state to retain ultimate control over the project.

The US\$217 million Al Manah financing was dominated by innovative equity arrangements, export credit agency support, and loans that, for a power project, carried a relatively short tenor.<sup>64</sup> The equity funding was provided through two different sources: sixty percent was provided by the developers and the International Finance Corporation, the private division of the World Bank ("IFC"), and forty percent was raised through a public share offering on the Omani stock exchange, the Muscat Securities Market. Thus, the project company (the United Power Company) is owned not only by foreign project sponsors and the IFC, but also by private Omani investors as well.

The debt financing consisted of the following loans: (a) a US\$15 million IFC loan, (b) two loans totaling US\$65.5 million from commercial banks that were guaranteed by the Export Credit Guarantee Department, the United Kingdom export credit agency ("ECGD"), and Compagnie Française pour le Commerce Extérieur, the France export credit agency ("CoFACE"), (c) a US\$45 million uncovered commercial bank

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64. Loan tenors ranged from eight to 12 years.



loan, and (d) a US\$17 million loan from local banks. The debt-to-equity ratio was 70:30.

As the first IPP in the Middle East, Al Manah presented its developers and lenders with a unique set of circumstances that had to be addressed in order to ensure a successful financing. To begin with, the developers were not sure that they could raise the necessary amount of public equity. In 1994, the Muscat Securities Market was not well developed and traded shares only in a limited number of companies.<sup>65</sup> In fact, the financing documents permitted the debt-to-equity ratio to rise to 75:25 if the public share offering on the Muscat Securities Market was not fully subscribed. The developers also encountered hurdles in seeking debt finance. Despite the healthy state of Oman's economy, at the time there was a general reluctance in the international banking community to lend to projects in the Middle East.<sup>66</sup> The IFC's leadership<sup>67</sup> thus proved vital in providing credibility to the project.

The export credit agency (or "ECA") commitment to the project produced both advantages and disadvantages. The involvement of ECGD and CoFACE provided a degree of comfort to the commercial banks that felt protected by the political leverage that these governmental credit agencies were capable of wielding.<sup>68</sup> Furthermore, ECA support ensured a relatively inexpensive means of finance for the project company, due to the resulting low pricing offered on the loans. Nevertheless, ECA participation also required time-consuming procedures that delayed the financing process.<sup>69</sup> In the end, however, it was the

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65. John Mobsby, *BOT in the Gulf—Al Manah Power Station*, PROJECT FIN. INT'L., Dec. 8, 1994.

66. See *Middle East Project Finance: Oman to Play Leading Regional Roles*, APS REVIEW DOWNSTREAM TRENDS, Apr. 18, 1994; see also Martin Amison, *Privatization and Project Finance in the Middle East*, INT'L FIN. L. REV., Nov. 1995.

67. As well as providing a direct loan, the IFC also acted as arranger and lead syndicate bank for the export credit loans and the commercial bank loans.

68. It is widely believed that the involvement of foreign government and multinational credit entities in a project make it (a) less likely that governmental agencies in the host country will engage in politically risky behavior and (b) somewhat more likely that the project will be accorded preferential treatment in the event of certain difficulties (such as a foreign exchange shortage). See Brach et al., *Today's Role for Export Credit Agencies and Multilateral Financing Institutions in Latin American Project Finance*, PROJECT FIN. INT'L, Nov. 18, 1998.

69. ECA support requires that certain eligibility factors are met with respect to the nationality of the investors and the origin of the exports being financed. *Id.* For exam-

ECA presence that sold the deal to the international banking community, as evidenced by the over-subscription at syndication.<sup>70</sup>

As a result of the success of Al Manah, the United Power Company embarked on a US\$183 million expansion to increase Al Manah's generating capacity to 270 MW. The financing was signed in December 1999, and included US\$60.5 million of debt financing that was arranged by commercial banks and included a CoFACE guarantee of off-taker credit. As with the initial project, the expansion was devised according to the traditional build-operate-and-transfer model and the power purchase agreements remained solely with the Ministry of Electricity and Water.

The Al Manah scheme and its expansion, together with Oman's demonstrated commitment to a comprehensive restructuring of its power sector, provided the impetus for three fast-track<sup>71</sup> private power projects and a host of future power asset sales.<sup>72</sup> Two of the new fast-track power schemes, Al Kamil and Barka, will be discussed later in this Essay. The most ambitious of these fast-track schemes, however, is the Salalah IPP, awarded to developer PSEG Global in December 2000. BNP Paribas was named as a financial advisor.

The 200 MW, US\$270 million Salalah IPP will be another first in the region for Oman—the first fully integrated private power scheme to combine generation, transmission, and distribution. The project company will not only build new generation capacity, but it will also take on existing capacity and the existing transmission and distribution networks in the area. The project company will also be responsible for billing and revenue collection. The realization of the Salalah project in Oman will mean the establishment of an important precedent in the Middle East—the development of private power companies that are permitted to sell and deliver power directly to end-users.

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ple, Office National du Ducroire/Nationale Delcrededienst, the Belgian ECA, had to withdraw from the deal as there was not enough equipment being sourced from Belgium. See *Manah Almost Clear*, PROJECT FIN. INT'L, Feb. 2, 1995. Furthermore, ECAs also impose certain policy requirements on the borrower, including for example, compliance with certain environmental and labor standards. Brach et al., *supra* note 68.

70. See *Manah Oversubscribed*, PROJECT FIN. INT'L, Oct. 27, 1994.

71. Oman's "fast-track" power program requires that these power projects are ready to come on-line between 2002 and 2003. See *Oman Unveils*, PROJECT FIN. MAG., Feb. 1, 2000.

72. See *Oman Seeks Investors to Develop its Power Sector*, REUTERS, Oct. 29, 2000.

In addition, Oman has, for the first time, announced plans to invite bids from private investors for three of its largest existing and fully operational power plants. The three plants, the Al Jizzi plant, the Al Rusail plant, and the Al Ghubrah plant, have a combined total capacity of 1600 MW.<sup>73</sup> This shift towards the privatization of existing power plants signals Oman's desire to usher in the next phase of its privatization strategy.

#### VIII. Taweelah Al IWPP (2000): TEMPLATE FOR THE FUTURE

The US\$1.4 billion Taweelah Al IWPP in Abu Dhabi broke new ground for Middle Eastern project finance. This project, a build-own-operate (or "BOO") scheme,<sup>74</sup> involved rehabilitating, refurbishing, and expanding an existing power generation and desalination plant to create a plant capable of generating 1350 MW and producing forty million gallons per day. When completed, Taweelah Al will supply about twenty-five percent of Abu Dhabi's power and water needs.<sup>75</sup>

The Taweelah Al transaction contained financing terms as attractive as any available in Europe and even more attractive than those being offered at the time in the U.S. project market.<sup>76</sup> The US\$1 billion financing boasted an 18.5 year term loan, the longest loan tenor in the region. It was also notable for the lack of ECA involvement. The fact that this project was able to obtain attractive low pricing despite such a long tenor and no export credit support is testament to the growing appetite of international financial institutions for investing in the region. Indeed, due to the overwhelming bank response during senior syndication, the financing never had to go to general syndication.<sup>77</sup>

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73. *Powering Up Oman*, PROJECT FIN. MAG., Feb. 9, 2001.

74. BOO projects differ from BOOT projects in that the BOO project does not revert to the government at the end of the term. BOO projects are gaining in popularity for a number of reasons: (1) the transfer conditions in a BOOT project distorts the pricing of the finance, (2) the transfer may ultimately prove unpopular with the public subscribers, (3) the transfer adds complexity to the structure, and (4) there may be uncertainty over whether the government will have the appropriate structures in place and/or the desire to take back the project in the long run. See Martin Amison, *Privatization and Project Finance in the Middle East*, INT'L FIN. L. REV., Nov. 1995, at 14.

75. See Ahmad, *supra* note 11.

76. See Fletcher & Davies, *supra* note 33.

77. See *Europe, Middle East and Africa Awards 2000, Power Deal of the Year: Al Taweelah Al*, PROJECT FIN. INT'L Y.B., 2001, at 111.

The equity structure of the deal was equally impressive. The project's use of back-ended equity, which provides that the debt financing be injected before the sponsors are obliged to inject their equity funding, set a precedent for a Middle East transaction. The credit strength of the sponsors enabled this structure to be adopted.<sup>78</sup> Although back-ended equity is a common feature in U.S. and European projects, it was a first for the Middle East. Furthermore, the developers achieved a far lower proportion of equity funding than other deals in the region, with the project obtaining a 75:25 debt-to-equity ratio.<sup>79</sup>

The terms of the US\$1.015 billion commercial bank facility were also notable for several reasons. The tenor of the loan was a straight 18.5 years, a previously unthinkable achievement in a region where twelve years was once considered aggressive.<sup>80</sup> Moreover, because the government wanted to set a long term benchmark for lending into the country, the loan did not have a "cash sweep" mechanism or an equivalent feature obliging the developers to refinance the bank debt prior to its stated maturity.<sup>81</sup>

While Taweelah A1's tenor is applauded as a sign of market maturity, many bank lenders are concerned that the regional bank appetite for long-term exposure may dry up due to the number of lengthy, liquidity-absorbing transactions that are due to come to the market in the near future.<sup>82</sup> A senior Gulf banker has said that "[t]here is a growing concern over the capacity of regional balance sheets to be exposed to this sort of tenor. If people keep on pushing for these deals without clauses allowing for refinancing at years ten to twelve, one is going to fail

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78. Fletcher & Davies, *supra* note 33.

79. *Id.* See also Nabeela Khan, *Landmark Success*, IFR REVIEW OF THE YEAR 2000.

80. Fletcher & Davies, *supra* note 33.

81. *Europe, Middle East and Africa Awards 2000, Power Deal of the Year, Al Taweelah A1*, PROJECT FIN. INT'L Y.B., 2001, at 111. In contrast, although the 1999 predecessor Taweelah A2 project carried a seventeen year loan tenor, it also contained an automatic refinancing provision that locks up dividends after year seven if the debt is not refinanced by then. Thus, in essence, the financial arrangers in the 1999 Taweelah A2 deal were able to sell the international bank market a seven year loan dressed up as a seventeen year tenor. Rod Morrison, *Omani Power Deals Stretch*, PROJECT FIN. INT'L Feb. 21, 2001, at 33; see *Taweelah Musings*, PROJECT FIN. INT'L, Sept. 22, 1999.

82. "Most of the regional banks have short-term funding, and with [asset/liability] mismatch management a dark science, their appetite for 15-20 year exposures are limited," says one regional banker. "We've not found the limit yet, but it's not so far away." *Special Report: Banking*, MEED, Mar. 2, 2001, at 28.

soon. Project sponsors are going to have to start listening to what the banks want."<sup>83</sup> It appears that, with the Al Kamil and Barka financings, the project sponsors have heard.

#### IX. BEYOND TAWEELAH: AL KAMIL AND BARKA (2001)

The Al Kamil and Barka power project financings follow the Taweelah template. The loans in both deals are not covered by export credit and carry the longest tenors ever done in Oman. However, both diverge from Taweelah A1 in that they provide incentives for the project sponsors to seek refinancing prior to loan maturity, albeit in different ways.

The Al Kamil 275 MW IPP was the first project to be awarded in Oman's fast-track private power program. This project is being developed by International Power on a BOO basis. The government chose to use the BOO model this time instead of the BOOT model used for Al Manah because the BOO model "is regarded as achieving the best value for money while being consistent with our wider privatization objectives."<sup>84</sup> Like Taweelah A1, Al Kamil's US\$100 million financing<sup>85</sup> is an uncovered, internationally syndicated loan with a lengthy tenor of sixteen years. In addition, the debt-to-equity ratio is approximately 80:20. Unlike Taweelah A1, however, the deal features straight amortizing financing with pricing that steps up to a higher rate over time to encourage refinancing. In addition, at years 1, 5, and 11, the loan provides a sweep to ensure that the coverage ratios for the debt are maintained.

The Barka IWPP scheme was the second project to be awarded in Oman's fast-track power program and is Oman's first IWPP. The project, which is sponsored by AES and Multitech, involves building a 427 MW, twenty million gallon per day power and desalination plant. The uncovered loan is made up of a US\$332 million term loan and a US\$16.6 million standby loan and has a sixteen year tenor, the longest in Oman to date.<sup>86</sup> Similar to Taweelah A2 (1999), the Barka financing contains a cash sweep and dividend lock-up at year eleven, which provides

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83. Tom Everett-Heath, *Shape of Deals to Come*, MEED, Oct. 20, 2000.

84. *Oman Unveils*, PROJECT FIN. MAG., Feb. 1, 2000.

85. The financing for Al Kamil was arranged by Bank Muscat and Société Générale. See PROJECT FIN. INT'L, Apr. 4, 2001.

86. The Barka financing was arranged by ANZ Investment Bank and Arab Banking Corporation.

an incentive for the sponsors to refinance the project before then. If the loan goes beyond year eleven, however, there is a bullet repayment at year sixteen. This bullet back-ends the repayment profile of the loan even further to improve the developers' internal rate of return.<sup>87</sup>

Whether the Salalah financing will follow the lead of the other two fast-track projects and offer a lengthy loan with a refinancing clause remains to be seen. It will be interesting to observe how new power deals throughout the Middle East grapple with the issue of what is considered a bankable tenor in the region. Indeed, it looks as if we will not be waiting long for the next IPP to reach financial closure.

### CONCLUSION

The privatization strategies of Abu Dhabi, Jordan and Saudi Arabia illustrate common trends in how countries in the Middle East are addressing their needs for greater capacity and efficiency in the power sector. The formula consists of (i) unbundling generation, transmission, and distribution activities and corporatizing them, (ii) encouraging IPPs and the gradual privatization of existing generation plants, (iii) maintaining a substantial degree of government control over the transmission sector, and (iv) establishing an independent regulatory body to monitor tariff charges and the performance of newly privatized companies. Although this formula has the advantage of being an easy way for the private sector to get involved, it also holds some challenges.

First, it may prove difficult for countries to make the transition from the single buyer model to an open electricity market. In the single buyer model, certain interest groups may become entrenched and will be reluctant to cede their powerful positions to a fully liberalized market.<sup>88</sup> Second, customer tariffs must be structured high enough to provide an attractive rate of return for investors, but low enough to still be palatable to consumers. This is especially true where governments have previously subsidized the cost of electricity. If government subsidies to consumers must remain, governments should only target

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87. Rod Morrison, *Omani Power Deals Stretch*, PROJECT FIN. INT'L, Feb. 21, 2001, at 33.

88. See *Saudi Arabia: Avoiding the California Nightmare*, *supra* note 50, at 4-5.

those consumers who truly need it, as is being proposed in Abu Dhabi. In addition, governments must be willing to cover the costs of these targeted subsidies, so that corporate utilities can maintain healthy balance sheets.<sup>89</sup>

Third, government aversion to providing sovereign guarantees makes it much more difficult to attract investors, including export credit agencies and multilateral institutions.<sup>90</sup> Although it is true that one of the necessary steps towards privatization is to create fully independent corporate entities that can stand on their own, it is not reasonable to expect developers to enter into unsupported contracts with newly formed companies that have no operating or financial history of their own. In order to have a successful project, the risks and returns to both the government and the investors must be balanced.<sup>91</sup>

The evolution of IPP financing structures in the region signals the increasing interest and comfort level that investors have for the Middle East. Export credit agencies and heavy equity participation are no longer the sine qua non of project financing in the region. Although Taweelah A1, A1 Kamil, and Barka have proved that long sustainable tenors can be achieved, the key to continuing project development in the Middle East will be the ability to expand the depth and diversity of the lending market. The international banks will eventually reach their country exposure limits and developers will have to look elsewhere to finance and refinance project debt. Alternative sources of financing include the capital markets, Islamic financing, and the regional bank market.

The international capital markets possess virtually untapped financing potential,<sup>92</sup> particularly for refinancing and/or expansion projects in the power and oil/gas sectors.<sup>93</sup> Pricing, how-

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89. One method that governments may employ to get around the problem of projects with uneconomic rates of return due to subsidized consumer tariffs is to pass through the subsidy to the project company by arranging cheap fuel supply contracts with state-owned fuel companies. This solution, however, creates an indirect subsidy to the project, which only serves to transfer inefficiency from the power sector to the fuel supply sector.

90. See Phillip Carter, *Generating Excitement*, PROJECT AND TRADE FIN., Mar. 1997.

91. *Privatization Issues in the GCC States*, PROJECT FIN. INT'L, Mar. 12, 1997.

92. Ras Laffan LNG Project has thus far been the only project bond to be issued in the Gulf region.

93. Project bonds are a good option for refinancing or expanding existing operational projects. Once a project is performing well and has begun to develop stable

ever, will ultimately dictate whether (and when) project bonds are issued.<sup>94</sup> The regional capital markets are still in a relatively early stage of development, but they will certainly play a larger role in the future.

The Islamic finance market<sup>95</sup> is another possible source of liquidity. In 1999, the Abu Dhabi-based Thuraya Satellite Company signed a US\$100 million Islamic facility with Abu Dhabi Islamic Bank (or "ADIB").<sup>96</sup> In the same year, ABC Islamic Bank arranged a US\$56 million facility for Sharjah Electricity & Water Authority.<sup>97</sup> In addition, it is rumored that there may be a tranche of Islamic debt in the upcoming Abu Dhabi Shuweihat IWPP financing.<sup>98</sup> Despite these recent inroads, many bankers express doubt about the ability of Islamic finance to achieve a dominant financial presence in the market. Structural complexity and Islamic banks' limited appetite for long tenor deals are cited as the main obstacles to its emergence as a principal source of funding.<sup>99</sup> However, others acknowledge that "if there is a liquidity squeeze around the corner, it is likely that the Islamic market will increasingly be tapped, particularly for smaller deals or for tranches worth US\$100-150 million on larger deals."<sup>100</sup>

The local and regional bank markets are currently the most utilized source of alternative financing. Sustained oil prices have left most banks in the region flush with cash. These banks must find ways in which to deploy their capital. In many cases, local

earnings and reliable cash flows, the bond market will be more likely to respond with longer maturities and competitive pricing. In the Al Manah expansion project, Goldman Sachs initially considered issuing a bond to take out the IFC and ECA loans. *See UPG to expand Manah*, PROJECT FIN. INT'L, May 7, 1998.

94. *See Shape of Deals to Come*, MEED, Oct. 20, 2000. Last year, one of the banks bidding for the arranger mandate for the Oman Gas Company pipeline project offered a project bond solution. Although the bid ultimately failed, it nevertheless demonstrates that project bonds continue to be considered a viable financing option in the region. *See Thinking New Thoughts*, MEED, Mar. 2, 2001.

95. The Islamic financing system is based upon the principle that Islamic banks share in the risks of a transaction in return for a share of its profits. Islamic finance must be clear of *riba*, which is capital that may be considered unjustifiable or excessive under Islamic law (this includes interest). *See Richard de Belder & Chris Ruder, Middle East: An Overview of Project Finance and Islamic Finance*, INT'L FIN. L. REV. (1999).

96. The Thuraya financing also included a US\$420 million international loan facility.

97. *See Thinking New Thoughts*, MEED, Mar. 2, 2001.

98. Ahmad, *supra* note 11.

99. *See id.*

100. *Thinking New Thoughts*, *supra* note 97.



projects have not created a sufficient volume of attractive lending opportunities. Thus, many local banks are taking more active roles in international syndicates and are participating in more cross-border deals.<sup>101</sup> Although there is a vast amount of liquidity currently available in the Middle East bank market, regional and local banks will need to devise medium-to-long-term strategies on how to best develop and sustain sufficient levels of funding to support future project deal flow. This will prove particularly important if long tenors continue to be the rule and/or the oil price drops to a lower level.

In conclusion, what was once considered a mirage in the Middle East is now starting to take on a more defined and lasting appearance. Many Gulf states have developed, or are in the process of developing, long-term, deliberate privatization strategies to meet their future demand for electricity. The regional finance markets are becoming more sophisticated and local banks are eager to assume more of a leadership role in these projects. It is time for governments to demonstrate their commitment to the process by establishing transparent regulatory structures, enforcing disciplined tariffs, and creating the right infrastructure to strengthen the regional markets. If reform is not implemented in this manner, the sustainability of the privatization process will be put at risk and the investment flow in the power sector will once again be reduced to a trickle.

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101. For instance, Saudi American Bank and Saudi Investment Bank participated at the arranger and co-arranger level, respectively, in Abu Dhabi's Taweelah A1 IWPP.