

Turning up the heat on Spanish renewables

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In Spain there are c.64,000 renewable energy assets financed with c.€44bn of debt. The Spanish government has recently changed the subsidy regime, which we expect to impact the profitability of some renewables plants significantly. Existing project finance structures could become unsustainable for these plants and we believe this could lead to a number of financial restructurings, featuring some complex stakeholder dynamics.

In light of their fiscal deficits, governments across Europe have been rethinking the generous subsidy regimes that they put in place to encourage renewable energy installations. Following cuts to the German regime earlier in 2013, the Spanish government announced in July 2013 that there would be changes to the 'Special Regime' in Spain.

The revised law, approved in June 2014, seeks to consolidate a series of previous laws passed since 2010 that have sought to gradually reduce the level of subsidies the government pays to renewable energy operators. Whilst this new law, RD 413/2014, is the final step in this series of reforms, and to an extent provides some "closure" on this issue, it contains a number of parameters that will allow the government to flex subsidies further in the future. Therefore the outlook for renewables operators and financiers remains, to some extent, uncertain.

The new remuneration framework replaces feed in tariff subsidies ("FITs") with a subsidy based on operational and investment returns, which the government believes are reasonable for a particular qualifying technology.

Changes to renewables subsidies elsewhere

The Italian government has proposed a draft reform to renewable energy subsidies with a reduction in the FIT. The proposal is for a reduction of c.8% for a project with a 20-year life or a larger reduction of 17%-25% if the life is extended to 24 years. Although we believe the impact will be limited to marginal plants, we will be watching this development closely.

The German government has proposed a further reform to financial support provided to renewables, but we understand that this only applies to new projects started in 2014 and beyond.

The UK government has proposed to terminate the Renewables Obligation in 2015, two years ahead of schedule. This is viewed as a retrospective change as it changes previously agreed remuneration schemes and is being challenged in court after changes to FITs in 2011 were ruled unlawful by the High Court in July 2014.

Asset revenues are now to be made up of three components:

1. Market price of electricity (generated by selling production into the free market);
2. Return on Operations (“Ro”) – a subsidy to enable a ‘standard’ plant to break even before taxes and financing costs (i.e. the difference between theoretical operating costs and the market price of electricity); and
3. Return on Investment (“Ri”) – a top up subsidy to provide a ‘reasonable’ return to investors, currently set at 7.5% IRR over the life of the asset.

Although at first glance the new subsidies appear sensible, the devil really is in the detail of the parameters, which were published separately via a ministerial order. The impact of the new regime will therefore vary significantly from one asset to another.

In particular, plants that have been in place for longer will receive lower, or no, subsidies where they are considered to have already received a reasonable return. For example, wind farms that were installed prior to 2005 will receive no Ri. Conversely, some newer technologies, such as thermo-solar arrays may benefit from the reform.

There are four key issues for asset operators, sponsors, lenders and potential investors to consider:

1. Asset efficiency compared with a standard plant

Ro and Ri are set based on ‘standard’ plants and do not reflect the actual costs of each real plant. Therefore, Ro for a given plant may not be sufficient to cover operating costs.

We have seen first-hand a number of PV plants that are less efficient than a standard plant, leading to regulatory payments being insufficient to cover costs, which prevents such projects from breaking even at the operating level (as was intended by the legislation).

2. Liquidity implications from retrospective application

The reform applies retrospectively to July 2013, meaning some assets may owe money to the government in respect of excess subsidies received over the past 12 months, potentially leading to immediate liquidity pressures.

3. Subsidy parameters remain susceptible to further tightening

Ro and Ri will also be affected by a number of variables that can be flexed by the government in the future.

Ro parameters, such as standard plant operating costs and production hours thresholds, will be reviewed and updated every three years, with the first revision in 2016. Any changes could affect the level of Ro subsidy received.

The headline IRR figure of 7.5% is actually defined as 300bps above 10-year Spanish government bond yields, which were c.4.5% in early/mid 2013. The reference bond yield is fixed every six years, with the next revision in 2019. Bond yields have subsequently fallen to c.2.5% in July 2014 and if yields remain below 4.5% in 2019 this could have a significant impact on the level of subsidies paid.

4. Stakeholder dynamics

If some projects need a capital restructuring, there are a number of important factors at play that will impact stakeholder dynamics:

- a. Project finance structures – many of which have out of the money, long dated swaps from pre 2008;
- b. The outcome of legal challenges to the new regulation in Spain by sponsors and the renewable energy lobby; and
- c. Relationships between financial stakeholders across a number of assets.

Potential solutions

Although there may be a number of self-help measures to improve efficiency, these are unlikely to be sufficient to compensate for lost regulatory revenues. The principle self-help measure is to renegotiate Operations & Maintenance contracts, but other costs should be reviewed including management fees, royalties, insurance, leasing etc.

Depending on the severity of the impact, some plants may need a capital restructuring. A key objective of any restructuring should be to maximise cash generation of the asset and minimise any leakage.

Looking forward

The coming months will be a critical period in understanding how sponsors intend to deal with the situation, including actions taken to reduce costs and optimise assets and, where necessary, the outcome of financial restructurings.

It will also become clear to what extent a market develops for the debt, or assets, as the impact on individual assets becomes clearer and financial stakeholders start to form a view on likely future parameter changes every three or six years.



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