

# Challenges in Structuring non-recourse Financing for Energy Projects in Saudi Arabia

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In recent years, the Kingdom of Saudi Arabia has witnessed a dramatic increase in the number of investors interested in financing energy projects in a Shariah compliant manner. This article examines a number of specific challenges in relation to structuring a financing in Saudi Arabia, and the issue of interest in the context of an independent power project. Previous projects in Abu Dhabi and Saudi Arabia are analyzed with a view to illustrating some of the imaginative solutions that have been deployed.

## Specific challenges in structuring a financing in Saudi Arabia

We have seen the growing use of diminishing Musharakahs and Bai al Ajals (purchase over time using installment payments) in terms of Shariah compliant financing structures and the increased use of Sukuk and Shariah compliant funds as a means of raising funds from parties other than traditional financing parties. As in other jurisdictions, many of these projects have a substantial component that consists of non-Shariah compliant funds, particularly financing received from international export credit agencies and conventional financiers.

Structuring the Shariah compliant financing or investment properly with the conventional financing is essential and is often made by way of a bifurcated structure so that no Shariah compliant investment is made directly into the project company. A number of challenges also exist in structuring a financing in Saudi Arabia, particularly the concept of security and the means of perfecting and enforcing security interests. This becomes particularly difficult with respect to certain types of property that are the object of financings, including immovable property such as real estate or fixtures on land.

### *Rahn*

Financiers normally wish to obtain a Rahn (a pledge) of the real estate, movable property of the project

company and the facility to be constructed for use by the project company.

Below is a brief discussion of each type of asset:

#### i. Real estate/immovables

While it was once the practice to record the liens of banks on the real estate title deeds, Public Notaries now refuse to record such liens, making it difficult to use real estate as collateral security for loan transactions from commercial banks. A notable exception to this is the Saudi Industrial Development Fund (SIDF) which is discussed below, and which routinely registers valid mortgage interests against real estate and improvements.

When possible, financiers will take an assignment of the lease on the relevant site. Also, because the SIDF takes a first-priority mortgage over the lease and improvements, it is often possible for other financiers to enter into an intercreditor agreement with the SIDF.

#### ii. Movable

In a project financing, the financiers normally wish to take a mortgage over all the movables that belong to the project company. The Commercial Mortgage Regulations establish a statutory framework applicable to mortgages over movable property.

However, the governmental bodies that are tasked with recording the Rahn on the title do not yet have a mechanism for recording such Rahn. For example, the Muroor (motor vehicle department) does not yet have a system for recording a Rahn on the Istimarah (title deed) of vehicles. The Commercial Mortgage Regulations provide that, for a Rahn taken in accordance with the steps of the Commercial Mortgage Regulations, the financier(s), in an event of default situation, must provide the defaulting

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borrower a notice of such default and a period of time within which to rectify the default. If the default is not corrected within the agreed time frame, an application is made to the Board of Grievances to conduct an auction sale of the movables that are subject to the Rahn.

iii. After-acquired property

Assets, or Marhoun, under the Shariah must be something that can be validly sold. Therefore, any Marhoun subject to a Rahn must (i) be in existence at the time of execution of the Rahn, (ii) have a quantifiable value and (iii) be saleable and deliverable. The definition of Marhoun creates a problem in terms of after-acquired property. This can be addressed in a financing through regular updates of the schedule of Marhoun/assets in the security agreement prior to each draw on a facility to ensure that the concerned Marhoun is covered by the security agreement.

*Assignment of contract proceeds*

It is possible to assign contract proceeds and other intangible rights under the Shariah, subject, however, to the caveat that it is not possible to “perfect” such assignments through recordation with a central registry. Instead, borrowers in Saudi Arabia are often asked to assign specific contract proceeds, with an acknowledgment from the payor that the assignment shall remain in effect until the assignee consents to any transfer or termination of the assignment.

Under Shariah precepts as applied in Saudi Arabia, however, unilateral assignments are not effective. In order to create an effective assignment of a contract of the relevant project company and/or contractual obligations of counterparties thereto, such counterparties must be given notice of the assignment and must consent to the assignment. Thus, an assignment of amounts owed to a project company to the financiers must include a written consent of such assignment by the payor(s) in order to be a perfected interest.

*Power of attorney*

Financiers to projects in Saudi Arabia often rely on a Wakalah or a power of attorney given to a designee of the financiers in order to exercise certain “step-in rights” in an event of default scenario. However, it is critical to note that powers of attorney in Saudi Arabia are revocable, even if the power of attorney is characterized on its face and in the security documents as an “irrevocable” power of attorney. In order to protect against the revocation of a power of attorney granting step-in rights, financiers often include a liquidated damages provision in the concerned security agreement that is triggered upon premature revocation. In our experience, liquidated damages have been enforced by the local courts as long as the liquidated damages approximate the actual damages and are not drafted as excessive financial penalties for non-performance.

*Pledge of interests in a Saudi limited liability company*

A Saudi limited liability company (LLC) is the corporate form most often utilized for Saudi Arabian joint venture entities that are partly foreign owned. A Saudi LLC does not issue share certificates.

Although this has been less of a problem for non-recourse financiers in the petrochemical sector, it has presented difficulties with non-recourse financiers in the power and water sector. In the absence of a share certificate that can be physically delivered to the financiers or even annotated, the pledge of interests in a Saudi LLC is not enforceable under local law. To get around this, financiers have required sponsors to form SPVs in offshore jurisdictions (for example the Cayman Islands or elsewhere) to serve as the shareholders in the Saudi project company and then pledge the shares as a form of second tier security, thus providing indirect control. However, careful structuring is required otherwise.

Moreover, payment made by a Saudi party (whether for services or dividends) to the offshore SPV will be subject to Saudi withholding tax at rates of between 5%.

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It should be noted that Saudi Arabian joint stock companies do have certificated shares that may be pledged to local financiers. In the power and water IWPP/IPP sector, the project companies have been formed as joint stock companies to satisfy the expectation of non-recourse financiers. Because of the time required to establish a joint stock company, the formation process should begin at an early stage.



#### **Interest payments under power and water project agreements**

In a typical independent power project (IPP), termination will be a key consideration that will be reviewed by the project financiers. The usual arrangement is that the power purchase agreement will be subject to termination in the event of specified events, which fall into three broad categories. First, events of default caused by the project company. These might include a failure to build the power plant on time, a failure to maintain a certain level of availability and the insolvency of the project company. Second, events of default by the offtaker. These might include a failure to pay the tariff in a timely manner, a failure to build any necessary transmission facilities and a failure to provide land necessary for the project company to build the power plant. Third, no-fault events. This would normally comprise force majeure events, which would normally be split between political force majeure events and natural force majeure events.

In a typical IPP, where there has been a default, the relevant party would be entitled to terminate the power purchase agreement. This would trigger a buy out obligation or buy out option, depending on the specific event. The buy out simply means that the plant, whether construction has been completed or not, would be transferred from the project company to the offtaker and the offtaker would then pay the project company an amount with respect to the plant that has been transferred to it. The actual amount payable would be set out in the power purchase agreement pursuant to a detailed formula. The actual amount payable would depend on the ground of termination. For example, termination because of an offtaker event of default would trigger the most generous pay out to the project company and would normally include an element of the project company's loss of profit.

Under each event of default, the project company would receive its outstanding bank debt. This would naturally include principal plus interest. The difficulty with certain jurisdictions of law in the Gulf based on the Shariah is that the interest element will simply not be recoverable on the basis that it is Haram. This presents a significant problem for any financier seeking to finance a power project. Considering that the capex of such a project is likely to run to several hundreds of millions of dollars, if not several billions, with a typical debt equity ratio of 80/20, the outstanding debt element at any one time could be substantial.

This issue was addressed in Abu Dhabi in its first independent power and water project, the Taweelah II IWPP. The project structure comprised a power and water purchase agreement (the PWPA) and a sovereign guarantee. The PWPA was governed by English law and the sovereign guarantee was governed by the laws of Abu Dhabi. The idea was that if the PWPA terminated, the offtaker would be obliged to pay the project company the relevant termination payments, including outstanding bank principal and interest. Because the offtaker was a

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special purpose vehicle with no assets, it would be unlikely that it would be in a strong enough credit position to pay the full amounts to the project company. As a result, the sovereign guarantee, entered into by the government, through the ministry of finance, was intended to support the obligations of the offtaker and allow the project company to claim termination payments from the Ministry of finance in the event that the offtaker refused or was unable to pay.

The difficulty was that the ministry of finance was only prepared to issue a sovereign guarantee governed by the laws applicable in the emirate of Abu Dhabi. The expectation of the lenders was that on English law sovereign guarantee would be issued and accordingly the structure was at risk of being rendered unbankable, even though interest based financing is common and legal in the UAE. The solution that was devised was to enter into a direct agreement between the project financiers and the ministry of finance. Although the ministry was reluctant to issue an English law sovereign guarantee, it accepted that English law direct agreements were necessary for each of the project agreements, including the sovereign guarantee. The direct agreement for the sovereign guarantee contained the usual clauses one would expect in a direct agreement, but also special provisions allowing the financiers (not the project company) to claim bank debt, including interest payments, directly from the ministry of finance. This worked in the context of an English law governed direct agreement.

In the context of Saudi Arabia, the first IWPP was the Shuaibah III project. When the request for proposals was issued, the documentation included a Saudi law power and water purchase agreement and a Saudi law sovereign guarantee. It was obvious from the outset that under no circumstances was the ministry of finance willing or in fact able to sign an English law direct agreement. This meant that the Saudi model set out in the request for proposals was fundamentally different to the model developed in Abu Dhabi under the Taweelah II project. This

created a significant problem for the government, financiers and sponsors in terms of resolving the impasse. Ultimately, as is the case with most deals, a compromise was reached. The parties agreed that the PWPA would simply be changed to an English law governed document. There would be no English law sovereign guarantee direct agreement on the basis that the ministry of finance was not permitted to enter into an English law agreement.

The rationale behind changing the governing law of the PWPA was that in the event of a termination, the project company would sue the offtaker under the English law PWPA and obtain an arbitral award that included the outstanding interest payments. The arbitral award would then be presented to the ministry of finance along with the Saudi law sovereign guarantee. The expectation, at that stage, is that the ministry would ultimately take a long term view and pay the interest payment on the basis that if they failed to do so the Kingdom's credit rating would be seriously damaged and future direct investment would be discouraged. Ultimately, it was a practical rather than legal solution to the issue of recovering interest.

### **Conclusion**

There are a number of challenges in structuring a non-recourse financing for an energy project in Saudi Arabia, particularly large projects that are partly financed using conventional financing. However, the fact that such projects are being closed and include both local and international financiers indicates that, with appropriate structuring, such financings are possible in Saudi Arabia.<sup>(3)</sup>

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