SADAF: the first independent Saudi Arabian power project

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In July 2003, Saudi Petrochemical Company (SADAF), an affiliate of Saudi Basic Industries Corporation and Shell Chemical Arabia, signed an SR 637 million (US$170 million) contract with the Jubail Energy Company (JEC) to build and operate a 250 megawatt (electric) / 510 tons/ hour (steam) power co-generation plant at its site in Al-Jubail.

The closing of the SADAF deal on July 15th marks a breakthrough in the financing of infrastructure projects in Saudi Arabia.

The Project

The plant is the first private independent power plant in Saudi Arabia and is expected to start up in the second quarter of 2005. Structured under the Build Operate Transfer (BOT) model, the project comprises the development of a co-generation facility that will supply power and steam to SADAF’s petrochemical complex in the Jubail Industrial City under the terms of a 20-year Energy Conversion Agreement (ECA). The ECA is a tolling-type offtake agreement under which the project receives "free" gas from SADAF (sourced from Saudi Aramco) and receives capacity payments from SADAF which are linked to the plant’s capacity and availability.

The project will help fulfill SADAF’s expansion of its styrene production with an additional 500,000 mt/y being added, raising total styrene capacity to 1 mt/y over the next few years. Other SADAF production lines besides styrene include 1.1mt/y of ethylene; 840,000 mt/y of ethylene chloride; 750,000 mt/y of Methyl Tertiary Butyl Ether; 670,000 mt/y of Caustic Soda and 300,000 mt/y of Crude Industrial Ethanol. The project will also generate significant energy cost savings for SADAF as it becomes the main source of electricity and steam for its petrochemical complex. At the time of closing Abdullah S Nojaidi Chairman of SADAF and Vice President, Petrochemicals at SABIC, also noted the importance of the plant to SADAF operations and added: "This is an important milestone for the region in providing a private independent power source for the first time at an industrial site".

The construction of the project is undertaken by Siemens AG of Germany under the terms of a fixed-price, date-certain Engineering Procurement and Construction (EPC) contract with the project company, JEC. The technology chosen by JEC rests upon Siemens/ Westinghouse’s proven W501D5A gas turbine.

The project will be located next to SADAF’s complex, on land leased from the Royal Commission of Jubail and Yanbu to SADAF. The project will enjoy the use of this land under the terms of a 20-year sub-lease with SADAF.

Diagram 1: Project Contractual Structure:

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The Sponsors

JEC is a 75/25 joint venture between the National Power Company (NPC) of Saudi Arabia and CMS Generation Company.

NPC is a 50/50 JV between two well-established Saudi Arabian family-owned conglomerates, the Al-Zamil and El-Seif groups, and represents a key player in the future of Saudi Arabia’s developing power generation market.

CMS is an integrated energy company, which has as its primary business operations an electric and natural gas utility, natural gas pipeline systems, and independent power generation. CMS will also provide operational support to the project under the terms of a 20-year Technical Services Agreement.

Ken Whipple, the chairman and chief executive officer of CMS Energy, said the SADAF project fits the company's strategy of meeting its commitments in the Middle East and Africa, while selling other overseas assets. Whipple said: "The SADAF project offers us an opportunity to do what we do best: build and operate an efficient power plant that provides reliable electricity to our customer. The entire output of this plant is committed to SADAF under a long-term contract, so this project also fits in with our strategy of reducing risk and producing more predictable earnings."

Financing

The limited recourse bank facilities were arranged and underwritten by Banque Saudi Fransi (BSF) and Credit Agricole Indosuez (CAI), the two joint-mandated lead arrangers and book-runners. Arab National Bank, Arab Petroleum Investments Corporation, and Riyad Bank were also brought into the transaction following a syndication launched in April, at the height of the Iraqi conflict. It is the first IPP to be financed on a limited recourse basis in the Kingdom.

The total project costs of US$195 million are financed by a US$167.5 million financing package which comprises of US$157.5 million of term loan facilities (including standby facility) and a US$10 million bond facility. Equity of US$45million will be contributed by the two sponsors.

The Saudi Context

Key to the development of the financing structure was addressing the security issues specific to Saudi Arabia, most specifically the difficulties in effecting security on physical assets and shares. Saudi Arabia adheres to Sharia law, a legal system based on the concept of Islamic teaching. It consists of a set of principles which are applied by Sharia courts to each particular case so there is no system of precedent. Although the legal system is increasingly being developed to provide assistance to the ever more complex commercial transactions that are being done in the region, the process is relatively young.

The Security Package

One of the most challenging aspects of the project for the banks was the security structure. One of the key elements that lenders seek in a traditional security package, control over project assets in the event of a default, was simply not an option in the Saudi Arabian context. Nor could security be taken over the leased land forming the project site. In addition,

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the difficulties involved in enforcing a share pledge in a Saudi Arabian limited liability company meant lenders could not take an effective share pledge. Inevitably, the sponsors were concerned that the security package would not become so complicated as to hinder the day-to-day management of the company. According to Sarah Moynihan of Allen & Overy who advised the lenders: "There was very much a drive to reach a sensible compromise".

The banks, with the support of their counsel Allen & Overy, tackled these issues through a number of arrangements which relied ultimately on an indirect pledge of shares. The sponsors incorporated offshore holding companies for JEC in Bahrain and the Cayman Islands and the lenders took security over the offshore vehicles. As Jamie Mabilat of CAI admitted: ‘A pledge of shares in holding companies and not the project company itself is never as good as having direct shares in a project company yet although it wasn’t perfect, we agreed on the basis that a number of restraining measures were added to the holding structure which ultimately gave the lenders the level of control they required".

Indeed, the lenders introduced mechanisms which would allow them to effectively take control of the holding companies should they need to commence enforcement action. These included covenants from the sponsors that nothing would be done to the holding companies which would have an adverse impact on the value of that security, including disposing of the shares. The structure also included a number of other controlling mechanisms such as pre-dated resignation letters from the companies’ directors which could be triggered by the banks in certain default circumstances. As Sarah Moynihan recognised: "The security arrangement was challenging but clearly not insurmountable’.

The Corporate Loan

Another concern was assuring financial security. One particular issue for the lenders was related to the termination provisions of the ECA. In most circumstances, if the contract is terminated, a termination payment is made which is meant to cover the value of the outstanding debt (and equity in certain circumstances).

The risk here was that should a dispute over these termination payments ever be brought to a local court, the court could decide that all interest paid up to the date of the termination should be treated as principal and as such go towards reducing the amount payable by SADAF as a termination payment.

Added to this, SADAF was keen to ensure that it would not necessarily have to pay any termination payment in a single lump sum. Constantin Koutzaroff of CAI explained: "If there is a termination and lenders are due to receive a lump sum payment of the amount that is outstanding in loan, a utility will be able to gather cash from many different sources. Yet in contrast, it is impossible for one producing company to repay you in one go. A commercial entity such as SADAF simply does not have an extra reserve to pay a US$150 million debt".

It was important for the banks to ensure that the ECA termination provisions be preserved in order to repay the full debt if the project defaulted, including any accrued interest. After some brainstorming, the banks devised a structure under which the termination payment became treated as a direct corporate loan (The Corporate Loan) from the banks to SADAF. The Corporate Loan, to be activated on termination of the ECA, allows the discharge of the JEC project debt to the extent of principal and interest. In its place, SADAF becomes indebted to the lenders in the same amount. SADAF, through The Corporate Loan, amortizes the termination payment over a period of 4 years rather than as a lump sum.

The Corporate Loan structure was effective because it made the direct arrangement between SADAF and the lenders subject to English law. This is done by calculating the relevant part of the termination payments under English law and allowing their enforcement before the SAMA Committee. On this issue, Peter Gray of Linklaters said: "The deal required some novel and innovative features".

The 15.5-year tenor is the longest tenor that has been achieved in Saudi Arabia. The lenders gained comfort from the fact the 20-year energy conversion agreement is longer than the tenor of the debt and leaves the lenders with a long tail of 6 years. According to Koutzaroff ,15 years was ‘logical’ for the project which was further supported by CAI’s long term commitment to the country and the appetite of the domestic and regional bank market.

Refinancing

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In February this year SADAF's debt was successfully refinanced. Taylor DeJongh working with Apicorp acted as Financial Advisor to the borrower in its issuance of a US$650 million commercial bank loan credit facility. The facility consisted of (i) a US$400 million seven year amortizing term loan tranche; and (ii) a US$250 million revolving line of credit due as a bullet payment upon final maturity at the end of year seven.

The arrangers of the facility were: Gulf International Bank (as Joint Bookrunner), HSBC (as Joint Bookrunner) with local affiliate the Saudi British Bank, The National Commercial Bank (Facility Agent), Saudi American Bank, Bank Saudi Fransi, and Saudi Hollandi Bank.

The Future

For a long time, it has been argued that there is enough money in Saudi Arabia to fully fund power projects. Yet the Saudi Arabian authorities, faced with an escalating demand for power, are clearly trying to put the provision of electricity onto a more commercial footing in order to attract private and foreign investment as the SADAF project proves.

The SADAF IPP project will undoubtedly provide useful lessons for future developers and lenders alike. Already the next Saudi Arabian power transactions are being structured including four captive co-generation projects for Saudi Aramco and a power and desalinated facility located at Shouaiba.

According to Sarah Moynihan: "the market should be flourishing". The power needs are certainly there; currently, the demand for power is growing on average 5 to 7 per cent annually. Clearly, the SADAF IPP project is only one step along the way to meeting the rising power needs of Saudi Arabia and more developments are needed. What this project has clearly demonstrated is that it is challenging but very much possible to structure a limited-recourse financing, within the regulatory and legal Saudi Arabian regimes, which is acceptable to local and international banks alike.

Table: 1 - SADAF Project Information
Sponsors: CMS Energy (US), National Power Company of Saudi Arabia
Offtaker: SADAF
Total project costs: US$200 million
Project debt: US$169 million
Lead Arrangers: Credit Agricole Indosuez, Banque Saudi Fransi
Arrangers: Arab National Bank, Riyad Bank, Apicorp
EPC contractor: Siemens
Sponsor counsel: Shearman and Sterling
Lender counsel: Allen & Overy
Offtaker counsel: Linklaters

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