Opportunities and challenges

Mansoor Jamal Malik and William Barrie of Al Busaidy Mansoor Jamal describe Oman's ambitious infrastructure plans and innovative project finance options

The Sultanate of Oman attracts both attention and developers looking for big project investment opportunities. High oil prices and increased demand for services and employment opportunities fuelled by demographic pressures are driving record government spending on major infrastructure and services projects under the country's eighth five-year development plan 2011-15. On January 1, the Omani ruler Sultan Qaboos bin Said unveiled an expansionary budget for 2013, hiking government expenditure by 29% to OR12.9 billion ($33.5 billion). The Government's determination to ramp up the pace of its economic stimulus and diversification programmes, a stable political climate, well-regulated banking system and an investor-friendly environment all combine to make Oman the preferred destination for project funds for 2013 and beyond.

The emergence of project finance in Oman

Project finance has long been used worldwide to fund large-scale natural resource projects, from pipelines and refineries to electric-generating facilities and water desalination projects. Increasingly, project financing is emerging as the preferred alternative to conventional methods of financing infrastructure and other large-scale projects in the Sultanate.

> Oman is the preferred destination for project funds for 2013 and beyond

Before the 1980s, the majority of project lending in Oman had been confined to natural resource ventures such as oilfield developments. Since then the range of sectors having recourse to project financing has broadened considerably, but the power and water sector has been the major beneficiary. The Omani Government's ambitious programme to privatise the water and electricity sector in the 1990s spurred the demand for project finance and led to the Al Manah Power Project. This was developed as a BOOT project (build, own, operate, transfer) and was the first independent power project (IPP) in the Gulf region in 1996. The project was financed by a group of international lending and export credit agencies and commercial lenders. As the project was a novel one for the time, it involved many complex legal and practical issues that were to be considered for the first time under Omani law. The risks for the lenders and investors were considerable and included, but not limited to: sovereign risk, construction risk, operating risk, market risk, regulatory risk, insurance risk, currency risk, change of law risk, *force majeure* risk, and cost overrun risk. As there was no precedent on how to best mitigate these risks, the lenders to the Al Manah project adopted the same practice followed on large-scale project finance transactions in other parts of the world, and allocated the risks contractually to the parties best able to manage them. This was achieved through construction guarantees, power purchase agreements (PPAs), land lease and usufruct agreements and other types of output contracts, fuel and raw material supply agreements, indemnifications, insurance policies, and other contractual agreements. The sponsors were initially required to provide credit support to projects through corporate guarantees, or other contractual undertakings to expire upon completion of the construction phase, with share pledges to remain in place until most of the debt was paid. The Omani Government would then assume the payment obligations under the PPAs and power and water purchase agreements (PWPAs).

As in other jurisdictions, the lenders and investors managed the risk by engaging independent technical advisers to closely monitor the project, through the imposition of reporting obligations on the project company and controls over project accounts exercised by security trustees and agents acting for the lenders. Later, the Management and Privatisation of the Electricity and Related Water Sector Law (Royal Decree 78/2004, Sector Law) reorganised the electricity and water sector. The Oman Power and Water Procurement Company (OPWP) stepped into the shoes of the Ministry of Electricity and Water (MEW) as the central buyer of all power and desalinated water. This reorganisation eliminated the Government's responsibility to provide those guarantees for OPWP's payment obligations in IPP and IPWP agreements that it had previously provided in respect of the MEW.

The success of Al Manah spurred the privatisation and project financing of many other infrastructure projects both on a non-recourse and limited recourse basis. For international and Omani sponsor companies undertaking projects in Oman, project finance provides a means to:

- finance joint ventures;
- finance a project that is too large for a single sponsor and facilitate a further public offering of a regulatory stipulated equity stake to the Omani public for their participation in privatisation projects;
- assign risks to parties best positioned to control them;
- insulate corporate assets from project risk by allowing for implementation of projects through project specific entities;
- keep debt off the corporate balance sheet;
- protect corporate borrowing capacity;
- maintain the credit rating of a corporate;
- improve investor return on equity.

Market trends

Growing demand

Oman's fast-growing population drives demand for infrastructure, economic growth and job creation. The demand for project finance is predicted to rise alongside the sustained pace of government spending. At the same time as the demand for capital is increasing, there is broad consensus in banking circles that liquidity available in

Oman and the GCC as a whole is shrinking. As the region starts to feel the impact of a drop in available international bank funding due to the retreat of major US and European banks, the eurozone crisis and a depressed global economy, project sponsors are looking at alternative innovative ways to fill the funding gap. Innovations made in other financial disciplines, such as leasing, insurance and derivatives-based financial risk management, have been applied quickly to project financing in Oman and such innovations have been found to be enforceable as a matter of Omani law.

Local currency financing

As local banks have grown in size and experience, local-currency funding is becoming increasingly available for project financing in Oman. This development has been particularly helpful to sponsors of infrastructure projects that generate local-currency revenues, as it has allowed them to avoid mismatches between those revenues and dollar denominated debt.

Project bonds

The bond markets have long promised to be an additional source of liquidity for funding projects but have been slow to take off in a region where capital markets are still maturing. There are signs that could be changing, with OR11 million of bond deals in the GCC in 2012, with government-related entities in the UAE and Saudi taking the lead. A number of key infrastructure projects in the regional pipeline are considering issuing project bonds. As bank financing becomes more expensive, project bonds are likely to become a more attractive option for project sponsors especially on re-financing of projects which have already achieved a stable and predictable cash flow.

Islamic finance

Islamic banking and finance emerged as one of the fastest growing segments within the financial services industry in Oman in 2012. The launch of two Islamic banks, seven Islamic windows in conventional banks, and the issue of the Islamic Banking Regulations (IBR) by the Central Bank of Oman in December 2012, represent a turning point in the alternative financing options available for projects in Oman. Immediately on the heels of the issue of the IBR, a major real estate developer announced a *sukuk* (Islamic bond) financing of an approximately OR58 million real estate project. The benefit of issuing *sukuk* bonds is that the deal can be offered to both conventional and Islamic banking sectors so there is more diversity in funding sources. The downside is the complexity and expense of structuring and drafting legal documentation to satisfy Sharia law requirements. Limited Islamic financing arrangements have been used as part of internationally-backed conventional project financing structures on past projects. However, the enthusiastic market response to the introduction of Islamic finance in Oman last year suggests that it will play a much more important role in project financing in the future.

Public participation in privatised projects

Under the Privatisation Law, the Sector Law and project agreements entered into by licensee project companies with government-owned Sector Law entities (such as the Electricity Holding Company), and as a condition of a licence granted to project companies by the Electricity Regulatory Authority, a stipulated percentage of a Sector Law licensed entity's issued share capital must be offered for public subscription within four years from the commencement of a project company's operations.

The legislative and regulatory framework

In the early days, the lack of legislative and regulatory framework in Oman was an impediment to project financing. In 1994, the international lending agencies advancing funding to the Al Manah project worked closely with the Omani Government to assist in developing a legal and regulatory framework for project finance transactions to follow. This legislative and regulatory framework has evolved, and continues to evolve, to provide security and protection for project financiers' interests. It also provides incentives, including the creation of registered, perfected, first priority security interests for the benefit of project finance lenders. These take the form of registered legal mortgages, commercial mortgages, share pledges, contractual and other assignments over and with respect to

Oman's fast-growing population will continue to drive demand for infrastructure

Author biographies

Mansoor Jamal Malik

Mansoor Jamal Malik is the managing partner and founder of Al Busaidy Mansoor Jamal & Co (AMJ), a top-ranked commercial law firm in Oman. He is widely respected for his corporate and project finance expertise gained from advising international banks, finance institutions, project consortia and government entities on Oman's major infrastructure and privatisation projects from Al Manah, the first independent power BOOT project in the GCC in 1996, onwards. Recent headline deals include advising on the set-up and IPO of a major Islamic bank, and the $350 million Al Ghubrah IWP, acting in the bidding stage for the successful consortium and the syndicate of lenders which subsequently financed it. Over a period of 30 years in Oman, Malik has built a formidable base of knowledge of the laws, practice and court system of the country, and an unrivalled network of relationships with government and regulatory bodies, and industry and business professionals.

Malik is a UK qualified barrister, and a member of the leading set of chambers of Robert Jay QC and Stephen Tromans QC, London.

William Barrie

William Barrie is a UK qualified solicitor with experience in project finance, Islamic finance, debt capital markets and structured finance. As an associate in AMJ's banking and finance team in Muscat, Barrie advises leading Omani banks and project sponsors bidding for power and water projects in Oman. Following his training at an international firm of solicitors, Barrie worked inhouse at a leading global bank in the City of London, where he was involved in large scale transactions in the transport sector.

immovable property, tangible and intangible property and rights inclusive of shares and securities and bank accounts, in existence as of the date of creation of security interests. There is no concept in Omani law of the floating charge as exists in other jurisdictions such as the UK, although the Ministry of Commerce and Industry has allowed the registration of such charges provided for in a commercial mortgage.

With regard to the priority of security interests in general, Royal Decree 32/94 establishes preferential rights for the Omani Government regarding liabilities outstanding in its favour over any registered securities created by a debtor in favour of another creditor (including secured creditors), and departments, agencies and commercial organisations in which it has a 51% majority shareholding.

Omani law allows for the appointment of security agents and trustees for holding collateral on behalf of project lenders. Such

> Islamic banking and finance was one of the fastest growing segments in the financial services industry in Oman in 2012

security agents and trustees would typically be an Omani licensed bank whose role is to facilitate the creation and enforcement of security interests while avoiding the inference of a foreign bank which, in seeking to create and enforce security interests, conducts business in Oman while unlicensed to do so.

Enforcement of security interests have benefited project lenders through the filing of applications to the court for a judicial sale by public auction. With the passage of time such enforcement has been tried and tested and the court processes have enhanced lender confidence in terms of the enforceability of their rights.

Project lenders may act as buyers in any judicial sale subject to any restrictions on foreign ownership of real estate under Omani land laws. Although project lenders do commonly enter into direct agreements with project company counter-parties to project agreements allowing them to exercise step-in rights, such arrangements are yet to be tried and tested before the Omani courts.

There are no restrictions on foreign exchange controls and the remittance of investment returns, foreign earnings from Oman or loan repayments to outside of Oman, other than the requirement to deduct withholding tax at source on certain specified payments to foreign companies without a permanent establishment in Oman.

For projects which are required to be privatised, the Government and regulatory authorities grant the necessary consents and permits required by developers for the implementation, operation and maintenance of their projects provided a valid application is submitted and the relevant information is provided in a timely manner. A key consent required by industrial projects and projects in the power-generating sector is the preliminary environmental permit issued by the Ministry of Environment Climatic Affairs for which developers are required to prepare an environmental impact assessment report for approval. Oman takes its responsibility with regard to the environment seriously and enforces the Oman Environment Law and Regulations stringently.

Foreign investors are permitted to own up to 100% of the equity of power and water projects.

As a matter of Oman Insurance Law, project insurances must be placed with Omani insurance companies. Typically, the national insurance companies reinsure the entire risks with overseas reinsurers. Any such insurances and reinsurances may be assigned by the project companies for the benefit of their lenders.

Private ownership of assets is safeguarded and no person may be prevented from disposing of his or her property except within limits of the law. Private property may only be expropriated for public interests according to the circumstances and manner stipulated by law against fair compensation.

All companies incorporated in Oman irrespective of foreign ownership are treated for taxation purposes on par with Omani companies (the maximum corporate tax payable by any company in Oman is 12%). Project companies may obtain tax holidays for periods of five years from the commencement of production or business operations, extendable for a further term of five years with the approval of the Council of Financial Affairs and Energy Resources. Entities licensed under the Sector Law however are not entitled to tax exemptions.

International arbitration contractual provisions and awards are recognised by the Omani Courts and by the Oman Arbitration Law. Oman is now signatory to the New York Convention on the Enforcement of Foreign Arbitral Awards.

Opportunities

While Oman may be a relatively small market compared to other GCC countries, it is thriving and an impressive roster of infrastructure and other projects worth over OR50 billion is planned or under way in the Sultanate. Such projects include new healthcare facilities such as the OR400 million International Medical City in Salalah, regional hospitals, over 100 schools, new airports at Duqm and Sohar, the expansion of Muscat International Airport, a new cargo terminal for Salalah port, new quays and a 200 million barrel storage hub at Duqm (one the of largest in the world), a network of smaller fisheries, and expansion of industrial facilities at Sohar. OR104 million of projects are under development by the Oman Tourism Development Company.

In the transport sector, in addition to airport expansion, a key element of the five-year plan is an extensive road-building programme to boost tourism and improve access between the interior of Oman and industrial port zones such as Sohar and Duqm. A tender for preliminary design of the delayed OR6 billion national railway which will form the southern end of a GCC-wide rail system was announced at the beginning of February 2013. Oman's power and water networks are being upgraded. In its seven-year plan 2012-2018, OPWP forecasts demand for electricity to grow at eight percent per year in the northern grid and the demand for potable water to grow at five percent per year. It is embarking upon an ambitious plan to develop IPPs and IWPPs across Oman to meet this projected demand. Other projects include wastewater and dam construction around the country.

Projects will be funded in part by revenue windfalls as a result of higher oil prices in recent years. High oil prices of $109 per barrel against a conservative estimate of $75 per barrel in 2012 delivered a budget surplus of OR1 billion against a budgeted deficit of OR1.2 billion, boosting state coffers. Analysts predict a similar surplus in 2013. Another source of funding is the GCC aid package, of OR3.9 billion over 10 years agreed for Oman in March 2011 at the height of the Arab Spring. The Government has earmarked part of this

funding to the national railway and other projects viewed as strengthening the free flow of trade and the wider GCC economy. However, such is the pipeline of ambitious projects that demand for project finance will remain high for the foreseeable future.

Challenges

Project finance remains the preferred form of financing for large infrastructure projects in Oman and the wider GCC, particularly for large scale power and water projects. The fact that, across the GCC, as much as OR31 billion of project finance transactions aim to reach financial close within the next two years and project finance capacity is estimated to be around OR9.6 billion a year, means there are growing constraints on bank capital where it is needed most.

The number of international banks interested in project finance is dwindling, or they are focusing on markets where pricing is higher. Banks which have historically been active players in the Middle East project finance arena have now drastically curtailed lending due to their own internal credit, liquidity and capital adequacy issues. The resulting funding shortfall is thought to be partially responsible for a general slow-down in project finance activity in the GCC in 2012, despite strong economic growth and oil-price generated surpluses. Several factors are behind this lack of appetite for project financing:

- the European sovereign debt crisis which has damaged liquidity in the European banking markets and driven up costs;
- the Arab Spring, which saw some European and US banks withdraw from the market;
- new international banking regulations known as Basel III make it less attractive for banks to lend on the 15 year plus tenors required for most projects.

For Oman, this may mean increased competition for more expensive financing. The challenge for the Government and project sponsors will be to maintain access to sufficient liquidity in the face of the funding gap, while ensuring costs remain within a budget that enables the project to be economic.

Protecting Oman's expansion plans

For 2013 and beyond, the Omani Government and project sponsors are likely to be considering alternative sources of project financing to the traditional banking markets to protect the pipeline of critical infrastructure projects. The role played in project financing by local banks will grow in importance as government entities and project sponsors in Oman look to an active Omani banking sector to plug any funding gaps. Although still in the early stages of development, Islamic finance along with conventional bond markets may represent alternative sources of finance which can be integrated with more traditional forms of project finance to make up any funding shortfalls. Bonds offer a good alternative, in particular for refinancing of projects to free up liquidity for future development activities, and may prove a good option for Oman's planned upgrade of power and water projects. Of one thing we can be certain: the Omani Government cannot afford to allow its ambitious expansion plans to be derailed. It has proved itself adaptable in the past to changing market conditions, and can be expected to forge ahead with confidence, meeting any financing challenges it faces head on.