A Mechanism to Promote Energy Efficiency Investments

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The importance of energy conservation/efficiency to mitigate the impact of increasing energy costs in most developing countries has been recognized. Studies have shown that the net potential benefit from industrial energy efficiency improvements in Sri Lanka correspond to an annual generation saving of Rs. 4.2 billion.

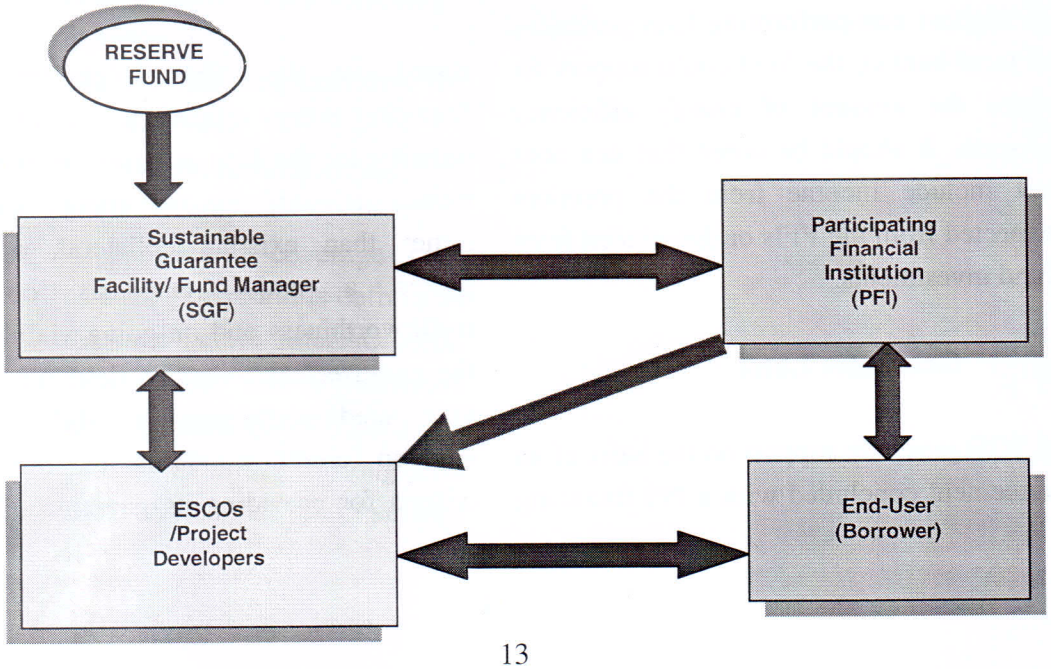
In most developing countries, various approaches for financing of energy efficiency projects such as concessionary loans and interest buy down mechanisms have been used with limited success because of financial institutions disinclining to finance energy efficiency projects, due to the lack of collateral. Lack of collateral has been identified as the main barrier for widespread commercialization and large-scale implementation of end-use energy-efficiency improvements.

A loan guarantee can overcome problems associated with collateral and reduce the cost of borrowing to end-users.

Sustainable Guarantee Facility (SGF)

A loan guarantee mechanism will provide a repayment guarantee to lenders as a collateral substitute and lower the cost of financing for borrowers. This will lead to a substantial increase in energy efficiency investments.

The diagram below shows operational structure of a Sustainable Guarantee Facility:



Important Features of a Sustainable Guarantee Fund

a) Resource for a Reserve Fund

A Sustainable Guarantee Facility (SGF) will require a reserve fund to provide loan guarantees. The main resources for a SGF reserve fund are donor funding, government/utility contributions, short-term investments, and guarantee premium contributions. Given that a SGF operates as a reserve fund, the resources making up the reserve fund can earn interest from short-term investments. It is important to note that the reserves in a reserve fund will only be used in case of a borrower repayment default to a bank.

b) Loan Loss Reserve and Guarantee Potentials

The basic idea behind a SGF is that the fund resources would be set aside or reserved according to a certain percentage based on estimated loan losses. If the loan loss reserve is set at 15% (generally based on highest non-performing loan portfolios of local banks), the fund could support six times the amount of energy efficiency projects. It should be noted that this does not include income from the premium expected from the PFIs or the interest from fund investments.

c) Guarantee Limit

A SGF grants its support on the basis of an agreement concluded with a PFI financing the project after examining an application submitted by a borrower/end-user according to the standard procedure specified by the facility. A major underpinning of the SGF approach is that the Facility will rely upon the credit expertise and due diligence performed by the PFIs for the successful funding of projects. A facility will seek to limit such defaults by establishing prudent credit standards for the projects that it guarantees. To provide an incentive for the PFIs, the guarantee offered by a facility is limited to a maximum of 75% of the outstanding loan balance.

d) Guarantee Premium

A SGF will charge an annual guarantee premium on the loan amount outstanding. A low initial premium is recommended to reduce interest rates of loans for energy efficiency projects. The SGF premium, charged annually, is mainly expected to meet the cost of facility management.

e) Credit Standards for Borrowers

Based on the inherent challenge of financing energy efficiency, given that the security for the loan is based on the cash flows generated by the energy savings rather than existing collateral, a SGF places a major emphasis on the creditworthiness and on-going viability of the end-user/borrower. To determine end-user creditworthiness, a SGF should develop credit standards as important criteria for providing its guarantee. These

standards are used to enhance the probability of repayment for loans made to energy efficiency projects, thereby preserving the integrity of funds as well as its guarantee.

The credit standards and information requirements are generally designed to serve as clear, transparent guidelines to qualify potential borrowers, lessees, and end-users for fund support.

The idea is to make access to fund support relatively easy and straightforward to generate a greater number of project applications. Borrowers that meet the standards outlined below are likely to be approved in an expedited fashion. If a borrower fails to meet the standards, the fund may still approve a guarantee request provided that appropriate mitigants are offered to offset the credit risk of the borrower.

General requirements for a loan guarantee:

- A favorable letter of reference from a bank;
- A favorable Credit Information report;
- Positive operating cash flow for the latest year;
- Positive net income for the latest 2 years; and
- A debt-service-coverage ratio of 1.25. (This ratio is defined as earnings before interest, taxes, depreciation, and amortization as a percentage of interest + current maturities on long-term debt. Note that cost savings from implementing the energy efficiency project may be included in the calculation.)

Importantly, the resources of a SGF will be available in perpetuity to provide loan guarantees in accordance with the operating guidelines. Upon successful payback of a guaranteed loan, the reserves of a SGF backing the loan will be free to back new loans. Traditional direct lending or grants approach support individual projects and thus are unavailable once spent.

In summary, a SGF is a proven and cost-effective mechanism to create a substantial increase in sustainable funding for a large numbers of energy efficiency projects.