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A Bad Month for the Southeast Asian Coal Power Juggernaut

Warning Lights Flashing for IPPs in Indonesia and Malaysia While Global Bankers Play Poker with Coal Risk

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The complexity of Southeast Asia's tortured relationship with coal can be difficult to pin down. Usually, the case for coal rests on an expedient growth agenda premised on unproven arguments that coal power is "cheap" and that the guarantees needed to attract foreign investment are a cost-free option. This is a high-risk scenario that is increasingly testing the abilities of the most capable government officials, especially those who are well aware of the long-term financial advantages of deflationary renewables and who shudder at the cost of locking in inflationary long-term FX commitments. The problem for the bureaucrats has been finding the right local examples that make it crystal clear that coal advocates and bankers have loyalty only to their own interests.

Thankfully, for observers of power sector policy, July was a month rich in examples of what needs to be fixed and what needs to be stopped in Southeast Asia. These two themes seem destined to shape the work lying ahead for the policymakers, power sector leaders, and investors who will re-shape Southeast Asia's energy landscape. This is not easy work however. The new market structures that are needed to create cost-effective economic incentives are emerging, but they must be customized for each country's market infrastructure. Nevertheless, the obvious first step in Southeast Asia is to stop underpricing fossil fuel risk which is locked into the long-term contracts that support independent power producers (IPPs).

What was behind July's turn of events? We have recent elections in Indonesia and Malaysia to thank for renewed confidence in the importance of addressing persistent corruption and governance problems that have afflicted the power sector for years. And just as government officials are focusing on efforts to clean up the sector, bankers are rushing in the opposite direction to lock in the bounty which results from old-style project finance deal-making. Despite much higher emerging market currency volatility in the first half of 2018, bankers remain eager to push deals into the market before higher rates and more active policy interventions complicate the sector's outlook.

Too Much Coal, Too Little Transparency—Corruption Questions Surround PLN's IPP Policies

Tracking the status of Indonesia's many IPPs is a complicated task made more complex by PLN's lack of transparency concerning its planning processes, the terms for project awards, and governance considerations related to the finalization of power purchase agreements (PPAs). Evidence of this problem emerged in mid-July, when reports in the Indonesian press confirmed that a member of the Indonesian house of representatives was being investigated by the KPK, Indonesia's Corruption

Eradication Commission, as part of a bribery case surrounding the proposed coal-fired 600MW Riau 1 IPP. [1] Parties involved in the IPP include Singapore-listed Blackgold Natural Resources, PLN subsidiaries Pembangkitan Jawa-Bali (PJB) and PLN Batubara (PLN BB), and China Huadian Engineering Co.

The Riau 1 IPP is a mine-mouth facility and was directly awarded to the consortium by PJB without a transparent bidding process. Many mine-mouth IPPs were not included in the planning process initiated at the beginning of the President's 35,000 MW scheme, and this proposed project appears to have been suddenly added in the 2016 RUPTL through a direct appointment scheme involving PJB.

In many ways, the circumstances surrounding the Riau 1 IPP are emblematic of Indonesia's strategic challenges, due to over-reliance on coal IPPs backed by a revolving cast of coal producers who are highly motivated to push speculative projects that will benefit narrow interests. According to press reports, the alleged bribe was paid by Johannes Budisutrisno Kotjo, a shareholder in Blackgold who was also, until the end of June, listed as a member of the company's key management as a consultant. Mr. Kotjo is a seasoned veteran of the sector, and observers of the global mining scene will appreciate the fact that Blackgold's 2017 annual report proudly notes that Mr. Kotjo "went into his first resources venture together with a major mining player, Robert Friedland...," who is well known for a string of governance-compromised transactions in emerging markets.

It is also notable that Blackgold had good reason to be highly motivated to secure a stake in the IPP, as it promised to provide demand for low-grade coal which would struggle to find a market outside of Sumatra. According to the company's disclosures, it currently has estimated reserves of 147 MT of lignite, with another 520 MT listed as resources. The loss-making company is still in start-up phase, with high funding needs. In April 2018, the company disclosed to shareholders that the Riau IPP is crucial to the loss-making company's future, as "the Consortium is working towards the signing of a Power Purchase Agreement with PLN for the sale of electricity from the Riau-1 project to PLN for a period of 25 to 30 years, alongside with a Coal Sales and Purchase Agreement for the sale of coal from the PT SB Concession to the Riau-1 Project, also for a period of up to 30 years."

What makes this case so significant is the individuals who have been caught up in the KPK investigation. The first target to be named was Eni Maulani Saragih, a Golkar legislator who is deputy chairwoman of House Commission VII, which oversees energy and mineral resources. The investigation has also spread to include Sofyan Basir, the president director of the state-owned monopoly electricity company PLN. As a result, the list of questions about PLN's questionable planning disciplines[2], which have produced overcapacity in the key Java-Bali grid, will grow longer as we wait for news about whether PLN will move ahead with the now stalled Riau 1 project and how it plans to manage the equally severe conflicts of interest associated with many of the mine-mouth coal IPPs that have won recent approval.

Malaysia Begins to Chart a New Course for the Power Sector

Just days before Indonesia's anti-graft investigators lifted the lid on severe problems with PLN's IPP program, Malaysia's new Energy, Technology, Science, Climate Change and Environment Minister Yeo Bee Yin announced Malaysia is cancelling four new IPP contracts. Minister Yeo was quoted as saying that "For certain reasons, the previous government (under Barisan Nasional) had approved a lot of IPP contracts through direct negotiation (or) direct award to build up the country's capacity

[1] http://www.thejakartapost.com/news/2018/07/15/kpk-raids-pln-president-directors-house-in-jakarta.html, http://www.thejakartapost.com/news/2018/07/15/kpk-detains-golkar-lawmaker-for-alleged-corruption.html

and users need to pay for that capacity… These IPP contracts that were directly awarded to not deserving companies, we are reviewing them, especially those that bring no cost implication to the government."[3]

These comments, delivered in an address to the renewable energy industry, are a clear indication of the new government's commitment to transparent market structures that will support the transition to more cost-effective energy options. A prominent part of this policy shift will be a move to open tenders. According to Minister Yeo, developers should not concentrate on relationship building, but focus instead on cost competitiveness. In the future, developers should "not be disappointed if you cannot arrange a one-to-one appointment with the ministry (because) you are still at a level playing field when it comes to anything that we open for tender, and only open tender in the ministry."

The Tyranny of the Horizon, or Who's Bluffing Who?

While power sector observers in Indonesia and Malaysia have spent the past few weeks rushing to keep up with new political trends, it has been business as usual for the finance community. One of the banking world's articles of faith about industrial scale finance is that structured finance products provide special solutions to risk management puzzles that can improve outcomes for everyone—both issuers and investors. While the theoretical promise of clever risk pooling and hedging strategies may be valid, it's crucial that all the parties have a very clear understanding of what the risks might be and how those risks will create winners and losers over time. As coal power assets begin to be stranded across a range of markets, investors and regulators are rushing to re-assess the way that risk ratings are attached to project loans. This process is relatively advanced in developed markets, but in Southeast Asia, the market signals remain subdued despite the speed of the transition taking place in India and China—and clear evidence of asset stranding.

Thanks to Temasek, one of the region's most respected asset owners, Southeast Asian investors are about to get a pop quiz on carbon risk and risk pooling. In late July, Clifford Capital, which is 40.5% owned by Temasek, announced that they were offering institutional investors a novel opportunity to invest in a pool of project finance loans.[4] The US$458 mn collateralized loan issue is backed by 37 different loans covering 30 projects in 16 countries, with exposure to Australia, Indonesia, and Vietnam accounting for 47.7% of the total exposure. Oil and gas projects would account for 39.5% of the pool, while 28.4% would be from conventional power projects—presumably coal and gas. Roughly three-quarters of the projects are currently in operation, and 38% of the obligations have the benefit of credit enhancement from export credit agencies or multilaterals.

So far, so good? Traditional logic suggests this would seem to be a straightforward way to create a diversified package of high yielding debt securities for institutional investors who normally lack access to project loans. But think again. It's always instructive to consider who the issuers are and why are they selling. The sellers are Clifford Capital (Temasek), DBS, HSBC, MUFG, SMBC, and Standard Chartered—all of whom have access to the teams of bankers and lawyers needed to evaluate the underlying risks. This suggests that some of the region's biggest financial sponsors of project financed infrastructure projects may see the balance of risks differently than potential investors who are more distant from the projects and markets. Clearly, they are looking to offload project debt and to reposition their balance sheets. Press reports obligingly suggested that the issuers were eager to "free" bank funds and "recycle" the capital into other infrastructure projects.

A little caution may be merited here, however. This outdated explanation may only be relevant to market strategists who have missed out on the cross-currents that are restructuring the infrastructure

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[3] http://www.theedgemarkets.com/article/yeo-bee-yin-malaysia-decided-cancel-4-ipp-contracts, http://www.theedgemarkets.com/article/disclosure-four-axed-ipps-put-due-several-issues-says-minister
[4] https://ijglobal.com/articles/134379/update-clifford-capital-prices-pf-backed-clo-securitisation

finance market globally. We see clear indications that power markets are changing in ways that may result in a de-coupling from traditional sovereign guarantee structures, as deflationary renewables undermine return structures for centrally-planned coal assets.

There is every reason to believe that these issuers are conscious of these global trends and are therefore looking to reposition their loan portfolios. Indeed, smarter banks and investors like Temasek are under pressure to re-assess their concentration risk exposures to heavily coal exposed markets like Australia, Indonesia, and Vietnam. At the same time, offering up a little non-power debt in order to start paring carbon-risk impacted paper could be a way to discreetly reduce risk before other Southeast Asian investors wake up and the liquidity associated with these exposures becomes worse.

Long-Term Investors Beware—Does Evercore Have an All Fees but No Future Policy?

For many years, the financing and advisory work for contentious Indonesian IPPs has been done by a closed circle of global and Asian banks. The ranks of banks willing to take on these assignments has begun to thin, however, as concentration risks (see above) and reputational risks have begun to grow. As they have exited the market, a new group of financial advisors and lenders has emerged. Most commonly, these new entrants have tended to be the more risk-tolerant state-owned Chinese banks that will sometimes step up when the engineering, procurement, and construction contractor (EPC) is Chinese.

This makes the news that Evercore, a U.S. investment bank, is reported to be the financial advisor to the sponsors of the coal-fired 1,320MW Tanjung Jati A IPP something of a surprise.[5] The project, also known as Jawa 4, has a long and tortured history with multiple stops and starts over the past 20 years. The current project sponsors, YTL Power (with 80%) and Bakrie & BroPower (with 20%) are reported to have completed negotiations with PLN on a PPA in February, and the necessary land acquisition for the plant and associated transmission and distribution links is said to be almost complete.

What makes Evercore's role in this transaction stand out is the seeming conflict between the firm's aspirations and its risk-tolerant attitude toward the Indonesian coal IPP market. It seems surprising that Evercore lacks awareness of the controversy attached to large project financings for coal IPPs which will service the over-crowded Java-Bali grid despite a reserve margin in excess of 30%.[6] The same skewed incentives that have resulted in the corruption investigation surrounding the Riau 1 project are just as relevant to the Jawa 4 project. This is arguably a project that PLN does not need. Bakrie's interests are clear—their coal units will presumably benefit. YTL is an established Malaysian coal power operator, but key family members are well aware of the risk of climate change—a posture which makes this investment seem like a strategic contradiction.

Evercore prizes its track record for growth as an independent investment bank, and—despite a long advisory track record in the energy sector—it has thus far steered clear of controversy in Asian markets where it has a small footprint. In recent years, the traditional leaders in Asian power advisory work have all spent time devising coal policies and re-assessing their commitments to the coal IPP market. Evercore does not appear to have any similar governance documents and appears to lack board capacity with deep Asian expertise. This raises obvious questions about whether they understand that this advisory role may not result in a financing that investors or the Indonesia public will thank them for.[7]

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[5] https://ijglobal.com/articles/134379/clifford-capital-launches-pf-backed-clo-securitisation, http://www.cliffordcap.sg/sites/default/files/20180725%20Press%20Release%20-%20TOF.pdf

[6] http://www.dunia-energi.com/listrik-surplus-pembangunan-pltu-di-pulau-jawa-dihentikan/

[7] http://investors.evercore.com/phoenix.zhtml?c=66653&p=irol-ir_rectrans2018

There is still time for Evercore to reconsider this piece of business with help from the firm's leadership. One might hope that Asia Co-Chairs Stephen CuUnjieng and Keith Magnus[8] could devote a little time to studying the firm's work for Energy Future Holdings, in order to understand how quickly markets can move toward more cost-effective power solutions, to the detriment of coal power bond holders. This is also a long-term governance issue that new board members Ellen Futter and Sarah Williamson[9] may want to address. Futter, formerly of the JP Morgan board,[10] is well positioned to give the leadership team a tour of the Museum of Natural History's excellent Gottesman Hall of Planet Earth where she is the President and Evercore Founder and Senior Chairman, Roger Altman,[11] is an Honorary Trustee.[12] Its exhibits provide a clear science-based lesson on how climate change works, and how it can destroy long-term value for asset owners.

[8] http://www.evercore.com/who-we-are/#!/our-team/global-advisory/senior-management
[9] https://www.fcltglobal.org/
[10] https://dealbook.nytimes.com/2013/07/19/2-jpmorgan-directors-resign/
[11] http://investors.evercore.com/phoenix.zhtml?c=66653&p=irol-govBio&ID=195958
[12] https://www.amnh.org/about-the-museum/board-of-trustees