SUSTAINABLE POWER PROJECTS: RISK, BANKABILITY AND PROFITABILITY

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The Perfect Storm: Money + Opportunity
Africa’s energy deficit affects over 600 million people – more than half of the continent’s population.1 Closing this gap requires considerable financial investment. With the world’s youngest workforce and falling trade barriers, the continent has become an attractive destination for infrastructure investment, particularly in the power sector. Despite the attractiveness of the opportunity, why are so many projects struggling to access the much-needed capital?

The simple answer is that most projects struggle to overcome the hurdle of ‘bankability’. In the broadest sense, bankability refers to the extent to which a project is considered financeable by conventional lenders such as developmental finance institutions. The lenders provide the debt financing for the project and therefore have a vested interest in ensuring that the project is structured in a manner that minimises the risk of default. In essence, bankability encompasses an assessment of a project’s collateral, future cash flows and probability of success.

Sharing the Burden with the Private Sector: Emergence of IPPs
Traditionally, utilities were responsible for the generation of electricity and selling to the end-users. Given the high cost of power generation infrastructure and the challenges faced by state owned utilities to finance such projects, Independent Power Producers (“IPP”) have entered many African markets. An IPP is an entity that is not a public utility but owns and operates a power generation facility for the sale of electricity to utilities and/or end-users. The objective of the IPP and its developers is clearly commercial and driven by a potential return on investment. Through IPPs, governments can use private resources to address developmental needs. Furthermore, unlike the traditional way of financing electricity generation, (i.e. public financing) using IPPs allows for reallocation of the project risks between the government and the private sector.

Well allocated risk is critical to the success of a power project. It ensures the equitable distribution of the economic benefits associated with the risk that has been assumed. The risk will typically be priced by the developer into the tariff and be reflected in the internal rate of return (“IRR”) for its shareholders. It is essential that the allocation of risks justifies the level of return on investment, and vice-versa. If the risk allocation results in a high tariff relative to the risk that has been assumed by the IPP, the outcome may be off-taker default or cancellation of the power purchase agreement (“PPA”). Conversely if tariffs are too low resulting in insufficient project returns, the project will be either un-bankable or unattractive for the developers.2 Both instances result unfair economic benefit for one party at the expense of the other which is not sustainable.

Bankability vs Profitability: Hiding behind the Lenders
The higher the risk, the higher the return – power projects in emerging markets are more likely to generate a higher return than projects in developed markets. The reason for this is because the developers will price the risk of developing the power project, raising finance, securing fuel supply for the plant, constructing the plant, and operating and maintaining it for the full term of the PPA due to the perception that these risks are more likely to materialise in an emerging market.

The lenders generally have a more conservative appetite for risk and will independently assess the accuracy of technical and economic assumptions of the project. However, whilst the risk assessment

Termination Payments: Risking it All

The disposition on payments in the event of a termination is perhaps one of the most contentious clauses within any commercial contract and this is no different for a PPA. Typically, termination in a PPA falls into three categories – (i) a default of the off-taker/utility (a buyer default) or a failure of the government to prevent a risk (a political force majeure), (ii) the default of the IPP (a seller default) and (iii) an ‘act of God’ or some form of supervening impossibility of performance (an ordinary force majeure). The market generally accepts that the lenders must be repaid for the debt they provide to the project, regardless of the circumstances pertaining to the termination. Where the buyer is in default or a political force majeure arises, again, the market generally accepts that both the debt from the lenders and equity contribution by IPP shareholders should be re-paid in the termination payment. However, there is some debate in respect of the market position for seller default and this debate illustrates the unreasonable risk allocation placed on utilities. Some developers argue for termination clauses providing for the payment of equity in the event of seller default. This means that in the event that the IPP itself defaults on its obligations in the PPA to such an extent that the agreement must be terminated, the off-taker/government will still pay the IPP’s full equity returns in the termination payment.

This kind of structure provides for a theoretically risk-free investment (which is argued for under the guise of bankability). In theory, the IPP has nothing to lose – equity will be paid in full. The argument used is that the off-taker/government will retain the project infrastructure/assets in the country after the termination so the full payment should be due upon termination. But why shouldn’t the IPP be penalised for defaulting on their obligations?

This is just one example of risk being unfairly allocated to the utility (and in turn the government) where the party best placed to mitigate against that risk is the private sector, being the IPP. The majority of state-owned utilities on the continent are heavily subsidised and dependant on government support and the Ministry of Finance/treasury will likely backstop the undertakings of the utility. The lenders will also have a direct agreement in place with the host government. However, the expectation that the host government must absorb the entire risk profile of a project for it to reach financial close diminishes the economic value of private sector participation. Financing and technical skills are an essential component of power projects but equitable risk allocation is also important to ensure that governments can comfortably support various IPPs.

Conclusion

The real question is how much risk should African governments be taking? Whilst there is a developmental need for private sector investment in the power sector across the continent, it is unreasonable for an IPP to expect a risk-free structure. A clear line needs to be drawn between bankability and profitability. An IPP must proverbially speaking, have “some skin in the game” to satisfy the government that there is enough incentive to complete the project. Despite the fact that most African governments do not have the wherewithal to develop power projects at the rate required to address the energy deficit, the market needs to shift towards more equitable terms that are sustainable for all the parties involved.