

A Cloudy Forecast?

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Renewables has become the buzz word in the energy and infrastructure space like no other. Certainly 2021 closed out with record procurements across the Gulf and the Middle East more broadly, signalling an entrenched energy transition which few would call anything less than the new normal. The figures are always tricky to compile with absolute accuracy, but Saudi's 1.4 GW round two of renewables procurement neatly sped into 1.2 GW of round three, with round four being touted as "imminent". The United Arab Emirates has closed or is in the process of procuring over 5 GW of renewables. Oman is procuring 500 MW of solar PV power, and Qatar continues to build its first ever renewables plant at Al Kharsaah (totalling 800.15 MW, which we closed a year earlier) that will put the upcoming football World Cup in October into the history books as the first ever carbon neutral sporting super-event.

This is all but a snapshot of some eye watering predictions, including by the Arab Petroleum Investments Corporation (Apicorp). Its regional 2021-25 investment report concludes that approximately USD805 billion of energy investments will be made regionally in the next 4 years. The particular point of interest is that while oil takes approximately 28 per cent of that pie, there is a visible drop between projects committed (USD127 billion) and projects planned (USD99 billion). The power sector, which again is increasingly renewables minded, shows a ramp-up trend, with USD93 billion of committed projects versus USD157 billion of planned deals.

Few would describe the 2021 energy market as anything less than boisterous, seemingly supercharged by the gloom of COVID-19 lock downs permeating the world in 2020. However, in 2022, the proverbial clouds are beginning to gather over the sunny renewables industry, and these warrant consideration as they are unlikely to disappear any time soon.

The Inflation Cloud

The seemingly inflation-proof westerns economies, more specifically the USA and the wider European market, have now experienced what developing world has for years considered the norm – escalating prices. The latest figures show most western economies languishing in the 8 per cent annual inflation category, something that no one would have predicted couple of years ago when all countries were beset by near zero inflation and looming deflation. The causes of that inflation are probably best left to the economists, but the results of that inflation are definitely being felt in the renewables market and have some interesting legal consequences.

For one, many renewables deals which were procured or awarded under a competitive bid basis last year are struggling to keep to their budgets. In part, the problem is a historical one. For several years, the input costs for renewables plants has been decreasing, in some aspects dramatically. Over the last decade the price of polysilicon, one of the major input materials for the manufacture of photovoltaic modules used in solar plants, has plummeted. Coupled with mass scaling of solar module manufacture, particularly in China, the overall cost of photovoltaic modules has dependably been trending downwards for over ten years. This means that in the red-hot, super competitive, Middle Eastern renewables market, developers frequently bid on projects on the assumption that not only current supply of photovoltaic modules would predictably be at prices secured at bid stage, but potentially decrease further as the relevant bid process was implemented and the procurer drew towards making a winning bidder announcement. In fact, it is the market's worst kept secret that some developers would plan to aggregate all of their won projects under a single supply arrangement, which would decrease input costs even further through additional economies of scale and negotiating power with suppliers. With modelled equity returns on most Middle Eastern renewables deals sitting at single digits, an improvement to that return by a single percentage point during construction was not something to be ignored by the developers.

Interestingly, once procurers caught on to the fact that winning developers might improve on their returns by delaying the purchase of supplies, such as the photovoltaic modules, or aggregating all supplies across several projects, rigorous claw-back provisions began to appear in the power purchase agreements. Essentially, the offtaker of power suddenly had the right to audit the accounts of the project company so as to determine whether the shareholders were benefitting from improved returns which exceeded those originally presented in the financial model at financial closing. To the extent that such returns did in fact exceed the previously projected returns, the project company and its shareholders were compelled to share in the spoils with the offtaker at a range of 50 per cent to 100 per cent of the excess profits. This obviously presented a myriad of additional issues, including the fact that the project company was effectively precluded from building up cash reserves, albeit at a level above those originally modelled, which might not have been immediately disbursed as dividend and could have been kept in reserve for the "rainy day" (literally). Worst still, to the extent that the offtaker audit discovered that equity returns had exceeded modelled returns for a number of years, the project company potentially faced the equivalent of back-pay liability in relation to cash which had already been disbursed to shareholders as dividend. This had conceptually put in jeopardy not only the project company's cash flow as it now had to fork out cash which it didn't have, but the project financing on which the project was built, as the resultant back-pay liability could affect the debt service cover ratio, potentially triggering a default under the financing.

However, that complication seems but a distant memory in today's market. Meeting projected equity returns is no longer a foregone conclusion. Instead, it has turned into a goal which, if inflation continues unabated, many developers might struggle to realise.

Fortunately for developers, most utility scale renewables in the Middle East are procured on limited/non-recourse basis, which therefore includes a set of bankability rules that lend considerable amount of scrutiny to risk allocation and project implementation. This is in spite of what we have observed - more relaxed adherence by developers and lenders alike to well established risk allocation principles - mostly under the justification of "market evolution" and being "commercial". Two particular project finance principles that most developers and lenders

retained in recent deals are (1) procuring all project works under a single, lump-sum turnkey construction contract, and (2) obtaining bonds from the construction contractor which are (among other things) back-to-back with the developers' bonds (bid bonds or subsequent development bonds) in favour of the procurer/offtaker. Unfortunately for contractors that have signed up to this market accepted practice, they have effectively committed to developing projects which, with every day, are increasingly more expensive to execute.

To put this into perspective, on one occasion we were told by a contractor that inflation in the last two years has hit an unbearable level: steel and copper rising by 55 percent, aluminium by 50 percent, silicon materials, required for the manufacture of photovoltaic modules, by a 270 percent, and logistics escalating in price by 700 percent. We cannot confirm the veracity of these claims, but if they are half true, the picture is pretty bleak, particularly since it does take on average 18-24 months to close a renewables deal tendered under a competitive bid.

Why Should We All Care?

The fact that no one had anticipated this inflationary environment is now resulting in considerable pain in the renewables market which no stakeholder should ignore. While developers and procurers might conceptually be shielded from this issue by virtue of robust, wrapped, construction subcontracting, the reality is that contractors cannot execute works at cost, or worse still at a loss, for an extended period. There will come a point, if it hasn't arrived already, at which contractors will weigh the loss of a bid or performance bond being called as less severe than to develop a project which is firmly in the red. After all, why throw more good money after bad!

This may have a damaging consequence on the market.

Firstly, if contractors continue to lose money on existing deals, the likelihood of their exit from the market increases. Some may even go insolvent, in which case the market will be left with even lower levels of supply in relation to escalating demand for renewables deals.

Secondly, even if developers and procurers/offtakers are contractually protected in relation to contractor default or underperformance, the resultant insolvency or walk-away by contractors may lead to stranded incomplete assets, potentially poorly manufactured primarily because of the contractors' desperate attempt to keep to budget, and are thus wholly unfitted for the long-term performance that they are meant to deliver.

Thirdly, the inflationary burns suffered by contractors and other stakeholders will leave a scorched market which might require considerable amount of time to recover. In the very least, the glorious record-breaking prices previously set by Middle Eastern renewables deals might be replaced by significantly more expensive assets.

The Counterintuitive Upside

However, therein might also lie the benefit. Developers and contractors alike have for years been complaining of diminishing margins in the face of a hypercompetitive (race to the bottom) market. Perhaps the exit of some speculative stakeholders who had previously bet on continuously decreasing cost of development and relaxed legal structuring will open the market to a more a balanced model. Imagine a new wave of deals which will be commercially rational

and legally sound – now that doesn't sound all that bad!

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