

The offshore wind farm sector is gaining momentum. New projects with a capacity of 866MW were installed in 2011. However, a uniquely difficult combination of risks has brought about significantly different approaches to project management between banks and utilities. While utilities strive for a high degree of autonomy in terms of structuring the projects, banks call for a direct influence on and total transparency in the project contracts. Understanding these different perspectives will help both sides to cooperate in order to finance the massive pipeline of future projects.

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Project Finance in Offshore Wind

Differences in Risk Approach Between Banks and Utilities

Market Overview – What Happened in 2011?

The European offshore wind farm sector experienced increasing activity during 2011, with a capacity of 866MW brought on-line and another 2.375MW now under construction. The vast majority of the new capacity (752MW) was built in the UK, but the forthcoming pipeline is mainly in Germany –

and indeed project finance for the sector was concentrated in that country, with three projects (Meerwind, Global Tech 1 and Baltic 1) raising a record € 2 billion in bank debt, an increase of 40% on the previous year and a demonstration of the country's ambitious plans gaining momentum.

Key Risk Factors

The offshore wind farm sector is marked by a uniquely complex combination of risks. Projects have to deal with major suppliers coming from very distinct industries and with no natural coordinator among them. A lot of the contractors involved themselves are breaking new ground in this still emerging industry as experience is still

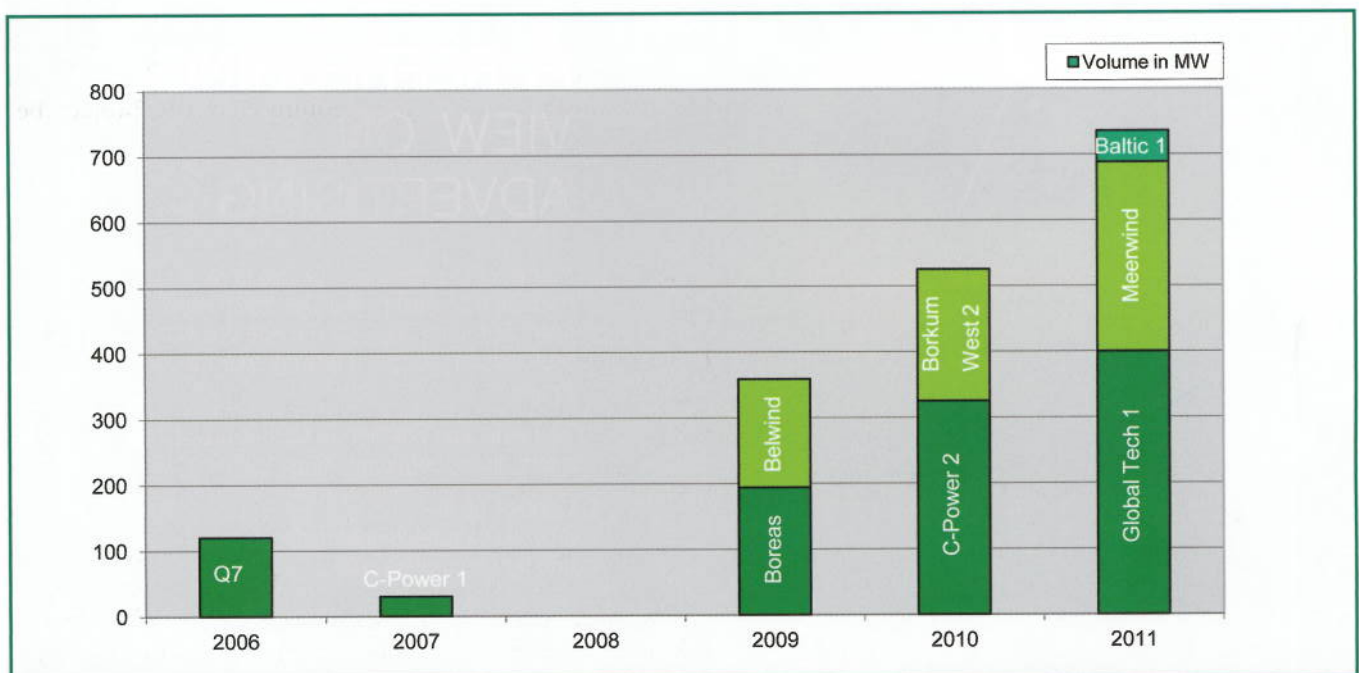
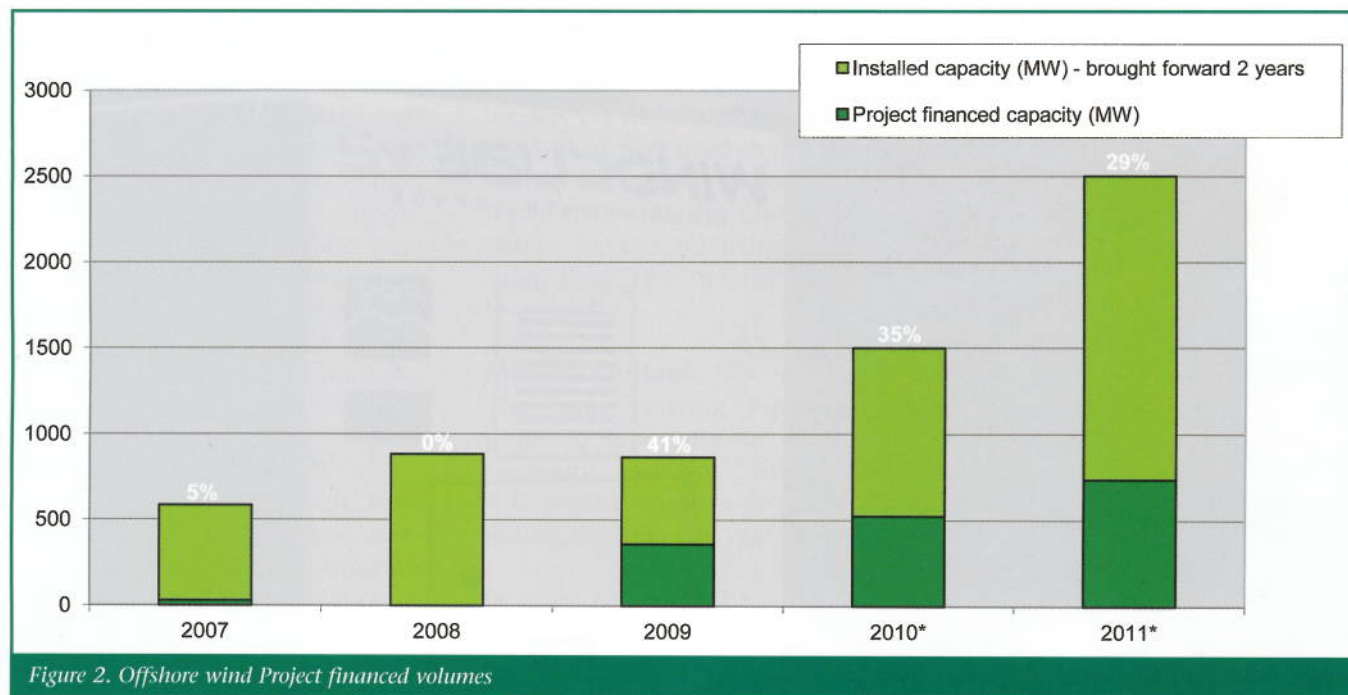


Figure 1. Project financed offshore wind farms per year

scarce. And, the very nature of the industry means that it will always be subject to weather uncertainty during construction, a risk factor which unavoidably multiplies interface risk between parties and

a time when syndication markets are closed means bringing in more banks, and having to accept multiple and conflicting requirements, making negotiations complex and time-consuming, as well as expen-

the sector, and large-scale transactions including construction risk have become a regular occurrence in continental Europe, certain commercial terms have become standard lender requirements.



requires special management and mitigation. Furthermore, the rapid move towards large, multi-billion projects in an industry where many suppliers are relatively small companies makes counter-party risk a serious issue.

At this early stage of the industry development, no obvious or industry-standard mitigation route has emerged, and risk mitigation approaches between banks and utilities differ significantly.

Difference in Risk Approach Between Banks and Utilities

The offshore wind industry began to require financing immediately following the financial crisis, at a time when banks were becoming more risk-averse, and were especially wary of a new industry they did not understand well. Offshore wind projects require large amounts of finance, which at

requires special management and mitigation. Furthermore, the rapid move towards large, multi-billion projects in an industry where many suppliers are relatively small companies makes counter-party risk a serious issue. Beyond a general requirement for conservative assumptions, banks tend to demand more influence on the contractual structure and commercial terms, as well as more transparency on technology, supply chains and contractors than investors, and in particular utilities, were used to. The market thus developed in two directions, with utilities funding and developing projects on their own, while smaller developers that required bank funding let their lenders have a large influence on the project.

The Banks' Approach

The offshore wind project market was created by a small number of financing institutions that took part in almost every deal, and, while the market today is broadening, the influence of these early deals on current transactions is strong. Even as an increasing number of banks are attracted to

For instance, banks focus specifically on the long-term ownership and the management of the projects. Seeking long-term stability and a clear involvement of experienced players, they typically require that the project be majority-owned by the original investors or by acceptable substitutes (with strict criteria for such acceptability). Additionally, long-term, full-scope operations and maintenance (O&M) contracts (at least for a period of ten years) with the turbine manufacturers are seen as essential – and lenders ideally want these contracts to have a pre-agreed price for the whole period.

Beyond these contractual requirements, lenders generally expect a direct involvement in commercial contract negotiations as well as a more intrusive due diligence and more detailed information provision. Due to the relative lack

of track record in the industry and the intrinsic higher risk profile resulting from the multiple construction interfaces, banks need detailed reviews of interfaces, overall project management and contingency planning, and require explicit warranties from the contractors, as well as detailed information on their supply chain, logistics and testing processes. Furthermore, they expect to remain fully involved throughout the construction phase and to keep a close eye on operations once the project is running.

The Utilities' Approach

Conversely, utilities, which have the necessary internal project management and negotiation capabilities, and have the experience of complex projects, do not see why they should accept such interference in their core business from lenders. They want to keep commercial relations with suppliers confidential, to manage risks, especially interface risks, internally, and to keep costs down by limiting the extent of warranties provided by contractors and, when possible, by splitting up tasks into multiple sub-contracts. In many cases, they have very broad relationships with their core suppliers, extending to other equipment than wind farms, and do not require explicit warranties as they expect these suppliers to do the right thing anyway, given their overall commercial context with them. In other words, they can manage some risks on a portfolio basis rather than on a project by project basis.

In that context, restrictions on their freedom to manage project ownership or O&M are not seen as easily acceptable, and, given that project finance tended to be cumbersome, complex and more costly

than balance sheet financing, it was largely avoided by utilities investing in the sector. As investment requirements increase that approach may change, but beyond finding an agreement with the lenders on the above issues, utilities will further need to make sure that rating agencies actually give them credit for the non-recourse nature of the financings, something they have not been willing to do so far.

Market Outlook

The huge existing pipeline of projects, especially in the UK, Germany and the Netherlands, will require massive investments during the next few years.

In order to accept the constraints imposed by the lenders, utilities will need to be convinced that the banks' approach also has some advantages, such as improved risk discipline, improved equity returns and access to new, ideally cheaper, pools of capital. These will make tolerable the limitations they have to accept on their freedom to manage projects as they please.

The good news is that the lending market is now showing signs of both depth and maturity, as standards slowly coalesce around a smaller number of key requirements, and more banks (as well as multilaterals and export credit agencies) are active. Solutions will be found to match the requirements of the lenders with what the investors are willing to do, and the rapidly increasing track record of the industry will allow parties to be more comfortable with certain risks.

In the end, the market will both converge towards an acceptable middle ground and diversify, as a

wider range of players will bring about structures with different risk allocation mechanisms such as minority equity stakes, post-completion refinancings, bond issues or portfolio transactions. ■

Biography of the Authors

Jérôme Guillet is a founder and Managing Director of Green Giraffe Energy Bankers (GGEB), created in early 2010 and focused on renewable energy financial advisory services. He has 15 years' experience in the energy project finance industry, including direct involvement in closing most of the non-recourse offshore wind construction financings done so far. Jérôme Guillet graduated from the Ecole Polytechnique in Paris and holds a PhD in economics from the Ecole des Hautes Etudes en Sciences Sociales in Paris.



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