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

El sector de la energía en la Península Ibérica es uno de los más afectados por la crisis, afirman los abogados en el informe anual de energía y renovables. Las continuas reformas normativas, los niveles de déficit tarifario y la caída en la demanda son aspectos que contribuyen a debilitar un mercado que hace poco era boyante. La incertidumbre regulatoria es un grave problema.

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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