Project Finance Outlook 2017
Policy Concerns Weigh on Credit Performance

Scope Ratings has a cautious outlook on the credit performance of European project financings in 2017. Political and economic uncertainties create event risk that will reflect negatively on most asset classes next year. We believe that renewable energy project financings will become more exposed to regulatory and revenue risks related to changes in support schemes in 2017. Falling costs and innovations in risk mitigation and financial structures are positive factors.

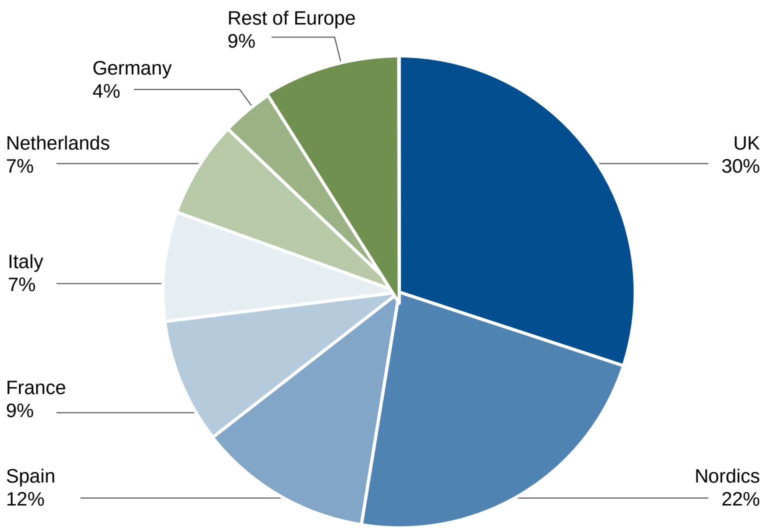
Our outlook on new issuance in 2017 is negative, particularly in the first two quarters, because investors are cautious about increasingly protectionist movements and the risk of populist backlashes undermining stability and predictability across sectors. Regulatory and policy uncertainties will suppress new issuance in renewable energy in particular. The low-interest rate environment, sizeable infrastructure investment needs coupled with tight public budgets, the emergence of new asset classes and offshore wind in particular, and a broadening and increasingly sophisticated investor base provide long-term support.

Event risks will lead investors to take a cautious approach this year in Scope's view. With Brexit negotiations yet to take shape and elections taking place in countries with historically significant European project-financing issuance volumes, including France and Germany, investors face a number of risks related to ongoing regional cooperation and continued support of existing policies and commitments.

In the renewable energy sector, we believe that regulatory and revenue risks will increase this year because payments will increasingly be market-linked, and competitive processes such as auctions or tenders will determine the level of support. Broader political change, such as the UK's decision to leave the European Union, will increase the risk of adverse policy changes, particularly in countries with powerful government opposition forces on the rise that, if in power, may decide to modify or discontinue its predecessor's policies in Scope's view.

Total issuance in the first half of this year saw declining volumes in Germany and France in particular, offset by notable increases in Norway and Sweden as well as the UK.

Figure 1: European project financing issuance H1 2016 (EUR 39bn)



Source: Thomson Reuters Project Finance International and Scope.

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Related Research

Phase-out of feed-in:
Renewables open to market risk
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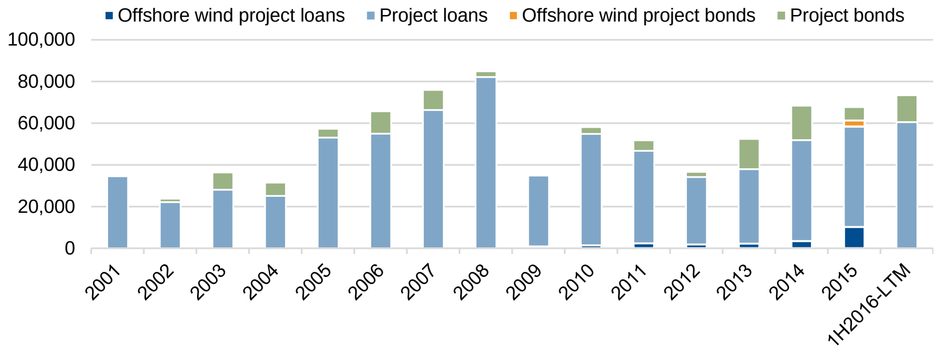
Project finance outlook 2017

European issuance will slow due to policy uncertainties

Scope expects that European project financing issuance will slow to around EUR 50bn-60bn in 2017 from up to EUR 70bn this year, mainly driven by weakening activity in the UK and its renewable energy sector in particular.

European project financing issuance will soften next year

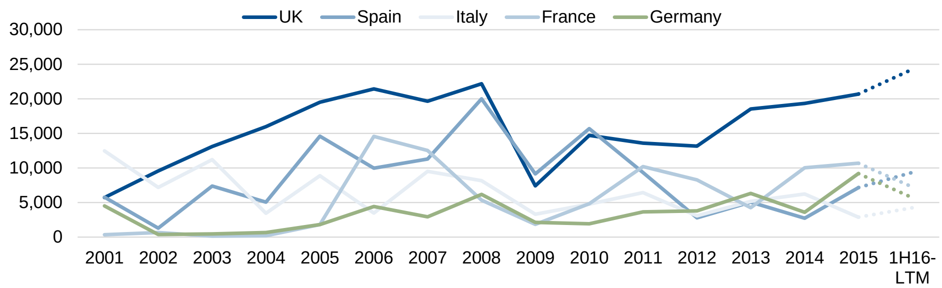
Figure 2: Historical European project financing issuance (EUR m)



Source: Thomson Reuters Project Finance International and Scope.

Strong UK issuance, France and Germany down in H1 2016

Figure 3: Historical project financing issuance in major countries (EUR m)

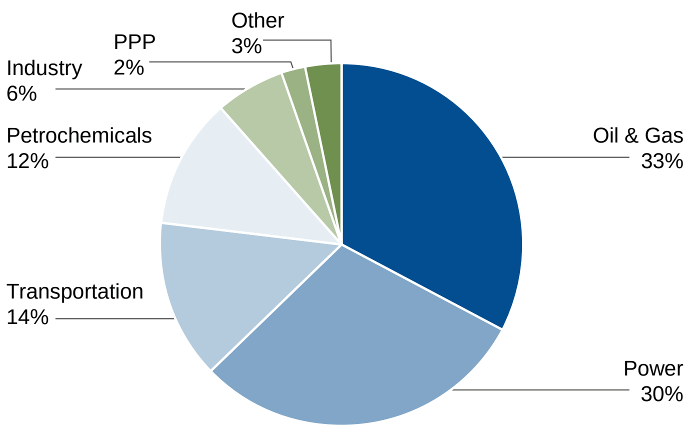


Source: Thomson Reuters Project Finance International and Scope.

Power and transportation sectors will drive new issuance

In terms of sectors, Scope expects that power, particularly renewables, and transportation will continue to dominate new European project financing issuance next year, with oil and gas representing the primary uses of funds in Russia, the Middle East, and Africa.

Figure 4: EMEA project financing loans by sector H1 2016 (EUR 76.6bn)



Source: Thomson Reuters Project Finance International and Scope.

Policy concerns and market risks weigh on credit performance

Strong UK issuance driven by mega offshore wind projects

The first half of this year was marked by strong issuance in the UK (EUR 11.7bn), with two mega offshore wind projects, Dudgeon (EUR 1.6bn) and Beatrice (EUR 2.8bn), in particular. Issuance was partially driven by project accelerations before the phase-out of the Renewables Obligation support scheme by next year. We anticipate some support through the second auction under the UK's contract for difference (CfD) scheme in April, allocating GBP 290m to less established technologies including offshore wind.

UK policy uncertainty and higher costs are credit-negative

We believe that competitive auctions will continue to put pressure on projects' revenue side. We also expect competitiveness of projects' output to decrease because of rising costs of imported components resulting from the weak pound and higher costs of capital, a credit-negative. We anticipate that in 2017, investors will be slower to fund long-term projects amid policy uncertainty resulting from the Brexit vote in June 2016. Policy uncertainties include the UK's future energy and emissions policies, access to energy trading with its EU neighbours, the build-out of cross-regional transmission capacity, supply security, and funding strategies including the future role of major financial institutions such as the EIB, the Green Investment Bank, or its successors. Recent adverse changes, including the cutting of support for onshore wind, solar power, and biomass last year, as well as the government's go-ahead in September for the UK's first new nuclear power plant in 20 years (Hinkley Point C) add to concerns.

Germany's switch to auctions marks drop in new issuance

After a record issuance of EUR 9.2bn last year with offshore wind a major contributor (over EUR 4bn across five projects), issuance slowed in the first half of 2016 to EUR 1.5bn. While we note that the German government affirmed its commitment to build out offshore wind up to 15 GW until 2030, it lowered its targets for mature technologies including onshore wind and solar PV. Issuance backed by mature technologies fell sharply because of uncertainty ahead of a move from fixed feed-in tariffs towards feed-in premium auctions for around 80% of new-build projects starting on 1 January 2017.

Auctions will lead to aggressive bidding – credit-negative

We anticipate that with the roll-out of auctions starting in April next year, the large ecosystem of developers that formed during the last decade's renewables boom will bid aggressively for support to retain market share, a credit-negative in our view. Our expectation reflects the pilot auctions for ground-mounted solar PV conducted earlier this year that have resulted in significantly lower subsidy levels. It will only become clear over the next years how many winning projects will be built and whether they are viable.

Uncertainty over support stunts issuance in France

Issuance in France slowed to EUR 3.3bn in the first six months after peaking at EUR 10.7bn in 2015, the highest since 2007. Legal uncertainty over its onshore wind feed-in tariff, the energy transition law that came into force at the end of last year, and the anticipation of further changes to its subsidy regime contributed to the decline.

Build-out targets partially mitigate bidding pressure

France adopted three decrees in June to implement a new subsidy regime based on public tenders and a capacity- and technology-determined instrument mix of feed-in tariffs and new feed-in premia. While feed-in tariffs will continue to be backed by purchase obligations of EDF, projects that benefit from a feed-in premium will be required to sell their electricity to a private buyer. Similar to the UK's CfD and Germany's feed-in premium, projects will be exposed to the risk of selling its output at a lower price than the reference value calculated by the public authority. We believe that, in contrast to Germany, France's targets to increase capacity deployment targets will somewhat offset competitive bidding pressure in 2017.

Innovations in risk mitigation and financial structures provide support

Scope expects the broadening of the investor base beyond banks towards institutional investors and increasing investor sophistication to continue to support innovation in risk mitigation and financial structuring techniques next year, reflecting positively on credit performance.

Institutional investors to increase allocations to PF

We believe that institutional investors will continue to increase their engagement across asset classes, helping to stimulate innovation in risk mitigation solutions. Following the retreat of many banks from the project financing market due to regulatory uncertainty, institutional investors responded to the prospect of attractive yields in the context of the present ultra-low interest rate environment over recent years. While investors initially focused on plain-vanilla, operational assets, many have since built substantial expertise and capacity to invest in project financing debt across asset classes, project stages, and investment vehicles.

Project bonds become mainstream

This trend has led to a number of innovations in the project financing sector. In particular it boosted issuance of project bonds, peaking at a record issuance of EUR 16.5bn or 24% of total project financing volumes in 2014. While banks have since recaptured market share with aggressive terms, EUR 7.9bn project bonds were issued in the first half of 2016, representing a 77% year-over-year increase.

Risk-averse investors push for new risk-mitigation solutions

Lower credit risk appetite of certain institutional investors have led to the development of new structures and risk-mitigation solutions, such as staggered issuance to match drawdowns with construction milestones and avoid negative carry. Another development was the successful use of a single-party EPC contract in an offshore wind transaction, a sector that traditionally relied on multi-contracting approaches exposing the issuer to the performance risk of a number of contracting parties. At the end of last year, the refinancing of an offshore wind park in Germany was wholly funded by project bonds set to mature at the end of the feed-in tariff period. Refinancing risk under merchant conditions was partially mitigated by a cash sweep mechanism that aims to reduce the notes' balloon payment at maturity.

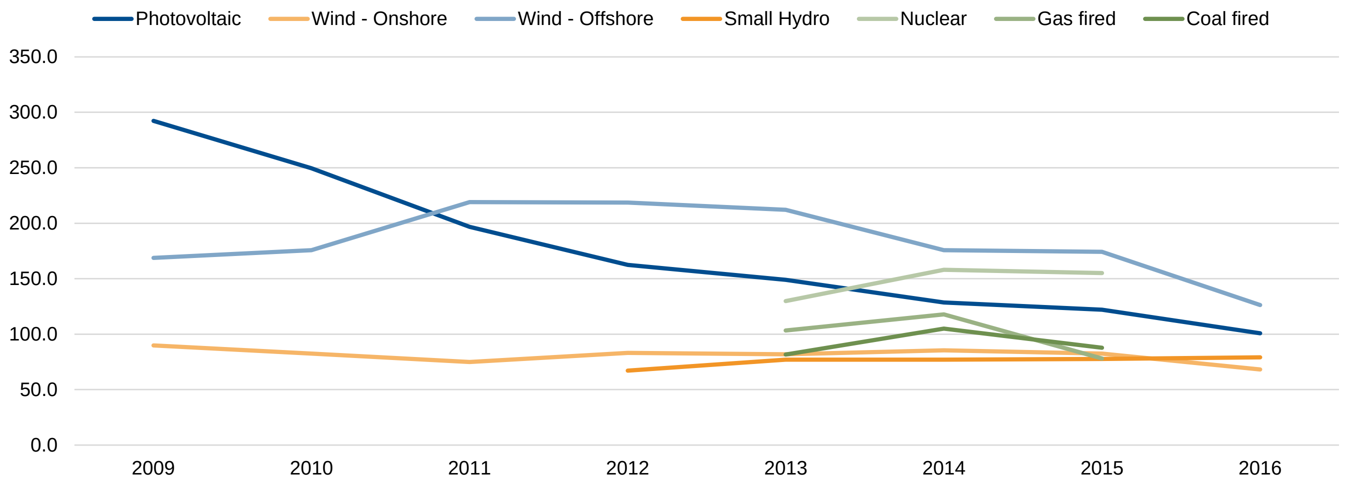
Corporate PPAs may mitigate regulatory and revenue risks

The increasing use of long-term power purchase agreements (PPAs) with creditworthy corporate offtakers will help to mitigate risks related to increasingly auction-based, market-linked subsidy regimes in Europe. Scope expects the recent trend of some renewables projects selling their output directly to corporate or industrial users (as opposed to utilities as the traditional buyer) to continue in 2017. From the start of this year until October, at least 1.32 GW in capacity were contracted by entering into PPAs with corporate offtakers such as Google and Facebook according to IJGlobal data.

Appendix I: Renewables open to market risk

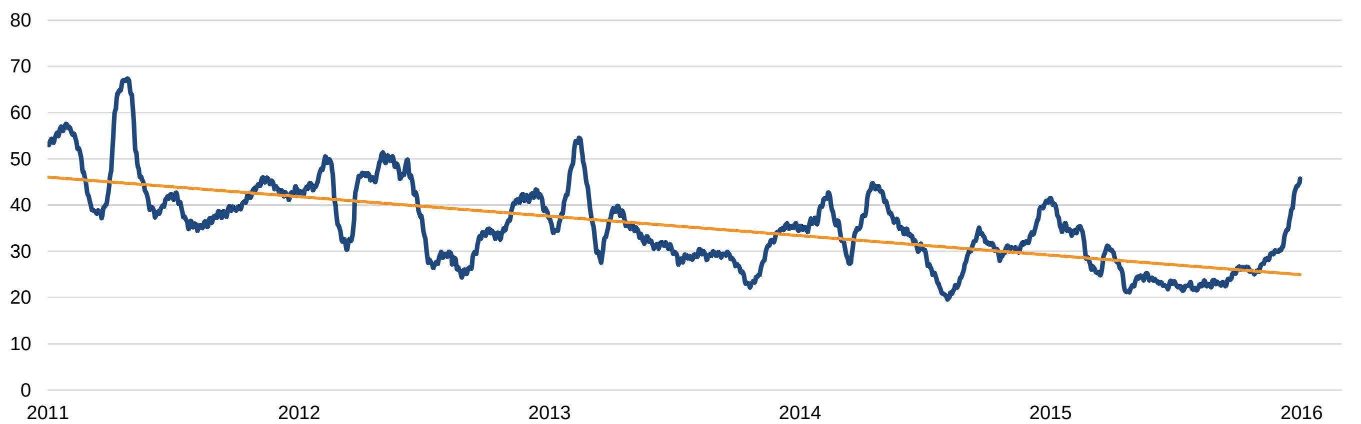
A key trend that will drive renewable energy credit performance is the ongoing review and adaption of subsidy schemes targeting an eventual phase-out of financial support. This development is related to several factors including technologies' increasing competitiveness with conventional generation (Figure 5), mounting electricity bills amidst continually declining wholesale prices (Figure 6), and rising grid costs from the growing share of intermittent generation, particularly wind and solar power.

Figure 5: Levelised cost of electricity (USD/MWh)



Source: Bloomberg New Energy Finance and Scope.

Figure 6: European Electricity Index Day Base (EUR/MWh)



Source: Bloomberg New Energy Finance and Scope.

Many existing projects continue to benefit from feed-in tariffs combined with priority dispatch which provides them with a fixed payment for each unit of produced power, eliminating market risk. Hence, the projects' credit performance primarily relies on resource availability and plant performance. However, starting on January 1, 2017, support across the EU must be awarded through competitive-bidding processes and payment mechanisms must expose projects to market-price signals.

While countries use different instruments to support renewables, a competitive-bidding process will generally determine the level of subsidies projects benefit from. Some countries, including the UK, France, and Germany, have implemented new schemes as recently as last year, and as such these new elements remain largely untested. Our outlook also considers the risk of lower subsidy payments resulting from aggressive projections underpinning developers' bids, as well as the risk of further policy changes.

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