### FALLING WHOLESALE POWER PRICES: WHAT STRATEGIES EXIST IN THE RENEWABLE ENERGY MARKET



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The coronavirus pandemic has resulted in a sharp decline in global energy demand. A fall in demand, with supply remaining unchanged, will result in a fall in price. Amid uncertainty and suppressed wholesale power prices, investment decisions are likely to be delayed or even no longer be considered viable. While there is no immediate solution to restoring global demand, paying close attention to the structured products available in the energy market may help provide certain competitive advantages. We explore the current market conditions and offer some new considerations for corporate and synthetic PPAs, as well as proxy revenue swaps.

"Amid uncertainly and suppressed wholesale power prices, investment decisions are likely to be delayed or even no longer be considered viable." Prior to the outbreak of the coronavirus pandemic, 2020 was forecast to be a record year for renewable energy additions. A wide variety of factors contributed to this forecast: a growing global demand for energy overlaid with increased governmental and corporate climate change awareness; renewable energy (including offshore wind) becoming a mature market; a period of stability in wholesale power prices; and the ever falling levelised cost of renewable energy projects increasing competitiveness against other energy sources. Very few events would have been able to stop this trajectory.

The coronavirus pandemic has led to many countries imposing lockdowns with all non-essential businesses and activities brought to a halt. With commercial and

industrial customers unable to operate, the result has been a significant decline in energy demand. Forecasts indicate that worldwide demand could drop 6% in 2020, with an 11% drop expected in the EU. As with all industries, a fall in demand (with supply remaining unchanged) will result in a fall in price, with the new price settling at a lower equilibrium point of the new supply and demand levels. For the energy sector, this fall in electricity demand materialises in a fall in the wholesale power price and a new lower market clearing price found. Taking the UK, Spanish and Italian markets as examples, the merchant price has fallen from around €45 per MWh in December 2019 to €25 per MWh in April 2020.

Based on the merit order effect, whereby the cheapest power contributes to the grid first, operational renewable energy projects should still have demand for their power given renewable energy has lower marginal costs than other generation types due to having no fuel costs. Operational renewable energy projects should therefore even see a rise in their market share in the overall energy mix (although falling demand has also led to a fall in the EU carbon prices meaning that it costs less to pollute, which may even the playing field). Notwithstanding this, the definitive trend for all participants is that the wholesale electricity prices are depressed.

The extent of the impact on the renewable energy market will be determined by how long the lower demand, and corresponding lower wholesale price, lasts. Predictions on timelines for when commercial and industrial factories will be able to operate again are inevitably difficult; some forecast that demand has already reached a floor, while other modelled scenarios have prices not fully recovering until 2025. Even if this latter forecast is overly pessimistic, it is clear that there will be wide ranging consequences in the short and medium term.

The first is that uncertainties in wholesale power prices will likely result in some new investments of development stage projects no longer being economically viable, or at least leading to developers taking a more conservative approach to such investments. This has arguably already been seen, with certain large utilities deciding not to take part in the Dutch zero subsidy tender for a 700 MW offshore wind farm in the North Sea that, traditionally, they would have been expected to. Power price uncertainty and supply chain concerns were cited for this decision. In addition to developers taking a more conservative approach, significant challenges will exist for project finance lenders forecasting power prices in terms of acceptable debt sizing for those projects selling on the merchant market. Merchant risk has been a long cited concern as the sector moves into the subsidy-free era, and while none would have predicted the cause of this sudden drop in wholesale power price, ways to manage these concerns are now having to be found in real time.

"One of the recent trends to tackle merchant risk was through long term corporate PPAs (CPPAs)." One of the recent trends to tackle merchant risk was through long term corporate PPAs (CPPAs). The second consequence that has emerged is that CPPAs may now become more difficult to come by due to corporates no longer being certain of their own energy demands; ironically, therefore, the very reason wholesale prices have fallen may be a factor in some corporates being more hesitant to enter into a CPPA. While demand uncertainties are clearly present, so too are opportunities. The ability for corporates to lock in long term low electricity prices may outweigh the short term demand uncertainty. From the generator's perspective, different considerations emerge; the credit risk of corporate offtakers has traditionally been a factor to

consider, but amid the current economic uncertainties, even more focus will need to be given to the credit ratings and credit support requirements of the corporate offtaker to mitigate offtaker default risk. These considerations combined may lead to a compromise being reached whereby the market going forward is for CPPAs to be entered into in order to avoid merchant risk, but for shorter terms than have traditionally been advocated. The result may be that the new gold standard is for shorter rather than longer term CPPAs to provide the balance needed between certainty and flexibility. A second trend that may emerge is the aggregation of offtake through the pooling of corporate offtakers to enable generators, and financiers, to take a view on credit risk across a pool of offtakers. More information on this can be found in our Future of Renewable Energy report.

Hedging products, such as synthetic PPAs, help mitigate against merchant price volatility. While not a silver bullet against subdued wholesale power prices, they may still be a welcome instrument for market participants. Through financially settling the variable spot market price against the negotiated fixed (strike) price, the synthetic PPA provides both generator and offtaker price certainty.

With increasing renewable generation coming online, and ever improving and reliable wind and solar data, products such as proxy revenue swaps, for example, are likely to become more attractive. A proxy revenue swap is a hedge which has a fixed payment for the variable value of the project's proxy revenues, and so looks to factor in weather, shape and merchant price risk. While such risks are not new to the market, this is still a relatively new and unfamiliar product, and so with the present challenges of CPPAs outlined above, this might drive greater interest and use of proxy revenue swaps. The elephant in the room of lower demand causing lower wholesale prices still remains, but utilising these products will offer solutions not provided by more vanilla structures and help provide greater competitive advantage in these difficult times.

A decline in power demand also correlates to a decline in CO2 emissions. Forecasts show that there will be an 8% drop in CO2 emissions this year. A similar pattern was seen during the 2008 financial crash, however, the stimulus programs chosen to aid recovery were carbon heavy and resulted in emissions soon rising above pre-crash levels. A green recovery is a desired approach not just for the climate, but after a decade of growth the economics of renewable energy has shifted, and so will be good for the larger economy too. Encouraging signs can be seen. The European

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Union Commission president called for 'building a resilient, green and digital Europe with the Green Deal at the heart of the recovery'. Germany has revised its offshore wind capacity target from 15 GW to 20 GW by the end of 2030, and Greece has granted extensions of various deadlines related to the licensing process and operation deadline for renewable projects so as to not penalise projects with operating support (variable premium) agreements with fixed completion deadlines. These measures should be lauded, although they are only the tip of the iceberg in terms of the true stimulus measures to come, and stakeholders will need to ensure their voices are heard amongst those pushing for recovery at all costs.

The increase in wholesale power price is intertwined with the economic recovery and returning demand. While the medium term outlook for renewable energy will to some extent be influenced by the global response to economic recovery, the long term trajectory of the sector remains largely unchanged given the underlying fundamentals of renewable energy projects remain strong. In the short term, industries will be inclined to favour a conservative approach, but as with all periods of uncertainty and change, opportunities do exist for those able and willing to take certain risks, and using structured products to help provide the financial certainty desired will be more important now than ever.

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