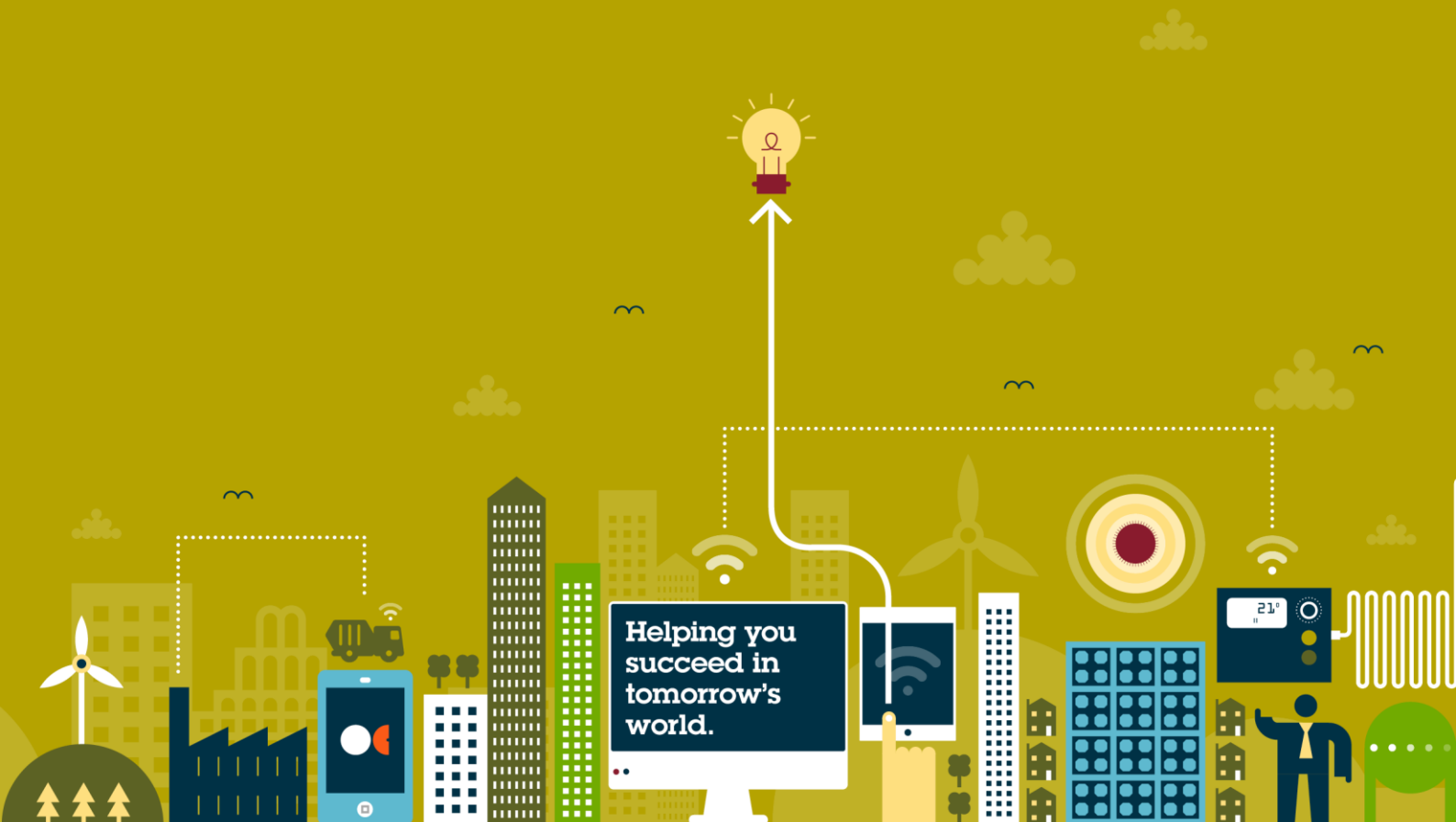


A new dawn for the energy market?
COVID-19, renewables financing and the
energy transition



Introduction

The global economic paralysis caused by the COVID-19 pandemic has been felt keenly across multiple industries, leading to unprecedented government intervention to help those impacted by ensuing work shutdowns. But despite all of the grim financial figures and sobering economic forecasts for the weeks and months ahead, the renewable energy sector has stood out for its resilience and adaptability.

This staying power has been in evidence despite sector-specific challenges such as the sharp fall in energy demand across multiple jurisdictions, and the impact this has had on power prices. The drop in demand has seen renewables' share of the overall energy mix go up – a plus for reducing carbon emissions. However, it has also led to greater swings in power price, which have in some cases gone negative. Battery storage installations, which could have helped smooth fluctuations in supply and demand, simply haven't reached the levels of deployment yet to provide a meaningful solution. With luck, this window into the future, to a renewables-dominated market that had not been forecast for another decade, will lead regulators to re-think how flexible generation can be better incentivised to crowd in investment.

However, the global energy transition has clearly not been immune to the consequences of COVID-19, with the International Energy Agency (IEA) at the end of May forecasting that investment in renewable power projects globally will fall by around 10% this year, with construction and final investment decisions impacted by lockdown measures, supply chain disruptions and social distancing guidelines, in addition to financing uncertainty.

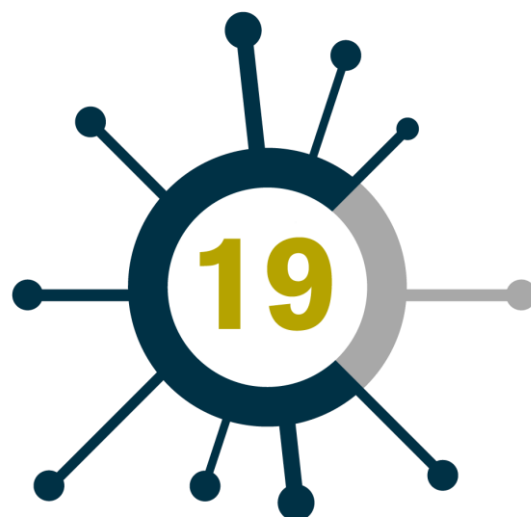
Yet the global health crisis could ultimately present an unprecedented opportunity to accelerate the energy transition, and there are ever growing calls from the IEA, business groups, politicians and the general public for governments to make renewable energy, decarbonisation and sustainability more broadly a core component of economic stimulus packages.

The sentiment was in evidence at the start of June when more than 200 of the UK's leading investors and corporations, co-ordinated by the Prince of Wales's Corporate Leaders Group (CLG), sent a letter to the UK government calling on it to put forward a COVID-19 recovery plan with the environment at its heart.

Recent months will also have emphasised the value of smart monitoring technologies, forecasting tools and other forms of data analytics for maintaining assets and optimising their performance. And, with the recovery likely to bring with it a renewed focus on cost-cutting and efficiency savings, the digitization of the energy sector is only expected to accelerate.

Finally, the pandemic could also lead to a permanent change in work practices, driven by greater health awareness, sustainability considerations and cost-cutting measures.

This should play into a dawning awareness that the worst effects of COVID-19, while already a human tragedy for hundreds of thousands, and an economic one for millions, will pale into comparison compared to the consequences of letting climate change continue unabated. This, it is hoped, will further galvanise efforts to accelerate the energy transition.



Deal activity holding up

With lockdown measures both in Europe and across the globe in place since March it would seem inevitable that renewable energy investment activity would start to experience a marked slowdown in the second quarter of 2020.

But while there have been inevitable challenges to concluding deals in the new world of virtual working, investors, lenders and advisors have all found ways to progress transactions, and investment levels and deal activity to date has held up better than many would have expected.

This is often because deals had reached a sufficiently advanced stage prior to the onset of the health crisis and deal teams have found a way to push them over the line. But there have been numerous other examples of sponsors opting to launch sales processes and financings well after lockdowns began. These range from solar photovoltaic to onshore and offshore wind, among other sectors, from Ireland to Poland - even if these transactions are taking longer to progress than normal.

"Bigger funds still have dry powder, and are looking for new deals," explains James Watson, Head of our International Head of Energy and utilities sector.

Nevertheless, there has been a drop in front-end M&A activity in the UK, he notes, while some investors may hold off on new investments until later in the year, when it is anticipated that a number of distressed portfolio disposals may come to market.

In Spain, meanwhile, arguably Europe's most active renewables market, Osborne Clarke's country head for energy and utilities Luis Castro has found that

"our work has been impacted less than we initially thought it would be...we were braced to expect a big slowdown in PPA, greenfield financing and M&A activity, but this hasn't been the case."

Indeed, the team's Madrid office has only really seen a pause in activity for 15 days during the lockdown, at a time of heightened market uncertainty.

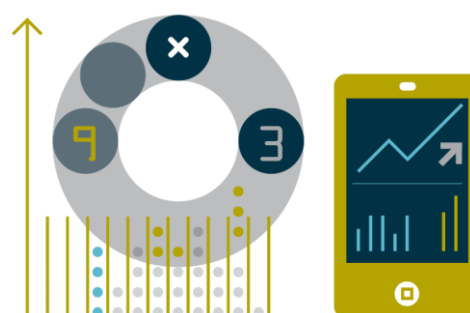
"We've been receiving numerous RFPs for both greenfield and brownfield deals, on buy-side and sell-side, and we've been hearing from the usual fund investors in addition to potential new entrants," Luis adds.

The continued buoyancy of the Spanish market has in a sense been a surprise, given how spot prices during the lockdown at times dropped 60%-70% below average prices seen over the same period last year. Average 10-year PPA prices available have also declined.

"Investors are largely expecting the recovery of the wholesale markets in the future, and are continuing to deploy capital," Luis explains, adding that fund managers still see Spain as a market where they can achieve a 7%-8% internal rate of return investing in ready-to-build projects.

The German market has also seen activity hold up reasonably well, even if there are ongoing (non-COVID related) challenges in evidence in the country, such as difficulties in securing planning consent for new onshore wind schemes.

"The German M&A market hasn't been too impacted by COVID. However, we encounter some delays in projects and some investors face some issues to engage in transactions due to travel restrictions," says Alexander Dlouhy, German Head of Energy & Utilities at Osborne Clarke.



European protectionism

The current health crisis has nevertheless led to some protectionist policy making, spearheaded by a [new EU regulation](#), coming into force in October 2020, which introduces minimum standards for national regimes and gives the European Commission the opportunity to comment on proposed investments. The European Commission's also issued guidance in March that member states implement new screening mechanisms for certain investments made by non-EU and non-EFTA residents on the grounds of potential risks to critical EU health and energy (grids and pipelines) infrastructure, among other considerations.

Spain is one of the EU countries to have already introduced such measures, requiring that non-EU and non-EFTA residents secure prior authorisation from ministers in order to close direct foreign investments. Such consents could take many months to come through, with the potential for transaction cancellations and substantial fines if these are not secured.

For international investors, measures such as those introduced in Spain could add an unwelcome extra administrative burden to transactions, even if the most intense scrutiny will likely be reserved only for large-scale grid and generation asset acquisitions. However, the measures could benefit European investors if they lead to a temporary decrease in competition for investments, presenting opportunities to pick up assets at lower prices.

Nevertheless, James notes some short-term liquidity shortages - *"as much as banks are raising cash it's often going out the door to existing clients...there is not a lot of cash available for new strategic decisions."*

This is because while banks are still keen to finance energy and renewable assets, which are seen as low risk and are well understood, they also have exposure to more stressed sectors which require more of their resources and liquidity.

"While your loan book may be 10% exposed to renewables, it could also be 30%-40% exposed to transport infrastructure, or other areas - lenders are not necessarily confident yet that they can release capital even to active areas of the market,"

he explains.

As such, pricing increases have eroded the rationale for certain transactions. But while some , deals may be on pause, they are far from cancelled.

Availability of finance

One of the key impacts on energy and infrastructure markets when the global financial crisis hit back in 2008 was a near total drying up of liquidity.

However, with banks' balance sheets now far more secure project sponsors still appear able to access debt from the lending market to finance new transactions. This is particularly in evidence where sponsors and lenders have strong existing relationships, even if finance is now in some cases being proffered at higher margins than before the COVID outbreak began. These pricing increases vary from lender to lender.



Power prices and PPA dynamics

While M&A and financing activity has held up relatively well in recent weeks, PPA negotiations have been more heavily impacted by COVID-19.

Given current wholesale prices (in addition to future power price projections) play a big factor in how PPA prices are calculated, it is therefore unsurprising that the drop in demand that has come from lockdown measures, and which has led to a slump in wholesale prices since the end of March, has in turn meant sponsors are now typically unable to lock in the sorts of offtake prices being signed off earlier in 2020.

Nevertheless, negotiations continue to progress in European PPA hotspots, such as the Spanish solar market, even if transaction closes may have to be deferred until there is a sustained recovery in pricing.

"With regards to PPAs, prudent investors are managing the situation by negotiating Ts&Cs and general conditions, but are not discussing pricing, and are waiting for a clearer picture in the next few months to close deals," says Luis.

In some situations, offtakers are showing a willingness to sign PPAs at pre-COVID levels, even if this means that in the short term they are missing out on cheaper sources of power elsewhere.

"The PPA market in Germany is a rather young market. Some market participants wanting to enter this market for strategic reasons are taking a long term view and are prepared to take lost revenue risks due to the COVID-induced current lower power prices. Others may well continue to sit on the fence and wait for the PPA market to evolve," adds Dlouhy.

In terms of already signed PPA deals, meanwhile, the downward pressure on wholesale power prices of recent weeks has also led to offtake counterparties examining the terms of already signed contracts with renewed scrutiny.

"There is a lot of innovation going on in the merchant PPA market, the Osborne Clarke team is very busy in this space," says Deborah Harvey, a specialist energy lawyer.

She adds:

"Current PPA prices is one issue, but we're also getting a lot of questions from clients around how they can get out of arrangements, or change terms - with cost pressures now coming to bear people are interrogating what they signed up to more, looking at how to enforce their rights."

This scrutiny means that renewable energy investors are likely to come out of the COVID-19 outbreak with far more experience dealing with all of the various contractual complexities of PPAs - and a better idea of the terms that they will want to see on new deals - than previously. This is no bad thing for the continued evolution of the post-subsidy market.

A green recovery

While economists differ in their forecasts of what the recovery will look like, it seems increasingly likely that many governments will in the coming months launch further comprehensive stimulus packages in an effort to create jobs and return their economies to growth.

Such initiatives will bring with them a fantastic opportunity to help accelerate the transition to a low carbon economy and boost the broader green agenda. This is a sentiment which is gaining increasing support from industry, business groups, politicians and broader society.

France's announcement of a EUR 8bn rescue package for its ailing automotive industry on May 26 is one early example of how many future stimulus measures could look. The programme includes EUR 1bn in grants designed to encourage consumers to buy electric vehicles.

A green recovery?

Green-minded stimulus packages should also play into initiatives and policy work already underway. In the UK, there were some positive indicators that this would be top of the agenda. For example, the 2020 budget unveiled in March including a GBP 800m allocation to Carbon, Capture and Storage projects, while Ofgem published a decarbonisation action plan in February mapping out how the UK will reach net-zero by 2050. National Grid, meanwhile, issued its first 'green bonds' in January to finance some of its network upgrades. And the BEIS-backed Clean Growth Fund also opened its doors in May, with the aim of supporting the commercialisation of new UK-based energy transition technologies. But while the UK Government's announcement of 30 June spoke about investing in 'green' infrastructure, it was underwhelming and lacking in detail.

"Apart from some high-level comments about boosting afforestation schemes, the was no sense that the recovery would be underpinned and harnessed by a focus on decarbonisation and net zero models " James says.

"Using this as a means to invest in the economy in the recovery would set the UK apart - we have a good track record with these issues and were a leading light in the early stages of the energy transition," It remains to be seen how this will play out in practice.

This harnessing of the recovery to stimulate green growth is a narrative that is in evidence across Europe.

"We have a prime minister absolutely focused on the green agenda, it will be the most important brick of the new scenario and the recovery of the Spanish economy,"

confirms Luis.

The country's government in late May presented to parliament a new draft climate law targeting net-zero emissions by 2050, marking "an important signal from the new government on the green deal," he says, adding that while there had not been any specific COVID-19-influenced low carbon policies announced.

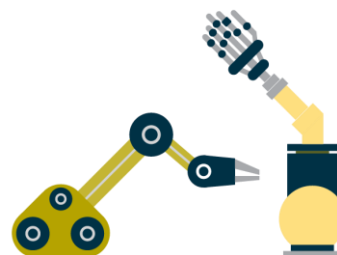
On the same day that the EU's environment ministers discussed the contribution of environmental and climate policies to economic recovery and recognised the value of the European Green Deal, the Spanish Council of Ministers approved [Royal Decree-Law \(RDL\) 23/2020 of 23 June](#). The RDL, which came into force on 25 June 2020, seeks to promote the development of businesses linked to renewable energies, given their importance in the economic recovery process and in meeting climate objectives assumed by Spain. "This is a highly expected regulatory announcement among the different stakeholders in the Spanish energy sector". The RDL anticipates the announced new regulation of access and connection to the grid, includes a new auction mechanism based on the "pay-as-bid" system, contemplates new business models (aggregated demand management, storage, hybridisation and citizen energy communities) and establishes measures to promote energy efficiency.

"Germany, too, is experiencing a rising demand for a green recovery and this goal is reflected in the EUR 130 billion stimulus package announced by the German government,"

says Alexander.

In the area of electric mobility, the package envisages a commitment of additional EUR 2 billion to promote the purchase of electric vehicles and of additional EUR 2.5 billion to expand the charging point infrastructure and to support research and development in the area of electro mobility and battery cell production. Furthermore, the government wants to allocate additional EUR 2 billion to energy-efficient renovation.

This sentiment could also help in firming up renewable energy roll-out targets over the next two decades.



A green recovery?

Germany's federal government also announced its intention to abolish the existing cap for photovoltaic projects eligible for support schemes and to raise the capacity target for the offshore wind sector from 15GW to 20GW by 2030 together with the aim of reaching 40GW by 2040. Furthermore, the government stimulus package envisages a EUR 9 billion boost to support "green hydrogen".

At EU level, too, big plans are afoot to help sustain investment in the energy transition, with the bloc in the final days of May unfurling plans to raise EUR 750bn in recovery funds, a big part of which will be intertwined with its green deal objectives.

The European Commission is set to double the current EUR 10bn it has set aside to support sustainable infrastructure, to boost deployment of renewable energy, battery storage, clean hydrogen and carbon capture technologies, for example, having warned in a leaked draft document in mid-May that the impact of COVID could potentially lead to a 20%-33% contraction in onshore wind and solar sectors this year.

The draft had also indicated that the EU could look to support member states in the tendering out of some 15GW of additional renewable energy capacity as part of the support measures over the next two years, although this proposal is yet to be confirmed.

Digitalisation

The digitalisation of the energy system could also receive an unexpected boost from the COVID-19 pandemic, with the merits of being able to remotely monitor renewable energy assets in real time, among other functions, becoming more readily apparent.

"Digitalisation within the energy transition will be a massive part of the recovery, as it will facilitate a switch to distributed generation which in turn will make things more efficient,"

James says.

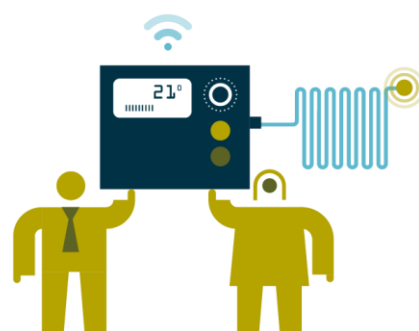
Indeed, fund managers have already begun to use predictive models for gauging future meteorological conditions in order to optimise their renewables assets in recent years, although *"what has been holding the practice back has been a need to collect meaningful data first,"* he adds.

Greater uptake of digital tools, powered by data analytics and artificial intelligence, will in turn create a virtuous circle.

"These technologies are going to become a requirement as there is renewed focus on cost-cutting measures [in the wake of COVID-19] - they can offer long-term efficiency savings and will only become more efficient as more data is gathered," says James.

They will also have growing importance as investors face having to at least temporarily lower the value of their assets.

"Under normal circumstances this would not be a priority, but they are now able to interrogate their asset base," says James.



Silver linings

COVID-19 has had a near unprecedented impact on economies across the globe, with the renewables industry, for its part, impacted by supply chain slowdowns and all of the challenges that come with having to work remotely.

Yet despite these obstacles, the sector has proved its resilience, with investors continuing to bid for operational assets and, where necessary, raise project finance for greenfield projects, even if this is often now on slightly less borrower friendly terms than pre-COVID.

The health crisis has also highlighted some of the challenges that come with the move to a post-subsidy market. With power prices down as demand has fallen, this has at least temporarily eroded the rationale for merchant and PPA-backed projects, and negotiations on such transactions have often slowed as parties involved wait for markets to stabilise.

But one of the silver linings to the pandemic could well be the opportunities that the recovery will present for an accelerated energy transition. There is a growing clamour from all parts of society to put sustainability and decarbonisation at the heart of the many economic stimulus packages that are now being prepared both by sovereign states and regional blocs such as the EU.

This, it is hoped, will stimulate greater investment in sectors such as electric vehicles, battery storage, decentralised power networks, and carbon capture and storage, in addition to bolstering the roll-out of established wind and solar technologies.

The COVID-19 outbreak has coincided with many countries confirming plans to reach net zero by 2050, but this will not happen without the decarbonisation of key sectors such as energy and transport.

The pandemic is providing an opportunity to accelerate the switch away from fossil fuels in these areas, with industry support packages expected to come with the sorts of strings attached that can truly foster this change.

Hand in hand with this, the crisis should also hasten the digitalisation of the energy sector. Smart monitoring of projects and use of predictive tools has come to the fore in this remote working era. With the benefits of such technologies having been highlighted, it is likely that their adoption by asset owners will accelerate in coming quarters. Not least, this will also allow investors to make efficiency gains on their portfolios at a time when cost-cutting is of particular importance.



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