REGULATORY RISK AT THE FOREFRONT OF ISSUES AFFECTING THE POWER SECTOR

Marsh's recently held European Power Forum in Istanbul focused on "Security of Supply". Regulatory risk and its impact on the power sector, was a key topic for discussion. Edwin Charnaud, Chairman of Marsh's Global Infrastructure Practice led a panel session on the subject.

He was joined by:

- Martin Bennett, Senior Vice President, Global Infrastructure Practice, Marsh.
- Jeffrey Altman, Senior Energy and Infrastructure Advisor, Strategic Assets Partners.
- James Wardlaw, Partner, Campbell Lutyens.
- Daniel Radov, Associate Director, NERA Economic Consulting.
- Erdinç Çetin, Project Finance Manager, Zorlu Enerji.

POLICY RISK HAS HISTORICALLY BEEN ASSOCIATED WITH EMERGING MARKETS, BUT THIS TREND APPEARS TO BE CHANGING

Today, there are probably few, if any, geographies that are safe from the threat of politically motivated regulatory changes. The past few years have seen taxation changes, revisions to feed-in tariffs, and eligibility changes that have eroded – and in some cases demolished – the value of generation assets.

As the power sector transformed from a regulated industry to a market-driven one, the expectation six or seven years ago was that moving towards market liberalisation would lead to regulatory risk diminishing and being replaced by market risk.

In fact, there has been a resurgence of regulatory risk as people have lost confidence in markets.

In the main, policy risk has arisen where countries can't afford the cost of previous regulatory intervention, and where existing policies had no cost protection or intrinsic cost overrun limitation feature. These policy risks are now on the rise in more developed countries, where there is particular concern surrounding environmental obligations to reduce emissions.

ASSESSING EXPOSURE TO REGULATORY RISK

In the past, this didn't seem important; owners and investors have looked at sub-sectors in isolation. Any attempt to understand regulatory risk has to be performed over a much longer timescale than the political cycle; however, establishing a view over the 25-year life of an asset is extremely difficult to do.

Regulatory change causes uncertainty, leading to downgrades and higher spreads, which are of great concern to all financiers. Regulators do not necessarily get the support from the markets when making regulatory changes because the markets don't believe the forecasts or some of the technical issues underpinning their decision. The perception that investors like regulated assets is simplistic. Investors like stable revenues, even more so if they are relatively high as a result of monopolies. Regulation is attractive if it creates a stable environment, but it is not attractive per se.

PROTECTING AGAINST REGULATORY RISK

The scope of political risk insurance can address many perils ranging from property damage risks through to discriminatory measures such as licence cancellation. The value to the insured isn't so much that of their assets, but more the value of those rights and abilities contained within a licence or concession. For insurers, the key criterion when underwriting political risks is to understand the nature of those rights, and what would breach them.

On a very basic level political risk insurance will exclude measures which governments take on a non-discriminatory and bona fide basis. Insurers also provide indemnity policies for what is really a fraction of the overall return that investors hope to receive. They are more willing to protect risks where the investment is aligned with and important to host government interests, and where the rights under the contracts or concessions are fair, reasonable, and clear.

To protect themselves against unforeseen regulatory or political risk, investors need to look at each investment on a long-term basis, and understand what exit options would be available and at what conditions.

DIVERSIFICATION AS A HEDGE AGAINST POLICY RISK

Diversification provides partial hedging, as follows:

- Sources diversification: In a generation portfolio, diversification across green energy and more traditional sources including gas, coal, and nuclear means you can benefit from (and be shielded from) different market developments. Such diversification will also allow you to manage the risk of legislative and tax changes placed on particular forms of energy.
- Geographical diversification: If you spread operations across three or four countries you can limit the impact of one country's political risk.
- Cash flow diversification: Distribution and transmission assets typically provide a more stable cash flow. By placing some regulated assets into the portfolio, you are diversifying from the important cash flow perspective, even though the risk profile remains the same.

FUTURE REGULATORY CHANGES TO THE POWER SECTOR

There is no question there will be further policy changes in the future. In Europe we are now seeing the unintended consequences that result from government policies – policies that are now being unwound. Regulators are starting to reassess the way regulation has been proposed so as not to deter future capital market investment.

In terms of new regulation, governments have a very difficult balancing act. When times were good governments could legislate around the development of renewables and create the subsidy regimes which have existed for the last decade or so; many of these policies have turned out to be unsustainable, because they are too expensive.

Policy change objectives need to assess the future very carefully to avoid creating new issues which could destroy yet more value across the power sector, particularly as Europe attempts to emerge from the economic impasse it has experienced in the last few years and works toward a position of growth.

MOVING FORWARD

Because of the short cycle of governments and the way in which politics works, it is important at the outset to make sure the provisions of offtake agreements are going to be fair and reasonable, and are also serving an essential need of a particular country. Where this is the case, any future government is going to be less likely to take discriminatory action against a project owner. Also, enshrining fair and reasonable measures at the outset within a longer term concession or licence is important as it effectively provides a right of recourse in the event of there being any future discriminatory action following a change of government.

For more information about the Global Infrastructure Practice and other solutions from Marsh, visit marsh.com, or contact your local Marsh representative.

EDWIN CHARNAUD
Chairman
Global Infrastructure Practice
+44 20 7357 3157
edwin.charnaud@marsh.com

MARTIN BENNETT
Senior Vice President
Global Infrastructure Practice
+44 (0)20 7357 2195
martin.bennett@marsh.com

SABRINA BAKER
Knowledge Manager
Global Infrastructure Practice
+31 10 406 0407
sabrina.baker@marsh.com

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