Social Infrastructure — Islamic Finance Opportunities

By Salman Al-Sudairi and Craig Nethercott

Throughout the Middle East governments are focused on continuing to upgrade the social infrastructure.

Qatar has ambitious plans leading up to the World Cup Finals and Abu Dhabi continues to pursue its Abu Dhabi 2030 plan. In Saudi Arabia the government is committed to an aggressive infrastructure development plan in the coming decades.

In order to meet the demands of a growing population and achieve the goal of making Saudi Arabia a regional and global centre of business, the Saudi Arabian government has earmarked a total investment for infrastructure projects over the next 20 years upwards of US$400 billion.

Such social infrastructure projects include the familiar increases in power generating and desalination capacity, but improving transportation infrastructure, building new (and improving existing) roads, bridges, airports and railways (including pilgrimage infrastructure) are increasing priorities in the development agenda.

While these projects have generally been dependent on direct government expenditure, there has been some limited private sector participation. With a broad spectrum of social infrastructure projects under development there should be much greater private sector participation in the future.

Private sector participation in public infrastructure through the "public private partnership" model (PPP) is well known in Europe. The PPP model has found some limited application in the Gulf states to date.

Abu Dhabi has used a PPP structure for its UAE University, Sorbonne and Zayad Universities and is considering a PPP structure for a road development (bids are currently being considered for the 327 km Mafraq Ghweifat highway).

> "The PPP model presents at first sight some structural "complications" for the Islamic financing of new build assets, such as a road or an airport terminal"

In Saudi Arabia, GACA (the aviation authority) used the PPP model for the expansion of the Hajj Terminal in Jeddah and has pre-qualified a number of consortia for the PPP redevelopment and expansion of Prince Mohammed International Airport in Madinah.

PPPs and Islamic finance

The PPP model presents at first sight some structural "complications" for the Islamic financing of new build assets, such as a road or an airport terminal. In a BTO (build transfer operate model) the physical assets, are transferred to the grantor on completion and are not available as a subject matter for an Ijarah structure.

This was exactly the issue facing the Islamic financiers (the Islamic Development Bank, Bank AlJazira and Credit Suisse) in the Hajj Terminal project, the first Islamic financed PPP (built on a BTO) in Saudi Arabia.

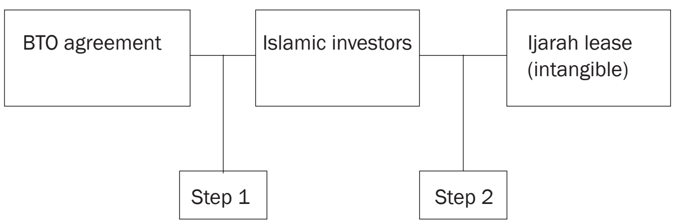
> "In Saudi Arabia, GACA (the aviation authority) used the PPP model for the expansion of the Hajj Terminal in Jeddah"

The Hajj terminal expansion (a separate terminal at the King Abdulaziz International Airport in Jeddah, Saudi Arabia dedicated to pilgrims and visitors of the holy city of Mecca) was financed with approximately US$205 million of Shariah compliant debt.

The sponsor, the Saudi Binladin Group, was awarded a concession (the right to operate the terminal) with the new and refurbished assets required to be constructed being transferred to GACA after completion of construction works. Therefore the new terminal assets constructed by the concessionaire could not form part of an Ijarah structure.

To overcome this issue the financing was structured under an Ijarah structure where rights under the concession agreement (the BTO Agreement granting the right to run the terminal) were sold to the Islamic financiers and then leased back to the sponsor in exchange for traditional rental payments. This structure is well suited to further infrastructure PPP projects (see figure 1.1 below).

Figure. 1.1 – Hajj Terminal Structure



Step 1. BTO Agreement between GACA and concessionaire. Rights under the agreement are sold to a third party. Islamic investors purchase BTO agreement rights from third party.

Step 2. Islamic Investors enter into a forward lease agreement of the rights under the BTO with the Hajj Terminal Development Company.

continued...

Social Infrastructure — Islamic Finance Opportunities (continued)

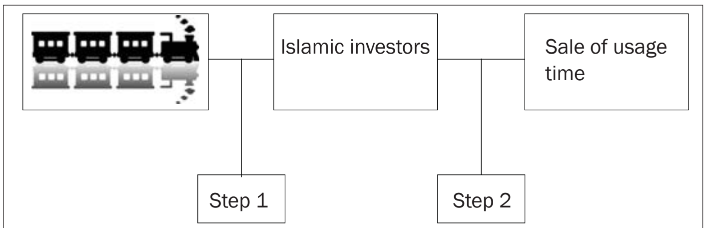
Other potential Shariah compliant structures

Beyond the Hajj terminal structure and the commonplace Murabahah facilities, hybrid structures such as the Mobily "Airtime" facility (the mobile telecom operator) are easily adaptable to PPP financings of infrastructure assets. In the Mobily transaction, the Islamic investors purchased a few billion US dollars of "airtime" on the Mobily network.

> "In the Mobily transaction, the Islamic investors purchased a few billion US dollars of "airtime" on the Mobily network"

This airtime was then sold on behalf of the Islamic investors to Mobily's customers at a profit. There is no reason why this structure could not be applied to road users, railway users or airport users.

Figure 1.2 – Hybrid Structure



Step 1. BTO Agreement (with respect to relevant infrastructure) between grantor and concessionaire. The concessionaire sells usage time on the relevant infrastructure (for example a usage right on a railway or a right to travel across a toll road).

Step 2. The Islamic investors sell the usage on the relevant infrastructure to end users at a profit via a marketing agent.

Conclusion

The growing demand for infrastructure projects and increased private sector participation therein, presents real opportunity for Islamic finance to support the development of social infrastructure. The investment in the development of suitable Islamic finance structures has already been made. Islamic finance investors are well placed to occupy a prominent role in regional infrastructure development in the near term.

Craig R Nethercott
Partner
Latham & Watkins
Email: craig.nethercott@lw.com
Craig is based in Dubai and Riyadh. He is co-chair of the firm's Global Islamic Finance Group and specializes in project and Islamic finance.

Salman Al-Sudairi
Senior associate
Latham & Watkins
Email: Salman.Al-Sudairi@lw.com
Salman is based in Riyadh and is a member of the firm's banking and