Economic and Financial Viability in RE Projects

Regional Meeting on Sustainable Energy for African Least Developed Countries

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The Centre’s Approach

The Centre combines research with project implementation to foster a dialogue between the private and public sector.

A strategic collaboration between the United Nations Environment Programme and Frankfurt School, the Centre is supported by the German Federal Ministry for the Environment.

Acting as UNEP’s main knowledge hub for sustainable energy and climate finance, the Centre carries out research with an orientation towards practical application:

- Implementing findings and instruments in the field and thereby functioning as think and do tank
- Crowding in new investors, in particular from the private sector
- Structuring and combining of innovative financing instruments
Project Preparation: Business Plan Development
The “ideal financing process”

- Lenders are approached with a stable business plan
- Equity is committed
- Risks are allocated to the party best able to manage them
- PPA is signed (or at least in the final phase of negotiation) and the project has all required permits
- Other key documents available for review: Connection Agreement, Engineering, Procurement and Construction Contract, Operation and Maintenance Agreement and the Government Support and Consent Agreement
- Equity is not fully committed and the financing structure still highly indicative
- Permitting process is ongoing and the project initiator cannot provide a draft PPA
- The role of the lender is often a broader and more active one involving some „coaching“ of the initiator
- Also, commercial lenders are often involved at an earlier stage in the process
- Risks are allocated in an inefficient manner

The ideal world…

…vs reality in less mature markets!
Project Preparation: Business Plan Development
Varying objectives of RE project stakeholders (non-exhaustive)

**Lender**
- Appropriate risk/return profile
- Balance sheet protection
- ALM guidelines
- Business creation/portfolio diversification

**Equity Investor**
- Equity IRR
- Appropriate risk/return profile
- Long-term involvement

**Utility/Regulator:**
- Decreasing average generation cost
- Diversification of technologies and energy mix
- Closing the demand-supply gap (if any)
- Macroeconomic viability of the project

**Developer**
Insuring a viable business case by creating a win-win situation for all stakeholders
## Definition of a Viable Business Case
### Financial vs economic viability of RE

<table>
<thead>
<tr>
<th>Economic viability</th>
<th>Financial viability</th>
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<tr>
<td>Does the project make sense from a societal/macroeconomic perspective?</td>
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<tr>
<td>• Average generation costs over the next +/- 20yrs?</td>
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<td>• Contribution to 'ideal' energy mix?</td>
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<td>• Additional generation capacity required?</td>
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<tr>
<td>• Diversification of technologies</td>
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<td>• Hidden subsidies and externalities taken into account?</td>
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<td>Does the project offer an attractive investment opportunity for a private sector investor (project perspective only)?</td>
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<tr>
<td>• Based on power purchase agreement (PPA) terms</td>
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<tr>
<td>• Ability to service debt</td>
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<tr>
<td>• Ability to pay dividends (EIRR)</td>
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<tr>
<td>• Payback periods</td>
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<td>• Considers risk profile of investment</td>
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Financial vs Economic Viability of RE
Balancing private and public sector needs

- Economic and financial viability can differ
- Economic viability driven by external factors
- Financial viability for RE should be driven by regulatory framework

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<th>Generation mix, fuel costs, demand growth</th>
<th>Regulator</th>
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<tr>
<td>High</td>
<td>Low</td>
</tr>
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<td>Economic viability</td>
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Attractiveness of projects for the society
Attractiveness of projects for an investor
Economic & Financial Viability of RE
Don’t tip the scales

Least cost development energy sector strategy

Many RE projects

Less RE projects

Inefficiency
Economic & Financial Viability of RE
Finding the sweet spot for all – price setting

- **Financial viability**: How much you have to pay at a min. to attract private sector activity

- **Economic viability**: How much you should pay at a max. to stick to the least cost development path

- **Steering the volume & speed of IPP activity**

- **Art of price setting**

- **LCOE**

- **IPP**

- **Economic viability benchmark?**

- **Additional generation capacity required?**

- **Average generation cost (of new capacity) in the grid (next 20 yrs)**

- **Adjustment for other advantages/disadvantages. (base load, tech diversification, …)**

- **Go/No-Go?**
Utilities and their quest to remain in control
Africa’s historical struggles – total cost and tariff revenues

Source: World Bank staff calculations based on utility data.
Key Takeaways

- Efficiency in the energy sector is reached if financial viability reflects economic viability.
- Regulation is key to create a level playing field and align economic and financial viability.
- Regulator to monitor economic viability and define financial viability.
- From the start of project development, responsible developers should take the necessity of balancing both economic and financial viability into consideration.
Back-up
Business Plan Preparation
Stages

- Evaluation phase
- Feasibility study phase
- Contract negotiation phase
- Fundraising phase
- Construction phase
- Operating phase

Decreasing uncertainty → Increasing level of detail and complexity
Business Plan Preparation

Stages
Utilities and their quest to remain in control
Africa’s historical struggles – total cost and tariff revenues

Source: World Bank staff calculations based on utility data.
Calculating the levelised cost of energy (LCOE) can provide a useful basis for comparing the generation costs of conventional energy sources and those of renewable energy.

Economic assessment that includes all the costs over a plant’s lifetime:

- NPV calculation performed and solved in such a way that the project’s NPV is zero for the value of the LCOE chosen. This means that the LCOE is the minimum price at which energy must be sold for an energy project to break even.

- Downside: Calculation based on the assumption that the timing and flexibility of electricity generation is irrelevant.
LEVELISED COST OF ELECTRICITY – COMPONENTS AND DRIVERS

Source: GET FiT Plus, DBCCA, 2011