ENERGY & RENEWABLES REPORT 2010: IBERIA'S ENERGY MARKETS IN FLUX – GETTING THE RIGHT MIX

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The Iberian energy markets remain an area of continuing activity, say lawyers. Inevitably the financial crisis has had an impact, but the sector in many respects remains largely healthy. The major utility players continue to develop their strategies at home and abroad, albeit there are some internal issues among a number of companies, while both Spain and Portugal continue to invest in the renewables sectors – an area in which Iberian companies are finding significant success internationally.

But uncertainty has emerged in some key areas, notably in relation to the tariff regimes that apply to renewable energy production in Spain, say lawyers there. The country can no longer afford its annual €14bn energy deficit and the Government is looking to better align the cost of production with consumption. But issues are also evident over the degree of interconnection of the Iberian Peninsula and the future direction of energy policies.

Clarification

Both Spain and Portugal have been at the forefront of the development and commercialisation of renewable energy in recent decades, notably in the solar photovoltaic (PV), thermo-solar and wind sectors, with Iberian companies now finding clear success exporting their know-how to new and emerging markets. But the regulatory regime that has most recently come to define and determine the viability of new production projects, at least in Spain, is subject to consistent revision, say lawyers.

"Renewables is an area of continuing activity but also uncertainty. There are increasing opportunities both for energy companies and the financiers behind them, but for good or bad the regulatory regime needs clarification," says Miguel Riaño, partner with Herbert Smith in Madrid.

There is an expectation of new regulation in the renewables field and talk of a reduction of perhaps 30% in feed-in tariff rates, say lawyers. But nothing is yet certain, there are no definitive facts.

Previous tariff reductions have predominantly impacted on the solar PV sector, but any new reduction may have a much broader impact. A further issue is the effect any retrospective changes may have, say lawyers, who report mixed messages emerging from the relevant Ministry.

"Since the Electricity Sector Law was enacted in 1997 we have had 12 years of patching up issues, which means we are now at the culmination of a bad process. Significant has been the lack of public debate throughout," says Juan Ignacio Gonzalez Ruiz, energy partner with Uría Menéndez in Madrid.

Los abogados coinciden en que sigue habiendo actividad en el mercado energético de la Península Ibérica. La crisis financiera ha tenido un impacto inevitable, pero el sector permanece relativamente saludable. Los principales actores del sector continúan desarrollando estrategias de crecimiento (aunque otros se enfrentan a problemas internos). Se sigue así apostando por el sector de las energías renovables, en el que las empresas ibéricas tienen un éxito considerable a nivel internacional. Aún con la lógica incertidumbre en algunas áreas clave como el sistema tarifario aplicable a la producción de energía renovable en España, y el rumbo que tomarán las políticas energéticas.
A recurring issue is in whose interests changes are being made. One clear aim of the previous amendments to the solar PV feed-in tariffs in 2008 was to discourage financial speculation, but now the government is no longer taking into account the views of the smaller players, some suggest. It is thinking of the biggest energy players in the market.

"There has been no public debate around what the new regulatory regime should be, or apparent consideration of the sector's needs. This is a country in which we have historically had a strong focus on the renewable sector, but adequate regulation remains alien to us," says Silvestre Arana, energy partner at Garrigues in Madrid.

The introduction of a pre-assignment register (Registro de Preasignación) has nonetheless restricted the number of new projects, says José Ramón de Hoces, partner with Pérez-Llorca. The aim is to enable the central government to better understand the volume of new construction in the market and alignment its ability to offer incentives to energy producers with Spain's regional administrations' desire for new schemes.

Ultimately therefore the problem is financial. In the current economic environment the government is focusing on the energy deficit it incurs, but without this cushion many energy companies and renewable producers will not be viable. The Government is perhaps using the deficit as a tool to manage inflation, suggest some.

> "What is evident is that transactions are more complex than before. There will be fewer deals but that demand a higher level of legal input."
>
> Juan Miguel Goenechea, Uría Menéndez

"The real problem that exists is that a system has been created which is financially unsustainable. There has historically been a very heavy subsidy of renewable energy production through very generous tariffs, which created a speculative bubble particularly in solar photovoltaic. The latter adds up to the huge historical tariff deficit. Pending securitisation, this now means that many energy companies' accounts are virtual," says Emiliano Garayar, Managing Partner of Garayar Asociados in Madrid.

Future perfect

In Portugal, the situation is similar but somehow different, say lawyers. The renewables sector has enjoyed a relatively stable tariff since 2005, and the energy deficit is considerably smaller, at around €2bn, but the current financial pressures now facing the government mean that revisions cannot be ruled out.

Nonetheless, alternative may exist. “Questions around tax credits for energy production, as already exists in the US, would circumvent or compensate for any direct cuts in prices paid, but would first need EU approval to ensure there were no State aid concerns,” says Rui de Oliveira Neves, partner with MLGTS.

The question of the cost of renewable energies is in any event a recurring one, but the development of the technology has to date meant that production costs have always fallen, say others. The introduction of the current feed-in rate in 2005 marked a significant drop in the price paid on the 2001 rate, but the current rate is now set for 15 years after commercial operation of existing projects (subject to a ceiling of electricity delivered to the grid).

The more pertinent changes in Portugal are however those affecting the distribution legislation framework, say some, and the ability to redevelop new and existing renewables sites with tenders for 1,500 MW of further production expected in coming years.

“There are questions around what new developments can be made in the renewables sector, both onshore and offshore, but many of the best solar and wind sites are already taken. So the issues now are more around improving the technologies to make them more efficient,” says Rita Roque de Pinho, partner with Cuatrecasas Gonçalves Pereira in Lisbon.

A better mix

A further issue across both Spain and Portugal is therefore what energies are required, and how to ensure a balanced mix and security of supply. Renewables may be preferred environmentally, but efficiency and energy storage remain challenges.

“The Spanish focus on liberalisation has meant a need to improve the energy mix, but there is not enough distribution capacity. What we have now however is a ‘porridge’ – with a changing focus on carbon, mineral and nuclear options, and an evident over-supply of natural gas,” says Hermenegildo Altozano, who leads the energy practice at Hogan Lovells in Spain.

The nuclear option

The nuclear question continues to reverberate in Spain and Portugal, but is often clouded by political sentiment rather than an objective analysis of the facts, say lawyers. In Spain, the issue has become more important following the Government’s decision to close one of its six plants, Santa María de Garoña near Burgos.

“The output of the nuclear power sector has remained stable despite some closures, as upgrades and efficiency gains at existing plants replace retired capacity. Despite nuclear power generating a significant portion of Spain's power supply, Prime Minister Zapatero has announced that Spain will gradually replace nuclear power with energy from renewable sources,” says Rafael Audiverty, partner with Roca Junyent.

Combined, nuclear energy accounts for almost 18% of Spain’s total electricity production, says José Giménez, partner with Linklaters in Madrid. “Currently, there are no plans to construct new nuclear power plants in the future, but rather only to maintain the installed output with the exception of the

Garoña plant whose authorisation has not been extended further than 2013."

Some believe however that the importance of the sector, and the emphasis on security of energy supply, may yet prompt a dramatic change of policy direction.

"It is possible that with respect the nuclear plants which are currently in operation, the Spanish Government could raise alternative investment or offer an extension of the moratorium period in order to secure the contribution gap they currently make in the Spanish electricity needs," says Israel Gómez-Caro, energy and infrastructure partner with Gold Abogados in Madrid.

A number of the major Spanish energy companies already operate nuclear facilities but the scale of investment required for a new plant, as well as the technological demands, may however require financial assistance from the Government and international input.

"Nuclear is efficient but it is clearly a long-term play and requires huge upfront development costs, that may require significant input from a foreign partner – the issue is who is currently developing the cutting edge technology, France, Germany and China;" says Javier De Montalvo, Head of Energy at Garayar Asociados in Madrid.

The same environmental and political issues also arise in Portugal but the debate is complicated further because of the relative size of the domestic energy market, believe some. "Not only is the amount of investment required an issue, and never more so than now, but also the amount of energy a plant would produce – it would pump too much energy in to the grid, the current distribution network would be unable to cope," says Rui de Oliveira Neves, partner at MLGTS.

There needs however to be a back up energy production capacity, say others, and that distribution alternatives will ultimately develop. Indeed, one may prompt the other. The discussion in Portugal over nuclear energy is not new and several entrepreneurs and private investors have defended the investment in nuclear energy.

"The nuclear theme shouldn't be a taboo issue but the challenge in Portugal is not only the political decision but also the cost / benefits equation, taking in consideration the other existing power production sources," says João Rosado Correia, partner with Garrigues in Lisbon.

Fundamentally the question in Portugal is also therefore one of interconnection, say lawyers. Connection to the grid in Spain is an emerging option but the network will have to expand further, through the Pyrenees to France or south to Northern Africa.

"Portugal does not have this technology so would have to import it, which again is a major political issue, while the costs involved in building a nuclear plant would also prove difficult. But any decision on nuclear power must be taken with the long-term in mind, and a project would in any event take 10 or 20 years to implement," says Manuel Vítor Santos, partner at PLMJ.

There needs to be more consistency around the energy policy in Spain, agrees Luis Pérez de Ayala, partner with Cuatrecasas Goncalves Pereira – his firm having advised the Medgaz consortium, that recently completed a €900 million 547km long pipeline connecting the Hassi R'mel gasfield in central Algeria to Spain.

"A problem is that, in the energy sector, we have jumped from being an adolescent to being fully grown without any of the associated pains. The Government has taken us down a certain path and then changed track." A further issue is the different perspective of central and regional government policies, say others. Some have even started charging wind energy companies for access to air.

"Spain's Autonomous Communities often distort the system by not taking into account the needs of the bigger picture. They are enjoying the benefits of the energy boom without any of the associated costs or regulatory and management pains," says Altozano.

Portugal has recently seen a debate open over both what types of energies the market needs and the long-term financial benefits of some of the current priorities.

The Portuguese government has nonetheless restated the importance of the renewables sector in its Stability and Growth Pact 2010-2013, which is intended to reduce public liabilities. The government has declared the primacy of renewables over other energy sources, with the National Program for Dams with High Hydropower Potential foreseeing the reinforcement of existing dams, and the construction of eight new dams, totalling over 1300 MW.

“You can adapt your work areas as long as you can ensure that you give the same level of service your clients expect. But many of the things we are now doing we were not doing before the crisis, and what is also significant is that we see the same banks in these new areas – it is clear that this is all very new for them too.”

Pedro Pérez-Llorca, Pérez-Llorca

The renewables sector now generates around a third of the country’s electricity needs, matching that produced by traditional carbon sources and from gas, including liquid natural gas (LNG).

“The question is should the country pay more for its energy in order to have a better world, but also to make it less dependent on energy imports in the decades to come. Energy security has been a major issue,” says Manuel Santos Vítor, partner with PLMJ.

March saw the approval or the country’s National Energy Strategy, which predicts an additional 3,000 MW of wind power by 2020, but also the publication of a manifesto questioning the rationale for paying more for renewable energies and alternative sources of energy. But for some lawyers there is nonetheless an acceptance that consumers will have to pay more in the short-term.

“There is a long-term agenda. An increase in domestically generated energy means a reduction over the long term in energy imports, which is ultimately good for the country’s trade balance, while further reducing the deficit,” says Pedro Siza Vieira, managing partner of Linklaters in Lisbon.

An additional issue is the capacity of the Portuguese energy grid to distribute energy efficiently and to cope with peaks and troughs in demand. The Energy Directorate has this past year opened up tenders for 15 new connection points as pilot projects, with the focus on solar photovoltaic and thermosolar plants, says Vanda Cascão, energy partner with Vieira de Almeida.

“The tender process was for around 35MW of capacity and heavily oversubscribed. In part this is because there have been no new series of connection points in the market for some time, but also because this is perceived as a stepping stone to much larger opportunities.”

In this instance the majority of projects are relatively small, but financing is inevitably a challenge, adds Jose Diogo Horta, partner with Cuatrecasas Goncalves Pereira in Lisbon. “The main strategic challenges for energy companies in Iberia include the restrictions on financing the new projects and also the difficulty in obtaining equity investors – while in Portugal there remains an interconnection deficit for new projects.”

Regulatory delays are also presenting problems, note others. Despite the government’s stated intentions to encourage new projects this has not led to a simplification of project licensing rules

“This is obviously incoherent and inconsistent with the public tenders that have been launched imposing tight deadlines and significant obligations both on promoters and on industrial partners," says Pedro Guimarães, partner with F Castelo Branco & Associados.

Full power ahead

Lawyers note that one area in which the financial crisis is having an evident impact is on the poor health of the major Spanish and Portuguese utilities, a number of which had run up large debts as a result of acquisitions . Iberdrola, the world's biggest wind energy generator, has recently agreed the $1.3bn sale of three gas businesses in the US, which it gained in the 2008 $4.5bn acquisition of Energy East – following earlier divestments of its 2.7 per cent stake in EdP, and 15.7 per cent holding in Petroceltic as it looks to reduce debt.

The gas lake

Much emphasis has been placed over the past decade on positioning Spain and Portugal as key gas and liquid natural gas (LNG) supply hubs.

"A LNG Iberian hub makes sense and is something that we have been speaking of for a long time. Seven of the existing 14 European LNG terminals are in the Iberian Peninsula: six in Spain and one in Portugal. There are also two new pipeline connections planned between Spain and Portugal in addition to the existing two," says Mónica Carneiro Pacheco, partner with Rui Pena Arnaut in Lisbon.

Cuatrecasas Goncalves Pereira has notably been advising the Medgaz consortium, comprising comprises Sonantrach, Cepsa, Iberdrola, Endesa and GDF Suez, which recently completed a €900 million 547km long pipeline connecting the Hassi R'mel gasfield in central Algeria to Spain. When it is finally switched on, the pipeline will have a capacity of 8 billion cubic metres and account for almost 20% of Spain's total gas imports.

The consumption of natural gas has grown in recent years, mainly due to the construction of combined cycle gas centres by electricity companies, say lawyers in Spain.

But such developments, plus Medgaz, mean that Spain has an excess of LNG capacity, which can be exported and may help the EU reduce its dependence on Russia and Eastern European connections. Spain can therefore reinforce its position as the southern border of the EU and the main entrance to Europe from Africa, says Raimundo Ortega, Head of Regulatory at Jones Day in Madrid.

But others say that there is a long way to go before this becomes a reality. "In order to become a hub, Spain must overcome problems such as its limited connections with the rest of Europe via France – currently made via three very low capacity gas pipelines. It would appear that this is not going to happen in the near future, and therefore the possibility of becoming a LNG hub for the rest of Europe is far off," says José Giménez, partner with Linklaters.

In addition, such over-capacity is leading gas prices to fall, meaning most gas and LNG supply contracts are working at (or very close to) take-or-pay levels, which in turn cause a fierce competition in end-user prices.

"The immediate outcome is an increase of price reopener disputes between sellers and buyers in respect of gas and LNG contracts, with many of those disputes ending in litigation or arbitration procedures," says Javier Santos, partner with DLA Piper.

Nonetheless, energy policy in Spain and Portugal continues to prioritise LNG, while the creation on of an Iberian gas market (MIBGAS) continues to develop, albeit slowly, say lawyers. As does the interconnection of infrastructure, including the construction of a 290km pipeline connecting the two countries' underground storage and liquefied natural gas terminals.

“The creation and implementation of the MIBGAS and the global liberalisation of the sector are still lagging. Exchanges within the Iberian Peninsula are rising and taking advantage of the available LNG reception capacity including the Sines Terminal, located in the south of Portugal,” says Ana Oliveira Rocha at PLMJ.

Nonetheless, there will be winners and losers in an enlarged Iberian gas market, suggest others. “It is too early to know exactly where that market will exist as new players are still entering and the correlation of forces between the two Iberian countries is yet to be defined. It is not difficult to predict however that Spanish companies will tend to dominate given the difference in size,” says Carlos Costa e Silva at Barrocas Advogados in Lisbon.

But questions surround the strategic direction of some companies, say others. Endesa is now a subsidiary of Italy’s Enel, after Acciona sold out is 25.1% €13.bn share, likewise Enel owns Viesgo, while Hidroeléctrica de Cantabria is owned by EdP.

Gas Natural and Unión Fenosa have sought comfort in mutual mergers, while others such as Iberdrola, suggest some, have the potential to be destabilised as a result of infighting between major shareholders.

“Companies have won size and dimension through merger but there are issues around stability. Spain remains a medium-size market, and if companies are to expand it has to be internationally; they have to punch harder,” says Garayar.

A significant focus of many companies is now on the US, as they look to leverage their renewables skills and portfolios following the US Stimulus Plan last year. Iberdrola has recently announced that around 40 per cent of its €18bn 2010-2012 capital programme will be largely focused on wind farms, electricity transmission and distribution in the US. Spain's Abengoa Solar has now signed an agreement in a joint venture with Total to build, own and operate, the first large scale Solar Power Plant in the Middle East. The $600m Shams plant in Abu Dhabi will produce 100MW of energy making it the world's largest concentrating solar power plant.

Among the Portuguese majors, lawyers point to the continuing success of EdP and Galp internationally, notably their focus on Brazil and Africa, including Angola and Mozambique – “EdP is regarded by many as the best model for international development by Portuguese companies,” says Rui de Oliveira Neves at MLGTS.

Lawyers may question the likelihood of a new major international player in Spain or Portugal, as a result of the difficulties in raising leveraged M&A finance and political opposition, but new players are arriving. Smaller acquisitions are closing while there is also the emergence of infrastructure funds in certain niche sectors.

Others note that the same funds are also taking sizeable positions in the major utilities. “Those that are now buying stakes in companies are the same that speculatively entered the renewable sectors and helped create the bubble that has so evidently burst there. They want now to focus on something more predictable,” says Altozano at Hogan Lovells.

“We have a continuous interest in South America, where we have been active for many years through our clients and contact local firms. But regionally, Brazil is at present the country which shows more opportunities.”

Iñaki Gabilondo, Managing Partner Madrid, Freshfields Bruckhaus Deringer

Expertise

Despite the ups and downs affecting the energy sector, lawyers nonetheless remain optimistic. Sales, acquisitions and divestments all mean continuing corporate work, while a tougher finance situation, regulatory uncertainty and emerging competition and State aid concerns – notably regarding the Spanish Government's encouragement of domestic coal – and the threat of disputes mean a demand for deeper analysis and stronger legal safeguards. The sector is in any event not a legal one but an economic one, emphasise others. And while issues such as connection barriers, distribution congestion and overcapacity need to be address, market opportunities do clearly exist.

The offshore sector remains in its infancy but nonetheless is one in which there is growing expectation. “Offshore is an option but it is a relatively expensive one and would likely require one of the major energy companies with the necessary resources to make the first moves,” says Rita Roque de Pinho at Cuatrecasas Gonçalves Pereira in Lisbon.

Concerns may also exist about the suitability of the Spanish and Portuguese coast lines, with the wave power scheme at Agucadoura in northern Portugal considered to have been a failure, but the first issue must be to clarify the applicable regulatory regime, notes José Eduardo Martins, partner with Abreu Advogados. Vanda Cascão at VdA agrees: “There is the potential for new creative new developments, such as offshore, but this is all up for debate. It requires a long-term investment.”

Concerns also surround the ability and opportunity for Spanish and Portuguese manufacturers to develop the offshore technology necessary, but some companies are already looking elsewhere to capitalise on emerging offshore markets. Iberdrola is notably among those awarded concessions in the UK to develop offshore wind farms.

“The geography of the Spanish coast does not largely permit these kinds of installations, for which reason Spanish companies are very much interested in the northern European countries whose seas and coasts do permit this,” says Giménez at Linklaters.

The scale of renewable energy developments in any event means growing interest among traditional project finance players, lawyers note. “Many investors are now beginning to turn away from demand-led infrastructure projects and look for opportunities not only in new markets but in new sectors altogether,” says Claudio Monteiro of Serra Lopes Cortes Martins in Lisbon. The difficult finance markets also present an opportunity for firms to demonstrate the depth of expertise they can offer clients, beyond regulatory expertise, say others.

“Previously, project finance was negotiated solely with the lead bank of the syndicate. Nowcompanies need to ‘road show’ all the consortium members. It takes longer and is a harder process, but in the end it is an opportunity for law firms to show their capabilities in supporting and intervening for their clients,” says Nelson Raposo, Managing Partner at Raposo Bernardo.

Femando Torrente

Fausto Romero-Miura, partner with Pérez-Llorca in Madrid, agrees that heavily regulated sectors demand the most transparent displays of expertise: "Through constant monitoring of the Government's regulatory tendencies, the transfer of this information to the client and the ability to reflect them in corresponding financing contracts."

The sector is also attracting new law firm players to the market, with the arrival in Madrid of Herbert Smith last year, attracting a number of the energy team from Linklaters, while more recently has been the arrival of another UK firm, Watson Farley & Williams, and former energy and projects specialists Joaquín Sales and María Pilar Garcia.

For the foreseeable future, Iberia's energy markets will therefore continue to present law firms with both opportunities and issues. The continuing domestic and European focus on expanding renewable energy production – Portugal's 2020 Energy plan estimates expenditure of €13bn by 2020 – means that even in the face of regulatory concerns, production will likely continue to expand.

While even in the traditional sectors, market consolidation, restructuring and expansion mean a continuing demand for expertise at home and abroad.

"The energy market has expanded from only five major players only a few decades ago to many thousands. But the level of sophistication has also increased, the technicians already know what the issues are and are now looking to the leading firms to help overcome them," says de Ayala at Cuatrecasas.