KEYNOTE INTERVIEW

The additionality allure


Investors in renewable energy funds want to back new clean energy fleets that are displacing existing fossil fuel generation, say the co-heads of Capital Dynamics' clean energy team, Barney Coles and Dario Bertagna

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Q Where are we today on the journey to net zero?

Dario Bertagna: Over the last decade we've made incredible progress, but the road to net zero is still long and twisted. The targets that have been set across the UK and Europe are very ambitious in terms of timing – the latest REPowerEU initiative, where member states are setting an ambitious goal of hitting 45 percent of energy use from renewables by 2030, will require substantial efforts from both governments and the private sector.

Will we get there in time? I'm not sure. It will certainly be challenging as there are still several asset development bottlenecks related to grid upgrades and planning approval processes. But the good news for discerning investors is that there remains a huge amount of investment into renewables required to support the power sector in meeting net-zero goals; particularly important in this period of geopolitical instability.

Q What impact is that geopolitical instability, and particularly war in Ukraine, having on the energy transition in Europe?

Barney Coles: Momentum behind the energy transition in Europe has been building over a long period of time and has intensified in recent years. The first multilateral agreement around the phasing-down of fossil fuel use was reached at the UN COP26 conference, for example, with reams of follow-up legislation passed at the back end of last year and early in 2022. However, events in Ukraine started to take over, which have temporarily destabilised the energy transition to some extent.

The situation is changing on a near daily basis, but what we have tangibly seen is countries such as Germany and Italy clearly pivoting away from using Russian gas as part of broader sanction programs. That has accelerated the need for countries to increase domestic energy generation, with renewables representing the quickest and cheapest way of increasing power capacity. Indeed, there have been indications of increased governmental support for renewables coming out of Germany and the UK, as well as other European markets, in recent weeks.

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> **DARIO BERTAGNA**

However, in the immediate term – until that new capacity is built – there are a number of bridging initiatives being implemented to literally keep the lights on during this coming winter. Unfortunately, out of necessity, we therefore expect to see the temporary reopening of mothballed fossil-fuel-based generators, which clearly will disrupt Europe's progress towards net zero. Longer term, the move away from fossil fuels and towards renewables is accelerating.

DB: Importantly, that acceleration is no longer solely driven by net-zero objectives. Political consensus across the continent has hardened around the need for energy security and minimising reliance on imported fossil fuels in light of the events in Ukraine.

Q How would you describe investor appetite for renewable energy today and how is it evolving?

Barney Coles: Investor appetite for European renewable energy has been increasing steadily over time. What is particularly interesting is the level of active engagement from investors based outside of Europe. There is a clear and growing recognition globally that Europe is the most attractive renewables market today, and that is being reflected in fundraising.

In particular, appetite has been supercharged over the past 12-18 months. That is due, in part, to institutional investors' increased focus on ESG investing. We have obviously seen the displacement of a lot of institutional investment in the traditional oil and gas space, much of which has shifted into renewables; a strategy that fits well with an investor's own net-zero and sustainability objectives. But there is also a growing recognition that correctly structured renewable energy investments offer a high degree of certainty around cashflow generation, and healthy risk-adjusted returns when compared to other core infrastructure strategies.

However, within that, we observe that more and more capital is looking for exposure to strategies that are building new renewable energy capacity and therefore actually contributing to the transformation of Europe's energy sector, as opposed to strategies seeking yield from existing operating assets.

Q What do high energy costs mean for the renewables market?

BC: The geopolitical situation has contributed significantly to higher power prices globally, which is having a crippling impact on household energy bills. But higher power prices also act as the market signal to new entry; marginal renewable energy projects that would not have been deemed economically viable just six months ago would now offer investors a commercial business case due to the forecast higher pricing.

In a purely economic sense, the high power price environment is creating the conditions for an extensive roll-out of new renewable energy generation infrastructure and therefore accelerating the energy transition. However, this must be balanced by the need to protect household energy bills in the short term, which is why we are seeing programmes of temporary government intervention.

Q What about the impact of inflation and wider supply-chain disruption on construction costs?

DB: While increased power prices have enabled renewable power plants to capture more revenues, this has been offset to some extent by increases in construction costs. The supply chain has also been disrupted during and following the pandemic; lead times for key components remain affected but we are finally starting to see significant improvement.

Crucially, the way we mitigate our investments' exposure to inflationary pressure is through optimisation of the revenue protection across all of our investments, either through structured power-purchase agreements with direct inflation linkage or by maintaining some limited degree of merchant exposure.

Q Against this backdrop, where are you seeing the most interesting renewable energy investment opportunities right now?

BC: We have a relatively narrow focus because we think that allows us to be more disciplined in delivering returns for our investors. We believe strongly that the most attractive opportunities in energy transition remain in well-structured investments in most mature renewable energy technologies – in other words, wind and solar.

In terms of stage of investment, we do not look to acquire operational assets that have already been de-risked. We view that investment space as mainly a competition between buyers' cost of capital, which also doesn't achieve what many of our investors are really looking for, which is true additionality. We deliver brand-new renewable energy infrastructure, which displaces fossil fuel generation across Europe. Our strategy involves building this infrastructure out, managing construction and finance and putting long-term contracts in place to cover the sale of the green electricity we generate (PPAs), creating certainty of cashflow, before eventually exiting to the competitive market for operating assets.

Finally, in terms of geography, we believe the UK, Spain and Italy, where Capital Dynamics has established vertically integrated platforms with 'boots on the ground', remain the most attractive jurisdictions from an investment perspective. It's no surprise the most interesting regions are where the basic fundamentals are most favourable; in other words, where the wind blows the most – the UK, Ireland and the Nordics – and where the sun shines the most – Southern Europe.

"We believe the UK, Spain and Italy… remain the most attractive jurisdictions from an investment perspective"

BARNEY COLES

DB: These are all markets that facilitate subsidy-free investment where new renewable plants can replace conventional facilities. Renewable energy investments no longer require a feed-in tariff to be viable and the PPA market in these jurisdictions is liquid and well developed. We recognised this trend early and this has enabled us to be among the first movers in these markets.

Q Clearly, renewable energy investment is inherently impactful from an environmental perspective. But what other ESG considerations do you take into account?

BC: You are right. Our investments are innately environmentally friendly, but that ignores a lot of the other work that we do, both on the environmental side and around other aspects of ESG. We have a stringent ESG scoring methodology which we use both to appraise any new investment and provide ongoing monitoring post-investment. Our proprietary score card, R-Eye™, produces a score for an investment of between one and five based on alignment with the relevant UN Sustainable Development Goals, and it goes on to form a critical component of investor communications as part of our suite of reporting. In other words, ESG is a major part of how we address renewables investing.

Obviously, our portfolios have low carbon emissions. However, the development, construction and day-to-day operations of a renewable energy plant will produce some degree of emissions, albeit tiny. We are committed, as net-zero investors, to offset those carbon emissions.

That said, the inherently environmentally friendly nature of our work means it is the social component of ESG that takes up most of our time and attention. Renewable energy investment commonly brings with it positive social impact, not least because these assets are built closer to the more remote communities of the UK and Europe. That infrastructure brings with it local jobs and skills, as well as being a focal point for the community. A typical wind farm may create up to 100 jobs through the construction and operational phase, for instance.

DB: Another aspect of ESG that is very important to us is our rigorous due diligence with regards to counterparty selection and our supply chains. We have very stringent onboarding criteria and are particularly focused on issues such as upstream labour practices. We work hard to ensure that all the counterparties we work with are reputable and are applying ESG criteria to themselves. ■