

Responses to Questions from SREP TFS Members on the Honduran Self-Supply Renewable Energy Guarantee Program

Prepared by the Inter-American Development Bank (IDB)

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We thank the governments of the United States and the United Kingdom for their questions. Please find below our responses.

Questions by the United States

(1) Has IDB considered a model where it would be working directly through commercial banks to support their entry into the energy efficiency/RE market?

Yes, it has, and in fact IDB has been supporting with its own capital credit lines with local banks in Honduras to on-lend to RE projects. In this case, however, IDB is proposing an alternative (yet complementary) approach, which will be able to more effectively utilize limited concessional finance resources, catalyze these investments in the short term, and provide the necessary demonstration to local financial institutions given that they are not yet prioritizing the specific market segment hereby proposed. As explained in the proposal, small-scale, self-supply renewable generation is in fact an underserved sector in banking. The project sizes are small relative to other utility-scale energy projects, and therefore energy divisions in banks typically do not cover them. These projects however are large in comparison with the corporate balance sheets of the companies that are implementing them, hindering their access to finance—in spite of the high financial returns of the projects—, since banks generally apply standard, asset-based risk criteria. This results in unnecessarily high risk premiums, high collateral requirements, and short loan tenors, which leads to these investments being often postponed or missed entirely.

Given these challenges, IDB is proposing this complementary approach to act as the anchor investor and attract other co-financing investment of at least 50 percent of the total cost of each project. IDB can structure SREP financing to mitigate risk for local commercial bank co-financing, thus crowding them in rather than out of these investments. The presence of IDB financing and the due diligence it entails, as well as the Program's Guarantee, investment-grade feasibility studies, and reduced transaction costs, will lower the risk profile of the projects and enhance the prospects of securing co-financing from FIs. In addition, in this case, given the limited size of the envelope, IDB's direct engagement in each transaction will also ensure optimal use of the concessional resources, targeting the projects where such resources have clear additionality, and thus ensuring both that risks are effectively mitigated and that the economic benefits of concessional resources are effectively passed to projects where such concessionality is needed to enhance financial viability.

(2) How does the efficiency of CIF funds compare to other CIF supported energy efficiency programs in other regions?

As we pointed out when responding a similar question concerning our Colombia CTF energy efficiency proposal, we think this comparison could be an interesting exercise, if properly done. However, we would strongly caution against looking at the related metrics (cost

effectiveness, leverage) without a robust comparative analysis of other factors, such as grid emission and other baseline factors, market segments, technologies targeted, and —most importantly— additionality of CIF (CTF or SREP) resources in each operation, as these factors can result in misleading metrics to understand the efficiency and leverage of the interventions. Another source of misleading asymmetries could be the ex-ante assumptions in terms of leverage/co-financing in each program proposal, which may differ significantly in their level of accuracy. With this caveat, and to give at least a basic sense related to the question, we took a sample of three RE/EE projects in other regions. Please note that we do not know the extent to which these figures (which differ significantly with each other) is representative of the CIF portfolio of similar programs. We do not know either to what extent the factors mentioned above in each of these countries and programs make them comparable to those in the proposed case. Below please find the results of the quick comparison:

	SREP Honduras Self-Supply Guarantee Program	Average of sample of 3 RE/EE programs in other regions
CTF cost-effectiveness (CTF \$/tCO ₂ reduced)	6.3	4.2
Total funding cost-effectiveness (Total \$/ tCO ₂ reduced)	56.3	38.5
Financial leverage (1:X ratio)	8.0	7.3

(3) Are there ways to enhance the efficiency of the TC elements of these projects by managing them together – given their strong similarities?

Efficiencies in the use of TC are already being captured given that the same team at IDB will be directly managing or providing inputs for the use of TC resources across various CTF and SREP programs, therefore: (i) avoiding any duplication in the activities funded; (ii) capitalizing knowledge generated by each feasibility study or capacity building activity supported by one or another program; (iii) optimizing procurement and cost of consultancies hired to conduct such studies, and (iv) leveraging other donor resources to share the cost of such TC activities.

The proposed size of the TC envelopes has been defined based on (i) the investment and mitigation results intended; (ii) the obstacle that feasibility study costs pose to the viability or investment decision-making of some of these operations (particularly of those done by first movers, where costs and risks are higher and even more uncertain before such studies), and (iii) the cost-sharing estimates done vis-à-vis other sources of financing for these TC activities (including the TC resources proposed under other CIF programs).

Questions by the United Kingdom

(4) We think the expert groups' previous reservation on the project remains valid. The SREP funds will be deployed to protect IDB not the private sector players who are required to raise 50% of the total project cost on their own. While the PAD sometimes refers to guaranteeing FI loans, the potential split and risk sharing between the use of the SREP resource is not discussed. We would like to be reassured that this issue has been fully considered, along with other issues raised by the expert group?

Yes, all issues raised by the expert group have been carefully considered. We offered detailed responses to all of them as part of our feedback to the evaluation (please see final version of the evaluation report with MDB comments), and have also made some adjustments to the project, where relevant. For example, as mentioned in your question, we now provide for the possibility of providing guarantee support to FIs also.

We would like however to provide further insight into the two points raised in this question: (i) SREP protecting IDB and not the final borrowers required to raise the additional 50%, and (ii) split and risk sharing with other FIs. Below some considerations on each of these points:

(i) SREP protecting IDB and not the final borrowers required to raise the additional 50%

SREP funding benefits final borrowers in various ways, on both risk and return aspects:

- SREP guarantees enables IDB's (and other FIs') debt financing, therefore reducing capital at risk for the final borrower (other debt or equity funding required up to 50% of project, instead of 100%) while enhancing financial return of the investment.
- SREP resources are proposed as guarantees, mainly, but per the proposal could also be structured as debt, thereby allowing IDB and SREP to finance up to 75-80% of total project costs, if there were no other sources of capital (equity or debt) that could complete the financing. Additionally the IDB could bring in other co-financiers to complete the financing package, including other concessional climate funds, if necessary.
- IDB's participation in the financing (for 50%) facilitates the raising of the additional financing required, since (i) IDB can directly bring other co-financiers, and (ii) its involvement—including the due diligence work it conducts and the fact that it is putting its own capital at risk, since SREP will only provide partial guarantee coverage—provides confidence to other lenders. Furthermore the SREP guarantee allows the IDB to provide junior, unsecured or lightly secured debt (debt secured only by the projects' assets, e.g. the solar panels), which frees up other assets that might be pledged to local banks to obtain additional financing, including short-term financing if necessary.
- Finally, risk should not be looked at in isolation, without considering reward: while SREP guarantees will be providing direct protection to IDB primarily, the financial beneficiary (from the IRR/return point of view) will be the final borrower, because the IDB will ensure that any reduction in the interest rate is passed on to the final borrower. The borrower's higher risk-taking is matched by higher returns.

(ii) Split and risk sharing with other FIs

The details of this will be determined on a case by case basis and cannot be defined in advance—they will depend on factors such as borrower needs and access to other FIs financing, as well as appetite from other FIs to participate, based on the credit rating of the borrower and the characteristics of the specific investment (size, required tenor, etc.). Based on this, the following possibilities have been identified, each of which will have different levels of participation by other FIs and arrangements in terms of risk sharing (and compensation):

- SREP provides partial guarantee to IDB, who is the only lender in the transaction: this will be the case only when (i) debt leverage required to make project financially viable is up to 50%, and (ii) other FIs are not interested/capable of financing.
- SREP provides partial guarantee to both IDB and other FIs on equal terms.
- SREP provides partial guarantee to IDB allowing for unsecured or minimally secured loans; borrower obtains senior or secured loans from other FIs which benefit from IDB's subordination (other FIs loans may have shorter tenors).

(5) On the results framework, the expected annual MWh savings (45,000 MWh) are about half of what was indicated in the original concept (80,000 MWh). Based on the expectation of 20MW RE capacity installed this implies a capacity factor of 25%. This suggests that the majority of new installations will be solar as opposed to biogas (CF 20% vs. 75%). Is this the intention or expectation (further to the annex I)?

The expected annual output from renewable energy is based on a pipeline of feasibility studies conducted to date in Honduras. At the concept note stage, early market and feasibility studies indicated solar and biogas/biomass as having the greatest potential among RE technologies for scale-up and applicability for self-supply generation investment by the private sector in Honduras. At the time, it was assumed that investments would roughly be split equally between these technologies, using the CIF recommended capacity factors for solar and biomass (no CF was provided for biogas).

The pipeline in Annex I has been refined to further reflect a nascent solar industry that is quickly garnering attention among private companies as a self-supply generation solution. This increased interest has resulted in a number of additional feasibility studies that are either underway or have been completed since the concept stage, demonstrating the potential for scale-up and replicability of solar projects. The IDB has played an active role in this developing trend through its Self-Supply Renewable Energy Finance Facility.

Although non-sugarcane biomass technologies are also emerging, access to feedstock and siting is more challenging. Biogas and biomass systems are inherently more customised solutions, tailored to particular industries and locations that must not only have sufficient electrical and process heat demand but also feedstock available in the right volume, quality, and distance from the site, among other considerations. Therefore, while the IDB's feasibility studies have identified projects that could demonstrate several technology applications within the Honduran market, the pipeline assumes a more conservative scale-up of these biogas and biomass investments.

The average capacity factors assumed currently are still 20% for solar and 75% for biogas and biomass based technologies, as in the original concept. However, the results framework

now reflects a pipeline allocating roughly 85% of investment to solar and 15% to biogas and biomass. Additional information from recent feasibility studies and supplier quotes was also incorporated into capital cost assumptions. Furthermore, biogas installations are smaller in capacity and have lower capacity factors than biomass ones. These factors were therefore considered in producing a more conservative target for the expected annual output from these installations.

(6) Gender considerations are not very fully developed in the proposal, and an implementation strategy on gender (potentially in the wider context of a social development/impact strategy) should be developed for the programme, as well as ensuring adequate gender/social development expertise within the project implementation team and evaluators

The IDB's Gender Action Plan for Operations 2014-2016 sets strategic priorities for private sector windows to promote the implementation of inclusive policies in private entities. The IDB's Structured and Corporate Finance (SCF) department therefore employs Gender Appraisals which help clients to develop strategies for gender equality through corporate processes (human resources, capacity building, and supply chain integration). The project implementation team currently includes two gender specialists who will be tasked with mainstreaming gender considerations into the proposed program.

Although within the project scopes of rooftop solar and wastewater biogas projects it is difficult to identify gender opportunities, outside of the direct project scopes we seek to engage clients we lend to on broader gender issues. The gender specialists will be engaged to explore opportunities with client beneficiaries and help implement measures where possible. This gender analysis implementation strategy will identify gender-specific opportunities by:

1. Assessing the company's workforce and supply chain for greater gender inclusion.
2. Estimating the costs and benefits to the company and nearby communities of increasing female participation.
3. Developing optimal business strategies for enhanced gender equity.

From a reporting perspective, the IDB's development effectiveness officers will assign monitoring and evaluation indicators to each project, which are included in an annual Project Supervision Report. In addition to climate, energy, and economic indicators, the development effectiveness system tracks sex-disaggregated indicators such as employment, training provided, and number of jobs added to the formal sector, where relevant. Although the program targets self-supply renewable energy projects with private companies—which limits the applicability of employment indicators—, these results will provide input into the CIF Admin Unit's as well as the IDB's monitoring and reporting outcomes, as part of the wider coordination between the CIF's gender working group and the MDBs that is set out in the CIF Gender Action Plan.