May 25, 2010

IFC's response to questions from the United Kingdom received May 24
Thailand Renewable Energy Accelerator Program

Dear Patricia,

Many thanks for responses to the questions we raised regarding the Thailand Renewable Energy Accelerator Programme.

Please note in relation to the issue of the possibility of a subordinated debt structure the CTF Financing Products, Terms and Review Procedures for Private Sector Operations states:

"MDB's will always seek the minimum conscessionality necessary to enable projects to happen and **will justify** the amount of concessionality requested in **each** CTF proposal". (par 10).

And

"In **all** cases, the **MDB would be responsible for explaining why it believes it can structure and implement the financeial instruments proposed in the CTF proposal**." (par 15)

While we recognise that it is unlikely that CTF funds will be subordinated in this instance, the proposal does see this as a **possibility**, however slim. We are still not clear on the circumstances in which CTF funds could be subordinated and what the justification would be. What are the senior lender constraints likely to be and might there be other ways in which these could be mitigated? What is the likely (however slim) proportion of the CTF funds that may be subordinated? Could it be for one or more of the potential deals? Should it turn out that there is a need for subordination, what conditions would go into the finance agreement to ensure that CTF funding is not exposed unduly? Could it also be clarified that in the event of a subordination of CTF funds that the pari passu IFC investment would be on the basis of a 50:50 apportionment of the loan?

Q: What are the senior lender constraints likely to be and might there be other ways in which these could be mitigated?
A: Subordinated debt would be used when the senior debt leverage that can be accepted by senior lenders is too low to enable the project to proceed.
Two examples of when this might occur are: i) for wind projects there is often quite high levels of uncertainty with regards to estimating energy production due to the complexities of measuring site specific wind resources and there can also be inter-annual variation in production. This limits senior debt leverage. Flexible subordinated debt can improve leverage and potentially enable a project to proceed; ii) for solar projects that use some of the more recent PV technologies such as thin film technology, senior lenders may take very conservative views on performance which may limit project leverage. This could be overcome with a subordinated debt tranche which enables the project to proceed.

Q: What is the likely (however slim) proportion of the CTF funds that may be subordinated? Could it be for one or more of the potential deals?
A: As stated in the Program Proposal IFC does not expect to use subordinated debt structures but would like to retain the flexibility to do so should specific project needs arise that require it. If 1 out of 4 projects required such a structure this could imply 25-30% of the total funds being subordinated.

Q: Should it turn out that there is a need for subordination, what conditions would go into the finance agreement to ensure that CTF funding is not exposed unduly?
A: As stated in the Program Proposal IFC would only structure a subordinated tranche of CTF funds if IFC was also taking a similarly structured subordinated exposure. This aligns interests to ensure CTF is only taking the risks that IFC would be comfortable to take with its own funds.

Q: Could it also be clarified that in the event of a subordination of CTF funds that the pari passu IFC investment would be on the basis of a 50:50 apportionment of the loan?
A: This would be a counterproductive structure to take. The intention in all cases is to minimize the amount of CTF funds used to enable a project to proceed. Subordinated tranches of debt take more risk than senior tranches and therefore, on commercial terms, must be priced higher. By increasing the proportion of relatively expensive IFC subordinated debt, a higher total amount of CTF funds would be needed for the concessional terms to have a material impact on equity returns and so to influence the project to proceed.

Regarding the issue of Demonstration as Scale and the response to the question asked previously, we understand now that the estimate of a tenfold increase in projects cannot be quantified, what are the steps in the process of achieving the envisaged market transformation? Can they please be spelt out?

The steps to be taken to achieve transformation are:

1. IFC makes investments in 3-4 wind/solar projects (structuring CTF funds to address the specific barriers in each case); IFC simultaneously works with local institutions, for example, universities and other market players to build local capacity for project development, manufacturing, EPC and O&M contractors, etc.
2. IFC works with local institutions (still to be identified) to create local capacity to gather and disseminate non-commercial information (access to market data has a significant impact on the perceived risk of the sector for investors and developers); IFC will also produce its own case studies and lessons learned documents for sharing at the operational and international level.
3. The establishment of successfully operating projects combined with more market information attracts additional developers and investors. Because there is a track record of projects beginning to emerge, investors are willing to lend at lower interest rates making projects more viable, and, because the track record reduces risks for developers, they begin to require lower rates of return to undertake a project. For these later entrants, the improved return and lower risks are enough incentive to motivate them to undertake projects without subsidies. If technology costs also decline over time, this will increase the rate of market uptake (and the contrary if technology costs increase).
4. As more wind and solar projects are developed, a demand for ancillary services is created. The capacity building programs that were initiated under the CTF program in earlier years begin to increase the skill base in Thailand which in turn reduces the risk for, and attracts more developers.
5. Eventually, a sustainable market is created.

It should be noted that the initiatives in this program are part of the larger CTF programmatic approach being undertaken by IFC and IBRD and which are leveraged by ADB. These include increasing local access to finance for energy efficiency and renewable energy projects through local financial institutions. As financial institutions get more comfortable with RE projects, access to and the cost of capital should both improve, further accelerating the rate of transformation.

Regarding developmental indicators related to market development, we recognise that it is difficult to quantify the number of new companies likely to be created, however there must be an expectation, based on a knowledge of the structure and capacity of Thai industry where this growth is likely to occur and in what proportion spread across the sectors listed.

While IFC is comfortable estimating and tracking indicators such as job creation, it is uncomfortable estimating and tracking the number of enterprises created for the following reasons. New jobs may be created by both existing companies and by establishing new companies; a few large companies may emerge or several smaller ones. Given that we are dealing with the private sector, it is near to impossible to anticipate what the market profile will be several years from now. For this reason, we prefer to focus on job creation versus company creation for the Thailand program.

Please can you respond to these questions in time for us to meet the Wednesday deadline.

Many thanks,

Simon