

Working Document

(to be discussed at the Rural Electrification Workshop on 29-30 September 2014, Brussels)

Electrification Financing Initiative (ElectriFI)

Introduction

The new **Electrification Financing Initiative (ElectriFI)** aims to accelerate access to (rural) energy in developing countries by boosting private sector to yield business opportunities.

Past efforts supporting rural electrification were predominantly grant-based and therefore not generating a leverage that would allow reaching the ambitious policy objectives, whilst the sustainability of projects was not optimal.

ElectriFI aims at increasing the leverage of the EU efforts and resources as well as at ensuring sustainability through establishing a real partnership, geared by economic results, with beneficiaries and stakeholders.

ElectriFI will support rural electrification investments that have strong features for scalability and will be flexible in allowing the support of different business models, utilities, mini-grids and will be open to the main actor, which is the private sector, and also to public or private institutions (including Local Authorities, Civil Society etc.) depending on the needs and opportunities in each targeted country/region.

Unlike past support initiatives and apart from increasing leverage and sustainability, ElectriFI, by closing gaps created by market failures in the rural electrification finance in developing countries, will also provide for the repayment of the EU support in case investment projects will be successful.

ElectriFI initial allocation will be **EUR 75 million** but depending on the response of the stakeholders, could grow considerably with additional funding from national or regional (including intra ACP) allocations in particular for countries and regions having selected energy, and access to energy, as a priority objective for their cooperation with the EU. Other donors and impact investors could also partner and contribute to ElectriFI resources. In due course, a funding platform may provide additional resources.

ElectriFI will also establish links and synergies with any other parallel programmes and schemes promoting private sector investments in energy and energy access, in order to deliver the expected results.

Proposed ElectriFI structure

The financial institutions perceive the risk in rural electrification investments as high for them to get involved unless there is enough equity, which is lacking in developing countries. The ElectriFI proposal is based on the assessment of (i) existing market imperfections and failures leading to sub-optimal investment situations and (ii) the investment needs and alternatives in terms of financial support such as grants, equity, loan and subordinated debt.

Following such assessment, including through exchanges with the industry and potential senior debt financiers, the subordinated debt option through predominantly convertible grants has clearly prevailed as the best possible alternative.

Subordinated debt qualifies as equity for senior debt lenders as long as repayment is from cash flows otherwise available for dividends and default rights are predominantly exclusive with senior lenders.

Grants to be converted into subordinated debt could be made available:

1. at a very early stage through a convertible grant mechanism: monies are made available which convert into subordinated debt upon reaching certain milestones (like feasibility studies completed, financial close, project completion, etc.), or
2. at a somewhat later stage through direct investment by subordinated debt, or
3. at a very late stage through contingent risk capital to be used to cover delay damages, cost overruns, etc. in order to reach completion of investments.

The benefits from using convertible grants into subordinated debt are:

- Early stage involvement: positions can be taken (and therewith projects / corporates can be supported) prior to full negotiation on shareholder agreements or loan documentation and addresses the widely recognised shortage in equity.
- Rights and obligations associated with equity investments are not incurred: liabilities, if any, are capped to the grant-amount, no board-seats required, no valuation dispute settlement mechanisms to be agreed, etc.
- Convertible grants will only be made available if the overall bankability of the venture has been evaluated by senior debt lenders, which implies senior debt is committed (and therewith EU resources can benefit from early due diligence work by prospective senior lenders).
- Leverage is high by use of convertible grants i.e. all senior debt can be regarded catalysed.
- Convertible grants that convert into subordinated debt allow the EC (i) to forego on yield expectations, (ii) to offer long term subordinated debt at concessional rates, (iii) to offer long term subordinated debt at zero rate or even (iv) to forego on full conversion, making ElectriFI the most flexible partner in reaching bankability.
- Subordinated debt (up to 30% of total project cost) can be made available in cases where equity availability is low or comprised of in-kind contributions (5% to 15% of total project cost).
- Subordinated debt follows a pre-agreed repayment schedule and therewith provides for a natural exit mechanism.
- ElectriFI being actually a risk sharing mechanism for rural electrification investments in developing countries and at early stages of investments, is by nature meeting the additionally criterion; moreover, the repayment terms mitigate the risk of generating profit from EU grants/resources that might be associated in traditional grant schemes.

The applicability of using convertible grants (into subordinated debt) is excellent in several business models that may prove high **scalability for rural electrification**. Such business models include (i) the Energy Service Companies for stand-alone photovoltaic systems, or (ii) the A-B-C Companies with anchor load (for example a sugar or tea factory selling excessive energy produced from PV panels and biomass to a local grid) for hybrid-mini-grid power systems. ElectriFI could also work for 'intermediary' finance routes such as microfinance institutions (MFIs) or distributors of renewable energy modules (e.g. of solar home systems).

In any case no business model should be à priori excluded from ElectriFI support whilst strong focus must lie on the assurance of sustainability by involving also financially a private sector, profit seeking entity assuring inter alia the maintenance of the project.

Considering that a major bankability issue is the local currency and that most, if not all, investments will have local currency payments whereas debt service obligations will be probably in hard-currency, the devaluation risks are to be borne by equity-providers together with ElectriFI (and any other available

support programme providing currency exchange guarantee as appropriate), thus making investments more bankable.

The EC will make sure that due synergies and complementarity will be established between ElectriFI and any other initiatives supporting investments in rural electrification in developing countries.

Given the role and competence of the Development Finance Institutions (DFIs) the EC will make the necessary provisions so that the initiative could benefit, as far as possible, from European DFIs expertise even beyond their involvement in the determination of the bankability of those investment proposals submitted under ElectriFI, for which they may participate as senior financiers. Likewise, industry representatives (such as the Alliance for Rural Electrification) will be involved with advisory capacity and with the aim to ensure use of appropriate technologies better responding to the rural electrification challenges. The EC will be involved in the decision making process with a veto right.

The management of ElectriFI can be rather lean, in particular if other complementary schemes such as the Renewable Energy Performance Platform (REPP) or any available EDFI resources could be used for the enhancement of effectiveness.

Targeted Countries:	Developing countries.
Targeted Projects:	Rural electrification projects having quantifiable impact on the reduction of greenhouse gas emissions are environmentally beneficial and/or generate energy savings, carbon credits and/or tradable renewable energy certificates.
Lead Investor(s):	EC initially with the possibility to accept transfers from other donors / (impact) investors.
Size	It is important to signal to the market (and to possible lenders) that a structural solution for lack of equity for rural electrification is being established through ElectriFI. EC's proposed initial commitment is sizeable (EUR 75 million) with the intent to add further important commitments in the course of the next 3-4 years and depending on results in the longer term as well.
Manager:	An option under examination is to delegate the management of ElectriFI through an agreement between EC and one EDFI, or a consortium thereof and depending on results the possibility of adopting a fund structure could be considered. In such case an EDFI member having passed the EC's 6 pillar assessment, or a consortium thereof could act as the Manager. Another option under examination is the provision of certain management services in the context of the Renewable Energy Performance Platform (REPP).
Role of the Manager	Manager tasks will include:

1. Sourcing Investment Opportunities from calls for proposals at a frequency allowing well spread workloads throughout the year. Project assessments will be carried out by a 'centre of excellence' including experts identified by both the EC and the Manager.

2. Prepare Investment Thesis

The Manager will prepare an investment thesis and will perform an initial Know Your Customer check, will guide every venture in corporate governance (CG) best practice matters and will (have) perform(ed) an initial environmental & social (E&S) review. The investment thesis will follow a format used by senior long term debt providers for obtaining an in-principal approval.

3. Compliance assessment

- a. The specific investment is to address a market failure or sub-optimal investment situation (lack of equity), which has proven to be financially viable but do not give rise to sufficient funding from market sources.
- b. The final recipients are to be potentially economically viable at the time of the support through an investment by ElectriFI.
- c. ElectriFI support is not to create a distortion of competition and is to be consistent with the State aid rules as appropriate for investments in developing countries.
- d. ElectriFI is to provide support to final recipients in a proportionate manner to the risks taken by the investors and limited to the minimum necessary.
- e. ElectriFI support is to create a leverage effect, mobilising an investment that exceeds the size of the EU contribution.

4. Market Sounding on Overall Bankability

The Manager will have the investment thesis screened by the senior long term debt providers with specific attention to KYC, CG and E&S. The Manager will request Letters of Intent (LOIs) from senior long term debt providers and a lead bank in case the transaction reaches positive feasibility results.

The LOI(s) will need to contain sufficient detail on terms and conditions of prospective long term subordinated / senior debt, including a list of due diligence items requested.

5. Project Development

Make convertible grant or subordinated debt available. The decision on instrument will vary and is dependent on the role (to be determined) of the Manager during the development phase. Often a convertible grant which converts into subordinated debt upon feasibility or reaching financial close is used to avoid taking up equity responsibilities (board meetings for example) and liabilities (any possible unforeseen claims for example).

ElectriFI will make available transaction and finance deliverables such as financial model, business plan in the form of an Info Memo explaining inter alia the 'convertible grant' to 'subordinated debt' conversion features, supply contracts, shareholder agreement, etc. The Finance deliverables will include the finance plan, draft term sheets, etc.

Governance

The EC will make investment decisions within an operational board on the advice of the Manager. EU Member States, the European Investment Bank (EIB), EDFIs, UNEP and industry representative bodies may be invited to participate in such board with advisory capacity.

Closings:

ElectriFI will target an initial closing by mid-2015 which will comprise EC's contribution only. From time to time thereafter EC may provide further funds.

Investment Restrictions:

Except with the consent of the operational board, ElectriFI will comply with the following restrictions:

- (i) The minimum investment support amount will be EUR 300.000 (tentative amount) whilst due support will be made available to group potential beneficiaries' smaller projects to a size acceptable for ElectriFI;
- (ii) The maximum investment support amount will be set considering the interest that from the start a bigger number of projects can benefit from ElectriFI;
- (iii) Investment made in a single country will never exceed in total 30% of the ElectriFI aggregated commitments and
- (iv) Investment support to a single entity will never exceed in total 10% of the ElectriFI aggregated commitments.

The ElectriFI investments will not exceed 50% of the total assets (after such investment) of an ESCO or A-B-C Company or 75% of envisioned equity.

Investment Criteria:

Anticipated investment criteria include:

- Location in the geographic area of the targeted countries.
- Energy generation technologies that support rural electrification.
- Renewable energy solutions (hybrid systems with fossil fuels could be exceptionally considered if indispensable for sustainability).
- Screened for bankability purposes by senior long term debt providers – LOIs received.
- KYC, corporate governance and environmental & social review are explicitly reviewed in the LOI-stage.
- Based on known technologies.
- A reliable and experienced operator.
- Project sponsors in possession of all the relevant permits and licenses.
- Holders of long-term power purchase or off-take agreements (in the A-B-C Business Model) to distribute electricity or other energy products generated or produced by the project.
- A financing model which shows sufficient cash flows to support lending (e.g. a target internal rate of return (IRR) of 10-15 % excluding emission credit and/or renewable energy certificate cash flows).
- A minimum project size of EUR 1.5 million (tentative amount) giving a minimum investment amount of EUR 300.000 (tentative amount). The creation of Energy Service Companies and other similar Special Purpose Vehicles (SPVs) may contribute to bundling a number of small energy efficiency projects, which will help finance them.
- Smaller project proposals, in particular those involving Local Authorities and/or Civil Society Organisations, will be encouraged to aim for possible bundling to reach a size acceptable for ElectriFI and reduce transaction costs.

Expected Returns

Expected returns on subordinated debt: approximately 2/3 of envisioned equity returns but dependent fully on the business case (no interest charges are possible; also partly grant-funding in addition to no charge for interest is possible).

Roles of the Parties:

The Manager will be responsible for management of the investment portfolio, including sourcing, evaluating, structuring, documenting and closing the ElectriFI investments, ongoing monitoring of the ElectriFI investments, and, as necessary, sale or restructuring of the ElectriFI investments. The Manager may also handle all of the aspects relating to the generation and monetization of carbon credits and renewable energy certificates.

Management Fee:	Through the end of the investment period, the Manager will receive an annual management fee (the “Management Fee”) to be agreed.
Reporting:	The Manager will produce audited statements on an annual basis and non-audited statements on a quarterly basis. Carbon finance and renewable energy certificate dealings will also be reported to investors at this time.
Valuation:	ElectriFI assets will be valued by an independent Auditor.
Exit Strategy:	ElectriFI will be repaid from regular subordinated debt service.
Carbon Credits/RECs:	The Manager will coordinate the carbon finance/REC sales activities on behalf of ElectriFI, including project qualification, emissions monitoring, approvals and contract negotiation with potential credit off-takers