Eastern promises

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Privatization has become something of a vogue throughout the Gulf since the once unpopular concept first reared its head in the region over a decade ago. But there is another idea that recently has begun to grip the imagination of GCC government ministries: adopting European style public-private partnerships for diversified municipal infrastructure projects. And now PPP deals are actually being plotted in several sectors, though largely on the back of power restructuring programs. Their viability, however, will depend on much more than just government enthusiasm.

At the core of all PPPs is the deployment of private sector capital. And within the PPP framework, this can result in greatly improved value for money for the government in terms of risks transferred to the private sector. Indeed, for this reason the PPP map has expanded rapidly across the globe in recent years.

In the Gulf, reliance on oil wealth has left many GCC states without the economic dynamics to cope with the needs of rapidly swelling populations. Accordingly, they have been working to stave off budget deficits, cut spending, and put their fiscal houses in order. And part of greater fiscal discipline has meant opening up infrastructure to private participation, thereby encouraging, in theory, the appropriate pricing of output.

This idea has started to work well for the power sector. Most notably, Abu Dhabi and Oman have worked hard to open up the sector to foreign participation, as the reception of their IPP programs to date testifies.

The Abu Dhabi government, for example, though in no need of foreign capital, nonetheless believes private participation will inject some market discipline into its utilities. It began by letting the private sector manage electricity generation, effectively through public-private partnerships ? competitively tendered long term arrangements to introduce private capital and management into the provision of public services, though with the government maintaining its majority stake. The question is whether a similar framework can, or should, be introduced for other infrastructure sectors, throughout the Gulf.

The extent to which any country can smoothly implement a broader PPP program depends on a number of factors. Among them are the country's prior experience with privatization, the presence of an adequate concession law, the creditworthiness of local authorities, and the sophistication of local investors.

But in the Gulf, other problems exist. Currently, the cost of basic public services is largely subsidized by governments, across the region. If market discipline really is the aim, this will have to change. With citizens all at once having to pay for what has historically been a ?free? service, or at least one whose nominal charge has been way below production costs, some annoyance is perhaps inevitable. ?It's a question of ideology as much as it is of economics,? contends a local banker.

The picture in the Gulf is clearly different from, say, the UK. ?For a start,? says one international lawyer, ?there's no established benchmark ? there is no way of testing whether such an approach is actually better value for money than public procurement.?

But one sector, aside from power, where PPP has made some headway is wastewater. Last December, the government of Ajman awarded a consortium of Black & Veatch and Thames Water a full PPP concession for the Gulf's first integrated wastewater project. The project calls for the Ajman Sewerage Company to invest $100 million in establishing a wastewater network for the emirate.

The idea to privately finance a wastewater network in the emirate had been on the table since 1995, when Black &

Veatch signed an initial MOU with the government.

The government opted for a PPP approach for its wastewater scheme, rather than attempting public procurement with municipal operation, since, according to Raj Kulasingam, partner at Denton Wilde Sapte (legal adviser to the consortium), ?Ajman recognized the clear benefits of private sector expertise that have been demonstrated elsewhere in the world.?

The project is a 27.5-year concession for the Ajman Sewerage Company, a 50:50 joint venture between the two co-developers, to construct and deliver wastewater services to 300,000 customers in the emirate. The Ajman government will retain a 20% stake in the project. What differentiates the project is the fact that the consumer, rather than the government, will be responsible for tariff payment.

But the deal became possible because of commitment to legal and regulatory reform. A new sewerage sector law for Ajman, outlining the obligations on the company, the government and residents, as well as the tariff structure, had to be drafted prior to the signing of the concession agreement.

?Governments are understanding that the legal framework needs to be in place, parallel or prior to trying to negotiate a concession agreement. In most places the ability to get such deals done depends on the government's understanding of the issues,? says Kulasingam. ?It has become more widely accepted that governments will have to pass laws to enable these projects to happen,? he adds.

The deal is not yet sealed. The sector law is awaiting final approval, and financing depends on it. Fuji Bank has been financial adviser to the developer on the project. The bank has reportedly been in discussion with other regional players to raise around $70 million in debt finance, likely to be structured as a club deal with four or five banks participating.

The tenor on the debt is expected to be between 12 and 15 years, an issue that is particularly important given the nature of the capital intensive business.

The introduction of tariffs is likely to be the most sensitive issue, and lenders are naturally looking for the right comfort. The project company will be responsible for revenue collection, which will involve customers paying a connection fee and a monthly service charge. The new sector law, however, outlines a mechanism for non-payment that should satisfy lenders and sponsors: if customers do not pay, enforcement will ensue, including electricity severance and court action.

?At the end of the day,? says one international lawyer, ?this is one of the toughest sectors to privately finance anywhere in the world. The real success of this deal will finally hinge on the Ajman's creditworthiness ? their ability to prop up the deal should it go wrong.?

Probably the most advanced Gulf state in terms of harnessing private sector capital and management for infrastructure projects is neighbouring Oman. ?Oman has been very successful in bringing in the private sector to date. It has a very strong legal and regulatory framework, and has been through the documentation on concession financings.? says SG's Matthew Vickerstaff. This would seem to make the Sultanate the perfect test ground for municipal PPP infrastructure deals.

One of the first projects to stir up private investor comfort, and faith in Omani PPPs, was Oman's Salalah container port project. The container terminal was a $260 million joint venture between Omani public and private companies, and Maersk Sealand, which signed in April 1998. It is already ranked among the top ten most efficient shipping terminals in the world and is currently looking at expansion.

Since then, the Sultanate apparently has been assiduous in cultivating local and foreign private investment. This was evident, for example, with the appointment of international experts to advise on power and water sector restructuring. Several projects have since come to the fore, especially in the power sector, which have arguably represented test cases for the broader privatization program.

The Ministry of National Economy has drawn up a substantial list of infrastructure to be privatized, or to submit to PPP treatment. ?The government realised that they had to mend their reputation internationally as regards privatization,? explains a foreign lawyer. ?The drop in oil prices was a good push for them to wake up and realise that one way of solving the problem was a revised privatization program. And this time they realised that it had to be done successfully, to give the right message internationally.?

Critical to this effort, of course, is the sophistication of the Omani legal framework, and the government's openness to private sector reform. ?Omani law is the most advanced of GCC legal systems by far,? explains a Muscat based international lawyer. But with the new privatizations and projects, the law is being tested to see whether it really is sufficient to handle the changes.

Another recent example of the government's sophistication when it comes to concession based private sector contracts is, according to Ewan Cameron, partner at Clifford Chance, its handling of the Seeb and Salalah International airports bid.

British Airports Authority (BAA) signed in October 2001 a concession agreement to manage and develop both international airports. Under the terms of the concession, BAA, with the local Bahwan Trading Company and Swiss-based ABB Equity Ventures, took a 75% stake in the venture that will operate both airports for a 25-year period. The agreement includes a commitment to invest in the construction of a new terminal at Seeb International Airport raising passenger capacity to 8 million.

Says Cameron, ?the earlier Salalah port deal was not properly tendered and became a negotiated deal instead. It is important to note the contrast between the way that was pursued and the recent airport deal. It is exemplary in terms of highlighting the government's ever maturing approach to getting PPPs to work. What we're really talking about is the maturing of the market.?

This market maturity is being translated into a broader application of PPPs. The government is actively pursuing projects in the defence, education, healthcare and accommodation sectors.

Says Cameron, ?There certainly is the political will to get these proposed PPP deals done, but what has to be recognised is the need for wholesale regulatory reform. This is why not much else has happened yet outside the power sector.? But, he adds, ?2001 was a year of widespread commercial legal reform throughout the Gulf, which should bode extremely well for future dealflow.?

Says Martin Amison, head of international practice at Trowers & Hamlins, ?these smaller project financed PPP deals are being done regionally and are indicative of the way things are going.? He adds, ?In order to get Gulf school deals done on a PFI basis, one would expect to see the relevant legislation in that sector.? If successful, the Omani examples could be held up as models for other Gulf states to adopt. Says Amison, ?the key is getting greater certainty into the process by developing standard form contracts to avoid lengthy repeated negotiations. You won't be able to make these smaller deals happen without developing standard documentation. But first we'll need to see a hospital, university or accommodation deal to produce the necessary momentum.?

As relevant will be finding funding for PPP infrastructure deals. One of the biggest challenges, according to Vickerstaff, will be currency risk. ?Omani rial based financing is tough if you also need to go to the international markets. Its difficult to get fixed rate funding for long periods and if you have to convert to dollars, you'll end up with a mismatch.?

According to a local banker, ?the major worry is that the international project finance banks are pulling out of the region, since project lending in the Gulf is not as attractive anymore, and margins are getting tighter.?

To this extent, competition is likely to heat up among local and regional banks. Lending limits confine some local lenders to participatory levels on larger deals. The desire among these banks for projects is there but they will be dealt with on a case by case basis. The lack of long term instruments also obviously restricts appetite somewhat. But for smaller PPP/PFI deals, their presence is likely to be felt more strongly ? if and when such deals happen.

Another issue worrying international lenders, and furthering the case for greater regional lending, is sovereign risk. Says one international banker, ?government ratings are of course not in the same league as, for example, OECD or European governments. The question is whether, in case a deal falters, governments in the Gulf step in to provide support. Frankly, the jury is still out on this question.?

But the need for credit enhancement is vital. ?Whether it be Ajman or Jordan, there has to be some government support,? says Cameron. This support may also take the form of political risk insurance or even ECA cover for larger deals, where it would make economic sense. New and innovative insurance tools for better risk allocation could yet help a nascent PPP market develop further.

Finding new sources of private capital will continue to preoccupy the region in its push towards private sector involvement. The need will become more urgent with the opening of larger markets such as Saudi Arabia. As Cameron puts it, ?in order for all the planned projects to happen, there will need to be more diversification in funding sources. And the future success of a wholesale PPP market depends intimately on the development of local and regional capital markets.?