

Kosovo Renewable Energy IPP and Commercial Finance Facilitation Project

The focus of this briefing with the Advisory Council is to solicit views regarding MCC's potential investments in strengthening the power sector in Kosovo by *fostering a market-driven approach* to lowering energy costs for households and businesses, encouraging energy efficiency, and developing new sources of electricity generation.

Threshold Program: An Overview

Kosovo is a small developing country with a population of 1.8 million, spread across 10,908 km, making it one of the most densely populated countries in the region. It is a young nation, having declared independence in 2008; with a young population having a median age of 27 years. It's GDP per capita of EUR 2,935 and average income around EUR 360 per month makes Kosovo one of the poorest countries in Europe with around 30% of the population living below the national poverty line.

Since gaining independence in 2008, the Government of Kosovo (GOK) has made significant strides in strengthening the administration of public services, upgrading public infrastructure and undertaking reforms to improve the business climate to attract private investment. Kosovo's services-oriented economy, with services making up around 50% of GDP, is poised for continued growth.

Kosovo was declared eligible for an MCC threshold program in 2016. A Constraints Analysis (CA) for Kosovo identified the lack of reliable supply of electricity as one of the binding constraints to growth. MCC's investment is designed to strengthen the power sector by fostering a market-driven approach to lowering energy costs for households and businesses, encouraging energy efficiency, and developing new sources of electricity generation.

Project Design Elements under Consideration

MCC's \$ 49 million Kosovo Threshold Program, signed into force on September 12, 2017, addresses two key constraints to Kosovo's economic growth: an unreliable supply of electricity; and real and perceived weakness in rule of law, government accountability and transparency. In an effort to deliver increased energy generation through commercially financed renewable energy, the MCC team seeks input and advice from the Council on:

Potential MCC Investments to Unlock Kosovo Renewable Energy IPP Development

Project Preparation: Provide targeted technical assistance to renewable energy IPP developers to better enable them to meet project financing requirements. Technical assistance to be provided including assisting renewable energy developers obtain higher quality source data, complete/verify required technical studies, understand project financing contractual/legal requirements, prepare project financing application documents/models and access/raise additional equity capital.

Access to Limited and non-recourse Commercial Finance: A non-bank financial institution (NBFi) offering targeted instruments unlocking long tenor, limited or non-recourse project financing interventions that specifically address the barriers identified within the Kosovo banking sector. The entity would transfer perceived country and market risks from banks' balance sheets to an external partner through commercial risk guarantees.

Reliable Energy Landscape Project

The core problem for the lack of reliable electricity in Kosovo is that demand significantly outstrips supply. The energy sector faces unexpected supply shortfalls, caused mainly by old and unreliable generation infrastructure, and the resultant need to import very expensive emergency supply.

Increased power generation is a key focus of the government and Kosovo has put in place incentives for private independent power producers (IPPs) to enter the generation market, such as feed-in-tariffs (FIT) for output from renewable energy sources (hydro, solar, wind, and biomass) and preferential dispatching (not based on merit order dispatch). However, few IPPs have entered the market mostly due to challenges in attaining finance.

Root cause analysis conducted by MCC and supported by due diligence in 2017/2018 by SSG Advisors revealed that that local renewable energy developers are capable of developing bankable projects although the sector would benefit from targeted assistance in enabling project financing. Not only do several developers possess internal technical teams capable of developing renewable energy sites, but some have already completed construction of initial sites or obtained financing to begin construction.

Currently, the majority of renewable energy developers are only able to access full-recourse financing that require significant collateral from other ventures. This practice not only prevents renewable energy developers with insufficient collateral to obtain financing, but it also limits experienced developers who have already tied-up their collateral on other projects from further developing new renewable energy projects.

The most significant barriers revealed in the analysis, however, exist within the Kosovo commercial banking sector that inhibit the provision of project financing, and with respect to MCC's potential investments, to the renewable energy sector. While Kosovo commercial banks expressed interest in the prospect of extending project financing to renewable IPPs and some have made collateralized loans to the renewable energy sector, the fundamentals of the banking sector make it unlikely that any bank will extend true project financing to renewable energy developers in the near future for the following reasons:

- Lack of renewable energy and project financing underwriting expertise
- Kosovo country risk
- Concerns regarding the renewable energy feed-in-tariff (REFIT)
- Small renewable energy market size
- Conservative nature of Kosovo banking sector

Proposed Approach

Based on gap analysis and theory of change, the Kosovo team believes an opportunity exists for MCC to play a catalytic role in enabling renewable energy project financing and expanding Kosovo's commercial banking products and services through a joint approach: (1) project accelerator/project development; and (2) access to commercial capital, leveraging targeted technical assistance to renewable energy IPP developers, regulators, and key financial sector stakeholders in an effort to standardize markets and transfer knowledge to institutions.

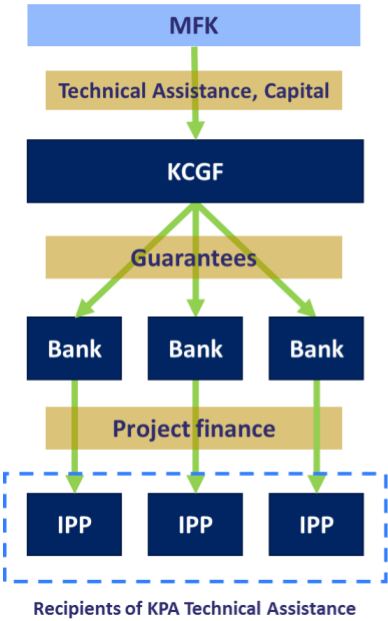
Given the potential to catalyze renewable energy project financing in Kosovo, several options for incentivizing local commercial lending are being developed based on a theory of change that believes most financial markets need external intervention to develop innovative products. Numerous case studies exist on best practices for governments catalyzing critical lending markets including the US mortgage and agricultural lending markets.

- Bring a select portfolio of renewable projects to financial close with 12-18 months.
- Attract an international developer/ renewable energy fund to co-invest & co-develop RE IPPs.
- MCC investments cover operational expenses funded through MKF against a defined business plan and pipeline developed after an initial market assessment.
- Staffed with a core development team and consultants incentivized to deliver to financial close.

Component 1: Project Accelerator – Focus on project preparation to consolidate and pool existing renewable energy IPP licenses into a portfolio through the technical assistance facility. Thereafter, DFIs would lead a consortium with local banks to provide project financing.

Component 2: Guarantee De-risking Mechanism – Catalyze Kosovo banks in extending project financing directly to renewable energy IPPs. MCC would either create a new Guarantee Facility or provide funding support to an existing one (e.g. Kosovo Credit Guarantee Fund) to develop and offer financial products designed to address specific financial barriers identified during the root cause analysis.

Proposed Structure



Project Accelerator delivers bankable RE IPP projects capable of financial close against a clear timeline

1. Technical assistance will focus on enacting required regulatory, legal and internal policies to enable KCGF to offer renewable energy guarantees.
2. Technical assistance to develop and structure market- appropriate guarantees that will catalyze renewable energy project financing.
3. Initial capitalization fund to KCGF for the renewable energy guarantees as well as assist in raising any additional capital required.

Technical assistance activities and initial capital to enable KCGF to offer renewable energy guarantees

Local Entity Serves as Lead Partner

Based on MCC due diligence work conducted over the last six (6) months, MCC identified an opportunity for it to scale up the existing [KOSOVO CREDIT GUARANTEE FACILITY \(“KCGF” or “Facility”\)](#) which is focused on guaranteeing commercial banks’ medium sized SME loan portfolios. The Facility was established by USAID and currently has capacity to guarantee up to \$25m in loans. MCC is considering working with local stakeholders to add project development capabilities to the Facility and to increase its guarantee authority to \$180m through the provision of technical assistance to the Facility aimed at attracting additional private capital and donor funds. The expanded guarantee authority and project development technical assistance will be used to bring new IPPs to the market.

MCC (through Millennium Foundation Kosovo – MFK) possible intervention is to fund the project development/technical assistance facility that will be managed as part of new improved Facility. MCC may also provide a grant to the new entity to cover organizational transformation costs and expected operational losses until it reaches breakeven. The Kosovo banks have expressed the ability to meeting the capital requirements of the projects if they are presented with bankable deals and a supporting guarantee. While the banks are acceptable of GOK risks, project financing is a new area for their bankers and risk officers.

Technical assistance would provide project development support bringing expertise to project sponsors, as well as alongside potential co-lending and investment partners accelerating a pipeline of bankable projects. MCC, through the Threshold Program, would fund the detailed feasibility study to design the financial and technical assistance needed to augment KCGF existing capacity and underwriting capability until the new portfolio generates cost-recovery operating revenue.

Project guarantees would be provided through KCGF via dedicated instruments structured to de-risk larger investments such as Renewable Energy IPPs. Guarantee capital would be provided by third parties generated through a number of potential approaches which could include (but not limited to) Development Finance Institution (DFI) debt and/or equity contributions, local and regional commercial finance institution equity contributions, and potentially coupled with subordinated risk guarantees. Alternatively, capital could be achieved through Kosovo government or local currency bonds.

This approach is modeled heavily after and builds from international development finance (World Bank, and USAID) past successes. The goal is to leverage MCC funding to unlock new investments in renewable IPP generation by (1) expanding commercial bank capacity for project finance non-recourse or limited recourse lending; (2) address a lack of project sponsor capacity to successful develop bankable IPP projects; and (3) increase commercial banks' ability to assume and manage extended loan tenors required for infrastructure lending.

Questions for the Advisory Council

MCC seeks the Advisory Council's feedback to inform our program development with the following questions:

- Initial reactions and concerns?
- Based on the options presented do you think the current proposed approach will achieve objectives without a financing component? What aspects of the model do you have questions about? Anything particular that you like or dislike?
- If MCC addresses the project preparation and development issues, will local or regional bank realistically then take on project financing risk or will they continue to sit on the sideline?
- Is there a moral hazard created by a guarantee model to incentivize banks to enter the project financing market?
- Is the idea of a demonstration effect real in your mind?
- For a small country such as Kosovo (with a high-risk reputation) how can we attract quality international project developers – should we pool IPP generators into a portfolio – to pursue investments along MCC and other DFIs?