

ENERGY & RENEWABLES REPORT 2009: DIVERSITY RICH ALTHOUGH CASH POOR

Posted on 28/06/2009



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At a time when many business sectors are facing falling consumer demand the energy sector remains an international success story of the Iberian economy. Despite a difficult financial arena, changing regulation and increasing competition, the sector may however be one of the few industrial areas able to power the region out of its economic malaise.

Recent months have seen continued manoeuvring among the major Iberian utilities as they fight for market share at home and abroad, with a growing emphasis on Latin America, Africa and increasingly the US. The renewables sector is also now going through a period of change as operators, sponsors and promoters wrestle with the implications of recent tariff and regulatory changes, particularly affecting Spain's photovoltaic and thermal solar sectors.

Consolidation

February finally saw Italy's Enel buyout Acciona's 25% stake in the number two Spanish electricity generator, Endesa for €8bn as well as €3bn of Iberian wind and hydraulic assets. The deal makes Enel the global number two renewables company behind Iberdrola, and brings to an end the expensive and bitter battle for control of Endesa first begun in 2007.

En tiempos donde muchas empresas están enfrentándose a un descenso de la demanda, el sector energético sigue fuerte. A pesar de los retos de financiación, la regulación volátil y la creciente

competencia en este sector puede ser una de las pocas áreas capaces de sacar a la Península Ibérica de su dolencia económica.

Likewise, ownership of Unión Fenosa has also been resolved after Gas Natural paid €5.825bn for constructor ACS' 35% stake in the third-ranked Spanish electricity company. The fallout from the deal is however a requirement by Spain's competition regulator to sell key assets, including its gas distribution networks, 2GW of combined cycle plant and its stake in pipeline operator Enagás.

Gas Natural is obliged to give first refusal for Unión Fenosa's 50% stake in Iberian wind and combined cycle energy unit Eufer to its joint venture partner Enel. Similarly it has to offer Unión Fenosa Gas to partner ENI. 'There have been some big projects in recent months but there are far fewer on the horizon. Much of the activity is being driven by operators needs to sell what might have once been strategic stakes in order to generate cash for core activities,' explains Emiliano Garayar, managing partner of specialist firm Garayar Asociados, which acted alongside Uría Menéndez in the sale of Unión Fenosa.

Yet to be resolved however is full ownership of Iberdrola – the world's largest renewables player. Although it repelled a potential bid from EDF last year, ACS holds 7.7% of the company and a further 5% in derivatives, and rumours persist of a potential takeover bid, although lawyers suggest that thanks to Iberdrola's international expansion, any takeover will require complicated and extended European, Spanish, UK and Federal US and State approval.

Fundamental to all these deals and for many more across the sector is the need for finance and liquidity, say experts. The Iberian market, as with foreign markets, is suffering from economic issues and borrowing is expensive. To help smooth the acquisition of Unión Fenosa, Gas Natural undertook a €3.5bn rights issue in March, while in recent weeks Iberdrola has sold 10% of its 24% stake in Spanish wind turbine manufacturer Gamesa – the third largest in the world after Vestas and GE – for €390m.

Juan Ignacio González Ruiz, energy partner at Uría Menéndez, suggests the main challenge facing both potential purchasers and developers is the credit crunch. 'Companies are experiencing difficulties financing their projects and, in those cases where they are able to secure financing, the conditions are much more onerous than a year ago – a consequence of this is that the profitability of projects has suffered a significant reduction.'

Others suggest that nonetheless the process of consolidation is not yet finished. 'There is continuing activity, the three big Spanish energy players are now established – Iberdrola, Endesa and Gas Natural- Unión Fenosa – but there remains room for perhaps one more major player or perhaps three medium size operators,' says Luis Pérez de Ayala, energy partner at Cuatrecasas, Gonçalves Pereira in Madrid and formerly Director of Legal Affairs at Enagás – of which Gas Natural recently sold a 5% €155m stake to Oman Oil.

Project pressures

Across Iberia the financial squeeze has inevitably also had an impact on projects under development – banks are not granting approvals and developers needing to generate cash are being forced to sell their projects at low prices. The economic crisis has made money more expensive and this has obvious consequences, say lawyers.

Financings for at least ten Iberian renewable energy deals have nonetheless been closed so far this year, with term loans usually aligned to the project's calculated amortisation period – around 20 years.

Recent loans have been priced around the Euribor plus 200-300bps, which, say lawyers, is about the best in the market.

'The immediate consequence is that projects now take more time to be implemented. Banks are facing difficulties in placing structured finance and avoiding credit risk. The project finance model is now completely different and new and innovative structures to finance renewable projects have to be implemented,' says Mónica Carneiro Pacheco, energy and finance partner at Rui Pena, Arnaut & Associados in Lisbon.

Energy companies, some lawyers suggest, now have to readjust their business models to a new economic reality, reducing the projects they are willing or able to invest in and assuming lower returns 'The crisis is pulling out of the market nonprofessional players without robust financial structures or resources who aim to make huge profits in the short run, says Fausto Romero-Miura, partner at Pérez Llorca.

There is a clear trend towards scale, notable across both the traditional and renewables sectors, say lawyers. 'Things have changed dramatically, and notably in sectors such as solar PV where there is clear governmental and regulatory pressure towards establishing a more competitive and perhaps professional industry,' says Francisco Solchaga, partner at Araoz & Rueda in Madrid.

Energy mix

Despite the fluidity and changing nature of the Iberian energy markets one thing remains clear, both the Portuguese and Spanish governments continue to look to the sector as a major economic driver and are increasingly promoting a more diverse mix of energy sources and resources, say lawyers.

Spain and Portugal have historically relied significantly on energy imports. Until recently, imported oil accounted for almost 57% of total Portuguese energy supply and solid fuels (mostly coal) nearly 13%. Oil (49%) and gas (18%) imports dominated Spanish energy supply needs alongside coal (15%) while almost half of domestic production came from nuclear energy – regarding which the Spanish government faces a testing political decision whether to approve an operational extension to the Garoña nuclear power station, which opened in 1971 (see box: The nuclear question). An important element of this drive towards diversification has clearly been both countries focus on developing renewable energy, with Spain and Portugal well above the European Union production averages and in line to reach its Renewable Energy Plan 2010 electricity generation goals.



'One of Portugal's main goals is to achieve a reduction in primary sources and to centre on energies with renewable sources. The production of wind power, solar energy, geothermal energy, wave energy, biofuel, biomass energies and algae and biomass energy, and the expansion of the natural gas market, are major targets for the coming years,' says João Rosado of Garrigues in Lisbon.

Spain and Portugal have in recent years decreased dependency on oil and coal but increased gas imports – predominantly from Algeria (which now connects directly to Spain) and Nigeria. The belief, says Manuel Santos Vitor, energy partner at PLMJ, is that Iberia can emerge as an alternative southern European gas supply route – in the face of Russia's decision last year to cut off supplies to Central and Eastern Europe via Ukraine – and as a regional hub for liquefied natural gas (LNG) distribution.

Portugal is also seeing a strategic move towards microgeneration, with small-scale producers now able to sell excess energy to the national grid, and a focus on mini-hydroelectric production – last year saw the approval of a series of new dams along the Alto Tímega as part of Iberdrola's proposed €1.7bn investment in the country's energy infrastructure.

'This will further reduce the need for large centralised generation capacity and, on the other hand, create a vast storage potential through the use of reversible groups which will contribute to keeping renewable and small decentralised plants operating off-peak,' explains Manuel de Andrade Neves, partner at Abreu Advogados.

The recurring issue for any energy source but particularly renewable sources however, is the fit with Governments wider energy plans, notes Vanda Cascão, at Vieira de Almeida. 'The recurring considerations for promoters must be to assess energies suitability within the total mix of energy sources, the ability to store latent energy and in ensuring efficiency of supply.'

Renewed energy

There is no doubt that Iberia's exploitation of renewable energy has also developed as a result of historically favourable feed-in tariff regimes set by governments. Recent regulatory changes in Spain, lawyers say, have however the potential to limit future growth particularly of solar photovoltaic (PV) and thermo solar energy – areas in which it currently leads the world.

'The growth of some renewable technologies such as PV solar power has been revealed as unsustainable and has generated disproportionate expectation to sponsors,' says Mariano López of Ashurst in Madrid.

Last September saw the Spanish government introduce feed-in tariff rate reductions (Royal Decree 1578/2008) – from 48 cents per kilowatt hour (kwh) to 34/32 cents per kwh – for incomplete projects and further reductions for projects that failed to apply for the new rate. May 2009 has seen further changes (Royal Decree 6/2009) aimed at reducing the government's €15bn energy deficit – derived from the higher price it artificially pays to encourage production. The measures introduced include permitting requirements to measure the total volume of renewable construction underway, new minimum finance requirements, and further tariff rate reductions. A 500MW new project development cap is also currently in place.

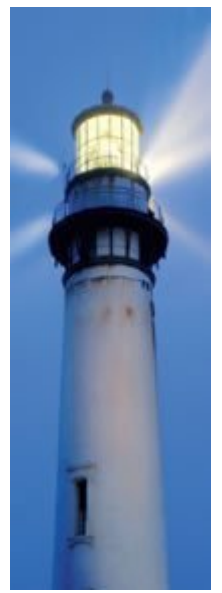
Other key elements of Royal Decree 6/2009 were measures introduced to tackle Spain's €14bn energy deficit, ahead of consumer price liberalisation, including a bonus official scheme, says Hermenegildo Altozano, head of the energy practice at Lovells in Madrid.

'The measures are intended to address the fact that Spain's utilities have for some time been selling electricity to consumers at a price below the production cost, to help them better manage and recover their losses, and to remove the government's ongoing obligation to fill the gap.'

'This latter regulation is really a challenge for promoters but a great chance for companies with strong financial resources, which enable them to finance 50% of the investment of the installation, with clear advantage over independent firms,' says Luis Antonio Castro Prieto of Legalia Abogados.

Project finance lawyers are seeing banks rapidly de-leveraging, equity being used to pay down debt, loan-to-value ratios are compressing and overleveraged companies are going bust as asset values fall. 'There will be a lot of competition among energy projects for a limited amount of funding,' says Israel Gómez-Caro, partner at Gold Abogados in Madrid.

The issue for many renewable companies is therefore how to adapt to this new business and regulatory reality. 'Unencumbered companies and strong financial investors shall be in a better position to survive, after the latest buoyant years where the very attractive tariff favoured many intermediates and opportunity investors,' says Rafael Cruz at Allen & Overy in Madrid.



Consolidation has already started, say some, while operators are looking to explore new markets, such as Italy or Greece, due to the uncertainty of the evolution of the tariff for future projects.

'While the oil price was above \$100 almost all renewable energy projects made sense. With prices now around \$60 companies need to concentrate their efforts in achieving more efficient and cost-effective renewable energy. The cost of energy in a crisis environment is critical,' says Jose María Viñals Camallonga, partner at Eversheds Lupicinio.

The nuclear question

Spain's incumbent government has maintained that it will not engage in further investment in the nation's nuclear energy plants and continues to look to phase out their use. It has publicly declared an intention to stop any further investment in nuclear production, but experts suggest it will likely grant an extension to the country's ageing reactors to avoid an energy gap.

Nuclear energy is a growing issue in Portugal also. It has no nuclear facilities but shares the production risks without any of the rewards. Two of Spain's nuclear reactors lie in Extremadura close to the Portuguese border.

'The cost-benefit ratio of nuclear power over other primary sources is still under debate. Portugal has no tradition of using nuclear power and the costs of setting up an appropriate regulatory and supervision framework would probably make it unfeasible.'

José Eduardo Martins, Abreu Advogados

'The debate on nuclear power needs to be put on the table. Provided that adequate safety measures are taken and third-generation nuclear equipment is used, the economic advantages of nuclear power are obvious, particularly as a base load source.'

Javier Santos, DLA Piper

'Nuclear sources are an alternative that should be open to discussion in the near future, namely because renewables cannot ensure stability and frequency in energy provision.'

José Diogo Horta Osório, Cuatrecasas, Gonçalves Pereira

'It is true that important political figures and other personalities of the private investment sector have recently been focusing on the capacity of nuclear energy to serve as a source for production of electricity. This could allow a reconsideration of the current government attitude in Spain.'

José Ramón de Hoces, Pérez Llorca

'Because of the redundancy factor, the implementation of a nuclear program in Portugal will always

depend on an association with Spanish nuclear companies or the creation of an original programme involving, at least, the implementation of two nuclear power plants.'

Joao Rosado, Garrigues

'Despite the challenges nuclear sources are facing, discussion on its implementation in Portugal is inevitable since the EU's energy targets are difficult to meet only with the wind, photovoltaic or even hydroelectric projects in place or under construction. We should not forget future energy needs.'

Mónica Carneiro Pacheco, Rui Pena, Arnaut & Associados

'In any event it will be complicated for a leading Spanish energy company to be prepared to develop new nuclear projects without financial support from the Spanish government and the main banks.'

Israel Gómez-Caro, Gold Abogados

Others believe however that the emphasis must remain on growing renewable energy supplies even in the face of lower oil prices, which should be regarded as a temporary situation.

For Bruno Azevedo Rodrigues, head of energy, utilities and environment at Raposo Bernardo, investing in renewables is a matter of common sense. 'There is no competitive advantage for Europe to base its energy policy on fossil fuel models.

Throughout Europe, with Portugal and Spain leading the way as two of the most active markets, the trend is for a growth in renewable energy, not the opposite.'

José Diogo Horta Osório, partner at Cuatrecasas Goncalves Pereira in Lisbon, agrees: 'Looking to the Portuguese marketplace, we strongly believe in further development of renewable energy in light of the commitment from the Government and private sponsors to increase their investments in the sector with a more specific focus on wave and solar energy.'

Portugal already operates the world's first commercial wave power plant, and has one of the world's largest operational solar plants, developed by GE at Serpa. But in recent months the headlines have been dominated by the €1.2bn acquisition by a Portuguese consortium of Babcock & Brown's local wind subsidiary – accounting for a quarter of the country's total wind generation capacity – evidence many suggest, of the significant optimism that surrounds the sector.

'The hydropower and wind sectors continue to be the most appealing in Portugal: the government's strategic guidelines for 2009 show a commitment to create more hydropower and wind parks and in addition, improve Iberian hydropower resources. The wind sector is, according to the analysts, taking the lead. Companies look at it with great potential and future development given its visibility and turnover,' says Jorge Santiago Neves, partner at Barrocas Sarmiento Neves.

International growth

Given the scale of opportunities and challenges facing the energy sectors – both traditional and renewable – there is some debate however whether the current situation is prompting more or less international interest in Iberian opportunities.

International solar facility manufacturers have reduced interest in Spain, following the recent Royal Decrees, while Enel's ability to gain control of Endesa has clearly not been without its issues. Nonetheless foreign investors continue to assess Iberian opportunities, say lawyers.

'Foreign companies such as E.On, Enel, Eni or Sonatrach are investing in the Spanish electricity and gas sectors, and taking advantage of the degree of liberalisation and market competition,' says Javier Santos, partner at DLA Piper in Madrid.

Mariano López of Ashurst in Madrid agrees:

'Clearly, Spanish companies are more focused on investing abroad and diversifying the location of

their energy assets in several regions of the world, but it is also a good opportunity for foreign investors to buy operating assets that have not been considered by some Spanish incumbent as strategic assets and which have been put on sale.'

The International Petroleum Investment Company (IPIC) of Abu Dhabi, a sovereign wealth fund, notably recently acquired Banco Santander's 32.5% holding in oil refiner Cepsa for €2.9bn (\$3.8bn) and looks likely to also buy Unión Fenosa's 5% stake. Others however point to the increasingly international diversification of Spanish and

Portuguese energy companies. 'Iberian opportunities are always attractive because of the legislative framework; however we now seeing more Iberian companies investing abroad, notably in East European countries and the US. Iberdrola Renewables and EDP Renewables are two remarkable examples of this internationalisation of Iberian companies, and which are now two of the biggest renewable energy players in the world, says Horta Osório at Cuatrecasas, Goncalves Pereira.

Also expanding are Gas Natural-Unión Fenosa and Portugal's Galp Energia, which are among those focusing towards oil and gas-rich Equatorial Guinea with the aim of developing its Bioko island – location of the capital Malabo – into a regional gas hub for West Africa. The companies are currently assessing the viability of building a network of pipelines and processing facilities, alongside senior '3G' consortium partners Eon and state gas company Sonagas.

'The issue for many companies is now where to invest. There are not so many opportunities in Europe in the current economic situation. Clearly Spain is no longer big enough for the major utilities who have expanded successfully, for example, into the UK and are now active in the USA. Traditionally though, Iberian companies have looked to the Hispanic-American markets. Many are already well established there, while others are now expanding,' says Pérez de Ayala at Cuatrecasas Goncalves Pereira.

Gas Natural-Unión Fenosa and Iberdrola are already significant players across Latin America and particularly Mexico, while Galp and Repsol are now actively exploring opportunities in Brazil's enormous 'pre-salt' crude oil fields – which some suggest may rival the North Sea in size and importance – alongside state energy company Petrobras, ExxonMobil, BG and Royal Dutch Shell.

Many oil and gas companies view Brazil as a growth market, as countries such as Mexico with its restrictive financial restraints, and Venezuela, under President Chavez, increasingly lose their commercial appeal, say lawyers.

It is towards the US however that many of Iberia's leading energy companies now have a strategic emphasis. The US Stimulus Plan – American Reinvestment and Recovery Act – has assigned up to \$92bn for new energy and infrastructure projects.

'Iberian companies are looking abroad, and particularly to the US given the emphasis President Obama is showing in investments on renewable energy. Spanish companies are well placed to carry out these projects which they have already started doing in places such as Nevada and Arizona,' says Luis Muñoz, energy and finance partner at Jones Day in Madrid.

“In 2008 there was a significant increase of litigation cases related to insolvency and unfortunately there is no reason to believe that this trend will alter during 2009.”
Vicente Sierra, Freshfields Bruckhaus Deringer



Challenges

Iberian's energy companies are clearly operating in the same context and facing the same issues as other businesses – with stricter credit limits and higher financing costs – say lawyers, with many in the renewables sector also however facing the uncertainty of regulatory changes and revenue

drops.

'We will continue to see projects – onshore and offshore wind, solar photovoltaic and solar thermal – but the recent tariff changes for PV and the preregistration for capacity approved in the new Royal Decree-Law on the electricity deficit have sent a rather confusing message to developers and investors,' says Javier Valle at Uría Menéndez in Madrid.

Silvestre Arana, head of the energy team at Garrigues, agrees: 'It is essential that the regulation of the energy sector in Spain endeavours to ensure legal certainty and this requires a stable regulatory framework that gives international investors comfort.'

The result, suggest some, is a sector that reflects wider energy market trends: the further concentration of companies, cuts in the investment plans, and consequently more joint ventures between companies looking to diversify into new energy areas.

The upside of these challenges is that energy players with the requisite scale and access to capital have further opportunities for growth, say lawyers. The momentum towards carbon-low and more sustainable energy sources is unstoppable, and will continue to be supported by governments albeit perhaps not as liberally as has previously been the case. The EU has set minimum national targets of around 20% for gross energy consumption to come from renewable sources by 2020. 'There is a clear tendency to increase the diversity of primary sources, driven not only by energy policy – greater independence, reduced price and shortage risks associated with fossil fuels – but also by environmental policy,' says José Eduardo Martins, partner at Abreu Advogados.

The future continues to present issues but nonetheless still looks bright for those energy companies able to overcome what some suggest are short-term financial or regulatory challenges. 'The main strategic challenges facing



“This is now a very hungry market, and if you cannot offer what is required, some one else surely can. Will clients pay for quality – I believe so.”

Ignacio Ojanguren, managing partner, Clifford Chance

Iberian energy companies are the international expansion of Spanish energy and utility companies, the legal development of off-shore wind farms and the stability of the feed-in tariff system,' says Antonio Morales, partner at Latham & Watkins in Madrid.

New investment opportunities clearly exist, in both established and new markets – internationally and in areas such as wind power, biomass and waste energy. The emphasis of governments across the world is towards the reduced use of fossil fuels and energy imports and towards cleaner, more sustainable and renewable technologies; areas in which Spanish and Portuguese energy companies continue to lead the world, and increased demand for which may also help the recovery of the Iberian economy.