Merchant projects in time of Covid-19

Investors must focus on fundamental value

Investors in projects with solid economic value and moderate leverage are in a strong position to proactively restructure debt and minimise losses in the event of a credit impairment. The severity of an impairment largely depends on a project's ability to generate cash flows over many years (i.e. its fundamental economic value). Fully merchant projects are currently most vulnerable to credit impairment events due to near-term liquidity pressures and increasing refinancing risks. But the question about severity is different and depends on value.

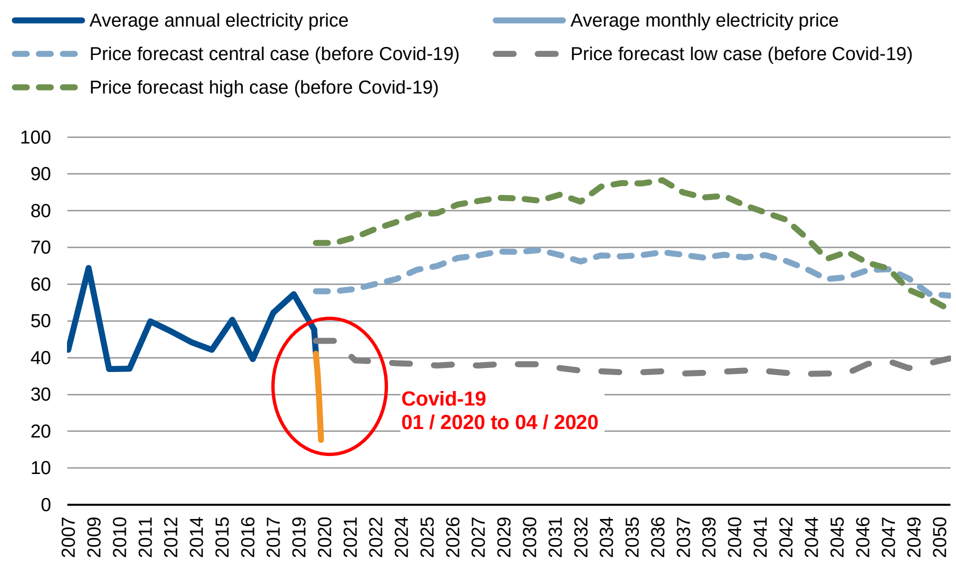
This report explains how Scope's analytical approach to PF credit analysis copes with shocks created by the Covid-19 crisis and historically low oil prices. The current environment has triggered precipitous price drops in power markets around the world, which are challenging most projects.

The case of merchant projects

Merchant projects are exposed to the risk of market price fluctuations since they are reliant on selling their output in the energy market, usually on a short-term basis. Development of merchant projects today vastly exceeds the development of subsidy-driven projects which have dominated new power developments in the last two decades.

The risk profile of merchant projects is very different from that of subsidy-driven projects and warrants a much higher focus on the project's fundamental economic value because of their participation in the power market and the current environment.

Figure 1: Historical and forecast annual average day-ahead prices in Spain (EUR/MWh)



Source: OMIE, Scope

Power prices have come under pressure across Europe since the beginning of this year (see Figure 1). Day-ahead prices have tumbled as a result of the Covid-19 crisis, depressing electricity demand. In addition, steep oil price declines have bolstered conventional power supply by decreasing fuel costs and their marginal cost of production.

Liquidity pressure is increasing for all merchant projects

Most merchant projects face the risk of becoming impaired if market dislocation and historically low power prices persist beyond this year. The severity of restructuring events will be very different depending on how much long-term value lies in the project.

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Related Research

General Project Finance Rating Methodology
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General Project Finance Analytical Considerations
September 2017

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Liquidity mechanisms will not reduce severity of restructuring

Virtually all merchant projects have structural features designed to mitigate liquidity risks that alter the likelihood of restructuring events. These protective features include debt-service reserve accounts, distribution lock-up triggers, and cash sweeps among others. These mechanisms allow a project to temporarily continue servicing its debt in the event of an operational standstill or lower-than-expected operating cash flows but will not reduce severity once already in restructuring.

Analysis overly focused on liquidity is flawed

This is one of the flaws of credit analysis overly focused on liquidity rather than expected loss; an analytical approach combining the likelihood and severity of restructuring events.

Severity from restructuring depends on a project's fundamental value

Project value and leverage are most relevant in a restructuring

Project value and leverage are what matter most in a restructuring. The potential severity of a credit impairment – whether there has been a failure to pay or not – and the economic loss that could result are a function of how much of the original value of the project survives the crisis and how such value is distributed among stakeholders. The capital structure after restructuring will reflect the relevance of stakeholders in relation to the role that senior creditors could play in strict isolation.

Focus on project lifetime coverage ratios (PLCRs)

Investors in merchant projects must apply additional scrutiny in their analysis when assessing a project's long-term fundamental value. Scope Ratings pays a lot of attention to stressed values of project lifetime coverage ratios (PLCRs). The implications of a potential credit impairment will be very different across projects, even when virtually all merchant projects in the countries most affected by Covid-19 are faced with liquidity stresses (and hence a rising likelihood of impairment).

Analytical focus areas for merchant projects

Merchant projects require fundamental economic value analysis

Scope emphasises the analysis of fundamental economic value in credit analysis of merchant projects, highlighting its significant influence on the severity upon impairment.

Electricity price forecast

Projects may be exposed to market price risk on both the input and the output sides

The most important cash flow driver in a merchant project is the electricity price. Price is usually the most volatile and difficult-to-predict factor in a project's revenue projections. Power output volumes, while potentially volatile as well, can often be estimated with higher accuracy based on resource studies and the track record of the technology used (e.g. PV solar). Projects that rely on sourcing a certain commodity as an input in its power transformation process (e.g. a gas-fired power plant) may be exposed to market price risk on both the input and the output sides in the absence of a long-term supply contract.

Price forecasts are inherently difficult due to the complexity of power markets, and therefore should always be accompanied by sensitivity and scenario analyses. Contingencies must be considered in stress assumptions.

Most sponsors rely on a dedicated power market study to forecast expected power prices and revenues over a project's entire operational life. Many studies also cover contingencies (e.g. price pressure due to higher-than-expected power capacity additions) and include downside assumptions. Senior debt may be sized on a more conservative 'low case' (see Figure 1) whereas sponsors are usually most interested in the expected scenario, sometimes even betting on upside potential.

Scope believes that power prices will recover to levels closer to their long-term averages in the medium term. While the timing of a recovery is inherently difficult to predict, we expect that industrial activity will resume once the socio-economic restrictions imposed in response to the Covid-19 crisis are lifted in the affected countries.

Power purchase agreements (PPAs)

PPAs are increasingly popular instruments

Power purchase agreements are an increasingly popular instrument to transfer all or part of the price risk to a third party (the offtaker). Offtakers are often utility companies or energy-intensive industrial companies looking to source the electricity they need without having to finance a power plant from their own balance sheet. Several projects analysed by Scope are taking hybrid approaches and transfer some of the risks to an offtaker, reducing the project's exposure to price fluctuations, while strict merchant projects by definition do not transfer any of their price and volume risk to a third party.

Useful life

Many merchant projects are expected to operate and produce cash flows for many years, often significantly exceeding the debt maturity. The present value of the future cash flows in this 'debt tail' is often significant. The expected cash flows in the debt tail represent value in excess of the debt instrument. These excess cash flows represent economic value available in restructuring upon a credit impairment (e.g. by extending the debt maturity), thereby decreasing the project's expected severity upon credit impairment.

Financial leverage

Credit risk is not necessarily higher, though, because merchant projects typically have lower leverage than comparable subsidy-based projects, precisely to compensate for their higher exposure to price and volume volatility. Creditors' collateral represents a larger nominal quantum of excess cash flows as a consequence, which must be adjusted for the additional risk related to its exposure to price volatility.

Conclusion

Only proper analysis of economic value can reveal strengths and weaknesses of merchant projects

Merchant projects may hide strengths and weaknesses for investors that only proper credit analysis that considers the economic value of a project can reveal. The likelihood of an impairment tells only one part of the story that can result in losses for the investor. To calculate the expected loss for the investor, it is necessary to analyse the severity of potential restructuring events, as this will provide the relevant credit view capturing the full credit risk characteristics comprised in this asset class.

This holds especially true in today's environment of broad liquidity pressure on virtually all merchant projects. Merchant projects with strong fundamental economic value are well placed to survive crises like the current one, despite the risk of becoming impaired due to lower-for-longer power prices.

The analytical elements presented reflect some of the most relevant areas in the assessment of merchant projects. For additional details, please refer to Scope's General Project Finance Rating Methodology. For an introduction to project finance risk for investors that are new to infrastructure and project finance, please refer to our General Project Finance Analytical Considerations, which sets the context for our methodology.

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