

# **Products and Infrastructure—Saudi Arabian Achievements and Ambitions: A Glance at the Past and Future**

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## **INTRODUCTION**

Saudi Arabia has experienced a rapid phase of project development in the last fifteen years. The significant projects financed by Islamic finance institutions and other finance providers have principally been in the industrial infrastructure sectors (mainly in the core areas of power [electricity] and oil and gas, with some activity in the metals and mining sector and the telecommunications sector). At the beginning of this period (circa 1995) project development practitioners (sponsors, lawyers, and bankers) were doubtful as to the practicality of completing a shari‘a-compliant project financing in Saudi Arabia within the confines of jurisprudence founded on the Hanbali *madhab* and where government institutions were perceived (rightly or wrongly) to be a roadblock to necessary legal structuring solutions.

However, with the assistance of the super-corporates of the Saudi economy, Saudi Aramco and SABIC (amongst others), and enthusiastic finance institutions, a path has been found to include shari‘a-compliant financing in development projects. Starting from a place of pessimism, we have arrived at a situation today where Islamic project finance is a common feature of project financings in Saudi Arabia. Shari‘a-compliant project financing in Saudi Arabia is reported to total US\$14.8 billion (or SAR55.5 billion) between 2004–12 with US\$795 million (SAR2.9 billion) in 2011 and US\$1 billion (SAR3.75 billion) in 2012 alone.<sup>1</sup> Indeed, shari‘a-compliant debt financing is arguably the more common form of financing in the small to medium development projects and is an important part of the large projects (where debt capacity exceeds available shari‘a-compliant debt capacity). The *istisna‘a* and *ijara* combination is seen with respect to physical assets without contention in numerous project financings and the

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commodity *murabaha* (*tawarruq*) makes frequent appearances in everything from straight corporate facilities and working capital facilities to project financings where the underlying project structure might present challenges to other shari'a-compliant structure alternatives.

However, the next wave of project development, in addition to the customary oil and gas and power transactions, involves important social infrastructure projects, including airports, houses, roads, and railways. Governments throughout the Middle East region have pledged substantial support for the overhaul of the region's infrastructure. Saudi Arabia alone awarded US\$24.93 billion worth of construction projects in 2011 and committed US\$44.6 billion and US\$39 billion for construction and infrastructure projects respectively in 2012.<sup>2</sup>

The transport sector is one of the main areas of expansion in the Middle East. More than US\$100 billion of rail schemes are planned or underway in the Gulf Cooperation Council (GCC).<sup>3</sup> In Saudi Arabia, the government is developing two main railway lines, namely the Saudi Landbridge Project, linking Saudi Arabia's main cities from east to west, and the Haramain High Speed Rail linking the cities of Mecca, Medina, and Jeddah.

Middle Eastern governments have flirted with the involvement of the public private partnership (PPP) model or other forms of private sector involvement in public infrastructure. In Saudi Arabia we have seen partial engagement with private sector participation in public infrastructure development. In 2006, The General Authority for Civil Aviation (GACA), advised by the International Finance Corporation, embraced the PPP model for the Hajj Terminal expansion in Jeddah. Again in 2011, GACA awarded the redevelopment and expansion of Medina airport to a consortium led by Turkey's TAV Airports Holding pursuant to a build, own, operate, and transfer long-term concession. In 2008, The Saudi Rail Authority (SRO) abandoned the proposed involvement of the private sector in the Saudi Landbridge (East West Railway project) after initially contemplating a build-transfer-operate scheme. The SRO was the biggest infrastructure client in 2011, awarding contracts on a procurement basis worth more than \$9 billion for its Haramain Rail Project. Similarly, the Saudi Electricity Company (SEC) has used a combination of a self-procurement and private sector development strategy.

The government in Saudi Arabia remains the dominant construction client in the Kingdom, having awarded 91.7% of the total contract awards. It is unclear whether the Saudi Arabian and other Middle Eastern governments will continue to publicly fund the vast majority of the next wave of public infrastructure projects, but to the extent that the private sector is involved it is interesting to examine whether the structures for shari'a-compliant debt utilized to date are suitable and can accommodate the public infrastructure development wave.

With an increased focus on public infrastructure and other non-industrial civil development, this paper will review the structures used in Saudi Arabia

to date and the ability to adapt such structures to the development of public infrastructure.

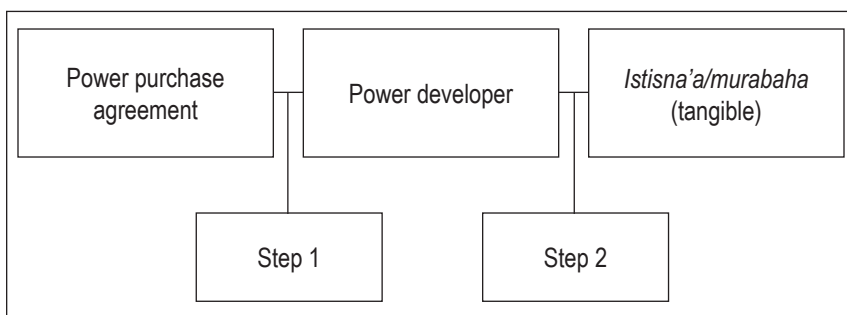
## INFRASTRUCTURE DEVELOPMENT MODELS

### BOOT – Power

The Saudi Electricity Company (SEC) has deployed private sector participation to meet in part the power supply demands in the Kingdom, reported to top 77 GW by 2020.<sup>4</sup> The SEC, like Abu Dhabi Water and Electricity Authority in Abu Dhabi, chose the “build-own-operate-transfer” model (the “BOOT model”) for four independent power projects (IPP) to date, namely Rabigh IPP (1.2 GW) (2009), Riyadh PP-11 (1.7 GW) (2010), Qurayyah (2 GW) (2011), and Rabigh 2 IPP (1.8GW) (2013). The first three of these IPP projects were successfully financed and are at different stages of operation (or construction) and the last (Rabigh 2) is in the tender stage.

Each of the Rabigh IPP (\$1.45 billion), the Riyadh PP-11 IPP (\$2.1 billion), and the Qurayyah IPP (\$1 billion) power projects in Saudi Arabia involved shari’a-compliant debt. The BOOT model is well suited to the application of an *istisna’a/ijara* structure—with the generator (the owner of the power plant) able to obtain shari’a-compliant financing on a procurement and lease basis. The compatibility of the BOOT model with the *istisna’a/ijara* structure is not controversial. The power purchase agreements in these transactions require the development of tangible greenfield assets that easily form the underlying assets of the *istisna’a/ijara* structure.

**Figure 1. *Istisna’a/ijara* – BOOT Power Structure**



Step 1 – Power developer signs long-term power purchase agreement with the Saudi Electricity Company (or its affiliate).

Step 2 – Power developer is obliged under the terms of the power purchase agreement to procure the development of the power generation assets. The power developer enters into an *istisna’a/ijara* to finance the power generation assets.

## BTO – Airports and Rail

With respect to the public transport infrastructure, some Saudi Arabian government agencies have for policy reasons chosen the “build-transfer-operate” concession model (the “BTO model”). Under the BTO model the concessionaire constructs the relevant assets and transfers title to the grantor of the assets on completion. In return for completion of the assets the concessionaire holds the rights to operate the concession assets under the concession agreement for an agreed-upon period, but not the title to the physical assets. Consequently, the concessionaire’s asset base for a potential project financing consists of only the “intangible rights” under the concession agreement—the right to operate the relevant asset on completion.

As already mentioned above, the BTO model was favored by GACA for the Hajj Terminal expansion project (see case study below) and for the Medina Airport redevelopment project recently awarded to the TAV/Saudi Oger consortium.

## The Tangible and Intangible Asset Conundrum

Whilst it is uncontroversial for tangible assets such as those underlying the BOOT model to form part of an *istisna’a* and *ijara* arrangement, the question has arisen in practice whether intangible assets, namely the rights under the concession agreement in the BTO model, form a legitimate basis for a shari‘a-compliant financing.

Before considering this question it is useful to look at case studies of:

- a) Tangible assets *istisna’a* and *ijara* combination (as seen in the Petro-Rabigh transaction and Riyadh PP-11 independent power projects);
- b) The intangible asset *ijara* (as seen in the Hajj Terminal expansion project); and
- c) The Sipchem *sukuk mudaraba* (which had intangible rights forming the underlying structure of the *sukuk*).

## CREATING THE MOLD IN SAUDI ARABIA

### Petro-Rabigh (Greenfield, Tangible Assets) – 2006

The Petro-Rabigh project, a 50/50 joint venture between Saudi Aramco and Sumitomo Chemical, involved the construction of a world scale petrochemical complex (capable of producing high-value petroleum products

and ethylene- and propylene-based petrochemical derivatives) and the upgrade of an existing refinery complex to a 400,000 bpd refinery. The total project cost was estimated at US\$9.9 billion and involved an approximately US\$5.8 billion financing, part of which (US\$600 million) was provided by investors in an Islamic tranche using an *istisna'a/ijara* combination.

At the time, the Petro-Rabigh Islamic financing was the first Islamic project financing in Saudi Arabia and the largest ever in a project financing. Prior to the Petro-Rabigh transaction there was enormous skepticism as to the doability of a shari'a-compliant project financing in the Kingdom. Whilst today the *istisna'a/ijara* structure looks uncontroversial,<sup>5</sup> the legal hurdles involved in deploying the structure at that time (2006) in Saudi Arabia were significant. At the time, it was difficult to receive Ministry of Commerce approval for special purpose companies to hold the financed assets; the Saudi Arabian Monetary Authority (the financial regulator) did not readily approve financial institutions using special purpose companies; the taxation treatment of the *istisna'a/ijara* cash flows was unclear; and the conventional lenders (the traditional providers of financing) were concerned as to intercreditor arrangements on enforcement and bankruptcy when the *istisna'a/ijara* assets were owned by the participants in the Islamic financing (and not by the borrower in the general pool of assets available to creditors). Although the *istisna'a/ijara* model had been seen elsewhere in the region, the *shari'a* boards of many institutions in Saudi Arabia had not encountered the documentation for an *istisna'a/ijara* as a part of a complex multi-tranche financing in Saudi Arabia.

### **A PERIOD OF REPLICATION TO A SETTLED MODEL (2006–2013)**

Following the Petro-Rabigh transaction, the market readily adopted the *istisna'a* and *ijara* combination to obtain Islamic finance institution participation in projects. We saw US\$635 million in the Saudi Kayan project (2008), US\$1.138 billion in the Maaden Aluminum smelter transaction (2009), and US\$990 million in the PP-11 IPP project (2010). In 2010 we also saw 1.075 billion from an *istisna'a* and *ijara* combination in the SATORP petrochemical transaction (the first large project financing by Saudi Aramco since Petro-Rabigh) and a later \$1 billion (3.75 billion SAR) *sukuk* issuance by the same project (2011). Most recently (2013), we have seen a US\$2 billion *sukuk* and US\$520 million provided under an *istisna'a* and *ijara* combination in the Sadara Project (a US\$20 billion joint venture between Saudi Aramco and Dow). Today the *istisna'a* and *ijara* combination with respect to physical assets is commonly seen and uncontroversial in Saudi Arabia.

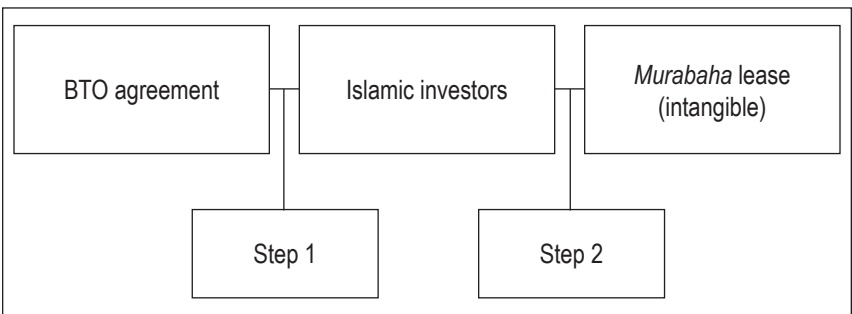
## REPLICATION AND EXTENSION

### Hajj Terminal Case Study (Intangible Asset) (2007)

Whilst the Petro-Rabigh transaction and its successors involved the Islamic financing of tangible assets by way of an *istisna'a* and *ijara* combination, the US\$205 million Hajj Terminal Islamic financing in 2007 was structured around an *ijara* in connection with intangible assets only.

The Hajj Terminal project required the refurbishment, extension, and operation of the Hajj Terminal at the King Abdulaziz International Airport in Jeddah, Saudi Arabia. The Hajj Terminal is one of the principal transport nodes for the arrival of *hajj* and *umrah* pilgrims in Saudi Arabia. The Hajj Terminal project was founded on a BTO model basis by GACA, meaning that following construction of the terminal assets by the concessionaire, ownership was transferred to the grantor of the concession, GACA. Following the transfer of the assets, the concessionaire held the right to operate the terminal for the term of the concession; however, the concessionaire held no tangible rights in the physical assets of the terminal constructed by it. This presented a challenge to the concessionaire (the Hajj Terminal Development Company, principally owned by the Saudi Binladen Group) and the Islamic investors (Bank AlJazira, Credit Suisse, and the Islamic Development Bank) in that the only valuable rights held by the concessionaire were the rights under the concession agreement—intangible rights only.

**Figure 2. Hajj Terminal Structure – Intangible Asset – BTO**



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.

Recognizing the modern value of intangible rights, and similar to the concept of sub-leasing under an *ijara*, the Islamic investors purchased for

US\$205 million the concessionaire's rights (sold to a third party by the concessionaire) and leased such rights to the concessionaire under an *ijara*. In return for the lease of the rights under the *ijara*, the concessionaire (HTDC) pays rental payments to the Islamic investors. Critical commentators have not universally supported the Hajj Terminal Islamic structure. The structure continues to cause debate; such debate is focused on the "intangible assets" comprising the bundle of concession rights and the applicability of the *ijara* to such assets.

## SHARI'A-COMPLIANT FINANCING OF INTANGIBLES

International Accounting Standards 38 describes an intangible asset as "an identifiable non-monetary asset without physical substance." Rights under concession arrangements are obviously intangible rights. The AAOIFI Shari'a Standards provide that a relevant state may grant a concession (a right of regulation) and can transfer such a right to another party.<sup>6</sup> The question then arises as to whether these rights are assets that can form the basis of a shari'a-compliant financing.

For an object to qualify as property (*mal*) in classical Islamic law it should have two characteristics:

- a) The possibility of physical possession; and
- b) Have potential for beneficial use. Intangible assets, such as the rights under a concession agreement (the usufructs), clearly fail the first test of physical possession.<sup>7</sup>

The Hanafis did not consider usufructs (*manfa'a*) as property (*mal*),<sup>8</sup> although the Hanafis recognized certain types of property (including services) that constitute intangibles as eligible property for a lease. Article 125 of the *Majallat Al Akham Al Adliya* defined owned property as "things of which man has become the owner, whether it be the things themselves or whether it be the use."<sup>9</sup> The Hanafis thus recognized the ownership of intangible assets, albeit those derived from physical assets.

Other schools have recognized usufructs as property (*mal*), based on "the apparent ground that the existence and custody of the underlying thing suffices as a token for the existence and custody of the usufruct."<sup>10</sup>

Contemporary scholars have challenged the validity of other intangible rights such as intellectual property on the basis that ownership of property is confined to tangible property only.<sup>11</sup> However, modern transactions have been established on the sale of a usufruct, which is in itself an intangible right, and now numerous transactions have been banked with intangibles as the underlying asset.<sup>12</sup>

## OTHER NON-BTO INTANGIBLE FINANCINGS IN SAUDI ARABIA

We have seen increasing use of intangibles underlying financing structures (outside of the pure infrastructure sector in Saudi Arabia). The recent offering and sale by Saudi International Petrochemical Company (Sipchem) of SAR1.8 billion publically listed *mudaraba sukuk* represents an example of the use of intangible assets forming the foundation of a shari‘a-compliant debt issuance.

Whilst Sipchem’s operating company subsidiaries owned assets which theoretically could be used to fund a potential issue of *sukuk*, many of those operating companies were party to existing secured loan arrangements with encumbered assets being unavailable for use in any meaningful capital-raising exercise (see Figure 3).

The Sipchem structure drew upon a previous market development, namely the Saudi Hollandi *sukuk mudaraba*. The Saudi Hollandi Bank *sukuk mudaraba*, which closed at the end of 2008, offers interesting background to the development of the Sipchem *sukuk*. With relatively few tangible assets to form the basis of the financing, the *mudaraba* assets under the Saudi Hollandi issuance comprised intangible rights being: “An undivided interest of each *sukuk* holder in the present and future business operations of the issuer.”

This structure has since been replicated in the Saudi market (with the documents often being used as a negotiating reference point by lead managers and issuers alike).

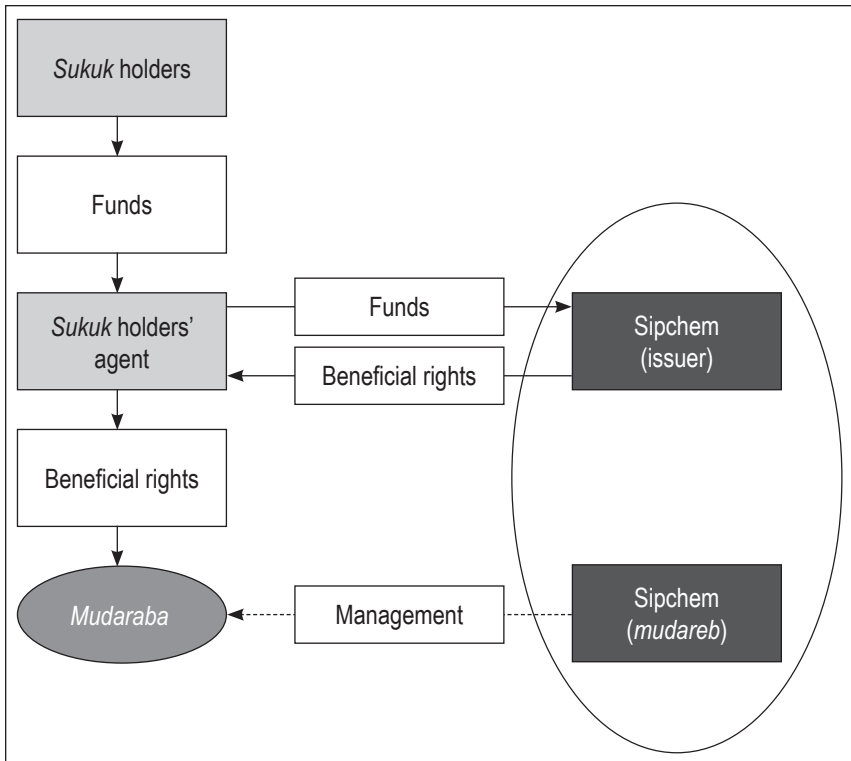
In Sipchem’s *mudaraba sukuk*, the key financeable asset was the right to receive distributions and other payments from its subsidiaries. The *mudaraba* assets were defined as follows: “An undivided interest in Sipchem’s existing and future business (including, amongst others, the right to share in distributions and any other payments made by any subsidiary to Sipchem once received by Sipchem but excluding the shares of any subsidiary of Sipchem or any interests in such shares or any votes attached to them).”

Stripping out the intangible rights associated with the equity in such a way and using it as the basis of the *mudaraba* underlined a real progression among shari‘a scholars in their acceptance of intangible assets as the basis for Islamic capital markets instruments, and it is indicative of the growing sophistication of the Saudi Arabian market.

The recent GACA *sukuk* issuance (2012), whereby GACA raised SAR15 billion for a ten-year term, provides another example of an intangible asset underlying a debt issuance. The structure underlying the GACA *sukuk* was a combination of a *murabaha* and a purchase of the following intangible rights pursuant to a benefits purchase agreement: “The benefits that are owned by the Issuer which entitles it to charge and collect fees from airlines . . . such fees being for: (i) the landing aircraft at King Abdulaziz International Airport in Jeddah, King Fahad International Airport in Dammam and King Khaled International Airport in Riyadh; and (ii) the parking aircraft at King



Figure 3. Sipchem *Sukuk* Structure



Abdulaziz International Airport (which, for the avoidance of doubt, shall exclude rights relating to the Hajj Terminal), King Fahad International Airport and King Khaled International Airport.”

**IS FURTHER INNOVATION NECESSARY?**

With wider practical application of the financing of intangibles, it is worth revisiting the model of the Hajj Terminal transaction (*ijara* with respect to intangible rights) and examining whether the *ijara* is the most appropriate vehicle for the financing of projects pursuing the BTO model. The BTO model involves the grant of rights with respect to the use of an asset for an agreed return for an agreed period. The concessionaire under the BTO model therefore holds a basket of rights akin to a usufruct. The *ijara* agreement itself represents the transfer of a usufruct with respect to an underlying asset and in the classical form requires the retention of the corpus of the leased properties and certain obligations with respect to, among other items, risk, damage, and maintenance focused on the tangible natures of assets.<sup>13</sup>

The classical *ijara* is therefore not designed to accommodate the transfer of a usufruct of an underlying asset of an intangible nature (in the case of a concession agreement, itself a usufruct). This is not surprising given the relatively recent economic prominence of the intangible asset. Looking at the developments in the financing of intangibles subsequent to the Hajj Terminal financing, there are now possible structural alternatives to the *ijara* for financings involving the BTO model. Following the structure of the Sipchem *sukuk mudaraba*, the Islamic investors could, for example, purchase the rights of the concessionaire under the BTO model (as under the Hajj Terminal financing) and the Islamic investors could then grant a sub-usufruct of such rights to the operator of the concession. This sub-usufruct would avoid the tortuous rationalization of the *ijara* model to suit intangible assets.

## CONCLUSION

The product suite in Saudi Arabia is well settled with respect to the financing of greenfield tangible assets pursuing the BOOT model. With respect to the BTO model, whilst the *ijara* has been utilized for the financing of projects, the *ijara* structure generates questions as to the suitability of this classical concept to intangible assets. Reviewing the developments in the Saudi Arabian market with respect to the financing of intangible assets, the evolution of other structures with respect to intangible assets now presents solutions with greater simplicity that do not require the rationalization of a classical structure designed for tangible property in an age where intangible assets were of less relevance.

The financial crisis in the Western economies has compressed the available debt capacity, is driving appetite for alternative funding sources, and is once again driving the further development of shari'a-compliant debt structures. Sponsors of development projects are embracing (and indeed investing in) the further enhancement of products (and the addition of new products) in the marketplace. The demand for shari'a-compliant financing in Saudi Arabia is poised to again deliver another round of advancement in meeting market demand.

## Endnotes

1. KIEP World Economy Update, May 31, 2013, Vol. 3 No. 24.
2. J. Dare, "Rail industry on track in the Middle East," *MENA Infrastructure*, Issue 7.
3. "Global Focus—2012—The Year Ahead," Standard Chartered Bank.
4. Saudi Arabian Monetary Agency, Forty-Sixth Annual Report, The Latest Economic Developments 1431 (2010 G), Research and Statistics Department.
5. The Islamic investors in the project entered into an investment agency agreement whereby the Islamic investors agreed to provide US\$600m in aggregate to the

investment agent (Gulf International Bank) for the purpose of investing in the *istisna'a* and *ijara* arrangements relating to specific components of the refinery. Petro-Rabigh, as procurer, entered into an *istisna'a* with the SPV, as purchaser, with respect to the purchase of a vacuum distillation unit and a VGO hydrotreater unit (hereafter the Islamic Assets), being integral parts of the project process. The Islamic Assets were to be delivered no later than the final completion date. At the same time as Petro-Rabigh entered into the *istisna'a* with the SPV, the same parties entered into an *ijara musufah fi al dhimmah* (forward lease) with Petro-Rabigh, as lessee and the SPV as lessor. Under the *ijara* Petro-Rabigh agreed to lease the Islamic assets from the SPV from the date of delivery of the Islamic Assets under the *istisna'a*. The Islamic tranche was provided by APICORP, Bank Al Bilad, Credit Agricole (then known as Calyon), Citibank, the Islamic Development Bank, Gulf International Bank, Riyadh Bank and Saudi British Bank.

6. See AAOIF Shari'a Standard No. 22, Appendix B: Basis of Shari'a Rulings, Management Contracts, page 408. AAOIFI Shari'a Standard No. 22 also recognizes the validity of a concession contract for the utilization, construction or management of contracts, provided there is no *riba*, *gharar*, or other prohibited practice.
7. Mahmoud A. El Gamal, *Islamic Finance Law Economics and Practice* (Cambridge, Cambridge University Press, 2006): 36.
8. Muhammad Wohidul Islam, "Al-Mal: The Concept of Property in Islamic Legal Thought," *Arab Law Quarterly* 14:4 (1999): 361–368.
9. *The Mejelle, being an English Translation of the Majallah el-Ahkam-I-Adliya and Complete Code of Islamic Civil Law*, translated by C. R. Tyser, D. G. Demertriades, and Ismail Haqqi Effendi, with a foreword by S. A. Rahman (Kuala Lumpur: The Other Press, 2007).
10. Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance, Religion, Risk and Return* (Lieden: Brill, 2006), 94.
11. Muhammad Taqi Usmani, *Copyright According to Shari'a*, at [www.albalagh.net/qa/copyright.shtml](http://www.albalagh.net/qa/copyright.shtml).
12. Mahmoud A El Gamal, 2006.
13. Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi, Maktaba Ma'Ariful Qur'an, 2007): 60.