Public-private partnerships: The changing face of infrastructure finance

Over 30 years of heavy investment in infrastructure development has seen the emirate of Dubai transformed from an under-developed backwater into a hub for project finance which is often cited as the poster child for the type of metropolis that can be created through dedicated infrastructure investment. With the growing appetite for public-private partnerships (PPPs) in the UAE, RAHAT HUSSAIN DAR analyzes the role Islamic finance will play in this new era.

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While the global economic downturn and increasing pressure on government spending resulting from reduced oil revenues and ballooning social welfare spending have led to a deeper evaluation of government spending, the UAE continues to invest heavily in infrastructure and, as mentioned earlier, with a greater focus on executing public projects under the PPP framework.

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At first glance, the asset-linked and risk-sharing nature of PPPs makes them an ideal fit for the application of Islamic finance structures, particularly Ijarah, Istisnah and Sukuk. The variety of Islamic finance structures and the ability to provide Islamic financing in conjunction with conventional financing also illustrate the versatility of using Islamic finance for PPP projects. Furthermore, one distinct advantage of using Islamic finance over conventional financing is the ability to tap into the significant local Islamic investor market. Islamic finance structures have already been used for PPP projects in a number of countries including Malaysia, Saudi Arabia, Pakistan, Jordan and Turkey, most notably for the 25-year build-transfer-operate (BTO) model contract to refurbish and expand the Queen Alia International Airport in Jordan and the expansion of the Prince Mohammad Bin Abdulaziz International Airport in Madinah.

However, the successful implementation of Islamic finance to PPPs in the UAE faces some stark challenges as outline in the following.

Awareness

PPPs require the project sponsor (such as the private sector participant) to contribute equity toward the project which, in turn, will require funding from banks. However, CFOs of most international developers may not be familiar with Islamic finance. Often, they will focus on the pricing of the Islamic financing, which is often not as competitive as the conventional financing option, when making decisions on financing. Consequently, there is an urgent need for stakeholders in the Islamic finance industry and the UAE government to increase awareness of the benefits of using Islamic finance for PPPs, particularly to potential overseas sponsors (which is the key investor base that the UAE wishes to attract).

Structuring and assimilation

There are some structuring hurdles in using traditional Islamic project finance structures for PPP financing. For example, when using a BTO model, the PPP project asset is transferred by the sponsor to the public authority on completion and cannot be used as the subject of an Ijarah financing. This issue was encountered in the PPP to expand the Hajj Terminal in Jeddah (based on Ijarah and Istisnah structuring). In this case, the sponsor transferred its right to operate the airport terminal (under the concession from the government) to the financiers, which was then leased back under an Ijarah structure. While this illustrates the flexibility of using Islamic structures, it also highlights the fact that current Islamic structures will need to be adapted for PPP projects.

Sukuk also represent an important source of finance for infrastructure projects, which require large capital outlays with long construction and amortization periods. However, the challenges to developing a PPP funding Sukuk facility relates to funding the

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construction phase of the PPP project, when the asset is being developed and yet to start generating income. Regulatory authorities and financial markets will need to develop a Sukuk market for long-term issuances to match the long-term profile of infrastructure investments. Furthermore, unlike conventional Istisnah project financing, where funds can be drawn upon stages, Sukuk are generally structured so that the investment proceeds are provided in one drawdown, resulting in issues of negative carry. There are also limitations on the tradability of Sukuk when used to fund greenfield projects.

Funding

As discussed in the foregoing, sponsors will often need bank funding to provide their equity contribution toward the PPP project. In recent years, we have seen that bank liquidity has tightened up for many Islamic banks, particularly in the UAE, due to a combination of withdrawals of government deposits (which have been utilized to plug budget deficits), increased capital and liquidity requirements under Basel III and a change in lending practices (a number of Islamic banks in the UAE have reduced lending in certain sectors, including real estate development, due to the recent economic downturn). The first PPP project implemented under new PPP legislation in the UAE (for the development of the Dubai court complex, including the construction of one of the world's largest automated carparks), was funded under a term loan facility.

While there is obvious scope and appetite for the use of Islamic finance in PPPs, it remains a relatively untapped market. In order for Islamic finance to emerge as a realistic alternative to conventional PPP financing, all stakeholders in the PPP and Islamic finance industries (including sponsors, contractors, governments and professional advisors) will need to play a part in both educating international investors on the benefits of Islamic finance and adapting Islamic finance structures so that they can be adopted into the complex PPP frameworks (which involve various layers of negotiations, corporate structuring, documentation and governmental approvals) with the degree of efficiency required to attract international participation.