Energy & Renewables Report 2012: Stabilising the energy market

When the floor beneath you is constantly shifting, there is no hope of building a solid foundation on which to base an entire sector. This is the case across Iberia, as regulatory uncertainty, budgets cuts and crippling tariff deficits are presenting the energy sector with some of its toughest challenges to date.

The Iberian energy sector is one of those most heavily affected by the crisis, say lawyers. New laws, critical tariff deficit levels and drops in demand are all contributing to weakening a previously buoyant market. Regulatory uncertainty is an overwhelming problem, and there is an urgent need for stability.

In Spain, the reduction in energy demand, close to 17 percent in electricity and oil and 15 percent in natural gas since 2009, coupled with a colossal electricity tariff deficit, are having an incredibly negative impact on the whole market.

The Portuguese energy markets are also facing, and adjusting to, new challenges not only from the crisis but also from measures under the Memorandum of Understanding (MoU) with the Troika. And it is the renewables sector that has been hit hardest. The National Action Plan for Renewable Energies has been downgraded, with a reduction in production and consumption, while new licensing has been suspended.

But it is not only in Iberia that the crisis has been affecting the sector. Budget cuts undertaken by governments worldwide are penalising renewable energies on a global scale, says Manuel De Andrade Neves, Co-Head of Public and Environmental Law at Abreu Advogados. “This sector, one of the most dependent on public financing, is one of the first to suffer the impact of spending cuts and the need for governments to increase their tax revenue.”

Uncertain times

The market is shifting, and regulators and lawyers alike are struggling to keep up. In Spain, the main problem is reducing the country’s electricity tariff deficit, which reached an impressive €24bn in December 2011, and which the Government is attempting to tackle using new regulations.

Ongoing reforms have brought about an unsustainable level of uncertainly, meaning that investors are staying away and many projects have been delayed, or cancelled. “The regulatory risk is high, and it is quite difficult to carry out any new deals in Spain," says Luis Pérez de Ayala, Energy Partner at Cuatrecasas in Madrid, "which is especially problematic for companies with big portfolios that they are trying to divest." The hope is that once some level of stability is brought to the regulatory environment then the market will pick up.

For the first time ever the country also has a gas tariff deficit, principally due to falling consumption levels, and the future of the renewable sector is also at risk. The market has moved from the development of renewable energy being a 'must' to where it begins to be questioned, says Javier Santos, Head of Energy at DLA Piper Spain, both in terms of overall capacity and cost.

The Government has drastically cut off the feed-in-tariffs for new renewable and cogeneration projects and reduced the tariffs for certain types of operating plants. Subsidies have also been reduced in a bid to lower the electricity tariff deficit, and in January 2012, they were frozen for any new renewable projects. "Currently the big challenge is being able to build and operate a renewable project without a feed-in tariff competing with the other energy sources," says Francisco Solchaga, Energy Partner at Araoz & Rueda.

Meanwhile the Portuguese Government, under its MoU, has committed to ensuring the sustainability of the national electricity system and to reduce the country's energy dependence. This means tackling the tariff deficit and promoting renewable energies in a way that limits additional costs to the feed-in tariff, which includes renegotiating the contracts/licences of renewables promoters.

Cash flows have been negatively affected, as has the risk profile of projects, compounded by a lack of financing and investment — which means bad news for the sector. "Investment in renewables is still very important to free the country from its energy dependence that contributes greatly to the transaction deficit," explains Lino Torgal, Managing Partner at Sérvulo & Associados.

The MoU commitments have, unfortunately, led to concern amongst potential investors as to possible effects on the profitability of the projects and their capacity to repay debts, and as a result investment is stagnating. And times of uncertainty in the energy markets are particularly relevant because energy investments are long-term, says Vanda Cascão, Partner at Vieira de Almeida & Associados. What this means is that investors are staying back from committing to projects as they have no idea how the reforms and the market are going to evolve in the long run. This comes at a time when the sectors need them most.

Positive signs

But it's not all bad news. The very successful privatisations of EDP and REN were an important factor in creating some level of confidence for the Portuguese energy sector over the past year, demonstrating that opportunities are very much available and outsider interest is ongoing.

Portugal is also one of the few countries in Europe on track to meet the EU's target of 20 percent 'green' energy consumption by 2020, explains João Nuno Barrocas, Partner, Energy & Natural Resources Barrocas Advogados, mostly due to the extensive use of wind energy, although solar is quickly catching up. And there are also on-going successful projects in photovoltaic and solar thermal.

In Spain, diversification is on the up in the renewables sector, particularly in auto consumption formulas, mini hydraulic centrals, biomass energy, bio fuels, energy storage systems, marine energies and wind plants. Lawyers are also seeing renewables promoters developing new projects without the need for Government subsidies, mainly in the photovoltaic sector.

And bad times are driving innovation. There is a new trend of Iberian companies seeking opportunities in other renewable energy related markets, rather than in projects itself, says Gonzalo Olivera, Energy & Infrastructures Partner at SJ Berwin in Madrid, such as smart grids, electric vehicles or urban waste disposal industries.

Spain's regulatory distress

Regulation is currently the hot topic in Spain. Reforms have been coming thick and fast over the past year, with plenty more forecast on the horizon. But not everyone is happy.

"The Government seems to have a disregard for the stability and predictability of the sector's legal framework," says Juan Ignacio González, Head of Energy at Uría Menéndez in Madrid. "Investors have carried out investments within a specific framework and if you change that and break certainty then anything can happen and it is very difficult to get the trust back." It will therefore take a long time to recover investor confidence.

The regulatory floor is far from solid, and lawyers and their clients are struggling to know where they stand from one moment to the next. "The Government is taking short-term decisions based on economic motives," says Juan Rodríguez Cárcamo, Of Counsel at Perez-Llorca, "and they are not looking at the long-term implications for the sectors."

Lawyers blame the current legal framework for the unsustainable electricity tariff deficit. Income from the electricity supply has been unable to cover all the costs of the system of the past decade, and the marginal price determination system is not working properly, creating windfall profits to some and defaults to others.

With the tariff deficit to control, the Government is currently finalising new legislation — the Bill on Tax Measures on Environmental and Energy Sustainability Matters — which, if enacted as is, will have an enormous impact on the balance sheets of energy producers.

The Bill is expected to drive an increase in the price of electricity, reduce demand and decrease the profitability, and subsequent value, of energy companies. It could also seriously affect the profitability of existing projects, causing difficulties in complying with on-going financial obligations. As a consequence, there is increasing concern among investors and lenders about the long-term 'stability' of the regulation and the Governments support and commitment towards renewable energy.

And it doesn't stop there. The Government is also intent on drafting a new Power Sector Act in 2013, and this is adding to the level of regulatory uncertainty. "Every time there is a new reform I get asked the same question by clients: Is this the last one? How can we be sure things won't change over the next few years?" says Pérez de Ayala at Cuatrecasas.

At the start of 2012, the economic regime for renewable energy was also frozen, putting a halt to awarding new renewable energy feed-in tariff (REFIT), with a major impact on the photovoltaic sector. This move is expected to have an immediate impact on current renewable power pipeline, says Rafel Audivert, Public Law Partner at Roca Junyent, including circa 4,500 MW of wind power projects, 550MW of solar PV projects, as well as a number of projects in other areas.

This regulation will prevent proponents of new cogeneration, renewable energy and waste-to-energy plants from receiving contracts to sell their electricity to the grid, effectively putting the domestic renewables industry on hold while the government drafts a new strategy for the electricity sector. In addition, says Raimundo Ortega, Of Counsel at Jones Day Spain, lawyers have begun to see claims against the Spanish state from investors in the renewable energy sector, as a direct result of previous regulatory changes affecting premiums.

These changes to both the traditional and renewable energy sectors are seriously undermining Spain's credibility as a stable country in which to invest. "Regulatory certainty is required for investors to have clarity on the return they will get on their investment," says Álvaro Valle de Alvear, Energy Partner at Garrigues in Madrid, "which means that while some of them are looking at possible opportunities, they are acting extremely cautiously prior to taking any investment decision."

But some perspective is needed, says lawyers, no matter how bad things seem. "You cannot look at the regulatory reforms in isolation – you need to put them in the context of the economic crisis we are living in," says Miguel Riaño, Managing Partner at Herbert Smith Freehills Spain. "We have a country-wide problem and these reforms just play a part in addressing that."

Portugal's legislative pain

The Portuguese Government is also intent on revising the regulatory environment. It is currently enacting new laws, revising the entire sector and has completed the transposition of the Third EU Energy Package, as required under the MoU. The new laws cover electricity, renewables and cogeneration, and, says Bruno Azevedo Rodrigues, Head of Energy and Natural Resources at ABBC, consist of a complete reshaping of the system, ranging from new licensing procedures, regulated tariffs, powers of the regulator, among others.

The Package was finally transposed into domestic law in October of this year, and although in general terms it has come into force, energy operators are in the process of adjustment to the new rules. The new legislation aims to increase competition, the sustainability of the relevant systems and provide incentives to investment directed by end-user benefits, says Duarte Brito de Goes, Partner at Campos Ferreira, Sá Carneiro & Associados, which is expected to ultimately lead to full market liberalisation in 2013.

This will impact on four key areas, explains Carla Martins Branco, Head of Energy at pbbr. It will strengthen the separation of the activities of the transmission system operation, production and marketing in order to promote competition and transparency in the market, and simplify licensing procedures. Also it will increase consumer rights and strengthen the competence and powers of the National Energy Regulator (ERSE).

ERSE can now put in place penalty measures for electricity and gas players operating domestically (pending further regulation) and settle intermediate disputes with consumers, including by arbitration. Also, there is expected to be a reduction of 70% of the incentive granted to thermal power plants and hydro-plants. The feed-in tariffs applicable to cogeneration have also suffered a significant reduction, says João Rosado Correia, Head of Public, Energy and Environmental law at Garrigues in Lisbon, although this only applies to new cogeneration projects.

In the renewable energy sector, an agreement has been reached between the Government and APREN (Renewable Energy Promoters Association) to decrease the electricity production costs, adds Brito de Goes at Campos Ferreira. This will permit more stability in the sector, especially due to the possibility of extension of the period of 'controlled' sale prices.

One further challenge linked to its Iberian counterpart, however, is that following Spain's introduction of new tax legislation on energy production, since all electricity is traded in MIBEL (the Iberian Electricity Market), this could cause some disturbance on price throughout the market. On the other hand, says António Vicente Marques, Managing partner of AVM in Angola, these events may drive the Portuguese Government to follow the Spanish approach.

Beyond Iberia

It is no surprise, therefore, that Iberian companies are focusing on opportunities abroad due in part to the crisis but mostly to the uncertain of the domestic regulatory frameworks. Companies are diversifying their business worldwide, and while investments are mainly focused on solar and wind projects, off-shore wind projects are also gaining interest.

Spain has been a pioneer in the development of renewable energies, and many companies, due to the lack of domestic opportunities, are selling their know-how and technology abroad, says Olivera at SJ Berwin, where the development of renewable energies is currently in an initial stage, or where sector stability provides more opportunities.

And Spain's law firms are also recognised in the international market for having a unique level of expertise. "We have seen and dealt with all types of problems that can face the energy sector," says González at Uría Menéndez, "and that level of expertise is a great help when following clients as they take their operations abroad".

Lawyers are seeing Iberian clients look for newer and less competitive, markets with the expectation of higher investment returns — the emerging markets, South America and South Africa, for example — countries with high economic growth rates and abundant opportunities where they can export their know-how and proven ways of developing operations. But the highest investment, according to recent statistics, has been in India, the US and China.

"Clients are looking into other jurisdictions where they can find both financing and a more stable regulatory environment," says Manuel Santos Vítor Managing Partner and Head of Energy, Natural Resources, Corporate and M&A at PLMJ. "This does not necessarily mean emergent jurisdictions but also mature jurisdiction, such as other European countries and the US."

Portuguese companies are very well prepared and able to offer high level expertise in several areas of the energy sector and therefore are an added value to energy projects developing in those countries. And many Spanish companies in renewable energies have also become global players, says Audivert at Roca Junyent. "Iberdrola, Solaria, Isofoton, ACS, Atersa, Gamesa, Acciona and Abengoa, for example, have taken part in many investment projects abroad."

Tough times ahead

But the domestic sectors, however, do still hold potential opportunities that could lead to a reenergising of the markets. "In the Spanish renewable energy sector, the changes to the transfer tax could reactivate the M&A market," says Valle de Alvear at Garrigues, "and provide a window of opportunity for investors". And, lawyers say, the development of hydro, biomass and wave energy power projects in Portugal will present many opportunities in the years to come.

One cannot forget that the crisis will not last forever and there is a need to prepare the grounds for mid and long-term demand, says Covadonga Del Pozo, who recently left Cuatrecasas to form energy and environmental boutique Del Pozo & De La Cuadra Abogados, including the future of nuclear energy and adapting existing networks to future needs.

In both Spain and Portugal, the Governments are attempting to raise the development and use of renewable sources, in the implementation of energy efficiency systems, smart grids/smart metering and sustainable mobility, specifically on electric vehicles.

The new 'green energy' economy is hoping to generating new businesses in, for example, the development of technology and specialised job opportunities. And the decarbonisation of the world E3 (energy-environment-economy) system means Member States will have to establish energy efficient mechanisms, and so adjust their national policies and legal frameworks — providing a big opportunity for law firms to assist.

Despite the similarities, both countries face different pressing challenges.

For Portugal, this is to reconcile reducing the tariff deficit under the MoU, while maintaining the expectations of investors and promoters of ongoing projects. All without forgetting the need for a global energy policy sufficiently attractive to retain and capture future investment.

While in Spain the pressing need is to solve the tariff deficit and create a new and sustainable energy system from a clean base. "This is what will start to build back investor confidence in the market," says Luis Gil Bueno, Senior Associte at Gómez-Acebo & Pombo in Madrid.

But the urgent need for investment into the Iberian energy sectors depends largely on creating regulatory stability and therefore certainty for investors. Lawyers agree that both Governments need to focus on guaranteeing investments, both for renewables and conventional energies. If they do so, then the sectors have a chance of conquering the crisis in the long-term. In the meantime, law firms are left firefighting against regulatory uncertainty with no real end in sight.

Looking for advice

Regulatory reforms are currently dominating Iberian legal agendas, as businesses struggle to understand the impact of the regulatory changes on their businesses, investments and profits. But there are other challenges that lawyers highlight as being part their clients' day-to-day dealings.

Spain's new tax measures, for example, coming into play by year-end, could lead to a series of claims against the Government, say lawyers, and law firm departments are being asked by energy companies to analyse potential claims. And restrictions in specific Portuguese tax benefits have been a reason for concern, says Miguel Lorena Brito, Head of the Public Law Department at F. Castelo Branco & Associados, in addition to increase of VAT and of property tax, which also affect energy projects.

In the Continental Europe gas sector, the price and price formulae of traditional oil-indexed gas supply contracts are being re-opened, and discussions between buyers and sellers are particularly difficult in current market conditions. “The economic implications (hundreds or even thousands of millions of Euros) make it very difficult to reach amicable agreements,” says Santos at DLA Piper Spain, “and as a consequence, litigation in this area, particularly international arbitration, is being seen more and more”.

In Portugal’s domestic market, lawyers are busy supporting clients in disinvestment projects and managing existing projects in order to optimise costs, says Joana Andrade Correia, Partner at Raposo Bernardo, and also the restructuring and refinancing of projects and transactions in full.

The main challenges for clients with interests in renewable energy are optimising their structures, management and production, says Antonio García Muñoz, Senior Associate at Lener, and exporting their know-how in building facilities and technological development. Companies are also increasingly interested in receiving legal advice on how to set up new branches abroad to promote the building of new renewable energy facilities.

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