New Zealand onshore renewables: Equity financing at the project level

Infrastructure Series: What's on the horizon?

Over the past couple of years New Zealand has seen a big increase in activity in onshore renewable energy development, particularly in solar. Announcements of new projects, whether at an early stage or having secured consent or even financing, have become somewhat regular through 2022. By all accounts the total pipeline has grown significantly. One noticeable feature has been that the participants have become more diverse, with numerous independent developers now pursuing new solar projects of varying scales.

Not every proposed project will be built of course. Securing equity financing for construction will be one of the last pieces of the puzzle for any renewable energy developer hoping to convert its pipeline into reality. Nevertheless, a developer's approach to equity funding and the characteristics of the anticipated funding will play an important part in decision-making throughout development. And one approach that we are likely to see more of in the New Zealand renewable energy market is co-investment at the project level.

Investor considerations in the offtake strategy

In New Zealand the "gentailers" remain the biggest players in New Zealand's renewable energy sector. To the extent they pursue new generation capacity they are of course well placed when it comes to offtake arrangements, given their own need for electrons to service customers and ability to form a view on merchant power prices.

Many independent developers on the other hand will hope to secure some sort of fixed price offtake for a period of time, to support or increase the quantum of a project financing, and with a view to attracting long-term, low cost of capital infrastructure investors who seek a degree of certainty on the revenue stream. Where this can be achieved, there may be potential to realise material premium on a full or partial sell-down to such an investor even before the project has been built, with many low-risk infrastructure investors willing to take construction risk in the sector. As is common in Europe, such offtake arrangements are often structured as a "virtual" power purchase agreement (PPA) or a contract for difference, which in substance converts the project's merchant power pricing into a fixed price for the term and agreed volume of the contract. But originating and securing such a PPA with a material fixed price period is not a simple undertaking.

Other investors may be willing, or even prefer, to take more merchant power price exposure. In this respect a key consideration for any developer's offtake arrangement will be the requirements and the risk and return profile of the anticipated equity investors.

The context in New Zealand

The backdrop to the growing pipeline in New Zealand has of course been the declining cost of renewable energy and the broader story of electrification and decarbonisation. Whilst New Zealand already generates roughly 82% of its electricity from renewable sources, the Government has set an aspirational target of 100% renewable electricity generation by 2030. Looking to the longer term, estimates will vary across different scenarios but the Infrastructure Commission has noted that an additional 14.8 gigawatts of new electricity generation is expected to be needed over the next 30 years to meet demand.[1]

On the investor side, at a global level there remains significant levels of undeployed infrastructure investment capital. The first half of 2022 saw yet another record period of fundraising for unlisted, closed-end infrastructure funds.[2] That is despite an increasing inflationary environment, which to some extent may reflect views of the inflation protection inherent in some infrastructure assets.

Equity financing strategy and recycling capital

In terms of securing equity financing, a key early question for a developer looking externally will be how it plans to structure the investment and the likely pool of investors it will target. In the case of independent developers wishing to create value across a pipeline of projects, existing shareholders will likely have a desire to maintain a controlling shareholding in the developer itself. For those developers and for energy utilities who are capital constrained, this is where co-investment at the project level comes into play. A partial sell-down at this level enables value created through the development process to be realised and recycled into pipeline, whilst shareholdings in the platform are preserved and a meaningful stake in the project is retained.

Bringing a co-investor into a project pre-construction became a regular occurrence in the European offshore wind market over the past five to ten years. For offshore wind, the scale of the projects and the size of the equity cheque required for construction (and more recently to fund the high cost of development in the first place) is a clear driver of a desire to partner. By way of example, Ørsted, a global leader in offshore wind, would typically divest 50% of its UK offshore wind projects to financial partners pre-construction under a "farm-down" model in order to free up capital for further projects. The structure they deployed would typically allow the financial investor to raise project debt financing at a holding company level whilst allowing Ørsted to retain an unlevered investment and its group-level approach to debt financing.

The same principle of leveraging value created through development and securing a co-investor to help fund construction can equally be applied on a smaller scale, to the extent that developers of onshore renewable projects in New Zealand are capital constrained. Alternatively, where value is tied up in an existing operating project, a similar approach could involve unlocking part of that value to help fund new projects.

The potential of co-investment

For a co-investment at the project level there is significant flexibility in terms of the structures and commercial outcomes that can be achieved. The arrangement might involve a single project, a pool of projects or perhaps a strategic tie-up that is more focused on the complementary expertise of the partners than funding requirements. In terms of shareholding levels and governance, there are a multitude of considerations and different approaches.

The overall strategy and process for securing equity financing is crucial. Any external process that runs close to (or as a necessary part of achieving) a financial close or final investment decision will need to cater for the remaining uncertainties in the development process and any "cliff edge" deadlines for the project.

When successful, in addition to securing the project's necessary equity funding, such a process can also help to build a developer's own conviction in the project and the developer's broader strategy. And for those who are capital constrained or hoping to take forward more opportunities than their own balance sheet will support, it can be a powerful enabling tool.

FOOTNOTES

1. Rautaki Hanganga o Aotearoa (New Zealand Infrastructure Strategy) 2022-2052, Infrastructure Commission, footnote 414.
2. See Infrastructure Investor's Fundraising Report H1 2022.