

East Cameron Gas Sukuk: The Dawn of a New Frontier

INTRODUCTION

It is a well-established fact that Sukuk instruments are fast becoming the instrument of choice for corporate and sovereign debtors who are seeking to tap into the rather liquid Islamic capital markets. Despite the rapid growth in the utilization of Sukuk instruments to finance projects, acquisitions and, in some instances, general financial needs of corporations in Islamic jurisdictions, such growth is yet to follow suit in non-Islamic jurisdictions such as the United States, the European Union and South East Asia (besides Malaysia).

This article argues that, with the appropriate level of research, structural innovation and co-operation with experienced financial institutions and structuring firms in Islamic jurisdictions, Western corporations can attract Islamic investments through the utilization of Sukuk instruments that are backed by assets in non-Islamic jurisdictions. While setting aside theoretical and technical aspects, I will discuss in this article, some of the key considerations surrounding the structuring, documentation and closing of the East Cameron Gas Sukuk transaction (ECP Sukuk) in an attempt to support the notion that Islamic structures are, to a great extent, compatible with some of the well established investment and finance techniques currently used in Western jurisdictions including the United States.

GENERAL LEGAL CONSIDERATIONS

Many of the members of the legal teams that advised the parties to the ECP Sukuk transaction will now agree that Shariah finance and investment precepts are likely to prove compatible with some of the established legal principles in force in the established Western jurisdictions. In the United States in particular, a complementary situation can exist between the precepts of Islamic finance and the fundamentals of American oil and gas law. The successful closing of the ECP Sukuk transaction, which constitutes the first-ever Sukuk backed by oil and gas assets in America (as described in more detail below), supports the foregoing conclusion. In fact, one can argue that American oil and gas law, under which oil and gas rights are characterized as severable and alienable real property with well-recognized legal attributes, satisfies a number of Shariah requirements. In fact, such characterization, with its well-defined scope and its ability for ring-fencing, would facilitate to a great extent the structuring of Sukuk instruments that are linked to US oil and gas rights.

In many key states where a significant portion of petroleum is produced both onshore and offshore, namely Texas and Louisiana, oil and gas jurisprudence recognizes that oil and gas in the ground, and certain rights granted in such

property, are in effect real estate. This characterization, and the concomitant benefits associated with real property rights, extends to grants of royalty interests. Because oil and gas law allows for an owner of the surface estate to sever the interests in the oil and gas underneath, an owner of the mineral estate is entitled to convey a partial interest—or a purely passive royalty interest (entitling the holder thereof to a cost-free stream of income from production)—to a third party without transferring rights to control the surface tract or to conduct petroleum operations. Therefore, with the well-established rules of a real property regime, the owner of an interest in oil and gas property may transfer a non-operating, purely economic interest to a third party who would then hold such an interest as real property. This ability to transfer what is effectively a Shariah compliant interest to a third party who would then hold such an interest in real property, fits – subject to appropriate structuring – into the paradigm of asset-backed Islamic finance and hence can be securitized in the context of a Sukuk product. In fact, as Shariah precepts encourage calculated risk sharing, Islamic investors may elect to participate in the risks and rewards associated with the production of underlying assets.

THE FIRST SUKUK OFFERING BACKED BY US OIL AND GAS ASSETS

As previously discussed, the ECP Sukuk, which closed in July 2006, entailed creativity in introducing a structure that applies traditional US oil and gas law to Islamic financing. Such natural fit aside, the deal required careful structuring to meet both the Shariah requirements and the tax, bankruptcy, corporate, regulatory and securities laws of multiple non-Islamic jurisdictions. The Sukuk provided an alternative to traditional borrowing, and allowed this ultimate issuer to take advantage of a largely untapped resource: liquidity in the Muslim world.

Success Factors and Indicators

The success of the Sukuk can be attributed to a number of considerations, including that oil and gas assets constitute are generally deemed to be Shariah compliant assets. In addition, the nature of oil and gas rights under US law facilitated the successful utilization of Sukuk instruments in the context of a US asset-based lending. A sign of the success of the transaction stems from the fact that it was purchased by both Islamic investors and conventional Western investors in a combined Regulation S international offering and a Regulation D US private placement. The Sukuk was underwritten and arranged by banks in both London and Beirut, with legal assistance provided by counsel in both Dubai and Houston. In addition, the ECP Sukuk was the first US Sukuk or, generally, Islamic securitization product to be rated by Standard & Poor's and was also the first to utilize hedging mechanisms. Arguably, it is one of the first

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true securitizations to comply with Shariah both in and outside Islamic jurisdictions.

Use of Proceeds

Under the proposed structure, the proceeds of the issue of the Sukuk will support capital and operating costs associated with drilling and operating wells in the Gulf of Mexico for a Texas-based oil and gas company. To avoid spoliation of the deal due to association with *riba* (prohibited interest), the funds raised through the offering were also used to eliminate nearly all of the company's outstanding conventional debt, leaving it with a debt to equity ratio acceptable from an Islamic perspective. For a combination of reasons, including international tax planning and bankruptcy remoteness, an intermediary issuer (a Cayman Islands exempted limited liability company) issued the Sukuk certificates and entered into a funding arrangement with a US-based special purpose vehicle, with the proceeds of such issue and the funding arrangement flowing back to the oil and gas operating company.

Structure

The attorneys and bankers structuring the deal had to overcome the difficulties arising from the issuance of Sukuk in connection with assets based in a non-Islamic jurisdiction. An overriding royalty interest was chosen as the asset to support the Sukuk. The properties burdened by the royalty consist of federal leases located off the coast of Louisiana. The oil and gas company that owns and operates the leases sold the royalty to a specially created entity. This special purpose entity, which will hold the royalty for the duration of the transaction (absent a default), was established using traditional structured finance techniques to maximize its bankruptcy remoteness. The structure employed in the transaction was also designed to take advantage of certain production payment bankruptcy law protections. Such special purpose entity which now holds the royalty interest takes no part in the conduct of the drilling or production on the property but holds a passive and non-working interest that entitles it to a portion of the stream of income generated by the sale of production from the burdened leases. Given the location of the offshore properties, the property rights analysis was based on the application of Louisiana law (under federal law, federal offshore leases are generally governed by the laws of the adjacent state). The transaction was structured so that the sale of the royalty interest would most likely be considered a true sale of a real property interest under Louisiana law. The fact that the conveyance of the royalty was designed to be a true sale of real property helped the deal from both a bankruptcy and a Shariah perspective. The investors share in the profits or losses derived from the success or failure of the underlying asset. In fact, from the perspective of Shariah, the Sukuk certificates represent an undivided beneficial ownership in the real property (in other words, the royalty).

Investors' Return and Securitization Considerations

The Sukuk holders can expect to receive a fixed return consisting of periodic payments of profit sharing from the

income generated from the royalty, as well as payments toward the redemption of the principal. The investors' return (structured as profit sharing) and the repayment of the investors' principal will depend on the performance of the underlying asset, in conformance with Shariah principles. As such, and absent a corporate guarantee, which would effectively shift the risk from the assets to the company, this was one of the first true securitization transactions in the Islamic finance and investment industry whether in or outside Islamic jurisdictions. Therefore, the Sukuk offering was non-recourse in that the ultimate issuer (the oil and gas operator) is not obligated to repay the Sukuk holders if the royalty cannot generate sufficient funds. The investors will bear the risk of the oil and gas reserves being insufficient to fully support the issuance of the Sukuk, the risk of a natural disaster knocking out production and price fluctuation risks.

Reserve Reports and Credit Enhancements

In addition to a comprehensive due diligence exercise, including a detailed oil and gas reserve report and an audit of that report, the structure included a number of mitigating factors and credit enhancements to reduce risk, including reserve accounts, security interests, conservative modeling, and some Shariah-compliant hedges. None of such mitigating elements, however, effectively shifts the risk away from the assets to the originator itself. The projected return—at more than 11 percent—reflects the calculated risk associated with the transaction.

Shariah Compliance

The lead managers retained two international Shariah scholars, one based in Bahrain and the other based in the United States, at an early stage of the structuring phase. In addition, the lead managers and the legal advisors had regular and detailed interactions with such scholars at the various stages of documenting the transaction. They reviewed the deal and issued a fatwa, making it possible to market the Sukuk to Islamic investors. Moreover, the ECP Sukuk transaction required a careful consideration of all of the issues raised in this article, including bankruptcy, tax, and securities law concerns, as well as the practical difficulties of cross-cultural co-operation.

In sum, the efforts extended and the creative structuring applied by bankers, originator, Shariah scholars and lawyers, allowed for the closing of this first-ever U.S. Sukuk offering in the amount of US\$165.7 million. This, in turn, may well encourage future economic co-operation between the United States and the Muslim world.

CONCLUSION

With the liquidity and growing prominence of the Islamic finance and investment industry, Western energy companies have an alternative source of funding that they can tap into. In particular, given their attributes, Sukuk instruments seem to provide an ideal format for such

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deals. As the secondary market develops, trading in Sukuk backed by Western energy assets (including renewable energy assets given Shariah's emphasis on ethical and green investments) may become commonplace. The connection between Islamic investment markets and the United States remains in its nascent stages, but the first U.S. Sukuk should encourage optimism on both sides of the cultural divide. It is expected that the successful closing of the ECP Sukuk transaction is likely to usher a new era in which Islamic finance and investment techniques can be utilized to successfully provide an alternative source of finance to companies and projects in non-Islamic jurisdictions. While most of such transactions are likely to be complex, hence requiring detailed analysis of legal, regulatory, tax,

bankruptcy, securities and other considerations, the Islamic finance and investment industry appears to have attracted experienced professionals who will play, along with Shariah scholars and attorneys, a pivotal role in the emergence of a new stream of Sukuk transactions involving assets in non-Islamic jurisdictions.

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TERMSHEET

East Cameron Gas Sukuk

INSTRUMENT	Sukuk Al Musharakah
ISSUER	East Cameron Partners
SPECIAL PURPOSE VEHICLE	East Cameron Gas Company
PRINCIPAL ACTIVITIES	East Cameron Partners is an independent oil and gas exploration and production company, based in Houston Texas.
ISSUE SIZE	US\$167.67 million
CLOSING DATE	July 2006
MATURITY	July 2019 (13 years from closing)
COUPON	11.25%
REPAYMENT SCHEDULE	Quarterly based on volume produced
IDENTIFIED ASSETS	Overriding royalty interests in oil and gas assets in the Gulf of Mexico, USA.
LEAD ARRANGERS	BSEC S.A and Merrill Lynch
LEGAL COUNSEL TO ISSUER	Baker Hostetler
LEGAL COUNSEL TO ARRANGERS	Vinson&Elkins LLP
LEGAL COUNSEL TO SPV	Walkers
GUARANTOR	East Cameron Partners
SHARIAH ADVISORS	Sheikh Yusuf Talal De Lorenzo & Sheikh Nizam M S Yaqoobi
METHOD OF ISSUE	Regulation S international offering and a Regulation D U.S. private placement
PURPOSE OF ISSUE	The proceeds of the issue of the Sukuk will support capital and operating costs associated with drilling and operating wells in the Gulf of Mexico for a Texas-based oil and gas company.
RATINGS	CCC+ (Standard & Poor's)