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Structuring a PPP deal in renewable energy without soverieng guarantee

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The 4th Annual MENA Clean Energy Forum took place in Dubai on last December 8th 2015. When attending the panel on Clean Energy Project Finance, I was posed the question whether there would be workable strategies to put in place for arranging project financing of renewables without recourse to sovereign guarantees, especially in emerging countries. My immediate answer was yes, certainly.

I then worked out some personal views on the matter I am now happy to share.

When is it possible to do a deal in an emerging renewables market without a Sovereign Guarantee?

As PPP builders, mostly standing by State side, we generally do not like to recur to arrangements such Sovereign Guarantees in order to make a PPP financially viable. The viability and bankability of the project structured as PPP should reside instead in its intrinsic capacity of both fulfilling its goals and achievements towards public side and generating enough cash to satisfy both sponsors and lenders on private side. A sovereign guarantee should be viewed as a means of last resort.

There's a difference between incentives, State subsidies and sovereign guarantees.

In general, sovereign guarantee is required when and where private investors and their financial supporters (lenders) may fear that their interests are not sufficiently protected over the long term.

We must recognize that, in some cases, having a sovereign guarantee backing the project is quite helpful indeed, particularly in case when infrastructure is of paramount importance for the country but long-term returns are uncertain, so that lenders in particular are unwilling to step in and provide required debt without a proper umbrella to protect them from future losses.

This uncertainty in future returns may reside in twofold:

a) **Business intrinsically risky** (as railways, huge investments upfront against uncertain returns);
b) **State party not enough reliable when it comes to assuring long-term stability** (i.e. policies or covenants) to the rules-of-game.

For example, this is the case when administrations change policies over the course of concession, thus jeopardizing the rules thanks to which investors can get their investments repaid. This is, again, the case of an Administration falling short of his regulatory duties and deviating from contractual statements already agreed with the private in terms, for examples, of adjusting tariffs with inflation overtime.

This customarily happens not only in so-called emerging countries, but also in developed countries as well. Take examples at local level, i.e. in car parking sector, where tariff policies may change over time with administrations.

It is worthwhile noting that this has little to do with the market risk assumption from private side, which is a pillar of PPP long-term agreements.

We may say that sovereign guarantee is working only in those cases in which Public side is not fulfilling its obligations, (i.e. in case where concessionaire is not allowed to raise tolls overtime), and not to exempt concessionaire from bearing the full market risk (that is to say, when the asset is not generating enough cash due to shortage in sales of products/services), as he's supposed to do.

Concluding, Sovereign Guarantee is something that is undue and unnecessary in cases where Governments are able to enforce and endure clear tariff policies, or assure otherwise market stability in the long term. In those cases, there is no need to trigger any Sovereign Guarantee.

Are there any examples?

We may look at what was the Italian experience at the beginning of the business, nearly ten years ago.

According to Eurostat, Italy ranks second amongst the biggest European producers of energy from renewable sources, second only to Germany.

In 2005 Italian Government launched the first so-called "Energy account" for incentivizing electricity from solar panels. We are now at the 5th wave of the programme.

Incentives are given on the bases of the energy produced, and not in form of grants as a means to reducing assets investments. In particular, incentives are given on a 20-year time span in form of feed-in tariffs for the energy fed back into the grid.

Level of tariffs has been decreasing overtime just for taking into account the dwindling solar panel costs, which became cheaper by around 80% over the past 6 -7 years.

If there's certainty over feed-it tariffs applied in the long term, there's no need to back the programs with State Sovereign Guarantees. Conversely, if there is uncertainty on this point, investors will seek protection on their investments in whatever form of financial guarantee may be provided by the State.

In order to overlook and to give necessary guarantees to the programme, Italy set up an independent Authority and separated the grid (ownership and management) from energy producers. In doing this, Italy reassured the market that things were managed properly and independently from government and related policy changings.

Most countries would prefer if some element of local financing were part of a renewables deal. What are the issues with doing this?

This largely depends if and at what conditions local financing will became available for funding those projects,

Sometime we come across tenders requiring bidders and their lenders to arrange some of the debt in local currency. Since the spread between interest rates may be against local currency when compared to USD and other international currencies, the request ultimately may result in a higher cost of lending.

However, there can be positive effects that offset such higher costs:

a) **Utilize PPPs as a way of developing local banking sector capabilities;**
b) **Draw other means (i.e. Islamic finance assets) of funding PPPs apart from commercial banking.**

We regard the use of Islamic finance instruments as extremely beneficial for funding PPPs. This requires though an extra care in order to adapt assets that play with different rules from conventional project financing, but ultimately results are exceptional in terms of extra funding availability and robustness given to the financial plan.

What incentives are required for international developers to consider this?

Incentives are required to bridge the gap between revenues and costs. Gap is narrowing though (costs are down by 80% relative to only few years ago), and state subsidies will be soon no longer required. According to an IRENA paper released in 2012 on PV energy production cost analysis, some of southern sunny regions or countries in the world have already achieved grid parity, and many others will do by 2020.

Of course, the use of feed-in tariffs, especially in the past, has been instrumental for the renewable energy market to grow and thrive. Nowadays one should ask if such incentives are still needed and what level of financial support is yet required.

PPP approach starts from, and is based upon a sound, bankable financial model with some assumptions and degree of risks associated to them of actually not happening as expected. One of the most sensitive ones is linked to the certainty of returns.

Returns are essentially the product of two factors, namely tariffs and volumes.

In PPPs the flow of returns should be stable, continuous and predictable as much as one can. Feed-in tariffs guaranteed throughout concession period is what most investors are concerned of.

When it comes to volumes, the presence of **take-or-pay clauses** defining pre-agreed quantities to be purchased by the off-taker would be also improving financial model bankability. However, this issue has to cope with a fair allocation of market risk between public and private side, in order to maximize value-for-money on public side and, ultimately, for taxpayers.

Incentives don't have to be seen only as financial benefit providers. A non-monetary positive aspect of incentives is that they can act as powerful stimulus for time completion. In many countries, in order not to lose them, project developers put enhanced efforts to match forecast time completion and start operating plant at the earliest. Nearly 80% of the plants built in Italy have been constructed strictly hitting time forecast schedule. Late completion would in fact jeopardize obtaining state incentives.

Concluding, the answer is yes, a PPP in clean energy production can be structured also without necessarily recurring to state guarantees as project backup. You have to find workable solutions though, but this the beauty of the PPP arranger job.