Energy & Renewables Report 2011: Recharging the energy sector

Many of Spain and Portugal's largest businesses operate in the energy sector but even they have not gone untouched by the financial downturn. Variable demand, reduced revenues and regulatory uncertainty are prompting energy players to change strategies, say lawyers in Spain. In Portugal, the drivers of change are more acute: the Government's ongoing privatisation programme.

Under the terms of the country's €78bn financial assistance package, Portugal must sell its remaining stakes in oil company Galp and leading domestic utility EdP, and privatise the electricity and gas distributor REN.

"It is a challenging but exciting time for the sector. We are seeing major structural change, and potentially the first true liberalisation of the electricity distribution sector in Europe," says Pedro Siza Vieira, Managing Partner at Linklaters in Lisbon.

Indirect effect

Over the past decade, across Iberia, generous "feed-in" tariffs have helped underwrite a boom in renewable energy production, creating world-leading companies and prompting a fragmentation of the market, and with it, the diversification and global expansion of the traditional energy businesses. The economic downturn is however now being felt both directly and indirectly.

In Spain, Government incentives encouraging domestic coal consumption – the subject of a state aid investigation – and renewable energy production has reduced the competitiveness of gas production, say lawyers. In addition, tighter lending criteria and dormant capital markets have reduced the ability of companies to make major new investments.

"The main problems we see are a lack of financing for projects, the absence of credit in the market and the need for companies to recapitalise, including in the face of expected regulatory changes in relation to wind and thermal solar projects," says Fernando Lillo, Energy Of Counsel at Jones Day in Madrid.

With more focus on internal and structural issues, there has inevitably been a reduction in acquisition activity and a focus on de-leveraging. "Companies are issuing equity to pay down debt, debt is being swapped for equity, loan-to-value ratios are reducing, companies are going bust, and asset values are falling," says Israel Gómez-Caro, Energy Partner at Gold Abogados in Madrid.

Recent years have seen market liberalisation, including in the energy distribution and supply markets, but recurring tensions exist.

"A preference for renewable energy as well as the need to support traditional sources, requires regulation that is compatible with this co-existence and that can guarantee security of supply with adequate returns," says José Giménez, Partner at Linklaters in Madrid.

In Portugal too, market liberalisation has progressed, but lawyers there note the market's fundamental difference to that in Spain – the sector is largely financed by consumers rather than state subsidies, albeit with major investment encouraged through long term power purchase agreements (LTPPAs).

The terms of the country's bailout are however shaking things up. VAT payable on energy supplies has increased to 23 percent and the Government has sought to revise downwards the remedies available for the early termination of LTPPAs.

"There is now a lack of agreement between the Government and traditional power generating companies prompting market uncertainty, and we will likely also see a revision of market policies and financial sustainability criteria, and potentially a new tax on power generators," says Manuel Santos Vitor, Head of Energy and co-Managing Partner at PLMJ.

Revisions are also predicted in the feed-in tariffs applicable to renewable energy production, adds fellow Energy Partner Ana Oliveira Rocha. "The challenge facing companies is to maintain the sustainability of their activities with a lower guaranteed income and more burdensome tax regime."

"Never before has the sector been put such a stress-challenge due to the prospective decrease of income and extremely unfavourable financing conditions," adds Bruno Azevedo Rodrigues at ABBC. "The economics of the electricity sector, in particular renewables, is less attractive each day."

Deficit

Many of the hardest blows being dealt to the energy sector are therefore not the result of fights between market players but changing Government policy.

Among the most significant developments in Spain has been the imposition of new regulations affecting the feed-in tariffs for the glowing solar photovoltaic (PV) sector. Among the changes, a 40 percent reduction in production prices and a limit on the capacity the grid will purchase.

“The outcome has been to reduce key elements of the sector in Spain to a state of almost paralysis,” says Hermenegildo Altozano, Head of Energy at Bird & Bird in Madrid.

Many solar PV investors and producers are now questioning the viability of schemes and the Government is facing a potential explosion in claims for losses. It is already the recipient of an arbitration claim worth up to €2bn by a group of 14 international investors, represented by Allen & Overy. Herbert Smith is acting on behalf of the Government.

The rationale behind the reduction was however simple, the country could no longer afford to subsidise production in the way it had been doing. Generous tariffs had helped generate a €20billion world-leading renewable sector valued, but also run up an energy deficit – the difference in price between what the Government pays producers and that paid by consumers – of €15.5bn.

The Government has sought to close the deficit gap through the issue of bonds via a dedicated Energy Deficit Fund (Fondo de Amortización de la Deuda Eléctrica) but in the current climate has struggled to raise consistent investor demand.

“One of the great challenges for the sector is how to correct and reduce the deficit and to decide if the solution requires passing all the production costs onto the final consumers,” says Javier Olmos, Energy Partner at Rousaud Costas Duran.

The operation of the ‘Production Pool’, the way in which electricity production costs are shared requires urgent reform, adds Javier de Montalvo, Head of Energy at Madrid energy firm Garayar Asociados. “The solution requires a firm political decision on the price paid but this is controversial in the current economic situation, and meanwhile, the deficit continues to penalise the balance sheets of companies.”

Regulatory uncertainty

The reduction in the solar PV tariff has had a negative impact right across the renewable energy sector in Spain, say lawyers. It has reduced investor confidence and the willingness of banks to finance projects against future earnings.

"This uncertainty coupled with potential future changes in the regulatory framework will stop new investment in generation and distribution assets, or at least delay the investment period," believes Francisco Solchaga, Partner with Araoz & Rueda in Madrid.

With future change likely to also impact the wind and thermo-solar sectors, the challenge is to recover investor confidence, says Gonzalo Olivera, Partner at SJ Berwin in Madrid. "This implies the need for regulatory stability and to establish reasonable short medium and long term planning." Lawyers in Portugal likewise highlight the importance of stability. But here too, change is coming.

"Project developers and lenders seem to be in suspense over how the austerity measures will impact projects, in particular the feed-in tariffs," says Bernardo Diniz de Ayala, Head of Public Law and Energy at Uría Menéndez-Proença de Carvalho. "They are afraid that a reduction – as in Spain – may affect the profitability of projects and promoters' capacity to repay debts."

This hesitation is again affecting the entire sector. "It is the main strategic challenge, in particular for the future of wind energy the only economically relevant renewable business of the last ten years," says António Teles, Partner with Sérvulo & Associados in Lisbon.

In addition, the Government's freeze on new public projects spending means fewer project licences, and many of those that are progressing require a down payment before work begins.

"The key issue facing energy investors is the availability and cost of funding and managing the evident other sector risks. In this respect, the stability of the regulatory and tax frameworks is critical," says Vanda Cascão, co-Head of Projects at Vieira de Almeida (VdA) in Lisbon.

The right mix

Such uncertainty is also impacting on some of the fundamental strategic issues facing Iberia's energy markets, notably the future production mix required. Spain continues to depend more on fossil fuels – oil and gas – than most other European countries and energy imports account for 66 percent of the trade deficit.

"A national priority should be to develop an energy policy aimed at reducing dependence on hydrocarbons, increasing efficiency, and developing new infrastructures to diversify not only the Spanish energy demand but the whole European market," says Rafael Audivert Arau, partner at Roca Junyent.

Steps have been taken to establish an interconnection between Spain and France – with 1400MW transmission lines under construction, doubling the current capacity – but there is unlikely to be any tangible result until 2014.

"Interconnection will however increase the energy exchange capacity, strengthen the security of both the Spanish and French systems and promote the integration of a greater volume of renewable energy – especially wind," says Carlos Vázquez Cobos, partner of Gómez-Acebo & Pombo.

Lawyers in Lisbon point to the urgent need also of further integration of Spain and Portugal's gas (MIBGAS) and electricity (MIBGAS) networks, a process delayed by technical and regulatory issues.

"We are definitely further away from the Iberian objectives respecting the diversification of gas supply and consumption. The fallout from the global financial crisis together with the recent developments in North Africa and the ongoing Sovereign Debt crisis has not helped in that respect," says Manuel de Andrade Neves, energy Partner at Abreu Advogados in Lisbon.

Since the earthquake that threatened to destroy Japan's Fukushima reactors concerns over the use of nuclear power have also become more acute. Germany may have announced it is to wind down its reliance on nuclear power but no such policy change is expected in Spain.

"The Fukushima accident may in the mid-term contribute to a reduction in nuclear energy within the Iberia market, but the current levels of nuclear resources will be maintained. Spain cannot currently afford to do otherwise," says Gonzalo Olivera, energy and infrastructure Partner at SJ Berwin in Madrid.

The country currently operates eight nuclear plants, which collectively account for around a fifth of total electricity output.

Portugal may not have its own nuclear production but nonetheless shares some of the benefits and risks of Spain's programme: the Almaraz nuclear plant is located in the bordering Extremadura region. "The nuclear option has suffered – we are yet to know if it was a fatal blow – but Fukushima has silenced any Portuguese nuclear ambitions," says José Eduardo Martins, energy and environmental Partner at Abreu Advogados in Lisbon.

International confidence

A more challenging domestic outlook is also helping to push more energy companies to new international markets, while also reducing inbound investor confidence, say lawyers. The ill winds blowing across the Peninsula are though helping to guide its world class solar and wind industries to the expanding energy markets of Latin America and Asia, to the US and to niche markets elsewhere in Europe.

Offshore wind production may be an emerging area of activity in Portugal – with EdP trialling projects – and less of a geographic possibility in Spain, but Spanish companies are major players in the sector. Leading turbine manufacturer Gamesa recently relocated its entire offshore R&D team to the UK, where Iberdrola already has substantial contracts.

International spike

Lawyers in Portugal by contrast are seeing a spike in international interest driven by the Government's privatization of REN and the sale of its remaining seven percent stake in Galp, and 21 percent stake in EdP – where MLGTS is representing the Government.

The Government has drawn up a shortlist of bidders for EdP, comprising China Three Gorges Corporation alongside Germany's E.ON, Brazilian state-run power holding company Eletrobras, and Cemig, controlled by the Brazilian state of Minas Gerais. A shortlist has also been decided for REN, and while not public, local reports have identified the UK's National Grid, Abu Dhabi's IPIC, Colombia's ISA and Cypriot financial group Tufton Oceanic as having presented bids.

Lawyers report that both EdP and REN will however play a role in deciding the winning bid – with a preference for those that support their existing strategies – and some suggest that China Three Gorges Corporation and National Grid the current favourites.

The uncertainty that surrounds Portugal's renewable tariffs may suggest the Government will have to accept reduced bids, but some take a more pragmatic view. "These are sophisticated companies which have undertaken very careful analysis – they will have various price scenarios prepared, depending on how the market and regulatory regimes looks most likely to evolve," says João Rosado Correia at Garrigues in Lisbon.

Portugal's energy companies are anyway also succeeding abroad, which may help boost prices. Galp has expanded into Brazil – and recently sold major stakes to Chinese investor Sinopec, which has also taken a 40 percent stake in Repsol YPF's Brazilian operations – and Africa, where REN is bidding for the Portuguese Government's remaining stake in Mozambique's giant Cahora Bassa dam. Where firms like AVM Advogados, which has an office in Lisbon, is now targeting inbound and outbound energy investment.

"We are seeing activity by Portuguese companies in renewable and energy transportation projects worldwide. With the US, Venezuela, Angola, Mozambique, and Brazil among the most interesting jurisdictions for companies," adds Jose Diogo Horta Osorio, Partner at Cuatrecasas Gonçalves Pereira in Lisbon.

Strategic focus

The outlook for the energy sector is therefore by no means clear but Governments recognise the need to encourage investment from both domestic and international operators, and to ensure the right mix and security of supply.

For law firms, it is a sector in which many are also diversifying their emphasis to encompass transactional, regulatory and disputes needs. In Portugal, the traditional energy expertise of many firms has seen a number emerge among the major winners in the privatisation process – MLGTS, Cuatrecasas, PLMJ, VdA, Rui Pena and Garrigues, where João Rosado Correia is drafting the country's new energy code, among them.

But challenges do remain. "Ongoing projects are being maintained, without significant problems, but those in the pipeline are stopped by a lack of funding, reduced revenues, or just a lack of confidence," says Joana Andrade Correia, partner with Raposo Bernardo in Lisbon.

Spain's recently published National Renewable Plan 2010-2020 maintains ambitious targets, but the country must first manage its over-capacity and tariff deficit problem, say many. "The question arises as to whether the new Government will follow the commitments made by the last one. There is a risk that the sector will be expected to take on board a sacrifice in "solidarity" with the current state of the Spanish economy," says Silvestre Arana, Head of Energy at Garrigues.

Nonetheless, complicated times demand more rigorous analysis. “Clients require advisers with wide experience – not just focused on renewables – and a depth of understanding of the regulation, commercial aspects and challenges. Deeper knowledge is now, more than ever, a valuable asset,” says Emiliano Garayar, Managing Partner of Garayar Asociados.

And while many energy players may be struggling, lawyers point to the expansion of the sector over the past decade as positive for both the market and law firms. Over 4,000 companies are estimated to be active in Spain’s renewable sector alone, while firms like Latham & Watkins, Bird & Bird, Watson Farley & Williams and Broseta are now challenging the established Madrid players.

“The energy market is one that continues to present opportunities. Many established energy companies are seeking to guide future energy developments, while the most successful renewable companies are expanding around the world, our own challenge is to help them do it,” concludes Luis Pérez de Ayala, Partner at Cuatrecasas in Madrid.

Source: Iberian Lawyer