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Trash & burn

By Rishin **PATEL**

ESG investors find exciting prospects in the rise of energy from waste in an environment of UK inflation transition.

The geopolitical factors influencing investor decisions have played a significant role over the course of 2018-2019. Interest rates are still trending at record low levels across the UK and Europe, and they are not expected to change any time soon. Indeed, Mario Draghi has hinted at continued economic stimulus in the Eurozone, which may include further rate cuts if the economy doesn't start to improve later this year.

In the USA, Donald Trump continues to battle with the Fed. And after multiple rate hikes over the last two years, it seems very likely that the Fed will have to implement at least one rate cut this year, maybe two, in an effort to preserve the surprising strong performance of the US economy.

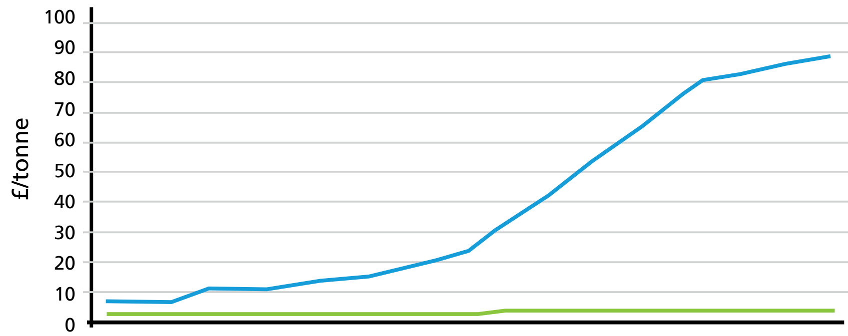
EfW enjoys new appeal

However, as investor yields are being squeezed in the western world, particularly in asset classes such as solar PV and wind, investors are increasingly looking at opportunities that were previously perceived as too risky. Energy-from-waste (EfW) being the most dominant by far in the UK over the past year. Previously, the risks associated with fuel supply were regarded as too high, but with the rise in landfill tax gradually increasing over recent years and a steep increase in the last decade, the economic returns available from EfW projects have materially improved. (See Graph 1).

The technological advancement in EfW and the level of output that these projects can now deliver is far superior compared to five or six years ago, making the asset class a viable and attractive alternative to landfill. This has led to waste management companies entering the sector alongside seasoned infrastructure investors keen to widen their investment focus.

In the UK, we observed a significant push to get EfW deals done over the last 12 months with Rookery, Earls Gate and Lostock EfW projects reaching financial close in quick succession, and we see a strong material pipeline of projects for 2019-2020. We expect at least three more landmark EfW projects will come to market over the next year.

Graph 1: Landfill Tax rates



	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Standard	7	7	7	10	11	12	13	14	15	18	21	24	32	40	48	56	64	72	80	82.6	84.4	86.1	88.9
Inert	2	2	2	2	2	2	2	2	2	2	2	2	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.6	2.65	2.7	2.8

Source: 360 Environmental

Global investors eye Europe EfW

As markets generally remain sluggish in the western hemisphere, with Brexit fog lingering over the UK and heightened trade tariff discussions between global superpowers, we have seen an uptick in investor interest and activity from elsewhere. This interest has largely come in waves from the Far East and the Middle East, where sponsors are looking further afield for yield especially in renewables such as offshore wind and large-scale concentrated solar power (CSP). Sponsor diversification has also been evident with focus on EfW in the UK and northern Europe from Middle Eastern investors.

With the contract for difference (CfD) round-three auction and allocation process well under way, we have seen an unprecedented amount of interest in the UK from international investors. Coupled with the EfW technological advancements, we expect both EfW and offshore wind to be the UK big winners of 2019.

CPI referencing for long-term contracts

Given the long-dated nature of CfD contracts, inflation assumptions within the sponsor financial model can have a significant impact on debt sizing and overall project economics. With indexation referenced to the consumer price index (CPI) in the underlying contracts, investors and their financial advisors will typically look to understand the impact of the uplift and how this can be managed effectively using derivatives. This reflects a significant change from the previous Renewable Obligations regime which referenced the retail price index (RPI), currently a much more liquid market.

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The UK RPI market is well established and derives its liquidity from the UK index-linked gilt market. However, the House of Lords has recently condemned the calculation methodology for RPI, which has resulted in a knock-on effect to the long end of the curve. This has led to market participants focusing their attention on future contracts referencing some form of CPI (or CPIH), which trades about 70-100bps lower than RPI (the 'wedge').

Luckily for CfD contracts, this should mean an increase in the size of the CPI hedging market, but it remains to be seen what the pace of this change is likely to be. Although, as the indexation for >

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the upcoming round is set to reference CPI instead of the so-called 'broken' RPI index, contracts are intended to be future proof.

Projects that won allocation in the last round have managed to hedge their CPI exposure through entering into an RPI swap along with a CPI-RPI wedge, accessed directly from the market. This synthetically creates a CPI swap that hedges the project's true exposure far more accurately. Markets will continue to develop on the back of the House of Lords' deliberations and the impact may be quite significant across the board.

However, we do expect to see competitive hedge pricing, an increase in liquidity appetite and more innovation on how these hedges can be placed. But one thing is certain, this transition will take time, as the market evolves and more CPI-linked issuances and CPI derivative flows are observed.

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Rishin Patel heads JCRA's Project Finance, Infrastructure and PPP business in EMEA, Asia and Australasia. JCRA's project finance team delivers independent advice and service on all aspects of interest rate, inflation, foreign exchange and commodity hedging for the public sector (PPP's), renewable energy developers and infrastructure funds. The transactions Patel and his team advise on are typically large and complex in nature. Patel has over ten years' investment banking experience servicing corporate and institutional clients at RBS, where he was responsible for distribution led financing origination and risk management solutions across multiple sectors and jurisdictions.
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