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Islamic Finance and LNG— Developments to Date

Craig Nethercott and Ed Hills
White & Case LLP

Islamic finance is big business. Although, according to a 2005 International Monetary Fund paper¹, there was only one Islamic finance institution in existence in 1975, the same research indicates there are now more than 300 Islamic finance institutions around the globe, with assets estimated in excess of \$250 billion. Furthermore, these assets are estimated to have a growth rate of more than 15 per cent per annum. Islamic finance is going only one way and that is up.

This phenomenal growth has a number of factors driving it. The sustained high oil prices of recent years have significantly multiplied the impact of the oil dividend in the Middle East, which has in turn increased demand for suitable investment vehicles. Alongside this, almost every Gulf economy is investing in upgrading both its natural resource development and industrial infrastructure. Project finance structures are the usual vehicles for funding these substantial investments. As the scope and scale of these projects have risen, so have their financing requirements: financings of several billion dollars are not uncommon in today's market. During recent years the Islamic financing components in these project financing structures have become familiar to the market and as a consequence, the average size of Islamic tranches in project financings has grown in tandem with the

financings themselves. Where it was once the case that the introduction of an Islamic tranche was perceived to introduce significant additional complexity to a project financing, this is no longer an issue for many project sponsors and lenders. On the financial institution side, the growth of available liquidity in the Gulf region has supported the creation of more regional Islamic lending capacity. A number of international lending institutions have seen real benefits in expanding into Islamic finance, which is allowing them to increase their participation, alongside their commercial tranche, in mega-projects. Over and above this, broader consumer demand for *Shari'a*-compliant financial services and products, both at a retail and institutional level is growing rapidly.

There is no reason to believe that the growth of the popularity of Islamic lending in project financing will do anything but continue. In fact, the average size of such Islamic facilities is likely to become larger. As Islamic finance instruments that will allow institutions to more easily digest long tenor deals are developed, growth is likely to accelerate. The eventual recovery of pricing in the Gulf region should have a similar catalytic effect: at the moment pricing on mega-deals in the Middle East is at historically low levels, making it difficult for some institutions to participate.



Craig Nethercott
Partner



Ed Hills
Associate

Deals to Date

While numerous high-profile project financings containing Islamic tranches have been closed in recent years, covering a broad range of sectors (independent water and power, petrochemicals and metals to name three) and countries (for example, Abu Dhabi, Oman and Saudi Arabia), demonstrating the viability of Islamic finance as a source of long-term project debt financing, there have been fewer Islamic financings for LNG projects.

The milestone project regarding LNG and Islamic finance remains the Qatari Qatargas II financing, which demonstrated the effective participation of a long-tenor Islamic tranche in a multi-sourced LNG financing, as an alternative funding source that could add lending capacity to such projects.

However, despite there being significant project financing activity in the LNG sector since then, Islamic financing has not taken a prominent place in LNG project financing plans following completion of the Qatargas II \$530 million Islamic tranche in December 2004.

With the flagship LNG projects in the Middle East having debt financing requirements running into the many billions of dollars and sponsors therefore looking to diversify funding sources, this may change. The need to diversify funding sources, together with the cultural desire to see the Islamic project financing market develop, has led both sponsors and Islamic finance institutions to put considerable effort into developing structures that can form a regular part of a project financing plan.

Islamic Finance Structures and the Qatargas II Islamic Tranche

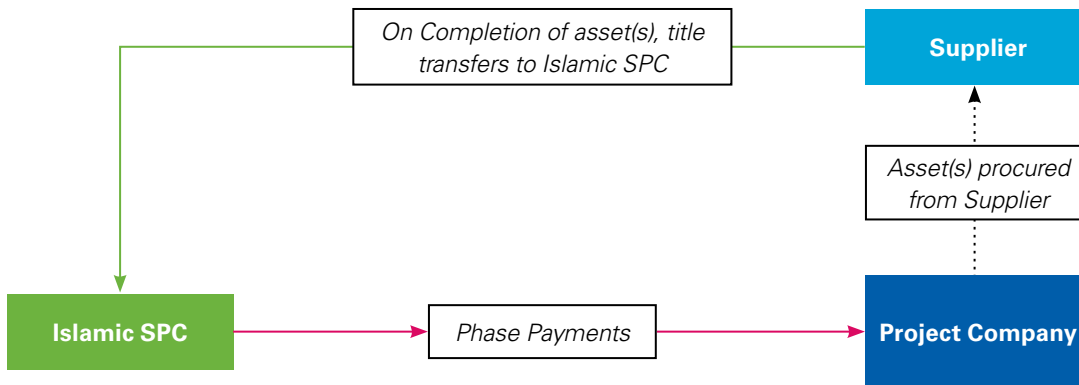
The \$530 million Qatargas II Islamic tranche formed part of a total financing package of \$6.3 billion. It was based (with some amendment) on the *Ijāra/Istisnā'* combination that first appeared in a multi-tranche financing in the Abu Dhabi Shuweihat power transaction in 2001.

In brief, an *Istisnā'* (a form of procurement agreement) is entered into between the project company and a special purpose company (SPC). Under the *Istisnā'*, the project company agrees to procure (construct) assets for the SPC by a certain date (equal to the project completion date agreed with the conventional lenders). Liquidated damages are payable in the event that the assets are not delivered by the certain date. At the same time the project company enters into a forward lease agreement (*Ijāra*) to lease the assets to be delivered under the *Istisnā'* for a fixed period (normally equal to the tenor of the commercial debt). Rent is payable under the forward lease agreement (*Ijāra*) in an amount that is broadly comparable to the principal and interest burden under the conventional facilities.

Depending upon the jurisdiction of the *Sharī'a* scholars, the *Ijāra/Istisnā'* combination used in financings is usually documented with an *Istisnā'* agreement, an *Ijāra* agreement, a Service Agency Agreement, Sale and Purchase Undertakings, an Investment Agency Agreement and an Islamic Facility Agreement.

The *Istisnā'* agreement operates for the construction phase of the project. When considering what assets should be financed under an Islamic financing, consideration is usually given to the value of the assets (which should be appropriate to the size of the project) and the nature of the assets (the assets are normally capital intensive items). Preference is usually given to assets which are easily identifiable. In the case of Qatargas II, elements of the liquefaction train were considered appropriate. In procuring (or constructing) the assets, the project company undertakes to procure the assets from suppliers in accordance with the specifications of the construction contracts and arrange for delivery of the assets on or before a scheduled completion date. Upon delivery of the assets to the project company, title to and possession of the assets passes to the SPC.

Istisnā' Structure



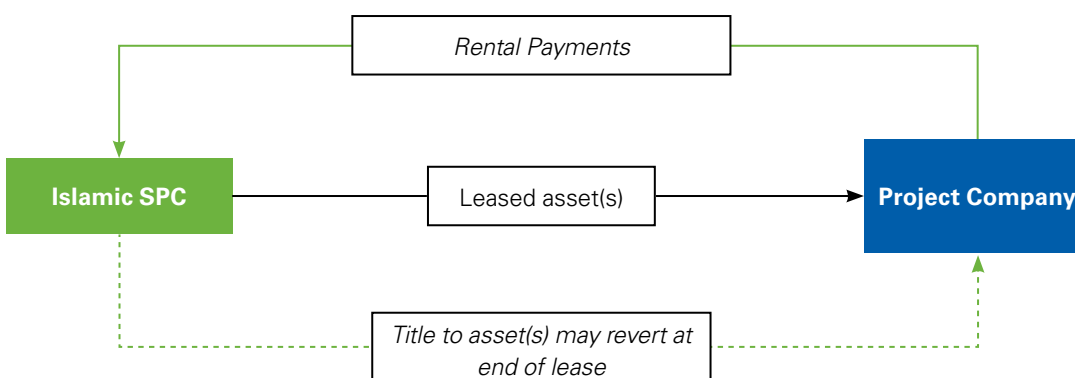
As consideration for the project company procuring the assets, the SPC agrees to pay the project company the amount of the facility via phase payments (equivalent to drawdowns under a conventional facility). Accordingly, under the *Istisnā'* agreement, phase payments are made with the same conditions to drawdown as under the conventional facilities. During the construction period of the project, the project company is also entitled to reduce the facility amount by altering the specifications of the assets.

In the event that the assets are not delivered by a certain date, the project company is obliged to pay liquidated damages to the SPC. The liquidated damages regime enables the Islamic facility participants to have a right to receive monies equivalent to repayments under the conventional

facilities upon dates equivalent to the scheduled repayment dates or in the event that the assets are not delivered, to be repaid the facility.

At the same time as entering into the *Istisnā'* agreement, the project company enters into a forward lease agreement (*Ijāra*) with the SPC for the operational phase of the project (the period following delivery of the assets to the SPC pursuant to the *Istisnā'* agreement until a date equivalent to the final maturity date under the conventional facilities). Under the *Ijāra* agreement, the project company leases the assets from the SPC in return for lease payments. The lease payments payable are broadly comparable to the principal and interest burden under the conventional facilities and are made at the same times as equivalent payments under the conventional facilities.

Ijāra Structure



As the owner of the assets, the SPC undertakes not to interfere with the quiet enjoyment of the assets by the project company. As in other Islamic financings, the SPC (in its capacity as lessor) is responsible for all major maintenance (repair, replacement and maintenance of a capital nature without which the assets could not reasonably be used by the project company). Such obligations are subcontracted to the project company (acting in its capacity as service agent) via a Service Agency Agreement and the project company is responsible for all repair and maintenance, other than major maintenance. Furthermore, the SPC is responsible for insurance of the assets and ownership taxes and it again subcontracts these obligations to the service agent.

The project company is entitled to terminate the *Ijāra* agreement voluntarily. On receipt of notice of any such termination, the assets will be transferred back to the project company upon receipt of a termination payment equivalent to the prepayment via a Sale Undertaking. Likewise, on payment of the final lease payment the assets are transferred back to the project company. Following an acceleration event, the SPC is entitled to terminate the *Ijāra* agreement and require the project company to pay outstanding amounts for the assets in accordance with a Purchase Undertaking. When the project company makes such a payment, the assets are transferred to it by the SPC.

Because Islamic facility participants are usually reluctant to enter into a Common Terms Agreement with conventional lenders, they normally elect to enter into an Islamic Facility Agreement. This agreement is largely the same in content to the Common Terms Agreement. Accordingly, it contains, amongst other provisions, representations and warranties, covenants, events of default, conditions precedent, conditions to expansion, completion requirements and so on and so forth.

An important element of the structure which has been used elsewhere in *Ijāra/Istisnā'* financings in the Middle East is the use of the SPC to act (on behalf of the Islamic facility participants) as the “purchaser” under the *Istisnā'* agreement and the “lessor” under the *Ijāra* Agreement. The SPC structure has perceived benefits for both the

Islamic facility participants (such as protecting the participants from the risks associated with the ownership of the asset—for example environmental liability) and the project company (the asset is not held by the Islamic facility participants directly and therefore the Islamic financed assets are isolated from the risk of insolvency to an Islamic facility participant). The relationship between the SPC and the Islamic facility participants is governed by an Investment Agency Agreement which also includes mechanics for the Islamic facility participants to make contributions towards phase payments, payments by the SPC and transfers by the Islamic facility participants.

The *Istisnā'/Ijāra* structure of the Qatargas II Islamic tranche has been replicated outside of the LNG industry in a number of places: in Oman in 2005, in the Sohar Aluminium financing (which included a \$260 million Islamic tranche); in Saudi Arabia in 2006, with the Rabigh refinery and petrochemical project (which included a \$600 million Islamic tranche), and also in the SABIC Yansab petrochemical project (which included a \$800 million Islamic tranche).

In addition to the financing of large immoveable project assets, the *Ijāra/Istisnā'* structure has been used successfully in other assets classes, including aircraft and ships. In the LNG sector, the *Ijāra* structure has been applied to the financing of vessels. Brunei Gas Carriers used the *Ijāra* structure for a ten-year financing of a 137,000 m³ LNG vessel. However, Islamic financing has not been a regular feature of LNG vessel new-build activity.

Limited Activity

Although project finance activity in the Middle East is reported to have reached \$30bn in 2005, up from \$18.5bn in 2004, with 2006's levels of activity due to break the records of 2005, Islamic financing forms only a tiny proportion of the debt financing in this huge market. The main reason for this is the current limited “additionality”—or additional capital participation—that Islamic financing brings in large project financings. Islamic finance products are most attractive to project sponsors when they deliver “additionality”, and the concept is therefore very important.

Currently there are two categories of participants in the Islamic project finance market. On the one hand there are the conventional lenders which have established “Islamic windows” (Islamic lending under a brand as part of general lending activity or with a separate balance sheet dedicated to Islamic finance activity), and on the other there are the dedicated Islamic finance institutions. When setting their exposure limits in a transaction, conventional lenders with “Islamic windows” aggregate their Islamic facility participation together with their conventional lending participation. As an example, a \$200 million credit exposure by a conventional institution could be divided \$100 million to the Islamic facility and \$100 million to the conventional one. From this it is clear that additional capital participation is only really achieved via dedicated Islamic finance institutions and to date their participation has been limited.

There are three issues in the market today that limit the ability of dedicated Islamic finance institutions to deliver the “additionality” that is required. They are price, tenor and the absence of a secondary market. Pricing of project financings in the Middle East has reached historic lows and the required participation is usually at least \$100 million. The combination of low pricing (in some cases reaching the cost of funds for institutions) and tenors of up to 15 years are an unattractive proposition for a number of dedicated Islamic finance institutions, which tend to focus on short tenor deals and retail financing. The position is then exacerbated by the absence of a secondary market or other tools to manage exposures. Of course, pricing will recover and Islamic institutions will become increasingly sophisticated in dealing with their balance sheets as the market continues to mature.

With limited additional capital participation being provided by Islamic tranches, for the reasons outlined above, sponsors have therefore balanced the benefits of the inclusion of an Islamic tranche alongside the perceived procedural burdens associated with the inclusion of an Islamic tranche in their financing plans. Thus far, Islamic finance

institutions and regulatory authorities have had to put considerable effort into the development of structures that work both within the legal and regulatory framework in the relevant jurisdictions and from the local *Sharī‘a* perspective.

However, the process burden associated with the inclusion of an Islamic finance tranche will diminish over time as products become more commoditised. For example, it is understood that in Saudi Arabia the Yansab Islamic finance tranche, having replicated to a great extent the earlier Rabigh Islamic finance tranche, was less of procedural burden than in the Rabigh deal.

The Sukuk (Islamic Bond) Market

Whilst the *Istisnā’/Ijāra* structure outlined above has not yet achieved regular participation in the financing plans for major LNG projects or vessels, the rapid emergence of the *Sukuk* (Islamic bond) market has been one of the most promising developments in the Islamic finance arena. It has been reported that in recent years Gulf Cooperation Council countries and private sector issuers have raised more than \$20 billion via *Sukuk*. In addition, we saw increasingly large *Sukuk* issuances in 2006, including the \$3.5 billion PCFC issuance in Dubai and the SAR3 billion (\$800 million) SABIC issuance in Saudi Arabia.

In brief, a *Sukuk* involves the issuance of certificates in the collective legal or beneficial ownership of the asset, with the certificate holders receiving an income derived from the asset. A *Sukuk* platform, which can be placed on top of the *Ijāra* structures deployed in Islamic project financing, could cure some, although not all, of the issues outlined above in relation to the lack of additional capital participation. However, issues do still remain regarding the liquidity, tenor and pricing of *Sukuk* issuance compared to the conventional debt financing or bond markets. What is certain is that as is the case with other Islamic products in the early stages of deployment, the *Sukuk* market will deepen and mature with time.

Conclusion

LNG mega-projects have dominated the Middle East project finance landscape for the last ten years. Although Islamic financing has not played a prominent role in these projects, considerable efforts are being concentrated on the development of the Islamic project finance market and simultaneous to this large-scale project finance activity and the pressures to diversify funding show no signs of abating. Having missed the first wave of LNG activity in the Middle East, as the Islamic project finance market matures opportunities will doubtless arise for it to play a far more prominent role in the next wave of LNG activity, including LNG fleet financing and plant refinancing.

Craig Nethercott and Ed Hills are partner and associate respectively in White & Case's Energy Infrastructure, Project and Asset Finance Group in London. They have worked on a variety of project finance transactions throughout the Middle East and Africa and most recently advised Saudi Aramco with respect to the \$9 billion Rabigh petrochemical and refinery project. Craig is Co-Head of White & Case's Islamic Finance Unit.

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¹ 'Islamic Finance Gears Up', *Finance and Development*, Volume 42, Number 4, December 2005