„What are the risks in the current economic, financial and political environment?”

[Banking perspective]

István Salgó
CEO, ING Bank N.V. Hungary Branch
Budapest, October 5, 2012

Introduction

- Natural gas and oil sector is primarily driven by geopolitical issues with transnational decision making, while
- Decision making in the power sector remained more on national level, which is driven by affordable price at acceptable level of supply security
- Main issues to be discussed in the power sector:
  - Security of supply – large import dependence of Hungary and Balkan states
  - Expected demand – economic development, industry, consumption, savings, new technologies
  - Role of sponsors, banks, government etc.
  - Financing mechanisms – PPAs, capacity fees, PPP, project finance, BS finance
  - Financing of renewable technologies – subsidization (mechanism and its burden on the economy/households), financing structures largely depending on the subsidy system (and its stability)

Transforming sectors

Transformation of energy sector

- Higher expected proportion of renewable energy increases the role of regulation, and transforms the market position of conventional technologies (competitive position, reserve requirements, etc.);
- Decentralisation of the power system needs to be handled both technologically (grid requirements), and financially (efficient financing of small and distributed projects);
- Transmission and distribution grids are facing new requirements (smart technologies, decentralization), which require large capex in the network; and
- Phasing out of nuclear technology on same markets has effected competitive position of other technologies as well.

Transformation of banking sector

- Basel III requirements affect financing ability of banks, due to higher equity related requirements:
  - **Capital requirements** (min. 7% of RWA reserve requirement depending on the activity of the bank) have been met at most European banks, and are likely to be met from going forward;
  - **Leverage ratio** (size of the BS – including off BS items – may not exceed more than 33x core tier 1 capital) needs to be managed with BS management; and
  - **Liquidity requirements** are scheduled to be introduced from 2015, which are going to effect lending appetite of banks. Client relationship is going to become crucial, and a strong relationship throughout all banking services will be a decision factor in lending decisions. Only banks having strong relationship with its clients (other than loans or deposits) will be able to pass stress tests with competitive capital structure.

Role of financing

Cost efficiency – Key for competitiveness

- Energy companies are operating on an international market, where competitiveness is driven largely by cost efficiency
- Similar technologies are available for market participants with similar cost characteristics
- Apart from commodity price differences on regional markets, financing costs of the projects can vary for different projects

Cost of financing has became a key success factor for energy companies

Key drivers of financing costs

Country risk

- Large differences can be observed in country risk premia within the CEE region
- Projects with capital intensive technologies (i.e.: nuclear, wind) will enjoy competitive advantage only based on location

Debt financing

- Debt facilities are cheaper source of financing, but not all projects are bankable
- Availability and cost of debt financing has became a curtail success factor for new developments
- Bankability needs to be evaluated from the planning phase

Regulatory risk

- A stable and predictable regulation improves financing position of projects
- A framework which provides the investors with a fair and market risk related return

Merchant risk

- EU regulation does not prefer PPAs
- Need for stable cash-flow for efficient financing – PPAs or/and capacity fees
- Merchant risk can be accepted by financing institutions only in stable regulatory environment, with market driven decision making

Financing mechanisms

FX issues

- In order to remain competitive on the regional market projects are financed by EUR loans in high interest rate level markets, while most of the revenues are local currency based
- FX hedging can be executed efficiently only up to 3 years, as beyond this liquidity is limited for the scale of a project
- Other FX risk managing alternatives:
  - FX risk to be passed-though to off-takers but this requires long term off-take agreements;
  - Guaranteed by sponsors but this exposes additional risk on ROE; and
  - Strengthening financing structure (i.e. lower leverage, higher DSRA, etc.), but this decreases ROE or increases output price.

Alternative financing solutions

- In current market circumstances banks risk appetite is low, and most project risks need to be taken by sponsors. As a result of this sponsors, taking all important risks, might take the decision to finance the projects on BS basis, which will influence their risk profile/rating;
- Non optimal use of the private sector (e.g. PPP financing structures) has resulted bad experience or perception for this financing method in Hungary;
- However we do believe that in the current macroeconomic and financing environment meaningful projects can be implemented only based on a joint effort of the relevant state/regulator and private partners.

Conclusions

1. Changing environment in the energy and financing sector
2. Cost of financing is an important success factor for projects
3. Bankability needs to be considered from the very beginning of the project development
4. Reasonable risk sharing needs to be elaborated among the involved parties (sponsor, banks, off-takers, suppliers, etc.)
5. Role of government/regulation needs to be re-evaluated (i.e. PPAs, capacity fees, financing structures)