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Structured finance: a Portuguese tool to achieve EU renewable energy targets

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Although market agents are still dealing with the ongoing impact of the sub-prime crisis, and issuers (and arrangers) face difficulties in placing new securitisation issues, experts already anticipate that structured finance will soon regain its importance in the financial markets, providing innovative finance solutions to market agents.

One sector in which structured finance will play an active role in the future is renewable energy. Synthetic securitisation can be used to finance wind and photovoltaic parks, facilitating the fulfilment of EU targets for the production of energy using renewable sources.

EU leaders have already endorsed European Commission proposals to establish a mandatory renewable energy target of 20 per cent of total EU energy consumption by 2020, and the commission has stated that it expects to see the package adopted by the end of 2008.

EU directives on the production of renewable electricity using renewable endogenous resources have established a common legal frame across EU member states (Directive 2003/54/EC on common rules for the internal electricity market and repealing Directive 96/92/EC). In each country, producers of electricity from renewable resources benefit from a guarantee that the electricity will be purchased by that country's supplier of last resort at a pre-determined price.

The price is determined under terms that allow for both reimbursement of and adequate remuneration for the investment.

The pre-determination of the price to be paid for the electricity, and the predictability of electricity production (statistical models allow for the calculation, with limited fluctuation, of the electricity to be produced by each park), provide for a steady cash-flow stream for up to 25 years.

Following recent and continuing market turbulence, investors are attracted by products with limited credit risk – such as notes where the payment of principal and interest is linked to the sale of electricity produced from renewable sources.

On the other hand, the opportunities available to energy producers in Europe are many and financial resources are limited. The traditional project finance model is inefficient, as banks require the borrower to satisfy a number of ratios during the life of the loan, which limit the payment of dividends and shareholder loans and consequently cause difficulties for the release of funds necessary for new investments.

Traditional securitisation is not an adequate model for this type of cash flow. Although the formula for calculating the price is pre-determined and the supplier of last resort is under a legal obligation to purchase the electricity produced, legally there is only the expectation of a cash-flow stream (and not pre-scheduled dates on which payment of a debt is due). Therefore, it is not possible to structure this transaction under the existing legal framework, as at present Portuguese law allows only for the assignment of credit rights (sale of receivables).

In addition, each renewable energy park represents an average investment of €10 million to €12 million, which is a very small amount considering that the costs involved in international securitisation can easily exceed €1 million in lawyers', rating agencies' and financial intermediaries' fees.

This chapter discusses the basic features of synthetic securitisation, using a special purpose vehicle (SPV) incorporated in Portugal.

Advantages of synthetic securitisation in Portugal

In late 2006 the Portuguese Securities Market Commission disclosed a proposal for review of the Securitisation Law. The proposed amendments will allow for the structuring in Portugal, using a *sociedade de titularização de activos* (a local SPV), of synthetic securitisation transactions. At the time of writing, the law has not yet been enacted, but market participants have been lobbying to speed up the process.

Once the law is implemented, there will be a number of advantages to using a Portuguese vehicle to structure a securitisation transaction where the underlying assets are expected cash flows for the sale of energy produced by wind and photovoltaic parks, even if such parks are not located in Portugal.

The first advantage is the costs associated with structuring a securitisation, including legal costs (as lawyers' fees tend to be significantly lower when transactions are structured using local Portuguese vehicles).

Furthermore, interest and capital gains on securitisation notes obtained in Portugal by non-resident investors benefit from an exemption from Portuguese income tax.

Pursuant to the enactment of the revised version of the Securitisation Law (and assuming that no significant amendments will be made to the draft issued in late 2006), it will be possible to use the same vehicle on an ongoing basis to recover the investment made in the construction of a park and then use such recovered original investment to finance the construction of a new park, and to do so on a recurrent basis throughout the European Union.

Proposed structure

Entity A is a fund or a company that invests in the construction and management of wind or photovoltaic parks in the European Union.

Entity A has selected a number of jurisdictions where, in view of the existing legal framework, the power produced by wind and photovoltaic parks may be sold to an entity that acts as a supplier of last resort, at a pre-determined price. Provided that legal requirements are duly fulfilled, the supplier of last resort will be under the obligation to buy the power for a pre-determined fee (set by law) and for a pre-determined period of time (usually 25 years).

In order to achieve the segregation of assets and requirements for each project, Entity A incorporates a subsidiary in the jurisdiction where the park is to be set up – Entity B. Entity B then incorporates a company in the same jurisdiction – Entity C.

Entity C will own the licence to act as producer of the electricity and will be responsible for the construction of the park (the model is still efficient if two companies are incorporated, with one holding the licence and the other owning the equipment and being responsible for the management of the park).

Entity C sets up the park using its own funds (equity and shareholder loans).

Entity A incorporates an SPV in Portugal, governed by the Securitisation Law – Entity D. As soon as the park is completed, Entity D issues notes which are placed exclusively with institutional investors through a private placement.

Entity D enters into a credit default swap (CDS) with Entity B. Entity D buys protection on the expected cash flows of Entity C (ie, the cash flows that will arise from the sale of power produced by the park, during the pre-determined period and at a pre-determined fee).

For the purchased protection, Entity D pays to Entity B an amount equivalent to the income arising with the placement of the notes (minus the costs involved with the structure of the transaction). Entity B agrees to pay on pre-scheduled dates certain amounts to Entity D. Such amounts are equivalent to the payments that Entity B must make to the holders of the notes (principal and interest).

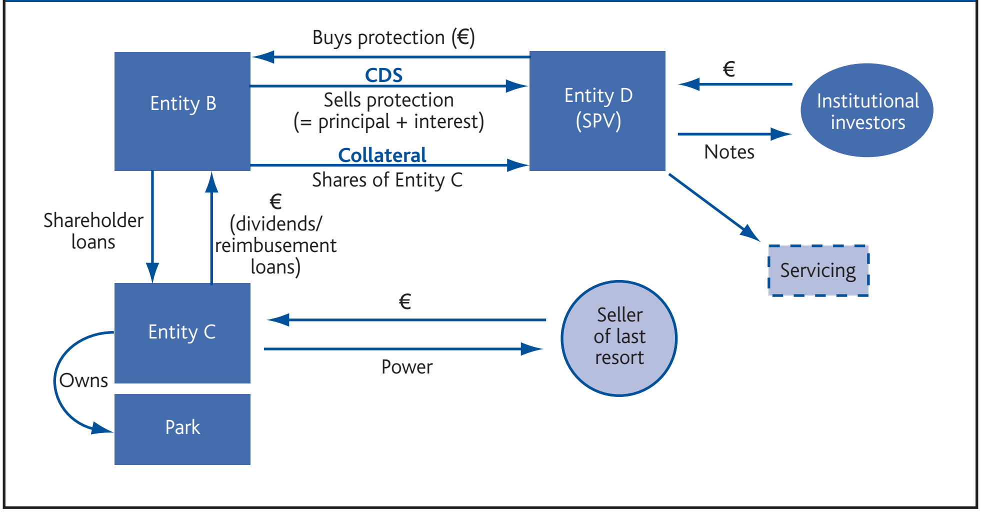
Payment obligations of Entity B under the CDS are financed by repayment of shareholders loans and payment of dividends by Entity C.

Entity C's income arises from the sale of electricity to the supplier of last resort.

In order to ensure that if Entity B defaults under the CDS, Entity D will keep receiving the cash flows that will allow it to pay interest and principal to the holders of the notes, Entity B posts as collateral (for the benefit of Entity D) the shares on Entity C, representing 100 per cent of the share capital of this entity.

In a default scenario, Entity D will be entitled to enforce the collateral, thus achieving control of Entity C (and therefore of the park that produces the electricity).

Figure 1



If the collateral must be enforced, Entity B will be entitled to the difference between the due amount under the CDS and the value of the shares, as the CDS must include the terms under which the shares of Entity C will be valued, thus granting sufficient protection to the promoters of the transaction (ie, the shareholders of Entity A).

In addition, it may be necessary to:

- insure the park in order to hedge the risk against damage caused by extreme weather and climate events (that may affect the ability of the park to continue to produce electricity and require reconstruction works); and
- enter into a swap agreement between Entity B and a bank to ensure that funds will be available on the dates on which payments under the CDS are due (and that will fund the payment of principal and interest under the notes).

Relevant legal issues

Synthetic securitisation

Entity B sells protection on the future sales, to be made by Entity C, of electricity produced by the park to the supplier of last resort.

Under the new law, it will be possible to sell future cash flows. Moreover, the wording of the law imposes no limits that would prevent a Portuguese SPV from purchasing cash flows of an originator not located in Portugal. It will therefore be possible to use the same vehicle to finance wind or photovoltaic parks across the European Union.

Collateral

The success of this model is conditional on a legal certainty – in a default scenario, the SPV (ie, Entity D) will be able to ensure the continuing operation of the park and the sale of electricity (and collection of the price) so that resources are available to meet the due payments to the investors that hold the notes.

In the proposed structure, this objective is achieved by the creation of a financial pledge over the shares of Entity C.

In 2004, Portugal implemented the EU Financial Collateral Arrangements Directive (2002/47/EC) by means of Decree-Law 105/2004 of May 8 2004.

Since the enactment of Decree-Law 105/2004, it is possible for a Portuguese entity to enter into a financial pledge. A financial pledge is a security interest that does not involve the transfer of title.

The parties are free to agree that in a default scenario (which may take place on the occurrence of any event described by the parties in the agreement as giving rise to an early termination), the value of the collateral shall be offset against the relevant financial obligations, which in the case of a pledge of securities may involve court sale or appropriation, when the asset are securities.

In a scenario of default by Entity B of its obligation under the CDS, Entity D will be entitled to appropriate the shares of Entity C, thus gaining control over the park (and therefore being able to ensure that the park will continue to operate and sell electricity).

The fact that Entity C is not located in Portugal is not an obstacle to this structure. As of the implementation of the Financial Collateral Arrangements Directive, a common platform has been achieved.

In Portugal, and pursuant to Article 21 of Decree-Law 105/2004, the validity and enforceability of collateral arrangements are determined by the law of the country in which the account where the securities are registered is maintained. Such jurisdiction will determine the formalities to be followed at the time of creation of the financial pledge over the shares of Entity C.

In order to achieve the most efficient tax structure, the parties should confirm in which jurisdiction the posting of collateral attracts the lowest taxes, as shares on Entity C (that will be posted as collateral) may be held either through an account located in Portugal or in the jurisdiction of the park (through an account with a financial intermediary on whose books the shares are registered).

Entity B may hold the shares of Entity C either in Portugal or in the jurisdiction where Entity C is incorporated. In the case of book-entry securities (ie, situations where Entity C shares take a book-entry form), the collateral shall be governed by the law of the country in which the relevant account is maintained.

If the assets provided as collateral are deemed to be located in Portugal, local perfection rules must be fulfilled in order to ensure the enforceability of the collateral arrangements, as such rules are deemed to involve public order issues. If the collateral provided by Entity B is held through an account located in a different country, the collateral arrangements shall be deemed valid if the perfection rules in force in such country have been duly fulfilled.

Portuguese perfection rules are straightforward and involve little administrative work. In the case of indirectly held book-entry securities, the security interest will be deemed created and perfected by registering it with a financial intermediary (Articles 6, 7(4)(b) and 8 of Decree-Law 105/2004). However, the tax treatment of pledges must be checked both in Portugal and in the jurisdiction where Entity C is located to determine the most favourable tax treatment. In addition, it must be checked whether the jurisdiction where Entity C is located has implemented the Financial Arrangements Collateral Directive.

The protection granted by Decree-Law 105/2004 is available to public entities, the Central Bank of Portugal, entities subject to prudential supervision (including credit institutions, investment firms, financial institutions, undertakings for collective investment and insurance companies), central counterparties, settlement agents or clearing houses and legal persons (including corporations), in this latter case provided that the counterparty is one of the previous entities.

In the proposed structure, Entity B is a corporation and therefore in order for the collateral arrangement to be governed by Decree-Law 105/2004, Entity D must be an entity subject to prudential supervision. SPVs governed by the Securitisation Law are subject to prudential supervision.

The incorporation of an SPV under the Securitisation Law is subject to prior approval by the Portuguese Securities Market Commission. Although SPVs must comply with prudential ratios, such ratios are not onerous. At present, the minimum share capital is €250,000. SPVs must also comply with the own fund requirements, which are determined by reference to the net asset value of the SPV's portfolio. These ratios are not expected to be amended under the new law.

Conclusion

The finance model described in this chapter is an excellent financing alternative for electricity producers that are setting up wind and photovoltaic parks across Europe (as well as small-scale hydropower plants) and whenever project finance does not prove to be a satisfactory solution.

The low structuring costs associated with a clear and straightforward legal framework make this structure attractive both to Portuguese and other EU electricity producers and regardless of the EU jurisdiction where the park has been set up.

Therefore, it is anticipated that synthetic securitisation will play an important role in fulfilling EU renewable energy policy, and Portugal may provide market participants with efficient tools to achieve that goal.