Financing for Renewable Energy projects in 2011 and beyond - road to recovery?

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France will have to invest heavily to meet its needs for electricity and security of its supplies until 2020. The financial crisis has led to a sharp tightening of financing conditions: rise of margins, fall of debt ratios, decline of financed investments, higher selectivity of projects, disappearance of syndication... Besides, some banks have disappeared from the market: Dexia, RBS...

However, the crisis has also led to a return to normal conditions of CAPEX with the return of economic profitability of projects as a result.

In this light, what may be expected in 2011 and subsequent years regarding the financing of Renewable Energies?

SPEAKERS

- Hajo Neugaertner, Head of International Project Finance, Commerzbank AG - Renewable Energies
- Laurent Inard, Partner, Head of Financial Advisory Services France, Mazars
- Pierre Parvex, Head of Renewable Energies, GDF SUEZ - Energy France
- Véronique Fröding, Lawyer, Gide Loyrette Nouel Paris
INTRODUCTION

France anticipates that its energy mix will contain 23% of renewable energies by 2020. This means that the production of wind energy will have to increase from 5,000 MW today to 25,000 MW, that solar energy will have to increase from 600 MW to 5,400 MW, and that biomass energy will have to increase to 2,300 MW from today’s non-existent levels.

Germany had even more ambitious environmental targets, and was planning for 60% of its total energy production and 80% of its electricity position to come from renewable energies by 2050. These objectives stem from the need to satisfy increased consumption levels, address the peak oil situation, and fight global warming.

In the lead up to 2020, France will have to invest heavily to meet its needs for electricity and security of supply. In this context, the impact of the financial crisis had to be considered.

On the down side, it has led to a sharp tightening of financing conditions, characterised by rising margins, declining debt ratios, decline of financed investments, higher selectivity of projects, and disappearance of syndication. In addition, certain banks such as Dexia or RBS have completely disappeared from the market.

On the more positive side, the crisis has led to the re-emergence of normal CAPEX conditions, resulting in a return to the economic profitability of projects.

In the light of these factors, what can be expected in 2011 and subsequent years regarding the financing of renewable energies? In particular, in terms of financing, legal and valuation aspects applicable to these projects.

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I. Feed-in tariffs and technical progress: sensitivity in the photovoltaic case

The regulatory framework has considerably evolved in France in recent months. 2010 saw tremendous upheavals on the tariffs side, with a drop in tariffs from approximately €0.60 in 2006/2007 to €0.44. Annual indexation has also dropped from 60% to 20% of inflation levels. As a result, the business model used to assess projects will have to be severely modified, as the expected returns will be quite different under the new tariff and indexation regimes.

To this end, it should be noted that the internal rate of return (IRR) of a project can be calculated on the basis of (a) free cash flows, (b) equity cash flows, or (c) dividends. The free cash flow method is biased in a number of ways and cannot be used for post-tax equity IRR purposes. The equity cash flow method is relatively simple and rapid, but does not take into account the annual net income profile of a project. The dividend method is therefore the preferred method for calculating the IRR of these projects.

In terms of project sensitivity to feed-in tariffs, the dividend method shows that the IRR of a given photovoltaic project benefiting from the 2010 tariff of €0.60 amounts to 16%. Under the 2011 tariff of €0.44, that IRR drops to 4%. In order to address this drop in profitability, it is necessary to implement both technical progress and cost progress. Rentals are also an important parameter when dealing with roof-based photovoltaic projects. They should be indexed with respect to tariffs and not with respect to inflation.

II. Renewable energies: the success story continues

Enormous investments in the renewables industry continue to fuel the growth path of this exciting sector. There has also been a tremendous increase in the annual installed capacity in wind and photovoltaic energy in Europe, North America and Asia, with significant potential going forward in Latin America, Africa, the Middle East and the Pacific.

In this context, 10 countries represented 80% of installed capacity in 2010, demonstrating the enormous potential that exists in the rest of the world. This strong growth path will continue as new countries turn to renewables, as new technologies are developed, and as public commitment and acceptance of renewables grows. Repowering will also play a greater role going forward. However, changes to remuneration regimes could act as a brake on this growth, as could a decline in the economic strength and political stability of certain countries. Permitting processes and debt financing could also act as constraints on such projects.

The global debt financing environment for renewable energy projects should also be considered. Following the financial markets crisis, most countries have undergone severe cuts in funding, fewer banks are involved in financing these projects, interest in certain regions (such as Eastern Europe) has declined, and syndication has become extremely difficult. All of this highlights the importance of the relationship with banks, and there should be a strong focus on close relationships, long-term investors and proven technologies.

From a lender’s perspective, France is an attractive market but faces a number of challenges including the cap on new photovoltaic installations that will apply as of 2011, at a time when the accelerated depreciation incentive on new investments will also come to an end. In addition, the permitting process is very slow. Politicians and local authorities are encouraged to better manage the permitting process, to encourage banks to continue their financial support – especially in smaller photovoltaic projects – and to also encourage developers to continue the good work they were doing in France.

III. The French renewable energy road map

In the context of France’s ambitious targets for 2020, there has been recent developments in France’s regulatory framework. While those targets have been set at the national level, it is also necessary to consider the role of local and
regional authorities. The latter will have an increasingly significant input into the permitting process going forward.

In terms of the French regulatory framework, the main authorisations/conditions required before financial closing include the lease, building permits, operating licences, operating authorisations, grid connection agreements, and the EDF power purchase obligation. Article 88 of the Grenelle de l’Environnement law has raised questions about the feed-in tariff, which may only be secured at the signing of the PPA with EDF. The EDF’s power purchase obligation covers 15 years for onshore wind and 20 years for solar, biomass or offshore wind.

The major upcoming public calls for tender include a biomass call for tender (submissions to be made by 28 February 2011), an onshore wind call for tender (9 November 2011) and an offshore wind call for tender (end 2010).

With respect to the security package in the financing of renewable energy projects, this package is usually granted for the following senior facilities: the term loan facility, the VAT facility, and the revolving facility, which finances corporate needs over the life of the financing. The security package takes the form of (a) cash flow security interests, and (b) conservatory security interests.

The cash flow security interest is the main security provided in renewable energy projects. It is easy and cheap to put in place, and is one of the most efficient securities available under French law. However, it is subject to strict formalities. The conservatory security interest is generally granted in favour of the bank, endowing it with ranking priority over the other assets of the SPV. However, its enforcement is no longer possible if insolvency proceedings are launched against the SPV.

The usual conservatory security interest includes a pledge on the SPV’s shares and bank accounts, a pledge on the project’s tangible assets, or a notarised mortgage. Particular attention should be given to building-integrated photovoltaic plants, where the security interest should be linked to the applicable lease agreement (usually an emphyteutic lease agreement).

IV. Realities and challenges ahead

GDF SUEZ currently generates 14 GW in renewable energies output each year, with renewables representing 20% of the Group’s overall power output. It has the intention of doubling its renewables installed base between 2007 and 2013. In France, renewables represent over 60% of the Group’s generation capacities. In addition, 294 MW of renewable capacities are currently under construction. GDF SUEZ is the leader in wind energy in France, with 54 wind farms in operation. In terms of its Grenelle objectives, GDF SUEZ is currently at 25% of the onshore wind target and 10% of the solar photovoltaic target. It still has a long way to go on the offshore wind, hydro and biomass targets. In addition, the cost of financing the Grenelle scenario is now under strong debate given the current economic environment. There is notably a fear that solar photovoltaic could enter a phase of out-of-control growth leading to a fundamental economic imbalance.

GDF SUEZ’s vision of the industry is that there is limited visibility on the evolution of activities due to stop and go regulatory moves. In addition, there is very little visibility with respect to project waiting lists, and non credible projects should therefore be removed from the lists. The use of misleading incentives should also be avoided, and the rapid development of the most competitive technologies (onshore wind and hydro) was to be encouraged. It should also be noted that the cost of sustaining renewables amounts to less than €4.00 per household per year in 2010. There is a need to reinforce local acceptability of renewables, and this can be achieved by sharing the benefits of plants with local authorities, in the form of local taxes, municipal fees or rents.

The importance of a clear road map is crucial, despite the currently unfavourable environment. There was a need to work towards greater transparency and increased long-term visibility, and to promote tools that would enable the benefits of renewable developments to be shared at the local level. Finally, it was necessary to create the conditions for a higher level of interaction between industry and the development of renewables in France.
Contacts:

**Mazars**

**Juliette Decoux**  
Partner, Head of "Energy & Utilities", Mazars  
+33 (0) 1 49 97 64 49  
juliette.decoux@mazars.fr

**Laurent Inard**  
Partner, Head of Financial Advisory Services France, Mazars  
+33 (0) 1 49 97 62 98  
laurent.inard@mazars.fr

**Jean-Paul Stévenard**  
Partner, Head of German Desk, Mazars  
+33 (0) 1 49 97 47 55  
jean-paul.stevenard@mazars.fr

**Commerzbank**

**Hajo Neugaertner**  
Head of International Project Finance, Commerzbank AG - Renewable Energies  
+49 (0) 40 368 322 71  
hajo.neugaertner@commerzbank.com

Mazars  
61, rue Henri Regnault  
92075 Paris - La Défense Cedex  
France  
Phone: +33 (0) 1 49 97 60 00  
Fax: +33 (0) 1 49 97 00 01

Commerzbank  
Ness 7-9  
20457 Hamburg  
Germany  
Phone: +49 (0) 40 36 83 26 49  
Fax: +49 (0) 40 36 83 49 09