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Procedia Engineering 77 (2014) 179 – 187

**Procedia
Engineering**www.elsevier.com/locate/procedia

Fourth International Symposium on Infrastructure Engineering in Developing Countries, IEDC
2013

Financing PF2 Projects: Opportunities for Islamic Project Finance

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Abstract

Recently the popular Private Finance Initiatives (PFI) was reformed into what is now known as Private Finance 2 (PF2). The move came against the backdrop of the unpleasant experiences which have bedeviled the PFI model leading to huge public sector bail-out and in some cases expensive buy-back schemes. One of the Principal areas being reformed is the financing structure which has often had a large portion of bank debt. The cost of capital on this significant portion of bank debt, studies have shown, has been responsible for the higher capital costs on past PFI projects. The proposed ideal financing structure for PF2 must be low cost funds such as pension funds and insurance funds. While this paper does not go into detail on how to structure a PF2 project using Islamic finance, it however argues that Islamic project finance holds a better promise for the financing of future PF2 projects. This is because apart from being interest-free, it also entails the sharing of losses should they occur, an act conventional project financiers are highly averse to doing.

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Peer-review under responsibility of the Accounting Research Institute, Universiti Teknologi MARA.

Keywords: PFI; PF2; Islamic Project Finance; Infrastructure; Public Services; Privatisation.

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1. Introduction

Infrastructures form the bedrock of modern societies; an adequate and efficient supply of the various types of public infrastructure and services helps nations achieve their economic growth objectives. The roles of infrastructure in ensuring economic growth have been established by various researchers across the globe. [1] has been able to show that the benefits derived from infrastructure exceeds the capital costs of the infrastructure. Sector-specific research has also found that, in the transport sector, improvements in transportation enhance economic growth, while [2] also found that a 1 MW increase in electricity supply generates an equivalent of \$1100-\$1700 dollars of productivity to the national economy. [3] Also found that improved infrastructure provision also contributes to private/personal economic growth. Given the importance of infrastructure in modern societies, governments across the world have sought ways of ensuring the provision of quality and efficient infrastructure owing to their link to in-flows of foreign direct investments (FDI). But the ability to foot the bills for huge public sector infrastructure has been a daunting task for which governments have looked to the private sector for assistance in the form of partnerships referred to as private finance initiatives (PFI) [4]. However, after more than two decades of practicing the model, the difficulties in achieving value for money has become recurrent across many projects due to the high cost of capital incurred under this financing method. This is even more acute owing to the long duration of PFI projects which range between 10 to 60 years. Even more worrisome is the percentage of debt in the financing structure, which is usually on a 10%-90% equity-to-debt ratio on most PFI projects under the best circumstances [5]. Owing to the effects of the huge percentage of bank debt on the financial performance of PFI projects, the UK treasury has taken a number of steps to reform the model into what it now calls Private Finance 2 (PF2). Under the PF2, in order to increase value for money the equity part of the financing structure has been increased to achieve a 25%-75% equity-to-debt ratio [6]. While using the increased equity to improve value for money, the UK government has also made it clear it intends to share in financing 50% of the 25% equity aspect of the capital cost of PF2 projects. However, debt still occupies a significant percentage (75%) of the cost of PF2 projects, even though the government has clearly stated it intends to seek low cost financing from insurance companies and pension funds for most PF2 projects. But [7] who has taken a critical look at the proposed mechanism for the delivery of PF2, concludes that the PF2 will lead to an increase in the cost of capital for the privately financed portion of projects. Given this scenario, it has become important to seek other cheaper sources of project financing and Islamic project finance model possess the characteristics of a model PF2-compliant financing mechanism. Hence the major objectives of this paper are to highlight the basic characteristics of Islamic project finance and show how compatible it is with the aspirations of the 'new' PF2.

2. The Journey to PF2

The PFI was developed in the UK in 1992 to overcome budgetary constraints in the development of large scale public infrastructure that were highly required to sustain economic growth. Hence, the UK government partnered with private consortiums to design, construct, finance and operate public services in return for a service charge in what became known today as public-private partnerships (PPP). The practice has caught on across the globe with multi-lateral institutions like the IMF & World Bank using the practice as a loan condition in developing countries of Africa and Latin America [8]. Donor institutions like the EU and DfID have also been 'exporting' this infrastructure 'silver bullet' to the third world and developing countries, but the UK still remains the largest player in the field of PFI [9]. With over 717 projects till date and an estimated £200 billion invested [7], it is no surprise that the most visible examples of failures of the PFI model also come from the UK. While it was initially meant to be used to overcome budgetary constraints in capital infrastructure development, overtime other reasons have been adduced for adopting this public procurement approach which include achieving better value for money, managing time and cost overruns, better innovation, increasing infrastructure stock faster than would have been possible relying solely on government tax revenue and overcoming corruption in public procurement. To a great extent the model has helped improve services from their historic levels, but there have also been counter occurrences which have cast a heavy shadow of uncertainty on the success of the PFI so far. While value for money seem to carry different meanings depending on which side of the PFI debate one stood, it is generally believed to simply mean

'getting the best technically available quality at the optimum price'. But an assessment of current PFI practices has shown that this does not seem to be the case across most PFI projects (VFM).

In terms of costs, PFI procured roads were found to be 24% more expensive than traditionally procured ones [10], but the authors were quick to point out that the additional cost was for risks being borne by the private providers. But the real price paid by citizens for these risks remain unclear [11], as the public sector has always had to cough out taxpayers' monies to save badly performing privately sponsored projects. Researchers and unions have over the years criticized the manner the PFI model was being practiced in the UK. Some have argued that governments should adopt the Design, Build & Operate model while government provides the finance through public borrowing [12]. This is because it is cheaper for the government to borrow than the private sector but the UK government has always defended its decisions supporting their stance with reports such as Arthur Andersen's *'Value for Money Drivers in the Private Finance Initiatives'*. But the failures that kept emerging across the globe were no longer easy to ignore and in extreme circumstance, have led to violence such as Cochabamba in Bolivia. Important failures such as those of Farum local government have become the poster child for what is wrong with PFI. The local government has been forced into administration after the failure of all its PFI projects and income taxes for the local government have been raised 3.2% in order to be able to foot its bills [13]. But the truth is that most failures have often resulted from the inability of the projects to perform financially and technically as proposed by the private sponsors leading to benefits short falls [14] and [15]. One of the problems has always been the large portion of interest bearing bank debt within the financial structure of PFI projects which requires to be paid in addition to the capital and the investors' profits. [16] found that a 1% decrease in the interest rate of the UK's current £40 billion PFI projects will generate an annual savings of £400 million. Researchers have often posited that the cost of capital on PFI projects was responsible for most of the short-comings of the model [17]. The impact of this interest bearing financing for infrastructure was even more pronounced after the global financial crisis. The crisis caused banks to close their doors on infrastructure financing and the few available funds were then subject to competitive demand which saw governments accepting loans with interest rates in the range of 17-33% to prevent on-going projects from failures. The result of this action in the UK was the increase in the contract price of 35 PFI projects by £1 billion over a 30 years period [18]. Oftentimes, financial details of PFI projects are never available to the general public so it could undertake its own independent analysis of government and provider's claims. Partnerships that are non-transparent and are mostly entered for financial and tax reasons alone are not worth pursuing [19]. This is because they only serve to allocate public wealth to private pockets rather than a concern for social welfare which the government seeks.

While the cost of projects essentially includes costs plus an agreed percentage for profits, the cost aspect involves a number of variables like the capital cost, cost of capital and cost of risks. But the cost of capital is also influenced by other external variables over which the project sponsors have no control including degree of investment risk, inflation rates, level of competition among lenders, stability of the market where the money will be invested and cost of money to the lenders [20]. From the foregoing, it is clear that the source of finance has a great influence on the viability of PFI projects and consequently value for money and affordability to end-users. Given this scenario, the thrust of the PF2, emphasizing the need for cheaper sources of financing like pension funds and insurance companies is highly welcomed [6]. However, one curious development in the new PF2 is the government's desire to co-finance 50% of the proposed 25% equity portion rather than the 75% debt portion for new projects which would have significantly reduced the final costs of the project and improved affordability which is increasingly becoming a central issue, especially in developing countries. It has been argued in the past that oftentimes governments are oblivious of alternative methods of financing their infrastructure projects [21]. But, given the visibility of Islamic financing models across developed countries and the close relationships that governments in these countries enjoy with the Arab world, it is somewhat baffling that projects are not being financed through this financial mechanism which shows great promise. There seem to be an 'intentional' amnesia on the part of governments who are seeking cheaper sources of finance for infrastructure, yet ignore the Islamic project finance model with its interest-free advantage that is unrivalled by any other financing source. It could be that governments are not aware of the Islamic project finance model or how it could be used to improve value for money and ultimately, affordability.

3. Islamic project finance: Merits and challenges

Islamic financial institutions are one of the fastest growing financial sectors locally and globally[22]. This is especially true in western societies like Ireland, UK, France, Russia, Netherlands and Luxembourg which have all crafted legislation to permit its use or are in the process of doing so after discovering that it can be used by Muslims and non-Muslims alike[23]. Foreign financial institutions such as Citibank have established Islamic Banking subsidiaries and many conventional banks –in the Muslim world but also in the United States and Europe– are now offering Islamic Products’ that are sometimes aimed at non-Muslims [24]. Being a financial system means that they have alternatives to almost all the conventional financial instruments available with the only difference being that, theirs must be shariah-compliant[†]. Project finance has found increased usage since the advent of the PFI, but the Islamic alternative has not had the same growth like its conventional counterpart. The reason is not unconnected with the conflict of certain Islamic principles with the fundamental debt-leveraged principle of Western project financing, the payment or receipt of interests on loans[25]. The compatibility between Islamic project finance and the PFI has been highlighted [26] and its ability to improve value for money has also been established [27]. The Islamic project finance is a microcosm of the larger body of Islamic economic and financial system incorporated in the Muslim holy book as a guide and framework to dictate their commercial behaviour in business transactions. Financing large scale public projects is a welcomed investment product for Islamic financial institutions and is in line with the missions of Islamic banking and finance [28]. With increasing advocacy for private involvement in the provision of public infrastructure, it is expected that Islamic finance would have been one of the major financing stream from which project companies would seek to finance their projects. The uniqueness of this project financing strategy lies in its repudiation of interest which happens to be the life-blood of the conventional project financing model. This has made the Islamic project finance model a marvel to western economists who wonder how finance and financial products can be productive in the absence of interests. Equally surprising is the fact that despite this singular advantage of interest repudiation of the Islamic financial model, not many countries in the Islamic world or those with a large Muslim population have adhered to or even practice or operate on the basis of the Islamic financial system. This limited practice from even Muslims, whose commercial lives are supposed to be governed by this financial system has contributed to the limited visibility of the Islamic financial system and has served to delay unleashing its potentials.

The Islamic project finance is a ‘partnerships’ based system [29], where the financiers partner with the entrepreneur to finance a project based on profits and losses sharing (PLS) according to an agreed sharing formula consented to at the outset of the project. This ability to absorb losses from the project makes it stand out against the conventional project finance and thus holds potentials for public infrastructure projects which are often risk prone. However, there are conditions which must be met in order to successfully deploy the Islamic finance for financing projects[23], but the interesting aspect is that the financing strategy is not limited to use by Muslims alone. The Islamic project finance is open for use by all and sundry subject to adherence to these basic conditions:

1. The venture to be financed must be a lawful venture according to the provisions of Islam, hence it should be devoid of alcohol, pork, gambling, pornography, arms etc.
2. The venture to be financed should not be one involving a high degree of uncertainty (*Gharar in Arabic*) in its transactions (speculation & Derivatives) [30]&[23].

Having satisfied the above conditions, the Islamic project finance is open to financing profitable ventures that contribute to societal well-being, hence, it can be said that it is a societal welfare-oriented financing model. This is why it employs project evaluation by social well-being as opposed to the conventional project finance which evaluates projects based on the rate of return achievable[31]. Given this characteristics of the Islamic project finance, it is clear this is a PF2-compliant financing because it incorporates the characteristics expected of financial products for the proposed PF2-low cost and Profits & Loss Sharing. Given the influence of bank debt on PFI value for money [12]&[32], and the influence of cost of capital on the final cost of PFI projects [17], it can be conveniently concluded that there is no better financing model to be employed on PF2 than the Islamic project finance with its interest free advantage. However, even where this financing model is being employed, there have

[†]The term “Shari’ah” refers to Islamic law and principles (DoF, 2010, p.3)

been lots of criticisms of the present state of Islamic project finance practice. There have been insinuations that the only difference between the Islamic project finance and the conventional project finance is only in the addition of the word ‘Islamic’, because many Islamic products have often been tailored to resemble those of conventional banks. Examples include Malaysia’s 1990 Private debt securities (PDS) which was found to be totally unacceptable in the Middle East and other parts of the globe[33]. Derivatives have been developed by Islamic banks which possess the same characteristics as those of the conventional banks. Other problems being faced are the lack of consensus among sharia boards of Islamic banks resulting in different regulatory challenges being faced in different countries. And the fatwas regarding some of the financial instruments too have not been consistent, with different schools of thoughts giving divergent directives on how to deal with the same issues. Furthermore, another inhibiting factor involves a well-known principle of *fiqh*[‡] which asserts that there cannot be two contracts within one [28]. Under the PFI, multiple contracts involving the contractors, operators, facilities managers and other stakeholders are formed. The fear according to Islamic jurists is that there could be a situation where the rights and obligations of the contracting parties are not honoured in future because of their inter-connectivity and dependence resulting in losses to other parties. Examples include situations where due to a default by the project company leading to the termination of their contract, the facilities management company which has a different contract with the project company would be affected adversely. This would happen even though the facilities management company has never defaulted in its own responsibilities. Furthermore, four sources of problems for Islamic finance have been highlighted [34] and these include: 1) Uncertainty regarding the somewhat unpredictable and subjective nature of the decisions of *Shariah* boards, 2) The lack of an overarching regulatory body for Islamic banking and finance, 3) The Islamic need to retain title in the project assets and the Western lender’s need for a security interest in those same assets and, 4) the Islamic requirement that the lender bear some of the project risk compared to the Western lender’s risk aversion. The management consultancy company KPMG, in its report [35], also highlighted six areas of concerns for Islamic finance globally and these include:

- 1) Complexity of risk weighting
- 2) Lack of human capital
- 3) Inadequate regulation and legal framework
- 4) Lack of a standard financial reporting mechanism
- 5) Existence of different interpretations of Islamic laws relating to financial transactions (*Fiqh Al-Muamalat*)
- 6) The difficulty of measuring performance of Islamic financial institutions

Transaction costs, inadequate expertise, the business environment and the problems of liquidity have also served as militating factors against the growth of Islamic project finance[36]

However, despite the seemingly divergent and conflicting edicts from different shariah boards and other challenges resulting from partnerships involving finance from conventional sources, one thing is clear and common among all Islamic banks, the repudiation of interests. Also because of the ‘partnerships-based’ relationship between the Islamic bank and the entrepreneur, they are obliged to oversee and monitor the health of projects more closely than their conventional banking counterparts. This concern with the project leads to another advantage, the continuous flow of information regarding the operations of the asset between the bank and those responsible for operating the asset[37]. There is also the incorporation of corporate social responsibility in all the bank’s transactions. This corporate social responsibility comes in the form of the compulsory alms (*zakat*), which is the disbursement of 2.5 percent of the venture’s annual starting balance to charity within the community in which the business is based at the end of every financial year. This action serves to empower stakeholders within the community where the business is based and consequently strengthens the business-stakeholder relationship which has been shown to be a critical factor in the success of large scale infrastructure projects [38].

3.1. Types of financing instruments

Like the conventional financing model, the Islamic project finance also has a variety of project finance instruments which serve different purposes depending on the type of project, the phase of the project, conformity with Islamic

[‡]*Fiqh* is Islamic jurisprudence, the science of religious law, which is the interpretation of the Sacred Law, *shariah*.

law and the nature of risks involved. The first major cost incurring stage on PFI is the construction contract, under this stage the options open to an intending project company willing to use Islamic finance include contractual structures such as *bai bithman ajil*, which is a sale where payment of price (cost plus mark-up) by the Islamic bank customer is deferred to a future date after the purchase of the asset for the customer by the bank; and *Ijara* [28]. Alternatively an *Istisna* contract [39] can be employed under which the Islamic bank enters into a contract with the project company to supply the project company the specified infrastructure at an agreed time and agreed price for which the Islamic bank would receive payments on a deferred basis. The Islamic financier would then become a buyer in a second contract between it and the construction company for the construction of the infrastructure specified by the project company for a lower amount, the difference of which covers the profits expected by the Islamic financier. One interesting point to note here is that, the Islamic financier bears the construction risks on the first contract between it and the project company, while it then transfers this risk to the construction contractor during the second contract between it and the construction company. However, in order to protect itself, the Islamic financier can enter into an agreement with the project company to supervise the construction work and be responsible for issuing certificate of payments which the construction company submits to the Islamic financier in return for the amount certified in the certificate. This ensures that the project company certifies and gets what it wants [28], and consequently other forms of protection like retention, performance bonds and liquidated and Ascertained damages (LADs) are equally permissible under the Islamic contractual structure. Another important aspect of large scale mega projects development involves risk allocation. However, in terms of risks, the conventional financiers are only exposed to default risks, but their Islamic counterparts are exposed to risks in many ways on a project due to the 'partnership-centred' approach of the Islamic project finance model [28].

Other financing instruments include the

3.1.1. *Mudaraba*:

This is a profit-sharing partnership under which one party (Islamic bank) provides capital and the developer acts as the investor and operator of the asset [39]. Under this arrangement, the developer (Project Company) would construct and operate the asset in question using capital supplied by the Islamic bank. The profits in this type of transaction is the amount by which the final asset exceeds the capital provided by the Islamic bank at current market price and this is shared by the bank and the developer on a pre-agreed ratio. However, prior to the commencement of the contract, the bank can specify certain conditions which may include seeking its permission before engaging in any operation outside what was agreed in the contract document. Also there is a restriction not to mix its finance with financing from other sources which are not shariah-compliant. Finally, the Islamic bank bears any loss resulting from the project [28], and the developer is not liable for failure to return the capital (except in specified situations) [39].

3.1.2. *Musharakat*

A *Musharakat* contract is an equity participation contract, whereby two or more partners contribute funds to carry out an investment [40]. Under this financing structure which works like a joint venture between the bank and a client/customer, both contribute to a joint fund for the project. However, profits are shared according to a pre-agreed ratio or percentage while losses are shared according to individual capital contributions. This is one of the main differences between *Mudaraba* and *musharakat* [28]. The other difference involves liabilities which are limited under *Mudaraba* but unlimited under the *Musharakat*. A variant of the *Musharakat* has been developed, which is referred to as a '*Declining/Diminishing Musharakat*'. While in a *musharakat*, the Islamic bank remains a permanent partner in the project, in a declining *musharakat*, the Islamic bank's share portion of the project is gradually paid off by the client and when it is finally paid off, the client retains full ownership of the project. However, prior to being completely bought-out, the Islamic bank continues to receive profits according to its remaining equity in the project [28]. This is the closest form to the Build, Operate Transfer (BOT) arrangement being used to deliver PFI projects. Furthermore, in order to help the government hasten its acquisition of full ownership of the project; an innovative method was developed where the government's portion of profits would be

stored in an Escrow account. When the amount in the Escrow account reaches the Islamic bank's invested capital, the bank is then completely paid off and the project becomes the sole property of the government [28].

3.1.3. Ijarah

This is a form of lease contract between a bank and its customer where the bank leases out equipment to the customer to use. The customer pays the bank for the use of the equipment but would not own the asset, hence the asset risks remains with the bank. But it is important to note that most banks do not just purchase item and wait for them to be rented, it's a request from a bank's client that triggers such a contract. However, the amounts to be paid in rental charges are crafted such that they cover the cost of the asset and a fair return to the bank. Perhaps the most important point which differentiates this leasing contract from conventional leasing contracts is that the rentals could be flexible and be made to reflect the changing economic and business conditions prevailing in real terms [28].

3.1.4. Islamic Sukuk (Bonds)

There are a number of other financing instruments tailored for different needs and these can be found in the relevant Islamic finance literatures available. The Islamic bond would be the last type of financing instrument discussed as its implementation differs markedly from the instruments that have been discussed so far. Islamic finance can be structured as Sukuk for fund generation and subscribed to by the public. This is one of the most popular type of fund generation instrument predominant in the Islamic projects finance arena. Sukuk are the equivalents of the conventional bonds and treasury bills for the purpose of generating fund and investment opportunity for the institutional investors and high net worth individuals. Technically, "*Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (ownership of) asset of a particular project or special investment activity, however, this is true after receipt of the value of the Sukuk, the closing of the subscription and the employment of funds received for the purpose for which the Sukuk were issued*" (AAOIFI[§], 2010, Shariah Standard no. 17)

One distinct feature of sukuk is that it is backed by a tangible asset, usufruct, services, or combination of all. For the purpose of project financing all the types of sukuk are relevant, but which of them is to be employed in a particular occasion is best determined by the nature of the project, some are structured as a single instrument, while the circumstance of the project may also prompt the combination of two to form a single sukuk as in the case of sukuk *istisna'-ijarah*.

The following are projects which were financed using different types of Islamic project finance instruments, they include:

- 1) Putra LRT II project Malaysia
- 2) Hub River Power Plant Project Pakistan
- 3) Truman Park & Maconda Park Apartments, United States-*Istisna'a-Ijara* Financing
- 4) East Cameron Gas Company United States-*Sukuk* Offering.
- 5) Saudi Chevron Petrochemical Project Saudi Arabia-*Rahn-Adl* Collateral Security Structure,
- 6) Utility Power Project Saudi Arabia - *Mudaraba-Murabaha* Financing
- 7) Sohar Aluminium Oman - *Istisna'a-Ijara* Financing
- 8) Kuala Lumpur International Airport-bai bithman ajil syndication
- 9) Equate project Kuwait

[§]Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

4. Conclusions

This article sought to point out why Islamic project finance is an ideal financing model for the proposed new PF2. The reasons are simply based on the characteristics which financing for PF2 must possess as espoused by the UK's National Audit Office [6] which include the need for such financing to be cheap and be ready to absorb risks. However, the study is not intended to be a 'manual' or a step-by-step guide on how to structure Islamic project finance contracts. What has been expressed is the belief that employing Islamic project finance holds the promise of increasing value for money and making large scale mega infrastructure projects cheaper due to the absence of cost of capital. The cost of capital has been shown to be one of the single most influential factors that determine the final cost of PFI projects. With its interest-free status, it is believed to be the ideal financing the project finance world requires at this time-post financial crisis economic resurgence.

Acknowledgements

The authors are grateful to Universiti Teknologi PETRONAS, Malaysia for financial support.

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