

SPANISH RENEWABLES BOUNCE BACK

IT HAS NOW BEEN OVER FOUR YEARS SINCE THE REFORM OF THE ECONOMIC REGIME FOR RENEWABLE ENERGY IN SPAIN, WHICH WAS LAUNCHED WITH THE APPROVAL OF PARLIAMENT BY ROYAL DECREE-LAW 9/2013. BY **MARÍA PILAR GARCÍA GUIJARRO**, PARTNER, AND **EDUARDO DACHARY GLARÍA**, ASSOCIATE, **WATSON FARLEY & WILLIAMS LLP**, MADRID.

After a lengthy period of stagnation for greenfield projects and a primary focus on refinancing for operating ones, the results of the two recent 3GW tenders – the second was extended to circa 5GW of awarded capacity – held in May and July 2017 respectively, confirm the ongoing shift of new projects' source of income from feed-in-tariffs to a gradually increasing unsubsidised market.

These two tender proceedings were also boosted by the prospect of Spain complying with its 2020 EU renewable energy targets. Equally important, the values agreed under the “reasonable profitability” principle that has played a pre-eminent role in the design of the regulatory regime since the reform might be revised in January 2020.

At the same time, the Spanish market is showing a trend to overcome its historical reluctance to use private energy sale and purchase agreements – namely, power purchase agreements or PPAs – though pool price-based structures will continue to be used alongside such PPAs.

Projects' ownership will likely continue a concentration process, from a very atomised market to one in the hands of funds and bigger producers, with innovative financing techniques sought by all market players, in order to fit in with both the new regulatory regime and the macroeconomic environment, the latter still defined by low interest rates and a liquidity surplus.

In such a context, project bonds emerged in 2017 as an alternative financing and refinancing instrument to those traditionally offered by Spanish banks, especially in the solar photovoltaic energy sub-sector.

Remuneration regime

The remuneration regime applicable to electricity production from renewable sources was implemented in Spain following the approval of Royal Decree-Law 9/2013, the foundations of which were encompassed in the Electricity Industry Law 24/2013 (LSE) that specified its basic principles, as well as the criteria and the remuneration review options for electricity production facilities using renewable sources, cogeneration and waste.

Further developing the LSE, Royal Decree 413/2014 (RD 413/2014), among others, established

remuneration guidelines for standard facilities covered by the specific remuneration regime, based on (i) standard revenue from the sale of the generated energy valued at production market prices; (ii) standard operation costs; and (iii) standard value of initial investments in a facility.

The LSE also establishes that the remuneration regime will not exceed the minimum level needed to cover the costs of production facilities using renewable energy, cogeneration and waste to compete on a level playing field with other parts of the energy sector in line with the 2014-2020 European Guidelines on State Aid regarding the protection of the environment and energy.

It also ensures producers owning projects with premium regulated remuneration (retribución primada) a right to obtain reasonable profits from referred standard facilities in each applicable case.

The new remuneration regime is therefore based on the principle of procuring “reasonable profitability” for projects, depending on their installed capacity rather than being proportionate to production. This reasonable profitability principle relies before tax on the average return in the secondary market of 10-year benchmark government bonds plus the relevant financial spread.

Currently this spread is set at 300bp, which means that for facilities with premium regulated remuneration at the time when RD-law 9/2013 came into force, the reasonable profitability rate was at 7.398%, while it is currently set at 7.503% – thus higher than before – for projects deriving from the three tenders held so far.

However, the remuneration guidelines grant the Spanish government the discretion to revise the reasonable profitability rates for the next regulatory period, ie six years, which is set to begin in early 2020. Any such revision, as per the LSE, “will be set taking into account the cyclical situation of the economy, of electricity demand and the adequate profitability for these activities”.

If the government decides to carry out such a review and, within that framework, considers it convenient to modify the value on which reasonable profitability rates for the remaining useful regulatory life of the standard facilities are based, the LSE establishes that said value modification must be made through a rule enacted as a law. The LSE also notes that “if the

review [of any remuneration guideline] was not undertaken, the guidelines are understood to be extended for the following regulatory period”.

Though this provision of the LSE suggests that if no law for the revision of the reasonable profitability rate is enacted then its current value will be maintained, according to government sources it could be also interpreted that if no revision is undertaken, the reasonable profitability would automatically be updated to the average return in the secondary market of 10-year benchmark government bonds for 2020 plus 300 basis points.

According to present forecasts, that would imply that the reasonable profitability rate is set between 4% and 5%. In this case, the financial impact would be greater for established operating projects than for projects resulting from the tenders, meaning a direct decrease in remuneration for the former, and tender price floors going down for the latter.

The potential that the government might adopt such an interpretation of the LSE has caused some controversy throughout this year, though it is still unclear what the outcome of any revision would actually be. Regardless, this represents a challenge for projects, as a decrease in the reasonable profitability rate could imply a change in financial decisions made by investors and financing providers.

Overview of tender outcomes

In line with the regulatory framework referred to above, three tender proceedings have been carried out to-date.

In terms of tender design, current Spanish tenders provide investment-based support, in the sense that the outcome of the auction is a discount on the standard investment value, from which the remuneration for the investment is finally obtained by applying the methodology set in RD 413/2014.

The 2016 tender resulted in a 100% discount on the standard investment value, while bidders offered the maximum permitted discount in the two 2017 tenders. These results have therefore confirmed investors' appetite for Spanish renewables and can be also considered successful in terms of costs for the electricity network, which is a major government concern.

With respect to the technologies auctioned, 500MW of onshore wind energy and 200MW of biomass were auctioned in the first tender held in January 2016. The May 2017 tender was technologically neutral, but primarily granted to wind, while the July 2017 tender, held after May 2017 tender's design issues had been raised by non-wind producers, was set for onshore wind and mostly for solar.

In any event, onshore wind power and solar had similar results and were granted approximately 4GW each in the last two tenders, according to the results published in the Spanish Official Gazette as of May 26 2017 and July 28 2017, respectively.

It is well-known that projects constructed under the auction that are awarded capacity are guaranteed less price volatility by the government given that a certain floor and cap is set with reference to the pool price. In turn, the price floors for the two recent tenders and the fact that there are circa 9GW of new projects to be developed in the following two years may have a material impact on the pricing of significant PPAs in the future, at least for those where awarded bidders will be involved.

Awarded bidders are required to build and commission the agreed projects by December 31 2019, so as to comply with the 20-20-20 EU objectives. Otherwise, certain guarantees required to bidders in the context of the tenders may be enforced. It is clear that the great volume of capacity awarded in the tenders means their outcome will have a strong impact on the further evolution of the Spanish renewables market.

Power purchase agreements

In July 2017, Portuguese company EDPR signed the first direct fixed-price PPA with Spain's Calidad Pascual for the sale of electricity from its Spanish wind farms. This is believed to be the first PPA between a renewable power producer and an end-consumer of electricity in Spain.

The Spanish renewables energy market has not historically had a culture of corporate or direct PPAs between producers and end-consumers. Among other reasons, to avoid possible loss of competitiveness, consumers have traditionally been reluctant to fix the price of their electricity consumption in the medium/long term.

Also, renewable producers have traditionally been compensated with feed-in-tariffs well above the market electricity price so the possible fluctuations in the latter have not been a concern for them or those financing their projects. In addition, market players have traditionally considered that the liquidity and creditworthiness of the electricity system is much higher in comparison with that offered by private counterparties.

Since the liberalisation of electricity supply, the Spanish regulatory framework theoretically enhances the signing of such agreements. The only applicable regulatory requirements are that both agents, producer and end-consumer, must be market participants and declare the existence of their direct energy transactions to the system and market operators. These requirements can also be allocated to a third party at the request of an energy supplier (comercializadora) involved in a transaction.

Regarding unsubsidised renewable projects, the number of PPAs, direct or financial, executed is highly likely to increase in the short/medium term. This new trend is likely influenced by several factors. Similar to what has taken place in other jurisdictions, as the cost of wind and solar power generation decreases, and the price on carbon emissions puts upward pressure on electricity prices, large corporations (and

progressively small ones too) are committing to use renewable electricity for economic reasons, while some of such corporations have committed themselves to reach a 100% renewable energy consumption rate.

To achieve this, they may consider a direct PPA with renewable producers rather than contracting with electricity suppliers with guarantees of origin, ie obtained from renewable sources. At the same time, energy suppliers are becoming more active in offering financial PPA solutions to hedge the risk of market price fluctuations.

Furthermore a PPA, direct or financial, could provide renewable generators with the price certainty or hedging they need to finance new sector projects – in effect making said projects bankable. In the context described above, it seems clear that these agents – with the assistance of financial institutions – will find satisfactory solutions for all parties.

In addition, since this type of transaction is excluded from the electricity market pricing system, both agents are aware of both revenue and costs in advance, allowing forward financial planning and investment policies that eliminate or reduce risk and uncertainty, thus also facilitating innovative new financing structures.

Although financial institutions are deepening their knowledge of the Spanish electricity market and becoming increasingly comfortable with market price risk – the recent financing of the Malpica de Bergantiños wind farm without regulated revenue being a good example – the banks' approach to full merchant unsubsidised projects still hinges on very conservative assumptions on projects' financial models.

Banks still generally require borrowers to comply with covenants such as cash sweeps and dividend lock-ups, which end up reducing project value for equity investors. In this context, financial or direct PPAs might help to bridge the gap.

Although it is very challenging for sponsors to find counterparties that can provide solid creditworthy structures in today's market, considering the large capacity volume awarded in the recent tendering proceedings, and consequently the increasing exposition of projects to merchant risk, project finance structures based on PPAs will likely become more common in Spain.

Alternative project finance

Several factors have contributed to the increased resources available for non-banking financing, such as a higher confidence in the new regulatory framework (LSE and RD 413/2014) and the progressively decreasing costs and time period needed to implement such transactions, together with certain other advantages for the involved parties. The most notable example of this trend is the emergence of project bonds.

Courtesy of project bonds, investors, whose numbers are on the rise, can now find less

volatile and secure returns on their investment (unless eventually upcoming revisions foster further changes to the remuneration scheme), issuers get to improve their financial situation by obtaining competitive fixed prices for their leverage and longer terms, while banks acting as arrangers may manage to get profitable fees for their pivotal role on such issuances.

This greater appetite for project bonds has gone hand-in-hand with the introduction of greater flexibility in the legal framework applicable to issuances of this type. Hence, private placements addressed to institutional investors can be negotiated in multilateral trading systems (MTSs) without the need to publish a brochure. The most popular MTS-type trading venue is the "Quotation Board" of the Frankfurt Stock Exchange.

The most common corporate structure used for transactions of this type is the "double LuxCo" scheme, which consists of interposing a second Luxembourg company between the sponsors of the issuer and the issuer SPV itself – assuming the latter is also a Luxembourg company – aimed at easing the enforcement of the pledge of issuers' shares.

Nevertheless, the double LuxCo scheme has significant structural costs and tax considerations. At the same time, recent legal developments in Spain have eased access to capital markets for Spanish companies and provided alternatives to the double LuxCo structure.

Law 10/2014, of June 26, brought parity for listed and non-listed companies regarding exemptions to the general withholding obligation for payments to foreign bondholders. In turn, Law 5/2015, of April 27 lifted quantitative limitations for public companies (sociedades anónimas) on the issuance of bonds to 50% of their equity, and made it applicable also to private companies (sociedades limitadas), which until then were prohibited from issuing bonds.

Apart from the upsurge in project bonds, financings will have to adapt to the new economic regime for projects resulting from the recent tenders, the use of PPAs, unsubsidised projects as well as to more refinancings to optimise cost-efficiency.

By way of example, Spanish infrastructure company Elecnor recently closed the first refinancing of an unsubsidised wind farm in Spain. The deal was based on electricity price projections of about €35/MWh over the lifetime of the debt, compared with current spot and forward prices ranging between €40/MWh and €50/MWh in the Spanish market. As part of this deal, Elecnor auctioned off its old turbines and provided a completion guarantee for the refinancing along with a two-year production guarantee.

Big industry players may be looking to sign such PPAs rather than just sell to the spot markets. The nature of said PPAs, together with the financing schemes arranged by large producers, will surely impact on how large new projects will be structured going forward. ■