Managing investment risks in the energy transition

David Scaysbrook, co-founder of Quinbrook Infrastructure Partners, argues that many investors have taken on too much risk in renewables, and explains why the US is a far more attractive market than Australia right now

Q You've recently reached a final close on your debut Low Carbon Power Fund. What is the strategy behind the fund?

David Scaysbrook: In many respects, it's a continuation of what Rory Quinlan, [Quinbrook's other co-founder] and I have been doing for a long time now: focusing on value-add energy infrastructure opportunities in the UK, US and Australia. But we've done a couple of things differently in this latest fund.

Firstly, we decided to combine our distressed-assets strategy with our new-build strategy. When we were at Capital Dynamics, we executed those distinct strategies in separate funds, but at Quinbrook we decided not to distinguish between them. We wanted more flexibility to be opportunistic and to execute on the best deals that came along in order to boost investor returns. This also reflected our view that we will see more distressed acquisition opportunities in renewables.

The second difference was to take a more private equity-style approach to building our portfolios, meaning that we've been sponsoring teams and building platforms in addition to a project-specific focus. We are building five platforms within the fund: three in the US, one in the UK and one in Australia. These contain a mix of operating and development assets in utility-scale solar and wind, distributed solar, battery storage, gas peaking and methane recovery. It's a diversified strategy and we've deployed about 40 percent of the fund to date.

> "We're seeing long-term offtake agreements being priced on a flat basis rather than escalating, which means you carry a degree of inflation risk"

Q How much are LPs being motivated by ESG considerations now?

DS: One of the biggest emerging themes is the crossover between increased LP focus on impact investing, new asset construction in infrastructure generally and concerns around valuations in the 'core' sector. We preach that if LPs want more tangible ESG impact from the deployment of their capital then they need to partner GPs that are building and developing new assets, which we do.

We understand that development and construction is higher risk, but we have the necessary industrial experience going back three decades. In the last two years or so LPs have been getting on board and have convinced their trustee boards and CIOs that investing in new-build infrastructure and value-add strategies can deliver the dual objectives of tangible and measurable ESG impact along with higher returns. This is contrasted with M&A strategies which rarely offer incremental ESG impact and are usually fully priced from a valuation risk perspective.

Q What's your view on where the renewables sector is heading, and the amount of risk investors are taking?

DS: We believe that investment risks in renewables are significantly greater now in many key respects than they have ever been. There are several reasons for this.

Firstly, contractual offtake tenors are getting shorter at a time when having con-

tracted revenues has never been so critical for mitigating downside risk. It's now rare to get a 25-30-year offtake agreement for power with a creditworthy buyer. Our general view is that – almost without exception and in every market we operate in – assets are trading on an overly optimistic view of the electricity prices they will be exposed to in the future. That's creating an illusory IRR in many investment 'base cases' that doesn't fit the descriptor of 'risk-adjusted' returns at all.

Secondly, we're seeing an unprecedented change in both the efficiency and capital cost of wind and solar projects as well as transformational impacts from battery storage. As efficiency goes up and capital costs come down, electricity prices also inevitably go down and potentially stay down for a long time. Yet we're still seeing a continuation of these 'hockey stick'-type power price projections on many projects, which makes no logical sense. There are very few commentators calling the prices of solar, wind and batteries in an upwards direction, so there's an absolute disconnect there that we think will cause a lot of investor pain.

Thirdly, we are seeing long-term offtake contracts being priced on a flat basis rather than with an annual escalator meaning that the sponsor is bearing more inflation risk. We have never seen so many 20-year power sales contracts being priced flat until now, especially while money is cyclically pretty cheap and inflation remains low. Generally, we see that the equity rate of return on that 20-year flat revenue profile is not offering adequate compensation for the inflation risk and the simple payback periods have been stretched too far.

And finally, there are unforeseeable changes in pricing and regulation to come by virtue of the stresses that an unprecedented splurge of intermittent renewables is having on centralised power grids.

> "The Australian power market has witnessed heavy intervention from both state and federal governments with pet projects and petty politics making it a 'minefield' for long-term infrastructure investors"

It is important to emphasise that there are ways to avoid, mitigate and manage many of these risks, but bidding for assets in competitive auctions does not afford you that risk buffer. We think that investors who consider operating assets as 'de-risked', and therefore a sounder investment than a 'develop and build' strategy, may need to reflect more on the risks of overpaying in an auction and having inadequate buffers to cope with the inevitable 'downsides' to come.

Q Why are investors taking on these extra risks?

DS: Because of the weight of capital that has entered the infrastructure sector and the stock of assets now built and operating. The many facets of the energy transition serve to highlight how many unknowables there are and why making more conservative investment assumptions to create a buffer for downside risk is so essential.

There has never been a more important time to have contracted revenues to protect the simple payback of invested capital. But having contracted revenues offering price certainty, a hedge to inflation and the prudent allocation of risk to the offtaker is almost 'nirvana' in today's markets. Equity returns in renewables have compressed in recent years but not because investments are 'less risky'.

Q What's your outlook on the US and Australian markets, and how do they compare?

DS: The US is a deep, liquid, fragmented and diverse market that is constantly offering us the full gamut of opportunities for our strategy, whether it's new build, development projects without access to completion capital, or distressed M&A opportunities. It's not without its risks, of course, but it's the market that just keeps giving in terms of dealflow and diversity of opportunities. The general regulatory trends are also very positive.

Australia, on the other hand, has been a 'basket case' in energy policy terms for at least five years, and it's only deteriorated. It is quite incomprehensible what has gone on from a political perspective. The Australian power market has witnessed heavy intervention from both state and federal governments with pet projects and petty politics making it a 'minefield' for long-term infrastructure investors. The risks, as things stand, are not compensated for by the returns on offer. There are just better places for Quinbrook to commit our investor's capital

We also think there's a significant risk that investors in certain Australian renewables assets will lose all their equity. We can only see value in assets such as the firming of intermittent renewables with flexible, peaking projects, and some interesting opportunities behind the meter. But unless things change, we won't be investing anytime soon in renewables that are generating into the wholesale power market unless they are deeply distressed assets or portfolios. It's a shame, but that's how we see it. ■