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The big squeeze on margins in South Africa's REIPP

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Editor's note: *The roundtable below took place before the recent naming of preferred bidders in the third round of REIPP bidding, though the discussions were highly prescient.*

The South African government will announce preferred bidders for the third round of its renewable energy independent power producer programme (REIPPP) imminently. In the first two rounds 37 projects reached financial close, with a combined capacity of 2,460MW. The third round of the programme is due to add a further 1,265MW of power to the grid, with financial close scheduled for July 2014

Most of the debt funding for the first two rounds came from a small group of local lenders, because the programme did not encourage the use of non-Rand currencies. The third round of bidding features an increase in corporate finance-backed submissions and a further tightening of developers margins. Now that state utility Eskom has made its first purchase of power from a first round project, will proven operational performance allow developers more financing options for a planned fourth round of deals?

Project Finance gathered nine market participants in Johannesburg to discuss the financing challenges facing the REIPP programme. The participants were:

- Helen Tregurtha, AIIM Africa
- Vincent Perrot, GDF Suez
- Demetri Pappadopoulos, Cennergi
- Yousuf Haffejee, Eskom
- Dan Zinman, RMB
- Mark Schmaman, RMB
- James Price, RMB
- Hugh Hawarden, RMB
- Mike Levington, Kabi Solar

Jon Whiteaker, Project Finance (JW): How much capacity is left in the local banking market to support the REIPP programme?

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Dan Zinman, RMB (DZ): We are not at the point yet where there isnt capacity in the domestic banking market. There is still significant capacity for the programme across all of the local banks, certainly for round three, four and potentially five as well. As projects come online and theres some operational history, I think there may be a natural exit from banks selling down to institutional investors and particularly those institutional investors who arent currently comfortable with taking construction risk

Demetri Pappadopoulos, Cennergi (DP): The banks have been available, but Im not sure for how much longer. We need to talk about rounds four and five what happens after that? Are the banks having a view that there wont be a round six? And the other issue is whether, rather than a round four, we move to a type of programme where we have a willing buyer, willing seller type of arrangement, which is something we should consider. Also, I wouldnt say that the costs have been that competitive and that needs to be considered, because tight margins are why a lot of developers didnt participate in the last round.

Mike Levington, Kabi Solar (ML): As long as you have a good, well-structured project, theres never been a problem finding appetite from the banks. And I think this has become a bit of a gold rush industry. There is probably close to 50GW of projects out there, wind and solar. I would say 15% of those that are in the hands of professional developers. Beyond that, those having trouble getting access to bank funding are generally those who probably dont know how to structure a project.

What you have seen in this round has been the rise of corporate financed transactions, and the sustainability of those is a concern. This process was established to use the banks as gatekeepers from the departments perspective of what were going to be sustainable deals. With these corporate deals, who is going to be the gatekeeper?

Yousuf Haffejee, Eskom (YH): I really want to understand the capacity environment from the lending institutions; at what point do you say you are too exposed to the renewable industry, and at what point do you say we have limits in terms of buyer exposure to Eskom?

Vincent Perrot, GDF Suez (VP): I dont think its a question of capacity. I think all the banks have the capacity to fund these projects. Its quite impressive that more than 80 projects have been supported by banks. But from a developers point of view I think theres a question to be asked whether we can try and attract more liquidity from other sources and try to push the price down, which will eventually benefit the tariff.

JW: Yousuf, do you know how many of the submissions received for the third round were corporate finance backed?

YH: Im merely the administrator and the buyer under the PPA, so I wouldnt be able to comment in terms of the amount of deals that have been corporate financed. But I can tell you there were more in round three than during the first window. And we are certainly seeing different forms of funding coming forward.

As the buyers office we see very little risk in that environment. Yes the procurement process was designed by the DoE for the banks to do a lot of the due diligence and the gate-keeping to ensure viable projects. And there is a question of whether those looking at alternative funding are doing the same amount of due diligence. But as the buyer, we are certainly comfortable with any forms of finance so long as the projects can deliver on the ground.

Mark Schmaman, RMB (MS): Its interesting. I would have thought that the strategy for some of the corporate finance deals would be to test the banks for financing after the award, once they have a PPA in hand, to potentially look to see if theres room for project financing to still come on board. I suppose the risk there is that the programme has gone through a bid process but the bidder could still fall away. The corporate finance-backed bids would obviously still need to meet all the due diligence requirements in order to secure bank funding post award.

JW: Does more need to be done to attract international investment into the programme?

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Helen Tregurtha, AIIM Africa (HT): Investors in our funds include the full range of investor types including international investors, and development finance institutions. They are very keen to invest in renewable energy projects in South Africa, but they find access difficult due to the rules of the programme around South African participation, Black ownership and increasingly with economic development.

Increasingly project sponsors, many of whom are foreign, are also funding greater proportions of the project equity, further shrinking access to the non-BEE allocation, being 60% of the project equity. So as much as we are seeing that theres interest from international investors to invest equity in these projects, there is limited space for them in the deals. Returns are also coming under pressure due to competitive tension which is causing some concern especially on the long term currency exposure.

James Price, RMB (JP): Eskom and the government are aware that if foreign banks are coming into the South African market theres going to be a cost of a swap from whatever currency, which has an implication on the governments balance sheet; they dont want dollar liabilities when they can get rand liabilities.

YH: The Treasury certainly wants a rand-based tariff. They categorically stated they do not want to dollarise the South African economy through this process. There was an extensive input prior to starting the RFP process with the lending institutions. Obviously the hedging instruments and the hedging markets are not as available for 20-year debt but weve seen the market come through in bidding all three phases on a rand-based tariff. So I think Treasury is still of the opinion that its method is sustainable.

HT: Shorter rand exposure would hold appeal to international financiers, but to maintain a competitive cost of capital over the life of the project would imply an assumed debt refinancing at some stage in the future, and while this is common place in Europe, it does obviously have its complexities.

MS: The difficulty is that if an international bank doesnt have good access to rand funding, they have to do currency swaps with potential breakage costs on any future refinancing, and I havent seen any international lender yet prepared to hold that risk.

VP: And in the current implementation agreement theres no allowance for termination payments for a cross-currency swap. I think Eskom and the DoEs position is very respectable in terms of trying to support the rand. From an equity providers perspective, we dont have any concern around the rand. It is a volatile structure, it comes at a cost and theres a long-term view that it will depreciate. But we wouldnt be in South Africa if we didnt have confidence in it.

YH: I think we must not underestimate the foreign bankers wanting to play in the space. Just a week ago we were informed by one of the Japanese lending institutions that it is looking at lending in the Brazilian and South African currencies. Obviously how they fund in terms of the hedging instruments or swaps were not sure, but international banks are looking at the market.

ML: If you look at the country right now were in a highly energy constrained environment. There are huge plans, not just on renewables but on coal, on nuclear, and youve got gas coming into the situation too. This market has moved away from, lets say, a developer market to a developer EPC market; youve got to be along the whole chain. Thats attracted some of the large international utilities into South Africa.

JW: What are the viable funding options available to developers, both now and for future rounds, and what type of structures are the banks happy to support?

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DP: Those who used corporate finance, once they have been successful, will probably look for project finance. Those of us who have used project finance from the start may look at refinancing opportunities once weve got to commercial operations and there is some predictability in revenues.

The issue, though, is that the REIPP programme was designed to establish a market, to create a platform for international developers to come in and play inside Africa, and to put South Africa on the map. It is almost a precursor for the coal and the gas programmes to come. But how does that funding requirement impact on the renewable energy process? If a lender has an opportunity to fund a 1,000MW coal plant versus 150MW wind deal, which way are they going to fund? And where does that leave renewable energy developers?

DZ: I dont think the two are mutually exclusive. For example, export credit agency funding which has not been tapped to a large extent on the renewable process I think there have only been one or two deals that have used ECA-backed funding in REIPPP but a coal-fired plant, which is multiples of the cost, could use ECAs to widen the pool of liquidity. We (RMB) have done a Hermes-backed deal where it was prepared to cover rand. I think Coface says that it could do that as well.

Hugh Hawarden, RMB (HH): Whether youre doing a massive base load fossil fuel fired IPP or a renewables deal, the ticket size is going to be roughly the same. So what that actually means is to do the base load IPP where the absolute number is much bigger, youre going to need a big club deal with different tranches of funding. It actually becomes a lot more complex. The return on effort becomes a lot lower than to do a renewables deal, such as a, 100MW wind farm all by yourself as a bank, which is a technology thats relatively simple and understood.

I think its a bit of a shame with the REIPP programme that due to the attraction and return on effort of lending larger ticket sizes (because as a bank we like to lend around R1 billion or so) it has left what I think are good smaller scale projects a bit out in the cold. The smaller projects are generally not as attractive to the banks and dont receive the same attention.

JW: How much have margins, including tariffs, debt pricing, EPC costs and shareholder ROIs, been reduced over the rounds, and how much room is there for further squeezing?

YH: Overall weve seen a 22% reduction in tariff prices between round one and two. Weve seen a 40% deduction in the price of solar alone, although this is largely because round one was not competitive. In that round the full 3,700MW was available, and the market knew that very few projects ticked all the boxes for qualifying. Therefore if you passed the qualifying stage there was absolutely no incentive to better the competitive price in the second stage of evaluation because you were almost guaranteed a PPA.

From what I hear round three is extremely competitive; theyre talking about wind bids below R0.70 per kWh, and PV under R1 per kWh. The sad part is that in round two, of the bids received there were some excellent deals which were unsuccessful because the allocated megawatts were reached through low priced bids.

HH: Reductions in the tariff are irrelevant, and I think we all know that the caps are actually irrelevant. There is too much tariff reliance in the bidding for exactly the reason Yousuf has been outlining; there are good projects that are missing out. And if you look at the generation capacity of the country, about 45GW or whatever we have, what difference is five cents going to make for a renewables project; its going to make very little difference in the general scheme of things. And so I think the focus on low tariffs is not really benefitting the country and may actually be favouring bad or riskier projects.

YH: Id probably beg to differ because where Im standing Im seeing good projects out there which are also low-price projects. So I think the proof will be in post round three when you get on the ground. Its only speculation that those that are more expensive are good, because

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those that are cheap havent been proven to be failures.

ML: What if you have a situation where we find everything goes well in the first round, but in round three 30-40%, or in an extreme situation 90%, of the projects dont even make it to financial close? Remember, these projects dont ever make financial close. Remember these projects are potentially closing before a general election where you could find the same currency volatility problems as seen for round two projects in terms of the ability to hedge out their risk.

VP: There is potentially an opportunity for the government to decide what is of more value, in light of the need to rapidly increase the installed capacity in the country, a few cents difference or having more projects allocated at the same time. Because there may be a large number of wind and PV projects that are at tariff levels that are acceptable from a value for money point of view. That could be an opportunity to get more projects at the same time and still get very good projects.

HT: With successive rounds of the refit programme, there is pressure on returns from an equity perspective. EPC pricing is also under pressure, especially when considered in the context of EPC wrapping. An area of contract evolution could be the split contract approach, but this does increase the risk for the project from the financiers perspective. As a result financing costs could go up, diluting the benefit of the reduced construction price.

FX risk is implicit in this market, and as much as the government takes FX risk from 60% of your project cost, often the contractors are taking the risk on the balance of that and they need to price that into their contract.

YH: But how competitive is the pricing amongst the banks? Are all the lending institutions within the same ballpark figure and it just depends on your relationship with the developer? There are so few players in the South African market. The other margins are coming down with the equity and EPC guys giving, but are the banks lowering their margin?

HH: Theres been no track record yet, but theres certainly a greater understanding from our credit committees. But in terms of offering more, where we have moved a bit is in terms of the structure of the projects, the gearing, the level of some mezzanine debt we want to inject. But still for some of the round three projects our sponsors were asking us to take risks that werent yet justified.

HT: But internationally these technologies are proven. In the end youre stuck with the lenders that can invest in rand, having to take the price that is very similar across the banks. Yes, one may give you a 1.25x debt service coverage ratio, versus 1.3x. But the 1.3x might give you a 16-year tenor, so you run the scenarios through your model and you pick one you feel you can work with, with relationships playing a big part.

YH: Im very concerned that theres insufficient competition in the legal consulting environment and certainly in the banking environment. Its sad to hear you say that well only borrow at a lower cost if we see the projects on the ground.

JP: It is very important to remember that the largest part of the debt funding cost the banks we cant influence at all; the base rate, the liquidity premiums, the statutory costs. That represents 90-95% of the cost of debt in this country. In other countries you have subsidised debt financing the projects but that isnt the case in this country. We have got JIBAR at about 6%. With hedging on top our best rates are 8.5% before you even start. You can move credit margins to zero and its not going to change the cost of debt by more than 1%, which in turn is not going to shift tariffs dramatically. We are directly dependent on how the Reserve Bank sets interest rates.

YH: Then I am right in saying there is very little competition amongst the banks? I think we need to think of a different model in terms of competition. Foreign lending and other forms of funding should bring that needed competition into the industry.

DZ: I dont think were saying that we have to wait for round three deals to close before there will be a reduction in risk and assessment of risk. I think were saying, once round one deals are operational there should be a natural reduction. From the other side of the argument, one of our credit committees biggest concerns when we brought them round three deals where our terms had been more aggressive, for example, was why we dropped the DSCR by ten points relative to

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round one.

Also, its not only about price I think there are other structural innovations that can also be brought to deals which can make them more competitive. A 5bp margin increase is often worth less than putting in inflation linked debt, for example.

JW: If you could make any changes to the structure of the REIPP programme for future rounds what would they be?

ML: Id rather you had a process where there was less development upfront. In the last round you had say 150 projects with over R500 million being spent on development, of which only a very small percentage is actually going to come to fruition.

I think it is very difficult to strategically plan the grid. I think it becomes impossible for Eskom or whoever plans the grid to do strategic planning when the decision as to where projects are going to be built happens on a yearly basis. You need defined connection points.

Also I think ISMO (the independent system market operator) needs to come into play. I think you need to be able to have a level playing field where projects can interact directly with end users. That will give confidence to power manufacturers and public manufacturers to open up smaller scale plants.

HT: I would like to see increased capacity allocated to each round and also the timings of bidding rounds and financial close sorted out so they dont clash. Its also worth considering giving projects independence to achieve close according to their own timetable, instead of programing all projects to close on one day. This may deliver benefits in terms of transaction legal costs, as well as hedging rates.

HH: I think the governments main focus on creating jobs isnt reflected in the way the programme has evolved because of the incredible focus on low tariffs. The race to the bottom contrasts with the governments objectives, the less jobs you create for instance, the lower your tariff will be.

A way to fix this would be to take away the local content requirements. At the same time make local content a higher scoring objective than tariff in the rating criteria, which should then drive local participation. What that will also do is increase competition between lenders by tapping into new funding pools. There are funding institutions that would be competitive, would be able to do this programme, the European DFIs for instance, which are often put off by the local content restrictions because, as a rule, they dont enter into restrictive procurement processes.

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