

Case study

East Cameron Gas Sukuk – a case study on sukuk
default

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Abstract:

East Cameron Partners (ECP) was the first US entity to issue sukuk through a two-tiered Musharakah structure. The issue was thought of as an advance in the US Islamic finance market where BSEC structured the deal, Merrill Lynch was the book-runner, KPMG were the auditors and the legal advisers were Vinson & Elkins LLP, Walkers and Baker Hostettler. In 2008, East Cameron filed for Chapter 11 bankruptcy protection under the US Bankruptcy Code.

Keywords:

East Cameron Gas Company, sukuk, SPV, default, asset backed.

Background:

In June 2006 East Cameron Partners became the first and only Sukuk issuers in the USA. The issue was through a SPV East Cameron Gas Company established in the Cayman Islands. A significant feature of the ECG sukuk structure was the classification of the overriding royalty interest in the oil and gas reserves as real property under US law.

The proceeds of the 13-year Sukuk for \$165 million was directed towards capital and operating capital costs associated with drilling and operating wells in the Gulf of Mexico for a Texas-based oil and gas company.

To avoid any association of riba with the deal, the funds raised through the offering were also used to eliminate nearly all of the company's outstanding conventional interest based debt, leaving it with a debt to equity ratio acceptable from an Islamic point of view.

The Sukuk issue was backed by natural gas royalty interests originating off the coast of Louisiana.

Campbell Evans, general manager of ECP, said that they chose to explore the Shariah securitization market as alternative to conventional oil and gas financing, adding that the transaction struck a balance between investors' needs and their requirements as an originator.

The East Cameron Sukuk had a fixed payment of 11.25% annually. However, there was also a variable component because the sukuk returns depended upon the production quantities (the overriding royalty interest specified a fixed quantity of natural gas be delivered to SPV). It also contained a redemption feature by where a percentage of the sukuk would be redeemed if production exceeded a certain level.

As the East Cameron Gas issuance is in the energy sector, sukuk holders were exposed to certain risks. Like the volatility of natural gas and condensate prices may adversely affect payments on the sukuk. In order to hedge against severe price fluctuations in oil and gas markets, there was a Shariah-compliant hedge that established a price collar between \$7 and \$8 per million BTU (MMBtu) on half the expected products gas production, and a put option at \$6 per MMBtu for an additional quarter of anticipated production (Goud,2009).

Role of rating agencies:

East Cameron Gas Co.'s \$165.67 million investment trust certificates (sukuk), surveying the securitization was vital for the sukuk holders. S&P downgraded the transaction to 'CC' from 'CCC+' when the structure hit a trigger, breaching a 90% minimum stressed reserve level of the hydrocarbon mix threshold. In March 2009, the agency cut the deal to 'D' on skipped payments and withdrew the rating; the latter event was in response to a failure to receive servicer reports (Lampasona, 2009). The deal initially stood at CCC+ largely because significant amounts of the energy deposits that collateralize the deal were proven undeveloped at that time.

A seemingly good deal going bad:

East Cameron Partners filed for Chapter 11 bankruptcy in Louisiana and, in the court proceedings, actually tried to argue that the Sukuk should be characterized as a secured loan and not a true 'sale of asset'. Ultimately, the court was not convinced and ordered the parties to transfer the title of the ORRI to the Sukuk-holders.

A court document points out that the judge approved the Asset Purchase & Sale Agreement between East Cameron Partners and EC Offshore Properties, Inc., which is owned by the certificate holders. According to Blake Goud, (personal communication, 25 April 2010), the Asset Purchase Agreement transferred the title over both leases (East Cameron block 71/72) to the sukuk certificate holders. "The purchase price, which will not be paid in cash, includes the liabilities assumed by the buyers, as well as the \$4.865 million extended as Debtor in Possession financing (DIP)," he said after examining the court order. The total DIP financing includes all principal, interest, fees, expenses and other charges (Goud, 2010).

What went wrong?

The sukuk legal structure was in fact imperfect to some extent. For example and without going into details, there were two SPVs, one on- and the other offshore. As the transaction is asset-backed it should have made it easier for the Sukuk holders to trigger the bankruptcy and take control of the assets. However, due to legal flaws in the structure they had to wait a year and a half for resolution. In light of recent developments, it becomes clear a third SPV independent of the others needed to be formed under a Musharaka, which would have made the separation of the assets from the bankruptcy estate much easier.

To sum it up:

The majority of the Sukuk being offered are sovereign issuances and are, by their very nature, not asset-backed. They are economically identical to conventional bonds. Corporate issuances may more often be asset-backed but they are a small part of the Sukuk market.

After the financial crisis has been the differentiation that is starting to appear between asset-backed and asset-based Sukuk.

There are some main defaults in the history of Sukuk issues: East Cameron Partners in the USA, Kuwait's The Investment Dar, KSA's Saad Group and the Nakheel Sukuk unit (a part of Dubai World).

Of the mentioned defaults, only one (East Cameron Partners) was actually 'asset-backed' while the others were 'asset-based'.

The ECG sukuk that it was the first legal case in Islamic finance history that proved the asset-backed structure can indeed protect investors once a default event is triggered.

Lessons learnt:

East Cameron was also the only one that was not issued by a sovereign entity. It was the only one in which the Sukuk-holders were able to take the underlying property interest and sell it to recoup their loss. In the other issuances, there were no assets to sell.

An empirical scan of the major Sukuk issuances in the past year shows that an overwhelming majority of the issuers of Sukuk were sovereign or quasi-sovereign entities and are, mostly, asset-based.

It will take many more Sukuk issuances and defaults to effectively test the financial and legal strength of the underlying structures. (ABRAR HUSSAIN) Islamic Finance news, 8-Feb-2012

Creating products that have consistent streams of income is a necessity in asset management but simply using traditional bonds and calling them Sukuk with no material economic difference is simply a financial sleight of hand. Some of this approach is based on the fact that the majority of asset managers are coming from the banking industry where fixed income products are the norm.

Some market analysts argue that if these sukuk were asset-based, then the sukuk holders would have joined the queue with the other creditors.