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Climate resilience in infrastructure finance

FW discusses climate resilience in infrastructure finance with Rizwaan Z. Sahib at BDO and Allan Marks at Milbank LLP.



Q&A:

Climate resilience in infrastructure finance

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THE PANELLISTS



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Prior to BDO, Rizwaan Z. Sahib spent over 16 years in the energy industry. He initially worked with the California ISO integrating renewable assets, implementing a demand response programme and supporting the settlements team. He then worked with startups, focused on energy efficiency and onsite load management solutions. He also performed energy audits and structured contracts to help clients save money and improve their sustainability profiles.



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Allan Marks is a partner in the Los Angeles office of Milbank LLP and a member of the firm's global project, energy and infrastructure finance group, as well as the firm's private equity, renewable energy, Latin America, and global risk & national security practices. He is one of the world's leading project finance lawyers, with deep expertise for over 30 years across many sectors: power and renewable energy, transportation, airports, rail, port terminals, water, fuels, social infrastructure, and telecommunications and digital infrastructure.

FW: Could you outline how climate change is affecting the way infrastructure projects are financed?

Sahib: Climate change is influencing both the types of projects attracting financing and the way investors are assessing projects' risk profiles. There is currently a financing frenzy for climate technology projects such as industry specific climate risk mitigation

models, carbon capture technologies and many others. Similarly, we are also seeing greater financing activity around renewables and climate mitigation solutions that cater specifically to the natural resource extraction and manufacturing sectors. Deal structures are also evolving. Banks and private financing institutions are placing higher risk premiums on projects and companies that eschew climate

mitigation and transition strategies, partially in expectation that these entities may face regulatory penalties. Meanwhile, governments are enacting regulations to respond to climate change, including establishing various grants, tax credits and other incentives to promote green investment. As a result, while deal flow is down generally, the climate tech sector is thriving.

Marks: Climate change affects infrastructure project financing in three distinct ways. First, more capital is being invested in energy and infrastructure. Second, private capital is increasingly attracted to project financings that rely on government financial support, including revenue subsidies, tax credits and co-financing. And third, the risks to physical infrastructure are growing to the extent they are increasingly exposed to climate impacts. Project finance investors, both equity and debt providers, are looking to invest in projects that not only provide a financial return but also have a positive impact on the environment and society. Project sponsors are increasingly incorporating environmental, social and governance (ESG) considerations into their project designs and financing structures. In the US, investment in clean energy and green projects continues to be fuelled by tax incentives under the Inflation Reduction Act (IRA) and a renewed interest in the Department of Energy section 1703 and 1706 loan guarantee programmes. The IRA reflected a push by the Biden administration and Congress to address climate change by broadening the applicability of tax credits traditionally available for renewable energy to newer technologies, such as ‘clean’ hydrogen, sustainable aviation fuels and dynamic glass, increasing the value of credits available for other technologies, such as carbon capture and storage, and incentivising the manufacturing of advanced technologies and mining of elements critical to those technologies.

FW: How would you characterise the risks facing infrastructure as a consequence of climate change across industries, supply chains and regions? In what ways are such risks being priced into financing deals?

Marks: Infrastructure networks are already being adversely affected by the physical impacts of extreme weather, climate variability and climate change. So, resilience becomes ever more critical. While these challenges differ in severity and immediacy depending on geographic region, the problem is a global one. Ensuring that infrastructure is climate resilient will help



to reduce direct losses and the indirect costs of disruption. Decarbonising electricity production while simultaneously electrifying other sectors of the economy, including buildings and transportation in particular, is foundational for any strategy to reach net zero by 2050, so that these adverse impacts do not become even more severe.

Sahib: Climate change has created many different types of infrastructure-specific risks, particularly those associated with activating and sustaining power grids. Extreme weather events like flooding and cold snaps are overwhelming previously resilient infrastructure, putting stress on major utilities and requiring retrofitting. At the same time, cities are focused on building new, more resilient infrastructure, and both existing and new projects are competing for capital. Most financial institutions are now risk-grading their lending facilities to reflect climate risks. In doing so, these organisations are formalising portfolio climate risk assessments. Large institutions are looking at what managing those risks will actually cost, which may impact capital allocation and the risk premiums of project financing. In addition, in some cases higher

interest rates are driving higher insurance premiums and refinancing rates. Overall, consideration of climate risks has increased the cost of capital.

FW: To what extent is climate change driving a shift toward infrastructure that is climate-resilient? How influential are sustainable development goals (SDGs) and emission reduction targets under the Paris Agreement?

Marks: The EU recently set an ambitious target to slash net greenhouse gas (GHG) emissions by 90 percent by 2040. The US Securities and Exchange Commission has just released its controversial final rule on climate-related disclosures, including scope 1 and 2 greenhouse gas emissions, if material. This next phase will be very telling as the climate agenda butts up against other factors, including hard to abate sectors, energy security and business cycles. Commercial challenges remain regarding the scaling of technologies like hydrogen and carbon capture and sequestration, which are favoured in the IRA and other incentive programmes. As the Organisation for Economic Co-operation and Development

(OECD) has noted, getting investment and climate policy right is a necessary condition of success, but it is not enough. Existing policy frameworks, institutions and economic incentives encourage incremental changes. Only systemic change will disrupt institutional inertia and vested interests that slow the pace of change in climate and development policy. The United Nations' sustainable development goals (SDGs) and Paris GHG reduction targets are not directly resulting in shifts in infrastructure investment so much as they provide a framework for national governments to act. Some of the largest emitters pay lip service, at least, to these goals, but more should be done if we are serious about averting the worst scenarios for climate impacts.

FW: What, in your opinion, are the defining characteristics of climate-resilient infrastructure?

Marks: The OECD and other agencies define climate-resilient infrastructure as facilities that are planned, designed, built and operated in a way that anticipates, prepares for and adapts to changing climate conditions. Climate-resilient infrastructure can also withstand, respond to and recover rapidly from disruptions caused by these

climate conditions. Ensuring climate resilience is a continual process throughout the life of the asset. Often, higher capital costs upfront result in greater resilience, more efficiency and lower operating costs for the long term. Efforts to achieve climate resilience can be mutually reinforcing with efforts to increase resilience to extreme weather and other natural hazards. But mitigation remains critical for system planners and regulators, since the degree of resilience needed depends largely on the degree to which climate impacts can be prevented or mitigated in the first place, and how quickly those steps are implemented.

FW: What steps do infrastructure businesses need to take to identify and quantify the risks climate change presents?

Sahib: Infrastructure businesses need longer-term climate studies and models to accurately identify and quantify the risks of climate change. Leaders need to understand both how weather systems change over time and how these changes may impact varying types and components of infrastructure. The volume of regulation will likely increase over time, so the need to invest in high quality risk assessment and management tools, while still meeting demand and

ensuring reliability, should be top of mind. Infrastructure companies should consider weighing in on policy development wherever they can. This can be accomplished several ways including convening with regulators to help inform decisions or, in the case of smaller infrastructure businesses, joining an industry group to guide the conversation.

Marks: There are several steps that investors and project developers should take to identify and manage climate risks. But it starts with regulators and policymakers, since so many infrastructure investments are dictated by public planning and environmental permitting processes. First, government agencies and regional organisations should use risk screening early in the development process to map vulnerable infrastructure and highlight ways to improve networks systemically. They should identify specific infrastructure that may be vulnerable to climate change, and they should take climate risks into account as a part of their approval processes for new infrastructure projects. Second, investors need access to credible and consistent data sources for undertaking risk screening, accounting for uncertainties. Third, investors and lenders should incorporate risk screening into investment decisions and credit assessment and deal terms at a stage where there is still a possibility to make revisions, balancing against the need for the project to be sufficiently well-specified to undertake the risk screening process and the need to adapt over time as conditions change. Fourth, protocols should be incorporated into project contracts and multiparty relationships that improve real-time communications and decision making to evaluate, monitor and react to climate impacts as they occur and to aid in recovery after casualty events. Fifth, there remains room for innovation in risk management through insurance products. We are in a transition period from healthy risk markets and mature insurance products to a better understanding of the probability and magnitude of climate risks, especially as they differ by location and as they impact whole infrastructure networks, not just individual facilities.

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ALLAN MARKS
Milbank LLP

FW: How can infrastructure businesses go about incorporating climate resilience into their corporate strategies?

Marks: Resilience means that the risks have been considered and managed to achieve an acceptable level of performance given the available information at a reasonable or affordable cost and that capacities to withstand and recover from climate impacts are in place. The costs of protection must be weighed against the consequences of damage or disruption. There will be increased investment in protective infrastructure. For other infrastructure, adaptation and resilience will result in absorbing costs from damage or disruption and in rebuilding and recovery to get power grids and transportation systems back online. Climate risks to infrastructure can be reduced by locating assets in areas that are less exposed to climate hazards like floods and wildfires. Assets should be designed and located to withstand climate impacts when they arise.

Sahib: Infrastructure companies need strategic roadmaps to plan for growth amid climate risks as part of their overall business strategy. Companies should draw upon the inputs of key functions across the organisation to define what climate resilience means for their business, identify significant risks and work collaboratively to build a long-term resilience strategy. As part of the organisation's broader enterprise risk management programme, it is important to incorporate climate risk exposure – particularly with respect to extreme weather as well as new and forthcoming climate regulations – and assess how it may impact valuations, compliance requirements and the reliability of their assets. Companies in traditional energy industries will need to focus on facilitating the energy transition and diversification of their portfolios. Their overheads will rise substantially due to the growing cost of methane recapture and the impact of new regulations. Some companies in this sector may struggle to finance projects, although there remains a healthy ecosystem of investors focused on traditional energy. It is expected, however, that newer technologies like renewables

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RIZWAAN Z. SAHIB
BDO

and decarbonisation tools will become more profitable.

FW: Looking ahead, what trends are we likely to see in infrastructure finance, particularly in terms of the ongoing demand for climate-resilient projects?

Marks: Renewable energy technologies have become increasingly cost competitive with traditional fossil fuel sources and will dominate near and medium term capital allocation in infrastructure investment. Energy storage and transmission upgrades will likewise attract substantial investment in the coming years. There is increasing interest among developers, investors and lenders in clean hydrogen, carbon capture and storage, and methane monitoring and containment. We also expect a shift from investing in new capacity to investing in adaptation and resilience, especially protective infrastructure facilities. The resulting demand for climate change mitigation will create more opportunities to invest in increased energy efficiency and in abating emissions in manufacturing, building and construction, shipping, air travel and agriculture. Energy and infrastructure, as an asset class, may be defined more expansively. The coordination

between public and private actors will evolve.

Sahib: Governments are likely to subsidise climate-resilient infrastructure projects because of their higher risk profile. We can also expect to see the need for more robust climate risk and strategy assessments for major infrastructure project financing, as investors increasingly recognise climate as a source of material risk. Additionally, private equity and sovereign wealth fund interest in the infrastructure investment space is likely to increase as they see strong demand and return opportunities. As a result, we will likely see a greater variety of alternative investments to finance these projects. Looking ahead, investors' appetite for climate-resilient infrastructure will likely stay strong. ■

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