How to attract new sources of capital to EU renewables


● Flows of institutional investor money into renewable energy projects are likely to be needed to enable European Union countries to meet their 2020 targets, because both banks and utilities are facing constraints on the amount of long-term capital they will be able to deploy.

● The bulk of the capital deployed by institutions such as pension funds, insurance companies and wealth managers into renewable generation projects is expected to go directly or indirectly (via specialist funds or bonds) into operating-stage assets. This would free up bank and utility money to be recycled into new development- and construction-stage opportunities.

● Institutional money is increasingly moving into renewables, with 2013 seeing record flows into specialist, quoted project funds and also directly into European projects. However the total institutional commitment remains small compared to overall EU investment in renewables.

● Significant barriers still stand in the way of greater institutional investment in EU renewable power projects. There are regulatory issues – some countries do not allow their pension funds to invest in infrastructure; EU unbundling regulations obstruct funds from investing directly in generation if they are also doing so in transmission and distribution; Solvency II regulations may limit insurers’ appetite for illiquid investments; and pension fund fiduciary rules do not include an obligation to consider climate change in asset allocation decisions.

● There are practical constraints. Renewable power projects may be of too small a ticket size to attract large funds; smaller funds lack knowledge and the resources to build specialist teams; some institutions may feel that they are other, less risky types of infrastructure they can invest in, and so it is not worth investing to build an expertise in clean energy; consultants, or “gatekeepers”, that advise pension funds on investments may not be familiar themselves with clean energy projects; and the new breed of quoted project funds may not be large enough – yet – to command the attention of a wide institutional audience.

● There are also policy and political issues. Long-term funds have become used to investing a percentage of their capital in infrastructure, but are hesitating about taking one step further into renewable power projects because of worries about the stability of subsidy support and what looks like a fracturing political consensus on future energy choices. This has the effect of reducing demand and raising the cost of what does get built.

● Financial experts at the Leadership Forum proposed many possible moves that could accelerate institutional flows. These included the packaging of project bank debt into something akin to collateralised debt obligations for on-sale to funds; and the return of securitisation to turn project debt into bonds that would fit into funds’ fixed-interest portfolios.

● In addition, there is scope for institutions to co-invest in projects with specialist quoted funds, or with development banks or commercial lenders. Pooled structures such as the UK Pension
Infrastructure Platform could also play a role, although it is far from clear at present what the UK PIP will be investing in.

- Insurance products, covering everything from variable power output to policy risk, could also play a role in de-risking clean energy projects for institutions, as could the development of a specialist engineering, procurement and construction, or EPC, sector that would continue to shoulder project risks through the operational phase, especially in offshore wind.

- Finally, the financial sector and policy-makers need to improve their understanding of each other. Lenders and institutions will have to accept that it is unrealistic to expect politicians to keep out of the energy policy debate through the electoral cycle; energy policy-makers should talk more often to treasury colleagues involved in setting financial regulations.

1. BACKGROUND TRENDS

New investment in clean energy in Europe rose sharply from $23.5bn in 2004 to a peak of $121.6bn in 2011, but then fell by 29% in 2012 to $86.5bn (see Figure 1). The trend has weakened further in 2013 to date, with figures showing investment excluding research and development at $34bn for the first three quarters of this year, down 41% on the equivalent period in 2012. The decline since 2011 reflects a combination of many factors including unfavourable changes in policy support for renewables in some countries, uncertainty over policy in others, and – more positively – sharp reductions in the cost of renewable power equipment, notably PV panels.

Figure 1: New investment in clean energy in Europe by asset class, 2004-12, $bn

Bloomberg New Energy Finance published estimates in late 2011 showing that the EU-27, as it then was, would have to invest a total of EUR 466bn in renewable generation capacity in the 2011-20 period to meet every country’s National Renewable Energy Action Plans. It exceeded the EUR 46.6bn-per-year run-rate in 2011 and, more narrowly, in 2012.

But if the EU were to continue investing up to the end of 2020 at the rate seen in the first three quarters of 2013, then it would end up some $86bn short of the amount required to hit the 2020 targets. For the UK, the gap would be proportionately larger, at $22bn in total over 2011-20,
reflecting its high requirement for new power capacity and the cost of the proposed offshore wind element.

Bloomberg New Energy Finance has also published figures (see Research Note Institutions nibble at project yields: who, why, how? 25 October 2013) showing a rising trend in institutional commitments to European renewable energy projects. Its figures add together direct investment in projects by the likes of Allianz, Munich Re and PensionDanmark, with investment via project bond issues or into specialist European renewable energy infrastructure and private equity funds, or via quoted project funds such as Greencoat UK Wind and Bluefield Solar Income Fund. On this measure, disclosed institutional commitments increased from around $1bn per year in 2008 and 2009 to $2.6bn in 2012. The equivalent figure for 2013 will be more than $3bn, and could be up towards $4bn.\(^1\)

On 4 December, a few days after the Leadership Forum, six insurance companies pledged to invest GBP 25bn in UK infrastructure, without giving any details on how this will be done, the timescale, or the possible share of clean energy projects in this total.

2. LEADERSHIP FORUM RESULTS

2.1. Polling
The Leadership Forum consisted of a series of frank and open discussions between the 62 high-level bankers, utilities, developers, institutional investors, asset managers and policy-makers. These were made on the basis of Chatham House Rules, so no comments made over 21-22 November are attributable to a named individual.

One type of output from the Forum was polling results from table discussions. Figures 2 and 3 show the polling results from two questions put to delegates, the first on the amount of money institutions are likely to deploy per year on European renewable energy project investments by 2020; and the second on the biggest issue currently deterring institutions from making investments in clean energy projects.\(^1\)

\(^1\) These figures are not comprehensive. For instance, they exclude commitments to renewable energy infrastructure funds that invest worldwide, not just in Europe. They exclude commitments to companies that develop and construct projects as well as operate them. They also exclude fund closings that are not disclosed.
investments in renewables. Figure 4 shows the response to another question, about the best way to encourage institutional investor capital to flow into the sector.

Figure 4: “What is the best mechanism to increase the flow of institutional investor capital into the clean energy sector in Europe?”

Source: Bloomberg New Energy Finance, Leadership Forum. Note: Securitisation also includes ways of bundling project debt; regulations on climate risk means those forcing institutions explicitly to take climate issues into account in their asset allocation decisions; regulations on liability balancing means steps that would make it easier for institutions to use infrastructure investments to balance their liabilities.

2.2. Scale

One of the specific issues that emerged strongly from the Leadership Forum was the need for scale when it came to renewable energy project investment opportunities. The representative of one large pension fund commented that many renewable energy projects, certainly most of those in Europe in sectors other than offshore wind, were too small in value to justify the due diligence that would be required before investing.

Meanwhile, the new quoted project funds launched in London this year (Greencoat, Bluefield, The Renewables Infrastructure Group, Foresight Solar Fund) are currently capitalised at GBP 135m to GBP 300m, in other words less than $500m each. The point was made at the Forum that this amount, also, is too small to feature on the radar screen for many large institutions. Once the quoted funds have grown to $1bn and beyond, however, there could be increasing interest in their shares from pension funds and insurance companies.

The third point that was made forcibly about scale is that even if the quoted funds grow in that fashion, and there is further institutional commitment via infrastructure and PE funds, the amount of money likely to flow to renewable energy projects in Europe per year will be far below what is required to bridge the estimated funding gap. The rest of the institutional capital will have to come from direct investment in projects, and via bonds and pooled arrangements.

2.3. Packaging

That puts the spotlight on ways in which project investments can be packaged so they become easy options for a wide range of institutions, small and large. One approach is to turn debt in operating-stage projects into bonds. This has had a bumpy history in Europe, including the
disappointing record of the Breeze bonds linked to German and French wind farms, issued in 2005-07. However experts at the Leadership Forum saw major scope for investment banks to use securitisation (the pooling and dicing of project loans into asset-backed securities), or credit derivatives, to provide large-scale opportunities for institutions that could be bought via their fixed-interest asset allocation rather than via their infrastructure allocation.

Co-investment has already started to become a way for non-specialist institutions to put money into projects, benefiting from the clean energy expertise of partners. For example, in May, Hermes GPE bought 50% of the Braes of Doune wind farm in Scotland from Centrica, joining co-investor Greencoat UK Wind, which had bought the remaining equity stake from SSE earlier in the year. In February, two Danish pension funds provided equity for the Butendiek wind project off the German coast, in conjunction with the Marguerite Fund and Siemens Project Ventures. The Forum heard predictions that co-investment could deliver direct capital from institutions that might not be committed otherwise.

Pooled arrangements such as the UK Pension Infrastructure Platform could also play a role. At present, the PIP has GBP 1bn of capital promised by 10 pension funds, although its backers have kept tight-lipped about the likely sector mix it will choose. At best, structures like the PIP could make it easier for small and medium-sized pension funds to invest in clean energy projects on the back of shared expertise rather than having to build up their own teams.

2.4. Risk mitigation

Something that would help the growth of these packaged and pooled approaches, as well as more direct methods of investing, is greater use of risk mitigation in clean energy. One point of view at the Forum was that the current risk premia for renewable energy are premised on it being a (relatively) low-risk sector. But the risk, and potential impact, of regulatory change is significant. For both equity and debt investors, renewable power projects have an inherently higher risk profile than longer-established PFI/PPP-type assets, bearing policy plus operational risks, resource risk (wind or irradiation) and power price exposure.

Under the heading of risk mitigation could be insurance products to cover wind and sunshine variations, in order to smooth out project cash flows for investors, policy cover against retroactive changes in subsidies, and greater use of EPC guarantees on project performance.

The UK Infrastructure Guarantee Scheme is supposed to de-risk investment in projects of "national significance", totalling up to GBP 40bn. Included in its list of pre-approved projects are road and rail undertakings, but also clean energy initiatives such as coal-to-biomass conversions and a large offshore wind farm. This sort of scheme, introduced elsewhere in Europe, could make it easier for institutions to commit direct lending to renewable power projects.

Development banks can also provide some of the cover to make projects more easily investible for others. On 2 December, the European Investment Bank said that GBP 305m worth of bonds had been issued to institutions to finance the transmission link to connect the Greater Gabbard offshore wind farm to mainland UK. The EIB added that a GBP 45.8m guarantee, which it provided as credit support under the Project Bond Credit Enhancement initiative, made possible a "rating uplift of one notch" to A3 with Moody's.

2.5. Building political support

The Forum heard many representations from lenders and investors to the effect that political arguments in countries such as Germany, France and the UK over energy policy were unsettling the financial community and delaying transactions. The background noise may well be pushing up the cost of capital, thereby making wind and solar more expensive relative to fossil-fuel alternatives, and therefore further ratcheting up the political furor over support for green energy.
The case was also made powerfully, however, that the financial community can do more to address political issues. In the first place, investors need to be more realistic about the fact that total policy certainty for new projects will never be available, given the realities of the democratic and electoral process. The key decision for them, rather, is whether they have sufficient confidence that there will be no retroactive cuts in support for existing projects.

Second, financiers can help to build voter—and therefore—political allegiance to the clean energy cause via the products that they make available. Crowdfunding, for instance, may not be significant in terms of the absolute amounts of cash it could raise for project development but it does give a large number of people of ordinary means a stake in the continuation of policy support. The same is true of quoted funds, if they can be tailored as much as possible to attract retail investors and high-net worth individuals as well as institutions.

However, there is no substitute for good investment performance— if well-tailored green project funds under-perform, as some "socially responsible investing" or SRI funds have, then these efforts will backfire.

There were a number of comments from participants at the Forum that renewable energy has no inherent "right" to receive investment. It has to stack up from an investment perspective (risk/return/scale) when competing directly with other sectors. There should be no feeling of "entitlement" in the sector that it automatically deserves investment.

There was another view at the Forum, from inside the industry, that the underlying obstacle to encouraging investment in clean energy is the structure of the power markets. As currently designed, this "provides for the sale and purchase of brown power only", one delegate said, and does not give institutions a reason to question their current asset allocation between green and fossil-fuel energy.

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