



Have you done your checklist?

More and more emerging market economies are seeking participation from the private sector to meet their respective energy infrastructure investment needs. Private sector investors have one non-negotiable requirement: their capital must be serviced. Policymakers too often forget this. Robert Pritchard, Managing Director at ResourcesLaw and Scott Flippen and Yi-Chun Lydia Liu, Associates at Taylor-DeJongh, explain more.



Energy policy is at the forefront of current debate in many emerging markets. In planning an energy infrastructure project for an emerging market economy, policymakers often underrate the importance of demonstrating that the capital required can be repaid by the project.

Yet this is exactly what is essential to attract the private sector, otherwise the capital must be provided out of public funds. Debt must be repaid; interest payments must be met; and equity capital must be compensated for the level of risk undertaken.

What are the implications of this for the financing of a new project? Proponents should be prepared to answer the threshold questions that bankers always raise:

- Is the economy growing and can it be expected to continue to grow?
- Is the market demand for the infrastructure already strong?
- Is there a creditworthy offtaker?
- Is there an enabling environment?

These questions are both basic and crucial, and without positive

responses a project will not pass muster. No amount of financial engineering can overcome weak project fundamentals and even projects with strong fundamentals will fail without a sustainable enabling environment.

As emerging economies turn to the private sector to meet energy infrastructure investment needs, it is more important than ever for policymakers to understand the steps necessary to attract and support investment in their countries' energy sector.

Need for capital is enormous

The need for investment is truly enormous; the International Energy Agency's (IEA) recently-released *World Energy Outlook 2006* estimates that developing countries will require over US\$10.5tn of energy sector investment through 2030. Some countries are struggling to decide how best to monetize untapped energy resources. Others are under pressure to secure resources to meet demand. The IEA predicts that between now and 2030 over 70% of energy demand

growth will occur in the developing world.

The sheer size of the required investment raises questions for many countries regarding the capacity of public finances to meet the need.

For example, statistics from a 2003 report prepared by the Asia Pacific Energy Research Centre show Papua New Guinea and Vietnam are projected to require 8.4% and 4.6% of their respective GDP for energy investments through 2020, while Japan and the US will require only 0.1% and 0.3% of GDP, respectively.

Lack of public funds has turned many developing countries to the private sector for the needed investment.

In addition, the private sector is attractive for other reasons. Private companies not only provide funds, but they also bring management and technical skills that increase efficiency.

A recently released World Bank study on private sector involvement in power markets, for example, shows that the privatisation of Chile's generation sector led to a doubling of annual

electricity production and a 37% reduction in wholesale electricity prices between 1990 and 1998. Private investment not only brings additional resources, but it also may better utilize the resources available.

Developing an energy strategy

Developing and following through on an energy strategy is the first step for policymakers to attract private investment. A clear strategy accompanied by appropriate incentives provides the right signal to private companies that the government supports their endeavours and helps mitigate political risk. One extremely successful example is Qatar.

Some 20 years ago Qatar was a relatively poor country lacking the resources and expertise to develop its huge natural gas reserves. That began to change in 1995 when Qatar, driven by a new leadership, initiated a series of new policies. These policies included changes such as amending the terms for exploration and production contracts and production sharing agreements (PSA) to attract private funds and expertise, with a special eye on liquefied natural gas (LNG) projects.

Other regulatory reforms included providing fiscal incentives such as tax holidays. Over the past five years, Qatar has successfully attracted over US\$40bn in investment to finance its mega projects such as RasGas and Qatargas. Private investments now account for more than one third of Qatar's oil production capacity and in terms of GDP per capita the country ranks near countries such as Italy and France.

Qatar is expected to become the world's largest LNG producer after 2010 and the government's current five-

year plan calls for US\$130bn to be invested in energy and infrastructure through 2011.

Establishing competitive energy markets

Promoting investment in energy delivery infrastructure is significantly more difficult than it is for upstream development.

One reason is the prevalence of monopoly infrastructure, such as power transmission lines or natural gas pipelines.

This is a dilemma for many governments. Monopoly control of critical energy resources must be monitored closely to prevent price gouging, thus many countries entrust control of these industries to state-owned enterprises.

However, SOEs can be inefficient, placing an undue burden on either consumers or government coffers and sometimes both. The most common solution has been to unbundle and privatise state-owned energy monopolies.

Private companies are more efficient when they are exposed to the forces of competition. An independent energy regulator can help create a competitive environment by ensuring open access to monopoly assets such as transmission infrastructure and enforcing universal licensing and technical standards.

The independence of the energy regulator is important in shielding the sector from political interference. Regulated tariffs may be needed to protect consumers, but with the understanding that private companies must be able to earn an economic return.

Setting below-market prices may earn political points in the short-term, but it is not a sustainable strategy.

Indonesia is a prime example of this. The country was once the world's leading LNG exporter, but subsidised sales to domestic natural gas

consumers diverted resources away from LNG exports. The country's LNG industry is now having difficulty meeting a significant portion of its sales contracts and foreign investors are approaching further participation in the country's upstream exploration sector with caution.

Supporting industries

Every industry can benefit from government support, and there are several methods that are especially appropriate for energy infrastructure. A performance guarantee by a government is one of them. Investors must have a high degree of comfort in the certainty of their investment's future cashflows because these projects are often financed solely on the basis of these flows.

Therefore, these guarantees of long-term take-or-pay offtake contracts, especially where the offtaker is government-owned, are often an effective way of ensuring that infrastructure projects obtain financing.

Some emerging market countries are seeking private investment that will change the composition of their primary energy usage for environmental or energy efficiency reasons.

This can be difficult to accomplish because there must first be sufficient demand to attract investment in the infrastructure needed to deliver new forms of energy.

Governments can help address these issues by introducing policies to create demand. Examples of such policies include environmental taxes on emissions that make clean energy substitutes more competitive, mandating a certain percentage of energy be supplied from renewable resources, or subsidising residential customers' initial connections to natural gas distribution networks.

These types of policies can help give investors comfort regarding the demand for the project to which they are committing funds.

Another means by which governments can support private investment in energy infrastructure is by collecting and making public data and information regarding the supply and demand balance within their economies.

Companies with access to reliable data can make better investment decisions and this helps the energy sector as a whole to avoid under- or overcapacity. It also prevents multiple companies from spending considerable resources collecting the same data.

What investors want

Private investors seek stable environments with manageable risks in which to invest and operate. The private sector possesses the resources, technology, and management skills needed to help fulfill the enormous investment needed in the energy sectors of many emerging markets.

A clearly espoused energy strategy combined with a stable environment and appropriate investment incentives form the foundation needed to attract this investment.

However, investment in many parts of the energy sector will also require a willingness on the part of governments to create competitive market conditions, to provide incentives for demand to reach critical mass, and to be realistic and forthcoming about the supply and demand balances within their countries.

Policymakers are effectively competing for capital, and their objective should be to construct an enabling investment climate. Then private investors will decide whether their capital can be safely serviced.