Practice&Law

THE VALUE OF RENEWABLE ENERGY

RICS information paper Much-needed guidance on putting a price on green power

Renewable energy is a valuation challenge, when the valuer has to deal with a variety of site conditions against a paucity of market evidence.

The valuation – including every assumption – must be soundly based at every step and fully and clearly explained. These are the conclusions of the RICS information paper, *Valuation of renewable energy installations*, published in May.

RICS information papers provide users with the latest thinking on an area of practice. They are not binding in the way that its practice statements and guidance notes are, but practising valuers are expected to know about them.

This information paper aims to help valuers dealing with the valuation of renewable energy installations as a separate asset, or where another property includes a substantial installation. Examples include wind turbines on a large rural estate, hydropower installations in a river running through a farm, large photovoltaic arrays and anaerobic digestion facilities. It covers the landowner's interest, as well as owner-occupier operators.

Comparables

The direct comparison approach to valuation will be of limited use in most cases because of the lack of available evidence and the difficulty in directly comparing one site against the next.

One site to come to the market that illustrates this point is the freehold of Cornharrow Hill in Dumfries and Galloway (see box, p40).

According to Andrew Watkin, head of the energy and marine team at Carter Jonas, agent on the Cornharrow sale, experienced investors will be more confident in their approach to yields, so the driving force for higher capital values will come from those most familiar with the technology and the market.

Opportunities

Another investment opportunity on the market is Puriton Solar Park, marketed through Alder King. This is a 12.6ha photovoltaic facility consisting of 20,000 panels with a capacity of 4.22MW. Revenue is £1.5m pa from electricity sales and feed-in tariff (FIT) and the park is let on a 35-year lease at an initial rent of £75,000 a year. The asking price is £886,000, suggesting an initial yield of around 8%.

Watkin's comments are echoed by Strutt & Parker's Robert Paul, author of the RICS guidance note *Negotiating terms for options and leases on energy installations*, who suggests that this is a challenging area that requires valuers to have considerable attention to detail. For example, the suite of legal agreements for a renewable energy scheme might include: options or leases for developer-led schemes; grid connection offers; power purchase agreements; access

REX FEATURES

agreements and wayleaves; section 106 agreements and procurement contracts governing warranties, maintenance and insurance. The ownership structure can add to the complexity and might involve leases to companies, community schemes and joint ventures.

Paul expects the market for let freehold interests to grow. Schemes brought to the market thus far have been too small for the major pension funds, but it is anticipated that the opportunity for an investor to aggregate a number of smaller investments over the next few years and then sell them as a whole, attracting strong bids from fund managers, will emerge.

Alasdair Reynolds, partner at Bell Ingram, spoke for many when he highlighted recent concerns over the future of renewable obligation certificates (ROCs), where continuing doubt had threatened to undermine the wind farm industry with fears of 25% cutbacks.

Reynolds says that it is essential to provide a continuing degree of certainty in order to underpin the market. Delays due to doubts over financial aspects were illustrated before the Department of Energy and Climate Change announced on 25 July that it would cut ROCs by 10%. The Treasury was said to be seeking bigger cuts, leaving investors nervous about expected returns. This in turn reflects the RICS paper, which lays great emphasis on the role of assumptions and special assumptions in these valuations.

Investment approach

The first problem with the investment approach will be a judgment about the rent – especially for a project still in its planning phase. Layered rents, with a base rent topped up by further payments based on achieved output, are common for wind farms. However, the wind does not always blow and technical problems can lead to no or low output. Leases often provide for several layers of rent, and some wind farms may never reach the threshold for payment of the higher layers. Against these considerations, most rental agreements are index linked.

Capitalisation periods need to be established. What is the duration of the planning permission, what are the restoration conditions and how do these relate to lease terms and reversionary aspects? All risk yields cannot be compared with a developer's hurdle rates for discounted cash flow (DCF) appraisals because of the different approaches on which they are built.

The example shows a valuation of a 10ha site leased to a good covenant for the construction and operation of seven wind turbines. A simple DCF appraisal of the landlord's interest would show an internal rate of return of 14% and "payback" within nine years.

Other traditional methods

Profits and depreciated replacement cost (DRC) methods present similar problems to those already discussed. Potential development sites, even with good option agreements in place, are particularly difficult. A site may only be one of many potential sites, especially in upland areas for wind power and the option holder's prime concern may be as much to exclude competitors from the general area as to

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ONLINE THIS WEEK

The decision in *Platform Funding Ltd* v *Anderson & Associates Ltd* [2012] EWHC 1853 (QB) provides useful guidance on the courts' approach to negligence claims against valuers where third parties have engaged in fraud. See PP 2012/119 at www.egi.co.uk

develop the particular site. The prospect of planning and potential difficulties in securing a grid connection will also need to be considered very carefully.

"Hope value" is therefore likely to follow a fairly flat trend until all the permits and contractual arrangements are virtually in place, and even then, the prospective investor is still relying on projections rather than actual outputs for the estimation of the variable rental element of a lease, adding to risk at this stage.

Discounted cash flow

The reservation with DCF for assessments of market value is always the extent to which the net present value is an "appraisal of worth" instead of a market valuation. Renewables are no exception.

Any market valuation involves careful consideration of the position adopted by the hypothetical willing seller and the willing buyer in the market. Large-scale developers, for example, will base their bid on a sophisticated DCF approach with its emphasis on the timing of income and expenses over an extended timeframe. This will be based on the developer's assumptions over costs, revenues, inflation, timing, taxation, interest and other factors.

The danger in sticking too closely to this approach is that the outcome will be an appraisal of worth rather than the "market value", which is commonly required. Nevertheless, elements of this process are likely to be useful in considering the factors that would influence the market value as between a willing seller and buyer. The practical issue is that for a larger development the start point may be a detailed appraisal of cash flow, although this may be less relevant for smaller projects.

The complexity of valuing renewable energy installations means that it is vital to deal clearly with:

- the acceptance and prior confirmation of instructions, considering any other users of the valuation;
- meticulous recording and consideration of all information physical, financial and otherwise;
- careful selection, justification, application and adaptation of methods;
- clear analysis of data and sensitivity; and
- comprehensive and clear reporting.

RICS members can download the paper at www.rics.org/guidance. Non-members can obtain copies from Fiona Mannix at fmannix@rics.org, or www.ricsbooks.com.

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INVESTMENT VALUATION EXAMPLE

- 10ha site for seven wind turbines on a 28-year lease, three years expired
- Turbines: 7 x 2.3 MW x 27% capacity. Output (electricity + ROC) = £83/MWh
- Basic rent: £7,000 + RPI for 14 years; £12,000 + RPI thereafter
- Turnover rent: 5% of gross income for 13 years; 9% thereafter
- Lease is taken from a larger site, rough grazing, of 100ha in total
- Let to a large well-established generator

BASIC RENT			
Term: 11 years remaining			
Rent		7,000	
YP for 11 yrs @ 8%		7.139	49,973
Reversion			
Rent		12,000	
YP for 14 yrs @ 10%		7.367	
PV £1 in 11 yrs @ 10%		0.351	31,030
TURNOVER RENT			
Turbines	7		
Installed capacity	2.3		
Capacity factor	0.27		
£/MWh	83		
Gross income	3,160,617		
Term: turnover 11 yrs remaining			
Rent @ 5% of turnover		158,031	
YP for 11 yrs @ 10%		6.495	1,026,410
Reversion			
Rent @ 9% of turnover		284,456	
YP for 14 yrs @ 13%		6.303	
PV £1 in 11 yrs @ 13%		0.261	467,953
REVERSION TO FARMLAND			
10 ha @ £2,000		20,000	
PV of £1 in 25 yrs @ 3%		0.478	9,560
			£1,584,926
REMAINDER OF SITE, FH VP			
90 ha @ £2,000			**£180,000**
GRAND TOTAL			**£1,764,926**

CASE STUDY: CORNHARROW HILL

This freehold site of 26ha forms part of the Wether Hill Windfarm. The tenant, ScottishPower Renewables Ltd, holds a 28-year lease from June 2006 for this part of the site. Five of the 14 turbines on this 18.2MW wind farm are covered by the lease and the index-linked rent has averaged around £57,900 a year since 2006. The site was subject to final and best offers recently, with an indicative price from Carter Jonas of £725,000, suggesting an overall yield of between 6% and 8%. Andrew Watkin offered the following comments on the marketing campaign:

- **Comparables for yields are hard to obtain as many transactions are off-market. Yields have not been tested by the open market.**
- **Any valuation is intrinsically linked to the wider market, influenced by the vagaries of electricity markets, the UK's uncertain regulatory framework and variable rent mechanisms. Assumptions over the price of outputs, principally electricity and renewable obligation certificates, are important to estimate future cash flows. From a freehold perspective, it is also important to consider how the tenant is valuing the outputs of the wind farm.**
- **Yields for freehold interests will depend on the type of investor. Experienced investors accept lower yields. Scale will be important as larger schemes can access infrastructure funding at lower hurdle rates, leading to higher capital values.**
- **Covenant strength is always important in judging risk, although projects are often held in special-purpose vehicles, which can cloud this aspect.**
- **Break clauses in favour of the tenant have been viewed pessimistically by prospective investors, although more experienced investors tend to take a more bullish view.**
- **Restoration covenants and the danger of the landlord's ultimate responsibility for restoration can also be a concern.**