

Sustainable Energy - Investment Change or Climate Change?

“As a large Financial Services provider, Deloitte not only has Financial Responsibility but also Social Responsibility”.

Mr. Roger Dassen, CEO Deloitte Netherlands

Introduction

Voices denying the link between Carbon Emissions and Climate Change have quietly died down. With a wide-screen documentary in cinemas and recent tangible weather changes, the public has also become more aware of the consequences of growing world-wide Carbon Emissions.

Following these developments mainly as a result of the Kyoto protocol, many governments are implementing and tightening Carbon Emission policies. These have not only increasingly effected society and daily business operations, but also sparked a doubling in sustainable investments over the last two years.

To find out more about the way the above developments are affecting investments and about the way investors and project developers are working together, the Energy Capital Markets (ECM) group of Deloitte Amsterdam has carried out a survey among the most prominent sustainable fund managers to find out more about the financial viability of sustainable projects.

Corporate Responsibility and Deloitte

Deloitte Netherlands is a leader in the marketplace in demonstrating Corporate Social Responsibility (CSR). We have published our first CSR stakeholder report 2005-2006 in September 2006 ahead of our direct competitors. This CSR report was based on the 2002 sustainability reporting guidelines of the Global Reporting Initiative (GRI).

The strategic concept of corporate responsibility assimilates Deloitte's ethical principles, promoting trust among stakeholders and involving them in societal developments and fits with Deloitte's international standard of excellence. Playing a role in the development of sustainable energy is one of the ways in which Deloitte wants to take on its social responsibility.

Energy & Utilities Group

ECM was designated within Deloitte to play a lead role in the development area of sustainable energy. This group has been serving a large client base over many years and has been the centre of excellence in the field of Energy & Utilities. In recent years, the group has focused on sustainability issues, resulting in the 2003 launch of the European Climate Change Service line.

As carbon policy impacts many aspects of a company's operations it is necessary to have a team with multi-disciplinary competences to be able to advise its clients timely and adequately. For instance, to assure compliance with changing carbon regulations, there are tax, accounting, legal and investment markets issues to deal with. Furthermore, when active emissions management is implemented, there are technical changes, trading operations, Joint Implementation and Clean Development Mechanism projects to handle. All of these require specific, multidisciplinary skills to be managed within acceptable risk limits.

Congress and Survey

The GRI congress in Amsterdam was an excellent opportunity for ECM to investigate investment in sustainable energy and to bring investors and project developers closer together. With high-profile speakers like former US Vice-President Al Gore and Dutch Crown Prince Willem-Alexander, the GRI event is well regarded and well attended. The “Global Reporting Initiative” is a large network of thousands of experts who participate in working groups and governance bodies to develop better ways to report on environmental performance. Deloitte is one of the organizational stakeholders of this former UN body, supporting the GRI’s mission and contributing to its budget. Deloitte asked 300 leading fund managers a number of questions about their ideas on sustainable investments, followed by a panel discussion to give room for further arguments.

Outcome of Questionnaire and Panel discussion

The combined outcome of the questionnaire and the panel discussion can be divided into four main questions:

- Do we pay the right price for our energy?
- What renewables do investors prefer?
- What are the drivers to invest in sustainable energy?
- Is there a balance between available capital and available projects?

Do we pay the right price for our energy?

First of all, this question sparked a general acknowledgement that energy costs are – far more than those of other products - strongly influenced by government policies. More than 70% of the respondents are of the opinion that fossil fuels are too cheap because of hidden subsidies. For example, the costs of health care related to air pollution and the costs of military protection of oil operations are not reflected in the ultimate energy price, paid by the end user.

Some participants added that sustainable energy would be cheaper than fossil fuelled energy when all costs of fossil fuel are taken into consideration, making subsidies redundant.

What renewables do investors prefer?

The general question, ‘What types of energy do you consider sustainable?’ was answered as shown in figure 1.

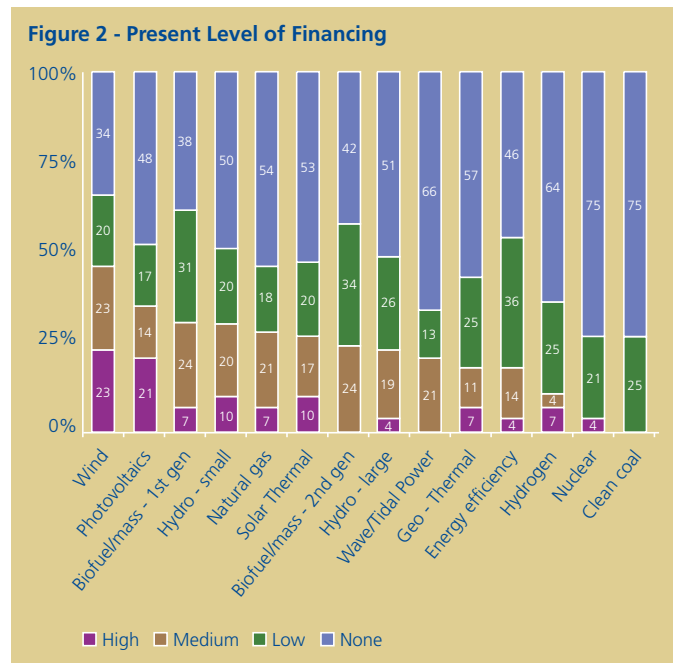
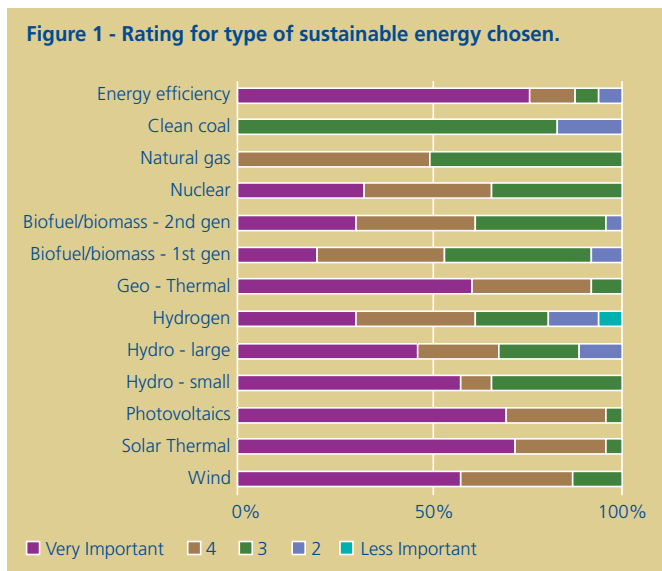
In line with the general perception, solar, water and geo-thermal energy are considered to be the most sustainable alternatives. More controversially, natural gas and even nuclear energy are seen by some as sustainable alternatives.

Nuclear energy would be considered sustainable thanks to a total absence of CO2 emissions and seemingly uranium resources. This in combination with a steep technical development curve for abatement technologies would have resulted in nuclear energy being perceived as a safe, economical and sustainable alternative for the future, so they argue.

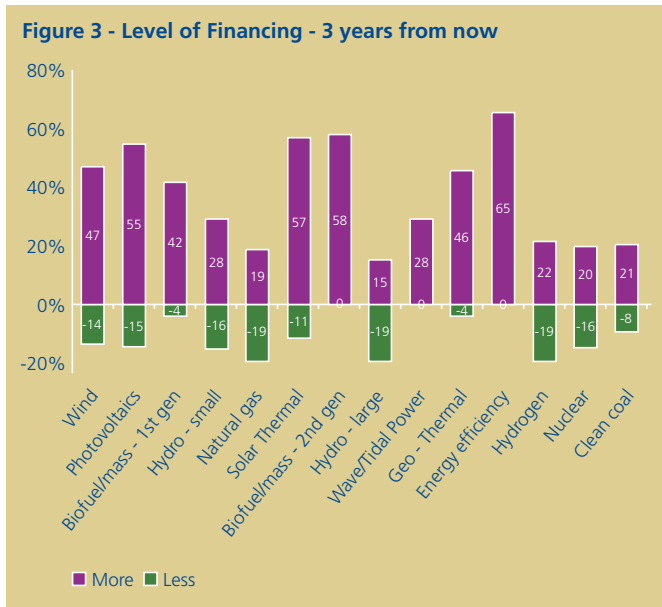
Opponents replied with the argument that the risk of nuclear fall-outs is mainly carried by society as only 2% of the possible damage is covered by insurance. Moreover they added that dismantling-costs of the plants is generally not included in nuclear power cost. Some went as far as saying that the nuclear option is ‘the most expensive’ if all costs are taken into account.

Preference for investment per type of renewable

The graph in figure 2 shows percentages how the participants have invested in each category of renewables. It furthermore states the percentage of participants in each investment profile.

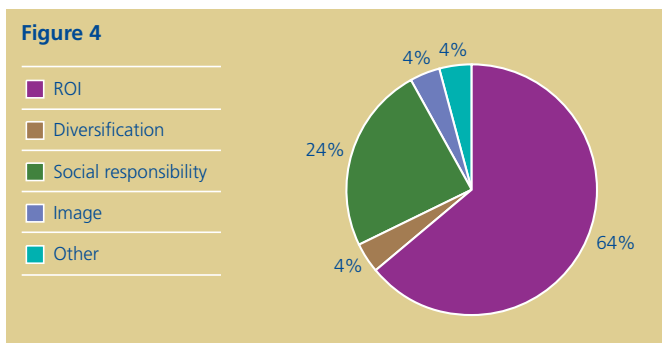


Moreover, we also inquired about future sustainable investment strategies. The following graph shows the expected level of investment per type in three years from now.



These graphs show a high correlation between perceived sustainability and popularity for investment: investment finds its way to where people believe it will make a difference. Furthermore, it seems that in particular geo-thermal- and solar energy are upcoming and seem to be gaining on wind as well-established and mature investment targets.

Financial Drivers for investment flows



The main driver to invest in sustainable energy projects is to generate return on investment (ROI). The majority of the participants emphasised however that this is combined with a strong feeling of social responsibility.

One of the participants illustrated this with the quote 'no planet, no business'. Participants indicated however that ROI demands of 30% were heard, indicating the importance of profitability.

The relation between available capital and available projects

One of the principal questions of the survey concerns the balance between available capital and suitable projects.

What is a good project?

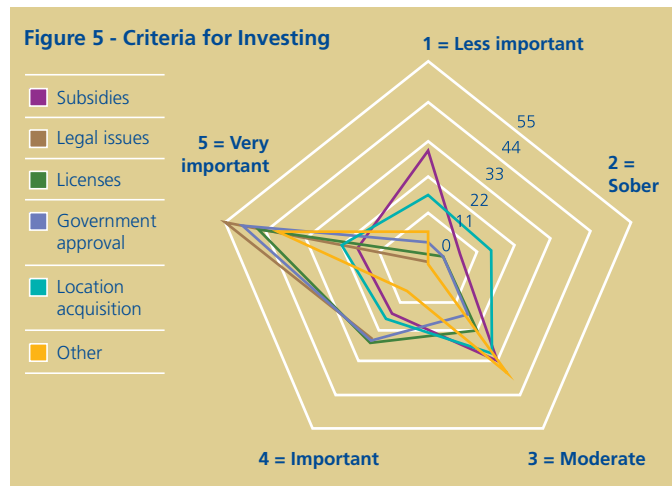
Besides the familiar criteria like financial return (ROI) of a project, the credit worthiness of the borrower, (financial) transparency, time to cash positive and the quality of the management team, there are some criteria that are more typical to sustainable projects.

Clearly, from a social responsibility standpoint, the environmental impact is an important criterion.

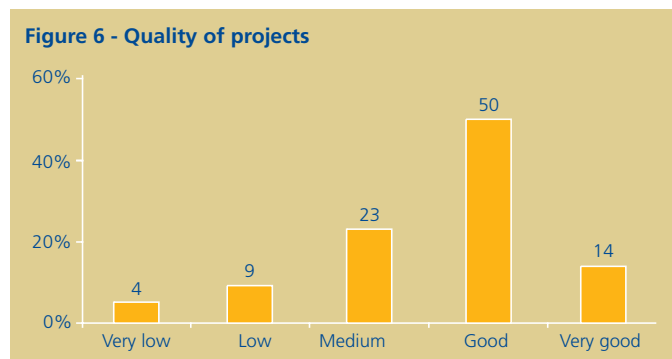
Striking is the importance of administrative and governmental support. The population of this research considers a lack of this support an important obstruction. The process of, government approval and an acceptable level of political risk are also indicated to be of higher importance than usual. Not only legal issues, subsidies and licences, but also soft support by the government are important elements in the assessment of projects.

On the administrative side it is important for projects to have their CO2 reductions measured in Certified Emission Reductions (CER's) to be able to trade their value. The accreditation of CER is of very high importance, but seems to be an insecure factor.

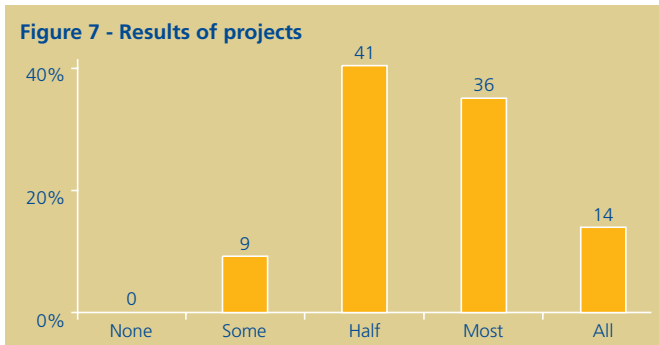
These last criteria lead to the conclusion that sustainable projects have more exposure to administrative issues than other projects.



With respect to the quality of the projects invested in, the participating fundmanagers indicated:



As the graph shows, 50 percent of the participants consider the quality of the projects invested in as good. However, as the following graph shows, this does not imply that the projects attain all goals set.



With respect to the projects' results, the outcome is less positive. Apparently the quality of a project is not a guarantee for its results.

The information above is of course based on the projects that have been given investment approval. Looking at the total number of proposed projects, the picture is a lot grimmer. Only 10% of the proposed projects meet the quality standards of the funds, showing that there is a high quantity of projects with an unacceptable low quality.

External hurdles for project financing

After having established the main criteria defining "good quality sustainable projects", we will look at the extent to which these are generally fulfilled.

Starting with external hurdles for projects, the typical sustainable criteria mentioned above are also the most important but also most difficult for investors.

A much heard complaint is the lack of consistency in subsidies, especially in emerging countries. In combination with non-transparency of the licensing processes this results in a high regulatory risk. All too often, this is linked to the absence of a general voice of support from governments.

However, also on the private law side, it seems difficult to find a solid legal framework to ensure success of projects. This problem typically occurs in emerging markets where rules are not (yet) clearly set and defined.

What can be done to alleviate these hurdles?

As for regulatory risk, all participants agree that 'energy is politics' and that strong regulation of the energy market is imperative to ensure security of supply to protect the environment. Nevertheless, it is also agreed that the development of sustainable energy will be strongly encouraged under more consistent regulations. The idea is that politicians should limit their interference with the due enforcement of legislation. At the same time however their influence to push EU coordination forward will have a positive effect. Besides, increased global understanding of Green House Gas issues and better International Law regulation in the field of Carbon Emissions and sustainable energy, an important element of which should be harsher legislation for non-Kyoto countries.

And of course, in the years to come there will be a continuing need for active government involvement in the form of subsidies and public support.

Internal hurdles for project financing

Besides the external hurdles, there are of course also internal hurdles that make projects unattractive for investors.

Although every project has credit risk and delivery risk, these tend to be bigger in sustainable projects as many of the proposals come from start-ups and there is no guarantee that the projects will result in tangible and tradable products. In general verification of results is difficult.

This is connected with the perception that there is a lack of capable developers, adequate project management and trustworthy knowledgeable middlemen.

What can be done to alleviate these hurdles?

To minimize the risks connected with the investment in these risky, but potentially very profitable projects, investors tend to form syndicates to share risk (and knowledge).

Furthermore, there needs to be more development and inflow of professional project experience in the market. This will improve Project and Risk Management, and the way projects are carried out, validated, monitored and evaluated.

Conclusion

The most important conclusion of the survey is that there seems to be an abundance of money in the financial markets to invest in sustainable energy, but a tight shortage of good quality projects.

To improve this and to convince investors to engage in projects, there needs to be a strong improvement in Risk and Project Management.

Also, to decrease the regulatory risk, clear and consistent procedures for granting licences and subsidies are required combined with a good knowledge of these procedures within the projects.

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- Advisory Climate Change Governance
- Project Finance & Budgeting
- Transport emissions advisory
- Global Deloitte Network

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Deloitte Financial Advisory Services

Energy Capital Markets

Orlyplein 10

1043 DP Amsterdam

P.O. Box 59237

1040 KE Amsterdam

The Netherlands

Tel: +31 (0)20 582 5420

Fax: +31 (0)20 582 5460

ecm@deloitte.nl

www.deloitte.nl

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