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CFLI Unlocking Capital – Investment Readiness Guidelines

Introduction

The CFLI Investment Readiness Guidelines are intended to facilitate discussion among financial institutions, project developers, investors, and government representatives on critical factors for mobilizing private finance for low-carbon solutions in developing countries. These Guidelines are not intended to supersede firm- or fund-level investment criteria for developing countries but are instead meant to provide a set of initial gating factors for consideration.

These Guidelines are based on the experience of lenders and other financial investors in these markets over the past decade. They represent the most fundamental and cross-cutting factors affecting investment. While the Guidelines are intended to be considered in their entirety, prioritization of specific policy prescriptions will vary greatly depending on the economic, legal, political, and financial development of a particular country.

Although investment decision-making is complex and dependent on contextual circumstances, which can vary widely from country to country, these factors may closely correlate with decreased project risk and increased likelihood of a project's consideration by investment teams.

Macroeconomic considerations

Political and macroeconomic stability and economic growth prospects

The presence of strong institutions with a track record of good governance and the commitment and capacity to provide stable macroeconomic management is a major factor for investors as are sound macroeconomic policies to drive broad-based growth and provide investors with broad assurance of the financial sustainability of their investments. Investors also require reliable data on the macroeconomic state of the economy (banking-sector health, employment numbers, etc.) to support their own reporting requirements.

Policy stability

Policy risks, such as expropriation, sovereign breach of contract, or lack of availability of hard currency, are crucially important considerations for investors. Low-carbon projects are particularly vulnerable to policy risk, such as the ability to predict and rely on stable tariffs, due to declining input costs and a reliance on government subsidies. The risk of policy reversals or renegotiations is often the single biggest concern of most investors in developing countries, particularly when such policies can be altered legally with ease by government agencies. These risks can only be partially covered through international political risk insurance.

Financial market depth

The existence of a local bank market that can provide both lending and other financial services, such as currency, interest rate swaps, access to listed markets, and even support for a robust green bond market, are important for international investors. The challenge of limited local commercial banking experience and capabilities, such as the lack of long-term fixed rate non-recourse debt, and limited liquidity in local debt and equity markets can be a hindrance for investors.

Currency stability

Mismatches between the currency denomination of a project's costs and the denomination of its revenues present extra costs and risks when neither local nor international markets provide the instruments needed to hedge those risks in sufficient size and tenor. This is particularly problematic in countries with volatile currency exchange rates and where significant current account deficits leave those currencies vulnerable to devaluation. Structures that are available to partially hedge local currencies tend to be inefficient and expensive. The degree to which a country can peg its currency to a hard currency or denominate project revenues in a hard currency is thus an important consideration.

Government commitment to stable and predictable investment incentives for low-carbon solutions

In addition to strong public government support, a variety of incentives and policies may signal a favorable business environment for the operator and, therefore, the investor. These signals may include establishing renewable energy targets and strategies, setting emission reduction targets, or revising far-reaching Nationally Determined Commitments. Other clear and tangible signals include establishing specific financial incentives, such as tax incentives or preferential treatment on import duties, and the establishment of clearly organized auctions, tenders, or feed-in tariffs.

Political will and execution capacity

Strong policy support and clear rules and regulation are important but equally important are the willingness, experience, and relevant technical skills to implement those policies and engage with investors. Most developing countries have little experience negotiating and executing international commercial agreements and technical assistance may be necessary until project development, engineering, technical, and commercial experience is gained. The willingness and ability of the host country and its population (pensions, entrepreneurs, sovereign wealth funds, development banks, etc.) to invest alongside international investors on pari passu or junior terms can also demonstrate local will and execution capacity, as well as local and non-local financial alignment.

Market considerations

Cost-reflective energy prices

Ensuring that power generators can charge the necessary cost-reflective tariffs is crucial to enabling private investment to flow to low-carbon sectors. In many cases, this will require the removal of energy subsidies for the incumbent fossil fuel industry such that retail energy prices may rise to reflect their true costs.

Power Purchase Agreements (PPAs) incorporating protections required by international lenders

PPAs must be of sufficient duration to match the tenor of financing required. International public and private sector lenders also often require that off-taker payments are denominated in dollars or euros, which can be challenging for off-takers whose income is in local currency. Additional elements typically required by lenders include agreement to settle any disputes in a neutral, offshore location, and other standard protections for the developer and its lenders. As the market develops, standardization of PPAs across the market becomes increasingly important to investors and developers.

Creditworthy or credit-enhanced off-takers

In most countries, the power off-taker is a government utility requiring some credit enhancement to support its payment obligations to the power producer. Such support may come in the form of partial or full sovereign guarantees (where possible within sovereign debt capacity limits), liquidity facilities, and laws assuring funding for the electricity sector. The stronger the PPA, the more likely the lender will accept something less than a full sovereign guarantee.

Ownership and local content requirements that are mindful of foreign investors' and local communities' needs

In some jurisdictions, foreign investment is limited to minority stakes, whereas investors may seek control. The relative paucity of well-capitalized local partners with relevant experience can be a barrier to developing a successful project. Similarly, while investors generally seek to work with local communities and source as much as possible from local markets, in some cases, government requirements concerning restrictive local content, if they materially impinge on the quality or economics of the project, can stymie investment.

Clear and predictable licensing and permitting procedures

The assurance that necessary licenses and permits will be awarded based on a fair, efficient, and predictable process is crucial to developers and their investors. Establishing land titles in markets where traditional land tenure is practiced is often costly and time-consuming, contributing to the uncertainty that is so problematic for investors. In some countries, governments provide a pre-permitting site, specifications, and license auctioned as part of a PPA.

Enforceability of contracts

Businesses require predictable local legal frameworks and confidence that contracts will be enforced promptly in local courts. Effective dispute resolution mechanisms are also essential to giving business confidence to enter into relationships with new businesses and partners in foreign markets.

Power grid capacity, stability, and ability to handle intermittent power

In many countries the national power grid has limited capacity to absorb new power and/or lacks the flexibility to be able to handle the intermittent power that is generated by most renewable energy sources. This can result in renewable energy plants being required to reduce their production, most of the time without compensation for such curtailment. A clear agreement is needed between decision makers who grant permits and licenses, private developers, and grid operators regarding necessary grid improvements, completion dates, and relation between those grid improvements and proposed renewable energy projects.

Effective community engagement

Ensuring that local communities are consulted effectively before construction as well as on an ongoing basis is important to the success of a low-carbon project. Developers and lenders conduct their own community engagement, but governments can help de-risk projects ex-ante by taking an active role in facilitating that engagement.

Size of the market and relevant deal flow

Smaller markets do not necessarily present greater risk, but generally offer less opportunity for financial institutions to reach economies of scale in their financing activities. These countries also present less opportunity for development of robust green bond markets. Regional integration may address this challenge, but creates new credit, structuring, and legal complexity. An institution's existing relationship in a smaller country, or the intensity of a small country's commitment to a particular policy agenda, may offset the difficulty of sourcing deals in a smaller market.

High quality engineering, procurement, and construction (EPC) contractors

The lack of availability of a sufficient number of high-quality, reliable developers and EPC contractors with strong, relevant experience and capabilities is a significant challenge to building new renewable energy generating capacity in emerging markets. While ongoing operations and maintenance capabilities are often available locally, it is important for investors to be able to rely on experienced international contractors who are willing to invest and capable of successfully delivering a project on time and on budget.

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