Evidence for the UK Parliament’s Committee on Energy and Climate Change Enquiry

Investor Confidence

October 2015
About IIGCC

The Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration on climate change for investors. IIGCC has 115 members – mainly mainstream investors – with a combined €12 trillion of assets under management.

IIGCC’s mission

IIGCC provides investors with a collaborative platform to encourage public policies, investment practices, and corporate behaviour that address long-term risks and opportunities associated with climate change.

IIGCC pursues its mission through two strategic objectives:

1. Changing market signals by encouraging the adoption of strong and credible public policy solutions that ensure an orderly and efficient move to a low carbon economy, as well as measures for adaptation.
2. Informing investment practices to preserve and enhance long-term investment values.

See more at www.iigcc.org
Summary

Successful implementation of the UK Government’s long-term economic plan will depend on modernising the country’s infrastructure. Low carbon energy infrastructure forms a substantial part of that plan.

To date, UK energy policy has been successful in attracting institutional capital. Whether it will continue to do so depends on the Government’s current energy policy review and the vision that it sets. With the correct risk profile, institutional capital can continue to be long-term, low-cost capital that complements investment by the financially constrained utilities.

Over the last 25 years, the UK has compared favourably to other countries in terms of policy and regulatory risk, not only in energy, but in overall infrastructure. This is in large part due to the UK’s best in class consultation process which gives timely notice of changes and opportunities to comment, coupled with an immutable commitment to grandfathering and avoidance of retroactive changes. Investment in renewables has been encouraged by the UK’s clear commitment to decarbonise as defined by the Climate Change Act. The series of changes to the energy policy announced by the new Government over the summer of 2015 is raising concerns with investors. Although not retroactive, these changes have come faster and with shorter consultation periods than in the past. This raises questions about the direction of future policy. To be clear: not all investors are writing off further investment in the UK, but investors do perceive that policy risk has increased and are closely monitoring developments.

The implications of these most recent changes have yet to play out for two reasons. First, there is a supply of new low carbon projects that have secured planning consent and will continue to benefit from the current subsidy schemes because of the transition rules. Second, we are still waiting for the Government’s new policy vision.

In forming that policy we understand that the Government needs to balance effort to meet its legally binding carbon reduction and renewable energy commitments with the need to keep consumer costs low, considering energy security and maintaining the UK’s competitiveness in the global marketplace. This can be a delicate line to walk as it involves several different trade-offs: Between short-term cost reductions and investment for the future, and between Government intervention and the cost of capital, which is in large part a function of policy risk.

IIGCC supports efforts to lower the cost of low carbon investment and believes government policy has been very successful at driving those costs down to date. However, when support is cut to levels below where the industry stands today, or is eliminated, low carbon investment falls, putting carbon and renewable energy targets at risk or requiring a frantic pace of investment in future years. While future policy remains uncertain, institutional investors are more likely to limit investment activity to grandfathered investments and will slow down investment until policy is clear. Already, the Committee on Climate Change has warned that delivery of carbon budgets in the 2020s is at risk. Whatever the outcome, it is clear that further and more regular engagement between the Government and institutional investors is needed to make sure that capital continues to flow.
Where is future investment in the energy sector going to come from? Which types of entities/organisations will invest?

The Institutional Investors Group on Climate Change’s 115 European members manage more than €12 trillion of assets. Globally, institutional investors manage around GBP 70 trillion, according to the OECD.

In particular, IIGCC members have already made significant financial contributions to the roll-out of low-carbon infrastructure. The UK has been a leading European destination for institutional investment into low-carbon technologies over recent years. Financial investors invested nearly EUR 6.4 billion in equity in EU renewable infrastructure in 2014, of which nearly EUR 4.0 billion was invested in the UK.\(^1\) The UK has been an attractive destination for institutional capital, due to its stable macro-economic environment, favourable economic outlook, and – historically – strong policy frameworks in the energy sector that have only recently been thrown into turmoil. This is against a background of strong growth of renewable energy to date: according to data by the Department of Energy and Climate Change, the total share of electricity generated from renewable sources increased to 25% in the second quarter of 2015.

Since the privatization of the UK energy sector in the 1990s, the overwhelming majority of the capital invested in UK energy has come from the private sector, primarily through institutional investors. It has come from institutional investors indirectly as via investments in listed utility and oil company shares and bonds or in private infrastructure funds. Increasingly of late it has come directly as pension funds and insurance companies make direct investments in unlisted energy project debt and equity. Maintaining these public and private, direct and indirect flows of institutional capital are essential for future UK investment.

Prior to 2010, most of the institutional capital flowed into the sector through listed utility debt and equity. Starting in 2010, with utility company balance sheets constrained and institutional investors improving their expertise, an increasing amount of capital has been invested as unlisted debt and equity by pension funds and insurance companies directly or indirectly through specialized infrastructure funds. With the conditions constraining utility balance sheets unlikely to change, these private investments are likely to increase.

These direct project investments with due diligence and valuations often rely directly on regulated cash flows and are thus more exposed to policy risk than utility shares: the typical listed European utility operates in multiple countries, across the entire sector vertical (generation, transmission and distribution), offering considerable diversity. Direct investments in projects do not have this diversity, hence the focus on regulatory and policy risk.

What are their criteria for investment decisions?

The role of the pension funds and insurance companies that account for most of IIGCC’s membership and who provide capital to the fund managers who are also IIGCC members, is to invest the contributions and premiums of workers and families in order to provide long-term financial security as pensions, life insurance or property and casualty losses. They are long-term investors, who have to match investments to their long-term obligations whilst maintaining liquidity.

On average, 90% of institutional capital is allocated to capital markets (i.e., listed equity and bonds) and accordingly, the majority infrastructure investment of IIGCC members is indirect investment through listed companies such as power utilities. IIGCC members are the most significant providers of capital to those companies. The remaining 10% of institutional capital is allocated to unlisted investments including real estate, private equity, hedge funds and infrastructure.

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Infrastructure, including energy infrastructure, has emerged as a distinct asset class and the trend is for pension funds and insurance companies to allocate 5-10% of their assets to infrastructure (EUR 600 billion to EUR 1.2 trillion if all IIGCC members made such an allocation). Infrastructure investment has risen rapidly in recent years, with pension funds and insurance companies investing both directly and through dedicated private funds.

Investors are attracted to infrastructure for several reasons – long term predictable cash flows from the provision of essential services, inflation protection as revenues are often linked to inflation, and lower volatility than the capital markets.

**Investment case**

IIGCC members have a fiduciary duty to invest their capital for profit in order to fulfil their obligations. The expected profit, or minimum rate of return on each investment is a function of level of risk of each investment over and above the “risk free” return of the local government bonds. Thus investors expect substantially higher returns from venture capital and private equity, and lower returns from real estate and infrastructure. Within infrastructure, the “hurdle rate” of return is highly project and sector dependent. The aim is always to optimise the risk-return relationship and to select the most attractive projects. This doesn’t mean a single-minded focus on chasing the highest returns, but choosing projects which optimise risk across any portfolio and offer attractive returns.

Returns are usually measured on the basis of their internal rate of return, which is the discount rate at which the present value of the cash flows from the investment equals the initial investment, or in other words the rate at which an investment breaks even. Annual dividend yields and cash flows are also considered. The investment case is an important part of any consideration given by an IIGCC member, and governments can go a long way to support institutional investment by providing the right stable macroeconomic and regulatory environment for projects to become more attractive. Nevertheless, infrastructure projects need to be commercially viable and competitive globally and to other investment opportunities across all asset classes. Currently, there is a large amount of competition to invest in good projects.

Many investors globally are beginning the journey of decarbonising their portfolios with many publically committing to invest in low carbon assets. With similar rates of returns, many investors would rather future proof their portfolios by allocating to a low carbon asset.

**Optimising portfolios**

GCC members aim to optimise their portfolios, in particular by selecting assets that have the right risk-return relationship and that have a low correlation to other assets so that risks are not amplified. They must also balance geographical considerations and the associated regulatory and macroeconomic environment, striking a balance between different asset classes and geographies and protecting themselves against macroeconomic risks such as inflation. IIGCC members evaluate investments in infrastructure against other opportunities, such as government bonds and equity markets, as well as against other industries and countries. Within our infrastructure investments, IIGCC members also tend to spread risk across sectors.

**Asset-liability match**

The overarching priority for institutional investors is always to match assets and liabilities, i.e. to ensure that asset owners can at all times meet their responsibilities towards pension and insurance policy holders which are often inflation-linked. Infrastructure investment requires high up-front capital expenditure but steady “annuity-type” cash returns over decades that are in general reasonably predictable, and hence can provide a good asset-liability match.
How does the UK compare with other countries in terms of policy risk? Are there examples of best practice that the UK could learn from?

Compared to other countries, over the past five years DECC has managed energy policy well, on schedule and without retroactive changes. Having said that, the frequency of consultations and changes can at times be daunting for investors to engage with. Since the RO was adopted in 2002 each year has seen at least one major energy consultation, and sometimes more. This is much heavier than in other countries.

Electricity Market Reform (EMR) is a highly ambitious and comprehensive framework that was intended to address a capacity crunch, deliver on carbon budgets and save consumers money. The intention was to accelerate the maturing of low-carbon technologies so that they could compete, in the end, on a technology neutral and level playing field. Until that moment, technology specific support would be provided.

In the process of implementing energy policy, the previous government made a number of announcements that were not conceived during the inception of the previous government’s energy policy – such as the early introduction of auctioning to groups of technologies, the freezing of the carbon price floor and the earlier closure of the renewables obligation certificate scheme for new large-scale solar projects.

Every change of policy involves a cost for some market participants. However, if policy changes are announced with sufficient lead time, are in line with the overall direction of energy policy, are not retroactive and result from an extensive and objective consultation they are acceptable to investors.

Recently, the UK government has made a surprise announcement that it would reduce subsidies for small-scale solar previously supported through the feed-in tariff scheme. This announcement came on top of the Conservative manifesto pledge to end all new support for onshore wind, early closure of the RO and removal of the climate change levy exemption for renewables.

Taken together, these changes – and the much faster than historical pace – have placed policy and regulatory risk at the front of investors’ minds. While these changes have been prospective, and therefore have yet to affect investment in projects that benefit from the transition, there is a potential that they could result in a substantial decline in UK low carbon investment. The list of low-carbon technologies that will still receive support from the UK has now become rather short. While some low-carbon energy projects will probably go ahead without support, deployment levels may not be high enough to deliver the UK’s legally binding carbon budgets.

There is no one single country that has developed an optimal approach. However, there is a clear relationship between a stable and reliable political framework and the minimum returns investors are willing to accept from projects. In some countries, investors require a hurdle rate in the high teens, whereas in other countries investors are willing to accept an internal rate of return (IRR) in the low single digits. The UK has dramatically reduced the cost of capital required by investors, but recent changes threaten to undermine the significant progress made over recent years.
How well does DECC consider the needs of investors in its policy making process?

Currently, the government does not fully consider the needs of institutional investors in its policy making process. The fundamental reason is a new belief on the reduced role of government in the energy sector. However, IIGCC does not believe that completely eliminating most subsidies for low-carbon energy will in the long run be the best way of delivering the best deal for consumers. The best deal for consumers will be delivered if the cost of capital is lowered further and cost reductions are rapidly reflected in support schemes. A transition to a low carbon economy unfortunately will not be achieved by market forces alone, especially while carbon prices remain low.

There are two central trade-offs that need to be managed. The first trade-off is between driving energy costs down in the short-run (with the downside of lowering investment levels), and ensuring long-term competitiveness and resilient ‘climate sensible’ infrastructure by investing for the future. If too little investment takes place now, energy prices will go up in the future and security of supply will be placed in jeopardy. At present, this trade-off between future benefits and present costs is not being managed, because the government is still reviewing its energy policy.

The second trade-off relates to the cost of capital and thus also to future energy prices. The basic trade-off is between government intervention today – which lowers the cost of capital and thus future prices by removing some of the risks such as fossil fuel price volatility reflected in wholesale market prices – and the trimming back of government intervention, which might reduce prices in the short run but drives up the cost of capital and thus future cost. Exposing low-carbon energy producers to full market risk would increase risks. Reducing risks by providing long-term contracts is a useful way to lower the cost of capital, as long as care is taken that these long-term contracts are set at the right tariff level and that cost reductions are reflected in those levels. This second trade-off is also not being addressed, because the government's energy policy vision has not been articulated yet.

The question should not be the extent of government intervention, but the quality of it. Government should put in place the right, stable long-term frameworks so that private capital can flow. IIGCC members are comfortable as long as government intervention does not crowd out, but crowds in private capital. In reality, without any form of government intervention, very little investment into decarbonisation and security of supply will take place from institutional investors – because the assets will not have the right risk profile. Institutional capital is needed because it is amongst the most long-term and low-cost sources of investment.

Government should manage support schemes so that the cost reductions are reflected in support levels. The best deal for the consumer will be delivered if the right balance between these two trade-offs is struck. However, the complete abolition of support schemes will cause upheaval across the project chain and dramatically reduce investment levels, since most projects will not meet risk-return requirements. Whereas in many European markets gradual reductions in support levels did not reduce investment levels, it can be safely assumed that the complete and sudden abolishment of support schemes will. Again, this would endanger attainment of the UK’s carbon budgets.
What steps could DECC take to reduce policy uncertainty and increase investor confidence?

In the short term, DECC needs to clarify whether it intends to proceed with an allocation round for technologies still receiving support this year. This is particularly relevant for IIGCC members, who are currently reviewing their involvement in the UK low-carbon energy sector. Many investors are no longer considering investments in UK energy related assets (across renewable, fossil, nuclear) due to specific UK policy risk.

In the medium term, DECC in consultation with HMT needs to clarify the scale of the levy control framework (the UK’s low-carbon support budget) beyond 2020/2021. This framework should be defined at least until 2025, in line with advice from the Committee on Climate Change, so that investment decisions with long lead times can be taken.

National Grid has recently predicted solar energy to be competitive with other sources of generation in 18 to 24 months. Support to solar energy should reflect these cost reductions, but not be reduced to an unsustainably low level. Storage and demand-side response are an important solution particularly for the rise of distributed, renewable energy sources. They should be cornerstones of government intervention in the UK energy sector.

The government should provide clarity on the future development of energy policy in the short term and post-2020. Central to this should be a new balance between government intervention and the market in UK energy policy.

DECC and HMT also need to actively and directly engage with the owners of capital in UK and Europe as there is significant investment potential close to home. Decision-making by the UK government should be more transparent and more mindful of the needs of institutional investors.